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Does direct foreign investment affect domestic credit constraints?

Ann E. Harrison[a,*], Margaret S. McMillan[b]

[a]*Department of Agricultural and Resource Economics, 329 Giannini Hall, University of California, Berkeley, Berkeley, CA 94720-3310, USA*

[b]*Department of Economics, 304 Braker Hall, Tufts University, Medford, MA 02155, USA*

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Abstract

Firms in developing countries cite credit constraints as one of their primary obstacles to investment. Direct foreign investment may ease credit constraints by bringing in scarce capital. Alternatively, if foreign firms borrow heavily from domestic banks, they may crowd local firms out of domestic capital markets. Using firm data from the Ivory Coast, we test whether: (1) domestic firms are more credit constrained than foreign firms, and (2) whether borrowing by foreign firms exacerbates domestic firm credit constraints. Results provide support for both hypotheses. We also find that state-owned enterprises (SOEs) are less financially constrained than other domestic enterprises.

Keywords: Foreign Direct Investment; Credit Constraints

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> ''Not all direct foreign investment around the world represents net capital flows. Often such investments are financed in local markets.''
> *Martin Feldstein (2000)*

*Corresponding author.

E-mail addresses: harrison@are.berkeley.edu (A.E. Harrison), Margaret.McMillan@tufts.edu (M.S. McMillan).

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1. Introduction

Firms in developing countries typically cite credit constraints as one of their primary obstacles to investment.[1] Direct foreign investment may ease credit constraints by bringing in scarce capital. For example, domestically owned businesses in poor countries are much more likely to face credit constraints than multinational firms.[2] This is one of the reasons policy makers in developing countries have eased restrictions on inward DFI and in many instances provide special incentives for DFI. Yet, if foreign firms borrow heavily from local banks, they may exacerbate domestic firm credit constraints by crowding them out of domestic capital markets.[3]

Apart from anecdotal and survey evidence, there is little empirical evidence on capital market imperfections and firm level investment in developing countries[4]. One reason for the limited empirical evidence is the difficulty in obtaining detailed firm-level data for these countries. Most of the existing evidence is difficult to interpret because these surveys are typically administered by institutions in a position to make loans such as the World Bank. Hence, firms have an incentive to report that they are credit constrained. Leading theorists, however, recognize the important role that capital market imperfections play in developing countries.[5] There is also a large body of empirical evidence for developed countries that suggests that capital market imperfections play an important role in determining firm-level investment decisions.[6]

In this paper, we analyze whether incoming foreign investment in developing countries plays an important role in alleviating domestic firms' credit constraints. We measure the impact of incoming direct foreign investment on domestic firms' credit constraints using firm-level data for the Ivory Coast. Specifically, we use an augmented Euler investment model to test the following hypotheses: (1) domestic

[1]In a recent survey of executives in 20 African countries, financing constraints were cited as a major obstacle to business expansion (Harvard Institute for International Development and World Economic Forum, 1998). In the Ivory Coast, financing constraints were ranked third out of 21; the first and second obstacles were taxation and political instability.

[2]In a recent survey on Kenya, the primary complaint of domestically owned businesses was credit constraints. Multinational enterprises in Kenya, however, did not cite credit constraints as a problem. Rather, they cited access to foreign exchange as their primary obstacle to doing business.

[3]For example, Stiglitz in an address to the Chicago Council on Foreign Relations (1998) argues that there is broad agreement about the fact that foreign direct investment brings additional capital. Feldstein (2000) argues that this is not necessarily the case.

[4]A recent exception is Love (2000), which shows that the sensitivity of investment to availability of internal funds (a proxy for financing constraints) is linked to overall financial development. Other exceptions are Tybout (1983), Harris et al. (1994), Jaramillo et al. (1996), Gelos and Werner (1999), Patillo (2000), and Bigsten et al. (2000).

[5]See for example, Aghion et al. (1999) and Banerjee and Newman (1994).

[6]For an excellent survey, see ‘‘Capital-Market Imperfections and Investment,’’ by R. Glenn Hubbard (1998). See also Schiantarelli (1996) on methodological issues.