Review of Economic Policy Impact on FDI in Developing Countries

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Abstract

This review was aimed at evaluating the impact of economic policies of developing countries on their FDI inflows and the effect of recent global economic crisis on it. Google Scholar was searched AND 35 reports were selected. The review yielded the following findings.

Some specific FDI-favourable policies are related to capital market liberalisation and privatisation of state-owned companies, easing out of foreign participation, good governance, free of corruption, good quality institutions, corporate tax rates, low tariff rates, degree of openness to international capital flows, no exchange rate distortions, contract enforcement, no nationalization risk, no bureaucratic delay, low inflation rate, greater economic freedom, adequacy of human capital, economic stability, public efficiency in terms of tax systems, easiness to do business, good contract laws, security of property rights, efficiency of justice, prudential standards and increased competition. Sometimes, international commitments in terms of bilateral agreements and preferential treatment may substitute for institutional quality needs. Certain constraints identified on FDI are: macro-economic instability, investment restrictions, corruption and political instability. Policies to remove them increases FDI. The policies addressing the risks of vulnerability to crisis of capital account liberalisation, political risks, macroeconomic variables and business conditions need to be in place. It is possible that conflicts may arise between country policies and interests of global firms, the need to be sorted out.

FDI may not always be the best option for economic growth of the country. FDI in developed countries is never m than 12% of total investments. Instead of policies specifically to promote FDI, credible enforcement mechanisms are required. Especially, when seeking international capital markets, policies to improve investment climate and functioning of markets need to be introduced. FDI cannot serve highly protected domestic markets. Domestic competition with foreign firms destroy local entrepreneurship. FDI for equity promotes inequality, decreases return on investment and infrastructure in open economy.

There was no policy change in any country during the recent global economic crisis except increase of import tariffs by a few countries and antidumping duty in US. Yet, only 2% of total global trade losses were accounted by them.

Responses to the global economic crisis were in the form of financial and monetary policies. Most countries selected one or more policies and combinations of recapitalisation of pledged or used amount, asset or bank creditor’s guarantees, asset purchases and lending by treasury of pledged amount or used amount, liquidity support, change in ST interest rate and fiscal stimulus.

Keywords: FDI, Economic Policy, Developing Countries, Fiscal Policies, Reforms

Introduction

The trends in FDI during the period of 1995-2015 are summarised in the latest UNCTAD report (UNCTAD, 2016). The total global FDI rose to 1.7 trillion USD in 2015. This represented a 36% increase over and is the highest level after the global economic crisis of 2008-2009. This global rebound was primarily due to about 90% increase in FDI in developed countries. Thus, the pattern of FDI by economic groups reversed in favour of developed countries. However, this growth was achieved mainly through mergers and acquisitions (61% increase in 2015) and not through productive investments. Much of the amount was also used for balance of payment adjustments after the crisis. Developing Asia accounted for about one-third of FDI inflows in 2015. The total FDI in developing economies also reached a new high of 741 million USD. Similar trend was projected for 2016 with a possibility of decline in FDI. An increasing trend during 1995-2000, a declining trend during 2000-2003, again an increase from 2003-2007 and another decrease during the global financial crisis period of 2008-2009 are observed.

In his paper, we review the FDI inflows into the developing countries during the first increase from 1995-2000 and the effect of global financial crisis on FDI during 2008-2009 in terms of their economic policies. Available published works are used for this review.

The objectives of this review:

1. To evaluate the impact of economic policies of developing countries on their FDI inflows.
2. To evaluate the effect of recent global economic crisis on the economic policies of developing countries in relation to their FDI inflows.

Method

The search for published works was done on the search engine Google Scholar using different search phrases to locate the available works. Those works conforming to the objective of the review at least partially were selected. The first five pages (extended to sixth page if any very significant paper is available) were only searched in the search engine as the works listed after fifth page are often repetitive. For selecting papers on the recent global economic crisis, the time line was specified to 2012 and after. Thus, 35 papers were available for this review.

The selected works for this review are discussed under each section below and listed at the end.

Findings

Policies which facilitate FDI for economic growth

Many research findings demonstrate the role of FDI on economic growth of developing countries. Such investments are essentially more from the developed to the developing countries. But, first we look at some general characteristics with their policy implications in the next section.

Characteristics of FDI and their policy implications

In a typical study, Borensztein, Gregorio, & Lee (1998) noted that FDI promoted economic growth through transfer of technology and there was little effect on domestic investment. The level of technology in the investing country should be superior to that of the receiving country. Then only technology transfer takes place. Consequently, FDI flows from developed to developing countries can facilitate technology transfer. However, it need not be necessarily so always as FDI flows can also be for other purposes like facilitating low cost manufacture, boosting local production levels, marketing and skill improvement. If technology levels of both investing and receiving countries are the same, the FDI may be for other purposes like market penetration, circumvent trade restrictions or global expansion strategies of firms. It is notable that direct investment from government-to-government is not usual. Governments contribute to international agencies like IMF and needing countries are assisted by these international agencies in the form of financing well-defined projects. Thus, FDI mostly occurs by firms from one country investing in another country to develop its own business. Contribution to the economic growth of host country is purely incidental arising out of the large-scale impact of firm investments.

Crowding of domestic investment by FDI

FDI may have some positive effect on domestic investment due to complementary activities arising from displaced local competitors. Thus, in effect, FDI pulls other sources of investments. If FDI augments economic growth, it should not crowd out domestic investment. However, crowding out of domestic investment by FDI was noted in some developing countries, especially in Latin America, due to the mismatch between the FDI policy and the country context (Agosin & Machado, 2005).

If the relationship between FDI and total fixed investment is positive, the possibility of crowding out of domestic investment can be discounted. In the study of Borensztein, Gregorio, & Lee (1998), the relationship between FDI and total fixed capital was positive and was, in fact promoting domestic investments. But this was only a baseline effect. Overall, FDI helped growth through efficiency improvement. In another similar study, these results were endorsed by De Mello Jr (1997).

Technology transfer dimension of FDI policy

The cumulative effect of FDI due to a bundling of technology transfer, capital stocks and other complementary factors was detected by De Mello Jr (1997). Efficiency spill-overs from FDI to domestic sectors with increased returns and increase in value-added content promoted economic development of the receiving country. The FDI policy needs to be directed towards one or more of these factors most favourable for growth.

FDI policies to facilitate technology transfer are aimed at promoting investments from industrially advanced countries to set up their own subsidiaries or units or to collaborate with local investors and firms. Successful FDIs of this type from US and Japan to the ASEAN countries during 1990 to 2000, according to Lee & Tan (2006). The technology transfer intensities increased significantly in all ASEAN countries. Singapore and Malaysia were leading both before and after the Asian Economic crisis of 1997. Evidently, these two countries had superior policies to attract FDI more specifically aimed at technology transfer.

Global dimensions of FDI policies

A detailed analysis of effect of financial globalisation on developing countries was presented by Prasad, Rogoff, Wei, & Kose (2003) in an IMF report. The authors discuss FDI as a component of financial globalisation. The opposing effects of restrictive and openness policies on financial integration (and therefore on FDI) are evident from the report.

Relatively few countries used the opportunities of integrating with global economy to garner most of the foreign capital flows into them. The factors which promote FDI into developing countries are: sufficient absorptive capacity to receive and spend FDI in activities of economic growth, macro-economic policies in favour of capital inflows, improved financial institutions and good governance.

The absorptive capacity becomes sufficient when human capital is adequate to support FDI and its activities. In their work, Borensztein, Gregorio, & Lee (1998) found the magnitude of economic impact depended upon the availability of human capital to absorb the funds in a useful manner. From these findings, we can deduce that policies for increasing human capital with suitable skill levels will increase the absorptivity of large FDI flows.

Increase in capital flows of FDI is facilitated when there are no restrictions on foreign investments and ownerships. During 1989-2001, restrictions on foreign ownership and thus on FDI has been decreasing all over the world as the report of Prasad, Rogoff, Wei, & Kose (2003) shows.

While the decrease in foreign ownership restrictions has been faster in the Western hemisphere, there was slow and steady decrease in Asia. Africa was hesitant to remove restrictions. African countries are strong in domestic investments and therefore, the need for FDI is only for technology transfer, poverty reduction and healthcare.

Macro-economic policies will help to increase FDI only if there is macro-economic stability. There are certain risks in capital account liberalisation, which have not been adequately appreciated. Vulnerability to crises is noticed with indiscriminate liberalisation of capital account. This is one reason for global economic crisis of 2008-2009, which will be discussed below. There is a strong debate on whether financial institutions need strengthening before capital account liberalisation or it will automatically happen as liberalisation will bring best practices into the country. During 1970-1998, restrictive policies have been reduced and policies of openness have increased in industrial countries. On the other hand, in developing countries, restrictive policies were more or less at constant level with only the nature of restrictions changing frequently. Openness has consistently increased since 1980’s (Prasad, Rogoff, Wei, & Kose, 2003).

In the report of Prasad, Rogoff, Wei, & Kose (2003), the relationship of FDI with financial integration has been discussed in detail. FDI, especially in the form of private capital inflows, increased substantially in more financially integrated (MFI) developing countries. Such countries in the developing category were very few. The policies in the developing MFI countries responsible for higher capital inflows into them were: capital market liberalisation and privatisation of state-owned companies. Other factors include: growing importance of depository receipts, cross-listings and emergence of institutional investors as major investors of FDI. Mergers and acquisitions of privatised state-owned companies and easing out the restrictions on foreign participation in financial sector of MFIs also played important roles in increasing FDI. Institutions of investors in industrial countries (mutual funds, hedge funds, pension funds, insurance companies) were responsible for major portion of capital flows from industrial to developing countries. Individual investors would have found it difficult to cross informational and transaction cost barriers. However, only a small portion of the total funds (say 5-15%) of the investors reach developing countries. But, its impact is big on the developing countries as their capital market size is small.

It is well-known that, in western countries, demographic shift towards ageing population will require large amounts of funds to maintain the post-retirement population. If the current savings rate is increased to meet this expenditure, it will result in reduce return on capital. Hence, FDI into countries where higher returns are possible is an attractive option, according to Prasad, Rogoff, Wei, & Kose (2003).

Many evidences suggest significant relationship of FDI with domestic investment and domestic growth. Vulnerability of developing countries to economic risks is influenced by source country from where the FDI flows. FDI decreases and borrowing increases with increase in corruption level of a country. Thus good governance becomes an important factor of FDI. Prasad, Rogoff, Wei, & Kose (2003) found that FDI decreases as corruption level increases.

In some studies, institutional quality improvement took place due to FDI (Alfaro, Kalemli-Ozcan, & Volosovych, 2008). If there is good institutional quality, corruption will be less.

In an important paper, Gastanaga, Nugent, & Pashamova (1998) tested the effect of some policy and institutional variables on FDI into 49 less developed countries. The variables were: corporate tax rates, tariff rates, degree of openness to international capital flows, exchange rate distortions, contract enforcement, nationalization risk, bureaucratic delay and corruption. Many policy and institutional variables were found to affect FDI. The authors noted that there is possible exaggeration of effects of individual policy reforms in the absence of controlling for the effect of other policies. In a related study on 66 developing countries by Makki & Somwaru (2004), sound economic policies of lowering inflation rate and tax rates and government consumption were found to promote FDI. According to Wei (2000) either an increase in tax rate on multinational firms or the corruption level in the host country can reduce FDI. In the case of FDI from Singapore to Mexico, an increase in corruption level by one unit will have the same effect as increasing tax rate by 50 percentage points in Mexico. Although American investors re averse to corruption in host countries, but are not stricter than OECD investors. Thus, there is some substitution effect between high tax rates and corruption. Corruption benefits individuals and tax benefits whole country.

Based on another study on Latin America, Bengoa & Sanchez-Robles (2003) observed that economic freedom, adequacy of human capital, economic stability and liberalised markets are necessary for increasing FDI in those countries. FDI was related to the economic growth. Similar conclusions were reached by Zhang (2001) also based on evidence from East Asia and Latin America.

Perceived constraints on FDI

Noting that macro-economic instability, investment restrictions, corruption and political instability impact FDI negatively, Asiedu (2006) studied on the effect of country characteristics like natural resources, government policies, market size, political instability and quality of institutions on FDI in 22 African countries for the period of 1984-2000. Natural resources and large markets promoted FDI. Lower inflation, good infrastructure, an educated population, openness to FDI, less corruption, political stability and a reliable legal system also had similar effects. A decline in corruption level from that of Nigeria to that of South Africa had the same positive effect as that of 35% export increase in fuels and minerals. Thus, small countries with low level of natural resources can attract FDI by improving policy environment and the institutions. Comparative results of two World Business Environment (WBE) survey 1999/2000 and World Development Report (WDR) survey 1996/1997 and firm ratings on the constraints of

FDI in Sub-Saharan Africa are insightful in this regard. WBR survey was more extensive in terms of number of countries and firm population covered. Interestingly, corruption, infrastructure, crime and inflation are among the first five constraints in both surveys although relative rating varied slightly. Among these, only corruption was rated by firms in the top high. Other constraints were rated very differently by firms in both surveys. Policies to remove the constraints should increase FDI.

Risks in FDI and policies to reduce risks

Effects of political risks, macroeconomic variables and business conditions on FDI were evaluated by (Singh & Jun (1995). They used a pooled model of developing countries. Qualitative index of political risk was a significant factor of FDI for countries which have high FDI inflows. For countries of low FDI inflows, socio-political instability (working hours lost by industrial disputes used as proxy) reduced FDI inflows. General quality index of business operations and taxes on international transactions were important FDI inflow factors for countries with high flows. Exports (especially manufacturing exports) was a significant factor for high FDI inflow countries. The feedback is mainly from exports to FDI. Main FDI attractant for FDI was exports.

Types and quality of institutions

Although quality of institutions have been stressed as an important determinant of FDI by many authors as discussed above, the answer to the question, which types of institutions are better, remains. From a study of the effects of both formal and informal institutions, Bevan, Estrin, & Meyer (2004) identified many formal institutions determining FDI flows from market economies to transition economies: private ownership of business, banking sector reform, foreign exchange and trade liberalization, and legal development. Informal institutions in the form of cultural dimensions of collectivism and future orientation (Hofstede, 2011) influence political, economic and regulatory institutions. These three formal institutions affect FDI inflows of the country. These results were reported by Holmes, Miller, Hitt, & Salmador (2013).

Country policies versus global firms: Assuring investment protection

Domestic price liberalization, non-bank financial sector development and competition policy did not affect FDI. Thus, both complementarity and conflicts between policy reforms and the interests of multinational companies are possible (Bevan, Estrin, & Meyer, 2004). In another work, Bénassy-Quéré, Coupet, & Mayer (2007) found that public efficiency was a major determinant of FDI in a broad sense. This included tax systems, easiness to do business, absence of corruption, transparency, contract law, security of property rights, efficiency of justice and prudential standards. The extent of competition also had a significant role. Capital concentration in both the source and the destination country positively influenced FDI.

International commitments arising out of GATT/WTO and preferential trade agreements were more credible than domestic policies in reassuring foreign investors on protection of their assets. These push up FDI into developing countries (Büthe & Milner, 2008). But regional inequalities in developing countries as a result of globalisation through FDI is an increasing concern. This seems to be happening in the case of China, as the report of Zhang & Zhang (2003) suggests. Bilateral investment treaties can boost confidence of foreign investors to developing countries as they are insulated against inefficient institutions through the treaty. Developing countries also accept the restrictions imposed by such treaties on their sovereignty as it helps to get more FDI.

Thus, higher number of bilateral investment treaties increases FDI. Sometimes, bilateral investment treaties substitutes for good domestic institutional quality (Neumayer & Spess, 2005).

FDI is not always the best option

According to Loungani & Razin (2001), FDI is not always beneficial for developing countries. They prescribe certain conditions under which it is not beneficial. Countries trying to expand their access to international capital markets should concentrate on developing credible enforcement mechanisms instead of trying to get more FDI (Albuquerque.2000- as cited by Loughani & Razin, 2001). A high share of FDI in capital inflows is not a sign of good health, as evidenced by the industrial countries where it is barely 12 percent of total investments. Therefore, policies directed at increasing that share are unwarranted. Instead, countries should concentrate on improving the environment for investment and the functioning of markets. They are likely to be rewarded with increasingly efficient overall investment as well as with more capital inflows. There are some other cases in which FDI might not be beneficial to the recipient country. This can occur, for instance, when FDI is geared toward serving domestic markets that are protected by high tariff or non-tariff barriers. FDI under these circumstances may become a political-economy lobbying facility to perpetuate the misallocation of resources. There could also be a loss of domestic competition that can arise when foreign acquisitions lead to a consolidation in the number of domestic producers, either through takeovers or corporate failures. Based on an analysis of 1975-1995 data, Beer & Boswell (2015) opined that dependence on FDI for development may not be suitable for countries concerned with equity. In such countries, FDI benefits only the elite segments of income-earning population over the poorest by 80%. The shift in capital and labour due to globalisation has contributed to income inequality throughout the world. Hence the FDI policies need to be adjusted accordingly.

Sub-Saharan Africa

A special case of Sub-Saharan Africa (SSA), different from other developing countries, was reported by Asiedu (2002). A lower return on investment and poorer infrastructure and lower marginal benefit from increased openness are identified as the reasons for lower FDI levels in SSA compared to other developing countries. This means, the policies that were successful in other regions had not been successful in SSA. On the other hand, using a different approach of mixed fixed and random panel data, Nair-Reichert & Weinhold (2001) found that the efficiency of FDI to raise future growth rate is higher for more open economies. Perhaps, this may indicate an inadequacy of openness in SSA countries or the categories of trade for which openness has been granted may need to be revised.

Impact of recent global economic crisis on economic policies of developing countries and their FDI

The most recent global economic crisis started in US during 2007-2008 and its effects echoed in Iceland (2008-2012), Irish banking crisis (2008-2010), Russian financial crisis (2008-2009), automotive industry crisis (2008-2010), European Sovereignty debt crisis (2009-2012) affecting mainly Greece, Portugal, Ireland, Spain and Cyprus, Greek government debt crisis (2009-continuing), Russian financial crisis (2014) and Chinese stock market crash (2015). The causes and effects are still being analysed by a number of researchers. Here, the focus is its effect on FDI policies in developing countries.

Pre-crisis, there were rapid strides towards positive net foreign currency positions. During the crisis, currency market upheavals generated irreversible currency-generated valuation effects (Bénétrix, Lane, & Shambaugh, 2015). Thus, the crisis reduced financial confidence of nations and they became cautious with every transaction. This slowed down FDI processes. These effects primarily happened in developed countries and hence investments into developing countries slowed down and the cautious approach of the receiving country also had its effect. The impact of the reduced FDI was greater on the developing countries than those on the developed countries. This was due to weak financial systems, policy deficits and weak institutions. Partially supporting these observations,

Ahmed & Zlate (2014) observed that net inflows into emerging market economies became sensitive to interest differentials post-crisis. Capital controls introduced after the crisis decreased both total and portfolio inflows. However, only portfolio investments were affected. There was no effect on direct investments. But based on the results of analysis of 100 countries during 2008-2009, Kee, Neagu, & Nicita (2013) failed to observe any change in trade policies of these countries for increased protectionism in response to the crisis. A few countries increased their import tariffs on some major goods. U.S. and EU relied on their antidumping duties to protect their domestic sectors. The rise in tariffs and antidumping duties was estimated to cause a decline in global trade by about 43 billion USD. But it explained only about 2% of total trade losses during this period. According to Chor & Manova (2012) the trade volumes were affected during the crisis mainly due to adverse credit conditions. Cost of capital and financial dependence of sectors were analysed for the sample countries which included six developing countries. The effect on export volumes was the dependent variable. For some countries, higher interbank rates resulting in tighter credit conditions lowered exports to US. Sectors which were dependent on external financing, but with few collateralizable assets and limited access to credit were affected most. Exports of more financially dependent industries were more sensitive to cost of external capital. The implications of all these on trade volumes revealed the real effects of the crisis and what policy interventions could achieve in ameliorating the problems.

Observing that international agreement on FDIs has been evading consensus so far, (Milner, 2014) pointed out to the increasing importance of bilateral investment and preferential trade agreements in FDI. The need for international investment agreement arises to remove the barriers of global investments in the form of unilateral protectionist trade policies leading to trade wars, shift in terms of trade, discriminatory behaviour and pressures from interest groups. Reserve levels in 2007 and recent real appreciation (as a predictor of devaluation and a measure of exchange market pressure) significantly predicted the global financial crisis in the work reported by Frankel & Saravelos (2012). Hence, FDI policies need to consider the impact on reserve levels, inflation and the exchange rate policy needs to reviewed regularly.

Categorising main FDI contributors (US, Japan, Eurozone, China) as core/centre countries (developed countries) and FDI recipient developing and emerging market countries as peripheral countries, Aizenman, Chinn, & Ito (2015) observed that before the crisis, strength of links of developing countries with core countries determined the financial variables of the peripheral countries. Around the period of emerging market crisis of 1990's and the recent global crisis of 2008, policy interest rates and term spreads also became significant. The trilemma policy arrangements including exchange rate flexibility, affect sensitivity of developing countries to policy changes and shocks in core countries.

Policy responses to the crisis

Policy reforms after the crisis were categorised into two by Lane (2013). These two categories are: reforms to reduce the likelihood of future crises and reforms to improve macro-economic and financial resilience if a crisis happens. According to Laeven & Valencia (2013) bank recapitalisation during the crisis positively, but disproportionately, affected the growth of firms dependent on external financing. Government interventions during the crisis were: recapitalisation of pledged or used amount, asset or bank creditor's guarantees, asset purchases and lending by treasury of pledged amount or used amount, liquidity support, change in ST interest rate and fiscal stimulus. One or more of these interventions were done by most countries, as listed by the authors. They have given the policy responses of various countries during the crisis in terms of financial policies of liquidity support and guarantees. Luxemburg gave the highest support of more than 50%. Evidently, liquidity support was not a favourite option of most countries as the support levels were less than 25% for all other countries. In the case of guarantees, some countries used both bank creditor's guarantee and asset guarantees. But many others preferred either of the two. UK, Netherlands, Belgium Germany and Korea supported asset guarantees fully. Guarantees exceeded GDP by more than 100% in many cases.

Recapitalisation of either pledged amount or used amount were done variously by different countries. Both options were used very highly by Iceland. Purchase of pledged or used amounts of assets were also done variously by different countries. High levels of both were used by Norway. Canada, Belgium and Switzerland occupied the next three positions in this respect. If we take one example of a country, Luxemburg used liquidity support mostly and recapitalisation of used amount exclusively as its policy response. Similar categorisations can be done for other countries also.

From a study of seven large emerging market economies, Gawande, Hoekman, & Cui, (2015) noted that participation in global value chains was a powerful factor in determining trade policy responses to the crisis. The tariff space available from WTO and PTA commitments was not used as protective policies by some of the emerging economies. Instead, they kept their tariffs low to enable export of products by foreign and domestic producers.

Conclusions

The aims of this paper were to evaluate the impact of economic policies of developing countries on their FDI inflows and the effect of recent global economic crisis on it. Using Google Scholar, 35 papers were selected for this review. They were discussed under various sections. The conclusions obtained from this review are listed below:

Some specific FDI-favourable policies are related to capital market liberalisation and privatisation of state-owned companies, easing out of foreign participation, good governance, free of corruption, good quality institutions, corporate tax rates, low tariff rates, degree of openness to international capital flows, no exchange rate distortions, contract enforcement, no nationalization risk, no bureaucratic delay, low inflation rate, greater economic freedom, adequacy of human capital, economic stability, public efficiency in terms of tax systems, easiness to do business, good contract laws, security of property rights, efficiency of justice, prudential standards and increased competition.

International commitments in terms of bilateral agreements and preferential treatment are better than domestic policies and they may substitute for institutional quality needs.

The constraints on FDI are: macro-economic instability, investment restrictions, corruption and political instability. Policies to remove them increases FDI.

The policies addressing the risks of vulnerability to crisis of capital account liberalisation, political risks, macroeconomic variables and business conditions need to be in place.

When there are conflicts between country policies and interests of global firms, the need to be sorted out.

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Responses to the crisis were in the form of financial and monetary policies. Most countries selected one or more policies and combinations of recapitalisation of pledged or used amount, asset or bank creditor’s guarantees, asset purchases and lending by treasury of pledged a

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