# FDI FLOWS AND HOST COUNTRY ECONOMIC DEVELOPMENT

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**ABSTRACT:** *The propose of the paper is to analyze the relation between economic development and FDI flows. FDI should have a positive effect on economic growth as a result of positive externalities generated for host countries by multinational companies (MNCs). There are several studies on this issue, some of them pointing out that FDI has a considerable positive effect on host country economic growth but the magnitude depends on host country conditions, while other works indicate that there is no powerful interdependence between inward FDI to host country economic growth. However, it is generally accepted that there is a functional link between the degree of openness of trade and foreign direct investment, especially in developing countries.*

**KEY WORDS:** *economic growth; foreign direct investment inflows; absorptive capacity; host / receiving country; home / source country.*

**JEL CLASSIFICATIONS:** *F21; F23; F43; E22.*

## 1. INTRODUCTION

In general, foreign direct investments can be described as flows of capital, technology and know-how from one country to another. Foreign direct investments (FDIs) represent one of the significant forms of capital flows, being indispensable for international economic integration. FDIs are also essential funding alternatives for investment and valuable tools for both company and economic development in host countries. FDI occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country. FDI data are usually reported in terms of stocks and flows. *FDI flow* refers to amount of FDI over a period of time, usually one year (new investments made during the reference period), while *FDI stock* represents the total accumulated value of foreign owned assets at a given point of time (Hill, 2011). *Outward flows and stocks* represent direct investment abroad and indicate investment

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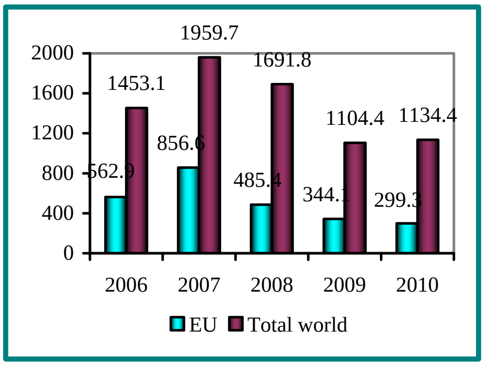
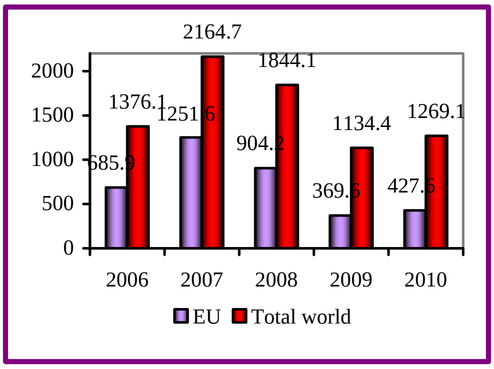
by entities resident in the reporting economy in an affiliated enterprise abroad. *Inward flows and stocks* occur when foreign capital is invested in local resources and express investment by foreigners in enterprises resident in the reporting economy (European Union, 2010, p.140). Outflows of FDI are the flows of FDI out of a country while inflows of FDI are the flows of FDI into a country.




*Source: http://www.oecd.org, FDI in Figures*

**Figure 1. Foreign Direct Investment Inflows (Billion USD)**




*Source: http://www.oecd.org, FDI in Figures*

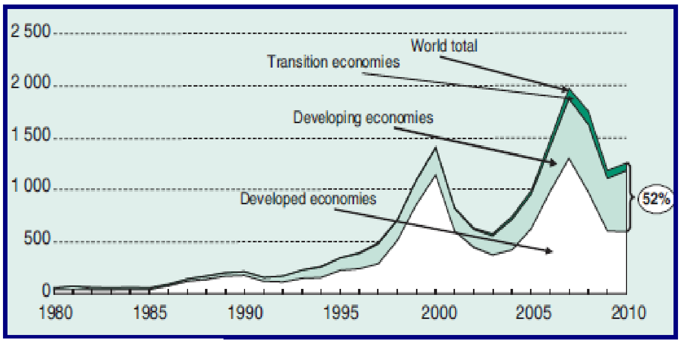
**Figure 2. Foreign Direct Investment Outflows (Billion USD)**

Due to the global financial crisis, economic activity in all major advanced countries, that represent the main source of FDI, contracted sharply. Thus, in 2010 global FDI inflows rose modestly, following the large declines of 2008 and 2009.

**Table 1. Distribution of FDI flows among economies in 2010, listed according to the magnitude of their FDI flows**

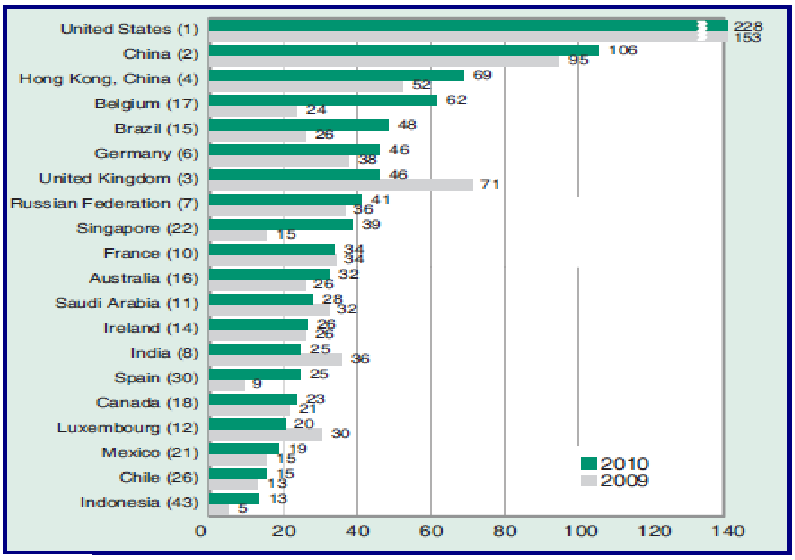
| Range | Inflows | Outflows |
|---|---|---|
| Above 100 billion USD | United States | United States, Germany |
| 50-99 billion USD | Belgium | France, Switzerland, Japan |
| 10-49 billion USD | Germany, United Kingdom, France, Australia, Ireland, Spain, Canada, Luxembourg, Norway | Canada, Belgium, Netherlands, Sweden, Australia, Spain, Italy, Luxembourg, Ireland, Norway, United Kingdom, Austria |
| 1-9 billion USD | Poland, Italy, Czech Republic, Austria, Sweden, Israel, Cyprus, Finland, Romania, Iceland, Hungary, Greece, Bulgaria, Estonia, Portugal, Malta | Finland, Israel, Poland, Cyprus, Denmark, Czech Republic, Hungary, Greece |
| Below 1 billion USD | Slovenia, Lithuania, New Zealand, Slovakia, Latvia, Bermuda, Gibraltar, Japan, Denmark, Switzerland, Netherlands | Bermuda, New Zealand, Slovakia, Bulgaria, Romania, Slovenia, Estonia, Lithuania, Malta, Latvia, Iceland, Portugal |

*Source: UNCTAD, World Investment Report, 2011*




*Source: UNCTAD, World Investment Report, 2011*

**Figure 3. FDI inflows, global and by group of economies, 1980–2010 (Billions of dollars)**




*Source: UNCTAD, World Investment Report, 2011, Note: Ranked on the basis of the magnitude of 2010 FDI inflows*

**Figure 4. Global FDI inflows, top 20 host economies, 2009 and 2010 (Billions of dollars)**

In this year, the share of FDI inflows for the developed countries'[1] dropped below 50% for the first time. In North America, inflows of FDI showed a strong turnaround with a 44% increase over the previous year while inflows to Europe fell down by 19%. Significant decrease occurred in the United Kingdom, Netherlands, Switzerland and Japan. Developing economies registered a smaller decline remaining

[1] UNCTAD follow the classification of the United Nations Statistical Office: *developed countries*: the member countries of the OECD (other than Chile, Mexico, the Republic of Korea and Turkey), plus the new European Union member countries which are not OECD members (Bulgaria, Cyprus, Latvia, Lithuania, Malta and Romania), plus Andorra, Bermuda, Liechtenstein, Monaco and San Marino; *transition economies*: South-East Europe and the Commonwealth of Independent States; *developing economies*: in general all economies not specified above.

the largest recipient for more than half of the total inflows. FDI flows to developing economies rose by 12%, thanks to their relatively fast economic recovery and the strength of domestic demand. This changing pattern of FDI inflows is confirmed also in the global ranking of the largest FDI recipients: in 2010, half of the top 20 host economies were from developing and transition economies, compared to just seven in 2009 (UNCTAD, 2011).

## 2. THE RELATIONSHIP BETWEEN FDI AND ECONOMIC GROWTH

FDI acquires increasing importance as an indicator of the international economic climate ensuring more direct and deeper links between economies. It can provide great advantages to host countries being an important source of economic growth. The role of FDI in the growth process has been the topic of debate in several countries. Thus, there are a number of significant papers analysing the relation between FDI and economic development exceptionally summarized by Andreas Johnson (Table 2) who presents an overview and summary of *eight empirical studies*[2] on the subject considered to be representative for approaches used and results found even if there are additional studies of FDI and economic growth (Johanson, 2006).

Some of these works indicates that FDI has a considerable positive effect on host country economic growth but the magnitude depends on host country conditions such as human capital abundance and macroeconomic stability. Other works conclude that there is no robust, independent influence of inward FDI to host country economic growth. The study developed by Johanson concludes that FDI should enhance host country economic growth through technology spillovers and inflows of physical capital. The author argues that FDI inflows have a positive effect on host country economic growth for developing countries but not for developed economies because in a mature market economy there is no difference between domestic and transborder investment. Developing countries experience both strong capital accumulation and technology transfer through FDI, whereas highly developed countries mainly benefit from FDI as a vehicle of global technology diffusion (Neuhaus, 2006).

More recent studies approach the issue for the case of one country/region, mostly for developing countries[3]: Nepal, Pakistan, Sub-Sahara Africa, Nigeria,

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[2] 1). Balasubramanyam, V.N., Salisu, M., Sapsford, D, (1996), Foreign direct investment and growth in EP and IS countries, The Economic Journal, no.106; 2). Borensztein, E., De Gregorio, J., Lee, J.-W. (1998), How does foreign direct investment affect economic growth?, Journal of International Economics, no.45; 3). Olofsdotter, K. (1998), Foreign direct investment, country capabilities and economic growth, Weltwirtschaftliches Archiv, no.134(3); 4). De Mello, L.R. (1999), Foreign direct investment-led growth: evidence from time series and panel data, Oxford Economic Papers, no.51; 5). Zhang, K.H. (2001), Does foreign direct investment promote economic growth? Evidence from East Asia and Latin America, Contemporary Economic Policy, no.19(2); 6). Carkovic, M., Levine, R. (2002), Does foreign direct investment accelerate economic growth?, University of Minnesota Department of Finance working Paper; 7). Choe, J.I. (2003), Do foreign direct investment and gross domestic investment promote economic growth?, Review of Development Economics, no.7(1); 8). Bengoa, M., Sanchez-Robles, B. (2003), Foreign direct investment, economic freedom and growth: new evidence from Latin America, European Journal of Political Economy, no.19.

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Bangladesh and India etc., suggesting either that FDI does not adequately describe the GDP or that there is positive relationship between FDI and GDP. Eventually, FDI may not only provide direct capital financing but encourages efficient production and creates positive externalities via the adoption of foreign technology and know-how. It is thus considered that FDI enhances the productivity of business leading to more competitive economies. Economic growth may induce FDI inflow, and FDI may also stimulate economic growth. According to specialists, for a given country, intense growth periods are characterized by attracting inflows of FDI.

**Table 2. Empirical studies of FDI and economic growth, approaches and results**

| Study | Type of data | Countries and time period | Empirical approach | Assumptions | Result |
|---|---|---|---|---|---|
| Balasubra-manyam et al (1996) | Cross section | 46 developing countries 1970-1985 | OLS regressions | FDI effects from technology spillovers, stronger effects for export promoting than import substituting | FDI has a positive effect but only for export promoting host countries |
| Borensztein et al (1998) | Cross section | 69 developing countries 1970-1989 | Regression estimations using SUR technique | FDI effects through technology diffusion | FDI has a positive effect on growth but magnitude depends on availability of host country human capital |
| Olofsdotter (1998) | Cross section | 50 developed and developing countries 1980-1990 | OLS regressions | FDI effects through technology spillovers | Increase in inward FDI stock has a positive effect on the growth rate |
| De Mello (1999) | Panel data and time series | 32 developed and developing countries 1970-1990 | Regression analysis, fixed effects | FDI effects from technology and improved management and organisation | Only weak evidence for FDI effects on economic growth |
| Zhang (2001) | Time series | 11 developing countries in East Asia and Latin America, varying time periods 1957-1997 | Analysis of causality between FDI and economic growth using Granger causality tests | There can be feedback effects from economic growth to FDI inflows | Evidence of growth enhancement from FDI, magnitude depends on host country conditions |
| Carkovic and Levine (2002) | Cross section and panel data | 72 developed and developing countries 1960-1995 | Regression analysis using OLS as well as GMM | Earlier macroeconomic studies suggest a positive role for FDI in generating economic growth | FDI inflows do not exert a robust, independent influence on economic growth |
| Choe (2003) | Panel data | 80 developed and developing countries, 1971- | Analysis of causality between FDI and | Rapid economic growth might lead to high FDI inflows | FDI Granger causes economic growth and vice versa but |

Economic Growth: The Case Of Subsahara Africa, Southwestern Economic Review, 2011; 4). Ayanwale, A.B., FDI and Economic Growth: Evidence from Nigeria, African Economic Research Consortium, 2007; 5). Sethi, N.; Sucharita, S., Effect of FDI on Economic Growth in Bangladesh and India: An Empirical Investigation, Working Paper, 2009

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|---|---|---|---|---|---|
| | | 1995 | economic growth using Granger causality tests | | the effects are more apparent from growth to FDI |
| Bengoa and Sanchez-Robles (2003) | Panel data | 18 Latin American countries 1970-1999 | Regression analysis, comparing fixed and random effects | FDI effects from technology spillovers | FDI has a positive effect on economic growth, magnitude depends on host country conditions |

*Source: Johnson, A., The Effects of FDI Inflows on Host Country Economic Growth, Working Paper Series, No 58 / January 2006, The Royal Institute of technology Centre of Excellence for studies in Science and Innovation*

Other authors, Bijsterbosch and Kolasa (2009), developed empirical studies on the importance of FDI inflows for the convergence process in general and for productivity gains in particular and which economic conditions affect the size of the benefits associated with FDI inflows. They reached the following conclusions: there is a strong convergence effect in productivity, both at the country and at the industry level; FDI inflow plays an important role in accounting for productivity growth; the impact of FDI on productivity critically depends on the absorptive capacity of recipient countries and industries; there is important diversity across countries, industries and time.

Although there is a general belief that FDI enhances the productivity of host countries and promotes economic development, the empirical evidence on the existence of such positive productivity externalities is not decisive. The macro empirical literature finds weak support for an exogenous positive effect of FDI on economic growth. Findings in this literature indicate that a country's capacity to take advantage of FDI externalities might be limited by local conditions, such as the development of local financial markets or the educational level of the country, i.e. absorptive capacitie*s* (Alfaro et al., 2010). Thus, host countries only achieve benefits from FDI once they have sufficient absorptive capacity related to human capital resource, absorptive capacity of domestic firm, financial systems, infrastructure, technological, and institutional development.

## 4. FDI INFLOWS IN ROMANIA

However, the importance of FDI for the Romanian economy is more than obvious as FDI make an essential contribution to economic growth. FDI contributes to the improvement of national economies by implementing advanced technologies, know-how's, most advanced equipment, new quality standards and by moving to a higher type of growth. By economic activity the main part of FDI went to industry (41.3% in 2008, 41.4% in 2009, 43.9% in 2010). Other sectors that have also attracted significant FDI were financial intermediation and insurance, trade, construction and real-estate transactions, information technology and communications.

Taking into consideration the contribution to the equity flow in foreign direct investment enterprises, there are 3 types of FDI, as defined by the National Bank of Romania in the FDI statistical surveys (NBR, 2008-2010): *greenfield*: establishment of enterprises by/or together with foreign investors; *mergers and acquisitions*: partial or full takeovers of enterprises by foreign investors from residents; *corporate development*: increase in foreign investors' equity capital in foreign direct investment enterprises.

**Table 3. Distribution of FDI in Romania by main economic activity**

- Million EUR -

| Economic activity | 2008 | | 2009 | | 2010 | |
|---|---|---|---|---|---|---|
| | Value | % | Value | % | Value | % |
| Industry | 20138 | 41.3 | 20680 | 41.4 | 23093 | 43.9 |
| Administrative and support service activities | 1617 | 3.3 | 2299 | 4.6 | 2560 | 4.9 |
| Agriculture, forestry and fishing | 707 | 1.4 | 552 | 1.1 | 1068 | 2.0 |
| Trade | 6060 | 12.4 | 6164 | 12.3 | 6519 | 12.4 |
| Construction and real-estate transactions | 6155 | 12.6 | 6453 | 12.9 | 4746 | 9.0 |
| Hotels and restaurants | 181 | 0.4 | 213 | 0.4 | 417 | 0.8 |
| IT and communications | 3283 | 6.7 | 3235 | 6.5 | 3081 | 5.9 |
| Financial intermediation and insurance | 10026 | 20.5 | 9510 | 19.0 | 10055 | 19.1 |
| Transports | 500 | 1.0 | 684 | 1.4 | 788 | 1.5 |
| Other | 131 | 0.4 | 194 | 0.4 | 258 | 0.5 |
| **Total FDI** | **48798** | **100.0** | **49984** | **100.0** | **52585** | **100.0** |

*Source: NBR, Foreign direct investment in Romania, 2008-2010*

Globally, the modest revival of FDI flows in 2010 brought out an uneven pattern among FDI components. Cross-border mergers and acquisitions (M&A) rebounded gradually, yet greenfield projects dropped both in number and value. In Romania, in 2010, out of the total FDI flows, 96.6% (EUR 3,928 million) went to corporate development, 2.3% (EUR 93 million) were destined to mergers and acquisitions and only 1.1% (EUR 46 million) to greenfield investment.

**Table 4. Pattern among FDI components in Romania, during 2007-2010**

- % of total -

| Types of FDI | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| Corporate development | 72.2 | 66.8 | 98.3 | 96.6 |
| Mergers and acquisitions | 10.5 | 32.0 | 1.1 | 2.3 |
| Greenfield | 17.3 | 1.2 | 0.6 | 1.1 |

*Source: NBR, Foreign direct investment in Romania, 2007-2010*

As foreign direct investments gain a great importance in the Romanian economy, more and more studies were developed to analyze if there is a certain relationship between FDI inflows and the GDP. Findings in the literature indicated though that there is a weak statistical dependence between GDP and FDI, but it can not be ignored the fact that FDI inflows have potential positive impacts on the economic growth of the host country.

## 5. CONCLUSIONS

A number of studies have tested the functional relationship between FDI flows, growth and dynamics of domestic investment flows, showing that FDI is an "accelerator" of domestic investments. It is generally accepted that most countries tend to attract foreign direct investment because of its acknowledged advantages as an instrument of economic development. Thus, evidence suggests that foreign direct investment is playing an increasing role in the global economy as firms increase their cross-border investments. The main benefits of inward FDI for a host country are (Hill, 2011): the resource transfer effect; the employment effect; the balance of payments effect; effects on competition and economic growth. FDI is an important tool for technology transfer, contributing relatively more to growth than domestic investment.

## 6. ACKNOWLEDGEMENT

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