

Benefits and drawbacks of foreign direct investment (fdi)



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Foreign Direct Investment (FDI) is the single most important mechanism for the globalization of the international economy. FDI is the investment of real assets in a foreign country, it is acquiring assets such as land and equipment in another host country, but operating the facility from the home country. FDI is viewed by many as necessary to stimulate the economies of both developed and underdeveloped countries. The global economy experienced a decrease in foreign investment flows. Developing countries have been hit the hardest by the decline in FDI as foreign investment is being redirected to more developed countries. It is expected that FDI will continue to be the most significant tool for globalization.

It is widely accepted that FDI inflows provide economic benefits such as increased competition, technological spillovers and innovations, and increased employment. The impact of foreign investment extends far beyond economic growth. FDI can be a catalyst for change to society as a whole, therefore one must think in terms of economic, political, social, technological, cultural, and environmental factors and examine all the effects of FDI in order to interpret the true long-term impact. Foreign investment and globalization continues to increase, developing countries desperately seeking to attract foreign investment can have undesirable outcomes. FDI can have numerous negative effects, such as job loss, human rights abuses, political unrest, financial volatility, environmental degradation, and increased cultural tensions.

The results of FDI on the global economy are complex and unpredictable, yet they can vary from country to country. This is due in part to the practices that are in place prior to receiving FDI inflows, such as deep-rooted social

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customs, political practices, laws and regulations. In more developed countries foreign direct investment resulted in rapid economic growth and social development and in unstable economies, underdeveloped countries, the results can be quite different.

Types of Foreign Direct Investment

According to Ali & Guo (2005) states the main types of FDI in world are Equity Joint Ventures, Contractual Joint Ventures and the establishment of Wholly Foreign Owned Enterprises. Contractual joint ventures were initially the most important in the world. Equity joint ventures and wholly foreign owned enterprises became predominant and recent years have seen a proliferation of wholly foreign owned enterprises. Equity joint ventures have been a popular entry mode for two reasons. Ali & Guo (2005) stated that most governments believes that equity joint ventures best serve the objective of foreign capital, technology, and management experiences. Secondly, foreign investors hope through engaging in joint ventures to get local partner's assistance in the domestic markets. Foreign investors have chosen wholly foreign owned enterprises as the preferred entry mode in recent years so as to avoid problems associated with equity joint ventures.

Motives for foreign direct investment

Kokko (2006) identifies Foreign Direct Investment literature three as the most common investment motivations: resource-seeking, market-seeking and efficiency-seeking. Kokko (2006) suggests that although most MNCs engage in FDI that combines the characteristics of each of these categories, the gravity of each motive on the formulation of the MNC's strategy may also

change, as a firm becomes an established and experienced foreign investor. The availability of natural resources, cheap unskilled or semi-skilled labor, creative assets and physical infrastructure promotes resource-seeking activities. According to Kokko (2006) the most important host country determinant of FDI has been the availability of natural resources, e. g. minerals, raw materials and agricultural products. Labor-seeking investment is usually undertaken by manufacturing and service MNEs from countries with high real labor costs, which set up or acquire subsidiaries in countries with lower real labor costs to supply labor intensive intermediate or final products. To attract such production, host countries have set up free trade or exportprocessing zones (Kokko 2006). Market-seeking investment is attracted by factors like the host country's market size, per capita income and market growth. For firms, new markets provide a chance to stay competitive and grow within the industry as well as achieve scale and scope economies. Apart from market size and trade restrictions, MNCs might be prompted to engage in market-seeking investment, when their main suppliers or customers have set up foreign producing facilities and in order to retain their business they need to follow them overseas Market-seeking also includes the search for strategic assets that enable the MNC to sustain and advance its international competitive advantages (Kokko 2006). The motivation of efficiency-seeking FDI is to rationalize the structure of established resource based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities. The intention of the efficiency-seeking MNC is to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and market

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structures by concentrating production in a limited number of locations to supply multiple markets (Kokko 2006). Ownership, location, and internalization are the three potential sources of advantage that may underlie a firm's decision to become a MNC. A key feature of this approach is that it focuses on the incentives facing individual firms.

Foreign Direct Investment (FDI) is determined by three sets of advantages which direct investment should have over the other institutional mechanisms available for a firm in satisfying the needs of its customers at home and abroad. The first of the advantages is the ownership specific one which includes the advantage that the firm has over its rivals in terms of its brand name, patent or knowledge of technology and marketing. This allows firms to compete with the other firms in the markets it serves regardless of the disadvantages of being foreign. The second is the internationalisation advantage, that is why a 'bundled' FDI approach is preferred to 'unbundled' product licensing, capital lending or technical assistance (Wheeler and Mody, 1992).

The location-specific advantages relate to the importance for the firm to operate and invest in the host country and are those advantages that make the chosen foreign country a more attractive site for FDI than the others. For instance firms may invest in production facilities in foreign markets because transportation costs are too high to serve these markets through exports. This could either be directly related to the actual nature of the good, either being a high bulk item or a service that needs to be provided on site, or due to policy factors such as tariff rates, import restrictions, or issues of market access that makes physical investment advantageous over serving the

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market through exports. Location advantage also embodies other characteristic (economic, institutional and political) such as large domestic markets, availability of natural resources, an educated labor force, low labor cost, good institutions (the clarity of country's law, efficiency of bureaucracy and the absence of corruption), political stability, corporate and other tax rates among others.

Negative effects of foreign investment on the economies of the Host:

Al Saffar (2010) states the criticisms directed against the common practices of foreign firms invested in host countries is that it's main focus in the recruitment of its investments in industries quarrying for the purpose of re-use in the country of origin of the capital without making any effort to engage in manufacturing activity and development commensurate with the goals and aspirations of these countries, which do growth and development. This type of investment is characterized by extension of the parent organization that harms the host country and adds nothing.

Al Saffar (2010) states some foreign-owned supplier to the supply of technology investment in the form of packages, the staff is unable to host countries for investment, dismantled and identified vocabulary to adapt and acquire scientific and technological expertise required for the manufacture of its terms, commensurate with the circumstances and their scientific and economic and social development. That this is clearly going to affect negatively on the possibility of acquiring technical staff Local technological skills and diverse as these companies by another would not be attributable to their employees from the landlords, the National, but routine job sites that

do not require sophisticated technical expertise. It thus does not allow creating a new class of professionals or the business of skilled scientific and technological and organizational and administrative, marketing and shielded from the possibility of opening prospects for new national projects and sophisticated and thus the host country has to invest in a spiral of underdevelopment.

Al Saffar (2010) argues that rejecting the foreign investor is often the transfer of advanced technology in his possession the grounds that the host country is unable to digest and absorb these advanced Technology and modern. So he would prefer to import from abroad with the full line of production and assembly and thus ignore the important one the main objectives of the host countries is that companies he training of technical staffing group to have and given an opportunity to digest and absorb these technology and benefit from the adaptation and manufacture of the spectrum and its uses in locations other economic, commensurate with their economic circumstances.

According to Al Saffar (2010) often foreign companies to import production inputs from abroad, such as materials preliminary and intermediate products as well as the import of spare parts for maintenance the project when you need after the run from their home countries is usually compared to less dependence on local inputs, leading to serious injury to the interests of the host country to the economic and trade deficits, including impair its ability to take advantage of natural resources and increase savings, which is desperately needed. We must give foreign investors a degree of

administrative control by virtue of its contribution to the top money on <https://assignbuster.com/benefits-and-drawbacks-of-foreign-direct-investment-fdi/>

investment projects, will limit or impair the effectiveness of policies sometimes economic development in the host country and restricts the varying degrees of independence of decision-makers local address balance of payments or to take any action, a suitable economic the impact and effectiveness of positive economic activities. (Al Saffar 2010)

The foreign investment of foreign companies, making the host country loses some capacity to make some economic and political decisions on the management of its affairs which increases the economic dependency of these countries to developed countries. Besides, these foreign companies is strong negotiating and bargaining power on the selection and sitting investment and size and type of production through a selective approach in the selection of sites investments, creating a sort of incompatibility between the objectives and interests of these foreign companies Invested with what is planned in the path of economic and social development or the desired prepared for those countries. (Al Saffar 2010).

The foreign invested companies operating in the area of services, media nd cultural services are often negatively affect the social systems and cultural and traditional values in the host countries .. As they are able to deploy Culture Western and especially American by selling programs on culture and magazines and music and films and books at low prices exceeding the cost price only slightly so as not to be able to become local companies to compete with these low prices. Accordingly, these companies impose its values and culture and traditions of other societies and lead to a breach of and disorder and social systems, social values and traditions rooted and

established who was raised by these communities generations long. (Al Saffar 2010)

According to Al Saffar (2010) depriving the host country for foreign investment from income tax imposed on capital funds or foreign companies on profits transferred abroad or at imports from foreign inputs as imposed by the Convention as well as imposed by the WTO members from the requirement of national treatment when the imposition of laws and taxes and fees on investment activity as is the case with the local foreign It shall be a great loss for the developing countries that depends to a large extent in the financing of development on the tax revenue.

Al Saffar (2010) states a key part of foreign investment consists of the profits realized locally and from here highlight the problem for local decision makers As for allowing foreign companies to transfer most of their profits to their mother countries, which means allowing them absorb the riches that have been newly generated by the activity within the host country, or a requirement that these companies this re-invest profits locally. This really means to allow it to expand and increase the control of the national economy and thereby expanding its market dominance in local raise the rates of prices of goods and services, leading eventually to increase their profits back Other.

According to Al Saffar (2010) Giving a lot of freedom for foreign companies to engage in unchecked activity will enhance their ability to evade compliance with laws and regulations issued by the Government of the country, the host and the virtue of its invoking a variety of pretexts, which

requires follow-up its affairs professionally and prevent it from Overcome any form of abuse.

Al Saffar (2010) states Some economists believe that foreign investment leads to the creation of dependency and development underdevelopment are to be based primarily on the shameless exploitation of cheap labor and exploitation of natural resources of the host country, thus leading to a loss of economic independence and political and greater dependency.

VARIABLES DETERMINING FDI INFLOWS

Gross Capital Formation, in a transition economy, improvements in the investment climate help to attract higher FDI inflows. It translates into higher Gross capital formation which in turn leads to greater economic growth.

Sridharan Perumal et al (2010) find little evidence of FDI having an impact on capital formation in developed countries and observe that the most important aspect of FDI in the selected sample of countries is related to ownership change. The relationship between FDI and Capital Formation is not simple (Sridharan Perumal et al 2010). In the case of certain privatization, it may not lead to increase at all or even result in reduction. Thus, the unclear relation between FDI and capital formation may also hold in a transition economy. However, a positive or negative and significant relationship between FDI and Capital Formation is expected. (Sridharan Perumal et al 2010).

Currency valuation The strength of a currency (Exchange rate) is used as proxy for level of inflation and the purchasing power of the investing firm.

Devaluation of a currency would result in reduced exchange rate risk. As a

currency depreciates, the purchasing power of the investors in foreign currency terms is enhanced, thus we expect a positive and significant relationship between the currency value and FDI inflows. The currency value can be proxied by the Real Exchange Rate, Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER). (Sridharan Perumal et al 2010).

Trade openness, Trade openness is considered to be a key determinant of FDI as represented in the previous literature; much of FDI is export oriented and may also require the import of complementary, intermediate and capital goods. In either case, volume of trade is enhanced and thus trade openness is generally expected to be a positive and significant determinant of FDI. (Sridharan Perumal et al 2010).

Infrastructure facilities, The well established and quality infrastructure is an important determinant of FDI flows. On the other hand, a country which has opportunity to attract FDI flows will stimulate a country to equip with good Infrastructure facilities. Therefore, we expect positively significant relationship between FDI and Infrastructure. (Sridharan Perumal et al 2010).

Labour cost, Higher labour cost would result in higher cost of production and is expected to limit the FDI inflows; therefore, we expect the negative and significant relationship between labour cost and FDI. (Sridharan Perumal et al 2010).

Economic stability and growth prospects, A country which has a stable macroeconomic condition with high and sustained growth rates will receive more FDI inflows than a more volatile economy. The proxies measuring <https://assignbuster.com/benefits-and-drawbacks-of-foreign-direct-investment-fdi/>

growth rate are: GDP growth rates, Industrial production index, Interest rates and Inflation rates. (Sridharan Perumal et al 2010).

Market size, Larger market size should receive more inflows than that of smaller countries having lesser market size. Market size is generally measured by Gross Domestic Product (GDP), GDP per capita income and size of the middle class population. (Sridharan Perumal et al 2010).

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