

Economic Factors

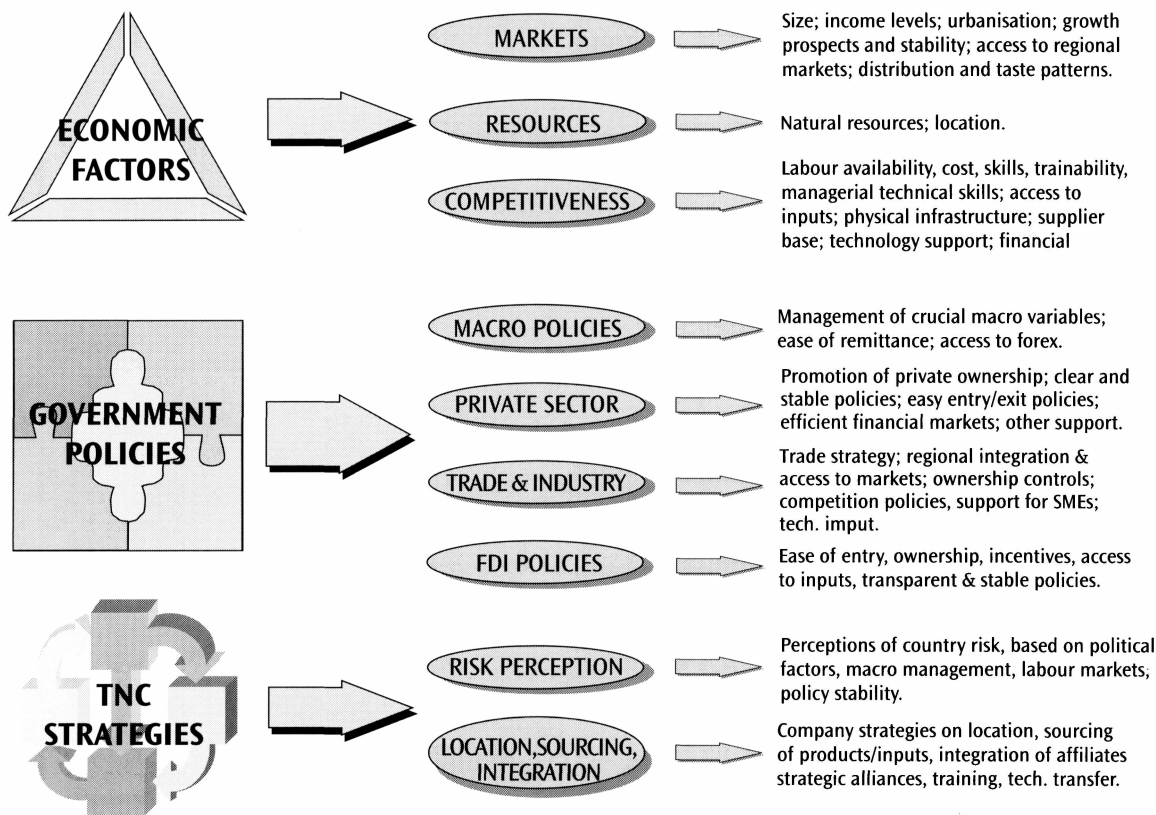
4.1 Introduction

Given the impact of technical change, the extent and pattern of FDI in the developing world can be explained by three sets of factors: economic attractiveness of host countries, the policy framework and its implementation by host governments and the strategies of multinational enterprises (see Figure 1).²⁸

4.2 Markets and Resources

The growing internationalisation of production and trade liberalisation mean that world markets are growing in significance and international competitiveness looms larger as a determinant of FDI. However, it is still true in the interim that large markets (or access to large trading blocs, considered later) remain an important factor in

Figure 1: Determinants of FDI in Developing Host Countries



attracting certain types of FDI that are mainly geared to local markets. The ability of China to attract such large amounts of FDI (apart from export-oriented investments from Hong Kong and Taiwan) is due in part to the size of its domestic market, and the prospects for India to attract growing MNE interest is based on this factor. The growth of investments in the South East Asian region is partly due to the growth of intra-regional trade and the prospects for the regional market as a whole.

While large domestic markets provide a particular attraction to foreign investors, experience shows that small economies can also generate a lot of FDI. Small states like Hong Kong and Singapore have been able to attract some of the largest amounts of FDI in the developing world, by specialising in entrepot trade and certain manufacturing activities aimed at export markets. This is not an easy strategy, since this involves either a favourable location or a base of skills and infrastructure that can enable export activity to take place. There are few small economies with this combination of advantages, and without them small economies may find it difficult to sustain large investment inflows. However, even if others cannot do a Hong Kong, there are important lessons to be learnt in order to improve existing prospects – human capital development, good infrastructure, open door policies to FDI, liberal trade strategies and stable government policies.

The resource base of the economy is important for attracting MNEs, but only a few resources (mainly petroleum and some minerals) are now powerful magnets for FDI. In the resource base may also be counted the location of the economy – countries that are fortunate enough to be close to major developed country markets or in a dynamically growing region can, *ceteris paribus*, expect to attract more export-oriented multinational enterprises. This applies, for instance, to Mexico in the context of the North American Free Trade Agreement, and to Asian countries in the ambit of Japan and NIEs.

4.3 Competitiveness

The factors that determine competitiveness and efficiency are increasingly significant in drawing FDI into manufacturing and services, as technologies continue to develop and the intensity of competition increases in trade and investment.²⁹ The cost of “raw” labour retains some importance, but its role in overall cost competitiveness is falling over time as skills and technical efficiency become more important to productivity, quality and flexibility.³⁰ In contrast to two decades ago, the increasing openness of economies means that all tradable activities have to be operated near ‘best practice’ levels of efficiency.

The supply of managerial, financial and technical skills is now crucially important, even for ‘simple’ activities like garment manufacture for export markets. While MNEs can provide many high-level managerial and engineering skills from abroad, this is expensive and does not compensate for a lack of skills in the shop-floor and technical workforce. Thus, a host country that has larger supplies of trained and trainable labour (that is, with the education and discipline to absorb new skills) is likely to attract more and “higher quality” FDI than others. The role of a skill base is far more significant for activities with more complex technologies, especially those in the engineering sector, like electrical and electronic products, machinery or transport equipment. In these industries, with very demanding needs of operator and supervisory skills, sophisticated production management and quality control and close interaction with other firms, there is a pressing need for numerate workers, large numbers of technicians and supervisors, and for growing proportions of university trained engineering and managerial staff. In addition, there is a need for constant training and retraining of existing employees in new skills and information. Countries that can supply these skill and training needs are thus better placed to participate in international production.

In addition, with the adoption of ‘lean’ man-

ufacturing techniques, a local base of competitive suppliers also becomes of significance to attracting FDI in industries that are highly 'linkage intensive'. These are the engineering activities noted above that also require a diverse range of technical skills. Here the availability of a range of local upstream industries and small and medium subcontractors is vital to flexibility and cost competitiveness. The significance of this is rising as multinationals introduce management techniques like total-quality-control and just-in-time deliveries to their affiliates in order to become cost efficient. Moreover, the existence of a strong local supplier base allows the host economy to capture more beneficial spillover effects from MNEs and lowers the initial cost to foreign investors of setting up facilities there. Thus there are strong complementarities between domestic and foreign private investments, and despite obvious areas in which they compete there is generally a need to promote both. MNEs now often induce their own suppliers from the developed countries to invest along with them in countries that lack a sufficient supply base, as is happening in Malaysia, but this also requires a good local base of skilled labour and training facilities.³¹ Those countries that have well developed supplier industries (like Taiwan) are able to draw more high value-added and technological-

ly advanced FDI. By contrast, countries with poor skill endowments find it increasingly difficult to attract FDI into linkage-intensive activities, and succeed only in getting final stage assembly with low local value added.

The importance of access to inputs at world prices and good physical infrastructure for attracting FDI into internationally competitive activities is self-evident. What is perhaps less known is the need for a good technology infrastructure for sophisticated FDI. A capable technology support system, with good standards, quality assurance and metrology facilities, institutions able to undertake contract research and provide an information base, can allow foreign affiliates to undertake more advanced technological tasks and raise the capabilities of local suppliers and competitors. This can in turn help attract FDI that uses more advanced technologies and transfers more technology-intensive tasks to affiliates.

An efficient national financial system is perhaps of less importance to multinational enterprises than to local firms, but its role in economic dynamism generally is growing over time. Moreover, a strong local financial sector and a flourishing and well-run capital market creates a better "image" in international capital markets, allow local firms to raise capital abroad, and can attract financial sector FDI.