Chapter 4

Socio–Economic Impact of Foreign Direct Investment in Developing Countries

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ABSTRACT

The purpose of this chapter is to empirically examine the impact of socio-economic determinate of foreign direct investment in developing economies. FDI is an important part of the massive private investment that is driving economic growth around the world, particularly in the past two decades. This was achieved by examining 10 African countries using data from world development indicators on FDI and socio-economic parameters ranging from 1990 to 2015. A panel regression model was applied to 260 samples. The results showed openness, exchange rate, domestic credit to private sector, and regulatory quality have a significant effect on FDI. Policy makers in African countries need to adopt institutional reforms that could contribute to improving their state of governance, promote their investment climate, and help in attracting more FDI.

DOI: 10.4018/978-1-5225-3026-8.ch004
Policy makers in recent years, especially in the developing countries, have noted that foreign direct investment (FDI) is necessary to boost socioeconomic growth in their economic environment. Over the years, FDI inflows have acted as strong determinants of economic development across countries (McKinney, 2014; Jensen, 2003; Li & Resnick, 2003). FDI is the net inflows of investment to acquiring long lasting management interest in an enterprise operating in an economy other than that of the investor (World Bank, 2016). It serves as an important source of supply funds for domestic investment thus, promoting capital formation in the host country (Omisakin et al., 2009). FDI inflows can assist an economy by giving opportunities for improving the level of the service sector. There have been different strands in the empirical and theoretical literature aimed at investigating the relationship between FDI inflows and their determinants in developed and developing markets. Many developing countries, including the least developed ones, have attracted only small amounts of FDI inflows despite their efforts towards economic liberalization in an increasingly globalizing world (UNCTAD, 2009).

Many reasons have been given for the importance of FDI inflows, including employment creation, foreign exchange, technology transfer, easier access to foreign markets, enhanced competition as well as the transfer of skills through training (Crespo & Fontura, 2007). For these reasons, strong recommendations have been made for developing countries to use foreign direct investment as a source of external finance. Accordingly, efforts have been made by many governments to develop policies to encourage inward FDI flows. Furthermore, FDI gives developing countries the opportunity to reduce dependence on foreign aid, thereby boosting the state’s sovereignty from donor policies. Many African countries have been committed to reaching the millennium development goals. As pointed out by Adewumi (2006), most developing countries across Sub-Saharan Africa are off track and this has left them desperate for significant levels of foreign investments to restore them to their earlier economic status. It is believed that most of these developing countries are lagging because of inadequate resources to finance long-term investments and this has proved to be a big setback to economic growth. According to Adams (2009), the direction and volume of FDI across countries and regions suggest that its attractiveness depends on institutional and country-specific factors. Some of these factors include the host country’s openness to trade as well as macroeconomic, political and social stability. Due to political and socioeconomic differences across developing countries, the growth effects of FDI varies from country to country.

According to Nunnenkamp et al. (2004), recipient countries with a better endowment of human capital are more likely to benefit from FDI-induced technology
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