JEL Classification Numbers:
019, 040

Summary of
WP/94/110

"How Does Foreign Direct Investment Affect Economic Growth"
by Eduardo Borensztein, Jose De Gregorio and Jong-Wha Lee

Technology diffusion plays a central role in the process of economic development. Recent growth literature has highlighted the role of the process of "catching-up" with the technologies available in more advanced countries in explaining the rate of growth in developing countries. An important component of this process is foreign direct investment (FDI) by multinational corporations, which is a major channel for access to advanced technologies by developing countries.

This paper examines empirically the role of FDI in the process of technology diffusion and economic growth in developing countries. To motivate the empirical work, the paper develops a model of endogenous growth in which the rate of technological progress is the main determinant of the long-term growth rate of income. Technological progress takes place through a process of "capital deepening," in the form of the introduction of new varieties of capital goods. Multinational corporations possess more advanced "knowledge," which allows them to introduce new capital goods at lower cost. However, the application of these more advanced technologies also requires the presence of a sufficient level of human capital in the host economy. The stock of human capital in the host country, therefore, limits the absorptive capability of a developing country.

The paper tests the effect of FDI on economic growth in a cross-country regression framework, utilizing data on FDI flows from industrial countries to 69 developing countries over the past two decades. The results suggest that FDI is in fact an important vehicle for the transfer of technology, as it appears to contribute to growth in larger measure than domestic investment. Moreover, a fairly robust finding is that there is a strong complementarity between FDI and human capital, that is, the contribution of FDI to economic growth is enhanced by its interaction with the level of human capital in the host country.

The contribution of FDI to economic growth thus comprises two effects. First, the results suggest that although FDI has higher productivity than domestic investment, the higher productivity of FDI occurs only when the host country has a minimum threshold stock of human capital because of the importance of the interaction between FDI and human capital in the host economy. Second, FDI has the effect of increasing total investment in the economy more than one for one, which suggests the predominance of complementarity effects with domestic firms.