Prabhat Patnaik

FDI As A Means Of Financing Development

Discussions on foreign direct investment (FDI) as a means of financing development often suffer from two different shortcomings. The first, a very basic one, confuses *real* with *financial* resources. The second does not distinguish between *different forms* of foreign direct investment. The question of financing development is concerned with finding the real resources for increasing the level of investment, or more generally capacity-enhancing expenditure in the economy. This becomes an issue only when the economy in question does not have any idle real resources, in the form of unutilized industrial capacity, or unusually large foreign exchange reserves, or surplus stocks of foodgrains and other commodities. If such idle resources are absent, then the real resources of the economy have got to be diverted from their current uses for increasing productive investment, entailing some sacrifice on the part of some members of society; or additional real resources have to be obtained from outside, in the form, for instance, of FDI.

Hence, the *question of financing development is not itself a financial question; it has to do with obtaining real resources for investment.* And FDI can help in financing development only if it brings such additional real resources to an economy that does not have idle real resources, i.e. is short of such real resources. If FDI merely brings *finance* to an economy that is not short of real resources, then it is not playing any specific *sui generis* role by way of financing development. Likewise if it brings real resources to an economy that already has idle real resources, then it is not making any *sui generis* contribution to financing development. Indeed, if its bringing such real resources has the effect of rendering existing real resources, which are being used in the economy, idle, then it might even be playing a negative role, of increasing, for no legitimate reason whatsoever, the economy's foreign dependence.

Unfortunately, much of FDI, even when it is authentic greenfield investment, either goes into economies which are not short of real resources, especially foreign exchange reserves built out of cumulated export surpluses, which is precisely what enhances their appeal as investment destinations; or has the effect of rendering existing real resources in the host economies idle. As a result, it does not contribute in any meaningful way to *financing development*. In the former case, which is typified by East Asia, it may still be useful in so far as it brings in technology or international market access, but it does not contribute to *financing development.* In the latter case, even such justification for it may lack credibility.

This latter case arises, not just with manufacturing investment, but with all kinds of FDI that have the effect of replacing domestic producers. If multinational corporations (MNC) retail chains replace domestic small retailers, or if MNCs operating in the extractive activities replace domestic firms already engaged in such activities, then not only is there no contribution to the *financing* of economic development, but there might be at least three serious deleterious effects: first, to the extent that the MNC investment is more import-intensive, it entails a leakage of demand from the domestic economy, and hence, a shrinking of the level of domestic activity, entailing *ceteris paribus* a contraction in output. Second, for this very reason, since technology used in MNC investment tends to be less labour-intensive, it contributes *ceteris paribus* to a contraction in the level of domestic employment. And thirdly, in addition to such contractionary output and employment effects, the economy's foreign dependence increases.

It is a well-known fact that FDI goes more to rapidly-growing economies which have already mobilized substantial investible resources to ensure such rapid growth, rather than to economies that have a paucity of resources, and hence experience slow growth or stagnation. The rapidly growing economies are attractive for FDI because they offer fast-expanding domestic markets. If the domestic market is the main target for such FDI, it necessarily means displacing domestic producers already operating in this market, and hence, causing *ceteris paribus* output and employment contraction.

Of course, it may be argued that the replacement of domestic producers by MNCs leads to technological upgrading. For instance, the replacement of domestic retailers by MNCs causes an improvement in the quality of service to customers. But it is a moot point if a contraction in employment can be justified in the name of providing better quality service to the domestic elite. In any case, blanket encouragement of FDI flows irrespective of where such flows go can have the effect of exacerbating the

domestic dualism in such economies, by generating unemployment in this manner, which is contrary to what should be the objective of development policy.

Another shortcoming of most discussions on FDI is the failure to distinguish between different forms of FDI. No matter whether its consequences are beneficial or deleterious, green-field investment represents genuine creation of fresh productive capacity. But almost a third of FDI flows into developing countries take the form of mergers and takeovers. These cannot be considered as means of financing development. They are associated exclusively with the inflow of finance; they do not bring in any real resources. Nor do they create any fresh productive capacity in the economy.

It may be thought that since equity is acquired in exchange for finance, those firms taken over by FDI, are left with finance as a result of such take-over, which they can use for undertaking productive investment elsewhere. But this is precisely the fallacy referred to above, namely the confusion between real and financial resources. *Investment in a developing economy can be restricted only by a shortage of real resources; it cannot be restricted by any shortage of finance, except through erroneous domestic economic policies.* It follows then that nearly a third of FDI inflows into developing economies, even though not contributing to any development finance, has the effect of "de-nationalizing" these economies by shifting control over productive assets from domestic nationals to foreigners. This constitutes a further argument against indiscriminate encouragement of FDI in the name of development finance.

Such indiscriminate encouragement has yet another consequence of note. The easing of FDI flows typically has the simultaneous effect of easing portfolio investment flows, including flows of speculative finance. This has the potential of destabilizing economies. And precisely because of this potential, it puts severe constraints on economic policy-making: governments, always chary of disturbing the "confidence" of speculative investors, have willy-nilly got to follow policies that cater to the caprices of speculators, even when such policies go against public interest. But such financial flows can be deleterious, not only in terms of their impact on policy-making, and not only when they precipitate capital flight. They have deleterious side-effects even when they flow in, since they cause exchange rate appreciation which has the effect of replacing domestic production by imports, and hence, causing output and employment contraction, even while pushing up the net financial claims of foreigners on the economy.

Nation-building in the developing world is a fragile exercise, which needs to be carefully nurtured and whose requirements have to be respected. A good deal of FDI now goes into the service sector, into financial activities and even into spheres like education. But education is not just a commodity to be produced, like soaps or toothpastes; it is a vital part of the nation-building exercise. To believe that the education system of a country can be propped up through FDI may appear plausible in the short run, but can have long run adverse consequences that may strike at the roots of national identities.

Likewise, the credit system in a developing economy with substantial peasant agriculture must be sensitive to the needs of the peasantry. Enforcing this sensitivity on foreign banks has proved, in practice, to be extremely difficult; what is more, when domestic banks have to compete with foreign banks, they too, even including State-owned banks, are forced willy-nilly to by-pass the needs of peasant agriculture. This can have very serious social consequences which a developing economy can ill-afford to ignore.

It follows that FDI flows into the developing world must fulfill two criteria: they must be economically justifiable; and they must not go against certain overriding social considerations which must temper economic policy-making in developing countries. To be economically justifiable, they must bring in real resources and must not give rise to domestic output and employment contraction. Only then can they genuinely aid development financing. What is needed, in short, is a nuanced approach to FDI flows, not one that believes that the more the FDI flows, irrespective of what kind and to what destination, the better.

Prabhat Patnaik *is an Indian economist, who has achieved international acclaim with his incisive analyses of various aspects of economics and politics. He is a professor at the Centre for Economic Studies and Planning in the School of Social Sciences at Jawaharlal Nehru University in New Delhi. Patnaik is currently Vice-Chairman of the Planning Board of the Indian state of Kerala.*