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Considerations about Foreign Direct Investments and Economic Development

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Abstract

Theoretically, inward foreign direct investments (FDI) can sustain the economic development of the host country due to their contribution to the increase in productivity and competitiveness. Starting from this idea and based upon the latest theoretical and empirical research regarding the economic development stages this paper underlines the relationship between the FDI inflows and the economic development by analyzing two representative macroeconomic indicators namely GDP per capita and the inward FDI stock as percentage in GDP for 141 worldwide countries at the level of the year 2013. The analysis presented in this study revealed that besides the quantity of the foreign direct investments received by a country there are other important factors related to the FDI contribution at economic development, respectively the quality of the foreign capital, and the existing conditions in the host economy.

Keywords: *foreign direct investments; economic development; key-drivers; investment development path; productivity growth*

JEL Classification: *F21; F23; O11; O52*

Introduction

Theoretically, supporting the modernization of local companies, the expansion of innovative research-development activities and participating to quality improvement of the local labour force, foreign direct investments (FDI) could play an important role in increasing the productivity of the host countries, sustaining economic development.

Technological innovation and knowledge are essential for the economic development and growth. Even more, practice proved that any sustainable economic development requires more than a "receptive" economy to technological inflows inputs. Therefore, in order to survive, companies of different sizes have to allocate important resources in view of obtaining high-technology and knowledge. In this context, and taking into consideration the lack of resources especially in the least developed countries, FDI inflows have the potential to improve the quality of the existing production factors and to develop several competitive advantages based on specialized factors.

From the point of view of the host country, the technological transfer by foreign direct investments generates positive effects, as for example: improving the workers' knowledge and abilities; the diffusion of the technological and managerial practices, reflecting upon the costs

and the quality of the goods and services; the development of the relations between transnational corporations and the local institutions; stimulating domestic companies to direct their efforts towards a technologies activity in order to face the growth competition etc.[1]

On the other hand, adopting existing technologies by scientific and technological transfer can boost productivity in less advanced economies where firms compete on the basis of price and/ or product quality. Comparatively, in the most developed countries companies must compete based on their own capabilities of technological innovation. Therefore, from a certain point of economic development productivity growth cannot be based on imported innovations as requires the development of new and unique products using the most sophisticated production processes.[2]

The analyses presented in this paper focuses on the relationship between foreign direct investment inflows and economic development, using most recent available data for worldwide countries.

Some Theoretical Aspects

Most of the theories in the field underline the fact that the relationship between foreign direct investment inflows and economic development is bi-directional[3]. As a country is developing, the conditions offered to local and foreign firms improve, with positive and direct implications on FDI inflows which, in turn, influence its economic development, acting upon competition and upon the benefits of local firms[4].

This dynamic interaction has been categorized in five stages of the investment development path as follows [5]:

- in stage one, foreign direct investment inflows are insignificant, as the infrastructure is not adequate, the local market is more reduced, the labour force is unqualified, and the legal framework is not developed;
- in stage two, the increased inward FDI are directed mainly to industries based on resources (as for example traditional branches of the processing industry) or on a low/medium level of knowledge (intensive branches in terms of labour force, distribution and commerce, and constructions);
- in stage three, foreign direct investment inflows growth is less significant, inward FDI being overcome by the foreign direct investment outflows;
- in stage four, inward foreign direct investment moves into the industry intensive in high-technology and knowledge;
- in stage five, both inward and outward FDI are very high.

According to this theory, in the first stages (stages one and two), specific most to the less developed economies, the FDI inflows prevail, while in the last stages (stages four and five),

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[1]Matei, M. (2004), *Foreign direct investments. Functions and evolutions 1990- 2000*, Expert Publishing House, Bucharest, p.162-240; Iacovoiu, V. B. (2009), *Foreign direct investments between theory and economic practice. Comparative analysis*, ASE Publishing House, Bucharest, p.149-205.

[2] Akçomak, I.S., Bas ter Weel (2008). "Social capital, Innovation and Growth: Evidence from Europe", *IZA Discussion Papers 3341*, p.1-26.

[3] Dunning, J. (2006), Towards a new paradigm of development: implications for the determinants of international business, *Transnational Corporations*, Vol. 15, No. 1, p.173-22.

[4] Voica, C. M., Panait, M., Investment Development Path in the European Union in the Context of Financial Crisis, *International Journal of Sustainable Economies Management*, 3(4), 33-44, October-December 2014, DOI : 10.4018/ijsem.2014100104; Durán, J., Ubeda, F. (2001), The investment development path: a new empirical approach, *Transnational Corporations*, Vol. 10, No. 2, p. 1-34.

[5] Narula, R., Dunning, J.H. (2010), Multinational enterprises, development and globalisation: Some clarifications and a research agenda, *Oxford Development Studies*, Vol. 38, No. 3, p. 263-287.

characteristic to developed countries, the foreign direct investments outflows surpass the inward FDI.

But the quality of FDI received by a country is just as important as its quantity, because "increased FDI does not necessarily imply a proportional increase in economic development"[6], fact demonstrated by the results of some studies conducted by Robert Lipsey (2000)[7], UNCTAD (2006)[8], and other specialists in the field (Boudier, 2008; Narula and Guimón, 2010)[9]. These researches proved that there is a diversity of exogenously determined characteristics that affects the investment development path of any given country, factors such as natural resource endowments, size and population, the degree of industrialization, the governmental policies applied, economic and political structure, and so forth. Thus, due to the fact that inward FDI effects intermingle with those of the other economic growth factors, the relationship between foreign direct investment inflows and economic development is difficult to test using empirical models.

Therefore, in order to progress towards a higher level of development a country has to attract foreign direct investments that "contributes to enhancing domestic technological strengths and location-specific assets", stimulating "the creation and development of competitive advantages based on innovation and knowledge"[10].

Although the inward foreign direct investments impact over the economic development depends in a great meassure by the quality of FDI received, generally, experts consider that its significantly higher the moment the value of the inward FDI stock as percentage in GDP exceeds the 40 % level.

Data and Methodology

In order to verify the applicability and the limitation of the statement above, we analyse in a static manner the two representative macroeconomic indicators namely Gross Domestic Product (GDP) per capita (reflects the level of economic development) and the inward FDI stock as percentage in GDP (shows the degree of penetrability of FDI received by a country). The values of these macroeconomic indicators for worldwide countries at the level of the year 2013 are presented in the appendix.

According to the latest theoretical and empirical research, these analyses are based on the economic development stages developed by Professor Xavier Sala-i-Martin[11] for the World Economic Forum (WEF). The stages of development according to the level of GDP/capita and the key drivers for every stage are presented in the table below (Table 1).

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[6] Narula, R., Guimón, J. (2010), The investment development path in a globalised world: implications for Eastern Europe, *Eastern Journal of European Studies*, Volume 1, Issue 2, p.5-19.

[7] Lipsey, R. (2000), Inward FDI and economic growth in developing countries, *Transnational Corporations*, Vol.9, No.1, p. 68-79.

[8] World Investment Report (2006), *FDI from developing and transition economies: Implication for development*, New York and Geneva, UNCTAD, p.144-145.

[9] Boudier-Bensebaa, F. (2008), FDI-assisted development in the light of the investment development path paradigm: Evidence from Central and Eastern European countries, *Transnational Corporations*, Vol. 17, No. 1, p. 37-67.

[10] Iacovoiu, V. (2014), The relation between innovative ability, competitiveness and net outward investment position. European Union case, *Economic Insights – Trends and Challenges*, Vol.III (LXVI), No.3, p.69-76.

[11] Becker, U. (2009). *Innovation and Competitiveness: A Field of Sloppy Thinking*, IPG 3/2009, p.117-138.

Table 1. Stages of economic development

Stages of development	GDP per capita (US$)	Key drivers
Stage 1 (Factor-driven)	<2,000	1. Institutions 2. Infrastructure 3. Macroeconomic environment 4. Health and primary education
Transition from stage 1 to stage 2	2,000–2,999	-
Stage 2 (Efficiency-driven)	3,000–8,999	5. Higher education and training 6. Goods market efficiency 7. Labour market efficiency 8. Financial market development 9. Technological readiness 10. Market size
Transition from stage 2 to stage 3	9,000–17,000	-
Stage 3 (Innovation-driven)	>17,000	11. Business sophistication 12. Innovation

Source: WEF, "The Global Competitiveness Report 2013-2014: Full Data Edition", Geneva, 2013, p.9-10

Although all of the factors will matter to a certain extent for all economies, in line with the economic theory of development stages, the relative importance of each factor depends on a country's particular stage of development. Thus, the basic requirements drivers are more important for countries in stage one of economic development, while the efficiency factors are particularly important for those countries that have reached the stage two of development, competing on the basis of price and/or product quality. Companies in these countries can adopt existing technologies by scientific and technological transfer in order to develop more efficient production processes and increase product quality. Comparatively, firms in those countries that have reached the innovation stage of development (stage 3) must compete through their own capabilities of technological innovation.[12] As presented above, for economies in stage three of development the productivity growth cannot be based anymore on imported innovations.

Data Analyses

The distribution of the 141 countries according to the values of the analysed macroeconomic indicators, in line with the theories underlined above, is presented in the table below (Table 2).

Table 2. Distribution according to GDP/capita and inward FDI stock as % in GDP

Stages of development	GDP per capita (US$)	Inward FDI stock as % in GDP (number of countries)			Total
		<20%	20-40%	>40%	
Stage 1 (Factor-driven)	<2,000	13	8	13	**34**
Transition from stage 1 to stage 2	2,000–2,999	1	1	2	**4**
Stage 2 (Efficiency-driven)	3,000–8,999	10	10	20	**40**
Transition from stage 2 to stage 3	9,000–17,000	3	7	12	**22**
Stage 3 (Innovation-driven)	>17,000	6	12	23	**41**
Total	-	**33**	**38**	**70**	**141**

Source: Appendix

[12] WEF, "The Global Competitiveness Report 2013-2014: Full Data Edition", Geneva, 2013, p. 10-11.

According to the data above, at the level of year 2013, half (50%) of the 141 analysed countries accumulated a significant stock of inward FDI (Figure1).

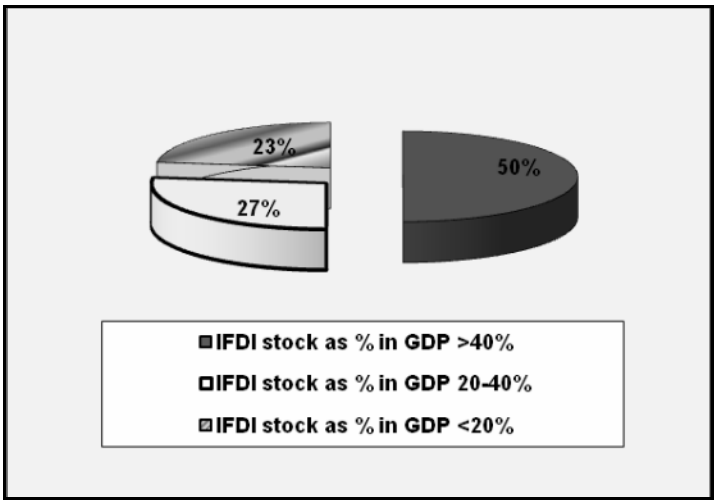

Fig. 1. Distribution of countries according to the level of inward FDI stock as % in GDP

Most of the countries that have accumulated a significant stock of inward FDI are found in stage 3 of economic development, respectively the innovation stage, as shown in the figure below.

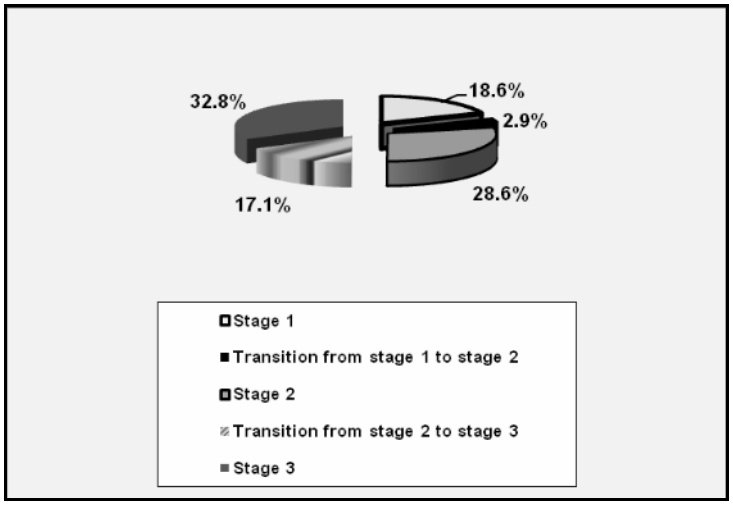

Fig.2. Distribution of countries with inward FDI stock as % in GDP >40% according to the stage of economic development

We note that 28.6% of the 70 countries that have attracted significant FDI inflows are in stage 2 of economic development (Efficiency-driven) while 17.1% are in the period of transition to stage 3. Thus, at the level of year 2013, only 50% of the countries that registered an inward FDI stock as percentage in GDP higher than 40% are found in superior stages of economic development, respectively stage 3 and transition from stage 2 to stage 3.

Also, it has to be noticed the following issues concerning the relationship between the inward foreign direct investments and the level of economic development of the host country:

I. States which have received significant flows of FDI (the level of inward FDI stock as percentage in GDP is higher than 60%) can be found in the first stage of economic development (Factor-driven) namely Nicaragua, Cambodia, Mozambique, Gambia Madagascar, and Niger. Between these countries, it has to be underlined the case of Mozambique which registers a very low level of economic development (GDP/capita is

605 US$) despite massive FDI inflows (inward FDI stock as percentage in GDP is 135.6%).

II. There are some countries in which the high level of economic development (stage 3) is mostly due to the positive impact of inward FDI (the level of inward FDI stock as percentage in GDP is higher than 85%), as shown in the table below (Table 3).

Table 3. Positive relationship between FDI and economic development

Crt. No.	COUNTRY	GDP/capita (current US$)	Inward FDI stock as % in GDP (%)
1	Luxembourg	110,664.80	235.1
2	Switzerland	84,748.40	109.0
3	Singapore	55,182.50	277.1
4	Ireland	50,478.40	162.7
5	Belgium	46,929.60	176.1
6	Brunei Darussalam	38,563.30	88.2
7	Hong Kong (China)	38,123.50	523.7
8	Cyprus	25,249.00	88.0
9	Malta	22,775.00	154.1
10	Estonia	18,877.30	86.2
11	Trinidad and Tobago	18,372.90	95.8

Source: Appendix

III. States characterized by similar levels of inward FDI stock as percentage in GDP shows different values in terms of economic development, as for examples the countries presented in Table 4.

Table 4. Inward FDI level and economic development

Crt. No.	COUNTRY	GDP/capita (current US$)
Inward FDI stock as % in GDP: 65%-70%		
1	Sweden	60,380.90
2	Iceland	47,349.50
3	Czech Republic	19,858.30
4	Nicaragua	1,851.10
Inward FDI stock as % in GDP: 85%-90%		
1	Brunei Darussalam	38,563.30
2	Cyprus	25,249.00
3	Estonia	18,877.30
4	Jamaica	5,290.50
5	Cabo Verde	3,767.10
6	Guyana	3,739.50
Inward FDI stock as % in GDP: over 100%		
1	Luxembourg	110,664.80
2	Switzerland	84,748.40
3	Singapore	55,182.50
4	Ireland	50,478.40
5	Belgium	46,929.60
6	Hong Kong (China)	38,123.50
7	Malta	22,775.00
8	Barbados	14,917.10
9	Lebanon	9,928.00
10	Montenegro	7,106.90
11	Mongolia	4,056.40
12	Mozambique	605

Source: Appendix

Although the examples may continue, we appreciate that the above data are relevant to demonstrate that the quantity of FDI received by a country is not a sine qua non to assess their impact upon the economic development.

Conclusions

In the context of the production internationalization and the economic integration, the number of economies inside which it has been reached the critical mass of foreign direct investments capable of generating positive spillovers represents almost half of the worldwide countries. But the triggering effects generated by the FDI inflows accumulated in significant stock are very different. Thus, at the level of year 2013, only 50% of the countries that registered a massive penetration of the foreign direct investments (the inward FDI stock as percentage in GDP is higher than 40%) are found in superior stages of economic development.

Moreover, the analysis presented above revealed that economies characterized by similar degrees of FDI penetration have registered different values in terms of economic development. In this respect, the best example is given by the countries which, at the level of year 2013, accumulated an inward FDI stock as percentage in GDP higher than 100%. Some of these countries (Lebanon, Montenegro, Mongolia, Mozambique) are found in inferior stages of economic development (GDP per capita less than 9.000 US$) while countries like Luxembourg, Switzerland, Singapore, Ireland, and Belgium recorded a level of GDP per capita between 47.000 US$ (Belgium) and 110.000 US$ (Luxembourg).

Therefore, besides the quantity of the foreign direct investment received by a country there are other important factors related to the FDI contribution at economic development, respectively the quality of the foreign capital, and the existing conditions in the host economy.

In our opinion, in order to progress towards superior stages of economic development where business sophistication and technological innovation represent the core of development a country has to attract foreign direct investments mostly oriented towards the activities that incorporate a higher content of local resources and most of all, technology and knowledge. Therefore, the foreign investments materialized into products and services that incorporate a significant degree of local resources (such as qualified labour force, knowledge, and technology) have the potential to boost the productivity growth in the host country, through the contribution to the improvement of the innovative capabilities and the qualification of the labour force, thus sustaining the economic development.

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Appendix

GDP/capita and inward FDI stock as a percentage in GDP (2013)

Crt. No.	COUNTRY	GDP/capita [1] (current US$)	Inward FDI stock as % in GDP [2] (%)
Stage 3 (Innovation-driven)			
1	Luxembourg	110,664.80	235.1
2	Norway	100,898.40	36.8
3	Qatar	93,714.10	14.7
4	Switzerland	84,748.40	109.0
5	Australia	67,463.00	37.9
6	Sweden	60,380.90	65.2
7	Denmark	59,818.60	47.3
8	Singapore	55,182.50	277.1
9	United States of America	53,042.00	29.4
10	Kuwait	52,197.30	12.1
11	Canada	51,964.30	35.1
12	Netherlands	50,792.50	78.5
13	Austria	50,510.70	42.9
14	Ireland	50,478.40	162.7
15	Finland	49,150.60	37.8
16	Iceland	47,349.50	69.6
17	Belgium	46,929.60	176.1
18	Germany	46,251.40	22.8
19	United Arab Emirates	43,048.90	26.2
20	France	42,560.40	38.5
21	New Zealand	41,824.30	44.6
22	United Kingdom	41,781.10	59.9
23	Japan	38,633.70	3.5
24	Brunei Darussalam	38,563.30	88.2
25	Hong Kong (China)	38,123.50	523.7
26	Israel	36,050.70	30.3
27	Italy	35,685.60	18.9
28	Spain	29,882.10	51.4
29	Korea, Republic of	25,977.00	12.8
30	Saudi Arabia	25,961.80	28.0
31	Cyprus	25,249.00	88.0
32	Bahrain	24,689.10	54.2
33	Slovenia	23,295.30	31.7
34	Malta	22,775.00	154.1
35	Greece	21,965.90	11.5
36	Oman	21,929.00	25.3
37	Portugal	21,738.30	57.1
38	Czech Republic	19,858.30	65.1
39	Estonia	18,877.30	86.2
40	Trinidad and Tobago	18,372.90	95.8
41	Slovakia	18,049.20	60.2
Transition from stage 2 to stage 3			
42	Uruguay	16,350.70	35.4
43	Chile	15,732.30	77.9
44	Lithuania	15,529.70	36.7
45	Latvia	15,381.10	50.6
46	Barbados	14,917.10	108.3
47	Argentina	14,715.20	18.1
48	Russian Federation	14,611.70	27.7

Appendix (cont.)

49	Venezuela, Bolivarian Republic of	14,414.80	15.0
50	Poland	13,653.70	47.9
51	Kazakhstan	13,611.50	55.9
52	Croatia	13,597.90	56.1
53	Hungary	13,485.50	83.2
54	Gabon	11,571.10	29.8
55	Brazil	11,208.10	30.3
56	Panama	11,036.80	73.7
57	Turkey	10,971.70	17.7
58	Malaysia	10,538.10	46.2
59	Mexico	10,307.30	30.8
60	Costa Rica	10,184.60	44.3
61	Lebanon	9,928.00	125.4
62	Romania	9,490.80	44.6
63	Mauritius	9,477.80	29.6
Stage 2 (Efficiency-driven)			
64	Colombia	7,831.20	33.7
65	Azerbaijan	7,811.60	18.7
66	Belarus	7,575.50	22.9
67	Bulgaria	7,498.80	96.6
68	Botswana	7,315.00	22.3
69	Montenegro	7,106.90	121.9
70	South Africa	6,886.30	38.3
71	China	6,807.40	10.1
72	Peru	6,661.60	36.4
73	Serbia	6,353.80	64.3
74	Ecuador	6,002.90	14.6
75	Dominican Republic	5,879.00	41.5
76	Angola	5,783.40	1.9
77	Thailand	5,779.00	47.9
78	Namibia	5,693.10	33.1
79	Algeria	5,360.70	12.0
80	Jamaica	5,290.50	88.5
81	Jordan	5,213.40	79.4
82	Belize	4,893.90	99.8
83	TFYR of Macedonia	4,838.50	51.4
84	Iran, Islamic Republic of	4,763.30	8.3
85	Bosnia and Herzegovina	4,661.80	45.2
86	Albania	4,460.30	47.3
87	Fiji	4,375.40	93.7
88	Tunisia	4,316.70	71.4
89	Paraguay	4,264.70	16.9
90	Mongolia	4,056.40	123.3
91	Ukraine	3,900.50	41.9
92	El Salvador	3,826.10	33.9
93	Cabo Verde	3,767.10	85.8
94	Guyana	3,739.50	85.2
95	Georgia	3,596.90	72.3
96	Armenia	3,504.80	52.2
97	Guatemala	3,477.90	19.0
98	Indonesia	3,475.30	25.3
99	Egypt	3,314.50	31.3
100	Sri Lanka	3,279.90	11.7
101	Morocco	3,092.60	48.4
102	Swaziland	3,034.20	23.7
103	Nigeria	3,005.50	15.9
Transition from stage 1 to stage 2			
104	Bolivia, Plurinational State of	2,867.60	34.5
105	Philippines	2,765.10	12.0
106	Honduras	2,290.80	54.5
107	Moldova, Republic of	2,239.60	45.9
Stage 1 (Factor-driven)			
108	Viet Nam	1,910.50	47.7
109	Uzbekistan	1,878.00	15.0
110	Ghana	1,858.20	40.9
111	Nicaragua	1,851.10	67.5
112	Zambia	1,844.80	53.1
113	Sudan	1,753.40	43.8
114	Côte d'Ivoire	1,528.90	26.3
115	India	1,497.50	12.2
116	Yemen	1,473.10	10.2
117	Cameroon	1,328.60	21.1
118	Pakistan	1,275.30	11.9
119	Kyrgyzstan	1,263.40	47.3
120	Kenya	1,245.50	6.2
121	Lesotho	1,125.60	57.6
122	Senegal	1,046.60	18.2
123	Tajikistan	1,036.60	19.1
124	Cambodia	1,006.80	61.7
125	Bangladesh	957.8	5.7
126	Zimbabwe	953.4	22.2
127	Tanzania, United Republic of	912.7	28.7
128	Benin	804.7	16.3
129	Burkina Faso	760.9	11.8
130	Mali	715.1	30.9
131	Nepal	694.1	2.7
132	Uganda	657.4	35.7
133	Rwanda	638.7	11.3
134	Togo	636.4	34.4
135	Mozambique	605	135.6
136	Guinea	523.1	53.0
137	Ethiopia	505	12.8
138	Gambia	488.6	84.6
139	Madagascar	463	61.1
140	Niger	415.4	64.3
141	Malawi	226.5	33.1

Source: 1) The World Bank, Data, http://data.worldbank.org/indicator/NY.GDP.PCAP.CD, on-line, [Accessed on July 16, 2015]; 2) Own calculations based on data available at UNCTAD, WIR 2014, p.209-214 (IFDI stock) and World Bank, http://data.worldbank.org/indicator/NY.GDP.MKTP.CD (GDP in current US$).