Internship on the Impacts of FDI on Development

Causal Homeostasis: FDI, Growth and Development

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When we discuss FDI and macro-dynamics the causality direction is not as clear as expected. FDI has a direct impact on different macroeconomic indicators such as growth, interest rates, exchange rates and balance of payments. Other indirect impacts can be assessed when analysing spatial dynamics and human development. However, the extends of how such macro-dynamics, and particularly growth influence FDI flows, need more research. Results have not been homogenous, and variations between countries on the relationship FDI-development, depend on specific inherent factors. Here, geography, political regimes, FDI's entry modes and sectoral composition can create differential paths from a macroeconomic perspective. Which causal relationships can we then establish between FDI, GDP growth and development? We are going to discuss this in two main sections: I) The different impacts of FDI in growth and development and II) How development conditions FDI inflows and the attractiveness of a host country.

FDI a booster for growth and development

It's known that FDI inflows foster economic growth by expanding capital stock. According to the recent growth theories, capital including FDI can permanently affect output growth through increased investment in technology and know-how, increasing the overall level of knowledge and technology in the economy, resulting in higher levels of efficiency and productivity. Nevertheless, the positive impact of FDI inflows in growth depends on the entry mode and the host country capacities to exploit the spillovers linked to these capital investments. On one hand, greenfield investments directly add to production capacity and contribute to capital formation and employment generation in the host country; while Mergers & Acquisitions (M&A) represent a change in ownership that does not necessarily involve any immediate addition to investment or employment in the country (UNCTAD, 2006), and therefore imitating the gains on GDP growth. On the other hand, De Gregorio (1992) shows, using panel data of 12 Latin American countries, that the effect of FDI on GDP growth can be three times larger than the one of domestic investment only when the country has a highly educated workforce.

As established by the basic Keynesian models an increase in investments whether it is domestic or foreign will have a multiplier effect on growth. FDI can contribute at the same time to the formation of human capital both by demanding and by supplying skills (Slaughter, 2002). When multinational corporations (MNCs) enter the market they may increase the demand for skilled workers if they do not substitute the local demand for employment. Increased demand for skills is expected to raise the wage and employment opportunities of skilled workers, creating incentives for overall investment in human capital and eventually GDP growth. MNC might as well affect the supply side of skills by investing in the training of their workers. The big exception here is FDI directed to extractive industries. FDI in this particular sector is usually capital intensive and requires lesser training. In fact, FDI in extractive industries can cause adverse macro-dynamics, creating path dependencies on commodities' export, appreciation of the exchange rates and even crowding-out the development of other economic sectors, phenomena known as the Dutch Disease.

FDI's technological spillovers are considered a fundamental channel to enhance GDP growth and development but only if a certain threshold of human capital, well-developed infrastructure facilities, an absorption capacity and a stable economic climate is attained in the host country (Balasubramanyam, 1998). The entry of a foreign firm or affiliate generally increases competition, and even if local firms are unable to imitate the technology of MNCs, increased competition forces them to increase the efficiency of existing technologies, to adopt or develop new more efficient technologies, or to invest in human capital. However, increased competition can also result in the crowding out of local firms and reduce domestic investment. Technological spillovers impact depend then on local characteristics and are mainly

industry-specific (Nunnenkamp, 2004). For example, in the case of Mexico, the industrialization excelled by exports and FDI determined its structural change and even exuberate inequalities within regions. Today, in Mexico local firms have limited capabilities to profit from technological externalities, resulting in a bifurcation in the economy with some sectors fully engaged in international trade, but poorly linked to the domestic economy, therefore unable to transmit the presumable benefits of FDI (Ortiz, 2013). In this case, FDI may boost GDP growth and improve the balance of payments but it doesn't reflect necessarily a sound domestic economy or higher development.

Even though Choe (2003) and Zhang (2001) detected two-way causation between FDI and growth, the effects are more apparent from growth to FDI. The results of Chowdury and Mavrotas (2006) suggested that FDI has in fact a lasting impact on the level of GDP, while GDP has only a short-run impact on FDI. Linkages between development are to be determine since they can impact directly or indirectly through GDP.

A Host Country Attractiveness

Generally, a growing economy is likely to attract more FDI since it provides new market and profit opportunities. The expected rate of growth has been found to be a highly significant determinant of FDI-GDP ratios. Hence, host countries can raise their overall growth rates through a variety of political and economic efforts not directly associated with FDI, since indirectly these policies would also affect FDI, conditioned to have a significant positive impact on GDP growth. In the short-run GDP can boost FDI. However, since FDI can't be easily withdrawn It will be more attracted by the long term prospects of the country and its policies. The idea behind this is that profits, losses and risks need to be shared among the host country and the foreign entity.

It was found that exchange rate distortions in host countries do not seem to exert a significant detrimental influence on FDI. (Gastanaga, 1998). Nonetheless, corruption has a deleterious effect on FDI inflows, while the accumulation of democracy and sometimes political repression have positive effects given the invested sector (Gossel, 2017). FDI is in fact the most desirable form of capital flow from LDCs since it is considered a long-term investment and being less volatile than portfolio and debt investments (World Bank,1999). Newly established countries, for example in the Sub-Saharan region, suffer from macroeconomic weakness such as low productivity, high inflation rates, underdeveloped infrastructures, low human resource development, small market size, political instability and widespread corruption (Al farooque & Yarram, 2013). Thus they seek to increase their economic growth rates by supplementing their domestic savings with foreign capital flows (Mody & Murshid, 2005), mainly in the exploitation of natural resources which can lead to extractive institutions and rent-seeking practices. To minimise risks of contract default or lack of law reinforcement, FDI is normally attracted to more democratic countries where institutions enforce property rights protection, policy and regulatory stability, reduce corruption and possible expropriation (Li, 2009). Thus, besides the access to better hard infrastructures, institutional development will be a key factor to attract FDI inflows and benefit from its effects on growth and externalities.

The countervailing view however is that FDI prefers autocratic regimes that can shield foreign investors from pressure for high wages, labour protection and taxes while offering policy options that are not subject to outside scrutiny (Gehlbach & Keefer, 2011). In addition, the need to attract FDI may pressurise governments to provide a climate more hospitable to foreign corporations than domestic citizens, and consequently, corporations may prefer to invest in less democratic countries that make it easier to exploit their oligopolistic or monopolistic positions (Resnick, 2001). To ensure then a positive impact on development, the host country should exhort redistributions in terms of R&D.

Conclusion

Feedback loops between FDI and Macro-dynamics are essentially dependent on the main ideal: development. FDI can enhance GDP growth and thanks to its externalities excel the host country's development potential. However, to do so a certain threshold of development is need to properly exploit technological and human capital spillovers. At the same time, the development boost is nothing but conditional to the FDI entry mode, political and sociological contexts.

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