THE ROLE OF FOREIGN DIRECT INVESTMENT IN UPGRADING CHINA'S COMPETITIVENESS

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ABSTRACT
This article assesses the role of foreign direct investment in upgrading the competitiveness of recipient countries with particular reference to the contemporary needs of China. In particular, it examines how this role changes as a country moves along its investment development path, and how host governments have to reorient their locational strategies in order to attract and retain the kind of resources and capabilities, which only foreign firms can provide.

Keywords: China, foreign direct investment, investment development path, competitiveness, location

INTRODUCTION

The accession of China to the World Trade Organization (WTO) brings with it huge opportunities, challenges, and responsibilities. The opportunities are largely self evident, notably for Chinese businesses to freely participate in an expanding global market, and to help shape the future structure, content and terms of world trade and investment agreements.

The challenges are no less demanding. For to fully exploit these opportunities, China must raise the productivity and export competitiveness of its industries, enhance the skills of its labor force, upgrade its legal and institutional infrastructure, and recon its economic activities. And it must do this in a way that promotes its comparative dynamic advantage, so enabling the country and its citizens to be beneficial participants in the global economy.

Over the past 30 years, the overwhelming consensus of scholarly research has shown that, provided the appropriate institutional framework is in place and the correct macro-economic policies are followed, trade, foreign direct investment (FDI), and cross border information and technology flows can play a critical role in advancing such goals.

In this presentation, I would like to share with you some of this evidence, and then recount a sample of the more recent research findings on how governments have sought to reconstruct their economic and industrial strategies in the light of the

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demands of the new global economy. More particularly, I propose to centre my remarks on three observations, each of which, I believe, is supported by extensive empirical research.

RAISING PRODUCTIVITY

Initial Observation

> *Inbound foreign direct investment raises the competitiveness of the host country industries, provided it is in response to appropriate economic policies on the part of the host government.*

My first experience in assessing the role inward FDI might play in helping to boost the economic performance of the recipient country was nearly 50 years ago when I was asked – as a young University lecturer – to document and evaluate the impact of US owned firms in British manufacturing industry on the productivity of their indigenous competitors and on the UK's export performance. The contents of this study and some related research I undertook 20 years later, may seem far removed from China's current economic needs and aspirations. But, in fact, there are several similarities, not least, that in the 1950s, the UK – like China today – after a period of turmoil and social upheaval, was struggling to re-energize its industrial machine and regain some of its earlier economic stature. Moreover, these findings have been repeated in many subsequent studies of inward FDI in respect of both developed and developing countries.

Let me just offer you a few of its key conclusions.

(i) In whatever industrial sector they produced, US manufacturing subsidiaries recorded superior levels of productivity and profitability than did their UK counterparts. Why was this? Primarily because, at the time, they were more entrepreneurial, more technologically competent, and possessed a greater fund of managerial and organizational expertise. By their presence in the UK, they also helped inject a new and welcome mentality of competitiveness and entrepreneurship into the business environment.

(ii) But to less interesting, between my first study in 1955 and the later one in 1976, the productivity and profitability gap between the US affiliates and their UK competitors considerably narrowed (Dunning 1976). This was almost entirely due to the knowledge transferred, examples set and competitive stimuli provided by the US affiliates. In addition, the spillover effects they had on the competitiveness of their UK suppliers and industrial customers were wholly positive.

(iii) The US affiliates tended to be concentrated in high growth, technology intensive and export oriented sectors. They supplied products with a high-income elasticity of demand. Over time, as the UK improved its innovatory infrastructure, they undertook more research and development activities in the UK, and gradually helped to upgrade the UK economy in a way which was consistent with tits long-term comparative advantage. Britain today is one of the most prosperous countries in Europe, and much of this it owes to inbound FDI and the global operations of its own firms.

(iv) For several years after the last war, the UK economy had been cushioned by protectionism, and the UK consumer had become accustomed to inferior quality standards. Not so the US consumer. One important consequence of the entry of US firms into the UK market, then, was that the higher norms expected of them were transferred to a UK environment. This not only benefited the UK consumer. It better enabled indigenous UK producers to penetrate more demanding consumer markets. Thirty years later, the arrival of Japanese auto and consumer electronic firms had an even more salutary effect in raising UK quality standards and consumer expectations. Indeed, Japanese foreign investors have been largely responsible for resuscitating a dying auto industry in the UK.

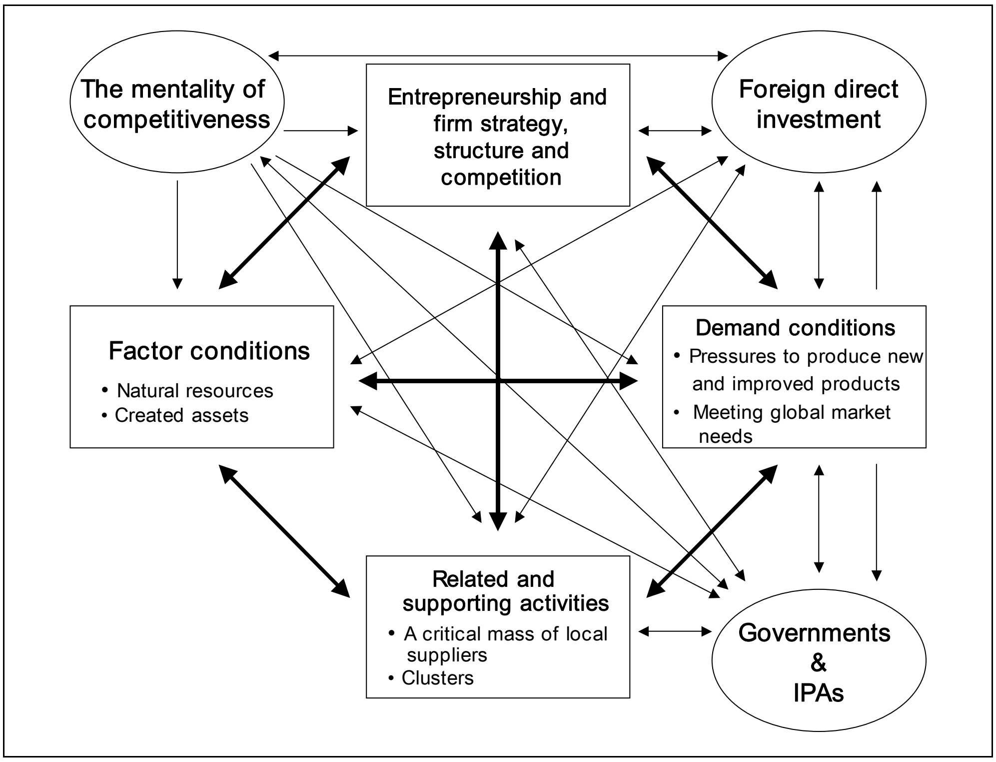
(v) Backed by UK regional policy, the US subsidiaries found it in their own interests to establish networks of related activities in particular regions of the UK – notably in the less prosperous areas and districts of above average UK unemployment. Indeed such clusters, with all the benefits now acknowledged by geographers and economists, were among the first to emerge in the post-war international economy.

(vi) The accession of the UK to the European Common Market in 1971, and the subsequent completion of the internal market of the European Union in 1993, led to a substantial increase of US direct investment in the UK – and particularly that of a high quality and export oriented variety.

In short then, the exposure of the British economy to US inward FDI in the early post-war period (and, incidentally, such investment accounted for 90 percent of all inward investment until 1960) was most wholly beneficial to its industrial regeneration. What lessons, I wonder, might China draw from that experience?

Those of you who are familiar with Michael Porter's 'diamond of competitive advantage' will recognize the contents of 1, which seeks to link the role of FDI to each of the main facets of competitive advantages I have just described. But outside the diamond and depicted by a series of circles is the *role of governments* and *investment* *promotion* agencies (IPA), and tow other 'external' influences viz *FDI* and the *mentality of competitiveness*. I will return to consider these influences a litter later in my presentation.

Figure 1. The Diamond of Competitive Advantage



Over the past 50 years, the UK experience with inbound FDI has been repeated many times over in the case of other developed and developing countries – both small and large, both liberal and coordinated market economies. In the case of China, a recent study, conducted for the IMF, has shown that, in the 1990s, inbound FDI accounted for 2-2.5 percent of GDP growth; and in the year 2000, foreign affiliates were estimated to have been responsible for no less than 48 percent of Chinese industrial exports (IMF 2002). The study also revealed that the labor productivity of these same affiliates was twice that of State owned enterprises.

Of course, there have been exceptions. Not all countries have always sought inward FDI. For example, for most of the post-war period, both Japan and India have stringently limited the participation of foreign owned firms. But with the advent of the global economy and as technology now moves more freely and speedily across national boundaries, both countries have stepped up their welcome to foreign investors. In the last five years for example, Japan has attracted seven times and India four times the FDI flows that they did in the previous five years. Central and Eastern Europe is another region of the world, where FDI inflows have risen from an annual average of $3.4 billion in the early 1990s to $23.2 billion between 1998 and 2000 (UNCTAD 2001).

The Investment Development Path

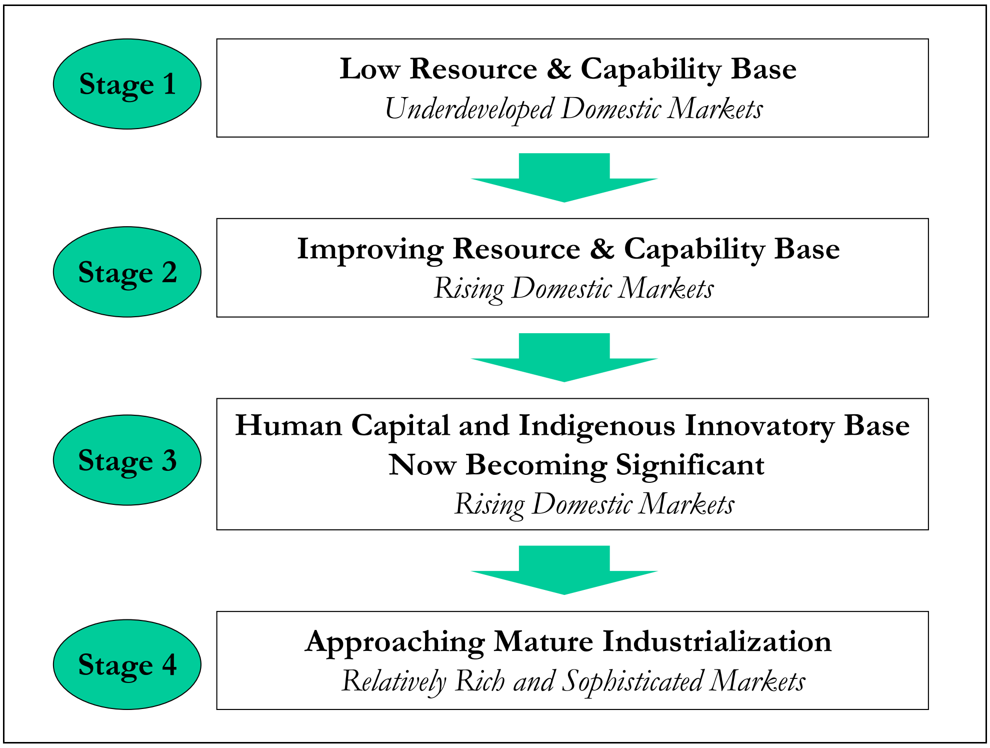
Now let me turn to the second theme of my talk. Put briefly:

> *The role FDI plays in upgrading the competitiveness of an economy is strongly related to that economy's stage and pattern of development.*

Indeed, on the basis of this assertion, it is possible to suggest the appropriate policies that governments might pursue to ensure that this role is consistent with its broader economic and social objectives. I first presented the idea about and the evidence for, and international investment development path (IDP), in respect of some 67 countries, at a Conference on Third World Multinational Enterprises in Hawaii in 1979. Using a cross sectional approach, I compared the outward and inward FDI positions of these countries with their GDP per head in the period 1967-75. In doing so, I discovered that a distinct pattern emerged. Over the last two decades, I have refined this concept and extended it to incorporate both trade and an industrial structural upgrading component (Dunning, Kim and Lin 2001). No less important, the IDP is now being used by policy makers in the formation of their structure adjustment strategies. It has also been tested, and found useful by IDAs in a variety of developing countries (Dunning and Narula 1996). I have not the time or space to develop the model fully (which I believe to be highly relevant to the Chinese situation), but Figure 2 sets out the main contents for four of its five stages. The fifth stage is currently only relevant to developed industrial countries, although I believe the advent of Internet driven communications is truncating the time scale of development quite considerably (Ozawa, Castello and Phillips 2001).

Stage 1 typifies the situation for low-income developing countries (or regions within developing countries). In this scenario, there is likely to be only a modest amount of inward FDI because of the lack of indigenous resources and capabilities and/or markets, and little outward FDI. Exports will consist of resource and/or low skilled labor-intensive products. Imports will mainly be made up of fairly standardized manufactured goods. Government policy is likely to be confined to providing the basic legal and commercial infrastructure and incentives (or protection) to local producers and foreign investors (particularly in respect of resource based activities).

Figure 2. Four Stages in the IDP & TDPs of Industrializing Developing Countries



Stage 2 is the stage in which most developing countries find themselves in today (although, in larger countries, the income of GNP per head may be greater or lesser in particular regions). Domestic incomes are now high enough and rising to attract some *market seeking* FDI – particularly that of an import substituting kind; while, as a result of an improved institutional infrastructure and the upgrading of indigenous capabilities, there is also likely to be some export oriented FDI – mainly of processed primary products or technology and light manufactures. Partly as a result of this type of inbound FDI, the composition of the exports of recipient countries is likely to shift towards labor intensive intermediate or final products; while that of its imports is likely to contain a higher proportion of more sophisticated capital and consumer goods. There may also be some outward FDI to adjacent regions or to the more advanced industrialized countries as a means of acquiring new competitive enhancing assets or market access. In Stage 2, government policy is normally concentrated on upgrading the quality of indigenous labor and managerial capabilities; on creating an active capital market and an effective (and accountable) banking system; and on ensuring a favorable business environment for both domestic and foreign investors.

Figure 2.a. Low Resource & Capability Base – Underdeveloped Domestic Markets (GNP per capita < $2,000 (2,000 values)

Stage 1

- Exports (X) mainly in resource and/or labor intensive sector (S)
- Imports (M) mainly in medium technology intensive and consumer goods sectors

- Modest IDI, and mainly in labor or resource intensive sectors
- Limited ODI in adjacent territories
- Little intra-industry FDI

Figure 2.b. Improving Resource & Capability Base – Rising Domestic Markets (GNP per capita < $2,000 - $3,500)

Stage 2

- Exports (X) still mainly in resource and/or labor intensive sector but increasing in medium technology sectors and services
- Imports (M) as in stage 1, but some also in more advanced technology sectors

- More IDI, and mainly in medium technology and consumer goods sectors; but also in some services (e.g. tourism)
- ODI beginning mainly in labor or resource intensive sectors
- Intra-industry FDI insignificant

Stage 3 is perhaps the most interesting one, and taken together with Stage 4 – for at least parts of the economy – is likely to be the most relevant one for the future of the Chinese economy – particularly in the larger cities and coastal areas. What we see here is a large and increasing domestic market which draws in *market seeking* FDI to supply those products which the investing country (ies) earlier had a comparative advantage in supplying; while, because of enhanced indigenous skills and managerial talent, there is an increasing tendency of foreign firms to engage in the higher value stages of export oriented activities. Because of the upgrading of domestic resources and capabilities, indigenous firms are now beginning to exploit their foreign markets by outbound FDI and/or cross border cooperative ventures; as well as seeking new outlets for increasing their own competitive advantages. An increasing proportion of exports now consist of medium to high technology intensive goods and services.

Figure 2.c. Human Capital and Indigenous Innovatory Base Now Becoming Significant – Rising Domestic Markets (GNP per capita < $3,500 - $8,000)

Stage 3

- Exports (X) now increasingly consist largely of medium technology goods and services. Resource intensive exports becoming relatively less important
- Imports (M) mainly consist of higher income consumer goods and technology intensive intermediate products
- Intra-industry trade beginning to become significant

- IDI now upgraded to supply more skill intensive goods and services
- ODI increasing in medium technology and some asset-seeking ODI in technology intensive sectors
- Intra-industry FDI beginning to increase

Figure 2.d. Approaching Mature Industrialization – Relatively Rich and Sophisticated Markets (GNP per capita $8,000 >)

Stage 4

- Exports (X) now mainly or higher income and medium to high technology goods and services
- Imports (M) are mixed, as some labor and resource intensive products are now cheaper to import than produce domestically. But import of more sophisticated consumer goods are rising
- Intra-industry trade is a growing percent of total trade

- IDI increasingly concentrated in more technology intensive goods sectors and information intensive service sectors
- ODI rising faster, and sometimes exceeding IDI; ODI more concentrated in medium and high technology goods and services; asset-seeking ODI continuing to grow
- Intra-industry FDI is now becoming an important component of all cross-border FDI flows

In these stages too, and especially in large countries like China and India, there is likely to be increasing regional specialization of economic activities; with agglomerations or networks of related activities such as the Bangalore cluster of software firms in India, and the Hong Kong cluster of financial services in South East Asia (Dunning 2000). In Stage 4 too, there is likely to be a sharp increase in innovatory related activities. Often foreign owned firms play a critical role in fostering such activities – particularly as part of their global or regional strategies. But so can (and do) national and regional governments, partly by their willingness to upgrade the supporting infrastructure for higher value activities, and partly by the framing of a positive FDI policy, and partly by offering the appropriate tax and other incentives for their indigenous firms to be more innovative and seek out new markets, and for individuals to be more entrepreneurial and upgrade their native skills.

Regrettably, I do not have the time or space to pursue these thoughts, or the contents of Figure 2, further, but I do believe that the idea of the IDP has relevance not only for national governments but for sub-national administrations and investment promotion agencies. Of course no one region or district – let alone one country – is precisely like another; and the shape and character of the IDP, and the speed by which one moves from one stage to the next is likely to be strongly contextual. But is does have general applicability, in so far as the form, extent and content of FDI and its impact on a nation's competitive position is likely to vary as development proceeds. SO, indeed, will that part of the development process and the strategies of foreign investors that it is within the power of host governments and IPAs to influence. And it is to this latter question that the third part of my presentation will turn.

CHANGING LOCATIONAL NEEDS OF FOREIGN INVESTORS

The third theme of my talk may be expressed as follows:

> *The advent of the global economy – and, in particular, the reduction in all kinds of spatially related costs, the growing importance of information and knowledge as the key components of the wealth creation process, and the emergence of cooperative alliances as a major form of cross-border economic organization, - is critically affecting both the locational strategies of business corporations, and those of governments of countries (and regions) as they seek to attract and retain the kind of value added activity best suited to their needs and capabilities.*

It is sometimes said that globalization is reducing the role and authority of national governments, and particularly so in the case of smaller nation states which are part of a regional union (e.g. Belgium in the EU). On the one hand, supranational entities e.g. the WTO and the World Bank seem to be taking over some of the responsibilities previously assumed by national administrations. On the other hand, in large or medium size countries like the US, China and the UK, one sees an increasing devolution or decentralization of (some of kinds of) economic decision taking to sub-national authorities. In the European Union too, *subsidiarity* is very much the name of the game!

At the same time, there is a general consensus among international business scholars that it is not so much that the economic tasks of national governments have become less extensive or important, but that the contents and prioritization of these tasks have changed. This view is based on the fact that it is increasingly the case that the attractions of countries to inbound foreign investors rest mainly in the possession of resources, capabilities and markets which are (a) location bound, i.e. immobile across national borders and (b) which critically affect the ability of domestic and foreign-owned corporations, whose own resources and capabilities tend to be mobile, to combine the two sets of assets in the most productive way.

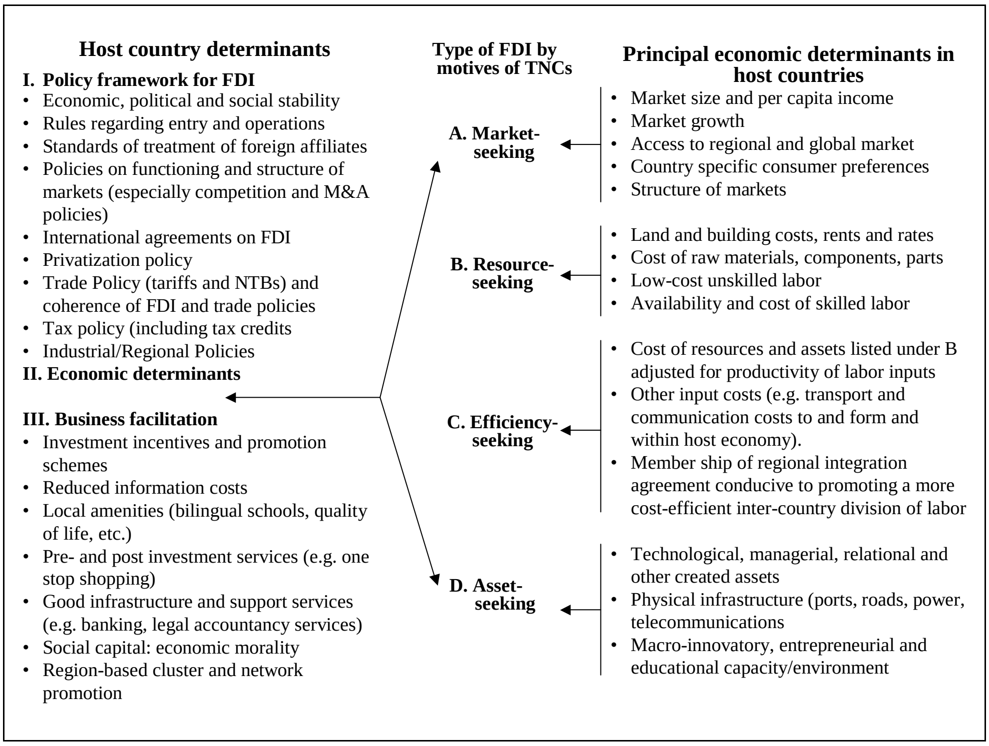
And the critical point here is that it is governments – whatever their political shade – which bear the major responsibility for creating and enhancing the value of these immobile assets – an increasing proportion of which are public goods. Even in such liberal market economies as the US, Federal or State governments control expenditure on education, pre-industrial R&D, transport and defense, health services and the environment (Donahue 1977). By such expenditures and by their monetary and trade policies, they can and do critically affect the locational attractiveness of the US (or parts of the US) to foreign investors (Doresmus, Keller, Pauly and Reich 1988). And, perhaps most important of all, as the experience of Japan clearly shows, is the culture, or mentality of a country's people and institutions towards the dynamics of market forces and technological change, and the demands of the global economy.

There is also accumulating evidence that the state of personal morality and the ethics of institutions has recently become an important locational determinant of firms. Consumers now are becoming more environmentally conscious; civil society, in the guide of a plethora of NGOs, is forcing both national governments and supranational agencies to think again on the 'rules of the game' underpinning global capitalism – and particularly on its implications for democratic governance and social inclusivity.

Many empirical studies, including one recently carried out by the (London based) *Economist Intelligence Unit*, are now suggesting that FDI inflows are extremely sensitive to the policy framework and the business environment of host countries. Among the positive variables, identified by the EIU in its 2002 survey, are the degree to which private property rights (including intellectual property rights) are safeguarded, the consistency, transparency and fairness of the legal, financial and tax system, the quality of the institutional infrastructure, 'one-stop' shopping for potential foreign investors, and a positive and welcoming attitude by IPAs. Among the significant negative factors listed i.e. those deterring FDI, are social unrest, the extent of crime and economic immorality, the level of corruption, the risk of expropriation of foreign assets, exchange controls, and an unfavorable macroeconomic environment. The value of each of these factors, you will observe, are primarily within the domain of government to influence; and such responsibilities, far from being diminished by the access of China to the WTO, have been considerably heightened.

So turning to Figure 3, we can see that foreign investors are not only concerned with the economic characteristics of host countries – which are, as indicated, often specific to the particular kinds of FDI (set out to the right of the Figure) but to the policy framework and business environment. Of those identifies, the ones shaded have, I believe, become more important over the past decade. Most of the determinants apply, to a greater or lesser extent, to all countries and regions, but some – such as the extent and content of privatization schemes and the quality of the institutional infrastructure – are particularly critical to transition economies and to developing countries or regions in the earlier stage of the IDP.

Figure 3. Host Country Determinants of FDI



Source: UNCTAD 1998.

I would like to make one final point. In a very real sense, governments of countries and regions are like business corporations. They are continually attempting to identify and upgrade their unique and sustainable competitive advantages. Moreover, in the light of frequent technological change and the demands of a dynamic, uncertain global economy, they regularly need to reappraise and recon their modes of governance. In the case of global business corporation, this, for example, has involved a reorientation of their governance profiles – as their *ownership* of non-core resources and capabilities has become less important than their *access* to them (Rifkin 2000), and as they have pursued more holistic and integrated product and investment strategies. But it is also involving a greater delegation of decision taking from the parent company to its subsidiaries to meet the specific needs of the local market place.

In the case of national governments, it has meant not only a reappraisal of the means by which the indigenous resources and capabilities for which it is responsible can be better deployed and upgraded, but also of the best ways to design and implement policy within a new global framework of shared sovereignty and inter-governmental alliances. And, as the Japanese business consultant Kenichi Ohmae has observed (1995), it is leading to a more active role being played by sub-national authorities in their efforts to attract inward FDI – most noticeably, as we earlier suggested, to fostering clusters of related value added activities.

It is such opportunities and challenges as these, which are facing China as it seeks to move along and up its IDP and TDP. I, for one, am fully confident that its people and institutions will readily rise to these opportunities and challenges; and, in so doing, will use all their considerable skills, wisdom and determination to turn it to their own – and to the global economy's – lasting benefit. I wish them well in this daunting, but worthwhile task.

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