# Economic Impact of Outward FDI on the Home Country of the Investor

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Thursday 6th August, 2015

## 1 Introduction

The World Investment Report of 2015 puts India as one of the largest outward investing economies.[1] Results of an IPA[2] survey reported India as one of the top global investing economies ranking sixth in the most promising investor home economies for FDI in 2014-2016 (UNCTAD, 2015).

## 2 What has led to this meteoric ascent of Indian multinationals?

The report argues that given the improving performance of the Indian economy, large Indian multinationals have stopped large-scale divestments and some have even resumed their international expansion including announcements of some intraregional investments in manufacturing (such as in the automotive and chemical products industries) in neighbouring countries. For instance, they report that in Bangladesh, Asian Paints (India) announced an estimated capital expenditure of USD81million in 2014 while Mahindra and Mahindra (India) invested more than USD200 million in 2013 in a plant to produce light trucks and utility vehicles. Besides intraregional investments, Indian businesses continue to be notable investors in Africa with Tata investing in Algeria in 2014[3], Mumbai-based ShriVallabh Pittie (SVP) group investing USD550 million in Ethiopia to construct Africa's largest plant to produce cotton yarn to export[4], and Bharti group undertaking eleven

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[1] From a mere 0.04 per cent in 1990, FDI outward stock as a percentage of gross domestic product for India meteorites to 6.3 per cent in 2014. Nevertheless, it still continues to be the last in the BRICS pack with South Africa leading the pack followed by Russian Federation, Brazil, and then China. FDI outward stock as a percentage of gross domestic product for South Africa rises from 13.1 per cent in 1990 to 38.3 per cent in 2014, for Russian Federation the stock rises from 1.3 per cent in 1993 to 23.3 per cent in 2014, for Brazil the stock rises from 8.6 per cent in 1990 to 13.4 per cent in 2014, and for China the stock rises from 1.1 per cent in 1990 to 7 per cent in 2014 (UNCTAD, 2015).

[2] IPA stands for Investment Promotion Agencies

[3] http://goo.gl/7X9HJK

[4] http://goo.gl/c9VJ3z

greenfield investment projects in Nigeria and Uganda in 2014 alone making it the second largest telecoms operator in Nigeria[5].

However there could be other reasons that could explain the increasing role of Indian multinationals in the global direct investment landscape. These factors could be related to a general improvement in the policy environment in India[6] and/or improvements in the policy and general macro-economic conditions of the countries in which Indian multinationals are investing[7]. Besides national efforts in encouraging outward direct investment, bilateral relationship between the home and the host countries including bilateral trade relationships, bilateral investment treaties and/or other investment agreements could also be an important explaining factor that encourages Indian businesses to invest beyond the national boundaries.[8]

## 2.1 What Are The Home Country Benefits from Outward FDI?

Researchers have long argued on whether countries should promote the presence of foreign multinationals within their home boundaries (inward FDI) or should encourage domestic multinationals to venture beyond home boundaries (outward FDI). Although arguments to support inward FDI outweighs outward FDI[9], domestic multinationals can be equally a good source of both direct and indirect effects on the home country cannot be refuted.

### 2.1.1 Direct Home Country Benefits from Outward FDI

Direct benefits from domestic multinationals to firms in the home country largely depends on the motives of domestic multinational moving its production facilities abroad. Although these motives can be related to firm-specific advantages (or the ownership advantages as Dunning's OLI[10] eclectic paradigm theory would suggest) it enjoys such as a premium on its intangible assets like goodwill, other more important questions faced by the domestic multinational is where to locate, what to locate (horizontal industry production or vertical industry production) and how to locate (mode of entry) cannot be ignored. Each of these motivated questions is a function of whether the answer leads to cost-saving for the domestic multinational. For instance, domestic multinationals are generally motivated to locate to countries where governments offer incentives in the form of tax

[5] http://goo.gl/0U2NVV

[6] Indian government along with other regulatory bodies such as the Reserve Bank of India (RBI) consistently formulate and/or update policies directed towards encouraging outward investment from India. RBI annually updates policies on direct investments made by resident Indians in its 'Master Circular on Direct Investment by Residents in Joint Venture (JV)/Wholly Owned Subsidiary (WOS) abroad'. Similarly, Ex-Im bank's support to Indian entities in their expedition overseas has increased significantly in the recent past - from 11 transactions in 2000, number of overseas investment assisted by Ex-Im bank increased to 48 in 2012 (Prahalathan et al., 2014).

[7] These improvements could be related to the liberalization of market entry requirements including a reduction in investment ceiling and/or increasing greater market access to regions and industries; improvement in business environment including reduction in bureaucracy and corruption by encouraging automatic route or 'no-approval-required' processes.

[8] India has signed 84 bilateral investment treaties (BITs) of which 69 are in force and 15 are signed and not yet in force. Besides BITs, India has signed 13 other investment instrument agreements (IIAs) of which 9 are in force and 4 are signed and not yet in force (The data has been collected from UNCTAD's Database of International Investment Agreements.).

[9] One of the reasons could be the ease of data availability to investigate the impact of inward FDI on host country.

[10] OLI stands for Ownership, Locational and Internalization.

holidays for a prescribed tenure, and/or prefer to operate a wholly-owned subsidiary in a foreign country (as against operating through exports, license or joint venture) when the country offers stringent patent protection laws to prevent foreign knowledge leakage in the host country. However, the most important question which a domestic multinational faces is related to what production facility should it locate in a foreign country if at all it wishes to locate. This is because the answer to this question will not only have an impact on the firm's balance-sheet but it will also reflect on the host and home country's balance-sheet. In other words, there are multiple ramifications to a firm choosing to produce in the horizontal industry (known as horizontal FDI) as compared to its choice of producing in the vertical industry (known as vertical FDI). The reason being the very distinction in the nature of the two forms of FDI where horizontal integration takes advantage of the closeness to foreign markets while vertical integration take advantage of factor cost differences (Erkilek, 2003). In other words, domestic multinationals that undertake FDI in the same industry can be thought of as multi-plant firms that seek to exploit their existing advantages and replicate roughly the same activities in a foreign location, and the major trigger of moving outward is the intention to reap benefits of the market opportunities abroad. On the other hand, domestic multinationals that undertake FDI in the upstream or downstream industry can be thought of as firms that geographically fragment their production into stages, typically on the basis of factor intensities, exploiting lower factor prices abroad or reducing transactions cost by internalizing upstream or downstream activities (Karolina Ekholm and James R. Markusen, 2006) (Kokko, 2006).

In other words, horizontal and vertical FDI has the potential of creating a complementarity and substitutional interaction between the domestic multinationals and the domestic firm in the home country thereby having a multiplier effect on its economic growth and other economic factors including domestic investment, domestic employment, balance-of-payments, technology and knowledge, and political decision-making in the home country (Kokko, 2006). For example, if the home country uses outward FDI as a substitute for its domestic investments (possibly because of diminished domestic investment opportunities on its domestic investment) then the increase in its outward FDI may cause a decrease in output in the home country thereby reducing the economic growth of the home country (Stevens and Lipsey, 1992). On the other hand, if the home country's outward FDI complements its local investments (where affiliate of domestic multinational uses home inputs to produce output in the home country) then an increase in domestic multinational activities abroad may promote higher domestic output thereby positively contributing in the home country's economic growth (Desai et al., 2005).[11]

[11] It should be noted that the existence, sign and dimension of direct benefits of outward FDI is also a function of home and host country characteristics. For instance, one can expect causality to also run in the direction where a higher economic growth in the home country may also encourage domestic multinational activities abroad. Dunning (1981) and Dunning (1986) show that a steady high economic growth in the home country could foster higher level of economic development in which domestic firms would have established ownership advantages before they would expand their operations abroad.

### 2.1.2 Indirect Home Country Benefits from Outward FDI

In addition to the above discussed direct benefits, researchers have also reasoned the indirect benefits (also known as spillover benefits) which domestic multinationals bring about to the firms in their home country. Such indirect benefits is characterized by the knowledge gathered by the domestic multinational which is a function of its own superior knowledge plus the foreign knowledge it gathers by operating outside its national boundaries.[12] Therefore the existence, sign and dimension of indirect benefits is not only a function of home and host country characteristics but also a function of the amount and type of knowledge it gains access to. However, such knowledge about productivity improvements, even though kept secret, gradually leaks out and eventually becomes a common knowledge in the home market in which both domestic multinational and domestic firm operate. Therefore, the spillover assumption is reasonable as such knowledge are not only limited to the receiving affiliate of the domestic multinational and in turn the domestic multinational itself but are also likely to spill over to the domestic firms that come in contact, directly or indirectly, with the domestic multinational. The transmission of such knowledge can indirectly happen through a. imitation - where domestic multinationals may bring more advanced managerial strategies acquired abroad to their home market creating an opportunity for domestic firms to learn through observation; b. the movement of labour - where domestic multinational employees that may obtain superior skills as a result of overseas experience (either directly or indirectly) can transfer these skills to future domestic employers in their home country and/or start a new firm in their home country; c. competition - where domestic competitors of domestic multinationals may be forced to become more efficient if multinational activities in a foreign country lead to enhanced productivity; d. exports - domestic firms might enter the export market due to a reduction in the sunk costs of export market entry or through an increase in the productivity levels because of information externalities from domestic multinationals. On the other hand, direct transmission of such knowledge can occur through vertical integration of domestic multinationals with home country domestic firms where the demand for intermediate inputs from home country suppliers may increase when domestic multinational successfully tap the foreign market and expand production abroad, also referred to as a "backward spillover". While "forward spillover" occur when domestic firms benefit from being customers to domestic multinationals (Jitao Tang, 2006).

[12] When addressing the spillover effects from domestic multinationals to other domestic firms in the home country, it is important to take into account the organizational structure of the domestic multinational. In other words, here the focus of analysis is on the domestic multinational whose headquarters is generally located in the home country. The headquarters generally undertakes R&D and other strategic financial and management activities. Therefore the headquarters continues to remain the main sources of proprietary advantages of the domestic multinational, and only part of these technological, managerial and organizational capabilities are transferred to its foreign arm. Thus, in principle, domestic multinationals, particularly its headquarters residing mainly in the home country, are expected to have more knowledge to transfer than its foreign arm. However, the dominant role of the headquarters of the domestic multinational is partially compensated by the fact that its foreign arm can indeed accumulate further knowledge and capabilities through local R&D activities, learning and through external linkages with the host country counterparts. Hence, the relative position between the headquarters of the domestic multinational and its foreign arm cannot be expected to change significantly as the growing role of the latter in technological accumulation and knowledge absorption is compensated by that fact that the headquarters of the domestic multinational can also absorb external knowledge available locally, and it will eventually gain access to foreign knowledge through their foreign arms' reverse technology transfer (Davide Castellani and Antonello Zanfei, 2006).

## 3 Conclusion

From viewing foreign multinationals as a source to depleting local economy prior to national liberalization in 1991, India has started to offer significant support to them. This changing attitude is largely the result of a changing view of the role played by foreign multinationals where they are now viewed as keys players in the global generation, adoption and diffusion of technology. In particular, foreign multinationals bring along with them a bundle of assets which might not be available locally, such as technologies, market and employment opportunities, and capital and management skills. Such assets through direct and indirect linkage in the host economy gradually leaks thereby having the potential to raise average productivity and innovation in the host country. Such benefits stand as a major justification to significantly increase public incentives to attract foreign multinationals. To this effect, India recently launched the 'Make in India campaign to attract global investors to manufacture in India. Moreover, it has done away with several technical adversities that was blocking foreign multinationals to invest in India.[13] However, benefits accruing from domestic multinationals should also not be ignored, and government efforts should also be directed in supporting Indian businesses to invest abroad. As Herzer (2008) puts it "..outward FDI allows firms to enter new markets, to import intermediate goods from foreign affiliates at lower prices, to produce a greater volume of final goods abroad at lower cost, and to access foreign technology... outward investing firms combine home production with foreign production to reduce costs and to increase their competitiveness both internationally and domestically.."

[13] See Press Release at http://pib.nic.in/newsite/PrintRelease.aspx?relid=123320

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