Who Benefits? Who Loses?

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Neoliberal approaches advocating unbridled liberalization of investment flows take it for granted that the free flow of investment across borders offers immense benefits to countries in terms of the transfer of technology, creation of jobs, quality products and services, along with managerial efficiency. These perceived benefits may hold true for some investments, but it would be a serious mistake to make broad generalizations because hosting investment flows is not without its potential costs. There is no denying that the trans-border movement of capital offers new opportunities to the owners and managers of capital to penetrate and expand their operations on a global scale. Nevertheless, it has important implications for governments and domestic firms as well as for workers, consumers, and communities in the host countries. Unfortunately, neoliberal approaches do not give adequate attention to these economic, social, and environmental costs and thus fail to establish the links between foreign investment and poverty reduction and development.

Given that investment flows have been one of the foremost economic, political, and social influences in the present world economy, the debate should move beyond the rhetoric that all investment flows are good or all investment flows are bad. Rather, the debate on investment flows should be situated in the wider context of global political economy, and therefore, should be centered on the moot questions: Who benefits? Who loses? What strategies are needed to ensure that FDI flows contribute to the fulfilment of wider developmental objectives, many of which are country specific?

These questions become even more relevant in the present context when attracting foreign direct investment flows is seen by policy makers as an important instrument to achieve higher economic growth and to reduce poverty. It is assumed that global investment flows will ensure large-scale employment opportunities, transfer of R&D, entrepreneurial skills, and new export opportunities. Particularly in the aftermath of the Southeast Asian financial crisis, the new global policy framework is cautious on inviting short-term portfolio investment flows but calls for a liberalized regime of FDI flows. This new emphasis in the global policy framework has not been adequately addressed by the critics of FDI flows.

INVESTMENT INFLOWS OR OUTFLOWS?

The term 'foreign direct investment' usually symbolizes investment by a foreign entity in a domestic company, but recent empirical evidence suggests that foreign capital does not always flow into the host country. The foreign company can finance the equity buyout of a domestic company through domestic banks and lenders. For instance, when the Japanese-owned tire company Bridgestone took control of the US-based Firestone in 1988, the equity purchase was largely financed by US domestic lenders. In such instances, there is no investment expenditure but only an international transfer of control of corporate assets. Take another example: Enron's Dabhol power plant in the Indian state of Maharashtra. The bulk of debt funds for this power plant were provided by Indian banks and financial institutions. Both these examples highlight a growing

trend of transnational corporations to raise equity and debt funds through domestic banks and financial institutions in the host countries.

In this context, it is important to debunk another myth that FDI should be encouraged because it is a non-debt creating capital. It is true that FDI does not involve the direct repayment of debt and interest, but at the same time, it does involve substantial foreign exchange costs. Capital can move out of a country through remittance of profits, dividends, royalty payments, and technical fees. In the case of Brazil, foreign exchange outflows in the form of profits, royalty payments, and technical fees rose steeply from $37 million in 1993 to $7 billion in 1998.

Due to rapid financial liberalization, the trend of significant foreign exchange outflows with a resulting negative impact on a country's balance of payments has gained additional momentum. This trend is most evident in several African economies such as Botswana, Democratic Republic of Congo, Gabon, Mali, and Nigeria where profit remittances alone are higher than FDI inflows during 1995-2003 (see Table 3.1).

If FDI is not related to exports, it can have serious implications for developing countries which are usually short of foreign exchange reserves. In India, a recent study by the central bank, the Reserve Bank of India, found that over 300 TNCs were net negative foreign exchange earners. In other words, these TNCs were spending more foreign exchange than they were earning. Moreover, nearly three-quarters of these outflows were related to the import of raw materials and technology.

Most services are not tradable, meaning that they need to be produced and consumed domestically. Given that the share of services in total FDI inflows has increased in recent years, foreign investments in the telecom, energy, construction, retailing, financial services, and other non-tradable sectors would involve substantial foreign exchange outflows over time in the form of imports of inputs, technology, royalty payments, and repatriation of profits. Thus, any cost-benefit analysis of foreign investment in the service sector should include such capital outflows based on an initial investment.

In addition, capital can also move out of the country via illegal means such as transfer pricing and creative accounting practices. It is an established fact that transnational corporations indulge in manipulative transfer pricing to avoid tax liabilities. Only recently, tax authorities, particularly in the developing world, have taken cognizance of widespread abuse of transfer pricing methods by TNCs. In the US, which has developed elaborate regulatory procedures to curb this activity, it has been estimated that annual losses in tax revenue are in the order of $30 billion on account of transfer pricing alone.

Thanks to creative accounting practices, firms can undervalue their levels of profits in order to reduce their tax burdens in host countries. For instance, oil giant Exxon never paid any taxes in Chile as it had never declared any profits during its 20 years of operating in the country. Even in developed countries, the recent spate of corporate scandals (from Enron to Worldcom to Parmalat) has brought to public notice pervasive corrupt TNC practices carried out in collusion with accountants, investment bankers, and regulators. In the real world where markets are imperfect and oligopolistic tendencies are significant, the predatory business practices of TNCs and their adverse consequences on domestic businesses, particularly infant industries, need no elaboration here.

IS INVESTMENT LIBERALIZATION A PANACEA?

Another common notion, that international investment liberalization is vital for higher economic growth, requires closer scrutiny. There is little evidence linking investment liberalization to growth. Liberalization of investment by itself cannot enhance growth prospects because it is a complex process, subject to a wide range of factors including capital accumulation and economic diversification. If one tries to match the periods of investment liberalization with the economic performance of countries, the results may appear contradictory. Growth started deteriorating around the 1970s when many countries moved towards liberalized investment regimes. The 1980s and the 1990s witnessed a sharp deterioration in the economic performance of many developed and developing countries. The worst decade for growth performance occurred in the 1990s. Restrictions on investments have not necessarily led to poor economic performance. Many countries enjoyed high growth without liberalizing their investment regimes, Japan, Taiwan, and South Korea being prime examples. These countries used a combination of policy measures (such as reverse engineering, technology screening, performance criteria, domestic content agreements, and exchange controls) to link FDI policy to their wider national development strategy.

To a large extent, the quality of investment determines growth and productivity rates. As mentioned in the previous chapter, the composition of private capital flows has undergone a rapid transformation in the last two decades. Although FDI has remained constant, short-term portfolio investment (which was negligible in the 1970s and 1980s) has become sizeable since the 1990s. Portfolio investments now surpass loans as the most important source of cross-border finance. Since most portfolio investments have only tenuous links with the real economy and are speculative in nature, their contribution to economic growth is highly questionable. Besides, the bulk of portfolio investment and other speculative funds are highly volatile and therefore are prone to reversals. A sudden withdrawal of capital can negatively impact on exchange and interest rates. Volatile capital inflows can substantially complicate economic management and threaten macro-economic stability. The boom-bust cycles of portfolio investment flows not only induce macroeconomic instability but also reduce the policy space to adopt counter-cyclical macroeconomic policies. Several episodes of financial crisis in Mexico, Southeast Asia, and Turkey in the 1990s not only point to the severe economic and social costs, but also to the preeminent role of unregulated short-term portfolio flows in precipitating a financial crisis.

In the last two decades, the attributes of FDI flows, known for their supposed stability and spillover benefits, have also changed profoundly. The stability of FDI flows has been questioned in the light of evidence suggesting that as a financial crisis or devaluation becomes imminent, transnational corporations indulge in hedging activities to cover their exchange rate risk, which in turn generates additional pressure on exchange rates. In the present context of rapid financial liberalization, the use of derivative instruments by TNCs for hedging and speculative purposes has become common. The increasing use of financial derivatives by corporations also adds to volatility.

Not all components of FDI flows are stable. It has been found that two components of FDI flows, namely, non-repatriated earnings and inter-firm loans, have a tendency to be highly volatile and pro-cyclical as TNCs reduce their exposure in deteriorating economic conditions in the host countries, thereby further exacerbating the financial crisis. In the

aftermath of the Southeast Asian financial crisis of 1997, there was a significant increase in repatriation of earnings by TNCs. Similarly, TNCs can reduce or recall loans to foreign subsidiaries in anticipation of devaluation, as witnessed during the Brazilian financial crisis of 1998.

DOES FDI TRIGGER ECONOMIC GROWTH?

Foreign direct investment is not an automatic route to economic growth. There is hardly any reliable cross-country empirical evidence to support the claim that FDI per se accelerates economic growth. On the contrary, there is growing evidence suggesting that FDI does not play a catalytic role in the growth process. Instead of creating economic growth, FDI responds to a 'success story' of economic growth. In the present circumstances, it is quite difficult to establish direct linkages between FDI and economic growth if other factors such as competition policy, performance requirements, labor skills, ownership ceilings, employment requirements, and comprehensive regulatory frameworks are not taken into account as well. Therefore, any assessment of the positive impact of FDI flows should be based on each project and its links with wider development objectives, such as income growth and distribution; employment expansion; the absorption of new skills and technology; and balance of payments stability.

What is good for a particular TNC may not be good for the host country. If the foreign company is not creating new assets, but merely acquiring existing, locally owned ones, then the net benefits of such investments are almost negligible to the host country. Corporate objectives do not always match those of governments. In contrast to transnational capital with its single-minded pursuit of profit maximization, governments undertake diverse social, economic, and political tasks to meet the needs of their citizens.

The positive impact of FDI also depends on several other factors, including the sector in which the investment is taking place. For instance, if the bulk of FDI flows are directed towards exploitation of natural resources in the host countries (as is the case in African and Latin American countries), then the benefits in terms of transfer of technology, knowledge, and skills would be negligible. Therefore, steps must be taken to ensure that the FDI in extractive industries contributes to poverty alleviation.

Since the bulk of FDI flows are associated with cross-border mergers and acquisitions, their positive impact on the domestic economy through technological transfers and other spillover effects has been significantly diluted. The prospects of technological transfers to host countries are slim on two counts. First, TNCs employ the technology that best suits their strategic needs, rather than the development needs of host countries. Second, much of the research and development by TNCs is carried out in their home countries rather than in host countries.

The other potential developmental gains from attracting FDI flows are dependent on a host of implicit assumptions. For instance, it is often assumed that the entry of foreign firms is going to solve the problem of unemployment in the host countries. But recent evidence and future prospects are not very optimistic on this aspect for three reasons. Firstly, TNCs usually employ highly capital-intensive processes that do not create large-scale employment opportunities. Although TNCs are believed to pay higher wages, their bias towards highly-skilled labor is well-known. Secondly, in the manufacturing and

service sectors, TNCs and their affiliates employ a variety of subcontractors and suppliers, which further limits the opportunities of direct employment. Thirdly, instead of creating jobs, M&A activity has contributed to massive job losses, particularly in the developed world where this activity is largely concentrated.

It is well-established that extractive industries involve huge long-term environmental and social costs, which are not taken into account as part of investment decisions. The bulk of large-scale mining, for instance, is undertaken by TNCs and their affiliates, which have failed to mitigate the environmental and social problems they cause, such as forest loss and the eviction of people from their land. Some of these impacts can be very long-lasting, thereby creating long-term liabilities to host countries. As backward (input-oriented) and forward (output-oriented) linkages of mining projects are weak, the much-touted benefits of attracting FDI in the mining industry are highly debatable. Although there are many reasons behind the relocation of industries, several recently reported instances suggest that foreign investors are relocating their polluting industries from developed countries to countries with lower environmental standards. A study conducted by the author found that several German investors were influenced by this factor in relocating their dye industry to India.

One of the guiding principles that determines the impact of FDI on national economic growth is whether foreign capital complements or substitutes for domestic capital. In several developing countries, it has been observed that foreign investment often displaces domestic investment. According to one recent study, the tendency of FDI to crowd out local investment rose in all developing regions, including sub-Saharan Africa, in the period 1990-1997 compared with 1983-1989. In Latin America, the increase in real investment has been only to the tune of one-third of the net capital inflow. In fact, if one takes the Latin American region as a whole, external savings have crowded out national savings. In New Zealand, both household and corporate savings have witnessed a steep decline since liberalization. There is ample evidence of lower private saving rates following liberalization in Argentina, Chile, Colombia, and the Philippines.

There are several instances where liberalization and globalization policies have contributed to a consumption boom. In Mexico, the inflows sustained a boom in private consumption after the country's capital account was liberalized in the late 1980s. In 1992-93, capital inflows were estimated at 8 percent of GDP. With higher interest rates in Mexico, the international investment banks and fund managers invested billions of dollars in financial markets and real estate, thereby creating a boom. Higher but unrealistic valuation of stocks and real estate coupled with the appreciation of the exchange rate fuelled the private consumption boom. There was a substantial hike in consumer lending after liberalization in Mexico as banks rapidly expanded credit card businesses and loans for consumer items. As a result, investment stagnated and foreign savings crowded out domestic savings. National savings as a proportion of GDP plummeted by more than 4 percent between 1989 and 1994. Mexico had to pay a high price for liberalization as its GDP contracted by 7 percent in 1995.

It is high time that policy makers move away from the idea of a 'race to the bottom' in order to attract FDI flows. Dictated by international financial institutions, market-oriented macroeconomic reforms coupled with good governance conditionalities have failed to attract FDI flows, as is clearly evident in the case of Africa. The entire continent attracts only a fraction of global investment flows despite widespread implementation of such reform packages as part of structural adjustment programs. It is not the lack of

market-oriented reforms and good governance institutions that prevent the flow of foreign investment to Africa; rather it is the small size of domestic markets, lower income per capita, poor infrastructure, insufficient growth prospects, locational disadvantages, civil unrest, and political instability in the continent that are responsible for meager investment inflows. By stalling economic diversification and shrinking public investment, a liberalized policy regime has contributed to the process of deindustrialization in several African countries. The share of manufacturing output in Gross Domestic Product (GDP) dropped sharply in Sub-Saharan Africa between 1980 and 1990 under the liberalized policy regime.

Despite a gradual erosion of policy space, policy makers should evolve a new strategy based on appropriate policy instruments and institutional arrangements to link FDI with their wider developmental goals suiting their local conditions. However, this would not be an easy task given the constraints posed by the international policy regime.

IS THE ENTRY OF FOREIGN BANKS BENEFICIAL?

The entry of foreign investment in the banking sector deserves detailed analysis since this sector has definite linkages with economic growth and development. As more and more developing countries are easing restrictions on the entry of foreign banks, the costs in terms of allocation of credit and financial efficiency have not been critically assessed. The impact of allowing foreign banks to acquire stakes in the domestic banking sector has been more dramatic in Central and Eastern Europe (CEE) where most domestic banks have already become, or are likely to become, subsidiaries of large foreign banks. In the wake of massive privatization programs in these countries, foreign banks have rapidly taken control over the domestic banking sector. In the nine CEE countries, foreign bank holdings rose from 20 percent in 1997 to over 60 percent by the end of 2001. In the Baltic states of Estonia, Latvia, and Lithuania, foreign banks (particularly from the neighboring Scandinavian countries) have captured the domestic banking market within a short span of time. In Estonia, for instance, foreign-owned banks increased their market share from 2.3 percent in 1997 to over 97 percent by 2000. The top three banks of Estonia—Hansapank, Uhipank, and Optiva— are now all foreign-owned. In Latvia, Poland, and Slovakia, foreign-owned banks accounted for more than 65 percent of the total market share in 2000. In terms of assets, over 90 percent of the Czech banking sector has come under the control of foreign banks.

In Latin America, similar trends are also visible. For instance, all the three top banks in Mexico (Bancomer, Serfin, and Banamex) have come under the control of foreign banks through M&A deals. With the recent takeover of Bital by a transnational bank, HSBC, the total foreign ownership in the Mexican banking industry has touched 90 percent of total banking assets in the country.

The rapid market-driven consolidation in the global banking industry has important implications for the allocation of credit, which in turn affects economic growth. Rampant competition in the domestic financial sector due to the entry of foreign banks could enhance the risks. Fearing erosion of the franchise value due to increased competition, domestic banks and financial institutions have a natural tendency to lend more money to risky projects in order to remain in business. Fierce competition in the banking sector has given rise to a situation where banks are increasingly resorting to speculative and risky activities (for example, foreign exchange speculation). A study by Andrew Sheng of

the World Bank found that increased competition was responsible for bank failures in Chile, Argentina, Spain, and Kenya.

Moreover, the entry of foreign banks in the domestic market does not necessarily lead to more credit in the domestic economy. Analysts have reported that, in several countries, the amount of real credit has actually declined in the wake of the increased presence of foreign banks. Based on the study of two of the earliest transition economies, Hungary and Poland, Christian Weller established a link between greater international financial competition and less real credit. Weller found that while the number of financial intermediaries, particularly foreign-owned ones, grew in both economies, the amounts of real loans declined. The decrease in total credit was more pronounced in Hungary. While real loans decreased by 5.2 percent in Poland from 1990 to 1995, and by 47.5 percent in Hungary between 1989 and 1994, the number of multinational banks increased from 0 to 14 in Poland and from 9 to 20 in Hungary. These economies experienced considerable deterioration in their growth rates during the same period.

While the entry of foreign banks is generally considered beneficial as they offer better quality services and more sophisticated products, and have 'deep pockets' to support losses, they can put domestic banks—whose long-term interests are aligned with the local economy—at a competitive disadvantage. Studies by UNCTAD have also shown that financial liberalization and the entry of foreign-owned banks into Africa have fragmented capital markets in which access to sizeable credit is biased in favor of larger foreign firms. It has been observed in some instances that the rapid entry of foreign banks could stall the development of the local banking sector, as witnessed in Australia in the 1980s. By neglecting small- and medium-sized enterprises (SMEs), foreign banks can even jeopardize the prospects of economic growth. If recent experiences are any guide, foreign banks have a tendency to serve the needs of less risky segments such as transnational corporations and 'cherry-picked' host country corporations. Therefore, the consequences for the real economy could be disastrous for many developing economies where small- and medium-sized enterprises constitute the backbone of the manufacturing and service sectors.

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Table 3.1: FDI Inflows and Profit Remittances in Selected African Countries, 1995-2003

Country	**FDI Inflows** ($ million)	**Profit Remittances** ($ million)
Angola	10,761	7,169
Bostwana	943	5,621
Cameroon	577	421
Congo, Dem. Rep. of	1,623	2,773
Cote d’lvoire	2,500	2,366
Gabon	-822	3,432
Guinea	244	332
Kenya	411	361
Mali	807	817
Nigeria	10,784	12,387
Senegal	712	541
Sudan	3,868	1,164
Tunisia	4,287	3,516
Zambia	1,158	362
Zimbabwe	910	837

Source : UNCTAD, Economic Development in Africa: Rethinking the Role of Foreign Direct Investment, New York, 2005.