

The effects of the Single Market programme on foreign direct investment into developing countries

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This article examines the possibility of investment diversion from developing countries to the Southern members of the European Union. While these groups of countries offer different locational advantages to foreign investors, the completion of the Single Market by 1993 might have improved the comparative attractiveness of the latter. It is argued here that much foreign direct investment, such as in natural resources and services, is location specific. Furthermore, much foreign direct investment in the manufacturing sector is aimed at supplying the domestic markets of host countries. Thus, only a small portion of foreign direct investment going to offshore export platforms in developing countries could, if at all, be negatively affected by the completion of the Single Market.

Introduction

Since the European Community announced, in the mid-1980s, its programme to complete the internal market by 1993 (COM, 1985), fears have been expressed that exports and foreign direct investment (FDI) flows into developing countries may be diverted to Greece, Portugal and Spain.¹ From 1993, access to the goods and capital markets of the European Union (EU) is completely free for the latter group of countries, but not for the former. Therefore, developing countries have been concerned about the possibility of investment diversion: they fear that foreign investors looking for low-cost locations who would have normally gone to developing countries might in-

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¹ Greece has been a member of the European Community since 1981; Portugal and Spain joined in 1986. At the time of the announcement of the Single Market programme, it was known that Portugal and Spain would join the European Community in the near future.

stead invest in the Southern members of the EU where wages, land for factory sites, costs of environmental protection and infrastructure are still relatively low and the goods produced have free access to the entire EU market. In addition to these advantages, the proximity of the Southern members of the EU to other markets within the EU implies lower transportation costs, as well as quicker and more reliable deliveries than would be possible for many developing countries.

Trade and investment-diversion apprehensions have been further exacerbated by the signing of preferential trade and economic cooperation agreements between the EU and Central and Eastern European countries. Of particular concern are the so-called "Europe Agreements" with Bulgaria, the former Czechoslovakia, Hungary, Poland and Romania. These countries possess some locational advantages that are similar to those of developing countries (as is also the case with the Southern members of the EU), and are granted higher preferential margins than any group of developing countries, including the signatories of the Lomé Convention (Gundlach, *et al.*, 1993). Moreover, these agreements envisage full membership of the signatory countries in Central and Eastern Europe in the EU after a certain convergence of their economic and political environments takes place, with the EU providing economic, technical and institutional help to facilitate that process. Furthermore, their historical, cultural and geographical links in terms of trade and cross-border investments make them "natural" candidates for EU membership.

The focus here is on the increased locational advantages of Greece, Portugal and Spain *vis-à-vis* the developing countries as a result of the completion of the Single Market, rather than on the future enlargement of the EU to encompass selected countries in Central and Eastern Europe. (Such an enlargement may be of even greater importance where possible investment diversion is concerned, as some of the locational advantages of the Central and Eastern-European economies, which they share with the developing countries, may last longer than those of Greece, Portugal and Spain.) Similarly, any investment diversion from developing countries to the nine more-developed members of the EU is not considered in this article; the focus is solely on a possible investment diversion from developing countries to the Southern members of the EU. This article discusses first the extent to which the fears of developing countries regarding investment diversion to Greece, Portugal and Spain can be justified on theoretical grounds, followed by some empirical evidence.

The conceptual framework

The initiative for the completion of the internal market of the European Community was taken in the mid-1980s. At that time, foreign investors could have easily anticipated that the European Community was heading towards the free mobility of goods and factors of production between its member countries, even if the final shape of the Single Market programme was not fully discernible. Since investment decisions are based on such anticipations, data on FDI until 1992 should be able to demonstrate the effect of the Single Market programme on FDI flows into developing countries (Gittelman, 1990). At the firm level, data on cross-border mergers and acquisitions show that European as well as other transnational corporations (TNCs) began their restructuring for the single, unified European market soon after the Single Market programme was announced, and have come a long way since then in their process of adjustment (Kumar, 1992).

The basic conceptual question is how far a formation, extension or completion of a common market, such as that of the EU, can divert FDI from developing countries to the less-developed member countries. In order to answer this question, it is appropriate to divide FDI into two categories. The first category includes those investments that are not likely to be affected by the Single Market programme on purely theoretical grounds. The second category includes investments that may be diverted from developing countries to the less-developed member countries. Such a division is guided by the motives of foreign investors. However, data on FDI are typically not available according to investment motives. Therefore, the discussion that follows is based more on a sectoral division of FDI that reflects, to a certain extent, investment motives.

Investments unlikely to be affected by the Single Market programme

The most obvious type of FDI that is not likely to be diverted from the developing countries to the Southern members of the EU is investments in natural resources, especially petroleum, mining and quarrying. Historically, natural resources have attracted FDI into developing countries; they were the main determinant of the inflow of foreign capital during the nineteenth century, up to the early twentieth century. Later, the share of the primary sector in total FDI flows into developing countries declined (Agarwal, 1979), and that trend has continued in recent years (OECD, 1993a).

Other industries where FDI would be expected to remain unaffected after the completion of the Single Market are construction, real estate, trade, transportation, storage, communication, finance, insurance and other services. In many (location-specific) services, developing countries do not compete for FDI with the Southern periphery of the EU. A foreign investor, for example, looking for investment opportunities in local construction business in India, Malaysia or Thailand will, most likely, not shift to Greece, Portugal or Spain in response to the envisaged greater factor and goods mobility within the EU. Similar to natural resources, investments in services are, generally, location specific.² Their mobility between host countries is rather limited unless they are geographically situated so close to each other that servicing all customers from a single location does not raise problems and costs. The Southern members of the EU are not only geographically distant from most developing countries, but also the movement of capital, people, goods and services between these groups of countries is largely restricted. Even if there was freedom of movement (which, to some extent, is the case with the developing countries under Lomé IV), a German bank or tourist agency, for example, could not substitute a foreign affiliate in Kenya with one in Portugal. Thus, competition between the two groups of countries for FDI in the services sector is non-existent or, at most, very weak.

The primary and services sectors together account for a high share of FDI into developing countries from the major source countries. Between three-fifths (Germany and the United Kingdom) and three-fourths or more (Japan and France) of FDI by developed countries into developing countries are in these two sectors (UN-TCMD, 1993b). The primary sector alone accounted for four-fifths of FDI into Indonesia during the 1980s (table 1). In Nepal, Papua New Guinea, the Solomon Islands and Viet Nam, one-half to three-fourths of total FDI is in the primary sector.³

² Kravis and Lipsey (1988, p. 2) maintained that services are defined by the fact that production and consumption take place simultaneously within a country, with only a few exceptions.

³ The data on FDI in the primary sector include FDI in agriculture, which absorbs in some cases (Bangladesh, Fiji, India, Malaysia, Papua New Guinea, the Republic of Korea, the Solomon Islands and Sri Lanka) nearly half or more of the foreign capital invested in the primary sector. It would be interesting to examine whether there are agricultural products in which these countries compete for FDI with the Southern members of the EU. Only if there are such overlaps can a case be made for investment diversion from the former to the latter. This is more likely to occur in the case of the Latin American countries than the Asian countries. Foreign direct investment in agriculture in the Asian countries is mostly in products such as tea (India, Sri Lanka), rubber (Malaysia) and timber (Fiji). In these cases, the locational choice of the investors is country specific and cannot be shifted to the Southern members of the EU.

Table 1. The sectoral distribution of foreign direct investment in Asian economies, 1986-1989 and 1989

(Percentage share)

Economy	Primary		Manufacturing		Services	
	Inflow 1986-1989	Inward stock, 1989	Inflow 1986-1989	Inward stock, 1989	Inflow 1986-1989	Inward stock, 1989
Bangladesh	0.4 ^a	25.1 ^b	33.2 ^a	34.3 ^b	66.3 ^a	40.7 ^b
China	4.5 ^a	8.2 ^b	52.9 ^a	47.6 ^b	44.2 ^a	40.1 ^b
Fiji	7.8	..	29.5	..	62.7	..
Hong Kong	-	-	17.4	25.9	82.6 ^c	74.1 ^c
India	0.6 ^d	6.1 ^c	92.1	89.1	7.2	4.8
Indonesia	82.5 ^f	81.7 ^g	13.7 ^f	15.4 ^b	3.8 ^f	2.9 ^g
Malaysia	11.4 ^a	28.3 ^b	76.4 ^a	41.2 ^b	12.2 ^a	30.5 ^b
Nepal	20.6 ^a	49.9 ^b	54.0 ^a	37.2 ^b	25.4 ^a	12.9 ^b
Pakistan	13.7 ^a	11.5 ^b	23.7 ^a	38.7 ^b	62.6 ^a	49.8 ^b
Papua New Guinea	41.8	60.2	8.6	10.9	49.7	28.9
Philippines	27.9	29.3	45.7	48.9	26.4	21.8
Republic of Korea	0.9 ^a	0.9 ^b	57.7 ^a	61.5 ^b	41.5 ^a	37.6 ^b
Samoa	15.9 ^b	..	27.3 ^b	..	56.8	..
Singapore	0.2	0.2	35.7	42.4	64.1	57.4
Solomon Islands	..	76.3	..	1.5	..	22.2
Sri Lanka	23.8 ^a	10.8 ^b	23.5 ^a	32.5 ^b	52.7 ^a	57.5 ^b
Taiwan Province of China	0.3 ^f	0.3 ^e	65.7 ^f	88.3 ^e	34.0 ^f	11.7 ^e
Thailand	3.2	9.2	49.0 ^g	42.8	47.8	48.0
Viet Nam	67.7 ^g	67.7	12.7 ^h	12.7	19.6 ^h	19.6

Source: UNCTC, 1992a.

^a 1985-1988.

^b 1988.

^c The share of services and construction has been obtained by deducting the manufacturing share from total FDI.

^d 1983-1986.

^e 1986.

^f 1987-1990.

^g 1990.

^h 1988-1989.

Many Asian countries have a high proportion of FDI in services (table 1). More than half of FDI in Bangladesh, Fiji, Hong Kong, Pakistan, Singapore and Sri Lanka is in services. In China, Papua New Guinea, the Republic of Korea and Thailand, these investments accounted for between two-fifths and one-half of the total inflows during the second half of the 1980s in response to liberalization and deregulation measures for services adopted by these countries. But relatively high shares of services in total FDI inward stock indicate that this sector had been attractive to foreign investors even earlier. Most likely, FDI in services will therefore remain largely unaffected by the completion of the Single Market.

In the manufacturing sector, FDI into developing countries will remain unaffected by the Single Market provisions to the extent that it is undertaken to supply the domestic market. Such investments are lured by market size and growth, advantages linked to the direct presence in the vicinity of customers, avoidance of discriminatory Government procurement policies and high transportation costs, if the same market were supplied through exports. These factors are not affected directly by the Single Market programme. Therefore, domestic market-oriented FDI into developing countries is unlikely to be negatively affected by that programme.

The size of the domestic markets of host countries (proxied by national income and its growth) is an important determinant of FDI.⁴ This applies certainly to countries with relatively large domestic markets and favourable growth prospects, such as India, China and Indonesia in Asia. High growth rates and increased income levels in the Republic of Korea, Malaysia and Thailand have raised the domestic demand in recent years so that these countries attract FDI not only in consumer goods, but also in intermediate-goods industries. In Latin America, Argentina and Brazil have large domestic markets, but income growth during the 1980s has been poor. The recent resurgence of economic growth has led to a revival of FDI in a number of Latin American countries (with the exception of Brazil) (Nunnenkamp and Agarwal, 1993; IMF, 1993; UN-TCMD, 1992). Hong Kong and Singapore are economies in which foreign investors have been producing goods primarily for export. As is argued below, the Single Market programme, in principle, could strongly affect export-oriented FDI in countries which compete for such investments with other low-cost economies within the EU.

Investments likely to be affected by the Single Market programme

In the past three decades, TNCs have shifted some manufacturing activities to developing countries in order to take advantage of comparatively low labour costs, or other factors of production such as land. Examples of such investments are those of United States consumer-electronics firms in the *maquiladoras* of Mexico and Japanese textile and consumer-goods firms in neighbouring Asian economies. In so far as this type of FDI is aimed at supplying the internal market of the EU, it may be affected by the Single

⁴ For a survey of relevant studies, see Agarwal (1980) and UNCTC (1992a). On the determinants of FDI from the United States, Germany and Sweden, see Dunning (1980), Agarwal *et al.* (1991) and Swedenborg (1979), respectively.

Market programme because the goods produced in the Southern member countries of the EU will not face entry barriers in other member countries, in contrast to those produced in developing countries (unless they are covered by preferential arrangements, such as the Lomé Convention).

Two interesting questions can be raised in this regard: what proportion of FDI in the manufacturing sector of developing countries is accounted for by export-oriented TNCs; and is that share high enough to justify the strong concern about an investment-diversion effect of the Single Market programme on FDI. In Asia, for example, manufacturing FDI is significant for China, India, Malaysia, Nepal, the Philippines, the Republic of Korea, Taiwan Province of China and Thailand (table 1). Of these, China, Malaysia, the Republic of Korea, Taiwan Province of China and Thailand are likely to have attracted significant amounts of FDI in export-oriented manufacturing. Still, the common impression is that the share of such investments in total FDI is small (Buckley and Artisien, 1988; UN-TCMD, 1993a). Moreover, the relative importance of labour-intensive, export-oriented industries (textiles, leather and clothing, food processing), has steadily declined during the past decade (OECD, 1993a), thus limiting the scope for investment diversion.

Another question is whether the existing comparative-cost advantage of developing countries *vis-à-vis* the Southern members of the EU can be wiped out by the removal of internal trade and investment barriers. This seems to be unlikely given that the free mobility of labour is more likely to raise wages in the South than lower wages in the North, because of the downward rigidity of labour remuneration in the EU.⁵ Moreover, the Social Charter of the EU tends to exert upward pressure on wages in Greece, Portugal and Spain. Additional pressures are exerted from the rising costs of land and the harmonization of environmental standards within the EU.⁶

Empirical evidence

The preceding discussion implies that the potential of the Single Market programme to have a negative impact on the flow of FDI in developing

⁵ From 1985 to 1992, unit wage costs increased in Spain by 47 per cent, in Portugal by 117 per cent and in Greece by 162 per cent. These increases were above those in other EU countries, the United States and Japan (Link, 1993).

⁶ For the indirect and dynamic effects of the Single Market programme on the locational advantages of member countries, see UN-TCMD (1993a).

countries is small. Nevertheless, it is useful to examine the existing data to see if there has been an investment diversion from developing countries into the Southern members of the EU provided here, using a univariate analysis.

The share of developing countries in global FDI flows, increased from 26 per cent in 1981-1985 to 30 per cent in 1992. In other words, the share of developing countries in total FDI flows was higher after the completion of the Single Market than during the first half of the 1980s. Any strong negative effect of the Single Market programme would be expected to result in a decline in that share. However, such a conclusion may have some drawbacks, in terms of concealing negative effects on some developing regions and because FDI flows into the United States slumped in the early 1990s, owing to the economic recession. Thus, the focus here is on regionally disaggregated data during the second half of the 1980s.

The share of Greece,⁷ Portugal and Spain increased from 5 per cent during 1981-1985 to 6 per cent during 1986-1990 and, correspondingly, the share of developing countries decreased from 26 per cent to 16 per cent in these two periods. These changes could be interpreted as evidence of an investment diversion from developing countries to the Southern member countries of the EU. Any dummy variable to capture the Single Market programme in an econometric study is likely to be biased in this direction. However, such a conclusion would be erroneous. Foreign direct investment in the Southern members of the EU did not grow at a higher rate than in the other EU countries. Therefore, it can be presumed that the increased flow of FDI into Portugal and Spain was an outcome of becoming a member of the European Community and not due to investments being diverted from developing countries. In the latter case, investment should have resulted in a rate of increase of FDI flows to the Southern members significantly above that observed in the other members of the European Community. This does not, however, exclude the possibility of investment diversion from developing countries in each and every case at the firm level. On the contrary, such a possibility can be envisaged explicitly in the case of export-oriented FDI. However, such investments are small for developing countries as a whole (Buckley and Artisan, 1988).

A substantial portion of FDI in Spain (which has attracted most of the FDI in the Southern periphery of the EU) is in the automobile industry. But

⁷ Greece has proved less attractive than Spain and Portugal to foreign investors after joining the European Community.

Table 2. The regional distribution of foreign-direct-investment inflows, 1981-1992
(Percentage)

Country/region	1981-1985	1986-1990	1986	1987	1988	1989	1990	1991	1992
	Annual average								
Developed countries and regions									
of which:	74.1	83.9	82.7	82.5	82.8	85.6	84.7	73.8	66.8
Western Europe	31.1	41.1	30.8	30.2	37.2	44.2	52.4	50.8	56.1
European Union	28.5	37.5	25.1	27.4	35.2	40.6	47.9	45.1	54.1
European Union, excluding Greece, Portugal and Spain	23.7	31.5	19.9	23.3	29.7	35.2	39.6	36.4	48.0
Greece, Portugal and Spain	4.8	5.9	5.1	4.2	5.4	5.4	8.3	8.7	6.4
United States	36.8	34.1	43.4	42.3	36.2	34.4	23.1	15.8	2.0
Developing regions of which:	25.9	15.9	17.2	17.4	17.2	14.3	15.2	24.5	30.1
Africa	3.3	1.8	2.2	1.9	1.7	2.4	1.0	1.8	1.7
Latin America and the Caribbean	11.5	5.1	6.3	6.8	5.6	3.7	4.3	9.3	9.7
West Asia	0.8	0.2	0.4	0.2	0.4	0.2	0.2	0.3	0.5
South and South-East Asia	9.7	8.7	8.3	8.4	9.3	7.8	9.4	12.9	17.7
Central and Eastern Europe	0.1	0.1	0.0	0.0	0.0	0.1	0.1	1.5	3.2
Memorandum:									
Oil-exporting developing countries	8.5	4.4	5.1	4.5	4.2	4.8	3.9	9.2	8.4

Source: UNCTAD-DTCI, 1994.

there is no evidence that investment is being diverted from developing countries. The industries that are of greater concern in this respect are leather, textiles and clothing. Still, no evidence is found that foreign investors shifted production in these industries from developing countries to Portugal or Spain after the Single Market programme was announced (UN-TCMD, 1993a). In a few cases where investments have been withdrawn from developing countries, this has been the outcome of technological advances. For instance, the introduction of robotics and lean-production methods has reduced the importance of labour costs in total production costs and has raised the need for production facilities to be located closer to the final market-place. In those cases, investors have typically returned to their home countries and have not relocated their plants in Portugal or Spain.

In Spain and Portugal, the biggest increase in FDI inflows came from neighbouring countries. Since 1986, foreign direct investment in Spain originating in France increased more than that from Germany, Japan, the United Kingdom or the United States (OECD, 1993b). Prospects of freer trade and larger economic integration between bordering countries generally lead to increased flows of FDI, especially from the more- to the less-developed partners; this might be better termed *the common-border effect*. Spain's share in outward FDI from France increased, for example, by 13 per cent between the periods 1982-1985 and 1986-1991, while the share of developing countries decreased only by 1 per cent in the same periods (OECD, 1993b). Thus, the massive growth of FDI into Spain from France does not reflect a diversion of French investments from developing countries.

Coming back to the regional shares in global FDI flows, it may be recalled that developing countries lost 10 percentage points between 1981-1985 and 1986-1990 (table 2). This cannot be explained solely by the Single Market programme. First, the share of the Southern members during that period increased only by 1.1 percentage points. It is the share of the remaining, more developed members of the EU that has registered the highest gain. But their comparative locational advantages *vis-à-vis* the developing countries were not expected to be influenced considerably by the completion of the Single Market programme. On the one hand, that programme might have enabled EU firms to achieve greater economies of scale and, as a result, they might have withheld some investments that would have gone otherwise to cheaper locations in developing countries. On the other hand, increased competition within the EU may have forced some firms to look for low-cost production sites in developing countries. Thus, it is highly unlikely that the

growth of FDI in the nine Northern members of the EU after 1985 reflected investment diverted from developing countries.

Latin America accounts for about two-thirds of the loss of developing countries' share in global FDI flows in the period 1986-1990. The decline in Latin America's share began in the 1970s, that is, long before the announcement of the Single Market programme in 1985. In 1979, the share of Latin American countries in world FDI inflows was more than 14 per cent; it declined to about 11 per cent during 1981-1985 and to 5 per cent by 1990 (table 2), mostly as a result of adverse domestic factors. The recent improvements in their internal economic conditions and their international-indebtedness position have led to increased FDI inflows in the 1990s, which suggests that the shifts in FDI flows into Latin America were independent of the Single Market programme.

West Asia accounts for less than 1 per cent of global FDI inflows. Prominent host countries in this region are Iran and Saudi Arabia. There has been considerable reverse flow of capital from Iran during the period under consideration due to an adverse political climate. In Saudi Arabia, FDI flows are subject to high fluctuations resulting from intra-firm transfers of funds. Thus, the decline of 0.6 percentage points in West Asia's share in global flows of FDI during the second half of the 1980s cannot be considered as an investment diversion resulting from the Single Market programme.

Africa has traditionally attracted a small share of global FDI flows. During the period under consideration, that share declined by one per cent (table 2). Most African countries are associated with the EU and have preferential access to its internal market, also for products that are produced in their territories by foreign investors subject to rules of origin. Therefore, the flow of FDI to these countries is the least likely to be negatively affected by the completion of the EU's internal market.

In so far as FDI is aimed at exploiting cost advantages and supplying the internal market of the EU, Asian economies would appear the most vulnerable to investment diversion as a result of the Single Market programme among all developing countries. The Asian countries are the only group of countries facing a net adverse impact on their exports as a result of the Single Market programme (Page, 1991). Because of its nexus with trade, FDI would appear to have also been negatively affected.⁸ The data in table 2

⁸ Mordechai Kreinin and Michael G. Plummer (1992) identified industries in the Association of South East-Asian Nations (ASEAN) that would be expected to suffer from trade diver-

show a loss of one percentage point in the share of Asian countries in global FDI flows during the period 1986-1990. But this loss, most of which occurred immediately after the Single Market programme was announced, is associated more with the boom of FDI in the United States and less with the changes in the share of the Southern members of the EU in global FDI flows. Therefore, without some significant evidence at the firm level, the Single Market cannot be said to have diverted FDI from Asia to the Southern members of EU.⁹ On the contrary, Asia's share has risen since 1991 above its 1981-1985 level, and that region has been hosting, since 1981, more than half of FDI flows to all developing countries. Moreover, the contribution of FDI to domestic capital formation of most Asian countries has increased during the second half of the 1980s (UN-TCMD, 1992).

Conclusions

By 1992, the most important directives of the Single Market programme had been adopted by the Council of Ministers. Surveys have shown that most TNCs had already taken into account the unified single market in their strategic planning (Gittelman, 1990). Therefore, the assumption that the impact of the Single Market programme should be visible in the data available by 1992 is plausible. It can be concluded from these data that there was not a discernible investment diversion in FDI flows from developing countries to the Southern members of the EU.

This is in conformity with a theoretical analysis that shows that FDI flows from developed to developing countries would be largely unaffected by the Single Market programme. Most FDI is industry and country specific, for example, natural-resource based or aimed at supplying the domestic mar-

(Footnote 8 continued.)

sion resulting from the Single Market programme. If it is assumed that the same industries are also subject to investment diversion and that investment is affected to the same extent as exports, then it can be calculated that, on an annual basis, FDI amounting to \$263 million (5 per cent of all FDI into ASEAN during the second half of the 1980s; UNCTC, 1992a) could have been adversely affected by the Single Market programme. However, if only those industries that have generally benefitted from export-oriented investment by TNCs are considered (textiles, clothing, leather and electrical equipment), investment diversion is reduced to \$134 million (or 3 per cent of total flows) in the same period. (In view of various assumptions underlying these calculations and a large number of factors affecting FDI flows, these number should, of course, be treated with caution.)

⁹ This argument cannot be used with the same force for African or Latin American countries, because the investment climate in the main host Asian economies was quite favourable and the decline of their shares cannot be related predominantly to domestic factors.

kets of the host countries.¹⁰ A relatively small part of FDI in export platforms motivated by the lower costs of production found typically in the developing countries could be adversely affected. Even in such cases, rising costs of land, labour and stricter environmental standards in the Southern member countries of the EU following the implementation of the Single Market programme would prevent investment from being diverted from developing countries.

An implicit assumption underlying the investment-diversion hypothesis is that the supply of funds for FDI is highly inelastic and a TNC can increase its investments in a country only by diverting funds from another country where it would have invested in the absence of the Single Market programme. To a certain extent, capital available to foreign investors is, indeed, finite. This applies particularly to human capital comprising experienced and dependable international business managers. However, the high growth of global FDI during the 1980s strongly suggests that the supply of investible funds is increasable. In recent years, the supply of these funds has been further strengthened by innovations of new financial instruments.

Moreover, the negative-impact hypothesis ignores the growth effects of the completion of the EU's internal market. It has been estimated that the removal of all restrictions on the movement of capital, goods, services and people between the member countries will add 1 per cent or more per annum to the growth of GDP of the EU as a whole (Hiemenz, 1990).¹¹ This will not only raise the available resources of the member countries for investing in the developing countries, but it will also increase the demand for goods produced by TNCs in developing countries.

Finally, the diversion of investment will also depend on the sourcing policies of the EU. If instruments influencing the sourcing activities of firms (such as local-content requirements and rules of origin) are tightened, firms would be under pressure to divert some of their investments from the developing countries to locations within the EU. If the borders around the Single Market are kept open to imports from non-EU countries, international competition will force European firms to look for low-cost locations in developing countries. Thus, the final shape of the external trade policy of the EU will have to be taken into consideration while evaluating the ultimate effect

¹⁰ A similar result was derived by Davenport and Page (1991), using FDI data up to 1988. However, they felt that additional data and research were needed to confirm their results.

¹¹ Depending on the projection assumptions and on whether dynamic effects are also taken into account, growth rates may be much higher (Cecchini, 1988; Baldwin, 1989).

of the completed internal market on FDI flows. It is important that the domestic environment for FDI in developing countries is not impaired. Countries with favourable investment opportunities, good growth prospects and hospitable policies towards foreign investors will be able to more than compensate for a possible investment diversion. ■

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