



RESEARCH ARTICLE

THE IMPACT OF FDI ON GROWTH IN DEVELOPING COUNTRIES-AN OVER VIEW

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ABSTRACT

Foreign direct investment plays an important role in the economic development of the country. It helps in transferring of financial resources, technology and innovative and improved management techniques along with raising productivity. An Indian company may receive Foreign Direct Investment either through automatic route or government route. In the last years, investment in the agricultural sector in developing countries has been neglected and the share of public expenditures as well as Official Development Assistance (ODA) in agriculture has declined. The rising commodity prices have served as a wake-up call to support agricultural development and ensure food security and poverty education. FAO has estimated that investment of USD 83 billion per annum is required in developing countries to meet the food demand in 2050. This estimate does not include the investment in public good provision such as infrastructure, storage facilities, market development or R&D. Government spending and involvement (e.g. through ensuring agricultural institutions, extension services, education, sanitation) in agriculture and provision of public goods are suggested to be most effective in increasing productivity, enabling capital formation, providing incentives and opportunities for farmers to increase their private investment, and strengthen the sector and smallholder farmers in order to take advantage of the prospective Foreign Direct Investment (FDI) in the sector. FDI in agriculture of developing countries was only 1% of total world FDI inflows, but has increased in the recent years, in particular in Asia and Oceania, Latin America and the Caribbean and South-East Europe and the Commonwealth of Independent States. However, developing countries receive (i) less FDI in food processing than developed countries, implying that a large share of higher value added activities takes place in developed countries, and (ii) more FDI in cash crops, e.g. renewable energy sector, than staple crops. Large-scale cash crops production may drive small-scale farmers out of production, increase farmer's production risks, and negatively impact food security.

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INTRODUCTION

The rising commodity prices and volatility in 2008 and subsequent concerns about food security have served as a wake-up call to reconsider the food system and foster agricultural development. These concerns are fueled by long term projections of increasing demand for agricultural commodities due to population growth, long life expectancy, rapid economic growth, increased purchasing powers and changing consumption patterns in emerging economies, land degradation due to intensive production and adverse climate change impacts, and increased demand for non-food crops and biofuels due to recent biofuels initiatives and legislation (e.g. Hallam 2009: 2, Miller *et al.* 2010, UNCTAD 2009: 93,

McNeill's 2009: 1) The agricultural sector has long been neglected as motor of development and poverty reduction, and a lack of private and public investment has led to lower productivity growth rates and stagnate production in many developing countries. To achieve food supply for a potential world population of 9.1 billion in 2050, USD 83 billion per annum should be invested in the agricultural sector of developing countries (FAO 2009a, b). Most of the investment is expected to come from farmers themselves, but also from the public sector providing infrastructure, institutions, and R&D. Public investment is found to be most effective to ensure food security and poverty reduction in agriculture, but might not be able to meet these investment needs. Although world inflow of foreign direct investment (FDI) to agriculture was small in the past – less than 1% of total world inflows between 2005 and 2007 (UNCTAD 2009:111) – FDI could contribute to bridge this investment gap. Public actors could therefore be effective in stimulating private investment into the

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sector while at the same time reducing risks and securing e.g. ensuring that FDI supports the country's development strategy and spillovers to small holder production systems (FAO 2009b, Miller *et al.* 2010, Hall *am* 2009: 3, 6). Already in the last decades, FDI and Transnational Corporations (TNCs) have been involved in agriculture in developing countries, in particular in the up- and downstream segment of the global agri-food value chain, but also through non-equity participation such as contract farming. Increased food prices have attracted "new investors" in agriculture, pursuing large-scale land acquisitions in developing countries (UNCTAD 2009: 93, 111). These developments have led to discussions about the forms of FDI and alternative business models in developing countries' agriculture, the potentials and challenges, and the economic, social, institutional, and policy requirements to benefit from FDI.

Types of Foreign Investment

Foreign Investment can be classified as,

- a) **External assistance or official sources:** Both concessional and non – concessional flows from official sources like official Development funds through bilateral agreement from International Monetary Fund, World Bank, Asian Development Bank and the like which includes Grants, concessional Loan and Non – concessional loan flows, sometimes it may be provided by developed countries to developing country with the objectives of assisting economic development.
- b) **Private capital flows or Non official sources:** These flows of investment from Multinational Corporations (FDI), Foreign Institutional Investors (FII), the Non – Resident investment, external bank loans, and other credits like buyers credit, Suppliers credit, Floating bonds and fixed bonds

It's clear from Table 1, that the inflow of the Foreign Direct Investment to India is merely 2.40 percentage of the total Foreign Direct Investment inflow to developing economy in the year 2008 and it increased to 4.59 per cent in 2010. The outflow of the Foreign Direct Investment from India in the year 2008 is US \$ 2,928 (2.53 per cent) and it increased to 6.5 per cent in 2009 and decreased to 5.39. But the inflow of the Foreign Direct Investment to Asia amounted to US \$ 2, 10,028 US \$ 79,412 million, which is less than the inflow to the Asian country. This trend has increased to an inflow of US \$ 3, 19,333 million in 2010 and on outflow of US \$ 1, 94,663 million.

In Table 2 the percentage of realization of the Foreign Direct Investment in respect to the approval was less, compared to later periods. The realization rate was very less in 1995 with the rate of merely 21%. This is due prior to 2003, the Foreign Direct Investment in India was very narrow which includes only equity part of the Foreign Direct Investment and does not include other forms like reinvested earnings by foreign companies, acquisition of shares and the like. After 2003, India accepted the International Monetary Fund road map to calculate the Foreign Direct Investment with wide coverage. Due to that the amount of Foreign Direct Investment inflow data shows very positive and high inflow into India during the later period and achieved Rs.89, 233 cores in 2010. This chapter shows the approved and actual inflow of the Foreign Direct Investment in India.

Urgent need for agricultural investment in developing countries

Agricultural investment is the most important and most effective strategy for poverty reduction in rural areas, where the majority of the world's poorest people live (World Bank 2008).

Table 1. Foreign Direct Investment flow by Region & Economy 2008 – 2010 (US \$ million)

Region/Economy	FDI Inflow			FDI Outflow		
	2008	2009	2010	2008	2009	2010
World	7,58,697	14,11,018	18,33,324	8,80,808	13,23,150	19,96,514
Developed Economy	6,11,283	9,40,861	12,47,635	7,48,885	10,87,186	16,92,141
Developing Economy	3,16,440	4,12,990	4,99,747	1,17,579	2,12,258	2,53,145
Asia	2,10,028	2,72,890	3,19,333	79,412	1,41,105	1,94,663
India	7,606	19,662	22,950	2,978	12,842	13,649
% in Developing Economy	2.40	4.76	4.59	2.53	6.05	5.39

Source: World Investment Report – 2010

Table 2. Year Wise Foreign Direct Investment (FDI) Approvals and Inflows (from August 2000 to February 2010)

Sino	Year (January – December)	Amount in Rupees core		Amount in US \$ in million		% age of realization rate inflow with Approval (in terms of Rupees)
		FDI Approval	FDI inflows	FDI Approvals	FDI inflows	
1.	2000	27590	13269	6985	3359	48.09
2.	2001	25140	10167	5986	2421	40.44
3.	2002	17237	12354	4009	2873	71.67
4.	2003	20940	16778	4653	3728	80.12
5.	2004	11058	18196	2304	3791	164.55
6.	2005	5417	11617	1178	2526	214.45
7.	2006	8741	17266	1900	3755	197.52
8.	2007	7900	19299	1775	4360	244.29
9.	2008	23003	50357	5111	11122	218.91
10.	2009	19911	79736	4773	9156	400.46
	2010	11884	89233	2941	21963	750.86
	Total	313117	372518	81890	89292	118.9709

Source: Ministry of Commerce & Industry, Department of Industrial Policy and Promotion.

Investing in agriculture reduces poverty and hunger through multiple pathways. Farmers invest to enhance their productivity and incomes. From society's point of view, this in turn generates demand for other rural goods and services and creates employment and incomes for the people who provide them -- often the landless rural poor. These benefits ripple from the village to the broader economy. Agricultural investments also key to eradicating hunger through all of the dimensions of food and nutrition security. Agricultural investment by farmers or the public sector that increases productivity at the farm level can also increase the availability of food on the market and help keep consumer prices low, making food more accessible to rural and urban consumers (Alston *et al.*, 2000). Lower priced staple foods enable consumers to supplement their diets with a more diverse array of foods, such as vegetables, fruit, eggs, and milk, which improves the utilization of nutrients in the diet (Buoy, Graham and Welch 2000). Finally, agricultural investments can also reduce the vulnerability of food supplies to shocks, promoting stability in consumption. However, low investment in the agricultural sector of most developing countries over the past 30 years has resulted in low productivity and stagnant production. The recent food crisis has exposed these weaknesses, as agricultural production was slow to respond to rising prices. Yet, the agricultural sector faces a considerable challenge over the next four decades. World agriculture must feed a projected population of 9 billion people by 2050, some 2.5 billion more than today, and most of the growth in population will occur in countries where hunger and natural resource degradation are already rife. Crop and livestock production systems must become more intensive to meet growing demand but they must also become more sustainable (FAO 2011, Save and grow). Sustainable intensive production systems are capital-intensive; they require more physical, human, intellectual and social capital in order to sustain and rebuild the natural capital embodied in land and water resources. Additional investments of at least US\$83 billion annually are needed in agriculture to meet targets for reducing poverty and the numbers of malnourished (Schmidhuber, Bruins and Baedeker 2009). Doing so in a sustainable manner that preserves natural resources and is conducive to long-term development will require even more funds. Increased investment by the public sector in developing countries will be necessary, which implies a reversal of the declining trend observed over the past decades. The share of public spending on agriculture in developing countries has fallen to around 7 percent, and even less in Africa (Hall 2011).

Characteristics of the agricultural sector in developing countries

Drivers of agricultural production are complex depending on site-specific, economic and socio-cultural factors, technologies, policies and market developments, which are shaped by actors such as self-sufficient and semi-commercial farmers, domestic private sector cooperatives or enterprises producing commodities for export purposes, state-owned enterprises acting as large buyers of agricultural commodities, or foreign firms (UNCTAD 2009: 99). Agriculture is of growing importance to achieve poverty reduction. Agriculture is at least twice as effective in reducing poverty as GDP

growth in non-agricultural sectors (ibid: 95, World Bank 2007: 6). Around 75% of the poor in developing countries live in rural areas, their income depending directly or indirectly on agriculture. In agriculture-based developing countries, the sector employs 65% of the labor force and contributes about 29% to the GDP on average (World Bank 2007: 3, 44). On global scale, poverty rates in rural areas have declined from 37% in 1993 to 30% in 2002. However, there are large variations across regions and countries e.g. the poverty rate in Sub-Saharan Africa and South Asia remains well above the global average. There is also evidence that the decline in poverty rates coincides with agricultural growth, which is correlated with the adoption of new technologies and productivity increases, economic and land reforms as well as trade and price policy liberalizations (ibid: 7, 44). The transmission of world market prices to the domestic level varies according to country and respective policies (OECD-FAO 2011: 12). Hence, small import-dependent countries (i.e. in Africa) have been severely affected by the food and economy: 4). over the period 1970-2008, more than 70% of wheat consumption was met by increments in wheat imports (FAO 2012a: 208-212). Cereals comprise about 40% of the food import basket of Least Developed Countries (LDCs), followed by oils, fats and sugar. Together, these commodity groups account for more than three-quarter of the value of food items imported by LDCs (Konandreas 2012: 61). To reduce vulnerability of smallholder farmers and ensure sustained access to food, FAO (2011b) suggests, amongst others, to facilitate access to agricultural inputs and management techniques which may reduce production risk and increase productivity. In LDCs increase in crop production often stems from expansion of arable land, yield-led improvement has only contributed to 1/3 of production increases in Sub-Saharan Africa (FAO 2012a: 178). Being afraid of adverse price shocks, smallholder farmers might refrain from investing into improved technologies and turn to low-risk and low-return production strategies, which impede long-term development (FAO 2011b). To countervail these developments, increasing investments from all actors, in particular from farmers themselves, governments and international donors, are needed (World Bank 2007: 20, FAO 2011b). However, agricultural growth does not automatically translate into positive social impacts (Feininger/Berlet 2011: 17) due to the prevailing imbalanced power relations in the food system and the failures to strengthen smallholder farmers (De Shutter 2011f: 2; in Wise/Murphy 2012; 26).

Institutional Investors in Agriculture

Private institutional investors such as investment banks, hedge funds and private equity groups, pension funds, sovereign wealth funds invest in fiduciary role large sums in real estate or companies on behalf of a third party. Some have gained a renewed interest in developing country's agricultural sector, which is, however, hard to empirically verify, as FDI data lacks sufficient detail or is highly aggregated. It is also crucial to consider that there is cross investing between the following groups of investors (McNally's 2009: 1, Selby 2009). Sovereign Wealth Funds (SWFs) are state-owned investment funds and have become important actors in the global financial market – having USD 5 trillion in assets under management at

the end of 2011. The cumulative value of the SWF assets has even risen by 10 % during the financial crisis. The majority of these funds is in relatively liquid financial assets in mature markets and only a small value of estimated USD 110 billion in productive assets, of which a quarter are in developing countries, concentrated on natural resources, real estate and banking. FDI by SWF accounts for 5% of their assets under management, which amounts to only 1% of global FDI stock in 2011 (UNCTAD 2012). SWFs are long-term and rather conservative investors, usually created when governments have budgetary surpluses or build up for future generations (McNeill's 2009: 3-4). SWFs are found to team up with host governments or local partners to pursue certain projects, but also with private institutional investors to make joint investments abroad. The countries involved in these deals are China, Korea, Gulf States, Saudi Arabia, United Arab Emirates and the target countries are mainly Congo, Ethiopia, Madagascar, Mozambique, Sudan, Tanzania, Cambodia, Indonesia, Laos, Pakistan, Philippines (McNeill's 2009: 3-5)

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."

Conclusions and Implications

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.

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