Foreign Direct Investment & Developing Countries: Its Impact & Significance

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Abstract

Foreign Direct Investment (FDI) has appeared to be the most important source of external flow of resources to the developing countries and has become an integral part of capital formation despite of their small share in global distribution of FDI. This paper discusses the impact of FDI on the economy of developing countries and its overall significance in the economy of developing countries and after the Global Financial meltdown FDI are searching for more lucrative investment opportunities and developing economies around the world provide the very good investment options for FDI.

Introduction

Over the past few decades emerging countries have become the major recipients of Foreign Direct Investment (FDI) as MNCs have started expanding their business operations beyond their national borders to the countries offering various advantages which they seek to exploit to gain. Foreign Direct Investment (FDI) has appeared to be the most important source of external flow of resources to the developing countries and has become an integral part of capital formation despite of their small share in global distribution of FDI (Kumar and Pardhan 2002).

FDI is a dynamic force of globalization and a vital aspect of economic growth that provides numerous benefits to the recipient countries. It impacts host countries by providing capital, foreign exchange, technology, competition and by increasing access to foreign markets (Crespo and Fontura 2007). It not only adds to capital but also induces some other important aspects of development. FDI brings in the much needed technology, skills, innovative capacity, and organizational and managerial practices between locations, as well as international marketing networks for the local firms which results in their expansion and foreign venture.

Developing as well as developed countries look to attract FDI due to the advantages that it offers for the growth and development. FDI can not only bring capital to an economy, but also transfer knowledge, technology and skills, as well as generate employment and trade along with its affect on domestic investment and innovation (Brooks and Sumulong 2003). Thus, the developing countries, majority of which function in the low-level equilibrium catch i.e. low savings rate which is followed by low investment rate resulting in low per-capita income growth rate, may evade unwanted economic situation by importing capital from abroad in the form of foreign direct investment (Hayami 2001). For the developing countries, The annual amounts of FDI inflow reached $1.24 trillion which showed a moderate increase of 5 percent from the previous year’s $1.185 trillion. This moderate increase was the result of high inflow of FDI in the developing and transition economies which together for the first time accounted for more than 50 percent of the world’s total FDI flows. The inflow of FDI to developing economies increased by 12 percent in 2010 and accounted for $574 billion. This increase in developing economies resulted due to the strong valuation of company’s assets, strong growth in the earnings and the robust economic fundamentals (UNCTAD, World Investment Report 2011). The changing pattern of FDI inflow and the efforts that the developing countries are making towards its attraction because of its positive implications is also evident from the global ranking of the highest FDI recipients in which half of the 20 top host economies where the developing and transition economies and also that three developing countries were among the top five largest FDI recipients in the world (UNCTAD, World Investment Report 2011). This offers a greater support to the idea that the importance of FDI to developing countries and their efforts towards it is greater, in spite of the fact that they received a far smaller share of FDI than the developed economies.

The increase in the globalization of capital flows indicates that the world economy is becoming increasingly interconnected resulting from the global extension of economic activities. Foreign Direct Investment can play a vital role in economic growth in developing countries by generating more benefits to the host economies rather than filling the short-term capital deficiency problems. According to the report of UNCTAD (2008), FDI...
inflow capable of creating employment opportunities, increasing productivity, transferring skills and technology, boosting exports and continuing the long-term economic growth and development of developing countries. FDI is also viewed as the largest source of external financing for developing countries.

**Problem Statement**
Foreign capital inflows, especially Foreign Direct Investment is playing a vital role in developing countries. The question whether or not FDI brings positive impacts on the host countries (developing countries) has been a subject of intense research. Many researchers believe that the effect is positive. There are assumptions of FDI being positive generating spillovers for the developing economy. These spillovers may get included through numerous modes such as technologically advanced firms results in knowledge spillovers through there interaction with the domestic companies, technicians, engineers etc. or through the hired technicians by the local firms. The benefits to host countries can be numerous through FDI like technology transfer, increased foreign funds, employment generation and so on.

**Purpose of the Research**
The purpose of the research study is to understand and asses the influence foreign capital has on the economy of emerging countries, with focus on Foreign Direct Investment. The study underlines the impending role that FDI undertakes in developing more sustainable and effective interventions. The benefits of FDI vary greatly across sectors i.e. in the primary, manufacturing, and services sectors. This research will also attempts to provide a better understanding of the relationships between FDI and economic growth by taking into account the influence of the host country’s absorptive capacity. To satisfy the objectives and the purpose of this research, the following points shall be discussed:
- Discussing the role of FDI in the present state of the world economy.
- Understanding the role of FDI for the sustainable development
- Considering the effects of economic development in the developing countries
- Home country’s measures to attract FDI
- Mode of entry adopting the foreign firms to entry into the foreign market.

**Aims and Objectives of the research**
The main basic objective behind doing the research is to make the countries compatible enough to compete and to just focus on single objective that makes one to think on a wider aspect. For many of the MNC’s the FDI acts as the source of capital. At the same time the FDI becomes the source of technology for the MNC’s.

The main objectives and aims of the research study are:
- To understand the factors that affects the FDI in the economic development of the country.
- To enable the understanding of a value added features of the FDI linked with the production facilities.
- To understand the role of employment opportunities provided by the FDI.
- To analyze the role of FDI on various rural activities like agriculture, food processing sectors etc.
- To analyze the efficiency and the profit levels of the MNC’s established in India.
- To analyze the impact of FDI on the primary, manufacturing and service sectors to promote the economic development.
- To understand the factors that affects the investors in deciding the investment area.

**Research questions**
The main questions were to be discussed through the study includes:
- Does the FDI play a major role in the economic development of the country?
- How much FDI affects the economic development in the developed and the developing countries?
- Does the FDI acts effectively in solving the problem of employment and distribution and economic development?
- Under what circumstances is FDI beneficial to the developing countries?
- What measures shall be applied by the countries to attract the FDI’s?
- What polices shall be framed and adapted by the developing countries to attract the FDI?
- Does FDI helps in the economic development of the under developed countries?
- What mode of entry shall be adopted by the foreign firms to enter into the foreign market?
- What shall be the linking matter between the FDI and export growth?
- How effective are the FDI polices?

**Hypothesis:**
The study refers that whether the foreign direct investment in the developing countries is dependent on the economic growth of the country or the economic growth is independent of the foreign direct investment.

**LITERATURE REVIEW**
Theories of FDI: Denison V., 2010, discussed about the FDI theories to make an overview of the main FDI theories. Under the conditions of financial growth, the FDI help to enhance the economic mechanism and understanding the behavior of economic agents considering both the micro and macro level. The basic objective of FDI’s is to motivate the firms and invest the abroad rather than export. Main motive of understanding the FDI theory is to highlight the theories motivate the needs of new approach.

Growth of FDI in emerging economies: According to Estrin and Meyer (2004), emerging countries over the past few decades have become the major recipient of FDI and this is because Multinational Corporations (MNCs) have expanded their business operations beyond their national borders into the foreign markets and have exploited the available business opportunities such as cheap labor, easy availability of raw materials etc.

Current Trend: According to World Investment Report (2011), the Global inflow of FDI in the year 2010 was estimated to be $1,244 billion marked with a small increase from that of $1,185 billion in the year 2009. This report however highlight the shift in the flow for FDI from developed towards transition and developing economies where for the first time the inflow engrossed approximately 50 percent of the world’s total FDI inflow thereby increasing the total FDI by 12 percent i.e. to $574 billion in the year 2010. This rise was the result of the potential domestic demand and rapid recovery of the economy. The attractive valuation of the assets, growth in earning and market growth in the developing countries led to a point where the cost of M&A doubled.

The shift in the FDI inflow towards the developing and transition countries is also evident from the 2010 ranking of the largest FDI recipient countries. The ranking clearly shows that majority i.e. more than half of the top 20 recipient economies were the developing or the transition economies as compared to 7 in the year 2009. Along with this, the ranking also shows that among the top five largest recipient of FDI, three were developing economies. The ranking also portrayed that while the US and China maintained their top position, some European countries moved down in the ranking and Indonesia entered the list of world’s top 20 FDI recipients for the first time.

The inflow of FDI to South, East and South-East Asia increased rapidly with an inflow of about 24 percent in the year 2010 and reaching $300 billion. This rise was especially in East Asia and South-East Asia. While in Latin America and Caribbean the inflow was $159 billion because of increased domestic and external demand, better macro-economic factors and high price of the commodity (ibid).

RESEARCH METHODOLOGY
Data collection method
Qualitative Research: As we know all the research has been conducted with some purpose of some benefits of the research outcomes. Qualitative research has been undertaken on the basis of the data collection techniques such as interviews and survey. Main objective of conducting qualitative research is to understand the people perception towards the particular topic or problem. When researcher intended to conduct qualitative research his main motive is to collect depth information regarding the topic and he/she design the questionnaire in a way by which he can collect more information to the respondents.

Sampling technique:
The target group of people for the research are the managers and the economists those are having an information of Foreign investment and how it affect the financial development of the economy. People from various finance company those are working at managerial level and having all the information about the current scenario of economic development. population is related people with the electronic industry for the research analysis. This main focus point of the research will be impact and the significance of the FDI and we also discuss about the factor those can affect the attraction of the FDI towards the particular country. The nature of the re-search is exploratory and descriptive because we explore new ideas and can also make some theories to attract the FDI and we can also throw light over the same factors which are far from the reach of the common people.

ANALYSIS AND FINDINGS
In the present world, the fundamental concern for the developing economies is not simply one of attracting FDI; the concern is how to develop long-term international competitive potency and how FDI can add to that development in the current situation of globalization (Buckley 1995).

Flow of FDI Globally: An overall view
The liberalization of capital markets, trade, and removal of barriers of business, advancements in technology, and the continuing internationalization of goods or services or even ideas over the past two decades is making the economies of the world as globalised one. As a result, with huge domestic market, low cost of labor, cheap and skilled labor, high returns of investment, developing countries are posing a significant impact on the world economy, mainly in the economics of the industrialized states. As the motivation packages and other public fiscal policies weaken, unrelenting...
economic recovery becomes more dependent on private investment. Foreign Direct Investment inflows of the world in 2010 increased modestly following the slump in the year 2008 and 2009. In the year 2010, the inflow of world’s FDI reached to $1.24 trillion which marked a 5 percent increase from the preceding years of 2008 and 2009. The cause of this growth is the inclination of FDI flows to the developing countries which for the first time ever accounted for more than 50 percent of total Foreign Direct Investment flows of the world. This increase in FDI flows in the year 2010, however, remained approximately 15 percent below the level which was before the pre-crisis of 2008 and 2009 and approximately 37 percent from its previous max in the year 2007 but in spite of all these, trade and the global industrial production was restored to normal i.e. pre-crisis level. This slight increase in the global resurgence of FDI also showed the jagged pattern in the components and the mode of Foreign Direct Investment.

In the year 2010, other aspects of global inflow of FDI also showed shifts in there existing pattern.

- Cross Border Mergers and Acquisitions recovered gradually whereas, the Greenfield mode lost its grounds and fell in both number and value.
- The shift of FDI towards developing countries resulted in the increase in profits of foreign affiliates causing a boost in reinvested earnings.
- The uncertainties covering the world currency markets and European debt caused a negative intra-firm borrowings and decrease in the equity investment.
- The sovereign wealth funds fell significantly while that by private equity firms recovered its impetus.
- The higher profitability and strong growth of economy of the developing economies along with improved performance of the world capital market resulted in the increase in the inward stock of FDI to $19 trillion i.e. 7 percent rise from the previous years.

Nonetheless, the unpredictability of the business environment, predominantly in developed economies, means that Transnational Corporations have stayed fairly vigilant with regard to their investment plans. Along with this the risk factors such as volatility of global economic governance, fiscal and financial sector imbalances, a probable extensive sovereign debt crisis and in some developed countries, increasing inflation and obvious signs of unpredictability in major emerging market economies, along with the others, might upset the recovery FDI which started after a turmoil of 2008 and 2009.

Current Trend:

The inflow of FDI in 2010, to both the developed economies and the transition countries contracted further. On the other hand, the inflows to the developing countries recovered strongly and rose to 12 percent i.e. to $574 billion. For the first time both the developing and the transition economies together in 2010, attracted more than 50 percent of the total FDI flows of the world. This increase in the FDI inflow in the developing economies can be seen as a result of their strength of domestic demands, speedy economic recovery and escalating south-south flow. The inflow of FDI to South, East and South-East Asia increased rapidly with an inflow of about 24 percent in the year 2010 and reaching $300 billion. This rise was especially in East Asia and South-East Asia. While in Latin America and Caribbean the inflow was $159 billion because of increased domestic and external demand, better macro-economic factors and high price of the commodity (ibid).

In the year 2010, cross-border M&A increased to $29 billion making Brazil the largest destination for FDI inflow whereas, FDI inflow in Africa showed downward trend. FDI inflows to South Africa decreased to slightly more than a quarter as compared to that of 2009. FDI flows in North Africa too slipped slightly by 8 percent in the year 2010, the uprising that started in the early 2011 held the flow of FDI in the first quarter of 2011. Inflow of FDI to West Asia, at $58 billion decreased, in spite of the stable recovery of the economy (World investment report 2011, p. 5).

The transition economies of South-Eastern Europe and those of Common wealth of Independent States recorded a minor reduction in FDI inflows in the year 2010 which was about 5 per cent, to $68 billion, which was 41 per cent in 2009. FDI inflows to these countries continued to decrease due to slow investment from the countries in European Union (ibid).

![Figure no. 5: Inflow of FDI to developing and transition economy (Billions of dollars)](image)

The transitional corporations for the purpose of maintaining competitive edge in the world market is maintaining their cost-effectiveness through increased investments in the developing countries.
The world ranking of the largest recipient of Foreign Direct Investment of 2010 also displays the changing trend in the flow of FDI. In this ranking, three out of top five were developing nations and half of the list which constituted the top 20 economies were from the developing and transition economies. While the US and China continued to occupy their top positions, some European countries slipped down in the ranking. Indonesia, for the first time entered the top 20 FDI recipients.

![Figure 6: Global FDI inflow, top 20 host economies 2010](image)

**Figure no. 6:** Global FDI inflow, top 20 host economies 2010

This swing of inflow of FDI towards developing and transition economies was also imitated in a change in the ranking of host countries by Inward FDI Performance Index of UNCTAD. This performance index measures the amount of Foreign Direct Investment that economies obtain in relation to the extent of their economy (Gross Domestic Product).

**Impacts of Foreign Direct Investment**

It is observed that the impact of Foreign Direct Investment is vague. FDI often crowds out domestic investment i.e. relocates or decreases it. FDI is also likely to arouse domestic investment by creating an investment environment favorable to it and, transferring technologies and management techniques. The relationship between FDI and domestic investment depends on, among other things, the quality of FDI, domestic regulatory environment and the time horizon studied. In the long run, if there are sequential investments to the initial one, FDI tends to have a favorable impact on domestic investment by stimulating it. The total effect is a sum of the component effects and quite difficult to predict.

A study carried out by Research and Information System for the non-aligned and other developing countries (RIS), India found that evidence of the effect of FDI on domestic investments is mixed.

The study was conducted taking a sample of 98 countries covering the 1980-1998 periods. The results for Asian countries are summarized below:

- In India, Fiji, Papua New Guinea, Philippines and Singapore FDI crowded out domestic investment.
- In Pakistan, China, Indonesia, Malaysia and Turkey FDI flow has not had any effect on domestic investment.
- In Bangladesh, Korea, Nepal, Sri Lanka and Thailand, FDI has had a positive effect on FDI by crowding in domestic investment.
- Of the 107 countries surveyed, FDI has had a positive effect on domestic investment in 22 countries.

**Analysis of FDI with its impact on Economic Growth**

The contribution of FDI growth and the FDI share of fixed capital are being analyzed on understanding the effect of economic growth in the developing countries. In the year of late 90’s FDI has being accounted as the capital flow of 50% towards the developing countries. Many of the developing countries have tried to attract more of the FDI’s by making their policies much more innovative and attractive. From the 1980’s downfall has made the debt crisis a chaos in the world economies and affecting the downturn of the economies. FDI studied positive effects including the productivity gains, technology transfer, managerial skills, employee training, and international production networks and gave the increased efforts to attract the FDI.

![Figure 7: representing the FDI in India and share of gross fixed capital formation (GFCF)](image)

**Figure no. 7:** representing the FDI in India and share of gross fixed capital formation (GFCF)

The diffusion of new technology shows the benefit to the foreign firms with the domestic markets and domestic firms by the introduction of new products. The benefit of the FDI plays an important role in developing the national economy and further promoting the growth of it. Even to support the entry of foreign firms to their country many of the governments initiated many special incentives.

CONCLUSION
Globalization is a wider aspect which has made many of the impossible the possible one, like the company lagging in certain aspect can adopt its availability from another country across the border, many countries hidden due to the lack of financial facility will now grow and develop themselves with the constant and a positive help of investment made from the developed countries on their will towards the developing countries to assist them in any terms and at the same time to fetch out the benefits which make them more stronger and stable in the global market. Under this research the researcher has focused mainly on the conceptual views of foreign direct investment (FDI) and its major impact and significance on the economic growth within the developing countries. Prospective of the research is to study the concern of developing a long term international competitive potency and to understand the aspect of development within the current situation of globalization.

After recovering from the downfall in the year 2008 and 2009 the world’s economy started moving towards the growth and development to make that it sustainably more appropriate in the year 2010. in the growth upliftment year 2010 shows the figure response the nearly maximum Foreign Direct Investment (FDI) inflows has taken a booming step towards the growth and development of the other economies lagging behind in the global change.

Foreign Direct Investment (FDI) is likely to be supported by the sectors in which the investment is to be made if the investment is done in the sector which is obsolete with no competiveness or not developing then the investment in such a sector many lead their money to the downfall. In the year 2010, the sector wise distinction is made to understand the areas of profit and development. In the sector of manufacturing contribution the FDI shows an optimistic growth factor by the modes of the entry of cross-border Mergers and Acquisitions and Greenfield investment FDI and the primary and the services sector showed a necessary decline. From the year 2005 to 2007 primary sector has struggled much to improve itself at the better part and processed towards the FDI attraction but the service sector was still struggling and losing its attraction and the manufacturing sector was showing a decline of almost 10 % below the pre-crisis levels. but as stated earlier manufacturing sector shown a better area for the investment of the FDI’s showed an approximate of 23 % in the year 2010 and the investment in this sector showed a better growth and economic development of this sector promoting the necessary growth of country and thus the world.

It is slightly concluded that analysis of FDI is considered with its impact on the economic growth. For such kind of analysis mainly secondary data is collected when the comparison of FDI with the economic growth of the developing countries. The study explained out the FDI’s contribution on the growth and the fixed capital and its effect on the economic growth within the developing countries. Under the part of conclusion, it was resulted out that nearly 50 % of the capital flow is decided on the developing countries, to attract the FDI.

REFERENCES


