

FDI and its Role in Developing Economy

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1. Introduction

Developing countries have characteristics of limited and unutilized resources which restrict the economy's growth process and pulls backward to the sustaining situation. So, according to Labenstein, a 'Big Push' is needed in the economy to accelerate the development process. So, in a developing country Foreign Direct Investment (FDI) can be considered as a 'Big Push' factor in the economy. The cash inflow and direct investment through FDI act like an economic catalyst which can boost economy's productivity. Through FDI comes cash inflow, technology transfer, management skills, innovative techniques, etc. these factors will increase the productivity in the economy making India self-sufficient and further increase in exports due to surplus productivity. FDI brings investment in the economy which can be utilized as a means of employment generation and poverty eradication through appropriate fiscal policies.

The economic benefits of FDI were identified a long time ago. A Harvard Business School paper published 30 years ago explained the benefits of FDI on an extensive review of economic literature (Wint 1986). The benefits traditionally attributed to FDI include job creation, transfer of technology and know-how, access to international market and access to international financing.

World Bank defined FDI inflows and outflows as "FDI net inflow are the value of inward direct investment made by non-resident investors in the reporting economy. FDI net outflow are the value of outward direct investment made by the resident of the reporting economy to the external economies."

The amount of FDI directly being invested has grown by 9% in 2013. The report on United Nations Conference on Trade and Development (UNCTAD) has shown that FDI inflows have grown year-on-year in 2013 and expected to rise further in the coming years. FDI in developing countries have increased considerably in comparison to developed countries due to emerging markets and availability of cheap labour. The global FDI have decreased global variation. The developed economies and countries have seen a significant decrease in FDI inflow, while FDI inflows to developing economies have been at high level. FDI flows to developing countries accounts for 55% globally. Developing Asian economies drove the increase while flow in Africa remained flat and decline in Latin America.

FDI flows to developed countries have dropped by 28% to \$499 billion. Inflows to United States fell to \$92 billion. FDI flows to Europe also fell by 11% to \$289 billion. Among European economies, inflows decreased in Ireland, Belgium, France and Spain, while increased in U.K., Switzerland and Finland. FDI flows in developing countries increased by 2% reaching \$681 billion. Developing Asia's inflow increased by 9% to \$465 billion in 2014. FDI inflow rose in China, India, and

Singapore. Developing Asia became the world's largest investor region.

Thierry Mayer at the OECD has published a new study of the interactions between aid, trade and investment policies to maximise benefits of the FDI. The paper concludes that for FDI to have a beneficial impact, it is important to increase absorption capacity by increasing human capital accumulation, increasing and improving transport infrastructure, and facilitating trade between developing countries.

2. Types of FDI

The types of Foreign Direct Investments are:

1. **Green Field Investment:** it is expansion of existing facilities. Green Field Investments are the primary target of the host nation's promotional efforts because they create new production capacities and jobs, transfer technology and can lead to the linkage with new market pace. It is done by crowding out the industry, as MNCs are able to produce goods more cheaply by using up the resources.
2. **Mergers & Acquisitions:** It occurs when transfer of existing assets from local firms to foreign firms takes place. Cross border mergers occur when the assets and operation of firms from different countries are combined to establish a new legal entity.
3. **Horizontal FDI:** It is investment in the same industry abroad as a firm operates in at home.
4. **Vertical FDI:** It takes place in two forms:
 - a) **Backward Vertical FDI-** where the industry abroad provides input for a firm's domestic production process.
 - b) **Forward Vertical FDI-** in which an industry abroad sells the output of a firm's domestic production process.

3. Role of FDI in different sectors

Industries: Developing economy is acquainted with limited resources for industrial development, due lack of investment, technology and management skills. FDI in industrial sectors through Mergers & Acquisitions, joint ventures, etc., has brought access to foreign players in Indian market. Foreign investors with large capital invest in industrial sector, booming the sector through technology transfer, utilizing unutilized resources, management skills and innovative techniques. It has brought competition and threat to local players; on the other hand it has increased the quality of the product and productivity in the market.

Banking: In context of developing nations like India, before 1991 had a weak banking system. Banking sector was not much developed, having poor service and not enough capital to make large credit. FDI in banking sector brought new

technology in banking sector which improved services with more strong credit facilitating provision. Private and foreign banks improved the infrastructure and service system in the banking sector such as computerisation, ATMs, customer service, etc. Banking sector is now capable of providing more credit which is essential for expansion and development of any individual or industry. This in turn will increase the productivity in the economy. So, FDI in banking sector has increased the credit facility for expansion of industrial and service sector.

Service: in developing country such as India service sector is the fastest growing sector and has the largest share in country's GDP. Service sector has played a dominant role in the growth of Indian economy, and role of FDI had been instrumental in the growth of service sector. FDI in services like telecommunication, information technology has led to the development of service sector. However, service export is mainly driven by information technology and communication. India has developed ICT considerably and has large number of IT professionals and skilled labours which led to increase in service exports.

4. FDI Externalities

There are two types of externalities associated with FDI—knowledge spillovers and pecuniary externalities. Knowledge spillovers take place when knowledge created by a multinational enterprise is used by a firm through demonstration effect, movement of labour or through transfer of knowledge from foreign firms to their suppliers or customers.

Second type of externality is pecuniary externality which takes place through interaction of firms. For instance, entry of foreign firms into various sectors creates an increased demand of inputs creating incentive for firms to invest in product upgrading, cost saving technologies or increased capacity, all of which may lead to better quality of product used as an input. Entry of foreign affiliates may change the market structure and increase the level of competition.

5. FDI and Exports

Relation of increasing FDI and exports is subject of country's policies. It is not necessary that increase in FDI flow in the economy will boost up the export. The first and foremost aim of attracting FDI inflow is to become self-sufficient and reduce import in order to improve country's Balance of Payments. However, along with FDI come technology and management skills in the country giving exposure to international market. This in turn increases the quality and quantity of productivity in the country which can compete in the international market, generating demand in global market and increasing exports. FDI may enhance export-oriented productivity and further improves export performance. Expansion in productivity due to increase in productivity reduces the unit cost and it also provides country with foreign exchange, which is essential for any country in early stages of development. India being the second fastest growing economy with large number of labour force and demographic opportunities has not a considerable share in global export share. India has just 2% of global share, whereas China has the 20% of global market share having great contribution in GDP making it the fastest growing economy of the world. If we analyze the flow of FDI pattern, China has attracted large quantity of FDI flow compared to India. Annual average flow of

FDI in China is \$48.79 billion (1991-2008), whereas in India it was \$7.76 billion during the same period.

Aitken et al. (1997) showed the effect of FDI with the example of Bangladesh, where the entry of one single multinational company in garment exports led to the establishment of number of domestic export firms, creating country's largest export industry. Many studies have found that FDI promotes exports of host countries. (Athukorala and Menon, 1995). Hu and Khan, attribute the spectacular growth rate of China during 1992 to 1994 to the productivity gain largely due to market oriented reform, which brought expansion in foreign trade and FDI.

UNCTAD (1998) is sceptical about the positive contribution of FDI on manufacturing export performance as it opines that capital and consumption goods not available locally are imported, and profits remitted, thus cutting into the export earnings generated. Ernst et al. (1998) observes the role of FDI was low in countries where local firms had good capabilities and could undertake subcontracting at low cost to the buyer. The FDI role tended to be larger where the local capabilities were weak especially concerned to developing countries.

6. FDI and Wages

According to large number of empirical studies, it has been found that foreign firms pay higher wages than domestic firms in both developed and developing economies. The difference between the wages ranges from 10 to 70%. The foreign firm's pay high wages to prevent labour turnover leading to knowledge spillovers leading to increase in competition from domestic players. Higher wages paid by foreign firms may be because of lack of knowledge about local labour market, higher labour volatility, or also may be a result of cherry picking (i.e., foreign firms acquiring domestic firms with above average human capital).

7. FDI and Poverty Reduction

Foreign direct investment is a key ingredient of successful economic growth and development in developing countries—partly because the very essence of economic development is the rapid and efficient transfer and cross-border adoption of “best practices.” Foreign direct investment is especially well suited to effecting this transfer and translating it into broad-based growth, not least by upgrading human capital. Growth is the single most important factor in poverty reduction, so foreign direct investment is also central to achieving that important World Bank goal. Government-led programs that improve social safety nets and explicitly redistribute assets and income might direct more of the fruits of growth to the poor. But these are complements—not alternatives—to sensible growth-oriented policies. And growth is needed to fund these government-led programs. Moreover, the delivery of social services to the poor—from insurance schemes to such basic services as water and energy—can clearly benefit from reliance on foreign investors. In short, foreign direct investment remains one of the most effective tools in the fight against poverty.

8. FDI and Employment

FDI often generates new employment (direct employment is higher in green field investments) and creates jobs

(indirectly) through forward and backward linkages with domestic firms. Estimates for a number of developing countries indicate that FDI has a multiplier effect on domestic employment. Aaron (1999) estimated that FDI in developing countries created about 26 million direct jobs and 41.6 million indirect jobs in 1997 (a multiplier of about 1.6). Lyanda (1999) obtained a higher estimate for Namibia: about 2 to 4 jobs were created for each worker (directly) employed by foreign affiliates.

Several studies have shown that workers in foreign owned enterprises (FOEs) are more productive than workers in domestic owned enterprises (DOEs). For example, Harrison (1996) analyzed differences in labour productivity between FOEs and locally owned firms in Morocco and Cote d'Ivoire. In 8 out of 12 industries in Morocco, output per worker was higher in FOEs than in domestically owned firms, with a difference in productivity ranging from 50% in electronics to about 130% in non-metallic minerals. In Cote d'Ivoire, the productivity gap existed in fewer industries (3 out of 12), however the gap was wider: ranging from 50% in chemicals to about 500% in oil.

Ramachandran and Shah (1998) also report that added value per worker is 59% higher for wholly owned foreign enterprises than for local firms in Kenya, 178% higher for FOEs

in Zimbabwe and 1,422% higher for FOEs in Ghana. The worker productivity gap may be partly explained by the differences in training opportunities for workers in FOEs and DOEs.

9. Conclusion

It is clear from above that FDI contribute to economic development, and all government wants to attract it. FDI inflow in developing country is dependent upon the policy framework, and business facilitation provided by government to foreign affiliates in the country. World market for investment is highly competitive, and for developing countries to seek such investment is necessary to accelerate economic growth. Policy recommendations for developing country should focus on improving the investment climate for all kinds of capital. Therefore, FDI can be effective in reduction of poverty, employment generation and overall development of the economy in developing country through appropriate government policy. The below table shows the necessary determinants of host country's to adopt for utilizing efficiently and attracting FDI for growth process.

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