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Role of FDI in Stimulating Economic Growth

Abstract

Foreign direct investment (FDI) has increased rapidly in developed and developing countries over the past two decades, and many studies find that it has significant linkages with economic growth.

The analysis in this paper is divided into two sections. The first section includes the various indicators that support economic growth. The analysis illustrates that economic growth indicators are dependent on FDI and vice-versa. Albeit there is a minimum requirement in terms of infrastructure and trade openness in order to attract international investments.

In the second section, various evidences from developed and developing economies across the globe are analysed and studied. The various complementary factors on which the impact of FDI depends arefound to be host country's economic conditions such as levels of financial marketdevelopment, institutional development, better governance, and appropriate macroeconomic policies. Furthermore developing economies need to increase their investment in human capitaldevelopment, infrastructures, and facilities for enhancing investment climate and international trade.

It is clearly evident through this study that, at a global level, FDI plays an important role in sustainable economic growth and preferred financing option would remain to be equity capital.

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Introduction

FDI refers to an investment made to acquire lasting interest in the enterprises operating outside of the economy of the investor. The investor's purpose is to gain an effective voice in the management of the enterprise. Some degree of equity ownership is almost always considered to be associated with an effective voice in the management of an enterprise and a threshold of 10% equity ownership qualifies an investor as a foreign direct investor.

In developing countries, foreign direct investment (FDI) seems to be perceived as most important, both in terms of its impacts and its size in comparison to other types of capital flows. FDI is considered to be a long-term capital inflow and has the smallest variation compared to other types of capital flows (Corsetti 1998; Turner 1991; Sarno and Tylor 1999; and Claesssens et al. 1995), and Wiboonchutikula et al. 2001). It is assumed to be more productive than domestic investment in endogenous growth models.There is direct implication that FDI can enhance growth in long-run by extending the existing reserve of knowledge in the host economy through skill acquisition and labour training. Hence, through knowledge spillovers and capital accumulation, FDI may play an important role for economic growth.

Another important indicator of macroeconomic performance is the gross domestic product (GDP) and its growth rate.GDP is shown as a function of labor (L) and capital (C). The increase in capital stock raises the production function leading to a higher level of real GDP. The economy is able to manufacture more goods and services and hence the average capital to labor ratio rises. High technologyspillovers and large capital stock increase economic growth.

FDI is a function of inflation, current account balance, market size, real exchange rate, capital market privatizationand liberalization values (Trevino et al. 2002).The main reason to engage in FDI is to revitalize innovation, strengthen productivity,technology transfer and encourage employment.

Indicators of Economic Growth

Human Capital

As developing countries made further progress, the existence of human capital for better growth gained more importance. The firms, governments and individuals; the investment is being allocated to the resources in human capital which in return encourage their production capacity and income. The pace with which the stock of human capital is building up is critical for developing countries to achieve their developmental goals, the most vital of which is poverty alleviation. Furthermore, a better reserve of human capital enhances efficiency in production and increases the absorption capacity of developing countries to absorb new knowledge and technology and use them to nurture their economy (World Bank 2005).

In terms of human capital development, developing countries have made some major advancement and the data from sources such as WDI and UNISCO indicate literacy rate average of schooling, secondary and primary school enrolment, life expectancy have gone up and governments set aside a greater portion of their national income to educational expenditures.One of the key factors behind FDI growth was a high level of human capital development. (Miyamoto 2003)

Technological Transfer

A model was constructed by Findlay (1978) to test the relationship between FDI and the technological progress in developing countries. It was believed that catch rate was a function of the technology gap between regions and technology diffusion was similar to the spread of diseases. Hence, the larger the gap between foreign and domestic firms, the more apparent the technology spillovers were. Technology diffusion was faster in these regions because of the frequent exchange of knowledge.It was assumed that the speed of technological progress in developing countries were in proportion to their degree of openness towards FDI.

The role of technology diffusion was studied by De Gregorio (1992) in the economic development of Latin American countries and it was found that the efficiency of FDI was three times higher than that of domestic investment. Wang and Blomstrom (1992) also found that FDI was very helpful for the development of less developed countries. In the host countries, due to the generation by more advanced technology and managerial experience, FDI accelerated the speed of technological progress. This type of demonstration by foreign investment companies can lead to "learning by watching" or "reverse engineering".

The role of foreign MNEs through knowledge transfers, technological spillovers, and the establishment of forward and backward linkages, is an opportunity to increase absorptive capacity during the "pre-catching up" stage,(Zhang 2009), FDI also plays a significant and positive role in explaining the internationalization of local MNEs (Banga 2009; Pradhan 2009).

The Extent of Financial Markets

The role of financial sector development on economic growth was first studied by Schumpeter (1911). It was argued by Patrick (1966) that financial sector induces economic growth through the following channels: reallocation of resources from traditional to growth-inducing sectors and the promotion of entrepreneurship in growth-inducing sectors.

Findings of Nair, Mahendhiran (2010) included that FDI, on its own, contribute to economic growth; financial sector development plays anpivotal role in further enhancing the contributions of FDI on economic growth; the impact on economic growth is found to be complementary; this impact of FDI and financial sector development is most important for developing countries, while being equally important for developed economies.

FDI promotes economic growth where financial markets are sufficiently developed (Alfaro et al. 2004).

The Openness Degree of The Economy

An econometric model was used which found positive and significant relationship between trade openness and FDI inflows.It was also irrefutable that there is gravity of trade openness in the attraction of FDI inflows in developing economies which according to UNCTAD (2009) attract only small amounts ofthe world FDI (Liargovas, Skandalis 2012).

Exports Volume

Economic theory suggests that FDI can generate positive spillovers to domestic firms in the host country. Since multinational corporations (MNCs) are a significant source offoreign capital and technology, their entry could facilitate the transfer of technical and business know-how resulting in competitiveness and productivity gains among local firms. (Rafaelita, Aldaba, Fernando 2010). Domestic firms also benefit from externalities and spilloversassociated with FDI through exports and international integration (Costa and de Queiroz 2002).

Global Evidences

Developed Countries

According to World Bank statistics, classification of developed countries is done on the basis of high income: OECD, high income non-OECD and higher middle income.

United States

The FDI contributes extensively to GDP growth in the U.S. economy and constitutes a crucial factor determining economic growth. It is important for the U.S. economy to continue to attract foreign investment (LucynaKornecki, Vladislav Borodulin 2011).

Turkey

Economic growth and FDI were co-integrated and the relationship between both wasfound to be positive and statistically significant. A strong evidence of a bi-directional causality was seen between the two variables.(Gunaydin, Ihsan; Tatoglu, Ekrem 2005).

Qatar

The study conducted by (Fadhil, Mohammed Ameen; Yao, Liu; Ismeal, Walaa 2012) have clearly proved that Qatar's inward FDI and economic

growth are causally related in a long term. Moreover, the the economic growth positively affects the inward FDI, but FDI is more sensitive to its own performance change than to the economy growth. The economic growth is negatively affected by the inward FDI, and more sensitive to the inward FDI change than to the economic growth itself.

Japan

FDI can play a rudimentary role in reviving economic growth. Japan's economy depends on FDI for a crucial part of its net capital inflows. The positive impactsof FDI are helping in creating new jobs(Bâlgar, Cristina; Dragoi, Andreea 2014).

Egypt, Jordan and Oman

The results from the research conducted by (Metwally, M M 2004) support that foreign capital inflow is strongly influencedby export of goods and services, which contributes to investment in the export sector and creates new markets for the domestic products. Hence, a greater inflow of foreigndirect investment is likely to contribute towards the improvement of current account. In the relationship between capital inflow and economic growth, a feedback effect was also found. A greater inflow of foreign capital leads to increase in the export of goods and services. This expansion leads to growth in GNP, which, in turn, attracts more foreign capital.

East Asia

FDI has a positive relationship with economic growth in high-income and middle-income countries. These countries have appropriate economic factors such as high government expenditure on investment in infrastructure,high education level, high level of financial development, and high degree in trade openness. It was found that FDI can promote more economic development in countries which have more appropriate factors such as infrastructure, high level of human capital,large degree of trade openness,financial development, and low level of corruption(Kotrajaras, Polpat; Tubtimtong, Bangorn; Wiboonchutikula, Paitoon 2012).

Poland

The research conducted by (Torrisi, C Richard; Delaunay, Christian J; Kocia, Agata; Lubieniecka, Marta 2009) concluded that the continued growth and success of economies in transition, is linked to their continued ability to attract FDI. FDI inflows are likely to sustain or accelerate the full transition to a competitive economy.

Thailand

The research conducted by (Tosompark, Chanikarn 2014) concluded that FDI is indeed growth-stimulator, but the benefits are not by free trade policy or by complete liberalization automatically. As Thailand faces over-reliance on the continuation of foreign capital inflows, as well as the increasingly noxious and dysfunctional nature of its domestic politics due to whicha loss of confidence in Thailand's democracy is felt, more emphasisshould be on strengthening infrastructure, education, market growth potential, and political stability.

Developing Countries

According to World Bank statistics, classification of developing countries is done on the basis of low income and lower middle income.

India and Malaysia

It is economic growth that promotes FDI inflows in the economy and hence, support GDP-driven FDI hypothesis. On the contrary, FDI inflows do not promote economic growth and hence rejects FDI-driven GDP hypothesis. But that does not mean FDI has no contribution towards economic growth. Its affect could be seenindirectly via export spillovers and productivity spilloverseffect on economic growth. There are various reasons. The possible reasons for FDI not promoting economic growth directly in India as well as Malaysia are low inflows of FDI, which is due to high tariff barriers, slow financial integration, low openness, low infrastructure, lack of tax breaks, etc. and low benefits from FDI spillovers(Pradhan, Rudra Prakash, 2008).

Vietnam

The study conducted by (Hoang, Thu Thi; Wiboonchutikula, Paitoon; Tubtimtong, Bangorn 2010) showed that there is a strong impact of FDI on economic growth in Vietnam. "Market stealing" effect is felt on the domestic investments, still FDI inflowhave an independent influence on its economic growth. Economic growth is not affected by interaction effects of FDI with human capital and trade,which implies that knowledge and technology transfer are not yet applicable for increasing economic growth.

Morocco

The research by (Baliamoune-Lutz, Mina N 2004) provided evidence of positive effects of FDI on economic growth. There is a bi-directional causality between FDI and exports, as well as a positive influence from exports to economic growth. Thus, it was seen that there are direct and indirect effects of FDI on growth.

SAARC Nations

A study conducted by (Bashir, Rizwana; Shakir, Rabia 2012) on causality between Foreign Direct Investment and Economic Growth in SAARC nations for the period over 1980-2010 highlights the significance of FDI for economic growth and stability under the hypothesis that 'FDI does Granger cause GDP'. Economic growth is one of the key determinants in attracting FDI hence, it also requires more attention.

Nigeria

According to the study there is a unidirectional relationship between the foreign direct investments and economic growth, indicating causality only from FDI to GDP.Economic growth as a measure of GDP in Nigeria is Granger caused by FDI, which reflects that Nigeria'scapacity to progress will depend on the country's performance in attracting FDI(Egbo, Obiamaka Priscilla, 2011).

Conclusion

The research clearly indicates that FDI has a bilateral relationship with economic growth in developed and developing countries. The developed countries benefit more as they have high degree of trade openness, high investment in infrastructure and

high level of financial development.Whereas in developing countries due to low investment in infrastructure, technology, human capital and other facilities, they are not capable of absorbing the possible benefit. It is evident that appropriateeconomic conditions play important roles in supporting FDI to stimulate economic growth.

So yes, there seems to be a positive association between FDI inflows and economic growth in a predefined period, provided thathost countries have reached a minimum level of educational, infrastructure and technological development.

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