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response 8 | week 9 |
11. apr.04

transition: role and impact of foreign investment

discussion Qs

- how much of a determinant has FDI been in accounting for different growth rates between transition countries?
- what are other factors related to the role of FDI in transition countries?

Foreign Direct Investment (FDI) has had varied impact on economic growth and redefinition of the institutional environments of transitioning countries. In its ideal form, FDI can provide not only access to capital, technology, and external markets, but can also create jobs and support networks of information and agreements that encourage greater production. However, critics such as Stiglitz warn about the different types of FDI that impact growth: “greenfield” investments that create jobs and wealth, versus exploitation through asset stripping (which can leave an area ever poorer than before the investment).

Huang and Di's 2003 paper raised some interesting points about the validity of attributing growth to the FDI factor. They argued that relying on FDI or risk assessments as major variables in growth overlooks the host-country context, and that examining domestic firm's ownership structures of FDI projects (rather than the more common foreign-to-domestic approach that focuses on flow of investment) reveals more significant and consistent signs of growth. By examining how China's institutional environment impacted ownership, they discovered a negative correlation between levels of institutional liberalization and foreign ownership of joint ventures.

Of the many ideas raised in the articles, three main factors related to understanding the role of FDI in transition countries stand out: scale of analysis (regional variation), rate and sequencing of government reform, and the institutional climate. Huang emphasized the importance of sensitivity to the scale of analysis by highlighting regional level variations in FDI's influence on economic growth and the political motivations that may or may not support domestic firms' interests. One case in point is that of the Malaysian government's attempt to drown out Chinese entrepreneurs by flooding the national market with FDI. The argument about the rate of transition reform wavers between two ends of a spectrum: gradualism versus shock therapy. The best formula depends on the institutional context and the political feasibility (the political status of domestic business in the government), and poses a trade-off between the depth of shock (severity of reform) and length of crisis. Huang's 2004 paper discussed evidence that foreign firms' regulatory advantages are especially substantial when compared to the politically weak domestic firms, and especially so in corrupt countries versus non-corrupt countries.

extra thoughts...

In lieu of last week's discussion on firms' widespread unreported business activities, I wonder how these authors account for the enormity of the “shadow sector” in their assessments and growth projections. This undoubtedly speaks to the great challenge of conducting research or obtaining accurate information in such restricted environments, and I was gratified by Huang's open discussion of shortcomings in the data collection methodology and general speed bumps in the research process.