

# What are the best avenues to build industrial capacities: FDI or domestically-owned enterprises?

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# What are the best avenues to build industrial capacities: FDI or domestically-owned enterprises?

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## Introduction

The development of industrial capacity is one of the central concerns for any country seeking rapid and sustained economic growth and rising material living standards. While there is very little agreement on how to drive economic growth, especially in the longer term<sup>1</sup>, economic history clearly shows that almost no country has ever grown wealthy without undergoing a process of industrialisation.

At least since Kaldor's growth laws, we have known that manufacturing is an important driver of economic growth due to the close relationship between manufacturing output and productivity growth (McCrombie 1983, Thirlwall 1983; see also Rodrik 2011 for a different way of making a similar point). Moreover, the growth of manufacturing creates employment opportunities for unskilled and semi-skilled individuals in the labour force who have had limited opportunities outside of the agricultural sector to earn their livelihood. In this sense, labour-intensive manufacturing is well suited to the agenda of eliminating persistent and widespread poverty in many developing countries. The rapid and remarkable poverty reduction observed in East Asia since the 1960s is, for example, attributed mostly to new waves of manufacturing-sector jobs in these economies<sup>2</sup>.

But manufacturing capacity requires investment. A number of case studies compiled by the Commission on Growth and Development suggest that successful growth performance requires maintaining an investment rate in the region of around 25% of GDP (CGD 2008). If

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<sup>1</sup> Kenny and Williams (2000) despair in a review of the so-called 'growth regression' literature that tests different specifications of endogenous growth models, complaining that over 100 different variables have been identified as significant.

<sup>2</sup> While the Green Revolution has certainly contributed to stabilizing food prices, it is generally presumed to have had only a moderate impact on labour demand (Otsuka, *et al.*, 2009). And many of the new technologies appear to have benefitted mostly richer farmers, especially in India.

such high rates of investment in manufacturing sectors are one of the keys to economic dynamism, an important question for poor countries seeking to industrialise is how to finance such investment. Funds for investment can either be raised domestically through savings and taxation or from abroad. While foreign funds might seem increasingly readily available in a world of ever more international networks of production, every economist knows that there is no such thing as a free lunch<sup>3</sup>. This paper examines some of the advantages and drawbacks of both methods of financing and suggests some areas of particular concern for policy.

## Building industrial capacity

Industrial capacity is not simply the ability to produce manufactured goods, but rather the ability to do so ultimately at costs that are internationally competitive, allowing for both import substitution, i.e., a *relative* reduction in the import of manufactures along with the increased export of manufactured goods. If competitiveness cannot be established in the medium-to-long run, either through cost advantage or product differentiation, then a sector is doomed to failure. In other words, industrial capacity can only be built and sustained in the long-run if firms, be they foreign or domestic, develop the capability to withstand international competition both at home and abroad.

Such capability rests on a number of closely interrelated components. The development of an industrial base requires the formation of large amounts of fixed (and variable) capital in the form of plants and machines. The accumulation of capital requires resource mobilisation on a vast scale and a deep restructuring of existing property relations. Such accumulating capital, be it publically or privately owned, cannot however generate profits unless it is allowed to benefit from a wide variety of infrastructure provided by government and society at large. Such infrastructure includes transport infrastructure and facilities but also effective institutions, an educated workforce and some degree of social peace.

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<sup>3</sup> For instance, the 'insight' that foreign loans will have to be repaid at some point and thereby have the potential to depress future growth is now so basic that it has even made it into introductory economics textbooks, e.g., Krugman and Wells (2012 , Ch. 24).

But fixed capital formation, while vitally important during early stages of industrial development, tends to decline in relative importance as a country accumulates capital. In fact, capital formation explains only a small part of growth patterns observed globally. Of increasing importance to modern industry is productivity growth, which is based on improved technology and learning (Stiglitz and Greenwold 2014). Firms must build, and be helped to build, their capabilities to learn new technologies, to adapt those technologies and processes to their own needs and ultimately to drive real innovation.

Learning, however, does not occur in a vacuum. For example, while Arrow's (1962) type of learning-by-doing is an important source of the accumulation of knowledge and skills over time, there is a natural limit to building competitive advantage based on learning from "unchanged" practises of one's own production activities (e.g. Romijn 1999).

Building industrial capacity is thus an effortful and expensive exercise whereby cumulative production experience needs to be complemented by the active innovative adaptability of firms. This adaptability includes technical and managerial agility in reacting to constantly evolving internal and external constraints through the rapid transformation of procurement, production and marketing practises (Tewari 1998).

Industrial capacity thus requires a set of improved models of managerial and technological practises that lead to responsive, cost-cutting and low-cost adaptation and imitation of production processes. Building such capacity also involves the adoption of procurement and marketing flexibilities that are increasingly responsive to rapidly changing market demand, both local and global. The successful development of improved capabilities by firms requires, of course, a business environment conducive to continuous learning and the assimilation of improved technological and managerial practises.

In the presence of widespread market failures, such as externalities and coordination problems that thwart industrial investment and the adoption of modern practises in the industrial sector, it is highly unlikely that local industrial capability can be built spontaneously. Creating the conditions for industrial capacity thus requires: 1) overcoming infrastructure deficits that bedevil investment in many low income countries, 2) taking corrective policy actions to overcome market failures that generate high transaction costs

and increased risk as well as lower economic returns, and 3) promoting innovative ways of generating knowledge spillovers. It is the role of government to put in place institutions capable of achieving these aims (Cimoli et al. 2009).

## Advantages of domestic investment

Outside of the Soviet sphere of influence, most cases of successful industrialisation have entailed building a class of domestic capitalists. And the reasons for this phenomenon have nothing to do with economic nationalism. Domestic capital is less footloose than FDI and it is easier to press domestic capital into the service of national development projects. The state-capital alliances of the East Asian tigers are a much cited example of this kind of development. Returns to domestic capital are more likely to be reinvested domestically. Also, leakages through wages paid to foreigners, dividends and interest payments are reduced, generating a positive feedback loop through demand multipliers.

Domestic investment can also act as a catalyst for foreign private capital flows, including FDI. Agglomeration effects and the diffusion of relevant information are two of the mechanisms through which domestic investment promotes FDI flows (Lautier and Moreaub, 2012). Agglomeration facilitates greater linkages between domestic and foreign firms and reduces transaction costs among part-suppliers, manufacturers and traders, enabling FDI firms to reap the benefits of specialization and division of labor.

With regard to information asymmetry, the very presence of a critical mass of local investment can signal the potential profitability of investing in a host country, thereby generating useful information externalities that can help attract prospective foreign investors. This phenomenon is of course not surprising as location decisions by FDI firms are often dictated by host-countries' real or perceived economic performance, including their market size and average rate of return.

Indeed, studies that have examined the relationship between domestic investment and FDI suggest that domestic investment produces a significant and positive effect on luring FDI to a host country (Ndikumana and Verick 2008, Lautier and Moreaub 2012). For example, using a large sample of cross-country observations from 1984 to 2004, Lautier and Moreaub

(2012) find that the stock of domestic investment committed in past years has a strong and significant positive effect on FDI inflows into host countries.

However, domestic enterprises might, unfortunately, be far from the technology frontier of their sector, have limited capacity for innovation and operate below minimum scale. They are also likely to have less knowledge of export markets.

## Advantages of FDI

FDI flows that bring experienced foreign manufacturing companies into the domestic economy have a series of advantages over investment by domestic firms. Most obviously, FDI represents new capital that does not have to be raised domestically through loans or savings. This is not simply a matter of convenience in terms of raising investment funds. Growth rates in the long run appear to be constrained by the magnitude of balance of payment deficits. Also in the long run, such deficits must be financed either by reduced consumption or by increased inflows of foreign funds (Thirlwall 2011).

Foreign firms are also likely to be more cost efficient producers. They will have access to more advanced production technology and will have more efficiently organised production processes. Borensztein et al. (1998) claim, for instance, that FDI is a more important source of technology than domestic investment. Moreover, many industries are characterised by increasing returns to scale in production and foreign firms are likely to set up plants that are above the minimum efficient scale threshold. Since such firms have typically already been successful exporters, they will also have built up knowledge about target markets and market trends, including how to serve demanding customers. Lastly, they will normally have greater managerial capacity, making them more able to react to challenges and significant changes in the market environment.

It is however important to understand that these benefits are all *potential* (Lall 2000). Evidence from cross-country studies indicate that the effect that FDI has on both overall economic growth and the development of local firms in the host economy depends largely on the presence of (net) positive spillover effects (Moran et al. 2005). Positive spillover effects depend not only on the type of FDI undertaken, but also on the 'absorptive capacity' of the

host economy, the most important determinant of which is the level of education and skills already present (Borensztein et al. 1998, Saggi 2000).

There is a large and growing empirical literature seeking to quantify the effects of FDI on overall growth, including the size of its spill-over effects on various aspects of the domestic economy (e.g., local firm growth, technological diffusion, wage growth) as well as to understand the drivers of these effects and the conditions under which FDI is indeed of unambiguous benefit to the host economy. Studies have focussed both on individual countries and on cross-country specifications (using both panel and synchronic data).

Since even a partial review of this literature is beyond the scope of this short paper, it will suffice to state here that most studies have been reporting increasingly large positive spillovers (Moran et al. 2005). Javorcik (2008) finds, for example, that managerial and technological knowledge spillovers from FDI firms have played significant positive roles in the gradual upgrading of local firm capabilities in the Czech Republic and Latvia. Available evidence also suggests that FDI promotes greater integration with the global market. Using trade and production data on outbound investment originating from the US and Japan, Lemi (2004) discovers, for example, that FDI leads to increases in exports, suggesting that the presence of foreign firms generates learning effects that encourages greater outward orientation of local firms in host countries.

Nonetheless, empirical results are often contradictory, reflecting the inherent difficulties in measuring spillovers, the weaknesses of cross-country regression designs, and the problem of fundamental uncertainty due to the lack of historic counterfactuals. Looking at whether FDI crowds domestic investment in or crowds it out in sub-Saharan Africa, Adams (2009) finds a net crowding out effect, whereas Ndikumana and Verick (2008) find quite the opposite.

Overall, there does not seem to be a clear empirically verifiable relationship between FDI and growth, and there is uncertainty about whether externalities generated by FDI even have net positive returns (Moran et al. 2005: 3). The positive effects of FDI tend to be strongest where foreign firms rely on, or build, networks of domestic suppliers and take on local staff in increasingly technical and managerial positions, allowing knowledge to trickle

into the wider economy. Javorcik and Spatareanu (2008) show, for example, that local firms linked with foreign multinationals in supply relationships benefit from sizable gains in productivity. In sum, the literature overall appears compatible with the position that net positive spillovers are by no means automatic, and thus need to be carefully nurtured.

## Flying geese, leading dragons and crouching lions

As the production of manufactured goods is increasingly characterised by the spread of functionally integrated, but geographically dispersed, production networks in which participating companies 'trade in tasks', that is, take on small slices of the overall production process, developing countries have few other choices but to seek integration into these networks (Page 2012). In many cases this implies either foreign direct investment or deep integration between domestic firms and their foreign customers. But how can companies in developing countries (which are almost by definition less efficient) hope to compete with highly efficient producers in more industrialised countries, not least in China?

The answer is that, quite possibly, they do not have to. Resolving this apparent paradox requires us to understand the flying geese paradigm, named for the overlapping inverted-V shapes displayed by flocks of geese in flight. The paradigm was first formulated by Akamatsu over 50 years ago to describe the industrialisation process of his native Japan. In Akamatsu's formulation Japan caught up with the West by going through cycles of import, own production and finally export for a variety of goods, with consumer goods followed later by capital goods (Kasahara 2004). Mapping the volumes of production, import and export volumes for different goods over time produces the overlapping inverted V diagram.

At the risk of oversimplification, in its modern formulation the flying geese paradigm is essentially a combination of Akamatsu's ideas with an international version of Vernon's product cycle theory. The modern paradigm is at heart a theory of regional integration and co-development that seeks to describe the regional industrialisation process in East Asia. The paradigm sees regional industrialisation as a series of 'orderly transitions', as a result of movements, through cycles, between products, industries and ultimately countries (Kasahara 2004). Countries will, as they develop their economies, successively lose their comparative advantage in labour-intensive simple manufacturing industries, due to rising



labour costs. These industries then become 'free' for other – poorer – countries to build, as they have a comparative advantage in such industries due to their lower labour costs, i.e., lower wages.

This dynamic sets up a leader-follower pattern amongst countries in which poorer countries can industrialise in the wake of their richer forerunners as the latter abandon once profitable industries and move to the production of more sophisticated and more capital-intensive products. Crucially, this pattern assumes a hierarchical regional structure with a dominant economy at its core<sup>4</sup>, and is driven by the actions of Trans-National Corporations (TNCs), which take such forms as FDI, outsourcing and licencing, often with support from the government of the dominant economy, which provides loans and overseas assistance (Kasahara 2004). Ever since Cumings' (1984) historical work, the flying geese paradigm has been the standard model used to describe the regional growth process in East Asia.

How is this relevant to a low income economy such as Ethiopia today? China is moving out of low skilled manufacturing sectors as rising wages make its production of low-tech manufactured goods less and less attractive<sup>5</sup>. Given the sheer scale and rapid projected growth of the Chinese economy, the 'freeing up' of low skilled manufacturing sectors by China presents a huge opportunity for countries struggling to build up industrial capacity. Lin (2011) estimates that China could shed up to 100 million jobs in low skilled manufacturing over the next few years and will thus become a 'leading dragon' by setting in motion a new series of transitions and a new flying geese formation.

Then the problem of low wages, especially in countries in sub-Saharan Africa such as Ethiopia, becomes a source of opportunity, as simple manufacturing flows out of China and into African countries in the form of FDI, making them the crouching lions of the metaphor. As Lin (2011) points out, even a relatively minor shift of Chinese manufacturing could have a substantial impact on less industrialised countries.

## Dangers and the need for a balanced strategy

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<sup>4</sup> Japan, originally.

<sup>5</sup> We ignore, for the sake of brevity, the complication posed by uneven development and large wage differentials between different regions in China, whereby poorer regions could also act as followers.

The overall situation then seems hopeful for aspiring African producers. But there are real costs and potential dangers attached to a growth strategy that relies too heavily on FDI. The problems are both practical and related to issues of political economy. In practical terms attracting FDI flows is neither cheap nor easy. Prospective host governments must not only complement internationally mobile investment flows with the provision of substantial immobile assets, such as infrastructure, but they also have to mount effective information and public relations campaigns to even be considered for FDI (Lall 2000).

After all, FDI flows in the world are still remarkably concentrated in a small number of countries. In 2013 Africa as a whole accounted for only 3.9% of global FDI inflows, compared, for example, to 29.4% for Asia (UNCTAD 2014). In addition to this factor, host governments typically have to offer other incentive packages, such as tax holidays, tariff-free import and export, and other direct and indirect subsidies.

The key question then becomes whether the positive externalities of a particular FDI project are larger than the cost of subsidies (which after all are provided by the taxpayer). And decisions will have to be made on a case by case basis. When analysing the costs and benefits of FDI projects, it is also important to recall that while FDI flows are not loans (which must be repaid with interest), any private capital invested in a country will typically be subject to dividend payments abroad and such payments can be higher than the interest rate on loans (a claim harking back at least to Kalecki 1993 [1954]). The correct comparator scenarios are therefore domestic firms financed by (a) foreign loans and (b) domestic loans. Of course, if domestic loans are extended to foreign firms, as is frequently the case<sup>6</sup>, the costs of the projects are compounded.

Moreover, the flying geese paradigm outlined above might paint too rosy a picture in its smooth sequencing of industrial growth across countries. There is a debate as to how far the paradigm is actually a valid description of the East Asian experience. Amsden (1991) questions its applicability in favour of more structural models, and Ginzburg and Simonazzi (2005) find that the paradigm can explain only the case of the electronics industry if it is

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<sup>6</sup> Although for instance Chinese firms in Ethiopia tend to use Chinese capital and only rarely borrow domestically (World Bank 2012).

adjusted to allow for substantial regional hierarchy. And this hierarchy is the crux of the problem.

Bernard and Ravenhill (1995) point out that the key assumption in the flying geese paradigm is the maturation of technology on a stable technological plateau, which makes wage costs the most important determinant of production costs and allows for production to move abroad in search of higher profits. Hence, they question whether such technologically stable states actually characterise industries in practice. They contend instead that innovation continues even in mature sectors of leader economies, implying that FDI is typically confined to technologically simple assembly processes with limited value addition. In their view “export manufacturing relies almost entirely on foreign technology and components and is carried out for the most part by subsidiaries of transnational corporations” (1995: 178).

In recent years, low income countries have increased their share of global manufacturing, but at the same time their share of manufacturing value added has fallen (Kozul-Wright and Rayment 2004). There is then a real danger that while manufacturing activity does indeed spread to poorer countries, the primary beneficiary will be foreign capital, and there is little in economic theory to suggest that such dominance would fade quickly.

The primary attraction for FDI in poor countries is low wages and relatively loose regulatory environment (see, for instance, World Bank (2012) on Chinese investment in Ethiopia. Where the flying geese paradigm suggests that Ethiopia might not have to compete with China on unit labour costs, there will still be, in fact, intense competition with other low cost producers in simple manufactures. Especially in sectors with relatively low (sunk) fixed capital costs, such as textiles and apparel, capital is highly mobile across countries.

The ultimate decision making metric for any firm deciding between production locations is profit; and in simple manufactures, wage levels and labour productivity are the key determinants of costs and, therefore, profit. There is evidence to suggest that, unsurprisingly, FDI flows to countries with lax labour laws and few protective measures for workers (Olney 2013). The intense competition at this low end of the production sophistication spectrum could leave, in fact, very little room for wage increases. While firms that serve the domestic market might be open to arguments that higher wages raise

aggregate demand, firms that are purely export-oriented are more likely, instead, to view rising wages as a pure cost. Similar arguments can be made for regulations concerning non-wage working conditions and the environment.

## Policy issues

With all of these considerations in mind, government should develop a balanced strategy that seeks foreign investment in carefully selected sectors and maximises the benefits to the domestic economy. In low income economies where domestic saving is low and technology is simple or in short supply, FDI is potentially a useful source of new capital and technology. The positive spillover effects arising from the direct or indirect, as well as vertical or horizontal linkages between local and FDI firms can also potentially enhance the level of productivity enjoyed by local firms.

Such spill-over effects do not, however, automatically arise simply through the very presence of FDI firms in the economy. It is not clear, for example, how FDI firms operating in enclaves, entirely relying on imports for raw materials and inputs (possibly including labour) and exporting their final products, generate local spill-over effects in the host country. In the absence of such positive spill-over effects, it is not clear why--from the point of view of economic efficiency--governments should go to great lengths to attract FDI inflows by instituting a range of incentives that dearly cost local taxpayers. Policies designed to attract FDI should thus evolve not just to promote even greater inflows of FDI, but also to find innovative tools that can widen the spectrum of technology and skills spread from the FDI firms to local firms.

While there is widespread consensus on the value of attracting FDI inflows, there is no agreement as to how best to do it. Beyond stability and market size, which are found to be strong predictors of FDI inflow across many studies, the empirical evidence supporting the effectiveness of other policy levers in attracting FDI is not very robust. The degree to which governments in low income economies can successfully attract FDI, for example, appears to be only modestly related to the levels of subsidies and incentives that they deploy for this very purpose. Since FDI has a tendency to complement domestic investment, effective industrial policy should target the formation of a critical mass of domestic investment,

which in turn could catalyse FDI inflow. While this strategy could create a virtuous cycle of agglomeration, it would not need to transfer taxpayers' resources to FDI firms in the form of excessive subsidies and tax breaks.

Crucially, such policy considerations must also include not just domestic firms, who need new technologies and processes and can learn from interacting with FDI project, but also the effect on the well-being of workers. It is worth remembering that FDI is not a humanitarian favour to the host economy. Profit-seeking foreign firms are given the privilege of entering and taking advantage of the low domestic standard of living (which underlies low wages), and government must make sure that they repay, in effect, this privilege.

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