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Role of foreign direct investment in economic growth of developing countries

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Abstract

According to theory, foreign direct investment plays a significant role as a stimulant for industrial growth and helps with capital accumulation and technical advancement. We examine how foreign direct investment affects economic growth within the framework of an endogenous model which is an assumption that economic growth due to internal factors such improvements in innovation, knowledge to increased productivity, positively affecting the economic outlook. We test the claim that higher economic development nations benefit more from FDI inflows.

Keywords: Economic growth, Foreign direct investment, Business Enviroment, Gross Domestic Product.

Introduction

There has been much discussion throughout the years over how foreign direct investment affects host countries' economic growth. It is actively sought for by almost all nations, and the literature demonstrates to its significance in fostering economic progress. According to Borensztein et al. (1998), the theory that foreign direct investment may significantly boost the economic growth of the receiving nation may consequently need the availability of superior technology in the host economy in a more favorable environment. Therefore, it would seem that the growth effect of foreign direct investment will vary throughout nations due to economic, social, and political variations. In this context, it would be tempted to speculate that FDI-led growth will be more prominent in in East Asian countries where admittedly greater levels of development and more favorable macroeconomic situations and Central Asian nations like Uzbekistan and Kazakhstan, nations with comparably less favorable economic environments and comparatively low levels of development.

That theory appears to be supported by the findings of Blomstrom et al. (1994), Coe et al. (1995), and Borensztein et al. (1998). Kumar (2007) posits that the primary factor separating affluent and poor nations is the financial and material resources that generate wealth. Consequently, the ability of less developed nations to accumulate capital and progress technologically is a critical component of economic development.

This study aims to explore the relationship between foreign direct investment and economic growth, as well as test the assumption that nations with greater levels of economic development benefit more from FDI inflows in terms of increased economic growth. We do a comparative analysis using current statistical data mentioned countries to ascertain the role that FDI plays in explaining economic development in emerging nations that are less developed than those that are more developed.

Literature review

There are several reasons why FDI might impact a host nation's growth in a favorable or negative way. These explanations are often included under the modernization and dependence theories, which are the two primary theoretical stances. Neoclassical and endogenous growth theories, which contend that foreign direct investment may stimulate economic growth in developing nations, serve as the foundation for modernization ideas. The neoclassical viewpoint is that capital investment is necessary for economic growth (Firebaugh, 1992), hence increasing domestic capital accumulation through FDI can increase the likelihood of economic growth. According to Sylwester (2005), FDI may even encourage domestic investment in the presence of complementarities, which would have a beneficial indirect influence on the overall level of investment. A different view of modernization theory does not distinguish between foreign and domestic investment, arguing that since "capital is capital," both domestic and foreign capital investments ought to boost output and the expansion of the businesses they are directed toward (Crenshaw, 1992). According to the new growth theories and endogenous growth models, technology and knowledge are factors of production (Romer, 1993; Romer, 1994). As a result, foreign direct investment linked to the transfer of managerial and production knowledge can significantly boost the host economy (Kumar and Pradhan, 2002). Of course, multinational companies (MNEs) that attract foreign direct investment have the potential to lessen the "idea gaps" and "object gaps" that Romer (1993) described as existing between industrialized and developing nations by providing new knowledge and investing in physical infrastructure such as factories and roads. As a result, emerging nations' absorption capacity would rise. Therefore, by enhancing local investment, FDI may provide externalities that are more useful (efficiency impact) than its direct production of output (Kumar and Pradhan, 2002). Conversely, proponents of dependency theory contend that reliance on foreign investment and aid should be anticipated to have a favorable influence on income disparity and a detrimental effect on growth (Chase – Dunn, 1975; Bornschier et al., 1978; Nolan, 1983). According to Bornschier and Chase-Dunn (1985), foreign investment produces an economic structure where monopolies predominate, which results in the "underutilization of productive forces." According to Chase-Dunn (1975), FDI may displace domestic investment and cause other distortions that might be harmful to the host nation's growth.

Discussion and analysis

Developing nations must support policies that strengthen domestic investment capacity and concentrate on FDI that increases returns on domestic output if they are to fully benefit from FDI. Therefore, in developing nations, foreign direct investment may be more beneficial if the receiving nation can manage, regulate, and steer FDI toward industries that have positive externalities on the national economy (Rhagavan, 2000).

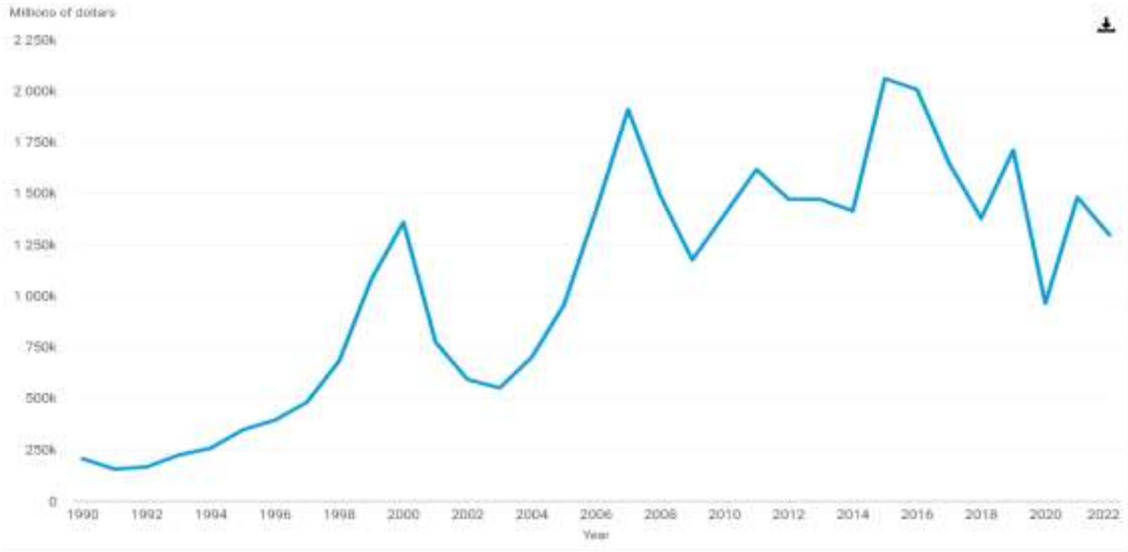
In order to explore the relationship between FDI and economic growth, Central Asian countries such as Uzbekistan and Kazakhstan, also East Asian country which is South Korea taken as an example. These countries demonstrate how internal policies and resources effect countries economic growth and attract FDI.

Foreign direct investment trends in 2023, global and by region, billions of USD and percentage changed compared to 2022.

Source: UNCTAD, based on FDI/MNE database (www.unctad.org/fdistatistics and information from The Financial Times Ltd, fDi Markets (www.fDimarkets.com) and Refinitiv SA.

Given graph demonstrates FDI trends in 2023. The total foreign direct investment landscape for developing nations saw a 9% decrease, totaling $841 billion. Asia's developing nations suffered the most, seeing a 12% decline. Additionally other developed economies saw 46% fall. Conversely, FDI flows in Latin America and the Caribbean were stable while falling by a little 1% in Africa.

Foreign Direct Investment in the word between 1990- 2022



Source: World investment report 2023 (2023) UNCTAD. Available at: https://unctad.org/publication/world-investment-report-2023 (Accessed: 05 April 2024).

Graph demonstrates FDI in the world between 1990th to 2022. In 1990 FDI was lowest at 250k and in 2014 FDI peaked to 2000k. However in 2022 investment level decreased to 1250k.

Uzbekistan

Located in the heart of Central Asia, Uzbekistan is a large landlocked nation with a growing lower-middle income economy. Its banking and manufacturing sectors are still dominated by state-owned businesses, and most of its international commerce is in commodities. An economic strategy has as its stated objectives achieving sustainable growth and eradicating poverty and underemployment as quickly as practicable. Attracting private and foreign investment has become a top priority as a result of the rapidly increasing external public debt, which is restricting the availability of public cash and loans to promote economic growth. The goal of the extensive market reforms that the Government of Uzbekistan (GOU) initiated five years ago was to enhance the business climate.

The biggest population in Central Asia, active and enterprising, somewhat well-developed infrastructure, and a sizable potential customer base are all reasons why Uzbekistan has the potential to develop into a powerful regional economy. Most foreign direct investment used to go into the mining, oil, and gas industries. FDI has, however, been trending upward in the last several years in the manufacturing, banking, tourism, and power generation and distribution industries. Overall, 2023 proved to be a prosperous year for Uzbekistan, marked by positive shifts in the country's economy. The GDP increased by 6% as opposed to 5.7% in 2022. The consumer price index ended the year at 8.77%, down from 12.25% in 2022. There was a significant increase in investment activity, rising by 22.1% as compared to 0.2% in 2022.

It is particularly noteworthy that the rise was attained as a result of a 26% increase in non-centralized investments and a 0.7% decline in centralized investments. While non-centralized investments climbed from 84.3% to 87.3% of the overall volume of investments in fixed assets, the percentage of centralized investments decreased from 15.7% in 2022 to 12.7% in 2023. Double-digit growth was evident in the expansion of international commerce; turnover rose by 23.9% to $62.6 billion. Nonetheless, the President pointed out certain flaws and issues that remained in the economy's progress last year in a critical manner during the discussions. He also outlined the responsibilities and actions that would be performed to address these issues in 2024.

Positive modifications to state regulations and the start of a privatization initiative made this diversification possible. There could be special investment possibilities if privatization is advanced further and a long-awaited capital market development policy is put into place. The GOU has worked to increase the nation's appeal to investors throughout the last five years. Through the adoption of the Law on Investments and Investment Activities as well as other acts that lowered tax burdens, loosened restrictions on access to specific commodities, and initiated the privatization of significant state-owned businesses, the GOU has updated its legal 2021, FDI has been coming in.

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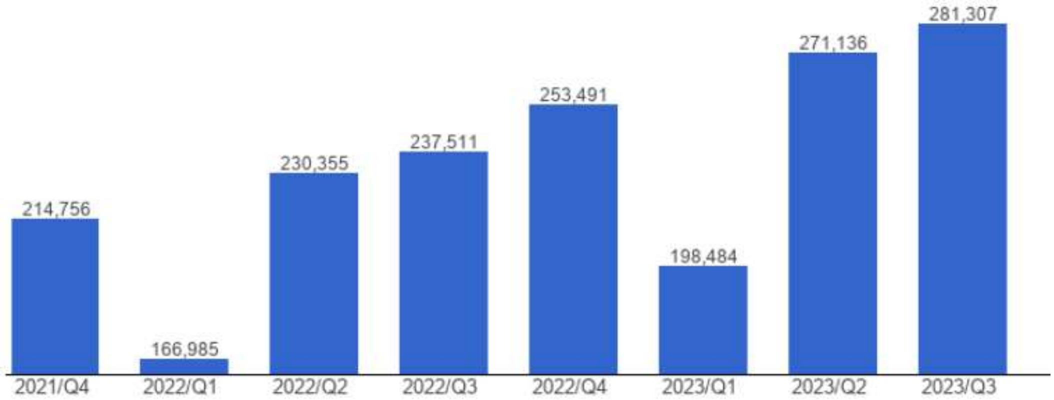
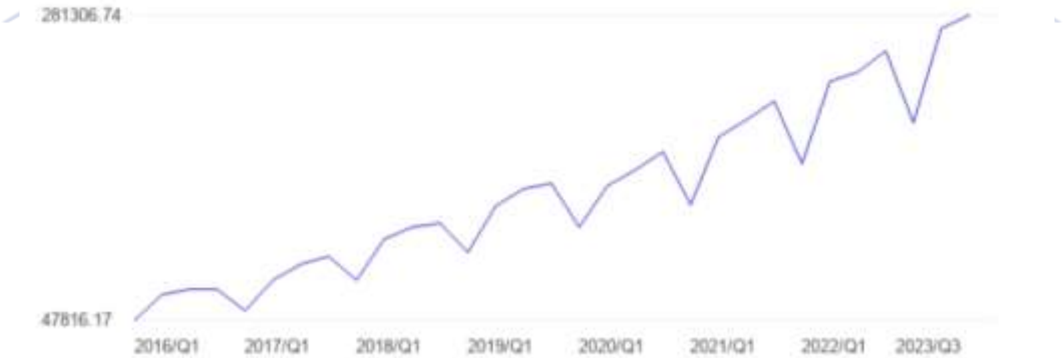
GDP In Uzbekstan between 2021 to 2023



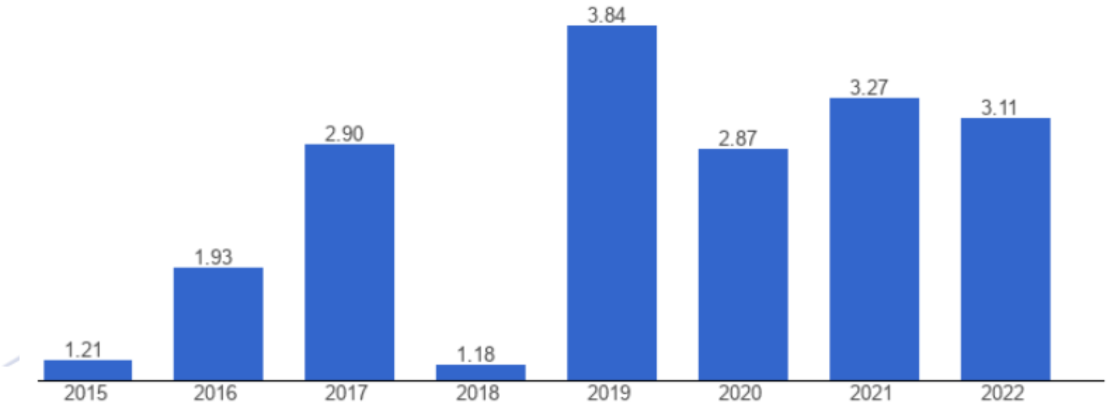
GDP in Uzbekistan between 2016 to 2023

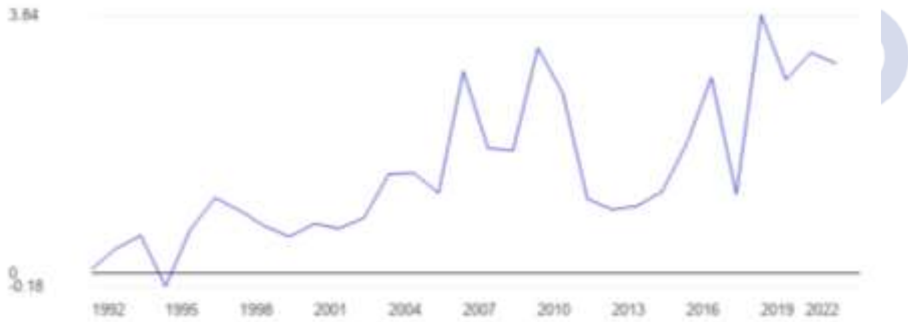


Measure: billion Uzbekistan Sum
Source: Statistics Agency under the President of the Republic of Uzbekistan

Graph demonstrates GDP of Uzbekistan between 2016 to 2023. During that time, Uzbekistan's average value was 145659.97 billion Uzbekistan Sum; the lowest value was 47816.17 billion Uzbekistan Sum in Q1 2016 and the highest value was 281306.74 billion Uzbekistan Sum in Q3 2023.

FDI in Uzbekistan between 1990 to 2022





Source: The World Bank

Given graph shows FDI from 1992 to 2022. During that time, Uzbekistan's average rate was 1.52 percent; minimum percentages were -0.18 percent in 1995 and maximum percentages were 3.84 percent in 2019. The most recent figure is 3.11 percent for 2022.

From the graphs given above, we can the relation between GDP and Foreign Direct investment. When the percentage FDI was at minimum GDP of the country was low too. Since the percentage of GDP was at minimum in 2016 at 47816.17 sum,in the same year FDI of the country was at 1.93 percent, comparably low point to other years . In general, overall increase in FDI resulted in increase in countries GDP.

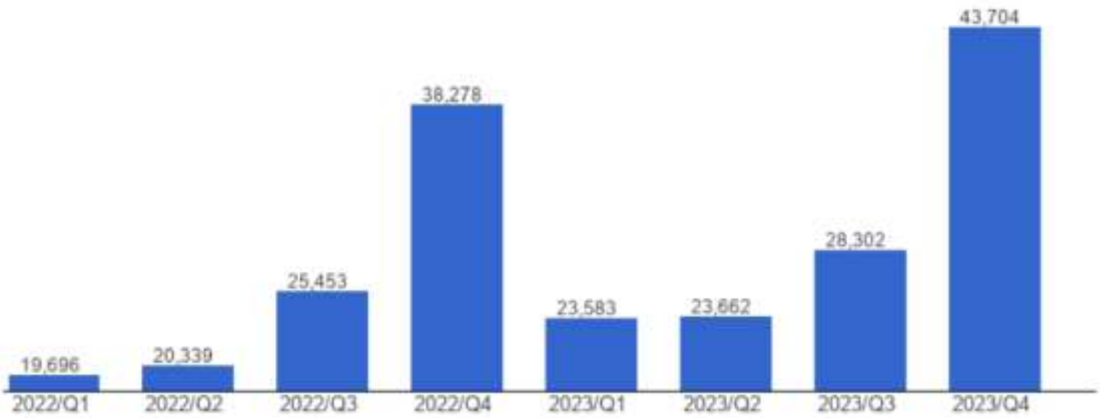
Kazakhstan

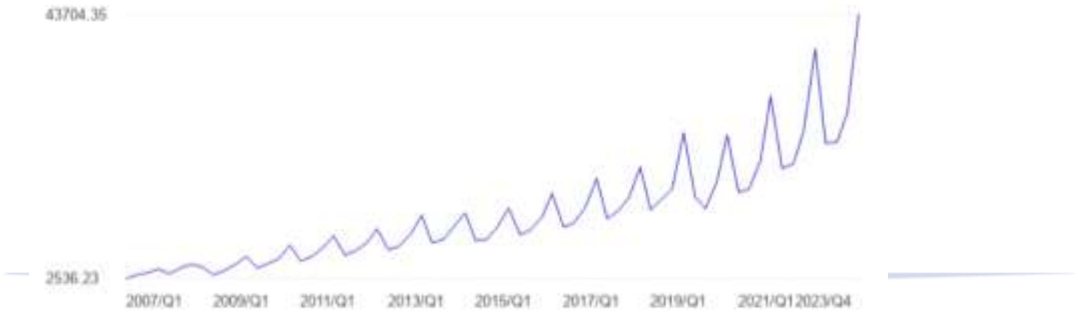
Since independence from the Soviet Union in 1991, Kazakhstan has made great strides toward developing a market economy. The country has garnered substantial international investment in order to use its copious mineral, petroleum, and natural gas reserves. According to official central bank figures, as of January 2023, the stock of foreign direct investment (FDI) was at $169.2 billion, of which $43.83 billion originated from the United States. Information that is accessible to the public shows that US investments in the hydrocarbons industry alone much surpass this stated figure.

According to UNCTAD's World Investment Report 2023 rise in the extractive sectors (to USD 4.1 billion), primarily from MNEs in the Netherlands and the United States, FDI inflows into the nation increased by 83.1% in 2022 to reach USD 6.1 billion, nearly double the quantities recorded prior to the pandemic. High profits in the extractive sectors helped reinvested earnings exceed USD 10 billion, the largest value ever recorded, but equity became negative. Around 68.3% of the nation's GDP, or 154.1 billion, was invested abroad during that time. According to the Kazakh Invest National Company, Kazakhstan had a net inflow of foreign direct investment totaling USD 4.1 billion in the first half of 2023, an 86% rise over the same time the previous year. $5.6 billion in FDI, the mining industry accounted for the largest share of all industry investments. Manufacturing ($2.9 billion), wholesale and retail trade ($2.5 billion), financial and insurance activities ($488.2 million), transport and warehousing ($577.8 million), construction ($189.8 million), professional and technical activities ($159.6 million), and real estate operations ($234.3 million) were the next most popular industries. The Netherlands (29.2%), US (13.7%), Switzerland (8.6%), China (6.1%), Russia (5.2%), and France (4.7%) are the top investment nations.

The Kazakh government has previously implemented a plan to attract FDI into a number of high-priority industries. Kazakhstan wants to diversify its economy and increase employment and economic growth by encouraging investment in non-extractive industries. Agriculture, food processing, chemicals, pharmaceuticals and medicine, textiles, wood, paper, and furniture; electrical and electronics; machinery and equipment; metallurgy; utilities; infrastructure and engineering; services; alternative energy; biotechnology; construction; and tourism are the industries that receive investment preference. Furthermore, within the same time frame, investments in the industrial sector increased by 60%. Construction and installation work started on 42 projects worth more than $3 billion in 2023. These initiatives included the building of a new KIA factory worth at USD 250 million, the creation of 1,500 employment opportunities, and the manufacturing of thermal insulation materials by the Italian business Cormatex. Moreover, prominent organizations that have showed interest in promoting renewable energy sources in Kazakhstan include Saudi ACWA Power, Chinese Power, German Svevind, Italian ENI, French TotalEnergies, and China Power.

GDP of Kazakhstan

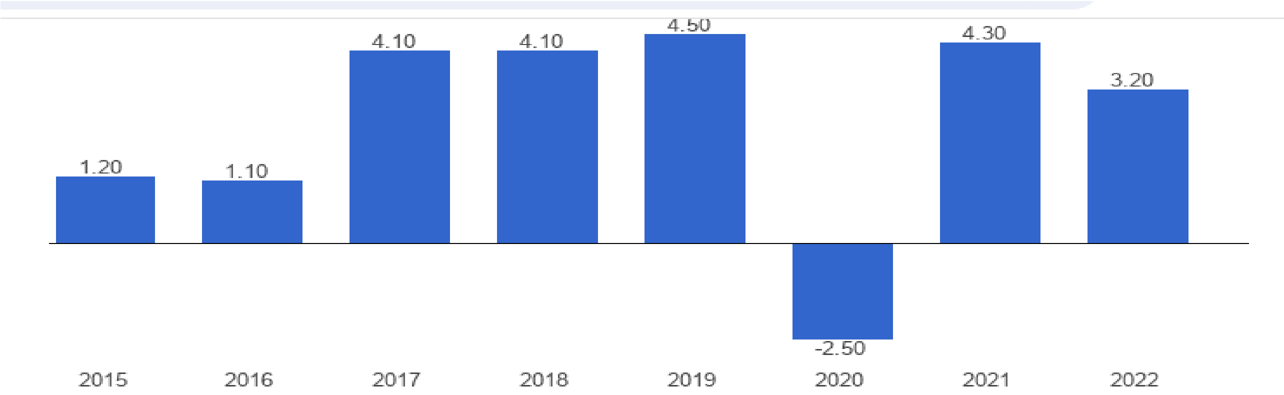


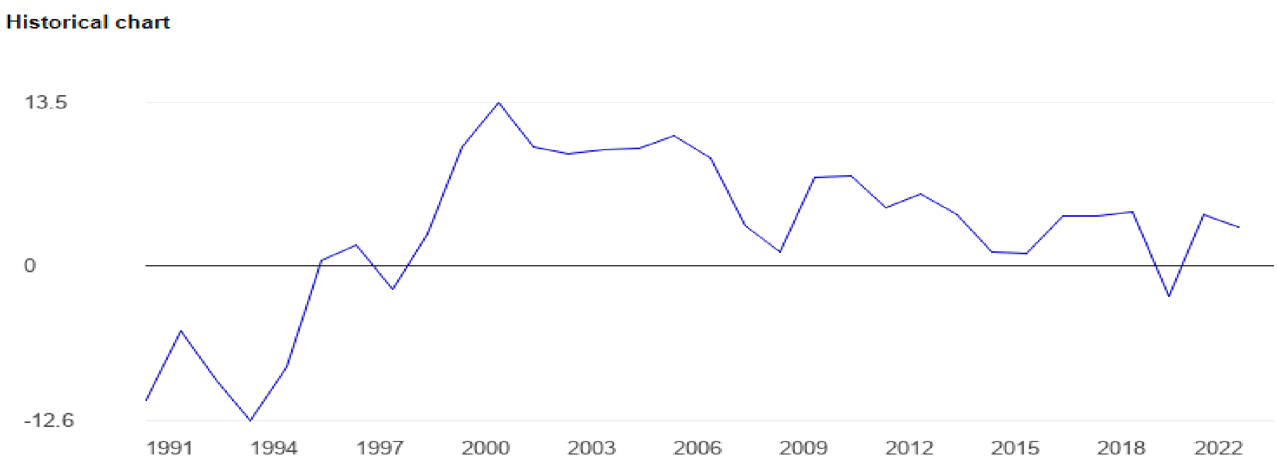


Measure: billion Kazakhstan Tenge
Source: Ministry of National Economy of the Republic of Kazakhstan

The graph demonstrates the GDP of Kazakhstan from Q1 2007 to Q4 2023. With a minimum of 2536.23 billion of Kazakhstan Tenge in Q1 2007 and a maximum of 43704.35 billion Kazakhstan Tenge in Q4 2023, the average value for Kazakhstan throughout that time was 12492.21 billion Kazakhstan Tenge.

Economic growth of Kazakhstan





Kazakhstan`s economic growth between 1992 and 2022 demonstrated. Kazakhstan's average at that time was 6.38 percent; minimum values occurred in 2018 at 0.2 percent and maximum values in 2004 at 13.01 percent. The most recent estimate is 2.18 percent for 2022.

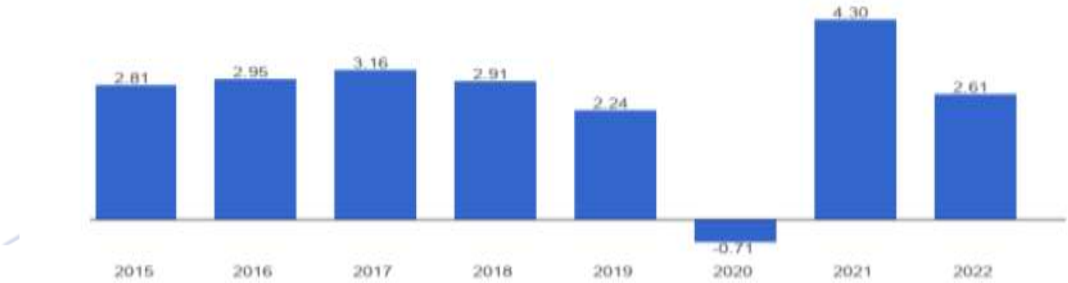
As mentioned above, the stock of foreign direct investment was at $169.2 billion. FDI inflows into the nation increased by 83.1% in 2022 to reach USD 6.1 billion, nearly double the quantities recorded prior to the pandemic. High profits in the extractive sectors helped reinvested earnings exceed USD 10 billion, the largest value ever recorded. According to the Kazakh Invest National Company, Kazakhstan had a net inflow of foreign direct investment totaling USD 4.1 billion in the first half of 2023, an 86% rise over the same time the previous year. $5.6 billion in FDI.

These all are result of government's action plan. Due to Kazakhstan's reputation for having an excellent business environment, several multinational corporations have chosen to locate their regional headquarters there. The government intends to establish a national firm called "Kazakh Invest," which would facilitate the operations of international investors in Kazakhstan. In general, the government has been progressively strengthening the business climate for foreign investors. In particular areas and industries, problems including corruption, overbearing bureaucracy, capricious law enforcement, and restricted access to a trained labor pool continue to exist in spite of institutional and legal changes. In addition, international investors continue to be concerned about the government's propensity to increase regulatory intervention in investor relations, support import-substitution policies, restrict the use of foreign labor, and meddle in business operations. Furthermore, because of Russia's long border and strong economic ties with Kazakhstan, Russian aggression against Ukraine and the sanctions that follow have an effect on Kazakhstan's investment climate. Kazakhstan lacks both a screening mechanism and explicit laws that address the impact of foreign direct investment on national security. According to the most recent Index of Economic Freedom, the nation is ranked 66th out of 184 nations and 81st overall out of 132 economies in the world.

South Korea

Due to its rapid economic growth and expertise in cutting-edge information and communication technologies, South Korea is an attractive destination for foreign direct investment. The Republic of Korea is classified by the World Bank as having a well-developed business climate. But even with the sophisticated and complex economy, South Korea's complicated, transparent, and national regulatory environment presents challenges for overseas companies. Additionally, low-cost producers like China have significantly weakened the competitiveness of the nation's manufacturing industry. The Republic of Korea recently decided to provide up to a 50% cash compensation for foreign investments in vital industries including semiconductors, batteries, and vaccines. It is legal for private organizations, both domestic and international, to form, own, and engage in profitable ventures in a variety of economic areas. However, the Foreign Exchange Transaction Act still imposes restrictions on foreign ownership for thirty different economic sectors (FETA). Notably, three industries are still off-limits to foreign investment: radio broadcasting, terrestrial broadcasting, and nuclear power generating. In the 2023 Index of Economic Freedom, South Korea is ranked 14th out of 184 nations and 10th out of 132 economies worldwide. Additionally, it ranks 19th on Kearney's 2023 Foreign Direct Investment Confidence Index.

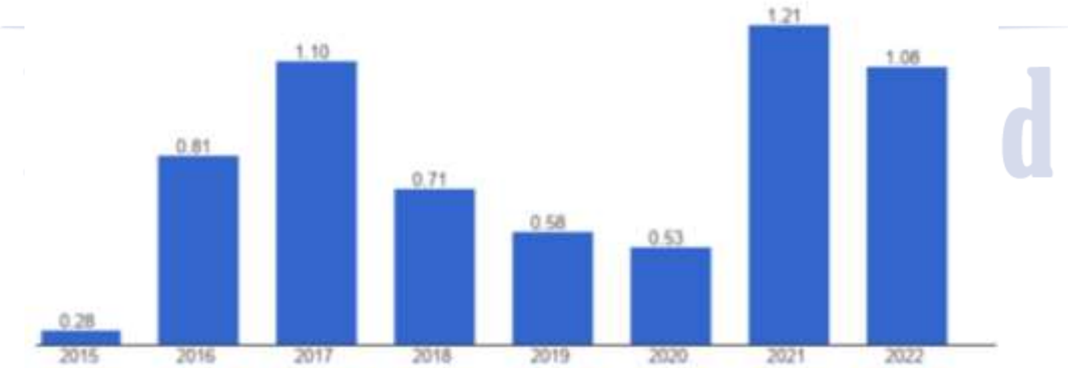
Economic Growth of South Korea



Source: The World Bank

Graph provides economic growth of South Korea from 2015 to 2022. During that time, South Korea's average percentage was 2.5 percent; it ranged from a minimum of -0.71 percent in 2020 to a top of 4.30 percent in 2021. The most recent figure is 2.61 percent for 2022. The annual rate of economic growth is typically between 2-3 percent. Every year, as the economy experiences booms and recessions, that varies. But if an economy increases at a consistent pace of five percent or more annually, that's a significant rate of economic growth. A 7–8 percent of annual expansion in the economy is extraordinary.

Foreign Direct Investment in South Korea



Source: The World Bank

Graph shows FDI in South Korea from 2015 to 2022. Average value during that period was 0.85 percent with a minimum of 0.53 percent in 2020 and a maximum of 1.21 percent in 2021. The latest value from 2022 is 1.08 percent.

As mentioned above, country`s specialization in new information and communication technologies and country's rapid economic development resulted in consistent economic growth. In addition, well developed business climate appeal foreign direct investment.

Conclusion and recommendation

This paper's main implication is that, in order to foster economic progress, governments in the area need to concentrate on foreign direct investment that increases citizens' ability for entrepreneurship and creativity and encourages domestic investment. Our findings show that the economic growth and market expansion of a nation are positively impacted by FDI. The case in Uzbekistan is an example of our assumption. In addition, in case of Kazakhstan, government policy and providing comfortable business condition which encourage the operations of international investors in Kazakhstan. That resulted in economic growth and higher GDP. In South Korea, consistent economic growth was achieved by the nation's specialization in new information and communication technologies and developed business environment.

It is recommended that, creating regulations that facilitate the inflow of foreign direct investment. However, guidelines must to be clear, practical, and consistent. Prioritizing the execution of certain essential policies in the pilot region can help to increase their viability. The policies can then be amended based on the lessons learned from their implementation.

Prevent FDI's effect on native industry. Private and public investments should be distinguished when bringing foreign direct investment. In order to support local investment and technological innovation, foreign direct investment (FDI) should be included.

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