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The Role of FDI in Economic Development

This paper deals with two questions: First, what are the determinants of foreign direct investment (FDI)? Second, what is the role of FDI in economic development? In order to provide some answers to these questions, we draw upon the existing theoretical and empirical literature as well as insights derived from five country studies that we have conducted. Important location advantages include a stable social, political and economic environment, liberal trade policies, and geographical proximity to large and growing economies. On the host country effects of FDI, we conclude that while FDI is not necessary to achieve economic development, the entry of foreign firms may play an important role in adding technology and competition to the host economies. However, foreign entry may lead to a loss in market shares, and thereby a loss in profits, for local firms. This problem is likely to be more important if foreign entry takes place in markets shielded from the competitive pressures of international trade.
JEL Classification: F23, O57

Growth in foreign direct investment (FDI) is perhaps the clearest sign of globalization in the past decade. The average annual growth rate of FDI has been 23 percent since 1986, which is twice as much as that of trade. Most international investments take place within the OECD area. However, during the 1990s, and until the Asian financial crisis in 1997, the share of FDI hosted by countries in the developing world increased.[1] Measured as a share of host country GDP, FDI flows to developing countries are typically greater than those to the developed world.

Some people view the presence of multinational enterprises (MNEs) in poor countries as a threat to economic development. Others see FDI as a potential source of economic growth. The present paper aims at clarifying the role of FDI in economic development and derive lessons and policy implications. We base our study on general theoretical and empirical literature and on

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1. The share increased from about 18 percent in 1990 to about 40 percent in 1994, but slipped back to about 25 percent in 1999.

specific studies of three Asian and two African countries.[2]

The paper is organized as follows. Section 2 discusses the determinants of FDI. In Section 3 we turn our attention to host country effects of FDI, focusing on FDI's role in economic development. The country studies are presented in section 4. Section 5 concludes.

Determinants of FDI

The most common starting point for discussing firms' choice of direct investment relative to other entry modes in a foreign market, is Dunning's OLI framework (Dunning 1977, 1981). This approach to understanding FDI is well known, and we will therefore only briefly mention its essential features.[3] First, to be competitive in a foreign environment, a firm needs some **O**wnership advantage, in the form of a unique production process, a patented good, or access to more intangible assets like reputation, trademarks and management systems. This competitive advantage may be used to penetrate foreign markets in different ways. For a firm to choose FDI, rather than, say, exports, there must also exist some **L**ocation advantage in the foreign country. Location advantages may come in different forms; firms aiming at reducing costs may be attracted by low wages, firms wishing to expand their international market share may be attracted by a large home market, and so on. Finally, given that the firm has decided to produce abroad, it can choose between various contractual arrangements, including licensing agreements and strategic partnerships. The theory therefore predicts that there must exist some **I**nternalization advantages making ownership preferable to more arms-length contracts. These advantages typically include a greater control over technology and reduced transaction costs.

Vertical FDI

FDI is commonly classified as vertical or horizontal. Vertical FDI involves a geographical decentralization of the firm's production chain, where foreign affiliates in low-wage countries typically produce labour-intensive intermediates that are shipped back to high-wage countries, often to the parent company itself. Vertical FDI is sometimes referred to as "efficiency seeking" FDI, since the main motive for the investment is to improve the cost effectiveness of the firm's production. In the textile and clothing industry, for example, global supply chains are common. The capital-intensive stages (textiles) are located in relatively capital rich countries, human capital-intensive stages (design and up-market apparel) are located in human capital rich countries, and labour-intensive stages (apparel) are located in labour abundant countries. Another industry where the production process can easily be separated into stages that differ in factor intensity is the electronics industry, which has played a major role in the industrialization of Malaysia.

A particular category of efficiency seeking FDI is sometimes referred to as "technology seeking" FDI. The attraction of the location in this case is not necessarily the low cost of labour, but its unique competence. FDI from industrialized countries to the Bangalore district in India, often labelled the Silicon

2. The authors have conducted four of the country studies (Kind 2000, Kind and Ismail 2001, Nordås and Pretorius 2000, and Nordås 2001), while Seljeflot (2001) has conducted the fifth country study as a thesis for the Siviløkonom degree at NHH (with NordåsBjorvatn as supervisor). The country studies build on a large number of sources, and focus on the relationship between trade, FDI and growth.
3. For a discussion of the OLI framework, see Markusen (1995) and Bjorvatn (2001).

Valley of Asia, is presumably motivated both by cost efficiency and access to an advanced IT milieu. Indeed, India has the second largest stock of IT specialists in the world, only surpassed by the US.

Horizontal FDI

Horizontal multinational companies produce the same product in multiple plants, and service local markets through affiliate production rather than through exports from the home country of the MNE.[4] Most of the global FDI is horizontal. For instance, Brainard (1997) reports that as little as 13 percent of the overseas production of U.S.-owned foreign affiliates is shipped back to the United States, and that only 2 percent of the output produced by foreign affiliates located in the US is shipped to their parents.

Horizontal FDI is sometimes referred to as "market seeking" FDI. The advantage of being close to the customers may be due to factors such as reduced transportation costs, smaller cultural barriers or avoidance of tariffs. Some countries have used trade policy deliberately in order to attract foreign investment: By erecting high tariff barriers they have made it more profitable for foreign firms to set up local subsidiaries than to serve the market by export from other countries.

For certain kinds of non-tradable services, such as real estate, hotels, retail trade, and part of the telecommunication, banking and financial sectors, there is no trade-off between trade and local production at all; market entry simply requires FDI or other contractual arrangements for local production. The importance of FDI in services has increased over time, accounting for more than 50 percent of total world FDI stocks in 1999, and an even higher share of FDI flows (UNCTAD, 2001).

Multinationals involved in extraction or use of natural resources are yet another case of FDI where there is no alternative to the local presence of the firm. Endowments of oil, gas, minerals, forests and waterfalls may be the most important attraction for international investment in a number of poor countries.

Greenfield versus acquisitions

In addition to the horizontal and vertical dimensions of FDI, investments may also be classified as either greenfield or acquisitions. A greenfield investment involves the establishment of a new production unit, whereas an acquisition is the purchase of (shares in) an already existing foreign company.[5] Most of the growth in FDI taking place in recent years has been in the form of acquisitions. Indeed, in 1999, acquisitions accounted for more than 80 percent of global FDI. Between 60 and 80 percent of FDI flows to developing countries, however, have been in the form of greenfield investments during the period 1995–99.

Public sector

The public sector potentially plays a decisive role in creating and strengthening a country's location advantages through supplying public goods and services, educating the labour force, and defining and implementing economic policies (see Dunning and Narula, 1996, for a thorough discussion). All these public sector activities may increase the profitability of an investment project, whether

4. When a substantial share of the foreign affiliate's sales is to third countries, the horizontal investment is often referred to as export platform FDI.
5. To qualify as FDI, an acquisition must involve the purchase of at least 10 percent of the shares in the target firm. Otherwise, the purchase is classified as a portfolio investment.

domestic or foreign. Likewise, inefficient public policies may discourage investments. 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.[6] Singapore, on the other hand, is well known for an excellent infrastructure and an efficient bureaucracy with a low corruption level, and is still an attractive location for inward FDI despite a high and rising cost level.

A widely used instrument to attract foreign firms is tax policy, of which Liberia is a well-known example from the shipping sector. We have also seen that several Asian and African countries have given special tax privileges to foreign investors, particularly in the manufacturing sector. Offering various incentives to attract FDI may certainly be a rational policy if foreign investment generates positive spillovers, since market forces alone would then attract too little foreign entry. Nonetheless, there is a fear that the outcome of tax competition between countries will evolve into a "race to the bottom" where the host countries gain very little from FDI. International investment agreements are probably required in order to reduce such problems (Oman, 2000).

In discussing public policy, it is important to bear in mind that firms not only seek business-friendly policies at a specific point in time. More importantly, an investment involves a long-term exposure to the economic and political conditions in the host country, and firms therefore look for some commitment from the government. 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 (Lipsey, 1999).

Host country effects

How may FDI affect economic growth and development, and what is the empirical evidence? In this section we will draw upon the existing literature to shed light on these issues. Later, in the section that follows, we look more closely at the experience of five developing countries.

FDI involves a combined flow of capital and technology. From growth and trade theory we know that capital inflows may increase GDP per capita in the capital importing country. Moreover, access to better technology, broadly defined, is the only source of sustained growth. Hence, the way in which more advanced technology spills over to the local economy, and the empirical importance of these spillovers, have been areas of intense research in recent years.

FDI is obviously not the only source of capital and technology. Countries may rely on their own savings or borrow money in international markets to add to the capital stock. And countries may rely on domestic research and development (R&D) in order to upgrade technological sophistication. However, developing countries may face constraints on international credit markets, and may not have the resources necessary to undertake domestic R&D. Moreover, FDI implies an element of risk sharing between the capital owners and the capital importing countries

6. Cited in UNCTAD (1994), page 83.

that may make this type of capital flow more desirable than loans. And FDI may be, if not the only, then perhaps the most cost efficient way for poor countries to gain access to new technology.

Clearly, the positive impact on the local economy is likely to be greater if the economy suffers from high unemployment. First of all, there is a direct effect: everything else equal, establishment of foreign firms increases labour demand in the host economy. Second, there is an indirect effect, as the foreign firm links up with the local economy by demanding intermediate goods and producer services from local suppliers. This indirect effect also adds to labour demand, and should lead to reduced unemployment or increased wages or a combination of the two.

In what follows, we shall discuss in more detail three mechanisms that have received a lot of attention in the literature on host country effects of FDI, namely technological spillovers, linkage effects, and competition effects.

Spillovers

Firms that establish affiliates abroad typically have some technological advantages that allow them to compete successfully with local firms. Consequently, there should be a potential for host country firms to learn from the foreign affiliates. Empirical studies show that technological spillovers, which should result in both higher factor productivity for local firms and in higher factor rewards, should not be taken for granted. First, the quality of human capital in the least developed countries may be too low to make effective use of the technology introduced by foreign firms (Borensztein, Gregorio and Lee, 1995, Salvatore, 1998, Haddad and Harrison, 1993, Kokko, 1994). This is also reflected in an empirical study by Blomström et al (1994), which shows that inflows of FDI have a significant positive effect on income growth for the most advanced developing countries, but no such effect on the least developed countries.[7]

Second, countries that have relatively stringent restrictions on inward FDI and force foreign firms into some kind of partnership with local firms seem to obtain relatively little spillovers. The reason for this is presumably that the headquarters of multinational firms are more reluctant to bring new and sophisticated technologies to countries where they have less control over their proprietary knowledge (Blomström and Sjöholm, 1998).

Linkages

A related question to that of spillovers, is whether foreign firms develop linkages to local firms. Strong linkages imply that the employment effect of FDI may be large. Moreover, interaction between local suppliers of intermediates and the foreign affiliate may be one channel through which learning takes place. For instance, foreign firms may place higher demands on the quality of the intermediates and on timely delivery, forcing local suppliers to become more efficient. More efficient local suppliers of intermediates will of

7. It is often difficult to distinguish productivity spillovers from exit (crowding out) of local firms in analysis that uses aggregate industry data. Blomström and Wolff (1994), for instance, show that there has been a convergence between the productivity level of efficient MNEs and the average productivity level of (the less efficient) local firms in Mexico. This may indicate that local firms have become more efficient due to spillovers from the MNEs. However, it may also indicate that the presence of MNEs has forced the least efficient local firms out of the market. As stressed by Blomström and Wolff, their empirical analysis cannot distinguish between these two sources of convergence.

course also benefit locally owned downstream firms.[8]

In a survey of empirical literature, Lall (1981, 1992) finds that there are relatively strong linkages between import substituting MNEs and local firms in large economies and, not surprisingly, particularly in countries that have strict requirements of local content. The same is true for MNEs that gradually change from import substituting to export oriented production, especially those that rely on stable and unsophisticated technologies. Purely export oriented MNEs, on the other hand, tend to have weaker linkages with the local industry. For instance, the efficiency requirements facing export-oriented MNEs that operate in the most complex sectors of the electronics industry have been found to reduce the scope for domestic linkages in developing countries to practically nothing (Lall, 1981:223).

Competition

Foreign entry may reduce the concentration of firms in a market, and thereby increase competition. This is likely to lead to lower prices, and perhaps a wider choice of goods. Tougher competition may also force firms to reduce organizational inefficiencies, so-called X-inefficiencies, in order to stay competitive. For evidence on this, see for example Blomström and Sjöholm (1998) and Kokko (1994).

On would perhaps expect the pro-competitive effect to be strongest in the sectors that are otherwise relatively protected from foreign competition. However, as noted by Graham and Krugman (1995), there is likely to be a sectoral bias in trade protection, in the sense that countries tend to protect those sectors where the domestic industry has a comparative disadvantage. Allowing inward FDI into these sectors may therefore crowd out local firms, and generate significant market power and pure profits to foreign firms without necessarily increasing the competitive pressure. In the extreme case, local firms could be wiped out of the market, leaving the foreign entrant with a monopoly position.

Consistent with this view, empirical studies indicate that the net gains from foreign investments are larger if they take place in sectors where the country has low barriers to trade (Salvatore, 1998) or, more generally, in sectors where the local firms are competitive (Kokko, 1994, and Salvatore, 1998).[9] The loss of sales for local firms is particularly serious if there are dynamic learning-by-doing effects in an industry, an argument underlying the infant industry policy implemented by a number of developing countries in the present and the past. In addition to the static profit-shifting effects of foreign entry noted above, there would then also be a dynamic loss to the host economy due to the reduced future competitiveness of local firms.

Country studies

This section discusses experience from South Korea, Malaysia, the Philippines, South Africa and Mozambique. The choice of countries has been guided partly by our prior knowledge of these countries, and partly by the fact that the countries together represent a fairly broad spectre of experiences in terms of FDI flows and FDI policies. Table 1 presents some

8. Improvements in firms' competitiveness due to demanding customers is a central argument in Porter (1990).
9. One qualification is needed here. One may expect that local firms that are sufficiently competitive to export the larger share of their output have a productivity level comparable to MNEs. Consistent with this view Blomström and Sjöholm (1998), in an analysis of Indonesian firms, find that MNEs do not significantly affect the efficiency of local export-oriented firms.

Table 1.
Economic and social indicators

	South Korea	Malaysia	Mozambique	Philippines	South Africa
Population, mill.	47.3	23.3	17.6	75.6	42.8
GDP, USD bill.	457.2	89.3	3.8	75.2	125.9
GDP per capita, 1960	904	1420	1153	1133	2191
Real GDP growth, 1961-70	7.4	5.6	na	4.3	5.7
Real GDP growth 1971-80	6.5	7.0	na	5.2	2.9
Real GDP growth 1981-90	8.1	5.1	-0.3	1.3	0.5
Real GDP growth 1991-99	4.6	5.6	5.2	2.7	1.5
Gross capital formation (% of GDP)	31.2	26.5	32.6	19.9	14.2
Exports (% of GDP)	44.3	131.5	11.7	67.0	29.1
Schooling, male, (female)	15 (14)	na	4 (3)	na	14 (14)
Corruption index, (ranking)	4.2 (42)	5 (36)	na	2.9 (65)	4.8 (38)

Population, GDP, gross capital formation and exports are from 2000, schooling refers to expected years of schooling in 1997 and the corruption index is from the corruption perception index published in 2001, which ranks 91 countries and the index is a number between 0 and 10, declining with corruption level. GDP per capita in constant 1985 USD in 1960, and 1995 USD in 1999 .
Sources:Penn World Tables, World Development Indicators

important economic and social indicators for the latest year available.

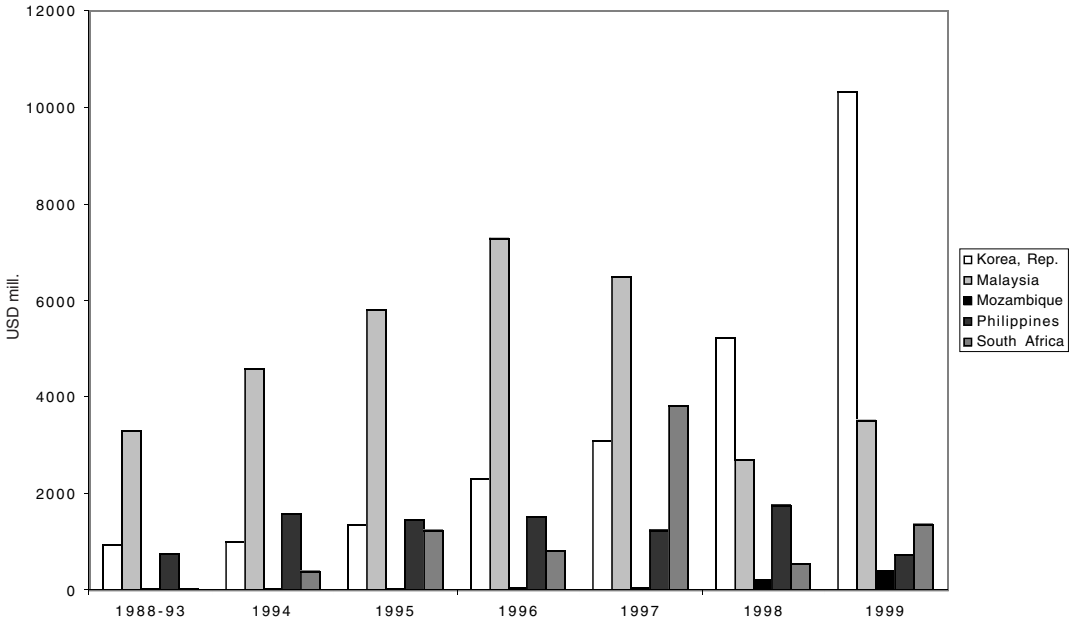
The absolute level of FDI flows varies a lot both between the countries and within countries over time during the past decade, as illustrated in Figure 1.[10] Malaysia was clearly the largest recipient of FDI inflows before the Asian financial crisis in 1997–98. FDI inflows to the Philippines have fluctuated around a flat trend, while South Africa experienced an investment boom shortly after the first democratic election in 1994, but the boom has not been sustained. Finally, Mozambique's FDI flows are very small in absolute terms, but have increased tremendously. Mozambique was the country with the highest FDI flows relative to GDP among the five in 1999, as shown in figure 2.

South Korea[11]

South Korea was the poorest country in our sample in 1960, but has grown rapidly since the Korean war and is at present by far the richest country in our sample. South Korea was totally dependent on foreign aid in 1960, when aid mainly from the US accounted for more than half of government revenue. This gave the US strong influence as far as industrial policy was concerned, forcing a more outward-oriented policy than the government

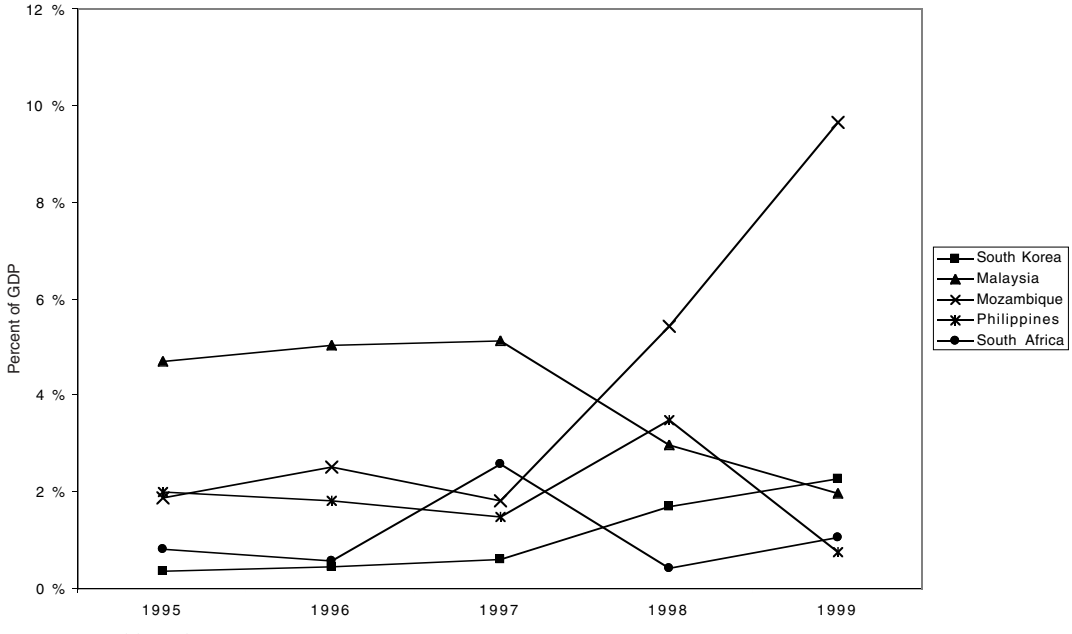
10. The first columns depict annual average FDI inflows during the period 1988-93.
11. See Seljeflot (2001)

Figure 1.
FDI inflows



Source: UNCTAD (2000)

Figure 2.
FDI inflows relative to GDP



Source: World Bank (2001)

wanted. South Korea's development success has been attributed to substantial investment in education at all levels and a relatively equal distribution of wealth and income. However, whether the success story has taken place due to, or in spite of, the country's industrial policy is a disputed matter (Pack 2000).

Local savings were inadequate to finance the investments necessary for achieving the country's development goals, and investments therefore in large part had to be financed from abroad. The South Korean government nevertheless led a very restrictive policy towards FDI and instead aimed at attracting foreign capital through loans. Since private companies did not have access to foreign financial markets, the government guaranteed private firms' borrowing abroad through state-owned banks. A criterion for getting such government-guaranteed loans was export performance, and this criterion was strictly enforced. The government also put in place various export incentives.

After the first industrialization phase with the establishment of labour-intensive manufacturing sectors, industrial policy aimed at fostering large-scale heavy industries. The instrument used in this development was the fostering of "national champions", the so-called chaebols, which received generous financial support. The chaebols were successful in establishing internationally competitive heavy industries, and over time also high-technology industries. Low cost of capital and labour – the trade unions were oppressed heavy-handedly – and the discipline imposed by international competition are common explanations for the success of the chaebols. In addition, the South Korean economic policy has been seen as flexible and able to adjust to new circumstances, at least until the mid 1990s. However, close ties between government and business, concentration of ownership and weak corporate governance over time developed into rigid structures that became obstacles to change and growth in a rapidly changing environment.

The Asian financial crisis in 1997–98 fully exposed the weakness of the corporate structures. Like crises before, this one also forced reforms, including the opening up of the economy to foreign investment. The opening process had, however, started in earnest when South Korea joined the OECD in 1996. A new and liberal "Foreign Investment Promotion Act" came into force in 1998. The new policy had a strong and immediate effect on FDI as figure 1 shows, but FDI was mainly in the form of mergers and acquisitions (M&As).

The main lesson from the South Korean case in shedding light on FDI and economic development, is perhaps that FDI is not necessary for economic growth. There are alternative ways of accessing capital and technology; purchasing machines on the international market and hiring foreign experts to communicate the technology to local workers has been the growth strategy of South Korea. Whether this strategy is the most cost effective way to access foreign technology is of course debatable. The "inside-firms" in the industrialization process, the chaebols, were given handsome subsidies. But the subsidies were conditioned on success in international markets, and this has most likely induced South Korean firms to cut costs and innovate.

The financial crisis in Asia exposed the relatively vulnerable condition of the South Korean economy, and in particular its financial sector. The crisis in South Korea can at least partly be explained by the close ties between a privileged business elite and government, which geared the economy to status quo rather than change. Still, the growth potential in South Korea and in the region is substantial, and when restrictions on FDI were finally lifted, foreign investors

entered the market in large scale, primarily through M&As as bits and pieces of the chaebols have been sold out.

Malaysia[12]

Peninsular Malaya achieved independence from Great Britain in 1957, and the present Malaysia was created in 1963. Partly due to large endowments of natural resources, Malaysia was by that time one of the richest countries in Asia. The country was a major supplier of raw materials to British industry from the outbreak of World War I and until independence, and during the 20th century Malaysia had an openness ratio that is higher than in most other Asian countries.[13]

Malaysia was not allowed to build up any strong industrial sector while it was a colony, and had a weak industrial base when it became independent. In order to diversify its economy and build a strong domestic industrial sector, Malaysia therefore implemented an import substitution strategy in 1957 where the emphasis was on serving the home market. This policy, which implied that the home market was protected by high formal and informal trade barriers, was used by a number of developing countries after World War II. Unlike for instance South Korea and Taiwan, Malaysia was not hostile towards inflows of foreign direct investments to serve the home market. On the contrary, Malaysia actively encouraged FDI as a means of increasing efficiency and getting access to advanced technologies from Western countries. This policy mix was initially quite successful in terms of growth in manufacturing employment and GDP, but the government was quick to change strategy when it became clear that the policy was unable to generate long-run growth and gave excessive profit flows to foreign capital owners. Since 1971 Malaysia has therefore been an export-oriented economy,[14] to a large extent relying on foreign investors. However, in order to reduce the profit shifting from local to foreign owned firms, Malaysia no longer encourages foreign investors to serve the domestic market.

Between 1985 and 1997 Malaysia had the sixth fastest growth rate in GDP in the world, with an annualised average of 4.9% per capita. During this period Malaysia experienced a significant increase in inward FDI from Japan, Taiwan and Singapore, countries that observed sharp increases in their cost levels. In order to stay internationally competitive, labour intensive export-oriented Japanese, Taiwanese and Singaporean firms invested in neighbouring countries with lower wage costs.

The electronics industry is the most important manufacturing sector in Malaysia, and accounted for 66 percent of manufacturing exports in 1995 (compared to 46 percent in 1980). This sector has been totally dominated by foreign firms – more than 80 percent of total investments in the sector were FDI in the mid 1990s (Phang 1998). The investments were initially undertaken in labour intensive activities, with little scope for knowledge spillovers and interaction with local firms. However, in an empirical study Ismail (2001) has found that the foreign firms in this sector over time have become more skill intensive, and developed stronger linkages to local industries and contributed to technology transfers to both local suppliers and local staff.

There are several reasons for Malaysia's success in attracting FDI. At least for the last

12. See Kind and Ismail (2001).
13. The openness ratio is defined as the sum of exports and imports as share of GDP.
14. An exception is the years 1981-1985 when the country implemented an unsuccessful import substitution policy with emphasis on heavy industrialization.

three decades the Malaysian political system has been relatively stable, and the macroeconomic policy has been prudent. Inflation has been low, and there have been comparatively small fluctuations in the exchange rate of the Ringgit. Moreover, Malaysia implemented a major export-oriented strategy in the mid 1980s; this was an almost perfect timing, due to the need of Japan, Taiwan and Singapore to locate a larger share of their activities abroad.[15] Compared to many neighbouring countries Malaysia has also benefited from a reasonably well-educated and English speaking labour force, and the government has actively held down wages in order to attract labour intensive industries and reduce unemployment.

The relatively high quality of Malaysia's infrastructure has also constituted an important location advantage for the country. The quality has been particularly good in the Malaysian Export Processing Zones (EPZs) that have been set up since 1971. Though many countries have EPZs, no one has been as successful as Malaysia in attracting manufacturing activity (both in absolute terms and as share of domestic manufacturing). Firms that have established themselves in the EPZs have received subsidized land rents and exemption from a large array of Malaysian taxes and duties, provided that the larger share of their output is exported to other countries. Indeed, firms that operate within the EPZs have generally not been allowed to sell on the domestic Malaysian market at all. Unfortunately, this has contributed to creating a dualistic structure of the Malaysian economy, with few links between those firms that operate within the EPZs and those that operate outside the EPZs. Moreover, there also seem to be relatively weak linkages between foreign and local firms within the EPZs. Thus, even though there exist cost-benefit analyses indicating the EPZs have been beneficial for Malaysia (e.g., Warr, 1987), there is clear evidence that Malaysia has a great challenge in integrating the production sectors.

The Philippines[16]

The Philippines was one of the most prosperous countries in Asia during the first decade after the Second World War and was the largest recipient of FDI inflows in the region in the 1960s. Thereafter the economy stagnated. By 1995 GDP per capita in the Philippines was only 25 percent of than in South Korea, and the Philippines is no longer a major host of FDI in Asia.

The Philippines achieved independence from the USA in 1946, and initially there was a free trade agreement between the two countries. Due to an inefficient macroeconomic policy and falling export prices, the Philippines entered into a severe balance of payment crisis in 1949. The political outcome of this crisis was that the country adopted a full-scale import substitution policy, and imposed comprehensive control on imports and foreign exchange. The first years of import substitution apparently worked quite well, and the country was relatively successful

15. A major reason for the FDIs undertaken by Japanese firms is that they were searching for alternative production sites after the "Plaza agreement" where Japan agreed to appreciate the Yen against the USD. The Plaza agreement was signed by the Group of Five (USA, Britain, West Germany, France and Japan) due to the increasingly larger trade surplus Japan had over the US. Subsequent to the Plaza agreement the Yen appreciated from Y260:USD 1 in 1985 to Y130:USD 1 in 1988 (Tan, 1997); the exchange rate thus doubled in just three years. Additionally, the rapid industrialization of Japan and the first generation Asian tigers resulted in sharp increases in their cost levels during the 1970s and 1980s, and this caused a massive migration of relatively low technology, energy-inefficient and labour intensive industries from these countries.
16. See Kind (2000)

in attracting FDI (primarily from the US). The majority of the foreign investments was made to serve the domestic market, and was concentrated in sectors protected by high trade barriers.

However, as we have observed in many other countries in Asia, Africa and Latin America, the import substitution policy did not succeed beyond the "first easy stage". The economy became slow to restructure, and the protection of the home market took on a permanent rather than a temporary character. This policy implied that both domestic and foreign investors in the Philippines were insulated from competition, and gave rise to extraordinary high profits despite long periods of negative growth in total factor productivity. Thereby foreign investors were able to extract large revenues from the Philippines, at the same time as the income distribution became extremely skewed. This in turn has resulted in a serious tension between capital and labour, with relatively militant labour unions.

Garments and IT-products are the most important export articles for the Philippines, but empirical studies find that firms in these sectors have very few linkages to the domestic economy, see, for instance, Cororaton and Abdula (1999). The same pattern is evident also in other sectors, and FDI in the Philippines does not seem to have contributed much to upgrading the production technologies in the country. Foreign firms have implemented very simple production processes with little scope for technological diffusion to local firms.

It is interesting to compare Malaysia and the Philippines when analysing the effects of FDI in the IT sector. The production process for IT services and goods can be split into a large number of sub-processes, and is therefore well suited for a strategy where the MNEs outsource sub-tasks to different countries according to their comparative advantages. This strategy requires extensive intra-regional trade. Empirical studies therefore indicate that relatively open economies with good international infrastructure are best able to build up a domestic base of support industries to the IT sector. The Philippine trading system has been cumbersome, consisting of a large array of different formal and informal trade barriers (at least until the 1990s). Malaysia, on the other hand, has greatly simplified its trading system over the last decades, and removed most trade barriers for export-oriented foreign firms. Thus, while both countries started with the most labour intensive operations in the IT sector, Malaysia has over time been able to produce more skill intensive goods and develop links to domestic firms. The Philippines, on the other hand, has continued to specialize in the lower end of the production chain.

The Philippines has a reasonably well-educated labour force, with an average year of schooling that is higher than in most other Asian countries. This location advantage is partly offset by the relatively high wages in the country, at least partly due to powerful labour unions. Moreover, the country has witnessed repeated periods of labour unrest. The Philippines has therefore had problems in attracting labour intensive industries. In fact, the Philippines seem to lack clear locational advantages. The infrastructure is very poor by most standards, and due to high unemployment and large social inequalities the country has been plagued by political instability. This resulted in the People Power Revolution in 1986. Since then the Philippines has been a democratic country, but there were several coup attempts in the late 1980s and early 1990s. There are thus great uncertainties involved for firms that invest in the Philippines. International studies further indicate that the notoriously inefficient and corrupt Philippine bureaucracy has been (and is) a major obstacle in attracting foreign investments.

South Africa[17]

South Africa is the largest economy in sub-Saharan Africa, and it was the richest country in our sample in terms of GDP per capita in 1960, mainly due to its vast mineral resources. The country has been the world's largest producer and exporter of gold and other precious metals for almost a century. Before the Second World War, South Africa was a relatively open economy with few restrictions on trade and foreign capital flows. Due to the significant mineral rents, the country did not need capital inflows from abroad in order to finance its industrialization. Nevertheless, the manufacturing sector was largely established through foreign direct investment, joint ventures with foreign companies and licensing of foreign technology. In most cases, technology transfers were much more important than attracting foreign capital.

The political developments in South Africa, particularly the apartheid policy introduced in 1948, provoked social unrest internally and condemnation from abroad, and the country gradually became an international pariah. The economy became more inward looking, introducing import substitution and capital controls. As in the Asian countries discussed above, import substitution initially attracted foreign investment motivated by access to a protected local market. The policy also ran into the same problems as in Asia. In spite of this and strong opposition from the mining sector, the import substitution policy was maintained, and it was reinforced by sanctions imposed on the country from abroad. During the period 1986–94 the country did not have access to international capital markets and there was an oil embargo in place during the same period. During the sanctions period foreign investors divested and sold their shares to local companies.

The mining sector's considerable revenue was largely invested locally and resulted in the development of huge industrial and financial conglomerates and a highly concentrated ownership structure. There was nevertheless a limit to how much resources the conglomerates could profitably invest in a stagnating local economy, and the leading South African conglomerates became multinational companies and South Africa a net outward investor. In the year 2000, four South African companies were among the 100 largest companies listed on the London Stock Exchange (FTSE 100), two mining companies, one brewery and one financial services company. The concentrated and tightly knit ownership structure in South African business has probably been a barrier to entry for foreign investors, particularly as far as acquisitions are concerned. Another special feature of the South African economy is a sophisticated financial services sector, accounting for about the same share of GDP as manufacturing

The first democratic election in South Africa in 1994 represented a turning point in South Africa's economic and social development. Remaining sanctions (except the arms embargo) were lifted and the new government introduced a more open trade and investment policy and a more prudent macroeconomic policy, which brought inflation down and put government finances on a sound footing. There are very few restrictions on foreign direct investment left, but South Africa does not offer special incentives to foreign investors. As opposed to the experience of South Korea when it opened up to foreign investors, South Africa received very little FDI inflows. Instead the country experienced net

17. See Nordås (2001)

outflows of FDI. Less than ten percent of these investments are destined for the other SADC countries. Yet, about a quarter of total FDI to SADC comes from South Africa.[18]

Why did the South African economy fail to attract FDI following the lifting of sanctions, liberalization and the euphoria at home and abroad facing the new South Africa? This is of course a difficult question, but the answer probably lies mainly in the long-term commitment of resources involved in FDI and the lack of a track record of the new government. Indeed, the liberal economic policy led by the new government has lost momentum and labour market reforms have even to some extent been reversed, as the liberal policy failed to create employment and general economic growth. In spite of this, international FDI confidence surveys cite western business traditions, a developed financial market, political stability and the rule of law as the main attractions of the South African economy. Slow growth is among the least attractive characteristics of the economy. This is largely a legacy of apartheid, which had damaging and lasting effects on the economy. The regime not only actively discouraged the accumulation of human capital and imposed insurmountable barriers to entry into the modern economy for the majority of the population, it also broke down the social fabric of the black communities.

South Africa's localization advantages are rich natural resources, good infrastructure, a stable policy environment, a highly developed financial market and a reasonably large market. However, slow growth, lack of skills, a highly distortive trade policy and social unrest, including a high crime rate, are the major obstacles to FDI inflows, while FDI outflows continue unabated.

Mozambique[19]

Mozambique is a least developed country and emerged from a devastating civil war only in 1992. Since then the country has grown rapidly and growth has accelerated over time, only interrupted by floods in 2000. Emerging from a crisis and having a very low income and production level, it does not take much economic activity to generate high short-term growth. Nevertheless, Mozambique's performance has been remarkable and the country has attracted substantial foreign direct investment in addition to aid inflows. In fact, the country received the fourth largest FDI inflows per capita in Africa in 1999,[20] and the sixth largest in absolute terms in 1998–99 (Odenthal, 2001). What appears to have attracted foreign investors are on the one hand swift and comprehensive economic reforms entailing privatization, trade liberalization and public sector reforms, and on the other hand rich natural resources.

The country has vast energy resources both in terms of hydropower and natural gas. The Cahora Bassa dam on the Zambezi river is among the largest hydropower plants in Africa with a production capacity by far exceeding local demand. In addition the country has a rich natural gas field. The largest foreign investment project is a South African/Japanese aluminium smelter plant (Mozal), which benefits from supply of low-cost electricity. Developments of the gas field are also under way. Mozambique is also rich in fertile land and fisheries and the country has a long coastline suitable for tourism. The country

18. SADC (Southern African Development Community) is a regional trading bloc aiming at introducing a free trade area by 2008.
19. See Nordås and Pretorius (2000)
20. If we count the Seychelles among African countries it was the fifth largest recipient.

has thus received a number of foreign investments in agriculture, food processing and hotels. Finally, Mozambique has received significant foreign investments in the financial sector following privatisation of state-owned banks.

One important factor for attracting FDI has been investments in infrastructure. Mozambique has traditionally been an important transit route and has provided port services for its land-locked neighbouring countries. During the civil war the transit routes were impassable, but rehabilitation has been a priority during the reconstruction of the country. The so-called Maputo corridor, a road and railway from the Maputo harbour in Mozambique to the central industrial district in Gauteng, South Africa is the cornerstone in Mozambique's growth and development strategy. Infrastructure has been upgraded in co-operation with South Africa, and an industrial development zone where investors enjoy investment incentives and exemptions from import duties has been established in the corridor. This is also where the Mozal aluminium smelter plant is located. The second largest transport corridor, the Beira corridor runs from the Beira harbour to Harare. It has attracted FDI in labour-intensive industries, mainly from Mauritius (Odenthal 2001).

Mozambique's development strategy shows that a least developed country need not be marginalized as far as FDI flows are concerned. When FDI is allowed and the business environment stable and predictable, it appears that business opportunities are not lost on investors. It is, however, an open question to what extent the energy-intensive industries such as the aluminium smelter will improve welfare in Mozambique through linkages to the rest of the economy, skills transfers and foreign exchange, or whether it is simply a channel for subsidized exports of hydropower.

In other sectors, FDI has created local jobs, opened up bottlenecks in the economy, particularly FDI in utilities and the financial sector, and created business opportunities for local suppliers. Finally, we note that some of the FDI to secondary and tertiary sectors follows in the footsteps of FDI in natural resources, in order to service these activities. Examples are investments in financial services, construction and retail trade in the Maputo corridor and Maputo itself, servicing the infrastructure projects, Mozal and the people involved in them. FDI in natural resources may thus crowd in investments in other sectors.

Discussion and concluding remarks

In this paper we have focused on two questions. First, what are the determinants of FDI? Second, what is the role of FDI in economic development? From our country studies we derive the following answers to these questions. First, on location advantages stimulating FDI:

1. **Stability:** For a given expected rate of return, risk averse investors favour an environment with less uncertainty. Political, economic and social stability is therefore a critical factor in attracting foreign investment. An important reason for instability is likely to be large income inequalities in society.[21] The Philippines is a case in point.
2. **Liberal trade regime:** In an early stage of economic development, a country's main location advantage is likely to be low labour costs (rather than a large domestic market). Hence, foreign investors will

21. For evidence of the positive link between income inequality and political instability, see Alesina and Perotti (1996), and for an overview of the political economy of growth, Alesina and Perotti (1994).

typically seek to export most of what is produced in the foreign affiliate. Moreover, important intermediates may have to be shipped to the affiliate from abroad, for instance the MNE's home country. Openness to trade, including low bureaucratic barriers, is an important location advantage. Malaysia is a good example in this respect.

3. **Access to large and growing markets:** Geographical, and perhaps historical and cultural, proximity to large and growing markets is an important advantage for a less developed economy. In order to keep transaction costs low, firms seeking to decentralize the production chain by locating labour intensive operations in low-cost countries, will typically favour countries that are not too far away. In addition, being close to larger and growing economies makes a less advanced country an interesting site for export platform FDI from outside the region. Both Malaysia and Mozambique have benefited from being close to the regional economic superpowers of Japan and South-Africa, respectively.
4. **Infrastructure:** Access to good communication networks is of key importance to many MNEs seeking new investment opportunities. Malaysia provides excellent infrastructure to investors, particularly in its export processing zones, and Mozambique is rapidly upgrading its infrastructure quality in its industrial zones.

Second, on host country effects:

5. **Economic development can be achieved without FDI inflows:** The case of South Korea shows with full clarity that impressive growth rates can be achieved with very little foreign direct investment. The country has relied on high domestic saving rates and foreign loans for investment, domestic R&D, reverse engineering, and import of foreign experts in upgrading local technology and know-how.
6. **FDI may be important for sustained growth:** Sustained economic growth requires technological change, where new firms with new ideas can enter and where old firms with old ideas may disappear. Easy entry and exit of firms is therefore important in the development process. Foreign entry may be particularly important in promoting competition, since foreign owners are less likely to be part of informal networks that may serve to limit domestic competition. In other words, foreign entry may create more "turbulence" in the market than would entry by a local firm. Many of the fast-growing economies of East Asia have shielded local producers from national and international competition. It is likely that the inefficiencies that were allowed to develop in these protected markets are one reason for the depth of the financial crisis in Asia starting in 1997.
7. **Profit shifting may be a problem, particularly when local markets are shielded from international trade:** Foreign firms entering a market and competing with local firms in markets for output and/or inputs may cause local firms to exit the market. This problem is particularly serious when local markets are protected from international trade, and hence large profits may be captured by entering the market. The Philippines, and Malaysia before the early 1970s, may serve as examples of this.
8. **Linkages and spillovers:** Local suppliers may be able to provide intermediates to foreign affiliates, and over time, these supplies may become more and more skill intensive. Extensive linkages with local firms represent one way in which techno-

logical spillovers may be transmitted to the local economy. In a market characterized by little competition, spillovers are likely to be small, since the need to innovate and upgrade technology in order to survive in the market, and therefore the incentive to do so, is also small. Again, the Philippines may serve as an example.

Geographical proximity to rich and rapidly developing countries is obviously an advantage to less developed countries in terms of attracting FDI. When Japanese companies invested abroad in order to reduce labour costs, they naturally chose locations in the region in order to minimize transaction costs associated with the decentralization of production chains. Later, other economic areas such as Hong Kong and Singapore have been added to the list of important sources of FDI in the region. This is an example of the "flying goose" model, with Japan being the lead goose.

South Africa is the economic superpower in Southern Africa, and South African firms invest in neighbouring countries, such as Mozambique. Mozambique offers investors a business friendly economic policy, including the provision of high quality infrastructure in the Maputo corridor. These policies combined with a rich endowment of various natural resources, have attracted an impressive amount of FDI in recent years. However, the South African economy clearly lacks the dynamism and strength of, say, the Japanese economy in the 1960s, 70s, and 80s. This obviously places poor countries in Southern Africa at a disadvantage relative to poor countries in East Asia.

While FDI is not needed to generate growth, one could argue that sustained growth requires flexible markets, with easy entry and exit of firms, and that foreign entry may play an important role in this respect. Most Asian countries have been very protective of local markets. Even countries like Malaysia, that have encouraged and received FDI on a large scale, have discouraged foreign competition on the local market. Rigid markets and close ties between governments and favoured enterprises probably contributed to the financial and economic crisis in Asia. Opening up for foreign ownership and competition on local markets is one step that may improve economic efficiency and reduce the danger for similar crises in the future. Indeed, this has been the response of South Korea in the aftermath of the crisis.

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