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**World Trade Organization**

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**FOREIGN DIRECT INVESTMENT, TRADE AND ECONOMIC DEVELOPMENT: AN OVERVIEW**

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# FOREIGN DIRECT INVESTMENT, TRADE AND ECONOMIC DEVELOPMENT: AN OVERVIEW

Michael Blanga-Gubbay & Stela Rubínová

## **ABSTRACT:**

This paper explores the dynamic relationships between foreign direct investment (FDI), international trade, and economic development. First, emphasizing the pivotal role of multinational enterprises (MNEs) - particularly in the context of Global Value Chains (GVCs) - it underscores how FDI and trade are mutually reinforcing. Then, it highlights the convergence of investment and trade policies, pointing out the impact of Bilateral Investment Treaties (BITs) on trade flows and the increasing inclusion of investment provisions in Regional Trade Agreements (RTAs). Third, examining global FDI trends, it shows that developing and emerging economies are still lagging behind, but they are fast growing in importance. Finally, it draws on a rich empirical literature to show how FDI drives economic development through knowledge spillovers, technology transfer, and export upgrading.

*JEL Classifications:* F21, F23, O19.

*Keywords:* foreign direct investment, international trade, economic development.

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# FOREIGN DIRECT INVESTMENT, TRADE AND ECONOMIC DEVELOPMENT: AN OVERVIEW

Michael Blanga-Gubbay & Stela Rubínová<sup>3</sup>

## 1 INTRODUCTION

In December 2021, 112 WTO members co-sponsored a Joint Statement on Investment Facilitation for Development. The initiative aims at enhancing the investment and business environment and at simplifying investment processes across all economic sectors. A key objective is to increase the involvement of developing and least-developed members in global investment flows. We use this as an opportunity to study the nexus between investments and development.

More specifically, this note explores the dynamic relationships between foreign direct investment (FDI), international trade, and economic development. First, it underscores how FDI and trade are mutually reinforcing, particularly in the context of GVCs and the role played by multinational enterprises. Then, it highlights how this intertwined relationship is reflected in the convergence of investment and trade policies, pointing out the impact of Bilateral Investment Treaties (BITs) on trade flows and the increasing inclusion of investment provisions in Regional Trade Agreements (RTAs). Third, examining global FDI trends, it shows that developing and emerging economies are still lagging, but they are fast growing in importance. Finally, it draws on a rich empirical literature to show how FDI drives economic development through knowledge spillovers, technology transfer, and export upgrading.

## 2 FOREIGN DIRECT INVESTMENT AND INTERNATIONAL TRADE ARE INTERTWINED

When a foreign entity constructs a new production facility in home or gains control of an existing local firm it undertakes foreign direct investment. In such relationships, the foreign parent company controls productive facilities of home affiliates. FDI thus gives rise to multinational enterprises (MNE) who own and control production facilities or other income-generating assets in at least two economies. This generates a complex and intertwined relationship between trade and FDI.

The two economic flows can be, in principle, both substitutes and complements. The substitutability effect might occur in presence of prohibitive or extremely high trade costs. Multinational firms, seeking to overcome high tariffs, transport costs and other trade costs, instead of exporting could replicate themselves around the world to serve customers locally. This so called **horizontal FDI** consists of investment in production facilities abroad to produce the same goods and services as those produced at home to serve the host foreign market (Markusen, 1984). To the extent that local production in the host economy replaces exports from the home economy, FDI and trade might be substitutes. On the other hand, the decline in trade costs has enabled firms to organise and spread

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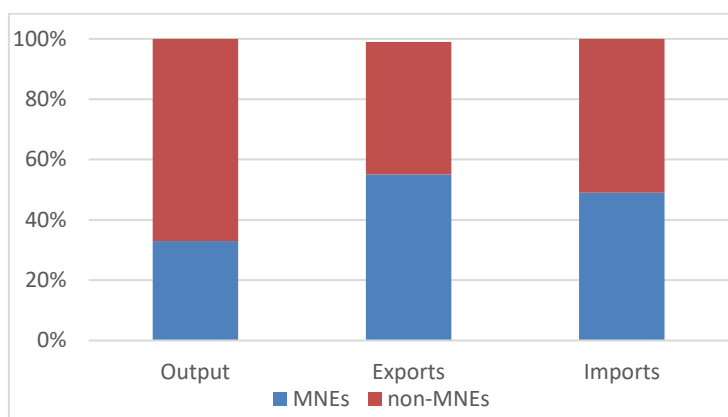
<sup>3</sup> This note has been prepared in response to a request by the co-coordinators of the Joint Statement Initiative (JSI) on Investment Facilitation for Development.

their production processes around the world, giving rise to complex global value chains. This so called **vertical FDI** seeks to improve operational and capital efficiency by gaining access to intermediate inputs, raw materials, or labour (Desai, 2009) around the globe. In this context, trade and FDI are complement.

In practice, and increasingly, FDI and trade are viewed as being complements (Helpman, 1984). The rise of global value chains has boosted trade in capital goods as well as intermediate goods and services (Yi, 2003; Amiti and Wei, 2005). Johnson and Noguera (2012) estimates that trade in intermediate inputs accounts for as much as two thirds of international trade. MNEs affiliates tend to rely on supply of intermediate inputs from their headquarters or from other affiliates located in third economies, increasing the host economy's imports and exports. The complementarity arises even in presence of horizontal FDI. This may be because affiliates or subsidiaries are used as “export platforms” – that is, investment in production capacity results in exports from that economy to other markets in its proximity (Grossman et al., 2006).

Given that multinational enterprises account for around half of world exports, deciding where to invest is simultaneously deciding from where to trade (OECD, 2018). This strong relationship between trade and investments stems from the fact that they mutually support and reinforce each other: investment liberalization, promotion and protection is perceived to be a crucial tool to facilitate and foster trade.<sup>4</sup> Simultaneously, deeper trade relationships encourage further investment flows across economies.<sup>5</sup>

**Figure 1: Importance of MNEs in the global economy, 2014**



Source: OECD (2018)

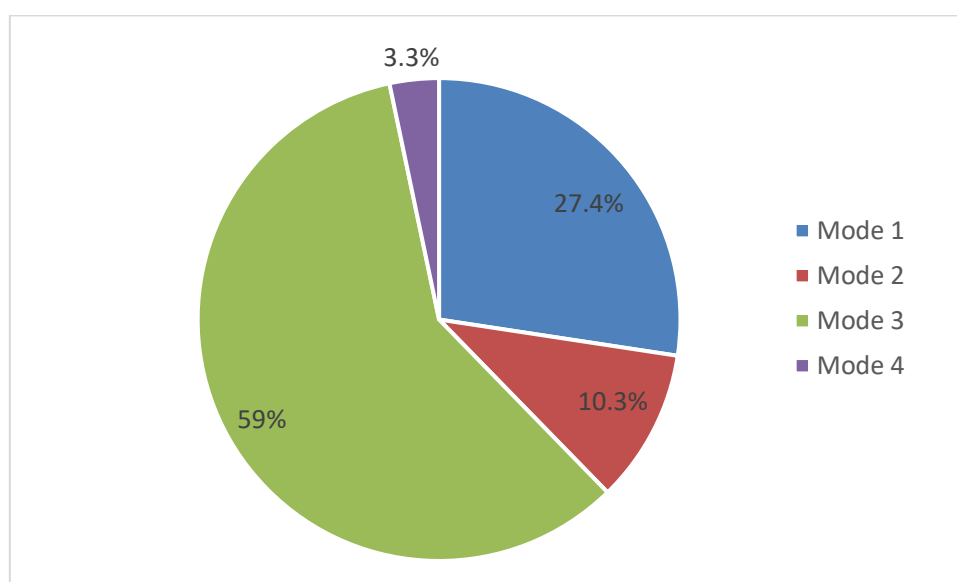
<sup>4</sup> Many papers have shown the predominant role played by multinational firms in global output and global trade (Bernard et al., 2009; OECD, 2018; Tintelnot, 2017)

<sup>5</sup> For example, Conconi et al. (2016), show that most firms serve a market via exports before engaging in FDI and investing there.

Evidence from particular sectors and economies supports the overall complementarity between trade and FDI. The trade orientation of FDI is well represented in the development experience of China and Viet Nam. At its peak in 2005, MNEs accounted for 58 per cent of China's exports. As local companies started to serve more and more global demand the share dropped to 34 per cent in 2021 (Zipser et al., 2021). In Viet Nam, MNEs accounted for around 70 per cent of imports and exports in 2021 (IFC and WTO, 2023). Other examples include Cambodia where 90 per cent of enterprises in the garment sector - Cambodia's main export sector - are under foreign ownership (IFC and WTO, 2023).

FDI plays also a crucial role in supplying services to foreign consumers. Sales through the establishment of foreign controlled affiliates worldwide (mode 3) are the dominant mode for trading services globally. In an unchanged pattern since 2005, commercial presence accounts for more than half (59 per cent) of global services trade.

**Figure 2: World trade in commercial services by mode of supply, 2019**



Source: WTO estimates

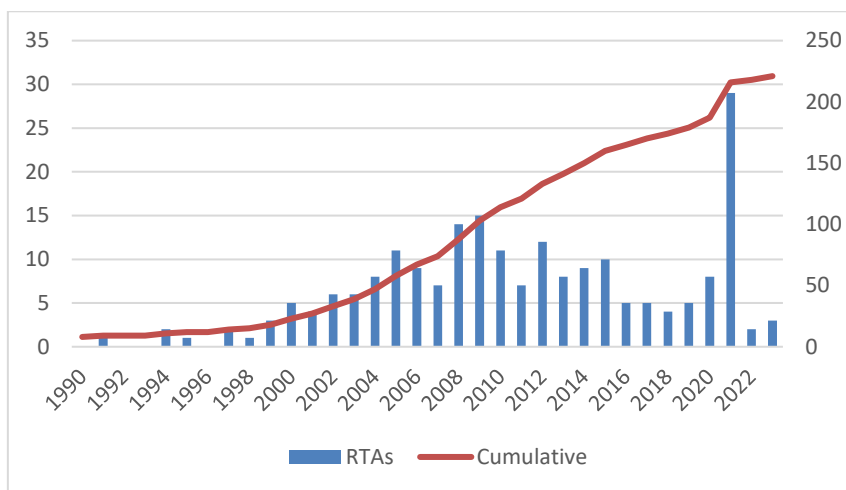
Note: The four modes of supply in services trade are: cross-border transactions (Mode 1); consumption abroad (Mode 2); commercial presence in another economy (Mode 3); presence of individuals in another economy (Mode 4)

### 3 INVESTMENT POLICY IS INCREASINGLY INTEGRATED WITH TRADE POLICY

In the last 60 years, world economies have created an extensive network of investment treaties that govern and protect international investments. These treaties were conceived to cover mainly the investment aspects of bilateral relationships. However, recent studies have shown that Bilateral Investment Treaties (BIT) have also a strong impact on bilateral trade flows (Heid and Vozzo, 2020). The emergence of GVCs has motivated trade negotiators to gradually incorporate an extensive range

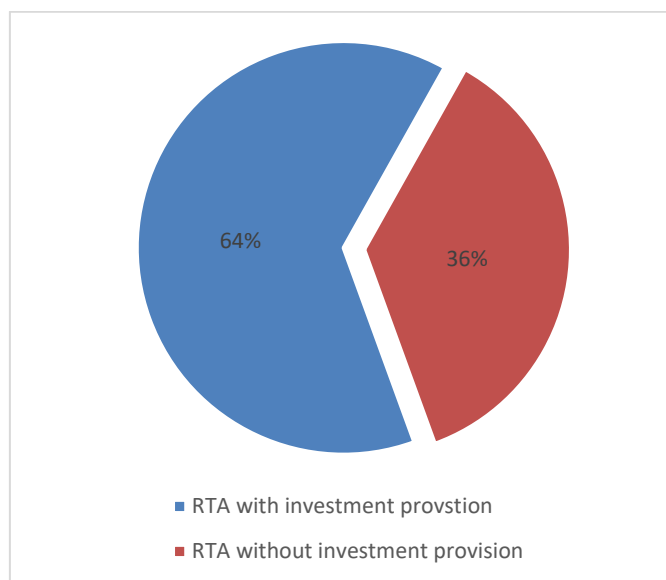
of investment clauses - provisions that liberalize, protect, and regulate investments - into Regional Trade Agreements (RTAs), and to reflect, within trade policies, the strong interlink between trade and investment. Consequently, this convergence of investment and trade policy has merged the traditional investment protection components found in bilateral investment treaties (BITs) with the trade liberalization elements inherent in RTAs. The number of investment provisions included in RTAs have steadily increased over time.

**Figure 3: The number of RTAs with at least one Investment Provision<sup>6</sup>**



Source: WTO Regional Trade Agreements Database

**Figure 4: RTAs with an Investment Provision, share of RTAs in force in 2023**

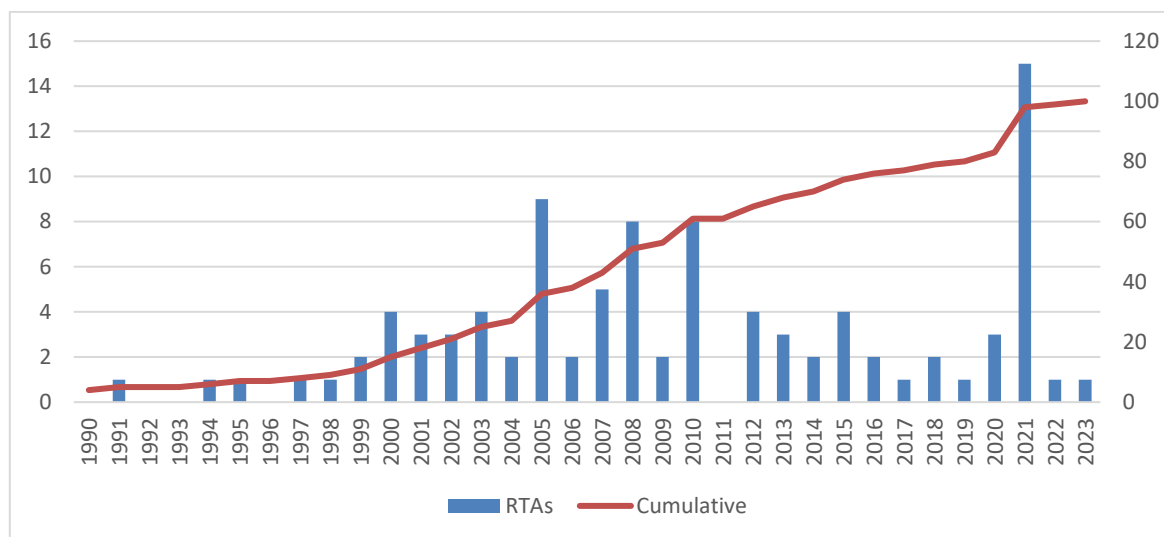


Source: WTO Regional Trade Agreements Database

<sup>6</sup> Investment provisions include: Liberalization, Promotion, Protection and/or Investor to State Dispute Settlement (ISDS)

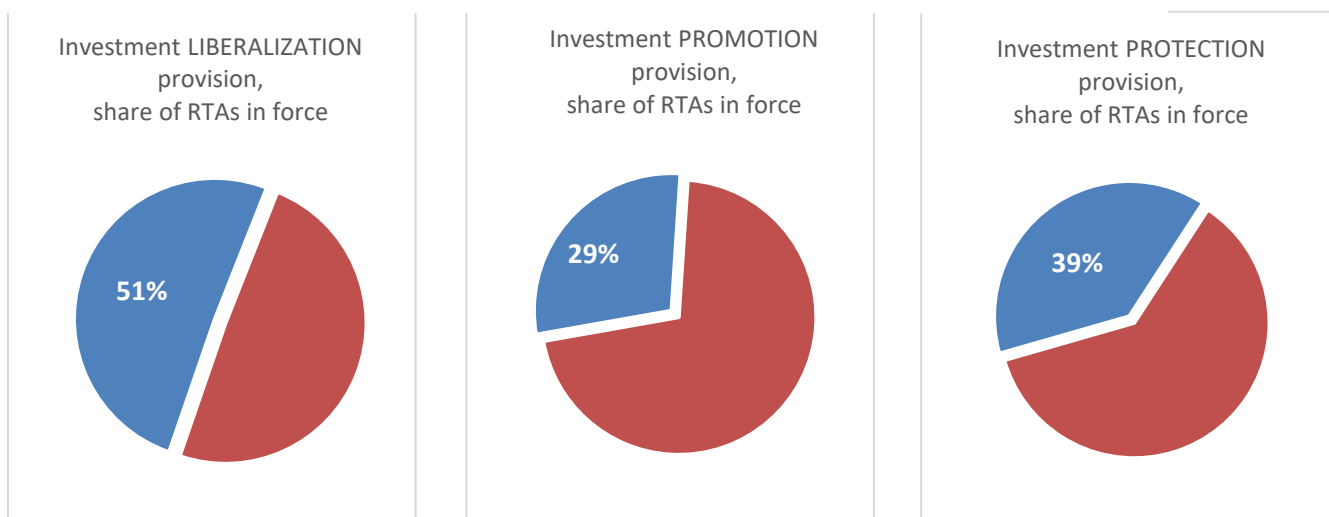
Even specific investment promotion provisions are increasingly included in RTAs. It is interesting to note that one third of active RTAs have explicit investment promotion provisions (and a half of them have investment liberalization provisions), while almost two thirds of active RTAs include some kind of investment provisions.

**Figure 5: The number of RTAs with Investment Promotion Provision**



Source: WTO Regional Trade Agreements Database

**Figure 6: RTAs with specific investment provisions, share of RTAs in force in 2023**



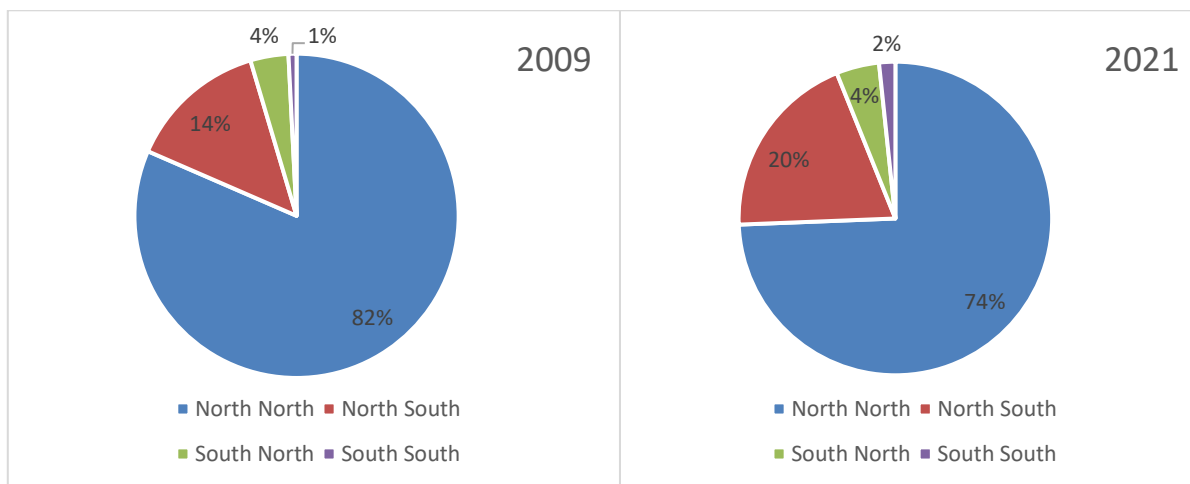
Source: WTO Regional Trade Agreements Database



#### 4 THE GROWING ROLE OF DEVELOPING ECONOMIES IN GLOBAL FDI

Most FDI is still among high-income economies. Data from the IMF confirms that FDI stocks among high-income economies account for roughly three quarters of all FDI stocks. Low- and middle-income economies host only 22 per cent of global FDI stock despite accounting for 38 per cent of global GDP.

**Figure 7: FDI stock by source and destination**

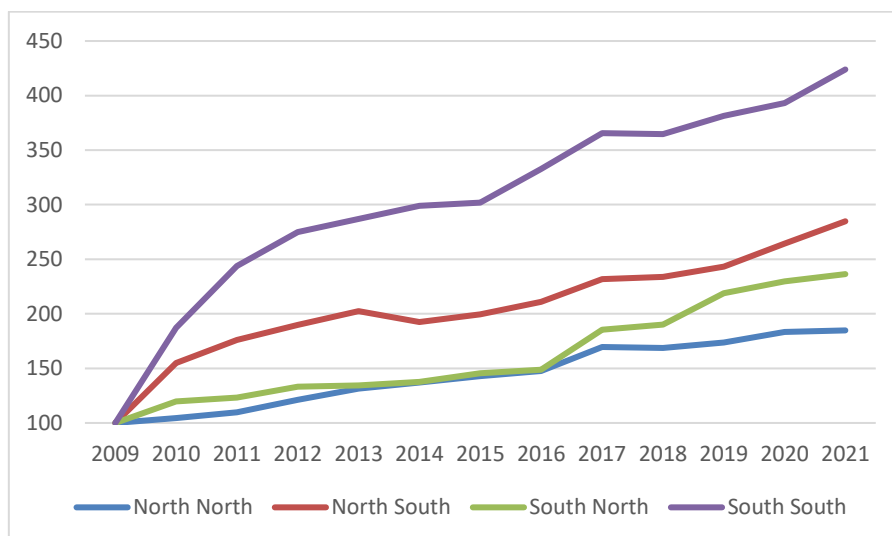


Source: WTO based on Coordinated Direct Investment Survey (CDIS) - IMF Data

Note: "North" refers to high-income economies. "South" refers to upper-middle-income, lower-middle-income, and low-income economies.

But the role of developing and emerging economies is increasing. Over the last 10 years, the stock of FDI from high-income to low- and middle-income economies grew more than twice as fast (185%) than the one among high-income economies ("only" 85%). And while FDI among low- and middle-income economies still represents the lowest stock of FDI, it experienced a growth of 324% over the last 10 years.

**Figure 8: FDI stock by source and destination (growth rate, 2009=100)**



Source: WTO based on Coordinated Direct Investment Survey (CDIS) - IMF Data

Note: "North" refers to high-income economies. "South" refers to upper-middle-income, lower-middle-income, and low-income economies.

Data from UNCTAD<sup>7</sup> - on FDI flows rather than FDI stocks - also confirm this reverse in the trend, and the growing importance of developing and emerging economies. In 2019, and in the subsequent years, FDI flows towards developing economies exceeded the flows towards developed ones.

## 5 FOREIGN DIRECT INVESTMENT ACCELERATES ECONOMIC DEVELOPMENT

FDI can play an important role in accelerating the host economy's economic growth and upgrading its economic structure. Foreign firms bring intangible assets such as new production processes, management know-how and established brand names. They also bring skills and help the diffusion of knowledge through employee training. MNEs' global production networks provide access to major markets and to imported intermediate inputs. This has a potential to increase productivity and innovation in the host economies, leading to higher output, quality upgrading, and better employment.

MNEs have high productivity, engage in innovation, face lower financial constraints, and operate with modern technologies. **MNE affiliates** in developing economies typically share these characteristics, at least when compared to other local firms. Empirical evidence also shows that acquisition by a foreign company improves firm performance. For instance, Arnold and Javorcik (2009) find that receiving FDI enhanced the productivity of Indonesian plants and their integration into the global economy through increased export intensity and greater reliance on imports of intermediate inputs. Similar evidence from China shows how foreign acquired firms improved their productivity, sales and investment (Liu et al., 2017). Evidence also suggests that high levels of FDI

<sup>7</sup> UNCTAD (2023): World Investment Report

in the automotive industry contributed significantly to the Czech Republic's and Slovak Republic's supply capacity and to their exports to third markets (Economist Intelligence Unit, 2010; Jakubiak et al., 2009). Shedding light on the channels through which foreign ownership boosts performance, evidence from Indonesian plants suggests that the benefits of foreign ownership are driven by continuous supply of headquarter services from the foreign parent (Javorcik and Poelhekke, 2017). Studying cases where foreign-owned plants were sold to local owners, the authors document a drop in productivity and a subsequent decline in output, profitability and trade participation of the divested plants.

An extensive body of literature looks at the potential of FDI to boost economic performance by improving the productivity of locally owned firms. Supply chain linkages between MNEs and local firms are viewed as the most promising channel (Alfaro, 2017). The presence of foreign firms **in the upstream industries** may provide local producers with more diverse and higher quality intermediates and capital goods and in this way allow them to increase their productivity, upgrade the quality of their products, and broaden their product range. For instance, based on interviews with Mexican firms producing detergents, Javorcik et al. (2008) report that input suppliers, often foreign affiliates, are the primary channel through which locally owned producers in the industry obtain access to innovations. This channel is supported by rich evidence from the trade literature that shows the importance of access to diverse and high-quality inputs for productivity, export quality and product scope (e.g., Amiti and Konings, 2007; Bas and Strauss-Kahn, 2015; and Goldberg et al., 2010).

MNEs **in the downstream industries** may provide their local suppliers with expertise, training and incentives for quality improvements and possibly even cooperate on development of new and higher quality products. Many MNEs subject their potential suppliers to technical audits and require improvements in performance or product quality as a pre-condition for receiving a contract. For instance, a survey among Czech manufacturing firms analysed by Javorcik (2008) shows that 40% of local suppliers receive some kind of assistance from their MNE customers, including personnel training, provision of inputs, help with quality assurance and help with finding export opportunities. Even more remarkably, 50% of domestic firms selling to MNEs report they have had to improve product quality in order to become suppliers. The resulting product upgrading and improved performance may then be reflected not only in the local firms' sales to the MNEs but also in their exports.

Surveying an older vintage of empirical studies, Havránek and Iršová (2011) concluded that there are economically significant improvements in productivity of local suppliers to MNEs, whereas the improvements of local buyers from MNEs are statistically significant but small. They also find that economies open to international trade and economies with underdeveloped financial systems benefit more. The studies surveyed include evidence for direct technology transfer from multinational affiliates to their local suppliers in Lithuania and for technology upgrading due to higher quality requirements on intermediate inputs from domestic suppliers in Indonesia (Javorcik, 2004; Blalock and Gertler, 2008).

More recently, studies based on detailed firm and transaction level data provide further evidence of these channels. Using firm level data from Romania, Bajgar and Javorcik (2020) document a positive relationship between the quality of products exported by local firms and the presence of MNEs in the upstream industries. Furthermore, Javorcik et al. (2017) show that Turkish firms in sectors and regions more likely to supply foreign affiliates tend to introduce more complex products. Using detailed transaction data from Costa Rica, Alfaro-Ureña et al. (2022) show that domestic firms experience strong and persistent gains in employment and productivity after they start supplying a MNE customer.

The impact of MNE presence on local firms operating **in the same industry** is in theory ambiguous. The competition from foreign affiliates may squeeze the sales of local firms, and push some out of the market. Foreign affiliates may also compete with local firms for resources, including labour, capital and intermediate inputs. On the other hand, the increased competition may motivate local firms to improve their productivity and upgrade their products. Moreover, either by observing the foreign firms or through hiring former MNE employees, local firms may learn about procedures that improve the quality and standardisation of their products, their marketing skills, and reliability of their shipments. Finally, domestic firms may also learn about the profitability of various export opportunities by observing their foreign peers' exports, and this knowledge may persuade them to make investments into quality upgrading, developing new products or even moving to different broad product categories. The marketing, distribution and delivery capabilities created by FDI in one product might enable the home economy to export all its final products that would not reach customers in the foreign market in the absence of FDI (Blonigen, 2001).

Evidence based on firm-level data suggests that MNE competition in output markets can motivate local firms to improve performance. Iacovone et al. (2011) find that following the entry of Walmart on the Mexican retail market, local Mexican retailers started to adopt advanced technologies, such as a temperature-controlled supply chain, in order to catch up. Similarly, evidence from Ethiopian manufacturing firms suggests that MNE competition motivates local firms to increase their productivity, which is primarily driven by technology upgrading (Abebe et al., 2022).

Studies using matched employer–employee data help shed light on the labour mobility channel and provide evidence consistent with knowledge spillovers through employees that worked for a MNE and subsequently moved to a local firm (Poole, 2013; Balsvik, 2011). Knowledge spillovers are also documented in the case of Intel's FDI in Costa Rica. Intel invested heavily in the training of its employees, leading to learning-by-doing and even the creation of several new firms. Intel also collaborated with public universities to improve their curriculum and teacher training in technical fields (Rodríguez-Clare, 2001). Evidence also suggests that MNEs help develop a better supplier base. As discussed above, local suppliers of MNEs improve their productivity as well as product quality and variety. A study of Bangladesh's garment sector suggests that these improvements benefit also local firms that share suppliers with MNEs, leading to product scope expansion and higher productivity (Kee, 2015).

Finally, firm-level studies also find support for increased exports and export upgrading thanks to the presence of FDI. Aitken et al. (1997) demonstrate that the presence of exporting MNEs in the same region reduces the costs of exporting for all Mexican firms. Using detailed Chinese trade statistics, Swenson and Chen (2012) find that MNE presence is associated with more and higher unit value trade transactions by Chinese firms in the same sector, while Swenson (2008) shows that it stimulates new export connections by Chinese exporters. Using cross-country data, Harding and Javorcik (2012) find that sectors in developing economies targeted by national investment promotion efforts tend to subsequently increase the unit values of exports.

## **6 CONCLUSIONS**

In this note we explored the dynamic relationships between foreign direct investment (FDI), international trade, and economic development. Trade and cross-border investment are crucial drivers of technology diffusion, development and economic growth. The increasing interconnectedness of the global economy, the organisation of production processes across economies, and the emergence of global value chains (GVC) has led to an even closer integration of trade and investments, which are mutually reinforcing. Companies operate on a global scale, and investments are made with an awareness of the potential for cross-border trade.

Research suggests that improving domestic conditions should have the dual effect of attracting foreign investment and enabling host economies to maximize the benefits of foreign investment (Alfaro, 2017). Spillovers from foreign to domestic firms depend on the domestic firms' ability to respond successfully to new opportunities, new technology, and new competition. That success is, to some extent, determined by local characteristics such as skills of the workforce and development of local financial markets as well as the overall institutional quality and the transparency of regulatory environment. Improvements in these areas encourage FDI and, at the same time, enhance the capacity of domestic industries to absorb new technologies and respond to the challenges and opportunities presented by foreign entrants.

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