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**F.D.I. IN EMERGING COUNTRIES**

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**ANNO ACCADEMICO 2014/2015**

# F.D.I. in emerging market

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## **1.Introduction**

Foreign direct investment (FDI) represented a significant factor in global economic development and integration in the 1990s. The process of transition from a command (planned) socialist economy to a capitalist system and the integration of Central and Eastern European countries into the world economy coincided with attributing increasing importance to FDI inflows. In comparison to other sources of funds (e.g., foreign borrowing and portfolio investments), FDI allows for knowledge and technology transfer, assists human capital formation, helps create a more competitive business environment, contributes to global trade integration, and enhances a culture of entrepreneurship (OECD, 2002).

The effects of their inflow in undeveloped or underdeveloped economies are particularly pronounced in the early stages of financial markets' development, which is characterized by low or very low liquidity, lack of market-based instruments, high interest rates, poor or inadequate physical infrastructure and equipment, and a high degree of uncertainty and mistrust among market participants.

When a multinational Enterprise (MNE) decides to invest equity in a foreign country, it faces at least two strategically important decisions.

First, it may opt to establish a foreign operation from scratch (invest in a greenfield facility) or to engage in an acquisition (buy equity share in an existing foreign entity).

Second, it may decide to do it alone (to establish a wholly owned subsidiary) or to involve a local partner (to establish subsidiary with shared ownership).

We refer to the first decision as relating to the establishment mode choice, and to the second decision as dealing with the entry mode decision.

In the second chapter we will focus on the theoretical definition and aspects of foreign direct investment (FDI) and emerging market (EM.). As we already said, FDI can be interpreted in various ways. A common definition is an investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses.

Until 1960, FDI by multinational enterprises was regarded as a form of international capital flows. Capital flow theory suggests that capital (financial) moves between countries in relation to differing interest rates in different countries (Hymer, 1979).

We will show the different studies about the three questions that dominate the FDI literature and we will explain the Vertical and Horizontal F.D.I.

In the third chapter we will explain the FDI determinants and economic growth in emerging markets, indeed, since capital formation and technological improvement are the motor of economic growth, FDI is expected to promote host countries' economic growth (Wang, 2009). In 2002, OECD reports that countries, particularly developing countries, emerging economies and economies in transition, consider FDI as a source of growth and economic modernization. For this reason, many governments, particularly in developing countries, give special treatment to foreign capital.

We will treat the FDI classic macro determinants based on the existent empirical literature, it is possible to create a set of potential determinant variables that influence the FDI flows and classify them into seven broad categories: Market size, Economic stability and Growth prospects, Trade openness, Currency value, Infrastructure facilities, Labour cost and Gross capital formation.

To sum-up, in the fourth chapter we will treat the FDI in :

- Russia, the 9th most populated country in the world with 142.5m people, but is the world' s largest country in terms of territory;
- Brazil, the largest country in both South America and Latin America region;
- China, the top recipient of FDI among developing countries and second in the world after the United States;
- India, the seventh largest country in the world in terms of geographical size.

The decision as to whether to establish an acquisition or a greenfield subsidiary or to opt for full or partial ownership in a foreign investment carries significant strategic importance owing to the inherent benefits and risks of each foreign establishment and entry mode. For instance, although acquisitions offer a speedy establishment of local presence, they may be associated with post-acquisition integration failures, which are often rooted in cross-cultural differences and technological mismatches. Reversely, although greenfields offer an opportunity to preserve and replicate valuable corporate cultures abroad, they require a longer establishment period and more time to build business networks locally.

Although the social dimension of institutions, as related to nations' norms, customs and traditions, is typically critical, we decided to ignore this dimension here, as social aspects of the institutional environment change very slowly over time 'in the order of centuries or millennia' (Williamson, 2000: 596).

So, this study consists of two conceptual parts: the first part discusses the main and moderating effects of institutional advancement on the choice between an acquisition and a greenfield entry mode, and the second part analyses the main and moderating effects of institutional advancement on the choice between wholly owned subsidiaries and subsidiaries with shared ownership.

## **2.Foreign direct investment & Emerging market**

In this chapter we will focus on the theoretical definition and aspects of foreign direct investment (FDI) and emerging market (EM.). As we already said, FDI can be interpreted in various ways. A common definition is an investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses.

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FDI is distinguished from portfolio foreign investment (the purchase of one country's securities by nationals of another country) by the element of control. Standard definitions of control use the internationally agreed 10 per cent threshold of voting shares, but this is a grey area as often a smaller block of shares will give control in widely held companies. Moreover, control of technology, management, even crucial inputs can confer *de facto* control.

FDI is not just a transfer of ownership as it usually involves the transfer of factors complementary to capital, including management, technology and organizational skills.

The past decades has witnessed a dramatic increase in Foreign Direct Investment (FDI) to emerging countries, with FDI increasing from \$24 billion (24% of total foreign investment) in 1990 to \$192 billion (66% of total foreign investment) in 1999. In the last two years, emerging markets claimed the largest share of international foreign direct investment, reflecting their faster growth rates in the years following the financial crisis. In 2013, the FDI increases by 11% to \$1.5 trillion, while FDI in emerging countries increase by 6.2% to a new high of \$759 billion, representing the 52% of the total This is good news, especially for poor countries that do not have access to international capital markets.

## **2.1 Meaning of F.D.I.**

From a theoretical point of view, three questions dominate the FDI literature:

- Why do national firms evolve into multinational organizations?
- Why do firms locate production in a foreign country rather than licensing or exporting?
- What determines the geographic pattern of FDI flows? that is, on what basis are host countries chosen?

The theoretical foundations addressing the first two questions are well developed. As Letto-Gillies's (1992) comprehensive survey points out, Hymer (1960) was the first to systematically analyze issues relating to the advantages of large multinationals, market imperfections, and control. Vernon (1966) built on the technological advantage theories, analyzing the strategic market implications of the product life cycle. Vernon (1979) reevaluated his own theory by indicating that multinational firms are now more geographically diffused than the product cycle would warrant, and the cycle has shortened considerably.

Caves (1982) developed the rationale for horizontal integration (specialized intangible assets with low marginal costs of expansion) and vertical integration (reduction of uncertainty and building of barriers to entry). Buckley and Casson (1976) extended Coase's (1937) explanation as to why multinationals internalize intermediate markets: internalizing intermediate production processes reduces uncertainty by circumventing market imperfections.

But Dunning (1973, 1981) was the first to provide a more comprehensive analysis based on ownership, location, and the advantages of internalization. Dunning's eclectic theory provides some answers about the geographic distribution of FDI by analyzing location factors (see §2.5.1). His taxonomy of location factors emphasizes possession of raw materials, labor costs, government incentives, and servicing of local markets. Dunning's model has been criticized for being tautological: it provides a taxonomy for a wide variety of variables that may be important. But the taxonomy does not provide theoretical justification of why certain location factors are important.

Others studies have also looked into the question of the effects (specifically, spillovers) of FDI.

Lucas (1993) analyzed FDI based on a traditional derived-factor demand of a multiple product monopolist.



But because his model is based on orthodox neoclassical foundations, potentially important variables other than the cost of capital and labor (such as a proxy for the size of the market) are not included in the analysis.

Casson (1990) has suggested that the theory of FDI is a "logical intersection" of three distinct theories: the theory of international capital markets, which explains the financing and risk-sharing arrangements; the theory of the firm, which describes the location of headquarters, management, and input utilization; and trade theory, which describes location of production and destination of sales. Although each theory provides some insight about the complexity of FDI flows, an integrated theory that combines these elements in an analytically persuasive way has not been developed.

### **2.1.1 Vertical and Horizontal F.D.I.**

Questioning which factors characterize the structure of multinational enterprises (MNEs) has been one of trade economists' concerns ever since Mundell [1957] related trade in goods with trade in factors and developed the trade model incorporating capital flows. Seminal works in the 1980s considered MNEs location choice by relating trade and foreign direct investment (FDI), providing a framework for explaining MNE's different activities. There have been different definitions of multinational enterprise that is variously termed as "transnational enterprise" (corporation), "international corporations" (firms), "global corporation", "denationalized corporation", "supranational" or "cosmocorporation". It was long described as an "enterprise which owns and controls income generating assets in more than one country" (Dunning, 1973). The ownership usually meant majority ownership (more than 50%), hence the control, of enterprises in more than one country. In this sense it is equated with foreign direct investment (FDI), so the MNEs structure is related to FDI motives.

Horizontal MNEs are concerned with market access, while vertical MNEs focus on comparative advantage. A horizontal MNE has headquarters in its home country while assembling final products in both the home and a host country. A horizontal MNE can avoid trade costs (such as tariffs and transportation costs) by locating an affiliate in a host country. FDI to establish a horizontal MNE primarily serves the local market.

Alternatively, a vertical MNE splits its production process into more than two locations. Keeping headquarters in the home country, a vertical MNE assembles final goods only in a host country. Vertical MNEs locate their affiliates in host countries' offering cheap factor inputs. FDI to establish a vertical MNE primarily serves non-local markets. Trade theory provides different FDI

implications depending on the MNE's structure. The horizontal MNE model shows that similarity in size and relative factor endowments between a home and a host country are important factors in determining FDI. The vertical MNE model emphasizes the importance of the two countries' relative factor endowments, since MNEs choose locations based on input costs. Different factor prices are the reason for establishing the vertical MNE. Recently, the knowledge capital model was developed to encompass both factor price and market access elements [Markusen et al. 1996; Markusen 1997]. Recent empirical and/or simulation models try to distinguish the horizontal MNE model from the vertical MNE model by examining the theoretical implications. The consensus is that horizontal FDI dominates when countries have similar relative skill endowments. Vertical FDI dominates when countries differ in relative skill endowments. Headquarter activities are assumed to be more skilled-labor intensive than production. Therefore, when hosts are skill-scarce relative to the home country, this will motivate firms to relocate production away from headquarters.

The knowledge-capital model (Markusen, 2002) integrates horizontal and vertical motivations for FDI in a single general-equilibrium model of multinational enterprises (MNEs).

The knowledge-capital model of FDI provides the most articulate general equilibrium model of MNEs with proper microeconomic foundations. It predicts that horizontal FDI dominates when markets in both countries are large and countries are similar in relative skill endowments. Scale economies at the firm level, arising from fixed costs associated with the knowledge asset, give rise to horizontal firms.

Knowledge assets are assumed to have a joint-input or public good character: once created, the assets can be supplied to foreign production facilities at relatively low additional costs. Horizontal firms have plants in several markets. Whether firms will service a particular foreign market through exports or through an additional local plant depends on plant-level scale economies relative to trade costs. Foreign markets should be large for firms to be able to exploit scale economies at the plant level.

Vertical FDI dominates when countries differ in size and relative skill endowments. The knowledge-capital model assumes that production can be geographically separated from the location of the knowledge assets (typically associated with headquarter activities). The activities associated with headquarters, i.e. the knowledge-based and knowledge-generating activities, and the managing and coordinating of plants, are skilled-labor intensive relative to production. These properties give rise to vertical MNEs: when relative skill endowments differ between countries this motivates firms to locate production and headquarters in different countries. In particular, if the parent country  $i$  is small and relatively skilled-labor abundant, while the host country  $j$  is large and

relatively skilled-labor scarce, this motivates firms to locate headquarters in country  $i$  and production in country  $j$ .

Since horizontal firms require additional skilled labor in the home country so as to manage and coordinate the additional plant, horizontal firms are assumed to be more skilled-labor intensive than either vertical MNEs or national firms. A foreign plant (of both horizontal and vertical firms) is assumed to be more skilled-labor intensive than national firms. The added skilled labor comes from the host country and reflects that technology transfer is not costless. That is, some additional skilled labor is needed in the host country so as to implement a blueprint in the foreign plant.

Carr et al. (2001, CMM hereafter) use the following specification to estimate the knowledge-capital model:

$$FDI_{ij} = \alpha_0 + \alpha_1 SUMGDP_{ij} + \alpha_2 (GDPDIFF_{ij})^2 + \alpha_3 SKDIFF_{ij} + \alpha_4 (GDPDIFF_{ij} \times SKDIFF_{ij}) \\ + \alpha_5 INVC_j + \alpha_6 TC_j + \alpha_7 (TC_j \times SKDIFF_{ij}^2) + \alpha_8 TC_i + \alpha_9 DIST_{ij} + \varepsilon_{ij}$$

Where  $FDI_{ij}$  denotes FDI from parent  $i$  to host  $j$ .  $SUMGDP_{ij}$  is the sum of real GDP in both countries. Its coefficient is expected to be positive.  $(GDPDIFF_{ij})^2$  is the squared difference in real GDP between the parent country and the host country and is expected to have a negative coefficient.  $SKDIFF_{ij}$  measures skill differences, defined as the relative skill endowment of the parent country minus that of the host country. Its coefficient is expected to be positive. The interaction term  $(GDPDIFF_{ij} \times SKDIFF_{ij})$  is expected to have a negative coefficient as the knowledge-capital model predicts that vertical FDI is high if the parent country is small and skill-abundant compared with the host country. The fifth and sixth variable,  $INVC_j$  and  $TC_j$ , measure the cost of investing in and exporting to the host  $j$ , respectively. The coefficient of  $INVC_j$  is expected to be negative. The coefficient of  $TC_j$  is expected to be positive since high trade costs stimulate horizontal FDI. The interaction term  $(TC_j \times SKDIFF_{ij}^2)$  captures that the positive effect of  $TC_j$  on FDI is mitigated when countries are dissimilar in relative skill endowments. Its coefficient is expected to be negative.  $TC_i$  is a measure of the cost of exporting to the parent country, and is expected to negatively influence FDI. Finally, geographical distance  $DIST_{ij}$  is added as an element in export costs or investment and monitoring costs.

So, the key variable in the knowledge-capital model for distinguishing vertical FDI within aggregate FDI is the skill difference term. If the empirical analysis leads to a positive coefficient, this confirms vertical motivation for FDI.

Further studies compare the explanatory power of restricted vertical and horizontal model against knowledge - capital model. An independent vertical model provides a poor characterization of the overall pattern of world FDI. The coefficients have the expected sign and are statistically significant. Yet, the model has much lower explanatory power than the horizontal model and the knowledge-capital model. The results provide strong support for the knowledge-capital model, but the results do not permit a distinction between the knowledge-capital and horizontal models (Markusen and Maskus, 2002).

Others papers indicate that vertical FDI shows up as important for certain sectors and host countries. Using disaggregated data for American MNEs, Yeaple (2003) finds that US MNEs locate types of production abroad in a manner that exploits host countries' particular comparative advantage: in industries with high skilled-labor intensities US multinationals favor skilled-labor abundant countries over skilled-labor scarce countries, whereas in sectors with low skilled-labor intensities they favor skill-scarce countries over skilled-labor abundant countries. Hence, the predictions of the knowledge-capital model regarding vertical FDI are found in particular in the least skilled-labor intensive industries. Likewise Feinberg and Keane (2001) and Hanson et al. (2005) find evidence of vertical FDI for certain manufacturing sectors and host countries only. In response to the aforementioned papers, Davies (2008) argues that the empirical specification of the knowledge-capital model should allow for non monotonicities in the range of positive skill differences. The original model of vertical FDI by Helpman (1984) predicts that vertical FDI occurs only when skill differences are relatively large. Hence, for small (positive) skill differences total FDI will decrease when skill differences increase, since horizontal FDI will decrease.

Only when skill differences become sufficiently large will total FDI increase as vertical FDI goes up. To capture these non monotonicities Davies adds a squared skill difference term to the CMM (2001) specification. Using separate subsets for positive and negative skill differences, and different datasets, he finds evidence of vertical FDI. In particular, when using FDI stocks he rejects the horizontal model in favor of the knowledge-capital model, illustrating the usefulness of a specification like CMM for demonstrating the co-existence of horizontal and vertical FDI in aggregate data.

### **2.1.2 Motivations for F.D.I.**

Why, then, direct investment? The important theoretical shortcoming of portfolio theory (i.e. the alternative of FDI) is that does not explain control. If interest rates are higher abroad than at home,

an investor will do well to lend money abroad, but there is no logical necessity for him to control the enterprise he lends to. So to explain why FDI, control must be explained.

There are two main types of reason why an investor will seek control. The first has to do with the prudent use of assets. The investor seeks control over the enterprise in order to ensure the safety of his investment. This reason applies to domestic investment as well. However, the effect is stronger if the country in which firms invest in has less skill endowment than home country. If the entrepreneur has no funds of his own in the enterprise he controls, his incentive not to go into bankruptcy is lessened. This is especially important in international investment where there is an inherent conflict of interest between investors of different nationality over how much reserves are to be kept in a particular currency. There also appears to be considerably more distrust in international transactions than in intranational and therefore more incentive for the capitalist to seek control. Whether the view that foreigners are less trustworthy than natives is in fact justified is irrelevant. All that is necessary is that investors feel that way, or that borrowers and governments feel differently about defaults than they do about internal defaults. This motivation is very similar to the theory of portfolio investment. The interest rate is the key factor in both. So this type of FDI will substitute portfolio investment when the distrust of foreigners is high or when fear of expropriation and risks of exchange-rate changes are high, but its movements will still be response to differences in interest rate. Another motivation, that does not depend on interest rate is communally known in literature as international operation FDI. Here, the motivation for controlling the host country firm is not the prudent use of assets, but something slightly different. The control of the foreign firm is needed in order to remove competition between that foreign firm and firm in other countries. Or the control is required in order to appropriate fully the returns on certain skills and abilities. It often happens that firms in different countries compete with each other because they sell in the same market or because some of the firms sell to others firms. If the markets are imperfect (i.e. bilateral monopoly or oligopoly) some form of collusion will be profitable. One possibility is to have the various firms owned and controlled by one firm. This is one motivation for firms to control enterprise in foreign countries. The other main motivation arises from the fact that firms are very unequal in their ability to operate in a particular industry. A firm with advantages over other firms in the production of a particular product may find it profitable to undertake the production of this product in a foreign country as well. The firm could also rent or sell its skill rather than undertake itself the foreign production. Which method it chooses depends largely on the degree of imperfection in the market for the skill. If this degree is high, the owner may not be able to appropriate fully the returns to the ability unless he controls its use.

These are the main two reasons why nationals of one country find it profitable to control firms in another country apart from the level of interest-rate and the desire to ensure the prudent use of the assets. The demand for a home country direct investment is then the demand by that country firms for capital to finance their own foreign activities. This is in contrast to the demand for capital by entrepreneurs of other countries for their activities. So the fundamental motivation for the investment is not the higher interest rate abroad but the synergy (i.e. pattern, know-how, skill-labor, market-share, scale economies, cost reduction ecc...) that derived from controlling the foreign firms.

Another interesting motivation for FDI derives from the product cycle theory by Vernon (Vernon, 1966). According to the product cycle hypothesis, firms that set up foreign producing facilities characteristically do so in reliance on some real or imagined monopolistic advantage. In the absence of such a perceived advantage, firms are loath to take on the special costs and uncertainties of operating a subsidiary in a foreign environment. One such special strength is an innovational lead.

The product cycle hypothesis begins with the assumption that the stimulus to innovation is typically provided by some threat or promise in the market. But according to the hypothesis, firms are acutely myopic; their managers tend to be stimulated by the needs and opportunities of the market closest at hand, the home market. The home market in fact plays a dual role in the hypothesis. Not only is it the source of stimulus for the innovating firm; it is also the preferred location for the actual development of the innovation. The first factor that has pushed innovating firms to do their development work in the home market has been simply the need for engineers and scientists with the requisite skills. That requirement when gauged through the eyes of the typical innovating firm, has tended to rule out sites in most developing countries and has narrowed the choice to some site in the advanced industrialized world as between such advanced country sites, the home market has generally prevailed. Locating in the home market engineers and scientists can interact easily with the prospective customers whose needs they hope to satisfy, and can check constantly with (or be checked by) the specialists at headquarters who are concerned with financial and production planning. The propensity to cluster in the home market is fortified by the fact that there are some well-recognized economies to be captured by an innovating team that is brought together at a common location. These include the usual advantages that go with subdividing any task among a number of specialists, and the added advantages of maintaining efficiency of communication among the research specialists.

The upshot is that the innovations of firms headquartered in some given market tend to reflect the characteristics of that market. Historically, therefore, US firms have developed and produced products that were labor-saving or responded to high-income wants; continental European firms,

products and processes that were material-saving and capital-saving; and Japanese firms, products that conserved not only material and capital but also space.

Although not essential to the product cycle hypothesis, it is commonly assumed that a triggering event is likely to be required before the producer will seriously make the calculations that could lead to the creation of a foreign producing facility. The triggering event ordinarily occurs when the innovator is threatened with losing its monopoly position. In the usual case, rival producers appear, prepared to manufacture the product from locations that could undersell the original innovator. The obvious question is why the original innovator was not already aware that the costs of production might be lower abroad. Part of the answer may lie in the indeterminateness of the threat before it has actually materialized: the difficulty of deciding what is at stake in failing to find the least-cost location, what alternative sites need to be investigated, and what the costs of investigation are likely to be.

These conditions change, however, as the threat begins to crystallize. Eventually, it may be clear that the innovator is threatened with the loss of its business in a given foreign market. At that point, the areas to be investigated as possible production sites have been narrowed while the size of the risk has been more explicitly defined. Accordingly, the decision whether to invest in added information is more readily made. Once having felt compelled to focus on the issue, the innovator will decide in some cases to set up a local producing unit in order to prolong some of the advantages that were created by its original monopoly.

It seems plausible to assume that the product cycle will be less useful in explaining the relationship of the US economy to other advanced industrialized country, and will lose some of its power in explaining the relationship of advanced industrialized countries to developing countries. But strong traces of the sequence are likely to remain. One such trace is likely to be provided by the innovating activities of smaller firms, firms that have not yet acquired a capacity for global scanning through a network of foreign manufacturing subsidiaries already in place. The assumptions of the product cycle hypothesis may still apply to such firms, as they move from home-based innovation to the possibility of exports and ultimately of overseas investment. Moreover, even firms with a well-developed scanning capability and a willingness to use it may be found behaving according to the expectations of the product cycle hypothesis.

As noted earlier, the specifications of new products are usually in such a state of flux that it is infeasible for a time to fix on a least-cost location. Some firms therefore are unlikely to make intensive use of their scanning capability when setting their first production facility. To be sure, such innovators cannot expect to retain their innovational lead for very long, in view of the fact that

the innovators of many countries now confront such similar home conditions. But a shadow of the hypothesized behavior may well remain.

A less equivocal case for the continued usefulness of the product cycle concept is found in analyzing the situation of the less-developed countries. Although income, market size, and factor cost patterns have converged among the more advanced industrialized countries, a wide gap still separates such countries from many developing areas. Accordingly, despite the fact that so many MNEs have created producing networks all over the globe, the subsidiaries of such firms located in the developing countries have yet to acquire all of the products that their parents and affiliates produce in richer and larger markets. Most of the developing countries, therefore, are still in process of absorbing the innovations of other countries introduced earlier, according to patterns that remain reasonably consistent with product cycle expectations.

The performance of firms in some developing countries, moreover, follows the expectations of the product cycle in a very different sense. Firms operating in the more rapidly industrializing group—in countries such as Brazil, India, China, South Africa and Korea—are demonstrating a considerable capability for producing innovations that respond to the special conditions of their own economies. Once having responded to those special conditions with a new product or process or with a significant adaptation of an existing product or process, firms of that sort are in a position to initiate their own cycle of exportation and eventual direct investment; their target according to the hypothesis, would be the markets of the other developing countries that were lagging a bit behind them in the industrialized pecking order.

## **2.2 Advanced, Developing and Emerging Market: definition and differences**

Advanced economies are post-industrial countries characterized by high per-capita income, highly competitive industries, and well-developed commercial infrastructure. The advanced economies are the world's richest countries and include Australia, Canada, Japan, New Zealand, the United States, and most European countries. Developing economies are low-income countries characterized by limited industrialization and stagnant economies. Of the developing economies, the most numerous group includes Bangladesh, Nicaragua, and Zaire. Emerging market economies or, briefly, emerging markets, refer to a subset of former developing economies that have achieved substantial industrialization, modernization,

and rapid economic growth since the 1980s. The economies are differentiated by degree of economic development and per-capita income. Currently, some 27 countries are considered emerging markets. These economies are found mainly in Asia, Latin America, and Eastern Europe. The largest emerging markets are China, India, Brazil, and Russia.



## **Advanced Economies**

Having reached a fairly mature state of industrial development, advanced economies largely transformed from manufacturing economies into service-based economies. Home to only about 14 percent of the world's population, the advanced economies have long dominated international business. They account for about half of world GDP, over half of world trade in products, and three-quarters of world trade in services. Advanced economies have democratic, multiparty systems of government. Their economic systems are usually based on capitalism, with relatively little government intervention in business. They have tremendous purchasing power, with few restrictions on international trade and investment. They host the world's largest MNEs. A leading example is Ireland, which has one of the world's best performing economies, a booming job market, and per-capita income higher than many of its European neighbors. Ireland succeeded through a program of strict fiscal and monetary policies. The government cut federal spending, taxes, and borrowing. Such policies gave rise to lower interest rates, more available capital, and attracted much FDI from foreign manufacturers in high-tech industries, such as Gateway and Polaroid. Over time Ireland has built up a strong educational system, producing a steady supply of skilled workers, scientists, engineers, and managers.

## **Developing Economies**

Developing country consumers have low discretionary incomes; the proportion of personal income spent on purchases other than food, clothing, and housing is very limited. Approximately 17 percent of people in developing economies live on less than \$1 per day. Around 40 percent live on less than \$2 per day.

To compound matters, birth rates in developing economies tend to be high. The combination of low income and high birth rates tends to perpetuate the poverty characteristic of developing economies. Developing economies are sometimes called underdeveloped countries or third-world countries. However, these terms are imprecise because, despite poor economic conditions, the countries tend to be highly developed in historical and cultural terms. Developing economies are also hindered by high infant mortality, malnutrition, short life expectancy, illiteracy, and poor education systems. For example, the proportion of children who finish primary school in most African countries is less than 50 percent.

Because education is strongly correlated with economic development, poverty tends to persist. Lack of adequate health care is a big concern. Some 95 percent of the world's AIDS victims are found in developing economies, an additional hardship that hampers their development. Ailing adults cannot

work or care for their children and require much medical care. As a result, productivity is stagnant, which means living standards deteriorate. Orphaned children are unlikely to get an education, and the vicious cycle of poverty persists.

Governments in developing economies are often severely indebted. In fact, some countries in Africa, Latin America, and South Asia have debt levels that approach or exceed their annual gross domestic product. This means it would cost a year's worth of national productive output just to pay off the national debt. Much of Africa's poverty is the result of government policies that discourage entrepreneurship, trade, and investment. For example, starting a new business in sub-Saharan countries in Africa involves an average of 11 different approvals and takes 62 days to complete. In the advanced economies, by contrast, starting a new business takes an average of six approvals and 17 days to complete. Bureaucracy and red tape in developing economies often hinder the ability of firms from these countries to participate in the global economy. International trade and investment help to stimulate economic growth, create jobs, raise incomes, and lower prices for the products and services demanded by consumers and companies. When countries are cut off from the global economy, the result is increased poverty and unemployment – conditions that can give rise to revolution, terrorism, and war. By contrast, nations that participate actively in the global economy enjoy economic stability and better living standards.

### **Emerging Market Economies**

Emerging countries are the countries whose economies are in a fast increase process, respective in transition phase to a market economy (Simon, 1997). These countries have a higher capacity than the developed countries to provide investors with opportunities to achieve higher profits. According to Simon, the most important features of the emerging countries refer to:

- the small size of the economy,
- GNP/Capita much lower than in developed countries,
- a reduced opening for accepting foreign investors,
- a high volatility of the exchange rate which implies greater risk in trading.

It is considered that the biggest emerging economies are China and India.

When we refer to the phenomenon of transition economy, suppose that the transition is made from an emerging economy to a developed economy. There must, however, not lose sight of the reciprocal of this phenomenon, namely the transition can be made also vice versa, from developed economies to developing one. Of course, the transition to a developed economy is a wanted

phenomenon, however it is the most widely-used usage of this notion, but it does not offer any guarantee that the converse is not true.

Most transition economies have been engaged in large-scale privatization of state owned enterprises. Privatization of state enterprises and promoting new, privately-owned businesses were important first steps in attracting foreign direct investment. Privatization refers to transfer of state-owned industries to private concerns. The transition economies hold much potential. Long burdened by excessive regulation and entrenched government bureaucracy, they are gradually introducing legal frameworks to protect business and consumer interests and ensure intellectual property rights. Yet, the changes that have been occurring in transition economies are often painful. For instance, within a few years of the collapse of the Soviet Union, the Russian economy shrunk by nearly half the size it had been at the beginning of its transformation in 1989. Russia endured high inflation with annual price increases reaching 100 percent or more, hindering foreign investment and economic development. Shaking off the Soviet legacy required the country to restructure not just institutions and firms, but also adopt new values about private ownership, profits, intellectual property, and other fundamental aspects of a free-market economy. Initially, western companies doing business in Russia found it difficult to recruit managers who understood modern management practices. Management education in Russia is just catching up with that of developed nations.

As transition economies liberalized their markets, many foreign companies initiated trade and investment relationships with them. Privatization provided many opportunities for foreign firms to enter these markets by purchasing former state enterprises.

In Financial Markets Encyclopedia, Simon distinguishes between three distinct categories of emerging countries, considering a similar classification for stock exchange that operate within these countries. Thus, he talks about:

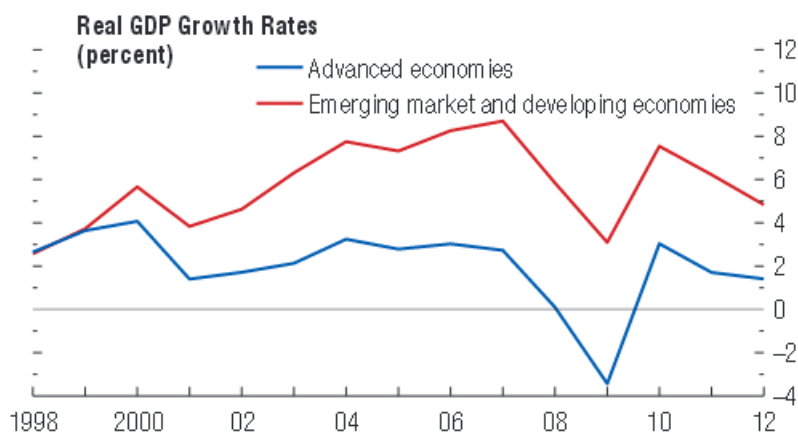
- the most advanced markets,
- narrow emerging markets,
- emerging markets (latent).

In the case of advanced emerging markets, Simon brings into question countries such as Malaysia, Mexico, South Korea, Taiwan, or Thailand whose inflation rates are quite low and in which there is some stability in the exchange rates. Financial and banking system are developed and have an opening to the international financial markets as shares and bonds, and trading system and financial securities settlement traded have a relatively sophisticated mechanism. These countries were not treated as developed countries category because it is considered that they are vulnerable to a possible volatility of the exchange rate and the stock market, a lot of local companies do not meet the conditions for listing, only companies that have exposure on the international market have

passed listing of shares to the stock exchange. Emerging markets generally narrow (as they called by Simon) does not provide an easy access of the investors on or of the international financial market, but this aspect belongs to the opening of each country belonging to this group. In the countries belonging to this group, the rate of inflation is high, the monetary and financial market is not developed enough to provide prospective investors optimal conditions for the conclusion of transactions. In these countries, the trading system of settlement of transactions requires major stabilization. It is not lost in sight of the fact that the spread between the poor and the rich is pretty emphasized. In this category we find emerging countries as: Argentina, India, Nigeria and the Philippines.

The third category proposed by Simon is that of emerging markets or latent markets. Their economic performances are quite poor and their access to international financial markets is very limited, and therefore the volumes of trading on these markets are greatly reduced. Of course, the performance of trading systems that dealt in securities settlement, is also reduced. Basically the economies of emerging countries are at the beginning of the road, they need capital to both support the entry on increasing trajectory and the financial institutions of market surveillance covering the investment on the stock exchange.

Many economists believe that the economies of emerging countries will be those that will boost the world economy and that they will be the new force in the world, in a specified time-frame. The same IMF report makes an analysis of the evolution of the global economy as a whole and separating performance of developed economies, from those of emerging economies and in the developing world. It can be seen from figure 1 that the performances achieved by the developing countries are higher than those of developed markets, both for the period of crisis and for the year 2012. These are the practical element that maintains the world economy on positive economic growth rates.



**Figure 1.** *The evolution of economic growth in emerging countries in the developing world*

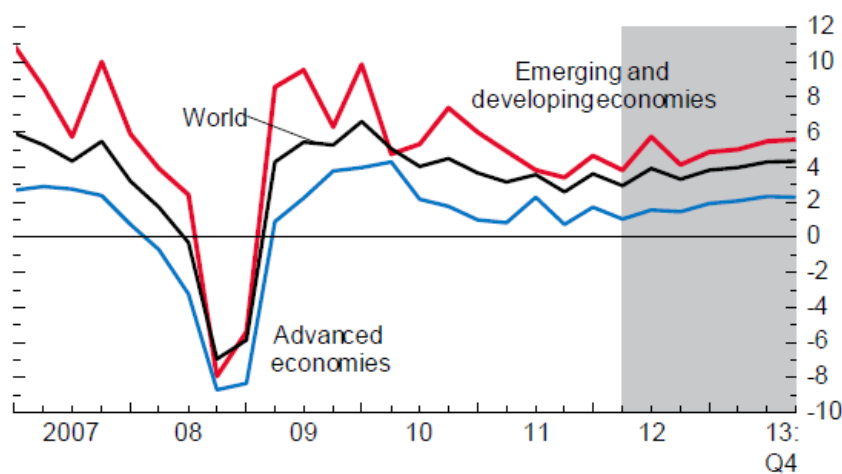
and for developed countries

Source: *World Economic Outlook. April 2014, the International Monetary Fund (IMF, 1986, p. 114)*

The previous figure shows trends in the rates of increase in real gross domestic product for the emerging countries in the developing world and in developed countries. The major advantage of the emerging countries in the developing world is that including the period of the crisis, they have recorded positive economic growth. Of course, the year 2009 was marked by a severe decline in the pace of economic growth in these countries, however, economic growth in 2009 is maintained at approximately + 3%. You may also

have noticed the steep decline of the indicator for developed countries, in the most affected year of the crisis. At that time, the vast majority of developed economies have seen a regression of the real GDP, unable to speak of a positive economic growth. The year 2010 has brought a greenbelt area in both the developed economies that have been able to re-enter on the territory of positive economic growth, as well as for emerging economies in the developing world.

In mid-2012, the IMF made a forecast for world economic growth to the end of 2012. This prognosis was + 3.5%, this being achieved by developed countries for which contribution it was estimated an increase of 1.4% but especially emerging countries for which estimated an increase of 5.6% at the end of 2012. Statistics show that by the end of 2012, the average economic growth of developed countries was about 1.5%, while the average economic growth of emerging countries in the developing world was approximately 5%. Also in mid-2012, the IMF has expanded its forecast for the end of 2013, according to which the world economy was supposed to achieve a 3.9 percent advance developed countries generated with 1.9% and economic growth in emerging countries of 5.9%, as in the following figure.



**Figure 2.** *The IMF forecast of economic growth for the end of 2013*

Source: *World Economic Outlook. International Monetary Fund (IMF, 2012)*

We conclude therefore that the emerging markets have brought an extra touch of interest from investors in the financial market, and the IMF forecasts encourages trading on these markets as long as the forecast is for growth of these economies.

### **2.2.1 Which are E.M.?**

Emerging markets are found in East and South Asia, Eastern Europe, South Africa, Latin America, and the Middle East.

Because of dynamic changes in these economies, the list of countries regarded as emerging markets is also evolving. For example, it can be argued that Hong Kong, Israel, Saudi Arabia, Singapore, South Korea, and Taiwan have developed beyond the emerging market stage and can be included in the most advanced markets group (§§2.2). Several emerging markets will join the group of wealthy nations in the not-too-distant future.

In 2004, emerging markets, including the Czech Republic, Hungary, and Poland, received a boost when they became members of the European Union. By joining the EU, these countries had to adopt stable monetary and trade policies. They leverage their low-cost labor to attract investment from Western Europe, thereby boosting their economies. Similarly, some countries currently classified as developing economies have the potential to become emerging markets in the near future. These include the European countries of Estonia, Latvia, Lithuania, Slovakia; the Latin American countries of Costa Rica, Panama, and Uruguay; as well as Kazakhstan, Nigeria, Vietnam, and the United Arab Emirates. Finally, economic prosperity often varies within emerging markets. In these countries, there are usually two sets of economies—those in urban areas and those in rural areas: urban areas tend to have more developed economic infrastructure and consumers with greater discretionary income than rural areas.

Those emerging markets in Eastern Europe such as the Czech Republic, Hungary, and Poland have also been engaged in rapid privatization of former state enterprises since 1989 after these countries transformed from centrally planned economies into liberalized markets. Therefore, these emerging markets are also referred to as transition economies. China and Russia are also considered transition economies (§§2.2).

In Eastern Europe, Western companies are leveraging inexpensive labor and other advantages in the region to manufacture products bound for export markets. Hungary, Poland, the Czech Republic, and other former East Bloc countries have made great strides in political and economic restructuring. These countries are well on their way to more advanced stages of economic development.

China is the largest emerging market, and its role in international business is expanding rapidly. With a population of 1.3 billion people (one-fifth of the world total), the Chinese economy continues to grow at an impressive rate of nearly 10 percent per year (even if in the mid-2014 is experiencing a slow down). The country has already produced numerous new global challengers, such as Shanghai Automotive (China's top automaker), Sinopec (a large oil company), and Shanghai Baosteel (a steel manufacturer), Alibaba (e-commerce giant). The Global Trend feature highlights China's growing role in international business.

According to a report from the International Monetary Fund (IMF, 2012), considered countries with an economy in transition in July 2012 are: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Estonia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine and Venezuela.

### **2.2.2. Features of E.M.?**

Emerging markets possess numerous advantages that have fostered their rise. The presence of low-cost labor, knowledge workers, government support, low cost capital, and powerful, highly networked conglomerates have helped make these countries formidable challengers in the global marketplace. Most emerging markets are characterized by a young population and a growing middle-class. While emerging markets represent attractive markets and low-cost manufacturing bases, they also tend to have inadequate commercial infrastructure, evolving legal systems, and a high-risk business environment. Despite their drawbacks, emerging markets have begun to produce new global challengers, top firms that are fast becoming key contenders in world markets. These firms pose competitive challenges to companies from the advanced economies, such as in Europe, Japan, and North America.

In a recent study, The Boston Consulting Group identified the top 100 firms from emerging markets that have successfully ventured into global markets. While many of these firms are from China and India, others hail from various other countries. For example, the Mexican firm CEMEX is one of the world's largest cement producers. In Russia, Lukoil has big ambitions in the global energy sector. In Turkey, diversified conglomerate Koc Holding owns Arcelik, the giant home appliance producer.

Emerging markets have fourth generally agreed upon characteristics. First, they have a lower-than-average per capita income. The World Bank defines developing countries as those with either low or lower middle per capita income, basically less than \$4,034.

Low income is the first important criteria because this provides an incentive for the second characteristic, rapid growth. To remain in power, and to help their people, leaders of emerging

markets are willing to undertake the rapid change to a more industrialized economy. In 2011, the economic growth of most developed countries, such as the U.S., Germany, the U.K. and Japan, was between 1-2%. In Turkey, Russia, Mexico and South Africa, it was between 3-4%, while Brazil's economy grew 4.5%. China and India both saw their economies grow more than a whopping 8%.

However, this rapid social and economic change can lead to the third characteristics, high volatility. This can come from three factors: natural disasters, external price shocks and domestic policy instability. Poor countries that are traditionally reliant on agriculture are especially vulnerable to disasters such as earthquakes (Haiti), tsunamis (Thailand) or droughts (Sudan). However, these disasters can actually lay the groundwork for additional commercial development, as it did in Thailand.

Emerging markets are more susceptible to currency swings, such as the dollar, and commodities, such as oil or food. That's because they don't have enough power to influence these movements. For example, when the U.S. subsidized corn ethanol production in 2008, it caused oil and food prices to skyrocket, leading to food riots in many emerging market countries.

When leaders of emerging markets undertake the changes needed for industrialization, many sectors of the population could suffer, such as farmers who lose their land. Over time, this could lead to social unrest, rebellion and regime change. Investors could lose all if industries become nationalized, or the government defaults on its debt.

If successful, the rapid growth can also lead to the fourth characteristics, higher-than-average return for investors. That's because many of these countries focus on an export-driven strategy. They don't have the demand at home, so they produce lower-cost consumer goods and commodities for developed markets. The companies that fuel this growth will profit more, which translates to higher stock prices for investors. It also means a higher return on bonds, which generally cost more to cover the additional risk of emerging market companies.

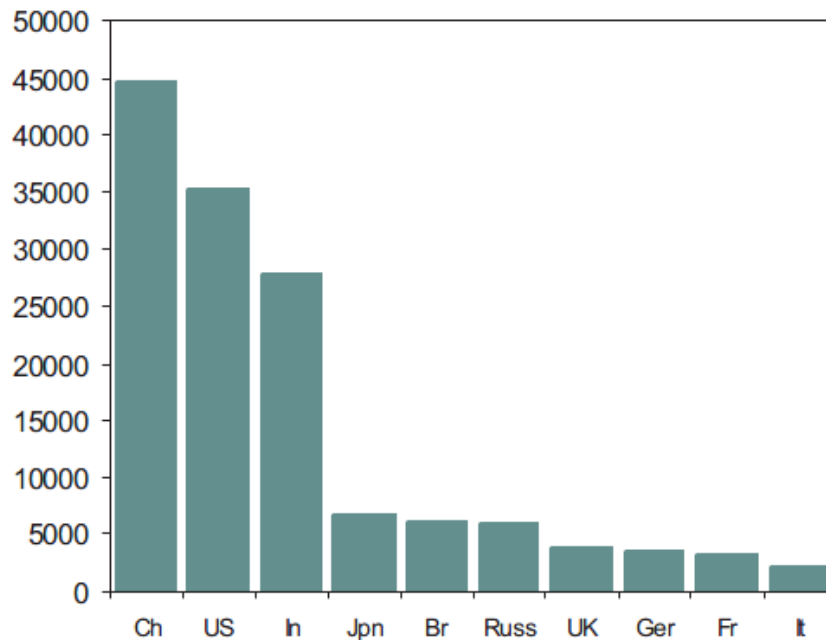
It is this quality that makes emerging markets attractive to investors. Not all emerging markets are set up to become breakout nations, and therefore good investments. They must also have low debt, a growing labor market, and a government that isn't corrupt.

### **2.2.3 The BRIC Countries**

The four BRIC countries, as they've been named by Jim O'Neill: Brazil, Russia, India and China are the ones that will dominate the world economy. Their importance is underlined in many analyses of Goldman Sachs, who believes that by the year 2050, China will bring forward the economy of the United States of America. Research carried out by Goldman Sachs (Goldman



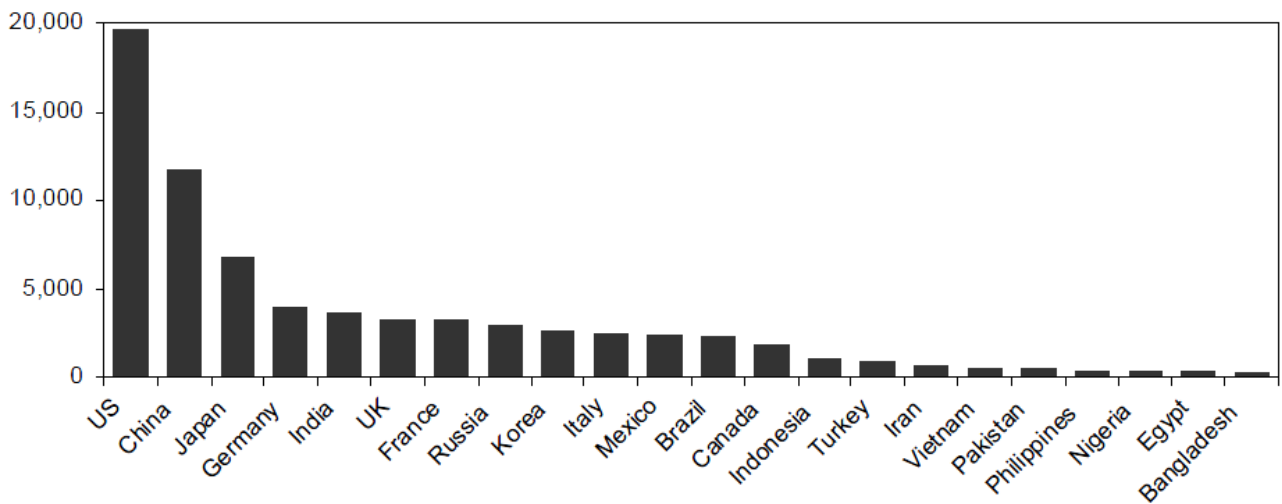
Sachs, *Dreaming with BRICs. The Path to 2050*, 2003) forecasts a growth of the most important economies of the world by 2050, as follows:



**Figure 3.** *Forecast rankings of the most important economies in 2050*

*Source: (Goldman Sachs, *Dreaming with BRICs. The Path to 2050*, 2003)*

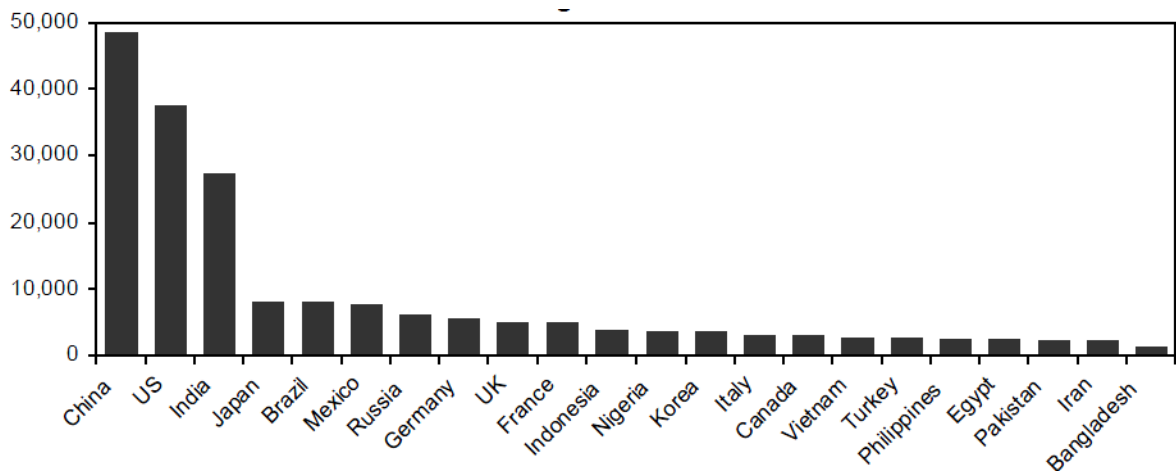
According to forecasts made by Goldman Sachs, the U.S. economy will be in second place in the world, followed by that of India. Brazil's and Russia's economies will seriously compete with Japan's economy in the year 2050. In a subsequent analysis of Goldman Sachs (Goldman Sachs, 2005), it shall revise forecasts trends in BRIC countries thanks to the strongest increases registered by them in relation to initial forecasts, from the moment of the first analysis. Thus, according to Goldman Sachs, top countries in terms of gross domestic product in 2025 will look like the following figure:



**Figure 4.** *The largest economies in 2025*

Source: (Goldman Sachs, *How solid are the BRICs?*, 2005)

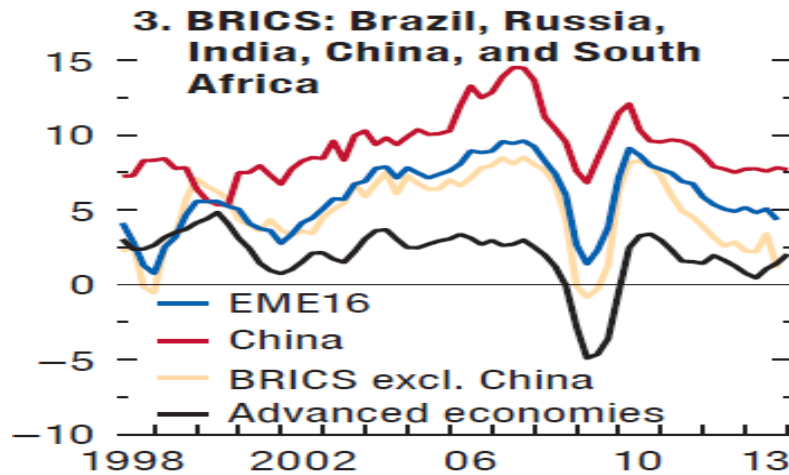
According to the same analysis, after 2025, respectively, by 2050, this will bring: first China, Germany will be brought forward from Russia, Mexico, Brazil and India. The standings will look like



**Figure 5.** *The largest economies in 2050*

Source: (Goldman Sachs, *How solid are the BRICs?*, 2005)

In 2010 South Africa joined the BRIC countries and so was taking birth the BRICS Association. South Africa has the same coordinates as well as major economic countries from BRIC. The following figure shows the evolution of the average economic growth for BRICS countries without China's economy (pink line), compared with the average economic growth for the 16 emerging economies (blue line) and China's economic growth (red line).



**Figure 6.** Evolution of the average economic growth for BRICS countries in comparison with the average of developed economies.

Source: World Economic Outlook. April 2014, the International Monetary Fund (IMF, 2014, p. 137)

In the previous figure, China's economy was dealt with somewhat distinct from the other BRICS countries' economies because it is the most dynamic of these, it is basically the engines of the global economy, during the crisis. BRICS countries average in terms economic growth, not taking into account China's economic performance, gets even the negative territory most affected crisis year-2009.

### 2.3 Entry modes

Firms may enter foreign markets in many different ways, including exporting, licensing, and direct investment (Root, 1994). Our interest is limited to the choice of entry mode in foreign direct investment (FDI), defined, as already stated, as investment that involves ownership and confers effective management control. Other forms of international expansion, including exporting, licensing, and nonequity alliances, do not constitute FDI and are beyond the scope of this work. The choice of entry mode is an important part of a firm's foreign investment strategy. Firms are not only concerned about what foreign markets to enter, and what activities to perform in those markets, but how to enter: whether by greenfield investment, by acquisition (brownfield), or by joint venture. Choosing one or another entry mode can have enormous strategic consequences for the firm. When undertaking foreign investment, firms face two basic decisions: whether to own all or part of the

investment, and whether to set up a new investment from scratch or acquire an existing entity. Full ownership may be achieved either through greenfield investment, which denotes setting up a new plant or other establishment from scratch, or through acquisition, which denotes the purchase of a controlling interest in a local firm. Partial ownership, or joint venture, is defined as the pooling of assets of two or more firms in a common and separate organization. Joint ventures may at times be the only entry mode allowed by the host government, but in many instances are also the preferred mode as they allow a firm to limit initial risk.

The choice of entry mode is a matter of high strategic importance, as each mode offers specific benefits and risks. Acquisitions offer the fastest means of building a sizable presence in a foreign market, yet are fraught with risks of overpayment, inability to fully assess the value of acquired assets, and post-acquisition challenges including cross-cultural integration. Greenfield investments offer the greatest control over the local affiliate, yet often require the longest time to establish, and require the greatest contribution of know-how.

Joint ventures are a way to draw on the resources of a local partner and to minimize risk, but also raise thorny issues of managing a partner whose interests may diverge over time.

### **2.3.1 Advantages/disadvantages**

The decision as to whether to establish an acquisition or a greenfield subsidiary or to opt for full or partial ownership in a foreign investment carries significant strategic importance owing to the inherent benefits and risks of each establishment and entry mode. For instance, although acquisitions offer a speedy establishment of local presence, they may be associated with post-acquisition integration failures, which are often rooted in cross-cultural differences and technological mismatches. Reversely, although greenfields offer an opportunity to preserve and replicate valuable corporate cultures abroad, they require a longer establishment period and more time to build business networks locally.

As we stated before each entry mode have their advantage and disadvantages. General advantages of choosing FDI as entry mode instead of any others are the more control provided over foreign operations, offers better understanding of host market, easier and quicker to adapt products for market and flexible respond to market changes. Disadvantages are high cost route (financial and personal commitment), more exposure to economic and political risk of the host and problems of managing the subsidiary at a distance.

A wholly owned subsidiary is the most costly method of serving a foreign market. Companies taking this approach have to bear the full costs and risks associated with setting up overseas operations. In contrast, wholly owned subsidiaries offer the benefits of managerial autonomy and

full control over local operations, yet the process of overcoming the liability of foreignness may be difficult without the legitimacy of a local partner.

If the entry mode is the Joint venture, additional advantages may arise. The feeling that multinational may benefit from a local partner's knowledge of a host country's competitive conditions, culture, language, political system and business system. Furthermore, company can share the costs and risk of setting up business with a local partner and in many countries political considerations make joint ventures the only feasible entry mode.

In addition, ventures with shared ownership enable MNEs to tap into valuable resources of a local partner and minimize investment risks, but they also are at times challenging to administer owing to the partners' diverging capabilities, interest and goals.

The other side of the medal in sharing the investment with a host partner is the risk of lose control of know-how or technology. A company that enters into a joint venture runs the risk of losing control over its technology to its venture partner and does not give a company the tight control over different subsidiaries that it might need if it wishes to pursue a global strategy. If competitive advantage is based on control over a technological competency, a wholly owned subsidiary will normally be the preferred entry mode, since it reduces the risk of losing control over that competency. Furthermore, owned subsidiary gives a company the kind of tight control over operations in different countries that is necessary for pursuing a MNE's global strategy.

### **2.3.2 the drivers**

Different approach and theory try to explain the drivers of the entry mode. One of the drivers is the experience of accumulated by the firms or its age. Several researches proposed that, with increased experience, firms perceive less uncertainty and become more confident of their ability to correctly estimate risks and returns and manage foreign operations, and thereby tend to enter with a wholly owned subsidiary than in a contractual mode or partial ownership.

More recently, transaction cost theory, which views multinational enterprises as efficient agents for transferring resources, has been helpful in explaining both the extent of ownership (full vs. partial) as well as the choice between greenfield investment and acquisition.

Regarding full vs. partial ownership, transaction cost theory asserts that because joint ventures involve a partner they run considerable risks of free riding and other opportunistic behavior. Accordingly, it has been hypothesized that the higher the proprietary content of intangible assets, such as technology or brand loyalty, the more a firm will prefer entry through full ownership rather

than partial ownership. Empirical investigations have demonstrated that entry by full ownership is positively related to intangible assets, operationalized as R&D intensity and advertising intensity . Regarding the choice between acquisition and greenfield investment, transaction cost theory stresses the distinction between exploiting existing resources and acquiring new resources. When firms seek to exploit their superior organizational and technical expertise, they often prefer greenfield entry as a way to install their managerial practices from the outset. Data on Japanese direct investment in the United States support the hypothesis that greater R&D intensity increases the likelihood of entry by greenfield investment rather than by acquisition (Hennart and Park, 1993).

At other times, firms enter foreign markets to acquire general knowledge of the local economy or product-specific knowledge which resides in local firms. In these instances, securing key resources may be best accomplished through acquisition or joint venture. Empirical studies have generally supported this view, showing for instance that as Japanese firms enter into new lines of business, they prefer joint ventures or acquisition to greenfield investment.

Building on transaction cost theory, Hennart and Park (1993) argued that firms whose competitive advantage was deeply embedded in the technical skills of their labor force would choose to enter through greenfield investment. Conversely, they argued that firms would prefer acquisition or joint venture when they enter a foreign market to acquire product-specific knowledge which resides in the local firm. From the knowledge-based perspective, greenfield investment may be the most efficient entry mode when a firm transfers knowledge from home country to foreign affiliate. Joint venture or acquisition may be preferred when the firm enters a foreign country in order to tap local skills and resources.

More recently, Hennart and Reddy (1997) applied transaction cost theory to the choice between joint venture and acquisition. Using data on Japanese firms in the United States, they found that joint ventures were preferred over acquisitions when the desired assets are 'indigestible,' i.e., when they are commingled with non desirable assets. Joint ventures were also preferred when the investors had no previous experience in America and hence may have sought to avoid post-acquisition integration problems.

The choice of entry mode has also been explained by cultural and national factors. The differences in culture between home and host countries increased the level of risk in post-acquisition integration, and would lead firms to choose less risky entry modes. Hence, greater cultural distance between the investing firm's home country and the host country was indeed associated with entry by joint venture and greenfield investment rather than by acquisition. Similarly, high sociocultural distance was associated with partial ownership rather than full ownership. In addition, perceptions of country risk and the level of economic development may affect the entry mode. Firms avoid

wholly owned subsidiaries in high-risk countries, while other researchers found that Japanese firms were especially adverse to acquisitions in less developed countries, yet showed a lesser aversion in developed countries.

Quite apart from difference in culture between investing and host countries, the investing firm's country of origin may be associated with preference for a particular entry mode, whether for cultural or institutional reasons. In studies of Japanese entry to the United States, Hennart and Park (1993) found that Japanese firms tended to prefer entry through greenfield investment rather than acquisition, perhaps due to strong ethnocentric orientation of Japanese culture. On the other hand, British firms with a long tradition of market for corporate control activities may have developed a preference for acquisitive entry. To sum up, previous researchers provide substantial evidence that cultural and national factors have a significant influence on a firm's choice of entry mode.

The different drives and theory analyzed characterized foreign entry mode choices as a static decision making process, assuming that a choice of a particular entry mode of a firm is independent of previous entry mode choices by the same firm.

Such an approach does not recognize that for many firms foreign investment is a sequential process, consisting of numerous investments made over time.

As stated by Kogut (1983), foreign direct investment decisions are not discrete, but might be best understood as part of a series of decisions that determine the volume and direction of resource flows among countries. Looking at entry decisions without regard to their sequential ordering overlooks the possible effect of one entry on subsequent entries. Empirical evidence to support this view was provided by Kogut and Chang (1996), who showed that Japanese firms with previous investment in a foreign market, especially in export-related distribution facilities, were more likely to invest subsequently. The conventional wisdom on the experience and the ownership control, but also transaction cost theory and cultural explanations, have limitations in explaining dynamic foreign entry mode choices. In recent years, numerous scholars have argued in what has come to be known as the knowledge-based theory of the firm (sometimes called the organizational capabilities perspective) that firms compete based on their ability to learn and to apply knowledge. Accordingly, multinational firms do more than seek to minimize costs arising from asset specificity and opportunistic behaviors. As explained by the knowledge-based perspective, multinational firms can be seen as a 'social community specializing in the speed and efficiency in the creation and transfer of knowledge' (Kogut and Zander).

If we accept this view, foreign market entry can be understood as an effort to exploit an existing knowledge base or to gain additional knowledge through exploration. The choice of entry mode is therefore more than a matter of cost minimization—it reflects a desire to find the most efficient way

to exploit and explore the knowledge base. Furthermore, it stands to reason that as firms gain experience the choices they make regarding knowledge creation and transfer may change. Entry modes that were most appropriate in early circumstances may become less so in later circumstances.

## **2.4 Effects of FDI**

The world economic literature and numerous empirical researches proved that positive effects of FDI are often overwhelmed by negative ones. Positive effects of FDI are more featured in case of greenfield investment. When FDI takes a form of simple merger and acquisition (M&A) actions positive externalities are much lower if not negative.

Ovin and Maček (2010) examined macroeconomic effects of inward cross-border mergers and acquisitions (C-B M&A) on the European host economies, which they divided into two groups: developed and transition countries. Their study demonstrated some concern about C-B M&A related primarily to unemployment, crowding-out domestic firms' investments, and uncompetitive behavior of foreign affiliates formed through C-B M&A. These fears were more or less based on the significant of such transactions on individual industries in transition economies. The authors also pointed out that the inward C-B M&A are important for economic growth and competitiveness development.

The results of their study indicated that extensive capital flows in the form of C-B M&A represent a transitional experience for both sets of countries, with a certain advantage for the developed countries. According to them, most C-B M&A can be found in those countries that have managed to establish a better functioning of their industrial, market, and financial structures with relatively stable political and economic conditions.

In contrast, FDI was an important source of developing country external finance for about 25 years after World War II. During 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 cheap(er) 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.

Theory provides conflicting predictions concerning the effects of direct foreign investments. Several approaches regarding the effects of FDI exist: Neo-liberal, Keynesian, so called dependency and new dependency schools are among best-known ones.

#### **2.4.1 Home country effects**

The home country environment, which determines a firm's institutional context, consists of an opportunity set that is determined by production factors (e.g., a country's physical infrastructure, labor quality) and institutions (e.g., credibility and effectiveness of a country's bureaucratic infrastructure). Since firms seek to capture profitable opportunities as defined by their opportunity set, their foreign market entry mode choice is likely to be contingent on the home country environment. FDI may have different impacts on the home economy. One of the most feared by policy-maker and labour organizations is the effect on the labour market, with FDI replacing home's country production and exports and consequently will lead to reduction of employment at home.

When analyzing the home-country employment effect of FDI, it is most important to take into consideration the motives of foreign investors moving abroad. Most widely spread is the distinction between horizontal and vertical FDI (see §2.1.1). Vertical FDI is made by firms that geographically fragment their production into stages, typically on the basis of factor intensities, exploiting lower factor prices abroad or reducing transactions costs by internalizing upstream or downstream activities (i.e., suppliers, marketing channels). If different stages of the production process are characterized by different levels of labour intensity, a reasonable strategy would be to allocate the stages with high labour intensity to countries with low levels of labour costs and the stages requiring lots of skills or capital to high-income countries.

With vertical investments, there is a complementarity between a firm's foreign and home operations, because both are needed to produce the good. When one of the activities expands, it accordingly causes the expansion of the other activity. However, in the short run, also substitution between the employment levels at home and abroad may take place if an activity previously conducted at home is relocated abroad.

In general, firms following the horizontal FDI model expand and enlarge their existing advantages by moving their activities abroad. Horizontal MNEs are multi-plant firms that seek to exploit their existing advantages and replicate roughly the same activities in many locations. By this model, the major trigger of moving outward is the intention to reap benefits of the market opportunities abroad and use the economies of scale effect.

If the produced good is tradable, we would expect a substitution between foreign and home employment: the firm either exports the good produced at home to other locations or produces it in its foreign affiliates. However, in the case of non-tradables, no such substitution is possible. Empirically results are ambiguous, and the stream of literature is divided into two groups.

The first group of studies dealing in detail with the employment effect of FDI found a substitution effect between a foreign subsidiary's activity and its parent's employment (Kravis and Lipsey 1988, Brainard and Riker 1997, Braconier and Ekholm 2001, Konings and Murphy 2001, and Cuyvers et al. 2005). Several studies have concluded that substitution occurs between countries with comparable factor endowments, which means that low-wage countries are better employment substitutes for one another than for parent (high-income) economy employment (Brainard and Riker, 1997; Slaughter 2000; Braconier and Ekholm, 2001; Konings and Murphy, 2003; Hansson 2005).

The second group of empirical works has concluded that the complementary effect prevails, which means that the positive employment effect from a foreign affiliate's activity was detected (Lopez-deSilanes et al. 1996, Feenstra and Hanson 1996, Lipsey et al. 2000, Markusen 2002).

The logic behind this is that the opportunity to invest in a low-cost host country could increase the firm's competitiveness, promote its use of economies of scale, and reduce its costs, which may lead to an increase in home-country employment (i.e., the case of vertical investments). What we seem to be seeing here is — as Ekholm and Markusen (2002) called it — that a “scale effect” dominates over a “substitution effect” for the home country's firms and the home country's employment. It was revealed, for example, in the North American car industry by Lopez-de-Silanes et al. (1996). Research on Japanese firms likewise revealed that their home-country employment is growing by investing abroad (Lipsey et al. 2000). It was explained as the result of allocating labour-intensive production to developing countries, which allows increasing supervisory and ancillary employment at home to service foreign operations.

### 2.4.2 Host country effects

The host country determines the formal (e.g., political risks) and informal (e.g., culture) institutional context with which a firm must deal in a foreign country. These conditions may affect firms foreign market entry mode choice. The effects generated by a FDI on the host country are mostly pictured as positive and enhancing. Pro- FDI economists assert that it, firstly, enables technology transfer in form of capital inputs, which could not be achieved by trade. Secondly, via FDI a competition is likely to be encouraged in domestic input markets. Thirdly, FDI contributes to human capital development as foreigners engage in employee training. Furthermore, Neo-liberals have a number of arguments defending foreign direct investment and explaining how they are beneficial for developing country as they contribute to development. They advocate free flow of capital arguing that it ensures economic efficiency; allows capital to seek the highest return across the borders; fastens economic growth as the free flow of capital reduces investors risk enabling them to diversify their investment better.

In addition, FDI is a primary source of financing for those country where the official capital flows are either stagnated or declined. In their place, private capital flows became the major source of external finance for a good number of emerging market economies. Foreign direct investment accounted for only about 30 per cent in early 1980s but over 60 per cent of private capital flows in 2000 and next few years then.

In addition to already mentioned FDI brings in financial resources, which are scarce in receiving country, creates new jobs, increases exports by raising efficiency and enhancing marketing opportunities, increases the availability and reduce the costs of public utilities, consumption goods and investment goods.

While admitting that benefits mentioned above can be provided by FDI many economists have reasonable doubts whether it happens every time in every country. Many scientists strongly disagree that one size fits all. That particular, more cautious approach is characteristic to representatives of so- called Keynesian school.

Keynesians argue that if FDI brought benefits in one country it does not necessary mean that the same will happen in another. Many things depend on prevailing conditions in receiving country. This means that the effects should differ not only across countries but also within countries at different time as conditions change. For instance, increased competition may be beneficial for the

host economy, however, not always. Coming international corporations may push out potentially more productive local business as they are yet not able to compete. In that case many jobs might be lost instead of creating, therefore government protection of local activities is needed.

Another delicate matter is the regulation and control of inward FDI flows by the host country. When attracting FDI governments can use tax cuts, subsidies and many other means. This not always has a positive outcome. Epstein (1999) claims that countries trying 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 creates attractive environment to FDI itself, fastens economic growth and increases total welfare. Such environment may be even more important than tax breaks.

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. 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 home 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. Countries not clearly understanding all the effects that FDI can bring to their economies sometimes engage in such kind of actions which ultimately can actually hamper growth (see§3.2.).

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

While neo-liberalism and Keynesians point of view is prevalently positive, the so-called "dependency" school developed the exploitation effect of home on host countries.

Representatives of that approach argue that FDI benefits the core industrial economies at the expense of the peripheral underdeveloped countries. As a result FDI can be contributing to increasing world inequality instead of giving positive externalities of FDI. According to the dependency school, in the long- run, FDI tends to impede economic growth and development of recipient economies. Although underdeveloped countries lack capital and industrial technology, they often are rich in natural resources and/or inexpensive labour. While income or wealth is created in the host country, it does not lead to an accumulation of wealth that would benefit the host economy. On the contrary, this wealth is transferred to the core countries. Consequently, the core stands to benefit from this structural dichotomy of the host economy because the foreign sector (i.e.,

the sector associated with FDI) does not benefit the rest of the host country because of lack of integration.

All cases mentioned above proved that incoming FDI needs more thorough examination and decisions about policy towards FDI should not be simply straightforward. Greenfield foreign direct investment really can contribute to development of host economy. However, some control over them is essential in order to ensure that a country will benefit. M&A investment can not only contribute to the development but even impede the economic growth of the particular country.

### **2.5.1 Dunning's eclectic paradigm**

The eclectic paradigm combines insights from resource-based, institutional and transaction cost theories (Brouthers & Hennart, 2007). The paradigm states that firms choose the most appropriate entry mode into an international market by considering advantages as they relate to three factors that make up the OLI framework: ownership (O), location (L), and internalization (I) (Dunning, 1988). Ownership advantages are firm-specific competitive advantages (resource-based view), which must be unique and sustainable (e.g., a firm's international experience, the ability to differentiate a product or service). Location advantages are country-specific (institutional theory) advantages of the international market. Internalization (transaction cost theory) advantages are the benefits a firm obtains by choosing a high-commitment entry mode rather than internationalizing through partnership arrangements (Dunning, 1988).

Ownership advantages refers to intangible assets which are possess by the firm exclusively and may transferred within MNCs at lower costs, leading to higher incomes or reduced costs. Ownership of limited natural resources, patents, trademarks etc, is some of the examples of ownership advantages. When the first condition is fulfilled, then location advantages determine who will become the host country for the activities of MNCs. Benefits of quantitative and qualitative factors of production, resource availability, lower costs of transportation, telecommunications, and large market size, common government policies, and distance from the home country, cultural relations etc. are the location specific advantages. I stand for internalization. When the first two conditions are fulfilled, it must be profitable for the firm to use these advantages in collaboration of some of the factors outside the country of origin (Dunning, 1973, 1980, 1988). The eclectic paradigm of OLI shows that OLI parameters are different from company to company and it reflects the economic, political and social conditions of the host countries.

Drawing on the OLI framework, studies have found that firms can internalize host country related risks and contingencies by means of high-commitment entry modes (Nakos & Brouthers,2002) and

that firms' perceptions about the host country's risk significantly influences their entry mode choice. In addition, some studies conclude that the level of ownership and locational advantages enhance firms' propensity to choose entry modes with higher levels of commitment. However, it remains unclear whether financially resource-constrained companies have access to other assets that would allow them to control their foreign market activities. Such assets could diminish the need for internalization (by means of costly, high-commitment modes like greenfield investments) of host country activities.

With regard to firms' sensitivity to external influences, the fundamental question leaving open space for new research is how different types of location-related risks impact firms' entry mode choice differently.

With regard to ownership status, the study by Pinho (2007) delves deeply into the effect of the firm's ownership status on foreign market entry mode choice, however the study remains an exception in this direction.

Let me now reiterate the propositions of the eclectic paradigm. The subject to be explained is the extent and pattern of international production, i.e. production financed by FDI and undertaken by MNEs. The paradigm asserts that, at any given moment of time, this will be determined by the configuration of three sets of forces:

- 1) The (net) competitive advantages which firms of one nationality possess over those of another nationality in supplying any particular market or set of markets. These advantages may arise either from the firm's privileged ownership of, or access to, a set of income-generating assets, or from their ability to co-ordinate these assets with other assets across national boundaries in a way that benefits them relative to their competitors, or potential competitors.
- 2) The extent to which firms perceive it to be in their best interests to internalize the markets for the generation and/or the use of these assets; and by so doing add value to them.
- 3) The extent to which firms choose to locate these value-adding activities outside their national boundaries. The eclectic paradigm further avers that the significance of each of these advantages and the configuration between them is likely to be context specific, and in particular, is likely to vary across industries (or types of value-added activities), regions or countries (the geographical dimension) and among firms. Thus there are likely to be country-specific differences in the ownership advantages of (say) Korean firms compared with (say) Canadian firms. The extent of market failure influencing, whether or not the market for technology is internalized, is likely to be different in (say) the wood and pulp industry than in (say) the semi-conductor industry; while the relationship to the comparative location advantages of Thailand and Taiwan as a manufacturing

base for motor vehicles may be differently regarded by (say) the Toyota than (say) the Honda Corporation.

The eclectic paradigm is best regarded as a framework for analyzing the determinants of international production rather than as a predictive theory of the MNE. No single theory can be expected to satisfactorily encompass all kinds of foreign-owned value-added activity simply because the motivations for, and expectations from, such production vary a great deal. The variables necessary to explain import-substituting FDI are likely to be different from those that explain resource-oriented FDI; and both are likely to be different from those that explain rationalized or strategic asset-seeking investment. In formulating operational hypotheses about the relationship between individual OLI variables and the level and pattern of international production, it is important to specify the context in which this relationship is being examined. But, similarly, no single theory of international trade can satisfactorily explain all forms of cross-border transactions in goods and services.

### **2.5.2 Internationalization theory**

Internalization theory tries to explain whether MNEs use leasing or licensing methods for the sale of their products abroad or they produce abroad through FDI by themselves. In other words it answers the question why a company prefers FDI instead of producing in the home country and then exporting it.

The theory is based on the study of Buckley and Casson in 1976. According to the theory firms maximize their profits in an imperfect competition environment. In this process if

- Transportation costs are high, there are trade barriers,
- There is the problem of inadequate foreign market information,
- There is information asymmetries between sellers and buyers,
- There are transaction cost-increasing conditions, the firm chooses internalization and make FDI.

Thus, firms may avoid delays, bargaining and customer ambiguities, and take the opportunities of the minimization of governmental regulations' adverse effects through transfer pricing and price differentiation between different markets. Due to market imperfections, firms aspire to make use of their monopolistic advantage themselves. Buckley and Casson (1976) suggest that firms can overcome the market imperfections by internalizing their own markets. That means, internalization involves a vertical-integration in the form of bringing new operations and activities under the

governance of the firm. Earlier these activities were carried out by the intermediate firms. Initially, the theory was developed by Coase (1937) in a national context and Hymer (1976) in an international context. Hymer identified two major determinants of FDI: one is removal of competition and the other is advantages, which some firms possess in a particular activity (Denisia, 2010). Dunning (1980, 1988) considered the internalization theory is a very important and used it in his eclectic theory. However, he argues that internalization theory explains only part of FDI flows. He draws partly on macroeconomic theory and trade as well as microeconomic theory and firm behavior.

### **2.5.3 Theoretical approach to FDI**

The Foreign Direct Investment (FDI) theories can be classified broadly into two categories. One is at the macro level and the other is at the micro level. Again at the macro-level, we have capital market theory, Dynamic macroeconomic theory, FDI theories based on exchange rates, FDI theories based on economic geography, gravity approach to FDI and FDI theories based on institutional analysis. At the micro-level, we have the theories like Existence of firm specific advantages (Hymer), FDI and oligopolistic markets, Theory of internalization, and Eclectic FDI theory (John Dunning). Recently another type of FDI categories discussed by the economists is the development theories which combine both the micro level and macro-level FDI theories. The development theories are Life cycle theory, Japanese FDI theories and five stage theories (John Dunning).

For a macroeconomic point of view, FDI is a particular form of capital flows from countries of origin to host countries and these capital flows are found in the balance of payments. The macroeconomic theories try to explain the motivations of the investors for investment in foreign countries.

Capital market theory is one of the oldest theories of FDI. According to this theory, FDI is determined by interest rates. Capital market theory is a part of portfolio investment.

Boddewyn's (1985) Capital market theory talked about three positions, which attract FDI to the less developed countries (LDCs). First is the undervalued exchange rate, which allows lower production costs in the host countries. Second position said that since there is no organized securities exists, therefore long term investments in LDCs will often be FDI rather than purchase of securities. Moreover, the third position is that since there is limited knowledge about host countries' securities that is why it favors FDI, which allows control of host country assets.

Another macroeconomic theory is dynamic macroeconomic FDI theory according to which the timing of investments is depends on the changes in the macroeconomic environment. The



macroeconomic environment consists of gross domestic product, domestic investment, real exchange rate, productivity and openness, which are the determinants of FDI flows. This theory states that FDI is a long-term function of multinational companies' strategies.

Similar to these two theories, FDI theories based on exchange rate tried to show the relationship between FDI and exchange rate. The theory tries to explain how the flow of FDI affects the exchange rates. The theory said FDI as a tool of exchange rate reduction. Another macroeconomic FDI theory is based on economic geography, which focuses on countries and explained why internationally successful industries emerge in particular countries (Nachum 1999). These explanations were based on the differences among countries in terms of availability of natural resources, nature of labor force and local demand, infrastructure etc. the FDI theories based on economic geography also covers the ways in which governments can affect the resources within the jurisdiction by various policy actions since economic unit of analysis is defined by political boundaries.

The Gravity approach to FDI explores that if two countries are very close in terms of geographically, economically, and culturally, then the FDI flows between the countries is the highest. The theory includes traditional gravity variables such as size, level of development, distance, common language and other institutional variables such as shareholder protection (La Porta et al., 1998) and openness to FDI flows as the determinant of FDI flows. Another macroeconomic FDI theory is based on institutional analysis, which was developed by Saskia Wilhelms (1998) explores the importance of institutional framework on the flows of FDI. The theory said that political stability is the key factor of a healthy institutional framework. According to this theory, FDI is determined more by institutional variables, laws, and their implementation and less by intransigent fundamentals. The four institutions contributing to FDI flows are governments, markets, education and socioculture (Wilhelms, 1998).

The Micro level FDI theories try to provide the answers of why MNCs prefer opening subsidiaries abroad rather than exporting or licensing their products, how MNCs choose their investment locations and why they invest where they do. The micro-level theories are discussed below.

Existence of Firm specific Advantage theory of FDI was developed by Stephen Hymer (1976). According to this theory, firms invest abroad because of certain firm specific advantages such as, access to raw materials, economies of scale, intangible assets such as trade names, patents, superior management etc., low transaction costs etc. etc. If markets work effectively and there are no barriers in terms of trade and competition, international trade is the only way to participate in the international market. Therefore, the realization of direct investment is determined by some certain

distortions, and these distortions were first noticed by Hymer. He believes that local firms will have always better informed about local economic environment and for FDI to take place there must some conditions. Hymer said that market imperfections lead to divergence from perfect competition in the final product market and MNE appears. MNEs face some adjustments costs when they made investments abroad and these are firm level costs. Hymer recognizes FDI as a firm level decision rather a capital market decision. He saw FDI as a means of transforming knowledge and firm assets both tangible and tacit in order to organize production abroad.

FDI and oligopolistic markets said that in a two-tier oligopoly model, there are two foreign investors one produces intermediate products and other produces final products. The two investors decide independently whether or not they will enter a host country. The entry of either of the firms incurs some fixed costs and generates technological spill over for the local firms of the same sector and reduces the marginal cost of production (Lin and Saggi, 2010). Hoenenand and Hansen (2009) said that FDI is a defensive move in oligopolistic markets. Knickerbocker argued that risk-averse firms follow their main competitors to avoid any distortions in oligopolistic equilibrium. When one firm in an oligopolistic markets moves, the other firms also reacts with countermoves at both domestic and international levels (Schenk, 1996). In oligopolistic markets, firms follow the actions of the market leader, if FDI is a move of the market leader then other firms also reacts by investing abroad and oligopolistic equilibrium sustains.

Theory of internalization and eclectic's paradigm were already discussed above (§2.5.1 and 2.5.2) and don't need further development.

### **3. FDI DETERMINANTS AND ECONOMIC GROWTH IN EMERGING MARKETS**

Foreign direct investment (FDI) is generally considered as a factor which enhances the host country economic growth, as well as the solution to the economic problems of developing countries. Since capital formation and technological improvement are the motor of economic growth, FDI is expected to promote host countries' economic growth (Wang, 2009). In 2002, OECD reports that countries, particularly developing countries, emerging economies and economies in transition, consider FDI as a source of growth and economic modernization. For this reason, many governments, particularly in developing countries, give special treatment to foreign capital.

Despite the fact that the impact of FDI on economic growth has been widely studied, there are still questions concerning the real effects of FDI, and also concerning the necessary conditions and the channels through which FDI leads to host country economic growth. Wang (2009) reports that the main conclusion to be drawn from several studies is that results are ambiguous. In fact, there are studies that have concluded that FDI is not significantly linked with economic growth (e.g., Carkovic and Levine, 2002; Alfaro et al., 2004; Falki, 2009; Georgantopoulos and Tsamis, 2011), studies that have concluded that FDI affects negatively host country economic growth (e.g., Borensztein et al., 1998; Mencinger, 2003; Kohpaiboon, 2003; Yousaf et al., 2011), and studies that share the widespread view that FDI generates economic growth (e.g., Nair-Reichert and Weinhold, 2001; Ram and Zhang, 2002; Bengoa and Sanchez-Robles, 2003; Wang, 2009; Andraz and Rodrigues, 2010; Agrawal and Khan, 2011). The ambiguity of results occurs either for cross country studies or country-specific studies. However, the number of studies that show positive effects is much higher than those that focus on negative effects. It's possible to notice a lack of consensus regarding the effects of FDI in the host country, that can be attributed to two different points of view: the existing theoretical and empirical literature.

On the one hand, the theoretical literature will be useful to explain the channels through which FDI affects economic growth. The existing theoretical literature is prevalently straightforward to consider FDI as a positive variable on the host country's economic growth, through the transfer of new technologies and know-how, human capital formation, integration in global markets, increase of the competition, and firms' development and reorganization. On the other hand, the existing empirical shows ambiguity of results. One of the many interpretation is that the effects of FDI on economic growth are dependent on the existing or subsequently developed host country's domestic conditions, such as the human capital, the economic and technological conditions, and the degree of openness of its economy. In this way, local authorities have a leading role in order to achieve the desired effects. These authorities can design more appropriate FDI policies so that the country has the necessary conditions to leverage the positive effects and mitigate the negative. The relationship between FDI and economic growth has been widely studied. Most of the empirical work on the FDI-growth relationship has been based on neoclassical models of growth as well as endogenous growth models. Under neoclassical growth models assumptions, long-run growth can only result from population/labor force growth (growth of factor inputs) and/or technological progress. Additionally, due to the assumption of diminishing returns to capital inputs, FDI would only affect output growth in the short run. In the long run, the host country would converge to its steady state and the only way for FDI to promote growth would be through permanent technological shocks (De Mello, 1997). In contrast to the limited contribution that the neoclassical growth theory gives to

FDI, endogenous growth models point out that FDI can contribute to economic growth in two ways. On the one hand, it is expected that FDI will increase economic growth through capital formation and technology transfers. Moreover, it is expected that FDI contributes to increasing the stock of knowledge of the host economy through labor training and skill acquisition and also through the introduction of better management practices (De Mello, 1997). As we have mentioned, FDI is defined as an investment involving the transfer of a vast set of assets such as capital and advanced technology and know-how. In this way, FDI contributes to physical capital formation in the host country with a direct impact on growth. Additionally, within the endogenous growth models, there are several channels through which FDI can affect the host country economic growth.

### **3.1 FDI classic macro-determinants**

Based on the existent empirical literature, it is possible to create a set of potential determinant variables that influence the FDI flows and classify them into seven broad categories: Market size, Economic stability and Growth prospects, Trade openness, Currency value, Infrastructure facilities, Labour cost and Gross capital formation.

#### **Market size**

Larger market size should receive more inflows than that of smaller countries having lesser market size. Market size is generally measured by Gross Domestic Product (GDP), GDP per capita income and size of the middle class population. It is expected to be a positive and significant determinant of FDI flows (see: Lankes and Venables, 1996; Resmini, 2000; Duran, 1999; Garibaldi, 2002; Bevan and Estrin, 2000; Nunes et al., 2006; Sahoo, 2006). In contrast, Holland and Pain (1998) and Asiedu (2002) capture growth and market size as insignificant determinants of FDI flow.

#### **Economic stability and growth prospects**

A country which has a stable macroeconomic condition with high and sustained growth rates will receive more FDI inflows than a more volatile economy. The proxies measuring growth rate are: GDP growth rates, Industrial production index, Interest rates, Inflation rates (see: Duran, 1999;

Dassgupta and Ratha, 2000). Contradictingly, when inflation is taken as proxy for the level of economic stability, then the classic symptoms of fiscal or monetary control will result in unbridled inflation. In connection with this, investors prefer to invest in more stable economies that reflect a lesser degree of uncertainty (see: Nonnenberg and Mendonca, 2004). Therefore, it is expected that GDP growth rate, Industrial production index, Interest rates would influence FDI flows positively and the Inflation rate would influence positively or negatively.

### **Labour cost**

Higher labour cost would result in higher cost of production and is expected to limit the FDI inflows; therefore, we expect the negative and significant relationship between labour cost and FDI. Labour cost can be proxied by wage rate (see: Lankes and Venables, 1996; Nunes et al 2006). There are few studies which find labour force determining FDI flows positively, (see: Wheeler and Mody, 1992; Kumar, 1994; Sahoo, 2006). However, Resmini (2000) did not confirm the significance of wages, perhaps because of using wages that are uncontrolled for productivity and exchange rates (Bevan and Estrin, 2004).

### **Infrastructure facilities**

The well established and quality infrastructure is an important determinant of FDI flows. On the other hand, a country which has opportunity to attract FDI flows will stimulate a country to equip with good Infrastructure facilities. Therefore, we expect positively significant relationship between FDI and Infrastructure. The previous studies of Wheeler and Mody (1992), Kumar (1994), Loree and Guisinger (1995) and Asiedu (2002) also support our expected hypothesis. The availability of quality Infrastructure can be constructed by considering Electricity, Water, Transportation and Telecommunications (see: Sahoo, 2006). Whereas, Nunes et al. (2006) consider public expenditure on capital to acquire fixed capital assets, land, intangible assets and non-financial and non- military assets for Infrastructure.

### **Trade openness**

Trade openness is considered to be a key determinant of FDI as represented in the previous literature; much of FDI is export oriented and may also require the import of complementary, intermediate and capital goods. In either case, volume of trade is enhanced and thus trade openness is generally expected to be a positive and significant determinant of FDI (see: Lankes and Venables,

1996; Holland and Pain, 1998; Asiedu, 2002; Sahoo, 2006). Trade openness is proxied as the ratio of the Export plus Import divided by GDP (Nunes et al. 2006; and Sahoo, 2006).

### **Currency valuation**

The strength of a currency (Exchange rate) is used as proxy for level of inflation and the purchasing power of the investing firm. Devaluation of a currency would result in reduced exchange rate risk. As a currency depreciates, the purchasing power of the investors in foreign currency terms is enhanced, thus we expect a positive and significant relationship between the currency value and FDI inflows. The currency value can be proxied by the Real Exchange Rate, Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER).

### **Gross Capital Formation**

In a transition economy, improvements in the investment climate help to attract higher FDI inflows. It translates into higher Gross capital formation which in turn leads to greater economic growth. Libor Krkoska (2001) and Lipsey (2000) find little evidence of FDI having an impact on capital formation in developed countries and observe that the most important aspect of FDI in the selected sample of countries is related to ownership change. The relationship between FDI and Capital Formation is not simple (Libor Krkoska, 2001). In the case of certain privatization, it may not lead to increase at all or even result in reduction. Thus, the unclear relation between FDI and capital formation may also hold in a transition economy. However, a positive or negative and significant relationship between FDI and Capital Formation is expected.

In addition to these seven determinants, the classic literature point out the FDI effects that can influence economic growth. These further determinants are: transfer of new tech. and know-how, human capital formation, integration into global economy, increasing competition and development and reorganization.

#### **1) Transfer of new technology and know-how:**

FDI can affect economic growth through the transfer of technology and know-how, and this impact can be positive and/or negative. FDI is a way to improve a country's economic performance through the transmission effect of more advanced technologies and management practices introduced by MNEs. In fact, MNEs are often regarded as the more technologically developed

firms, which is explained by the fact that MNEs are responsible for almost all the world's spending on research and development (R&D).

Also, MNEs as usually considered as a major source of technology dispersion, due to their presence around the world. Although technology transfers can occur in different ways, such as "backward" linkages

with local suppliers, linkages with competing or complementary firms in the same industry, migration of skilled labor, and the internationalization of R&D, OECD (2002) report that the evidence of positive spillovers is strongest and most consistent in the case of "backward" linkages. Through "backward" linkages with local suppliers, the new technologies are transferred in the form of training, technical assistance and other information provided in order to improve the quality of suppliers' products (OECD, 2002). Additionally, MNEs also provide support to their local suppliers in purchasing raw materials and intermediate products, assist suppliers to find additional customers and even in the improvement of its facilities.

Another strong source of technology transfer is the link that MNEs establish with local research entities, such as public institutes and universities.

The transfer of technology, however, can also bring negative effects. MNEs may have an adverse reaction to the host country's R&D in order to continue to hold a technological advantage compared to local firms. This can lead MNEs to transfer only inappropriate and capital intensive technologies.

Furthermore, the host country can become dependent on technologies introduced by multinationals, since there is a decline in local firms' interest in the production of new technologies. In these circumstances, the host country dependence on MNEs' technology will be perpetuated.

## **2) Human capital formation**

A second determinant through which FDI can affect the host country's economic growth is human capital formation. This determinant may facilitate the occurrence of positive effects but also negative effects.

According to OECD (2002), FDI has not only a direct influence on human capital enhancement but also an indirect effect. The improvement of the human capital can occur through training that workers receive during the observation of new operations developed by multinationals (OECD, 2002). In fact, it happens often that the labor force is not able to use the new technologies

introduced by MNEs, which leads them to provide the necessary training that lead to the upgrading of skills in the host country.

MNEs generally invest in training, being impossible to lock-in such resources. The training provided by MNEs can be beneficial to other firms and to the locality, since labor trained in one firm often moves to other local firms. It is possible that some employees may use new knowledge to create their own firms and then they will transmit their knowledge to the workers of this new firm. OECD (2002) states that MNEs are responsible for human capital enhancement of the host countries, also because they demonstrate to local authorities the need to have a qualified labor force (the indirect effect). In this way, countries try to attract FDI via enhanced human capital.

As regard to the labor force, there also exist negative consequences from FDI inflows. The use of advanced technology by multinationals leads us to predict the need for fewer workers than that used by local firms, leading to the consequent increase in unemployment (OECD, 2002). Additionally, local firms will feel the reduction in the local authorities' support (Ford et al., 2008). These authors argue that local authorities, verifying that MNEs are a source of training and improving the levels of education, reduce public spending in this area which mitigate the aforementioned benefits of FDI on human capital formation.

### **3) integration into global economy**

FDI contributes to the integration of the host country into the global economy particularly by engendering and boosting foreign trade flows (exports and imports) (OECD, 2002).

Positive effects occur if FDI contributes to increased exports, which depends on the motivations underlying the investment. The positive impact on the host country's exports tend to be higher in the case of FDI motivated by the availability of natural or human resources in the host country or in the case where the host economy is used as a platform for penetration via exports into third countries (OECD, 2002; Ietto-Gillies, 2005).

Additionally, the export operations of MNEs may influence local firms in several ways. Some local firms may become multinationals suppliers or subcontractors, which leads local firms to export, although they do not always export under their own name. The exports operations of MNEs could



help local firms to enter the same foreign markets due to the creation of transport infrastructure or resulting from the dissemination of information about the markets.

In addition the development of collaboration or imitation push local firms to learn from MNEs on how to penetrate export markets. Another form of local firms' integration in the international market is through their inclusion in the MNEs' strategy. This may lead local firms to follow the MNEs to other markets or even replace other suppliers in multinationals subsidiaries in other countries (OECD, 2002). The OECD (2002) study refers to the trade associations that MNEs are generally prominent members, as important sources to pass knowledge about the world market, because they are a center for exchange of relevant experiences.

The further integration into the global economy provided by FDI can, however, have negative effects on the host country. Some authors, suggests that FDI has a far greater impact for imports than for exports, which influences negatively the balance of payments.

This strong impact on imports is due to the fact that MNEs have a great need of goods and raw materials which often are not available, either in quantity or in quality, in the host country (OECD, 2002). Another explanation is that the investment made may have as its main objective the supply of the local market (market-oriented or market-seeking investment) and thus does not encourage exports (OECD, 2002; Ietto-Gillies, 2005). FDI may be the easiest source of spreading economic problems occurring in the world, particularly those that have occurred in the MNEs' countries of origin. Host countries become more open economies and more subject to changes in the global economy. Additionally, the purpose of improving the balance of payments through the initial financial flows received is not always achieved in the long run. These effects can be mitigated or contradicted (in stages of low FDI inflows) through the usual repatriation of multinationals' subsidiary profits to their countries of origin (OECD, 2002; Ietto-Gillies, 2005;).

#### **4) increasing competition**

FDI can also play an important role in improving the factors of production and accumulation of capital in the host country, due to the competition it creates. First, because of their superior capabilities, MNEs are able to enter into sectors with high entry barriers, reducing or eliminating existing monopolies in these sectors, which will change the structure of the national economy (Blomström and Kokko, 1998).

The presence of multinational subsidiaries affects the existing equilibrium in the market, forcing local firms to take action in order to protect their market shares and profits (Blomström and Kokko, 1998).

According to the same authors, the increased competition causes an increase in R&D expenditures by local firms, and in some cases local firms take advantage of the improvements made to gain more market share and also become multinationals' suppliers.

De Mello (1997) and Driffield (2000) also report that existing firms are forced to improve their technology and methods to face competition, making investments in equipment and in its employees. Even if local firms are unable to imitate the MNEs' technology or production processes, they are subject to greater pressure to use the existing technology more efficiently.

But the increased competition does not produce only positive effects on the host country. As reported by OECD (2002), MNEs sometimes have the potential to acquire a dominant share of any given market segment which lead to the disappearance of local firms (crowding out effects), causing adverse effects on competition. Anti-competitive effects can also arise because MNEs tend to be larger than domestic firms, benefiting from international integration and scale economies.

Frequently MNFs possess advanced technology and knowledge that allows them to produce at lower costs, displacing domestic firms. In order to face the strong competition from MNEs, concentration can also occur between local firms to achieve gains in economies of scale, reducing competition.

Additionally, competition between MNEs and local firms will also influence access to human resources. MNEs more easily attract the more skilled workers either through their economic power or through better career possibilities they are able to offer, preventing local firms from hiring these workers. Finally, another effect that is recorded by several studies is that caused by the competition created in access to credit, which will bring negative consequences to the host country's economy. In fact, MNEs tend to be partly financed by the host countries' financial markets. This increase in financing needs in the country will increase the costs of credit and will change the access to credit. Problems in access to credit are mainly experienced by local firms which have a smaller structure, and then find it difficult to support the increased costs of credit, plus their weak bargaining power with financial institutions (compared to multinationals). This competition for funding could preclude some local firms from necessary investments for their development or even for their maintenance, leading to their disappearance.

## **5) development and reorganization**

FDI is probably a key element in the process of creating a better economic environment, with consequent positive effects on economic growth (Hansen and Rand, 2006). In fact, FDI is a source of change in host countries' firms. In the case of FDI being achieved by takeover or by a process of privatization, MNEs force the adoption of their policies and procedures in the firms they acquire, and these measures are usually complemented by the incorporation of workers from other subsidiaries of the multinational (OECD, 2002). The changes are especially important if the practices used by the MNE are more efficient than existing ones, which will generate efficiency gains. The structure of local firms suffers also changes by copying the structures used by MNEs, which are considered more efficient

## **3.2 FDI and the effect on economic growth**

### **3.2.1 Theoretical standpoint and empirical literature review**

There are a variety of empirical studies addressing the relationship between FDI and the host country's economic growth which includes many countries with different levels of development, and focus on different time spans. Despite the fact that the impact of FDI on economic growth has been widely studied, Wang (2009) reports that the main conclusion to be drawn from several studies is that results are ambiguous. UNCTAD (1999) analyzed 183 studies covering 30 countries since 1980 and concluded that in the majority (55% to 75%), large positive effects were found but in the remaining, the effect found was clearly negative. OECD (2002) also reports that only 11 in the 14 studies concluded that FDI contribute positively to economic growth. In this way, our review of empirical literature will focus on more recent studies, conducted over the last 15 years.

A growing strand of the empirical literature attributes the lack of robust results to that the growth impact of FDI may depend on the characteristics of the developing country in which FDI takes

place. It is argued that the host countries' capacity to absorb FDI productively is linked to their GDP per capita. Host countries with a better endowment of human capital are supposed to benefit more from FDI-induced technology transfers as spillovers from foreign affiliates to local enterprises are more likely. Openness to trade is considered important as foreign direct investors are said to increasingly pursue complex integration strategies which require the unrestricted import of intermediate goods at all stages of the production process (UNCTAD 1999). The extent to which multinational enterprises transfer modern technology and know-how to their foreign affiliates may depend on the host countries' institutional development, which captures factors such as the rule of law, the degree of corruption, the quality of public management, and the protection against property rights infringements and discretionary government interference.

And indeed, the empirical picture seems to become clearer once host-country characteristics are taken into account. Blomström et al. (1994) find that the positive impact of FDI on economic growth is confined to higher-income developing countries. According to De Mello (1997), the larger the technological gap between the host and the home country of FDI, the smaller is the impact of FDI on economic growth. Borensztein et al. (1998) find that FDI enhances growth only in countries with a sufficiently qualified labor force.

Balasubramanyam et al. (1996) stress that openness to trade is essential for reaping positive growth effects of FDI. Regression analysis by Alfaro et al. (2001) suggests that FDI is associated with faster growth only in host countries with comparatively well-developed financial markets.

In one way or another, these studies corroborate the hypothesis that developing countries must offer a supportive business environment and must have reached a minimum level of economic development before they can capture the growth-enhancing effects of FDI (OECD 2002). However, as all these results are based on FDI flows which are not corrected for potential endogeneity biases (i.e., higher economic growth causing higher FDI flows), the finding that host-country characteristics matter for the growth effects of FDI may also be sensitive to the choice of the explanatory FDI variable. As a matter of fact, Carkovic and Levine (2002) find that the exogenous component of FDI flows does not exert a significant independent influence on the growth rate of GDP per capita even if non-linearities caused by host-country characteristics are considered. To our knowledge, comparable empirical studies using FDI stocks as explanatory variable do not exist.

Against this backdrop, it seems that the favorable perception of FDI among policymakers in developing countries and external advisors may easily be exaggerated. However, before coming to such a verdict, one should address another important shortcoming of almost all previous cross-

country studies, namely the use of overall inward FDI positions as explanatory variable. As we argue in the following, such highly aggregated data cannot capture important aspects of the relationship between FDI and economic growth. This is why we differentiate between major sectors as well as between specific manufacturing industries in which FDI takes place. Industry characteristics such as the technology intensity, factor requirements, linkages to local and foreign markets, and the degree of vertical integration of the foreign affiliates are likely to shape the growth impact of FDI in various ways. Industry characteristics may influence (a) the extent to which FDI supplements (“crowds in”) or displaces (“crowds out”) local investment, (b) the amount of technology and know-how transferred from parent companies to foreign affiliates, (c) the compatibility of technology transfers to the host countries’ factor endowment and, hence, the degree to which local suppliers, competitors, and buyers can benefit through spillovers, (d) the amount of foreign exchange earnings generated through FDI-induced exports or lost through the repatriation of funds, (e) the extent to which foreign affiliates foster competition in the host countries by breaking up oligopolistic market structures, or stifle competition through their market power, and (f) the degree to which the location competition for FDI increases or decreases distortions in the host countries’ economic policies.

These factors are closely linked to the different motives for FDI in developing countries. For instance, resource-seeking FDI in the primary sector tends to involve a large up-front transfer of capital, technology and know-how, and to generate high foreign exchange earnings. On the other hand, resource-seeking FDI is often concentrated in foreign-dominated enclaves with few linkages to the local product and labor markets. Furthermore, its macroeconomic benefits can easily be embezzled or squandered by corrupt local elites. Rather than enhancing economic growth, resource-seeking FDI in the primary sector might lead the country into some form of “Dutch Disease”. By contrast, efficiency-seeking FDI in some parts of manufacturing draws on the relative factor endowment and the local assets of host countries (UNCTAD 1999). This type of FDI is more likely to bring in technology and know-how which is compatible to the host countries’ level of development, and enables local suppliers and competitors to benefit from spillovers through adaptation and imitation. Additionally, the world-market orientation of efficiency-seeking FDI should generate foreign exchange earnings for the host countries. As a result, one would expect a relatively strong growth impact of FDI in industries that attract efficiency-seeking FDI. Market-seeking FDI in services and other parts of manufacturing can benefit host countries’ consumers by introducing new products and services, by modernizing local production and marketing, and by increasing the level of competition in the host countries. However, fiercer competition may also lead to crowding out of local competitors, especially if foreign direct investors command over

superior market power. Moreover, in the long run, the host countries' balances of payments are likely to deteriorate through the repatriation of funds since market-seeking FDI often does not generate export revenues, especially if the protection of local markets discriminates against exports. Hence, the growth impact of this type of FDI should be weaker than the growth impact of efficiency-seeking FDI. Finally, it has been argued that the growth effects of FDI depend on the interplay between industry and host-country characteristics. Two opposing hypotheses are advanced in the literature. Building upon a standard Heckscher-Ohlin model structure and augmenting it by international technology flows, Kojima (1973) reckons that FDI in developing countries will be more growth-enhancing if it is undertaken in more labor intensive and less technology intensive industries. In these industries, the technological differences between the affiliates of foreign direct investors in developing countries and the local enterprises are considered relatively small. Therefore, technological spillovers to local enterprises should be more likely. By contrast, Dutt (1997) develops a Keynesian model with international transfers of capital and technology (but without local technological spillovers), from which he concludes that the impact of FDI on economic growth in developing countries should be greater if the inflow of FDI goes into technologically advanced industries. The rationale behind this proposition is that an increase in the capital stock in technologically less advanced industries lowers the export prices in developing host countries and, thus, leads to a deterioration of their terms of trade.

A first attempt to discriminate empirically between the two hypotheses was undertaken by Dutt (1997). In contrast to both models, he finds no difference in the growth impact of FDI between high-technology and low-technology industries. However, Dutt's empirical analysis is flawed in three respects. First, Dutt does not distinguish between resource-seeking FDI in the primary sector and FDI in manufacturing. In addition to six manufacturing industries, his high-technology group includes "coal and petroleum products". Second, Dutt's industry classification ignores that, irrespective of the technology intensity, the growth impact of FDI in manufacturing should differ depending on whether FDI is efficiency-seeking or market-seeking.

Mohd et al. (2013) evaluate how the banking sector development influence FDI inflow. The present study highlights the importance of the quality aspect of banking development in the FDI and economic growth link. The overall quality of banking development as proxy by the index of banking development quality is shown to be positively related to economic growth in developed countries. However, for the impact of FDI, while on its own it is negatively related to economic growth, but when the impact of FDI is assessed together with the quality of banking development, it is shown to contribute positively to economic growth. These findings imply that the quality of

banking sector development in developed countries contributes to enhancing a country's ability to take advantage of FDI spillovers. In other words, banking development quality is considered as one form of absorptive capacity that allows developed countries to absorb the positive growth effects of FDI.

On the contrary, the results for emerging countries show that the quality of banking development plays no role in influencing the impact of FDI on economic growth. That is, in emerging countries, the quality dimension of banking development has yet to represent an absorptive capacity in facilitating the growth effects of FDI. Nevertheless, for emerging countries, the quality of banking development, on its own, is shown to promote economic growth and such findings are broadly consistent with the financial development literature that points toward the growth enhancing role of banks. The findings that the quality dimension of banking development constitutes an important element in influencing the impact of FDI on economic growth for developed countries but not for emerging countries somewhat point out the disparities in banking sector development between developed and emerging countries. The results imply that the quality of banking development in emerging countries has yet to reach a level that allows it to importantly influence the growth effects of FDI.

### **3.2.2 FDI: Friends or Foe?**

Developing countries have strongly been recommended by international organizations and other external advisors to rely primarily on foreign direct investment (FDI) as a source of external finance. It is argued that FDI is superior to other types of capital inflows in stimulating economic growth for several reasons. In particular, FDI is supposed to be less volatile, and to offer not just capital but also access to modern technology and know-how.

However, empirical evidence supporting this policy advice is surprisingly hard to come by. Some studies do find a positive relationship between FDI inflows and economic growth in the host countries. Yet, the link between FDI inflows and growth is far from firmly established once endogeneity problems and the heterogeneity of host countries are taken into account. Moreover, if

FDI stocks are considered instead of FDI inflows, previous studies typically fail to establish positive growth effects. Accordingly, Caves (1996: 237) reckons that "the relationship between a LDC's stock of foreign investment and its subsequent economic growth is a matter on which we totally lack trustworthy conclusions." In the analysis of some empirical studies carried out, we realize that in the majority of studies positive effects seem to prevail, although negative effects and the possibility of neutral effects are not uncommon. This occurs either for cross-country studies or country-specific studies. However, as UNCTAD (1999) emphasizes, the results should be interpreted with caution since the variables used, particularly those concerning FDI, are far from perfect. The majority of studies use FDI flows, which underestimate the local value of MNEs' subsidiary investment (UNCTAD 1999). Several explanations have been advanced for the presentation of mixed results in different studies. First, Nair-Reichert and Weinhold (2001) emphasize that it can be caused by potential errors in the estimation method. Second, Mohnen (2001) and Asheghian (2004) indicate that it may be caused by a lack of analysis of the host country's domestic conditions. In fact, studies using cross-sectional data share the assumption that all nations share common features. According to Asheghian (2004), this presumption is not valid, since there are differences between the host countries, not only in economic, political and institutional structures, but also in how they react to "external shocks". Finally, Wang (2009) suggests that one possible reason is the use of total FDI. Then, we explore the differences between countries analyzed, since it is the factor most discussed in the literature.

As OECD (2002) report, the positive impact of FDI on host countries' economic growth does not happen automatically, being dependent on the host country's domestic conditions. The review of empirical studies tends to confirm this idea. Host countries' domestic conditions in terms of technology, human capital, degree of openness, and regulatory frameworks can influence the way FDI affects the economic growth through the determinants listed in Section 3.1. In fact, concerning the cross-country studies, we realize that only 3 studies obtain a negative (direct) impact of FDI on the host country's economic growth (Borensztein et al., 1998; Mencinger, 2003; Omran and Bolbol, 2003). However, we also realize that in Borensztein et al.'s(1998) study, the interactive term of FDI with human capital is significantly positive, evidencing that the effect of FDI on economic growth is dependent on the level of human capital available in the host economy. Also, Omran and Bolbol's(2003) study obtained a favorable effect of FDI on growth if interacted with financial variables at a given threshold level of development (the interaction term is positive and significant). Concerning Mencinger's(2003) study, the author did not take into account interactive terms. Concerning the country-specific studies, the conclusion is similar. For instance, Berthélemy and Démurger (2000) analyzed the role played by FDI in the process of Chinese growth over the time



span 1985–1996 and concluded that while the direct effect is rather small, the total impact of FDI is actually higher if we also consider the positive and significant coefficient of the interaction term between FDI and human capital. Zhang (2001b) also obtained a significantly positive coefficient of the interaction term between FDI and human capital. Additionally, Ford et al. (2008), focusing on a different country (the United States) obtained a negative direct effect of FDI on growth. Considering the interaction of FDI with human capital, the coefficients obtained are all positive and significant, suggesting that only states that contain a comparatively well-trained workforce have the capacity to take advantage of the presence of foreign technology. Vu (2008), focusing on the Vietnam case, concluded that the indirect effect of FDI on GDP through labor productivity are both positive and significant. Analyzing the impact of FDI on Malaysia economic growth, Baharumshah and Almasaied (2009) showed that interacting FDI with human capital and financial development has affected growth prospects positively. Regarding the moderating effects of openness of the economy, Kohpaiboon's(2003) results for the case of Thailand support the 'Bhagwati' hypothesis that, other things being equal, the growth impact of FDI tends to be greater under an export promotion trade regime compared to an import-substitution regime. In fact, the interactive term (between FDI and openness of the trade policy regime) is significantly different from zero and has a positive sign. Moreover, the significant and negative sign of the FDI coefficient implies the FDI inflows could have even generated a negative effect on growth performance of the Thai economy under the import-substitution regime.

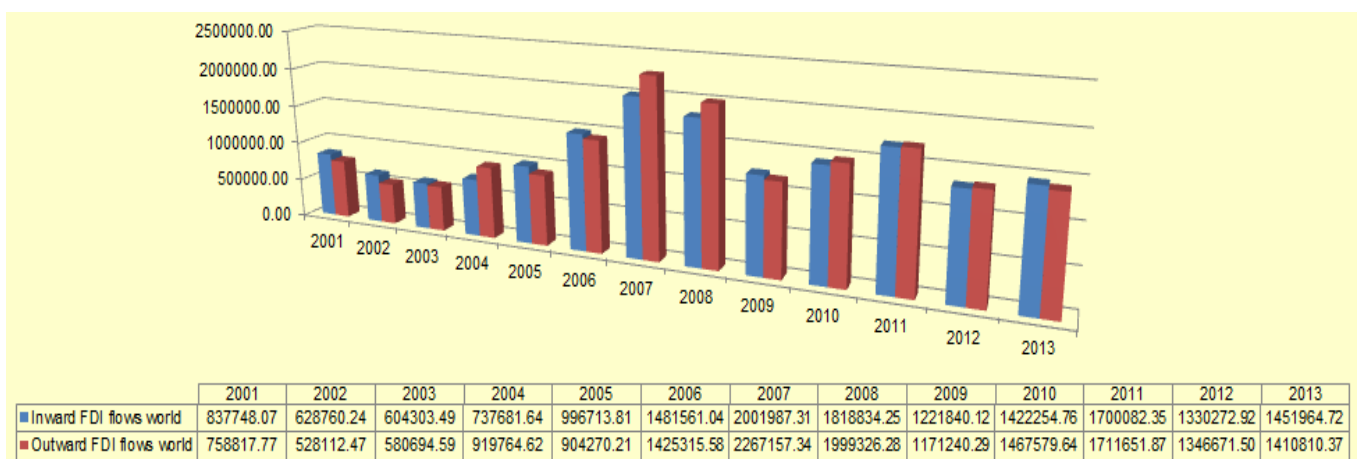
To sum up, our review of empirical studies indicates that when we take into account interactive terms of FDI with human capital, openness of the economy and financial market development, that is, when considering the various channels through which FDI can affect the host country's economic growth, which are influenced by host country domestic conditions, the impact of FDI on growth is enhanced. However, the results of these studies should be read carefully since most of the studies do not take into account the possible existence of bidirectional causality between the two variables. Herzer (2012) challenge the widespread belief that FDI generally has a positive effect on economic growth in developing countries. He examined the nature of the growth effect of FDI using panel cointegration techniques that are specifically designed to deal with key problems plaguing previous studies of the FDI–growth nexus: omitted variables, endogeneity, cross-country heterogeneity, and neglected long-run level relationships. Employing data for 44 developing countries over the period from 1970 to 2005, it was found that the effect of FDI on economic growth in developing countries is negative, on average. However, there are large differences in the effect of FDI on economic growth across countries. More specifically, an increase in the FDI–GDP ratio is associated with a long-run decrease in GDP in about 60% of the countries, while in about

40% of the cases, an increase in the FDI share is associated with a long-run increase in GDP. In general, irrespective of the sign, the effect is small. In contrast to previous studies, the results suggest that the effectiveness of FDI does not depend primarily on per-capita income, human capital, openness, and financial market development. Instead, the results suggest that the cross-country heterogeneity in the growth effect of FDI can be explained mainly, or most directly, by cross-country differences in freedom from government intervention, freedom from business regulation, FDI volatility, and primary-exports dependence. However, there are several factors such as openness, per-capita income, human capital, property rights and freedom from corruption—that are highly correlated with the cross-country differences in these freedoms, suggesting that these factors may play an important indirect role in the FDI–growth relationship. This finding supports the conclusion of Harrison and Rodríguez-Clare (2010), that countries do not benefit from “hard” interventions, such as tax breaks and subsidies, to attract FDI. It is also consistent with theoretical models suggesting that FDI may reduce real income in the presence of trade barriers (Brecher and Alejandro, 1977). Finally, many developing countries are still heavily dependent on primary commodity exports. Several of them, such as Mexico, Venezuela, Zambia, and Zimbabwe, have experienced long periods of stagnation, or even decline. The results suggest that the growth effect of FDI is negatively associated with primary exports dependence, which may, at least in part, explain why some developing countries experienced losses from FDI. However, a word of caution is needed. It does not follow from this conclusion that there is a negative relationship between the growth effect of FDI and natural resource abundance. Many resource-abundant countries, such as Chile, India, and Indonesia (all of which have positive coefficients on the FDI variable), have diversified their exports in order to reduce their dependence on primary product exports. Therefore, it seems unlikely that natural resource abundance per se is negatively related to the growth effect of FDI. In addition, there are large differences in the productivity of exports among primary-products exporting countries (Hausmann et al., 2007). The result that primary export dependence reduces the effectiveness of FDI might thus apply to some, but certainly not to all, countries. In conclusion, it can be said the negative effect of FDI found for many countries need not remain negative. The results suggest that economic reforms aimed at (i) improving resource allocation by eliminating market-distorting policies, (ii) minimizing the regulatory burden on business, (iii) reducing FDI volatility by increasing political and economic stability, and (iv) removing primary export dependence by diversifying the economy can increase the likelihood that FDI will promote growth.

### 3.3 Recent new features on FDI flows

During the last few decades, the process of globalization has brought with it (as both cause and consequence) a new economic geography, characterized (among other things) by the emergence and intense development of both the emerging market economies and the multinationals originated within them. As important vehicles of this change, foreign direct investments have registered some unprecedented dynamics and trends, having the vocation of continually transforming the global architecture for years to come. Some researchers claim that “the internationalization of business firms from emerging economies has deep historical roots which can be traced back to the late 19th century”, although “many MNEs from emerging economies had a humble origin as regional trading and commercial ventures” and “their participation in globalization (...) did not occur until much later in the 1980s” (Yeung, 1999). Others argue about a sequencing of “three waves of outward FDI (OFDI)” from emerging and developing economies: the first wave lasted from the 1960s to mid-1980s and its geographic destination was mainly represented by other developing countries in the same region; the second wave lasted from mid-1980s to 1990s and has as destination “mainly developing countries, but also (...) more distant locations, including developed economies”; the third wave started in the 1990s and has continued in the 2000s, being mainly defined by regional destinations, but including also developed economies (Gammeltoft, 2008). Whereas “since the 1990s, the global competitive landscape is becoming increasingly populated by MNEs originating in countries that are not among the most advanced in the world” (Guillén and García-Canal 2009), the consensus seems to occur nowadays on considering “the rise of emerging MNEs starting in the early 2000s as a long-term trend with important consequences for the global economy” (Ramamurti and Singh, 2009). That is the reason why, within the last few years, an increasing body of scientific literature has emerged emphasizing on both the determinants and the (new kinds of) impacts this phenomenon generate. For instance, Sauvant and colleagues (2010) refer to the fact that “Various traditional factors, among them the continuing liberalization of FDI regimes worldwide, competition among firms from all parts of the world, and technological and logistical advancements, influence and support global OFDI flows from both developed and emerging market MNEs. In the future, however, several non-traditional factors might additionally shape the FDI landscape”, and enumerate among these factors “natural resource constraints and the challenge of sustainable economic growth” (Savant et al., 2010). On the other hand, after analyzing the impact of OFDI on home countries, Globerman and Shapiro (2008) conclude that “the linkages between OFDI, globalization and real income growth in developing countries are not as straightforward or as significant as in the case of developed countries”; a more in depth approach develop Mendoza and Irmak (2008) when arguing: “outward FDI from emerging markets (...) strengthens the

competitiveness of the firms involved; it helps the economic performance of their home countries; it opens new sources of long-term capital flows (and the benefits associated with them) for other countries; and, more broadly, it becomes another avenue for the integration of emerging markets into the globalizing world economy” (Mendoza and Irmak, 2008). The dynamics of global FDI flows since the beginning of the 21 century (Figure 7) reveal quite similar evolutions as regards inward and outward FDI flows; during this period, there are seven years when IFDI world flows surpassed OFDI world flows (with a maximum difference of approximately 16% in 2002) and another six years when OFDI world flows were dominant (with a maximum difference of approximately 13% in 2007). As vehicles of the globalization process, their patterns follow the general “turbulent” tendencies that faced the world economy; thereby, the most impressive figures belong to the year 2007, which represented a peak both in terms of inward and outward FDI flows. The world economic crisis has marked the evolution of FDI flows, which is still trying to recover after its 2009 depression.



**Figure 7.** *Inward and outward FDI flows, annual, 2001-2013 (US Dollars at current prices and current exchange rates in millions)*

Source: UNCTAD Stat, 2014

As regards the contribution of different groups of countries to the global IFDI and OFDI flows, Figure 8 and Figure 9 reveal:

- Figure 8: a sharp cutting contribution of the developed economies to the world IFDI flows – from 72.02% in 2001 to 38.96% in 2013, 2010 representing the first year when IFDI flows from developing and transition economies have surpassed the IFDI flows from the developed countries. This significant shift marks a whole new phase in the evolution of the world economy (see also

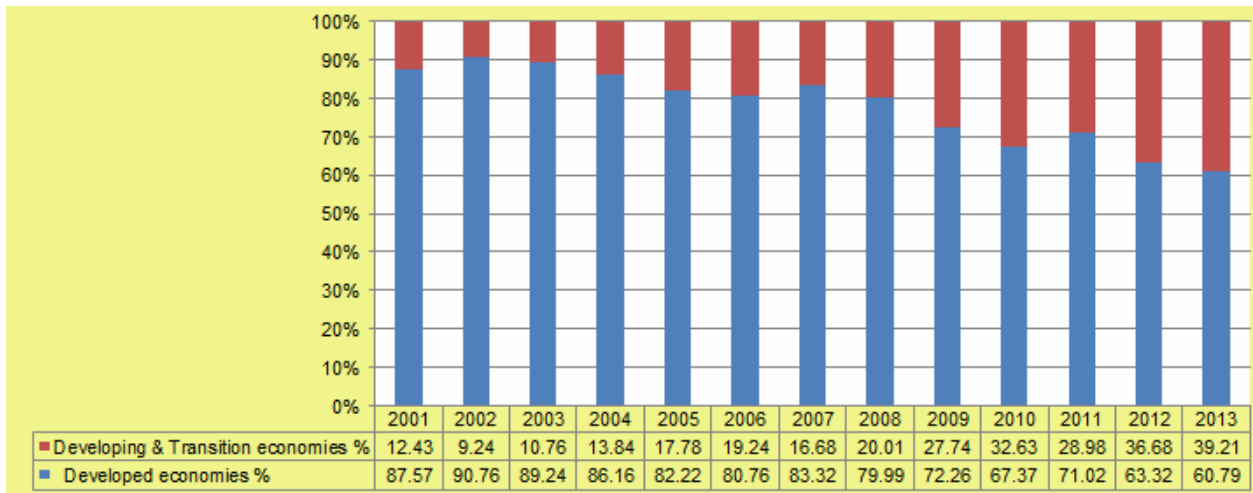
Figure 9), indicating the rising power of the developing and transition economies: although the traditional literature on international business mostly emphasized on the “north - south” flows (because of the firsts needs for expansion and of the latest “availability” for hosting) and on “north - north” flows (because of their potential and resources), the new realities suggest the need for a new theoretical paradigm in analyzing the dynamics of FDI – beyond a “south - south” one (based on similarities of needs and possibilities);



**Figure 8.** Contribution to IFDI flows, annual, 2001-2013, by groups of countries (%)

Source: UNCTAD Stat, 2014

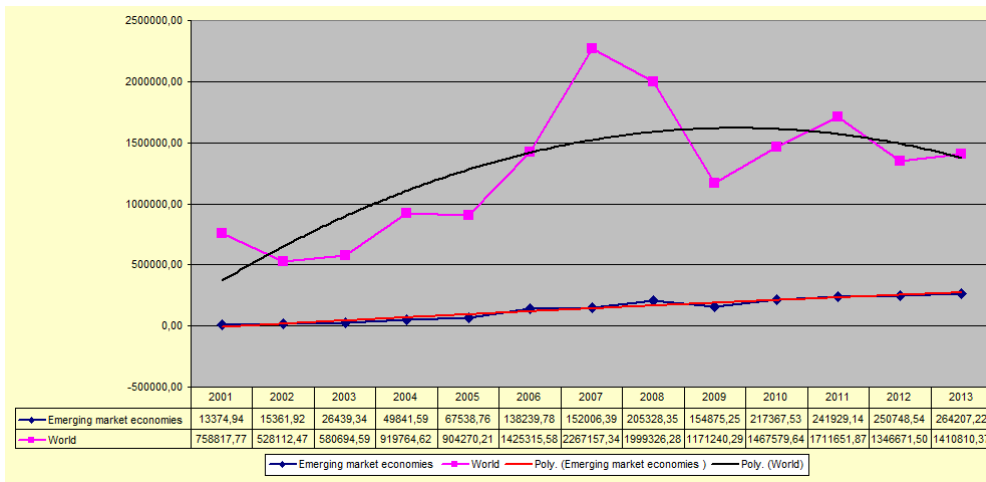
Figure 9: an impressive downsizing contribution of the developed countries to the world OFDI flows – starting with 87.57% in 2001 (and reaching a peak of 90.76% in 2002) to 60.79% in 2013; so, if in 2001 the contribution of the developing and transition economies to the world OFDI flows was 12.43% (and it registered its bottom in 2002 with a 9.24%), it reached almost 40% in 2013. Thereby, the changing patterns of world FDI flows (both inward and outward) are more than clear, certifying not only the growing importance of the outward FDI flows from developing and transition economies to the world OFDI, but also the growing importance of emerging multinationals from these countries (as mainly contributors and beneficiaries of these flows) within the new, emerging, global architecture.



**Figure 9.** Contribution to OFDI flows, annual, 2001-2013, by groups of countries (%)

Source: UNCTAD Stat, 2014

As the emerging market economies have started to become rising stars on the global arena, both the inward and outward FDI flows (originated from them and hosted by them) represent genuine indicators of the new roles they are about to take. The term itself (emerging market economies) has no unanimous recognition (among researchers or international institutions which are dealing with it) regarding its content: different entities define and characterize differently the emerging market economies. More than that, during the last few decades, the concept has reunited different countries, according to different criteria. Because this paper does not aim to emphasize and debate the conceptual differences and controversies regarding the emerging market economies, some methodological clarifications are necessary. Into its most recent World Economic Outlook (WEO) released in April 2014, IMF lists the following emerging market economies (IMF, 2014): Argentina, Brazil, Bulgaria, Chile, China, Colombia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine and Venezuela (§2.2.1). The aforementioned emerging market economies (EMEs) will especially be considered further during this analysis. As regards the dynamics of the outward FDI flows from EMEs comparative to the dynamics of the global outward FDI flows on annual basis, Figure 10 reveals a huge difference: while the global OFDI flows have almost doubled their value between 2001 (758817.77 mills. USD) and 2013 (1410810.37 mills. USD) – which already is a significant evolution, the OFDI flows from EMEs have increased by almost 20 times in the same period (from 13374.94 mills. USD in 2001 to 264207.22 mills. USD in 2013).

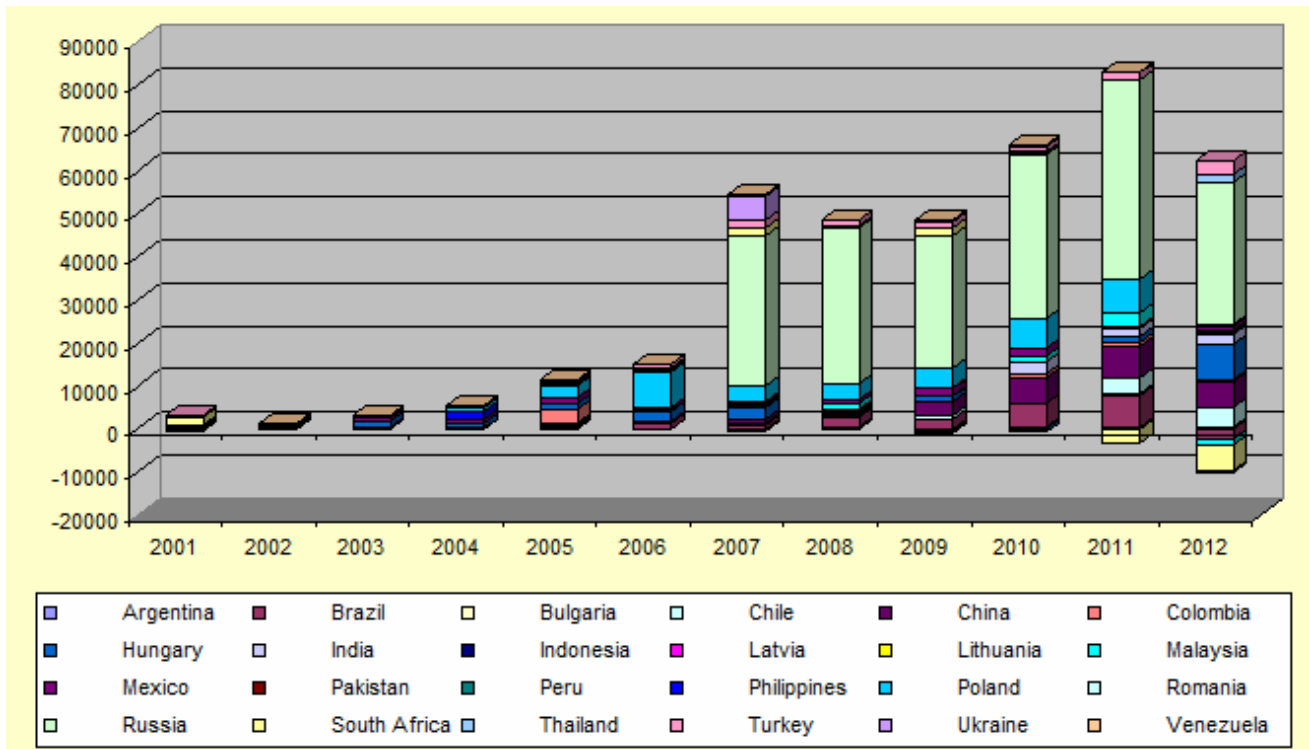


**Figure 10.** OFDI flows, annual, 2001-2013 – world versus emerging market economies (Millions USD) Source: UNCTAD Stat, 2014

This racket evolution is reflected on the rising contribution of OFDI flows from EMEs into the global OFDI flows : if in 2001 OFDI flows from EMEs counted for 1.76% into the global OFDI flows, in 2013 they reached 18.73%. After several years of constant rising (between 2001 and 2006), the year 2007 registered the poorest contribution of OFDI flows from EMEs into the global OFDI flows (6.7%), but the year 2008 represented the beginning of a recovery period, followed by intense increase.

Developed Europe, on the other hand, has passed through an interesting period between the years 2001 and 2013 in terms of FDI flows. Broadly, the value of IFDI flows in 2013 represents only 63% comparative to the value of IFDI flows in 2001, while the value of OFDI in 2013 represents only 72.71% comparative to the value of OFDI flows in 2001. The year 2007 represented the peak of evolution (both in terms of IFDI flows and OFDI flows) within this period, when the values of IFDI flows and OFDI flows were more than double comparative to their average values registered throughout all the other years: 911458.59 mills. USD inward FDI flows in 2007 (comparative to an annual average, except for 2007, of 406019.52 mills. USD) and 1329886.68 mills. USD outward FDI flows in 2007 (comparative to an annual average, except for 2007, of 523297.02 mills. USD).

If taking the case of all the EMEs (according to IMF’s classification), the evolution of their FDI flows towards the Developed Europe is captured in Figure 11 – based on the new UNCTAD’s Bilateral FDI Statistics (2014). Data were collected for each country by adding the values of FDI flows abroad, by geographical destination.



**Figure 11.** FDI flows abroad, by geographical destination – from Emerging Market Economies to Developed Europe, 2001-2012 (millions USD)

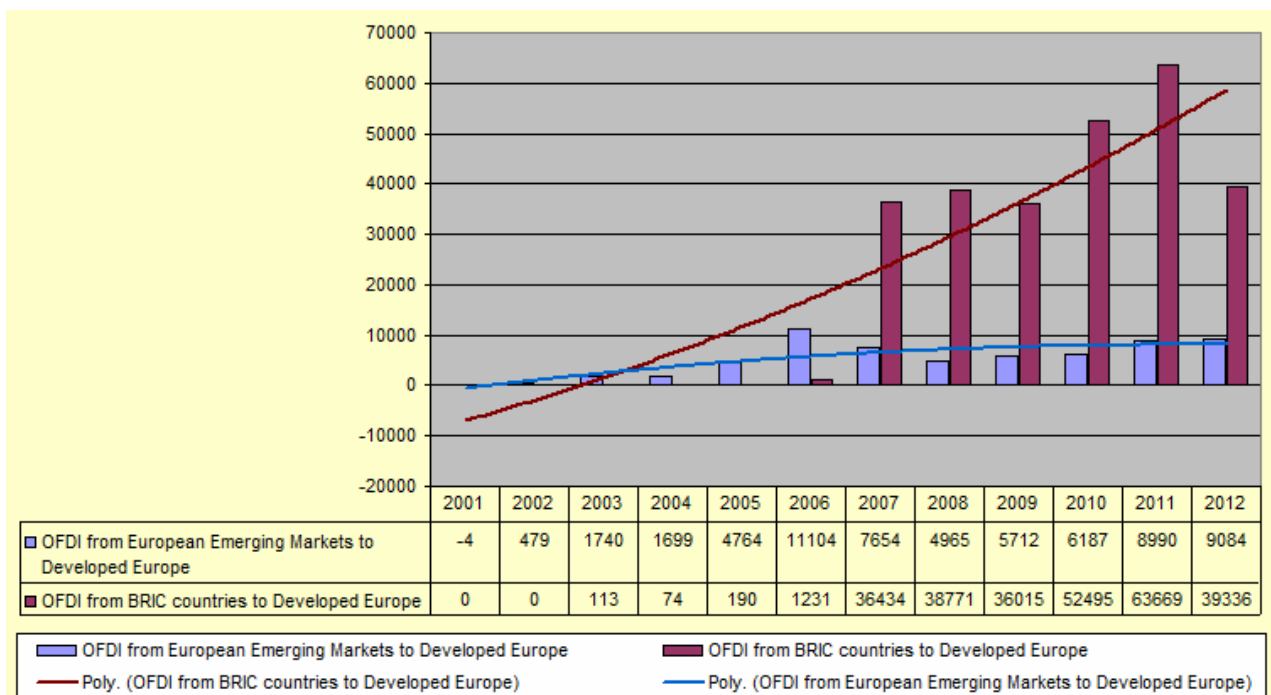
Source: UNCTAD Stat, 2014

Figure 11 indicate in 2013 a value of OFDI flows that is more than 22 times higher the value of 2001: 52174 mills. USD comparative to 2292 mills. USD, with a peak value of 79691 mills. USD in 2011. Russia’s massive presence – which was captured by UNCTAD’s Bilateral FDI Statistics only starting from 2007 – makes the big difference between the year 2006’s values and the next ones. The values of OFDI flows from Russia to developed Europe have represented (since 2007) about two times than the maximum value previously registered, continuing to represent more than 57% from the total in the next analyzed years.

Among all the EMEs, Russia definitely represents the most important source of FDI for the developed Europe countries. As regards the presence of its BRIC colleagues – Brazil, India, and China, they have had (by comparison to Russia) rather modest contributions: the highest value of OFDI flows from Brazil to developed Europe was in 2011 (7737 mills. USD), representing about 10% of the year’s total; the highest value of OFDI flows from India to developed Europe was in 2010 (2807 mills. USD), representing about 4% of the year’s total; and the highest value of OFDI flows from China to developed Europe was in 2011 (7597 mills. USD), representing less than 10% of the year’s total.



When comparing the OFDI flows from the EEMEs to developed Europe versus the OFDI flows from BRIC countries to developed Europe (Figure 12), the graph reveals a significant difference between the two series of data. The values of OFDI from the BRIC countries to developed Europe surpass four to eight times the values of OFDI from the European Emerging market economies (EEME) countries to developed Europe. Thus, the EEMEs have rather a peripheral contribution as source of FDI flows for the developed Europe, despite their spatial proximity on one hand, and their belonging to the same superstructure (the EU), on the other hand. If consider separately each of the EEMEs: Bulgaria has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2008 (640 mills. USD) – which represented 1.31% from the total year’s value; Hungary has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2012 (8226 mills. USD) – which represented 15.76% from the total year’s value; Latvia has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2007 (236 mills. USD) – which represented 0.43% from the total year’s value; Lithuania has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2007 (508 mills. USD) – which represented 0.94% from the total year’s value; Poland has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2006 (8429 mills. USD) – which represented 55.76% from the total year’s value; and Romania has the highest contribution in terms of OFDI flows from the EMEs to developed Europe in 2006 (206 mills. USD) – which represented 1.36% from the total year’s value.



**Figure 9.** *OFDI flows from European Emerging Markets Economies versus OFDI flows from BRIC countries – to Developed Europe, 2001-2012 (Millions USD) Source: UNCTAD Stat, 2014*

## **4. F.D.I. in RUSSIA, BRAZIL, CHINA, INDIA.**

### **4.1 RUSSIA**

Russia is the 9th most populated country in the world with 142.5m people, but is the world's largest country in terms of territory. According to its constitution, the Federation is structured as a multi-party representative democracy. The president is primarily responsible for domestic and foreign policy. Russia has a market economy with enormous natural resources, particularly oil and natural gas.

#### **4.1.2 FDI in Russia**

Following the collapse of the Soviet Union, Russia opened its doors to FDI. After initial flat growth in the 1990s, FDI peaked in the mid-2000s following the liberalization of certain sectors of the economy. After 2005, FDI inflows grew exponentially, due to investments in newly liberalized sectors such as the power generative industries, the automotive and real estate sectors. After reaching record heights in 2008, the financial crisis led to a collapse in FDI, as the global economy entered into a recession. Since the severe drop in 2009, FDI has recovered partially, reaching USD 45bln in 2012, the fourth highest level ever recorded in Russia's history. Foreign investors remain motivated by the continued strong growth of the consumer market and affordable labour costs, coupled with productivity gains. They also continue to be attracted by high returns in energy and other natural-resource related projects. In terms of the number of projects, the largest investors in Russia are the US and European countries. Increased Russian consumer spending is driving FDI growth in consumer sectors, such as the automotive and food markets. Between 2007-2011, the US was a leading investor in Russia with 122 projects, corresponding to 16% of total projects. Leading US companies, such as Boeing, Cisco, ExxonMobil, were active in sectors including automotive, IT, food, and oil and gas. The second largest investor was Germany, with 99 projects in a range of sectors including oil and gas, banking and consumer goods.

#### **4.1.2.1 Why invest in Russia?**

##### *MARKET OPPORTUNITIES*

- Domestic market.

Russia's large, expanding consumer market continues to be its most attractive feature, as noted by 70% of our respondents. A large population,<sup>47</sup> rising disposable income and a burgeoning middle class is drawing global interest. Russia's GDP per capita of US\$14,105 is the highest among the BRICs. The country also has the world's ninth-largest consumer market in terms of domestic size. Furthermore, it is touted to become the largest consumer market in Europe and the fourth largest in the world by 2020. Russia's middle-class population has increased substantially throughout the 2000s, with GDP per capita growing at more than 5% annually over the past decade. Consumer spending is slated to almost double to US\$3 trillion by 2025, increasing the country's competitive strengths.

- Well-developed telecom infrastructure.

Sixty-four percent of respondents see Russia's telecommunication infrastructure as an attraction. The country has the largest online population in Europe, with 73.8 million users. Internet usage is highest among the urban youth. Russia stood at the 56th of 142 countries on the WEF Networked Readiness Index, which measures a country's ability to tap opportunities offered by ICT, up 21 places from 2011. Telecom operators are further modernizing infrastructure to provide improved services. On the other hand, 27% of our respondents do not see Russian telecom infrastructure as attractive, chiefly because there is regional variation in development. The Russian Government is considering initiating private-public partnerships to bring fiber access to rural areas to promote economic inclusion.

- Abundant natural resources.

The oil and gas sector has been the cornerstone of Russia's economic growth. Unsurprisingly, 61% of the respondents think that natural resource endowment is Russia's most competitive feature. Russia holds the world's largest natural gas reserves, second-largest coal reserves and the ninth-largest crude oil reserves. This wealth of natural resources attracts many foreign companies. However, the sector remains vulnerable to fluctuating global oil prices. According to the OECD, Russia is one of the most energy-intensive economies in the world. The Government needs to promote new, knowledge-driven sectors to ensure sustainable growth. In addition to energy-based natural resources, Russia has one of the world's largest reserves of freshwater and vast high-quality

arable land. Russia's strategic location should help it to benefit from the increasing global demand for food, water and land — and the ensuing spike in global prices.

### *HUMAN CAPITAL AND INNOVATIONS*

- Favorable skills at reasonable cost.

Fifty-six percent of the investors we surveyed are attracted by Russia's skilled workforce, and 61% to the associated cost competitiveness. This advantage is linked to the sound education system, as noted by another 61% of the respondents. A literacy rate of 99.4% puts Russia ahead of other BRIC countries in terms of educated population. Furthermore, Russia has the seventh-largest labor force in the world (and the largest in Europe), which is 75 million workers strong. Compared with the talent pool in the US, Europe and elsewhere, a higher proportion of Russia's labor force is equipped with tertiary education. While this is promising for the country, enthusiasm is limited to existing investors. Firms that are not doing business in the country have mixed views about the potential of its human capital, with only 32% highlighting Russia's local labor skills as a competitive advantage, and 46% identifying labor costs and education as an attractive feature. Despite a high level of educational achievement, Russia's educational performance ranks below most OECD countries. In addition, the lack of business education is fueling a widening skills gap. To build a knowledge-based economy, Russia needs to integrate business elements into its education system.

- Research, innovation and entrepreneurial environment.

Our respondents have mixed views about Russia's research and innovation capabilities. While 51% see this as an attractive feature, another 33% are less sure of R&D availability and innovation in the country. Furthermore, 42% of investors surveyed point out the need to improve Russia's entrepreneurial culture. The lack of sufficient funding and a supportive environment for startups has translated into a shortage of new ventures. The perception is supported by Russia's poor performance on the innovation and business sophistication sections of the WEF's Global

Competitiveness Report 2012–2013, placing 108th of 144 nations. The country has a need for new, scalable businesses built through innovation.

- Transport and logistics infrastructure.

Respondents continue to have mixed views on Russia's transport and logistics infrastructure. While 46% of the investors find it attractive, a substantial 43% disagree. The development of Russia's

infrastructure lags behind other emerging countries. The WEF's Global Competitiveness Report 2012–2013 ranks Russia at 101 out of 144 on the quality of its overall infrastructure, significantly below China (69) and India (87). The quality of roads is ranked even lower, at 136 this year, down from 130 in 2011–12. According to estimates, the Russian economy loses out on 3% of GDP annually because of underdeveloped road infrastructure and the inability to capitalize on transit potential. However, railway infrastructure is much better — Russia sits at 30th in the Competitiveness Report. Infrastructure spending is expected to grow in the wake of the 2014 Olympics and the 2018 World Cup. The Government plans to spend over US\$1 trillion on infrastructure development before 2020. It also plans to increase private participation in building, operating and financing infrastructure projects.

#### **4.1.2.2 The more attractive sector**

##### *Manufacturing: automotive and chemicals*

Manufacturing leads FDI activity in Russia, both in terms of project numbers and job creation. In terms of projects, however, sales and marketing is quickly catching up. Furthermore, strategic functions, such as research and development (R&D) and education and training, are emerging as popular recipients of FDI projects, albeit at a slow pace. However, FDI in strategic functions and sales and marketing is still not creating many jobs. In terms of employment, the labor-intensive manufacturing activity accounted for 98.2% of jobs created by FDI in 2012, up from 90.7% in 2011. On average, a manufacturing project in Russia created 219 jobs in 2012, in comparison to 122 jobs in 2011. Companies from Germany, France and Japan were the most active investors in manufacturing. A large number of jobs were created in the establishment of plants and factories, particularly in the automotive and chemicals sectors. St. Petersburg, Kaluga and Nizhny Novgorod were popular destinations for FDI. Foreign companies set up base in these regions, to cater to both local demand and international requirements. Their interest is sustained by Russia's strategic location, relatively low labor costs and capacity for high-quality work.

The automotive sector continues to receive the highest number of FDI projects in Russia. In 2012, the sector accounted for 21.1% of total projects and 35.9% of the jobs created. The majority of these projects came from Western European companies, particularly from Germany. St. Petersburg and Kaluga proved to be the most attractive regions for investment in the automotive sector. The automotive cluster of Kaluga, which was created five years ago following Volkswagen's decision to

invest in this geography, positively influenced several other players to join the car maker. Kaluga now hosts some of the sector's biggest manufacturers, and has successfully transformed the region's industrial complex. According to Ernst & Young's estimates, the value of Russia's car market increased by 21.9% to RUB2.3 trillion (US\$77 billion) in 2012. Unit sales increased by 10% to 2.94 million, touching the pre-crisis level of 2008. This is in stark contrast to Europe, where sales fell to a 17-year low. This performance was also reflected in FDI numbers. There was a 50% rise in investment between 2011 and 2012, with a substantial spike in projects from Germany and Japan. In 2012, German carmaker Volkswagen continued to invest across the value chain. It set up new vehicle assembly operations with GAZ in Nizhny Novgorod, established a training center for car manufacturers and opened a new sales and marketing office. During the year, PCMA Rus, a joint venture (JV) between PSA Peugeot Citroën (70%) and Mitsubishi Motors Corporation (30%), constructed a €50 million production plant to meet local demand. The presence of big carmakers improves Russia's reputation in the industry, and attracts investment from automotive servicing companies and component suppliers. Many global automotive companies — including GM-Avtovaz, Avtovaz-Renault-Nissan; and Sollers with Ford, Toyota, Mazda, and Isuzu — are now teaming up with local Russian companies to benefit from economies of scale and conduct joint R&D. The Avtovaz-Renault-Nissan alliance aims to gain a combined market share of 40% in Russia by 2016. Instead Chemical sector received 14 projects in 2012, up from 9 in 2011. Half of these projects came from German companies. Export-oriented manufacturing sectors, such as chemicals, are expected to prosper from Russia's accession to the WTO, due to export-tariff reduction. Such developments have enticed companies such as Dow Chemicals, BASF, Lanxess and Thyssenkrupp to set up plants and manufacturing facilities in the country. In 2012, Thyssenkrupp set up a polymer factory in the Nalchik province of Russia, creating employment opportunities for 2,500 people. Further, Germany's Linde entered into a JV with Russia's OJSC Kuibyshevazot to produce industrial gases.

### *Business services*

Russia is shifting its focus from resources to services. And the increase in the number of FDI projects in business services, from 5 in 2007 to 17 in 2012, reflects this. The majority (89.6%) of these projects involved foreign companies setting up sales and marketing offices in the country. Unsurprisingly, investors had a clear preference for Moscow, Russia's most prominent and developed urban center, when investing in services projects. The greater part of this investment came from the US, Netherlands, Spain and the UK. Accelerated domestic business activity and the

availability of a well-educated and skilled workforce are major drivers of investment in this sector. Russia's recent accession to the WTO has augmented Russia's services appeal for foreign investors. Furthermore, as part of the accession, Russia concluded 30 bilateral agreements on market access for services, which permit 100% foreign-owned business service companies to be established in the country.

### *Technology*

Tax incentives and subsidies in Russia's high-tech hubs are rapidly catching the attention of foreign investors, especially those from the US, who are increasing investments in Russia's technology sector. As a case in point, the number of projects in the computer and software sectors has increased from 6 in 2011 to 15 in 2012. Moscow and St. Petersburg are the hot spots for technology investment. With almost half of its population using the web, Russia has become Europe's largest internet market. In response to this, companies such as US-based eBay are expanding their Russian presence. In 2012, IBM invested in several branch offices across the country to tap new growth opportunities, and to serve its growing client base in and around the region. In addition, the company has teamed up with the Skolkovo Foundation and leading Russian innovation companies — Rusnano, Russian Venture Company and ITFY — to foster a culture of applied research and commercialization, as well as give a boost to its microelectronics industry.

### *Food*

The food sector received merely 6 FDI projects in 2012, compared with 13 in 2011. On a positive note, projects initiated in 2012 were relatively more job intensive, with one project creating an average of 120 jobs in 2012 against 64 in 2011. Companies from the US, Switzerland and Finland were the most active investors in the sector between 2007 and 2011. However, their interest seems to have waned in 2012, with no projects initiated during the 12 months.

### *Machinery and equipment*

This sector received 6 FDI projects in 2012 after seeing 14 in 2011. While the number of projects fell, the average number of jobs per project increased from 138 to 217 on the year. During 2012, Italian plant-maker Danieli signed an agreement to establish a machine-building factory for the production of metallurgical equipment. This initiative could create several jobs.

RANK JOBS	SECTOR					PROJECTS
		2011	2012	Change	Share	2012
	share					
1	Automotive	18	27	50.0%	21.1%	4,790
					35.9%	
2	Business service	12	17	41.7%	13.3%	59
					0.4%	
3	Chemicals	9	14	55.6%	10.9%	2,540
					19.0%	
4	Software	4	8	100.0%	6.3%	26
					0.2%	
5	Transport services	5	7	40.0%	5.5%	-
					-	
6	Computers	2	7	250.0%	5.5%	-
					-	
7	Food	13	6	-53.8%	4.7%	720
					5.4%	
8	Non-metal mineral	5	6	20.0%	4.7%	450
					3.4%	
9	Mach. & Equip.	14	6	-57.1%	4.7%	1,300
					9.7%	
10	Plastic and rubber	5	4	-20.0%	3.1%	140
					1.0%	
	Others	41	26	-36.6%	20.2	3,331
					25.0%	
	Total	128	128	0.0%	100.0%	13,356



### **4.1.3 KEY AREA TO IMPROVEMENT**

Foreign companies indicated that they are often burdened by excessive red tape, caused by inconsistent, lengthy and non-transparent bureaucratic procedures. Consumer market firms endured problems with ‘time-wasting bureaucracy’ whilst industrial Firms encountered problems around a lack of transparency during large scale investment projects. The Russian government is aware of these problems and has suggested the creation of an anti-bureaucracy filter for business legislation as part of the country’s long-term economic policy objectives.

#### *Corruption*

Corruption is still a major issue in Russia, resulting in a lower Transparency International ranking (133rd out of 176) than countries such as Togo and Uganda. The researcher indicated that corruption occurred in 40% of foreign investors experiences in Russia. In the consumer markets this figure was even higher at 60%. Levels of corruption varied per region, with Moscow and St. Petersburg (the most important regions in terms of FDI) performing relatively badly. KPMG’s study also revealed that corruption is more widespread at a federal level (70% of cases) whereas it was far less at a regional level (30% of cases). A common problem for foreign businesses in many regions is that government repeatedly expects them to make further direct investments in the region, despite there being no business incentive for the firm to do so. Tax incentives are often tied to compliance with these requests, making many investors suspicious of such incentives. Some companies have even experienced government dictating which investments they have to make. A perception problem exists at regional levels, where foreign businesses are seen as short-term cash cows that can be used to directly supplement regional budget shortfalls. This view not only drives investors away (to more business-friendly regions or countries) but also fuels corruption. The view widely exists that investors should pay extra for the ‘privilege’ of doing business in a region.

#### *Infrastructure*

The investors expressed concerns about the availability of physical, social and financial infrastructure. Utilities and the road infrastructure in particular do not always meet business needs. Fortunately, the government has set the maintenance and repair of road and rail infrastructure as a high priority. According to foreign investors, the social infrastructure (including hotels, kindergartens and housing) is not sufficient outside of major cities. Additionally, the absence of a comprehensive financial infrastructure hampers the efficient raising and allocation of capital.

### *Application of the rule of law*

Russia has a body of conflicting, overlapping, and frequently changing laws, decrees and regulations, which complicate the legal environment. In an attempt to address these challenges, in 2010, the government set the objective of coordinating and overseeing efforts to improve the business and investment climate, including the protection of foreign and domestic investors. In 2011, President Medvedev appointed Investment Ombudsmen in each Federal District to perform similar roles at the regional level. The government also encouraged international business leaders to participate in the discussion of dispute resolution mechanisms, as well as individual commercial disputes, as part of their work in the FIAC. While these steps offer some promise, overall the country's investment dispute mechanisms remain underdeveloped and largely non-transparent compared to western standards.

### *Property rights*

The 1991 Investment Code prohibited the nationalization of foreign investments, except following legislative action deemed to be in the national interest. Such nationalisations may be appealed in the courts of the Russian Federation, and the investor must be adequately and promptly compensated. In reality, compensation has not always been adequate. For example, Russia forced Shell to reduce its share in the Sakhalin field from 55% to 27.5% for USD 7.5bn in 2006, which was considered deeply below market value. At the sub-federal level, expropriation has occasionally been a problem - as has local government interference and a lack of enforcement of court rulings protecting investors.

## **4.2 BRAZIL**

The federative Republic of Brazil, is the largest country in both South America and Latin America region. In the past decade, Brazil's economy has grown to such extent that Brazil is now labelled an economic superpower. With an average annual GDP growth of 4.2% over the past five years, increasing wealth of the home market and a vast amount of natural resources, Brazil's future is looking bright. The principal economy of South America overtook the UK in 2011 to become the 6th largest economy in the world and is expected to become the world's 5th largest economy by 2017.

## **4.2.1 FDI IN BRAZIL**

On a global scale, Brazil is ranked as a top destination for foreign direct investment. It accounts for more than half of total FDI inflow in Latin America. In 2011 alone, almost USD 70 billion was routed to Brazil. The country saw a record amount of incoming investments due to a combination of World Cup in 2014, the 2016 Olympic Games and the discovery of very large deep-sea oil fields on top of economic growth. The Central Bank of Brazil estimated that FDI in Brazil has increased from USD 22.2 billion in 2006 to reach USD 69.5 billion in 2011. This amount is further expected to grow towards 2016, to an estimated amount of USD 74.0 billion, equal a the steady annual increase of 2%.

### **4.2.1.1 FDI per sector**

The growth of inward FDI is sector-bound. Both the primary sector (agriculture and mineral extraction), and industry have seen double-digit growth in the previous five years. FDI in services more than doubled between 2010 and 2011.

#### *Agriculture and mineral extraction investment*

From 2006 to 2011, foreign agriculture investments increased from USD 1.5 to 10.3 billion. FDI in agriculture and mineral extraction showed fluctuating levels. As the demand for mineral resources and commodities will further rise going forward, foreign investments are expected to increase.

#### *Investment in industry*

Brazil has one of the largest industrial sectors of the Americas. From 2006 to 2011 foreign industry investments increased from USD 8.6 to 26.8 billion. This is attributable to increased Chinese investment in the technology sector as well as infrastructure investments towards the World Cup and Olympic Games. With the increasing welfare of the domestic and world population, the demand for Brazil's automobiles, machinery and equipment and other consumer products is likely to increase. The automotive industry has seen a particular boost. A large contributor is German-based ThyssenKrupp, investing EUR 5.2 billion into building a steel mill in the state of Rio de Janeiro.

#### *Investment in services*

The tertiary sector, or the service sector, is Brazil's largest business segment and the largest sub-segment for FDI in 2011. This is mainly attributed to investments in commerce and telecommunications and financial services.

#### **4.2.1.2 How to invest in brazil**

Today, all investments made by foreigners shall be registered electronically through the Brazilian Central Bank, in the so called Electronic Declaratory Registry of Direct Foreign Investment implemented by the Central Bank (Registro Declaratório Eletrônico de Investimentos Externos Diretos - RDE-IED). Investments in cash are recorded in the amount of the foreign currency transferred to Brazil, are converted into Brazilian currency (Reais) as paid in capital on the date of inflow. Although an investment in cash is the most common form of initial contribution, "assets in-kind" may also be contributed by foreign investors into Brazilian companies. However, the contribution of noncash items may be more cumbersome, and in some instances requires feasibility analysis. The Brazilian company which is the recipient of the foreign investment in cash or in kind must obtain a number from the RDE-IED, corresponding to the Investor (foreign investor)/Receiver (Brazilian company) pairing, through the Information System of the Central Bank (SISBACEN). Such RDE-IED number must be indicated in the exchange agreement related to the foreign investment. The Brazilian company must then register the foreign investment before the Central Bank through the SISBACEN RDE-IED system within 30 days from the closing of the foreign exchange agreement sustaining the respective inflow foreign capital. Profits arising from the investment of foreign capital that are reinvested into the company, when formally capitalized and properly recorded in the local books, must also be registered with the BACEN as an amendment to the original certificate of foreign capital investment. Foreign capital invested in Brazil is granted the same legal treatment applicable to Brazilian capital under similar circumstances. However, Brazilian law requires that foreign capital that is brought into the country on account of direct investment must be registered with the Brazilian Central Bank in order to guarantee remittances of dividends, interest, and return of original invested capital without taxation thereon. As a general rule, and besides regulatory requirements for certain business sectors, there are no legal minimum capital requirements unless: (i) the Brazilian entity applies for the so called RADAR license which allows the entity to engage on import or export transactions of goods, or (ii) hires an expatriate to become a general manager/director of the Brazilian entity, in which case a minimum capital of: (i) R\$600,000 per individual, or (ii) R\$150,000 per individual, in addition to the generation of at least 10 new jobs within a 2-year period, counting from the incorporation of the Brazilian entity or arrival of the foreign individual in Brazil.

#### **4.2.2 CONTINGENCIES IN BRAZIL**

To make a successful investment in Brazil, we need to consider different regulatory issues:

##### *Bureaucracy*

Although, Brazil's business environment is more friendly than most other high growth markets, transparency is sometimes lacking and there are considerable bureaucratic rules for certain businesses and industries. Brazilian bureaucracy affects business and investments at all stages. The World Bank has reported that starting a business in Brazil takes an average of 13 processes and 119 days, which is much longer than it takes in the other BRIC countries. However, due to increasing professionalism of the government the level of bureaucracy is becoming more manageable, although it remains an area that should be properly assessed and addressed.

##### *Corruption*

Corruption is not uncommon in both the government and business. Despite several efforts to improve the situation, bribes and embezzlement are still common and accepted by society in general as the price of doing business. However, Brazil is probably no more corrupt than other countries of similar size and wealth. A poll by Transparency International with international businessmen from around the world has shown that Brazil is doing better than the other BRIC countries when it comes to corruption in business. Brazil has created several institutions that investigate corruption scandals, revolving around the public-prosecutor's office, a semi-autonomous part of the federal government and its local equivalents.

##### *High import tariffs*

Traditionally, Brazil is known for its extremely high import tariffs (up to 60%) which are higher than in most other countries in the world. Brazil's government sets product classifications that determine rates for specific imports. Where exceptions meet the best interests of the Brazilian economy, import duty rates may be negotiated. Importers must pay the import duties for federal and state value added taxes at ports and these could be (partly) recovered for goods to be manufactured or sold in Brazil. Certain sectors (e.g., petroleum products and weapons) require departmental or ministerial approval for imports. As member countries of MERCOSUL (Common Market of the Southern Cone), the three nations exempted from Brazil's import duties are Argentina, Paraguay

and Uruguay. All other exporting nations must pay the Common External Tariff (CET), which averages 14% to 20%, depending on the imported merchandise. Brazilian authorities maintain a list of imported products exempted from the CET including computers, telecommunications equipment and some capital goods. On average, it takes 7 documents and 17 days to comply with all procedures to import goods. Between 2010 and 2011, the cost to import a container increased with approximately 30% to USD 2,275.

#### *Complex and time consuming import procedures*

Customs clearance in Brazil is a complex procedure. The Brazilian customs is very lengthy and controlling the invoices and the many other paperwork request slows down the process. Upon import customs clearance of parts, it is necessary for importers to complete the invoice in Portuguese, including weight, material, and the manufacturer's name for each item. Moreover, it frequently happens that certain procedures and regulations change without prior notice. To lessen the import duty, it is necessary to show that the imported products are not locally available. The result of the stringent import procedures is that it may take up to a few weeks, sometimes even a few months, before the cargo is released from the seaport or airport.

#### *Complex and time consuming procedures for starting a business and registering property and land*

In a study on business regulations of 183 countries, Brazil is positioned at place 126, leaving only India behind among the BRIC countries. The scores of Brazil on the individual rankings show that a lot of changes can be made to improve the business climate for both local and foreign firms in Brazil.

#### *Starting a business*

In Brazil, starting a business can be a long procedure. On average, it takes 13 procedures and 119 days to register a firm. However, between 2010 and 2011, the cost for starting a business has decreased from 13.5% to 5.4% of the income per capita.

#### *Registering property and land*

Since 2011, Brazil has become slightly less forthcoming concerning registering property and land. It takes an average of 13 procedures and 39 days to legally register property and land. Registering property, relative to the property value, is less costly than in India and China.

## **4.3 CHINA**

Over the past decade, China has established itself as the top recipient of FDI among developing countries and second in the world after the United States. In 2006, inflows to China reached an estimated \$69 billion, which represented 10% of world FDI flows. Investment began to pour into China after 1992, and annual inflows have been over 40 billion dollars since 1996. Trending steadily upward, FDI inflows were at 63 billion dollars in both 2004 and 2005. These inflows are by far the largest of any developing country and have remained remarkably stable and robust despite substantial fluctuations in the Asian and global economies. China has accounted for about one-third of total developing-country FDI inflows in recent years. China is not just a magnet for FDI but it is increasingly also a source of FDI. Although its outward investment is still small in absolute terms, especially compared to the huge inward flow, China's overseas enterprises have been quietly gaining importance as new sources of international capital. China's FDI outflows grew 32% to \$16.1 billion in 2006.

### **4.3.1 China Inflow FDI: Trends and main features**

#### **a) Trends**

An important part of the economic reform process in China has been the encouragement of foreign direct investment (FDI). The expansion of FDI into and from China has been accompanied by a rapid economic growth and an increasing openness to the rest of the world. FDI flows to China have increased massively in recent years, reaching an estimated \$69 billion in 2006, which represented 10% of world FDI flows. Since economic reforms launching in 1979, China has received a large part of international direct investment flows. China decided to accept foreign investment in 1978 and broke sharply with socialist orthodoxy in establishing Special Economic Zones (SEZ) in 1979 and 1980. Nationwide the impact of FDI was moderate until the early 1990s. China moved from restrictive to permissive policies in the early 1980s, then to policies encouraging FDI in general in the mid-1980s to policies encouraging more high-tech and more capital intensive FDI projects in the mid-1990s (Fung et al., 2004). During the permissive period, the Chinese government established four Special Economic Zones (SEZs) in Guangdong and Fujian provinces and offered special incentive policies for FDI in these SEZs. While FDI inflows were highly concentrated within these provinces, the amounts remained rather limited (Cheung and Lin, 2004). After 1984, Hainan Island and fourteen coastal cities across ten provinces were opened, and FDI levels really started to take off. The realized value of inward FDI to China reached US \$3.49 billion in 1990.

This kind of preferential regimes policies resulted in an overwhelming concentration of FDI in the east. The expected spillover effects from coastal to inland provinces failed to materialize. In reaction to the widening regional gap, more broadly-based economic reforms and open door policies were pushed forward in the 1990s. In the spring of 1992, Deng Xiaoping adopted a new approach which turned away from special regimes toward more nation-wide implementation of open policies for FDI inflows. New policies and regulations encouraging FDI inflows were implemented and produced remarkable results. Since 1992 inward FDI in China has accelerated and reached the peak level of US\$45.5 billion in 1998. After a drop due to the Asian crisis, FDI inflows into China surged again, so that by 2003 China received US \$53 billion in FDI, surpassing the United States to become the world's largest single recipient of FDI. The peak of \$72 billion recorded in 2005 is partly related to changes in the methodology underlying Chinese FDI statistics – for the first time data on Chinese inward FDI include inflows to financial industries . In 2005, non-financial FDI alone was \$60 billion, and it registered a slight decline after five years of increase. FDI into financial services surged to \$12 billion, driven by large-scale investments in China's largest State-owned banks. However, a significant share of China's inward FDI might be the result of round-tripping. FDI to China may be overstated by between 10% and 25%. The United Nations put China's stock of inward FDI close to \$400 billion, around 16% and 43% of China's GDP and Gross Fixed Capital Formation respectively.

#### **b) main features**

Naughton (2007) emphasizes that three distinctive characteristics have marked investment in China over the past decade and that each of these characteristics reflects the dominant role played by the cross-border restructuring of export-oriented production networks that originally developed in other, neighboring East Asian economies. The first specificity stressed by Naughton (2007) is that foreign direct investment has been the predominant form in which China has accessed global capital (as opposed to portfolio capital or bank loans). Between 1979 and 2000, China's actual usage of foreign capital amount to more than \$500 billion of which more than two third are in the form of direct investment (Fung et al., 2004). The second specificity is that an unusually large proportion of Chinese FDI inflows are in manufacturing industry, as opposed to services or resource extraction. The third specific characteristic of China's FDI inflows is the predominance of other East Asian economies, especially Hong Kong, Taiwan and Macao as sources. An additional important feature of China's FDI inflow is that they are mostly concentrated in the eastern coastal regions. Some regions of China are in fact even more open to FDI than a "typical" Southeast Asian nation. Inflows into Guangdong and Fujian, scaled to GDP, were of course well above the Chinese national



average. For the 11 years from 1993–2003 the average annual incoming FDI/GDP ratio was 13% for Guangdong and 11% for Fujian. Other open coastal areas were only a step behind Guangdong: Inflows to Shanghai averaged 9% of GDP, and those to Jiangsu and Beijing averaged 7%. As noted by Naughton (2007), these inflows were sufficiently large to transform these regional economies. The contractual forms in which FDI is embodied in China have evolved steadily toward modes that permit the foreign investor a higher level of control. In the early 1980s, FDI was dominated by contractual joint ventures (JVs) and joint development projects. After the mid– 1980s, China began to strongly encourage the use of equity joint ventures (EJVs), which became the dominant mode of investment. As China evolved toward a market economy, the share of FDI in the form of wholly owned subsidiaries of foreign companies has climbed steadily, and in 2005 it accounted for exactly two-thirds of total realized FDI inflows. Foreign-invested enterprises (FIEs) play a large role in China's economy, accounting for 27% of value-added production, 4.1% of national tax revenue, more than 58% of foreign trade in 2005, and 88% of high-technology exports, nearly all under Export Processing arrangements. Companies from 190 countries and regions have invested in China, including 450 of the world's Fortune 500 companies. By the end of 2005, FIEs in China employed more than 24 million workers. Manufacturing accounted for 63% of registered foreign capital at the end of 2005. To a large extent, this emphasis is explainable in terms of the restrictions that China has maintained on foreign entry into the most important service sectors (Naughton, 2007). While large proportions of FDI inflows in all developing countries typically go to wholesale and retail trade, transport and telecommunications and finance, wholesale and retail trade, they are clear underperformers in China. Naughton (2007) notes that these three sectors together account for 27% of world developing-country inflows (including China) but only 4% of inflows into China itself. In China, by contrast, incoming FDI in the service sector is highly concentrated in real estate, specifically in property development. This sector accounted for 11% of total investment in 2005. The real estate industry has indeed become a hot spot for FDI. FDI in real estate could be as high as \$9 billion (UNCTAD, 2007). According to SAFE estimates, FDI now accounts for 15% of China's real estate market. The high tech sector has just begun to catch up and cross border M&A barely took form. In these areas, there is still a large gap between China and developed countries. It seems nevertheless that FDI in China's manufacturing sector is shifting towards more advanced technologies. The number of foreign-invested R&D centers has risen to 750 in China by the end of 2005, with at least 107 set between October 2004 and September 2005 (Locomonitor, 2005). Examples in the automotive industry are numerous and include Nissan Motor, Toyota Motor, Honda Motor, Hyundai and DaimlerChrysler.

### **4.3.2 Factors affecting China inward FDI**

Economists usually agree that FDI flow to countries with stable macroeconomic environment, commitment to market reforms, and other favorable conditions such as high productivity and low costs of labor, good infrastructure, etc... The literature on FDI determinants is very extensive and there has been a fair amount of work specifically on the determinants of FDI inflows into China. A primary source of information on the motivations behind investment by Multinational Corporations (MNCs) in China comes from studies based on interviews and questionnaires (Grub et al., 1990) or on bilateral FDI flows to uncover difference in terms of motives across source countries. Analyses from the US-China Business Council and from UBS AG estimate that 75% of Western and Japanese MNCs are in China to sell to the domestic market. Export back to their national market seems to be a feature of Hong Kong, South Korean, and Taiwan firms. Numerous studies have relied on province-level data to investigate the determinants of Inward FDI into China through the analysis of the locational choice of FDI within China. While this piece of research ignores the characteristics of home countries and foreign companies that decide to invest in China, it sheds light on the important pull factors behind FDI in China. One of the main provincial characteristic attracting FDI has been found to be its market size and growth, which have been measured by provincial GDP, GDP growth, per capital income, and population. All studies have found support for market-seeking FDI motive in China (Cheng and Kwan, 2000; Coughlin and Segev, 2000; Gong, 1995; Sun et al., 2002; Wei and Liu, 2001; Zhang, 2001). An equally important factor in attracting FDI has been low labor costs. Cheng and Kwan (2000), Coughlin and Segev (2000), Sun et al. (2002) and Wei and Liu (2001) find that higher real average wages have a negative impact on FDI flows. At the same time labor quality has been shown to be also very important in most studies (with the exception of Cheng and Kwan (2000)). The proxies for labor qualities have varied throughout the studies: number of research engineers, scientists and technicians as a percent of the total employees (Sun et al., 2002; Wei and Liu, 2001), percent of population with primary, junior secondary, and senior secondary school education (Cheng and Kwan, 2000), overall labor productivity (Coughlin and Segev, 2000). Another factor that plays an important role is infrastructure development. To measure this impact the most often used proxies are railways and highways per km<sup>2</sup> (Sun et al., 2002; Berthélemy and Démurger, 2000; Zhang, 2001; Cheng and Kwan, 2000), but other variables, such as GDP per km<sup>2</sup>, staff and workers in airway transportation per thousand population (Coughlin and Segev, 2000), freight-handling capacity by seaport, postal and telecommunication values (Gong, 1995) were used as well. All these variables (with the exception of Coughlin and Segev, 2000) have proved to be significant determinants of provincial FDI. Fung et al. (2005) however find empirically that soft infrastructure in the form of more

transparent institutions and deeper reforms outperforms hard infrastructure in the form of more highways and railroads as a determinant of FDI into Chinese provinces. Most recent studies control for agglomeration effects, which stem from positive spillovers from investors already producing in this area. This gives rise to economies of scale and positive externalities, including knowledge spillovers, specialized labor and intermediate inputs. Thus high FDI today implies high FDI tomorrow. Such high persistence over time is reinforced by the nature of FDI, which involve high sunk costs and is often accompanied by physical investment that is irreversible during short run (Kinoshita and Campos, 2004). The methodologies to test the hypothesis of agglomeration effect vary from one paper to another. Zhang (2001) and Sun et al. (2002) proxy agglomeration effect by a level of manufacturing output and level of foreign investment, respectively. Wei and Liu (2001) introduce the ratio of population to the land area. Coughlin and Segev (2000) incorporate spatial dependence into their regression analysis, which increases validity of the estimated coefficients when compared to ordinary least squares. The degree of openness, measured by trade to GDP ratio, has also been taken into account. Sun et al. (2002) state that the impact of this factor is ambiguous, since a more open economy attracts FDI because foreign investors are already familiar with the host economy, but it also increases the competition. However, most papers find that the first effect is stronger (Sun et al., 2002; Zhang, 2001; Berthélemy and Démurger, 2000; Wei and Liu, 2001). In order to control for incentives that were introduced by Chinese authorities to attract FDI, some studies included variables that control for Special Economic Zones, Open Coastal Cities, Economic and Technological Development Zones, and Open Coastal Areas (Cheng and Kwan, 2000; Gong, 1995; Zhang, 2001; Wei and Liu, 2001). Naturally, these variables have yielded significantly positive coefficients. Huang (2003) claims that the above-mentioned factors do not correctly explain FDI flows to Chinese provinces. He formulates a “demand perspective” on FDI, which stresses that China’s lagging internal reforms contributed to the fantastic growth of FDI in China during the 1990s. He argues that the large inflow of FDI is not only the consequence of good policies, but also results from certain distortions in the Chinese banking market and in state investment policies. Two institutional features are at work. First, Chinese private companies are often discriminated in terms of property rights protection and market opportunities in comparison to state or foreign enterprises. Despite the large size of the banking sector, many private enterprises are excluded from credit market, because lending of state banks is determined by policy reasons, rather than by commercial motives. Such uneven playing field motivates private entrepreneurs to look for a foreign investor. The second reason for high FDI in China is the participation of foreign investors in the privatization process of state-owned enterprises. Very often, public enterprises that are privatized possess good technology, human capital, extensive distribution network and access to

finance. However, due to repeated interventions of state authorities into investment process and other types of mismanagement, they are unprofitable and have to be privatized. As for the choice of potential buyers, private enterprises are again discriminated and state bureaucrats favor foreign owners over Chinese private ones. Havrylchyk and Poncet (2007) introduce, beside traditional determinants, proxies of the restricted access to external funding by private enterprises and of state interference related mismanagement of state enterprises to explain the cumulative stock of FDI across China. They find empirical support for these two mechanisms: (1) Private enterprises are forced to look for a foreign investor in order to escape constraints imposed by the state dominated banking sector; and (2) Foreign investors acquire SOEs if there are frequent intervention by state bureaucrats into the investments decisions. They conclude that further state's disengagement from credit allocation and investment decisions should diminish the demand for FDI in China and set it free for more efficient use in other regions.

#### **4.3.3 Main countries of origin of investment**

*Source countries* – While the number of FDI source countries in China is quite large, a handful countries account for the sums invested. Hong Kong comes first as a single investor and the newly industrialized economies (NIEs) have been the largest investors as a group. Four ASEAN countries (Thailand, Philippines, Malaysia, Indonesia) have substantially increased their presence in China since the early 1990s. Among the developed countries, Japan and the United States have been the most important investors in China. The other developed countries have made rather small amounts of investment in China, even though they have shown an increasing interest in China in recent years.

## **4.4 INDIA**

Spread over three million square kilometres and located entirely in the northern hemisphere, India is the seventh largest country in the world in terms of geographical size. India's neighbours are Bangladesh and Myanmar in the east; Buthan, China and Nepal in the north; Pakistan in the west, and Sri Lanka in the south. Moreover is the largest democracy.

### **4.4.1 INDIA LAND OF OPPORTUNITIES**

India has been a favored destination for investment in the light of its large domestic consumption-based economy, favorable demographics, skilled workforce and the continuing focus on emerging markets. Over the past decade, India has registered an impressive growth performance on the strength of far-reaching structural reforms. The country's GDP grew by 7.9% for the 10 year period ending 2012–13, despite the global economic meltdown of recent years. India's economy has strong fundamentals and is host to several eminent global corporate giants that are leaders in their respective fields. According to UNCTAD's World Investment Prospects Survey, is the third-most attractive destination for FDI(after China and the US) in the world. Moreover has a robust, transparent and stable financial market, which has gradually evolved from a highly controlled system to a liberalized one. India has systematically evolved from a closed-door economy to an open one, since the beginning of economic reforms in the country in 1991. These reforms have had a far-reaching impact and have helped India substantially realize its significant growth potential. Currently, the Indian economy is characterized by the Government's liberalized foreign investment and trade policy, with a significant role being played by deregulation and the contribution of the private sector. The country has developed into a trillion-dollar economy with a largely self-sufficient agricultural sector, a diversified industrial base and a stable financial and services sector.

### **4.4.2 FDI INDIA**

Foreign direct investment (FDI) in India has played an important role in the development of the Indian economy. FDI in India has in a lot of ways enabled India to achieve a certain degree of financial stability, growth and development. This money has allowed India to focus on the areas that needed a boost and economic attention, and address the various problems that continue to challenge the country. India has continually sought to attract FDI from the world's major investors. In 1998 and 1999, the Indian national government announced a number of reforms designed to encourage and promote a favorable business environment for investors. FDI's are permitted through financial collaborations, through private equity or preferential allotments, by way of capital markets through euro issues, and in joint ventures. FDI is not permitted in the arms, nuclear, railway, coal or

mining industries. A number of projects have been implemented in areas such as electricity generation, distribution and transmission, as well as the development of roads and highways, with opportunities for foreign investors. The Indian national government also granted permission for FDI to provide up to 100% of the financing required for the construction of bridges and tunnels, but with a limit on foreign equity of INR 1,500 crores, approximately \$352.5 million. Currently, FDI is allowed in financial services, including the growing credit card business. These also include the non-banking financial services sector. In 2007, India received \$34 billion in FDI, a huge growth compared to the previous years, but significantly less than the \$134 billion that flowed into China. Physical infrastructure is the biggest hurdle that India currently faces, to the extent that regional differences in infrastructure concentrates FDI to only a few specific regions. While many of the issues that plague India in the aspects of telecommunications, highways and ports have been identified and remedied, the slow development and improvement of railways, water and sanitation continue to deter major investors. Federal legislation is another perverse impediment for India. Local authorities in India are not part of the approval process and the large bureaucratic structure of the central government is often perceived as a breeding ground for corruption. Foreign investment is seen as a slow and inefficient way of doing business, especially in a paperwork system that is shrouded in red tape. In FDI equity investments Mauritius tops the list of first ten investing countries followed by US, UK, Singapore, Netherlands, Japan, Germany, France, Cyprus and Switzerland. Between April 2000 and July 2008 FDI inflows from Mauritius stood at \$ 30.18 billion followed by \$5.80 billion from Singapore; \$ 5.47 billion from the US; \$ 4.83 billion from the UK; \$ 3.12 billion from the Netherlands; \$ 2.26 billion from Japan; \$1.83 billion from Germany; \$ 1.41 billion from Cyprus; and \$1.02 billion from France.

#### **4.4.2.1 Policies and Procedures of India FDI**

The initial policy stimulus to foreign direct investment in India came in July 1991 when the new industrial policy provided, inter alia, automatic route approval for projects with foreign equity participation up to 51 percent in high priority areas. In recent years, the government has initiated the second generation reforms under which measures have been taken to further facilitate and broaden the base of FDI in India. The policy of FDI allows freedom of location, choice of technology repatriation of capital and dividends. The rate at which FDI inflow has grown during the post-liberalization period is a clear indication that India is a fast emerging as an attractive destination for

overseas investors. As part of the economic reforms program, policy and procedures governing foreign investment and technology transfer have been significantly simplified and streamlined. Today FDI is allowed in all sectors including the service sector except in cases where there are sectoral ceilings.

#### **4.4.2.2 India as an Investment Destination**

FDI is seen as a means to supplement domestic investment for achieving a higher level of economic growth and development. FDI benefits domestic industry as well as the Indian consumers by providing opportunities for technological upgradation, access to global managerial skills and practices, optimal utilization of human and natural resources, making Indian industry internationally competitive, opening up export markets, providing backward forward linkages and access to international quality goods and services. FDI policy has been constantly reviewed and necessary steps have been taken to make India a most favourable destination for FDI.

There are several good reasons for investing in India:

- Third largest reservoir of skilled manpower in the world.
- Large and diversified infrastructure spread across the country.
- Abundance of natural resources and self-efficiency in agriculture.
- Package of fiscal incentives for foreign investors.
- Large and rapidly growing consumer market.
- Democratic government with independent judiciary.
- English as the preferred business language.

- Developed commercial banking network of over 63000 branches supported by a number of National and State level financial institutions.
- Vibrant capital market consisting of 22 stock exchanges with over 9400 listed companies.
- Congenial foreign investment environment that provides freedom of entry, investment, location, choice of technology, import and export, and 11. Easy access to markets of Bangladesh, Bhutan, Maldives, Nepal, Pakistan and Sri Lanka.

#### **4.4.2.3 Factor affecting India FDI**

The factors that can narrow the gap between FDI approvals and actual foreign direct investment inflows and indeed make India a preferred destination for global capital are:

1. Availability of infrastructure in all areas i.e. transports hospitality, telecom, power, etc.
2. Transparency of processes, policies and decision making and reduction of government decision making lead time.
3. Stability of policies i.e. entry, exit, labour laws, etc. over a definite time horizon so that definite plans can be made.
4. Acceptance of International Standards including accounting standards.
5. Capital account convertibility so that all capital and payments can flow easily in and out of the economy.
6. Simplification of the regulatory framework in general and tax laws.
7. Improvement in bandwidth for internet and data communication.
8. Improvement in the enforcement of intellectual property rights.
9. Implementation of the WTO agreement full.

All investments foreign and domestic are made under the expectation of future profits. The economy benefits if economy policy fosters competition, creates a well-functioning modern regulatory system and discourages artificial monopolies created by the government through entry barriers. The future policies should be designed in the light of the above observations. The most important initiatives that need attention are:

1. Empowering the State Governments with regard to FDI



2. Developing fast track clearance system for legal disputes.
3. Changing the mind set of bureaucracy through HR practices.
4. Developing basic infrastructure.<sup>5</sup>
5. Improving India's image as an investment destination

## **4.5 BRIC COUNTRIES: DRIVERS OF ECONOMIC GROWTH**

### **4.5.1 Brazilian drivers**

The expansion that the Brazilian economy has displayed and is likely to exhibit in the future is driven by several different growth factors:

#### *Level of welfare in the home market*

One of the key drivers of the growth of Brazil's economy is the level of welfare of the home market. Brazil has a relatively large home market with a population of almost 200 million people and the overall welfare of the population is strongly increasing. The World Bank now classifies Brazil as an upper middle income country with the likes of Russia, Argentina and Mexico. In the five years leading up to 2011, Brazil's GDP per head more than doubled from USD 5,970 to 12,830 per annum. The increase in welfare is also reflected in a larger amount of middle class Brazilian families. Between 2005 and 2011 over 40 million people have entered the middle class, which comprised 54% of the population in 2011. The increasing welfare of the population has had and will have a profound effect on the Brazilian economy. The average Brazilian will increasingly demand more and higher quality goods and thus drive further economic growth. Additionally, consumers are increasingly utilizing consumer credit and long- term financing. This enables many Brazilians to buy property or to start a business.

#### *Infrastructure investments*

A second principal driver for growth is infrastructure investment. Infrastructure being a critical constraint to economic growth in Brazil, initiatives in recent years signal that the government is willing to address these structural constraints to growth. Brazil's facilitation of the World Cup 2014 and the Olympic Games of 2016 have prompted an increase of infrastructure investments with a total of BRL 33 billion allocated to the implementation of infrastructure projects.

### International demand for commodities

An additional driver for the growth of the Brazilian economy is international demand for agricultural and energy commodities. Brazil benefits from increasing international demand of commodities as it possesses a vast amount of natural resources. Its export products include soybeans, oil and steel products. With the world population currently close to 7 billion people and a further increase of 3.6 billion people forecasted towards 2050, demand for the world's commodities is likely to further increase. In addition, the anticipated increase in welfare of developing countries, and China and India in particular, will further increase the demand for Brazil's natural resources.

### Public policy

Finally, public policy is key to further growth of the economy. Going forward, a public focus on enhancing foreign investment is necessary to further induce economic growth. By introducing the first phase of the Growth Acceleration Program in 2007, Brazil's government initiated its active encouragement of foreign direct investment. The instatement of Dilma Rousseff, one of the lead responsables, as Brazil's new president in 2011, emphasizes that foreign direct investment will remain on the public agenda in the years to come.

## **4.5.2 Russian drivers**

Russia has a commodity oriented growth model, which can cause fluctuations in times of low commodity prices. The key driver to Russia's GDP growth is its vast stock of natural resources. In fact, two-thirds of Russia's stock market is dominated by the extractive industries. The abundance of natural resources continues to be Russia's most globally competitive feature. Russia accounts for some 20% of the world's gas reserves, 18% of the world's coal reserves and 5% of the world's oil reserves. Together with its hydrocarbon deposits, Russia is also home to one of the world's leading mineral industries. From bauxite to iron ore, gold to platinum and a lot of mineral types in between, Russia ranks amongst the world's top 10 in terms of both production and reserves. For example, Russia accounts for nearly 25% of the world's diamond production by value. Another key driver of the Russian economy is the strong domestic demand. From 1998 onwards, the consumer boom in Russia was the result of nearly eight years of economic prosperity and growth in credit facilities. This resulted in a doubling of real disposable incomes and the emergence of a middle-class, with growth averaging over 6.5% a year. This increase is expected to continue in the coming years. Driven by the booming consumer market, consumer-related sectors have been responsible for a

large share of Russia's economic growth. Although domestic fixed investment suffered a decrease in 2011-2012, investments are likely to pick up ahead of the 2014 Winter Olympics in Sochi. As Russia is hosting another major sport event, the 2018 FIFA World Cup, fixed investments are likely to enjoy an additional increase in the near future. Investments will go towards the host cities of the sport events, including Sochi, Rostov-On-Don, Nizhny Novgorod and Kazan. Other projects that may stimulate fixed investment growth include: the Skolkovo Innovation Hub; Russia's aspirations for Moscow to become an international financial center; and Russia's railways modernization program.

### **4.5.3 Chinese drivers**

#### *Size and growth of the Chinese economy and prospects*

Market-oriented FDI aims to set up enterprises to supply goods and services to the local market. This kind of FDI may be undertaken to exploit new markets. Apart from the traditional reason for circumventing tariff barriers, the market size, prospects for market growth, and the degree of development of host countries are very important location factors for market-oriented FDI. The general implication is that host countries with larger market size, faster economic growth and higher degree of economic development will provide more and better opportunities for these industries to exploit their ownership advantages and, therefore, will attract more market-oriented FDI. Even for export-oriented FDI, the market size of host countries is important because larger economies can provide larger economies of scale and spill-over effects. China has a population of 1.2 billion, with a vast potential for consumption. Investors regard the Chinese market as the last enormous market that has not been developed in the whole world. Over the past decades or more, the scale of China's economic reconstruction has been expanding increasingly, with the purchasing power of the people strengthening rapidly and markets becoming increasingly brisk. Although China's per capita GDP is still very low, its rapid economic growth and continuously increased purchasing power has made China attractive to market oriented FDI, such as in the fields of basic chemicals, drinks, household electrical appliances, automobiles, electronics, pharmaceutical industries. The economic growth rate in China has slowed down since 1996 due to the adjustment of overall growth at the beginning of the 90s. In recent years, the economic growth rate still remains at around 7 per cent. Considering such important factors as the level of economic development, the potential for technology advancement and the effect of restructuring, it is quite possible for China to keep economic growth at a rate of 6-7 per cent in the next 10 years. If this is the case, China will remain a fast expanding huge market for foreign and domestic investors. There exists, however, a downside factor: the rapid increase in the production capability and the slow growth of per capita income and consumption

have resulted in periodical saturation in China. The phenomenon of supply exceeding demand exists in most industries but in China it has been severe in certain sectors or activities.

#### human resource endowments – cost and productivity of labour

One of the most important factors to attract FDI in China is the advantage in competitive production factors – labour force, land and natural resources. The degree of development of host countries is often considered one of the most important determinants of FDI flows because it is positively related to domestic entrepreneurship, education level, and local infrastructure. With the world's largest population, China has rich resources of labour, with average salaries of workers remaining at a relatively low level. China has paid great attention to the education of its people such as nine-year universal compulsory education. Therefore, Chinese labourers are of relatively high quality and there are comparatively numerous technical personnel. Some fields, however, are in short supply – skilled managers, engineers and technicians. It is often argued that the labour cost in determining FDI flows should be the efficiency wage rate, which is adjusted in line with productivity rather than the “absolute wage”, especially if FDI is export-oriented. In terms of the efficiency wage rate, China still has good advantages as confirmed by empirical research. China is also very rich in energy reserve. Chinese production of oil, its predominant fuel, is among the highest in the world (Saudi Arabia being the main producer) in spite of the fact that China imports it owing to high consumption. China is the largest producer of coal, roughly one third of the world's total production and its coal industry has been troubled by a serious oversupply problem. As with coal, China's electric power supply is also experiencing an oversupply problem. Other major natural resources such as land, iron and other minerals are economically available. These factor cost advantages have been experiencing some erosion however. With the globalization of the world economy and the liberalization of international trade and the giant strides in technological innovation, the advantage of a cheap labour force has become less important for foreign investors. China's disadvantages in terms of technology gaps and lack of labour qualification in some areas will also take some time to improve.

#### Physical, financial and technological infrastructure

It can be presumed that the availability of physical infrastructure affects the decision of selecting the investment place: The more highways, railways and interior transport waterways are adjusted according to the size of host province, the more FDI inflows. Another important variable is the level of telecommunication services. Higher levels of telecommunications services will save time and reduce the costs of communication and information gathering, thus facilitating business activities.

Research confirms the assumption supported by other empirical studies that the provinces with more developed infrastructure are likely to succeed in attracting FDI. The same inference can be made for the technological infrastructure. In recent years, pushed by the market competition, the upgrading speed of China's industrial structure has been accelerated. Especially, the development of high-tech has been greatly speeded up. Currently, China and its provinces have elaborated various five-year plans and the development of high-tech industry has been a top priority. The current level of the technology of China and its provinces functions in order to attract FDI and induce the technology transfer.

#### *Openness to international trade and access to international markets*

China has adopted the so-called "export promotion development strategy" which was proven to be a remarkable success in the Asian NIEs. Together with export promotion policy, China has implemented economic reforms and open door policies and made efforts to promote trade by concluding several bilateral trade arrangements and adopted unilateral actions. There has been substantial progress in reducing tariff barriers in the 1990s: the average tariff rate on imports declined from 42.9 per cent in 1992 to 23.6 per cent in 1996 and to 17.6 per cent in 1997. China has also formulated and implemented a series of preferential policies to encourage international trade. Duty exemptions for intermediate products used in the production of exports have been particularly important in boosting China's foreign trade.

However, there remain several barriers to free trade including administrative enforcement and non-tariff measures. The local content requirement and the export proportion requirement may inversely act to promote FDI. The import substitution policy may function to promote FDI in the short term but further competition, which can be created from the increase in import, may positively act to promote new additive investment in current investors for introducing high-technology production. Also, Chinese further acceptance of multilateral investment arrangement is necessary to promote FDI into China. For example, China still does not allow wholly foreign-owned companies to trade in many areas even though it has started to liberalize it. China's entry into the WTO will be conducive to the settlement of the problems. If foreign invested companies are permitted to establish their own retail trade, that would help them to expand the scope of their investment and increase their market portion. In terms of accessibility to international markets, China has also some merit. Export-oriented FDI aims to use particular and specific resources at a lower real cost in foreign countries and then to export the output produced to the home country or to third countries. Even though the most important location factors for export-oriented FDI are resource endowments, research found that China has a relatively attractive and strategic geographic position in that its territory is huge and offers access to other Asian countries and the Americas.

### Investment protection and promotion

Investment protection – There have been no cases of expropriation of foreign investment since China opened up to the outside world in 1979. In fact, the Joint Venture Law was amended to forbid nationalization, except under special circumstances. While most cases have been resolved through negotiation or mediation, there remain some possibilities that local authorities can be influential sometimes. The Contract law, which came into effect in 1999, also functions to protect FDI and will have a major impact on how Chinese and foreign companies meet their obligations in the China market. The law's purpose is to protect the legal rights of all parties while allowing them to determine their own remedies for dispute resolution and breach of contract and to promote foreign investment. While the law is viewed as a step in the right direction with regard to transparency and procedure, the real enforcement still has significant shortfalls.

Investment promotion – Deng's tour of China's southern coastal areas and SEZs marked an epoch for Chinese FDI policy. His visit set the scene for China's move away from the uneven regional priority toward nation-wide implementation of open policies for FDI. The Chinese government then adopted and implemented a series of new policies and regulations to encourage FDI inflows. Also the Chinese government has started to introduce various investment promotion policies and expanded thereafter. The Special Economic Zones of Shenzhen, Shantou, Zhuhai, Xiamen and Hainan, 14 coastal cities, dozens of development zones and designated inland cities all promote investment with unique packages of tax incentives. The Chinese authorities have also established a number of free ports and bonded zones. Sometimes, Foreign investors obtain incentives and benefits after direct negotiation with the relevant government authorities since some of these may not be conferred automatically. The incentives available include significant reductions in national and local income taxes, land fees, import and export duties, and priority treatment in obtaining basic infrastructure services. The Chinese authorities have also established special preferences for projects involving high-tech and export-oriented investments. Priority sectors include transportation, communications, energy, metallurgy, construction materials, machinery, chemicals, pharmaceuticals, medical equipment, environmental protection and electronics. Tax incentives, which are among the most outstanding investment promotion policies, were also made available for FDI. From 1980 to 1993 China used extensively a wide range of tax incentives, including income tax exemption and reduction, tariff-free for imported equipment and construction materials. Although in 1994 the unified taxation system applying both domestic and FDI firms was introduced, a five-year tax refund scheme was granted for FDI firms, and tariff-free treatment was

extended. In addition, preferential treatments were granted in some specific sectors and industries. Currently, the targeted economic sectors and industries in which FDI is encouraged include agriculture, resource exploitation, infrastructure, export-oriented and high-technology industries. To encourage reinvestment of profits, China has been offering FDI a refund of 40 per cent of taxes paid on its share of income, if the profit is reinvested in China for at least five years. Where profits are reinvested in high-technology or export-oriented enterprises, the foreign investor may receive a full refund. Many foreign companies invested in China have adopted a strategic plan, which requires reinvestment of profits for growth and expansion. While the Chinese government continues the VAT rebate system in an effort to maintain the profit margins of exporters in the midst of the Asian economic slump, State Taxation Administration plans to eventually phase out the rebates to modernize the current two-tier tax system for domestic and foreign enterprises. Discrepancies between central government, provincial and local tax regulations may also hamper foreign investment, particularly in remote and impoverished areas. The State Taxation Administration has also been working on unification of the two enterprise income tax laws for foreign and domestic enterprises. Administrative procedures such as collecting, assessing and reporting tax have been improved. It has been argued earlier that preferential FDI policies by eastern regions might be one important factor to bring their overwhelming performance of attracting FDI so far. It appears that favourable FDI policy by each regional authority or the central government, China, should attract more FDI into the regions of China compared with other regions or countries. As one of the policies to further attract FDI into China, it is often suggested that China open new investment sectors. With the saturation of traditional industry, new momentum should be made by further opening the priority sectors such as automobile, chemicals, electronics and agriculture, and by allowing FDI in other areas such as finance, and other service sectors which are areas which can create a new wave of FDI in China.

#### **4.5.4 Indian drivers**

India has emerged as a strong economy over the years. The recent global financial and economic crisis had an impact on India's economic growth momentum during FY09. However, the economy has been remarkably resilient against shocks such as turmoil in the global and domestic financial markets, severe drought conditions and hardening international crude oil prices, sustaining its GDP growth. It has managed to escape relatively unscathed from the global economic turmoil owing to strong fundamentals, which would continue to drive its growth. Thus, it is important to undertake integrated efforts to further strengthen these fundamentals and fulfill the aspiration of achieving a strong growth in future. Strong growth can only be achieved through realisation of full-growth

potential of some key growth areas. This section seeks to identify potential growth drivers that could stimulate growth and drive the Indian economy on a high and sustainable growth path. In this endeavour we begin by identifying substantial investments in physical, growth drivers social and agricultural infrastructure as the key growth drivers which will enable the economy to achieve 'inclusive growth'. Although we expect these three factors to contribute significantly in India's growth story during the current decade (2011-20), the role of other factors (such as technological progress, improvement in productivity and India's young demography, etc) should not be underrated. Further, Government of India (GoI) and the private sector need to undertake necessary integrated efforts to strengthen these growth drivers and achieve high GDP growth. The following section elucidates future growth drivers of India's economic growth:

### Investment in physical infrastructure

Sustained increase in infrastructure is expected to be one of the crucial factors for sustaining strong growth during the current decade. Significant investment in physical infrastructure will also lead to employment generation, increased production efficiency, reduction in cost of doing business and improved standard of living. According to D&B's estimates, infrastructure investment (as measured by Gross Fixed Capital Formation) is expected to surge to 12.1% of GDP by FY20 from 7.0% of GDP in FY11. Rising demand for infrastructure facilities, given the rapid growth in urbanisation, bulging of the middle class and an increasing working-age population, would engender substantial increase in infrastructure investments during the current decade. Apart from development of infrastructure facilities in existing cities/towns, increased focus is expected on infrastructure development in new townships/rural areas. Regional-urban development plans will be made to identify new growth corridors. D&B expects a substantial rise in rural infrastructure development, which will provide further impetus to economic growth in rural areas, in turn resulting in significant reduction in poverty. Increased investment in rural infrastructure will benefit the rural population through higher income, rise in employment opportunities, and lower cost of basic goods due to improvement in transportation facilities. Nonetheless, improvement in rural infrastructure will need to be properly targeted to benefit the rural poor.

### Electricity

In view of the rapid growth in urbanization and industrialization, total demand for power is expected to increase substantially during the current decade. This will require substantial increase in the power generation capacity and in turn infrastructure investments in this segment. As per Investment Commission of India, more than 78,000 MW of additional power generation capacity is



being planned during the current decade including set up of 9 Ultra Mega Power Projects with power generation capacity of 4,000 MW each. Considerable investments are also expected in the transmission & distribution network (including an additional 60,000 circuit km of transmission network expected by 2012) during the same period. Substantial capacity addition in generation & transmission of electricity will require significant investments. We expect infrastructure investment in the electricity sector to grow at CAGR of around 20.0% during FY11-FY20 and it will account for 4.3% of GDP FY20. Moreover, permission for 100% FDI for generation, transmission & distribution of electricity coupled with incentives such as income tax holiday for a block of 10 years in the first 15 years of operation, waiver of capital goods and import duties on mega power projects are likely to attract private investment in this segment.

### Oil & Gas

Demand for oil is expected to increase substantially by 2020, primarily driven by the transportation and industrial sectors. On the other hand, the growing requirement of gas for the domestic power and fertilizer sectors is expected to raise demand for gas during the current decade. Domestic production of oil & gas is expected to increase considerably by 2020, given the recent exploration and development efforts underway in the country. However, it might not be able to meet the entire requirement in the country, which implies need for a huge amount of oil & gas imports. Development of technologies enabling efficient use of fossil fuels coupled with use of renewable energy sources could help in filling the demand-supply gap for oil & gas. GoI has already started taking initiatives to encourage exploration of alternate fuel sources such as coal bed methane (CBM), gas hydrates, hydrogen fuel cell, and blending of bio-fuels to reduce the country's dependence on imported fuel.

### Road

With a growing population in India, demand for road transport would increase further by 2020. While state highways are expected to link most districts in the country, all-weather rural roads are expected to provide access to the furthest outlying villages. Moreover, construction of the golden quadrilateral, Delhi-Mumbai-Chennai-Kolkata-Delhi, is expected to help link these metros and other northern, southern, western and eastern cities by 2020. A massive 10-year program (2005-15) has been implemented by National Highway Development Project (NHDP) in a phased manner with an investment of 2356.90 bn including the completion of the works under NHDP Phase I and II, up gradation of 12,109 km of national highways on Build, Operate and Transfer (BOT) basis in Phase III, widening of 20,000 km of national highways to two lanes with paved shoulders in NHDP

Phase-IV, six-laning of 6,500 km length of selected national highways in Phase V, development of 1,000 km of expressways under NHDP Phase-VI and construction of 700 km of ring roads in major towns and bypasses and construction of other standalone structures giving a boost to the development of roadways. This, along with Ministry of Road Transport and Highway's decision to accelerate implementation of National Highways to achieve a completion rate of 20 kms of highways/day will require substantial investment in road infrastructure. This translates to a 35,000 km at the rate of 7,000 km per year during 2009-14. Further, a larger amount of population is expected to move toward 'own car travel'. However, substantial investments for creation and/or improvement in mass/public transport systems could help reduce the use of vehicles on roads in major metro cities. Various infrastructure development projects in the transport sector will require increased amount of investments. While GoI will continue to be a major source of funds (especially for construction of rural roads), private sector participation in development and operation of transport infrastructure (especially in the urban area and inter-state highway projects) is expected to increase substantially. GoI is already making efforts to attract private investment by offering projects on Build Operate and Transfer (BOT) basis. It has taken various policy initiatives that are likely to result in increased participation of private players in road construction projects. Moreover, internal generation of resources by transport services is likely to increase by 2020.

### Education

Although literacy rates in India have increased considerably, from 18.0% in 1951 to 65.0% in 2001 and 74.0% in 2011, they are far below the UMI (upper-middle income) reference level of 95% and vary substantially among males and females as well as urban and rural regions. Nonetheless, the projected increase in per capita income, government schemes such as mid-day meals, availability of schools within habitation and incentives for attending school (like providing textbooks and uniform, etc) are expected to result in a higher enrollment ratio, especially in case of girls, and in turn help increase the literacy rates by 2020. Moreover, dropout rate at primary level are expected to decline further. Apart from primary education, higher as well as vocational education is expected to assume significance in the current decade. The Eleventh Five Year Plan which envisages large expansion in higher education by setting up 1455 new educational institutions comprising central universities, IITs, IIMs, NITs, IISERs, SPAs and Polytechnics is expected to provide further boost to higher education in India.

## Rail

Rapid urbanization along with increased domestic industrial activity is expected to accelerate growth of Indian railways during the current decade. According to the Ministry of Railways' estimates, demand for passenger and freight services would surge, which would require expansion of 25,000 kms of new lines by 2020. The Ministry of Railway has already initiated rail connectivity projects in north eastern states and Jammu & Kashmir at an estimated cost of 280 bn. With the railway network spread to the furthest regions of the country (especially in north eastern parts), rail freight traffic is expected to increase substantially during the current decade. Manufactured products would account for a larger share in bulk cargo while a larger proportion of liquids would be transported through pipelines. The development of fast inter-city rail services is expected to increase passenger train traffic by 2020. Moreover, high population density and traffic congestion problems in major metropolitan cities of India are likely to result in development of underground or flyover rail-based mass transport systems during the current decade. Apart from the various capacity expansion projects for cargo and passenger train traffic, improved customer service, comfort and safety, reduction in freight costs & tariffs, reduction of the uneconomic services, and subsidies can ensure sustained growth of railways.

## Health and sanitation

Improvement in health and sanitation facilities can be achieved through improvement in access to and utilization of health, family welfare and nutrition services with special focus on under-served and underprivileged population. It is expected that during the current decade as well, the responsibility of implementing healthcare and sanitation program will mainly lie with the state government and local bodies while financial assistance will be provided by the central government and external agencies.

## 6. Conclusion

The Foreign Direct Investment (FDI) theories can be classified broadly into two categories. One is at the macro level and the other is at the micro level. Again at the macro-level, we have capital market theory, Dynamic macroeconomic theory, FDI theories based on exchange rates, FDI theories based on economic geography, gravity approach to FDI and FDI theories based on institutional analysis. At the micro-level, we have the theories like Existence of firm specific advantages (Hymer), FDI and oligopolistic markets, Theory of internalization, and Electic FDI theory (John Dunning). Recently another type of FDI categories discussed by the economists is the development theories which combine both the micro level and macro-level FDI theories. The development theories are Life cycle theory, Japanese FDI theories and five stage theories (John Dunning).

FDI is considered to be a beneficial solution for transition countries as it enables a significant infusion of capital in order to mitigate the inherited systematic problems in the economy and society.

In the analysis of some empirical studies carried out, we realize that in the majority of studies positive effects seem to prevail, although negative effects and the possibility of neutral effects are not uncommon. This occurs either for cross-country studies or country-specific studies. However, as UNCTAD (1999) emphasizes, the results should be interpreted with caution since the variables used, particularly those concerning FDI, are far from perfect. The majority of studies use FDI flows, which underestimate the local value of MNEs' subsidiary investment (UNCTAD 1999).

As OECD (2002) report, the positive impact of FDI on host countries' economic growth does not happen automatically, being dependent on the host country's domestic conditions. The review of empirical studies tends to confirm this idea. Host countries' domestic conditions in terms of technology, human capital, degree of openness, and regulatory frameworks can influence the way FDI affects the economic growth through the determinants listed in Section 3.1. In fact, concerning the cross-country studies, we realize that only 3 studies obtain a negative (direct) impact of FDI on the host country's economic growth (Borensztein et al., 1998; Mencinger, 2003; Omran and Bolbol, 2003). However, we also realize that in Borensztein et al.'s(1998) study, the interactive term of FDI with human capital is significantly positive, evidencing that the effect of FDI on economic growth

is dependent on the level of human capital available in the host economy. Also, Omran and Bolbol's(2003) study obtained a favorable effect of FDI on growth if interacted with financial variables at a given threshold level of development (the interaction term is positive and significant). Concerning Mencinger's(2003) study, the author did not take into account interactive terms. Concerning the country-specific studies, the conclusion is similar. For instance, Berthélemy and Démurger (2000) analyzed the role played by FDI in the process of Chinese growth over the time span 1985–1996 and concluded that while the direct effect is rather small, the total impact of FDI is actually higher if we also consider the positive and significant coefficient of the interaction term between FDI and human capital. Zhang (2001b) also obtained a significantly positive coefficient of the interaction term between FDI and human capital. Additionally, Ford et al. (2008), focusing on a different country (the United States) obtained a negative direct effect of FDI on growth. Considering the interaction of FDI with human capital, the coefficients obtained are all positive and significant, suggesting that only states that contain a comparatively well-trained workforce have the capacity to take advantage of the presence of foreign technology. Vu (2008), focusing on the Vietnam case, concluded that the indirect effect of FDI on GDP through labor productivity are both positive and significant. Analyzing the impact of FDI on Malaysia economic growth, Baharumshah and Almasaied (2009) showed that interacting FDI with human capital and financial development has affected growth prospects positively. Regarding the moderating effects of openness of the economy, Kohpaiboon's(2003) results for the case of Thailand support the 'Bhagwati' hypothesis that, other things being equal, the growth impact of FDI tends to be greater under an export promotion trade regime compared to an import-substitution regime. In fact, the interactive term (between FDI and openness of the trade policy regime) is significantly different from zero and has a positive sign. Moreover, the significant and negative sign of the FDI coefficient implies the FDI inflows could have even generated a negative effect on growth performance of the Thai economy under the import-substitution regime.

To sum up, our review of empirical studies indicates that when we take into account interactive terms of FDI with human capital, openness of the economy and financial market development, that is, when considering the various channels through which FDI can affect the host country's economic growth, which are influenced by host country domestic conditions, the impact of FDI on growth is enhanced. However, the results of these studies should be read carefully since most of the studies do not take into account the possible existence of bidirectional causality between the two variables.

Herzer (2012) challenge the widespread belief that FDI generally has a positive effect on economic growth in developing countries. He examined the nature of the growth effect of FDI using panel

cointegration techniques that are specifically designed to deal with key problems plaguing previous studies of the FDI–growth nexus: omitted variables, endogeneity, cross-country heterogeneity, and neglected long-run level relationships. Employing data for 44 developing countries over the period from 1970 to 2005, it was found that the effect of FDI on economic growth in developing countries is negative, on average. However, there are large differences in the effect of FDI on economic growth across countries. More specifically, an increase in the FDI–GDP ratio is associated with a long-run decrease in GDP in about 60% of the countries, while in about 40% of the cases, an increase in the FDI share is associated with a long-run increase in GDP. In general, irrespective of the sign, the effect is small. In contrast to previous studies, the results suggest that the effectiveness of FDI does not depend primarily on per-capita income, human capital, openness, and financial market development. Instead, the results suggest that the cross-country heterogeneity in the growth effect of FDI can be explained mainly, or most directly, by cross-country differences in freedom from government intervention, freedom from business regulation, FDI volatility, and primary-exports dependence. However, there are several factors such as openness, per-capita income, human capital, property rights and freedom from corruption—that are highly correlated with the cross-country differences in these freedoms, suggesting that these factors may play an important indirect role in the FDI–growth relationship.

This finding supports the conclusion of Harrison and Rodríguez-Clare (2010), that countries do not benefit from “hard” interventions, such as tax breaks and subsidies, to attract FDI. It is also consistent with theoretical models suggesting that FDI may reduce real income in the presence of trade barriers (Brecher and Alejandro, 1977). Finally, many developing countries are still heavily dependent on primary commodity exports. Several of them, such as Mexico, Venezuela, Zambia, and Zimbabwe, have experienced long periods of stagnation, or even decline. The results suggest that the growth effect of FDI is negatively associated with primary exports dependence, which may, at least in part, explain why some developing countries experienced losses from FDI. However, a word of caution is needed. It does not follow from this conclusion that there is a negative relationship between the growth effect of FDI and natural resource abundance. Many resource-abundant countries, such as Chile, India, and Indonesia (all of which have positive coefficients on the FDI variable), have diversified their exports in order to reduce their dependence on primary product exports. Therefore, it seems unlikely that natural resource abundance per se is negatively related to the growth effect of FDI. In addition, there are large differences in the productivity of exports among primary-products exporting countries (Hausmann et al., 2007). The result that primary export dependence reduces the effectiveness of FDI might thus apply to some, but certainly not to all, countries. In conclusion, it can be said the negative effect of FDI found for many

countries need not remain negative. The results suggest that economic reforms aimed at (i) improving resource allocation by eliminating market-distorting policies, (ii) minimizing the regulatory burden on business, (iii) reducing FDI volatility by increasing political and economic stability, and (iv) removing primary export dependence by diversifying the economy can increase the likelihood that FDI will promote growth.

Based on the existent empirical literature, it is possible to create a set of potential determinant variables that influence the FDI flows and classify them into seven broad categories: Market size, Economic stability and Growth prospects, Trade openness, Currency value, Infrastructure facilities, Labour cost and Gross capital formation.

There are a variety of empirical studies addressing the relationship between FDI and the host country's economic growth which includes many countries with different levels of development, and focus on different time spans. Despite the fact that the impact of FDI on economic growth has been widely studied, Wang (2009) reports that the main conclusion to be drawn from several studies is that results are ambiguous. UNCTAD (1999) analyzed 183 studies covering 30 countries since 1980 and concluded that in the majority (55% to 75%), large positive effects were found but in the remaining, the effect found was clearly negative. OECD (2002) also reports that only 11 in the 14 studies concluded that FDI contribute positively to economic growth. In this way, our review of empirical literature will focus on more recent studies, conducted over the last 15 years.

A growing strand of the empirical literature attributes the lack of robust results to that the growth impact of FDI may depend on the characteristics of the developing country in which FDI takes place. It is argued that the host countries' capacity to absorb FDI productively is linked to their GDP per capita. Host countries with a better endowment of human capital are supposed to benefit more from FDI-induced technology transfers as spillovers from foreign affiliates to local enterprises are more likely. Openness to trade is considered important as foreign direct investors are said to increasingly pursue complex integration strategies which require the unrestricted import of intermediate goods at all stages of the production process (UNCTAD 1999). The extent to which multinational enterprises transfer modern technology and know-how to their foreign affiliates may depend on the host countries' institutional development, which captures factors such as the rule of law, the degree of corruption, the quality of public management, and the protection against property rights infringements and discretionary government interference.

And indeed, the empirical picture seems to become clearer once host-country characteristics are taken into account.

To sum up, we explored the differences between countries analyzed, since it is the factor most discussed in the literature.

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