FOREIGN DIRECT INVESTMENT
(Unit-5)

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Introduction

The international movement of capital, in all variety in forms, aspirations and impacts, is the prominent feature of the economic landscape. Facing deep economic crisis and seeking after effective ways of recovery governments are supposed to be more attentive to economic and not political rationale in their decision-making. It gives for scientists a hope to be heard and motivation to move forward. The political and economic reforms that swept across the erstwhile communist and socialist countries, economic liberalizations in other countries and the continuing liberalization under the auspices of the WTO have been accelerating the pace of progress towards the borderless world.

Types of International Capital Movement Can Be Distinguished:

First is international borrowing and lending which can be seen as inter-temporal trade. Country, abundant with capital, exports future consumption at a price of interest rate. Borrowing country imports current consumption at the same price (Krugman, Obstfeld, 1994).

Second is international capital movement takes a different form, that of foreign direct investment. In most common sense, foreign investment is international capital flows in which a firm in one country creates or expands a subsidiary in another. To put it in other words, it is a measure of foreign ownership of productive assets, such as factories, mines and land. The politicians in our home country seem to have no doubt about the growth effects of foreign capital.

The attraction of foreign direct investments (FDI) is often underlined as a precondition for a successful economic venue by most governments of less developed countries. Strategists in high developed countries seem to be more cautious. Loudly arguing for a free movement of capital, western governments do a lot in restricting the entrance of foreign investors to their own market. Moreover, maybe they have a good reason of doing so.

Types of Foreign Investment

Broadly there are two types of foreign investment, namely, foreign direct investment (FDI) and portfolio investment. With reference to India, foreign investment may be classified asfollows:

FDI refers to investment in a foreign country where the investor retains control over investment. It typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together.

If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That is, in the case of portfolio investments, the investor uses capital in order to get a return on it, but has not much control over the use of the capital.

FDIs are governed by long-term considerations because these investments cannot be easily liquidated. Hence, factors like long-term political stability, government policy, industrial and economic prospects etc., influence the FDI decision. However, portfolio investments, which can be liquidated fairly easily, are influenced by short term gains. Portfolio investments are generally much more sensitive than FDIs. Direct investors have direct responsibility in the promotion and management of the enterprise. Portfolio investors do not have such direct involvement with promotion and management.

Since the economic liberalization of 1991, there has been a surge in the FDI and portfolio investment in India.

There are mainly two routes for portfolio investments in India, viz. by Foreign Institutional Investors (FIIs) like mutual funds, and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs).

GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilizing foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies satisfying certain conditions are allowed to access foreign capital markets via Euro Issues.

Forms of FDI

Foreign Direct Investment (**FDI**) is a direct investment into production or business in a country by an individual or company in another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds.

Broadly, foreign direct investment includes “mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans”.

In a narrow sense, foreign direct investment refers just to building new facilities. The numerical FDI figures based on varied definitions are not easily comparable. As a part of the national accounts of a country, and in regard to the GDP equation Y=C+I+G+(X-M), I is investment plus foreign investment, FDI is defined as the net inflows of investment (inflow minus outflow) to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.

FDI is the sum of equity capital, other long-term capital, and short-term capital as shown the balance of payments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise.

There are two types of FDI:

- Inward and
- Outward,

Resulting in a *net* FDI *inflow* (positive or negative) and “stock of foreign direct investment”, which is the cumulative number for a given period. Direct investment excludes investment through purchase of shares. FDI is one example of international factor movements

Foreign direct investment incentives may take the following forms:

- Low corporate tax and individual income tax rates
- Tax holidays
- Other types of taxconcessions
- Preferential tariffs

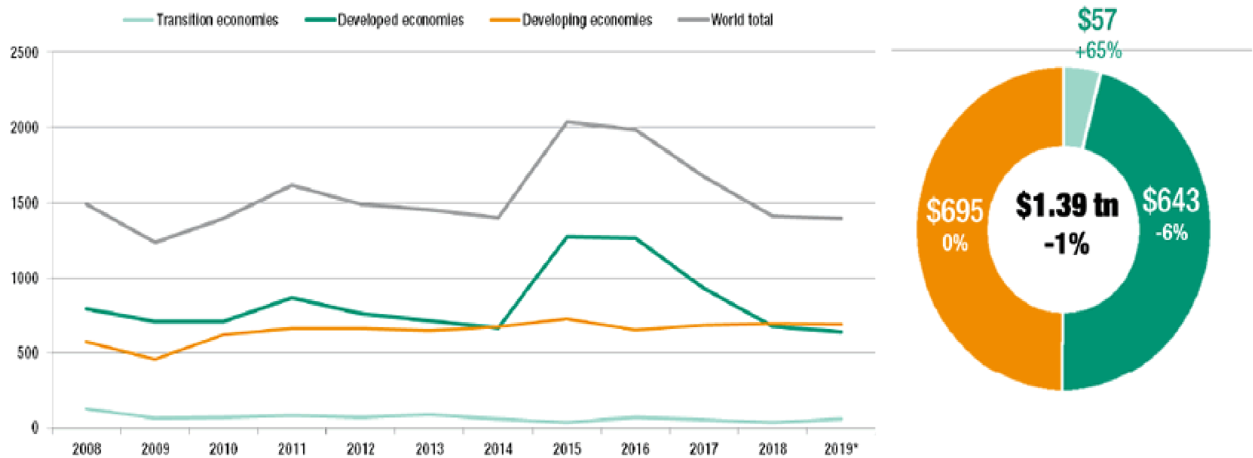
- Special economic zones
- EPZ – Export Processing Zones
- Bonded Warehouses
- Maquiladoras
- Investment financial subsidies
- Soft loan or loan guarantees
- Free land or land subsidies
- Relocation & expatriation
- Infrastructure subsidies
- R&D support
- Derogation from regulations (usually for very large projects)

FDI in World

Foreign direct investment on local firms in developing and transition countries suggests that foreign investment robustly increases local productivity growth. The Commitment to Development Index ranks the "development-friendliness" of rich country investment policies. foreign direct investment (FDI) totaled US$1.39 trillion in 2019, slightly less than a revised $1.41 trillion for 2018. But flows are still expected to rise moderately in 2020, according to an UNCTAD Investment Trends Monitor published on 20 January. The United States remained the largest recipient of FDI, attracting $251 billion in inflows, followed by China with flows of $140 billion and Singapore with $110 billion. FDI flows to North America remained flat at $298 billion. But flows to developed economies as a group decreased by 6% to an estimated $643 billion – just half of the peak amount recorded in 2007. "The trend for developed economies was conditioned by FDI dynamics in the European Union," the monitor says, "where inflows declined by 15% to an estimated $305 billion." UNCTAD found that flows to developing economies remained unchanged in 2019 at an estimated $695 billion, meaning that these countries continued to absorb more than half of global FDI. Analysis of the different developing regions showed the highest growth for Latin America and the Caribbean, at 16%. Africa continued to register a modest 3% rise while flows to developing Asia fell by 6%.

FDI inflows: global and by group of economies, 2008–2019*

(Billions of US dollars)



Source: UNCTAD (Preliminary estimates)*

After two years of low inflows, countries with economies in transition saw FDI rebound in 2019 to an estimated $57 billion. The 65% pick-up was driven partly by expectations for higher economic growth in the region in 2020 and more stable prices for natural resources.

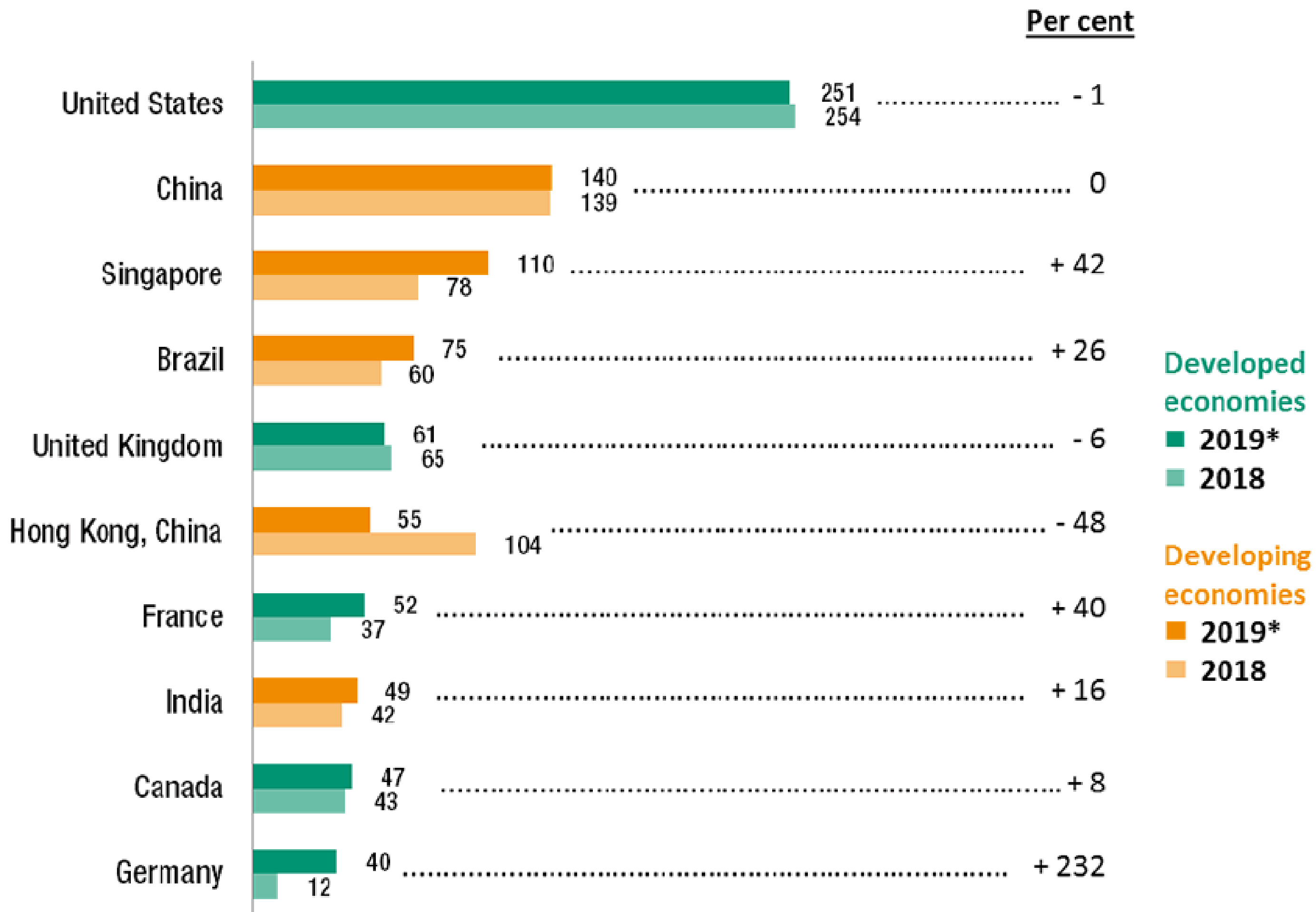
The UNCTAD monitor also highlights other FDI trends:

- FDI in the United Kingdom down 6% as Brexit unfolds.
- Hong Kong, China divestments cause a 48% FDI decline among turbulence.
- Singapore up 42% in a buoyant region of the Association of Southeast Asian Nations.
- Zero-growth of flows to both the United States and China.
- Inflows to the Russian Federation more than doubled to $33 billion.

- Brazil up 26% at the start of a privatization programme.
- German inflows triple as multinational enterprises extend loans to foreign affiliates in a year of slow growth.
- Cross-border mergers and acquisitions decreased by 40% in 2019 to $490 billion – the lowest level since 2014. The fall was deepest in the services sector (-56% to $207 billion).

FDI inflows: top 10 host economies, 2018 and 2019*

(Billions of US dollars)



"In a global economy, the United States faces increasing competition for the jobs and industries of the future. Taking steps to ensure that we remain the destination of choice for investors around the world will help us win that competition and bring prosperity to our people."

Purpose of overseas investment

- While claiming that FDI benefits receiving country, encourages growth and development, Neo-liberals would say that countries should open up and let the market to work freely; that all the efforts should be concentrated on attracting FDI because it means development of the country; that every country should welcome FDI because it will improve economic conditions and increase potential of the receiving country's development the purpose of overseas investment

- When attracting FDI governments can use tax cuts, subsidies and many other means. When deciding to slow down the volume of incoming foreign capital governments most commonly use institutional barriers of FDI: ownership restrictions, rate of return restrictions, project approval requirements, trade and financial restrictions etc. China's government proved as very rational decision maker in attracting FDI when economic rationale suggested they should and hampering the flow foreign capital when positive effects approached the apex.

- However, often it is difficult for developing country Governments to manage foreign investment to their advantage as there is a large asymmetry in bargaining power between core countries investors on the one hand and host governments - especially those from countries that are poor, lack scarce natural resources and/or small - on the other.

Finally, not all types of FDI equally contribute to the development of local economy. As it is stated in World Investment Report 1999, “green field investment is likely to encourage development most while mergers and acquisitions (M&A), that entail a simple change of ownership can be of dubious value”.

Benefits of Host Country (FDI)

Foreign Direct Investment (FDI) has become a very popular means of transfer for capital flows from one country to another. In short, FDI refers to an investment in which an entity for another country invests capital in some income generating assets in another country and maintains full or partial control over such assets acquired.

There are several benefits of foreign direct investment which accrue to both the home country as well as the host country. However, it must be noted that such benefits accrue only when appropriate regulation and an ethical sense of doing business exists with the home country, the host country as well as the foreign investor.

Some benefits of foreign direct investment are mentioned below.

- **Technological Gap:** Generally, it is seen that underdeveloped economies or developing economies have a very low level of technology. Although there may be opportunities and resources which can be used to have economically viable production, however, technology may be a huge constraint to utilize such resources. Here, foreign investors from developed countries can provide the needed technical assistance to such countries. The gains can be shared in the form of royalties or a share of profits from such investments.

- **Exploitation of Natural Resources:** Many-a-times it is seen that underdeveloped and developing countries have abundant natural resources, but they do not possess the needed technical and managerial expertise to exploit these resources. FDI helps such countries get access to the needed technical expertise resulting in higher income for the governments and local communities.

- **Employment Generation:** FDI in a host country results in the generation of jobs for both skilled and unskilled labor. The foreign investors open offices and factories which require people to work. Employment ultimately leads to better living conditions and higher standards of living among the workers.

- **Development of Managerial Pool:** Often it is seen that such MNCs develop managerial talent. Firstly, these companies provide their own seasoned and developed managers to setup and run the entity in the host country, while doing so, these managers also seek to develop the next set of managers who will take over the reins and these managers are appointed from the host country mostly due to them having better knowledge of the local market.

Effects of FDI

- Positive effects of FDI are more featured in case of green field investment. When FDI takes a form of simple merger and acquisition (M&A) actions positive externalities are much lower if not negative.

- In the early stage of market economy, foreign direct investments may produce some externalities in the form of higher employment rates and technology transfers, often filling the "idea gaps" between old and emerging market economies.

- Nevertheless, they often cause a lot of harm too as not a charity but the aspiration to earn more via cheaper resources- land and labor is the primary aim of investors.

- Foreign investors can reduce employment by dismissing local workers, by crowding out local businesses that cannot compete with multinationals; technology transfers may not occur if the degree of market integration is insufficient; positive capital flows often turn to negative if investors use cheap local raw materials and resources and sell expensive final goods.

- In the years of booming economy, domestic producers in advanced economies are strong enough not to be forced out of business by foreign competitors. The effects of FDI became more positive. Enhanced competition, knowledge and technology spillovers, financial stability of incoming investors can bring externalities that are more positive.

- In a high turbulence, economic environment governments need to be strategic and more calculative inviting multinational competitors to operate side by side with home industry. According to numerous literatures effort to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues, which could otherwise be used to invest in education and infrastructure what ultimately fastens economic growth and increases total welfare.

- One more aspect that is important is that FDI might serve not only a way of doing money, but also a way of acquiring a certain control, both economic and political, in the host country (Krugman). On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth in developing countries. Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways.
- The evidence also appears to suggest that FDI is favorable to economic welfare only if appropriate conditions exist in the host economy. This includes such factors as adequate absorptive capacity and human capital, a capacity of domestic businesses to face and hold out foreign competition, abundance of projects and market gaps that cannot to be filled up by home producers.

The reason of eased restrictions on FDI was diminishing lending of commercial banks to developing economies. The composition of external capital underwent a dramatic transformation during this period. Because of the Asian and Russian financial and economic crises, official capital flows in these countries either stagnated or declined.

Political Risk

Political risk is a type of risk faced by investors, corporations, and governments. It is a risk that can be understood and managed with reasoned foresight and investment. Broadly, political risk refers to the complications businesses and governments may face as a result of what are commonly referred to as political decisions—or “any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives”.

Political risk faced by firms can be defined as “the risk of a strategic, financial, or personnel for a firm because of such nonmarket factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labour, and developmental), or events related to political instability (terrorism, riots, coups, civil war, and insurrection).” Portfolio investors may face similar financial losses.

Macro-Level Political Risk

- Macro-level political risk looks at non-project specific risks. Macro political risks affect all participants in a given country.
- A common misconception is that macro-level political risk only looks at country-level political risk; however, the coupling of local, national, and regional political events often means that events at the local level may have follow-on effects for stakeholders on a macro-level.
- Other types of risk include government currency actions, regulatory changes, sovereign credit defaults, endemic corruption, war declarations and government composition changes.
- These events pose both portfolio investment and foreign direct investment risks that can change the overall suitability of a destination for investment.

- Moreover, these events pose risks that can alter the way a foreign government must conduct its affairs as well. Macro political risks also affect the organizations operating in the nations and the result of macro level political risks are like confiscation, causing the seize of the businesses' property.

Micro-Level Political Risk

- Micro-level political are project-specific risks. In addition to the macro political risks, companies have to pay attention to the industry and relative contribution of their firms to the local economy.
- An examination of these types of political risks might look at how the local political climate in a given region may affect a business endeavor. Micro political risks are more in the favor of local businesses rather than international organizations operating in the nation. This type of risk process includes the project-specific government review Committee on Foreign Investment in the United States (CFIUS), the selection of dangerous local partners with political power, and expropriation/nationalization of projects and assets.

- Political risk is also relevant for government project decision-making, whereby government initiatives be they diplomatic or military or other may be complicated as a result of political risk.

Whereas political risk for business may involve understanding the host government and how its actions and attitudes can affect a business initiative, government political risk analysis requires a keen understanding of politics and policy that includes both the client government as well as the host government of the activity.