Foreign Direct Investment in Transition Economies: Strengthening the Gains from Integration

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LSE

and

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University of Bath

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Objective

- To review the literature in order to understand factors leading MNEs to invest in transition economies
- To analyze the impact of their investment, in terms of the impact on local firms and via horizontal and vertical spillovers
- To provide policy recommendations for host economies about how to influence FDI to increase diversification and integration of the transition economies of South Eastern Europe and the CIS
Outline of Presentation

- Introduction
- The pattern of FDI into transition economies
- The determinants of FDI to transition economies
- The potential impact of FDI
  - Macro-economic
  - Horizontal spillovers
  - Vertical spillovers
  - Diversification
- The impact of FDI on Transition Economies
  - On acquired firms
  - Spillovers
- Policy implications
Introduction

FDI undertaken by MNEs in pursuit of their own strategies, not consideration of political or development agendas

Ghemawat (2007) identifies three MNE strategies in global economy

- **Adaptation**: adjusting to differences around the world and activity locally in each country
- **Aggregation**: centralizing parts of their operations regionally or globally for scale economies and to integrate innovation
- **Arbitration**: moving goods/services from high to low cost areas i.e. offshoring, global sourcing
Nature and pattern of FDI in transition economies

- Level of FDI to transition economies relatively low in early years (Table 1)
- FDI highly concentrated to Czech republic, Hungary and Poland initially
- Increase in FDI to CIS and Balkans since 2000, but still highly concentrated to resource rich economies (Russia, Azerbaijan, Kazakhstan)
- Sectoral distribution in Bulgaria and Russia. Most FDI to tertiary sector. In Russia, oil and gas predominated initially (tables 2 and 3)
Table 1: FDI Flows to Transition Economies ($bn)

<table>
<thead>
<tr>
<th>Region</th>
<th>1990-2</th>
<th>1993-6</th>
<th>1997-00</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Europe</td>
<td>6</td>
<td>24.9</td>
<td>62.5</td>
<td>17.5</td>
<td>21.5</td>
<td>8.3</td>
<td>16.3</td>
<td>29.5</td>
</tr>
<tr>
<td>Of which Czech Rep</td>
<td>1.7</td>
<td>5.5</td>
<td>9.1</td>
<td>5.4</td>
<td>8.3</td>
<td>1.9</td>
<td>3.9</td>
<td>11.6</td>
</tr>
<tr>
<td>- Hungary</td>
<td>3</td>
<td>10.2</td>
<td>8.1</td>
<td>3.6</td>
<td>2.6</td>
<td>0.9</td>
<td>3.7</td>
<td>3.1</td>
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<td>- Poland</td>
<td>1</td>
<td>5.0</td>
<td>14.6</td>
<td>5.8</td>
<td>3.9</td>
<td>3.9</td>
<td>5.4</td>
<td>10.0</td>
</tr>
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<td>- Bulgaria</td>
<td>0.1</td>
<td>0.3</td>
<td>1.8</td>
<td>0.8</td>
<td>0.9</td>
<td>2.1</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>- Romania</td>
<td>0.1</td>
<td>1.1</td>
<td>4.3</td>
<td>1.1</td>
<td>1.1</td>
<td>1.8</td>
<td>6.4</td>
<td>6.6</td>
</tr>
<tr>
<td>- Serbia</td>
<td>0.1</td>
<td>1.0</td>
<td>1.0</td>
<td>0.2</td>
<td>0.1</td>
<td>1.3</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>CIS</td>
<td>-</td>
<td>12.8</td>
<td>30.4</td>
<td>4.8</td>
<td>5.0</td>
<td>5.3</td>
<td>13.7</td>
<td>12.4</td>
</tr>
<tr>
<td>Of which Russia</td>
<td>-</td>
<td>1.6</td>
<td>6.3</td>
<td>15.7</td>
<td>2.7</td>
<td>3.5</td>
<td>8.0</td>
<td>15.4</td>
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<td>- Ukraine</td>
<td>0.2</td>
<td>1.2</td>
<td>2.5</td>
<td>0.8</td>
<td>0.7</td>
<td>1.4</td>
<td>1.7</td>
<td>5.4</td>
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<td>- Kazakhstan</td>
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<td>3.0</td>
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<td>2.1</td>
<td>4.2</td>
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<tr>
<td>- Azerbaijan</td>
<td>-</td>
<td>1.0</td>
<td>2.3</td>
<td>0.2</td>
<td>1.3</td>
<td>3.2</td>
<td>3.6</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: UN (2002), EBRD Transition Report, various years
### Table 2: FDI Flows in Selected Transition Economies by Sector (% share), 2000

<table>
<thead>
<tr>
<th>Sector</th>
<th>Bulgaria</th>
<th>Poland</th>
<th>Russia</th>
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</thead>
<tbody>
<tr>
<td>Primary Sector</td>
<td>1.8</td>
<td>0.4</td>
<td>10.7</td>
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<tr>
<td>- mining</td>
<td>0.7</td>
<td>0.3</td>
<td>10.0</td>
</tr>
<tr>
<td>Secondary Sector</td>
<td>20.5</td>
<td>22.3</td>
<td>31.6</td>
</tr>
<tr>
<td>- food</td>
<td>4.0</td>
<td>4.4</td>
<td>18.5</td>
</tr>
<tr>
<td>Tertiary Sector</td>
<td>74.7</td>
<td>77.3</td>
<td>67.7</td>
</tr>
<tr>
<td>- finance</td>
<td>45.0</td>
<td>21.1</td>
<td>0.6</td>
</tr>
<tr>
<td>- trade</td>
<td>7.0</td>
<td>8.0</td>
<td>19.5</td>
</tr>
<tr>
<td>- transport</td>
<td>6.6</td>
<td>36.6</td>
<td>29.9</td>
</tr>
<tr>
<td>FDI flow ($bn)</td>
<td></td>
<td>9.3</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Source: UN (2002)
Table 3: Sectoral Distribution of FDI Stocks, 2000 (% shares)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Bulgaria</th>
<th>Poland</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Sector</td>
<td>1.4</td>
<td>6.8</td>
<td>15.6</td>
</tr>
<tr>
<td>- mining/petrol</td>
<td>1.2</td>
<td>6.5</td>
<td>15.1</td>
</tr>
<tr>
<td>Secondary</td>
<td>51.9</td>
<td>39.3</td>
<td></td>
</tr>
<tr>
<td>Tertiary</td>
<td>45.7</td>
<td>59.9</td>
<td>46.2</td>
</tr>
<tr>
<td>- finance</td>
<td>7.3</td>
<td>20.3</td>
<td>1.3</td>
</tr>
<tr>
<td>- trade</td>
<td>19.2</td>
<td>16.9</td>
<td>10.7</td>
</tr>
<tr>
<td>- transport/communication</td>
<td>12.3</td>
<td>9.9</td>
<td>27.5</td>
</tr>
</tbody>
</table>

Source: UN (2002)
Determinants of FDI in transition economies

- Develop and test formal econometric model of factors driving FDI

- Literature indicates key determinants include
  - Host economy locational factors i.e.
    - Institutional development
    - Market size
    - Input costs
    - Investment risk
  - Source economy factors i.e.
    - Size (scale economies)
    - Level of development
    - Costs
  - Differences between source and host economy e.g.
    - Distance (transaction cost)
Determinants of FDI in transition economies

- Bevan and Estrin (B&E) (2004) and Bevan, Estrin and Meyer (BEM (2004) test these ideas.
- Use FDI flow from source to host economy in a year as observation point.
- Source economies = EU15
- Host economies = transition economies in Central and Eastern Europe, Balkans plus Russia and Ukraine.
- Gravity-type model based around GDP of host and source economy, distance, unit labor costs and “risk” (B&E) or institutional development (BEM).
- Risk measured by risk ratings.
- Other controls include trade and capital costs.
- Institutional development measured by EBRD transition indicators.
Findings

- Positive significant effects from source and host GDP and distance – gravity effects (table 4)
- Unit labor costs effect negative and significant
- FDI and trade found to be complementary
- No effect of host economy risk on FDI
- However, institutional development matters, notably privatization, banking sector development, trade liberalization and legal institutions
- Competition policy not significant
Table 4: Determinants of FDI inflows to transition economies

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>$\text{FDI}_{i_t}$ (levels)</th>
<th>$\text{FDI}_{i_t}$ (lagged form)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\text{GDP}_{i_t}$</td>
<td>0.02***</td>
<td>0.02***</td>
</tr>
<tr>
<td></td>
<td>(3.66)</td>
<td>(3.72)</td>
</tr>
<tr>
<td>$\text{GDP}<em>{i</em>{t-1}}$</td>
<td>0.003***</td>
<td>0.003***</td>
</tr>
<tr>
<td></td>
<td>(10.65)</td>
<td>(10.45)</td>
</tr>
<tr>
<td>$r_{i_t}$</td>
<td>0.33</td>
<td>0.33</td>
</tr>
<tr>
<td></td>
<td>(0.53)</td>
<td>(0.52)</td>
</tr>
<tr>
<td>$\text{trade}_{i_t}$</td>
<td>221.70</td>
<td>293.37</td>
</tr>
<tr>
<td></td>
<td>(1.46)</td>
<td>(1.71)</td>
</tr>
<tr>
<td>$\text{risk}_{i_t}$</td>
<td>0.69</td>
<td>0.51</td>
</tr>
<tr>
<td></td>
<td>(0.33)</td>
<td>(0.33)</td>
</tr>
<tr>
<td>$\text{Distance}_{i_t}$</td>
<td>$-0.06***$</td>
<td>$-0.06***$</td>
</tr>
<tr>
<td></td>
<td>($-4.23$)</td>
<td>($-4.52$)</td>
</tr>
<tr>
<td>$\text{ULC}_{i_t}$</td>
<td>$-272.29^{**}$</td>
<td>$-255.15^{**}$</td>
</tr>
<tr>
<td></td>
<td>($-3.19$)</td>
<td>($-1.86$)</td>
</tr>
<tr>
<td>Constant</td>
<td>160.40</td>
<td>134.72</td>
</tr>
<tr>
<td></td>
<td>(1.20)</td>
<td>(0.88)</td>
</tr>
<tr>
<td>No. of obs.</td>
<td>981</td>
<td>829</td>
</tr>
<tr>
<td>No. of groups</td>
<td>198</td>
<td>198</td>
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<tr>
<td>$R^2$: within</td>
<td>0.1339</td>
<td>0.1357</td>
</tr>
<tr>
<td></td>
<td>0.2712</td>
<td>0.2672</td>
</tr>
<tr>
<td>$R^2$: overall</td>
<td>0.2163</td>
<td>0.2318</td>
</tr>
<tr>
<td>Wald $\chi^2$</td>
<td>197.52</td>
<td>187.88</td>
</tr>
</tbody>
</table>
How might FDI affect performance and integration

Parent MNE
- country of origin
- industry
- organizational centralization
- size & experience

FDI Project
- subsidiary role
- mode of entry
- centralization
- knowledge management
- ...

Knowledge

Linkage effects

Competition

Local Firms
- intra-industry spillovers
- inter-industry spillovers
- absorptive capacity
- entrepreneurship
- clusters
- ...

Natural environment
- pollution havens
- global standards
- ...

Social Issues
- 'ethical' business practices
- labour standards
- wages
- ...

Institutions
- policy framework
- FDI laws
- competition laws
- educational system
- ...

Macro-economy
- balance of payment
- capital stock
- employment
- ...

Macro-economy
Potential effects of FDI on host economy

1. Macro-economy
   - Endogenous growth models indicate that FDI might increase growth, provided sufficient “absorptive capacity” (human capital) – see Borenstein et al., 1998
   - FDI impacts positively several macro-policy variables: balance of payments, employment, investment, exports
Potential positive spillovers

**Horizontal**
- Knowledge diffusion by demonstration effects
  - Local firm observe technology and managerial practices and thus adopt it...
- Knowledge diffusion by movement of employees
  - Employees are trained in MNE, and take up jobs in local firms, or set up their own business ...
- Access to export markets
  - Utilizing channels and reputation build by MNE
- Local Supplier industries and markets for specialized inputs supporting an industry
  - Indirect benefits for firms in the same industry

**Vertical**
- Vertical linkages (as supplier or customer)
  - Direct knowledge transfer
  - Economies of scale
Potential negative spillovers

**Horizontal**
- Attraction of the most productive resources
  - Highly qualified workers may leave local firms because MNE pay better
- Loss of market share and excess capacity
  - Mainly a short-term effect as capacities cannot be adjusted immediately

**Vertical**
- Reliance on imported components (existing suppliers of the MNE) and displacement of local suppliers
- Dependency relationships
Horizontal spillovers: Study design

“knowledge flows … leave no paper trail by which they may be measured and tracked” (Krugman 1991: 53).

knowledge spillovers are difficult to quantify.

Indirect measurement:
- Relate performance changes of potential recipient firms empirically to the presence of FDI in the same industry.
- Knowledge spillovers are measured by changes in local firms productivity and the influence of FDI to the share of foreign-owned firms in the industry.
- The predominant approach in the literature of FDI spillovers: 38 studies worldwide
Horizontal spillovers: 38 studies

- 16 on developing/emerging economies,
  - Positive effects: e.g. Blomstrom (several studies) and Kokko (1996) on Mexico, Kokko et al. (1996) on Uruguay, Sjoholm (1999) on Indonesia, and Chuang & Lin (1999) on Taiwan.

- 12 on transition economies,
  - Positive effects: e.g. Liu (2002) in China, Yudayeva et al. (2000) in Russia, Sinani & Meyer (2002) in Estonia
  - Negative effects, e.g. Koning (2001) for Bulgaria, Romania and Djankov & Hoekman (2001) on the Czech Republic

- 10 on developed countries.
  - Positive effects: e.g. Caves (1974) for Australia, Globerman (1979) on Canada, Liu et al. (2002), Haskel et al. (2002) both on the UK,
  - Negative effects, e.g. Barrios et al. (2001) and Flores et al. (2000) for Southern European countries
Horizontal spillovers: 38 studies

- Cross-sectional data (19) versus panel data analysis (19, mainly recent studies).
- Firm level data (24) versus industry level data (14) as unit of analysis.
- Spillovers received by domestic firms only (23) versus spillovers received by domestic and foreign firms (15).
- Foreign presence (spillover proxy) is measured the share of foreign firms:
  - in industry employment (13),
  - in industry sales/output/value added (11),
  - industry equity and other definitions (14).
- Local firm performance – the dependend variable – is measured by:
  - output, value added or sales per employee (15),
  - the *growth* of output, value added or sales (13),
  - or other measures (10).
The effect of spillovers on firm productivity: Composite t-statistic without (T) & with (Tw) weights

<table>
<thead>
<tr>
<th>Groups of Studies (1)</th>
<th>Nr of observations</th>
<th>All Studies</th>
<th>Excluding outliers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All (2)</td>
<td>Excluding outliers (3)</td>
<td>T (4)</td>
</tr>
<tr>
<td>Developed Economies</td>
<td>26</td>
<td>23</td>
<td>19.5***</td>
</tr>
<tr>
<td>Transition Economies</td>
<td>21</td>
<td>19</td>
<td>15.0***</td>
</tr>
<tr>
<td>Developed Economies</td>
<td>22</td>
<td>22</td>
<td>2.2**</td>
</tr>
<tr>
<td>Cross-Section data</td>
<td>26</td>
<td>23</td>
<td>22.6***</td>
</tr>
<tr>
<td>Panel data</td>
<td>43</td>
<td>41</td>
<td>9.7***</td>
</tr>
</tbody>
</table>

The table above shows the composite t-statistic for spillovers on firm productivity across different groups of studies, including Developed Economies, Transition Economies, and Cross-Section data. The t-statistics are presented for both All Studies and Excluding outliers conditions, with and without weights (T and Tw, respectively).
Why would results vary? Different contexts

- Level of Economic Development
  - Developing and Transition Economies may need more of what MNE are willing to give

- Time Trend
  - Technological change may imply diminishing effect in recent years (e.g. due to tighter IPR)
## Horizontal spillovers: Meta-analysis

<table>
<thead>
<tr>
<th></th>
<th>Log(N)</th>
<th>Average time period of study</th>
<th>Dummy Developing Countries</th>
<th>Dummy Transition Countries</th>
<th>Dummy Cross-Section v. Panel Data</th>
<th>Dummy Industry level data</th>
<th>Dummy Domestic firms only</th>
<th>Dummy Spillover is share in employment</th>
<th>Dummy Spillover is share in equity</th>
<th>Dummy if Level of Dep. Variable</th>
<th>Dummy if Growth of Dep. Variable</th>
<th>Constant</th>
<th>No. Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log(N)</td>
<td>0.45* (1.74)</td>
<td>-0.026 (-0.59)</td>
<td>1.06* (1.68)</td>
<td>1.49 (1.38)</td>
<td>1.77*** (2.87)</td>
<td>1.59* (1.76)</td>
<td>- (-0.09)</td>
<td>-</td>
<td>-</td>
<td>-0.024 (-0.53)</td>
<td>-0.024 (1.55)</td>
<td>-3.60** (-2.04)</td>
<td>64</td>
</tr>
<tr>
<td>Average time period of study</td>
<td>0.44 (1.57)</td>
<td>-0.024 (-0.52)</td>
<td>1.05 (1.64)</td>
<td>1.45 (1.20)</td>
<td>1.78*** (2.89)</td>
<td>1.59* (1.77)</td>
<td>- (-0.09)</td>
<td>-</td>
<td>-</td>
<td>-0.056 (-0.08)</td>
<td>-0.046 (1.13)</td>
<td>-3.50* (-1.68)</td>
<td>64</td>
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<tr>
<td>Dummy Developing Countries</td>
<td>0.47 (1.60)</td>
<td>-0.046 (-0.90)</td>
<td>0.75 (1.13)</td>
<td>1.41 (1.37)</td>
<td>2.06*** (3.53)</td>
<td>1.35 (1.43)</td>
<td>- (-0.09)</td>
<td>-</td>
<td>-</td>
<td>0.85 (0.96)</td>
<td>0.75 (1.13)</td>
<td>-3.49* (-1.97)</td>
<td>64</td>
</tr>
<tr>
<td>Dummy Transition Countries</td>
<td>0.51** (2.05)</td>
<td>-0.024 (-0.53)</td>
<td>1.02 (1.55)</td>
<td>1.47 (1.420)</td>
<td>2.03*** (3.09)</td>
<td>1.86* (1.89)</td>
<td>- (-0.09)</td>
<td>-</td>
<td>-</td>
<td>-0.19 (-0.25)</td>
<td>0.55 (0.74)</td>
<td>-4.33** (-2.65)</td>
<td>64</td>
</tr>
<tr>
<td>Dummy Cross-Section v. Panel Data</td>
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<tr>
<td>Dummy Industry level data</td>
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<td></td>
<td>-</td>
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</tr>
<tr>
<td>Dummy Spillover is share in employment</td>
<td></td>
<td></td>
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<td>Dummy Spillover is share in equity</td>
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<tr>
<td>Dummy if Level of Dep. Variable</td>
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<td>-</td>
<td>-</td>
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<td></td>
</tr>
<tr>
<td>Dummy if Growth of Dep. Variable</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>-3.60** (-2.04)</td>
<td>-3.50* (-1.68)</td>
<td>-3.49* (-1.97)</td>
<td>-3.49* (-2.04)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
<td></td>
</tr>
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Spillovers: Meta-analysis

Predicted t-statistic by study characteristics

Base Case = Developed Country, 1995 data, n = 3425, panel data, firm level data
Figure 2: Meta-analysis of horizontal spillovers: Predicted t-statistics by characteristics of the study
Sources of variation in FDI impact

- Industry specific factors
- Entry mode:
  - JV – sharing resources of two partners can increase spillover
  - Greenfield projects – create new businesses and direct impact on employment
  - Acquisitions – change performance and spillovers for existing firms
Evidence on the impact of FDI on Enterprise Performance

- Based on Estrin et. al, 2007 survey on TFP
- Three categories of paper (C1-3) – focus on C1 (large samples, control for selection and panel data methods)
- Focus on TFP measures of firm performance
- 9 C1 studies of TFP: all show privatization to foreign owners increases TFP
- Holds in countries with stronger and weaker institutions (e.g. Hungary versus Russia)
- Domestic private ownership raises TFP but effect is quantitatively smaller than for foreign ownership
Evidence on the impact of FDI on transition economies

Horizontal Spillovers
- We have seen, evidence is contradictory
  - Meyer and Sinani, 2007, find no significant effect for transition economies, which are on the declining part of the U-shaped curve

Vertical Spillovers
- Empirically difficult to identify because requires detailed input-output data; Jovorcik 2004 does find evidence of background linkages in Lithuania. Intra-industry effects small
Direct effect of FDI on host firms positive – higher TFP, productivity, profitability

Spillovers – perhaps greater potential from vertical than horizontal – depends on absorptive capacity, entrepreneurship and bargaining power to accrue benefits to local firm

Policy implication at three levels – institutional environment, to facilitate maximum spillovers and to increase trade integration and diversification
Policy conclusions 1: Institutional environment

- Since FDI clearly benefits performance of recipient firms, need to understand factors encouraging greater FDI
- Improved institutional environment – notably legal arrangements, reduced corruption, strong property rights enforcement
- Reduced business risk – sound macro-economic policies, e.g. fiscal and monetary policy
- Privatization, allowing foreign firms to participate
- Perhaps not competition policy!
Policy conclusions 2: Spillovers

- Literature stresses role of absorptive capacity which links to quality of human capital, and of management, highlights role of education and management training policies.

- Spillovers rely on transfer of labor, skills and know how to new firms, which requires low barriers to entry in labor and product markets, e.g. support for entrepreneurship, flexible labor markets.
Policy conclusions 3: Global integration and diversification

Considerable evidence that trade openness and FDI work together. Trade liberalization enhances FDI, and openness increases the spillover benefits from FDI.

Key is to create an environment to which value enhancing MNEs wish to come and in which local firms and workers are able to maximise the spillover benefits from their investment.
Integration, Diversification and MNE Strategy

- MNEs invest abroad to achieve their own strategic goals, not those of the host economy.
- Ghemewat’s three strategies of MNEs point to policies for governments seeking to increase integration and diversification.
- Adaptation and Aggregation: requires governments to liberalize local markets and open up to trade.
- Arbitration: requires governments to encourage export centered production on the basis of local resources e.g. low cost labor, to provide a global base for MNCs.