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FDI in LDCs:
Facts, theory and empirical evidence

by

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Abstract

One of the most striking signs of globalization is the strong growth in foreign direct investment (FDI) during the last two decades, and particularly since the second half of the 1980s. The present paper describes recent trends, with emphasis on issues related to developing countries. It explains what motivates firms may have to undertake FDI, and analyses how FDI may affect host country welfare.

Executive summary

One of the most striking signs of globalization is the strong growth in foreign direct investment (FDI) during the last two decades, and particularly since the second half of the 1980s. The OECD countries are the dominating source countries of FDI, and are also the major recipients of these investments. In the 1990s, up till the financial crisis in Asia in 1997, a growing share of global FDI was hosted by less developed countries. In particular, Latin America and East Asia have attracted significant amounts of FDI in the 1990s. Africa, on the other hand, is fairly marginalized in terms of FDI inflows.

The importance of FDI within these less developed regions of the world varies a lot between countries. For instance, FDI inflows to Korea and the Philippines have been modest compared to, say, Malaysia and, recently, China. This has not prevented Korea from experiencing rapid economic growth in the 1980s and 1990s. Evidently, large inflows of FDI are not a necessary condition for economic growth. In Latin America, Paraguay and Uruguay have been much less successful than their larger MERCOSUR counterparts, Argentina and Brazil, in attracting FDI. And in Africa, although the overall picture is gloomy, countries such as Namibia and Botswana have experienced satisfactory growth rates and fairly large inflows of FDI.

The Asian crisis led to a drop in the share of global FDI flowing to Asia and Latin America. Compared to other forms of capital flows, such as portfolio investments, FDI has proven to be far less sensitive to economic fluctuations, of which the Asian crisis is a dramatic expression.

Firms that are competitive on international markets may choose FDI for a number of reasons. Broadly speaking, three motives have been identified in the literature. First, market seeking FDI, where important factors are trade costs, market size, costs of setting up a new plant or acquiring an existing foreign firm, production costs abroad, etc. Second, efficiency seeking FDI, where the main attraction of a foreign location is low labor costs and, perhaps, well qualified labor, together with low trade costs, since intermediates produced in the foreign affiliate generally are shipped back to the parent firm. Third, monopoly seeking FDI, which is particularly important when the investment is in the form of an acquisition. The motivation in this case is to reduce the competitive pressure on international markets.

In addition to these locational advantages, host countries should have macroeconomic and political stability in order to be attractive for FDI. Multinationals need some assurance that their investments will not be expropriated by host governments, that profits can be repatriated, that the local currency is convertible, etc. If a country cannot offer this kind of assurance, it will probably not be an attractive place for FDI.

One way for a country to signal a commitment to a set of liberal trade and investment policies is by joining a regional integration agreement. It may be more costly to reverse liberal policies for a member of such an agreement than for a non-member, for instance because doing so may trigger a punishment reaction, such as a trade boycott, from the member countries adhering to the rules.

Regional and global integration agreements also affect market size and trade barriers, and hence may have an impact on FDI. Most likely, the impact will be positive, but equally likely, the positive impact will not be evenly distributed among member countries.

It is evident that FDI may contribute greatly to the host economy. For instance, the foreign dominated electronics industry in Asia has provided foreign-exchange earnings, employment and skills acquisition in the host economies. In Taiwan and Singapore, where educational standards and infrastructure are well developed, this investment has also spawned many local suppliers, competitors and service firms, including independent indigenous enterprises which are highly successful in world markets and which have, in some cases, become multinationals themselves.

Foreign ownership is however not a precondition for economic growth. South Korea experienced rapid economic growth during the 1980s and until the financial crisis in the late 1990s, relying largely on domestic technology and domestic ownership. Korean entrepreneurs were encouraged to unbundle foreign packages of technology and adapt them to local conditions, a process known as reverse engineering. Moreover, Korean firms were guided by their foreign customers on designs and production and management techniques. Evidently, learning can take place through the contact with demanding customers, and does not require the local presence of multinational firms (Rhee et al, 1984).

Still, other countries relying on local capabilities, such as India, have not been as successful as South Korea in generating long term growth. The reason may be that successful implementation of protectionist policies requires a degree of political autonomy and flexibility that most governments do not have. Policies that at the time of implementation may well have been sensible become locked in through the pressure of special interest groups, and over time become incompatible with economic growth and development.

Although the general attitude towards FDI today is very positive, foreign entry is not necessarily a blessing for the host country. Particularly if the host country is a less developed one, the impact of FDI may be great, both positive and negative. Foreign firms may be a lot more effective than local firms. If they compete on the same market, the foreign firm is likely to capture significant market shares from the local firms, possibly eliminating local firms altogether. Certainly, foreign firms may be a valuable source of technology to less advanced countries. But empirical research suggests that if the technological gap is too great, the ability of the local firms to learn much from its foreign competitor may be limited. Following this reasoning, it may be beneficial for less advanced countries to expose their markets to firms which are not radically more advanced than themselves, which could be interpreted as an argument in favor of South-South integration.

Given the general wish to attract FDI, countries may start competing against each other in order to do so. Such competition need of course not be wasteful. For instance, improvements in infrastructure and educational programs that strengthen a country's locational advantages are productive investments. Other forms of competition are not productive, however. Tax competition may lead to a race to the bottom and undermine the governments' ability to perform important functions, such as the provision of health care and redistribution of income. There may be a need for international agreements on FDI in order to avoid such tax competition, and to ensure that the benefits of FDI are shared fairly between the MNE and the host country.

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Introduction

One of the most striking signs of globalization is the strong growth in foreign direct investment (FDI) during the last two decades, and particularly since the second half of the 1980s. The present paper starts out by defining FDI and describing recent trends, with emphasis on developments in developing countries. Section 2 explains what motivates firms may have to undertake FDI. In Section 3 we apply the theory presented in the previous section on issues related to FDI. Section 4 deals with the issue of host country effects of FDI and derives policy implications. Section 5 concludes.

1. Facts

1.1 FDI defined

FDI is an investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management. The OECD and IMF interpret "an effective voice" to involve the possession of ten percent or more of the ordinary shares of a corporate enterprise by one owner. Alternatively, if no single owner has 10 percent or more of the shares, the criterion is that a group of investors controls more than 50 percent of the shares. There is however no international consensus on the minimum equity stake. Partly for this reason, countries differ in their definitions of FDI.[1]

Note that in addition to new equity and loans from parent firms, reinvested earnings in the foreign affiliates are also registered as FDI. In addition, foreign affiliates may raise money in the host country or in international capital markets. These modes of expanding foreign affiliates' activities are however not registered as FDI.

FDI may involve either the establishment of a new production facility, a so-called "greenfield" investment, or a purchase of (shares in) an existing foreign firm, a cross border acquisition, in the statistics often reported under the heading "M&A" for "mergers and acquisitions". In case a firm acquires more than 50 percent of the shares in the acquired firm, this is a "majority M&A", and in case it acquires less, it is a "minority M&A".

FDI should be contrasted with portfolio investments. By definition, a portfolio investment involves a smaller ownership share in the company in which an investment has been made. The time horizon of a portfolio investment is often short term, which also means that this kind of capital is much more sensitive to short term fluctuations in the host economies than is FDI. Typically, portfolio investors are institutional investors, such as pension funds, trust funds, and life insurance companies. These investors are passive in the sense that they do not take part in the management of the company they have invested in. FDI on the other hand is generally undertaken by large, multinational enterprises (MNEs) with a clear ambition of using their ownership position to exercise control.

FDI should also be contrasted with strategic partnerships and licensing agreements, non-equity relations that have been growing in importance recently. Technology partnerships have been formed in information technology and pharmaceutical and automobile industries in the 1990s, in order to reduce both the competitive pressure in the market and the costs and risks associated with R&D. These kinds of partnerships and networks are not captured by traditional measures of international production, such as FDI (UNCTAD, 1999a: 8).

[1] On international differences in definition of FDI, and a discussion of data on FDI, see Dunning (1993), Ch.1.

1.2 Global growth in FDI

During the last two decades, and particularly since the end of the 1980s, we have witnessed a strong increase in foreign direct investment (FDI), both in absolute terms and relative to trade.[2] In fact, the growth in FDI, at a yearly average of 23 percent since 1986, has been twice that of trade. Today, 25 percent of global value added takes place in multinational enterprises. And one third of the MNEs value added is created in foreign affiliates. In Canada and Ireland foreign affiliates account for over 50 percent of manufacturing production (OECD, 1998b: 21).

Sales from the foreign affiliates ($11 trillion in 1998) exceed that of global exports ($7 trillion in 1998), implying that international production is a more important means of delivering goods and services to foreign markets than is trade. Moreover, intra-firm trade, i.e., international trade between various units within the same MNE, constitutes a substantial share (30 percent) of world trade.

Multinationals tend to be important in knowledge-intensive sectors, characterized by high levels of R&D relative to sales, a large share of highly skilled workers, new and/or technically complex products, and high levels of product differentiation and advertising. Examples of such industries include electronics, automotive, computers, and chemicals. Major MNEs in these industries are General Electric (the largest MNE in the world), Ford Motor Company (the second largest), IBM (the seventh largest), and Hoechst AG (the 13th largest).[3]

FDI growth has been particularly strong in the service sector. Today, nearly half of the world's FDI stock is in services. Growth in FDI in services has been mainly in the form of mergers and acquisitions, notably in sectors such as banking, insurance, and telecommunications. In fact, service industries accounted for more than half of all cross-border M&As during the period 1991-1998. In manufacturing, accounting for 40% of cross-border M&As, industries such as petroleum, chemicals, pharmaceuticals, and automotive have also seen some major mergers. Recent examples include British Petroleum-Amoco in the petroleum industry, Daimler-Benz-Chrysler in the automotive industry, and Astra AB-Zeneca Group Plc in pharmaceuticals (Kang and Johansson, 2000: 20).

As is evident from Table 1, the growth in cross-border M&A has been very strong in the second half of the 1990s. In 1999, M&A accounted for more than 80 percent of global FDI.[4] This means that the addition to international production capacity is far less than that implied by the value of annual FDI flows.

Table 1. Growth of FDI

	Value at current prices			Annual growth rate				
	1982	1990	1999	1986-90	1991-95	1996-99	1998	1999
FDI	58	209	865	24	20	32	44	27
M&A	. .	151	720	26	23	47	74	35

Source: UNCTAD (2000) Table 4, page 5.

Note: Values in billion dollars. Growth rates in percentages. Data on cross-border M&A available from 1987 onwards.

[2] Unless otherwise indicated, the information in Section 1.2 and 1.3 is gathered from UNCTAD's World Investment Report, various years.

[3] UNCTAD's World Investment Report ranks the world's 50 largest non-financial MNEs.

[4] UNCTAD's World Investment Report 2000, subtitled "Cross-border mergers and acquisitions and development", contains an in depth discussion of M&As.

About 90 percent of the worldwide majority-owned M&A purchases takes place in developed countries. In developing countries, FDI inflows are mainly in the form of greenfield investments. The lesser importance of M&A in LDCs is partly due to the fact that poor countries typically offer fewer suitable firms to acquire, and partly because of a more restrictive take-over legislation compared to OECD countries, particularly with respect to majority take-overs.

Note that the large share of M&A in total FDI in the late 1990s is not unprecedented. There was also a wave of takeovers in the late 1980s resulting in a share of M&A relative to total FDI close to what we see at the end of the 1990s. From Table 1 we see that in 1990, M&As constituted more than 70 percent of total FDI. In absolute numbers, however, both M&A and FDI in general were much larger at the end of the 1990s than a decade earlier. Moreover, while the cross-border M&As of the 1980s often crossed industry borders, most of the recent M&As are concentrated in the same or related industries; the business philosophy has changed from conglomerate building to one emphasizing the need to focus on core activities.

Regional distribution of FDI

The majority of FDI takes place between major OECD countries, notably between the EU and the USA. The EU is the largest source of FDI, with an outflow of $510 billion in 1999, nearly two thirds of world outflows. With foreign investments of $199 billion, the UK in 1999 replaced the US as the world's largest foreign investor for the first time since 1988. EU's share of FDI-inflows was 35 percent, and the corresponding share for the US was 32 percent.

Table 2. Regional distribution of FDI

	Inflows					Outflows				
	1995	1996	1997	1998	1999	1995	1996	1997	1998	1999
Developed countries	63	59	59	72	74	85	84	86	92	91
Western Europe	37	3	30	37	35	49	54	51	63	64
United States	18	21	24	30	32	26	20	23	21	19
Japan	-	0	1	1	2	6	6	6	4	3
Developing countries	32	38	37	26	24	15	16	14	8	8
Africa	1	2	2	1	1	0	-	0	0	0
Latin America	10	13	15	11	12	2	2	3	2	3
Asia	21	23	20	13	11	12	14	10	6	5

Source: UNCTAD (1998) Table 4, UNCTAD (1999a) Table 8, UNCTAD (2000), Annex Tables B.1 and B.2.
Note: Numbers as percentage of global FDI flows.

LDCs' share of FDI-inflows has been growing has been growing in the 1990s, at least up till the financial crisis in Asia which started in the fall of 1997. In 1990, this share was 20 percent, reaching 37 percent in 1997. The majority of these investments are hosted by the Southeast Asian countries (19 percent in 1997) and Latin America (15 percent in 1997), with Africa's share being a modest 1.6 percent. China alone represented one third of non-OECD inflows in the period 1990-96. Indeed, during this period China was second only to the US in terms of FDI inflows.

As evident from Table 2, the share of global FDI destined for LDCs fell due to the Asian crisis in 1997, to 24 percent in 1999, South-East Asia losing 10 percent and Latin America 3 percent relative to 1996. Similarly, the share of FDI outflows from LDCs dropped from 14 percent in 1997 to 8 percent in 1999. It is however important to note that although the

crisis led to a decline in Asia's and Latin America's share of global FDI, in absolute terms, the drop in FDI was much less dramatic. In fact, FDI inflows to Latin America were five percent *higher* in 1998 than in 1997, even though this continent registered a 4 percent reduction relative to global FDI in the same period. The relatively modest response of FDI flows to most Asian countries in a period of deep financial and economic crisis, is evidence of the long-term nature of this kind of capital flows relative to portfolio investment.[5]

Even if LDCs receive less FDI than the more developed parts of the world do, the importance of these capital flows for developing countries is arguably greater. For one, FDI is likely to be relatively more important in less advanced countries as a source of capital and technology due to limited access to international capital markets and small amount of domestic R&D. Moreover, the size of LDC economies is generally smaller than that of developed economies. In fact, the FDI/GDP ratio is higher in developing countries than in OECD countries (UNCTAD, 1999a: 19). Correcting for size also reduces regional differences in FDI inflows within the developing world. Table 3 below reports FDI as a share of GDP to developing regions. Note that in 1970, Africa attracted more FDI relative to GDP than Latin America and Asia.

Table 3. FDI in dollars per $1000 of GDP

	1970	1975	1980	1985	1990	1995	1997
Africa	7.9	3.1	0.8	6.0	5.1	10.9	14.7
Latin Am.	6.7	10.5	10.0	10.1	8.5	19.8	33.8
Asia	2.7	4.0	4.3	4.6	12.4	24.2	28.3

Source: UNCTAD 1999b

While growth in FDI to LDCs has been large, at least in absolute numbers, growth in other forms of capital flows to LDCs has been even greater. Table 4 below illustrates the rise in private capital flows from the OECD area to developing countries.

Table 4. Capital flows to developing countries

	$ billion		Percent	
	1988	1996	1988	1996
I. Official development finance	61	70	64	22
II. Export credits	-2	4	-2	1
III. Private flows	37	234	38	76
1. Direct investment	19	60	20	20
2. International bank lending	8	70	8	23
3. Bond lending	2	86	2	28
4. Other private lending	4	12	4	4
5. Private grants	4	6	4	2
Total capital flows	96	308	100	100

Source: OECD (1998, Table 2).

Private capital has increased its share from 38 percent of total capital flows to LDCs in 1988 to 76 percent in 1996. The largest increases have been in bank lending (from 8 percent to 23 percent) and in bond lending (from 2 percent to 28 percent), with the share of FDI being constant at 20 percent. The reasons for the large increase in private capital flows to LDCs include liberalization of trade and investment regimes, financial market integration, restored

[5] For a more detailed discussion of FDI inflows to Southeast Asia, see Thomsen (1999).

financial solvency of debt-distressed countries and the transformation of several countries from planned to market economies. Note that Table 4 does not capture the effect of the financial crisis in Asia. In 1997, bank and bond lending and portfolio flows to a number of the crisis-struck countries fell dramatically.[6]

1.3 FDI in LDCs

In colonial times, MNEs in the developing world were usually directly set up or supported by the state, and enjoyed their patronage as long as the companies advanced the economic and political objectives of the colonial powers. Examples include the British East Indian Company, the Dutch East Indian Company, and Royal African Company. Originally, these companies were engaged primarily in trade, shipping and finance. But gradually, during the late nineteenth century, Northern firms became increasingly involved in direct production in the developing world, particularly in the extraction of natural resources and estate agriculture.

In the inter-war period, in response to the import substitution policies initiated in some LDCs, multinationals also entered into manufacturing, notably in Latin America and to some extent in India. This development continued in the first two decades after the Second World War, as countries became independent, and policies of import substitution became more widespread.[7]

Independence also brought with it nationalization of certain industries, such as natural resources. For instance, in the copper industry, host government ownership accounted for only 2.5 percent of total production capacity in the early 1960s but had reached 43 percent by the end of the decade, and 60 percent at the end of the 1970s. MNEs are still involved in natural resources, but not necessarily as equity owners. Instead, they typically offer financial and marketing services to the state owned companies.[8]

In the 1970s, while FDI kept growing, commercial bank lending grew even more rapidly, and surpassed FDI in importance as source of foreign capital to LDCs. With the debt crisis in the 1980s, foreign commercial bank lending came to a virtual halt, and the relative importance of FDI grew. In the 1990s, with privatization and deregulation, also the service sector, including banking, insurance, and infrastructure services, became the subject of FDI. Together with the removal of trade barriers, liberalization of FDI legislation also increased investment in labor intensive industries.

1.3.1 Asia

Trends

FDI inflows to Asia have been growing both in absolute terms and as a share of global FDI inflows since the late 1980s. In the late 1990s, China emerged as the largest FDI recipient in the developing Asian region, and the second largest recipient worldwide, with FDI inflows of $40 billion in 1999.[9]

The Asia crisis, starting in the fall of 1997, caused a reduction in FDI inflows, particularly in 1998, but this reduction was small compared to the large outflow of portfolio capital from the region. For instance, in 1997, FDI inflows to Indonesia, Malaysia, the Philippines and Thailand (the ASEAN4-countries) [10], were at the same level as in 1996, but portfolio flows and bank lending fell by almost 100 billion dollars, implying significant

[6] See for instance UNCTAD (1998, Figure 5).
[7] For a historical overview of international production, see Dunning (1993, Chapter 5) and Helleiner (1989).
[8] Reported in Helleiner (1989, page 1461).
[9] Section 1.3.1 is largely based on Thomsen (1999).
[10] In addition to these four countries, ASEAN consists of Singapore and Brunei.

outflows of these types of capital. In terms of FDI outflows from developing Asian countries, these have been reduced by a quarter due to the crisis.[11]

Some countries in the region in fact experienced an increase in FDI in 1998. FDI in Korea has increased dramatically at the end of the 1990s, from less than $3 billion in 1997 to $10 billion in 1999. For the first time in the 1990s the country became a net FDI recipient. The increase in FDI was mainly in the form of foreign acquisitions of Korean firms, due to low stock prices and the country's removal of restrictions on acquisitions by foreign investors in 1998. In fact, with M&A inflows of $9 billion, Korea was the largest recipient of this kind of FDI in developing Asia.

Thailand also experienced a large increase in FDI inflows, as a number of weakened financial institutions were acquired by foreign investors. The Philippines, too, registered large increases in FDI. The greatest drop in FDI inflows took place in Indonesia, partly due to political unrest.

The reasons for the relative stability in FDI inflows to Asia are good long-term prospects of the region, cheap assets, due inter alia to currency devaluations, and FDI liberalization, particularly with regards M&A.

Intra-regional investment has been increasing markedly since the second half of the 1980s, and today accounts for a large share of FDI inflows in the region. Table 5 reports inward investment in Thailand, Indonesia, the Philippines and Malaysia.

Table 5. Inward investment in ASEAN4 countries by investor country, 1997

	Thailand	Indonesia	Philippines	Malaysia
Japan	30	20	25	32
NIEs	30	28	16	34
US	17	7	30	14
Europe	12	28	23	13
Others	11	17	6	7

Source: Thomsen (1999, Table 2). Numbers are percentages of total inward FDI stock.
Note: NIEs are "Newly industrializing economies", including Korea, Singapore, Taiwan, Hong Kong.

The table shows that Thailand and Malaysia have received roughly two thirds of their FDI from regional investors, evenly distributed between Japan and East Asian Newly industrializing economies (NIEs). Looking beyond ASEAN, we also know that over half of FDI inflows to China comes from Hong Kong based investors.

Reasons for the rise in intra-regional FDI include increasing labor costs in Japan and the strong appreciation of the Japanese yen in the late 1980s, the response from Japanese firms being to start production and exports from other countries in the area, such as Malaysia and Thailand. Similarly, Taiwan and other Newly Industrialised Economies also increased their FDI in the region, partly as a response to a loss of preferential market access to OECD countries.

In Thailand and Malaysia, FDI in the manufacturing sector is dominated by projects in electronics. In Thailand, computer parts and integrated circuits make up almost one third of total exports, and these sectors are dominated by MNEs. Non-manufacturing FDI in these two countries is mainly in finance, construction and real estate. In Indonesia, important manufacturing sectors for FDI are chemicals and paper. In addition, there is a lot of FDI related to the country's large oil and gas sector. FDI in electronics is growing in both Indonesia and Philippines. FDI into China and Vietnam is largely in relatively labor intensive manufacturing sectors, such as textiles and footwear.

[11] Thomsen (1999, Figure 7).

Policy environment

Most countries in East Asia have been very restrictive in allowing market seeking FDI, i.e., FDI aimed at supplying local markets. Foreign firms have been prevented from acquiring a majority stake in a local company or owning the land on which the factory is built. They have also often faced various performance requirements related to the transfer of technology or the employment of local personnel. Restrictions on FDI inflows for ASEAN4 are discussed in a case study below.

MNEs wishing to export most of their output are generally treated much more favourably. Malaysia has been a pioneer amongst the East Asian developing countries in attracting export-oriented firms, with export promotion policies in place since the 1970s. But there are exceptions. The Philippines, at least until the 1990s, did not generally welcome FDI.[12] The Republic of Korea, too, relied to a greater extent on licensing arrangements and local resources in order to attract and develop technology. Partly due to these policies, FDI inflows in the period 1990-97 to the Philippines amounted to $8 billion and Korea $10 billion, which should be contrast with Malaysia's $35 billion of FDI inflows.

Today, national policies on international investment and trade have converged towards a more liberal policy framework. One reason for this development is the recent financial crisis, forcing countries to liberalize their FDI policies in order to attract capital and stabilize their economies. Another reason is the increasing importance of China as target of FDI during the 1990s. Many countries in the area, in the fear of being marginalized in terms of investment inflows, have increased their efforts to attract foreign capital. One important effort in this respect is the ASEAN Investment Area (AIA), signed in October 1998, which is a binding agreement to foster investment liberalisation within the region. According to this agreement, investment barriers will be eliminated and national treatment granted for ASEAN investors by 2010 and for all investors by 2020. The agreement also paves the way for the members to provide transparent investment policies and administrative processes.

Box 1. Restrictions on FDI in the ASEAN4

i) Screening

A foreign investor wishing to invest in one of the ASEAN4 must usually go through a screening agency or Board of Investment (BOI). The principal aim of such an agency is to further the development strategies of the host government. The agency will favour certain sectors on a priority list or those investors which fulfil pre-established criteria, usually related to exports.

For instance, export-oriented firms, particularly those locating in export processing zones (EPZs), are given numerous incentives in all four countries, including automatic approvals, land ownership, full control of the affiliate, tax holidays and duty free imports of components. From a regulatory point of view, investors wishing to export most of what they produce will find the ASEAN4 countries almost as open as OECD countries. In addition, firms that are likely to transfer technology will generally be favoured. The countries, in particular Thailand, also favour companies investing in disadvantaged regions.

The screening agencies have gradually been transformed into investment promotion agencies, and in this process, they have attempted to streamline procedures by setting up one-stop shops for investment approvals. In some cases, however, these agencies appear not to be very efficient. Both foreign and domestic investors in Indonesia have complained about cumbersome and time-consuming licensing procedures and high facilitation costs, and Japanese investors have ranked the complexity of administrative procedures as the principal problem encountered in their operations in Indonesia. In contrast, The Malaysian Industrial Development Authority is generally recognised to be one of the more effective agencies in the region.

Box 1. (Cont.)

ii) Foreign equity limits

Screening agencies are concerned with new investment projects or the expansion of existing ones. Acquisitions of local companies by a foreing investor are a different matter. In most cases, until recently, foreign investors were limited to minority stakes in local companies, regardless of the specific sector. The foreign equity share ranged from 30 percent in Malaysia to 49 percent in Indonesia and Thailand. Some sectors, such as banking, had even lower limits. Foreign investors do not always demand complete control of an investment, but in many of the most technologically sophisticated sectors and those where brand names are important, these companies usually prefer maximum control over their assets through full ownership. A minority ownership requirement can thus act as a significant barrier to investment in these sectors.

In addition, the authorisation process in these cases is often different from the usual BOI procedure. In Malaysia, the investor must have the approval of either the Malaysian Industrial Development Authority or the Foreign Investment Committee, or both. Among the other requirements, the investor must demonstrate that the merger will lead directly or indirectly to net economic benefits in relation to such matters as the extent of indigenous Malay participation, ownership and management, as well as income distribution, growth, employment, exports, quality, training, R&D, etc.

Since the onset of the financial crisis in the region, there have been some attempts at relaxing the foreign equity limits, most notably in Indonesia.

iii) Negative lists

A complement to equity limits for acquisitions, is the use of negative lists of those sectors in which foreign investment, including greenfield investment, is not permitted or in which there are specific sectoral foreign equity limits. Negative lists provide a useful benchmark of the degree of openness of each economy, as well as to the extent of liberalisation over time. Negative lists have been considerably shortened over time in Indonesia, the Philippines and Thailand. For instance, a proposed revision of the Alien Business Law in Thailand aims to reduce the number of sectors on the negative list from 63 to 34.

iv) Restrictions on land ownership

Another restriction impeding foreign investment, concerns the right of foreign-owned corporations to own land. Without the ownership of the land on which the factory is built, the foreign investor faces additional insecurity about the future policies of the host government and is also unable to use the land as collateral for local borrowing.

Source: Thomson (1999).

1.3.2 Latin America

Trends

In the early decades of the twentieth century, FDI inflows to Latin America, measured as a share of GDP, were far greater than those flowing to East Asia. In 1950, Latin American GDP per capita was more than three times the Asian average, making it a far more lucrative location for market seeking FDI. By the 1980s, Latin America was overtaken by newly industrial East-Asian countries such as South Korea and Taiwan. The increased size of the Asian market attracted FDI to the region, and, as is evident from Table 3, in the first part of the 1990s, FDI/GDP was higher in Asia than in Latin America.

This trend was again reversed in the late 1990s. This is of course partly due to the fact that the impressive economic growth in East Asia not only attracted FDI, but also increased

the denominator of the region's FDI/GDP ratio. But FDI has picked up in Latin America due to political stability and successful policies in many of the continent's larger economies, such as Brazil, Mexico, and Argentina. Table 2 shows that, until the Asian crises, Latin America has attracted a steadily increasing share of global FDI during the 1990s. In 1999, FDI inflows to this continent were $90 billion, a 23 percent increase over 1998. Brazil is the largest recipient with $31 billion, followed by Argentina with $23 billion and Mexico with $11 billion. An important driving force of FDI inflows into Latin America is privatization of services and natural-resource state enterprises. In addition, regional trade agreements such as MERCOSUR and NAFTA and proximity to the US market in the North are also important factors attracting FDI to the region.

The United States is the largest investor in Latin America, but investments from EU-countries, and in particular Spain, have increased in recent years. In 1998, about $8 billion were invested within the region, Argentina, Brazil and Chile being particularly active in intra-regional FDI.

Box 2. MERCOSUR

In 1986, Argentina and Brazil formed a bilateral trade agreement, stipulating the elimination of all trade barriers over a ten-year period. Five years later, this agreement was extended to include also Paraguay and Uruguay, and the agreement was called MERCOSUR. A customs union was established in 1995, with free trade in (most) goods among the four member countries, and a Common External Tariff (CET) for trade with third countries. It should be noted that the integration process has not led to an across-the-board reduction of external tariffs for all countries. In some cases, such as the region's automobile industry, there has in fact been a general increase in the external trade barriers as a result of the integration process. For instance, in 1994 Brazil raised its tariffs on automobiles imported from non-MERCOSUR countries from 20 to 70 percent, and bilateral agreements between the MERCOSUR countries grant preferential treatment to companies with assembly plants in the customs union

In addition to the trade arrangements, a new investment regime has been established to promote and protect investment in the MERCOSUR. Intra-regional investments are granted national treatment, and most restrictions on capital and profit remittances have been removed.

Although there has been a considerable liberalization of the trade and investment regime in MERCOSUR in the 1990s, it is uncertain how much of the reforms should be credited to the formal integration agreement. Unilateral liberalization has been important; most notably, Argentina fundamentally changed its FDI legislation in 1976, to guarantee foreign firms essentially the same rights and obligations as national firms, and unlimited repatriation of profit. Moreover, multilateral initiatives like GATT/WTO have also been important in guiding economic reform.

During the first half of the 1990s, intra-region trade increased rapidly. In terms of FDI, Argentina and Brazil have been the most favored locations, while Uruguay and particularly Paraguay have lagged behind. Again, the success of Argentina in attracting FDI is not necessarily related to MERCOSUR as such. The most important reason was Argentina's comprehensive privatization program, opening up several public service industries, such as telecommunication and transportation, to foreign investment. Successful macroeconomic reforms, which managed to bring down public deficits, inflation and interest rates, and ensured convertibility of the currency also increased the attractiveness of Argentina as host to FDI. Moreover, in 1991 Argentina introduced a system of quotas on imports of finished automobiles, which induced foreign car producers to invest in order to serve these markets through local production.

Inflows of FDI to Brazil have generally fallen well short of those to Argentina, even though the Brazilian market is about four times larger. The reason is primarily Brazil's more unpredictable macroeconomic environment. However, in recent years, Brazil has carried out successful reforms and stabilization, which have contributed to a marked increase in FDI to this country. Since the mid-1990s, Brazil has replaced Argentina as the most favored MERCOSUR location for US investment.

Source: Blomström and Kokko (1997: 31-38).

1.3.3 Africa

Trends

FDI inflows to Africa, at $10 billion in 1999, account for just over 1 percent of global FDI flows. Still, FDI inflows to Africa at the end of the 1990s seem to have stabilized on a much higher level than in the early 1990s.

The United States and a small number of Western European countries constitute the most important source countries for FDI flows to Africa. Recently, investors from other developing regions, particularly Southeast Asia, have also emerged as new actors on the African FDI scene. For example, Telekom Malaysia has formed a consortium with SBC International of the United States to invest $1.2 billion in the privatized South African Telkom. Similarly, Korean investors have been very active in the recent FDI boom in Morocco, including a $400 million investment by Daewoo.[13]

Traditionally, two large economies, Egypt and Nigeria, have received the bulk of FDI flowing to Africa, with shares of more than 67 percent in 1983-1987. In 1993-1997, however, this share declined to 38 percent. In 1999, Angola and Egypt were the largest African FDI recipients, followed by Nigeria. Table 6 reports various measures of FDI growth in some recent African "frontrunners", i.e., countries that have performed well in terms of various measures of FDI. The table also includes average figures for Africa and LDCs.

Table 6. FDI inflows of African frontrunners

	Average FDI per year			FDI per $1000 GDP			Ratio of FDI to GFCF			FDI per capita		
	1987-1991	1992-1996	Change	1987-1991	1992-1996	Change	1987-1991	1992-1996	Change	1987-1991	1992-1996	Change
	(Million $)		(%)	(Million $)		(%)	(%)		(%)	($)		(%)
Botswana	56.7	137.9	143	18.6	33.1	78	6.5	12.9	100	46	95	108
Eq. Guinea	11.1	109.7	888	82.9	689.8	732	30.2	285.2	845	32	282	778
Ghana	11.9	121.4	920	2.1	20.5	869	1.7	14.9	754	1	7	778
Mozambique	9.2	33.3	263	6.8	23.5	247	1.2	3.6	201	1	2	228
Namibia	29.6	108.4	267	14.3	37.5	163	8.4	16.8	99	23	72	221
Tunisia	86.4	387.3	348	7.8	23.3	197	3.5	9	158	11	44	16 672
Uganda	-1.4	77.6	19 796	-0.1	15.9	18 816	-0.1	10.3	15 175	0.0	4	16 672
Africa	60.1	96.1	60	6.7	10.4	54	3.3	5.9	77	5	7	39
LDCs	212.1	613	189	8.2	17.3	111	3.5	6.8	98	8	20	164

Source: UNCTAD (1999b)

Note: GFCF = gross fixed capital formation. May be higher than 100 percent, since FDI includes acquisitions of existing capital stock.

The frontrunner states are dynamic economies, but at different levels of economic development. Equatorial Guinea, Mozambique and Uganda are least developed countries, while Botswana and Tunisia are middle-income countries. The main attraction of Equatorial Guinea for foreign investors is the country's oil and gas reserves. Natural resources are also very important in Botswana, Ghana, Mozambique and Namibia, but these countries also experienced market seeking FDI fueled by the relatively strong growth in their economies in recent years. Tunisia has not only attracted market seeking FDI, but also efficiency seeking FDI, in particular into the textile and apparel industry.

Since 1996, the industries attracting the most FDI in Africa are telecommunications, food and beverages, tourism, textiles and clothing, mining and quarrying. Evidently, natural resources is not the only sector attracting FDI to African countries. For instance, FDI from Germany is increasingly going into the manufacturing sector (64 percent in 1996). FDI from UK is more than 60 percent manufacturing and services.

[13] Most of the information in this Section is collected from UNCTAD (1999b).

Box 3. Resource-led growth and FDI in Botswana

Africa has long been particularly dependent on FDI for the development of its natural resources. One country that has managed this relationship successfully is Botswana. At independence in 1966, it was one of the world's poorest countries. Since then, it has been one of the world's fastest growing economies, with annual growth averaging 14 percent during the period 1965-1980 and 11 percent during the period 1980-1990. By 1990, with a per capita income of $2040, Botswana was comfortably a middle-income economy.

The country's success has been based almost exclusively on the expansion of mining and quarrying. Their share of GDP rose from only 1 percent in the early 1970s to over 50 percent in 1988-1989. Government revenues from mineral taxes and royalties have risen steadily, to over 50 percent of the total. Diamonds are the main source of income, accounting for well over three quarters of total exports during the 1980s.

With limited domestic resources and mining know-how, the Government of Botswana had to attract FDI. The main supplyer of capital, entrepreneurship and technology was De Beers of South Africa. From the opening of the first mine in 1971, all Botswana diamond mines have been owned by Debswana, a 50-50 venture between De Beers and the government.

Stable internal policies and good governance have contributed greatly to the country's impressive growth record. Still, doubts about resource-led development remain. The future of the economy continues to depend on the prospects in the world diamond market. Not much FDI has yet been attracted to manufacturing or services; their combined share has remained at only 7 percent of total inward stock during the 1980s. Botswana's challenge is to transfer its experience in managing the development of its primary sector to organizing the expansion of the rest of the economy.

Source: UNCTAD's World Investment Report1993

Policy environment

The African frontrunners share some important features. The policy environment includes relative stability in economic policies, in particular macroeconomic policies; a high degree of investment protection; favourable trade policies; extensive privatization programmes; the implementation of investment promotion policies, including one-stop agencies that can give foreign companies quick and non-bureaucratic assistance in all aspects of their investment projects; and education programmes, particularly at primary and secondary levels. In addition, the physical infrastructure is well-developed, and economic growth is fairly high.

Table 7. Selected indicators of African frontrunners

	Rate of inflation		Government surplus	
	1980-1990	1990-1996	1980-1990	1990-1996
Botswana	10.9	11.8	9.4	5.5
Equatorial Guinea	17.3	11.7	- 14.0	- 4.9
Ghana	47.4	30.8	- 12.0	- 6.8
Mozambique	52.3	43.2	- 18.2	- 5.8
Namibia	17.5	10.5	- 1.6	- 4.0
Tunisia	8.3	5.2	- 4.7	- 3.8
Uganda	103.5	16.9	- 9.5	- 3.0
Africa	16.1	30.7	- 6.7	- 3.8

Source: UNCTAD (1999b).

Most African countries have concluded bilateral investment treaties with other countries that aim at protecting and promoting FDI. African countries have also increasingly signed double taxation treaties, making it more attractive for foreign investors to invest in a country, by

avoiding paying taxes twice on the same transaction. The majority of African countries have also signed multinational agreements dealing with the protection of FDI, such as the Convention establishing the Multilateral Investment Guarantee Agency (MIGA) and the Convention on the Settlement of Investment Disputes between States and Nationals of other States. Investment promotion agencies have also been established. For instance, in the Southern African Development Community (SADC), all 14 member states have established such agencies.

Box 4. South Africa and SADC

Ever since South Africa emerged from apartheid in 1994, hopes have been high that it could become a "growth pole" for the region, contributing positively through both trade and FDI to the development of its neighbours, especially those associated with it in SADC. With GDP exceeding $129 billion in 1997, South Africa's economy is about three times larger than the combined GDP of the other 13 SADC member countries. After 1994, trade between South Africa and its neighbouring countries increased rapidly.

So far, little information is available on the actual role of South African MNEs in the development of the region. Even before 1994, South African FDI into southern Africa had increased significantly. Most of these investments were made by mining companies, often accompanied by investments by financial firms providing financial services to farmers. More recently, South African MNEs have also invested in food processing, retailing and other services in the region. South African Breweries purchased Cervejas de Mocambique when the latter was privatized in 1995. All in all, this company now operates in 11 African countries and employs about 7000 people.

Table 8. South Africa's FDI stock in selected African countries

	1993	1994	1995	1996	1997
Botswana	34	38	73	65	60
Lesotho	17	16	52	30	40
Namibia	32	37	204	180	191
Swaziland	26	28	48	48	113
Zimbabwe	35	35	43	30	46
Others	663	746	657	643	860
Total	806	900	1067	996	1310

Source: UNCTAD (1999: 12)
Note: Numbers in millions of USD

So far, the hope that regional trade with South Africa could induce higher growth in the area has not yet been fulfilled. One reason is, of course, the South Africa's disappointing growth rates of less than 4 percent in recent years. Import barriers is another issue, but barriers to trade are coming down. In 1995, South Africa started a process of progressive import tariff reductions in accordance with its obligations as a member of the World Trade Organization: Its average import protection in manufacturing is due to be reduced from 19 percent in 1994 to just 8 percent in 2000. However, the exclusion of some sectors from liberalization will reduce the effects of this change.

Trade liberalization is certainly also an issue within SADC. In 1996 all member countries signed the SADC trade protocol that provides for the creation of a free trad zone among member countries by the year 2004. The protocal still pends ratification by the member countries.

Source: UNCTAD (1999b, Box 2).

1.4 Summary

Since the mid-1980s, FDI has been increasing rapidly in the world economy. The OECD countries are the dominating source countries of FDI, and are also the major recipients of these investments. In the 1990s, up till the financial crisis in Asia in 1997, a growing share of global FDI was hosted by less developed countries. In particular, Latin America and East Asia have attracted significant amounts of FDI in the 1990s. Africa, on the other hand, is fairly marginalized in terms of FDI inflows.

The importance of FDI within these less developed regions of the world varies a lot between countries. For instance, FDI inflows to Korea and the Philippines have been modest compared to, say, Malaysia and, recently, China. This has not prevented Korea from experiencing rapid economic growth in the 1980s and 1990s. Evidently, large inflows of FDI are not a necessary condition for economic growth. In Latin America, Paraguay and Uruguay have been much less successful than their larger MERCOSUR counterparts, Argentina and Brazil, in attracting FDI. And in Africa, although the overall picture is gloomy, countries such as Namibia and Botswana have experienced satisfactory growth rates and fairly large inflows of FDI.

The Asian crisis led to a drop in the share of global FDI flowing to Asia and Latin America. Compared to other forms of capital flows, such as portfolio investments, FDI has proven to be far less sensitive to economic fluctuations, of which the Asian crisis is a dramatic expression.

2. Explanation: Dunning's OLI-framework

In recent years we have witnessed large-scale privatization and extensive liberalization of international investment rules in most parts of the world. Such policy changes are obviously important in explaining the great rise in global FDI: It gives multinational companies the *opportunity* to invest abroad. But in order to understand the rise in global FDI, we must also understand why multinationals find it profitable to use this opportunity: We must search for factors that *motivate* FDI. In short, we need a theory. Such a theory must answer the following three questions: 1) What makes a firm competitive in foreign markets? 2) Why would a firm choose foreign production? 3) Why would a firm choose to own the foreign production unit?

In his widely acclaimed OLI-framework, Dunning (1993) provides a synthesis of the answers proposed by the literature to the three questions raised above.[14] Three conditions, namely ownership advantages (O), location advantages (L), and internalization advantages (I), all have to be satisfied for a firm to undertake FDI.

Ownership advantages

A firm selling in a foreign market has certain disadvantages relative to its local competitors. The disadvantages could be related to language and cultural barriers, limited knowledge about local tastes and institutions, etc. The hypothesis is that given these disadvantages, the firm operating in the foreign environment must possess some advantage over local firms in order for foreign production, or indeed international sales of any kind, to be profitable. This advantage could be in the form of a more cost efficient production process, a unique product, better access to international capital market, international marketing facilities, etc.

[14] See also Markusen (1995) for an overview and a discussion of the OLI framework.

Location advantages

A location may offer various kinds of benefits to firms. First, it may be home to *natural resources*, such as oil, minerals, or trees, which attract firms involved in the extraction of these resources. This is sometimes called resource-seeking FDI.

Second, countries may be endowed with a low cost, and perhaps highly qualified, *labor force*. Firms seeking to reduce labor costs or perhaps gain access to ideas and technology may be attracted to such a location. This kind of FDI is referred to as "vertical" or "efficiency seeking" FDI. It is called vertical, since it involves a geographical decentralization of the firm's production chain, where the affiliates typically produce labor intensive intermediates that are shipped back to high-wage countries, often to the parent company itself. The name efficiency seeking stems from the fact that the main aim of the investment is greater cost efficiency in production. For instance, Japanese companies involved in labor intensive manufacturing industries such as electronics components, chemicals, electrical appliances, and textiles have invested heavily in neighboring countries in order to reduce labor costs. FDI aimed at accessing highly qualified labor in a certain area, such as the IT-expertise in California's Silicon Valley, is sometimes referred to as "technology sourcing" FDI.

Third, a location offers proximity to *local customers*. This is sometimes referred to as "market seeking", or "horizontal", FDI; "market seeking" since the aim of the investment is to supply local markets, and "horizontal", since the affiliate basically does the same thing as the parent firm. By locating in a specific area, firms save on trade costs, such as tariffs. This rationale for FDI is therefore sometimes referred to as the tariff-jumping argument. If plant specific costs are not too high relative to the foreign market size, it may be more profitable to service foreign markets through FDI rather than exports.

An illustration of tariff-jumping is the large amount of FDI into Latin American markets for automobiles, protected from imports by a high tariff barrier. Another example is the investments in Europe and the US by Japanese car producers, aimed at servicing local markets. For certain kinds of non-tradable services, such as real estate, hotels, retail trade, telecommunication, and part of the banking and financial sectors, there is no tradeoff between trade and FDI at all; market entry simply requires FDI.

Most of the global FDI is horizontal. Brainard (1997) reports that only 13 percent of the overseas production of U.S. owned foreign affiliates is shipped to the United States, while only 2 percent of the output produced by foreign affiliates located in the U.S. is shipped to their parents. Not surprisingly, vertical FDI is relatively more important when hosted by LDCs.

Fourth, there may be a *strategic incentive* to invest abroad. We may call this "monopoly seeking" FDI. Particularly when the investment is in the form of an acquisition, the market power, and therefore the profit of the investing firm, is likely to increase (since the number of competitors goes down, at least in the short run). But also greenfield investments may have a strategic motivation. Firms may wish to have production plants in several locations because such a presence may deter entry by potential newcomers (Ganslandt, 1998).

Finally, low wages and a large local market are not sufficient conditions for attracting FDI. The *public sector* supplies public goods and services and defines and implements economic policies and all these public sector activities affect the profitability of an investment project, whether domestic or foreign. As an example, 16 leading MNEs operating in India named regulatory control, bureaucratic intervention, and the lack of adequate infrastructure, particularly telecommunications and transportation as major difficulties in operating in that country.[15]

[15] Cited in UNCTAD (1994), page 83.

In relation to this last point, note that firms not only seek business-friendly policies at a specific point in time. More importantly, since an investment in a particular country involves a long-term exposure to the economic and political conditions in that country firms typically look for some commitment to these policies. They need to be assured that their investment is safe from expropriation, that profits can be transferred out of the country, and that potential disputes between the host government and the multinational firm will be solved in a fair and efficient way. Countries with a record of economic, political and social stability are likely to be attractive to foreign investment. For instance, multinationals investing in Central and Eastern Europe listed macro-economic stability as key to realizing the potential of their investment (UNCTAD, 1998).

Signing international trade and investment agreements may serve to commit to a set of policies and to signal this commitment to the rest of the world. Fernandez and Portes (1998: 214) argue that for Mexico, NAFTA serves mainly as a commitment and signaling device:

> Mexico joined NAFTA on rather unfavourable terms, securing very little in concrete tariff reductions or other concessions from the United States. Although this was not perceived as an insurance premium by U.S. policymakers, Mexican policymakers may have perceived it as such. Again, this is particularly relevant in the context of foreign investment. To persuade U.S. investors to take advantage of Mexico's low labor costs by investing in Mexico, it was necessary to reassure them not only that tariffs for Mexican exports to the United States were low but also that they would stay low and that contingent protection would be less likely to be imposed.

A similar argument has been offered by Blomström and Kokko (1997b).

Internalization advantages

In order for the MNE to choose FDI rather than arms-length agreement, such as licensing or strategic partnerships, there must exist some advantage of conducting the business internally within the firm. These advantages include greater control over the technology and quality of the product. In addition to problems tied to control of arms-length operations, negotiating such deals may be difficult and costly, as emphasized by Blomström and Kokko (1997a: 8):

> Markets for technology are typically imperfect, which makes the transaction costs for sales to outsiders high. For instance, it is difficult to judge the value of any specific technology and agree about prices and licensing costs that are acceptable to both parties. Consequently, MNEs often prefer direct investment before licensing, and the preference for FDI may be particularly strong when the newest and most profitable technologies (or those that are very close to the MNEs principal line of business) are exploited.

Limiting the spread of technology may be particularly difficult in many LDCs, due to weak patent protection systems. This fact may induce firms to avoid arms-length agreements and choose FDI in these countries. As an example, India banned direct investment by Coca-Cola hoping that the company instead would choose to license the production of its soft drink to a local producer. The weakness of Indian property right protection, however, discouraged the American company from entering into a licensing agreement, and the company instead decided to leave the market (Vishwasrao, 1994). In Indonesia and the Philippines, foreign investors are required to phase down their participation in a company over time. Rather than adding to domestic capabilities, the result has been a reduction in investments and technology transfer from the parent firm. Generally speaking, empirical research indicates that restrictions

on FDI have not been successful in increasing technology transfers to the host economy (OECD, 1998a: 61-62).

3. Applications

In this section we discuss three issues in light of the theoretical overview presented above. The first issue deals with the fact that FDI is particularly prevalent in knowledge-intensive sectors. Can the OLI-approach explain this fact? The second issue concerns the rise in acquisitions. When do firms choose this form of market entry, and can we explain its recent rise? Finally, we focus on economic integration and market entry. What are the likely effects of increased market integration on FDI? This last question has received a lot of attention in the literature, and is also the issue that will receive the most attention here.

3.1 R&D, FDI, and OLI

Multinationals are often found in industries in which products and production processes are unique to firms, typically the result of large investments in R&D and a large employment of highly skilled labor. The OLI-framework may shed light on this observation. First, knowledge is often firm specific, for instance in the form of patented products and production processes. Knowledge is an ownership advantage that may make the firm competitive in world markets. Second, knowledge can easily be transferred between countries at little extra cost. If the firm derives its ownership advantage from firm specific knowledge, the costs of establishing a foreign affiliate are probably modest, compared to a situation where the ownership advantage is embodied in a particular kind of machinery. Third, it may be preferable for an R&D intensive firm to internalize its foreign operations by choosing FDI, rather than to enter into a licensing agreement, in order to keep a tight control over its technology.

In sum, the ownership, location, and internalization advantages are all highly relevant for R&D intensive industries. The observed importance of FDI in these industries is therefore in line with the predictions of the theory.

3.2 Entry mode: Greenfield versus acquisition

In Section 2 we discussed a firm's choice between FDI and alternative modes of servicing foreign markets, such as exports. In what now follows, we shall dig deeper and study a firm's choice between different forms of FDI, notably the choice between greenfield investment and acquisition.[16]

For the investing firm, an important advantage with acquisition relative to greenfield is that an acquisition reduces the competitive pressure in the market. This is likely to increase profits through a higher price on the firm's output and perhaps a lower price on its inputs. We would therefore expect acquisitions to increase in importance in markets where the competitive pressure increases, for instance due to international economic integration, as will be discussed in Section 3.3 below. The entry costs may also be lower under acquisition than greenfield. It is costly for a new firm not only to set up a new production site, but also to hire a new staff, to establish distribution networks, and to acquire manufacturing skills adapted to local conditions; a type of infrastructure and information that an existing firm is likely to have. Yet another feature of acquisitions is that this mode of entry allows quicker entry into a market relative to greenfield. If, for strategic or other reasons, the investing firm seeks a quick entry, an acquisition may be the right choice.

[16] For an analysis of a firm's choice of entry mode, including the option of acquisition, see Bjorvatn (2000a) and Norbäck and Persson (2000).

The most important advantage with a greenfield investment is that it gives the investing firm a higher degree of flexibility. Acquiring another firm to a large extent also means acquiring its technology, its staff, and its organizational structure. Quite likely, therefore, ownership advantages are easier to transfer to a new venture. The greater technological and organizational flexibility of greenfield investments may also translate into lower production costs. It is also possible that a firm would be less inclined to transfer technology and know-how to an acquired firm, since the possibility of controlling the use of such knowledge may be weaker in the case of an acquired affiliate than in a new venture. If internalization of knowledge is important to a firm, it may favor greenfield over acquisition.

From this discussion, we would expect greenfield to be relatively more important for a firm with a technological edge over its competitors. There may be three reasons for this. First, a firm which possesses a strong technological advantage over its competitors may not be too worried about the competition, and therefore less inclined to choose acquisition in order to reduce the competitive pressure in the market. Second, a highly efficient firm would tend to choose greenfield in order to implement its technology in an efficient manner. Third, greenfield may also be chosen in order to protect its technology.

Empirical evidence from OECD supports this prediction. Greenfield is generally preferred to acquisitions in countries and sectors where the investing firm has a technological and competitive advantage. For example, Japanese MNEs entering Europe have relied on greenfield in semiconductors and transport in the UK, a sector where Japanese firms have a technological edge over their UK-counterparts. When entering the European market for chemicals, on the other hand, Japanese firms have chosen to acquire existing firms in Germany and the Netherlands. One likely reason for this preference of acquisition over greenfield is the fact that technologically, the European firms in this sector are more on par with their Japanese competitors, and therefore that the need to internalize knowledge is less important (Kang and Johansson, 2000). Also in line with this theory is the fact that most FDI in less developed countries is in the form of greenfield investments.

3.3 Economic integration and FDI

A large literature, theoretical and empirical, analyses the effects of economic integration on FDI.[17] Economic integration can be defined as a reduction in transaction costs between countries, on goods and factors of production, and an international harmonization of national legislation on trade and investment.

A reduction of international transaction costs can be due to political choice (as when tariffs and non-tariff barriers are reduced, international investors are granted national treatment, countries sign international dispute settlement treaties), or by technological change (as improved ways of shipping goods bring down transportation costs and the developments such as the Internet reduce communication costs).

We shall distinguish between “global integration”, for instance due to WTO-agreements, and “regional integration”, as exemplified by regional trade agreements such as the EU and NAFTA.

Global integration

A reduction in international trade costs is likely to increase the profitability of vertical FDI, and reduce the profitability of horizontal FDI. Recall that in the case of vertical FDI, the most important L-advantage was access to cheap and perhaps well qualified labor, the output mainly being sold on the international market. Cheaper access to the world market through a reduction in trade costs makes such an investment more profitable. In the case of horizontal

[17] Two central contributions are Markusen and Venables (1996, 1998).

FDI, on the other hand, the prime L-advantage was proximity to local consumers. As trade costs go down, the world in a sense becomes smaller, and locating close to final demand, i.e., the tariff-jumping argument, becomes less important. Hence, one should expect an increase in trade and a reduction in market-seeking FDI as trade costs go down (at least if the foreign affiliate is not heavily dependent on imported intermediates).

Empirical evidence on the effects of economic integration on FDI is mixed. Brainard (1997) finds that a reduction in trade costs causes a substitution away from FDI and towards trade; i.e., a support of the tariff jumping argument. Other empirical studies suggest that economic integration has had the opposite effect, namely causing an increase in FDI. Feinberg et al. (1998) studies trade liberalization between Canada and USA in the 1980s and early 1990s, and report (on page 771) that "reductions in Canadian tariffs actually *increased* capital and employment in Canada by U.S. multinational companies. Overall, trade liberalization appears to have stimulated growth for the U.S. multinational companies." Given the open conclusion from theory on the consequences of economic integration on FDI, for instance depending on whether FDI is horizontal or vertical, the mixed empirical evidence is not surprising. See however the discussion in Box 5 below.

Box 5. Economic integration and FDI growth: A puzzle?

From the discussion in Section 1 we know that the majority of FDI is market seeking, at least in the OECD area. At first sight, then, one should, following the tariff-jumping argument, expect economic integration to lead to a reduction in FDI, which is contrary to what we observe. How do we explain the rise in FDI in a period of increasing international economic integration?

One explanation would be that economic integration not only involves a lowering of trade costs. Other features associated with integration may dominate the tariff jumping argument and stimulate more horizontal FDI. For instance, economic integration also involves a liberalization and harmonization of national rules and regulations on foreign investment. Typically, a number of services, such as banking, insurance and telecommunication, have been shielded from foreign ownership. As a result of national initiatives and international agreements, such as the WTO-agreement on telecommunications services which came into effect in 1998, a number of services have been made accessible for foreign ownership. It is possible that the observed rise in FDI is simply the realization of a potential that has been there for a long time, but a potential which foreign investors were previously prohibited from exploiting.

Another feature of economic integration is that international communication costs have also gone down, particularly with the possibility of transmitting electronic information via Internet. Lower costs of communication makes coordination of decentralized production easier, and may therefore stimulate FDI. Economic integration may also lead to higher world income and therefore larger markets, which tends to increase market-seeking FDI.

Also factors not directly linked to integration could make FDI more attractive to firms. For instance, technological improvements which reduce marginal production costs tend to make other variable costs, such as trade costs, relatively more important. Hence, even though trade costs in absolute terms have gone down, their relative importance in total sales costs may have gone up, making it more important for firms to locate closer to final demand.

Box 5. (Cont.)

It is also possible to argue that a reduction in trade costs *as such* may trigger an increase in FDI. For instance, if the foreign affiliate is highly dependent on imported intermediates, a reduction in trade costs increases the profitability of foreign production. This effect may dominate the tariff-jumping argument, i.e., the argument that a reduction in trade costs increases the profitability of trade relative to FDI. Yet another argument is that for strategic reasons, a reduction in trade costs may trigger FDI. The reason is that a reduction in trade costs, by making world markets more accessible, also increases the profitability of entry in a market. It may be in the interest of incumbent firms to block such entry in order to keep competition at a minimum. One way of doing this is to invest abroad, thereby reducing marginal sales costs. If the potential entrant observes that the established firm has low sales costs, it knows that competition in case of entry will be tough. The response of the potential entrant may therefore be *not* to enter, and the incumbent firm has achieved what it set out to do. Hence, the optimal strategy for the incumbent firm as a response to lower trade costs may be FDI (Ganslandt, 1998).

It may also be true that a reduction in trade cost increases the host country benefits of FDI. If this is the case, one might expect countries to become more positive towards hosting multinationals, and stimulate increased FDI by implementing FDI-friendly policies. The reason is basically as follows. In markets of imperfect competition, it may be beneficial for a country to grant its industry some degree of protection from foreign competitors in order to avoid too much profit ending up in the pockets of foreign owners. High trade costs may provide exactly this kind of protection when the foreign firm is an exporter. A lowering of trade costs increases the competitiveness of a foreign exporter, thereby weakening the protectionist argument for keeping the foreign firm at a distance from the local market. The host country benefits of FDI, including increased consumer surplus and technological spillover effects, may then dominate the protectionist argument for dealing with the foreign firm as an exporter. The result may be a change in attitude towards FDI on the part of host countries, which may lead to more FDI taking place (Bjorvatn, 2000b).

We also know that most of the recent surge in FDI has been in the form of acquisitions. Reduced international trade costs offers one explanation to this development. By intensifying international competition, lower trade costs may force companies to act in order to maintain the profitability of the firm. Focusing on core activities by selling out peripheral operations and purchasing operations closer to the main line of operations may cut costs. In addition, as argued above, acquiring international competitors may increase profits by reducing the competitive pressure in the market. Hence, pressure on profits caused by reduced trade barriers may stimulate cross-border mergers and acquisitions.

Regional integration

So far, we have studied economic integration as an overall reduction in international transaction costs. Frequently, economic integration takes place on a regional basis. In this case, the effect on FDI also depends on the response of firms located outside the integrating region.

Almost every country in the world belongs to a regional integration arrangement (RIA), and 55 to 60 percent of world trade now occurs within such trading blocs.[18] Some of the most important RIAs are the European Economic Area, including the EU and EFTA; NAFTA, with United States, Canada and Mexico as participating countries; ASEAN, involving Indonesia, Malaysia, the Philippines, Singapore, Brunei, and Thailand; MERCOSUR, with Argentina, Brazil, Paraguay and Uruguay; and SADC, which involves most countries in southern Africa.

[18] For an overview over regional integration arrangements over, see Schiff and Winters (1998). For analyses, see Fernandez and Portes (1998) and Blomström and Kokko (1997).

There are at least three reasons why RIA should increase FDI into the integrating region. First, a reduction in intra-regional transaction costs increases the effective market size of the region, which in turn makes it a more profitable area for foreign investment. Second, RIAs sometimes involve an increase in trade barriers to the outside world. From the tariff-jumping argument, we know that such a policy can be expected to increase investments into the region. Third, many RIAs feature explicit dispute resolution mechanisms. If effective, these should stimulate both FDI and trade.

Note that an increase in FDI is not likely to be evenly distributed between the integration countries. Countries with the strongest locational advantages are the ones that are likely to attract FDI.

RIAs do not necessarily increase extra-regional FDI. Foreign firms that prior to the RIA were already established in many of the integrating countries may choose to rationalize their operations by reducing the number of foreign affiliates in the region. Moreover, higher trade barriers to the outside world would tend to make efficiency seeking investments less profitable. Similarly, if imported intermediates are important in the foreign affiliates' production process, higher trade costs may reduce the attractiveness of FDI.

Empirical research indicates that RIAs on balance are likely to attract more FDI into the region. For instance, there was a considerable inflow of US direct investment into the European Community after its formation. Similarly, there was an upsurge in Japanese investments in Europe as a consequence of the 1992 common market program (Blomström and Kokko, 1997b).

RIAs may have another effect, which may perhaps be more important in politically less stable developing countries. RIAs, by raising reform decisions from national to international levels, may serve as a commitment to a policy of liberalization and a signal to foreign investors about this policy. As argued earlier, this may have been the main benefit of NAFTA for Mexico.

3.4 Summary

Firms that are competitive on international markets may choose FDI for a number of reasons. Broadly speaking, three motives have been identified in the literature. First, market seeking FDI, where important factors are trade costs, market size, costs of setting up a new plant or acquiring an existing foreign firm, production costs abroad, etc. Second, efficiency seeking FDI, where the main attraction of a foreign location is low labor costs and, perhaps, well qualified labor, together with low trade costs, since intermediates produced in the foreign affiliate generally are shipped back to the parent firm. Third, monopoly seeking FDI, which is particularly important when the investment is in the form of an acquisition. The motivation in this case is to reduce the competitive pressure on international markets.

In addition to these locational advantages, host countries should have macroeconomic and political stability in order to be attractive for FDI. Multinationals need some assurance that their investments will not be expropriated by host governments, that profits can be repatriated, that the local currency is convertible, etc. If a country cannot offer this kind of assurance, it will probably not be an attractive place for FDI.

One way for a country to signal a commitment to a set of liberal trade and investment policies is by joining a regional integration agreement. It may be more costly to reverse liberal policies for a member of such an agreement than for a non-member, for instance because doing so may trigger a punishment reaction, such as a trade boycott, from the member countries adhering to the rules.

Regional and global integration agreements also affect market size and trade barriers, and hence may have an impact on FDI. Most likely, the impact will be positive, but equally likely, the positive impact will not be evenly distributed among member countries.

4 Evaluation

Theoretical studies have typically been concerned with the positive question; why do firms choose FDI rather than alternative modes of servicing foreign markets, such as exports? Host country effects of FDI and policy implications have received less attention.[19] One possible reason for this relative neglect may be the consensus that appears to prevail today that FDI is good for host economies, and that the challenge for host economies is simply to attract more of it.

Even in less developed countries, where the skepticism against multinational companies and FDI has traditionally been widespread, the general attitude now seems to be far more positive. For instance, UNCTAD (1999b) reports that: "Foreign direct investment is welcomed and, indeed, actively sought by virtually all African countries." While it may well be true that FDI on balance is beneficial to host economies, the picture is not so clear from a theoretical viewpoint at least. Particularly when host countries are less advanced, the impact of FDI can be expected to be great, and not necessarily positive.

4.1 Positive effects

Foreign entry may increase competition in the domestic product market and benefit domestic consumers by lowering prices and by adding new product varieties to the market. In the factor market, increased competition is likely to increase wages and reduce unemployment. A foreign firm is likely to possess ideas and knowledge that differ from those of local firms, and can therefore be expected to add more to competition than entry by a domestic firm. Similarly, foreign firms are not likely to be part of local, informal business networks aimed at sustaining a situation of "gentlemanly competition." Foreign entry may therefore create more turbulence than domestic entry and thus have a stronger pro-competitive effect (Caves, 1971).

Job creation may take place not only in the foreign affiliates. Local suppliers of intermediate goods may enter the market and existing ones expand their output and employment in the face of increased demand for such products from the foreign entrant.

In less developed host countries, MNEs may also provide valuable services in assisting local firms to reach OECD markets with their products. Services include design, packaging, distribution, and servicing, and financial services.

FDI may generate tax revenues to host governments, at least if the MNEs are not offered extensive tax holidays, and bring added supply of foreign currency, given that the foreign affiliates produce for international markets. In this way, FDI may reduce the "twin deficits" plaguing many countries in the world, namely the budget deficit and current account deficit. FDI may also stimulate economic growth by adding capital and technology to the economy. Particularly in poor countries that may not have easy access to international credit markets, FDI may be an important source of capital accumulation.

The positive effect of FDI that has received the most attention in the literature is the potential for technological spillover effects. For most economies, MNEs are an important source of technology. Even though MNEs through FDI keep a stronger control over its technology, relative to say licensing agreements, there may be significant spillovers from MNE to local firms.

[19] Exceptions include Ono (1990), Richardson (1998), Motta (1992), Horstmann and Markusen (1992), and Bjorvatn (2000b).

Box 6. Local learning from MNEs: The garment industry in Bangladesh

The success of garment exports from Bangladesh illustrates the positive impact of learning through trade in association with MNEs. Starting from virtually zero in 1978, export earnings from garments reached $560 million in the fiscal year 1989-1990, 40 percent of total export earnings. The average growth rate in garment export-value was over 120 percent in the 1980s.

The process started in 1979 with a non-equity arrangement with a developing country MNE, the Daewoo Corporation of the Republic of Korea. That company signed a five-year collaboration agreement with the Desh Garment Company of Bangladesh, under which Daewoo provided; six months of training for Desh workers in Korea; assistance in start-up activities, including the installation of machinery purchased from Daewoo; supervision of production managed by Desh; and marketing services.

It was initially impossible for Desh to sell garments in the international market without Daewoo's expertise. A so-called "triangular trade" arrangement was established; first, Daewoo received a letter of credit from an overseas buyer; second, it opened a back-to-back letter of credit addressed to Desh; and, finally, Desh shipped its garments under the Daewoo brandname directly to the overseas buyer, while it received payment from Daewoo. In this triangular trade, Daewoo assured product quality throuth production line supervision and quality inspection, while Desh could fully utilize the established marketing networks of Daewoo and learn the necessary marketing techniques.

The speed of learning was so rapid that Desh cancelled its collaboration agreement in 1981, after only about one-and-a-half years of factory operation, long before the expiration of the agreement. Export performance following the cancellation was impressive, as Desh acquired the ability to handle all its export marketing and to purchase all its inputs from abroad, including from non-Daewoo sources.

Meanwhile, 115 of the 130 Daewoo-trained workers left Desh to set up their own, or to join other newly established, garment companies. Those workers were major agents for imparting export skills throughout the whole garment industry, contributing to the great increase in export earnings. Indeed, many new garment companies did not need the expertise of foreign companies because of the existence of those workers. The remarkable speed with which the ex-Desh workers transmitted their production, marketing and management know-how to hundreds of other factories demonstrates the potential for learning through from MNEs.

Source: UNCTAD's World Investment Report 1992

Spillovers may lead to a reduction in the home firm's production costs over time. Exactly how foreign entry affects local firm production costs is of course an empirical question, and a very difficult one to answer. Spillovers may be channeled via the labor market, as local workers are trained in the foreign firm and later take their acquired knowledge to domestic firms. For instance, there are several case studies demonstrating that MNEs train workers and managers who are later employed by local firms. In this case, FDI, i.e., the local presence of foreign production, may be a precondition for local learning.

Empirical evidence suggests that the spillover intensity from FDI may depend negatively on the technology gap between local and foreign firms (Blomström, 1986, Cantwell, 1989, Kokko et al., 1996). In order to learn from foreign firm technology, the technology employed by the foreign firm must, so to speak, be within the reach of local firms. As an example, Kokko (1994) shows that there are few signs of spillovers in Mexican industries where the foreign affiliates have much higher productivity and larger market shares than local firms.

Finally, being exposed to (foreign) competition may force the domestic firm, which in the pre-liberalization enjoyed a protected monopoly position, to reduce organizational and

technological inefficiencies, so-called X-inefficiencies. On the basis of a study of industry in six developing countries, Bergsman (1974) argues that internal inefficiency is several times as important as "external" inefficiencies caused by monopolistic pricing in the output market.

4.2 Negative effects

While FDI may increase competition in the host market, this is not necessarily the case. Moreover, increased competition need not be a positive thing for the host country. Regarding the first point, whether or not FDI leads to increased competition, we should note that the mode of entry is likely to be important. Entry in the form of an acquisition may simply be a change in ownership, for instance replacing one domestic monopolist with a foreign one. Clearly, consumers need not be affected by this kind of FDI. Indeed, if the foreign firm prior to the acquisition supplied the market through exports, the acquisition reduces the degree of competition in the host market and probably harms consumers.

Regarding the second point, namely that increased competition not necessarily is a good thing for the host country, note that any improvement in consumer surplus must be weighed against reduced profits for locally owned firms. Since MNEs generally operate in oligopolistic markets, there may be a substantial potential for profit shifting due to foreign entry. Theoretically, at least, the loss in domestic profits may well dominate the gain for domestic consumers. In the extreme case of profit shifting, the foreign entrant may act as a predator, eliminating local producers from the market.

Looking at the effects of MNEs on concentration in 46 Malaysian industries, Lall (1979) concluded that the presence of foreign firms tended to increase concentration. Similar results have been reported in Mexico (Kokko, 1994). The evidence therefore suggests that there is a larger risk that MNEs crowd out local firms in LDCs than in developed countries.[20]

The danger that foreign firms may replace weak domestic firms is relevant also in the more developed parts of the world. It has been suggested that the entry of US firms in European markets has increased competition in the industries where local firms had some traditional technological strength, whereas local firms in other industries – and especially in countries where markets were too small to allow both kinds of firms to operate at efficient scale – were forced out of business or pushed to market segments that were ignored by the foreign MNEs (Cantwell, 1989).

There is also a danger that a foreign takeover will lead to a closing down of the local headquarters and R&D operations, concentrating these activities in the country of the parent firm. Such a move took place in connection with foreign takeovers in the Brazilian car industry (UNCTAD, 1999a: 40). The effect on the host economy may be negative, since R&D may have important spillovers to the rest of the economy.

4.3 Policy implications

What kind of FDI should a country try to attract, and what can the country do in order to attract it? As we have seen above, FDI may generate both static and dynamic gains for the host economies. The static benefits of FDI include a reduction in macroeconomic imbalances such as unemployment, government budget deficits, and current account deficits, and improved resource allocation through increased competition in local markets. FDI may also generate long-run growth effects, by adding to the capital stock in the host economy, and in particular by adding to its stock of technology and know-how through spillovers.

The effect on competition is likely to be larger if the investment is in the form of a greenfield rather than acquisition, and if it is horizontal rather than vertical. The effect on job creation and the twin deficits is likely to be stronger if the foreign affiliate purchases a

[20] For an analysis of predation and FDI, see Bjorvatn (2000b).

significant share of its intermediates locally, rather than through imports. Significant government income is conditioned on the MNEs not being granted generous tax holidays.

Technological spillovers are likely to be stronger if the foreign affiliate uses a technology which is somewhat more advanced than that of local firms, but where the technology gap is not too large. Spillovers are also likely to be more important the stronger are the linkages to the local economy. Linkages are likely to be more important the larger is the share of locally supplied intermediates, the larger is the share of skilled workers employed locally, and the closer geographically the foreign affiliates are to local firms.

Potential host country governments face a dilemma. In order to get the most out of a foreign affiliate, they may wish to place a number of conditions on FDI, including local joint venture partners, local content requirements, limits on expatriate personnel, compulsory licensing and other forms of mandatory technology transfers. Such restrictions on firms intended to encourage technology transfer may however backfire. Firms may simply choose not to invest in a country with numerous conditionalities tied to the investment, as the earlier mentioned case of Coca-Cola in India shows.

In practice, the bargaining power of host countries may be fairly limited. Given that MNEs can choose between a number of countries in which to invest, potential host countries may find themselves involved in an international tax competition situation, where countries overbid each other in offering incentives to attract FDI. The result of such a "race to the bottom" may be that host countries gain very little from FDI. International investment agreements are probably required in order to reduce such problems.[21]

Perhaps the most important asset for a country, not only for attracting FDI but also for increasing the potential for economic growth, is a highly skilled and highly motivated labor force. Such an asset is attractive for firms irrespective of whether the aim of the investment is to supply the local market or international markets. Moreover, education policies may enhance the capacity to absorb foreign technologies once an investment has been made, thereby increasing the spillover effects to the local economy.

Regional integration provides foreign investors with access to a larger market and may service as a commitment to a set of liberal and business-friendly policies. This may spur increased investment from abroad. It should however be noted that regional integration also increases the attractiveness of neighboring countries that are also members of the RIA. A lowering of trade costs between countries may lead to a relocation of industries, possibly resulting in a core-periphery outcome in which the core-countries attract both intra-regional and extra-regional investment, the periphery-countries ending up as losers from the integration process.

An important location advantage for a country in terms of attracting FDI (and, of course, for stimulating business in general), is a well-developed infrastructure. Good infrastructure, widely defined to include both physical infrastructure such as roads, ports, international airports, telecommunications and electricity, as well as institutional infrastructure including a well functioning and honest bureaucracy, reduces transaction costs and therefore increases the profitability of doing business in the country.

Macroeconomic stability is clearly an important factor determining a country's attractiveness for foreign investors. Blomström and Kokko (1997: 38) conclude that for the MERCOSUR area "macroeconomic stability appears to be a more important determinant of FDI inflows than is regional integration." Argentina, which is a much smaller economy than that of Brazil, experienced large inflows of FDI even before the effective implementation of the MERCOSUR agreement, largely due to macroeconomic reforms that brought down inflation and interest rates, and secured the convertibility of the local currency. Similarly, in

[21] See for instance Wildasin (1988) on tax competition.

Europe, while membership in the EU (then; EC) brought large increases of FDI to Spain and Portugal, Greece was marginalized in terms of FDI inflows, basically because its macroeconomic policies proved unattractive to foreign investors.

Box 7. Liberalization and FDI in India

The liberalization of macroeconomic policies in India in the early 1990s included liberalization of regulations on FDI. The first liberalization introduced in July 1991 provided automatic approval of FDI project proposals with up to 51 percent foreign equity ownership in 34 priority industries. At the same time, local-content requirements were withdrawn. In 1992, and again in 1993, a series of proposals were made to dismantle more barriers to FDI, such as restrictions on the use of foreign brand names and trade marks and on participation in mining and a number of minerals. In January 1993, the Foreign Exchange Regulation Act was amended to remove restrictions on foreign-owned enterprises and accord them national treatment. Full ownership was allowed for foreign firms on a case-by-case basis. Foreing investors have freedom of repatriation of earnings, as well as repatriation of divested capital.

To complement the relaxation of investment rules, import duties were lowered to 85 percent for general goods and to 35 percent for capital goods, and the rupee became convertible in 1994. An array of tax holidays and capital-gains concessions was also implemented to attract FDI, especially in the energy sector that was opened to foreign firms in 1992. Taking advantage of liberalized policies, several MNEs, including Pepsi Cola, Nestlé, Suzuki and Colgate Palmolive, increased their stakes in their existing affiliates in India to 51 percent from 40 percent or less. Exxon, IBM and Coca Cola are examples of MNEs that have disinvested from India following the Foreign Exchange Regulation Act of 1977, but have returned to take advantage of the sizeable domestic market.

Infrastructure services — power and telecommunication — and petroleum refining are important sectors for FDI. In manufacturing, sectors such as food processing, electronics parts, chemicals and industrial machinery attract FDI. In services, FDI is concentrated in the development of computer software and financial industries. In early, 1993, there were 25 software centres located just outside Bangalore. These centres prinicpally act as offshore maintenance facilities to service computer software for companies throughout the world. The main factors drawing FDI to Bangalore are relatively low salaries, the availability of qualified software engineers and the increasing ease of communications. Between 1985 and 1990, FDI in that industry has come from both large computer firms, such as Texas Instruments, as well as small joint ventures, such as Verifone.

Even though economic liberalization has made India a more attractive location for investment, both domestic and foreign, there is a potential for further improvements. A survey of the investment perceptions of 16 leading MNEs cited an array of difficulties in operating in India. The complex web of regulatory controls and bureaucratic interventions is of particular concern. The lack of adequate infrastructure, particularly power, telecommunications and transportation, is also regarded as a major constraint.

Source: UNCTAD's World Investment Report 1994

Many countries discriminate between vertical and horizontal FDI, promoting the former and discouraging the latter. Malaysia, for instance, has been very successful in attracting firms to its Export Processing Zones (EPZs). EPZs grant firms a number of advantages, including tax holidays, zero or low tariffs on imported intermediates, property rights over land, streamlined application procedures, etc. The country is however much more restrictive when it comes to allowing entry of multinationals wishing to service the local Malaysian market. For instance, there are local participation rules attached to market-seeking investments, including minimum domestic ownership shares and local management requirements.

Restrictions on horizontal FDI are understandable and can in certain cases be defended on economic grounds by reference to the problem of profit shifting and the infant industry argument. But the implementation of such policies requires a great deal of knowledge about supply and demand in specific markets, knowledge that governments are not likely to have, and which can perhaps be obtained only at great cost. Moreover, given that market characteristics change over time, for instance due to technological progress, policies must change as well. This requires a degree of political autonomy and flexibility that governments typically do not have. For instance, the infant industry argument is an argument for a temporary protection of an industry. But given that such a policy has been introduced, special interest groups are likely to form to secure the continuation of the policy. The result could be a permanent protection of the industry, which might well reduce rather than increase the competitiveness of local firms.

Foreign firms in EPZs typically have few links with the local economy, and the potential spillover effects may therefore be limited. Export-oriented investors are often less willing to establish links with local companies because of the need for high quality inputs at competitive prices in order to compete in world markets.

This tendency is exacerbated by the fact that the host governments often promote sectors such as electronics in which there are no pre-existing indigenous capabilities and hence no potential local suppliers. In addition, of course, given the tax and tariff exemptions, there may be little tax revenues to collect from these MNEs. Thomson (1999: 27), analyzing the case of the ASEAN4 countries, namely Indonesia, Malaysia, the Philippines, and Thailand, argues that the emphasis of host countries on export promotion is unwise:

> Not only have exports been limited to a small number of products, usually intermediate ones, and sectors, the export sectors have also tended to be virtual foreign enclaves within host countries. They have often been characterized by low value-added (principally from labour-intensive assembly operations) and a poor record of technology transfers. Many of the most successful export sectors in the ASEAN4 are highly import dependent, and this has limited the impact of massive devaluations in these economies on exports. In some sectors, imports represent 80-90 percent of the value of exports. The high import dependence for MNE-related exports is symptomatic of the poor linkages between foreign affiliates and the local economy more generally. Poor linkages reduce the scope for technology transfers through FDI which could assist in local industrial upgrading. Arguably, the failure to upgrade production in light of greater competition in labour-intensive activities from China and Vietnam is one of the underlying structural problems which served to undermine confidence in the years preceding the crisis.

5 Concluding remarks

During the last two decades we have witnessed a radical increase in FDI. Most FDI flows take place between countries in the OECD area, but increasingly countries outside this area are hosting foreign owned production. Factors such as the size of the local market, the quality and price of the local labor force, the quality of physical and social infrastructure, and macroeconomic stability are important location advantages that may attract FDI.

It is evident that FDI may contribute greatly to the host economy. For instance, the foreign dominated electronics industry in Asia has provided foreign-exchange earnings, employment and skills acquisition in the host economies. In Taiwan and Singapore, where educational standards and infrastructure are well developed, this investment has also spawned many local suppliers, competitors and service firms, including independent indigenous enterprises which are highly successful in world markets and which have, in some cases, become multinationals themselves.

Foreign ownership is however not a precondition for economic growth. South Korea experienced rapid economic growth during the 1980s and until the financial crisis in the late 1990s, relying largely on domestic technology and domestic ownership. Korean entrepreneurs were encouraged to unbundle foreign packages of technology and adapt them to local conditions, a process known as reverse engineering. Moreover, Korean firms were guided by their foreign customers on designs and production and management techniques. Evidently, learning can take place through the contact with demanding customers, and does not require the local presence of multinational firms (Rhee et al, 1984).

Still, other countries relying on local capabilities, such as India, have not been as successful as South Korea in generating long term growth. The reason may be that successful implementation of protectionist policies requires a degree of political autonomy and flexibility that most governments do not have. Policies that at the time of implementation may well have been sensible become locked in through the pressure of special interest groups, and over time become incompatible with economic growth and development.

Although the general attitude towards FDI today is very positive, foreign entry is not necessarily a blessing for the host country. Particularly if the host country is a less developed one, the impact of FDI may be great, both positive and negative. Foreign firms may be a lot more effective than local firms. If they compete on the same market, the foreign firm is likely to capture significant market shares from the local firms, possibly eliminating local firms altogether. Certainly, foreign firms may be a valuable source of technology to less advanced countries. But empirical research suggests that if the technological gap is too great, the ability of the local firms to learn much from its foreign competitor may be limited. Following this reasoning, it may be beneficial for less advanced countries to expose their markets to firms which are not radically more advanced than themselves, which could be interpreted as an argument in favor of South-South integration.

Given the general wish to attract FDI, countries may start competing against each other in order to do so. Such competition need of course not be wasteful. For instance, improvements in infrastructure and educational programs that strengthen a country's locational advantages are productive investments. Other forms of competition are not productive, however. Tax competition may lead to a race to the bottom and undermine the governments' ability to perform important functions, such as the provision of health care and redistribution of income. There may be a need for international agreements on FDI in order to avoid such tax competition, and to ensure that the benefits of FDI are shared fairly between the MNE and the host country.

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