

FOREIGN DIRECT INVESTMENT AND MANUFACTURING

***Text of Speech by Mr. T.C. Venkat Subramanian, Managing Director & CEO
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Introduction

There are many ways in which FDI can help to enhance a country's manufacturing and export competitiveness. In order to attract export oriented FDI and to ensure that such investment translates into development gains, a country needs to find the most effective ways to make the choice of locations as well as the target segments, conducive to the kind of export activities the MNCs aim to foster.

In today's rapidly globalising world, successful exporting needs not only competitive products, but also marketing expertise and access to international markets. Giving greater access to FDI can provide major benefit in this respect especially in markets in which established brand names and large distribution networks are important assets. FDI can also be effective means of providing resources, such as skills, training, technology, capital goods and intermediate inputs needed to exploit a country's existing comparative advantages.

The most prominent role played by FDI in the exports of developing countries is in the manufacturing sector. In the manufacturing sector, foreign affiliates tend to be the leaders in export-oriented and marketing, and linking up to marketing and distribution channels is crucial. The impact of foreign affiliates on the domestic companies' export activities can be both direct and indirect. Direct effects occur when exporting foreign affiliates establish backward linkages with local firms, which then become indirect exporters. Indirect effects of the presence of export oriented foreign affiliates occur when local firms manage to copy the operations of foreign affiliates, employ staff by foreign affiliates, and benefit from improvements in infrastructure and reductions in trade barriers undertaken in response to the demands of foreign companies.

Importance of Export related FDI

Expanding exports is a means to an end – economic development. To achieve this end, promotion of export oriented FDI should be an integral part of the overall developmental strategy. FDI can help a country in its efforts to raise exports in all kinds of industries by providing the missing elements, that they need to compete or by improving local based skills and capabilities.

In general, two possible relationships describe FDI and exports: (1) substitutes, and (2) complements. Substitutive relationship assumes that international trade is driven by differences in factor endowments and factor prices for homogenous products. These differences become smaller when international factors become mobile between countries. This school of thought also assumes reduction in import tariffs reduces exports and encourage foreign direct investment.

A complementary relationship indicates that FDI and exports move in the same direction. Under this relationship, trade happens when FDI creates or expands the opportunity for export growth. Production by foreign companies of one product may increase total demand for its entire product line, making FDI and exports complementary.

Empirical evidence shows that FDI has complementary relationship with exports. Data shows that nearly one-third of world trade is among TNCs and their foreign affiliates, with much of this trade in intermediate goods. The ratio of intermediate goods imports to total imports ranges from around 50% in Canada, Germany, the UK and the US to almost 60% in France and a very high 70% in Japan.

MNCs account for a large share of world exports and imports. Their role is greater in technology and skill intensive industries, the most dynamics and high value added activities in trade. MNCs are increasingly setting up integrated production systems across countries with considerable specialization in technologies and labour costs. Thus intra-firm trade is playing a greater role in some of the most advanced areas of trade. MNCs are also very active in sourcing natural resources and resource based manufactures from developing

countries and relocating simple labour intensive activities and processes to tap low wages.

FDI and foreign affiliates have played a crucial role in China's export dynamism in recent years. China's impressive export growth during the 1990s has been accompanied by a substantial growth in FDI inflows. From less than 9% of total Chinese exports in 1989, the share of foreign affiliates jumped to 48% in 2000, and more than 90% of exports by foreign affiliates were manufactured goods. At the same time, the share of exports by foreign affiliates in technology-intensive industries – such as electronic circuits and automatic data processing machines – rose from 59% in 1996 to 81% in 2000. In the case of Costa Rica and Hungary also, high export performance has been accompanied by substantial increase in FDI inflows.

FDI and foreign affiliates have also played a crucial role in the export performance of export processing zones (EPZs) whose focus has been export-oriented manufacturing. In China, the vast majority of manufactured exports are from the special economic zones. In Malaysia, as much as 75% of all manufactured exports were produced in such zones. Over 95% of Mauritius' manufactured exports are produced in EPZs, while in Kenya 75% of manufactured exports emanate from such zones. Further, exports from Mexico's maquiladoras account for over 50% of manufactured exports, and 80% of all exports in the Dominican Republic.

FDI in Privatisation

In recent years, privatization and disinvestments of public enterprises has become an important channel for the flow of FDI into many emerging economies. Brazil is the most successful country in using privatization to attract FDI. Of the over US\$ 90 billion of privatization proceeds garnered during the 1990s, nearly 35% was contributed by FDI. Similarly, a significant portion of FDI in Argentina and Chile was also through the privatization of public enterprises. Privatisation-related FDI transactions have also been a key determinant of FDI inflows into Central and Eastern European countries. China is also embarking into a

programme of converting departmental enterprises into corporations and privatizing government companies.

FDI Performance Index

In terms of FDI performance index, India is ranked 119 (and China is ranked 47) amongst 140 countries covered for the period 1998-2000 (UNCTAD, World Investment Report 2002). In terms of FDI potential, India is ranked 104 (and China is ranked 84) amongst 140 countries covered for analysis. In terms of absolute FDI inflows, India is ranked 6th among Asia's leading economies, after China, Hong Kong, Singapore, Taiwan and Thailand.

Global Competitiveness Index

As per the World Economic Forum's latest Growth Competitiveness Report, 2002-03, India was ranked 48th in the Growth Competitiveness Index (GCI) during 2002, which is much lower than that of other Asian countries like Malaysia (27th), Thailand (31st), and China (33rd). Nonetheless, India's overall position on the GCI improved by 8 positions in 2002 from 56 in the previous year. More significantly, in terms of technology ranking, India's ranking at 57 in 2002 represents an improvement of 8 places from the earlier ranking of 65. This compares favourably with China's ranking of 63rd during the same period.

FDI in India

Since the early 1990s, FDI inflows in India have witnessed a robust rising trend, reflecting primarily the liberalized policy measures. From an annual average US\$ 703 million during 1990-95, FDI inflows reached a peak of US\$ 3.6 billion during 1997, and stood at US\$ 3.4 billion during 2001. During the first ten months of the year 2002 (i.e. January to October), FDI inflows were to the tune of US\$ 3.2 billion. On a cumulative basis, since 1991, FDI approved by the Government is around US\$ 76.3 billion, while the total FDI inflows add up to US\$ 31.4 billion.

India's FDI inflows as a percentage of total GDP is quite low in comparison with other developing countries. Despite being the 12th largest economy in the world in terms of GDP, India was able to attract FDI equal only to 0.9% of its GDP in 2001. In contrast, FDI inflows into Vietnam were 6.8% of its GDP in 2000, Malaysia – 3.9% of GDP. Similarly, China attracts FDI equal to 3.8% of its GDP. Thailand, which has a relatively low FDI-GDP ratio among the major developing country recipients of FDI, had a ratio four times that of India in 2000.

India's FDI inflow data is largely under estimated. India's FDI inflow estimates, in the Balance of Payments, do not include reinvested earnings (by foreign companies), inter-company debt transactions (subordinated debt) and overseas commercial borrowings by foreign direct investors in foreign invested firms, as per the standard IMF definitions. Taking these together, India's true level of FDI could be in the range of about 8 bn (or 1.7% of GDP).

In India, FDI has been primarily targeted towards infrastructural development, with almost one third of the approvals being directed towards the power and telecommunications sector alone. Only one-fourth of total approvals were directed towards major exporting sectors like textiles, chemicals & pharmaceuticals, leather goods, transport, metallurgical industries and food processing industries. The idea is that once infrastructure is developed, attracting FDI in to export-oriented industries will become demand driven based on the competitiveness of the individual industries. We need to wait and see how the FDI flow into infrastructure industries drives the growth of FDI into other manufacturing sector.

There are misconceptions that FDI comes to India because of the presence of relatively cheap labour. Another misconception is prevalence of large market in India. MNCs look more at productivity than the low wages in any country. Besides tackling issues related to labour productivity, India should also internationally improve its image vis-à-vis its managerial skill, cost of skilled labor and their availability, degree of entrepreneurship, labor working conditions, etc.

India has one of the most transparent and liberal FDI regimes amongst the emerging and developing economies. Most of the manufacturing sectors have been on the 100% automatic route. Foreign equity is limited only in production of defence equipment, oil marketing, and government owned petroleum refineries. Similarly, most of the mining sectors are on the 100% automatic route. 100% equity is also allowed in infrastructure services such as highways and roads, ports, inland waterways and transport, urban infrastructure and courier services.

As regards the future strategies, India needs to initiate the second-generation economic reforms, mainly in terms of creating enabling conditions to sustain the inflow of FDI. If we look at the global scenario on this subject, UNCTAD has reported that in the year 2001, 208 changes in FDI laws were made by 71 countries. Of this 194 (93%) created more favourable investment climate as an effort to attract more FDI. The favourable measures taken by these countries are broadly classified into:

- Liberal entry and operational conditions (26%),
- Promotional incentives (24%),
- Guarantees (22%),
- Sectoral liberalization (21%).

The approach paper to the Tenth Five Year Plan (2002-07) has proposed an indicative target of 8% GDP growth. With an average Incremental Capital Output Ratio (ICOR) of 4.0 as witnessed in the last two plans period, the investment requirement to achieve this growth rate would be 32%. Assuming that the rate of domestic saving increases to 26%, the gap in investment requirement would still be 6% for this period. This gap has to be largely filled by FDI. This requires an average FDI inflow of US \$ 9.8 billion in the Tenth plan period.

A strategic approach could be targeting fortune firms to attract FDI. Instead of generic policies and incentives, there is a need to give firm specific policies, customised to the requirements and expectations of such companies. Emerging MNCs from developing world could also be targeted. Estimates put that there

were over 50000 MNCs by the end of 1990's. Large number of them has their origin in developing economies of Asia and Latin America.

Important element to such an approach would be:

- Ensuring that what is targeted through investment promotion is in line with firm's broader development and industrial strategies.
- Providing a package of incentives in a focused way to encourage target MNCs to invest in strategic activities (taking into account WTO rules on export subsidies).
- Involving foreign affiliates in the development and upgrading of human resources.
- Developing high quality infrastructure such as SEZs/EPZs and technology parks.
- Providing targeted support for foreign enterprises and cluster development.

Concluding Observations

Building export competitiveness is a high priority for both developed and developing countries. Given the dynamic changes characterizing key export industries and the rising competition among countries, the need for countries to continuously move up the value chain and improve the attractiveness of their locational advantages is a challenging task for policy makers in developing countries. Even traditionally significant recipients of export-oriented FDI need to keep moving up the value chain to maintain their competitiveness as an export base.

Policies to attract and benefit from export-oriented FDI should take into account the increasingly competitive environment for promoting FDI. Towards this end, countries would need to consider some key factors:

First, countries need to increasingly recognize the importance of undertaking more targeted efforts to promote export-oriented FDI. The main advantage of a

targeted approach is to improve the chance of attracting the type of investments that can help meet the development objectives of a country.

Second, in selecting the policy packages for investors, countries need to identify the most effective ones in a specific context, and also ensure that such package conform with the international regulatory framework, notably WTO rules.

Third, expanding exports is only a means to an end – to promote development. To fully benefit from export-oriented FDI and facilitate an upgrading of export-oriented activities, host countries need also to encourage linkages between the foreign affiliates and local suppliers. Linkages with foreign affiliates are a key channel for diffusion of skills, knowledge and technology among domestic forms.

To sum it up, the degree of success of a host country in attracting export-oriented FDI, and in reaping the development benefits from such investment critically depends on its ability to develop the domestic resources. Countries which have been successful in boosting export competitiveness and leveraging export-oriented FDI, have focused on developing resources while also targeting foreign investment.