FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH NEXUS: AN ENDOGENOUS PERSPECTIVE

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ABSTRACT

This thesis provides a comprehensive theoretical analysis of the relationship between foreign direct investment (FDI) and economic growth within the framework of endogenous growth theory. The relevance of the study arises from the increasing importance of international capital flows as a driver of long-term economic development and structural transformation in the globalized economy. The primary objective is to examine the economic essence of FDI and to substantiate its role in promoting sustained economic growth through internal mechanisms such as innovation, human capital accumulation, and technological progress.

The research is grounded in modern theoretical approaches, including endogenous growth models, international production theory, and new economic geography. It explores the channels through which FDI contributes to productivity enhancement, knowledge spillovers, and efficiency gains, while also analyzing the conditions under which these effects are maximized. Particular attention is given to the role of absorptive capacity, institutional development, and innovation systems in mediating the FDI–growth relationship.

The findings suggest that FDI acts as a catalyst for economic growth by facilitating technology transfer, enhancing human capital, and stimulating innovation-driven development. However, its impact is conditional upon the structural characteristics of the host economy. It is concluded that strengthening domestic capabilities and fostering an innovation-oriented environment are essential for ensuring that FDI contributes effectively to long-term and sustainable economic growth.

Introduction

In the contemporary global economic system, foreign direct investment (FDI) has emerged as a central mechanism linking national economies to the international production

structure. As globalization intensifies, the mobility of capital, technology, and knowledge across borders has significantly increased, making FDI a crucial determinant of economic growth and development. Unlike portfolio investment, FDI involves long-term commitments and direct participation in production processes, thereby generating substantial effects on the host economy.

Traditional neoclassical growth models, particularly those associated with Robert M. Solow (1956), emphasize capital accumulation and exogenous technological progress as the main drivers of economic growth. However, these models fail to adequately explain the persistent differences in growth rates across countries. In response, endogenous growth theory emerged as a more comprehensive framework, highlighting the role of internal factors such as human capital, innovation, and knowledge accumulation.

Within this theoretical context, FDI is considered a key channel through which external resources contribute to internal growth dynamics. It enables the transfer of advanced technologies, managerial skills, and organizational practices, which enhance the productive capacity of the host economy. As argued by Paul M. Romer (1990), knowledge and innovation are central to long-term growth, and FDI plays a significant role in facilitating their diffusion across countries.

The importance of FDI is particularly pronounced in developing economies, where domestic resources are often insufficient to support rapid industrialization. In such contexts, FDI not only supplements domestic investment but also promotes integration into global value chains, thereby enhancing competitiveness and export performance.

This thesis aims to analyze the nexus between FDI and economic growth from an endogenous perspective, focusing on the mechanisms through which FDI influences growth and the conditions under which these effects are most significant.

Theoretical Essence and Economic Content of the FDI–Growth Nexus

The relationship between FDI and economic growth has been extensively explored within the framework of modern economic theory. From an endogenous perspective, economic growth is driven by internal factors, including human capital accumulation, innovation, and technological progress. FDI contributes to these processes by serving as a conduit for knowledge transfer and productivity enhancement.

According to Gene M. Grossman and Elhanan Helpman (1991), international trade and investment play a crucial role in the diffusion of technology and the expansion of productive capacity. Their models demonstrate that openness to foreign investment can accelerate growth by increasing access to advanced technologies.

Similarly, Robert J. Barro and Xavier Sala-i-Martin (2004) emphasize the importance of human capital and policy frameworks in determining growth outcomes. In this context, FDI enhances growth by complementing domestic investment and improving the efficiency of resource allocation.

The endogenous growth framework suggests that the benefits of FDI are not automatic but depend on the host country's capacity to absorb and utilize foreign technologies. This highlights the importance of education, research and development, and institutional quality in maximizing the growth effects of FDI.

Functional Role of FDI in Economic Growth

FDI influences economic growth through multiple channels. First, it increases capital accumulation by supplementing domestic savings and investment. Second, it facilitates technology transfer, enabling host countries to adopt more efficient production methods. Third, it promotes human capital development by providing training and skill enhancement opportunities for the local workforce.

At the firm level, foreign enterprises introduce advanced managerial practices and organizational structures, which improve productivity and competitiveness. These effects often spill over to domestic firms through imitation, competition, and labor mobility. As noted by Richard E. Caves (1996), multinational enterprises play a critical role in shaping industrial dynamics and promoting efficiency.

At the macro level, FDI contributes to economic diversification and structural transformation. It enables countries to shift from low-value-added activities to more sophisticated and technology-intensive sectors, thereby enhancing long-term growth prospects.

The Relationship between FDI, Innovation, and Productivity

Innovation and productivity are central components of endogenous growth theory, and FDI plays a significant role in enhancing both. By introducing new technologies and processes, foreign firms stimulate innovation within the host economy. This leads to increased productivity and improved economic performance.

Empirical and theoretical studies suggest that the presence of multinational corporations encourages domestic firms to invest in research and development, thereby fostering an innovation-driven growth process. Zvi Griliches (1998) emphasized the importance of knowledge spillovers in driving productivity growth, highlighting the role of external sources such as FDI.

However, the extent of these benefits depends on the absorptive capacity of the host economy. Countries with higher levels of education, stronger institutions, and more developed financial systems are better able to capture the positive effects of FDI.

The Importance of Absorptive Capacity and Structural Conditions

The concept of absorptive capacity is central to understanding the FDI–growth nexus. It refers to the ability of a country to effectively utilize external knowledge and technologies. According to Wesley M. Cohen and Daniel A. Levinthal (1990), absorptive capacity depends on prior knowledge, human capital, and institutional frameworks.

In the context of FDI, absorptive capacity determines whether foreign investment leads to positive spillovers or remains isolated within foreign-owned firms. Countries with weak institutions and limited human capital may fail to benefit fully from FDI, resulting in limited growth effects.

Structural conditions such as financial development, infrastructure, and trade openness also play a crucial role. These factors influence the efficiency of resource allocation and the integration of foreign firms into the domestic economy.

Conclusion

In conclusion, the relationship between foreign direct investment and economic growth is complex and multifaceted, reflecting the interaction between external capital flows and internal development mechanisms. From an endogenous growth perspective, FDI serves as a key driver of economic development by facilitating technology transfer, enhancing human capital, and promoting innovation.

The analysis demonstrates that the impact of FDI on economic growth is conditional upon the structural characteristics of the host economy, including its absorptive capacity, institutional quality, and level of technological development. Countries that invest in education, innovation, and institutional reform are more likely to benefit from FDI and achieve sustainable growth.

Under modern economic conditions, policymakers should focus on creating an enabling environment that supports innovation, strengthens human capital, and enhances institutional effectiveness. Such measures will ensure that FDI contributes not only to short-term economic expansion but also to long-term, sustainable development.

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