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FDI's Role in Emerging Economies

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Abstract
This paper reviews the role of foreign direct investments in emerging market economies. The paper also exposes the merits and demerits of FDIs in emerging economies in order to understand the inflow and outflow of FDIs around the world and exhibit the global trend of FDIs. Many multinational firms have invested in emerging economies due to their attractive geographical location and cost minimizing factors including low wages, large market and growth opportunity. China, India and Brazil are the most attractive location for FDIs inflow in the world due to these factors. Some of the factors that discourage the foreign investors from investing in any country are the adverse law and order situation and lack of infrastructure. All those emerging economies that have no political and terrorism issues are flourishing because they have been able to attract major chunk of FDI which is playing vital role in strengthening economy due to capital inflows and currency appreciation. The paper conclude that FDIs have significant impact on the economies of different countries although there are certain unfavorable impacts of FDIs in the emerging economies but all in all the positive impacts are far more beneficial than the negative ones.
Keywords: FDI, Emerging Economies, Economic prosperity, BRIC,

Introduction
FDIs are considered to be an important source of financing throughout the world. Many economic analysts and policy makers are confident about the ultimate significance of FDI in host country. Evidence of the significance of FDI for developing as well as developed countries can be trace down without much impenetrability and complexity. FDI play a vital role in strengthening the economic infrastructure of a country through its diversified forms like sales subsidiaries, production subsidiaries or green field FDI. Multinational companies have emerged as a source of participation in global activities and world trade. Mohammad Amal (2011)i has observed in the past thirty years that the foreign direct investments are being shifted towards the developing countries due to several benefits in developing countries including cheaper labor cost, more business opportunities and attractive market capacity.

Brazil in Latin America, China and India in Asia are the biggest location for FDIs in the world. Many developed countries are investing their money and starting new projects there due to maximum profit chances. Europe is another attractive location for the foreign investors due to its combine currency "Euro" that is less prone to be depreciated due to combine economy effect. Some firms may borrow funds through international money market or borrow host country currency to meet the local expenses. Globally investors tend to invest more in acquisition as compared with other forms of investments like green field investment and joint ventures.

This paper has shown the FDIs role in the world economy since after the economic revolution in 1990s. Many FDIs started to move towards the emerging economies due to fruitful returns. scores of benefits that the investors got from investing there includes; abundance in natural resources, low labor cost, large market size, excessive potential customers probability and growth chances. FDIs also help the host country to get more inflow of capital, increase liquidity and appreciate the local currency. FDIs also raise the living standard of the local residents due to more employment opportunities. On the other hand it may adversely affect the domestic manufacturer and due to increased imports resulted in adverse balance of payment position if FDI had not been handled properly.

Literature Review:
As mentioned above that this research paper is about the foreign direct investments in emerging market economies. Philippe Bacchetta (2000)ii has thoroughly covered the necessary aspects of the foreign direct investments in emerging markets starting from the historical background of foreign direct investments since early 1990s when foreign investments were considered only in developed countries and the rest of the countries were deprived of this opportunity to avail the foreign funds to boost up their economic strength. Soon after the socio-economic revolution, this concept began to change that investments should be made in developed countries only. Many multinational companies started to realize that a strong economic market is not the only place form where they can maximize their profits and capture firm's growth; emerging economies also possess great opportunities that can assist the multinational firms to maximize their profits, achieve customers' goodwill,

expand and grow their business. Mohammad Amal (2011) believe that many multinational companies moved their businesses in emerging markets and within a period of twenty years there was approximately 900% increase in the foreign direct investments inflows in the emerging market economies. His study believes that if the global financial crisis would not have come then the statistic could have been shown more increase in the foreign direct investments inflows. Furthermore, he has also discussed the concern of investors about the fact that out of top ten countries receiving largest foreign direct investments inflows seven are from the emerging economies. Silvio Contessi and Ariel Weinberger (2009)iii have also proved it by saying that Asia and Latin America receives greatest share in foreign direct investments respectively from the whole world. All the multinational companies tend to invest their funds in these continents because of their abundance in natural resources, large markets and probability of getting more customers. According to Marianne Ganster (2007)iv many countries of Asia and Latin America possess very good geographical location that attracts tourists and some have sea ports and sea routes that made the import and export easier. She also reiterates that real estate projects are also very profitable in many countries. Thus, investors tend to invest in multiple projects as the chances of loss are quite low.

Amal, M. (2011) has also defined the criteria to choose the country where a firm should launch the project, the firms may have two concerns; some firms are more concerned about the economic and political conditions of the host countries before making investments while others are more concerned about the competitors' arrival and market capturing. Each firm has its own preference while choosing where to invest and the decision may change on a long term basis. Report of the working group of the Capital Market Consulting Group assures that a firm may choose among the types of foreign direct investments as well that whether it should invest in a joint venture or buy an already running business (acquisition) or invest in an entirely new project. Often firms prefer joint venture when they are entering in a country for the first time and when they get entire knowledge about the country; its laws and customers concerns then they shift their selves towards green field investments.

As far as host country is concerned, foreign direct investments inflows bring both merits and demerits along with it. Feng Zhang (2008)v has lighten one of the good impacts that the foreign direct investments bring with them is the corporate social responsibility under which they perform community development projects for the well being of the local residents. Many health programs, education programs, natural disaster relief camps are organized by these multinational firms. Linda Goldberg (2004)vi effect focuses on the currency appreciation, as the continued inflow of capital in the country increase liquidity in market and help to appreciate the local currency, employment opportunity is also increased. Yuriy Gorodnichenko, Jan Svejnar and Katherine Terrell (2008)vii believes that advanced technology is brought in the country that help the research and development (R&D) to perform better and even the local firms get global knowledge and experience to expand their business as well. Adewale Adeoye (2009)viii precisely says that foreign investments help the local citizens to raise their living standard and give them more purchasing power due to currency appreciation.

Another side of the frame gives almost opposite picture of inflow arrival in the domestic currency. Since the foreign investors will bring R&D in the host country then obviously they would be the first to implement them and attract customers towards their products, ultimately the demand of the domestic product will be decreased and the local manufacturer will be in loss. Joseph H. Davis, Roger Aliaga-Diaz, William Cole and Julieann Shanahan (2010)ix pointed out that if manufacturer will bear loss, then he will fire the employees to cut his expenses, and it will lead to a rise in unemployment rate. This will create a monopolistic market environment that will be lead by the foreign investor. Alicia Garcia Herrero and Daniel Navia Simon (2003)x say when foreign products will be in high demand therefore imports will be increased more than the export of the domestic products that will cause a deficit in the balance of payment. Another major factor of the current era is war and terrorism. Those countries that have insecurity issues due to terrorist attacks may lose their FDIs. Pakistan is one of the example that has lost many of the foreign projects regarding power generation due to its unfavorable law and order situation and frequent terrorists' attack that are being uncontrolled. All these factors can adversely affect the economy and trade environment of a country.

It can be said that like everything foreign direct investments also have positive and negative impacts, but its positive impacts are far more influencing then the negative aspects therefore in the current scenario, majority of the countries are looking forward towards the foreign direct investments inflows for their economic growth and stability. Klaus E Meyer (2005)xi has regarded Brazil, Russia, India and China (BRIC countries) as the largest to possess foreign investments. Linda Darragh and Nurkholisoh Aman (2012)xii showed several ways in which firms invest in these countries like they can have different cost structures. Some firms rely more on the cost of equity by issuing shares and allowing the shareholders to take part in the decision making, while other firms who do not want others to interfere in the business decisions prefer to borrow debt form the financial institutions and international capital markets by having more cost of debt. There is no hard and fast rule that which sector should adopt which type of cost structure, the whole decision is based on the firm's financial condition and future aspects.

There are many theories regarding foreign direct investments that assist a firm to take decision whether to invest in the project or not. Christopher Kramer (2010)xiii prefers to adopt John Dunning's theory there are four conditions over which a firm takes investment decisions. First of all the firm has to seek knowledge about the assets and funds that are available to the firm to start up a new project, if the firm has positive net present value of the assets then the firm has to look at the market in which it is going to establish the new project. If the cost is affordable and less than the future expected cash flows then the firm can think of accepting the project. Third point that should be kept in mind is the location advantage because if the firm is at a place quite far from the market then the competitor may took advantage of early delivery of product and the transportation cost will also be increased if the manufacturing location is far from the distributors and retailers. If all these factors are met then at last the firm has to see that whether the project is helpful in attaining the long term objectives of the firm or not. In many projects, profits are not worthy for instance; the projects started by the governments and social workers' association is for the well being of humanity rather than for obtaining profits. So if the project is assisting in achieving the goals of the firm then the firm should opt for it and such foreign direct investments are made by the investors.

Mohammad Amal (2011) also favored these types of tools to make the foreign direct investment an effective for any economy as it helps to gain profit for the firm, meet the necessity of the local residents and government also gain capital through the excise duty and other trade taxes that are implemented on the foreign investors.

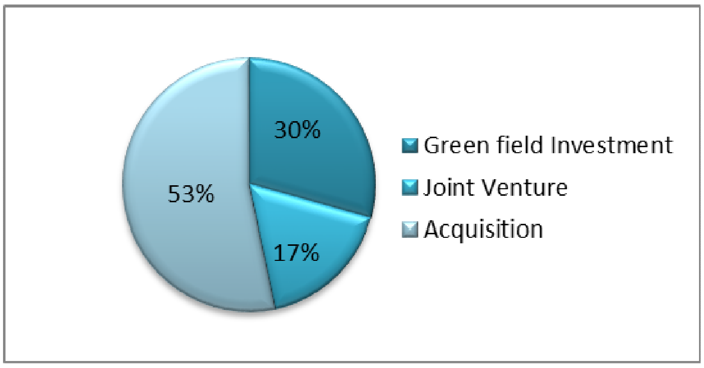
Matthew Sweeney (2010)xiv believes that emerging market economies are greatly comprised by the Asian countries among which China is the most successful in receiving foreign direct investments. He further added that China is also an active member of World Trade Organization. Krishna Chaitanya, Vadlamannati and Emilia Vazquez Rozas (2007)xv says that the foreign direct investments flow to other counties also depend on Chinese foreign direct investments flow; if Chinese inflow decrease rest of the countries would get more foreign direct investments inflows and vice versa. Sumon K. Bhaumik, P. L. Beena and Laveesh Bhandari (2003)xvi regard India, Malaysia and Thailand as other Asian countries that largely attract foreign direct investments and also perform their corporate social responsibility effectively. Sean Williams (2011) consider Brazil, Argentina, Mexico and Panama from Latin America are regarded as foreign direct investments attention seekers. David Lynn, Tim Wang and Cassondra Mehlum (2011)xvii consider Brazil an outstanding location for foreign direct investments inflow and expect it to be the 5th largest foreign direct investments receiver. According to Marianne Ganster (2007), Mexico due to NAFTA and Panama because of its sea route (Panama Canal) attracts huge foreign direct investments inflows.

Africa previously called "the dark continent" is unable to attract many of the foreign investors due to its improper infrastructure, lack of technology and scarcity of natural resources like electricity, water and natural gas. Here infrastructure includes all the things that are necessary for firm before making investment in a country. This inadequacy has left the African countries far behind in the race of economic stability. J. R. Kehl (2007)xviii said that only 2% of the entire world's foreign investments come to this unprivileged continent. Jeremy Baskin (2005) pointed out that Egypt, South Africa, Algeria, Tunisia and Morocco are those African countries that receive a minor part of the world's foreign direct investments. However, Adewale Adeoye (2009) has very aptly pointed out that if the government ensures availability and safety of all the macroeconomic factors, then the inflow of FDIs in the country can increase substantially.

Forms of Foreign Direct Investments

FDIs can enter into the domestic country through various means. The mode of entrance depends on both the investor and the country's perspective of business. Acquisition of domestic firms is done when any firm wants to give the entire firm to the foreign trader against a fixed deal. Joint ventures are more preferred when the domestic government wants the local traders to mingle with the international traders in order to have global views of business along with profit sharing. On the other hand, green field investments are setup of an entirely new firm that provide employment opportunity to the local resident but increase the competition in local market. The pie chart shows the preferred mode of entry for the investors to enter into the host country.

FORMS OF FDI's



(Report of the working group of the Capital Market Consulting Group (2003), Foreign Direct Investment in emerging market countries)

Role FDI's in Host Country

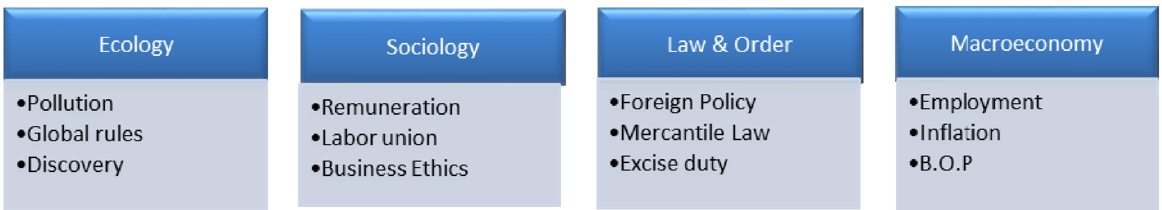
It is open secret in modern world that emerging economy cannot achieve economic growth unless they find right mix of factors that can transmit positive signals for FDIs. Countries that allow the foreign investments to be injected in their domestic markets have first created an environment where the foreign investors have more confidence. Moreover, these investors bring about healthy fruits for the economy even though it's not always been positive with this type of reliance for economic growth.

Feng Zhang (2008) have identified that most of the MNCs in emerging economies nowadays are more engaged in performing activities pertaining to corporate social responsibility and are doing their best to serve positively towards the environment where they are conducting their business. Working for the well being of humanity in health sector, educating people of lower class and doing a hygiene campaign are some of the social works done by these firms.

Jose De Gregorio (2003)xix, pointed out that one of the positive role that FDIs have on the host country is that if one of the foreign investor will earn positive inflows in that particular country that the rest of the investors will also be motivated to invest in the same geographical area, hence the host country will get huge inflows in the form of foreign investments and liquidity will be increased in the market. If the investor is getting capital through buying local firms' shares then both the foreign investor and local trader will be benefited.

One of the positive roles that FDI bring is the increase employment opportunities for the local residents especially the long term projects which also assist to strengthen the economy. Alicia Garcia Herrero and Daniel Navia Simon (2003) pointed out that as FDIs increases investment in domestic country, the capital inflows in the country also increases which bring a direct impact on supply of the domestic currency and exchange rate.

FDIs also assist to be a role model for the local firms and they can make their strategies according to the multinational companies that can help them to have sound position in market. Several current technologies are carried by the FDIs and the global knowledge they possess also diffuse in the local markets. Linda Goldberg (2004) gave the account that these FDIs also help to train the local employees according to the global standards, give them high remuneration and allowances to keep them motivated to work. Thus, they set a standard for the local firms to act in accordance with. FDIs also serve as a stimulus to opt for R&D (research and development) in the market environment to compete with others and attract customers by fulfilling their needs through innovative products. For the purpose of innovation, many discoveries are also made in the respective countries.
Yuriy Gorodnichenko, Jan Svejnar, Katherine Terrell (2008), pointed out that pressure by the outside world on the host economy to upgrade the technology is somewhat released through FDIs. The emerging markets are able to get innovation and idea about R&D through these FDIs and hence the economy can handle the global market competition.



(Klaus E Meyer (2005), Foreign Direct Investment in Emerging Economies)

FDI does not always carry all well for the emerging economies as it may have its side effects which must be understood and taken care of properly. These effects include:

- ✓ The domestic country may face problem if the financial condition for the local trader is not sound due to influence of foreign products. There is a risk that the foreign investment will dominate the local one that can lead to a domestic crisis.
- ✓ Since local products demand decrease, the production will also be decreased. This will lead to reduction in employment as the firm would cut down the expenses through easiest mean of firing the employees.
- ✓ Export may be influenced as well; the demand for foreign goods will be higher than the supply to foreign countries. Ultimately there will be an imbalanced situation.
- ✓ There are two factors that will be highly influenced; first export and the other is labor demand. Decrease in production will decrease the hiring of labor that will lead to unemployment increment. Power retention in the hands of foreign investors may also create monopoly in market and adverse effect over the stock market.
- ✓ Another risk that is always attached with the foreign investments is of unstable foreign exchange rate. Although hedging and derivatives serve as tools that minimize the risk but still chances of loss exist and weak host currency can decrease the profit while exchanging them with a strong international currency. Depreciation of host currency can badly impact profits of the firm.

FDI's Perspective

FDIs are the biggest source of investment globally and for a few decades FDIs are more attracted towards emerging economies due profit opportunities. Klaus E Meyer (2005) has argued that about 75% of the market supply is constituted by FDIs in India, Egypt, South Africa, Hungary and Poland. Although the size of project started in these countries are rather small with low number of employees but with the passage of time hiring will also be increased.

Silvio Contessi and Ariel Weinberger (2009) argued that these FDIs help the investing countries to earn more profits because of availability of more customers in local markets and a great concern of buying imported products. Hence overall productivity of the host country is increased. Many of the other factors that attract FDIs in emerging countries include; low labor cost, abundance in natural resources, market size and potential growth, government assistance in terms of some tax exemption etc.

According to Jose De Gregorio (2003)xx, Chile is yet another country that enjoys large amount of FDIs due to its abundance in natural resources and almost 75% of the world's foreign investors are attracted to the mining sector of Chile.

Another important reason to invest in emerging countries is that the chances of growth in emerging market service sector is far more than the rest of the world and due to expanded market size the chances of profit maximization is greater and the risk of loss is almost none. IMF has also declared that US firms can earn more by investing in the emerging countries than they could have earned in the developed countries.

These attractive factors have made it possible for the Japanese firms to invest and expand their business in emerging countries as well. Japan has further made economic growth through foreign investment in new markets.xxi Here one point should also be kept in mind that the shares of the emerging market firms are more risky than the developed country's shares because in the emerging markets the funds are injected by the foreign investors and hence it depends on the foreigners that whether they would let the money be in the emerging market or not. If a huge amount is taken away from the economy then the shares of rest of the local firms will also be influenced.

Methods of Investment in Emerging Countries

Regional integration agreements like SAARC, SADC, and ASEAN are some ways through which FDIs can intervene in an economy. MNCs have various methods of investment in emerging countries that depends on their management techniques. Investors that need full control over the firm invest more in equity while those who borrow funds from the money market have more cost of debt as compared to cost of equity. Hence it can be said that every firm has a different strategy to manage its cost of capital.

A few scenarios are discussed below:

- Majority of the green field investors prefer to keep the equity in their own hands and do not sell their shares publicly so that nobody can interfere in their decisions and management style and they can enjoy independent control over the firm. Thus, their cost of capital lacks cost of debt completely and the whole cost depends on the equity portion of the firm.
- Projects that are involved in the extraction of natural resources may have many equity holder partners due minimize the risk of loss and have dominancy in the emerging market.
- Foreign investors may get the capital through international banks and other international capital markets like International Finance Corporation.
- In order to meet the necessity of the firm and manufacturing processes, some foreign investors also

borrow the currency of that emerging country in which the firm is currently carrying out its operations.

Conclusion

The whole research paper and the findings conclude that the overall impact of foreign direct investments on the emerging economies is beneficial. Foreign investments assist both the host country and the foreign investor to gain maximum profits in terms of money and social responsibilities. The only hurdle in this way of progress is the inadequacy of infrastructure and terrorism issues. Those countries who have resolve these problems are enjoying foreign investments hugely. These investments are opening new doors to the emerging countries especially India and China are making the most of it. These emerging economies are far sighted about the boosting effect of foreign investments and hence it can be observed that in the past ten years these countries have made their economy stronger through the enforcement of these FDIs. Brazil as the 5th largest economy is standing on the first place as far as economic establishment through FDIs is concerned. Russia on the other hand; instead of political clashes and revolution has made its economy to regain the position trough the international investments. India has managed to attract the foreign investors due to its fertile land and rich cultural values. China has adopted the strategy of providing cheap labor cost. Most of the foreign investments are attracted in the Chinese markets due to its low labor cost. By having a keen observation on the BRIC countries it can be resolved that emerging economies can managed their strengths by welcoming foreign investments and providing opportunities to their natives to show their potential and talent internationally. Hence their people can get international recognition which would bring more investments and economical strength to their homeland. Current scenario shows that the role of foreign investments will tend to increase with the passage of time and many emerging countries like India is expected to come in line of developed countries through foreign investments.

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