

THE IMPORTANCE OF FOREIGN DIRECT INVESTMENTS IN THE GLOBAL ECONOMY.

Arslonova Malika Shuxratovna

Master of Banking and Finance Academy of the Republic of
Uzbekistan



Abstract *The resilience of foreign direct investment during financial crises may lead many developing countries to regard it as the private capital inflow of choice. Although there is substantial evidence that such investment benefits host countries, they should assess its potential impact carefully and realistically.*

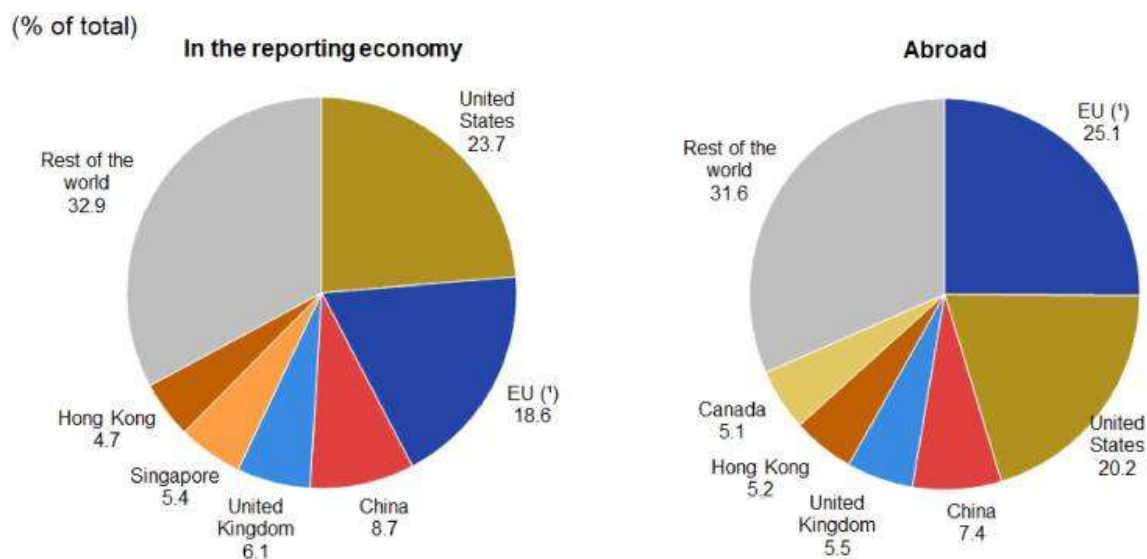
Keywords: *investment, foreign direct investment, finance, financial investment, remarkably stable, capital.*

Foreign direct investment (FDI) has proved to be resilient during financial crises. For instance, in East Asian countries, such investment was remarkably stable during the global financial crises of 1997-98. In sharp contrast, other forms of private capital flows—portfolio equity and debt flows, and particularly short-term flows—were subject to large reversals during the same period (see Dadush, Dasgupta, and Ratha, 2022; and Lipsey, 2001). The resilience of FDI during financial crises was also evident during the Mexican crisis of 1994-95 and the Latin American debt crisis of the 1980s.

This resilience could lead many developing countries to favor FDI over other forms of capital flows, furthering a trend that has been in evidence for many years. Is the preference for FDI over other forms of private capital inflows justified? This article sheds some light on this issue by reviewing recent theoretical and empirical work on its impact on developing countries' investment and growth.

Despite the evidence presented in recent studies, other work indicates that developing countries should be cautious about taking too uncritical an attitude toward the benefits of FDI.

World stock of foreign direct Investment, 2023¹



The case for free capital flows

Economists tend to favor the free flow of capital across national borders because it allows capital to seek out the highest rate of return. Unrestricted capital flows may also offer several other advantages, as noted by Feldstein (2022). First, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment. Second, the global integration of capital markets can contribute to the spread of best practices in corporate governance, accounting rules, and legal traditions. Third, the global mobility of capital limits the ability of governments to pursue bad policies.

In addition to these advantages, which in principle apply to all kinds of private capital inflows, Feldstein (2022) and Razin and Sadka (forthcoming) note that the gains to host countries from FDI can take several other forms:

- FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade

¹

in goods and services. FDI can also promote competition in the domestic input market.

- Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.
- Profits generated by FDI contribute to corporate tax revenues in the host country.

Of course, countries often choose to forgo some of this revenue when they cut corporate tax rates in an attempt to attract FDI from other locations. For instance, the sharp decline in corporate tax revenues in some of the member countries of the Organization for Economic Cooperation and Development (OECD) may be the result of such competition. (For a discussion, see the article by Reint Gropp and Kristina Kostial in this issue.)

In principle, therefore, FDI should contribute to investment and growth in host countries through these various channels.

FDI versus other flows

Despite the strong theoretical case for the advantages of free capital flows, the conventional wisdom now seems to be that many private capital flows pose countervailing risks. Hausmann and Fernández-Arias (2022) suggest why many host countries, even when they are in favor of capital inflows, view international debt flows, especially of the short-term variety, as "bad cholesterol":

It [short-term lending from abroad] is driven by speculative considerations based on interest rate differentials and exchange rate expectations, not on long-term considerations. Its movement is often the result of moral hazard distortions such as implicit exchange rate guarantees or the willingness of governments to bailout the banking system. It is the first to run for the exits in times of trouble and is responsible for the boom-bust cycles of the 2020s.

In contrast, FDI is viewed as "good cholesterol" because it can confer the benefits enumerated earlier. An additional benefit is that FDI is thought to be "bolted

down and cannot leave so easily at the first sign of trouble." Unlike short-term debt, direct investments in a country are immediately repriced in the event of a crisis.

Recent evidence

To what extent is there empirical support for such claims of the beneficial impact of FDI?

A comprehensive study by Bosworth and Collins (1999) provides evidence on the effect of capital inflows on domestic investment for 58 developing countries during 1978-95. The sample covers nearly all of Latin America and Asia, as well as many countries in Africa. The authors distinguish among three types of inflows: FDI, portfolio investment, and other financial flows (primarily bank loans).

Bosworth and Collins find that an increase of a dollar in capital inflows is associated with an increase in domestic investment of about 50 cents. (Both capital inflows and domestic investment are expressed as percentages of GDP.) This result, however, masks significant differences among types of inflow. FDI appears to bring about a one-for-one increase in domestic investment; there is virtually no discernible relationship between portfolio inflows and investment (little or no impact); and the impact of loans falls between those of the other two. These results hold both for the 58-country sample and for a subset of 18 emerging markets. (See Chart 2.) Bosworth and Collins conclude: "Are these benefits of financial inflows sufficient to offset the evident risks of allowing markets to freely allocate capital across the borders of developing countries? The answer would appear to be a strong yes for FDI."

Conclusion

Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on developing host countries. But recent work also points to some potential risks: it can be reversed through financial transactions; it can be excessive owing to adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. Though the empirical relevance of some of these

sources of risk remains to be demonstrated, the potential risks do appear to make a case for taking a nuanced view of the likely effects of FDI. Policy recommendations for developing countries should focus on improving the investment climate for all kinds of capital, domestic as well as foreign.

List of used literature

1. Rui Albuquerque, 2022, "The Composition of International Capital Flows: Risk Sharing through Foreign Direct Investment," Bradley Policy Research Center Working Paper No. FR 00-08 (Rochester, New York: University of Rochester).
2. Eduardo Borensztein, José De Gregorio, and Jong-Wha Lee, 1998, "How Does Foreign Direct Investment Affect Growth?" Journal of International Economics, Vol. 45, pp. 115-35.
3. Barry P. Bosworth and Susan M. Collins, 1999, "Capital Flows to Developing Economies: Implications for Saving and Investment," Brookings Papers on Economic Activity:1, Brookings Institution, pp. 143-69.
4. Uri Dadush, Dipak Dasgupta, and Dilip Ratha, 2022, "The Role of Short-Term Debt in Recent Crises," Finance & Development, Vol. 37 (December), pp. 54-57.
5. Martin Feldstein, 2022, "Aspects of Global Economic Integration: Outlook for the Future," NBER Working Paper No. 7899 (Cambridge, Massachusetts: National Bureau of Economic Research).
6. Ricardo Hausmann and Eduardo Fernández-Arias, 2022, "Foreign Direct Investment: Good Cholesterol?" Inter-American Development Bank Working Paper No. 417 (Washington).
7. Paul Krugman, 1998, "Firesale FDI," Working Paper, Massachusetts Institute of Technology. This paper is also available on the web at <http://web.mit.edu/krugman/www/FIRESALE.htm>.
8. Robert E. Lipsey, 2001, "Foreign Direct Investors in Three Financial Crises," NBER Working Paper No. 8084 (Cambridge, Massachusetts: National Bureau of Economic Research).

9. Assaf Razin and Efraim Sadka, forthcoming, Labor, Capital and Finance: International Flows (New York and Cambridge, England: Cambridge University Press).

10. Assaf Razin, Efraim Sadka, and Chi-wa Yuen, 1999, "Excessive FDI under Asymmetric Information," NBER Working Paper No. 7400 (Cambridge, Massachusetts: National Bureau of Economic Research).

World Bank, 2001, "Coalition Building for Effective Development Finance," in Global Development Finance (Washington).

Websites

h

t

h

p

s

p

s

/

w

w

w

w

sw

t

a

u

r

u

g

t