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How Beneficial is FDI for Developing Countries?

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Although FDI benefits the host country, its potential impact should be carefully and practically accessed. FDI is viewed as the “good cholesterol” where as international debt flow of short term varieties are considered “bad cholesterol”. According to the article we had to read, 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 straight away reprised in the event of a crisis.

Foreign direct investment has been proven to many to be resilient during a financial crisis. A good example would be the Mexican crisis that took place a few years back during 1994-1995 and the Latin crisis in the 1980’s. The resilient of foreign direct investment during a financial crisis can lead to many developing countries to monitor it as private capital inflow of choice, rather than investing in other forms of private capital such as portfolio equity’s, debt flows, and in particular, short term flows which were all subjected to large reversals during the same period. The private capital flows across borders, because it allows capital to seek out the highest rate of return. Countries often choose to exempt some of its revenue when they cut corporate tax rates in an attempt to attract FDI from other countries. FDI also allows the transfer of technology, particularly in the form of varieties of capital inputs, which cannot be achieved through financial investments or trade in goods and services.

There are many paradoxical findings that FDI is a relatively bigger portion of total inward investment intro riskier countries. FDI tends to take advantage of the countries where the market is inefficient. It happens because of foreign investors prefer more to operate directly instead of relying on local financial markets, supplies, or legal arrangements. In riskier countries, the share of total inflows is higher and the risk is measured either by countries credit ratings for self governing debt or by other indicators.

FDI might not be beneficial to developing countries when foreign investors increase vital inside information about the productivity of the firms under their control. That fact gives them an information advantage over "uniformed" domestic savers, whose buying of shares in domestic firms does not involve control. Taking advantage of this superior information, foreign direct investors will tend to retain high productivity firms under their ownership and control, and sell low productivity firms to the uniformed savers. As with other adverse selection problems of this kind, this may lead to over investment by foreign direct investors.

According to the article by Hausmann and Fernandez-Arias (2000) the best solution for developing countries to increase their overall amount of inward investment of all kind, is to focus on concentrating on improving the environment for investment and the functioning of markets. By doing so, they are likely to be rewarded with increasingly efficient overall investment as well as with more capital inflows. Although it is very likely that FDI is higher, as a share of capital inflows, where domestic policies and institutions are weak, this cannot be regarded as a criticism of FDI per se. Indeed, without it, the host countries could well be much poorer.

The growth that was received by FDI in recent years slows with the impact of the financial crisis and investors' heads are turning towards developing economies. FDI inflows grew from just USD $58 million in 1982 to nearly USD $100 billion in 2005 and more than USD $1400 billion in 2008. The global stock of FDI is in excess of USD $1500 billion. The global recession is speeding up the shift of focus to developing countries as they remain the only source of growth in the world economy. At the same time, because of these countries have become key destinations for FDI their companies are rapidly internationalizing and becoming multinational enterprises.