

A Review of the Effects of Foreign Direct Investment on Economic Growth

J. C. Sharmiladevi¹

Abstract

The literatures of international business is increasingly dominated by the beneficial effects of Foreign Direct Investment (FDI) on host economies across the globe. The encouragement FDI is receiving from international operations of multinational enterprises on the one side and governments on the other side diversified capital flow internationally. FDI is viewed as a panacea for economic development of developing and emerging economies, including India. With time, the benefits which India received from FDI operations have been accessed both theoretically and empirically with different data sets, methodologies and variables. This review paper makes an attempt to examine the nexus between FDI and economic growth in recent literatures.

Keywords: Foreign Direct Investment, Economic Growth

JEL Code: 023

¹ Assistant Professor, Symbiosis Centre for Management Studies, Pune, Symbiosis International University
Email ID: sharmiladevi@scmspune.ac.in

A Review of the Effects of Foreign Direct Investment on Economic Growth

Introduction

In the past two decades nations around the globe have witnessed huge flow of private capital flow in the form of Foreign Direct Investment (FDI). FDI is functioning as an instrument in enhancing the phase of economic growth of developing economies. It is an important source of development finance which contributes to multiple gains by providing new investments, better technology, management expertise, export markets, creates forward and backward linkage, a phenomenon has been widely accepted in the literatures of international business. With the prevailing resource constraints accompanied with lack of investment, market forces, private sectors and governments also rely upon FDI as an engine for sustaining economic growth.

Economic theory suggests that FDI can have a positive effect on the economy, as the output in an economy influences FDI flows. For India, FDI remain small when measured as a proportion of gross domestic product (GDP) or total investment and plays a very small role in the development of our economy. This contrasts with the very important role that FDI has played in the economic development of other fast growing Asian economies such as ASEAN, China, Singapore, Thailand, Indonesia and Malaysia (Palit & Nawani, 2007). FDI led growth hypothesis has not adequately tested in the current Indian context and those scanty literatures which actually tested is not yielding consistent results. The reasons are many. Hence this paper examines the literatures which examine the link between FDI and growth. Addressing the gaps in the existing literatures, will help the research fraternity, key areas upon which further research must keep focus.

Literature Surveys

A detailed survey of literatures examining the role played by FDI on economic growth is undertaken here. The literatures are also reviewed chronologically. The increasing role played by FDI in enhancing Economic Growth of the emerging and developing economies have kindled the interest of many researchers which brought forth many research studies examining the positive link between FDI and Economic Growth. [(Quazi 2007), (Vadlamannati et al 2009); (Wang, 2009) (Pradhan R. , 2006)].

De Mellow's (1992) research in OECD countries concludes that FDI had significantly positive effect on economic growth for countries with high income. De Gregorio (1992) indicates that at the macro level using aggregate FDI flows for a broad cross-section of countries – suggest a positive role for FDI in generating economic growth especially in particular environments. Blomstrom et al (1994) argue that FDI has a positive growth-effect when the country is sufficiently rich. Balasubramanyam et al (1996) stress that trade openness is crucial for obtaining the growth-effects of FDI Borensztein et al (1998) identified that FDI has a positive significant effect on economic growth and contributes to economic growth to countries when the labour force has attained certain level of educational standard. Dua & Rashid, (1998) found a long run relationship between GDP and FDI. Alfaro et al (2004) found that FDI promotes economic growth in economies with sufficiently developed financial markets. Pradhan (2002) estimates a Cobb-Douglas production function using aggregate data for 1969-97 finds that FDI has no significant impact on growth. Tanna & Lensink (2003) argue that FDI has a positive growth-effect when the country has a highly educated workforce that allows it to exploit FDI spillovers. Study conducted by Sahoo & Mathiyazhagan, (2003), and Kumar & Pradhan (2002) consider FDI-growth relationship to be neutral for India.

Lall & Rajneesh (2004) are of the view that removal of restrictions on FDI does not create the complementary factors which MNEs need, it only allows them to exploit existing capabilities more freely available. Agrawal (2005) obtains panel estimates for five South Asian countries, including India, for the period 1965-96 and found that the growth impact of FDI is negligible. Young (2007) examines the effect of economic integration on FDI flows in ASEAN 5 countries. His results indicates that FDI flow into ASEAN countries was found to be inversely proportional to the per capital income of the five countries.

Chandana & Peter (2006) indicate that FDI has got only a transitory effect on growth in India. Balasubramanyam et al (2006) indicate that, for India, at present, it is not FDI which promotes growth, but it is growth which attracts foreign firms, since FDI is one of the several factors which contributes growth. Singhania & Akshay (2011) used an ARIMA model-Auto Restricted Integrated Moving Average to explain the variations in FDI inflows into India, and their results indicates GDP along with other factors like inflation and scientific research are significant determinant factors for FDI inflow into India.

To increase economic growth of India more direct foreign investment is required. And in the same line higher inflow of direct foreign investment is enhancing economic growth and for

enhancing higher economic growth more foreign investment is required (Sharmiladevi & Saifilali, 2013). Vital parameters which influences the internal business environment of a nation like growth rate, inflation, IIP, exports is having a direct influence upon India's credibility in the international arena in terms of attracting more FDI. (Sharmiladevi & Saifilali, 2013). Anastasia & Panagiotis (2014) conducted a panel data analysis for 20 years for countries in European Union and found that FDI exerts only a slight positive effect on GDP in European Union countries.

Conclusion

The literatures examined above gives us an indication that, there are increasing number of studies which support that FDI causes economic growth. Differences in the results can be attributed to factors like, use of different time series data, treatments given to data for overcoming inbuilt structural breaks and stationarity issues, methodological aspects, models adopted for analysis like Causality analysis, ARIMA models, and vector error correction/vector auto regression models.

Most of the above studies are of recent ones, where the time period considered was after 1990, that is, after globalization. But the process of liberalization, globalization and privatization (LPG) has thrown open only the necessary conditions for the entry of FDI, but in itself LPG has not created the sufficient conditions for enhancing the prospects of FDI. Materializing the benefits of FDI is a long term process, and it depends upon many factors like, the existence and establishment of linkages between foreign and local affiliates, inter firm linkages, absorptive capacity of human resources, motivations behind initiating FDI by individual MNCs, overcoming socio-cultural environmental differences, government initiatives.

Few research studies gives us the direction upon which we need to concentrate for enhancing FDI benefits upon growth. Research undertaken by Bajpai & Sachs (2006) concludes that a restricted FDI regime, high import tariffs, exit barriers for firms, stringent labour laws, poor quality infrastructure, centralized decision making processes and a very limited scale of export processing zones make India as an unattractive investment location. A recent study by Gould et al (2014) concludes that liberalizing policy constraints, modest corporate tax and improving governance and transparency could help to substantially improve FDI flows to Asian countries.

References

Agrawal, P. (2005). *Foreign Direct Investment in South Asia: Impact on Economic Growth and Local Investment*. In: E.M. Graham (ed.), UK: 94-118.

- Alfaro, L., Chanda, A., Kalemli-Ozcan, S., & Sayek, S. (2004). Alfaro, FDI and economic growth: the role of local financial markets. *Alfaro, L., A. Chanda, S. Kalemli-Ozcan and S. Sayek (2004) Journal of International Economics, 64(1)*, 113-134.
- Anastasia, A., & Panagiotis, L. (2014). Foreign Direct Investment and Growth: EU, EMU and Transition Economies. *Journal of Economic Integration, Vol.29, No;3,* 470-495.
- Bajpai, N., & Jeffrey, D. S. (2006). Foreign Direct Investment in India: Issues and Problems. *Harvard Institute of International Development, Development Discussion Paper No: 759.*
- Balasubramanyam, V., Salisu, M., & Sapsford, D. (1996). "Foreign direct investment and growth in EP and IS countries". *Economic Journal 106 (434)*, 92-105.
- Blomstrom, M., Lipsey, R., & Zejan, M. (1994). What Explains Developing Country Growth. *NBER Working Paper No: 4132*.
- Borensztein, E., De Gregorio, & J.W.Lee. (1998). How Does Foreign Direct Investment Affect Economic Growth. *Journal of International Economics, 58-84.*
- Chandana, C., & Peter, N. (2006). Chandana Chakraborty and Peter Nunnenkamp (2008), "Economic Reforms, FDI and Economic Growth in India: A Sector Level Analysis. *World Development, Vol: 36, No: 7*, 1192-1212.
- De Gregorio, J. (1992). Economic Growth in Latin America. *Journal of Development Economics, 58-84.*
- De Mellow, L. (1992). Foreign Direct Investment in Developing Countries and Growth: A Selective Survey. *Journal of Development Studies, 58-84.*
- Dua, P., & Rashid, A. I. (1998). Pami Dua and Aneesa I. Rashid (1998), "Foreign Direct Investment and Economic Activity in India," *Indian Economic Review, New Series, Vol. 33, No. 2*, 153-168.
- Gould, M. D., Tan, C., & Amir S.Sadeghi Eme. (2014). David M. Gould, Congyan Tan and Amir S.Sadeghi Ememgholi (2014), "Attracting Foreign Direct Investment: What can South Asia's Lack of Success Teach Other Developing Countries?", *South Asian Economic Journal, 15 (2)*, 133-174. *South Asian Economic Journal, 15 (2)*, 133-174.
- Kumar, N., & Pradhan, J. (2002). Foreign Direct Investment, Externality and Economic Growth in Developing Countries: Some Empirical Explorations and Implications for WTO Negotiations on Investment. *Research and Information System.*
- Lall, S., & Rajneesh, N. (2004). *Understanding FDI assisted Development*. London: Routledge.
- Palit, A., & Nawani, S. (2007). Technological Capabilities as a Determinant of FDI Inflows: Evidence from Developing Asia and India. *Working Paper No: 193*, 3-21.

- Pradhan, J. (2002). Foreign Direct Investment and Economic Growth in India: A Production Function Analysis. *Indian Journal of Economics* 82 (327):.
- Pradhan, R. (2006). FDI in the Globalization Era: Chinese and Indian Economic Growth, . *Prajnan*, 34, 323-343.
- Quazi, R. (2007). Investment Climate and Foreign Direct Investment: A Study of Selected Countries in Latin America. *Global Journal of Business Research, Volume 1, Number 2*, 1-13.
- Sahoo, D., & Mathiyazhagan, M. (2003). Economic Growth in India: Foreign Direct Investment Inflow Matter? *Singapore Economic Review*, 2003.
- Sharmiladevi, J., & Saifilali, M. (2013). A Granger Causality Analysis of Foreign Direct Investment in India. *Global Journal of Arts and Science*, 53-62.
- Singhania, M., & Akshay, G. (2011). Monica Singhania, Akshay Gupta, (2011) "Determinants of foreign direct investment in India", . *Journal of International Trade Law and Policy, Vol. 10 Iss: 1*, 64-82.
- Tanna, H. s., & Lensink, R. (2003). Foreign Direct Investment, Financial Development and Economic Growth . *Journal of Development Studies*, 142-163.
- Vadlamannati, K., Tamazian, A., & Irala, L. (2009). Determinants of Foreign Direct Investment and Volatitlity in South Est Asian Economies. *Journal of the Asia Pacific Economy*, 246-261.
- Wang, M. (2009). Manufacturing FDI and Economic Growth: Evidence from Asian Economies. . *Applied Economics*, 41,, 991-1002.
- Young, Y. S. (2007). Economic Integration, Foreign Direct Investment and Growth in ASEAN five members. *psarir.upm.edu.my/5038*.