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POLICY AREA:
Trade and Investment

How to attract Quality FDI?

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Abstract

Quality FDI that help integrating the indigenous firms of developing countries into world-wide supply-chain networks have proven a promising tool for advancing these countries, as has been evidenced in numerous scientific studies. In their aim of setting up a strategy with Africa, the G20 countries together with International organizations should consider measures of turning FDI into quality FDI as one element of such strategy, and to this end should support own efforts of African countries.

Challenge

One of the major topics of the current G20 Agenda under German presidency is to promote sustainable development with a special focus on Africa, including initiatives under the label of a "Marshallplan with Africa". This is in line with steps taken by the EU to develop a new Africa strategy replacing the Cotonou Agreement of 2000. All these endeavors take into consideration the close neighborhood of the African and European continent, the responsibility for one another on the ground of a shared history and in anticipation of a shared future, and the interconnectedness of any problems of one world region for all other regions in times of increased globalization.

One of the guiding ideas of the Africa strategy is that private, not public, investment is required to create the long-term employment opportunities so badly needed in Africa. This makes foreign direct investment (FDI) a first-range tool of choice for such strategy, in Africa as in other developing countries. Admittedly, FDI in developing countries has got a bad reputation as it is often set tantamount to first world's postcolonial exploitation of the raw materials and cheap labor from the third world, associated with pictures of leaking oil fields and collapsing factories. But rather than exploiting Africa, FDI can help integrating developing economies into the global production chains, and has done so already in the case of many emerging countries. The trick is to attract "Quality FDI" that links foreign investors into the local host country economy. Quality FDI may be characterized as contributing to the creation of decent and value-adding jobs, enhancing the skill base of host

economies, facilitating transfer of technology, knowledge and know-how, boosting competitiveness of domestic firms and enabling their access to markets, as well as operating in a socially and environmentally responsible manner. To achieve this, potential host countries need tailored policies to support a smooth integration of indigenous and foreign firms into world-wide supply-chain networks.[1]

Recent research offers empirical evidence for strategies in developing countries that successfully turned FDI into such quality FDI (see Moran et al., 2016, for a detailed research survey). The essence of this research is to advocate a light form of industrial policy: a policy that seeks to hitch FDI to development goals and to generate backward linkages as deep as possible into the host economy.

To be sure, such industrial policy in favor of quality FDI requires foremost action to be taken by the developing host countries themselves. Africans need to develop their own, African solutions, and scientific research can but offer some suggestions on what might work and what not. [2] Thus, on the one hand, a potential host country may need to get the framework conditions for foreign investors straight. That may involve opening up markets and allowing for FDI inflows, in order to unleash the competitive pressure multinational investors exert on their local suppliers and the assistance they offer to them. It may involve further putting up the infrastructure required for a quality investor, such as transport facilities, energy supply, an adequately skilled workforce and access to credit by a business-friendly financial system. On the other hand, the host country may need to design the elements of such light industrial policy. It needs to identify target activities expected to induce spillovers from FDI to the indigenous economy. The host country may, for instance, encourage first-time foreign direct investors and foreign direct investors from diaspora members because they are more open-minded towards linking up with domestic suppliers, and it may address in particular foreign direct investors with middle-level technology, which is likely to match better with the technology of domestic suppliers. Scientific evidence also advises to abstain from any policies favoring specific companies or prioritizing SMEs.

But besides such efforts of the developing FDI host countries themselves, there is still a vital role to play for external actors such as international organizations, multilateral financial institutions, and advanced countries like the G20, their major mission being to complement and fund such efforts. The explosion of international private sector investment flows has not eliminated the need to support growth-and-development programs in developing countries, even beyond emergency aid and pure poverty reduction programs.

Proposal

Accordingly, as the G20 countries aim at setting up a strategy with Africa, they should adopt the support of quality FDI as one promising element of integrating the indigenous economies of the African countries into world-wide supply chains. To this end, G20 countries, cooperating closely with international organizations such as UNIDO, UNCTAD, Worldbank and WTO, and involving the work of NGOs, could pursue the following, evidence based suggestions.

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[1] This is notwithstanding the merits of the Trade Facilitation Agreement that recently entered into force in the realm of the WTO and the G20 Trade and Investment Working Group (TIWG) and that provides for an easier and more efficient trading access between countries. Rather, this agreement represents a necessary condition for improved FDI, which yet has to be complemented by a sufficient condition describing the desirable content of this exchange.

[2] Scientific evidence for the following suggestions can be found in Moran et al. (2016) and the exhaustive literature cited there.

1. **Contribute to the set-up of Investment Promotion Agencies (IPA)**. A successful IPA could target suitable foreign investors and could then become the link between them and the domestic economy. On the one side, it should act as a one-stop shop for the requirements such investors demand from the host country. On the other side, it should act as a catalyzer to the host's domestic economy prompting it to provide the top notch infrastructure and the ready access to skilled workers, technicians, engineers and managers that may be required to attract such investors. [3] Moreover, it should engage in after-investment care, acknowledging the demonstration effects from satisfied investors, the potential for reinvestments, and the potential for cluster-development as a result of follow-up investments.
   External donors could contribute to establishing such IPA by paying internationally competitive salaries to the professional, high-expertise IPA staff that would be required for targeting large investors pro-actively. Moreover, G20 countries could adopt a mentoring role for such IPAs and provide advice on how to use them effectively for marketing the developing host countries to multinational investors.

2. **Set up a vendor development program** to support the match making process between foreign customer and local supplier. To strengthen the capacity of the domestic economy, such program may offer financing opportunities to indigenous suppliers for required investment on the basis of purchase contracts from foreign buyers. [4] Moreover, it may reimburse the salary of a manager in a foreign plant acting as a talent scout among domestic suppliers. [5]

3. **Support the establishment of Export Processing Zones (EPZ)** in a way that they spearhead into the domestic economy of the respective developing country**.** G20 countries could mentor the design of regulations for such EPZs. Thus, for instance, regulations discriminating against creation of local supplier relationships need to be avoided. Instead, a secondary industrial zone could be set up for local suppliers, be it as a geographical site adjacent to EPZs or be it as a legal status allowing for easy foreign-domestic linkages, with, e.g., databanks and "marriage counselors" to assist in supplier selection.[6]

4. **Improve the functioning of financial markets worldwide**, to enable developing countries harness their FDI. For instance, better financial market institutions even in FDI source countries help overcoming deficient financial markets in host countries, thus increasing FDI flows to developing countries. [7]

5. **Fund and promote scientific research on efficient policies for the development of less-developed countries.** G20 countries should provide their universities and research institutions with sufficient funds to allow for research in the interest of developing countries. T20 think tanks could continuously provide thought-provoking impulses and survey the academic literature for innovative studies and new evidence.

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[3] See, e.g., case studies on the State Development Committee (PDC) of Penang in Malaysia, on the Costa Rican Investment Promotion Agency (CINDE) and on the Motor Industry Development Programme (MIDP) in South Africa (Moran 2014, Barnes et al. 2015). See also Harding and Javorcig (2012) who find that in developing countries targeted sectors receive more as twice as much FDI as non-targeted sectors.
[4] See the the Local Industry Upgrading Program (LIUP) of Singapore.
[5] See the example of the Singapore's Economic Development Board (EDB).
[6] See cases of Malaysia versus Mauritius (Moran et al., 2016).
[7] See Görg and Kersting (forthcoming), Donaubauer et al. (2016).

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