

# FOREWORD

Development experience over the past 50 years suggests that trade liberalization and increased international integration are critical elements of a successful strategy to promote economic growth. The World Bank has been an advocate and supporter of a trade agenda that enables developing countries to gain as much access to foreign markets as possible, but it has also stressed the importance of developing countries opening their own markets to international trade and investment.

This volume presents a rich set of analyses exploring how trade and foreign direct investment (FDI) can help increase economic growth by allowing firms to tap into and benefit from the global pool of knowledge. The chapters demonstrate that both obtaining access to foreign markets and opening their own economies to trade and FDI are crucial to promoting economic growth in developing countries, because they stimulate international technology diffusion. The volume also identifies government policies that can facilitate technology transfer and its absorption in the developing world.

Among the conclusions emerging from the research contained in this volume, a number stand out. First, the evidence suggests that an open trade regime facilitates the diffusion of knowledge. Undistorted access to capital equipment and imported inputs that embody foreign knowledge allow firms to acquire know-how; the greater competition from imports lowers the mark-ups over costs that firms charge customers. At the same time, given that technology markets are associated with increasing returns, imperfect competition, and externalities, the argument against trade protection is not unconditional. The conclusions hinge on the scope of knowledge spillovers. International spillovers, for which there is considerable evidence, strongly tilt the balance in favor of free trade. If national spillovers are also important, there may be a potential role for intervention. Trade policy, however, is

not the instrument of choice in this situation, as it does little to encourage local research and development and necessarily leads to other distortions.

Second, FDI policies in most developing countries have become more liberal in recent years. But government policies often distinguish between types of FDI, providing greater incentives to joint ventures with national firms than to fully owned subsidiaries of multinational enterprises. Such a policy stance often reflects a desire to maximize technology transfer to local firms and agents. The evidence suggests, however, that policies that discriminate between types of FDI are unlikely to promote technology transfer. By attempting to force multinational enterprises to license their technologies or engage in joint ventures, host countries may lower the quality of technologies they receive and reduce incentives for foreign firms to invest at all.

While the magnitude of international technology diffusion undertaken by multinational enterprises need not be socially optimal, evidence presented in this volume reveals that such firms are keen to transfer technology to their local suppliers. Policies that increase incentives to source locally, as opposed to regulation or legislation requiring that multinational enterprises engage in international technology diffusion to local competitors, have a greater likelihood of being successful. Examples of such a policy are supplier development programs that aim to prepare local companies to understand and meet the needs of multinational enterprises. The services provided under such programs can be effective in assisting firms, provided they are well designed, mobilize the right type of skills, and ensure that their target audience is aware of the services on offer.

Many countries actively seek to attract foreign investors through up-front subsidies, tax holidays, and other grants. A rationale for such investment incentives may be based on positive externalities generated by inflows of FDI. Local suppliers may benefit not just through expanded sales but through access to technologies provided by the investors. Such positive externalities may be enhanced by the prevalence of “follow the leader” behavior among multinational enterprises. Given the oligopolistic nature of markets within which FDI occurs, a new entrant may result in additional investments by both competitors and upstream suppliers of inputs, components, and services. An implication is that a host country may be able to unleash a sequence of investments by successfully inducing FDI from one or two major firms.

If the local economy lacks a well-developed network of potential suppliers, multinational enterprises may be hesitant to invest, and local suppliers may not develop because of lack of demand. In the presence of such interdependence, growth may be constrained by a coordination problem that can partially be resolved by initiating investments from key firms. Such coordination problems cannot be tackled solely through investment incentives. Policy efforts need to focus primarily on improving the investment climate and reducing the costs of absorbing

technology, a complex task that involves building human capital and expanding national innovation systems. Thus while there may be a case for investment incentives, it is a conditional one. To be effective, the investment climate and absorptive capacity must meet certain conditions. Moreover, given competition among countries in attracting FDI through incentive packages, policymakers must carefully examine the magnitude of potential costs and benefits associated with such policies.

**François Bourguignon**

*Chief Economist and Senior Vice-President*

*The World Bank*