3.2 Direct Investment Impacts on the Balance of Payments

3.2.1 Host Country Impacts

The contribution and impact of direct investment to the merchandise trade account of the balance of payments of the host country is dependent on the trade flows of imports (inputs) and exports (outputs) with regard to specific investment projects.

The sourcing of inputs due to a direct investment will be related to the ability of local sources to meet the needs for capital equipment, intermediate goods, services and raw materials for the investment project and will likely be sector dependent. In developing countries, the evidence is that direct investment projects undertaken by multinationals have a high propensity to import inputs. Studies have indicated that import propensities of between 20 and 30 percent are not uncommon.[7]

For exports, a distinction has to be made regarding the orientation of the investment project, that is, whether the investment is export-oriented or local market-oriented.

If the investment is the result of import substitution policies by the host country then imports should be reduced. However, import substitution investment induced through trade barriers will not necessarily reduce imports if the investment results in high-cost, inefficient productive capacity. Export-oriented investment, unless heavily subsidised, has to be efficient to compete on the world markets. Indeed, the developing countries that have embraced export-oriented investment have generally had better economic performances than countries adopting import substitution policies.

The effects of direct investment on host country exports are examined by comparing the different export propensities of multinational enterprises to those of local enterprises. Many studies have shown that the market structure of a sector is an important factor. Sectors with highly competitive local market conditions generally showed a higher export propensity for domestic industries. In addition, other important factors in the studies that affected the export propensities of foreign and domestic corporations included: the relative distribution of foreign and domestic enterprises across industrial sectors; the concentration levels of local and multinational enterprises in industrial sectors which were characterized with import-substituting production; and, the export product differentiation in terms of labour-intensive production compared to capital-intensive production, that is, assembly production versus high value-added manufacturing processes (e.g., semi-conductors).[8]

The timing of balance of payments flows can also have an important impact. Early in a project, investment flows will be high while imports are at a minimum; but as the project becomes fully operational and at a high productive capacity, the level of inputs will often rise, although an export-oriented project will continue to generate positive balance of payments

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[7] *See Vaitsos (1975) and Lall and Streeton (1977).*

[8] *See Cohen (1973,1975), Evers (1977), Lall and Streeton (1977) and Newfarmer and Marsh (1981)*