Does domestic financial development enhance the linkages between foreign direct investment and economic growth?

Chee-Keong Choong

Received: 29 July 2009 / Accepted: 30 November 2010 / Published online: 20 March 2011 © Springer-Verlag 2011

Abstract The study examines the relationship between foreign direct investment (FDI), financial development, and economic growth in a panel of 95 developed and developing countries from 1983 to 2006. The study moves away from the traditional cross-sectional analysis, and focuses on more direct evidence of the channels via which FDI might help or retard economic growth. Using generalized method of moment (GMM) panel data analysis, we find strong evidence of a positive relationship between FDI inflows into a country and its economic performance. We also find evidence that domestic financial system is a significant prerequisite for FDI to have a positive effect on economic growth. Policy implications are clear. Effort should be made to reform and improve the development of domestic financial system in order to benefit more from the presence of FDI.

Keywords Foreign direct investment · Financial development · Economic growth · Panel data analysis

JEL Classification F21 · F34

1 Introduction

There is increasing empirical literature focused on the relationship between foreign direct investment (FDI) and economic growth and have consistently shown that FDI
is a crucial catalyst of economic development. The advantages of FDI are considered to be twofold. First, FDI can promote economic growth through spillover effects such as technological change, improved efficiency of locally owned firms via contract and demonstration effects, capital accumulation, human resources augmentation and development (human skills and employment), and expanded international trade (De Mello 1997; Blomstrom and Kokko 1998; Todo 2003; Basu and Guariglia 2007). Second, FDI flow tends to be more stable compared to other private capital flows, as FDI is purportedly more costly to reverse and less sensitive to regional and global crises (Lipsey 1999).

However, a number of studies do not find any significant unqualified statistical relationships between FDI and economic growth (Grilli and Milesi-Ferretti 1995; Aitken et al. 1997; Aitken and Harrison 1999; Mencinger 2003; Carkovic and Levine 2005). For example, Aitken and Harrison (1999) find that the effect of FDI on productivity is quite small in Venezuela between 1979 and 1989; that is, FDI raises productivity within plants that receive the investment but lowers that of domestically owned plants. Similarly, Haddad and Harrison (1993), and Carkovic and Levine (2005) find little support that FDI has an exogenous positive effect on economic growth. Recently, Ghosh (2003) argues that although private capital flows are conducive to economic performance, these flows also may generate the problem of macroeconomic vulnerability and financial instability. Whereas, Kosack and Tobin (2006) show that, both theoretically and empirically, foreign aid and FDI affect economic growth in poorer countries differently and they conclude that the poorer countries need more foreign aid than FDI in promoting economic growth.

Rather, some studies argue whether FDI promoting economic growth is contingent on the country-specific characteristics, or absorptive capacity. For instance, De Mello (1997) shows that there are a number of factors, which can influence the absorptive capacity of recipient countries to successfully harness FDI toward sustained economic expansion. Also, Blomstrom et al. (1992) find that the initial level of development helps determine the absorptive capacity of a recipient, and Balasubramanyam et al. (1996) and Borensztein et al. (1998) argue that trade policy and human capital development significantly enhance the connection between FDI and economic development, respectively. Indeed, Baltagi et al. (2007, 2008) find that the role of FDI is significantly influenced by the third countries effects and the complex integration strategies of multinationals, especially the bilateral trade costs among host countries. Baltagi et al. (2007, p 273), for example, argue that “… These policies [investment liberalization, training programs, and other FDI-attracting policies] can only be effective if a country is not too remote from large foreign consumer bases.” Hence, are the effects of FDI contingent on the absorptive capacity of recipient countries, with particular respect to domestic financial system?

1 See De Mello (1997, 1999) for a comprehensive review of the relationship between FDI and economic growth, and Blonigen (2006) for a recent comprehensive survey of empirical studies for determinants of FDI.

2 See Buckley et al. (2002) and Akinlo (2003) for a comprehensive survey on the channels via which FDI may affect (positively or negatively) economic performance.