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The role of FDI in emerging market economies compared to other forms of financing: Past developments and implications for financial stability

Contribution
to the CGFS Working Group on FDI in the Financial Sector
of Emerging Market Economies

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1 Introduction

Since the beginning of the 1990s foreign direct investment (FDI) has become the most important source of foreign capital for emerging market economies (EMEs).[1] Official flows have lost much of their erstwhile significance, while bank lending has been muted since the debt crisis of the 1980s. Portfolio investments have grown notably, but tended to be quite volatile. In particular, they have decreased markedly in the aftermath of the Asian crisis of 1997-98. In contrast, FDI flows to EMEs continued to increase over the nineties. Indeed, after the Asian crisis positive net private capital flows to EMEs persisted only because of substantial FDI activities.

The increasing reliance of EMEs on FDI is often seen as an extremely welcome development. Many positive implications are ascribed to these particular capital transfers that apparently set them apart from other types of private capital flows. The import of improved management techniques and of more advanced technologies as well as the related easier access to international financial markets are among the commonly cited advantages associated with FDI. In addition, FDI is also expected to be a relatively stable long-term commitment on behalf of a multinational enterprise (MNE). All this together should have significant benefits for the recipient countries in terms of economic growth and reduced external vulnerability. Especially, even large current account deficits are often viewed as clearly sustainable as long as they are largely financed through FDI instead of bank lending or portfolio investments, which are both known to be highly volatile.

This sanguine mainstream view of FDI has recently been increasingly questioned.[2] Doubts have been expressed as to whether the positive effects of FDI have perhaps been exaggerated and the longer-term stability assumptions of FDI really conform to reality. A review of the available evidence suggests that FDI may indeed possess the above-mentioned desirable features, but that their realisation depends on a combination of other factors that need to supplement direct investment activities. Moreover, the volatility of FDI can be significantly higher than commonly thought. Also, acquisitions by non-residents of utilities and other public enterprises could help prolong unsustainable macroeconomic policies. Under the circumstances, the benefits of importing know-how would fade against the country's hidden increase in its external vulnerability. While such risks call for a qualification of the previously

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[1] There is no generally accepted definition of the group of EMEs. The IMF uses the broadest conceivable definition in its World Economic Outlook (WEO), comprising all non-industrialised countries (see WEO of September 2002, Table 1, p 12). Others define EMEs as a group of more advanced developing economies, although no general agreement exists as to which countries should be included. In principle, this paper follows the IMF and treats all non-industrialised countries as emerging markets.

[2] See eg Haussmann and Fernandez-Arias (2001), pp 37-43 and Lehmann (2002), pp 16-19.

rendered positive assessments, they do not seem to necessitate a comprehensive reappraisal of the role of FDI.

The remainder of this paper is structured as follows. Section 2 discusses the problems pertaining to defining what actually constitutes FDI and the measurement problems that result from these difficulties. The upshot is that the recorded items can vary widely from one country to the other and FDI statistics must therefore be interpreted with a sense of caution. Section 3 provides a historical overview of the evolution of capital flows, with special emphasis on the development of FDI. Until the late 1960s, both data limitations and the paucity of actual flows to today's EMEs effectively reduce this to a chronicle of capital flows to the present-day industrialised countries. However, most emphasis is put on developments over the last thirty years when capital flows to EMEs can well be tracked. Sections 4 and 5 discuss the driving forces of FDI and the implications of FDI for economic growth and the balance of payments. Section 6 then summarises the main conclusions.

2 Definitions and measurement problems

The concept of FDI has undergone several changes over time, and the available definitions are not uniform. Historically, a certain threshold of equity acquired and the idea that the investor plans to exert a controlling influence are closely connected to the notion of FDI. In order to harmonise the differing concepts of FDI, the OECD and the IMF have developed the following definition: "Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an entity resident in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise"[3]. The above-mentioned definition itself does not specify what actually constitutes a lasting interest. However, this is spelled out in the OECD's implementation recommendations. They recommend that "a direct investment enterprise be defined as an incorporated or unincorporated enterprise in which a foreigner owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise. ... An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence, or participate in the management of an enterprise; it does not require absolute control by the foreign investor"[4]. Accordingly, contractual arrangements not associated with an equity holding of at least 10% but still allowing the exertion of control (such as sub-contracting, licensing or franchising) are not covered by the definition of the OECD and the IMF.

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[3] OECD (1996), pp 7-8. The wording of the IMF definition is identical except for the parentheses.

[4] OECD (1996), p 8.

The acquisition of a controlling stake in a company based on foreign soil can take different forms. The basic distinction is between acquiring a substantial interests in an existing firm, the take-over of an enterprise (M&A) and the build-up of a new production unit (greenfield investment). While traditionally greenfield investments have been responsible for the lion's share of FDI in emerging markets (usually accounting for more than 80%), the last years have seen a surge in cross-border M&As, reaching more than 50% in 1998 and standing roughly at 40% of all FDI in 1999 and 2000.[5] In line with the above-mentioned definition, FDI can be considered either as flows or as stocks. While stocks provide information on the extent to which a firm or a country has established a presence in a foreign economy, the data on flows are used to assess the sustainability of balance of payments developments.

Putting the definition of the OECD and the IMF into practice by the individual countries is fraught with many technical difficulties, in spite of ongoing efforts to harmonise the collected and reported information. The valuation of contributed machinery or intangible assets which are often part of a direct investment is one of the problems. More importantly, FDI data should in principle also include information on reinvested earnings as well as international lending and interest payments between individual firms of MNEs.[6] Unfortunately, the latter items are often not included in recorded data. Such omissions are particularly widespread in the data reported for FDI in EMEs.[7]

Moreover, national statistics may not reflect the proper final destination of an investment. If an investment is channelled through a subsidiary holding company, it will be attributed to the country of the holding company and not to its final destination. Also, in some countries investors from the host country may repatriate their own capital to gain the preferential treatment often accorded to foreign investors.[8] In such cases, FDI data give no reliable information on the process of international integration.

3 The evolution of capital flows to emerging market economies

3.1 A brief historical overview of capital flows until the 1980s

Cross-border capital flows - whether bank lending, portfolio investments or direct investments by international operating enterprises - enjoy a long tradition. While evidence of such flows in Europe dates as far back as the Middle Ages, the modern multinational enterprise came into existence

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5 UNCTAD (2001), p 338.

6 While interest payments within MNEs are typically not classified as FDI but as current account transactions, it can be argued that they should be treated as FDI.

7 See Lehmann (2002), pp 6-9. According to a recent note from the ECB, the numbers reported by the IMF on FDI in EMEs for the period 1994-2001 exceed those from the IIF by up to US$ 40 billion per year, those for total private capital flows by about US$ 100 billion. The main reason for these discrepancies is thought to lie in differences in data compilation methods. See ECB (2003).

8 See Lehmann (2002), pp 19-20.

during the Industrial Revolution in the second half of the nineteenth century. In the fifty years preceding World War I the world economy was by many standards as highly integrated as it is today. Capital flowed unimpeded mostly from the more developed European countries to the emerging economies of the time such as Australia, Canada, Russia and USA. Outflows peaked at close to 10% of GDP in Britain and were only slightly lower in countries such as France, Germany or the Netherlands.[9] These flows predominantly took the form of portfolio investments through the acquisition of long-term government debt or the purchase of corporate bonds, usually issued to finance railroads and other infrastructure projects. The purchase of controlling interests in manufacturing enterprises abroad seems to have been the exception rather than the rule and probably accounted for less than one-tenth of all cross-border investments.[10]

The latter verdict, however, must be qualified somewhat, as the distinction between controlling and non-controlling equity investments was not clearly defined and certain kinds of purchases were a priori not recorded as FDI. Equity investments in exchange-traded companies, for instance, did not count as FDI, regardless of the quantities purchased by a single investor. Also, there were sizeable differences in the categories of capital outflows among individual countries. While capital outflows from Europe favoured financial investments, most US outward investments in the pre-WW I period took the form of FDI.[11]

As a consequence of World War I and the breakdown of the gold standard, countries moved to impose numerous restrictions on trade and capital flows. Still, immediately after World War I and until the late twenties, capital movements remained sizeable. The bulk of outflows in the inter-war years originated in the US, since most of the former lending countries faced large financing needs themselves as a consequence of the war. However, capital flows from the US during this period were increasingly characterised by a rise in the share of bonded debt and a relative decline in FDI. Eventually, after interest rates were raised sharply in the US in 1928, US lending came to a stop. Owing to the ensuing global economic crisis, many debtor countries became unable to service their accumulated debt burdens. As a consequence, the scale of international capital flows continued to decline.[12]

This global retrenchment was slowly reversed after World War II, though private capital flows were for quite some time extremely concentrated among the most industrialised countries. With portfolio investments and bank lending very subdued, the massive capital needs in Europe and Japan for reconstruction were initially met by official flows, but relatively soon mainly by a rise in FDI (with the most important investors coming again from the US). The upswing of FDI was facilitated by advances in

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[9] See IMF (1997), p 113.

[10] See Lipsey (1999), p 312.

[11] See Lipsey (1999), pp 311-314.

[12] See Eichengreen and Fishlow (1996), pp 9-12.

transport and communication technology, making it easier to exert control over an enterprise that was geographically distant.

Table 1

Net private capital flows to emerging market economies, 1971-1989

- US-$ billion -

Countries/Position	Annual average 1971-1981	Annual average 1982-1989
All countries	**11.4**	**16.6**
FDI	5.3	12.0
Portfolio investment	0.6	6.2
Others	6.4	-1.7
Africa	**n.a.**	**4.2**
FDI	0.8	1.3
Portfolio investment	0.0	0.1
Others	n.a.	2.8
Asia	**8.1**	**10.3**
FDI	1.7	5.0
Portfolio investment	0.2	1.1
Others	6.2	4.2
Middle East and Europe[1)]	**-14.6**	**1.1**
FDI	-0.6	0.5
Portfolio investment	-0.1	4.9
Others	-13.9	-4.4
Western Hemisphere	**17.9**	**1.0**
FDI	3.4	5.2
Portfolio investment	0.5	0.1
Others	14.1	-4.3
Memorandum items:		
Total capital flows, net	n.a.	41.4
Net official flows	n.a.	27.3
Changes in reserves	-20.8	-2.5
Current account	-2.1	-30.0

1) Including the later countries in transition.

Source: IMF, World Economic Outlook, September 2002; IMF Database.

The relative importance of FDI in international capital flows started to recede temporarily in the late sixties. From that time onwards, for more than a decade, bank lending became increasingly important for EMEs, with inflows to Latin America being especially pronounced (see Table 1). However, the first oil price shock deeply changed the use of borrowed funds. Instead of sustaining investment and growth, bank lending widely helped to maintain or raise the level of imports and to finance capital

flight.[13] This period came to an end in the early eighties, when a protracted debt crisis erupted. While the crisis was triggered by a steep rise in US interest rates and a downturn of the world economy, its underlying cause was the unproductive use of borrowed funds.

Regarding the following years until 1989, bank lending to EMEs remained subdued, whereas official capital flows became the most important source of foreign finance. In the period 1982-1989 total net official inflows amounted to an annual average of US$ 27 billion, whereas net private capital flows had dropped to only US$ 14 billion per year. It should be noted, however, that FDI recovered substantially at the same time, flowing mainly and almost equally to Asian and Western Hemisphere countries.

3.2 Capital flows since the beginning of the 1990s

The period since the beginning of 1990 witnessed an immense upward shift in the level of capital inflows to EMEs. The years from 1990 through 2002 can nevertheless be grouped into two distinguished phases.

The first phase lasted until the Asian crisis erupted in 1997 and was characterised by a steep increase in both FDI and portfolio investments. Bank lending and trade credit were rather volatile, but on the whole increased as well (see Table 2).

The second phase was characterised by a sharp downward correction in total capital inflows, followed by a recovery since 2002. Looking at the development of the individual categories of capital flows to EMEs during this second period, it is striking that FDI actually increased until 2001 and has fallen only slightly since then. The picture is completely different for portfolio investments and bank lending as well as trade credits, all of which have shown significant retrenchments. The most recent recovery in total inflows can thus be attributed to the strength of FDI activities, while the net outflows in other categories of the EMEs' capital account have slowed down.

The upward shift in the average level of inflows since the beginning of the 1990s has mainly reflected substantial progress in proceeding with economic reforms in the recipient countries. With the demise of central planning regimes many EMEs increasingly adopted market-oriented and stability-oriented policies associated with the concept of the "Washington consensus". The lowering of international barriers for trade and investments, together with improved macroeconomic policies, heightened the attractiveness of EMEs as capital importers either in the form of FDI or as portfolio investments.[14] These factors also spurred the development of EME's financial sectors, including stock markets, thus enabling them to to improve the outlook for satisfactory economic growth by enhancing financial intermediation. Moreover, the implementation of the Brady Plan

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[13] See Eichengreen and Fishlow (1996), pp 21-22.

[14] See World Bank (2002), pp 59-61.

for the resolution of the debt crisis of the 1980s, which implied a securitisation of the banks’ restructed claims, generally stimulated bond issues by emerging market borrowers as a new vehicle of capital inflows after the banks had remained hesitant.

Table 2

Net private capital flows to emerging market economies, 1990-2003

- US-$ billion -

	Annual average									
Countries/Position	1990-1996	1997-2002	1996	1997	1998	1999	2000	2001	2002 *	2003 *
All countries	**142.0**	**61.0**	**228.8**	**102.2**	**62.1**	**84.8**	**29.4**	**24.9**	**62.4**	**64.9**
FDI	62.0	156.8	114.4	141.7	153.6	164.0	158.0	172.1	151.3	160.9
Portfiolio investment	59.0	5.2	90.2	46.7	-0.1	34.3	-4.3	-42.6	-3.0	-4.0
Others	21.0	-101.0	24.1	-86.2	-91.5	-113.4	-124.3	-104.6	-85.9	-91.9
Africa	**7.1**	**9.7**	**11.9**	**9.4**	**11.6**	**15.1**	**6.1**	**6.9**	**8.8**	**8.9**
FDI	2.5	10.9	3.6	7.8	6.4	9.3	7.7	22.3	11.8	10.1
Portfiolio investment	1.8	1.1	2.8	7.0	3.7	8.2	-2.2	-9.0	-1.0	-1.3
Others	2.9	-2.4	5.5	-5.4	1.5	-2.5	0.6	-6.4	-2.0	0.1
Asia	**60.4**	**0.6**	**122.1**	**7.1**	**-45.9**	**6.8**	**-12.9**	**16.7**	**31.6**	**7.9**
FDI	31.7	56.3	53.4	56.8	59.7	61.2	54.2	47.1	58.7	59.0
Portfiolio investment	16.5	-0.8	32.8	7.3	-17.9	14.4	4.3	-13.5	0.7	-9.7
Others	12.2	-54.9	35.9	-56.9	-87.7	-68.8	-71.4	-16.8	-27.8	-41.3
Middle East and Turkey	**22.5**	**-11.0**	**7.2**	**15.0**	**9.1**	**0.2**	**-22.4**	**-48.4**	**-19.6**	**-9.4**
FDI	3.5	7.5	4.8	5.5	6.5	5.5	7.9	10.8	8.8	11.5
Portfiolio investment	6.3	-10.5	1.8	-0.9	-13.2	-3.2	-13.7	-22.0	-9.8	-6.6
Others	12.7	-8.1	0.6	10.4	15.8	-2.1	-16.7	-37.1	-18.6	-14.4
Western Hemisphere	**40.0**	**45.6**	**64.9**	**69.3**	**72.7**	**49.7**	**48.6**	**22.8**	**10.3**	**26.5**
FDI	18.2	58.7	40.3	56.1	60.1	64.1	64.7	66.9	40.4	45.6
Portfiolio investment	26.8	10.6	39.5	25.9	22.3	11.9	4.7	-2.2	1.0	7.6
Others	-5.0	-23.8	-14.9	-12.7	-9.8	-26.3	-20.8	-41.9	-31.1	-26.7
Countries in transition	**11.8**	**16.2**	**22.6**	**1.3**	**14.6**	**13.0**	**10.0**	**26.8**	**31.2**	**31.1**
FDI	6.1	23.4	12.3	15.5	20.9	23.9	23.4	25.1	31.5	34.7
Portfiolio investment	7.5	4.7	13.3	7.5	5.0	2.9	2.6	4.2	6.1	6.0
Others	-1.8	-11.9	-3.0	-21.6	-11.3	-13.8	-16.0	-2.5	-6.4	-9.6
Memorandum items:										
Total capital flows, net	165.0	92.1	226.5	170.5	132.0	97.0	29.6	40.3	83.0	83.1
Net official flows	23.1	31.1	-2.3	68.3	69.9	12.2	0.2	15.4	20.6	18.2
Changes in reseves	-69.9	-97.4	-108.1	-68.8	-48.2	-87.9	-113.2	-119.9	-146.6	-129.7
Current account	-80.8	32.9	-96.5	-69.1	-52.3	34.1	128.4	94.7	61.3	41.7

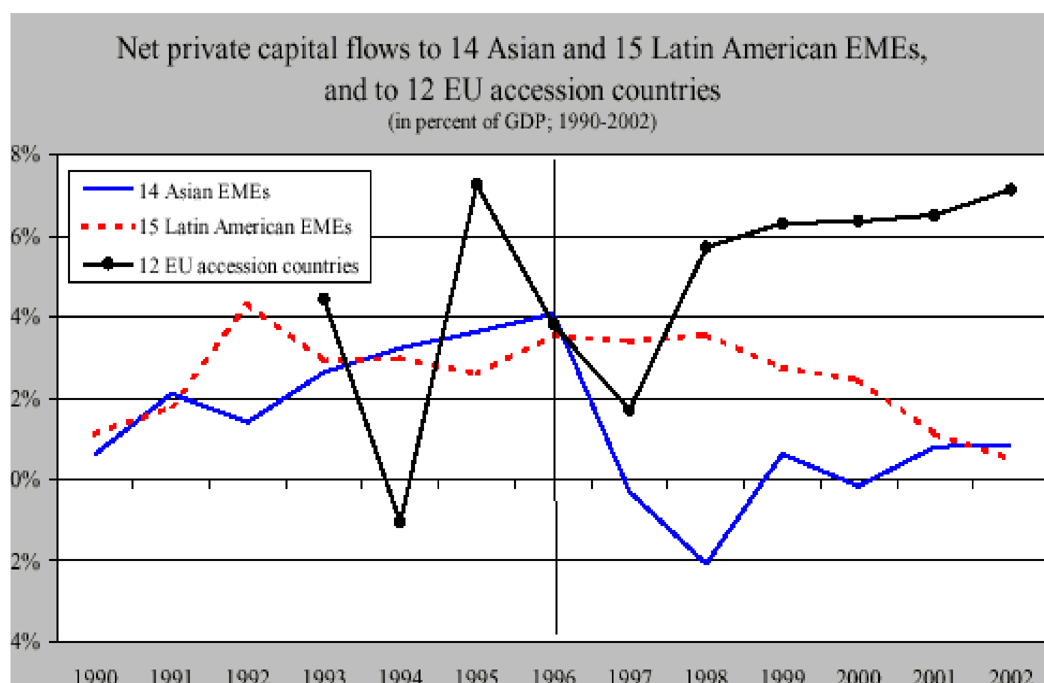
* Estimate or projection. - Source: IMF, World Economic Outlook, September 2002; IMF Database.

In the aftermath of the Asian crisis, according to the ECB, net private capital flows to 45 EMEs declined to 1% of GDP in 2002, after having stood at 3.7% of GDP in 1995.[15] As already mentioned, during this period FDI not only held up but actually increased. Striking is the shift that occurred simultaneously in the relative shares of net private capital flows for the different regions. While in 1996 the capital flows were evenly spread at around 4% of GDP, by 2002 the Asian share had fallen to 1% of GDP and that of Latin America to only 0.5% of GDP, while the European

[15] See Dorucci et al. (2003), p 2.

accession countries enjoyed an increase in their share to 7% of GDP (see Figure 1).[16]

Figure 1



Source: Dorucci et al.(2003), p 13.

The behaviour of capital flows since the beginning of the 1990s is reminiscent of earlier boom-bust cycles. Some commentators have remarked that the size of the retrenchment exceeds that experienced in earlier periods and should be seen as a source of concern since the ability of many emerging markets to meet their external obligations may be jeopardised. Such risks may be mitigated by both the size and the stability of FDI flows, although – as will be discussed in section 5 – FDI can sometimes be less beneficial in terms of balance of payments financing than often assumed.

4 The driving forces of FDI

The geographical composition of FDI is highly concentrated. This pertains to recipient as well as donor countries. Generally speaking, the bulk of FDI originates in and is destined for industrialised countries.[17] But the distribution of FDI, based on gross flows, is also highly concentrated within the group of recipient EMEs. During the 1990s the share of the top ten recipients never dropped below 64% of total flows to emerging markets.[18]

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[16] See Dorucci et al. (2003), pp 12-13.

[17] The US, the EU and Japan accounted for 75% of all inflows and 85% of all outflows during the period 1998 - 2000. Similarly, for stocks these countries accounted for 59% of inward and 78% of outward investment. See UNCTAD (2001), p 9.

[18] Yet the concentration for other private flows is higher still, with 75% going to the top ten recipients. BIS (2002), pp 7-8. For an overview of the geographical distribution see European Commission (2002), pp 83–84.

The single most important factor as to why to invest in emerging markets – in particular in their fast-growing services sectors – seems to be the size of the market and more promising profit expectations. According to one IMF study, the profitability of investments by US firms in twenty EMEs visibly exceeded the rate of return realised in industrialised countries from 1989 through 1998.[19] This aspect is apparently followed by the export orientation of the host country. It is noteworthy that the seven largest exporters among the emerging markets are also among the top ten recipients of FDI flows.[20]

While these factors pertain to the recipient countries ("pull factors"), an important driving force of FDI can also be found in circumstances prevailing in the supplier countries ("push factors"). Empirical studies indicate that private capital flows to EMEs were in general positively influenced by slow GDP growth in industrial countries. In particular, economic slack in the US and to a lesser extent in Europe and in Japan seems to have played an important role in this respect.[21]

The stylised facts indicate that FDI predominantly enters EMEs with sufficiently developed institutions and relatively positive fundamentals. Regarding flows of FDI, the picture changes, however, if one considers not only the absolute value of FDI flows but also their relationship to other categories of capital flows. On this basis, FDI shows the highest share in countries with weak institutions and high risks.[22] The explanation is essentially that capital markets tend to be underdeveloped in emerging market countries. As a consequence, most EMEs are still unable to borrow in their own currency (problem of "original sin"). Thus, FDI may substitute for structural deficiencies in terms of missing or incomplete markets. By internalising these weaknesses, a MNE can extend its range of operations into underdeveloped economic environments. A high share of FDI in the total capital inflows of a given country is therefore likely to be an indication of weakness rather than strength.

5 The implications of FDI for emerging market economies

5.1 The effects of FDI for economic growth

The most obvious effect of FDI on the growth potential of host countries may be the provision of additional capital. The inflow of foreign funds can help overcome the pervasive investment-saving gap, thus enabling countries to grow faster without sacrificing current consumption.[23] Indeed,

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[19] See Lehmann (2002), pp 9-10.

[20] Thus Brazil, China and Mexico accounted for about half of all inflows during the 1990s, while interestingly India – though with a growing share – came in only in 14th place. World Bank (2002), p 39.

[21] See Dorucci et al. (2003); pp 8-9.

[22] See Loungani and Razin (2001), pp 3-4.

[23] See Lipsey (1999), p 308.

in many theories of economic development the main driving force behind a higher growth potential is seen in an expanding capital base.[24] By attracting foreign venture capital, the growth potential could be raised without incurring the vulnerabilities typically associated with external debt burdens. In addition, the investment by one MNE in a foreign firm can induce other MNEs to invest in the same host country as well in order to retain a role as a supplier of intermediate products. Moreover, MNEs usually enjoy better access to international financial markets than firms based only in the host economy. Also, a positive effect on the saving gap can be expected if the MNE is seen as an attractive investment opportunity by local residents or firms.[25] Estimates have put this latter effect at one extra US dollar of domestic investment for every US dollar invested by an MNE, which substantially exceeds estimates for the effects of portfolio flows or bank lending.[26] Furthermore, FDI may have a positive influence on the development of the local stock market if foreign firms were to recover part of the investment by selling equities in the host country. Additionally, the liquidity of stock markets is increased if foreign investors choose to purchase existing equities of the local firm as part of the investment.[27]

Another avenue in which FDI can bear positively on growth in EMEs is through endowing host firms with more efficient technology as well as management techniques. Otherwise domestic resources would have to be spent by firms on either undertaking their own R&D or on importing the required technology.[28] The new growth theory has highlighted the role of technological innovation or – more relevant for EMEs – the role of technology diffusion. By supplying new state-of-the-art technology and by training the local employees the foreign investor can also initiate a spill-over process where local firms will eventually adapt and implement the superior technology, thus raising productivity and boosting growth additionally. In the longer run, FDI in the financial sector of EMEs can be particularly helpful in this regard, thereby also enhancing the stability of the domestic financial system. M&As typically provide advantages of the latter kind, while greenfield investments are usually even more beneficial because they generally imply the desired transfer of additional venture capital.

Since FDI will usually be a long-term commitment, its contribution to growth is generally taken for granted. Keeping only to the effect of providing additional capital, the picture is not quite that clear-cut, however,

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[24] Other factors being technological progress, population growth and natural resources. See Moosa (2002), p 73.

[25] See Moosa (2002), pp 71-73.

[26] See Loungani and Razin (2001), p 2 and World Bank (2002), p 62. However two caveats are in order. First, with the rise of the share of M&As this effect will in all likelihood be reduced. Second, the effect depends upon a minimum quality of the investment climate. See IMF (2001), pp 157-158.

[27] See Claessens, Klingebiel and Schmuckler (2002), pp 3-4.

[28] See European Commission (2002), p 85.

because the actual inflows must not be very large. This is due to the fact that, if a developed capital market exists in the host country, the foreign investor could in principle borrow the needed funds locally.[29] As a negative side-effect, local investors might be crowded out, especially if the MNE possesses market power and can gain preferential access. Furthermore, for the economy as a whole the positive effect on the supply of capital might be significantly reduced by the preferential treatment often extended to MNEs as incentives to invest. Depending on the size of the subsidies, the expected contributions of FDI on growth may be partly or even completely lost.

Yet, investments by MNEs can also be accompanied by sizeable capital leakage effects back to the home country, depending on the size of repatriations taking place. Moreover, the competitive structure of the economy might actually be worsened rather than improved, as MNEs often wield considerable market power that enables them to collect monopolistic or oligopolistic rents.

The empirical evidence on the relation between FDI and growth is mixed, with several studies not finding any significant correlation and others noting that FDI can act as a significant impetus to growth but only if the level of human capital has crossed a certain threshold.[30] The intuition behind this result is that the more advanced technologies can be fruitfully put to use only after the required human capital has been acquired. Should the technology, however, exceed the absorptive capability of the host country, no trickle-down effects will ensue.[31] Similarly, it can be argued that the products of MNEs may often be too capital intensive for the needs of the host country. The effect may then be to create "dual economies", with one modern sector and distinct from it a backward domestic sector with only limited overlap. FDI of this kind might consequently result in an excessively capital-intensive production process, leading to a less favourable development of the overall employment situation.[32]

5.2 The benefits and risks of FDI in terms of balance of payments financing

An investment by a foreign company can affect the balance of payments of the host country in several ways. Clearly, the recipient country may experience a one-time inflow of capital and later – should the enterprise function profitably – a continuing outflow of funds due to profit repatriations. Further balance of payments effects result from the

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[29] See Loungani and Razin (2001), pp 4-5.

[30] See IMF (2001), pp 161.

[31] See eg Hausmann and Cortes (2001), pp 119-121; World Bank (2002), pp 59-61.

[32] See European Commission (2002), p 85 and Moosa (2002), pp 86-89. Also, the World Investment Report 2001 stresses the need to develop linkages between the MNE and local suppliers more strongly in order to reap the potential benefits of FDI. See UNCTAD (2001), pp 134-135.

operations of the enterprise over time. In this regard, a distinction can be made between direct and indirect effects. Direct effects include inflows of equity capital, export revenues, loans from the home country, imports of goods (from raw materials to capital goods), payments of licence fees and interest as well as after-tax profits that accrue outside the host country. Indirect effects include those changes in flows that are due to the substitution of local resources for previously imported goods and services.

The effects of FDI on trade flows depend on whether the investment is targeting the host country's market or the world market including the home country. Horizontal FDI, ie investment in a company that essentially produces the same goods, may aim at jumping trade barriers or reducing transaction costs. It will then tend to dampen previous imports of the host country, as the export base is transferred inside the targeted market. By contrast, if horizontal FDI is motivated by advantages in production costs, the host country's exports would increase. Vertical FDI, where different production stages take place in different locations, will usually be focussed on the world market. Its effects on the balance of payments appear to be more difficult to predict, hinging on the value added in each stage of the production process and the internal pricing policies of the MNE.[33]

As a result of these conflicting factors the empirical evidence as to whether in the long run FDI tends to improve or deteriorate the balance of payments of the recipient EMEs does not seem to be conclusive. One general remark may be in order, however. The import content of output produced in emerging markets is often much higher than in industrialised economies. Therefore, FDI in EMEs will usually be less beneficial in terms of the balance of payments than is the case for industrialised countries.

Moreover, as FDI flows are often thought of as being inseparably combined with the related physical investments, they are mostly pictured as being immobile and bolted down and thus deemed to be much more stable than other flows. This, however, is to some extent a flawed perception. Should a direct investor purchase real assets by means of capital transfers but later on use these assets as collateral to obtain a local loan of the same magnitude which is subsequently transferred to his home country, then even though FDI flows have taken place, no lasting inflow would have occurred.[34]

Finally, it must be mentioned that FDI in the form of M&As often does not enhance the export capacity of the host country nor reduce its dependency on imports, while profit repatriations have to be anticipated. Under the circumstances, FDI inflows to finance protracted current account imbalances might contribute to prolonging unsustainable policies.

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[33] See European Commission (2002), p 86 and Moosa (2002), pp 82-85.

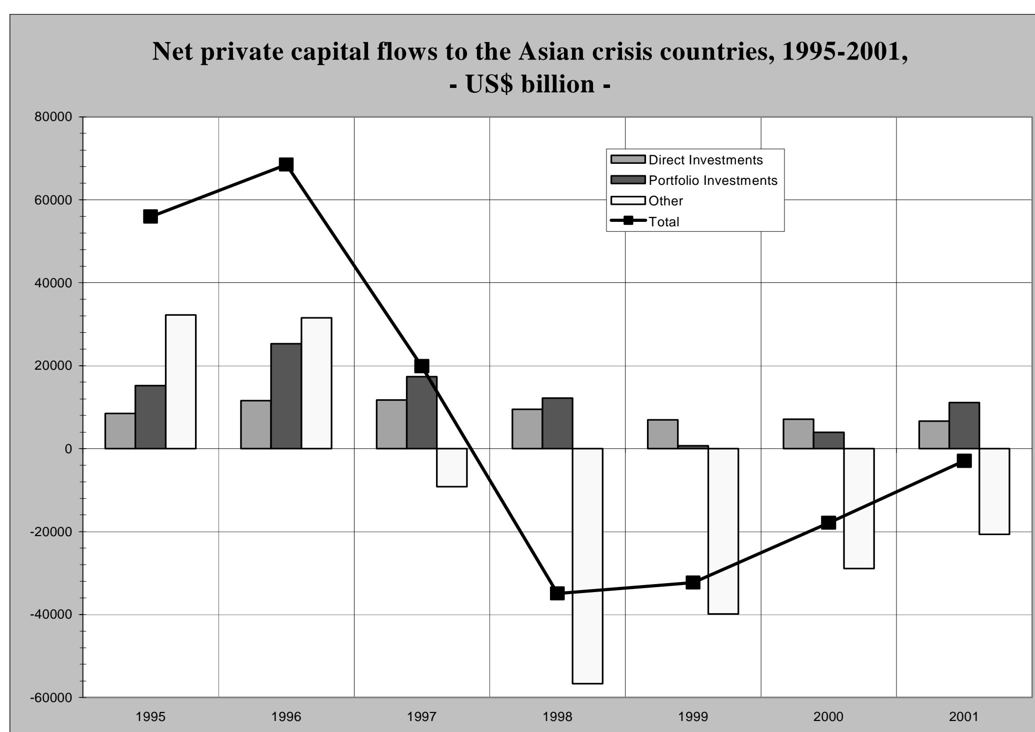
[34] This is most likely of relevance if an investor fears that a financial crisis might develop with a possible sharp devaluation of the host country's currency. As interest rates in EMEs are typically higher than those of industrialised countries, the incentives to take up a credit in the host country will in other circumstances be restrained.

Recent developments in the transition economies and Latin America offer examples in this respect

6 Conclusions

The probably most frequently cited positive aspect of FDI lies in its alleged stability relative to other types of capital flows. In the aftermath of the Asian crisis, for example, the inflows of FDI to the crisis countries held up fairly well with only slight reductions, while portfolio investments and bank lending saw significant retrenchments (see Figure 2).

Figure 2



Source: IMF, International Financial Statistics. Countries included: Indonesia, Korea, Malaysia, Philippines and Thailand. For 2001 no data on Malaysia were available.

The low volatility of FDI flows has been confirmed by numerous empirical studies.[35] If ranked from highest to lowest volatility, the following rough ranking would emerge. Bank lending exhibits the highest volatility, followed by portfolio investments. The least volatile private capital flows are associated with FDI, while the volatility of official flows is even lower. As official flows have continuously lost in significance for emerging markets, FDI represents the most stable capital inflow for EMEs.[36] As a consequence, FDI is very often seen to be a “safe” form of financing which exhibits a low volatility, while other capital flows are viewed as more unstable, with the power to generate balance of payment crises if investors suddenly decide to pull their money out of a given country.

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[35] See Fernandez-Arias and Hausmann (2001), p 95.

[36] See Osei, Morissey and Lesink (2002), p 18. Official flows increased considerably following the Asian crisis but have receded to their pre-crisis levels since then.

Rather typical is the assertion that even large current account deficits should not be problematic at all, as long as FDI inflows are of about the same magnitude.[37]

Besides showing a stable flow pattern, the stability attribute is also extended to the stocks of FDI, which are seen as essentially fixed investments that are fundamentally of a long-term nature and which cannot be liquidated at short notice or only at a substantial cost. The liquidity of a typical FDI investment will tend to be limited by its large size, its role in a long-term firm-specific strategy, higher search costs to find a buyer and a more difficult replication at a later point in time than is true eg for portfolio investments.[38]

A further stability-enhancing aspect has been derived from the empirical experience that in EMEs most of the income generated from FDI is subsequently reinvested in the host country. Also, the affiliates of a MNE in an emerging market will typically have better access to international financial markets than purely domestic firms. Should the country experience times of increasing financial turbulence, it will then stand a better chance of tapping into those markets, which can reduce the overall level of distress in an economy.

However, several aspects can impair the positive features of FDI, implying a more evenly balanced view about the benefits and risks of FDI. Four arguments suggest that the role of FDI in financing current account imbalances appears to be less beneficial than generally assumed.

- First, much of recent FDI flows was related to privatisation activities. This pertains particularly to the transition countries, but to a lesser degree also to Latin America. The supply of privatisation opportunities is likely to shrink over the next years, reducing the scope for FDI in the EMEs. This will then result either in reduced total private capital flows or in a changing composition towards more volatile components. Furthermore, by softening the balance of payments constraints, large privatisation-related inflows can also exert a lastly malign influence. Inflows related to the privatisation of firms (eg utilities) that do not subsequently raise the export potential can serve as a cushion against the pressure for urgent but politically difficult reforms. The upshot could be increased external vulnerabilities.

- Second, while the machinery etc. that is associated with FDI may be immobile and difficult to liquidate, FDI as such is no more than a capital inflow that, considered in economic terms, extends the liabilities of the host country's balance sheet. As mentioned above, these inflows can be much more liquid and therefore volatile than the machinery put in place. In fact, hedging operations provide possibilities to "liquefy" an investment should the economy enter a time of distress. Interestingly,

[37] See eg Deka Bank (2003), pp 2-6.

[38] See BIS (2002), pp 9-13 and Lehmann (2002), p 20.

these options are limited to relatively advanced emerging economies, as functioning capital markets are needed to undertake the necessary hedging operations. While relatively well-developed financial markets are surely an asset in attracting foreign capital in the first place, they also set the stage for an easier repatriation of FDI. Likewise, extensive inter-company lending, which is usually made according to short-term financial considerations, can induce a high degree of volatility.

- Third, drawing on data for US firms, there is evidence that earnings repatriations tend to show a rather stable pattern if economic conditions worsen for the group as a whole. Not only does this translate into a potentially highly volatile pattern of reinvested earnings, but stable earnings repatriations may also aggravate a situation already characterised by private capital outflows.[39]

- Fourth, due to the fact that an MNE can trade goods and services internally at artificially increased prices, capital can be reallocated from host countries to other parts of the MNE network in an effort to raise profits or reduce taxes.

Yet, these critiques, too, need to be put into perspective. FDI is not risk-free in terms of the balance of payments, but so far it has been the least volatile of all private capital flows. As long as emerging economies are unable to borrow long-term in their own currency, FDI seems at present to be the best option. Even though the positive effects as a provider of capital and a stimulant of growth may depend on specific circumstances and not accrue with every long-term foreign investment, the empirical studies either indicate that it outperforms other types of flows in these regards or at least does no worse. Thus, while FDI might not be a panacea and there is every reason to monitor developments in the capital account closely regardless of the types of inflows, FDI does represent the least risky type of capital inflows.

However, it does not follow that countries should strive for a high share of FDI in their total flows. As empirical studies suggest, a high FDI share is likely to point to an inadequately developed institutional framework. Economic development therefore inevitably has to contend with rising flows of a more volatile character. Under these circumstances, high priority must be given to establishing stable domestic financial markets. By providing know-how and resources, eg in the instalment of state-of-the-art risk management techniques, FDI in the financial sector of EMEs can play an important role in attaining this objective.

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[39] This could be observed during the Mexican and Asian crises. See Lehmann (2002), pp 20-24.

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