



# Investment, trade openness and foreign direct investment: Social capability matters

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## ARTICLE INFO

Available online 21 August 2012

JEL classification:

C21

F43

O11

Keywords:

Trade openness

Foreign direct investment

Investment

Social capability

Instrumental variable threshold regressions

## ABSTRACT

This paper investigates whether the impacts of trade and foreign direct investment (FDI) on domestic investment depend upon social capability of a country. Applying the instrumental variable threshold regressions approach to cross-sectional data for 85 countries, it finds that social capability such as human capital, financial development, and political institutions defines the impacts of trade and FDI on domestic investment. Particularly, trade adversely affects investment in low-human-capital, less-financially-developed, or more-corrupted countries, but positively affects it in countries with opposite attributes. In contrast, FDI has a positive effect on investment in countries with low human capital, less-developed financial sectors, or high corruption, but a negative impact in countries with opposite attributes.

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## 1. Introduction

Trade and foreign direct investment (FDI) are considered as important openness strategies in promoting economic growth, especially for developing countries, despite that the exact relationships of growth with trade and FDI are yet far from being incontrovertible. This paper attempts to change the direction of the debate by focusing on the impacts of trade and FDI on domestic investment, instead of economic growth. The emphasis on domestic investment is motivated by three observations. First, investment is an essential element of aggregate demand and fluctuations in investment have substantial effects on economic activities and long-term economic growth. Second, the extent to which FDI enhances economic growth depends upon the degree of complementarity and substitutability between FDI and domestic investment. As claimed by *de Mello (1999)*, some degree of complementarity is required for FDI to contribute to economic growth. Third, a question as to whether trade's contribution to economic growth and development works through physical capital accumulation or productivity growth remains unsolved. Therefore, identifying the role of trade and FDI in domestic investment helps clarify the influence of globalization on the growth process, and hence shape relevant policies and institutional reforms.

The literature on FDI and domestic investment suggests that FDI may crowd in domestic investment by providing scarce capital and hence relaxing firms' financial constraints (*Stiglitz, 2001*), by increasing productivity through externalities and spillovers of managerial and technological know-how (*Borensztein, De Gregorio, & Lee, 1998; de Mello, 1999*), and by creating a demonstration effect on the direction of investment (*Wen, 2007*). However, FDI may displace domestic investment if multinational firms borrow heavily from domestic credit markets and compete for limited investment opportunities in the host countries (*Feldstein, 2000*), if

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new technologies embodied in FDI accelerate technological obsolescence of traditional technologies (Young, 1993), or if policies offering preferential tax treatment and other incentives to induce FDI inflows introduce significant distortions between the returns to foreign and domestic capital (Easterly, 1993).<sup>1</sup>

Meanwhile, the literature on trade liberalization suggests that the liberalization fosters domestic investment by allowing domestic agents to import relatively cheaper and more efficient capital goods, thereby removing structural constraints on investment and increasing efficiency of capital accumulation (Baldwin & Seghezza, 1996; Lee, 1995). Openness to trade also stimulates domestic investment by encouraging competition in domestic and international markets and generating higher returns on investment through economies of scale (Eicher, 1999; Lee, 1993; Young, 1991). But opposing arguments are not hard to build. If market or institutional imperfection exists, trade openness can lead to under-utilization of human and capital resources, concentration in extractive economic activities, or specialization away from technologically advanced, increasing-return sectors.<sup>2</sup>

Inconclusive results might indicate that trade and FDI are not among the primary determinants of domestic investment. Another possibility, however, is that trade (FDI) might have a nonlinear or even non-monotonic impact on domestic investment. A large macro literature finds evidence of an exogenous positive effect of trade (FDI) on economic growth only when the economies have reached certain threshold of social capability (Abramovitz, 1986),<sup>3</sup> either because of the technological constraints or because certain complementary reforms of institutions and appropriate macroeconomic management are prerequisite for a country to benefit from openness. In terms of trade, for example, Dowrick and Golley (2004) and Kim and Lin (2009) emphasize real GDP per capita, Bhattacharyya, Dowrick, and Golley (2009) focus on institutional development, Borrmann, Busse, and Neuhaus (2006) and Freund and Bolaky (2008) highlight labor market flexibility and government regulation, respectively, while Chang, Kaltani, and Loayza (2009) provide evidence of policy and institutions in defining the link between trade and growth. Likewise, several cross-country studies conclude that FDI leads to economic growth only when host countries have sufficient levels of human capital (Borensztein et al., 1998; Wang & Wong, 2009; Xu, 2000), per-capita income (Blomstrom, Lipsey, & Zejan, 1992), trade openness (Balasubramanyam, Salisu, & Sapsford, 1996), or domestic financial institutions (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004, 2010; Alfaro, Chanda, & Sayek, 2009), among others.

Along the same line, we investigate whether the link between domestic investment and trade (FDI) are regime specific, depending upon social capability of the local economy, with specific reference on human capital, financial development, and governance. The importance of human capital presumably relates to the ability of a highly skilled workforce to absorb and adopt new technology and knowledge embodied in foreign investment or imported capital goods (Abramovitz, 1986; Benhabib & Spiegel, 2005; Borensztein et al., 1998; Cohen & Levinthal, 1989; Kneller, 2005; Kneller & Stevens, 2006). Well-developed financial markets are crucial to facilitating investments, by creating economies of scale for investors and allocating capital to its most productive use. Moreover, in Alfaro et al. (2004), well-developed financial markets can efficiently create backward-linkages between foreign firms and domestic firms in upstream industries in the host country. As a result, the existence of foreign firms will increase the domestic investment in upstream industries. Well-developed financial markets also enable domestic firms and entrepreneurs to capitalize with new multinationals (Alfaro et al., 2010). Better governance should get prices right by providing appropriate incentives for agents to invest in growth-enhancing innovations, as they can be assured that they will reap the reward of their effort. Corruption may also induce under-investment in public capital (Del Monte & Papagni, 2001).

Additionally, unlike most of the previous studies that treat trade and FDI separately, we model trade and FDI in a regression exploring the effects of globalization on domestic investment. Since prior research indicates both positive and negative influences of FDI on trade (e.g., Aizenmam & Noy, 2006; Blonigen, 2005), omitting trade or FDI variable makes it difficult to assess whether the significant relationship between domestic investment and trade (FDI) holds when controlling for FDI (trade), whether each has an independent impact on domestic investment, or whether overall openness matters for domestic investment but it is difficult to identify the separate impact of trade and FDI. This paper thus brings two strands of literature together, the one on the trade-investment link and the other on the FDI-investment nexus, and addresses how globalization determines domestic investment.

More importantly, to evaluate whether the relationships of domestic investment with trade and FDI are regime specific, this paper uses the instrumental variable threshold regressions approach proposed by Caner and Hansen (2004). This methodology allows us to deal with the endogeneity of trade openness and FDI so as to concentrate on the causal effects of the exogenous components of international trade and FDI and uncover potential nonlinear threshold effects on the nexuses. And it does not split the sample of countries according to some predetermined rule, but allows the data to determine which regime a country belongs to. Moreover, the threshold methodology allows all parameters of the model to discretely differ across regimes, which

<sup>1</sup> The empirical literature is also diverse. Studies reporting strongly positive effects of FDI on domestic investment include Van Loo (1977), Noorzoy (1979), Jansen (1995), Sun (1998), Bosworth and Collins (1999), Harrison, Love, and McMillan (2004), Tang, Selvanathan, and Selvanathan (2008), and Ang (2009). But others point to little effects (e.g., Alfaro et al., 2009; Bonfiglioli, 2008; Borensztein et al., 1998; Devereux & Freeman, 1995) or negative impacts of FDI on domestic investment (Harrison & McMillan, 2003; Lipsey, 2000).

<sup>2</sup> Such theoretical ambiguity on the effects of trade openness is reflected in the empirical literature as well. Some papers point to strongly positive effects of trade on domestic investment (Balasubramanyam et al., 1996; Bleaney, 1996; Harrison, 1996; Levine & Renelt, 1992; Salahuddin & Islam, 2008; Wacziarg, 2001) while others find negative effects (Rodrik, 1998; Serven, 2003).

<sup>3</sup> Other scholars refer to absorptive capacity (Cohen & Levinthal, 1989), technological capability (Kim, 1980), learning systems (Lundvall & Johnson, 1994), and capacity competitiveness (Fagerberg, Srholec, & Knell, 2007). These different labels describe similar underlying concepts (Fagerberg & Srholec, 2008), with a shared emphasis on trust and social capital, sound governmental and nongovernmental institutions, human capital development, and managerial and technical competence.

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