Explore the costs and benefits of FDI in low income countries

In this paper we are going to look at the costs and benefits of Foreign Direct Investment (FDI) in low-income countries. Since the 1980s there has been a dramatic increase of FDI into low-income countries. This has been as a result of greater interest in FDI as the world gradually integrates further, a process that we will refer to as globalisation.

Let us quickly define what FDI is, FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset.[1] The differentiation between FDI and a portfolio investment approach is slight but with portfolio management the parent firm would not take an interest in the running of the affiliate firm. We usually refer to the firms as either the "parent firm" (the investor) and the "affiliate" or the "subsidiary" (the asset). There are three ways in which FDI can be made:

- Equity capital more than 10% of the ordinary shares or voting power in the enterprise is normally considered a FDI. This can be done through either mergers & acquisitions or greenfield investments.
- A reinvestment of earnings by the Multinational (MNE) of the affiliate earnings represents a large portion of FDI
- Other capital which is borrowing and lending of funds between the MNE & the affiliate.

Why is it that FDI is being used to stimulate growth in the world's poorest countries? The traditional methods for stimulating growth used to be aid from multinational organisations such as the IMF & World Bank, but these organisations have cut back on their aid so these countries have had to look elsewhere for capital[2]. FDI has other potential benefits over direct aid such as new technologies, organisational and managerial skills. These in turn lead to job creation and economic growth that the aid was meant to do. It also has other follow through effects such as promoting healthy competition, innovation, and the promotion of savings and capital acquisition. In the ideal situation we would see major reforms in the domestic policies and practices of

these Less Developed Countries (LDC) but this is harder to achieve. Here we have touched upon the potential benefits that we will look at in more detail a little later.

As expected there are critics of the policy of FDI, they claim that it can lead to possible negative effects on the "home" country (where the outflow of the capital originates) such as FDI sends the jobs to other countries and puts a downward pressure on wages. In the "host" country (which receives the FDI) there are worries about the medium – long term impact on that country's balance of payments, potential monopolies emerging, and more seriously the impact FDI will have on the government to manage the economy. These critics are also worried that as these governments have to sign multilateral agreements it goes even further in hindering the management of the FDI inflows.[3]

Lets consider the reasons why firms engage in FDI, they could after all stay in their home country and just export their goods to these poorer countries or license their technology to foreign companies. There are good reasons for becoming a MNE through FDI, one of these is that the firm effectively remains in control, it can take advantage of its technology and brand names, use their own managerial style and marketing networks. Also it is more profitable to be producing in different countries than to be exporting from the home country exclusively. Most importantly for the MNE they can make more money through FDI instead of licensing. There is another factor, which we haven't considered, and that is the costs the MNE would have to incur if it was located in only one country. That is the avoidance of transaction costs associated with transactions from afar, e.g. contracting and quality assurance in dealing with suppliers, export/import firms and foreign licensees.

We have seen why firms engage in the practice of FDI but we are going to turn our attention to what effect FDI has on trade for both the home & host country. We look at the effect on trade because it has a benefit for the host country in particular. As the host country is now a producing nation, it leads to an increase in their exports. At the same time the critics argue that the home nation suffers as a result of this and loses out on exports which in turn affects the country's employment and balance of payments. This view came about from studies by Mundell in an article he wrote in 1957 in the American Economic Review. Even when FDI is in place, the host country

does not reduce its imports, which disproves the theory of Mundell, that the home country loses exports. The host country now has more money available as it is exporting so it can improve things in the country. [4]

Looking at this we see that as a result of FDI, trade increases which improves the economy. So lets look more closely at some of the other costs and benefits to the LDC. We mentioned in our introduction that as a result of FDI we see technology transfer and creation of employment in the LDC, and it is these factors that are the significant benefits of FDI. Technology transfer includes not only scientific processes, but also organisational, managerial and marketing skills. This benefits not only the affiliate of the MNE but also the country as a whole as they are able to use their resources more efficiently with the new technology. Sometimes we find that the affiliate licences out the technology they have acquired to a domestic firm that in turn leads to an economic benefit to the country. This is also called a technological spillover and this has two routes it could take, firstly vertical and secondly horizontal. Vertical spillover is when the affiliate transfers the technology free of charge to firms supplying inputs or servicing distribution or retailing operations. Horizontal spillover is where the new technology is copied or learned by competing firms. FDI can also bring about other benefits such as an increase in technological capabilities as a result of increased competition and this ends up leading to greater efficiency. We also see that FDI has a benefit to human capital, as the home economy has to train people in the host economy so that the affiliate can use the new technology and apply their knowledge in local firms. [5]

Having studied one of the major benefits of FDI let us look at the employment that this creates in the LDC. The MNE helps fill lacking managerial skills through training that is passed onto local managers and entrepreneurs. Usually the labour market is affected by the amount of technology transfer in particular the upgrading of skills. Something, which is clear, is that FDI increases the total available amount of capital, which in turn leads to more labour or higher wages.

We have seen the benefit of FDI now lets look at the potential costs of FDI. There are many critics of FDI and they claim that it creates balance of payments problems, which leads to the host being exploited, as it cannot manage its own economy.

However for there to be a negative impact on the balance of payments international trade theory says the country must be under fixed exchange rates. If they were under floating exchange rates this would mean instead of having a deficit in their balance of payments they would have depreciation. There is also the worry that the MNE who is powerful will be able to exploit the local market where they have high profits, high barriers to entry etc. There is the counter view that the MNE will do the opposite and that they will create more competition by removing an oligopoly. There is also the worry that the MNE will be pressured by the home country, which in turn could cause problems in the host country, but usually these are unfounded criticisms.

In conclusion FDI is a very important to world development and further growth. It is probably the most important way that technology is transferred to LDCs, it also leads to a higher productivity amongst the workforce in the locally owned firms (witnessed usually in the manufacturing industry). It is true that there are some concerns about FDI but in this global economy LDCs needs FDI just as much as the MNE needs to invest in LDCs. Any potential concerns can be put aside as the benefits are much greater than the costs, as we have seen.

Endnotes:
[1] P KRUGMAN & M OBSTFELD, "International Economics Theory & Policy" v5 Addison-Wesley Publishing
[2] Statement by Horst Kohler, Annual Meetings Prague, IMF 2000
[3] WTO "Trade & Foreign Direct Investment" October 1996
[4] R MUNDELL, "International Trade and Factor Mobility", American Economic Review 67, 1957 pp 321-35
[5] E MANSFIELD et al, "Technology Transfer, Productivity, and Economic Policy", 1982 New York: W.W. Norton