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Foreign Direct Investment: Political and Economic Risks

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Abstract

The paper is about the increasing foreign direct investment and the risks following it. Objective: The objective of the paper is to find out the risks that a home and host country can face in terms of political and economic system. Findings: After the study we came to know that the change in political and economic environment of host country also makes changes on home country and the business has to be suffered and vice versa. Since the FDI is key to economic growth and prosperity every country wants to welcome it. But due to lack of proper matching between the goal of host and home country they have to face lot of challenges. So before entering into trade relations both have to think and rethink before making policies and protocols. Methods: The paper is basically exploratory in nature. The different political and economic environment has been taken into consideration from the various nations. Study Area: Industry, Technology, and political and economic systems have been chosen into study.

Keywords: FDI, Economic Growth, Political Risks, Economic Risks.

1.

1.1 Introduction

The globalization has brought the different parts of the world together at one common place. The business and trade activities have no limit now. A country or a person of a country can go beyond the country's boundary to make an investment and organize a business. But along with the highly paced technology and extended and advanced form of business the political system and economic systems are also being affected directly and indirectly. Not only today but the past is also the proven fact of this statement. The East India Company of Britain colonized India in the name of business. There are several facts and figures which show the political and economic risks level along with the economic growth and development generated by Foreign Investment. This paper is also trying to dig out those hidden risks and challenges that a host country and home country both facing by FDI.

Duce and Espana (2003) has defined the FDI as investment made by the people of one country to another country directly in the enterprise. In the investment there are two parties: home country and host country. Home country is the one which is making investment and host country is the one where the investment has been made. As an investor one can enter via enterprises or any business firms which already exist in the

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home country or other than the host country. Also they may invest in the enterprise of home country where the ownership is of host country. Anyway it is a means of investing money directly into the foreign land. As we already mentioned about the globalization every firms and investor want to extend the boundary of investment. Now, firms are growing day by day and extended in the international market. Home country promotes the FDI to bring the foreign currency and host country promotes for increasing export rather than import. We will talk about it in detail later in the paper. The concern here is the difference in political and economic environment. The system of one country may not match with other. So after the countries come into trade relations the influence of one country create significant impact on other. We will be pointing out the extent to which each sector will be affected politically and economically in this paper.

1.2 Background of FDI

FDI has both pros and cons in the economy. There are controversial argument in the favor or against of the FDI. Before talking about its advantages and disadvantages we should understand the trend of FDI and economic growth along with the political and economic influence. It is harder to exactly point out the exact evolution of foreign investment. The importance of private sector has been increased due to the huge contribution of private firms in economic growth. This is what boosting up the FDI to grow.

According to Charles P. Knidlerberger (1983) there are several phases of FDI in the history. There is no debate that Foreign Investment in any countries contributes for the economic development through financially and technologically. The main thing is they make investment in industrial development which promotes the agricultural and other sector of the economy well. So it is true that countries are welcoming FDI since very long ago. Here as per the Charles's paper we have categorized the remarkable incidents into five phases which are as follows:

Different stages of FDI

Phases	What happened?
First Phase (1870- 1914)	A channel for transferring resources. Route of flow changed due to World War I.
Second Phase (1918-1938)	World War I ruined the corporate activity. US stock rose heavily and attracted more FDI.
Third Phase (1939-1960)	Second World War took place and USA dominated the international business and investment. European Investment increased the role in Foreign Investment.
Fourth Phase (1960- 1978)	Continuous fall in USA and UK stocks and rise in Germany, Japanese, and Swiss stocks. Investment in developing countries increased.
Fifth Phase (1978-Today)	Increased in number of Multinational Enterprises. Globalized with advanced technology.

	Open market economy and high competition in the market.

Source: This table has been used to clarify the history of FDI in terms of different stages which is based on articles of Charles P. Knidlerberger.

The above trend in the historical base shows the increasing flow of FDI. The developing countries in the past have been changed into very advanced and well developed in today's world's economy. There are several trade Zones like NAFTA, ASEAN, EFTA and several other. These are evolved for securing the investment and smooth handling of trade activities. In some of the Asian countries like Afghanistan and Some African Countries like Syria investor feels unsecured due to war and terrorism. So a country should provide a good environment for the trade activities. We are trying here to point out those risks and challenges caused by foreign investment for both of the parties involved in trade.

1.3 Problem Statement: Political and economic risks in home and host countries due to FDI.

a. Research Objective: To find out the political and economic risks due to FDI in home and host countries.
b. Research Questions:
   - ❖ What is the importance of FDI in economic growth?
   - ❖ How FDI helps in balance of payments and trade balancing?
   - ❖ Who will get more benefits: home or host country?
   - ❖ What are the political risks?
   - ❖ How does it affect economically?

1.4 Scope of the Study

The scope of the study is Trade zones, economic and political systems of the countries, Industrial sector and Treaties.

2. Literature Review

Authors have different view on who benefits more than each other in case of foreign direct investment. As we came to know that it plays vital role in resources utilization and economic growth we should also know the pros and cons of the investment. While transferring the foreign currency we are also welcoming the political and economic norms and systems. Also it is true that countries with same systems are likely to make good trade relations. The dominating countries or strong one can attract or somehow encourage other to join the same system. The data shows that democratic countries are pretty successful than other in trade. It is also proven that communist and communist countries can have very good trade relations and can make faster economic changes. For the detail and the proven facts we have chosen following papers which are helping us to equip our paper with resources.

2.1 Saleh and Deena(2015) have presented a paper entitled with “FDI and Economic Growth in Developing Countries” which is a comparative study of Egypt and Turkey. The paper has tried to examine the relationship between FDI and economic growth in such countries. It has also clarified that for the better comparison political and economic background should match. Also the paper gives brief idea of impacts of such investment in host countries.

2.2 The paper by Solomon Slusova Babatunde has shown the challenges in developing countries regarding the handling of FDI. The study is trying to examine the challenges and opportunities faced by host countries due to foreign investment. The context of Nigerian Construction sector has been presented as a sample of study and the whole study shows how FDI has created impacts on Nigerian GDP. The paper is helpful for the study of challenges in host countries and possible measures to be taken.

2.3 Selma Kurtishi (2013) has mentioned some especial effects of FDI in home countries. The paper tries to examine that FDI is a important tool which is a key to make economic growth of any country and along with the pros there are also some cons especially in host countries. But the issue here is the flow of FDI and its channel. Sometime failure to identify the good channel and proper way of investment may turn into a huge loss.

2.4 Li Peiyu (2014) has mentioned the importance of FDI in terms of Developing countries and the infrastructure in the article “Importance of FDI by Developing Countries”. The article has tried to raise the much more significance of having FDI in developing countries although there seems to be lots of challenges and political instability due to FDI.

2.5 Oskara and Marzanna(2008) have pointed out some of the key roles of FDI in the development of the countries. In order to be ready with development activities fundamental infrastructural development is necessary and FDI plays the role of assistance in outsourcing the capital. Actually it plays vital role in developing countries competitiveness and comprehensive economic growth.

2.6 Fawaz Binsaeed(2009) has found out some critical aspects of FDI which are called factors affecting FDI in the paper “Factors Affecting Foreign Direct Investment Location in the Petrochemicals”. Foreign Direct Investment (FDI) is an important source of capital and economic growth in developing countries. It provides a package of new technologies, management techniques, finance and market access for the production of goods and services. However, attracting FDI is a major challenge for host countries as it faces the challenge of identifying the major factors that motivate and affect the FDI location decision.

3. List of Hypothesis

3.1 FDI helps in economic and financial growth of the both parties: Home and host.

3.2 FDI has direct and indirect impacts on economic system of home countries.

3.3 FDI has direct and indirect impacts on political system of home countries.
3.4 Due to FDI the economic and political environments are influenced: home and host countries.

4. Data Collection, Discussion and Results

The technology transfer also transfers the culture and some environmental elements. We are trying to point out the influences of the invested money into the foreign land. Simply there are always two parties at the time of investment. One makes investment and another holding the invested capital. The home country and the host country both have to go through the benefits and challenges. We all can assume and we are pretty familiar with the benefits of FDI for home and the host countries. Home country is the one making the investment. As a benefit they bring foreign currency which helps to increase GNP. Also they may utilize the other's natural resources and can have extension of the business in foreign land. On the other hand host country can improve its balance of payments. Since the investment increases the productivity they can reduce the import and increase export which is biggest advantage for the country's GDP. The foreign investment may help to utilize the local resources and the local products. Employment opportunities also increase very faster. So overall the nation gets benefited for economic and technological growth. Along with these advantages one has to bear the possible risks as well. This paper has categorized those risks under two categories.

4.1 Political Risks
4.2 Economic Risks

4.1 Political Risks

Before making any investment the parties of the countries have to go via treaties and protocols. These protocols have to ensure the security and benefits over the investment. So such treaties and set of protocols already mention the terms and conditions to agree. No one can go beyond those terms and conditions for certain span of time. It is obvious that each country has their systems of politics to govern. So once the treaties are formed and trade is established they get influenced by each other's political environments.

Mashrur Mustaque khan and Mashfique Ibne Akbar (2013) has mentioned some quite meaningful points in their paper. They have pointed out some of the critical issues in FDI which should be taken care before making any sorts of investment. Not only in case of Host country but also a home country should be aware of those investment awareness elements. Some of the political issues are as follows:

4.1.1 Government Stability

The security is directly related with government stability. Highly liquidated political environment and conflicting politics can ruin the overall investment. So no firms or investor wants to invest in such situation. In terms of host country the country already rejects the trade relation proposal from such nations since the environment may transfer or somehow influence. The recent example of USA can be taken as a evidence. US government has banned some Muslim countries to enter into the US territory due to terrorism. It can be a very big issue that may stop from getting into trade relations. For the host country no firms or investor wants to go for business in such situations.

The recently published BBC report shows that 70% of the Afghanistan is suffered by Taliban. US is invading to eradicate the terror since a long ago. Due to such highly threatened environment no firms want to enter and do business.

4.1.2 Ethnic Tensions

It is a war between two or more parties of different ethnic group for their right. There are several tribes and group of people who are fighting for the rights and orders with set of demands with the nation. In 1947 AD India and Pakistan also got separated due to religious tensions between Hindu and Muslim. After that they have never been together and also don't have good trade relations. People find more insecure environment in such case. So the host and home both parties are not ready to accept for the trade. Host country may fear of cultural transfer and same sorts of policy transfer in the country. Home country has to pay very big if the investment is made in such situations.

As of 9 January 2019: the Syrian Armed Forces held 62.0% of Syrian territories; SDF-held territory constituted 27.9%; 2.8% was controlled by Hayat Tahrir al-Sham, 7.2 % was controlled by rebel groups (including Al-Tanf rebels) and Turkey; and 0.1% was held by ISIL. It was published by a journal recently in January. There is a terrorism caused by terrorist group ISIS. The conflict is between Syia and Sunnis. These are two Muslim groups and fighting with each other since a decade. Due to war there is no development at all. People find themselves very unsecured and threatened. USA has even used chemical weapons to control the terror. But still the tension is same. So in this situation no investment is possible to be made.

4.1.3 Democratic Accountability

The Democratic accountability is the key to trust each other. One nation trusts another on the basis of the democratic norms and values that a country is following. But in some cases the environment is different. Although the country claims to be democratic if the country cannot follow the norms and values of the democracy then it is also not considered to be a good practice. Investor finds the environment threatened and full of tensions. Today in current scenario no firms are ready to invest in North Korea it is because of the democratic credibility. Even if the market is free and very less competition almost 0 competition is there no investor dares to go and make investment there. So it is also a risk to invest in such nation where the democratic norms and values are not addressed well.

4.2 Economic Risks

Economic risks are related to either a firm can collect its investment or debt back or not. Brian Perry (2018) has defined several risks caused by FDI. Political, Economic and Sovereign risks. Out of those we would like to talk here about the Economic. It is clear that a country with good economic growth also has good returns probability. A country with sound financial situation and advanced development infrastructure certainly has better business environment. Although an investor goes through minute environmental scanning over the country they are facing the troubles from such investment. Here we are trying to find out those risks which might be obstructing in the investment pathways.

4.2.1 Monitoring and Controlling

Either host or home country both are affected by this action. To invest one has to go minute scanning of the investing countries and the economic systems and elements. The strategic secrets of the countries play vital role to compete. If a government reveals those secrets to welcome FDI then the competitive advantages will be loosed. As a result they cannot have strong feet in the global competitive environment. Host country and home country both are suffered by this effect.

4.2.2 Inflation

The rise in investment increases the demands for raw materials in the host countries. By the increase in raw materials the goods and services price level will rise up and the same value of money will be able to buy lesser. The investor will be losing the part of profit. The host country people will suffer from the price rise for the goods and services. It will not be motivating the local investor to make more investment in the productive activities.

4.2.3 Interest Rates

The entry of foreign firms increases the use of money and debts. The excessive demand of money can increase the interest rates. As a result only a limited person can access to the business activities. No one will be ready to take loan from the banks and spend in the market share. So as a result the host country's stock market will go down. Home country also loses the part of profit due to rise in payback amount of debt.

4.2.4 Imbalance in Taxes and Subsidies

Government might have imposed the different policies for taxation and subsidies for the new commerce. Either rise or fall in the tax rate and subsidies has direct impact on the country's economy. It will imbalance the business environment. Home country will be losing the part of profit due to rise in tax rate. But the host country will face fall in GDP and fall in Export. The balance of payments can move back to negative as well.

5. Conclusion

At the end the paper has tried to go deeper into the issue to find out the result. Political and economic system of the country does not match with each other. Although most of the countries are following similar democratic political system and free market economy the norms and protocols of the use of those systems matters. One has to think before making investment and also before letting somebody to enter into the country. The very good example is of The East India Company entered into the India. Company entered as a business firms but slowly collapsed the whole political and economic systems. They colonized the nation for more than 200 years. During this period India people had to sacrifice their political and economic rights. Leading firms, businesses and ruling units were under the control of Britain due to the entry of a small company for a business. This is a representative example and there are plenty of other examples in the market where some host countries have engulfed the whole foreign investment in the name of law. The higher taxation in the name of so called subsidies is penetrating the investor and saying no to new investments. Without foreign investment no country can make economic growth and developments.

A suitable environment for the firms to invest and a good firms entering into the new country can help in economic advancement of both host and home countries. UN is now working on reducing and almost eradicating the poverty from the world. This is possible via good trade environment and treaties. So reducing the risk level the globalized environment should be filled with healthy and fair competition. All the nations should act like a united nation in terms of business.

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Table: Different Stages of FDI

Source: This table has been used to clarify the history of FDI in terms of different stages which is based on articles of Charles P. Knidlerberger.