

**Building Trade Capacity and Attracting Foreign Direct Investment**  
By: Dr. Francis Chigunta

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## **FORWARD**

Dear YES Family,

As our small planet becomes a global village, countries become more inter-dependent and closely bound by economic necessity and by common concerns for our collective safety, security and well-being. Trade and foreign investment continue to grow as influential means of promoting prosperity and employment around the world. Economic liberalization is transforming the face of countries like China and India, which are fast-becoming economic giants. The power of trade and foreign investment can indeed be harvested towards the creation of better jobs for greater numbers. It is the hope of the YES Campaign that we will together be able to achieve this goal.

This publication examines the twin phenomena of trade and foreign direct investment in today's world, and also the impact it has on the heavily indebted poor countries. Finally, it suggests different ways in which these powerful forces can be channeled to the benefit of the developing world.

I am deeply appreciative of the efforts of Francis Chigunta, a scholar at Oxford, who has authored this publication. He researched and examined the existing writings on the subject, and has prepared this document as a guide for us, as we go through the complementary Summit Sessions.

We hope that this will inspire you to innovate and attempt to further the work of the YES Campaign in your countries. We will do our very best to provide you with the kind of technical assistance that will best empower you to be agents of change and progress. In keeping with this aim, I would like to take this opportunity to direct you to our website where we have a wealth of relevant research material, contributed by you and by other experts in the field: [http://yesweb.org/2006/call\\_papers\\_mm.htm](http://yesweb.org/2006/call_papers_mm.htm)

The Knowledge Hub for Kenya 2006 also includes a valuable section that has been researched and compiled by our erstwhile colleague, Karina Kumari. She has carefully chosen and set-up this collection of papers, research materials and e-book materials for the Summit. These can be accessed at [http://yesweb.org/2006/other\\_pubs\\_mm.htm](http://yesweb.org/2006/other_pubs_mm.htm)

I hope that this will be of help to you as we walk through this Summit, and return to our countries, richer by virtue of our shared knowledge and experiences over the course of these few days.

Lastly, I want to thank everyone for participating and pledge my continued support to the cause of our professional development as practitioners of the art of changing the lives of individuals and communities, for the better.

In solidarity,



Poonam Ahluwalia  
Executive Director  
YES Campaign

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## 1. Introduction

Countries around the globe are adopting new approaches to growth and development based on economic liberalization and on the recognition that integration into the global economy is now their most important challenge. In particular, developing countries have increasingly come to see foreign direct investment (FDI) and international trade as a source of economic development and modernisation, income growth and employment. Countries have liberalised their FDI regimes and pursued other policies of attracting investment. They are also promoting trade liberalisation, with many addressing the issue of how to best pursue domestic policies to maximise the benefits of foreign presence in the domestic economy. This paper examines the role of foreign investment and trade in promoting economic growth and possibilities for the HIPC countries to attract FDI and promote trade, what it means, how the core competencies can be built in countries to compete with countries like India and China, and so on. The paper also address the issue of what attracting foreign and promoting trade mean in terms of youth employment. The paper begins by looking at FDI and its potential benefits for HIPC countries. This is followed by a discussion of trade, trends and benefits. However, the paper does not solely focus on the positive effects of FDI in developing countries. It also addresses concerns about potential drawbacks for the host economies, economic as well as non-economic.

## 2. Foreign Investment

Foreign investment, especially foreign direct investment, is seen as an important source of capital for developing countries. The United Nations Conference on Financing for Development (Monterrey, 2002) argues that private international capital flows, especially FDI, along with international financial sustainability, are critical complements to national and international development efforts. Whether FDI can contribute to growth and development, especially in HIPC countries, obviously depends on how the gains from investment are distributed among sectors and across society.

In the immediate post-war period, stimulated by the success of the Soviet Union, most developing countries pursued a policy of investment-led growth. The emphasis was on increasing the investment rate and not on the productivity of investment. However, many of the developing economies found that higher investment (which represents a sacrifice of current consumption) did not lead to high growth as many were faced with declining investment productivity. In recent years, many of these countries have shifted their focus from the absolute level of investment to the productivity of investment. The most important shift in this regard has been a move to trade liberalisation. In addition, most developing countries now welcome Foreign Direct Investment (FDI) as an important factor which contributes to economic growth through technology transfer and efficiency improvement.

However, there is little systematic evidence on the effects of FDI on income distribution, poverty and development, and no evidence of any direct link between FDI and poverty reduction. However, FDI can contribute indirectly to poverty alleviation by increasing national income and thus promoting economic growth, to employment creation, and to enhanced skills and technology.

### 2.1 Perceived Benefits of Foreign Investment

The benefits that foreign investors may bring to their host countries, although not guaranteed, may be vital in helping developing countries meet the challenge of integration into the competitive global economy. The major potential benefits associated with foreign investment include:

- **Technology Transfer:** MNCs typically are among the largest, most sophisticated, and competitive companies, with the resources to develop and apply innovations in materials, processes, and other aspects of manufacturing and distribution to their production and distribution facilities throughout the world. Indeed, in today's economy, major manufacturers are global actors who seek access to suppliers and markets throughout the world. Host countries that are successful in attracting MNCs will gain exposure and access to this corporate know-how, which will prove invaluable to the development of their industrial base. Local companies that establish relationships with the MNCs will be able to adapt this know-how and will learn the ways of competing in international markets. Local managers and employees of the MNC will gain similar knowledge.

- **Job Creation:** Countries with economies in transition often have high rates of underemployment or outright unemployment. Attempts to combat unemployment through such measures as the creation of public-sector jobs often prove to be unsustainable. Direct investment by MNCs creates jobs. Moreover, through the learning process described above, these jobs will provide important benefits for the local economy.
- **Export Development:** Foreign investment often leads to exports from the recipient country to nearby markets, or even to the home country of the MNC. These exports provide hard currency that is vital to sustained economic growth. Hard currency is necessary for servicing foreign-debt obligations, financing the purchase of imported products, and financing domestic investment. Indeed, this desire for foreign exchange from exports has prompted countries to lower trade barriers and integrate themselves into the global economy. Moreover, foreign investment helps countries diversify their exports. Growth in new export products, which are known as nontraditional exports, is particularly important for developing countries that have traditionally exported commodities (such as coffee, sugar, bananas). Diversification of the export base leaves a country less vulnerable to the harmful effects of a drop in commodity prices.

Poor countries on average are helped by foreign investment in the form of money, equipment, machines and factories, as well as infrastructure improvements such as roads and bridges. Without question, poor countries can be subject to abuse from foreign investors.

The potential drawbacks include the deterioration of the balance of payments as profits are repatriated, the lack of positive linkages with local communities, the environmental impact of FDI, especially in the extractive and heavy industries, the social consequences of an accelerated commercialisation in less developed countries, the effects on competition in national markets and the risk that host countries, especially small economies, may experience a loss of political sovereignty. Even some of the expected benefits may prove elusive, if, for example, the technologies or know-how transferred through FDI turn out to be ill-adapted to the host economy, depending on its current state of economic development.

Critics argue that foreign investment often leaves poor people vulnerable to the worst forms of corporate abuse. While governments in poor countries are keen to attract multinational investors, it is claimed that all too often big business is allowed to trample on peoples' rights, evicting them from their homes, squeezing them out of business and refusing to allow workers to join unions or make a decent wage.

It has also been observed that there is no automatic link between FI and growth. A report by ActionAid (2002) points to the experience of Latin America and the Caribbean in the 1990s compared with the 1970s to argue that "there is no automatic link between increased FDI and (economic) growth." FDI in the region was 13 times greater in the 1990s than in the previous period, while growth in the region's gross domestic product was 50 percent lower. The reason was that FDI was concentrated in buying state-owned assets, such as mines or telecommunications companies, rather than creating new industries that provided new jobs and technology.

On balance, the benefits of FDI exceed the costs. Benefits are, however, not homogeneously distributed across sectors and countries. Clearly, for maximising the benefits of FDI, policies matter. Many challenges befall the host country authorities, who often need to improve economic structures, infrastructure and human capital, while at the same time putting in place environmental, social and competition safeguards. Home countries' authorities do, however, share a responsibility for maximising the benefits of FDI for development, for example by pursuing policies of openness to trade and technology transfer that do not unduly hold back the activities of MNCs in developing economies. Corporate responsibility is also an issue, particularly where MNCs provide large sources of government revenue, or otherwise wield significant economic power relative to the host country authorities. This is all the more reason why underdeveloped countries should choose wisely which foreign companies they allow to come in. Furthermore, their governments should maintain some control over the activities of those companies. As many observers note, foreign investment can only bring benefits if carefully managed.

## 2.2 Types of Foreign Investment

Foreign investment can take many forms, depending on the type of investor, the investor's investment objective, and the degree of risk the investor is willing to assume. Here we look at the types of investment currently being practised in developing countries, also known as emerging markets, as well as in many developed countries.

- **Country Funds.** This vehicle has been developed to allow investors to participate in the booming stock markets of certain countries. These funds collect pools of investment capital and invest them in the shares of foreign companies available on local stock markets. The funds may be country-specific or may cover entire developing regions, such as Asia or Latin America, so as to diversify and thereby minimize the risks particular to a single country.

Investors have responded well to these funds. In recent years, some funds have enjoyed rapid growth, and there has been an overall increase in the number and coverage of funds. Some investors prefer the flexibility of being able to exit emerging markets quickly, especially in light of their volatile nature. In other countries, such as Chile, regulations may prevent foreign investors from buying stock issues directly, leaving country funds as their only vehicle for entering the market. Managed funds save investors the trouble of finding accurate information about companies in emerging markets and of monitoring conditions in those markets. Since country funds enable investors to exit markets quickly in response to changing conditions, such funds are thus often described as "hot money," a term also used to describe the funds placed by investors in bank accounts in developing countries. Because these accounts typically pay high interest rates (in response to the greater risk associated with these countries as well as the tight monetary policies commonly used to control inflation), investors tend to withdraw funds if interest rates fall.

- **Foreign Direct Investment.** In making direct investments in foreign companies and countries, investors are foregoing the advantage of rapid exit, which they describe as liquidity. They are willing to make a longer-term commitment, which involves a higher degree of risk, because they anticipate returns on their investment to exceed the costs implied in the higher risk. FDI usually involves greater amounts of capital than indirect investment (such as through country funds). Combined with the higher degree of commitment and longer investment time horizon (i.e., the length of time investors are willing to risk their capital in anticipation of the expected returns), these types of investment usually bring greater benefits for host countries than indirect investments and, therefore, are the investments that recipient countries are most eager to attract. FDI can take many forms:

- Minority stakes in host-country firms, for example, through the direct purchase of shares on the local stock exchange. These investments are often referred to as passive or portfolio investments, because the investors do not assume control of the firm's operations and may have very little input into how the firm is managed. Minority stakes in foreign firms are often obtained through privatizations of state-owned enterprises and debt-equity swaps of both private and state-owned firms.
- Licensing agreements with host-country firms. The MNC may transfer the rights to use a specific technology to a local firm, which would be responsible for production and marketing in the local market. The local firm would pay the MNC for the right to use its technology. This type of arrangement offers the MNC a low-risk way of entering a foreign market. MNCs sometimes acquire shares of local firms with which they enter into licensing agreements.
- Joint ventures are firms that are established and jointly owned by foreign investors in conjunction with local partners, usually private firms, but sometimes state-owned enterprises or even government agencies. Foreign investors may assume minority or majority positions as well as varying degrees of operational control. Combinations of foreign investors sometimes establish joint ventures in host countries to reduce the start-up costs of establishing solely-owned operations. For example, Ford (U.S.) and Volkswagen (Germany) created an automobile assembly joint-venture operation in Brazil known as Autolatina.

Joint ventures give foreign investors the advantage of a larger presence in the local market, but with less risk than would be involved in the outright purchase of a local firm or the establishment of a wholly-owned subsidiary in the host country. Joint ventures are often used by MNCs to enter new markets that are perceived as having great potential, but also as having relatively high risk. They give MNCs a chance to gain firsthand knowledge and experience in local markets as the basis for deciding whether they want to make a full-scale commitment.

- Majority stakes in host-country firms, through share purchases, privatizations, debt-equity swaps, or other techniques. This option requires a greater level of commitment from the foreign investor as well as a longer time horizon regarding expected returns. MNCs that invest in local firms provide major benefits for the firms and an economic stimulus for host countries as well. Usually, such investments will reflect the MNC's global production and distribution strategy and, as such, will accelerate the host country's efforts at integration into the global economy.
- Wholly-owned subsidiary in the host country. This option represents the highest level of risk and commitment by the MNCs and is usually reserved for the local markets seen as having the greatest profit potential. Major multinationals usually have large presences, primarily through wholly-owned subsidiaries, in the major emerging markets. These operations are usually vital components in their global production and distribution strategies.

Vehicles for foreign investment have multiplied in recent years because advances in computer and communications technologies have forged closer links among financial markets around the world and have allowed for greater innovation in the development of different investment instruments geared toward investors' needs. Our focus in this paper is on foreign direct investment (FDI). The term FDI will be used interchangeably with 'foreign investment' or simply 'investment'.

### 2.3 Global Trends and Flows of FDI

The magnitude of FDI flows continued hitting new records in the course of the previous decade, before falling back in 2001. In 1973 global foreign direct investment flows totalled just \$21.5 billion. In 2000 they reached \$1,492 billion – almost 70 times the 1973 level.

However, developing countries only attracted 30 percent of all foreign direct investment flows in 2001. More than 80 per cent of the recipients of these inflows, and more than 90 per cent of the initiators of the outflows, were located in "developed countries". Even the minority of FDI that does go to developing countries is spread very unevenly, with two-thirds of total OECD FDI flows to non-OECD countries going to Asia and Latin America. The top 20 developing countries got 90 percent of the total foreign investment, leaving the 100 other developing countries to share out the rest.

But these FDI inflows do represent significant sums for many developing countries, several of them even recording FDI-to-GDP ratios in excess of 50 per cent. In most developing countries, the manufacturing sector is by far the largest recipient of FDI. In recent years, an increasingly large share of the FDI flows has been through mergers and acquisitions. This partly reflects a flurry of transatlantic corporate takeovers, partly the large-scale privatisation programmes that were implemented throughout much of the world in the 1990s. However, in developing countries greenfield investment has remained overall the predominant mode of entry for direct investors.

### 2.4 Foreign Investment and Growth

The effects of FDI on macroeconomic growth is commonly considered the most potent source of poverty relief, particularly in the poorest countries. Beyond the initial macroeconomic stimulus from the actual investment, foreign investment, especially FDI, may influence growth by raising total factor productivity in the recipient economy. This works through two channels, namely (i) the spillovers and other externalities vis-à-vis the host country's business sector, and (ii) the direct impact on structural factors in the host economy.

Most empirical studies conclude that FDI generally does make a positive contribution to both factor productivity and income growth in host countries. It is, however, more difficult to assess the magnitude of this impact - not least since large FDI inflows to developing countries often concur with unusually high growth rates triggered by unrelated factors. As regards the question of whether FDI tends to crowd out domestic investment, thereby dampening its overall impact on growth, the evidence is generally mixed. Some studies find evidence of crowding out, while others conclude that FDI may actually serve to increase domestic investment.

In the least developed economies, FDI seems to have a markedly less benign effect on growth, which has been attributed to the presence of 'threshold externalities'. Apparently, developing countries need to have reached a certain level of development in educational and infrastructure levels before being able to benefit from a foreign presence in their markets. An additional factor that may prevent a country from reaping the full benefits of FDI is imperfect and underdeveloped financial markets. Weak financial intermediation hits domestic enterprises harder than MNCs, and may in some cases lead to a scarcity of financial resources that effectively precludes them from seizing the business opportunities that arise from the foreign presence. Foreign investors' participation in the infrastructure and financial sectors can help on these two grounds.

The extent of **technology transfer** through the presence of MNCs is a crucial point, not least since multinational enterprises are among the world's most important players in creating and developing technology. Since many cutting edge technologies are not taken to the market, developing countries have increasingly come to view investment as one of the most important means to acquire knowledge and upgrade their domestic production base, as well as to improve the environment. Current empirical evidence would appear to support the following generalisations:

The most frequent channel for technology benefits to the host economy from FDI works via the vertical linkages that MNCs create. MNCs attempt to minimise the value of explicit and implicit transfers toward their host country business partners, but they are rarely able to wholly avoid them. Backward linkages (with suppliers) are found to contribute to the technological level of suppliers though MNCs' demand for quality improvements, which in many cases even induces foreign-owned enterprises to train their subcontractors and suppliers. Forward linkages (with clients) are particularly important where MNE presence makes a higher quality of input goods available to the host country business sector. An additional route for technology transfers are horizontal linkages, whereby competing host country enterprises learn via demonstration or direct competition. Also, recent studies have concluded that labour migration (trained employees shifting employment from MNCs to domestic companies, or setting up their own enterprise) is important.

There are significant differences between host countries' ability to benefit from technology transfers from various kinds of FDI. In particular, if the relative difference between the technological level of host country enterprises and MNCs (the "technology gap") is large technology transfer is usually impeded. In addition to the relative levels of technology, an absolute minimum of human capital is found to be crucial if domestic enterprises are to be able to appropriate foreign technology. These findings are observationally equivalent with the externalities thresholds identified in the economic growth chapter.

However, concerns have been voiced that the technologies transferred by MNCs, being usually enterprise specific, are often ill-suited to the host economy at large. An even graver concern, particularly to emerging economies, is the risk that the takeover of a national technology-intensive enterprise by a foreign competitor could actually lead to a technology transfer out of the host economy.

An aspect of FDI that affects social concerns alongside with purely economic objectives is the potential for **human capital enhancement**. The major impact of FDI on human capital appears to have occurred not principally through the efforts of individual MNCs, but rather from government policies seeking to attract FDI via enhanced human capital. Once individuals are employed by MNE subsidiaries, their human capital may be further enhanced through training and on the job learning. Those subsidiaries may also have a positive role on human capital enhancement in other enterprises with which they develop links, including suppliers. To the extent that human capital is thereby

enhanced, this can have further knock-on effects both as that labour moves to other firms and to the extent that it leads to employees becoming entrepreneurs. Thus, the issue of human capital development is intimately related with other, broader development issues. Nevertheless, the following general points can be made:

Human capital enhancement may be related in various ways to the issue of the transfer of technical knowledge. In some Asian economies there has been a rather low level of transfer of both technical knowledge and management techniques, and also of training in general, as the majority of FDI inflows has been in low to medium technology industry that does not require much skill. Even in the high technology sectors, the wide technology gap has inhibited the ability of the local employees to learn, either because the gap is so great that it is hard to bridge, or because the perceived gap simply deters MNCs from attempting to bridge it.

The most important point for policy makers lies in the interaction between for human capital development and technology diffusion. Policies to further the latter will inevitably involve action by government and other public agencies to enhance human capital, as requirements and opportunities become apparent. Also, technological diffusion will increase the incentives for companies to take a stronger interest in human capital enhancement. Finally, such policies could serve to attract, in particular, FDI into relatively high value added areas.

In the field of employment, the presence of MNCs have the potential, but not the certitude, to raise labour standards a part of the way toward the levels prevailing in the investors' home countries. Also, while the overall employment effects of FDI are not always clear, a higher share of employment by MNCs in developing countries often lifts members of the labour force out of the informal and into the formal economy.

The relationship between FDI and **corporate sector competition** is a complex one. Clearly, the entry of foreign competitors in itself acts to raise competition, particularly in economies where competition policies are weakly enforced and market incumbents assert undue influence on pricing. On the downside, however, a higher incidence of strategic alliances, higher concentration ratios and, in some cases, higher entry and barriers have raised host country concerns about their domestic competitive environment.

However, the benefits of MNC entry via competition presuppose that domestic enterprises are sufficiently healthy to face the foreign competitors (or, alternatively, that the host market is large enough to accommodate several MNCs). In some well-documented instances, a few MNC entrants have crowded out all the domestic competitors. While this need not be a problem if the host markets are fully contestable, developing countries' experience show that it can be a significant problem in practice, and the development of an adequate competition law framework is necessary. There may also be a need to accompany competition policies by policies to enhance the competitiveness of domestic sectors (e.g. eliminating obstacles to business development such as excessive regulation).

Finally, the successful introduction of competition may have a negative short-term effect on the host countries' employment rates, but in the longer term this trend should be reversed by the stronger economic growth stemming from more competitive markets. This accentuates a general need for labour market flexibility, and it may present national authorities with difficult policy choices.

### 3. Foreign Investment and International Trade

There is a strong link between foreign investment and trade. This is mostly through the role of companies. Companies play a vital part in international trade - in most cases it is companies that actually do the trading. However, not all companies are of equal importance in international trade. Transnational corporations (TNCs) or MNCs are companies whose operations extend beyond the boundaries of the country in which they are registered.

In recent years, the number of MNCs has grown rapidly. In 1970 there were 7,000, today there are over 60,000. They are also growing in size. The top 500 companies in the world are all worth over £7 billion (larger than the annual income of all but three African countries). In 1998 the annual turnover of BP was larger than the income of all the least developed countries combined.

All this makes MNCs very important players in international trade, accounting for upwards of 70 per cent of world trade. Around one-third of international trade doesn't even involve anyone outside these companies - it takes place solely between different parts of the same TNC.

Of the largest 100 economies in 1999, nine were countries and 51 were companies.

Not surprisingly, governments in poor countries are keen to attract multinational investors – as they can bring much needed capital, jobs, new technology and managerial skills, helping to raise the standard of living for many poor people. As these countries sweep aside the state-dominated, inward-looking approaches to development that were in vogue in both developing and developed countries, they have abandoned antagonistic views toward MNCs as well.

Countries that had previously spurned foreign investors are welcoming them with open arms. Even North Korea, for many years one of the world's most isolated countries, has begun to open its doors in search of foreign investment, particularly from neighboring South Korea and Japan.

### **3.1 Potential Benefits of Trade**

International trade can reduce poverty by increasing incomes and providing people with the things they need to live a healthy and productive life.

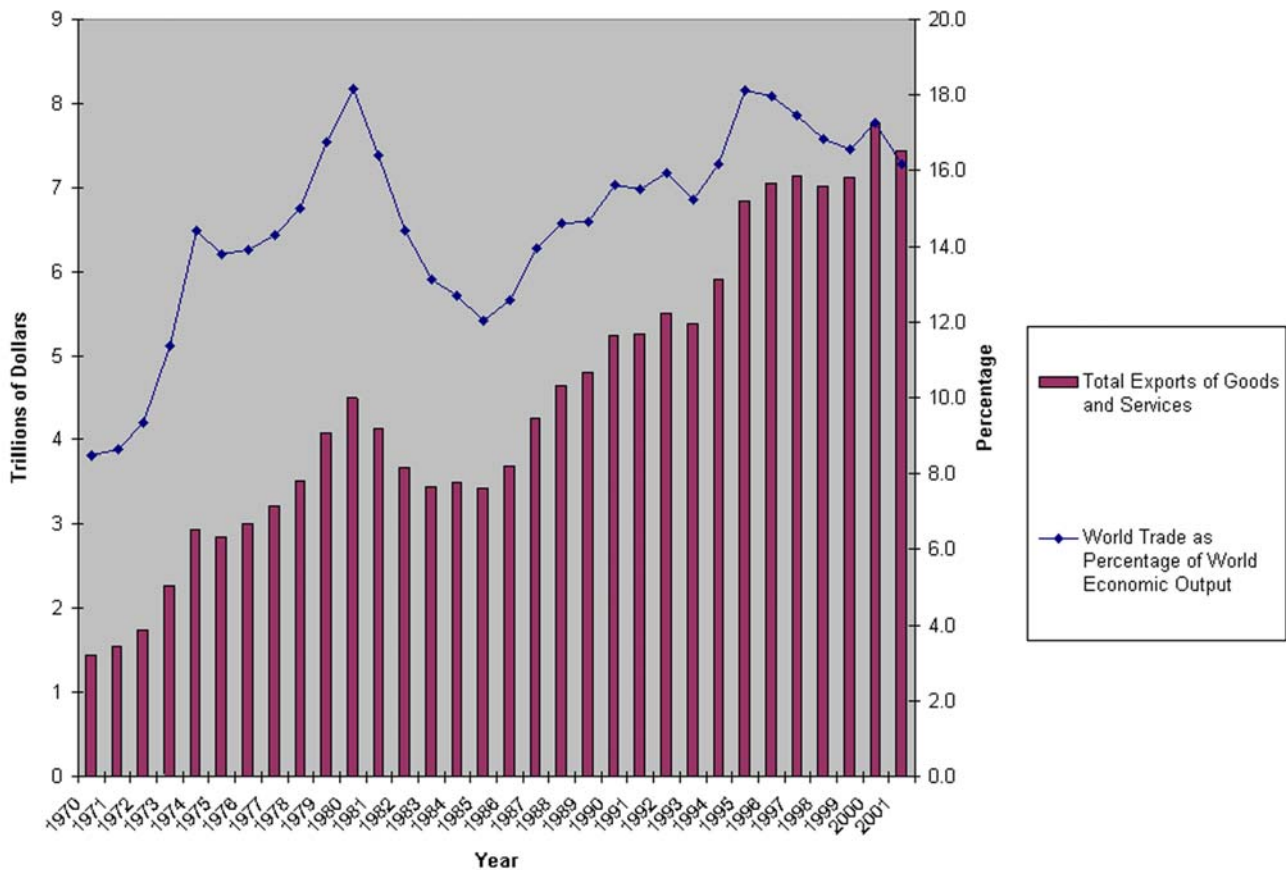
- International trade can contribute to reducing the price of products in poor countries, making them more affordable to those most in need.
- International trade can also give poor countries access to goods that are not locally available - for instance, raw materials that can be combined with other goods to produce a final product; machines with new technology that enable less expensive or less environmentally damaging industry; or new medicines that can combat disease and illness
- International trade can give poorer countries access to the much larger and wealthier markets in rich countries. It can give them the potential to sell more products and at a higher price than they could if they were only trading locally.
- International companies may set up in a poor country in order to produce products for trade. Managed properly this can bring new investment, employment and training in new technology.

The experience of some countries, such as South Korea and Taiwan, shows that with the right international conditions, and the right domestic economic policies, countries can use international trade to develop at unprecedented rates. However, for these processes to bring the desired positive effects, they do need to be carefully managed.

### 3.2 Trends

The value of international trade has increased more than tenfold since 1970 and is now worth over £11.5 billion every day.

**Figure 1: World Trade as a Percentage of Gross World Product (1970 – 2001)**



Source: World Watch Institute  
Graph by Tom Hale, July 2003

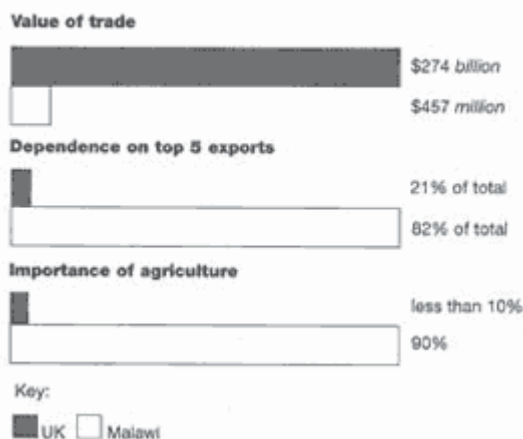
International trade involves individuals, companies and governments - all buying and selling from each other. However, governments are responsible for setting the conditions in which all this trade happens. For instance, they can decide how much trade takes place and who is involved; they might charge taxes on some forms of trade but offer subsidies for others.

### 3.3 Share of Countries in International Trade and Tradable Commodities

Rich countries dominate international trade. In contrast, poor countries' share of world trade is tiny. The 48 poorest countries in the world only account for 0.4 per cent of world trade. More worrying still, this share is declining rather than growing. Poor countries have seen their share of world trade halved in the last 25 years.

Many poor countries also tend to rely heavily on two or three products that may account for 75 per cent or more of their trade. This leaves them very vulnerable. For instance, if there is a sudden fall in the world price of one of these products or if a major crop is struck by disease, it could have a devastating effect on the whole economy.

### How the other half trades



In addition, poor countries are also losing out because of the type of goods they sell. Generally the poorest countries, especially those in Africa, sell raw materials. This is a problem because the price of raw materials is in long-term decline. Underlying trends, such as the development of artificial alternatives, are reducing the demand for raw materials and pushing down prices.

Significantly, producing and selling raw materials rarely involves the technology that goes into the production of manufactured goods. This is one reason why poor countries miss out on many of the latest technological developments. Although some poor countries, such as India and China, have benefited from the massive expansion of international trade in recent decades, many have not and are continuing to lose out.

### 3.4 Challenges

Conventional economic theory holds that a completely liberalized global market is the most efficient way to foster growth, because each country specializes in producing the goods and services in which it has a comparative advantage. Yet, in practice, cutting trade barriers and opening markets do not necessarily generate development. Rich countries and large corporations dominate the global marketplace and create very unequal relations of power and information. As a result, trade is inherently unequal and poor countries often experience not rising well-being but increasing unemployment, poverty, and income inequality.

An additional problem is that free trade is not equally 'free'. Agricultural subsidies and other trade barriers in the US and the EU prevent poor countries especially those in Africa, from gaining access to the most important markets, while they open up their own markets to US and EU exports. Critics of free trade point out that many of the world's richest countries sheltered their economies by protection when they were at the start of their own growth. Further, trade is so dominated by transnational corporations that new trade rules mainly benefit those companies. A number of NGOs have started to promote "fair trade," arguing that trade can promote development if it is environmentally sustainable and includes respect for human and labor rights.

Under intense pressure from the domestic textile lobby, the US administration is considering reimposing quotas on clothing imports from China. The announcement came after imports of certain types of textiles surged by as much as 1,500 percent following the expiration of a worldwide textile quota system at the end of 2004. By targeting clothing imports, the administration may also be trying to win more support for the proposed Central American Free Trade Agreement that many lawmakers from the textile-manufacturing states in the US have viewed with suspicion. (*Wall Street Journal*)

Wealthy countries like to preach free trade, yet at the same time they wish to maintain their tariff barriers against imports from poorer parts of the world. But would trade be fair if it were truly free? This *New Statesman* article

thinks so, but fails to provide any solutions to how poor countries could turn the currently unfair structures of international trade to their benefit.

According to a new report from the UN Food and Agriculture Organization (FAO), real prices of most farm products have fallen and the long-term forecasts do not look encouraging. While the lower price gives many urban consumers access to a more nutritious diet, it hurts billions of people who derive their livelihoods from agriculture, especially in poor countries that depend on a single commodity. (*UN News*).

On average, however, trade and investment benefit poor countries. Studies have shown that foreign investment is better than no investment at all. Poor countries with large infusions of foreign investment tend to be economically better off than poor countries with small doses of foreign investment.

To quote Firebaugh (2003:1):

“It is important to point out that poor countries are not poor because of foreign investment. They were poor before foreign investment came along. There is also no evidence that, when both domestic and foreign investment is made in a poor country, the domestic investor is unable to compete with the foreign investor.”

Without question, poor countries can be subject to abuse from foreign investors. However, this is all the more reason why underdeveloped countries should choose wisely which foreign companies they allow to come in. Furthermore, their governments should maintain some control over the activities of those companies.

#### **4. Investment, Trade and HIPC Countries**

In the face of inadequate resources to finance long-term development in developing countries, especially Highly Indebted Poor Countries (HIPC) countries most of which are in Africa, and with poverty reduction and other Millennium Development Goals (MDGs) increasingly difficult to achieve by 2015, attracting foreign investment has assumed a prominent place in the strategies of economic renewal being advocated by policy makers at the national, regional and international levels. The experience of a small number of fast-growing East Asian newly industrialised economies (NIEs), and recently China and India, has strengthened the belief that attracting foreign investment, especially FDI, is key to bridging the resource gap of low-income countries and avoiding further build-up of debt while directly tackling the causes of poverty.

##### **4.1 The Debt Problem and Economic Growth**

The theoretical literature on the relationship between external debt and economic growth has focused largely on the harmful effects of a country’s “debt overhang”—the accumulation of a stock of debt so large as to threaten the country’s ability to repay its past loans, which, in turn, scares off potential lenders and investors. That is, if a country’s debt level is expected to exceed the country’s repayment ability with some probability in the future, expected debt service is likely to be an increasing function of the country’s output level. Thus, some of the returns from investing in the domestic economy are effectively “taxed away” by existing foreign creditors, and investment by domestic and foreign investors is discouraged.

Debt overhang also depresses growth by increasing investors’ uncertainty about actions the government might take to meet its onerous debt-servicing obligations. As the stock of public sector debt rises, investors may worry that the government will finance its debt-service obligations through distortionary measures, such as rapidly increasing the money supply (which causes inflation). Amid such uncertainty, wary would-be private investors tend to remain on the sidelines. And even when they do invest, they are more likely to opt for projects with quick returns rather than for projects that enhance growth on a sustainable basis over the long run.

Moreover, debt overhang may also discourage efforts by the government to carry out structural and fiscal reforms that could strengthen the country’s economic growth and fiscal position, because a government whose financial position is improving almost inevitably finds itself under increasing pressure to repay foreign

creditors. This disincentive to reform would exist in any country with a heavy external debt burden, but it is of special concern in low-income countries, where structural reforms are essential to sustain higher growth.

However, not all foreign borrowing dampens investment and growth. At low levels of debt, additional foreign borrowing could stimulate growth, to the extent that the additional capital financed by this new borrowing enhances the country's productive capacity. Higher output, in turn, would make it easier for a country to service its debt. As debt and the capital stock increase, however, the marginal productivity of investment falls. In short, the negative effects of debt overhang are likely to take effect only after a certain threshold level has been reached. The empirical literature has found mixed support for the debt-overhang hypothesis.

In theory, the *service* of external public debt (the payment of interest and repayment of principal)—to be distinguished from the *stock* of external debt—may also affect growth by discouraging private investment or altering the composition of public spending. Higher external interest payments can increase a country's budget deficit, thereby reducing public savings. This, in turn, may either drive up interest rates or crowd out the credit available for private investment, depressing economic growth. Larger debt-service payments can also inhibit growth by squeezing the public resources available for investment in infrastructure and human capital. Indeed, such non-governmental organizations as Oxfam International see high external debt service as a key obstacle to meeting basic human needs in developing countries. It is in this context that the HIPC Initiative was introduced.

#### 4.2 The HIPC Initiative

Twenty-eight heavily indebted poor countries were receiving debt relief under the HIPC Initiative by mid-2004, eight years after the Initiative was launched by the IMF and the World Bank and endorsed by governments around the world, and about four years after it was enhanced to provide more substantial and faster debt relief.

The HIPC Initiative, the first coordinated effort by the international financial community to reduce the foreign debt of the world's poorest countries, was based on the theory that economic growth in these countries was being stifled by heavy debt burdens, making it virtually impossible for them to escape poverty. However, most of the empirical research to date on the effects of debt on growth has lumped together a diverse group of countries, including both emerging market and low-income countries; the literature focusing on the impact of debt on low-income countries (those with 2001 per capita gross national income of less than US\$865) is scant.

The 1996 launch of the HIPC Initiative by the IMF and the World Bank revived a long-standing debate over the relationship between foreign borrowing and economic growth. The goal of the HIPC Initiative—which provides comprehensive debt relief to poor nations struggling to service heavy foreign debt burdens—is to prevent unsustainable debt burdens from hampering development in the world's poorest nations. Indeed, one of the principal motivations for the HIPC Initiative is concern that a heavy debt burden compromises economic growth. But HIPC is insufficient to promote growth. There is a growing consensus that HIPC countries need increased private capital flows and access to international markets in order to promote sustained growth.

#### 4.3 The Need for Trade and Foreign Investment in HIPC Countries

In recent years, the developing countries have made serious attempts to attract investment. Although the developing countries have a clear preference towards official/private debt flows than foreign private capital in the form of FDI. Nationalists wished to build strong home-grown champions and feared FDI would erode sovereignty and culture. Out of the net long-term resource flows to developing countries, FDI initially constituted only a small portion in comparison to official/private debt flows. However, the situation changed drastically in the 1990s: debt flows have virtually stagnated while FDI has increased five-fold from US \$ 36 billion in 1991 to US \$ 178 billion in 2000. Today, FDI flows contribute more resources to the developing countries than the debt flows.

With the global debt crisis of the 1980s, developing economies realised the dangers of debt finance. One distinct disadvantage of debt finance is that it creates fixed debt-servicing obligations. During the debt crisis, even when the borrowing agency was a private entity, government had to eventually come to its rescue for maintaining the credibility of the country. The growing volume of FDI, the stagnating volume of debt flows, and the servicing aspect of debt finance—all have contributed to the current policy shift of the developing countries towards FDI. The developing economies have also realised that in case of foreign investment, equity needs to be serviced only if profits are made.

#### 4.4 Arguments for Foreign Investment in HIPC Countries

Growing FDI inflows promise a variety of potential benefits to HIPC recipients. FDI flows can provide a relatively stable source of finance for less developed countries, and they have tended to be considerably less volatile than other types of capital inflows for middle- and high-income countries. There are various channels through which FDI flows are thought to affect recipient countries. Notable among them are the following:

- FDI inflows tend to raise domestic fixed capital formation in the developing countries. While the link between capital inflows and investment may have weakened during the 1990s, this is probably due to shifts within FDI, toward mergers and acquisitions instead of “greenfield” investments (i.e., a firm started from scratch).
- Multinational corporations tend to pay higher wages than domestic enterprises and can offer valuable training opportunities to workers.
- FDI promotes technology spillovers as multinational corporations incorporate new technologies in their subsidiaries. As new technologies are generally developed and adapted by firms in industrial countries, FDI may be the most efficient way for developing economies to gain access to them. In addition, this knowledge may become more widely available in the country over time, as employees with experience in the techniques used in foreign companies switch to other firms.
- In the 1980s and the 1990s, a large portion of growth in trade is accounted by the intra-firm trade of the multinational enterprises. If trade is to be the engine of growth, the role of FDI cannot be overlooked.
- Export-oriented FDI could play an important role in the process of export-led industrialisation in the developing countries. Affiliates of multinational enterprises have marketing channels in place, possess experience and expertise in the many complex facets of product development and international marketing, and are well placed to take advantage of inter-country differences in the cost of production. The successful examples, which are often cited, are the newly industrialising economies.
- Finally, foreign investment could increase competition in the host-country industry, and hence force local firms to become more productive by adopting more efficient methods or by investing in human and/or physical capital.

#### 4.5 Investment Flows

The developing countries have by and large been minor players in global growth in attracting private external capital, particularly foreign direct investment (FDI). While FDI inflows to developed economies increased from US \$ 137 billion in 1989 to US \$ 1005 billion in 2000, in the same period flows to developing economies increased from US \$ 60 billion to US \$ 240 billion.

Despite the increase in FDI in developing countries to record levels of several hundred billion dollars annually during most of the 1990s, almost all of it was concentrated on only a dozen countries, particularly China. FDI from western multinational corporations far exceeded the \$50 billion or so that was provided in loans and credits from bilateral aid agencies and multilateral institutions, like the World Bank and the International Monetary Fund.

It should be stressed here that most HIPC countries, most of them in Africa, did not benefit from the increase in FDI. In 2001, 44 sub-Saharan African countries received less than \$3 billion between them. In the same year, the world's 49 least developed countries (excluding oil rich Angola) received just \$2.7 billion.

It is important to note that annual FDI flows to Africa doubled during the 1980s to \$2.2 billion compared to the 1970s. The flows increased significantly to \$6.2 billion and \$13.8 billion, respectively, during the 1990s and 2000-2003. Nevertheless, a comparison of these figures with flows to other developing regions shows that Africa receives a very low share of total global flows and flows to other developing countries, and these have been on a steady decline for three decades. Africa now accounts just for 2-3 percent of global flows, down from a high of 6 percent in the mid-1970s, and less than 9 percent of developing country flows compared to an earlier peak of 28 percent in 1976.

Related to these trends is the fact that, in contrast with all other developing countries, Africa has remained aid-dependent, with FDI generally lagging behind official development assistance (ODA). Between 1970 and 2003, FDI accounted for just one-fifth of all capital flows to Africa. However, since the early 1990s, the share of FDI has risen sharply averaging an estimated one-third of total capital flows to Africa during 2000-2003. The sharp increase in FDI in relation to ODA is also partly a reflection of the decline in aid flows to Africa.

As the 2003 UNCTAD report observes, a comparison across regions offers only a partial perspective on FDI grounds and can be misleading if not properly situated in a broader economic context. Over the past three decades, Africa's share of world output has also been falling, dropping decade by decade from 3.1 percent in the 1970s to 1.8 percent in the period 2000-2003. Africa's share of world trade also fell over this period from a high of 6 percent in 1980 to 2 percent in 2001 before recovering slightly to 2.2 percent in 2004. More significantly, income levels have stagnated: in per capita terms these are lower for the region as a whole, and for most countries, than they were in 1980.

The 2004 UNCTAD Report on Trade argues that trade liberalization has made few advances in poverty reduction. However, international trade can play a crucial role in the development of Least Developed Countries if governments in both poor and rich states undertake substantial change in the international trade system. What trade and foreign investment can bring are major economic benefits, including technology transfer, job creation, and export development. It is encouraging that countries that began by attracting investment in low technology industries like textiles and apparel (the so-called "sweatshop" industries) are now attracting investment in higher-technology industries. Data-entry and pharmaceuticals firms now operate in FTZs in the Dominican Republic, for example.

This path from low- to high-technology industrial development mirrors that followed by countries that are now major international exporters (including goods of high-technology), such as Japan, South Korea, and Taiwan. Although they did not rely much on foreign investment, they followed many of the same policies that are necessary to attract foreign investment and develop a successful export base.

This experience points to a valuable lesson for countries that now seek to promote trade and capture foreign investment. Simply put, they must create and maintain conditions that stimulate private investment, domestic as well as foreign. Private investment, whether local or foreign, will take place when the right conditions are in place. Although it is a necessary aspect of strengthening economic growth and development, domestic investment in most developing countries will not suffice by itself to finance their growth and development needs. Given the changing conditions that point to shortages in traditional sources of external capital, foreign investment must make up for the lack of indigenous capital.

Given the paucity in FDI flows to many HIPC countries, especially those in SSA, it is important to examine the determinants of FDI. This can throw light on what needs to be done in order to promote FDI in HIPC countries.

#### 4.6 Determinants of FDI

There is a large body of literature dealing with the determinants of FDI. What we shall do here is to draw upon some selected studies in an effort to identify what appear to be the main factors influencing FDI inflows. One study worth noting is UNCTC (1992), which surveys the cross-section, time series, and survey evidence on both outward and inward FDI, sourcing by multinational firms, offshore assembly and export subsidiary operations, bargaining between government and multinational firms, tax and related incentives and political risk. Some of the principal conclusions of this UNCTC study relating to developing countries are as follows.

First, even if a production process is capital or research and development (R&D) intensive, there might be a part of the process that can be carried on advantageously in a developing country. Second, regarding locational advantages, the most important factors motivating import-substituting production are market size and tariff protection. By contrast, wages and other costs appear to be important factors for inward FDI to produce for the export market. Third, tax and other financial incentives may be important after the decision by a multinational firm to invest abroad has been made, in which case incentives might determine which country will in fact be selected for investment purposes. Fourth, though offshore production and export-oriented production may not generate significant FDI inflows, there may nonetheless be positive employment and foreign exchange benefits in host countries. The study also calls attention to the impressive unilateral efforts of many developing countries in recent years to deregulate their economies and to reduce or remove tariffs and other trade barriers in order to shift resources from import-competing to export sectors.

Bajo-Rubio and Sosvilla-rivero (1994), in an econometric study of the determinants of FDI in Spain for the period 1964-1989, found that flows of inward FDI for Spain depended mostly on macroeconomic variables. But they also found that tariff reductions and accession to the European Community were important to some extent as well.

Lucas (1993) analyses the determinants of FDI inflows into countries in East and SouthEast Asia. Among his findings worth noting are: (1) FDI inflows depend more on wages than on cost of capital; (2) FDI inflows are more responsive to aggregate demand in export markets than in host country markets; and (3) political stability is an important determinant of inflows.

As a general matter, incentives designed to encourage FDI inflows do not appear to matter very much, although once it is decided to engage in FDI, the presence of incentives may affect the magnitude and geographic location of the FDI.

#### 4.7 How to promote Trade and attract Foreign Investment in HIPC Countries

Today, developing countries compete against each other for FDI by offering a range of tax and financial incentives. But what is more effective is to establish a favourable climate for investment. Below we make some suggestions on how HIPC countries can create a favourable climate for investment:

- **Local Market Characteristics.** This is the single most important factor centered on the attractiveness of the host country as a market for the MNC's products or services. The size of the local market, relative wealth or purchasing power of the population, and growth potential of these variables, as well as of the economy as a whole, comprise the most basic criteria that MNCs use to decide if a potential site merits further consideration. The country's natural-resource base and geographic location are also important in this regard.
- **Market Access.** Local laws and regulations that grant or do not unduly restrict a firm's access to local markets may enhance its earnings potential and profitability. Countries where the state exerts a large degree of control over economic activity and restricts the private sector's freedom to conduct business are not attractive to potential investors. The regulatory environment must also allow MNCs to compete on an even footing against local companies (foreign firms are often monitored more closely than their local counterparts).

- **Labor Force.** Foreign investors examine the quality of the local labor force because they must recruit their potential employees from that labor force. In many industries, particularly industries that use a high amount of labor to create a finished product (such as textiles, apparel), MNCs seek to establish plants in developing countries to take advantage of their lower wage rates. As part of their overall global strategy, MNCs may locate the labor-intensive phases of production, for almost any type of product, in low-wage countries.

It is important to note, however, that pay scales are not the only determinant of the attractiveness of the labor force. Investors also look at the quality of education in the host country, because better-educated workers will be easier to train and will reach their peak output sooner than workers who are not as well educated. Still another factor in labor-force productivity is the degree of worker absenteeism. The costs and productivity of labor are key ingredients in product competitiveness in the international marketplace.

- **Currency Risk.** The cost of local currencies in relation to the major currencies (especially the dollar) relates directly to the costs and profits of MNCs, which evaluate their financial results on a consolidated global basis against the major currencies. Since MNCs make investments in local currencies, the risk of currency devaluation affects the value of their financial assets after taxes as well as of their earnings and profits expressed in hard currencies. When the local subsidiaries of MNCs pay for imports or remit interest payments, the local currency cost will rise as the dollar and other hard currencies grow stronger relative to the local currency. Exports from host countries may serve as a hedge against currency devaluations, but MNCs can do little to combat the devaluation of assets.

Appropriate exchange-rate policy adjusts the value of the local currency on a steady, predictable basis, which contributes to economic stability and investor confidence. The valuation of the currency is important for MNCs that want to export from host countries as well as for the countries themselves, which seek to generate export earnings. Local currencies that are overvalued (i.e., that cost too much when measured in hard currencies) hurt exports from the local country, because such exports are more expensive than exports from competing countries.

- **Capital Repatriation.** Investors focus on the regulations affecting their ability to take invested capital and profits out of the host country, which they may do in a variety of ways. Relevant regulations may consist of tax rates, restrictions on the ability to take hard currency out of the country, or burdensome procedures for doing so (such as requiring permits or approvals from the central bank). Typically, local subsidiaries will transfer profits to the parent company through dividends, interest payments, or royalties and/or technical assistance payments. MNCs may also wish to sell some of their holdings of the local company. Countries that restrict these activities have less attractive investment climates than countries that allow the free movement of capital and profits.
- **Protection of Intellectual Property Rights.** Intellectual property refers to a company's ownership of the intangible as well as tangible products of its research. These include its manufacturing processes, software, and marketing techniques. In the major industrialized countries, a company's ownership rights are protected through the use of patents, copyrights, trademarks, protection of trade secrets, and other laws covering proprietary technical data. Given that a significant proportion of their assets consists of intangibles, the protection of intellectual property is a high priority for MNCs, particularly in dynamic industries such as computers, telecommunications, and pharmaceuticals, in which technology is a major competitive weapon in the development of new products and markets. Moreover, for the host countries, the attraction of these types of industries is of the highest priority, because they offer the highest potential benefits in terms of technology transfer and the development of a local high-technology industrial base. However, to attract investment in these industries, host governments must ensure the effective enforcement of intellectual property rights, avoiding the compulsory licensing of registered technology and other interventions in technology-licensing agreements between private firms.

Some countries are lax in the protection of intellectual property because companies that use proprietary technology illegally may spring up quickly and provide jobs and growth for the host country. In the entertainment industry (through illegally produced videos, movies, and music) and the pharmaceuticals industry (through illegally copied drugs), this practice is widespread and costs the rightful owners of the patents and copyrights hundreds of

millions of dollars in lost revenues. Because of the stakes involved, the protection of intellectual property has become a major trade issue between countries.

- **Trade Policies.** Trade policies affect the cost and ease or difficulty of moving imports into and exports out of host countries. This ability is important for MNCs, who use foreign facilities to export to other markets as part of their global production and distribution strategy, thereby maximizing their efficiency on a global basis. As an example, part of the appeal of regional trade agreements for an MNC centers on the access to neighboring countries that would come with investment in a member country.

The cost of imported products is affected by the applicable tariff rate as well as by the local currency exchange rate. Import costs are important for manufacturers who use imported inputs in producing a finished product. Tariff rates that are higher compared to those in other countries raise the cost of an MNC's finished goods. Since cost is a crucial factor in the competitiveness of exports on international markets, high tariffs make countries unattractive to foreign investors. Similarly, quotas, burdensome licensing or approval procedures, and other nontariff barriers for imports may also raise costs or slow the production cycle and consequently dampen competitiveness and investment.

Licensing procedures also affect the ability to export goods out of the host country. Many countries require exporters to go through several steps before they can ship their products. For example, they may have to get permission from the central bank, clear their goods through customs, or secure other approvals. Fees may also be charged for exporters to obtain the necessary licenses and permits. These requirements may raise costs and delay the appearance of the finished products at the market; given the intense competition among global producers in numerous industries, higher costs and delays make host countries less competitive and less attractive.

- **Government Regulation.** The regulatory climate, a term used to describe how government regulations affect business operations, may have a very significant impact on operating efficiency and cost and therefore on firms' profitability and competitiveness. An attractive regulatory climate is an important consideration in the investment-site decision. It is important to note that some degree of government regulation is essential in protecting the interests of producers and consumers and thereby ensuring the integrity and smooth functioning of the marketplace. However, from the standpoint of foreign investors — indeed, of all economic actors — too much regulation can create distortions that raise costs and cause markets and firms to function less efficiently.

For example, many governments have labour laws designed to protect workers' jobs by making it difficult for firms to dismiss workers despite changing market conditions. Other laws may dictate wage rates for workers (such as the minimum wage law in the United States) or may require firms to provide a host of benefits. These laws may raise costs for foreign investors, who often look for competitive edges in labour costs in assessing potential investments. Thus, laws intended to help workers may actually hurt them by discouraging investors from investing their capital and creating jobs.

Government regulations in other areas also discourage potential investors. Policies may dictate interest rates and/or designate priority sectors where available capital should be invested. Governments may create numerous procedures for getting foreign investments approved or establish other bureaucratic requirements or restrictions that may hamper investors' ability to move their capital and/or profits into and out of the country quickly. Again, investors seek flexibility to enable them to respond to rapidly changing market conditions, a consideration that is of growing importance in the competitive economy of the 1990s. Regulations that hamper firms' flexibility thus serve as a deterrent to investment. Restrictions on firms' activities, such as when governments reserve specific sectors for state-owned enterprises, have the same effect.

- **Tax Rates and Incentives.** A key factor in the investment decision involves how taxation affects a firm's normal operating environment. Excessive tax burdens on investments and profits will discourage MNCs from investing in a prospective host country. The tax burden involves not only tax rates, but the tax treatment of dividends, royalties, remittances, and other transactions between local subsidiaries and their parent companies.

To improve their attractiveness relative to competing countries, many countries offer packages of tax and other incentives for foreign investors. These incentive programs, which will be described in more detail below, may be helpful for host countries in attracting investment, provided that the other key investment criteria are in place.

- **Political Stability.** This element is a fundamental aspect of the investment decision: investors simply will not risk their capital in an environment that is perceived as unstable, because the risk of losing their investment will be perceived as too high. Stable political environments give investors confidence that the “rules of the game,” or laws and regulations governing their investment and the markets in which they operate, will remain basically the same over the long term. This confidence is important, because when capital is risked in a direct foreign investment, a long-term time horizon is usually required for the investment to generate the expected profits. Investors’ confidence reflects not only their perceptions of the current climate but their expectations about the political as well as economic outlook over the medium and long term.

Aside from the characteristics of the political regimes, the attitudes of government officials, labour leaders, and private-sector leaders in the host countries also affect perceptions of the host country’s stability and attractiveness as a site for foreign investment. Some countries may espouse a policy of encouraging foreign investment on one level, while at other levels officials may seek to impede such investment through bureaucratic obstructions and other means. Similarly, labour leaders who hold nationalistic views and who threaten strikes or other forms of upheaval against MNCs help create a climate of instability that undermines foreign investment. Private-sector leaders may wish to keep MNCs out of their local markets for fear of not being able to compete with them. These groups may take advantage of weak political systems and change the rules of the game in ways that are unfavorable to foreign investors.

- **Macroeconomic Policy Framework.** Macroeconomic policy management has a large impact on investor confidence in the host country, as countries that are economically well-managed are less likely to experience turbulent economic performance, which may exercise a negative impact on profitability for both local and foreign-owned firms. Economic volatility raises uncertainty for investors.

Foreign investors respond to economic uncertainty in countries in which they have already invested by diminishing the size of their investment (and their exposure to potential negative risk) or by withdrawing from the country altogether. In countries where they are not exposed, foreign investors will not risk their capital until the economic situation becomes more stable. (Domestic investors often respond to economic turbulence in their home country by depositing their money in foreign bank accounts or otherwise investing abroad. This phenomenon is known as capital flight.)

The most important aspect of macroeconomic policy stability centres on a low, predictable rate of inflation. Hyperinflation causes difficulties for firms in managing their operations—for example, in devising accounting procedures and managing cash flow. When countries impose shock programs in an attempt to control inflation, recessions often result. For example, Brazil in 1990 implemented a severe shock program to control repeated episodes of hyperinflation, and, as a result, many foreign firms sustained major losses.

- **Infrastructure/Support Services.** A host country’s physical resources—roads, ports, airports, telecommunications networks and facilities, availability and cost of energy—have a great impact upon the cost and efficiency of production and transportation. Countries must strive to keep these resources modern and defect-free in order to maximize their attractiveness as a site for foreign investment. Regardless of how well a country may rate in terms of investment criteria, one with a poor infrastructure may have difficulties in capturing a significant amount of foreign investment.

Infrastructure also consists of the services necessary to support manufacturing operations. These services include those provided by law, insurance, and accounting firms; commercial and investment banks; and transportation facilities via air, sea, and land. Raw materials and other manufacturing inputs must be available in sufficient quantities and at competitive prices. Stable, secure relationships with local suppliers are important. Strong local service and supply companies both benefit from and contribute to attracting foreign investment.

## 5. Potential Benefits of Foreign Investment for Youth Employment

In order to assess the potential benefits of FI for youth employment, it is important to discuss the level of youth unemployment, especially in HIPC countries.

### 5.1 Youth Unemployment in HIPC Countries

The unemployment problem of young people is a pressing economic and social in both developed and developing countries alike. The International Labour Organisation (ILO) estimates that the 74 million young women and men who are unemployed throughout the world represent roughly two-fifth of all unemployed persons globally. Most of the unemployed youth are found in developing countries. Many more are under-employed, with a large number working in the informal sector. The large and growing problem of unemployment among young people is both a gross waste of resources and source of social problems.

Although the issue of youth employment creation cannot be dealt with independently of the other dimensions of youth employment, there is need to place employment creation for young people at the centre of efforts to attract foreign investment and promotion of trade.

### 5.2 Trade and Foreign Investment as a Source of Employment for Youth

Trade and foreign investment have played a key role in the industrial development of many countries throughout the world. They are not, however, a magic wand that will eliminate the problems of poverty and underdevelopment in a single stroke. As countries strive to promote trade and attract foreign investors, they should have realistic expectations about what these can do for them. In our view, the potential of investment and trade as a source of youth employment lies in the following:

- **Human Capital Formation**

It is evident from this paper that foreign investors examine the quality of the local labor force because they must recruit their potential employees from that labor force. Investors also look at the quality of education in the host country, because better-educated workers will be easier to train and will reach their peak output sooner than workers who are not as well educated. Still another factor in labor-force productivity is the degree of worker absenteeism. The costs and productivity of labor are key ingredients in product competitiveness in the international marketplace. The youthful nature of HIPC countries implies that the major beneficiaries of foreign investment will be young people who mainly comprise the labour forces in HIPC countries. The promotion of foreign investment entails training youth in order to create a skilled and quality labour force. At the same time, the need for a quality labour force that can enhance productivity through minimal absenteeism would entails undertaking serious HIV/AIDS prevention programmes given the seriousness of the pandemic in many HIPC countries in Africa.

- **Direct Employment Creation**

As MNCs and other foreign firms set up enterprises in the HIPC countries, they will create employment opportunities for young people who account for the majority of the labour forces in the HIPC countries. Depending on a number of factors, including the type of technology employed by foreign firms, the employment of young people may have an appreciable impact on youth unemployment. Governments in the HIPC countries can greatly assist in the promotion of direct employment for youth by putting in place incentive structures that would promote employment-intensive growth through directing investment to sectors that are most employment intensive. Labour-intensive manufacturing industries, including garments and textiles, electronics, leather products and food processing, have traditionally provided a key source of employment in developing countries. As these industries can produce for the export market, incentive structures can make an effective contribution to employment creation.

Loosening of employment regulations, such as easing restrictions on hiring and firing, can also make a contribution to employment creation. The idea is that a less regulated market will be more attractive to employers. This approach has been successfully used in Export Processing Zones (EPZ).

- **Opportunities for Exports**

Access to international markets may enhance the earnings potential and profitability of enterprises run by young people. This is particularly the case in agriculture. In Uganda, many rural youth are benefiting from the export of high value crops such as vanilla.

- **Opportunities for Technology Transfer and Entrepreneurship**

Once youth are employed by MNC subsidiaries, their human capital may be further enhanced through training and on the job learning. Those subsidiaries may also have a positive role on human capital enhancement in other enterprises with which they develop links, including suppliers. To the extent that human capital is thereby enhanced, this can have further knock-on effects both as that young workers move to other firms and to the extent that it leads to youth employees becoming entrepreneurs.

## **6. Conclusion**

This paper looked at the role of investment and trade in promoting economic growth in poor countries and possibilities for youth employment creation. It shows that trade and foreign investment are major factors in the global economy of today and tomorrow. Developing countries that establish appropriate policies and manage them effectively will be well-poised to capitalize on the record increases in investment and capture the foreign investment that will propel them on the path to prosperity. This is the more reason why there is need to promote investment and trade in HIPC countries. FDI initially constituted only a small portion in comparison to official/private debt flows to these countries. However, the situation changed drastically in the 1990s: debt flows have virtually stagnated while FDI has increased five-fold from US \$ 36 billion in 1991 to US \$ 178 billion in 2000. Today, FDI flows contribute more resources to the developing countries than the debt flows. With the global debt crisis of the 1980s, HIPC countries know the dangers of debt finance. Foreign investment and trade can also be used to promote youth employment in the HIPC countries. Although investment and trade will not eliminate the problem of unemployment in a single stroke, countries that strive to promote trade and attract foreign investors can realise some benefits.