

Abstract

F.D.I. in Emerging countries.

The principal aim of this dissertation is to analyze the impact of Foreign Direct Investment in the emerging market, especially in the BRIC countries. After the introduction I explained theoretical definition and aspects of foreign direct investment (FDI) and emerging market (EM.). 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. The investment can be Horizontal or Vertical. 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. 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.

Important is also the study of the different entry modes in a foreign market. It is possible in many different ways, including exporting, licensing and direct investment. 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 non-equity 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.

Moreover I tried to find the motivations for FDI; 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 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 know in literature as Another motivation, that does not depend on interest rate is communally know 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 arise 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 choose 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 etc...) 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.

After that I focused on the emerging markets. 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.

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.

In the third chapter I explained 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.

I 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.

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 occurs 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 (Rodriguez-Clare, 1996; 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 MNFs' 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 (Loungani and Razin, 2001; 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 MNFs 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; Ozturk, 2007).

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.

To sum-up, in the fourth chapter I studied the BRIC countries. I analyzed the reason that push the firms to invest in these countries, the different policies and procedures that characterize this market and the factors that affect the investment in the BRIC. Finally I focused on the drivers that can foster the economic growth in Brazil, India, China, Russia.

These are the BRIC countries, as they've been named by Jim O'Neill, 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:

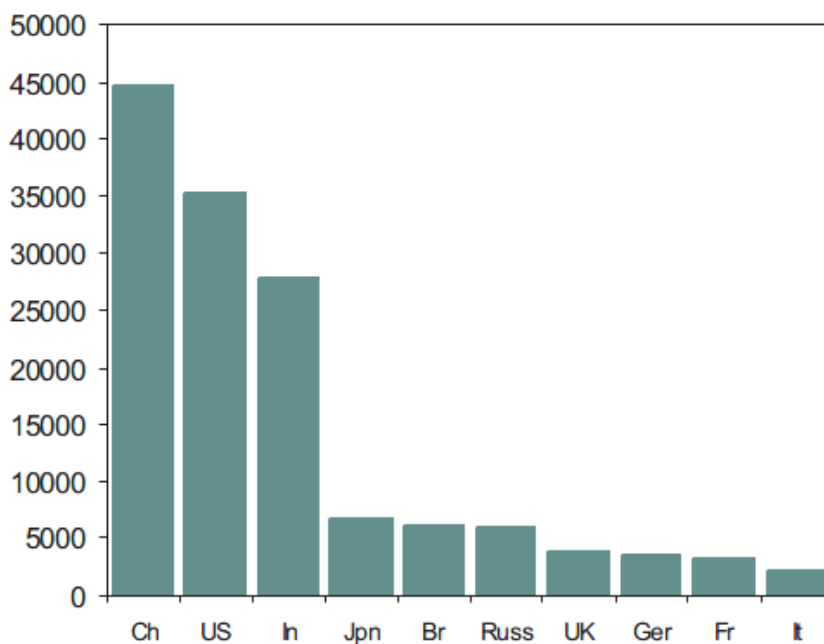


Figure 3. *Forecast rankings of the most important economies in 2050*

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:

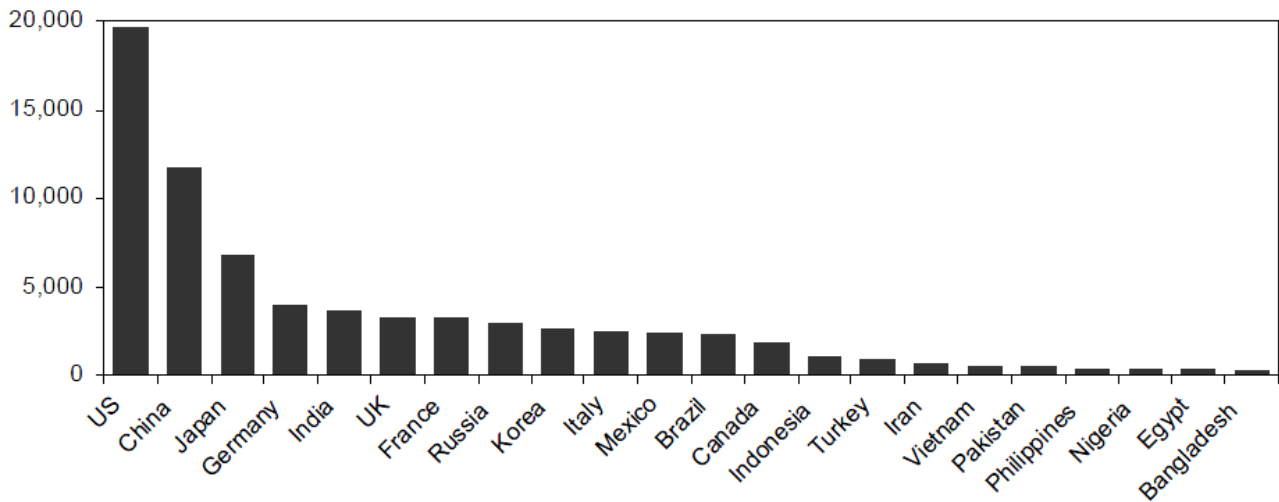


Figure 4. *The largest economies in 2025*

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

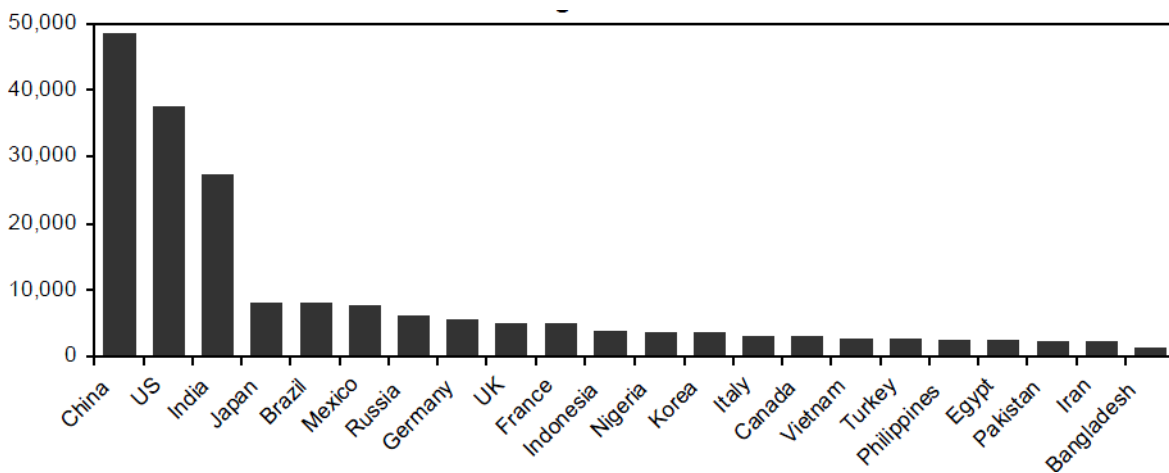


Figure 5. *The largest economies in 2050*

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).

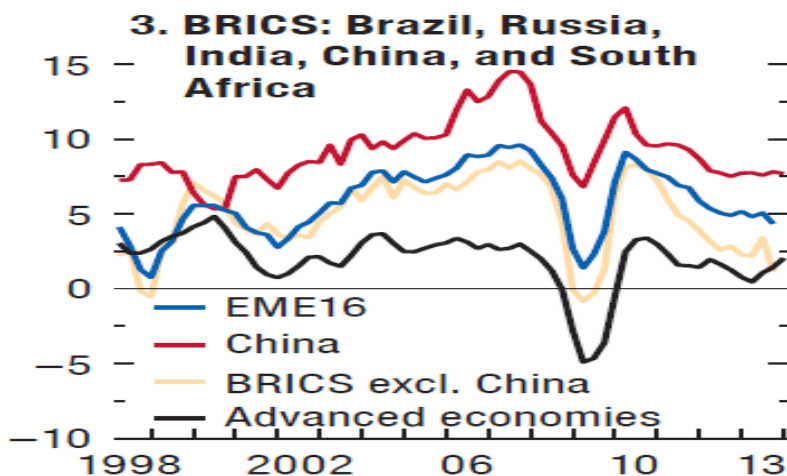


Figure 6. Evolution of the average economic growth for BRICS countries in comparison with the average of developed economies.

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.