Foreign Direct Investments: Pros and cons for the West African Economy

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Structure of the Presentations

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- ❑Role of Foreign Investment in Economic Development
- ❑Potential Negative Impacts of Foreign Investment
- ❑**Measures to make FDI Flows Beneficial**
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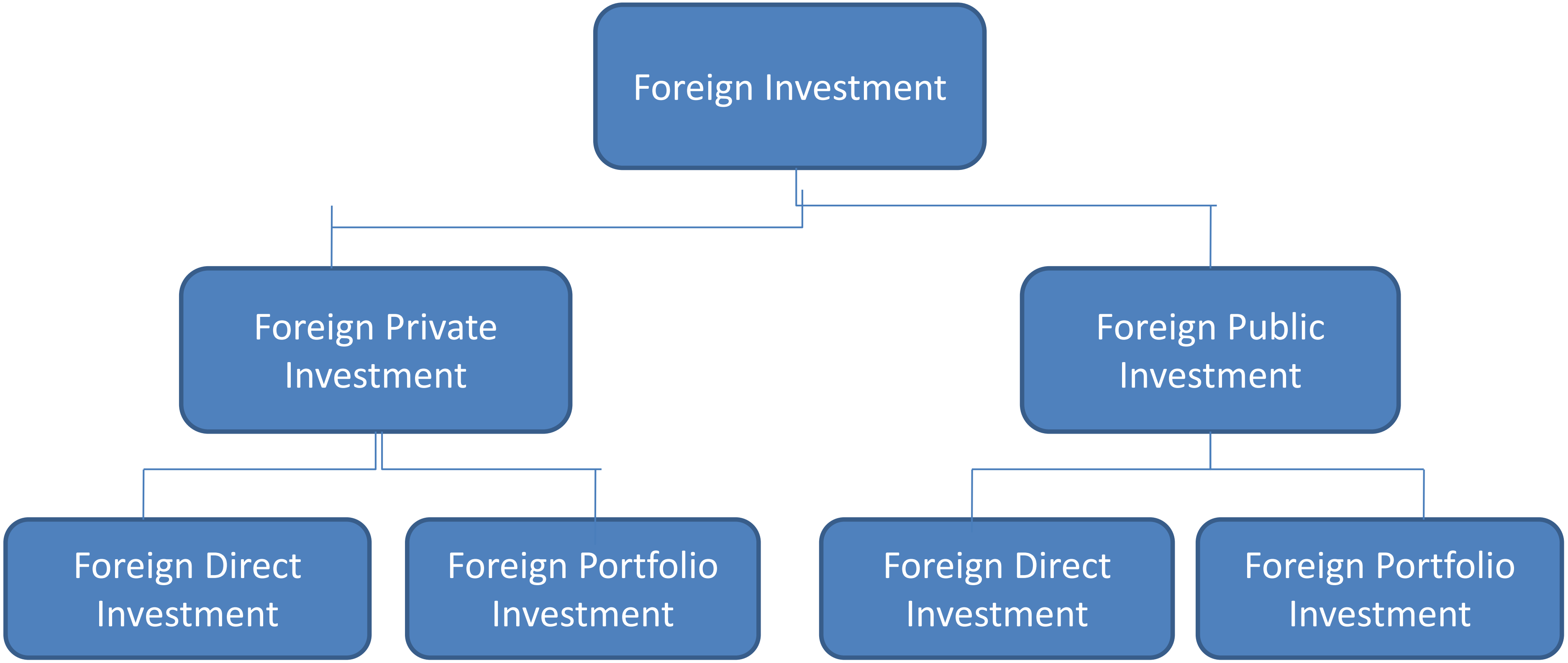
A. What is Foreign Investment?

1. Definitions and Structure

- Foreign Investment (private or public) can either be direct (i.e. FDI) or indirect (I,e foreign portfolio investment - FPI).
- FDI and FPI could be differentiated along four broad lines.
- **First**, as opposed to FPI, FDI do include transfer of financial and non-financial resources (e.g. technology and, intellectual capital).
- **Secondly**, while change in ownership usually result from FPI transferred, this is not necessarily so under FDI.
- **Thirdly,** FDI usually occur through foreign firms which equally control the deployment of the assets transferred while FPI exercise little or no control over the management of the assets transferred.
- **Lastly,** while FPI is sensitive to return on investments overseas, FDI is rather motivated by the double coincidence of the corporate objective(s) of the foreign investors as well as the desire of the recipient economies.

Figure 1: Structure of Foreign Investment



2. Differential Attributes of FDI and FPI Compared

In brief, some salient differential attributes of FPI and FDI could be compared:

- ❖ FDI is sector -and firm-specific while FPI is not;
- ❖ FDI can transfer technology as well as improve access to market while FPI can assist at strengthening capital market development in the host economies;
- ❖ FDI is less volatile to changes in domestic economic indices than FPI;
- ❖ differences in the volatilities between FDI and FPI are smaller in developed economies than in developed economies; and
- ❖ FDI flows appear more sustainable than FPI (at least based on the aftermath of the financial crisis that occurred in South East Asia between 1997 and 1999).

- Clearly, the dissimilarities and possible complementarities between FDI and FPI justify the bases that policy regimes concerning attracting and regulating them must equally differ.
- For instance, evidences from South East Asian crisis suggest that policies to attract FPI should be applied more cautiously than those towards FDI because boom-bust cycles of capital flows are more noticeable with FPI.

3. Affiliates of Foreign Direct Investment

A direct investment enterprise may be an incorporated enterprise (such as a **subsidiary** or an **associate** company) or an unincorporated **branch** enterprise.

- It is possible that any of the affiliates of FDI (i.e. subsidiary, an associate or a branch) may further own its subsidiaries, associates and branches in host economies or in the third countries and these in turn may have their own affiliates again and so on **(figure 1).**

Subsidiary Companies

A subsidiary firm is an incorporated company in the host economy in which a foreign investor owns more than 50% of its shareholding as well as voting power.

Associate Companies

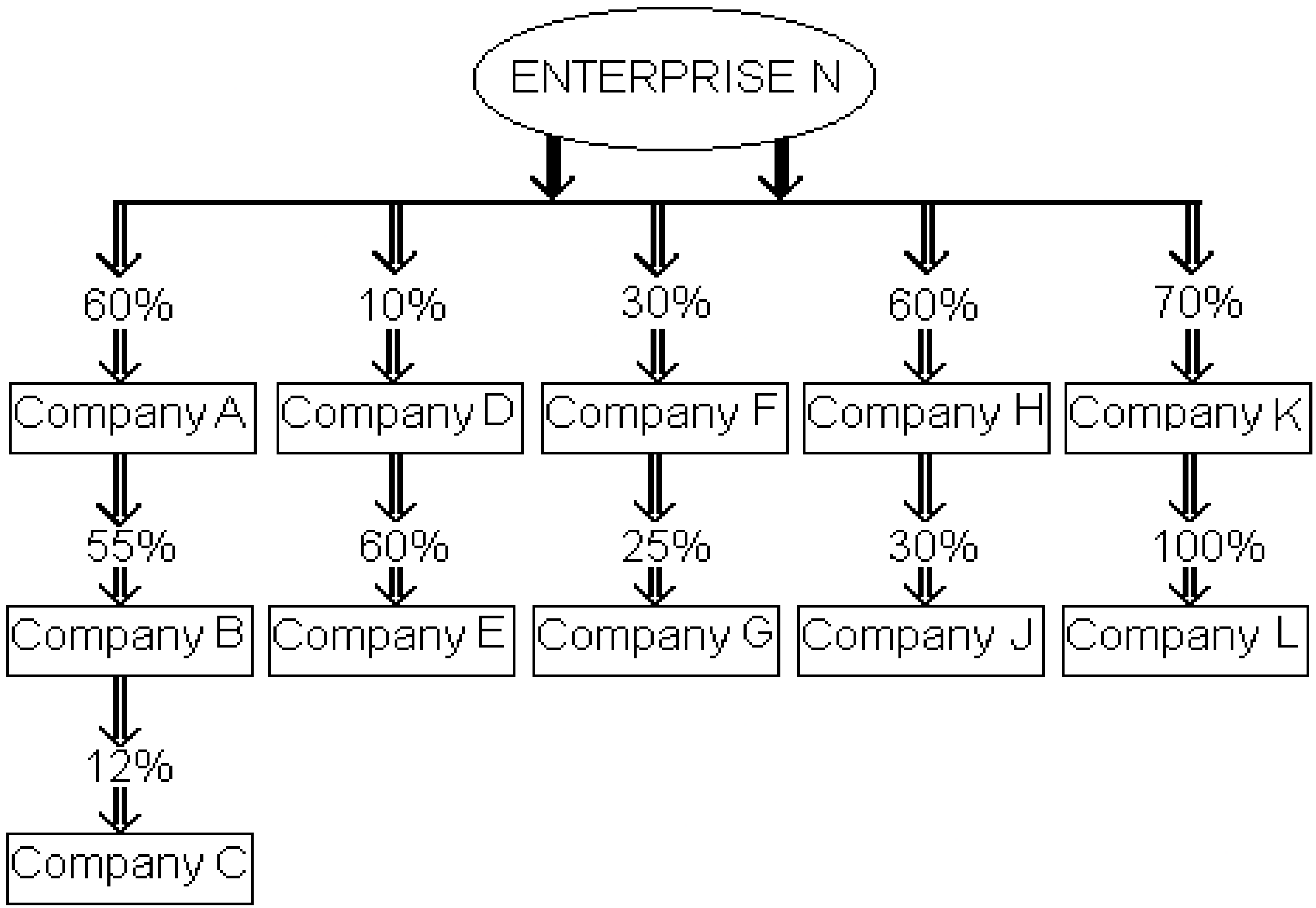
Company **D** is an associate of enterprises **A** if **A** and its subsidiaries control less than 50 % of the shareholders' or members' voting power in **D**

Branches

A direct investment branch is an unincorporated enterprise in the host economy(100% shareholding)

- **With these developments, the legal structures surrounding the intra-firm relationships within the various affiliates of TNCs could be very tedious.**

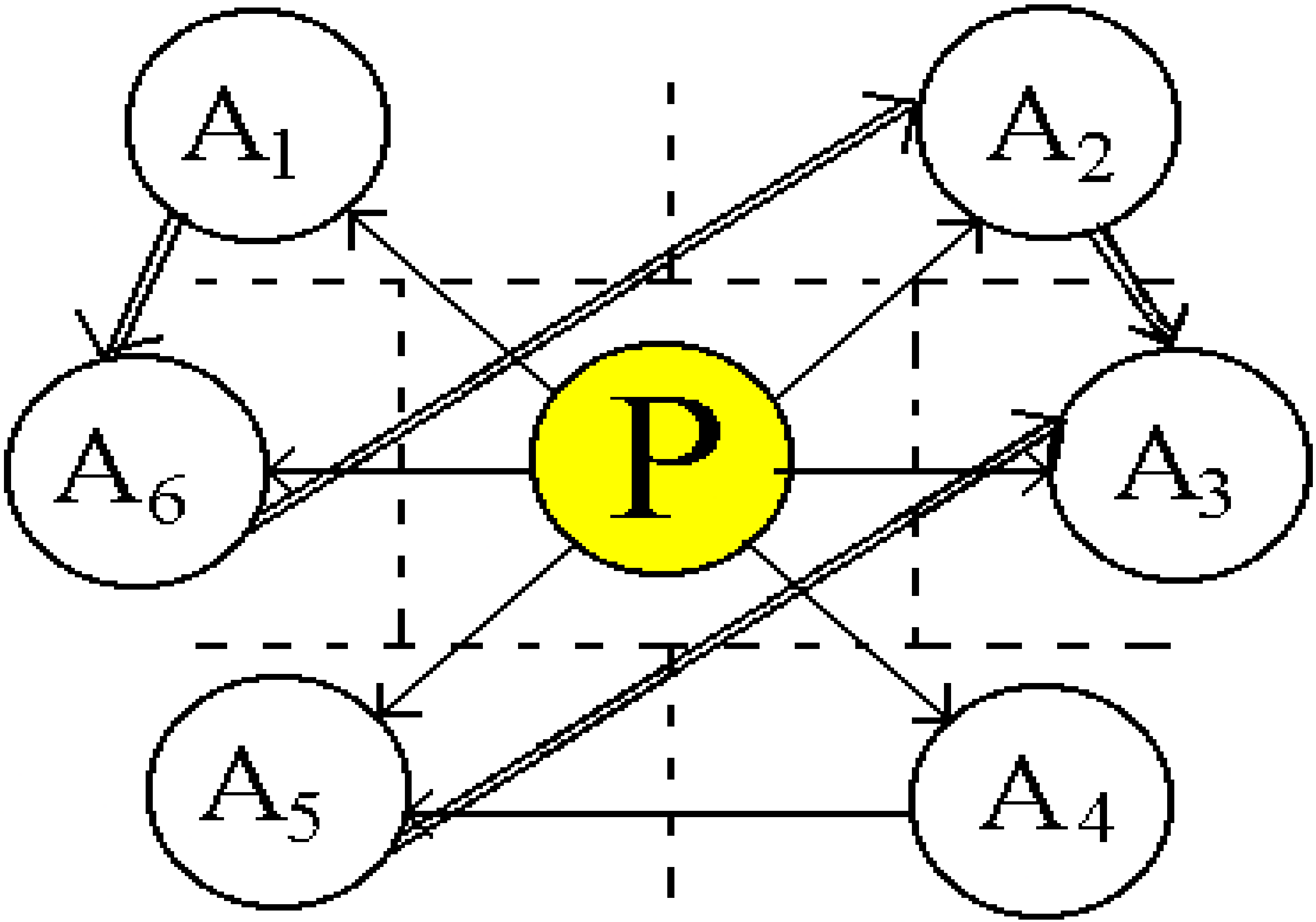
Figure 1: Analysis of Branches, Subsidiaries and Associates of a TNC



4. Transnational Strategy

- Initially TNCs usually pursue "**binational strategy**" in which they perceive each foreign national market as unique and separate from the other national markets.
- At this stage, investment in country **A** is meant to supply the market in that country **A** alone.
- With favorable development from the various trade deregulation and liberalization brought about by World Trade Organization (WTO) and its predecessor (General Agreement on Trade and Tariffs – GATT), trade barriers had collapsed, technological capabilities developed, and international competition more intense and the simple binational strategy have become unrealistic and consequently dropped in favor of a "**transnational strategy**"
- Under the new strategy, each national market is seen as an integral part of a broader regional or global market.
- A TNCs shift from the stand alone strategy (i.e. binational) to integrated international production under the transnational strategy, in which each of their affiliates has a peculiar service/ production to offer the TNC systems as seen in **figure 2**

Figure 2 Transnational Strategy



B. Role of Foreign Investment in Economic Development

- Nigeria is seeking to enhance the inflow of FDI to complement domestic saving to meet the required investment demand and to benefit from the economy-wide associated gains of these financial resources.
- This approach is part of a broad strategy aiming at sustaining high rates of economic growth, increasing employment opportunities and improving living standards in line with the **Transformation Agenda** of the current administration.

1. **Foreign Investment as Impetus to Economic Growth**

FDI has shown its ability to contribute significantly to all three components of growth:

i) FDI increases capital stock,

ii) boosts human capital accumulation (though usually unmeasured in labor stock), and

iii) speeds up technological advances in host countries.

a)FDI and Capital Formation

- TNCs do mobilize resources within their own corporate systems, particularly when their affiliates raise funds through bonds, loans, and equity issuances in host economies.
- Because TNCs typically have access to a wide variety of financing options, the risk-adjusted cost of capital is usually lower for them than the domestic firms
- They can undertake projects for which domestic investors do not have the capacities to assume or which are considered too risky
- TNCs have more stable forms of financing than their domestic counterparts
- Even though FDI may have a debt-creating component, it is essentially equity investment.
- Consequently, **Profits are repatriated only when a project yields return and part of the profits is routinely reinvested in the host country**

b)**Foreign Investment and Productivity Growth**

- ❖ Arguably the most effective means of transferring best practice is FDI as foreign investment tends to package and integrate elements from all of the above mechanisms.
- ❖ The most important benefit of FDI is that it provides, along with financial resources, access to the whole range of technological, organizational and skill assets, as well as the markets of the parent company.
- ❖ FDI transmits best practice in two ways: **i)** internal transfers of technology and skills to their affiliates in the country, and **ii**)technological **diffusion** to a broad section of companies and institutions within the economy
- ❖ Direct investments are thus the only mechanism for a host economy, like Nigeria, to obtain the latest technologies and thus able to expand the productive base of the economy.

Foreign Investment and Productivity Growth(Cont..)

The diffusion process takes place through four main channels:

i) backward linkages with local suppliers (sourcing),

ii) forward linkages with local producers and distributors,

iii) horizontal linkages with local competitors, and

iv) linkages with local institutions such as universities and research institutes as well as vocational training centers.

- To developing countries, like Nigeria, the most important channel of diffusion is usually through local sourcing; i.e the purchase of inputs and services from local instead of foreign suppliers.
- Whenever the costs of doing so are lower than the resulting overseas purchases, foreign investors have an interest in developing local suppliers, helping them set up facilities, raise technological and skill levels, obtain inputs, and expand markets.
- This is one of the most powerful mechanisms for transmission of best practice into the country.

2. Foreign Investment as a Mechanism for Social Advancement

FDI constitutes also an important advocate for improved social norms in the area of environment and labour/employment standards

a)Employment and Labor Standard

Because of their special features; FDI often plays a unique role in employment creation and upgrading through 3 basic mechanisms:

First, foreign affiliates employ people in their domestic operations.

Second, through vertical backward and forward linkages, employment is created in enterprises that are suppliers, subcontractors, or service providers to them.

Third, as FDI-related industries expand and the local economy grows, employment is also created in sectors and activities that are not even indirectly linked to the original FDI

As part of the cross-border transfer of its human resource management practices, FDI also brings with it the kind of modern industrial relations that are prevalent in advanced countries.

b)Environmental Standards

- Though there have been cases where powerful companies relocate polluting production to countries or regions out of considerations of weak environmental standards (Niger Delta), there is no conclusive evidence that this is the rule
- The impact of industrial activities on the environment is thus closely linked to the **production efficiency** of firms and their capacity to manage environmental risks.
- That is environmental damage tends to be greatest in low productivity operations that employ obsolete technology, outdated work methods, poor human resource management techniques
- In reality, therefore FDI is actually better positioned to uphold higher environmental standards than their domestic counterparts
- Because of their connections to the developed world, where affluent and environmentally demanding markets call for stringent environmental regulations and environment-friendly products, FDI is therefore a conduit for transferring clean technology and sound environmental management systems

3. Positive Spillover Effects

As a form of international capital movement, FDI shares many of the potential benefits and cost of other forms of capital flows

FDI is unique in producing stronger links of integration for the host country's economy with the global economy.

These links go well beyond financial integration and factor mobility since they allow for the possibility of transfer of technology from the home countries of TNCs to the host countries like Nigeria

Short term capital flows/bank credit may stop or reverse directions (leads to outflows), but transfers of technology and the associated productivity impact of FDI can be long lasting.

On the import side, FDI allows for importing foreign firms- specific technology into the host country.

On the export side, TNCs provides numerous opportunities for domestic firms to gain access to new markets (regional and international), and thus enhance more direct mechanisms for export growth in the country.

Positive Spillover Effects(Cont..)

Essentially, FDI generates two types of spillovers.

- When local firms benefit from the presence of affiliates of TNCs competing with them in the domestic economy, the phenomenon is called **horizontal spillovers**
- On the other hand, **vertical spillovers** refers to productivity spillovers arising from linkage opportunities between foreign investors and their local suppliers
- Vertical spillover takes the form of :
- direct knowledge transfer from foreign customers to local suppliers;
- higher requirements regarding product quality and on-time delivery introduced by TNCs, which provide incentive to domestic suppliers to upgrade their production management or technology;
- indirect knowledge transfer through movement of labour;
- increased demand for intermediate products due to TNC's entry which allows local supplies to reap the benefits of scale economies ; and
- competition effect- when multinational acquiring domestic firms choose to source intermediates abroad thus breaking existing supplier-customer relationships and increasing competition in the intermediate products market.

C. Potential Negative Impacts of Foreign Investment

Conflicts do arise between foreign investors and their hosts because of the following reasons, among others:

- While TNCs want sales in the local market (host economy) and in the regional market, recipient economies would prefer that TNC products are exported;
- While the TNCs would want to transfer their entire profits to their parent company abroad, the recipient economies would want such profits to be re-invested;
- While TNCs would prefer to control the joint venture enterprises, recipient economies would want them (the enterprises) to be under their own control;
- While TNCs would prefer the supply of spare parts, the recipient countries would favour domestic production of them or at worst freedom to order from any part of the world;
- While TNCs would want the joint venture to be their subsidiary, the recipient economies would advocate for greater share of the equity;
- While TNCs would like to enjoy access to local financial institutions resources, the recipient economies would prefer foreign financing of the joint venture for fear of crowding out domestic entrepreneurs;
- While TNCs would want their research and development (R & D) performed at the parent company sites or selected affiliates of the TNCs, recipient economies would want them performed at host economies;
- and while TNCs usually request for protection against removal of foreign property, recipient economies would equally want to secure guarantee against abuse of their dominant position

Potential Negative Impacts of Foreign Investment (Cont..)

- From the above divergences it became clear that though FDI has a key role to play in host countries' economic development, this should not be construed to mean that FDI can never lead to undesirable outcomes under all circumstances.
- Indeed, even with the best of intentions, FDI may sometimes produce objectionable results that are harmful to host developing countries.
- It is also undeniable that some foreign investments may be exploitive in nature and need to be properly regulated
- Numerous cases of abuse and complicity of TNCs against their hosts have been identified over the years.
- They include, among others:

1. The "Crowding Out" Effect of Foreign Investment

There is the concern that foreign investments may take away the investment opportunities of domestic firms, thereby driving them out of business

- ❖ If the foreign investor finances a project by borrowing from the host country financial market (eg MTN) under conditions of scarce resources, domestic interest rates may rise as a result, which may make borrowing unaffordable for some domestic firms
- ❖ If FDI enters the economy in activities in which competing domestic firms already exist, they (FDI) may reduce domestic investments that would have been undertaken by domestic producers.
- ❖ Even in new activities beyond the current reach of domestic investors FDI may preempt investments by domestic firms which, with proper nurturing, could enter the market successfully
- ❖ Crowding out occurs if the foreign investment deliberately uses predatory practices to force domestic competitors out of business, or to retard their establishment

2. Foreign Investment and Balance of Payment Problem

- Another wide-spread concern regarding FDI is that to the extent that profits are repatriated, they constitute a financial outflow that has to be set against the net annual contribution of FDI inflows to a host country's balance of payment
- The concern about such payments becomes pertinent when there is doubt as to whether a particular investment will make a net contribution to the host economy or not, particularly after allowing for all the future outflow of resources accompanying it as well as other problems associated with **transfer-pricing devices**
- This is why the dependencia view FDI as merely providing a sort of short-term relief to capital deficient economies with long – run negative repercussions on such recipient economies
- As foreign investors bring into a host economy increasing investment capital, it is merely a signal that they intended to take out multiple of the same amount of capital at future dates.

3. Conflicts on Technology Transfer

- As earlier said, corporate strategies and objectives of TNCs concerning technology transfer do not always coincide with the national objectives of their(TNCs) hosts
- For instance, technological information are usually coded by the TNCs to prevent its being imitated or copied, a full transfer is more of a '**dreamlike contemplation**' (reverie) than reality; and a good draftsman must know this before drafting a joint venture agreement
- Since the resource structure of a host economy may differs from what a particular technology requires, it is not always advisable to allow TNCs to impose parent firms' technology in its proto-type format without modifications

4. Transfer Pricing Issue of TNCs

- Since the TNCs can transfer production from one country to another in relation to costs changes, they are able to relocate production globally (as opposed to interrupting it) by switching orders and production among their affiliates.
- In addition, TNCs are equally able to control both the export price and import prices of the same international transaction through **transfer pricing**
- Transfer pricing arises when two affiliates of a TNC transfer tangible or intangible goods or services between themselves at an intra-firm determined prices.
- That is, if the price on an intra-firm transaction deviates from the price that would have occurred if the parties had not been related (often referred to as the arm's length price), then a transfer pricing is said to result.
- Within TNC-systems, transfer pricing is difficult to detect because the transferred assets are often specialized or intangible in nature (like technology).
- Thus, accurate information on the true value of the product will be difficult to find as the TNC has considerable discretion in setting its transfer price across their affiliates in different countries.
- Anytime TNCs use transfer price as a strategic device, its effect is felt on the domestic trade policy of the host economies.

5. **Foreign Investment Creates Enclaves in Host Economies**

- Perhaps the greatest concern with regard to FDI is undoubtedly that such investments are narrowly based, with limited overall impact on the receiving countries, and benefiting only a small group of the population
- Such anxieties are most exemplified in Nigeria upstream Petroleum industry and other raw material extraction projects, which are typically very capital intensive and employ a small fraction of the national workforce.
- This means that few vertical linkages, either backward or forward, exist with the host country, making their indirect effects on the domestic economy negligible.
- To make things worse, sudden large inflows of foreign exchange tend to raise the real exchange rate of the naira and thus render many non-extraction activities unprofitable (the Dutch Disease) since many years ago.
- With the wide range of exemptions and special privileges granted to investments located in the EPZs, they too exhibit very limited linkage with the local economies at large.

D. Measures to make FDI Flows Beneficial

- ❖ Determine Whether and how FDI Fits in with Development Objectives
- ❖ Think in terms of Quality, not Quantity
- ❖ Prepare and Negotiate Well
- ❖ Reduce Conflicts and Corruption
- ❖ Provide Appropriate Infrastructure and Skills
- ❖ Implement FDI Policies Consistently and Actively
- ❖ Understand the Pros and Cons of international Investment Agreements
- ❖ Facilitate Trade
- ❖ Provide a Transparent and Appropriate Incentive and Regulatory Framework

Establishment of ECOWAS Investment Guarantee/Re-insurance Agency

- While market return in ECOWAS is comparatively higher than similar emerging markets in the world, the risk profile of the Region tends to measure higher as a result of political risk factors.
- Beyond the risk of appropriation, which has dropped almost completely, new forms of political risks have played up in the last decade to deter FDI from the region the more.
- These risks range from corruption, to communal unrest and disruption to business operation, unilateral investment policy changes etc.
- While the rest of the world is not immune to these risks, the establishment of **a Regional Investment Guarantee Institution** as a mitigating measure has bolstered investor confidence on the safety of their investment capital and in turn ensure better flow of FDI into those markets.

Establishment of ECOWAS Investment Guarantee/Re-insurance Agency(Cont..)

- There arose a need for the study to determine the necessity for the establishment of a political risk mitigating institution, which the business community has requested for on various occasions.
- Such a scheme is required for the effective operation of the ECIM and is an important aspect of financial markets integration in ECIM.
- This project also seeks to conserve foreign exchange for the region by providing reinsurance window for the insurance industry which hitherto places most of the reinsured risks with institutions outside the region.
- The study has been concluded and submitted (on the 27th July, 2012), and the Commission is about to fashion out implementation strategy.

F. Conclusion

My presentation here suggests that although the mechanisms underlying FDI and development have not changed, the intricacies of these mechanisms need to be better understood if they are to prove beneficial to West African economy.

TNCs and FDI may well lead to an increase in productivity and exports in Region, but they do not automatically result in increased industrial capacity, which ultimately determines economic growth in the long run for the country.

FDI per se does not provide growth opportunities unless a domestic industrial sector exists which the necessary technological capacity to profit from the externalities generated by TCNs activity.

Conclusion(Cont..)

- In spite of the enormous natural and human endowments of the Region, a wide gap exists between the investment resources available in the Region and the level of investment required to develop existing resources in order to ensure that ECOWAS citizens derive optimal value and enjoy increased welfare from these endowments.
- This resource gap requires that capital flows from capital surplus regions of the world into ECOWAS to bridge the deficit.
- Foreign investment will however flow to the regions where risk can easily be mitigated, returns are commensurate to risk and safety of capital can be guaranteed.
- This is the basis for putting in place a regional investment / re-insurance agency
- In addition, it is important that our regional economy emerge with effective negotiating strategies with TNCs
- **The global economy never gives what one deserves except by negotiation**