CHANGING ROLE OF THE PUBLIC SECTOR IN THE PROMOTION OF FOREIGN DIRECT INVESTMENT

Raj Kumar*

Foreign direct investment (FDI) is one of the key drivers of globalization. The challenge for developing countries is to tap FDI in a way that promotes their long-term development objectives. Governments of developing countries need to go beyond offering a “passive open door” regime for FDI to one that positively enhances required human resource skills for the absorption of FDI. In that regard, Governments, through the public sector, need to create a conducive policy environment that enables FDI to contribute towards enhancing the international competitiveness of the host country on the basis of a dynamic development of comparative advantage.

Foreign direct investment (FDI) is one of the key drivers of globalization, along with trade and portfolio flows such as debt and equity, all of which, together with the information, communication and technology (ICT) revolution, are major forces in increasing the process of global business activity. FDI induces trade and deepens interdependence among nations. Indeed it is difficult to find any policy regime, be it in taxation, investment protection or foreign exchange transfer in both developed and developing countries that does not have an active stance on promoting foreign direct investment. FDI involves the effective management control of a resident entity in the host country by an enterprise resident in another country, and hence has corporate governance implications.¹ It has also been viewed in some circumstances as infringing on a country’s sovereignty through foreign control over its resources, particularly where natural resources such as minerals, oil, forests and water are involved, and a threat to domestic investment promotion. Others have questioned the benefits of

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¹ In the past boundaries of firms were solely determined by ownership, but now de facto they are much fuzzier as their capability to control the allocation of resources through a variety of networking arrangements which include strategic alliances and long-term contractual relations with suppliers or what sometimes is referred to as a group of related suppliers. The most obvious manifestation of this change in thinking has been the widespread deregulation and liberalization of markets, the privatization of State-owned enterprises that is open to foreign participation and deeper integration of asset markets.
FDI on national security grounds, and even on the grounds that they contribute to a weakening of domestic investment and consequently undermine the strength of national industries. Attitudes are changing, however, and FDI, with certain reservations, is being regarded as “good cholesterol” and part of the solution to promoting development.

Despite reservations concerning FDI involvement in some strategic sectors, why has FDI evolved to be the mantra for promoting economic progress by national Governments, some of which in the past viewed FDI with much suspicion? Indeed FDI flows have been cited as one of the key ingredients for the success of many East Asian economies despite the recent fall in the volume and quality of FDI in some countries. Just as country attitudes have changed in favour of market-oriented and private-led economies, a parallel shift in thinking has been evolving that recognizes that the cost of giving up all or part of domestic ownership and management control in some sectors and in some circumstances is outweighed by the benefits from FDI. Sometimes there is little choice. Most developing countries do not have the necessary level of savings and know-how to sustain economic growth. FDI after all provides a composite bundle of capital stock, technology and know-how as well as in some cases market access that can have an impact on output, trade and employment for the recipient economy. There are difficulties in pursuing old public sector-centred and nationally oriented strategies in the new technological and competitive setting.

**FDI flows and destination**

The *World Investment Report* by UNCTAD (2003) indicates that FDI grew by 29 per cent in 2000 from 1999, faster than other economic aggregates like world production, capital formation and trade, reaching a record of nearly US$ 1.4 trillion. However, in 2002 as a result of the simultaneous economic slowdown in the world’s three largest economies, the United States of America, Japan and the European Union, this rate fell sharply for the first time in a decade to less than half of this amount at US$ 651 billion, roughly reflecting 1998 levels (UNCTAD, 2003) (see table 1).

The continued sluggishness in the world economy and weak equity prices have affected FDI flows in 2002 and 2003 as well. This is compounded by a feeling of uncertainty caused by geographical tensions.

The comparison of the world maps of inward and outward FDI in 2000 and 1985 reveals that FDI reaches many more countries in a substantial manner than in the past. More than 50 countries (24 of which are developing countries) have an inward stock of more than US$ 10 billion, compared with only 17 countries in 1985 (7 of them developing countries). Despite this, FDI is unevenly distributed. The prime destination for the bulk of the FDI flows is to developed countries, with the United States being the largest recipient. Developing countries absorbed some US$ 162 billion in FDI inflows in 2002 (which is a fall of about a third from 2000),
Table 1. Total FDI inflows
(Millions of dollars)

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a Israel and Japan.

about a quarter of the world’s share, but this is a reduction from the 41 per cent share achieved in 1994 (figure 1). In absolute terms, this amount achieved in 2001 was a fall from the record of US$ 246 billion achieved in 2000. Of this, developing countries in Asia received some US$ 95 billion in 2002 (compared with US$ 142 billion in 2000, which was a record), with China taking the lion’s share of about $ 53 billion, followed by Hong Kong, China (US$ 14 billion, representing a large drop from 2002). ASEAN-10 got only 13.2 per cent of the Asian share in 2002, and this is well below the 25 to 30 per cent Asian share prevailing before the 1997 crisis. The crisis, while drastically affecting portfolio flows, did not result, except in the case of Indonesia, in outflows in FDI. From 2000 to 2002, FDI in the ASEAN-10 countries decreased by 13.4 per cent from US$ 18.6 billion to about US$ 14 billion, mainly from the traditional sources of the United States, Europe and Japan (see table 2 and figures 2 and 3). Between 1990 and 1997, East Asia attracted more than 17 per cent of the world FDI.

2 In 2002, for China national sources indicate that FDI stood at almost $ 53 billion, its highest ever, while for Hong Kong, China, it fell to 13.7 billion.
Mergers and acquisitions (M&A) have accounted for a substantial share of FDI in recent years, although there has been a fall from record levels in 2000, mainly owing to declines in share prices and the economic downturn. The immediate benefit of cross-border M&A in East Asia following the crisis was to provide funds to help solvent firms with short-term liquidity problems to avoid bankruptcy. In some cases, the M&A was hostile in nature involving a forced sale of assets. There is insufficient evidence that cross-border M&A transactions have had a significant impact in restructuring the economies of the crisis countries, although they have now declined. The World Bank (2001) noted that foreign acquisitions of the M&A kind, unlike greenfield investments, do not contribute directly to added investment and thus may have lowered the impact of FDI on domestic investment. In the long run it remains to be seen whether such acquisitions could lead to new capital flows and improved access to technology and organization techniques.

Some sectors have taken a larger hit than others, in particular airline and tourism industries, and ICT (“the new economy” service sector), which were at the centre of cross-border investment in the 1990s. The ICT sector is undergoing a consolidation process as a result of the burden of sizeable debts due to unrealized investment returns. A restructuring, backed by better economic performance, can lead to an eventual upturn in investment (OECD, 2003).

3 In the five countries most affected by the Asian financial crisis, the value of cross-border M&A was higher in 1998 than in 1997, largely owing to increases in M&A activity in the Republic of Korea and Thailand. Krugman (2002), described such FDI involving the forced sale of assets as “fire-sale FDI” and poses the question whether foreign corporations are taking over domestic enterprises because they have special competence, and can therefore run them better, or simply because they have cash and the locals do not? The answer is probably some of both, and more research is required.
### Table 2. FDI inflows

* (Millions US dollars)

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- .. Not available
- a Estimates.
Figure 2. FDI inflows to China, Hong Kong, China and 
Taiwan Province of China


Figure 3. FDI inflows to selected economies

Competitiveness of TNCs

What is in it for the 65,000 transnational corporations (TNCs) with about 850,000 foreign affiliates, more than half of which are in electrical and electronic equipment, motor vehicle and petroleum exploration and distribution companies? While national Governments see FDI as a way to spur national development, TNCs seek to enhance their own competitiveness in an international context, i.e., to sustain income growth in a liberalizing and globalizing world. The nature and accelerating pace of technological change are the driving forces and make it necessary to shift activities up the value chain. This is most noticeable in the merger of communication and information processing technologies. The rising complexity of information flows, the changing competitive conditions and the diversity of possible locations mean that TNCs have to organize and manage their activities differently. This requires not only changing management and technical skills but also changing relations with buyers, suppliers and competitors to manage better processes of technical change and innovations. An objective is to find the best match for their mobile assets (e.g., technology, R&D, training and strategic management) with the immobile assets of different locations within an integrated production and marketing system. The most attractive immobile assets, apart from primary resources and a large domestic market, are now world-class infrastructure, skilled and productive labour, innovative capacities and an agglomeration of efficient suppliers, competitors, support institutions and services. Within this framework of an international integrated production system involving intra-firm division of labour and value added, any part of the chain of an enterprise can be located abroad while remaining fully integrated into a corporate network. The boundaries of what is internal or external to the firm are shifting as processes and functions become divisible. A highly visible group of large TNCs continues to grow, often with turnovers larger than the national incomes of many developing countries. Consequently, competition between countries is de facto competition among individual country’s enterprise groups, for example, Boeing of the United States and Airbus of the European Union in aerospace and IBM (United States), Siemens (Germany), Nokia (Finland) and Ericsson (Sweden) in IT hardware.

The challenge for Governments is to develop an FDI strategy in this new competitive context that can benefit countries in terms of their own endowments and development objectives. There are market failures in the investment process and

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4 Besides international enterprises in the top 100 TNCs such as the Vodafone Group, General Electric, Exxon/Mobil Corporation and Royal Dutch/Shell Group, some leading ones are in Japan such as the Toyota Motor Corporation and Mitsubishi Corporation, whose revenues exceeded $100 billion in 2001. In the same list are 5 firms headquartered in developing countries such as Petronas (Malaysia) and L.G. Electronics (Republic of Korea).

5 Market failure can occur when correct signals to economic agents are not present to make proper investment decisions and these could take the form of markets failing to exploit existing endowments fully or to develop new competitive advantages owing to a lack of information or weak markets and institutions.
divergences between TNC and national interests, and this implies a government role of intervention in the FDI process to attract or promote specific types of FDI or regulate and guide it. In this regard, several issues could be raised. First of all, what is the scope of the public sector in this process? Is it one of a passive “open door”, i.e., adopting an FDI-friendly environment, or aggressive targeting and screening of TNCs to ensure that the FDI produces value added activities including local content and technological transfer? Further, should Governments provide direct support to promote FDI or even participate as joint venture parties? How much public investment and/or subsidies should be directed to support FDI? Secondly, what is the relationship between FDI and the domestic private sector: is it complementary and reinforcing or detrimental to the growth of the domestic private sector? A large part of FDI is export-oriented and hence affected by volatility in the business cycles of the home countries and trading partners. Hence, there are arguments that pure reliance on FDI may not sustain economic development and that domestic sources of growth, particularly those from the private sector, should be nurtured. These questions are not exhaustive but only indicative of the issues that arise in the consideration of FDI and as discussed later, have been incorporated in the changing FDI strategies of the Governments in the Asia-Pacific region.

**Objective**

The objective of this article is to examine the changing nature of the role of the public sector in FDI and domestic private investment promotion. Section I examines briefly the experience of selected East Asian countries in FDI. Section II evaluates the relationship between FDI and the domestic private sector, and specifically evaluates evidence on whether FDI crowds in or crowds out the domestic private sector. The nature of the crowding-in and crowding-out process is considered. Section III discusses the role of the public sector in FDI and domestic private sector promotion, including some pointers for the responsibilities of the source countries and the foreign investor. Section IV provides the summary comments and conclusions.

**I. ASIAN EXPERIENCES IN FDI**

The Asia-Pacific region is a vast and diverse one, and hence the level and range of FDI across sectors vary in accordance with national endowments, absorptive capacity and policy stance towards FDI.

China, India and the Republic of Korea have placed more emphasis on promoting domestic investment while countries like Hong Kong, China, Singapore and Malaysia have adopted growth strategies with a heavy reliance on FDI and trade. The latter view is, however, changing with the recent slowdown in the world economy, and the growing recognition of the need to balance FDI with domestic sources of
growth. Hence, in terms of policy stance there are variations in FDI policies across countries and within a country over time.

This section focuses on East Asia, which has a strong pro-export bias in the trade regimes of the countries and which has a wide and long exposure to FDI. The key features in FDI policies can be summarized as follows:

- There has been a differentiated, strategic and evolving approach to FDI policies that covered those that protect certain sectors on “infant industry” grounds and policies that actively attract FDI to selective sectors mainly to promote exports, through a variety of investment incentives that have included free trade zone facilities, tax holidays and other fiscal incentives, and freedom to repatriate profits and capital. The balance between reliance on FDI and domestic sources of growth has varied across countries and over time.

- Over the years there has been a liberalization of foreign equity limits in some sectors, lowering or elimination of local content requirements and an expansion in the positive list of sectors/industries where FDI is permitted, including participation in privatization programmes.

- FDI-specific laws in one form or another have been enacted to spell out the main features of FDI regimes that are distinct from those applying to the domestic entity. However, in some countries, foreign investors are increasingly treated in the same manner as domestic companies with relevant provisions being incorporated in general business and commercial laws as in many developed countries.

- There have been increasing numbers of bilateral treaties for the promotion and protection of FDI as well as the avoidance of double taxation.

- In some countries there has been a growing shift to promoting FDI that embraces international production networks with a greater focus on dynamic effects of FDI – technology transfer, skills development and market access in addition to the traditional goals.

- There has been a fostering of the growth of dynamic industrial clusters that promote backward, forward and horizontal linkages marked by sustained exchanges of information, technology, skills and other assets.

- There has been a trend in some countries, particularly since 1996, towards FDI incorporating less greenfield investment and more M&A that do not involve immediate new investment in terms of creation of new assets but a change of ownership. This is reflected in both the manufacturing and services sector, e.g., banking.

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6 After strong growth of cross-border M&A in 1999 and 2000, the value fell by half in 2001, owing to concern over the global economy, sagging stock prices, lower corporate earnings and governance practices. This trend is likely to continue in 2002 (see UNCTAD, 2002 and Global Business Policy Council, 2002).
Reinvestment of earnings is becoming a significant source of FDI flows, particularly in the ASEAN countries, and such earnings accounted for more than 75 per cent in Malaysia and Singapore and 33 per cent in the Philippines in 2001.

The FDI regimes in East Asia have been by and large export-centred and have undergone rapid changes in the light of changing technology, economic conditions and the nature of competition. A recent survey of the executives of TNCs indicates that trade openness and growth are important for expanding FDI opportunities (Global Business Policy Council, 2002).

The key types of FDI are as follows:

1. The predominant type of FDI has been outsourcing to reduce production costs in terms of labour, infrastructure and natural resources as well as to promote exports, more traditionally in textiles and assembly/manufacture of electronic products, and more recently of cars. Production tends to be relocated in stages from more advanced to less developed countries in search of lower labour costs, i.e., the so-called flying-geese pattern of FDI. This process is a continuing one, and some examples include relocating production from home countries to China, Malaysia, the Philippines, Thailand and Indonesia. Most of the investment by Hong Kong companies in mainland China as well as Japanese, United States and European investment in Asia since the 1970s has fallen into this category. Firms in garments and footwear with leading brand names such as Reebok, Adidas, London Fog and Nike have set up buyer-driven production networks. By and large the flying-geese pattern has been most prevalent in such industries as garments and toys, where sunk costs are low.

2. An important form of FDI has been the creation of new comparative advantage by accessing information, technology and marketing channels as well as new technologies, products or services. This has been initially with conventional international production networks (IPNs), i.e., within multinational enterprises, and later to new IPNs consisting of inter- and intra-firm relationships through which TNCs organize a complete range of business activities, including R&D, product design, supply of inputs, manufacturing, distribution and support services. Examples include automobiles and ICT products. The experiences in countries in East Asia have

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7 Basically the “flying-geese” hypothesis focuses on changes in industrialization and comparative advantage. Lead country firms through FDI move production of their second-tier production to follower countries to take advantage of lower costs in order to raise the competitiveness of the products in the world market. This leads to an increase in exports of follower countries. The process over time moves production to follower countries, and as comparative advantage trends change, the location of the follower countries changes. In the description for East Asia, Japan is the lead country, followed by newly industrializing countries and areas, (Republic of Korea, Taiwan Province of China, Singapore), which are in turn followed by ASEAN-4 (Indonesia, Malaysia, Philippines, Thailand), and more recently China and Viet Nam.
a tiered development pattern reflecting a hierarchy of technological capacities, infrastructures and labour costs. For example, disk drive production has been able to obtain relatively low-cost labour (e.g., Thailand, Malaysia, China), a growing pool of technical personnel (e.g., Singapore, Malaysia), capable supplier firms (e.g., Singapore, Malaysia) and advanced infrastructure (e.g., Singapore).

Some emerging trends:

1. There has been a growing shift of FDI to China in terms of both outsourcing and IPNs in the light of low labour costs, a large domestic market as well as China’s entry into the World Trade Organization (WTO). This is putting pressure on ASEAN countries such as Malaysia and Thailand to move up the value chain of production. China is already becoming a rising competitive location for technology-intensive activities for TNCs.

2. Newer countries are joining in the flying-geese formation of FDI, e.g., Viet Nam, India and Bangladesh, although it is concentrated on lower-value products.

3. Countries like China, Malaysia and Thailand as their skill and infrastructure base improve will provide competition to older industrializing countries and areas like Singapore and Taiwan Province of China.

4. A new pattern of flows in terms of source and destination countries is emerging. TNCs from Hong Kong, China, Singapore and Taiwan Province of China have become very active in promoting FDI in North-East and South-East Asia. Outward investment from China, India, Malaysia and the Republic of Korea is gaining momentum.

5. There is expected to be continued development of subregional growth triangles despite setbacks caused by the 1997 crisis, as they involve collaboration of the three factors of land, labour and capital. Some important ones include the Greater Mekong subregion (Cambodia, Lao People’s Democratic Republic, Viet Nam, Thailand, Myanmar and China), the biggest project extended beyond the ASEAN Investment Area (AIA)\(^8\) based on an agreement signed in 1998 and the potential for broadening this Area to ASEAN+3 (ASEAN, China, Japan and the Republic of Korea), which besides becoming a huge free-trade zone could also develop into a pan-East Asian integrated production network.

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\(^8\) The main elements of AIA are: a co-ordinated ASEAN investment cooperation and promotion programme that will generate increased investment from ASEAN and non-ASEAN sources; provision of national treatment to ASEAN investors by 2010 and to all investors by 2020, subject to some exceptions; and opening all industries to ASEAN investors by 2010 and to all investors by 2020, subject to some exceptions.
II. FDI – CROWDING IN OR CROWDING OUT OF DOMESTIC INVESTMENT?

Does FDI crowd in or crowd out the domestic private sector? Does it redirect government capital expenditure to activities to promote FDI at the expense of others? Crowding out or in can take place in either product or financial markets. Crowding in means the development and upgrading of domestic firms to benefit from linkages with foreign affiliates to raise the efficiency of production and contribute to the diffusion of knowledge and skills from TNCs to the local enterprise sector, and the degree to which affiliates integrate themselves into the local learning system. It also includes new investment in upstream or downstream production by other foreign or domestic producers or increases in financial intermediation. Crowding in could also take the form of accelerating government investment in improving physical infrastructure and the educational system to promote FDI. By contrast, crowding out can take two forms. First, using the “infant industry” argument, FDI in the product market may abort or distort the growth of domestic capabilities in competing industries with direct exposure to foreign competition or retard the growth of the local innovative base. This can make technological upgrading and deepening dependent on decisions taken by TNCs and could in some cases hold the host economy at lower technological levels than would otherwise happen with potentially efficient domestic enterprises. The second form of crowding out is in terms of access to finance and skilled labour, resulting in an uneven playing field for domestic firms. This can raise the cost to local firms in terms of finance and skilled personnel. In some cases TNCs can create dual labour markets as well as raise the entry cost for local firms or simply deprive them of the best factor inputs.

In practice it is difficult to draw a distinction between crowding out and legitimate competition, and this is a policy challenge between regulating foreign entry and permitting competition. While the aim is to develop the domestic private sector, it should not lead to the propping up of local uneconomic firms for long periods at a heavy cost to domestic consumers and economic growth. For new industries, the test is whether these investments would have been made at all without FDI. At the same time, in some circumstances one could raise the question whether FDI is more efficient than domestic investment, particularly if its sustainability depends on the incentives provided. From the public investment point of view, there could be a diversion of public investment from domestic-oriented activities to those that serve

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9 Technology transfer can cover a range of areas such as product technology (i.e., proprietary product know-how, product design and specifications, R&D collaboration), process technology (provision of machinery and equipment, technical support on production planning, quality management) and organizational and managerial know-how (inventory management, quality assurance systems, network management, financial purchase, marketing techniques).
the foreign investor in terms of infrastructure that facilitates foreign investment projects rather than those in regions that are insulated from such investment or those that could have been given to the domestic private sector to develop new and niche areas.

Most investigations of this issue consider the matter in terms of the contribution of FDI to economic growth. Does one dollar of FDI produce more or less of this in terms of new investment? De Mello (1997) surveys the recent literature on the impact of inward FDI on growth in developing countries. He concludes that the ultimate impact of FDI on output growth in the recipient economy depends on the scope for efficiency spillovers to domestic firms, by which FDI leads to increasing returns in domestic production and increases in the value added content of FDI-related production. Also FDI is believed to be a very important source of human capital augmentation and technological change in developing economies since it promotes the use of more advanced technologies by domestic firms and provides specific productivity-increasing labour training and skill acquisition. Through a survey of the literature that employs various growth-FDI econometric models, at both the country level and the sector/industry level, De Mello makes the following conclusions from various studies that are also considered by Mody and Murshid (2002):

1. FDI is positively associated with growth, but only where human capital is sufficiently high, and higher-income countries gain more from capital flows than poor countries. Further, investment is pro-cyclical and influenced by financial market development.

2. Overall, the impact of FDI on growth depends on various types of externalities and productivity spillovers and the foreign investor’s willingness to transfer newer technologies. The absorptive capacity of the recipient country is an important element to induce the multiplier effect on growth.

3. The impact of cross-border knowledge transfer depends on the technological gap between the technology leaders and followers, and the bigger the gap, the greater the diffusion.

4. The degree of substitutability between capital stocks embodying old (domestic) and new (FDI-related) technologies seems to be higher in technologically advanced than developing recipient economies, and the evidence shows limited technological transfers incorporated in FDI.

5. The evidence highlights the importance of existing factor endowments, thereby reinforcing the hypothesis of the development threshold as a crucial determinant of FDI, and in this regard ensuring a better environment for domestic investment would undoubtedly increase a country’s ability to host foreign investment.

Borensztein, de Gregorio and Lee (1998) in their cross-section regression framework study of FDI flows to 69 countries over 20 years conclude that FDI is an important vehicle for the transfer of technology, contributing more to growth than domestic investment; however, the effect of growth is dependent on the quality of
human capital available in the host economy, and more specifically the level of educational attainment. They observed some evidence of crowding-in effects, but the results are less robust.

UNCTAD (1999) in another review of industry and country examples for crowding out and crowding in noted that the evidence may not be clear-cut and mostly neutral, i.e., one dollar of FDI leading to an increase in domestic investment by just one dollar. Caution is expressed on the results of various findings as the variables are viewed as far from perfect and there are secondary effects that are impossible to measure. In most cases, crowding out does not mean an absolute reduction in total investment, but rather that its increase is not proportionate to FDI flows. Hence, crowding out cannot be ruled out, but it does not appear to be the general case. Examples from countries in East Asia – Indonesia, Malaysia and Thailand – that have relied heavily on FDI show that it may take some time for indirect effects on domestic investment to take place, particularly those relating to the microelectronics sector. UNCTAD noted that in the absence of TNCs, it is unlikely that those investments would have been made at all. Initially, however, many of the foreign affiliates were essentially assemblers with few linkages to the rest of the economy. Over time, domestic suppliers of service and inputs have emerged. In a study of 39 countries covering a period between 1970 and 1996, it noted that out of the 12 Latin American countries included in the test, none was in the group with crowding-in effects, while neutral and crowding-in effects prevailed in 12 Asian countries. The study also showed that mining and other raw material extraction projects generated few linkages and therefore their indirect effect on domestic production was negligible.

Looking at possible crowding-out effects of public investment, those made in infrastructure, skills development and other related activities usually tend to benefit not only FDI but domestic private investment as well, and in some sense are public goods. Nevertheless, there could be investments that are solely for the support of FDI such as factory shells, free trade zones and their administration as well as subsidies that can be more costly, unless the FDI bring in benefits that give a return on the investment. Otherwise, it could represent a high opportunity cost for public investment in other areas. Available evidence in the literature is, however, scanty.

Much more research is also needed to draw firm conclusions about overall crowding-in and crowding-out effects. In new areas of investment, particularly in high technology, and in new activities beyond the current reach of domestic investors in developing countries, there are more likely to be favourable benefits to capital formation than in foreign investments in areas where domestic producers or service providers already exist. In the latter case, except in terms of competition with domestic laggards, FDI may take away investment opportunities that were open to domestic private investment prior to the foreign investments. However, the nurturing of domestic firms may be required in this regard so that they can enter the industry successfully without being swamped by FDI that may pre-empt domestic investment. Indeed, this
was the rationale for limiting FDI in certain high-technology industries in the Republic of Korea and Taiwan Province of China. In these cases, the policy makers view that domestic firms could emerge paid off. However, an example of costly intervention in favour of domestic firms in high-technology industries was the Brazilian informatics policy of the early 1980s that involved restrictions on FDI in information technology activities. For some countries the best strategy may be the Korean/Indian type, where the focus has been on building local managerial and technological capacities and using FDI in a selective and strategic manner.

III. THE ROLE OF THE PUBLIC SECTOR

The key issue about the role of the Government is not whether it should intervene but the kind of intervention, including direct participation if there is insufficient capacity in the local private sector. Some macroeconomic policies and investment-friendly policies are necessary, although not sufficient in today’s world of increasing competitiveness in attracting investment. The crucial role for the host Government is to create conditions as well as be proactive in developing these new drivers to attract international production and services in the light of the fact that contract manufacturing has grown rapidly to take advantage of differences in costs and logistics. This implies giving equal emphasis to promoting domestic private investment to benefit from the FDI. Simply opening up an economy is only the first step, and no longer enough to attract sustained flows of FDI and upgrade the quality. At the minimum, foreign investors are expecting assurances of the rule of law, a commitment to be treated no less favourably than competing domestic investors and provisions for the free transfer of capital, profits and dividends, guarantees against expropriation of their assets and binding arbitration of disputes.

The report of the panel on high-level financing for development (United Nations, 2001) to the Secretary-General advised host Governments not to exempt foreign investors from domestic laws governing corporate and individual behaviour, or to use costly and discretionary investment incentives or those that eroded labour and environmental standards in a “race to the bottom”. The report also said that developing countries needed to continue improving their attractiveness to FDI through positive actions (i.e., by improving standards of accounting and auditing, transparency, corporate governance and public administration) rather than through tax concessions, which should be regulated and discouraged.

An OECD study (Oman, 1999) indicates that incentives-based competition for FDI can be intense in selected industries (e.g., automobiles) or for particular investment projects. Most incentives-based competition is effectively intraregional,

\[\text{10 The Monterrey Consensus (2002) gives a strengthened role to the State with regard to the private sector and markets, particularly in terms of setting appropriate frameworks to regulate markets.}\]
i.e., within a region. While data on direct financial/fiscal cost per job are not readily available, OECD estimates that in the automobile industry the cost in OECD as well as developing countries can exceed US$ 100,000 per job. Hence the distortion effects of incentives on a de facto basis work against local firms and against firms in sectors or types of activities that are not targeted. Undiscerning use of investment incentives and other discretionary policies by Governments to attract FDI can have a negative effect on FDI flows, partly because incentives could be viewed as unsustainable.

The competition for FDI raises the delicate question of how to ensure accountability of government officials, particularly those involved in the negotiation of discretionary incentive packages. A strong rules-based approach to attracting FDI, including safeguards for labour standards and the environment, can provide the policy transparency necessary to limit rent-seeking behaviour. Policies on FDI are also needed to counter two sets of market failures. The first arises from information or coordination failures in the investment process that can lead a country to attract insufficient FDI and more importantly the wrong quality of FDI. The second results when private interests of TNCs diverge from the interests of the host countries. This can lead to negative effects of FDI or a failure to harness fully the potential of the FDI.

The challenge for the Government is achieving the right balance in terms of promoting synergy between FDI and domestic private investment in terms of a win-win situation for the citizens. At the heart of these endeavours is improving the competitiveness of a country’s economy to improve its economic fundamentals and enhance living standards. As the performance of economies, industries and firms is continuously compared and benchmarked across nations, it means that individual firms and countries must also benchmark all activities against the best of competitors in a changing world economy marked by knowledge and technology-based advantages. In other words, apart from the series of measures to liberalize the economy and promote FDI that many countries are in the midst of implementing to varying degrees, there is a need for proactive policies aimed at shaping new industrial and service locations through a cooperative approach between the public and private sectors.

What determinants of competitiveness should the public sector focus on? The standard determinants of competitiveness are not only the economic, technological and measurable attributes such as strong economic fundamentals, political stability, technological effort, human resources development, physical infrastructure and financial and labour market flexibility. There are also non-economic factors, some of them controversial, such as the promotion of democratic institutions, human rights, corporate governance, anti-corruption and a host of other subjective criteria. Effective governance is therefore essential to encourage both sound FDI and domestic private investment. The role of the Government spans virtually all aspects of economic development, and here, the focus of the discussion is narrowed down – only aspects that have a direct bearing on promoting FDI and domestic private sector linkages will be considered. In
addition, specific government measures to nurture the domestic private sector in the deepening global integration of production will be discussed. This is not to downplay the other policy areas, which, depending on the stage of economic development and individual country circumstances, can give rise to different priorities.

A typical FDI-promotion model encompasses the following:

(a) Liberalization of FDI regimes by reducing barriers to entry, strengthening standards of treatment for foreign investors and improving the functioning of markets, i.e., the enabling framework, which virtually all countries are implementing in varying degrees;

(b) Governments actively attract FDI by marketing their countries usually through one-stop national investment promotion agencies;

(c) The targeting of foreign investors at the level of industries and firms in the light of the country’s developmental priorities;

(d) The need to promote sequential investment once the initial investment has been made.

It is the last two of the above elements, (c) and (d), which differentiate from the first generation of promotion as exemplified in (a) and (b). These require a special public proactive interventionist approach to nurture specific clusters that build on the country’s competitive advantages. The most important is through production linkages between foreign affiliates and domestic firms to enhance their efficiency. Investment promotion increasingly needs to improve and market particular clusters that appeal to potential investors in specific activities. The more targeted and fine-tuned the approach, i.e., matching the specific functional needs of corporate investors with specific locational products, the more costly it is. It takes time and also requires sophisticated institutional capacities. Linkages can take several forms: backward (i.e., sourcing from domestic firms), forward (i.e., foreign affiliates selling goods to domestic firms for distribution and marketing) and horizontal (i.e., cooperation in production as well as interaction with domestic firms engaged in competing activities). Linkages can also involve entities like universities, training centres, research and technology institutes, export promotion agencies and other official and private institutions. The relationship may take the form of R&D contracts with local institutions such as universities and research centres and training programmes for firms by universities and training centres (see UNCTAD, 2001c; Shen, 2002).

Governments can encourage the creation and deepening of such linkages when they are economically desirable by lowering the costs and raising the reward for linkage formation for both TNCs and local firms. The standard way has been through fiscal, financial and other incentives to forge local linkages in developing countries. Assuming an overall economic and political policy environment that is conducive to investment, the most important factor influencing linkage formation is the availability
of local suppliers with competitive costs and quality. As discussed in section III above, the technological and managerial capabilities of domestic firms also determine the ability of the host economy to absorb and benefit from the knowledge that linkages can transfer. In this regard, policy measures to strengthen the legal and institutional framework for linkage formation has become necessary. The traditional tools to promote linkages like local content requirements, restrictions on sales of goods and services in the territory where they are produced, a requirement to transfer technology and employment performance, are either no longer permissible in the context of the WTO and other agreements such as North Atlantic Free Trade Agreement (NAFTA) or are in the process of being phased out.

At the same time, policy measures need to nurture and sustain SMEs as well as to sustain institutions that provide financial, technological and training support in the process of fostering the development of viable suppliers, as well as sources of growth of the economy in their own right. Some other areas of public intervention are:

(a) Guaranteeing the accuracy of market and business information of linkage formation that could cover names and profiles of supplier information, product price information and a range of up-to-date databases depending on individual country strategies;
(b) Matchmaking, i.e., facilitating one-to-one TNC-supplier encounters and negotiations, acting as honest broker in negotiations and helping with bureaucratic processes;
(c) Facilitating technology upgrade in various ways, including technology transfers as a performance requirement, partnerships with foreign affiliates in technology upgrading programmes and strengthening inter-firm linkages in training;
(d) Promoting supplier associations for private sector training programmes and collaboration with international agencies;
(e) Legal protection against unfair contractual arrangements and other unfair business practices, including an effective competition policy;
(f) Finance – encouraging the support by foreign affiliates to domestic suppliers through fiscal incentives, co-financing or guarantees, and in some cases monetary incentives.11

The relative weight assigned to each of the elements depends on the objectives of the individual programmes. Some noteworthy examples of linkage programmes

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11 This has been mainly through performance-based and cost-sharing mechanisms. In Singapore, the programme shared salary costs of experienced engineers and managers of TNCs, who agreed to assist in supplier upgrading activities. In Taiwan Province of China the programme subsidized training and technology consultations to enhance supplier capacity. See Shen (2002).
are the National Linkage Programme of Ireland (essentially a brokerage service to promote local sourcing by foreign affiliates), the Industrial Linkages Programme of the Small and Medium Industries Corporation of Malaysia (including the Global Supplier Programme, which covers a range of areas including training, product development and testing), the Czech Republic’s National Supplier Programme (a programme that includes collection and distribution of information, matchmaking and upgrading of Czech suppliers). All of these go to show how wide the range of policy measures are.

There are two other areas that require an important focus irrespective of any specific linkages that need to be forged. The first is the need to create high-level technical manpower geared closely to activities desired by the Government. Singapore, for instance, has one of the world’s strongest structures for pre- and post-employment training. In the Republic of Korea, a high training levy on large firms has enabled the setting up of the Korea Advanced Institute of Science and Technology and the Korea Institute of Technology aimed at exceptionally gifted students. The second is assistance to small and medium enterprises, which Governments at all levels of development have supported through selective measures to level the playing field in relation to large firms. The basis of global competition is increasingly one of supply chains competing with one another, and hence an SME policy will also have to create effective supply chain management to improve productivity through better work processes and technology (see Asian Productivity Organization, 2002).

To maximize the benefits from FDI, a vibrant and technologically dynamic domestic enterprise sector is crucial. As profit margins are eroded on lower-end products, technological innovation is the only path to capturing markets in the higher end of the market chain and creating new ones (World Bank, 2003). In this regard, measures are required to build and strengthen technological infrastructure as well as upgrade the technological competence of firms to remain competitive. Building R&D is an important element, and this could be supported through direct funding, fiscal incentives and assistance in application of new production techniques and new products, as experience of OECD countries shows. A culture of being receptive to change is an important strategy that should permeate all levels. For countries that do not have sufficient skilled personnel it may well be advantageous to attract the “best brains” with proper incentives, as the United States and Singapore have done. A new growth driver in the “knowledge economy” is intellectual property (IP), and its management cuts across industries and involves IP creation, protection, use, valuation and technology transfer. The global agreement on IP, called TRIPs, is now part and parcel of WTO membership. While there is some controversy on patents working against the interests of developing countries, carefully worked out intellectual property protection can boost domestic innovation and improve access to new technologies. In particular, the Government could encourage local firms in IP management to develop patents and assist in the funding of costly patent applications.
Over time as domestic enterprises improve their capability, and the technological and managerial gaps between foreign and domestic firms are narrowed, government programmes could be redirected elsewhere, or reduced. Indeed, the Irish National Linkage Programme was terminated recently after 15 years of fostering domestic supplier industries and service providers that are running on their own.

**Role of the foreign investor and source country Governments**

There are a number of areas in which Governments could encourage support from foreign investors and source country Governments in the current climate, where the traditional role of the corporation is changing from pure profit-oriented organization to one of taking a role in other attributes of economic development. The Monterrey Consensus, adopted in March 2002, clearly recognizes that while Governments provide the framework for the operations of foreign investors, businesses, on their part, are required to engage as reliable and consistent partners in the development process. They should take into account not only the economic and financial but also the developmental, social, gender and environmental implications of their undertakings – what is commonly referred to as corporate social responsibility (CSR). TNCs and other firms should be encouraged to accept and implement the principle of good corporate citizenship and should, inter alia, subscribe to the United Nations Global Compact, an initiative encouraging the private sector to embrace, support and enact a set of core values in the areas of human rights, labour standards and environmental practices.\(^\text{12}\)

Source countries too are expected to facilitate and encourage investment flows to developing countries. In this regard, they supported the Monterrey Consensus proposal to increase their support to private foreign investment in infrastructure development and other priority areas, including projects to overcome the digital divide in developing countries. This could be achieved through a range of instruments including export credits, venture capital, leveraging aid resources and risk guarantees.

Moran (1998), reviewing case studies from Latin America and East Asia, noted that the impact of foreign investment on the host economy differs systematically as a function of the relationship between the foreign affiliate and the parent company, which, in turn, depends directly upon the kind of investment regime offered by the host country. He noted that host investment rules that impose domestic-content, joint-venture and technology-sharing requirements create inefficiencies that slow growth

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\(^\text{12}\) The Global Compact network ultimately receives its most significant reinforcement at the country and community levels, where national and business leaders, in partnership with labour and civil society groups lead the movement to make the principles a practical reality through partnership processes (see Global Compact Office, 2002). Developing a CSR strategy based on integrity and sound values with a long-term approach offers both business benefits to corporations in terms of sustainable competitiveness and social benefits to civil societies as a whole.
and generate, in many cases, a negative net contribution to host economy welfare, especially if they are backed by trade protection or other kinds of market exclusivity. Moran argues that allowing foreign investors to operate with wholly owned affiliates free from such regulations can provide a far different incentive structure for upgrading technology and business practices to maintain a competitive position in international markets.

IV. SUMMARY COMMENTS AND CONCLUSIONS

The paper has shown that attracting FDI has become an important instrument of economic policy in the evolving technological and competitive setting of the world economy. FDI has been viewed as bringing not only capital but also technology and know-how as well new trade opportunities that can give a fillip to domestic investment and therefore promote overall economic growth. Studies show that the impact of FDI on economic growth is positive in the following circumstances:

- The higher the value added content of the FDI-related production, the greater the spillover effects to domestic firms, and the greater the impact.
- The impact is stronger the more technologically advanced the industry/sector hosting the foreign investment.
- The greater the absorptive capacity, particularly under conditions of political stability, good macroeconomic performance, superior human capital, good governance and high-quality infrastructure, the more sustainable is the foreign investment.
- A country with a high level of financial integration may better deploy FDI than countries where there are structural deficiencies.

If the above conditions are not sufficiently present, the impact of FDI is ambiguous, and in some cases, there may be no impact on domestic investment or even a negative impact through outflows in the form of capital and increased imports. Crowding-in or crowding-out effects of FDI are hence strongly dependent on the presence of the above-mentioned conditions. In today’s world the choice is not between FDI and domestic firms, but how to link and develop synergy between the TNCs and domestic firms.

A strong and vibrant base of domestic enterprise can develop linkages to enhance the potential source of productivity gains via spillovers to domestic firms as shown successfully in China, Taiwan Province of China, Malaysia, Singapore and Thailand. There is no strong evidence of domestic firms losing out from foreign investment unless the industry is protected or run as an “enclave” investment such as natural resource extraction with little value added. Indeed the promotion of domestic private investment goes hand in hand with FDI, as there are synergies to be gained.
Over time, domestic enterprises themselves take on the role of foreign investors as they gain financial strength and acquire and/or develop their own technology. The changing competitive conditions backed by the accelerating pace of technological change implies that both transnationals and countries need to develop partnerships to provide the optimum benefits from their assets.

Nevertheless, long-standing complaints emerging from the experience of developing countries highlight the negative side of FDI:

- A growth strategy purely reliant on FDI can introduce volatility in economic growth through business cycles of the home countries of investors and trading partners.
- The foot-loose nature of FDI in low-technology activities, where labour and costs of the business are a priority, and where sunk costs are low.
- Transfer pricing and other devices resulting in revenue erosion.
- The reluctance or lack of incentives for TNCs to transfer technology or skills in joint-venture operations.
- The pursuance of anti-competitive practices leading to an unacceptable degree of market concentration.

These and many other complaints may undermine the benefits of FDI and only go to show that Governments need to assess them more critically. This could be partly due to highly skewed agreements in favour of the investor, and partly due to weak understanding of or preparedness for the implications of the investment. This underscores the necessity for developing countries to increase their knowledge and information base focusing on a wide range of issues that will confront various entities in the economy that interface with the foreign investment activities as well as strengthen the quality of government regulations and their implementation. In the case of M&As, an important form of FDI in recent years, the firm-specific motivations underlying them need to be carefully considered, as productivity-enhancing effects cannot be taken for granted.

The challenge for developing countries in this new competitive context is to tap FDI to promote economic development in terms of their own endowments and development objectives. Comparative advantage is not a static concept but is dynamic in nature. The Government’s role in this fast-changing technological and competitive environment is not merely one of a “passive open door” but one where it is proactive in terms of forging linkages between international and domestic firms through lowering the costs and raising the reward for linkage formation for both the TNCs and the local firms. The Government’s responsibility is one of enabler and facilitator of FDI and the private enterprise system. In this regard, there is also a need to reorient educational policies to develop skills that are internationally demanded, promote high-level
technology and specialist knowledge and adopt selective measures to support domestic firms to benefit from the spillover effects from FDI. For countries that do not have a well-developed private sector, there may also be a case for the Government to take the lead, as Singapore and Malaysia have done in some sectors, be it in the form of joint-venture partners or supporting collaboration efforts by the local private businesses with foreign investors. Care, nevertheless, must be taken as experience has shown that not all measures have yielded positive results from FDI, particularly when domestically owned firms have a weak capacity to absorb or when the terms under which the FDI is undertaken do not promote much value added or transfer skills and technology in a muted form.

The active promotion of good corporate governance as part of the process to attract FDI as well as to nurture competitive domestic enterprises, covering not only the incorporated sector but also SMEs, should also be part and parcel of education and training in a technologically advanced and socially responsible market economy. A conducive economic and political environment, transparent government policies and business ethics remain paramount to sustaining investor confidence.

It also has to be recognized that promoting FDI is a costly exercise, as well as a learning experience. Indeed, the Asian crisis of 1997 and the volatile economic conditions have made countries such as Singapore, Malaysia and Thailand reassess the need to rely on FDI for growth and realize that local private sector investment should also be bolstered to create robust domestic sources of growth. The balance between the costs and benefits has to be weighed very carefully. As countries like China, Malaysia, the Republic of Korea and Singapore have shown, it is possible to transform a country’s competitiveness to create new products and services and reduce costs of others through a judicious blending of foreign capital, know-how and technology with the abilities of local people and firms to innovate. Some label this the Asian miracle, but there is an important role for well-designed country policies and programmes.
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