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FOREIGN DIRECT INVESTMENT IN THE FUNCTION OF ECONOMIC GROWTH AND ECONOMIC RECOVERY

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Abstract: *Economic growth is one of the key indicators of the quality of macroeconomic performance. However, from the aspect of time that is required for its increase, it can be said that the possibilities for the acceleration of the economic growth rate have changed significantly over time. In the period before the Industrial Revolution, European countries took 350 years to double its per capita income, in the 19th century, after the Industrial Revolution, England was needed 60 years ago, and at the end of the 20th century, a number of developing countries, the Asian Tigers, was succeed to double the per capita income of less than ten years. According to a recent growth theory, long-term economic growth can be explained on the basis of its growth sources: it is based on the increased use of factors of production (capital and labor) and increased factor productivity, due to the technological progress and more efficient use of production factors. Under this model of endogenous growth, foreign direct investment is emerging as a factor that contribute greatly to the economic growth of all components: they increase the accumulation of capital, the level of development of human capital and the level of technological development in the host country. With that in mind, the aim of this paper is, on the basis of the analysis the influence of FDI on economic growth, contribute to lightening the role that they play in improving the competitiveness of the host country, with a special focus on Serbia.*

Keywords*: foreign direct investment, economic growth, national competitiveness, Republic of Serbia.*

1. Introduction

The central preoccupation of economic policy makers of each country was and still is to deal with the problems in the field of economic development in order to find the best

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possible development solution. There are many factors that impact on this phenomenon with different intensity and, therefore, there is possibility to its observation from different angles.

In the contemporary process of globalization of the world economy foreign direct investment represent very often the only possible saving solution for many capital poor countries. They can act as a catalyst to augment domestic savings, but also as a means to transfer technology, managerial know-how and skill, organizational know-how, so they dominance in the movement of international private capital flows, can be proven by multiple opportunities that they provide to the host country.

There is various opinions among researchers in terms of the effects of foreign direct investment on the host country economy. They can range from very positive, those who treat foreign direct investment as a determinant of economic growth and development, to extremely negative, those who expose the suspicion and mistrust of the positive effects of cross-border investment activities of multinational corporations in the host country. On the other hand, the fact that foreign direct investment accompanied by both positive and negative effects on the economy of the host country indicates that these effects occur in reality at the same time, not isolated and independent of each other, makes it necessary to find a way to maximize effectuate positive and minimize the negative effects.

For developing countries and countries in transition foreign direct investment represent the most effective tool for increasing productivity, employment and international competitiveness and a mechanism for raising the standard of living and reaching a dynamic economic growth. However, foreign direct investment is one of the key development factors, since the benefits that host country achieve does not approves automatically. It can contribute to achieving long-term sustainable growth and development of the host country only under the condition of existence right policy framework and investment climate that contributes to the achievement of the profit interests of foreign investors and is in the interest of development of the host country.

According to the laid objective the paper is structured as follows. After introduction the attention will be routed towards the theoretical explanation on the relationship between foreign direct investment and economic growth. In the third part of the paper the direct and indirect effects of foreign direct investment on national competitiveness in the case of Serbia will be considered. In the conclusion brief review of the main remarks will be given.

2. Theoretical Considerations on the Relationship of Foreign Direct Investment and Economic Growth

In the analysis of the impact of foreign direct investment on national competitiveness is a key issue of the way upon which, or specific channels through which foreign direct investments contribute to improving the competitiveness of an economy. Therefore, in order to more clearly understand the impact of FDI on national competitiveness seems necessary theoretical analysis of the literature on the relationship between this phenomenon and the economic growth in the host country.

In the mid eighties, a group of economists led by Paul Romero construct a model in which the group as a key determinant of economic growth occurring endogenous variables.

"Whereas the neoclassical theory treated technological progress as an exogenous process and focused on capital accumulation as the main source of growth, the new growth theory has focused on issues relating to the creation of technological knowledge and its transmission. It views innovation and imitation efforts that respond to economic incentives as major engines of growth. Therefore, it emphasizes the role of R&D, human capital accumulation, and externalities (Grossman and Helpman 1991, Lucas 1988, Romer 1990)" (Fan 2002, 7).

With the emergence of endogenous growth theory focus of economic policy holder and an economist in the host countries directs the research of the channels through which foreign direct investment promote long-term growth. In the neoclassical growth model with diminishing returns of physical capital and exogenous technological progress, foreign direct investment does not realize the impact on long-term growth rate, but only to the level of income. Exogenous increase in foreign direct investment increases the level of technical equipment of labor and output per employee, but only temporarily, due to diminishing returns (the marginal product of capital) set limits to growth. Thereupon, foreign direct investment impact on the long-term rate of growth only through technological progress and increasing employment as exogenous variables.

In contrast to the neoclassical growth model, in endogenous growth models, the long-term growth rate is determined by the activities of the government and of the host countries of foreign direct investment. According to the traditional neoclassical growth theory, state activity achieving only short-term impact on the growth rate, and hence the success of the policy of encouraging foreign direct investment is limited. If the growth is endogenous, the policy of the host country should be focused on creating the conditions for a permanent increase in the growth rate of output in order to host country become more attractive destination for foreign direct investment.

Assuming that the determinants of growth are endogenously determined and that foreign direct investment do not only involve the transfer of capital, but also the transfer of knowledge and technology, there may be different channels through which FDI promotes growth in existing theoretical models.

Through the accumulation of capital, foreign direct investment promote growth by introducing new technology and inputs in the production function of the host country. In the case of new input introduction, output growth is the result of using a wide range of intermediate products. In the case of the introduction of new technologies, foreign direct investment are presented in the role of potential sources of productivity growth through spillover effects on domestic enterprises.

Foreign direct investment represent an important source of technological change and the factor of augmenting human capital, whereas encourage the use of advanced technology in enterprises and encourage productivity of workforce through various mechanisms, such as training and education of employees in affiliates in the host country.

Under the technological changes in the trade literature implies the process of innovation in product in technology advanced economies or the process by which new products are created through research and development activities. Knowledge transfer from technology leaders to followers can be defined as a process of transformation products that are in the advanced stage of the life cycle of new products. However, the main drawback of international trade attempts in the fact that it ignores the fact that an increase in human capital through technology transfer or knowledge contributes to the innovation of the manufacturing process, which ensures good produced using a new technology that is transferred through foreign direct investment, which undoubtedly increase contributes to increasing of total returns.

Transfer of technological know-how through foreign direct investment contributes to the improvement of technological knowledge in the host country in two ways or through two channels: first, the training of the local workforce employed in the affiliates of the multinational corporations and diffusion of such acquired skills and knowledge into the local economy, and second, by the introduction of advanced management and organizational skills and knowledge of foreign affiliates, on the other hand.

A key element of endogenous growth theory represents the study of various forms of externalities and analyzing of their impact on the long-term growth rate. The underlying assumption of endogenous growth models is that the existence of various forms of externalities stops infinitely declining marginal productivity of capital. On that basis, foreign investors increased productivity in the host country, while foreign direct investment contribute to increase the level of domestic investment activity and act as a catalyst for technological progress in the host country. Due to the potentially large external effect than in the case of the introduction of new inputs, transfer of knowledge and technology becomes the most important mechanism through which foreign direct investment promotes growth in the host country.

“Romer (1993: 548) has argued that by bringing new knowledge to their host countries, MNEs may help to reduce ‘idea gaps’ between developed and developing countries which are sources of growth. Thus FDI’s effect on growth in host countries could be more valuable than its direct generation of output by complementing the domestic investments. The indirect effect of FDI on growth in the host country may comprise a sum total of its externalities on domestic investments through knowledge spillovers and vertical linkages” (Nagesh, Jaya 2002, 5).

In one extensive study, Wang (1990) builds a dynamic two-country model to study the interaction between growth and international capital movement. Perfect capital mobility links the two regions. Human capital plays an important role in determining the effective rate of return for physical capital and hence affects the direction and magnitude of international capital movements. The analysis again takes account of FDI, in this case by incorporating Gerschenkron’s (1962) hypothesis on technology transfer in that the rate of technological change in a less developed country is considered to be an increasing function of the amount of foreign capital operating there. With capital already moving internationally, the model predicts that the steady-state income gap is narrowed by an increase in the growth rate of human capital and the technology diffusion rate in the less developed country (LDC). One of the messages emerging from the analysis is that opening to FDI from more advanced countries has important beneficial implications for a developing country. Foreign investment facilitates domestic technological change, and hence increases the rate of income growth (Fan 2002, 7).

Regarding from the perspective of the traditional theory, the increase in productivity is a measure of the contribution of exogenous technological change to economic growth. However, the modern explanation of the development process, with the advent of endogenous growth theory, revealing the gaps in this interpretation of the development process. Depending on the nature of technology (capital or labor savings), the structure of the economy and the degree of substitution of factors of production, technological change may lead to more or less the productivity of factors of production. At the same time, organizational and marketing skills and knowledge as an integral element of improving the quality of the technological process, are given the role of total factor productivity growth.

It is well known that the best transfer of knowledge and skills across the borders of the national economy can be achieved through various mechanisms. However, the most effective transfer and application of the “best of knowledge and skills” is realized through foreign direct investment of multinational corporations, which are a key prerequisite for the economic development of developing countries. The biggest benefit of foreign direct investment in the host country is not only reflected in the transfer of insufficient financial resources, but also in providing access to technological, organizational skills and knowledge of the market and the country's investors. With some exceptions,[1] the vast majority of fast-growing economies in the beginning of the development process relied solely on foreign direct investment, as a condition for achieving rapid economic transformation (e.g. Chile, China, Malaysia, Singapore and Thailand).

3. Direct and Indirect Effects of FDI on Economic Growth and National Competitiveness – Example of Serbia

From the point of view of GCI, establishing links between foreign direct investment and national competitiveness is not an easy task. The complexity of this problem is caused by the character of this index: it is a comprehensive index that takes into account the microeconomic and macroeconomic aspects of national competitiveness.

By subtle analysis it may find that foreign direct investments interact with all 12 pillars of competitiveness, both in terms of the ability to attract these investments, and in terms of the effects that these investments generate. In fact, technological equipment, openness and market size occur as direct beneficiaries of the benefits from the presence of foreign direct investment, infrastructure, higher education and training, market efficiency, labour market efficiency goods and services generate indirect benefits, whereas they are a precondition for the inflow of foreign direct investment, while institutions and macroeconomic stability are a *conditio sine qua non* for attracting foreign direct investment. It is not rare case that the concepts of export performance and competitiveness are identified and treated synonyms.

Indirect effects of FDI on exports of an economy can be found mainly in increasing the capacity of local firms to export, to meet international competition. Overall competitiveness is much improved by the exposure of a competitive environment in which MNCs have certain specific benefits related to export activity. If direct effect is easier to quantify, is generally resumed percentage calculations, indirect effects, in particular the determination and quantification is much more difficult, requiring in-depth analysis based on complex regression models. But it is important to note that the indirect mode of

[1] In some countries, as Japan and Korea, high rate of economic growth was achieved by the minimum of presence of foreign direct investment. Many countries tried to lead such strategy, but their attempts remain without success.

influence in time can gain the sense of macroeconomic dimensions of competitiveness, engaging demonstration effect through much of the economy sectors.

Analysis of past experience proves unequivocally that as the key issues in the field of foreign trade can be identified: (1) a higher rate of import growth than export growth rate, which was initiated the dynamic growth of the trade deficit, indicators of low competitiveness of the Serbian economy, (2) the high import dependence on exports, since export growth entails the growth of imports, (3) a constant trade deficit, which crucially affects the movement of the external current account deficit, and (4) the unfavourable structure of foreign trade, given that the export structure is dominated by labour-and resource-intensive products, whose leading position for a long period of time shows a slow and limited change in the structure of exports by factor intensity. In addition, insufficient quantum of inflows and unfavourable sectoral orientation of foreign direct investment, mainly to the service sector slows further complicates the issue and change the export structure towards increasing the share of products that would be competitive in the global market.

In the recent period of intense implementation of reforms, foreign direct investment served as a driver of growth and development of Serbian economy and a key mechanism for resolving balance of payments difficulties, apropos the source off finance the current account deficits. However, the unsustainability of foreign direct investment, in terms of their sectoral orientation, indicate necessarily the importance of applying the economic policy measures aimed at encouraging the inflow of the those kind of foreign direct investment that are geared towards the production and export of higher quality processed products. It's also represents a requirement for dynamic growth of the Serbian economy, improvement of the balance of payments and improve its competitive performances.

The high degree of dependence between exports and competitiveness, according to the World Economic Forum, can be seen in the second phase, which includes economy based on efficiency (Serbia ranks among the efficiency driven economy). It is notable that 10 pillar of competitiveness, openness and market size, establishing a direct link between exports and national competitiveness.

Based on the fact that the size of the country is one of those crucial factors that determine the amount of resources available for development and the degree of dependence of an economy from the outside world, it could be concluded that for the Serbia, as a relatively small country with limited resources, effective integration into the global economy is necessary to accelerate growth and development. This immediately suggests that increase in exports is an imperative to improve the economic performance of Serbian economy in the future and a key determinant to improve its competitiveness.

Before going further with this analysis is interesting to note that from the perspective of the 10th pillar of competitiveness, namely market size, the last five years Serbia ranks from 72nd to 67th, making it very low in the hierarchy of competitiveness global (the middle of the list). Indicator of market size include the level of exports, entitling us once again to support the link between FDI inflows and the level of competitiveness as it is calculated in the World Economic Forum.

Based on data for Serbia, we can say that during the global economic crisis, there has been a decline in FDI, which are now at a very low level. The decline in investment activity, in addition to maintaining stable the index of market size, is accompanied by a fall in the competitive position of the country.

In a sample of 148 countries, according to the level of competitiveness, Serbia has a very low rank. According to the degree of market orientation of the economy, in addition to a small number of competitive advantages Serbian economy (legal rights index, imports as a percentage of GDP and the number of procedures to start a business), there are a number of competitive disadvantages expressed primarily in the market for goods and services.

It should be noted that within this pillar of competitiveness (efficiency of the goods market - pillar 6th) there are indices that are related to foreign direct investments. According to the business impact of rules on FDI, Serbia is placed on 129th position, and to the prevalence of foreign ownership on 118th position. Thus, it can be concluded, among other things, that there are not enough foreign direct investments and the environment for their attraction is not attractive enough. This conclusion is confirmed by the value of the sub-indices of 10th pillar - market size. As mentioned previously, FDI contributes to GDP growth and increasing exports. According to the volume of GDP, Serbia is ranked on 73rd place, and to the volume of exports as a percentage of GDP to 71st place, therefore, we are somewhere in the middle of the list. The main recommendation is that in future pay more attention to these economic policy measures that encourage FDI just because of their multiple direct and indirect effects.

Conclusion

Theoretical considerations on the relationship between foreign direct investment and economic growth create a necessary basis for the analysis the effects of that phenomenon on national competitiveness. Available evidence, both in theory and practice, indicate on the fact is that foreign direct investment is accompanied by both positive and negative effects that propagate simultaneously or out of phase in the host country economy. Based on this belief, the problem turns into a manipulation of these effects, so that the positive parts to be operated with maximum efficiency

This paper considers the relationship between foreign direct investment and national competitiveness in the case of Serbia and determined the proportional relationship between these variables. Along with a slight increase in the inflow and the level of national competitiveness was at a constant level, while the last year has decreased. Given the fact that Serbia is lagging behind other countries in the region in terms of foreign direct investment, as well as in terms of the level of competitiveness, in the future should pay more attention to economic policy measures aimed at achieving the best possible results in these fields.

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STRANE DIREKTNE INVESTICIJE U FUNKCIJI PRIVREDNOG RASTA I OPORAVKA PRIVREDE

***Rezime**: Privredni rast predstavlja jedan od ključnih pokazatelja kvaliteta makroekonomske performanse. Međutim, posmatrano sa aspekta vremena koje je potrebno za njegovo uvećanje, može se reći da su se mogućnosti za ubrzanje stope privrednog rasta tokom vremena bitno promenile. U periodu pre industrijske revolucije, evropskim zemljama je trebalo 350 godina da udvostruče svoj per capita prihod, u XIX veku nakon industrijske revolucije, Engleskoj je bilo potrebno 60 godina, a krajem XX veka, veliki broj zemalja u razvoju, azijski tigrovi, je uspeo da udvostruči per capita prihod za manje od deset godina. Prema jednoj novijoj teoriji rasta, dugoročni privredni rast se može objasniti na osnovu rasta njegovih izvora: on se bazira na uvećanoj upotrebi faktora proizvodnje (kapitala i rada) i uvećanoj faktorskoj produktivnosti, zahvaljujući tehnološkom progresu i efikasnijem korišćenju faktora proizvodnje. U okviru ovog modela endogenog rasta, strane direktne investicije se javljaju kao faktor koji u velikoj meri doprinosi svim komponentama privrednog rasta: one povećavaju akumulaciju kapitala, nivo razvoja humanog kapitala i nivo tehnološkog razvoja u zemlji domaćina. Imajući to u vidu, cilj ovog rada je da na osnovu analize uticaja stranih direktnih investicija na privredni rast, doprinese rasvetljavanju uloge koju one imaju u unapređenju konkurentnosti zemlje domaćina, sa posebnim osvrtom na Srbiju.*

***Ključne reči:** strane direktne investicije, privredni rast, nacionalna konkurentnost, Republika Srbija.*