Foreign Investment Revisited: Editorial

Philip Daniel


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Article

In any country the early stages of industrialisation are usually the work of foreigners, because usually only they have knowledge and the capital. This was true of the industrialisation of Britain from the 15th century to the 17th century, when the foundations of later greatness were being laid, and it is true of every modern industrial country since that time, except the USSR. The USSR relied on foreigners for knowledge, but supplied the capital herself, by squeezing it out of her farmers. Japan used both foreign knowledge and foreign capital, but the very unequal distribution of income in the country enabled her wealthy classes to supply a much greater proportion of the required capital than is possible in more egalitarian countries.

There is no question that industrialisation is impossible in the Gold Coast without bringing in the knowledge of expatriates; the question is only on what terms they come in, and how much of their own capital they may invest.¹

The quotation from Arthur Lewis illustrates an old orthodoxy to which the conventional wisdom has now returned. In the intervening decades, ‘structuralism’, dependency theory and, less frequently, Marxism have provided the intellectual underpinning for a quite different programme of political action. That programme, under the generic name of ‘economic nationalism’, rejected foreign direct investment (FDI) as an agent of socially acceptable economic growth. It espoused instead nationalisation of foreign-owned enterprises, capital formation in state-owned enterprises, deficit financing, trade and exchange restrictions and protectionism.

Stagnation in Latin America, economic collapse in much of sub-Saharan Africa and the demise of central planning as a viable system of economic organisation in Eastern Europe and Russia have led to widespread rejection of the programme of economic nationalism by aid donors, international financial institutions and, under pressure from their own populations as well as from abroad, by the vast majority of governments in poor countries. Liberalisation is the slogan of the hour and foreign investment is to be the spearhead of renewed economic development for those countries which did not become newly-industrialised countries (NICs) in the manufactured exports boom of the 1980s.

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And yet the basic questions asked (first with positive presumptions, then with negative ones, and now with positive ones again) do not go away. Why does foreign investment occur? Does FDI bring benefits to its hosts? If it is beneficial, can governments do anything to obtain more of it?

The articles in this *IDS Bulletin* have their origin in a seminar series at the Institute of Development Studies, Sussex arranged in the summer of 1990 to consider these questions once again in the new international context of enthusiasm for FDI. That context, however, is structurally different in major respects from the world upon which Arthur Lewis was commenting: we now have strong regional trading blocs; there is wide differentiation among ‘developing countries’; industrial organisation has been transformed from ‘fordism’ to ‘flexible specialisation’ (Kaplinsky, Kaounides, Auty in this *IDS Bulletin*); above all, capital exports to developing countries have become much less important in world financial flows than reciprocal investment among the major industrialised nations (Julius, in this *IDS Bulletin*). Just as governments in the South have espoused ‘open policies’ once again, it seems that the international economy is much less likely to respond with enthusiasm.

The world presumed by Arthur Lewis in advising the ‘Gold Coast’ was one in which net capital exports from rich to poor countries were part of the natural order. The problems for government in a developing country concerned how to obtain a reasonable share of this ‘natural’ flow and how to channel it to desired domestic uses. Such a presumption is invalid this time around. Since the onset of the debt crisis in 1982, net capital flows have come to be channelled in the other direction, from debtor to creditor nations. As DeAnne Julius points out, real FDI flows to developing countries in the 1980s were lower in real terms than those in the 1970s. It is appropriate to ask, as do many of the authors in this *IDS Bulletin*, why FDI takes place at all.

The core of any explanation is that there is some specific advantage to the investor which makes the expected return on investment sufficient to warrant the additional risk and uncertainty that accompanies investment outside the familiar home environment.² In the case of natural resources the incentive to FDI is clear: mineral deposits, forests and fisheries do not move to world financial centres, companies must move to them. In the case of manufacturing, the motivation for FDI in a world of competition and free trade would be harder to discern; it seems that the dominant factor, at present, is the need to gain and retain access to local or regional markets and to avoid trade barriers.³ In a sense, FDI is a product of rent-seeking on a global scale, whether those rents are generated by natural monopolies or regulatory barriers. Less pejoratively, FDI can be viewed as linked to the pattern of trade; it is in fact a substitute for trade where, for some natural, technological or regulatory reason, trade opportunities are restricted.
It is unsurprising that surveys of the subject have found that fiscal incentives and special promotional measures have little impact on the direction of firms’ FDI, unless the measures are specifically protectionist; it is, perhaps, more surprising that comparative labour costs are mentioned by relatively few companies as a prime motivation for overseas investment. The changing motivations for foreign investment in a ‘post-fordist’, but increasingly protectionist world are addressed from a variety of perspectives in this IDS Bulletin.

Traditional economic theory has regarded the inflow of foreign investment to create expert and import-substitution industries as unambiguously beneficial to the host country. Foreign investment can supplement domestic savings and encourage technology transfer. During the era in which Arthur Lewis wrote, industries based on foreign investment were presumed to increase the propensity to save, and to stimulate new wants and aspirations by encouraging the import of hitherto unknown commodities and services.

Growth, in neoclassical theory, is brought about by increases in the quantity of factors of production and in the efficiency of their allocation. In a simple world of two factors, labour and capital, the common presumption for low-income countries is one of abundant labour but scarce capital; shortage of domestic savings is the constraint on capital formation and hence growth. Even where domestic inputs, in addition to labour, are in ready supply, increased production may be limited by scarcity of imported inputs. Foreign investment is a means by which the host country taps foreign savings and thus relaxes both constraints.

Following World War II, the emergence of ‘structuralist’ thinking offered a more sceptical set of presumptions about the benefits of foreign investment.

The principal criticisms were, first, that foreign-owned companies, especially in expert industries, tended to function as enclaves with limited linkages to the rest of the local economy; second, that their propensity to import inputs stifled local industry and prevented realisation of ‘dynamic efficiency’ gains from industrialisation; and, third, that the potential gains from trade and investment were siphoned away from poor countries by structural features in the operation of trans-national corporations (TNCs) and international markets.

These structuralist arguments were used to support a switch in development strategy away from primary commodity exports and foreign investment towards import-substituting industrialisation and reliance on state enterprise. It is this switch which, in turn, has suffered reversal in the 1980s at the hands of revitalised orthodoxy. While both orthodox and structuralist cases offer important insights, both suggest an inevitability of outcomes which discounts the importance of national and international...
policy on the part of governments. The developing country successes seem to have been those whose governments deliberately steered their economies towards patterns of incentives (and institutions) which made the neoclassical impetus to growth feasible, but did so with a sharp understanding of the structural obstacles to be overcome. The point, however, is that governments could act, for good or ill.

Many of the papers in this IDS Bulletin offer ideas on how governments might act, both to promote FDI and to ensure that it operates to the host-country’s benefit. Although the authors write from a variety of perspectives (inheriting perhaps both neoclassical and structuralist traditions), and with differing degrees of pessimism or optimism about prospects for industrialisation and growth, a marked unanimity emerges. There is a role for ‘industrial strategy’ on the part of governments, though not for detailed intervention in production, investment and trade decisions of firms. Governments’ macroeconomic management is more important than specific incentives, investment codes or institutional devices to promote foreign investment. Indeed, the complementarity between domestic and foreign private investment is widely stressed; measures that discriminate in favour of the latter (as many ‘codes’ do) are neither effective in promoting FDI nor efficient in promoting economic growth. On the other hand, in formulating industrial strategy and the ‘rules of the game’ for FDI, governments have to be aware of sectoral differences (for example in the degree of natural monopoly) and of structural change within sectors (such as the downscaling of efficient plant size in a variety of manufacturing processes). It seems that general ‘investment codes’ are rarely of much practical use.7

Drawing upon her recent research project investigating the reasons behind the surge in FDI among developed countries, DeAnne Julius presents an optimistic view of the role of FDI in national and international economic expansion. Nevertheless, she argues that the developing countries have missed much of the FDI boom of the 1980s and, in fact, received less new FDI in real terms over the decade than they did in the 1970s. Her evidence points to an explosion of investment among the ‘group of five (G5) – the USA, Britain, Japan, Germany and France – who together account for more than 75 per cent of world FDI outflows. All of them had large and growing FDI outflows and inflows, with the inflows overwhelmingly sourced from among the G5 themselves.

Julius sees trade and FDI as complementary; where a firm sells it will tend to invest. Just as trade liberalisation provided impetus to world economic expansion in the 1950s, liberalisation of capital movements and, possibly more important in Julius’ view, removal of restrictions on trade in services, have stimulated FDI and FDI-led growth in the 1980s. ‘For developing countries,’ she writes, ‘trying for export-led growth while excluding foreign investment is competing in world markets with one hand tied behind the back.’
Julius offers some lessons for developing countries from the experience of the FDI boom among the G5. First, discrimination in favour of FDI is pointless; a better climate for FDI is created by parallel and equivalent stimulation of domestic private investment. Second, the rationale for excluding FDI from selected sectors should be re-examined since the competitive pressure of FDI can bring efficiency gains in capital use. Third, a stable, low inflation macroeconomic environment is fundamental, and much more important than special incentives. Fourth, foreign exchange regulations must permit profit and capital outflows at a reasonable exchange rate. Fifth, special ‘investment promotion’ institutions and measures designed to aid foreign companies are met and, in any case, to be counter-productive because of the discrimination implied against domestic private investment.

Exploring a related set of issues at the level of national government policy in smaller developing countries, Charles Harvey too seeks to establish an important link between FDI and the growth of domestic private investment. Just as renewed flows of FDI imply increased reliance on equity finance in international capital flows, so Harvey argues that the promotion of domestic use of equity finance should receive more attention. He uses the case of Botswana to illustrate how this might be done, without falling into the trap of providing excessive grants to parastatals (‘equity’ but with no expectation of dividends) or engaging in grandiose schemes to establish notional stock exchanges when there are too few stocks to trade and too little liquidity to lubricate the secondary market.

Harvey sets this discussion against the background of a review of changing attitudes towards both FDI and equity finance. He sees the pendulum swinging back towards the uncritical enthusiasm for foreign investment that prevailed in the closing years of the colonial period and which in part caused the violent swing towards economic nationalism and restrictive approaches to foreign investment. Harvey argues that the important economic lessons about inappropriate foreign investment (the dangers of excessive protection, of the grant of monopolies and of over-generous taxation incentives) should be recalled together with the political lessons that point to ensuring host country benefits, in a visible way, and devising policies to stimulate a complementary local private sector. In other words, renewed enthusiasm for FDI should be carried through in a way that does not provoke a further round of nationalist hostility.

Raphael Kaplinsky offers a sceptical review of the future for export-led growth of LDCs based on investment in manufacturing by transnational corporations (TNCs). His scepticism, however, is directed towards prevailing views of the advantages and incentives which LDCs can or should offer, and towards the export-orientation of investment rather than towards foreign investment itself. Kaplinsky argues that patterns of industrial organisation have undergone wholesale and rapid change since the ‘new international division of labour’, underpinning the growth of manufactured exports based on exploitation of cheap labour and economies of scale in production, reached its apogee in the
late 1960s. Instead of searching for cheap labour, TNCs now seek to maximise the potential of their labour resource. They seek ‘economies of scope’ rather than economies of scale, proximity to final markets and flexibility in production processes. For their location decisions, therefore, TNCs seek countries which can offer final markets, proximity to suppliers and a strong human capital base (the presence of which is an alternative explanation of the rapid growth of NICs in the new era).

The new ‘flexible specialisation’, Kaplinsky argues, offers renewed opportunities for NICs, and some other LDCs to attract foreign investment in smaller scale and locally specialised production. It may even stimulate South-South cooperation. It is likely, however, to marginalise still further the countries of sub-Saharan Africa (except a post-apartheid South Africa and its periphery) where infrastructure is debilitated, entrepreneurship has been channelled into rent-seeking or basic survival and the human capital resource is poor.

Among the location-specific advantages sought by foreign investors in the ‘post-fordist’ world of flexible specialisation a critical mass of firms, workers and ancillary support (government initiatives and university research capability) conducive to the use of new technologies and materials will be prominent. Lakis Kaounides argues that the nexus of innovation known as the ‘materials revolution’ already functions as a key determinant of industrial location and business strategy, and thus of the direction of foreign investment flows.

Past paradigms of organisation under industrial capitalism, according to Kaounides, have been technologically based upon a given array of materials (such as the well-known base metal commodities): their relative prices and the technologies available for fabricating them, or combining them with other materials, underpinned a relatively inflexible system of industrial production. Sectoral specialist and ‘mono-material’ companies predominated; economies of scale were of great importance; and a ‘fordist’ model of industrial organisation was followed.

In contrast, materials now used depend on the specifications and properties required by the particular end product or use. Scientific developments disseminated into industrial processes, backed by heavy R&D investment, make it possible to intervene in the molecular and atomic structure of materials. New materials resulting from these processes (quickly and flexibly available in small batches) support the new forms of industrial organisation identified by Kaplinsky: ‘post-fordism’ or ‘flexible specialisation’. As this form of capitalist organisation spreads, economies of scope become more important than economies of scale and companies are forced to abandon their ‘mono-material’ specialisms.
Kaounides argues that adaptation to new materials will be central in determining whether industrialisation strategies pursued in the various groups of NICs can be sustained in the 1990s and beyond. He argues that attractiveness to foreign investment will be important for countries wishing to acquire new materials technology, while failure to create a base for new materials industries will reduce attractiveness to foreign investment.

A sector considerably affected by developments in flexible specialisation and new materials is heavy and chemical industry (HCI). Richard Auty takes the HCI sector as a case study in experimentation with alternative strategies: the extremes are represented by ‘Girvan’ (interventionism, state ownership and protected extension into downstream processing) and ‘Blitzer’ (neoliberal reliance on free markets, private investment and free trade). Auty reviews three contrasting experiences: the nationalisation of the Caribbean bauxite industry and its subsequent extension into downstream processing by state-owned enterprises (SOEs); the experience of resource-based industrialisation (RBI) in a variety of oil-exporting countries; and, finally, the ‘big push’ towards HCI in a number of NICs, especially Mexico, Brazil and South Korea.

Auty finds successes in South Korea and in Saudi Arabia’s RBI. In support of ‘Blitzer’ he finds that sound macroeconomic policy, a competitive exchange rate and a substantial equity stake by MNCs are important ingredients of success. He finds very little to support in ‘Girvan’, but argues that vigorous industrial policy on the part of governments has been a major contributor to success – especially in South Korea. The maturation period of HCI to reach self-sustainability and international competitiveness is quite long, requiring governments to take a stand on protection or subsidy; the Korean government did this explicitly, offering subsidy in exchange for specific performance targets. Again, HCI is a sector in which capital inflows can be secured at favourable prices (through, for example, subsidised suppliers credits); the implication of Auty’s case is that the package of government policies adopted helps to determine whether these favourably priced capital flows can be obtained.

Philip Crowson in his article on changing perceptions of foreign investment in the metals mining industry views the alternative strategies identified by Auty as ‘swings in the pendulum’ of developing country response to perceived investment conditions. Crowson, too, sees a considerable reduction in conflict between mining MNCs and host governments since ‘natural resource nationalism reached its apogee at the same time as mineral commodity prices, in 1974’.

He sees the price cycle, however, as being of great importance. The cycles in the mining industry have tended to be of wide amplitude but of long duration; the industry suffers a great deal from the problem of ‘lagged perceptions’ and from corporate and host government strategies erected on the false
premises of these lagged perceptions. The boom prices of the late 1960s and early 1970s were expected to be a permanent feature in a world of supposed natural resource scarcity; this perception brought about both over-investment and over-optimism about taxable capacity. The subsequent prolonged slump has led to a major restructuring of the industry, with high returns perceived in cost-cutting and smaller scale, specialist investments, and to a significant liberalisation of investment conditions in developing countries. Crowson cautions that the return to approximate equilibrium in metal markets since 1987, and the return to occasional periods of firm prices, have led to some tightening of conditions, especially in popular developed country environments for mining, such as Canada and Australia.

Crowson identifies a broad consensus over the structure of mineral investment agreements and the structure of taxation of the industry; he is less sure that there is consensus about levels of taxation and suggests that this is an aspect of the swing of the pendulum. On the company side, the renewed consensus derives from the withdrawal of the oil companies from the mining business (often by way of management buy-outs), the restructuring of companies and thus the arrival of new managerial personnel unencumbered with the legacy of the period of intense conflict. The restoration of market balance and the rise of ‘environmental risk’ in developed countries to offset supposed ‘political risk’ in in LDCs have also been important. On the host government side, the investment famine of the 1980s coupled with structural adjustment policies, led to changes of approach. Crowson points to the widespread use of contract negotiation and private firms as another source of consensus.

Etsuro Ishigami offers a study of the FDI performance of the fastest-expanding capital exporter of recent decades, Japan. Echoing DeAnne Julius, he finds a major break in the destination of Japan’s FDI around 1977–78. Before the, Japan’s FDI went mainly to Asia and Latin America; subsequently it flowed more strongly to the US and, to a lesser extent, to Europe.

Once again, we find that location-specific factors drive the investment outflow. In the case of Japan’s investment in South East Asia, cheap labour was the principal motive; in the USA and Europe, fear of loss of expert markets led to ‘precautionary’ FDI. Intensified trade restrictions and concern for bilateral trade reciprocity in the US and Europe led Japanese firms to locate in those markets, even where such relocation depressed profitability in the short run.

Since 1986 there has been a rapid expansion in Japan’s FDI in the countries of ASEAN (which Ishigami distinguishes from the original NICs of the region). The expansion was driven, as in the case of the original NICs, by further appreciation of the Japanese yen and the search for cheap labour, but also by important new factors: the spread of US protectionist barriers to affect the NICs themselves (as
well as products originating in Japan), and the creation of a regional international division of labour by Japanese firms.

As the technological level of the NICs advanced, it became rational for Japanese firms to seek their cheap labour and export platforms elsewhere. Countries like Thailand and Malaysia encouraged the move by offering special incentives for companies intending to export manufactures. Japanese investment in ASEAN contains a higher proportion of manufacturing FDI than elsewhere and now involves a large number of small and medium sized firms. Electronics firms, for example, have tended to be followed into ASEAN by their own suppliers; this both because local suppliers were not available and because governments imposed local content incentives or restrictions.

Ishigami concludes with the observation that growth of manufactured experts on the basis of Japan’s fluid regional division of labour may not provide a secure foundation for ASEAN trade growth. He finds that the net balance of trade contribution of Japanese FDI is often negative. This is because new ‘flexible specialisation’ forms of industrial organisation and the stimulation to Japanese suppliers to set up in ASEAN means that ever-expanding imports of capital goods from Japan in quantities outweighing the contributions of Japanese firms to experts. The new regional division of labour is thus founded on continuing and increasing capital flows to ASEAN from Japan, flows that could decrease as rapidly as they have recently increased.

John Thoburn and his colleagues report the results of their detailed study of investment in China by Hong Kong companies under China’s ‘Open Policy’. Their focus is on those companies investing in the neighbouring Pearl River Delta, outside the Shenzhen Special Economic Zone (SEZ) set up by the Chinese Government specifically to promote such FDI. Once again, special circumstances are immediately striking. Thoburn et al. describe investment in China by Hong Kong companies as ‘forced relocation’ brought about by rising labour costs and acute land shortage at home.

Hong Kong investment appears to have responded more rapidly to a congenial working environment (in terms of attitudes of local officials or freedom to employ workers of the firm’s own choice, for example) than to formal incentives provided by the Chinese authorities. The variety of contract forms available to foreign investors reported by Thoburn et al. is extremely wide, but the available legal framework appears to have been of little use in the event of disputes. Their findings reinforce the point made by others in this IDS Bulletin that the operating climate for investment, ranging from sound macroeconomic policy to freedom of operation with respect to employment practices, is more important than specific incentives or coordination mechanisms provided by governments in attracting FDI.
In terms of earlier structuralist criticisms of FDI, Thoburn et al. reach positive conclusions about the contribution of Hong Kong companies in China. There have been benefits to local partners through returns on equity participation, or through local returns on equity participation, or through local processing and assembly fees. Although tax payments have as yet been modest, infrastructure costs have been fairly low since the FDI studied went to an already developed area rather than to an SEZ. The Hong Kong companies appear to have brought about significant increases in foreign exchange earnings and to have transferred technology, albeit in labour-intensive, ‘low-tech’ consumer goods industries.

The evidence of these articles suggests that FDI certainly has brought about substantial stimulus to economic development, but almost always in specific, and perhaps difficult to replicate circumstances. It is a major feature of the modern world economy, but the volume of flows among industrial countries now far exceeds the flows to developing countries. There is thus little justification for suggesting that rapid adoption of liberal policies will enable renewed flows of FDI quickly to restore substantial capital exports from rich countries to poor. This is not to argue for a return to ‘inward-orientated’ policies; on the contrary, the papers in this IDS Bulletin provide little, if any, grounds for restoring the agenda of economic nationalism. Indeed, it is now possible to make a realistic (and, for many countries, modest) assessment of the scope for FDI inflows, their potential costs and benefits, and the measures needed to secure them.

2 See for example the framework proposed by Dunning (1985) described by Thoburn et al. in this IDS Bulletin.
3 The supply elasticity of FDI is discussed by Helleiner (1987: 71) who also reports on a major survey of international companies’ motivations for undertaking FDI.
5 The authors most commonly credited with initiating the structuralist case are Singer (1950), Prebisch, mainly in the documents of the UN Economic Commission for Latin America, but also in Prebisch (1963), Myrdal (1957) and Hirschman (1958). For a review of the origins of these doctrines see Singer (1984).
6 These alternative views of FDI and export industries are discussed at greater length (in the context of mineral exports) in Daniel (1990).
7 Points which also emerge strongly from the editor’s own case study of FDI in Papua New Guinea (Daniel and Sims 1986).
References


