

ANAYSIS OF THE RELATIONSHIP BETWEEN FDI AND ECONOMIC GROWTH – LITERATURE REVIEW STUDY

Ph.D Student **Lenuta CARP**

“Alexandru Ioan Cuza” University of Iasi, Romania
lenutza_carp@yahoo.com

Abstract:

The aim of this paper is to emphasize the importance of the FDI flows on the host country economic growth, through the view of the representative, theoretical and empirical research for the approached field. After analyzing the literature review concerning the effects of FDI in the beneficiary country, the following results were obtained: the impact capital flows exert on host country is significant and the main channels through which the effects are transmitted are: financial markets, host country absorptive capacity, human capital and technological.

Key words: foreign direct investment, economic growth, determinants, channels

JEL classification: E22, O40

INTRODUCTION

The volume and the value of FDI flows increased significantly under the impact of globalization and intensification of the existing connections between different financial markets, among developed economies and the developing ones. The recent evolutions of global economy have strongly affected the dynamic of FDI and also the impact of foreign capital flows exert on economic development.

The current economic crisis highlighted the fundamental role foreign flows play in the reintegration process of transition and developing economies in the structure of the global market, as FDI are appreciated to be “the definite element of the economic growth, of promoting intensive, qualitative and efficient factors. This is why, the importance of the investment, their role in the conditions of the restructuring economy are extremely real” [Munteanu and Tudor, 2009]

The specialists in the economic and financial field give a special and increased attention to the equivalence between FDI and the growth economic rate because of the importance of foreign capitals and fundamental channels in propagation the consequences in the real economy. The position of the investment market at the intersection between financial sector and the real one justify the necessity of understanding the manner FDI influence host country economic development through adequate instruments. The problem identified in the representative literature, in which we may also include the object of this study, concerns the controversial aspect of the economic and financial implications FDI generate on the degree of economic expansion measured by the growth rate of GDP. In conclusion, the problematic consists in the next question: do FDI contribute to the beneficiary country economic growth?, the analysis being focused on emphasizing the causes of FDI and the channels that encourage achieving the aims.

The results of the empirical analysis can be structured in two contradictory approaches: on the one side, foreign capitals are considered a fundamental factor involved in solving the difficulties about the low value of the local capital and productivity in the selected countries and on the other side, FDI are seen as an essential determinant of foreign capital inflows.

The second part of the paper presents the problematic relation between FDI and economic growth, through the relevant literature reviewing the concepts and the main causes of FDI. The third part presents reveals aspects about the research methodology in the previous studies. The last section of the literature review is a conclusion reached after the analysis of the literature.

THE CORRELATION BETWEEN FDI AND ECONOMIC GROWTH OF THE HOST COUNTRY

FDI effects on host country economic growth are intensively debated in the literature because of their controversial character. Before the analysis of the consequences foreign capital flows generate, we consider appropriate a short review of the definitions of this concept and determinants that influence the investment decision.

The definitions given to the concept of foreign direct investment in the significant literature are characterized by a high level of homogeneity. In the approach of Voinea [2005, p: 172], FDI reflect “placement of equity by foreign investors (residents) in other countries in the establishment and development of companies in various fields of activity”, while Durroset [2005, p: 65] considers them “major determinants of globalization”. IMF [2009] and OECD [1999] highlights that these capitals emphasize the wish to obtain a long term interest by an entity resident in an economy (direct investor) in an enterprise resident in another economy (direct investment enterprise), the investor being engaged in the business influencing and controlling it; this combination justifies the FDI classification in foreign direct investment and portfolio investment [Whyman, 2006], the latter being used to obtain gain [Guillochon, 2001]. Previous research proved with strong arguments that developing and transition countries recorded a strong investment jump through the advantages they benefit after FDI penetration: technological transfer, industrial reorganization, development of labor force skills, influencing the production, incomes, prices and the entire economy [Ranjan, Agrawal, 2011; Accolley, 2003], being favorable for improving the quality of the production factors and enhance “some competitive advantages based on specialized production factors” [Anghel, 2002, p: 38]. The positive effects ISD generate in the host country are determined by carrying them out in long term ensuring a high level of stability. The beneficiary countries developed various strategies to attract foreign capitals, preferring them over other capital sources because they do not raise public debt and have a positive impact on the balance of payments through reducing the deficit. Capital outflows as part of the profits repatriation depend on the economic result of the enterprise, answering the interest of the investor and the state that encourages economic development [Negritoiu, 1996].

FDI impact on national welfare of the host country is different, according to the fundamental determinants and the type of investment carried out: for a new investment (Greenfield), the effect is significant by creating new production capacities, new working places, the born of a new consumer and a new taxes payer; the participation in the privatization process exert impact on the economy, even though, most of the times, taking over an enterprise by foreign investor signifies a crucial decrease in the number of jobs [Bonciu, 2003].

The results of the analysis proved the influence exerted by the characteristics of the countries on investment decision and efficiency of carried out operations, along with: economic performances of the multinational company, ways of entering the market, the level of competition and inherent risks. The empirical research at the macroeconomic level emphasize the fact that FDI externalities are influenced by the absorptive capacity for the host country and limited by local conditions, financial market development or the level of education [Sarkar, 2007; Johnson, 2006]. Azman-Saini, Baharumshah, Law [2010] confirm based on the analysis results the direct correlation that exists between the absorptive power of foreign capitals by the authorities and a higher level of economic expansion.

The dynamic of the global economy revealed the necessity of modernizing the infrastructure of the control and communication system [Minai, 2011], with the correlation between the evolution of the foreign capitals and the exchange rate fluctuation and the volatility of commodity prices on international markets. The investment process is directly connected to the advantages foreign investor wants to obtain: location, property and internationalization, presented in the theory called the Dunning’s paradigm [Stoiana & Filippaiosa, 2008; Andrei, 2009]. This paradigm highlights that the firm chooses FDI as a manner to serve foreign markets than other alternatives such as: licenses,

joint venture, strategic alliances, management and export contracts [Eiterman, Stonehill & Moffett, 2009] relative to the following objectives: market, resources or actives seeking [Moosa, 2002].

The dilemma surrounding the relation FDI – economic growth allows the research approach from two main views: studies that identified a positive relation between those two variables [De Mello, 1999; Chong, Baharumshah, 2010] and those that found a negative relation [Moran, 1998] or no correlation [Ericson și Irandoust, 2001]. The impact analysis of foreign capital flows on the development of the beneficiary country underlines the role of the channels through which FDI exert a positive impact: exports, the extend of financial markets, development of human capital skills, technological and know-how transfer, raise in local enterprises productivity by incitement produced by foreign competition, ensuring a fair distribution of incomes (through tax payments, lower production prices, increased use of labor force) [Zait, 2003].

A positive connection between the two variables is obtained through the strong and worldwide extended financial markets channel [Alfaro, 2010; Durham, 2004; Hermes & Lensink, 2003; Chee & Nair, 2010], as an insufficient level of development of the markets and financial institutions prevent getting of a high level of economic growth [Abzari, Zarei, Esfahani, 2011]. The relation between rate of accumulation and national income growth rate has the positive implications on the balance of payments by financing the deficit.

The studies that identified a negative correlation as a result of the research are greatly reduced as number, but the most important are: Durham [2004], Lyroudi [2004], Carkovic & Levine [2005] and Lipsey [2006]. The unfavorable approach of the relation between FDI and the economic growth is surprised by Durham [2004] after researching a panel formed by 80 countries, member and non-member OECD in the period 1970 – 1980, but sustain the important role played by financial and institutional absorptive capacity. In the same view is included Kholdy [1995] who applies Granger causality test on 10 economies from Eastern Asia. The negative connection is also demonstrated by Lyroudi and Papanastosiou [2004, p: 98] through the Bayesian analysis and Carkovic and Levine [2005, p: 197] who got negative results through taking into account a certain level of education, economic and commercial development in the beneficiary country, as “the exogenous part of FDI do not exert a positive and robust influence on economic growth” and “does not exist any empirical, trans-national and confident evidence to support the claim that FDI accelerates economic development”, while Lipsey and Sjöholm [2005, p: 297] noted that “there is no universal relation between the ratio of FDI inflows in GDP and the national growth rate”.

There are a significant number of studies which identified a positive correlation between FDI and economic growth, both in developed and developing countries. The neoclassic theory situates the local market size at the basis of foreign capital entering and the microanalysis implemented by specialists [Alfaro, 2003; Vu, Noy, 2009; Marwah, Tavakoli, 2004] points out a strong connection in the manufacturing, primary and services sector. The positive correlation between FDI and the effects generated in the economy requires the insurance of a minimum level of human capital, economic and financial stability and a degree of markets liberalization [Blomstrom, 1996; UNCTAD, 1999; Sarkar, 2007]. Salman, Feng [2009] and Misztal [2010] mentioned the role of the foreign capitals in gaining an increased GDP rate through contribution to: human resources development, capital formation, raising the level of competitiveness on the local market.

The technological progress stimulated by the capitals transfer has a favorable impact on national productivity, increasing the industries role in achieving a GDP major growth rate. After the technical transfer, Borensztein, De Gregorio și Lee [1998] observed a positive trend materialized in development of production equipments encouraging FDI penetration and national welfare. Lipsey [2006, p: 417] based on analysis of the information took from the balance of payments of 25 countries from Center and Eastern Europe argues that the relation between the variables is a “positive. Significant and robust”. Bengoa and Sanchez – Robles [2003, p: 529] found in the countries from Latin America a positive connection, “the beneficiary country requesting adequate human capital, economic stability, market liberalization to benefit from long term capital flows”.

It is widely known and accepted the fact that FDI generate both positive and negative effect, that involve costs and cause benefits, but, the latter are net superior to expenses caused by carrying

out the investment. International capital flows strongly influence national welfare through promoting competition on domestic market, increasing innovations and the degree of occupied population [Herman, Chisholm, Leavell, 2004, p: 15]. According to the empirical studies, the direct impact on economic growth is addicted to the adopted market strategies, being used for orientation and reference for other states with unfavorable results [Huidumac Petrescu, Joia, Hurduzeu, Vlad, 2011].

The reintegration process of developing countries in global economy influences FDI orientation to certain countries or regions causing the reestablish external balance as a consequence for reducing the deficit [Wijeweera, Villano, Dollery, 2010]. De Mello [1999] believes that between increasing GDP growth rate and human capital development is a direct connection as “the measure in which FDI stimulate development depends on the substitution level among FDI and domestic investment”.

In the category of variables used in econometric models, GDP is often the dependent one and as independent variables can be used: labor force, level of development of financial and banking sector, stock capitalization, technology, human capital, competition and volume of exports [Hermes, Lensink, 2003; Jalayi, Sabbaghpur Fard, 2009]. A distinctive approach was carried out by Vu Le and Suruga [2005] to investigate the correspondence among FDI – economic growth – public expenses.

Johnson [2006] searches in 90 selected countries foreign capitals impact on increasing physical capital, obtaining a positive result in developing countries and a negative on in the developed economies. A superior rate of economic expansion can be obtained if through actions of authorities it is followed the promotion of the national interest and opening the extension perspectives. The economic and financial implications on development are produced both directly through the essential channels which permit externalities transmission and indirectly by amplification competitiveness, innovative techniques and the modernization of productive equipments.

The model of Jayasuriya [2011] states the positive connection between variables considering investment ratio, political instability, conditions for implementing commercial operation, to gain national welfare. The advanced technology is favorable to business extend, but capital accumulation ensure the adequate space for enhancing national productivity through a bigger number of jobs and persons involved in lucrative activities whose incomes guarantee the functionality of productive cycles.

The degree of openness to exterior stimulate FDI entering to develop new business projects which will ensure the premises for a sound development through competition on local market and stimulating future penetrations [Razin, Sadka, 2001]. The size of local markets and their development level determines long term capital attraction, creating the necessary framework for achieving double growth rates in developed economies than in developing ones. The beneficiary countries of international flows have as main objective a high level of economic development, enriching the access conditions through an economic and financial stability framework which guarantees property rights [Casi, Resmini, 2010; Büthe, Milner, 2008; Ford, Rork, 2010; Homlong, Springler, 2010]. FDI volume is strong correlated to the country economic growth measured by GDP growth rate, foreign investments could be carried out in all economy branches without breaking the state property, the norms about antimonopoly legislation, norms considering environment protection and the moral ones [Rusu, 2000].

The views concerning the connection between FDI and economic growth reveal foreign capitals importance on host country economy, the differences among approaches appear because of variables selection.

APPRECIATIONS CONSIDERING RESEARCH METHODOLOGY IN PREVIOUS STUDIES

Most of the studies and papers which treated the relation between FDI and growth economic rate emphasize the use of both quantitative and qualitative instruments, the starting point for the

research being represented by the theoretical approach and the information structured in tables and graphics. So, in the introduction section, are revealed the main concepts to operate with, including: foreign direct investments, economic growth, human capital, technological progress. Often, in the analyzed studies we found a combination between the theoretical and empirical approach, the latter having the role to sustain the results obtained from theory, to strengthen previous studies conclusions or to enrich the carried out research by adapting them to the current situation.

In the relevant literature, the most used methods to analyze the correlation between international capital flows and the host country economic growth rate are: the correlation and regression research, VAR method, OLS method, stationarity test, Granger causality test, GMM method, induction.

CONCLUDING REMARKS

The essential literature for the subject and the results of empirical research carried out offer sound arguments to sustain the significant impact FDI exert on host country economic development through various channels: human capital, technological transfer, the extend of financial markets, the openness degree of the economy, exports volume. In the same time, we easily realized the entire concordance between externalities and the advantages multinational follow through extending their businesses in different geographic regions.

The correlation between FDI – growth economic rate (GDP rate) express the role that absorptive capacity plays in the host country on the intensity connection between reminded variables, the results obtained could be taken as a reference for responsible authorities with attraction of an increased volume of investments.

Future research area includes the analysis of the connections among variables and increased the impact on economic development of Romania or developing countries from South – East Europe; it can also be relevant a comparative analysis of the implications in developed countries to developing countries. The research perimeter can be significant extended as the methods are more and more various, the techniques and instruments which are basic for the analysis, being favorable for a better understanding of correlations.

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