How to attract Quality FDI?

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No. 2 | February 2017

KIEL CENTRE FOR GLOBALIZATION

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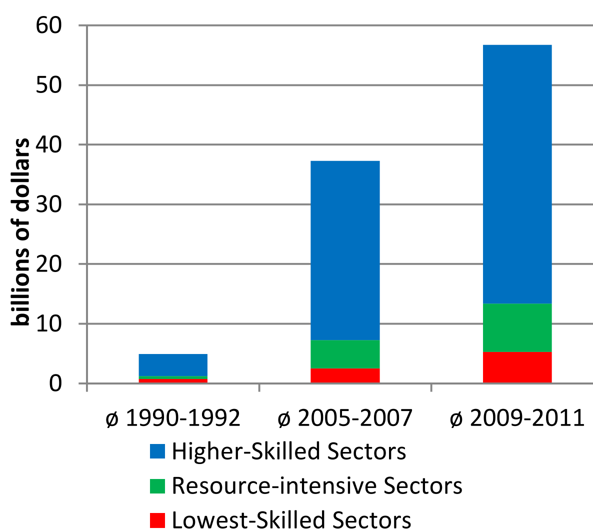
Introduction

Foreign direct investment in developing countries has got a bad reputation in some popular discussions where it is set tantamount to first world's postcolonial exploitation of the raw materials and cheap labour from the third world, associated with pictures of leaking oil fields and collapsing factories. While this does happen, data show that FDI in developing countries increasingly flows to medium to high-skilled manufacturing sectors rather than to resource-intensive and low-skilled sectors (Figure 1). And as skill levels needed by FDI increase so do wage levels (ILO 2007, Coniglio et al. 2015). Accordingly, many emerging economies have built their success to a considerable degree on FDI flows to cover their enormous need for investments.

Figure 1: Manufacturing FDI Flows to Developing Countries



Source: UNCTAD 2014

The trick is to attract "Quality FDI" that links foreign investors into the local host country economy. Quality FDI may be characterized as contributing to the creation of decent and value-adding jobs, enhancing the skill base of host economies, facilitating transfer of technology, knowledge and know-how, boosting competitiveness of domestic firms and enabling their access to markets, as well as operating in a socially and environmentally responsible manner. To achieve this, host countries cannot just wait and see what international market forces may bring to them. Rather, they need tailored policies to overcome domestic imperfections that hinder a smooth integration of indigenous and foreign firms into world-wide supply-chain networks. Recent research offers evidence for strategies in developing countries that successfully turned FDI into such quality FDI. The idea underlying the following suggestions is to learn the lessons from past experience.[1]

The suggestions

1. **Open up markets and allow for FDI inflows**. Reduce restrictions on FDI. Provide open, transparent and dependable conditions for all kinds of firms, whether foreign or domestic, including: ease of doing business, access to imports, relatively flexible labour markets and protection of intellectual property rights.
2. **Set up an Investment Promotion Agency (IPA)**. A successful IPA could target suitable foreign investors and could then become the link between them and the domestic

[1] For more detail and background see Moran et al. (2016).

economy. On the one side, it should act as a one-stop shop for the requirements such investors demand from the host country. On the other side, it should act as a catalyzer to the host's domestic economy prompting it to provide the top notch infrastructure and the ready access to skilled workers, technicians, engineers and managers that may be required to attract such investors. [2] Moreover, it should engage in after-investment care, acknowledging the demonstration effects from satisfied investors, the potential for reinvestments, and the potential for cluster-development as a result of follow-up investments.

3. **Think carefully about sectors / activities to be targeted.** Investment / location decisions of suppliers may be dependent on those of prime multinational investor into the host economy.[3]
4. **Put up the infrastructure required for a quality investor**: such as sufficient close-by transport facilities (airport, ports), adequate and reliable supply of energy; provision of adequately skilled workforce, facilities for the vocational training of specialized workers, advisably to be designed in cooperation with the investor. [4]
5. **Strengthen backward linkages from FDI to the indigenous economy**. Allow for the competitive pressure of foreign entrants on their local suppliers in order to raise competitiveness of the latter, [5] and allow for multiple forms of direct assistance from foreign to domestic firms, in the form of training, help with setting up production lines, management coaching regarding strategy and financial planning, financing, assistance with quality control and introduction to export markets. [6]
6. **Encourage spillovers from FDI to the indigenous economy**. Local firms set up by managers who had started in multinational firms are more successful and more productive than others.[7] Managers of local firms gain knowledge on new technologies and marketing techniques by studying and imitating their multinational competitors.[8] Similarly, worker movements from multinational to local firms spread knowledge and skills.
7. **Encourage first-time foreign direct investors**. Foreign firms that are not already part of an extensive network of subsidiaries are more ready to accept linkages to domestic suppliers. [9]
8. **Encourage foreign direct investors from diaspora members**. These are also more likely to generate linkages to domestic firms and contribute to the internationalization of the host country.[10]

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[2] See, e.g., case studies on the State Development Committee (PDC) of Penang in Malaysia, on the Costa Rican Investment Promotion Agency (CINDE) and on the Motor Industry Development Programme (MIDP) in South Africa (Moran 2014, Barnes et al. 2015). See also Harding and Javorcig (2012) who find that in developing countries targeted sectors receive more as twice as much FDI as non-targeted sectors.

[3] See case studies of the Indian automotive market (McKinsey 2001) and of Wal-Mart entering Mexico (Javorcik et al. 2006).

[4] Same sources as before.

[5] See, e.g., a case study of Mauritius (Rhee et al. 1990).

[6] See Javorcik and Spatareanu (2005), Blalock and Gertler (2008), Godart and Görg (2013), Görg and Seric (2016).

[7] See case study of Ghana (Görg and Strobl 2005).

[8] See case studies of Czech Republic and Latvia (Javorcic and Spatareanu 2005) and of 19 sub-Saharan African countries (Boly et al. 2015).

[9] See Amendolagine et al. (2015).

9. **Provide for access to credit**; reform domestic financial markets. Setting-up a business-friendly financial system helps indigenous firms to respond to challenges and impulses from foreign entrants, to self-select into supplier status, and to thereby grow and prosper.[11]
10. **Set up a vendor development program to support the match making process between foreign customer and local supplier**. To strengthen the capacity of the domestic economy, it may offer financing opportunities to indigenous suppliers for required investment on the basis of purchase contracts from foreign buyers; [12] or reimburse the salary of a manager in a foreign plant acting as a talent scout among domestic suppliers. [13]
11. **Shape Export Processing Zones (EPZ) in a way that they spearhead into the domestic economy.** Avoid EPZ regulations discriminating against creation of local supplier relationships. Set up a secondary industrial zone for local suppliers, be it as a geographical site adjacent to formal export processing zones or be it as a legal status allowing for easy foreign-domestic linkages, with, e.g., databanks and "marriage counselors" to assist in supplier selection.[14]
12. **Refocus the "Who Is Us?" perspective and address related concerns adequately**. "Us" should be understood as the firms that are most beneficial to the domestic economy irrespective of the nationality of their owners, i.e., the firms that create the highest-skilled and highest-paying jobs, the least-expensive products and the most competitive exports. [15]
13. **Be patient and rely on the gradual structural transformation of the domestic economy**. Investors may come in waves, e.g., first, investors in thermionic tubes, valves and transistors, then, in television and broadcasting systems, and finally, in computers, computer peripherals, and data processing systems. Along such avenues, FDI may contribute to diversifying and upgrading domestic production. [16]

Notes of caution

1. **Do not insist that all inward FDI be at the most sophisticated technical level.** International firms with middle-level technology can provide benefits and connect up with local suppliers whose capabilities match the foreign firms more closely.[17]
2. **Do not confound supply-chain creation with support for SMEs**. Medium-sized and larger indigenous companies are often more apt to link with foreign investors in win-win scenarios than their smaller counterparts. [18]

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[10] See Boly et al. (2014).
[11] See Alfaro et al. (2009).
[12] See the the Local Industry Upgrading Program (LIUP) of Singapore.
[13] See the example of the Singapore's Economic Development Board (EDB).
[14] See cases of Malaysia versus Mauritius (Moran et al., 2016).
[15] See the argument about pros and cons of Japanese investment in the United States (Reich 1990).
[16] See Amendolagine et al. (2013), and the afore-mentioned case studies of Malaysia, Costa Rica and South Africa (Moran 2014, Barnes et al. 2015).
[17] See Boly et al. (2015), Pérez-Villar and Seric (2015).
[18] See UNCTAD (2011).

3. **Do not subsidize specific companies**. Public support should take the more general form of creating reliable infrastructure and offering specific vocational training.

The role of external donors and developed countries

1. **There is still a vital role for external donors such as developed countries and multilateral financial institutions in supporting developing countries**. The explosion of international private sector investment flows has not eliminated the need to support growth-and-development programs in developing countries, even beyond emergency aid and pure poverty reduction programs.
2. **Developed countries should improve the functioning of financial markets worldwide**, to enable developing countries harness their FDI. For instance, better financial market institutions even in FDI source countries help overcoming deficient financial markets in host countries, thus increasing FDI flows to developing countries. [19]
3. **Developed countries should intensify support for effective FDI promotion of developing countries**. Targeting large investors pro-actively in particular sectors requires specific and expensive expertise on the side of the Investment Promotion Agencies, with a professional staff to be paid at internationally competitive salaries, the costs of which could be borne by external donors. Moreover, developing countries need help in learning how to use IPAs effectively for marketing their countries to multinational investors.

Concluding remark

The essence of the suggestions is to advocate a light form of industrial policy: a policy that seeks to hitch FDI to development goals and to generate backward linkages as deep as possible into the host economy. The evidence cited here shows that progress in developing countries can be achieved without either substantial levels of protection or large amounts of direct support, through focusing on Quality FDI.

[19] See Görg and Kersting (forthcoming), Donaubauer et al. (2016).

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