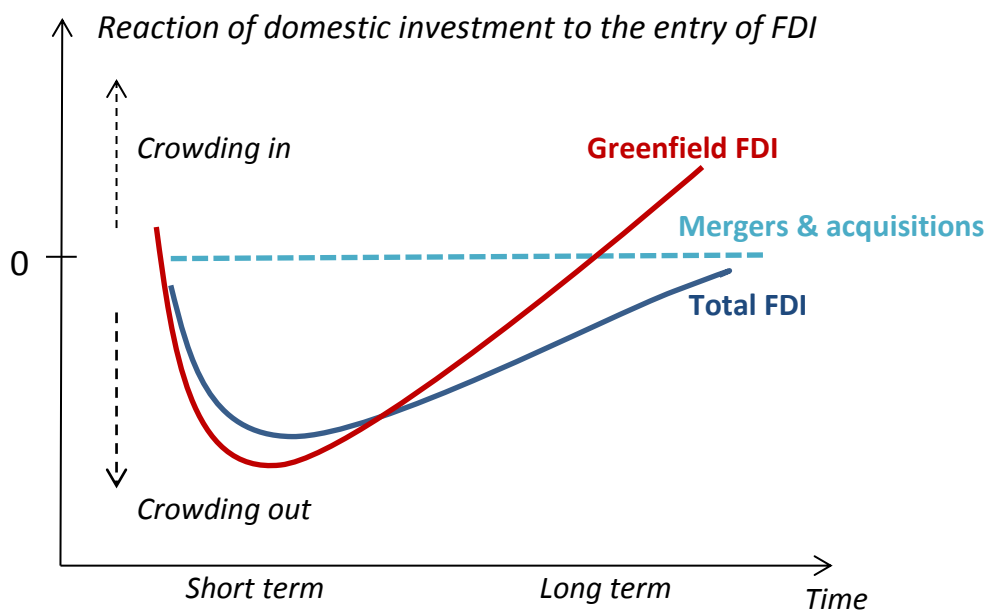


# Does FDI crowd out domestic investment?

By [Cristina Jude](#)

*Foreign direct investment (FDI) inflows are often considered a complement to domestic savings that facilitate the financing of local investment projects. However, as a result of increased competition, they tend to crowd out domestic investment in transition countries in the short term. This effect is mitigated if local financial markets are sufficiently developed.*



**Chart 1: Domestic investment is crowded out as a result of FDI entry.**

*Note: Dark blue curve: effect of FDI inflows on domestic investment; red curve: greenfield FDI (creation of a new company ex nihilo); dashed blue line: mergers and acquisitions.*

In the chart above, 0 indicates the absence of any response of domestic investment to FDI inflows. A curve below 0 indicates a crowding out effect (substitution) while a curve above 0 indicates a complementarity effect (crowding in).

## **FDI impacts domestic investment both via a competition mechanism and an easing of financial constraints**

FDI represents a complement to domestic savings, facilitating the financing of local investment projects. On the one hand, it can directly contribute to raising the stock of capital, through the investment made by the subsidiaries of multinational enterprises (MNE). On the other hand, domestic companies are likely to react to the entry of foreign investors by increasing or decreasing their own investment. In fact, the entry of foreign companies

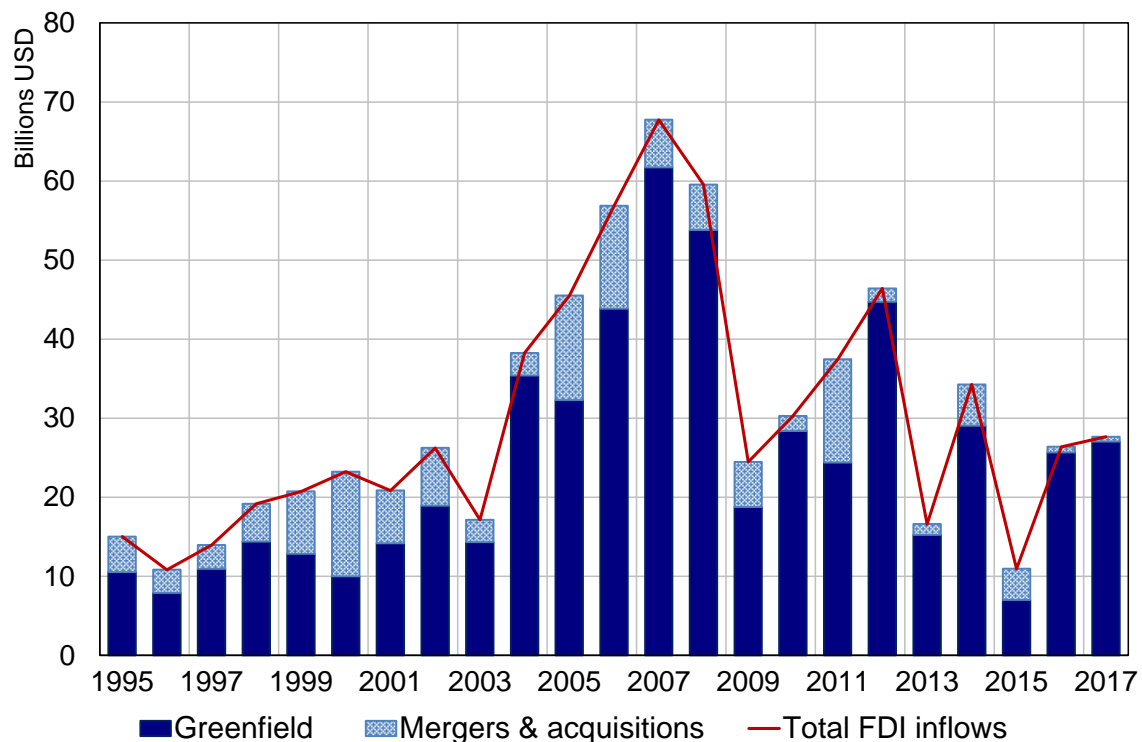
modifies the demand addressed to domestic firms. Demand may thus decline, as a result of stronger competition ([Markusen et Venables, 1999](#)), or rise, if foreign companies source locally ([Javorcik, 2004](#)). Finally, when capital flows associated with FDI increase the liquidity of domestic financial markets, they can lower interest rates and thus ease financial constraints for domestic companies ([Harrison et al. 2004](#)). Therefore, depending on the relative importance of these effects, either a crowding out effect or a crowding in effect will prevail.

### **Difficulty in identifying the impact of FDI on domestic investment...**

The empirical literature does not draw a clear conclusion about the effect of FDI on domestic investment: some studies find a crowding out effect ([Morrissey et Udomkerdmongkol, 2012](#)); others establish a crowding in effect ([Al-Sadig, 2013](#)). Furthermore, according to several experts, domestic investment is not influenced by FDI inflows ([Farla et al. 2016](#)).

In order to examine the role of FDI in the dynamics of domestic investment, we estimate an augmented investment function. This analysis is carried out on a sample of 10 countries from Central and Eastern Europe over the period 1995-2015. These countries have been the recipients of substantial FDI inflows over the last three decades (see Chart 2) and have thus undergone major industrial transformations during the period of economic transition.

FDI appears to have had a particularly significant impact in emerging and developing countries, which often suffer from a savings deficit. If FDI were to crowd out domestic investment, the policies designed to attract FDI may be called into question.



*Chart 2: Net FDI flows in countries of Central and Eastern Europe.*

*Note: The data correspond to all 10 countries in the sample. Red curve: total net FDI inflows; blue bars: breakdown between greenfield FDI and mergers and acquisitions. Source: UNCTAD.*

## FDI is at the origin of a creative destruction phenomenon

[We](#) highlight a two-step impact (J-shaped curve) of FDI on domestic investment (see Chart 1). In the short term, domestic investment, which is penalised by increased competition, declines following the entry of foreign companies. As domestic companies adjust and establish trade linkages with foreign companies, the crowding out effect diminishes. The time needed for the crowding out effect to fade is estimated at 4-5 years. In the longer term and under certain conditions, domestic investment is spurred by the spillover effects resulting from the integration of foreign subsidiaries into the economy. However, this complementarity is not systematic.

## The reaction of domestic investors depends on the entry mode of foreign investors

Depending on the entry mode of foreign investors, FDI can take the form of so-called "greenfield" investment (i.e. the creation of a new company ex nihilo) or mergers and acquisitions (i.e. the acquisition of an existing company).

Greenfield companies which display higher productivity and lower marginal costs rapidly capture some of the demand addressed to domestic companies. As a result, they generate a stronger crowding out effect in the short term. However, greenfield companies also establish

trade linkages within the domestic economy, especially if they rely on local suppliers: this will benefit domestic companies in the long term.

Conversely, mergers and acquisitions do not have a significant effect on domestic investment. Indeed, they consist in transferring ownership of existing assets, without any immediate increase in the capital stock. In addition, market competition is not significantly altered as the companies concerned by these transactions are already present on the market. While upgrading and expansion investments may take place following a merger or an acquisition, the effect is more gradual and leaves domestic companies with more leeway to adjust.

**If the crowding out effect is dominant, financial development can still contain it**

As capital flows, FDI is likely to fuel domestic financial systems, by increasing the supply of liquidity and lowering interest rates. Subsequently, developed financial systems - be it the banking sector or the capital market - can facilitate access to financing for domestic investors, thanks to their ability to effectively redistribute resources. Using interaction variables, [we](#) show that developed financial systems offset, to a certain extent, the crowding out effect.

From the perspective of financial development, the entry mode of foreign investors appears again crucial. While mergers and acquisitions do not immediately contribute to capital accumulation, they can nevertheless be complementary to domestic investment, provided the financial systems are sufficiently developed. Indeed, in the case of mergers and acquisitions, the funds are not immediately allocated, and are thus mostly channelled into the domestic banking sector and used to finance domestic investment projects.

Finally, insofar as the short-term crowding out effect results from a competitive mechanism, leaving the most productive firms on the market, the average productivity level of the economy increases and the overall effect on national welfare should be positive. Nevertheless, encouraging the entry of FDI in underdeveloped domestic industries or introducing incentives to use local inputs may be useful in mitigating the crowding out effect in the short term.