Chapter 2
Conceptual Framework
2.1 Introduction

Conceptual Framework is very important for the key terms used in any study under research. In this section the target is to highlight key issues and explanations related to the terms of study such as FDI and components of BOP. Obviously, the conceptual framework is the theoretical existing knowledge related to the topic available and acts as generally acceptable elucidation of the behaviours of various entities.

2.2 Foreign Direct Investment (FDI)

Liberalisation, Industrialisation, Privatisation and Globalisation, have all contributed to the spread of Multinational Corporations and Trans National Corporations. The primary task of both is that they invest in foreign entities and take benefit of the foreign land. This is befitting for them in the short as well as long run. These MNCs and TNCs exhibit skills that are unmatched by other domestic organisations such as financial services, capital, heavy machineries, strategy etc. (Eurostat Pocket Book, 2007). The shift of the global economy from independence to interdependence has allowed the way for increase in the investment by the MNCs and TNCs throughout the world. This has led to emergence of new terminology in the international economics such as Foreign Direct Investment.

2.2.1 Meaning of FDI

The flow of international finance or more clearly the capital may be in the form of direct investment or portfolio investment. Direct investment refers to investment in new facilities or for strategic reasons while on the other hand the latter refers to acquisition of securities that considers what was said by Keynes as speculative motive (OECD, 2002). FDI is the natural outcome of the institutions of the home countries and host countries (OECD, 2008). IMF defines FDI as “Investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The investor’s purpose being to have an effective voice in the management of the enterprise.” In essence, FDI transfers to the host countries; capital, managerial skills, technical know-how, innovation, technology etc. Thus, it is a long term international capital movement with the intention of managerial control over the ownership in the host country. Thus, an important element which decides about FDI is the share in ownership. In this regard, it is clear that UNCTAD defines that FDI is the
investment that reaches with a level of 10% investment in the equity of the company. Thus, any investment below 10% is not considered FDI rather it is considered Portfolio Investment (PI).

### 2.2.2 FDI and Other Forms of Capital Inflows

In an era where sustainable development is considered one of the important goals of the economy, it is FDI that is accepted as a medium to achieve the same. It is expected that FDI through MNCs will act as stimulus to growth in host countries in comparison to any other type of capital inflows such as Aids, International Loans etc. In case of developing economies, where there is constraint on domestic savings, FDI supplement the national savings and may promote economic growth (Moosa, 2002). FDI is considered superior to other forms of capital as they are non-debt creating on one hand and non-volatile on the other hand. Though, volatility in the long run is subjected to analysis, in short run it is not present due to the involvement in ownership. Another reason is that the return on FDI depends on the real activities in the economy, that is, the return depends on the performance of the projects financed by the investors. FDI facilitates international trade on one hand and transfer of knowledge, skills and technology on the other hand. A comparison of FDI and Portfolio Investment will reveal that FDI has a long term perspective and thus it even sustains at the time of crisis. In this regard the observations of UN are relevant to quote “FDI flows to developing and transition economies in 1998 declined by about 5 percent from the peak in 1997, a modest reduction in relation to the effects on other capital flows of the spread of the Asian financial crisis to global proportions. FDI flows are generally much less volatile than portfolio flows. The decline was modest in all regions, even in the Asian economies most affected by the financial crisis.” Another point to be noted is that debt inflows generally finance consumption rather than investment in the host country while FDI is used productively. FDI has stronger effects on economic growth, as FDI provides for more than just capital such as international technology, management know how and penetration in new markets. However, several empirical findings indicate that FDI is not always homogeneous and its analysis depends on time variation and location specific factors.
2.2.3 Types of FDI

(A) By Motive

(a) Resource Seeking

This type of FDI is motivated due to the existence of natural resources in host countries. It has a historical development of its own since times immemorial and remains a relevant source of FDI for most of the developing countries. At an international level the relative importance of resource seeking FDI has increased in countries having low protectionism and has decreased in countries having high protectionism.

(b) Market Seeking

This type of FDI is attracted by the size and growth of the markets of the host country/countries. The probable advantages are the strategic positioning, large customer base, avoidance of imports barrier, etc (Bjorvatn, Kind & Nordas, 2001). Stating simply, direct investments seeking markets whether old or new comes under the category of market seeking FDI. Important elements while considering market seeking FDI are transport costs, transfer pricing, tariffs, non-tariff barriers to trade, uncertainty in exchange rates due to high volatility etc. The ultimate motive of the MNCs or TNCs involved in market seeking FDI is to overcome trade protection in order to supply goods and services to the local market (Gari & Jasefsson, 2004).

(c) Efficiency Seeking

Efficiency seeking direct investments rests on low cost of production, specialised skills, low cost trade, low cost of auxiliary trade services etc. The MNCs and TNCs involved hope to increase their efficiency by exploiting the benefits of economies of scale both internal and external. This type of FDI is widely found in developing countries.

(d) Strategic Asset Seeking

This type of FDI is present in the post globalisation stage of the firms or in the stage of Trans nationalisation. Through this, assets are created that focus on skills and technology (Saeed, 2001). Hence, it is a tactical investment to prevent the loss of
resource to a competitor. Assets of foreign firms are secured by new plants and acquisitions or joint ventures to create synergies with the existing pool of assets through common ownership.

(B) By Direction/Flows

(a) Inward FDI/ FDI Inflow

This type of FDI comes from the flow concept in macroeconomics. Inward FDI or FDI inflows refers to the foreign capital coming into the domestic economy. Every country is in need of foreign capital particularly the developing countries due to limited domestic capital (Jones & Wren, 2006). Different features of the country may attract the foreign investors. As already the motives has been discussed the same motives guide the investors in selecting the area of investment.

(b) Outward FDI/ FDI Outflow

This type of FDI is the division on the basis of the flow concept of macroeconomics. This refers to all the funds that are invested by the domestic economy in the foreign land (Dreyhaupt, 2006). Sometimes it is also termed as capital flight, the capital that moves out of the domestic country due to unfavourable factors in the domestic economy or due to better favourable factors in other countries.

(C) By Target/ Entry Mode

(a) Greenfield Investment

It involves an investment where fresh production facilities are established by the company (Griffin & Pustay 2005). It allows the firm to establish its operations in a new market where growth is expected.

(b) Mergers & Acquisitions

Acquisition as FDI entry mode is nowadays largely used as it gives control to the firms without increasing market competition. Under acquisition a foreign firm acquires the assets and control over the home firm. Thus, it enters the market without increasing the competition. An acquisition is more beneficial than a Greenfield Investment. (Buckley, 1981).
(c) **Joint Venture**

A joint venture is typically defined as a business enterprise which is partly owned by a firm together with one or more partners. The definition of a joint venture imply that the total share of assets owned in the host country company will be less than 50%, and therefore not controlled by the parent firm. A mutually exclusive fact with the definition is therefore that a foreign subsidiary does not fall into the category of a joint venture (Eiteman, Stonehill & Moffett, 2004; Bergstrom & Wanngard, 2005).

(d) **Licensing**

Foreign firms often indulge in international licensing agreement to manufacture and sell in the host country. The process involves a licensor in the home country to get an opportunity for sharing resources with the licensee in the host country. The resources includes patents, trademarks, managerial skills, technology etc. This type of route makes possible for the license to manufacture and supply goods and services in the host country without opening a new operation base overseas. Licensing acts as a flexible international agreement which can be tailored as per the needs and requirements of both licensor and licensee. The main advantages of licensing includes reaching new markets not accessible by export, quick expansion without large capital investment, minimisation of political risk and it paves the way for future investments in the market. Figure 2.1 summarises the types of FDI:

![Types of FDI](image)

**Figure 2.1. Types of Foreign Direct Investment**

Source: Prepared by the research scholar
2.2.4 Theories of FDI

Though separate theories for inward FDI are not available yet the generalised FDI theories may be interpreted to understand and develop theoretical discussions on FDI flows.

(A) Classic FDI Theory

The proponents of this theory are Hymer (1960) and Kindleberger (1969). They highlighted the linkages of FDI with the imperfect markets. Market imperfections such as factor market imperfections, goods market imperfections, scale economies and government controlled restrictions are the reasons for FDI flows. Hymer (1960) has observed that for companies to involve in FDI they need a competitive advantage compared to foreign producers. But the classical theory failed to explain why companies will involve in FDI flows when other option such as exporting is available. Latter theories of FDI by various authors focused on this fundamental issue.

(B) Internalization and Transactions Cost Theory

Among others, Buckley and Casson (1976), developed the theory of internalization that explains why companies opt for FDI flows rather than exporting. While exporting, the company involves in inter country transactions but with FDI flows, the transactions become inter corporate (as the firm may operate subsidiary in foreign country). This according to Buckley may be termed as internalization of knowledge, human capital and patents by the company when it involves in outward FDI. Transactions cost theory by Coase (1937) explains that in order to lower the transactions cost, the firms involve in FDI flows. The reason for transactions cost is the presence of imperfect markets. This works as an incentive for the companies to keep production within their organisations. Even the cost associated with transactions outside the firm such as contractual costs can be minimised while pursuing FDI flows.

(C) Location Theory

FDI flows may be due to pull factors or push factors and in both the cases it is the location that plays a vital role. Several firms are motivated to invest abroad due to one or other reasons. Vernon (1966) observed and concluded that investment in production of more technical products should be located in countries with suitable
infrastructure. On the other hand, according to him, more standardised products can be produced in less developed regions where the costs are lower. This decision may act as motivation for FDI flow in respective regions.

(D) Eclectic Paradigm Theory

Also known as OLI framework, was developed by Dunning (1977, 1988) and was an attempt to blend all previous theories related to FDI. According to this theory by Dunning, the firms engage in FDI flows due to three advantages:


Location Advantage: Supported by Butler (2000)

Internalization Advantage: Supported by Griffin & Pustay (2005)

Figure 2.2 Summarises the Theories of FDI:

![Theories of FDI](image)

*Figure 2.2. Theories of Foreign Direct Investment*

Source: Prepared by the research scholar

2.2.5 Macro Economic and Micro Economic Aspects of FDI

Macroeconomic aspect of the FDI is connected with issues such as domestic capital formation, balance of payments, taking advantage of external market to grow faster. On the other hand, the micro economic aspect is related to issues such as cost reduction, product quality improvement, changes in industrial structure, inter-firm linkages etc. At macroeconomic level FDI is aggregation of investment by all MNCs while ignoring the individual specific features of the MNCs but that cannot be done in case of micro economic impact of FDI. The micro economic effects of the investment
by MNCs may differ from one MNC to another MNC notwithstanding the difference in the industry.

2.2.6 Crowding-in and Crowding-out Impacts of FDI

Crowding in means the activation in the investment of the host country in upstream or downstream production due to FDI flows by the producers. FDI in exports motivates and encourages downstream production while on the contrary FDI in infrastructure motivates and encourages upstream production as is generally accepted both theoretically and empirically. The multinational corporations presents special opportunity for exports by access to inter firm markets that are large enough which have their setup in the host countries. These opportunities are available as a prerogative to foreign affiliates. The growth due to capital flow and higher efficiency achieved along with it may in turn encourage higher investments in the economy. This has been identified by several researchers (Coviello & Mcauley, 1999).

Another issue to be looked upon is that at times foreign investment takes away the investment opportunities open to domestic firms. This may happen when domestic enterprises are heavily contemplating investment. MNC’s in host country may decide for expansion and diversification and may be willing to raise capital from host economy’s financial market. This may be a negative move as capital funds may move frequently towards the MNC’s in comparison to the domestic firms. This will create capital problem for the domestic enterprises and may led them out of the competitive market. Sometimes the exchange rate in the economy gets appreciated due to large inflow of foreign exchange by MNC’s in their move to acquire domestic firms (Fujita, 1995). In turn, this leads to less competitive exports of the host economy and as a result discouraging and declining domestic investments for exports led market. These issues have a crowding out impact on domestic enterprises.

FDI as a double edged sword involves crowding in and crowding out impact on host economy. Several regulations are formulated and implemented by host country with respect to crowding in and crowding out. These regulations includes performance requirements with parameters such as local content, export commitment, technology transfer, balancing of dividend and foreign exchange neutrality. For MNC’s these performance criteria may make FDI less attractive due to fall in relative trade.
openness. Thus, MNC’s face problem in deciding the location for their operations. This creates a need for trade-off between trade openness and performance criteria.

2.2.7 Advantages of FDI for the Host Country

At the outset, deficiency in availability of domestic investment and foreign exchange are removed by FDI. Other lacunas in the domestic entrepreneurial capacity may also be overcome by FDI inflows. Out of several advantages of FDI, the prominent advantages are as follows:

(A) Resource-Transfer Benefits

Foreign Direct Investment adds to the growth rate of the country and positively contributes to the host country’s economy by providing technology, capital and management expertise. Without FDI these benefits appear either unachievable in the short run or are expensive for domestic economy. An example of resource transfer benefits is the encouragement of FDI by Indian government in petroleum industry.

(B) Capital Availability

Host country firms, particularly in developing countries, do not have access to financial resources but MNC’s due to their financial strength and economies of scale seldom face such a problem. MNC’s may get the funds through internal financing (retained earnings, capital reserves etc.) or may raise from financial markets easily due to their reputation which may not be the case with host country domestic firms (Acedo & Jones, 2007). This fact was identified by Indian government and therefore foreign entities were invited to form joint ventures in different sectors in the Indian economy.

(C) Technological Progress

In the era of globalisation, technological progress and economic growth are inter-linked and there appears to be a bidirectional causality between technological progress and economic growth. It is now widely accepted that economic growth and industrialisation are stimulated through technology. The progress can take two forms. One way is that the technology is incorporated in a production process which includes the technology for discovering, extracting and refining oil. Another way is that technology can be incorporated in a product which includes use of personal
computers. However, developing countries in general have failed to develop indigenous product and process technology due to lack of research and development expertise (Chandra, Styles & Wilkinson, 2009). This is particularly the case for less developing countries as well. Therefore, less developing and developing countries have to rely on developed or highly industrialised countries for technological requirement. This is possible through FDI and economic growth may thus be achieved. One of the prominent reason to invite foreign firms for FDI is to acquire relevant technological know-how.

(D) Management Expertise

Management expertise and skills acquired with the inflow of FDI generates important advantages for the host country. Human resources from subsidiaries of MNC’s in host economy having expertise in managerial, technical and financial affairs helps to promote entrepreneurship and establish indigenous firms. The micro and macro environment of the MNC’s is affected by the level of expertise MNC has. Thus, management and professional skills of other stakeholders such as local suppliers, domestic distributors, and domestic competitors may improve. But it is to be noted that these benefits may be reduced if most skilled jobs in the MNC subsidiaries are reserved for foreign nationals (Ruzzier, Hisrich & Antoncic, 2006).

A major negotiating point between MNC willing to undertake FDI and host government is the chunk of job shares going to citizens of the host country. Due to this concern of host economy several of the MNC’s convince host country government to create large proportion of management and highly skilled jobs for citizens of the host economy.

(E) Employment Effects

Most of the developing and less developed economies are always in search for the method to create more jobs. FDI brings with it a promise and opportunity to generate employment benefits for the host economy. Recall the Toyota FDI in France that resulted in employment benefits of both direct and indirect nature. When MNC’s employ a large number of host country citizens, the direct effects are clearly visible on the employment (Autio, Sapiengza & Almada, 2000). On the other hand, indirect effects are termed to the process where jobs are created as a result of investment or
local spending by the MNC’s in the host country. Generally, such process creates jobs in local market benefitting local suppliers. The indirect effects should not be undermined as they are at times large enough than the direct effects. For example, in the FDI investment by Toyota in France around 2000 direct jobs were created along with 2000 more jobs in auxiliary industries.

However, critics of the globalisation identify that the new jobs created by FDI does not necessarily represent net additions in employment. As an example, the new jobs created by FDI by Japanese auto companies in India has been offset by jobs lost by the Indian citizens in US based auto companies as Japanese firms gave a tough competition to US auto companies. Due to this type of substitution effect in the labour market the net employment benefits generated by FDI may not be as large as envisaged by MNC or for that matter host country government (Maeseneire & Claeys, 2012).

(F) Effect on Competition and Economic Growth

Theoretical considerations in economics highlights the dependency of efficient market functioning on an adequate competition level between producers. Foreign direct investment increases options for consumers which in turn improves the competition level in domestic markets. This escalates the prices down and economic welfare of the consumers is also increased. Increased competition accelerates capital investments by enterprises in equipment, plant and research and development while struggling to gain over their competitors. The long run outcomes may include innovation (both product and process), increased productivity and accelerated economic growth. Competition in service domestic markets due to FDI is important covering services such as telecommunications, retailing, financial services etc. Generally, it is important when exporting is not an option as the service has to be produced at the place of delivery.

In retail sector also, foreign direct investment has helped in increasing competition. Consumers get benefitted by fall in prices and increase in choices. World Trade Organisation’s sponsored agreement of 1997 in which 68 countries were parties (accounting for 90% of world telecommunications revenue) took the invitation of opening their domestic markets for foreign investment. They pledged to promote competition with common and fair rules in telecommunications.
The agreement was successful in increasing competition in most of the domestic telecommunications market. Three benefits are clearly visible of the above mentioned agreement. First, the proponents of globalisation strongly believed that FDI Inflows and increased competition has accelerated investment in the modernization process of telephone networks all over the world thus giving better service to the consumers. Second, consumers will be benefitted by lower prices due to the increased competition. The WTO agreement estimates suggested that due to the agreement of 68 countries, the average cost of international calls was dropped by 80% and the total saving of the global consumers was about US$ 1000 billion in three years period. Third, it is argued by multilateral institutions that trade in goods and services involves the flow of information between buyers and sellers. An improvement in the service quality of telecommunications along with reduced prices results in increase in the volume of international trade. Thus, reforms in telecommunications sector promoted international trade in other goods and services.

2.2.8 The Costs of FDI to Host Countries/ Disadvantages

There are three costs that are of concern to host countries. They arise due to possible adverse effects of FDI on competition in the host economy, the perceived threat to national sovereignty and autonomy and adverse effects on the balance of payments. They are discussed in the following sections.

(A) Adverse Effects on Competition

In the previous section, advantages of foreign direct investment were discussed. In this section MNC’s adverse effects or in other words the concern of host countries would be discussed. The primary concern of host country is the power of foreign MNC’s that may be greater than indigenous competitors. In case an MNC is part of a multilateral international organisation, the foreign MNC may subsidize its cost in the host economy by drawing funds generated elsewhere. This could allow the MNC’s to monopolize the market and may drive indigenous companies out of business. In a monopolized market, prices can be easily raised by the MNC’s more than prevalent in the competitive market having negative effects on the economic welfare of the host economy. This negative effect is greater in economies having few large firms of their own (generally the case of developing or less developed countries). Though, it is not a major concern in most industrialized nations.
Another perspective of the argument related to competition may be linked to the concern of infant industry. Imports control may be employed till the local industry is not at par to compete with MNC’s. The extension of this argument tends to develop a notion of restricting FDI in growing industries.

In other words, a country having potential comparative advantage in a particular sector if allows FDI in that sector, indigenous enterprises may lose the opportunity to develop and grow. Though, it is also argued by economists, that the above reasons are often propagated by inefficient domestic competitors through political lobbying with host country government in order to restrict direct investment by MNC’s. For the same political gimmick, the host government may highlight its policy to restrict FDI in order to safeguard the interests of a particular industry. It generally happens to the labour intensive industries as their vote bank share is substantially large in democracy.

(B) National Sovereignty, Environmental Concern and Autonomy

Most of the host governments have a concern that FDI comes with a cost, that is, loss of economic independence. The key decisions affecting the host country’s economy both at micro and macro level, may be made by an MNC having no long term real commitment to the host country. This means a policy where government has no real control. An example of this concern is what was practised by European nations towards the US MNC’s as they considered the establishment of US MNC’s in Europe as threat to their national sovereignty. The same concern is now prevalent among the eastern/developing nations with respect to western/developed countries FDI. In India, some time back there was a fear that if MNC’s owns assets in Indian economy they can somehow “hold the country to economic ransom”. However, with the passage of time such concern have died down and economists have labelled such an argument as irrational. A very popular political scientist Robert Reich has argued that such concerns are outcome of outmoded thinking and lack of economic reasoning as they fail to acknowledge and appreciate growing interdependence of the world economy. In an international economic environment where firms from all countries invest in each other countries, it is remotely possible for one nation to hold another to “economic ransom”. The following statement by an author is worth quoting:
“As investors search the globe for the highest returns, they are often drawn to places endowed with bountiful natural resources but are handicapped by weak or ineffective environmental laws. Many people and communities are harmed as the environment that sustains them is damaged or destroyed -- villages are displaced by the large construction projects, for example, and indigenous people watch their homelands disappear as timber companies level old-growth forests. Foreign investment-fed growth also promotes western-style consumerism, boosting car ownership, paper use, and Big Mac consumption rates towards the untenable levels found in the United States -- with grave potential consequences for the health of the natural world, and the stability of the earth’s climate, and the security of food supplies.” Hillary French, “Capital Flows and the Environment,” Foreign Policy in Focus, 1998

The government of developing countries has a history of supporting this strategy. Foreign MNC’s when involving in FDI have ultimate control over technology. Thus, it becomes difficult for the domestic firms to develop their own technology as they even do not have access to fundamental technology. This problem has been identified by most of the developing countries. The government of the host country has insisted that licensing must be used as an agreement to transfer technology instead of Greenfield investment or mergers and acquisitions. Under licensing, host economy enterprises get access to the valuable technology in return for royalties. However, it has been observed that licensing agreement is less attractive for MNC’s. Through licensing the technology, MNC’s take risk creating a future rival as in the process developed country’s firms learn at heavy cost in developing countries. Due to this trade off, a choice between FDI and licensing becomes a key point in negotiating between an MNC and a host government. The final outcome depends on the respective bargaining power of MNC and the host government.

2.2.9 Government Policy Instruments and FDI

In order to understand and tackle the issue of bargaining power between MNC and host government, it is of paramount importance to highlight policy instruments that host government may use to regulate FDI oriented activities by MNC’s. The policy instruments are used by both home countries and host countries in their inward FDI and outward FDI regulations. The following are the important ones:
(A) **Home-Country Policies**

Through the use of government policies, home country can encourage or restrict FDI. Both aspects are discussed in the following section.

(a) **Encouraging Outward FDI**

Many nations that invest appreciate government backed insurance programs to cover various types of foreign investment risks. The various categories of risks insurable with the help of governmental programs include the risk of nationalisation (expropriation), inability to transfer profits to home country and war losses. The objective of such programs are to be useful and provide firms an encouragement to undertake investments in politically unstable nations. Apart from that, few of the highly industrialised nations have capital funds available through banks that provide government loans to firms involving or willing to involve in outward Foreign Direct Investment. Many countries have also abandoned double taxation of foreign income in order to encourage firms to engage in Foreign Direct Investment. Thus, taxation in home and host country are not imposed simultaneously on a firm. Several countries, owing to their political influence have been successful in bargaining less restrictive norms for their domestic firms to engage in Foreign Direct Investment. The best example of this is that India relaxed Foreign Direct Investment norms in 1980’s due to the presence of United States of America.

(b) **Restricting Outward FDI**

Highly industrialised countries have attempted to have control over outward FDI. Out of the concern for balance of payments disequilibrium of the country, the policy adopted has been put a limit on capital outflows. For example, Britain has from the early 1960’s until 1979 adopted exchange control regulations in order to limit the amount an enterprise could take out of country from its capital. In such case through the argument at surface is to improve balance of payments position, the underlying reason is to make it difficult for firms to involve in Foreign Direct Investment. Additionally, several nations has manipulated tax rules to discourage the home firms to invest abroad and encourage them to invest in the domestic market. Again the objective is to generate employment in home country rather than in host country. In countries where unemployment as a problem has been politically accelerated in
discussions or elections are nearby, the argument and the need to restrict Foreign Direct Investment is exploited.

It is also noted that at times national firms are not allowed to invest abroad in certain countries due to political reasons. The reason for such prohibitions may be formal or informal or both. For example, US rules prohibited home firms to invest abroad in nations such as Libya, Cuba and Iran due to the fact that their political ideology and actions were contrary to the interests of United States. In 1980’s, United States firms were informally prohibited to invest in South Africa due to political disagreements. The objective was to pressurise South Africa to abandon apartheid laws and to an extent the strategy was successful.

(B) Host-Country Policies

The situation and stand of host country is different from that of home country. In this regard, host country is interested in restricting FDI and at times encouraging FDI depending on the situation and need of the hour. In the past, political stand and ideology has been used to formulate policy on such issues. But from the last decade of 20\textsuperscript{th} century the radical stand of countries towards FDI has been declining.

(a) Encouraging Inward FDI

Host governments offer attractive incentives to foreign firms to invest in their economy. The most common incentives include tax concessions, subsidies, grants and low-interest loans. Incentives are given by the host country in view of the probable gain from the resource transfer and employment effects of FDI.

Sometimes, even governments compete to give incentives to the foreign firms for investing in their country. This is common in United States where state governments compete with each other for investment and in this process gives substantial incentives to foreign firms. An example to cite is when Kentucky offered Toyota a package of US$ 112 million as incentive to build its US automobile plants. Another example with respect to India is Special Economic Zones (SEZ) setup that provide heavy incentives to the foreign firms. Tax holiday for the foreign invested firms in some cases may extend up to a period of 10 years under SEZ scheme.
(b) Restricting Inward FDI

In one way or the other host governments use a number of control measures to restrict FDI. The two prominent measures are ownership constraints and performance requirements. There are several forms of ownership constraints differing from developing to developed countries. It also happens that sometimes foreign companies are excluded from certain industries. For example, foreign companies are excluded in Sweden for tobacco and mining. In Brazil, foreign firms cannot participate in development of certain natural resources. Same are the provisions in Finland and Morocco. The host governments raise two reasons for imposing ownership constraints. First reason includes exclusion of foreign firms from certain industries due to national security or competition. Foreign competition is restricted to benefit small and medium enterprises in the host country with the help of import tariffs and controls on FDI. Recall that in India too same is practised. Previously there used to be a long list of items of SMEs that were excluded from the list of foreign investment. However, the number of items with restrictions has gone down in last few decades.

The second reason is that ownership constraints can help in maximising the resource transfer and employments benefits arising due to FDI. In the early 1980’s, most of the developing governments only allowed joint ventures but avoided either greenfield investments or mergers and acquisitions. The ownership constraints make it difficult for the foreign firms to leave the host country immediately. This saves the country from crises such as the replica of Asian crises of 1997.

On the other hand, performance requirements also have several forms. In technical terms performance requirements acts as controls over the MNC’s subsidiary in host country. The general ones are related to local participation in management, technology transfer, exports tariffs and requirements related to local content. The underlying logic behind performance requirements is that it maximises benefits for the host country and minimises costs of Foreign Direct Investment for the host economy. In other words, it creates a successful trade off between FDI benefits and costs. Generally speaking, all countries employ one or the other performance requirement according to their situation. Though, it is to be noted that performance requirements are rigorously practised by less developed countries. With respect to
developing countries, depending on respective country’s growth projections they may or may not involve in such policy measures.

2.2.10 International Institutions and the Liberalization of FDI

When the international economic environment was unorganised there was very less involvement of multilateral institutions in the governing of FDI. With the formulation of World Trade Organisation (WTO) in 1995 the situation has changed drastically as WTO has taken on the objective of promoting international trade in services. Many services needs to be generated where they are sold and therefore for such services exporting is not an option (for example, rail transport services cannot be exported or financial services). In the light of this limitation, WTO has involved in formulating regulations governing FDI. As WTO promotes free trade, it pushes countries for liberalisation of economy including relaxing the norms for FDI particularly in service sector. It was due to the continuous effort of WTO that in 1997 multilateral agreements were finalised to liberalise trade in financial services and telecommunication services. The agreements contained clauses that directed the signatories to liberalize regulations governing FDI particularly in financial services and telecommunications services.

However, WTO has also failed in establishing universal set of rules regarding liberalisation of Foreign Direct Investment. The failure is not in the sense of relative achievement but in the sense of absolute achievement. India and Malaysia have raised concerns and so far have rejected the attempts of WTO at ministerial level talks. On the same line the Organisation for Economic Cooperation and Development (OECD) in 1995 has started discussions with its member nations (The OECD is a Paris-based intergovernmental organization of "wealthy" nations whose purpose is to provide its 29 member states with a forum in which governments can compare their experiences, discuss the problems they share, and seek solutions that can then be applied within their own national contexts. The members include most European Union countries, the United States, Canada, Japan, and South Korea). The objective was to develop a multilateral agreement on investment (MAI) that will include a provision of discriminating with foreign investors as illegal. This would have liberalised regulations regarding FDI in 29 member states of OECD. Unfortunately, in early 1998 the discussions failed to reach any conclusion as United States refused to sign the
agreement. The argument of United States was too many exceptions present in the agreement. Environmental and labour groups were also against the agreement as they found no binding agreement on environmental and labour concerns. In future, the negotiations on MAI may be reopened. From past times till now several negotiations, meeting and talks have taken place at global as well as regional level with the sole objective of relaxing the norms for FDI globally. The discussions have proved fruitful in the sense that global restrictions have gradually came down and continue to do so.

2.2.11 Discussion on the Pros and Cons of FDI

With respect to the advantages and disadvantages of FDI as has been discussed in the earlier sections there is a need to understand that these advantages or disadvantages are relative and temporal and not absolute, as is considered by few. By liberalising or regulating FDI the aim of host economy government is to boost industrial development. This includes the changes that are required in economic and political environment. Thus, the discussion on pros and cons of FDI in host country is basically a debate between reforms towards policy liberalisation or more policy regulation for FDI. This is the policy question for host country government. However, recent trends clearly suggest pro FDI laws than anti FDI laws in practice (UNCTAD, 2000; 2004). It is important to examine the states of infant industry as an argument to support foreign investment regulation. Shafaeddin (2000) while reviewing the theory of Frederich List argues that most of the countries have developed its industrial base by relying on infant industry protection. He mentions “Both early industrialized and newly industrialized countries applied the same principle, although to varying degrees and in different ways”. At the time when classical economists propagated the benefits of free trade Britain was able to take extra ordinary advantage due to its dominating position though at the cost of less developed economies. List has pointed out that protection in international economic environment must be a means and not an end. Thus, it should be a temporary stage to benefit from free trade. The argument still exists as in the present era of globalisation, where different levels of industrialisation prevails market failures restricting the free international competition in order to promote in the least developed countries effective industrialisation. Thus, it is logical and acceptable to protect and encourage infant industries through foreign investment regulation. However, it is to be strictly noted that regulation must be selective not universal and protection must also be at balanced level.
In another perspective it has been argued that regulation disfavours developing countries as it impedes FDI. Developing countries have very high costs of entry as well as long procedures to invest in FDI. Though the regulation aims at achieving outcomes by countering monopolies and negative externalities in real terms regulation in developing countries is associated with corruption and illegal practices. Three important measures for achieving policy coherence are:

(i) Reducing the number of procedures for MNC’s;
(ii) Minimising the time required to complete the process; and
(iii) Minimising official costs of entry.

The above measures if not properly implemented will benefit only the regulator and not the society as a whole and will discourage MNC’s. Not implementing such important measures will also not attract the investors and it may pose major problem of finance for those countries that do not have large domestic investment. This shows that excessive regulation may not benefit the society and a situation will come where liberalisation will give superior social outcomes. United Nations Conference on Trade and Development (1998) and United Nations Industrial Development Organisation (2003) have also identified measures involved in FDI liberalisation. These are as follows:

(i) The elimination of market anomalies that are out of restrictions and incentives for foreign investors as these may discriminate against some investors or may favour some investors;
(ii) National treatment, fair and equitable treatment and most favoured nation treatment for foreign investors; and
(iii) Disclosure of information, competition rules and prudential supervision in order to guarantee proper functioning of the market.

Another point to be appreciated is that policies meant for liberalising FDI are not compulsorily the best policies for creating an advantageous investment environment and at times less for promoting or motivating Foreign Direct Investment. Due to the presence of government regulation, liberalisation of FDI must not be seen as a declining role of the state. The overall positive impact of FDI liberalisation highly depends on the presence of competent and well organised market supervision. Thus, economists have argued that FDI liberalisation and regulation are complementary and
not contradictory in order to fully utilise the benefits of FDI for the host country’s industrial development. Therefore, the debate between FDI liberalisation and FDI regulation is a matter of time and situation. Promotion of investment is a highly complex process where investors have to consider specific business environment of the country and then building strategy. Investors therefore considers several variables in order to take decisions regarding FDI. There is also an important role of benchmarking countries for the decision making process. Still the target of attracting and inviting investors has become quite difficult and complicated as several variables need to be considered for decision making with respect to FDI.

2.3 Balance of Payments

The Balance of Payments accounts are an integral part of the national accounting of an economy. The accounts maintain a record of all transactions between “residents” of the country and “residents” of other countries or rest of the world. Residents as defined includes individuals, businesses, government and allied agencies, and international organisations. According to Kindleberger (2002), “The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time”. According to the latest Balance of Payments Manual of IMF (Manual 6th Edition) “The balance of payments is a statement that summarizes economic transactions between residents and non-residents during a specific time period for a particular country”. In order to know what is happening to the international payments, governments keep track of the transactions between countries. The record of such transactions is made in the balance of payments accounts (Lipsey & Chrystal, 2007). Another aim of balance of payments is that it reports country’s foreign transactions and crises related to exchange rate and reserves comprising of both gold and foreign currencies. The policymakers with the help of balance of payments check the equilibrium or disequilibrium condition. Thus, balance of payments provides strategic information to both governments and private individuals and firms. Balance of Payments as a concept under macroeconomics starts from the discussion on money flow and real flow (Meade, 1951). Where money flow and real flow are termed as part of circular flow of income. The following are the models of circular flow of income.
Figure 2.3. Two Sector Model of Circular Flow of Income

The two sector model as shown in figure 2.3 clarifies that there is no interaction with the rest of the world and only households and firms are the economic units. Households in this sector purchase goods and services from firms and in turn pay money technically known as consumption expenditure. Firms, on the other hand, purchase factor services, such as Land, Labour, Capital, Enterprise etc. from the household and in turn pay factor payments such as Rent, Wages, Interest and Profit. It is clear that this model does not have any leakage or injection in the economy. In such a model there is no need to prepare balance of payments because there is no interaction of the economy with the rest of the world.

Figure 2.4. Three Sector Model of Circular Flow of Income

Source: Prepared by the research scholar
The three sector model is still a model of closed economy but it includes the government sector which acts as a liaison between the primary economic units of the economy that is households and firms. On the other hand, the four sector economy model is the model of open economy where the external world interact with the economy. Thus, apart from including sectors of both the two sector model and three sector model, it includes Rest of the World as the fourth economic entity. Obviously, the fourth sector model considers both injections in the economy and leakages from the economy. Figure 2.5 explains the four sector model of the circular flow of income.

![Figure 2.5. Four Sector Model of Circular Flow of Income](Image)

Source: Prepared by the research scholar

It is the four sector model in which there is a need of preparing balance of payments as it interacts with rest of the world. Though theoretically, circular flow of income can be expressed with respect to two sector economy (with two economic units that is Households and Firms), three sector economy (with three economic units that is Households, Firms and Government) and four sector economy (with four economic units that is Households, Firms, Government and Rest of the World), the reality in today’s global world is of four sector economy where there is substantial interaction with the rest of the world. Thus, there is a need to keep record of all the transactions between economic units of domestic economy with the economic units of rest of the
world. This record when presented in a summarised form annually by every country individually is known as Balance of Payments. In short, the balance of payments is a summary statement in which all transactions of the residents of a country in relation to the residents of rest of the world are recorded during a particular period of time, usually a financial year. The objective is to communicate about the international financial position of the country to the users of the international financial information so as to take decision or formulate necessary policies such as monetary, fiscal, investment, trade policies etc. The information is also of paramount importance to the central banks, other commercial and multinational banks, multi-lateral organisations such as IMF, IBRD, ADB etc.

It is to be noted that all transactions individually cannot appear in the BOP statement as it is not practical on one hand and will not suffice for decision making on the other hand. Therefore, as a summary statement balance of payments statement is aggregation of the important variables coming into the statement (Kemp, 1975). Because of this, sometimes balance of payments is also known as Account for International Settlement.

2.3.1 What Kind of Transactions are Included in BOP?

There are a list of transactions that are included under Balance of Payments, the transactions are generally termed as international transactions. An international transaction comes with the exchange of goods and services or assets between the residents of the country preparing BOP and the residents of rest of the world. Certain other transfers such as gifts and unilateral transfers are also included in balance of payments (IMF, 2009).

The definition of residents of a country refers all the citizens of a country whether living in the country preparing balance of payments or living outside it. Though, specific countries have technical definition of residents of a country that differs from country to country. Thus, all professionals and workers who are currently employed in rest of the world are considered residents of the country for the sake of preparing Balance of Payments. Similarly, the case of corporations can also be analysed and discussed. The activities of a resident corporation are included in the balance of payments of the country. All the corporations that have been incorporated in a country are considered residents of that particular country and are thus included while
preparing balance of payments. But the foreign branches, affiliates and subsidiaries are not included while preparing balance of payments. As a time dimension concept, it is the flow of goods, services, gifts, and assets between the residents of a nation and the residents of other nations during a particular period of time.

2.3.2 Components of Balance of Payments

Transactions falling under balance of payments are recorded as per the principles of double entry bookkeeping under which each international transaction undertaken by the country will result in a credit entry and debit entry of equal size. It is to be noted that balance of payments is an application of double entry bookkeeping as it records both transactions and the flows associated with those transactions. In accounting language, debits and credits are done that are meant to be balanced. However, accounting balance is not synonymous with equilibrium. Few items in the balance of payments are pure flows such as exports while others are flows arising from changes in stocks. The Nominal accounting rule of accounting principles under Generally Acceptable Accounting Principles (GAAP), that is, Debit to pay all expenses and losses; credit to all gains and incomes, is applied while recording the transactions in Balance of Payments. As the statement is a position statement, the total amount of debit must equal to the total amount of credit. Any discrepancy is balanced by specific item known as “Errors and Omissions”. The following are the different heads under balance of payments:

(A) Current Account (CA)

The current account is a summary record of a nation’s goods and invisibles (services) transactions with the rest of the world. The current account includes all transactions which give rise to the national income or uses the national income. Further, the current account consists of two major items, namely merchandise exports and imports; and invisible exports and imports.

(a) Merchandise Exports and Imports

It refers to exports and imports of tangible goods. Merchandise exports, that is, sale of goods abroad, are credit entries because all transactions giving rise to monetary claims on residents of rest of the world represent credits. On the other hand, merchandise imports, that is, purchase of goods from abroad, are debit entries because
all transactions giving rise to foreign money claims on the home country represents debit. Merchandise exports and imports form the most important international transaction of most of the countries.

(b) Invisible Exports and Imports

Invisible exports includes sale of services and are considered credit entries and invisible imports that is purchase of services are debit entries. Important invisible exports include sale of services like transport and insurance, foreign tourist expenditure in the home country and income received on loans and investments abroad which means receipt of interests and dividend. Purchase of foreign services like transport and insurance, tourist expenditure abroad and income paid on loans and investments by foreigners in the home country form the important invisibles entries on the debit side.

(B) Capital Account (KA)

The capital account shows the short term and long term capital transactions. Capital outflow represent debit and capital inflow represent credit. For example if an Australian firm invests $100 million in India, the transaction will be represented as a debit in the Australian Balance of payments and a credit in the Balance of Payments of India. Payment of interest on loans and dividend received are recorded in the capital account, since they are real payments for the services of capital. Interest paid on loans given by foreigners or dividend on foreign investments in the home country are debits for the home country, while on the other hand, interest received on loans given abroad and dividends on investments abroad are credits.

(C) Unilateral Transfer Account

Unilateral transfer is a comprehensive term for gifts, private remittances, government grants, reparations, government reliefs etc. Unilateral payments received from abroad are credits and those made abroad are debits.

(D) Official Reserves Account

Official reserves represent the holdings by the government of official agencies of the means of payment that are generally accepted for the settlement of international claims such as Dollars, SDR, ADR etc.
Table 2.1

*Format of Balance of Payments*

<table>
<thead>
<tr>
<th>Items</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Exports</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Imports</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Trade Balance (1 -2)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Net Invisibles</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Current Account Balance (3 – 4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Net External Assistance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Net Commercial Borrowings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Net NR Deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Net FDI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Net Portfolio Investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Net Other flows</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Capital Account Balance (6 to 11)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Official Reserves (Adjustment)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Titled according to APA 6th edition
Source: Prepared by the research scholar

2.3.3 Meaning of Current Account Balance

The balance of current account reflects the value of flow of visible and invisibles between home countries and foreign countries. It refers to net of all these flows. When net inflow of the current account balance is positive or favourable it is because inflows exceeds outflows. On the other hand, when there is net outflow or a negative net inflow the balance of current account is negative or unfavourable because it represents that inflows are less than outflows. A current account surplus refers to excess of overall exports over imports of goods and services. A deficit, on the contrary, means that the country has to pay other nations in the course of interaction with rest of the world in visible as well as invisibles.

The current account balance represent net foreign investment in national income accounting which stands as the basis of macro-economic analysis. It is related to both national savings and domestic investment.

Symbolically,

\[ CA = I_t = S - I_d \]

Where,

\( CA \) is current account balance
If is investment abroad
S is National Savings

Iₜ is investment in home country.

Thus, it is clear that current account balance equals the difference between national savings and domestic investment. The current account balance also has implications on domestic variables such as domestic production, domestic income, and domestic expenditure. Symbolically,

\[ Y = C + I_d + G + (X - M) \]

Where,

- \( Y \) is National Income
- \( C \) is domestic consumption or consumption expenditure
- \( I_d \) is domestic investment by firms in the economy
- \( G \) is government expenditure
- \( X \) is exports
- \( M \) is imports

While \( C, I_d, \) and \( G \) include purchase of both domestically produced and imported goods and services. Imports must be subtracted separately because imports are not demand for the home country’s products. Absorption (A) is another concept used in BOP Accounting and symbolically it is represented as follows:

\[ A = C + I_d + G \]
\[ Y = A + (X - M) \]

Where,

- \( A \) is Absorption

Thus, in conclusion

\[ CA = I_f \]

Or

\[ CA = S - I_d \]

Or

\[ CA = Y - A \]
2.3.4 Balance of Payments Disequilibrium

Equilibrium as an economic concept refers a point where two economic forces are stable irrespective of the usage of micro economic study or macro-economic study. Disequilibrium as an antonym of Equilibrium then refers to instability in the economic forces represented by certain specific variables. A disequilibrium in the balance of payments refers to either surplus or deficit in balance of payments represented and expressed in the form of foreign exchange. A surplus means that supply of foreign exchange exceeds the demand for foreign exchange. On the other hand, a deficit balance means that demand of foreign exchange exceeds the supply of foreign exchange. Though there are economic, social and political factors behind disequilibrium condition, economic factors are primarily of our concern which are as follows:

1. Development disequilibrium

   Large scale expenditure for development increases the purchasing power as well as aggregate demand and prices. This results in increasing imports. This type of disequilibrium is common in the case of developing countries, because the above factors and large scale imports of capital goods needed for carrying out the various developmental programmes give rise to a deficit in the balance of payments.

2. Cyclical Disequilibrium

   The disequilibrium caused due to fluctuations in the business cycle in an economy. There may be periods of recession, depression, boom, stagflation etc. that may not help to maintain the desired equilibrium in the balance of payments statement.

3. Secular Disequilibrium

   In macroeconomics secular term is used to indicate long term behaviour or long term relationship between economic variables. So secular disequilibrium refers to the disequilibrium that lasts for long period and thus affects long run production function at both firm and economy level. For example, in the long run, in developed countries, disposable income is high and so is aggregate demand. This in itself means high production costs due to high wages. These factors results in imports being much higher than the exports.
4. Structural Disequilibrium

Structural changes may also push the economy to witness disequilibrium in the balance of payments of the country. Such changes includes alternative sources of supply in use, development of better substitute, substantial increase in production efficiency, discovery of new resources or reservoirs of resources etc.

2.4 FDI and the Balance of Payments

Given the concern about current account deficits, the balance of payments effects of FDI can be an important consideration for a host government. There are three potential balance-of-payments consequences of FDI. First, when an MNC establishes a foreign subsidiary, the capital account of the host country benefits from the initial capital inflow. (A debit will be recorded in the capital account of the home country, since capital is flowing out of the home country.) However, this is a one-time only effect. Set against this must be the outflow of earnings to the foreign parent company, which will be recorded as a debit on the current account of the host country.

Second, if the FDI is a substitute for imports of goods or services, it can improve the current account of the host country's balance of payments. Much of the FDI by Indian companies in the United States and United Kingdom, for example, can be seen as substituting for imports from India. Thus, the current account of the US balance of payments has improved somewhat because many Indian companies are now supplying the US market from production facilities in the United States, as opposed to facilities in Indian. Insofar as this has reduced the need to finance a current account deficit by asset sales to foreigners, the United States has clearly benefited from this. A third potential benefit to the host country's balance-of-payments position arises when the MNC uses a foreign subsidiary to export goods and services to other countries.

2.5 Adverse Effects of FDI on the Balance of Payments

The possible adverse effects of FDI on a host country's balance of payments position have been hinted earlier. There are two main areas of concern with regard to the balance of payments. First, as mentioned earlier, set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as a debit on the capital
account. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary's home country.

A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country's balance of payments. One criticism levelled against US owned companies in India, for example, is that they tend to import many component parts from US. Because of this, the favourable impact of this FDI on the current account of the India’s balance-of-payments position may not be as great as initially supposed. The US companies have responded to these criticisms by pledging to purchase 75 percent of their component parts from Indian based manufacturers.