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Foreign Direct Investment and Economic Growth

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Foreign Direct Investment and Economic Growth

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Various proposals are currently being suggested to encourage higher foreign direct investment in countries within the euro area, particularly between individual member states. The intended goal is to assist in stimulating economic growth in the euro area. Against this background, this article provides an overview of the large and heterogeneous academic literature on the influence of direct investment on economic growth. The results of the existing studies indicate that direct investment often acts as a kind of catalyst and that a positive influence on economic growth becomes more probable when a country has a population with a high level of education, high-quality infrastructure, or a developed financial system.

Foreign direct investment (FDI) is central to the economic integration of a country or economic area and represents an important financing source for capital investment. In addition, direct investment can also support the transfer of technology, expertise and organizational capital between countries, and thus also stimulate productivity growth. In recent years, however, FDI inflows to the euro area have exhibited muted development. After the strong FDI inflows in Europe in the 1990s, during the creation of the unified single market and the preparation of a monetary union, a decrease in the international significance of the euro area as an investment destination began in the 2000s. For most countries within the euro area, shares in inflows of direct investment made worldwide have steadily decreased and fallen considerably once again in the course of the financial crisis and the debt crisis in the euro area (see, e.g., [Baldi et al., 2014](#); UNCTAD, 2015). Direct investment from the northern member countries to the southern peripheral countries within the euro area in particular has fallen further below its already low level before the crisis. Capital links between northern and southern countries in the euro area were characterized relatively strongly by debt instruments and weakly by equity ever since the beginning of the monetary union. The significance of the central and eastern European countries, some of which have since entered the euro area, showed stable development up until the crisis, then decreased in recent years, likely connected with the slowing economic catch-up process ([EBRD, 2013](#)). In contrast to Europe, the significance of the United States as an international investment destination has remained more or less stable since the beginning of the 2000s. Emerging and developing countries, however, were able to markedly increase their significance as investment destinations in the course of dynamic economic growth. The decrease in significance of the euro area as an international destination for investment is mostly associated with comparatively less dynamic economic development in Europe and an improved regulatory framework for investors in other regions of the world (see [OECD, 2015](#)). Furthermore, the argument is often made that the unified services market in the European Union is not yet complete, curbing cross-border investment within this sector (see, e.g., [Baldwin et al., 2008](#); [Francois and Hoekman, 2010](#)).

Over the course of the gradual improvement of the economic situation in the euro area and the weakening of economic growth in developing countries, it seems as though the significance of the euro area as an investment destination – at least for now – will not decline any further (see [Ernst & Young, 2015](#); UNCTAD, 2015).

Positive growth effects of FDI are found in empirical studies

Given this background of low FDI inflows, various think-tanks and political consultants have argued for an improvement of the basic conditions for direct investment to countries within the euro area – particularly those within the monetary union (see, e.g., [Garnier, 2013](#); [Baldi et al., 2014](#); [Enderlein and Pisany-Ferri, 2014](#)). It has been argued that foreign equity capital can contribute to the stimulation of economic growth within the euro area. This line of argument is based on the results of the academic literature, which has frequently investigated the empirical connection between FDI and economic growth with a variety of methods. A survey of these studies indicates that positive effects on economic growth could be found for FDI in most cases ([Carkovic and Levine, 2002](#); [Alfaro and Carlton, 2007](#); for a comprehensive overview of the literature see [Contessi und Weinberger, 2009](#); [Deutsche Bank Research, 2014](#)). However, the estimates of the size of the effect vary considerably, which makes it difficult to quantify the growth-enhancing effect of FDI. Some authors find that an increase of the inward FDI-to-GDP ratio by one percentage point raises economic growth by more than one percentage point, while others find very low effects. Various studies indicate that additional factors, summarized under the concept of absorption capacity, play a decisive role in the influence of FDI on economic growth. These include the education level of the population (see, e.g., [Borensztein et al., 1998](#)), the quality of the infrastructure ([Donaubauer, 2014](#)), and the development of the financial and bank system (see [Alfaro, Chandra, Kalemli-Ozcan und Sayek, 2006](#)). The role of trade openness – measured by the share of exports and imports in the gross domestic product – is also frequently highlighted ([Balasubramanyam et al., 1996](#); [Turkcan und Yetkiner, 2010](#)). Overall, the results of the academic literature indicate that FDI works as a catalyst and strengthens existing developments. Investigations focused on the newest developments at the European level (see, e.g., [EU Commission, 2012](#); [Baldi and Miethe, 2015](#)) show that the influence of FDI on gross domestic product growth increases as the absorption capacity of a country improves.

Limits of Empirical Research

When interpreting these scientific results, it must be kept in mind that empirical investigations are complicated by the fact that FDI and economic development mutually influence one another. On the one hand, FDI can increase economic growth, on the other hand, however, countries with stronger economic growth attract more FDI inflows ([Eicher et al., 2012](#); [Bloningen und Piger, 2014](#)). Difficulties in econometric analysis also arise due to the fact that direct investment represents pure financial flows within balance of payments statistics. According to international criteria, a share of at least ten per cent of voting capital is considered a direct investment. The various motives for FDI among companies typically cannot, or only insufficiently, be assessed using balance of payments statistics. Direct investment can be made with respect to the construction of production facilities (greenfield investment) or in the course of mergers and acquisitions (brownfield investment). Furthermore, balance of payments statistics do not reveal whether direct investment has been made with the aim of acquiring a new market (horizontal FDI) or in order

to manufacture intermediate products in other countries (vertical FDI). In addition, offshore financial centers may distort data on foreign direct investment ([Zucman, 2013](#); [Hanlon et al, 2015](#)).

In recent years, an increasing number of studies have been published, which attempt to isolate the effect of FDI on variables such as productivity or economic growth using data which has become more readily available at the firm level. Based on this data, it has become more possible to differentiate the various motives for direct investment. The results of these studies can also be interpreted to suggest that a positive but milder effect on economic growth can be expected from FDI inflows (see, e.g., [Keller und Yeaple, 2009](#); [Girma et al., 2014](#)). Many of these studies indicate that direct investment can increase the productivity of all companies and thus the growth potential not only of those companies that receive foreign investment capital. As shown by [Bitzer und Görg \(2009\)](#) in particular, however, these results exhibit a high degree of heterogeneity between various countries and sectors. For this reason, the findings of these studies cannot necessarily be generalized.

Conclusions

In recent years, inflows of FDI to the euro area have exhibited muted development. This has led to calls to improve incentives for direct investment in order to contribute to an increase in economic growth. Although it is empirically difficult to establish an independent causal effect of direct investment on economic growth, the results of many studies indicate that direct investment not only provides financing capital for capital investment but can also stimulate economic growth indirectly through the transfer of management knowledge or technology. Overall, the results of the existing literature indicate that direct investment primarily functions as a catalyst and that growth-enhancing effects are higher where there is a high quality infrastructure or high level of education in the population.

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