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The role of multinationals in sparking industrialization: From "infant industry protection" to "FDI-led industrial take-off"

by
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Although not yet fully conceptualized as a new catch-up model in mainstream development economics, the infant industry argument (protectionism designed to replace imports with domestic substitutes) is giving way to a foreign direct investment (FDI)-led model of industrialization.

Industrialization used to be an arduous long-term process of structural upgrading. It took Britain nearly a century subsequent to the Industrial Revolution to become the world's industrial leader in the second half of the 19th century. The United States replaced Britain in only about half a century. The spectacular rise of China has shortened the catch-up process even further, with the country having swiftly surpassed Japan in 2010 to become the world's second-largest economy within three decades after the adoption of an open-door policy in 1978. Behind this time-compressing trend of economic growth is the ever-accelerating dissemination of industrial knowledge from advanced to emerging markets. Most recently, this advance comes at the hands of multinational enterprises (MNEs) and through breakthroughs in information technology.

To absorb and assimilate modern technology, the currently advanced economies used to resort to "infant industry protection" in their early stages of growth. The prime examples are the United States, Germany and Japan, which achieved great success with the catch-up strategy of infant industry protection or "import substitution" (two phrases used interchangeably in development economics).

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This approach required the catching-up economy to go through a sequence of imports, domestic production and finally exports (if practical)—involving the "visible hand" of government as a way of building up *nationally owned* industry under protectionism. During the course of technological learning, a protected industry had to secure industrial knowledge abroad (via many avenues, from licensing to copying) or create its own, which would be costly, time-consuming and often fruitless.

In many instances, protected industries stayed in the import substitution phase without attaining export competitiveness. The required government involvement often resulted in inefficiency, corruption and monopolies. During its heyday of import substitution, Latin America fell victim to this *dénouement*, especially since it neglected to build export-oriented labor-intensive industries, in which the region would have had a strong comparative advantage, thereby failing to mobilize its most abundant factor, labor, to trigger bottom-up industrialization. Latin America depended on "protected-market-seeking" FDI in its comparatively disadvantaged industries (those incommensurate with its prevailing factor endowments and technology). Its reliance on "resources-seeking" FDI in particular led to a collusive alliance between MNEs and local elites, a form of the "resource curse."

In sharp contrast, however, China's catch up now tells a quite different story, an alternative approach that is in tune with the *zeitgeist* of today's global economy and can comply with WTO rules. China has unequivocally demonstrated the efficacy of what may be called "FDI-led industrial take-off," a strategy that is a much quicker (indeed, virtually instant) and more effective means of acquiring modern technology and export competitiveness than old-fashioned import substitution.

In comparison to infant industry protection, this FDI-led take-off strategy can create an entirely new export-driven industry practically overnight—either wholly or jointly foreign-owned, depending on the host country's policies. MNEs generate and possess industrial knowledge and, above all, access to export markets. Inward FDI can instantly complete the otherwise-prolonged three-stage sequence of imports, domestic production and exports. It also produces technological spillovers to the host economy. Indeed, China skillfully carried out this new strategy by actively welcoming MNEs — early on, in its comparatively *advantaged*, labor-intensive light industries (notably, apparel, footwear, toys) and, more recently, in its capital-intensive, scale-driven industries (especially, automobiles, consumer electronics), thereby emerging as the workshop of the world. In this process China lifted hundreds of millions out of abject poverty.

In addition, China is adopting a more directly outward-focused approach: "knowledge absorption via acquisition" (i.e. buying out technologically advantaged firms overseas), as best exemplified by Lenovo (which acquired the former IBM PC division in 2005) and Volvo (which was purchased by Geely in 2010). Although this newer approach is often blocked by political concerns in host countries (as is the case of Huawei's recent attempt to purchase 3Leaf Systems in the U.S.), FDI thus works both ways in China's efforts to acquire industrial knowledge. Most interestingly — and paradoxically, given its state-dominated polity -- China's approach is far more outwardly integrative and far more strongly market-driven than the conventional "closed-economy" strategy of import substitution pursued earlier, say, by postwar Japan.

On the whole, therefore, China's policymakers have made effective use of a new catch-up model that is powered by the logic of MNEs' profit-seeking activities. The model of FDI-led take-off has rendered that of infant industry protection obsolete. It is true that China now has to reformulate and refine its growth strategy as it climbs higher on the ladder of development, which increasingly requires more autonomous technological capacity. Nonetheless, China's initial growth strategy and the way this has been implemented need to be conceptualized as a new approach that capitalizes on MNEs' participation in export-driven, labor-intensive industries as a jump-starter of industrialization. The days of infant industry protection are clearly over in the annals of catch-up doctrines.

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