THE ROLE OF FOREIGN DIRECT INVESTMENT AND NATURAL RESOURCES IN ECONOMIC DEVELOPMENT[8]

By
José De Gregorio

- A REVIEW BY P. D. GOLIT[9]

INTRODUCTION

The paper analyzed the role of Foreign Direct Investment (FDI) and discussed the part played by natural resources in economic growth. Some of the issues regarding FDI in developing countries were considered, particularly, two issues highlighted in recent discussions and research. The first was whether and through which channels FDI affects economic growth. The second was the impact on economic growth of the exploitation of natural resources, normally developed by foreign investors. The policy implications regarding the treatment of FDI in developing countries were examined.

The study was organized into 4 parts. Part 1 reviewed some stylized facts about the behavior of FDI. Part 2 provided the evidence and mechanisms showing that FDI affects economic growth. The link between the exploitation of natural resources and economic growth was discussed in part 3, while part 4 gave the concluding remarks.

8. Central Bank of Chile Working Papers No. 196, Enero 2003.
9. Mr. P. D. Golit is an Assistant Economist in the Research Department of the Central Bank of Nigeria.

SUMMARY OF THE PAPER

The paper established that capital flows to emerging markets declined in the later part of the 1990s, but with a change in composition in favor of FDI. Whereas before 1990, emerging economies received only 13 per cent of worldwide FDI in a typical year, by 1996 that share had more than doubled. In all emerging regions, the relative importance of FDI in capital inflows has been rising, from about 10 per cent of total inflows in the early 1990s to 35 percent in 2002. Today, it is widely noticed that FDI will be the major, and indeed almost only, vehicle of foreign financing in developing countries for years to come.

The paper showed how foreign direct investment tends to be more persistent than other types of flows, especially in Latin America. In times of turbulence, more liquid flows (like portfolio flows and debt) may increase the volatility of the capital account, with adverse consequences for exchange rates and economic activity. Thus, less developed economies tend to be bias toward FDI vis-à-vis other forms of capital.

The study explored whether FDI foster growth beyond its simple contribution to capital accumulation. If it does, policy makers may wish to give special consideration to policies that promote the inflow of FDI. From available empirical evidence, it has been revealed that:

FDI is about three times more efficient than domestic investment.

There is a threshold level of income above which FDI has extra effects on economic growth, and below which it does not. Only countries that attain a certain level of income can absorb new technologies and benefit from technological

diffusion, and thus reap the extra advantages that FDI can offer.

The interaction of FDI and human capital has an important impact on growth and for a country to take advantage of technological diffusion due to FDI, it must have a high level of human capital.

More-open economies experience greater benefits from FDI. However, some of the empirical literature differed from the above views. More recent cross-country evidence found that growth and a good macroeconomic environment are what drive FDI, rather than the other way round.

From the raging debate, the author argued that the existence of a positive externality from FDI to economic growth remains an unsettled issue, and therefore the policy implications are not straightforward. Even if there is a positive externality, as most cross-country studies indicate, the implication that there should be special policies to foster foreign investment does not necessarily follow. As a result, a number of issues call into question the case for special incentives. To justify special incentives, it is necessary not only to prove that FDI has a positive effect on growth, but also that it is possible to identify policies that promote FDI without inducing distortions that may offset the gains in growth. What is really needed to support a policy of special incentives for FDI, therefore, is empirical evidence of a positive relationship between discriminatory policies in favor of FDI and economic growth. Discriminatory policies open the door to rent seeking, reduce incentives for local entrepreneurship, and induce other distortions in the economy. If many countries bid against each other to attract the same foreign investment, they may end up dissipating all the potential gains from such investment.

The author also addressed the current debate on whether the exploitation of natural resources is good for growth. Recent empirical research has found a negative relationship between abundance of natural resources and economic growth. Sachs and Warner (1995) found such a negative relationship using cross-country regressions. However, Lederman and Maloney (2002) reexamined the econometric analysis of Sachs and Warner and argued that, after controlling for omitted variables and endogeneity problems, their finding does not hold. Even though empirical evidence appears inconclusive, as the case with FDI, the author found it useful to review the channels through which having natural resources might be detrimental for growth, and what might be the policy implications.

In conclusion, the author maintained that the benefits of FDI for economic growth cannot be denied, but there is no solid basis for arguing that any one sector should be promoted against another and, therefore, inducements to FDI should not be made on a discriminatory sectoral basis without some clear rationale. More so, there are no strong reasons to argue that developing natural resources rather than manufacturing may be detrimental to growth. However, taking full advantage of the benefits of FDI requires a well-educated labor force, to promote technological diffusion and adopt better technologies. There is no reason for countries to segregate between local and foreign investors. Countries making a transition toward being a reputable recipient of FDI must provide certain guarantees to foreigners such as access to foreign exchange to remit profits and capital. Policy makers must also appreciate that attempting to compel capital flows to take or maintain one form or another may create artificial distortions. In addition, a strong system of prudential regulation of the financial sector is vital to the stability

of the economy and capital flows. Greater openness and progress in transportation and communication could overcome some of the disadvantages that discourage FDI inflow. What is more important for the choice of location is not special incentive like lower taxes or access to foreign exchange, but rather the strength of institutions. Access to customers is obviously the most important factor but the stability of the social and political environment and the cost of doing business are very critical. While, growth-promoting institutions are fundamental in attracting FDI.

COMMENTS

The study is very relevant to Nigeria and quite timely in view of the current image laundering and campaign drive by Mr. President towards luring foreign investors into locating in the country. For such efforts to succeed, the critical issues raised by the author must be given due consideration. Even though Nigeria has the market potential to attract FDI, the socio-political environment is basically unfriendly, while the cost of doing business remains largely unfavorable. In the face of frequent political/ethno-religious conflicts, epileptic power supply and greatly inadequate physical infrastructure, no rational investor will contemplate making any meaningful investment in Nigeria when the cost implication is clearly prohibitive.

Secondly, the study has brought to the fore the critical role of education in economic development by emphasizing the relevance of human capital for a country to reap the extra-benefits from FDI, beyond its mere contribution to capital accumulation. Interestingly, the study has exposed the importance for a developing country like Nigeria to appreciate that mere attraction of FDI is not enough to make any significant impact on economic growth. Thus, only a high

level of human capital can guarantee technological and managerial spillovers from FDI by promoting technological diffusion and the adoption of better technologies.

The study has also shown that special incentives such as lower taxes, access to foreign exchange, privatization and deregulation of markets are not the most important drivers of FDI inflow as currently perceived in Nigeria. Rather, it has emphasized the role of national legislation in creating better investment security, fair competition and corporate responsibility by enthroning equitable, transparent and safe investment practices through the strengthening of institutions. Thus, growth-enhancing institutions are critical in attracting FDI.

It is also important that the author should have noted the inherent conflicts between the policy objectives of the host country which is to spur economic development and that of the foreign investors who strive towards enhancing their global competitive positions. Given these divergent interests, little wonder that only petite or no technological transfer has resulted from FDI inflow in developing countries. Thus, any resort to discriminatory policies to attract FDI into Nigeria may not be necessary after all.

A more important omission in this paper and perhaps the most crucial factor in determining FDI inflow into developing countries relates to the issue of administrative efficiency and corruption. Persistent and endemic corruption is a significant cost component because it adds to total spending through unofficial financial settlements. It also constitutes unnecessary but costly bottlenecks and delays the speed of transactions. Nigeria currently ranks as the second most corrupt country in the world. Foreign investors, no doubt, can not be expected to patronize such countries.