International Journal of Social Science and Economic Research

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON ECONOMIC GROWTH IN DEVELOPING COUNTRIES

Jayant Mansharamani

Pathways World School Aravali

DOI: 10.46609/IJSSER.2023.v08i10.018 URL: https://doi.org/10.46609/IJSSER.2023.v08i10.018

Received: 19 September 2023 / Accepted: 20 October 2023 / Published: 2 November 2023

1. Introduction

1.1 Background

For developing nations, foreign direct investment (FDI) is a critical source of capital inflows. It is the investment made by foreign corporations in a country's local market. FDI has the ability to considerably contribute to economic growth, job creation, and technology transfer in developing nations. The purpose of this research study is to examine the effect of FDI on economic growth in emerging nations. Foreign Direct Investment (FDI) is critical to developing nations' economic development. It entails foreign firms investing in domestic businesses and industries in order to build a long-term interest and influence.

FDI provides several benefits to developing countries, including expanded job opportunities, enhanced technology transfer, improved infrastructure, and access to new markets. By reviewing real-world instances, we may obtain a better grasp of how FDI has benefited developing countries while also recognizing the obstacles they confront.

1. China as a Model of FDI-Driven Growth

The inflow of FDI has been a major contributor to China's spectacular economic growth during the last few decades. In the late 1970s, China opened its doors to international investors, drawing corporations looking for low-cost manufacturing and access to a large labor pool. As a result, FDI was critical in converting China into a worldwide manufacturing powerhouse. The development of Special Economic Zones (SEZs) and the admission of international firms such as Foxconn and Intel spurred this boom. FDI not only helped to create jobs, but it also aided in knowledge transfer, technology adoption, and infrastructure development.

2. Vietnam: Realizing Its Economic Potential

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Vietnam, like China, has witnessed tremendous economic growth as a result of FDI. In the late 1980s, the government implemented market-oriented reforms, resulting in an influx of foreign investors. FDI was critical in propelling export-oriented industries including clothes, textiles, and electronics production. Multinational firms such as Samsung and Nike constructed production plants, providing local residents with job possibilities. This infusion of foreign cash has accelerated Vietnam's industrialisation and resulted in long-term GDP development.

3. India: FDI's Effect on the Growth of the Services Sector

Although FDI has often been linked to manufacturing, the services sector is also greatly impacted by it. In the case of India, FDI has helped to fuel the expansion of sectors like telecommunications, business process outsourcing, and information technology. FDI has made it possible for India to overtake other countries as a worldwide leader in services and IT by luring international corporations like IBM, Microsoft, and contact center goliaths like Accenture. As a result, there are now more job possibilities, export revenues are up, and innovation and information exchange are encouraged.

4. Brazil: FDI-based infrastructure development

Brazilian efforts to accelerate the development of its infrastructure have benefited greatly from FDI. The nation has welcomed international investment in industries including telecommunications, energy, and transportation. For instance, China's engagement in Brazil's energy industry has contributed money and knowledge to the creation of significant hydroelectric dams. Similar to this, international corporations have aided in the development of Brazil's telecommunications sector by enhancing connection and boosting national economic activity.

The importance of FDI on economic growth in underdeveloped nations cannot be overstated. We can examine how FDI has contributed to job creation, knowledge transfer, infrastructure development, and sectoral growth via real-world instances. However, it is critical to recognize that problems and hazards exist, such as the possibility of exploitation, reliance on foreign markets, and the need to balance development with sustainable practices.

To maximize the beneficial impacts of FDI, developing nations must promote investment-friendly conditions, stimulate innovation, and emphasize human capital development. Continued study and policymaking should aim to ensure that FDI benefits all stakeholders, including local communities, employees, and the economy as a whole, while avoiding possible risks and vulnerabilities.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

2. Literature Review

The literature has identified a number of different forms of FDI. First of all, horizontal FDI happens when a corporation makes investments in the same sector of the economy as its home nation. With this kind of investment, the business may increase its market share, get access to new clients, and take advantage of economies of scale. A German automaker setting up a factory in China, for instance, would be regarded as engaging in horizontal FDI.

In the same industry, vertical FDI refers to investments made at several stages of the manufacturing process. This kind of investment enables businesses to benefit from cost-saving possibilities by moving particular production phases to nations with cheaper labor costs or areas of specialized knowledge. For instance, vertical FDI is demonstrated by a Japanese electronics business investing in a factory in Malaysia to produce components for its goods.

Thirdly, investments in unrelated businesses or sectors are referred to as conglomerate FDI. By investing in sectors with various growth drivers or cyclical patterns, conglomerate FDI companies seek to diversify their business portfolio and lower risk. A US-based technology business acquiring a European pharmaceutical company would be an illustration of conglomerate foreign direct investment.

A number of studies have been done to examine how FDI affects economic growth in developing nations. Foreign direct investment is described as a kind of international investment that represents the goal of a resident entity in one country to acquire a long-term stake in a company based in another economy, according to the OECD standard definition of FDI. (OECD, 1990) In a 2011 research, Musau examined how FDI affected Kenya's economic expansion and development. According to the report, FDI benefits Kenya's economic development and growth.

Gachino (2012) examined the effects of FDI on firm-level capabilities and human capital development in the manufacturing sector in Kenya in another research. The study discovered that FDI had a favorable effect on firm-level competence and the growth of human capital. The effect of FDI on technology transfer and the reduction of poverty in Africa was examined by Ikiara (2003). The study discovered that FDI may make a major contribution to technology transfer and the reduction of poverty in Africa.

2.1 Theoretical Framework

The link between FDI and economic growth is explained by a number of theoretical frameworks. The endogenous growth hypothesis states that FDI can boost economic growth by boosting the host nation's stock of knowledge and technology. Alfaro and others (2010) According to the principle of comparative advantage, FDI can aid developing nations in narrowing their focus on

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

producing the commodities and services in which they have a competitive advantage. (Panth, 2013)

According to the idea of agglomeration, FDI may cause economic activity to cluster, which may result in the production of advantageous externalities and economies of scale. 2014 (Milliou)

3. Determinants of FDI

3.1 Market size and potential

Several variables influence the flow of FDI to developing nations. These characteristics include market size, natural resources, political stability, infrastructure, and human capital, according to the World Bank (2013). Asongu et al. (2018) investigated the factors of FDI in fast-growing economies. Natural resources, political stability, and infrastructure, according to the research, are important predictors of FDI in fast-growing economies.

1. Market Size: The amount of demand for products and services in a country is referred to as market size. Large consumer markets are appealing to foreign investors because they provide a large client base for their products or services. Foreign investors are establishing or expanding their operations in developing nations with huge populations in order to access into these markets.

For instance, India's enormous population of nearly 1.3 billion people attracts global firms looking for expansion prospects. The presence of a sizable customer base supports FDI inflows, which in turn support economic growth by boosting output, creating jobs, and raising revenues.

2. Market Potential: A country's market potential refers to its development prospects and future demand for products and services. It takes into account issues like as growing earnings, urbanization, shifting consumer tastes, and the emergence of middle classes. Investors predict future development and profitability in developing nations with great market potential.

China is a prime example of a country with enormous market potential. Its fast economic expansion, urbanization, and growing middle class have resulted in a massive consumer market. Foreign investors have been lured to China to benefit on the country's expanding demand for a variety of goods and services, resulting in significant FDI inflows and contributing to the country's economic development.

3. Access to Regional Markets: In addition to the local market's size and potential, emerging nations with good geographic positions and access to regional markets can attract FDI.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Regional integration agreements, such as free trade agreements and customs unions, can improve market access and allow international investors to reach a larger client base.

For instance, Southeast Asian nations like Thailand and Vietnam have profited from their close proximity to the expanding economy of China and other ASEAN members. As investors want to take advantage of regional integration measures, broaden their market reach, and profit from possible synergies within the area, these nations have seen considerable inflows of FDI.

3.2 Natural Resources

1. Abundance of Natural Resources: Natural resources including minerals, oil, gas, and agricultural items are frequently abundant in developing nations. The extraction, exploitation, and export of these resources provide lucrative economic prospects for international investors. For instance, Saudi Arabia and other nations with large oil reserves have seen a significant increase in foreign direct investment (FDI) from global companies active in the oil industry.

2. Resource-Based businesses: Resource-based businesses might draw FDI owing to their potential for significant returns because they are built on the foundation of natural resources. These sectors include forestry, agriculture, mining, and energy. Developing nations with abundant natural resources frequently receive FDI in industries involved in their extraction and processing. For instance, the mining and forestry sectors in nations like Brazil and Indonesia have drawn foreign direct investment.

3. Commodity Prices and Market Conditions: FDI inflows are influenced by the cost of natural resources on the international market. Investors are more willing to place money in nations where those resources are abundant when commodity prices are high. Variations in FDI flows might result from price fluctuations. Commodity price spikes frequently result in greater FDI inflows to developing nations. In contrast, a drop in prices can cause FDI inflows to diminish and have an effect on economic expansion. For instance, the recent drop in oil prices has an impact on FDI inflows into oil-dependent nations like Venezuela and Nigeria.

4. Infrastructure Development: Investing in natural resources frequently necessitates the construction of substantial infrastructure, such as ports, pipelines, and energy facilities. Developing nations that make infrastructure investments to make it easier to collect, process, and export natural resources typically draw larger levels of FDI. In addition to facilitating resource extraction, improved infrastructure also improves the overall investment climate, luring more FDI into other industries and fostering economic expansion.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

5. Political and Regulatory Environment: A nation's political stability and legal system have a big impact on FDI inflows. Developing nations are more likely to draw FDI if their political climates are stable and their laws governing the utilization of natural resources are open and transparent. Foreign investors are encouraged to participate in the nation's resource sector by a favorable investment climate since it gives them confidence. For instance, robust legal frameworks and regulations for the mining industry have been developed in nations like Chile and Australia, drawing sizable FDI.

3.3 Infrastructure

1. Infrastructure as an Enabler of FDI: Infrastructure refers to the physical and institutional frameworks required for a society or an economy to function, such as public utilities, electricity grids, and transportation networks. Having a good infrastructure is essential for luring FDI in. In order to assure effective production, distribution, and communication, investors need well-developed infrastructure. Because they provide lower transaction costs, better market access, and increased operational efficiency, nations with strong infrastructure networks are frequently more alluring to international investors.

2. Transportation Infrastructure: For the efficient flow of products, people, and services, transportation infrastructure, such as roads, trains, ports, and airports, is essential. A country's ability to cut transportation costs and support efficient supply chain operations makes it more desirable to international companies. For instance, the Panama Canal extension, aided by FDI, has made Panama into a significant logistics and transshipment hub, drawing more FDI and promoting economic growth.

3. Energy Infrastructure: For industrial production and company activities, a dependable and economical energy supply is essential. Developing nations are more likely to draw FDI if their energy infrastructure—including their power generating, transmission, and distribution systems—is well-developed. For instance, Ethiopia's investment in renewable energy infrastructure, such hydroelectric power plants, has increased domestic energy availability and encouraged FDI in industries like manufacturing and agriculture that need significant energy inputs.

4. Communication Infrastructure: In the era of digitalization, a reliable communication infrastructure is crucial for simplifying corporate transactions, information sharing, and connecting to international markets. Developing nations are better positioned to draw technology-intensive investments and knowledge-based enterprises if they have modern telecommunications networks, internet access, and digital infrastructure. For instance, the fast development of mobile communications networks in sub-Saharan Africa has made it

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

easier for foreign direct investment (FDI) to enter markets like e-commerce and mobile banking, therefore promoting economic growth and financial inclusion.

5. Social Infrastructure: In addition to physical infrastructure, social infrastructure, such as access to housing, healthcare facilities, and educational institutions, can affect FDI inflows. Businesses benefit from having educated, healthy employees because it increases production and lowers operational risks. The climate is made more favorable for foreign investors by nations that spend in social infrastructure, such as high-quality healthcare and education, especially in industries that demand skilled workers. For instance, Costa Rica's efforts in healthcare and education have boosted the country's appeal as a location for FDI in the technology sector.

3.4 The Role of Host Country Policies

Host country policies play a critical role in attracting FDI to developing countries. According to UNCTAD (2011), international agreements can play a significant role in attracting FDI to developing countries. These agreements provide legal protection to foreign investors and create a stable investment climate.

Moreover, host countries can adopt policies that are favorable to foreign investors, such as tax incentives, streamlined regulations, and investment promotion agencies. A study conducted by Voorpijil (2011) analyzed the gains and losses of foreign involvement in Kenya. The study found that the Kenyan government's policies towards FDI have been favorable, leading to a significant inflow of FDI.

4. Empirical Evidence: Impact of FDI on Economic Growth in Developing Countries

4.1 Case studies of the impact of FDI on economic growth in developing countries

Several empirical studies have been conducted to analyze the impact of FDI on economic growth in developing countries. A study conducted by Chowdhury and Mavrotas (2006) analyzed the impact of FDI on economic growth in 69 developing countries. The study found that FDI has a positive impact on economic growth in developing countries.

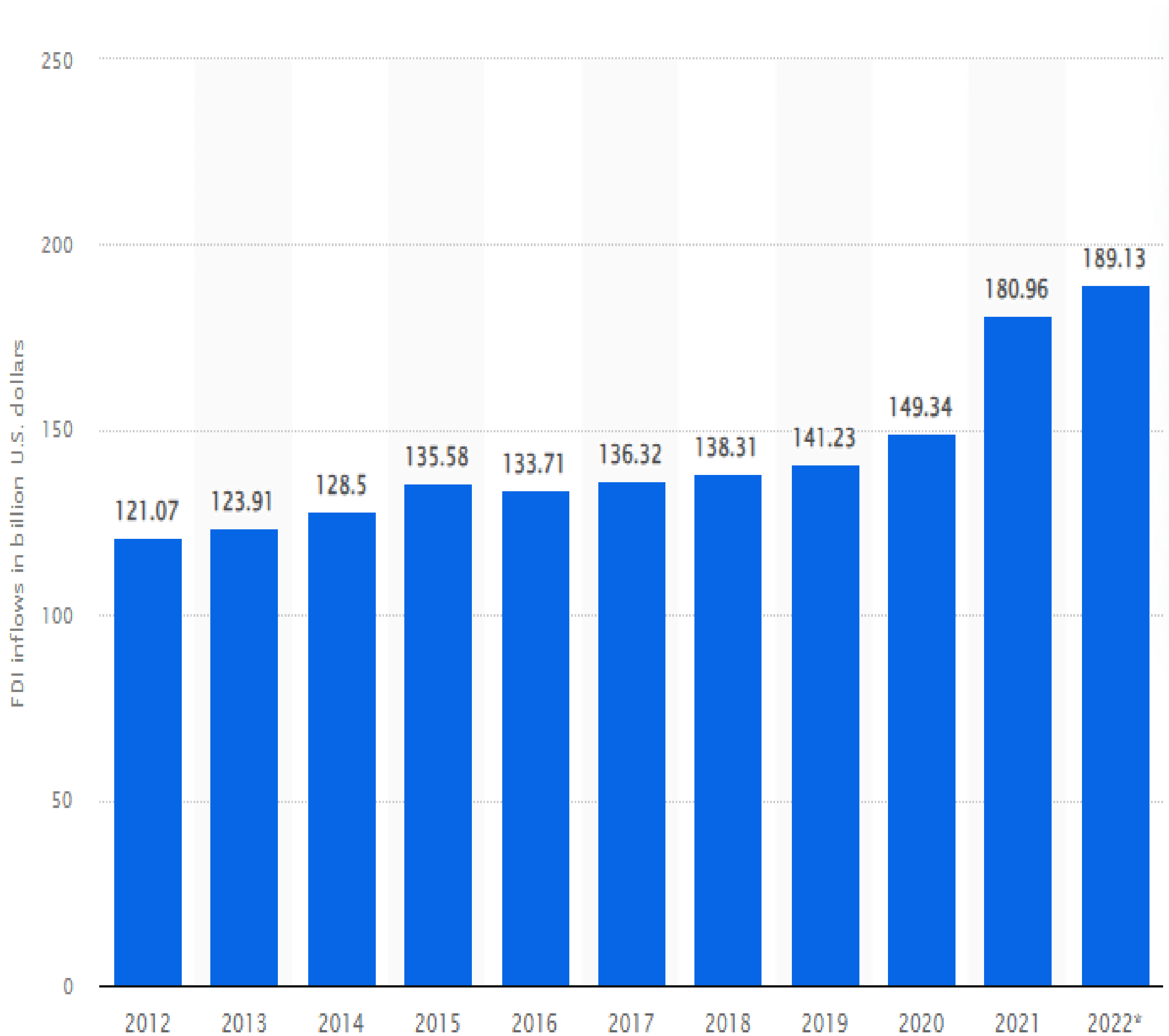
Another study conducted by Suliman and Elian (2014) analyzed the impact of FDI on economic growth in Sudan. The study found that FDI has a positive impact on economic growth in Sudan. A study conducted by Kimani (2015) analyzed the impact of exchange rate volatility on FDI in Kenya. The study found that exchange rate volatility has a negative impact on FDI in Kenya.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Addtionally, as a developing country China has also economically developed because of FDI. As the annual inflows of foreign investment in the country grew so did the its growth in many scales and sectors.

Figure 1: Annual flow of foreign direct investment (FDI) to china from 2012 to 2022:

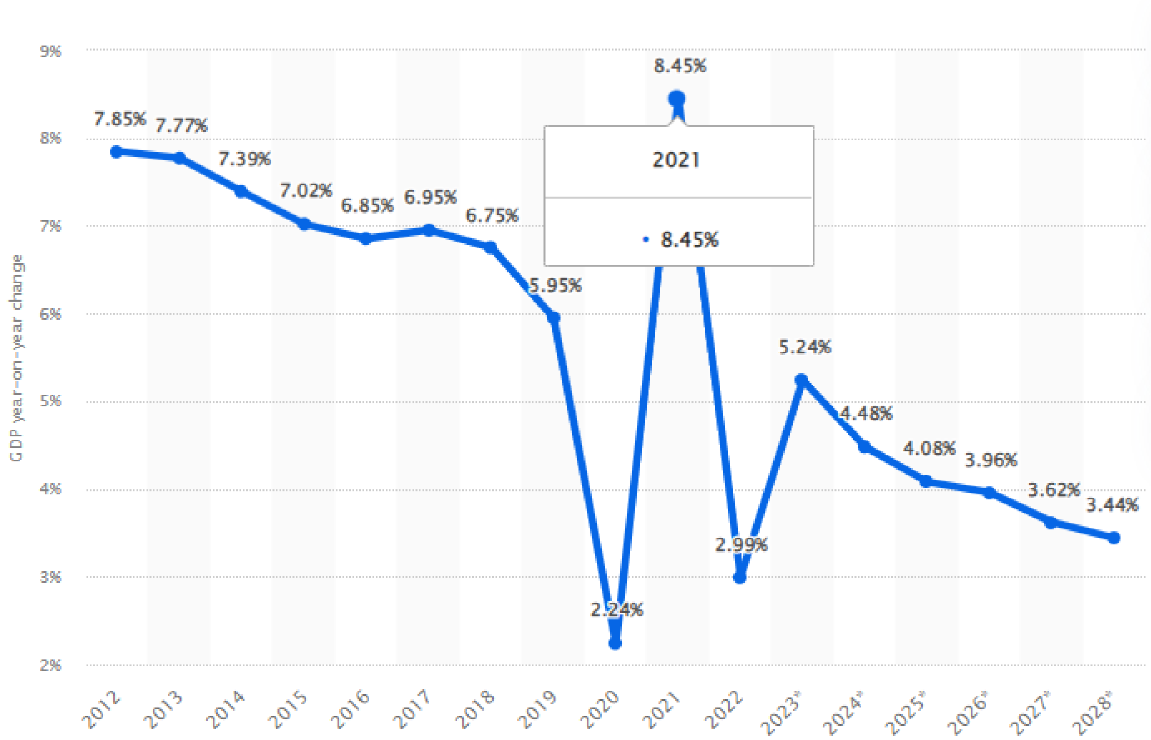


The annual inflow of FDI in China is at an all time high in 2022. Coupled with increase in the inflow of foreign direct investment the Chinese economy has developed as their GDP had reached an all time high in 2021 with 8.45% GDP.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Figure 2: Growth rate of GDP in China from 2012 to 2022.



4.2 Successful FDI impact on economic growth

In addition, China's government policies and regulatory changes have been extremely important in luring FDI. An inviting business climate has been developed as a result of the creation of Special Economic Zones (SEZs), the easing of investment restrictions, and the adoption of investor-friendly laws. China's attraction to foreign investors has grown thanks to market liberalization and trade opening up. FDI inflows have also been aided by significant expenditures in infrastructure, such as transportation networks and energy systems. The effectiveness of FDI facilitation has increased as a result of institutional improvements, including the simplification of administrative processes and the creation of investment promotion organizations.

Economic Growth: China's FDI-driven growth strategy has produced a number of fruitful results. The country's technical advancement and industrial growth have been boosted by FDI, which has also helped knowledge spillovers and innovation diffusion. Additionally, FDI has significantly contributed to the creation of jobs by absorbing excess labor and advancing the development of human capital. As a result of the FDI inflow, China has been able to move from industries that rely heavily on labor to those that rely heavily on technology. As a result, China has increased its sectoral global competitiveness and developed into a manufacturing and exporting powerhouse.

China's FDI experience has not been without difficulties. Lessons learned. Key problems have included balancing the interests of native stakeholders and international investors, managing risks related to FDI, and assuring the preservation of indigenous industries. Another critical component has been addressing social and environmental issues like economic disparity and pollution. China has also acknowledged the need to strengthen domestic innovation capacities so that it may go from being a technology receiver to a leader in the field. Priorities have also been placed on encouraging inclusive growth and resolving problems with income inequality.

China's economy has grown and undergone transformation as a result of its success in luring and expanding FDI inflows. China's success has mostly been attributed to government policies, market liberalization, infrastructural development, and institutional reforms. Technology, job prospects, industrial upgrading, and increased global competitiveness have all been delivered to China via FDI. The need for good risk management, addressing environmental and social issues, stimulating innovation, and inclusive growth are still present. From China's example, other developing nations may benefit and use FDI to achieve sustainable economic growth. In order to maximize the advantages of FDI while resolving the accompanying problems, further study is required.

Conclusion

In conclusion, FDI may considerably support economic development, the creation of jobs, and the transfer of knowledge in developing nations. Theories that explain the connection between FDI and economic growth include the endogenous growth theory, competitive advantage theory, and agglomeration theory.

According to empirical data, FDI has a favorable effect on economic growth in developing nations. The size of the market, available resources, political stability, infrastructure, and human capital are all factors that affect FDI. Policies of the host nation are essential in luring FDI to developing nations.

Therefore, developing nations should implement measures that benefit international investors and provide a stable investment environment. To draw in more FDI, developing nations should concentrate on enhancing their infrastructure, human capital, and political stability.

References

Alaba, O.B. (2003). Exchange rate, uncertainty and foreign direct investment in Nigeria 1.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Alfaro, L., Chanda, A., Kalemli-Ozcan, S., &Sayek, S. (2010). Does foreign direct investment promote growth? Exploring the role of financial markets on linkages. Journal of Development Economics, 91(2), 242-256.

Asongu, S., Akpan, U.S., &Isihak, S.R. (2018). Determinants of foreign direct investment in fast-growing economies: evidence from the BRICS and MINT countries. Financial Innovation, 4(26).

Chowdhury, A., &Mavrotas, G. (2006). FDI and growth: what causes what? The World Economy, 29(1), 63-77.

Gachino, G.G. (2012). Foreign direct investment, firm-level capability, and human capital development: evidence based on Kenyan manufacturing industry. African Journal of Science, Technology, Innovation and Development, 4(4), 162-204.

Ikiara, M.M. (2002). The impact of foreign direct investment (FDI) on technology transfer in Africa: conceptual issues and a research agenda. African Technology Policy Studies Network (ATPS) Special Paper Series No. 6.

Ikiara, M.M. (2003). Foreign Direct Investment (FDI), Technology Transfer, and Poverty Alleviation: Africa's Hopes and Dilemma. African Technology Policy Studies Network (ATPS) Special Paper Series No. 16.

Kimani, N.M. (2015). Impact of exchange rate volatility on foreign direct investments to developing countries: case of Kenya. Jomo Kenyatta University of Agriculture and Technology, 154.

Milliou, C. (2014). Location for foreign direct investment in vertically related markets. Review of International Economics, 22(2), 326-341.

Musau, A.K. (2011). The impact of foreign direct investment (FDI) on economic growth and development in Kenya. Paper submitted for the Annual Africa International Business and Management (AIBUMA) Conference, Nairobi.

Nurkse, R. (2009). Hans H. RagnarNurkse's (1907–2007) Development Theory: Influences and Perceptions. Classical Development Economics and Its Relevance for Today, 183-202.

OECD.(1990). OECD benchmark definition of foreign direct investment.

Onyeiwu, S., &Shrestha, H. (2004).Determinants of foreign direct investment in Africa. Journal of Development and Society, 20(1-2), 89-106.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Panth, S. (2013).Technological Innovation, Industrial Evolution, and Economic Growth.Routledge.

Pradhan, R.P., Bagchi, T.P., Chowdhury, K., & Norman, N.R. (2012). Growth, foreign investment and trade-openness interactions in ten OECD countries: a panel-VAR approach. International Journal of Banking, Accounting and Finance, 4(4), 273-293.

Pritchard, R. (1996). Economic Development, Foreign Investment and the Law. Kluwer Law International & the International Bar Association.

Reinhart, C., &Rogoff, K. (2003). FDI to Africa: the role of price stability and currency instability. IMF Working Paper, 03(10).

Sacerdoti, G. (1997). Bilateral treaties and multilateral instruments. Journal of International Economic Law, 269, 261-287.

Sharifi-Renani, H., &Mirfatah, M. (2012).The impact of exchange rate volatility on foreign direct investment in Iran.Procedia Economics and Finance, 1, 363-373.

Sornarajah, M. (2004).The International Law on Foreign Investment.Cambridge University Press.

Suliman, A.H., & Elian, M.I. (2014). Foreign direct investment, financial development, and economic growth: a cointegration model. Journal of Development Areas, 48(3), 219-243.

UNCTAD.(2011). The Role of International Agreements in Attracting Foreign Direct Investment to Developing Countries.UNCTAD Series on International Investment Policies for Development.

UNCTAD.(2005). Trade and Development Report. Geneva.

Voorpijil, R. (2011). Foreign Direct Investment in Kenya: The Gains and Losses of Foreign Involvement. Radboud University Nijmegen, Netherlands.

World Bank.(2013). Handbook of Statistics. Washington, DC.

World Bank.(2004). Global Development Finance.World Bank, Washington, DC.

World Bank.(2011). World Development Report.Conflict, Security, and Development. Washington, DC.

