FOREIGN DIRECT INVESTMENTS AND EFFECTS IN DEVELOPMENT COUNTRIES

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Abstract

Foreign direct investment (FDI) has long been seen as a crucial instrument in the process of transforming the former centrally planned economies of Eastern Europe into vibrant market systems. This paper analyze direct (as a capital inflow) and indirect impact of FDI inflows on economic growth of transition countries during 1990s. The main conclusion of this paper and a recommendation for policy makers is that FDI does not in every situation bring long-term benefits for the host countries. By improving the absorptive and adaptive capabilities of domestic firms and by adopting more active policies toward FDI, the development effects of FDI inflows are more likely to occur.

Key words: foreign investment, economic growth, developing countries, transition economies

1. Introduction

The main objective which transition countries tend to achieve is reaching an long-term economic growth which will be upon enlargement of investments, improvement of the technological base and augmentation of the competetiveness of their products on the international market. In realization of this process of transition most of the FDIs were going in to the existing capacities of this countries and by that providing better use of the existing resources and growth of the productivity. In the second phase of conducting the process of transition, after the depletion of the existing resources (in the period of ending of the privatization) the long-term development can be achieved primarily through the greenfield FDIs, so today, the most progressive transition economies are more and more oriented towards their attraction. Having in mind the role that FDI had have in the process of transformation of the former Eastern block in to contemporary market economies, the attraction of the foreign capital is one of the priorities of this countries in the future period.[1] Namely, although eleven years is to short period upon which could be brought global conclusions, this paper has for purpose to show the positive as well as the negative effects (which often are forgotten) of the influx of the FDI on the transitional countries in the past period and also to give specific recommendations in leading of the economic policy in manner to use the positive and to minimize the negative potential effect.

2. The influence of the FDI on the investment level in the country

Although the transitional countries are characterized with high stock of capital in the economy as a result of the excessive investment during the planning period a significant part of that capital was physically and above all morally obsolete. The investments for regeneration and later for increasing of the domestic stock of the capital and also for keeping up with the relatively newest technological achievements in the world is crucial element for achieving an long-term growth.[1] The symbolic level of domestic savings and the quite low accumulation of the transitional economies has emphasized the importance of attraction of the foreign capital in the initial phase of the transitional process, necessary for filling the investment gap and for utilization of the reallocation reserves. FDI are considered as most useful and most cheap source of capital for transitions countries. They have few advantages in relation with other sources which can also be used, such as: borrowing abroad and portfolio investments. [2] Here we are not mentioning the foreign help, although it was present in large scales in transitional countries, which, of course, should not be an orientation for the reformist governments.

The advantage of the FDI in relation with the loans from abroad is in the fact that FDI does not implies significant outflows in the future which can endanger the current balance and the economic growth in that periods although frequently is forgoten that the FDI has their own otflows as a result of capital repatriation and in situations where branches pay annuities based on the loans of their parent companies (something that is considered as an classic loan).

The advantage of the FDI in relation with the portfolio investments is in the fact that FDI represent much more stable source of capital, something that was shown during the time of the global economic crisis and in the last years where FDIs in the transitional countries continued to grow, although the majority of this countries had lost the approach to the international financial markets and had experienced a great escape of "hot" capital. [3]

FDI-s are much more stable in relation with the portfolio investments because they imply investments in fixed assets which represent the long-term intentions of the investor since it's much harder to withdraw capital invested in fixed assets in relation of the capital invested in securities. Financially observed FDIs represent inflow of foreign resources which increase the total investments in the host country. The participation of the FDI in the overall domestic investments increases between the transitiotion countries.

Besides the initial capital inflow FDI are also created by the reinvested profit of the branch as well as all the loans from the parent company. If the branches use this funds for construction of new or for promotion of the existing objects, equipment etc., the total investments in the host country are increasing. On the type of FDI which enters depends the effect of the total investment in the country. In general the greenfiled FDI has the biggest effect on the increase of the investments unlike the mergers and acquisitions which essence above all is change of ownership of the existing resources and not creation of new one. But, the mergers and acquisitions can influent on the increasing of the total investments in the future periods if investors invest in new objects and equipment for the bought branches. [4] Both FDI types can influent on increasing of total investments in the future periods. That happens if as a result of the initial investment of the transnational companies (TNCs) comes to an increase in the inflow of FDI from other TNCs or if comes to increase of the domestic investments. There are more reasons for that: [5]

- First, the investment of one TNC can cause entry of other TNCs which are in strong ties with the initial investor (suppliers of certain parts, providers of certain services) and which follow him on every market in which it enters;
- the investment of one TNC can signal to others TNCs that exists favorable investment climate in some country which up till then was not enough known and bay that way dicreases their risk for investing. Also, the investment of more TNCs in a same field allows subsequent investment of domestic na foreign investors in that same field if the given investment, lead by their own motives, patronize the development and construction of the missing infrastructure,
- FDI can stimulate the domestic investments if a complementarity exists in the production of the domestic enterprises and the foreign branches. In that case the branches can establish strong ties with the domestic enterprises allowing them help in technology and finances and simultaneously representing stable purchase or sales market for their products. Domestic firms then have enough motives an possibilities to invest additional assets;
- the experience in most of the transition countries indicates that the newly created branches of TNCs during their business have much bigger tendency for investment in comparison with the domestic firms and by that way participate even after the initial investments in the increasement of the investments in the host country.

By this four ways FDI can influent on the increasement of total investments so 1US $ of FDI can generate increasment of the total investments for more then 1US $. Different research indicate that the size of this effect (crowding – in) ranges between 1.5 and 2.3 whereby differences are noted between different countries and productional sectors. The sectors such as mining and extractive industries have less indirect investments because the intesity between the branches with the domestic enterprieses is smaller.

3. Indirect effects fro FDIs

The transitional countries characterise high level of capital equipment which is technologically obsolete. One of the priorities of this countries is modernization of their technological base where the FDIs bigger role can have. The past period have proved that the changes in the technological base were more intensive in the countries which had bigger FDI inflows. The experience of the progressive transitional countries indicates that they starting back from the recovery of the industrial production (during the 90s) the growth rate in the technologically intensive sectors were bigger then the average growth rate in the economy. That in the same time has caused positive changes in the structure of the industrial production of these countries in direction of increasement of participation in technologically intensive sectors (electronic, electrotechnical, automotive, precision industries) and in the whole industrial production as well.

The introduction of new tecnologies represents one of the much more important elemnts of the process of restructuring the existing enterprises in the transitional countries. There are several positive effects that FDIs can have in that process: [6]

- By buying the existing enterprises the TNCs usually bring new tecnology which modernizes and promotes the production in the enterprise. And more important, the foreing investors usually bring a contemporary managerial and organizational knowledge from marketing fields, financing an strategic planning, which generally are missing in this enterprises which are in phase of habituating on the market business conditions.
- The restructuring process demands significant capital investments an different promotions. One of the reasons which influented on the different dynamics of the restructuring process in individual transitional countries is the lack of financial assets as a result of the weak domestic financial system. Unlike from the domestic firms which can have problems in capital obtaining the foreign investors much easier and by much favorable condititons then the domestic firms can obtain capital from the foreign banks or just simply to invest one part of their own free assets and bay that way to decrease the expenses of obtaining the necessary capital.
- The foreign investor usually already has very well constructed global distrubitive network which allows the privatized enterprise approach to the foreign markets and strong incentive for quality increasement, export increasement (direct and interfirm) and realising of the economy of scale. Some surveys done on this subject show significant influence of FDIs on the volume of restructuring.

The introduction of new production lines, promotion of technologies, reorganization, productivity and employment increasement, selling and buying is much more present among the firms which have foreign owners then among the privatized firms with domestic owners and especially then state runed firms. FDI can also have a wider effect on the restructuring process of the transitional economies by influenting whole industrial branches and not just the privatized enterprises.

The entry of FDI in individual branches can increase the competitive pressure and can compel the existing domestic enterprises to find ways for improvement of their operation. The effect of TNC entering on the local economy is bigger if domestic firms in the period before and after the TNC enters have had satisfactory market position (from their poin of view), so the motives for productivity increasement were minimal. That especially is case with the market countries in transition where in the past period existed very high barriers for entry. TNCs unlike the majority of domestic ennerprises can easily eleminate the given barriers and increase the level of competition on that markets.

The effect of FDIs on competition on the domestic market does not necessarily be positive because exists a great risk TNC to eliminate the domestic competition due to its advantages. The entry of TNCs can condition decrease of sells for domestic firmc by that negatively influenting on the degree of utilization of their capacities and the possibility of utilization the effect of economy of scale and that can result in decline of productivity in domestic firms and in their possibilities for competitive fight. Also, the presence of TNCs can influent on the capabilities of the domestic firms to obtain financial and other necessary resources during the strengthening of the competition on the financial and purchase markets. That can create danger for creating a monopoly which from the aspect of the domestic economy is even more unfavorable in relation with the situation when one domestic firm has the predominant position, because the TNC can the reallized profit, on the basis of its monopoly position, transfer to its domicile country and by that comes to an outflow of domestic resources abroad. The effect can much more negative if TNC uses the mechanism of transfer pricing for decreasing of its tax base. This negative effect will be especially manifested if TNCs are protected from the competition of other foreign companies due to protectionist foreing trade policy of the domestic authorities.

The domestic authorities can cause negative consequences also in case when they are giving excessive benefits for FDIs (something that is often used for atracting FDIs). That can cause unequal yields for the foreing and for the domestic capital and by that way to influent negatively on the competitive capability of domestic enterprises, while to the TNCs branches allows to work profitable and to increase its market position without significant transfer of new technology. Too strongly accented competitiveness of TNCs decreases the capability of domestic enterprises to undertake new investments something that influents negatively on the level of investments in the country (crowing-out effect). Also must have in mind that the FDI inflow can decrease the level of concentration on the domestic market and can strengthen the competition in the initial period but the overall (dynamic) effect can be negative, if comes listed phenomena occur.

The effect of inflow of FDIs on the domestic economy can depends from the shape of entry of FDIs.

Greenfield FDIs, generally, increase the number of enterprises in individual sectors and intesify the competitiveness although we must have in mind that thanks to the advantages that they have in comparison with the domestic firms, this FDIs can also eliminate the domestic enterprises and increase the concenatration in the branch, as it is shown early on. The acquisitions (through privatization) of the domestic enterprises can also have negative effects and not just (as we'v seen before) positive effects. That mostly happens if the acquisition allows the investor to acquire a monopoly position, something that decreases the incentive for intensifying the technology transfer, know-how, etc. The strengthening of the competition due to TNC entry can result with positive effects on the national economy also in the cases when comes to elimination of one part of domestic firms. If from the market disappear the unefficient domestic firms which in normal conditions would not exist, then the competitive preassure which comes form TNC can release one part of the domestic resources in future which is base for a lon-term economic growth. The total effect of FDIs on the domestic market and its potential for economic growth can be, as we are seeing, different, depending on the capabilities of domestic enterprises and of the meassures of the economic policy of the country recipient of FDIs. If

TNCs are entering in markets where domestic firms have technological, financial and other advantages for fight with the competition the effect of competitive increase can be positive. But if TNC are entering in market where exist technological and financial weak local enterprises and where exist possibilities for product differentiation and for achieving the effects of economy of scale it is a great possibility for creating an TNC monopoly and for limiting the domestic enterprises on individual market niches. That can lead up to creation of double economic structure where the great TNCs are on one side against small local entrepreneurship, by which significntly decreases the resistance of the domestic economy on the market cycles and on the TNC strategy changes. But if the economic authorities in the coutry lead a policy of competitiveness which understands liberalization of external flows, efficient antitrust legislation, decrease of barriers for entry on the market and if they have strategic approach towards FDIs which understands their sectoral targeting and (occasional) limiting of their entry in individual sectors only then it’s possible to expect that the presence of TNCs on domestic market will have positive effects on the domestic firms.

The increase of competitiveness of the domestic firms means that the technological gap between them and the foreign branches is decreaseing, something that will lead to reduction of the demand for TNCs products creating among them greater motive for transfer of new techologies. The transfer of bewer technologies by itself gives possibilities for emergence of technological externalities.

4.The ties between domestic firms nad TNCs

The changes in the contemporary business of TNCs in the direction of creation more flexible organizations and focusing on the core of the business conditions transfer of the majority part of the process of production on the external producers retaining for istelf only some functions such as reasearch, development and marketing. If the foreign branch establishes long-term relations with the domestic firms that can result in significant externalities from the branch to the firm which are providing increasement in productovity and promotion of the business of domestic firms. TNCs can influent on the great market participation and TNCs can be a sign for weak domestic firms, that will say small posibillity for emergence of positive externalities. This tendency in TNCs operating it is also known by the term “outsourcing”. The improvements in domestic firms are coming by several ways: [7]

- orders from foreign branches increase the sell and employement of the domestic firm and potentially can allow realization the effect of the economy of scale. To some firms TNCs can ;
- help financialy to restore/build productional capacities;
- transfer new technologie and give technical assistance in form of information for increasing the level of quality of products which matches the TNCs demands;
- provide training of the employees and help the promotion of management and the organization of the firm;

- help to find additional buyers, including the branches of TNCs in other countries.

As a result of the listed TNCs help the domestic firms can improve their business without additional expences which will occur whet that improvement will be done by the firms themselves and that also will decrease the total losses of the promotion. The overall effect on the sountrie's economy of the host country will be positive if the listed effects of the newly created bonds between the branches and domestic firms exceeds the loss of ties between the given firms and the domestic firms who are squeezed out from the market by the entry of TNCs. In that case, the bonds between the branches and domestic firms result in economic activity increasement and in current balance improvement (because the inputs which are imported for the TNCs needs now are coming from domestic firms). The strengthening of the domestic suppliers for TNCs can condition appearance of externalities from them to other producers in the country (to their suppliers or competitors) by which the positive effect spreads on the major part of the economy. Simultaneously can be expected that the ties between tha branches and the domestic firms on the level of whole economy will intesify over time as the level of the domestic economy grows and the new firms become TNC suppliers.

The TNC branches can also establish ties with the domestic buyers of the products which they produce although this cases were rarity in transitional countries. The entry of TNCs can allow to the buyers of this products to obtain quality products by favorable prices, because TNCs with its international characteristics (techology, resources…) can have advantage in terms of quality in relation with the domestic producers and the price of this products in the same time is lower then the price of the same products imported by the domestic firms abroad (necause of the smaller expences and tarrifs).

The entry of TNC will intesify the competition on the domestic market and will condition the local producers to promote the quality of their products what all together allows the buyers of the given products to decrease the input costs and further raising of the productovity. The ties which are established between the branches and the domestic firms can't allways influnet on economy improvement and on creation of potential for economic growth. The TNCs can limit its local suppliers on production of exclusively lower value products and lower technology levels but they can also determine to keep the existing suppliers from other countries. In that case the chances for more intesive transfer of technologies and know-how are much smaller. The level of possible externalities depends as well of the relation between the branches and the domestic firms. If an classic sell and buy relation exist then exists a smaller possibility for appearance of externalities in relation when a long-term contraction for cooperation are existing. The lack of ties between the domestic enterprises and foreign branches significantly complicates the development of new technological base of the country and stresses the danger of turning the local economy in to reservoir cheap labour force. In that case exists a real of relocation of TNC in other countries when the expences of the labour force grow that can cause significant problems in the domestic economy. Examples of relocation of the whole factorie Mannesman from Hungary to China and the factory Flextronics from Hungary to Ukraine in year 2002 are telling us enough about in addition of the previous told case. From the aspect of the country it is necessary to come to establising of ties and externalities. In that context the governments of the transitional countries with heir meassures can stress the occurrence of such ties. The most important factor that influents on the decision of TNC to establish cooperation with the domestic firms is the availability, expences and quality of the potential suppliers. The state with its meassures should influent on the development of the technological capabilities of the enterprises and not just ties to be realised but also to come to externalities based on that ties, because their precondition is appropriate absorption capability of the firm. That implies governmental support in: the process of training and increasement of competence of the domestic labour force, encouragement of TNC involvment in the process of promotion of technological capabilities and their possibilities to obtain the necessary financial assets. Sometimes the bonds are not established because of that the TNCs does not have enough information about the potentially quality suppliers. The state can compensate that deficiency by establishing of associations of certain types of suppliers and with appropriate policy that promotes establishment of ties between TNCs and the domestic companies.

5.Conclusion

Having in mind the previous listed data stands out the need for more active policy towards FDIs which must be more incorporated in th domestic strategy for development. That understands different neassures directed on the strengthening of the absorbable capabilities of the domestic economy which understand reforms in education and in national innovative system (encouraging of inventions and innovations), construction and modernization of the infrastructure, strengthening of a new sector of small and middle sized enterprises for establishing of stronger bonds with the foreign investors and by that creating base for future growth. Simultaneosuly preconditions for competitivenes should be created preconditions for competitivenes of the domestic enterprises (new and old one) without direct interference of the state. That can be achieved through stabilization of macoreconomic conditions and through reform of the domestic financial system (so the expences of the capital will decrease and would be paralleled for domestic enterprises and for TNCs), through providing indirect support to those enterpises for who will be confirmed that are having potential but support limited in time after which the supprot ends. While the suuport should not be given through “soft” loans or through high foreign trade protection but through help in reduction of employees and encreasement of their capabilities and through takeover of some social functions, all that in purpose of better preparation for market match. Support but also and incentive in increasing the competitivenes of the domestic enterprises implies changes in the antitrust policy, decreacing of the barriers for entry of the firms in the market and decreasing the barriers for exit from the market in order not to allow TNCs toe acquire a monoply position but also simultaneously a incentive to be given to the domestic enterprises for faster restructuring.

All listed positive and negative effects that FDIs can have on the aconomy of the host country and in the case of transitional countries as last among the European countries who entered in the transitional process have that advantage to dispose with the experience of the other countries in terms of the effects and determinants of FDI inflows. The given experience should be used in a way for bigger usage of the positive effects of FDIs on the domestic economy. But the fact that the transitional countries had started reforms in time when some other countries are ending them can represent an potential limit for bigger inflow of quality FDIs. The more progressive countries already have certain advantages which are hard for reduction, such as smaller risk because of the advanced reforms and more stable political situation (more favorable investment climate) as well as the so far experience of the foreign investors. Also the chances for imminent entry of the more progressive countries in EU gives strong incentive for investing in them. When one investor invest significant assets in plant in cartain country it tends its future investments to tie with that country so it can use the economy of scale, something that leaves a little space for other countries to attract the given TNC. Serbia can not account on a rush of foreign investors because ten years has past from the fall of the communism so the investors now are motivated exclusively by the possibilities for earning profit. Having this in mind it is necessary an active policy to be leaded towards FDIs which implies much more intensive promotion of the country by a constant promotion of the domestic investment climate br various (allready mentioned) meassures of the economic policy.

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