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The influence of FDI on economic development in China, South Korea and Japan using the Investment Development Path Theory

Topic and Research Question

The thesis examines the relationship between foreign direct investment (FDI) and economic development and seeks to trace the development paths and the current development status of China, South Korea and Japan by using the Investment Development Path (IDP) theory of John H. Dunning. The three countries appear to be in different stages of their development and have some similarities but also some different policies regarding FDI. Therefore they are interesting targets for a comparison and can be used as a test whether FDI is a possible indicator for economic development, as the IDP-theory by Dunning suggests. The specific research questions of this thesis are:

- On which stages of the Investment Development Path are China, South Korea and Japan?
- Is the IDP a useful tool for estimating and comparing the development stages of countries?

State of the Art

Many researchers have applied the IDP theory to examine the relationship between FDI and economic development. Buckley and Castro have used the IDP theory to analyze the relationship between FDI and per capita income in Portugal from 1943 to 1996. The results support the IDP. Bellak analyzed the IDP of Austria and found that Austria's NOI position has always been negative and does not follow the predicted IDP, even though it is economically more developed than many other European countries. Even the UNCTAD 2006 World Investment Report analyzed the emergence of MNCs in developing countries using the IDP theory. The results of the report supported the IDP theory. But UNCTAD also found out that some developing countries such as Brazil, China, India, Mexico, South Africa and Turkey produced OFDI earlier than expected according to the IDP.

Methodology and Approach

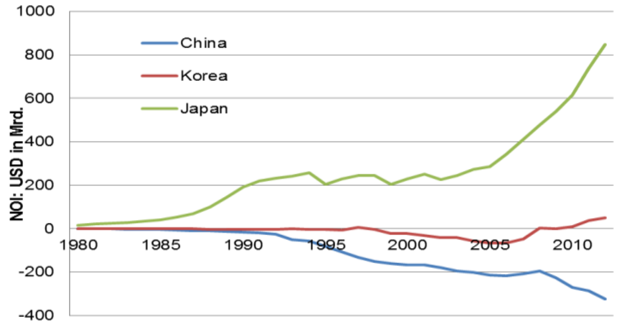
First the study examines different theories of economic development and draws the distinction between economic growth and development. Different indicators of economic development are discussed. The ingredients and sources that are needed for economic development are identified. FDI is a very good source as it provides several components needed for development at once (e.g. capital and technology). The pros and cons of FDI and its effect on economic development are examined. The framework of analysis is based on the IDP-theory and concentrates on the different characteristics of outward (OFDI) and inward FDI (IFDI) and the resulting net outward investment (NOI) in the different stages of the IDP. The height of the IFDI and OFDI stock are compared to determine the NOI position. Furthermore, the growth rates of IFDI and OFDI and the GDP per capita change over the various stages of the IDP. The study also considers the sectoral distribution of IFDI, as well as motivation, destination and sectoral distribution of OFDI.

	I	II	III	IV	V
NOI	0 → negative	Negative → closer 0	Positive	Positive	Around 0
Motivation of OFDI	-	Resource Market	Efficiency, Market, Strategic Asset	Efficiency, Strategic Asset	Efficiency, Strategic Asset
Sectoral distribution	Primary	Primary, labour-intensive industry	More complex industry, services	Knowledge-based, services	Knowledge-based, services
Destination/ countries	Regional/ developing	Regional and global /developing	Global/ both	Global/ developed	Global/ developed

Main Facts

In 1979 China allowed FDI for the first time. Since then the government has taken measures to make the country more attractive for investors, like the reform and opening-up policy. China is the 2nd largest target country for IFDI worldwide. Recently the government's priority is improving the quality of IFDI, whereby the total volume might be reduced. IFDI plays a crucial role in the introduction of new technology to China. The government policy encourages leading MNCs to relocate their R&D centers to China. The decrease in the IFDI is therefore an indication of the development and maturation of the Chinese economy. OFDI was completely liberalized for private companies in 2003. Since then OFDI from China has increased dramatically but is still low on a per capita base. Nevertheless the increase is a sign for the growing competitiveness of Chinese companies and increasing economic development.

In the beginning of South Korea's industrialization the government chose an investment policy based on foreign and domestic credits. Therefore IFDI played only a minor role in its industrialization. The Asian crisis of 1997 brought Korea into a difficult financial situation and Korea was forced to start FDI-friendly policies to meet the requirements of the IMF. But also the reluctance of foreign creditors brought Korea to the brink of insolvency. To overcome this crisis the Korean government started the active promotion of IFDI. But even after the transition to a more proactive FDI regime, the ratio of IFDI to GDP is still far lower than the global average. The amount of OFDI remained insignificant until the mid-1980s. From the mid-1980s, the Korean won appreciated, labor costs increased and the balance of payments was positive. To stay competitive, more and more labor intensive production was moved to low-wage countries. Since 2005, the government actively promotes OFDI to transform Korea into one of the largest investor countries.



FDI has never been the dominant strategy for Japan's economic growth, technology transfer or capital accumulation. Historically Japan even hindered IFDI as part of its strategy to develop the domestic industry. Only after the burst of the bubble in the 90s Japan started to deregulate IFDI. Nevertheless Japan is still one of the most closed countries towards IFDI while it is one of the largest outward investors worldwide. In 2011 the OFDI was more than four times as high as the IFDI. The government limited OFDI until 1968 and full liberalization took place in 1972. In the mid-1980s Japan started becoming a major outward investor. With the increasing development of the Japanese economy OFDI played a crucial role in its industrial restructuring. But the Japanese OFDI also played a big role in the catching-up process of industrialization of other East Asian countries. Japanese companies changed the division of labor in East Asia.

Results

The results suggest that Japan is currently in the fifth (and highest) stage of the IDP, South Korea in the fourth and China in the third stage. It turns out that especially China follows the predictions of the IDP and pursues a relatively open FDI policy, while Japan stands out by an extremely low IFDI and an extremely high OFDI and thus does not comply with the IDP. South Korea's FDI policy was rather closed towards inward FDI before the Asian crisis in 1997, but subsequently the attitude towards FDI changed significantly and corresponds to the IDP since then. Especially Japan and Korea have chosen a development path (almost) without IFDI in the beginning of their industrialization. Both relied on local and foreign loans to finance development. The three countries also exhibit some similarities. All of them rely on a strong government that controls the FDI and uses it for developmental purposes, which also appears to contribute to their economic success.

The IDP-theory is useful to get an overview and easy to apply. OFDI as an indicator of development shows whether the companies of a country are internationally competitive. However, there are also weaknesses. Dunning gives the impression that FDI in addition to GDP is the only measure of economic development and IFDI the only way to acquire foreign capital and know-how. As can be seen in Japan and South Korea, there are also alternative development strategies that work without or with a very small volume of IFDI. Both countries financed economic development by domestic or foreign loans and acquired technology through reverse engineering or the assistance of foreign experts. In addition, the development was strongly coordinated by the government. Therefore, next to FDI there are many other aspects that influence the economic development, such as government, geographical location, free trade zones or the openness of the economy.

References

All references can be found in the full version of the MA thesis available at http://othes.univie.ac.at/

About the Author

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