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Foreign direct investment and growth under economic integration

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Abstract

This paper studies foreign direct investment (FDI) and economic growth in a two-country endogenous growth model. Starting with a core-periphery steady state in the world, the model shows that economic integration gives rise to FDI, leads to an expansion of R&D activity in the industrial core, and increases the world growth rate. In that process, the peripheral country enjoys a rise in the level of living standards. The model suggests that the often-observed positive correlation between inward FDI and economic growth does not necessarily imply any causal relationship—both of them respond endogenously to economic integration.

Keywords: Endogenous growth; Agglomeration; Economic integration; Foreign direct investment; Trade costs

JEL classification: F21; F43; O31; R12

1. Introduction

There is no doubt that foreign direct investment (FDI) is an important aspect of the recent wave of globalization. According to UNCTAD (2001), FDI inflows in the world

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rose from $57 billion in 1982 to $1271 billion in 2000. In the past few decades, the growth rate of world FDI exceeded both the growth rates of world trade and GDP. Although a large portion of world FDI is hosted by developed economies, FDI flowing into developing countries also increased at a rapid pace over the years, rising from an annual average of $13.1 billion for 1981–1985 to $240.2 billion in 2000 (UNCTAD, 1994, 2001).

Much of the rise in global FDI can be attributed to economic integration-falling barriers to international investment and trade. It has been well documented that communication and transportation costs have been decreasing considerably in the last few decades (see, for example, Dollar, 2001). Tariffs have also been reduced significantly through several rounds of multilateral negotiations under the GATT and trade policy initiatives by individual or groups of countries (Clemens and Williamson, 2002). These developments certainly help multinational firms manage production across borders and reduce the costs of intra- and inter-firm trade.

Furthermore, the attitude of policy makers towards inward FDI has been turning increasingly positive in recent years, and this has been reflected in changes in FDI policy (UNCTAD, 1998). It is especially true for developing countries. Many now believe that FDI brings capital to the host country and helps create jobs. FDI is also viewed as an important source of technology-FDI transfers advanced technologies and management to the host economy, and improves the skills of local workers through training.

In light of these potential benefits, researchers have begun investigating the role of FDI in economic growth. Blomström et al. (1994) and Borensztein et al. (1998) examine empirically the role of FDI in economic growth in a cross section of countries and find evidence that FDI promotes growth under certain conditions.[1] In a related field, studies of the determinants of inward FDI from the host country perspective often point to rapid actual or potential growth in the host economy as one of the factors that attract FDI (e.g., Lipsey, 2000; UNCTAD, 1998; and a number of papers cited in Chakrabati, 2001). The observation of large FDI inflows into several fast-growing East and Southeast Asian economies seems to be consistent with this notion.

This raises a question about the relationship between FDI and growth: Does growth cause FDI, or the other way around? In this paper, I present a novel point of view: both FDI and growth respond endogenously to a fundamental change in the world economy–economic integration. Specifically, I construct a two-country model in which FDI and growth are endogenous. The model is a hybrid of an endogenous growth model and an economic geography model. The growth element of the model closely follows Grossman and Helpman (1991). Due to knowledge spillovers, positive growth can be sustained through ceaseless expansion of product varieties. In addition, I assume demand and cost linkages in manufacturing production in the spirit of Krugman and Venables (1995)—manufacturing firms use the manufacturing composite as an intermediate input in their production. These linkages, along with trade costs and firm-level scale economies, give rise to an endogenous spacial distribution of manufacturing.

I show in this model that beginning with an asymmetric steady state (long-run equilibrium) of manufacturing agglomeration where both research and development

[1] There is also a growing empirical literature on the productivity effects of FDI at the firm level (e.g., Aitken and Harrison, 1999).