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12. Conclusions for Economic Policy

Saul Estrin and Klaus E. Meyer

INTRODUCTION

In this final chapter, we bring together material from the surveys and cases to analyse the interrelationships between FDI and economic policy. When interpreting the qualitative and quantitative data one has to keep in mind the sample of countries chosen for the study. All four are emerging markets, with institutional infrastructure and business environments less conducive than those of any developed economies. On the other hand, they have all consistently received significant amounts of FDI in recent years, and these FDI inflows have had important impacts on domestic investment and growth (see Table 1.2). This stands in contrast to the majority of developing countries, where FDI flows are usually very modest.

Our research program was not especially well designed to address the impact of the policy environment on FDI because we concentrated our attention on firms that had made the decision to enter, rather than the full set of potential entrants. Nonetheless, our study sheds some light on these issues, particularly through the case studies that place examples of FDI into an evolving policy context. We also consider the relationship between the policy environment and entry mode, which the theoretical framework in Chapter 1 suggests will be important in determining the performance of foreign subsidiaries and the spillover benefits and costs for the host economy. We therefore start by summarising the main findings from the survey, and the implications for the policy environment and the spillover effects of FDI. We use the data to speculate on the reasons for the modest levels of FDI in our sample countries, and on the interrelationship between motives for FDI entry mode and the evolving policy environment.

Policy-makers in emerging models are usually motivated to encourage foreign direct investment primarily because of the external benefits that they yield. FDI would be of less interest if it were merely an incremental form of investment finance, especially if domestic investment were thereby crowded out. Once again, the case studies provide a rich menu of spillover benefits from FDI to emerging markets, which we analyse and compare in the third section. These are often associated with particular entry modes and motives

for entry, and there are also clearly important industry specific factors at work. Final conclusions to the study are drawn in the fourth section.

STRATEGY AND CHARACTERISTICS OF INVESTING FIRMS

Foreign investment is widely expected to have beneficial effects on host economies, yet the expectation is based on certain assumptions of what investors actually do. By incorporating strategic management and economic analysis, this study allows us to reassess whether the characteristics of inward foreign investment actually matches the expectations of policy makers and economic analysts.

It could be expected that much FDI into developing countries would take the form of outsourcing manufacture to low cost suppliers and investing to exploit location specific assets, for example, natural resources. Such investments would primarily lead to enhanced exports and balance of payments benefits. The survey reveals that this is not an accurate description of FDI into our four host economies. Around three quarters of FDI is “market-seeking” - that is, aimed at supplying the domestic market in the host country - except in Vietnam where the proportion is around 50 per cent. Moreover, the survey reveals that most foreign direct investments are small; at the time of formation the median number of workers was 40 in Egypt, 30 in India, 76 in South Africa and 85 in Vietnam, although some have subsequently grown significantly. The median value of fixed assets was also modest, ranging from $690,000 in India to $1.67 million in South Africa. Less than twenty per cent of FDI subsidiaries in each country employed fixed assets valued at more than $10 million.

Global sourcing strategies lead to the transfer of supplier relationships. Manufacturing companies often prefer to use the same suppliers worldwide, especially in the automotive industry. Thus, Honda’s investment in motorcycle assembly in Vietnam triggered further investment by its Japanese suppliers, while Behr moved to South Africa to supply the new overseas operations of its German customers. In recent years, many MNCs have shed peripheral product lines and expanded their core businesses, often by acquisition. They increasingly serve worldwide markets and reorganise their supply chain to take advantage of locational advantages worldwide (see Meyer, 2003). For example, among our cases, Heinz changed its strategy by refocusing on a narrower product line but with a large international presence, including in Egypt. For companies aiming to become global leaders in their market segment, competitive interaction with global rivals may induce early entry in emerging economies to reap first or second-mover advantages. This appears to be the motivation for Carlsberg acting soon after Heineken entered Vietnam, and NGK Ceramics following competitor Corning into South

Africa. On the other hand, some firms, including ABN Amro, have divested from selected emerging market operations as part of a global restructuring.

One can infer some important lessons for policy makers. Although many developing economies could provide low cost settings for western firms, very few countries actually succeed in attracting significant numbers of MNC's. The investment that occurs often generates little local employment, and primarily focuses on meeting the needs of domestic markets, and therefore is concentrated in large or fast growing economies. Hence, even in countries like those in our sample, with quite significant FDI flows, policymakers should not look to FDI primarily as a source of employment creation: the main benefits instead must derive from spillovers that improve competitiveness. Moreover, policy-makers need to create an infrastructure, such that investing firms can, with limited risk, take up the opportunities offered by the comparative advantage of potential host economies, for example relatively cheap labour or raw materials.

The sectoral allocation of FDI to our sample of emerging markets was also somewhat surprising. Manufacturing accounts for only 41 per cent of entry into Egypt, 59 per cent into India, 51 per cent into South Africa and 73 per cent into Vietnam. Moreover, only in Vietnam does basic manufacturing predominate; in India and South Africa a significant proportion of FDI is in capital goods, including vehicles. Financial and business services and tourism are perhaps what one might have expected, accounting for 35 per cent, 14 per cent, 26 per cent and 20 per cent of entrants in our sample respectively[60]. Thus, when thinking about FDI, policy makers should not only concentrate on the industrial sector; as the cases illustrate, spillovers often derive from developing capital markets or business services through foreign entry.

We also find that local familiarity, experience with emerging markets and integration into regional trading blocks plays an important role in the FDI process. This suggests that the problems for foreign firms operating in the more complex institutional environments of emerging markets must, to some extent, be mitigated by experience in similar economies. The case evidence confirms this finding, as we will see below. Moreover, many investors originate within the region, and regional trade and integration policies, as well as global ones, often influence location decisions. For example, we observe an increasing role of regional rather than global exports in the survey, especially in Vietnam and Egypt. Policymakers may therefore want to think more carefully about how to develop their FDI strategies in the context of regional trade policies and the development of regional groupings.

Mode of Entry

We have seen that one can distinguish between three categories of FDI: "efficiency-seeking", for example, for low-cost labour; "resource-seeking",

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for example, for raw materials and "market-seeking", for example, for enhanced sales and sales growth. Resource- and efficiency-seeking firms usually invest to export; market-seeking ones to supply the domestic market.

As noted above, a surprisingly large proportion of FDI in our sample has been motivated by market rather than efficiency- or resource-seeking reasons. Models of comparative advantage would instead lead us to expect efficiency-seeking investments, especially searching for low cost labour, to predominate in such markets. But in South Africa and Egypt, only around one quarter of FDI entrants are efficiency-seeking. Investments into India follow a split pattern, with most FDI being of a market-seeking character but with a small yet significant efficiency-seeking sector, especially in IT. Vietnam however, has a much larger efficiency-seeking FDI sector, representing a majority of all investments. This is also reflected in the sectoral distribution of FDI to Vietnam, which is more concentrated in basic manufacturing, and in the regional character of FDI source firms, disproportionately based in South East Asia. Of the exports undertaken by foreign affiliates in our sample countries, in India and South Africa around half are destined for the global market by foreign affiliates, but, as noted above, in Vietnam the majority goes to regional markets. The proportion of regionally focused trade is also growing in Egypt.

Acquisitions are the most common mode of FDI entry in developed countries. They are also sometimes argued to generate the greatest technological spillovers through technology, skill transfers and backward linkages because they directly impact on a current firm in the host economy, and thus on it's existing supply chains and distributing outlets. In our sample, we find the dominant entry mode to be greenfield and joint venture; acquisitions represent less than 5 per cent of FDI in Egypt, India and Vietnam. As discussed below, this is because appropriate acquisition targets are scarce and capital markets are less well developed. These factors may together explain the relatively low levels of FDI going to many emerging markets. However in South Africa, where the industrial and institutional structure is more mature, entry by acquisition has been more common. Compared to developed economies, foreign entrants also rely relatively more on their own resources than on what can be purchased in the local market place, either unbundled or as a bundle of resources, through acquisition. This is again a reflection of the weaker business environment in emerging markets and is correlated with the mode of entry.

We summarise the motives and entry modes among our twelve cases in Table 12.1. Nine of the twelve display a significant element of market seeking, while efficiency seeking unambiguously and solely motivates only one case firm. There are proportionately more acquisitions in the cases than the survey (five out of twelve), but greenfield / joint venture predominate. Interestingly, all the investing firms already had experience in other emerging markets. The cases clearly confirm that the business environment in the host =

Table 12.1 Motives and entry mode of twelve studies

	Name	Motivation	Mode of Entry	Prior experience in Emerging Markets
SA1	NGK	Efficiency-Seeking	Greenfield	No
	Behr	Efficiency/Market-Seeking	Acquisition	No
SA3	ABN Amro	Market-Seeking	Expansion/ Acquisition	Yes
VN1	SEAB	Market-Seeking	Joint Venture	Yes
VN2	ABB	Market-Seeking	Joint Venture	Yes
VN3	Honda	Market-Seeking	Joint Venture	Yes
	Bacardi-Martini	Market-Seeking	Joint Venture	Yes
IN2	Packaging	Market-Seeking	Joint Venture	No
IN3	ABN Amro	Market-Seeking	Greenfield	No
EG1	ECMS /	Market-Seeking	Acquisition	Yes
	MobilNil	Efficiency/Resource-Seeking	Acquisition	No
EG2	GSK	Market-Seeking	Acquisition	Yes
EG3	Heinz	Market/Resource-Seeking	Joint Venture	Yes

economies have a significant impact on the mode of entry, leading to relatively higher proportions of joint ventures and greenfields, and therefore upon the subsequent performance and impact of the investments on the host economy.

We have also explored the resources regarded by managers as important for their competitiveness. In all four countries, the three most important assets for success are found to be brands, management and technology. It is interesting, though perhaps not surprising, that these are provided primarily from the resources of the investing firm. The contributions of local firms remain largely in the province of local know-how; networks for business and distribution and marketing skills, assisting foreign firms in doing business in the host economy environment. Resourceful and entrepreneurial local firms are more attractive business partners, in whichever form of collaboration. They thus would not only attract more business relationships, but also be able to extract more spillovers from them. Policy-makers may thus aim to support local firm development as indirect means to attract FDI by building local resources, especially through education and strengthening absorptive capacities. More attractive acquisition targets may then stimulate more FDI capital inflows.

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THE INSTITUTIONAL AND POLICY ENVIRONMENT

This section aims to contribute to a better understanding of how business strategies and performance are influenced by the 'investment climate', more specifically the local institutional environment and the policy implications of the analysis. Overall, this task has been a considerable challenge because the relevant institutions seem to be very specific to each case, allowing for few generalisations (Table 12.2). We encountered a lot of discussion, or more precisely complaints, about general issues such as bureaucracy or corruption, yet the issues that actually impacted on business were often very specific to the industry, if not the firm. Arguably, this is a finding: which institutions really matter for an investment project is specific to each industry and each location, and how the specific context differs from the general norms established in mature market economies.

Before delving into specific aspects of the institutions, we discuss the assessment of the local business environment by survey respondents. In the further discussion, the institutional and policy influences on entry strategies

Table 12.2 Institutional influences on establishment of the firm

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#	Firm	Institutions influencing FDI	Impact on business strategy
SA1	NGK Behr	Industrial policy to attract FDI to this sector	Motivated the FDI
SA2	EST	No institutional influence with crucial impact	---
SA3	ABN Amro	Financial sector deregulation	Timing of entry
VN1	SEAB	FDI laws	Need for local partner
VN2	ABB	FDI laws, public sector procurement	Need for local partner
VN3	Honda	FDI laws, tariff-barriers, fiscal incentives, local content requirements	May have motivated the FDI, the choice of partner and the extent of local sourcing.
IN1	Bacardi-Martini	State-level regulation of alcoholic beverages industry	Limited foreign ownership, 74%
IN2	Packaging	General FDI liberalization	Timing of entry, initial sharing of equity.
IN3	ABN Amro	Financial sector de-regulation	Timing of entry, sharing of equity for some business segments.

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EG1	ECMS MobiNil	Telecom liberalization & regulation	Timing of entry, design of the bid for ECMS.
EG2	GSK	Regulation of pharmaceuticals industry: drug approval, pricing, intellectual property rights	May have motivated initial tariff-jumping FDI.
EG3	Heinz	Licensing of food products, investment incentives	No clear impact.

and performance of FDI projects are grouped in three categories. Firstly, as we have seen from the survey, formal institutions, such as the legal code, as well as informal ones, such as law enforcement, affect both foreign and local businesses. Secondly, capital markets are important when it comes to acquisitions as a possible entry mode. Thirdly, the cases report several incidences of sector-specific regulation being crucial for investors' entry strategy, not only in the financial sector and natural monopolies such as telecommunication, but also in manufacturing sectors such as pharmaceuticals in Egypt and alcoholic beverages in India, and almost all sectors in Vietnam.

Investor Assessments

The business environment is widely regarded as crucial in determining the scale and format of FDI, and we have seen considerable evidence of its relevance in determining the mode of entry and the balance of resources provided from the source firm or the host economy. In the survey, we explicitly investigated managers' perceptions of the quality of the host country's labour force, the quality of local inputs and the institutional and legal environment. We find managers' perceptions about many aspects of the business environment in our sample of emerging markets to be good. For example, managers' evaluation of local labour quality and availability in four skill categories from skilled manual workers to executive managers is relatively high, around or above 4, with little variation across countries or over time. Since developing economies often suffer from skill shortages this result is surprising. One interpretation is that foreign firms in our sample are sufficiently small, to avoid the labour supply constraints. Another is that they are able to attract the "pick of the crop" by paying very high wages, and filling any gaps that emerge with expatriate workers. If this is the case, the foreign investors may simply be creating "enclaves" in the host economy, and the spillover benefits for the host economy may be limited.

We have similar findings with respect to other aspects of the business environment; the quality of local inputs, in terms of raw materials and machinery; availability of real estate; the quality of professional services; and the reliability of telecommunications and utilities. The quality of most local inputs at the start of operations is evaluated modestly well, above 3 in Egypt, India and Vietnam and above 4 in South Africa. Once again, this may simply reflect the superior purchasing power of FDI firms. However it is encouraging to observe considerable improvement in the evaluation of the quality of local inputs by 2000 in the first three countries, though there is no change in South Africa. Given that all of our countries received reasonably significant flows of FDI over this period, we can infer from the data that ensuring a supply of reasonable quality inputs is a pre-requisite for FDI to

developing countries, and that policies with respect to labour skills and infrastructure, particularly of utilities, electricity and telecommunications are vital.

However, the survey reveals that managers' evaluation of the host economy's institutional and policy environment remains poor, with a high proportion of issues evaluated in the 2's (not very conducive). Moreover, except in Vietnam, there is no evidence of improvement in any of our countries. This is the area where our findings conform with external perceptions of doing business in emerging markets. The institutional environment, including the general legal framework, is typically evaluated below 3. The predictability of government policy is also evaluated very poorly. The conduciveness of central government to FDI is evaluated at 2.9 in Egypt, 3.3 in India and South Africa and 3.6 in Vietnam. Central governments are therefore regarded as failing to follow policies conducive to FDI, and the evaluation of provincial and local governments is even worse. Foreign investors do not regard many governments in emerging markets as business friendly, even in countries like those in our sample that have prioritised FDI, and the situation is not seen as having improved greatly outside Vietnam up to 2001. The survey suggests that institutional problems are concentrated in the public sector itself, and relate to unpredictability of policy, legal frameworks and complexity of the business environment. The survey only covers firms that have chosen to invest, many of which have managerial experience in similar business environments that has probably enabled them to develop mechanisms to cope with weak institutions. It seems likely that firms which are not able to manage the risks of operating in such environments instead choose not to invest.

The survey therefore suggests that the relatively weaker institutional environment in emerging markets distorts the choice of entry mode away from acquisitions and in favour of greenfields and joint ventures. The balance of resources critical to the success of the FDI is shifted away from firms and markets in the host economy, relying disproportionately on source firms. The difficulty for many western firms in resolving these problems, especially those with limited experience in emerging markets, probably helps to explain the relatively modest FDI flows to most emerging markets. For those firms that do enter, the critical issues remain the policy, legal and institutional environment, rather than difficulties in obtaining inputs.

General Institutional Environment; Formal and Informal

The "institutional framework" is a broad concept that includes both formal and informal aspects (North 1990). It influences foreign investors in establishing the range of feasible strategies, the transaction costs of alternative modes, and the need for context-specific resources. Moreover, institutions are critical for political risk analysis as even small changes in

pertinent legislation can have a major impact on profitability. For instance, local business communities dominated by state-owned enterprises, as in Vietnam, complicate business relations and may increase political risk as policy interventions may favour them in comparison to foreign investors.

The cases as well as the survey evidence point to a variety of aspects of the general policy framework that, although not aimed at FDI, are of major concern to (potential) investors (Table 12.2). Complaints about general issues such as bureaucracy or corruption were common but firms that had decided to invest (all of our sample countries) had found ways to address these. The institutional problems that really had an impact on our firms were instead very specialised to the industry, if not the firm itself. However, the cases do point to a variety of aspects of the general legal framework that are of major concern to investors. For instance, in Egypt and India the labour law has frequently been described as problematic, as foreign investors complain about the 'pampering of workers'. In India, laying-off employees appears almost impossible. Restrictive labour law inhibits FDI by acquisition as it inhibits the post-acquisition restructuring and modernisation of production processes. Bureaucracy in Egypt is still very difficult according to various studies (El Mikawy and Handoussa 2002), which creates a need for a local partner. In South Africa, the visa and immigration regulations has been frequently mentioned as an obstacle. Yet overall, the cases make few references to institutional factors inhibiting entry strategies.

On the positive side, wider policies of liberalization affecting industry facilitate FDI, and in many cases crucially influence the timing of entry. Liberalisation also changes the competitive conditions for local firms who may in consequence actively seek a foreign partner to cope with the anticipated increase in competition. At the same time, when liberalisation is still partial, foreign investors are interested in partnering with local firms that can contribute location-specific capabilities, especially for those concerned with establishing a position in the local market (Packaging, SEAB, Bacardi-Martini, Heinz).

In setting up operations, our cases provide evidence that investors do consider the national institutional framework as well as institutions at the specific investment location. Industrial policy may intentionally favour investment in special industrial zones by providing incentives such as tax and tariff exemptions, as in Egypt (Mikawy and Handoussa, 2002). Industrial parks providing infrastructure have been attributed a pivotal role for instance in the development of software clusters in India, Brazil and Israel (Commander, 2004). Moreover, the Indian and Vietnamese cases illustrate the importance of sub-national institutions at the level of states or provinces. In contrast, Egypt and South Africa are administratively more centralised such that this issue has arisen neither in the cases, nor in the domestic policy debate.

The Bacardi-Martini case illustrates the obstacles for businesses that operate nation-wide, if regulatory regimes and/or pertinent tax legislation vary within a country. The case also points to the potentially detrimental effects of sub-national competition for FDI (also see Oman (2000) who describes the situation for the Indian automotive industry). For foreign investors, complex regionally diverging regulation creates obstacles to FDI, increases costs of information gathering and negotiations, but also increases the need for local partners that help with these tasks. As a side effect, complex and de-central regulatory institutions also increase the scope for corruption.

In further analysis of the intra-country variation of FDI volumes and entry modes within Vietnam, we found a clear pattern of provinces that are more progressive in implementing liberalization and establishing effective law enforcement also attracting more FDI, in particular in form of greenfield projects (Meyer and Nguyen 2003). Formal rules are largely set at national level, but informal institutions, that is implementation of the law, vary within Vietnam and are influenced by local policy makers. Licensing decisions are made by the Ministry of Planning and Industry, and may be influenced by politics on a national level, yet recent decentralization has given provincial authorities more authority. In this process, informal institutions at the local level have become more important, including FDI promotion, promotion of market institutions and access to industrial real estate. The ability to strike a deal at local level is often seen as a disadvantage because of the potential for bureaucracy and corruption. Yet, in Vietnam and China it may actually be an advantage because the overall framework is rather restrictive and entrepreneurially minded local authorities may use their leverage to improve the business climate. Local government taking a progressive approach to reform may thus facilitate foreign investment. Thus we conclude that, for foreign investors, complex and regionally divergent regulation creates obstacles to FDI, increases the costs of information gathering and negotiations and increases the need for local partners to help with these tasks.

The Supply Side: Capital Market Development

The development of capital markets is often considered a major facilitator of mergers and acquisitions, and in consequence companies are more likely to pursue acquisition-based growth strategies where capital market institutions are highly sophisticated. The difference in entry patterns that we observe between South Africa and the other countries of our study may be related to the larger and more developed capital markets (see chapter 1), though better resource endowment of local firms provides an alternative explanation. The liquidity of capital markets, and markets for corporate equity in particular, is a function of the institutions governing capital markets, as well as the

'supply' by owners willing to sell their businesses, which in turn depends on institutions in the host economy.

Capital markets first of all may be the place where the deal is struck, as acquirers may acquire shares through the stock exchange before launching a bid to take over the firm. This did not happen in our South African cases, yet they appear to be indirectly facilitated by several capital market-related institutions:

- Stock markets provide benchmark prices for the valuation of corporate assets and entire firms.
- Information on firms is more readily available if accounting standards are sophisticated, and specialist intermediaries provide the required services, notably independent auditing. In the absence of information systems, information asymmetry between seller and buyer may create 'market for lemons problems' and inhibit efficiency of markets for corporate equity.
- Specialist intermediaries, such as investment banks, stockbrokers and even consultancies experienced with mergers and acquisitions are available to provide support services to any firm considering an acquisition. ABN Amro provides some such services in South Africa and India. Yet they withdrew from Egypt in the early 1990s and they do not have an operation in Vietnam, which is a symptom of the level of capital market development.

Apart from these capital market institutions, liquidity of markets for corporate control depends on owners of firms being interested in selling their businesses to foreign investors. This "supply side" of markets for corporate control is created by those willing to sell a good company at an attractive price. In emerging economies, a high proportion of firms tends to be owned by state-entities, or by domestic family-controlled business groups, as in India. Hence, the availability of firms for possible acquisition depends on privatisation policies and on business groups' corporate strategies.

Policy has been important in determining the opportunities for potential foreign investors in partnerships with state-owned enterprises. Most important, naturally, is privatisation, which creates a supply of potential acquisition targets. Privatisation has played a substantive role in all four countries, yet not nearly on the scale as in Eastern Europe in the 1990s. Privatisation also explains a lot of the volatility of FDI capital inflows reported in balance of payment statistics (see chapter 1). For instance, in Egypt the privatisation of telecommunications has been crucial for the establishment of *ECMS* and the take-over of mobile services from the state-owned service provider. In India, privatisation has been officially initiated in 1991, but the implementation has been slow (chapter 5). Where there has been privatisation, local Indian business groups have participated as the main bidders, quite in contrast to Eastern Europe. Hence, few FDI projects (and none of our cases) are related to privatisation in India.

In Vietnam, state-owned firms dominate the local economy, and foreign investors until recently were dependent on cooperating with them to get access to resources such as real estate and export licenses, or more broadly legitimacy with local authorities. Government policy recently encouraged state-owned firms to seek foreign partners, and thus created incentives to be proactive in building relationships with foreign investors, facilitating the creation of joint ventures in Vietnam in the 1990s (chapter 9) and in Egypt in the 1980s (chapter 3). There has been some privatisation, but not in forms that would allow foreign investors to acquire firms. However, the ABB Transformers case illustrates how a foreign investor can attain control over an existing operation in ways that resemble a partial acquisition, yet creating considerable challenges for management.

In Vietnam, acquisitions were not permitted until 1997. Initially foreign ownership was limited to 30 per cent of equity, with each foreign investor holding no more than 10 per cent; and this had to be approved on a case-by-case basis by the prime minister's office, making it practically impossible for most investors. Thus, acquisition was mainly an option for acquiring a firm previously established by another FDI firm.

Private ownership of local industry facilitates acquisitions, as foreign investors would negotiate directly with the owners without need to involve government authorities. Private owners may be willing to sell for a good price if as entrepreneurs they want to sell out their business, as Ziton to EST in South Africa and ABI and APIC to GSK in Egypt, or if business groups sell non-core business units, as in the Packaging case.

However, private ownership is no guarantee that local owners would be interested in selling the companies to foreign investors. For instance, many family-owned Indian business groups are not interested in selling their businesses. In consequence, they would have a strong bargaining position when negotiating with potential foreign investors and ask for high premiums for a local firm. The willingness of family owned businesses to sell out is a function of their corporate strategy and performance. Where local conglomerates are restructuring, their divestment of peripheral businesses may create opportunities for increase of FDI, as for instance Thailand and Korea after the Asian crisis of 1997 (Zhan and Ozawa 2001). Business groups in India do not yet seem to restructure on large scale to create more focused operations (Khanna and Palepu 1999), but the Packaging case illustrates that even in India the divestment of business groups from peripheral operations can create opportunities for inward FDI.

Thus, capital market development influences opportunities for FDI by acquisition in various ways, both in terms of institutions and in terms of the 'supply' of attractive firms that might be acquired. Since FDI in form of acquisition tends to be larger, capital market development is in particular related with the volume of FDI-related capital flows, less with the number of FDI entries. Multinational firms preferring to grow internationally through

acquisitions may choose not to invest where capital markets do not facilitate such entry, or choose an alternative mode of entry.

Thus, ironically, our study suggests that policy-makers wishing to facilitate enhanced FDI flows in emerging markets need to develop a vibrant domestic private sector economy, thereby creating acquisition targets these can then act as vehicles for skill, technology and management transfers to the wider economy. They also need to strengthen capital market institutions, increasing liquidity and developing a market for corporate control.

Industry Specific Institutions

The cases frequently refer to industry-specific regulatory institutions, rather than general societal or national institutions, when discussing institutional influences on entry strategies and performance. Examples include the industrial policy in the automotive sector, regulation of the banking sector, licensing and pricing of pharmaceutical products.

The case of the South African automotive industry represents a positive influence of industrial policy. In fact, the automotive policy may have been absolutely critical for the establishment of the export-oriented automotive components industry (chapter 8, also see Barnes and Lorentzen 2003). A key element of this policy has been a tariff regime for imports of cars and components based on local contents with import-export complementation. Local content is measured on a 'net foreign exchange usage basis, which allows export revenues to be deducted from the value of imports on which tariffs were to be paid. This industrial policy succeeded in attracting foreign investors such as NGK Ceramics and Behr, and in creating an automotive (supplier) cluster in South Africa. Local content requirements have also encouraged the development of the local supplier network serving Honda's motorcycle manufacture in Vietnam, where Japanese foreign investors have established some key suppliers.

Other industry specific policy influences arise from the removal of barriers to business. In particular, the timing of entry and the acceleration of resource commitments is determined by changes in the regulatory conditions and the liberalization of the industry (McCarthy and Puffer 1997). Where local firms control industry-specific 'rights' such as operating licenses, these institutional arrangements can induce foreign investors to choose JV or acquisition as entry mode. The importance of business licenses has declined in recent years with liberalization, yet path dependency leads to continued operation of businesses set up during the more protectionist period. In Egypt, GSK established local manufacturing at least in part to ease access to local pharmacy market and to protect international patents through a local presence. As the intellectual property rights were strengthened and the market was liberalised in the context of Egypt's association with the WTO, there were some fears that local production would be reduced. However, in the

case of GSK, the opposite happened; the operation was upgraded to become a regional supply hub for Africa, the Middle East and parts of Europe.

The banking sector is by necessity a highly regulated industry as sound banking practices are essential to ensure the functioning of the financial sector. This regulation also sets the conditions for foreign banks operating in the country, for instance by limiting the number of banking licenses, or by requiring local equity ownership or local management. The step-wise liberalization of the banking sector in South Africa and India thus created the business opportunities ABN Amro has been pursing, gradually expanding into different newly liberalised segments of banking.

Industry-specific regulation also affects entry mode as remaining restrictions on foreign ownership are often limited to industries considered politically sensitive. In India, this includes alcoholic beverages, as illustrated by the Bacardi-Martini case where foreign ownership has been limited to 74 per cent. Liberalization of such industries would see new entrants establish wholly-owned affiliates, while existing JV may, possibly after some time-lag, be converted to full foreign ownership.

For empirical analysis the industry-specificity of institutions creates a methodological problem. Since empirical studies normally control for industry-specific effects with industry dummies, these controls also capture for industry specific regulation, or other institutional arrangements that affect the particular industry only. In this way, empirical studies may underestimate the impact of institutions.

In conclusion, institutions affect foreign entry and performance in multiple ways. Yet these influences are often specific to the markets in which firms act, including output, input and capital markets, as well as the specific site of the FDI. Further studies of institutions and FDI may thus focus on industries or locations.

CONCLUSIONS

Our hypothesis in this study has been that, given the characteristics of the source firm, the institutional environment of the host economy will influence the mode of entry of FDI, and through that the performance of the enterprise and the nature of the spillovers generated for the host economy. For example, weak institutions and supply side constraints in terms of acquisition targets and capital market structures might distort entry patterns in favour of greenfield or joint venture entry modes. The literature suggests that the direct technological spillovers from these entry modes, might be more modest than from entry through acquisitions. If they acquire an existing firm, the source firm needs to work directly with existing employees, managers, technologies and supply chains, and is therefore more likely actively to upgrade these. With greenfield entry, the source firm could instead set up systems of

technology, management and input supply paralleling activities in other subsidiaries, but potentially with only limited impact on the host economy. Similarly, when JV's are created primarily to circumvent policy regulations or domestic ownership, the local partner may have little or no influence on the subsidiary which is formed, and may not have the capacity to absorb the transfers of technology and skill.

We find considerable evidence for these views in our survey. Regression analysis indicates that entry mode is associated with the business environment (see Bhaumik, Estrin and Meyer, (2003)). Moreover, as we have seen, the bulk of entry outside South Africa is either greenfield or joint venture, and the source firm supplies the majority of the resources critical to success. These patterns of entry mode are counterintuitive given that entry is usually "market-seeking", rather than representing efforts to outsource manufacture to low cost supplies or investing to exploit location specific assets, for example natural resources. With market-seeking entry, one would expect acquisitions as a predominant entry mode so the foreign firm could rapidly acquire market share and obtain knowledge of how to operate on local markets. The very low level of acquisition in our survey indicates that the supply-side constraints must be severely binding, and this is an issue of major concern for policy makers who wish to enhance the flow of spillover benefits from FDI.

The quantitative survey provides little hard evidence on spillover benefits from FDI however. We included questions about the impact of FDI on domestic firms in the sector, or up and down stream, and on training, but were unable to identify any significant patterns of spillover benefit by sector or entry mode. It is likely that this reflects deficiencies in the data rather than a substantive conclusion from the study; missing values are prevalent in these questions. Unfortunately this means that the survey data are silent on the issue of spillover benefits and their relationship to entry mode. We systematise the evidence about spillovers from the cases in Table 12.3. It can be seen that there is a considerable variation in the main areas of spillover, from traditional benefits like training, knowledge and management to capital market development, creation of clusters and assisting competition. It is clear however that most entrants were in some ways influenced by the policy environment in making their investment decisions, and that in addition to the private benefits, each investment yielded some positive external benefits to the host economy.

Liberalisation has created many opportunities for FDI, and determines in particular investor's choices of timing, equity stake and locations, including intra-country locational choices. In larger, decentralised countries like India and Vietnam, the institutions at the state or province level are often also crucial. Industry specific policies are often more important than general FDI ones

12.3 Spillovers

	Firm	Entry Mode	Spillovers
SA1	NGK Behr	Greenfield Acquisition	Development of a new industrial cluster with strong supplier networks
SA2	EST	Acquisition	Improved export market access
SA3	ABN Amro	Greenfield	Efficiency of capital markets, competition; banking infrastructure for business
VN1	SEAB	Joint Venture	Local partner use knowledge spillover to build new facility
VN2	ABB	Joint Venture	Technical training, product improve local infrastructure.
VN3 IN1	Honda Bacardi-Martini	Joint Venture Joint Venture	Waste treatment technology expected to create spillovers to local businesses.
IN2	Packaging	Acquisition	n/a
IN3	ABN Amro	Joint Venture	Efficiency of capital markets, competition between foreign banks; banking infrastructure for business
EG1	ECMS MobilNil	Joint Venture	Development of telecom industry, service to other businesses
EG2	GSK	Acquisition	Exports, from mid 1990s
EG3	Heinz	Joint Venture	Training in technology and marketing; developing farming practices, exports.

. They may be actively promoting FDI in a sector, as in the South African car industry; neutrally regulating an industry, as in the financial sector; or inhibiting FDI by over-regulation, as in the Indian alcoholic beverages industry. The presence of FDI may itself create pressures on both local firms to upgrade their technologies and on local institutions to accommodate the needs of a market economy.

There are also some interesting country differences in our survey data and cases. To a significant extent, efficiency-seeking greenfield entry has been the predominant pattern in Vietnam and for a significant minority of investments in India, notably in the IT sector. The technology spillover benefits from this mode of entry to other firms in the industry, or up and down stream, are perhaps likely to be limited, though they help to integrate the host country into the global economy. In contrast, FDI in South Africa, Egypt and non-IT sectors in India has been primarily market-seeking and more likely to be through acquisition or the formation of joint ventures. Investments of this sort may improve business performance in the host

economy by upgrading technologies, intangible assets, management capabilities and labour skills within existing organisations.

In environments where market-seeking investors predominate, foreign affiliates learn ways to operate in the local environment, often using know-how from acquired firms or joint venture partners. They may thus have little incentive to try to alter the business environment. This is perhaps the case for many firms in Egypt or India in our sample. If investment is efficiency seeking and greenfield in form, so that success requires the investors to achieve more alone, and to operate competitively on global markets, this may create powerful lobbies supporting reform to the institutional and policy structure. This is consistent with the findings from our sample in Vietnam.