MAKING THE MOST OF FDI

by

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Introduction

UNCTAD's Global Investment Trends Monitor published in January 2024 indicates that over the years, global capital flows in FDI have been experiencing an uncomfortable buoyancy. Global economic uncertainty and vulnerability accentuated by a changing geopolitical landscape have resurfaced the need to diversify concentrated country risk, particularly in global supply chains. Countries across the globe through national security and country-specific strategies are assisting domestic businesses to diversify their country-risk especially associated with FDI. Yet, the ironic contradiction remains that businesses are continuing to more or less stabilize their concentrated risks in existing country-wise FDI portfolios.

For example, the echoes of the COVID-19 pandemic have had far-reaching implications such that it brought to the forefront the risk of having China as a fulcrum in the global manufacturing supply chain. Accordingly, a China-plus-one strategy gained momentum in international business strategic circles proposing India and other ASEAN economies as their China-plus-one competitive collaborators. Countries such as Germany even promulgated their first comprehensive strategy on China to enable German businesses to build China-independent international business operations. Yet, foreign businesses are not only continuing to remain directly invested in China but also argue that continued investments in China are now imperative to remain competitive both in China and globally. One of the reasons being the endogenous relationship between what determines FDI flows and what determines FDI spillovers.

Take German direct investments in China. It is reported that German FDI in China in 2023 inched up by 4.3 percent to a record-high of Euro 11.9 billion. As per a Business Confidence Survey 2023/24 conducted by the German Chamber of Commerce in China, over 90 percent of the German interviewed companies intend to remain invested in China over the next couple of years. More than half (54 percent) of the interviewees are planning to increase investments, and 79 percent say that it is necessary to do so to remain competitive in the domestic and global markets.

Governments and Multinationals

Simply put, multinationals, on the one hand, primarily invest in foreign markets to benefit from cost-arbitrage on the factors of production giving them a cost-competitive advantage while accessing domestic and other international markets. Internationalization of production activities enables firms to better manage risks associated with arm's-length market transactions. Host economies, on the other hand, perceive multinationals as a conduit of advanced technology with the potential for domestic technological diffusion. Although direct diffusion could take place through technological handovers, indirect diffusion would entail a spillover of technological knowledge across the domestic economy.

Governments, therefore, continue to attract multinationals not only because of their direct contribution to capital formation but also with the expectation that their operations would facilitate the diffusion of foreign technology and ideas toward the domestic economy. Typical policy examples to attract multinationals revolve around providing preferential treatment including tax incentives, exemption, or reduced import tariffs, amongst others. Besides tangible incentives, host economies have also started to widen the incentive net to include intangible incentives such as national treatment for multinationals, thereby facilitating a level playing field for both multinationals and domestic firms to operate within national borders. Moreover, a holistic development of a country's ecosystem encompassing economic, political and institutional factors continue to incentivize multinationals. While governments lure foreign companies with incentives, the creation of absorptive capacity and capabilities as a lure cannot be wished away.

Spillovers, Absorptive Capacities and Capabilities

Arguably, the very presence of multinationals could initiate the process of domestic technological diffusion. The idea is that potentially more advanced foreign technological capabilities and/or efficient organizational structure of multinationals gradually leak out of firm boundaries and become common knowledge readily available for absorption in the domestic economy. For instance, multinational entry into the host market could facilitate technological spillovers whereby domestic firms by imitating or reverse engineering foreign technologies potentially close the technological gap between leaders and laggards putting the domestic laggards onto an innovation trajectory. Besides imitation, other channels through which foreign technological ideas can spill over into the domestic economy include labor mobility, competition amongst firms, and integrating foreign technological ideas into domestic production, amongst others. In the above-mentioned survey, more than 50 percent of the interviewed German businesses report that Chinese competitors are already innovation leaders or become so within their respective industries in the foreseeable future.

However, the extent of such absorption is conditioned on a country's capacities and capabilities to absorb and assimilate, internalize, and capitalize on the available foreign knowledge. For example, domestic firms can only imitate or reverse engineer a foreign technology depending on the domestic availability of human capital endowment. There is ample cross-country research evidence to suggest the determining role of a country's human capital absorptive capacities and capabilities play in the existence and magnitude of FDI spillovers in the host economy. Accordingly, countries have also started to direct policies towards the development of a country's absorptive capacities and capabilities in, say, human capital.

Take China's multi-prong policy approach to building the country's human capital. The Chinese continue to emphasize providing basic compulsory public education at large. Taking a cue from joint venture successes in manufacturing, the country extends support to multinationals to collaborate with their vocational schools, colleges, universities, and training institutions. China emphasizes the importance of skills endowed in its diaspora, designing policies and programs at the national, provincial, and city levels to not only encourage their relocation back home but also ensure a seamless integration back into the Chinese economy. China further adds value to its human capital by tapping into a global pool of talent, whether in terms of short-term business or employment exchange, or long-term residency.

Inadvertently, a country's absorptive capacities and capabilities not only enable spillover facilitation from FDI within the country but also act as a determining factor for FDI inflows in the country. For example, in the aforementioned survey, 15 percent and 16 percent of the German interviewed companies stated the unavailability of local talent as one of the challenges they face when deciding to invest in both China and non-Chinese Asian markets, respectively.

Lessons for Countries

In an increasingly bipolar world with perceived multipolarity, globalization appears to have entered into a phase where the costs emanating from geopolitical risks are beginning to overshadow the benefits of internationalizing business operations. While multinationals reduce their overall portfolio exposure, governments can strategically bargain a higher share in the reduced portfolio. The bargaining chip here is a robust and resilient ecosystem which inadvertently also helps multinationals in managing international risk exposure.

Accordingly, countries such as India where growth and development trajectories are heading in different directions, need to start investing in building the country's absorptive capacities and capabilities. For example, the unavailability of skilled labor has been cited as an obstacle to German investments in India. One of the ways India can address domestic skilled labor shortages is by encouraging brain circulation, both of foreign workers and the Indian diaspora. For example, India prides itself in having signed a bilateral agreement on a comprehensive migration and mobility partnership with Germany. Greater Indian labor mobility to Germany could indeed result in potential monetary remittances to India, a benefit to India. Nonetheless, the Indian government should encourage brain circulation from Germany, of both German and other foreign workers as well as the Indian diaspora, either through long-term residency or short-term employment exchanges. By augmenting human capital, brain circulation would not only help India develop its existing human capital capacities and capabilities but also facilitate FDI inflows in the country.

To conclude, the endogenous relationship between the determinants of FDI and the determinants of FDI spillovers cannot be shrugged away. Policymakers need to recalibrate and go beyond the traditional variables such as direct tax incentives to multinationals. New-age FDI policies would need a holistic approach requiring policy intervention on all fronts of economic development, domestically and internationally. For example, just like financial market development can ease credit constraints in the domestic economy facilitating FDI spillovers, visa reforms could also ease labor shortages in the domestic economy also facilitating FDI spillovers. Accordingly, a comprehensive FDI policy would include policies targeting domestic financial sector liberalization and visa policy reforms.

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