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FDI and Industrialization: Evidence from Selected Asian Developed and Developing Countries

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ABSTRACT

The objective of this study was to analyze the role of FDI in the industrialization of both developed and developing economies in Asia. This study primarily seeks to examine the way(s) through which FDI can be a positive or negative driver for industrialization within these diverse two economies. The research have adopted an ex-post facto design, which is characterized by the inability to manipulate the data, ensuring the analysis is based on actual historical events and trends. The study have focused on five developing and five developed economies within Asia, encompassing a data span of 29 years (1990–2018). To estimate the influence of FDI and other variables, the research study have applied panel data regression and have applied the Fixed Effects Model (FEM) to account for variations across countries. Alongside FDI, other key variables has been incorporated into the analysis included inflation, trade, labor participation rate, and gross capital formation. The outcomes have revealed a nuanced relationship between FDI and industrialization: in developing economies, FDI has a positive effect, fostering industrial growth, while in developed economies, FDI shows a negative impact on industrialization. This divergent outcome underscores the different economic structures and stages of industrial development in these economies. Furthermore, in developing economies, inflation and gross capital formation have found to contribute positively to industrialization, suggesting that these economies benefit from capital investment and moderate inflation levels in their pursuit of industrial growth. In developed economies, gross capital formation has also demonstrated a positive influence, while the labor participation rate exerted a negative impact on industrialization, indicating that in more advanced economies, the dynamics between labor and industrial growth may be more complex and potentially hindered by structural labor market factors. These findings offer valuable insights into the varying effects of FDI and other economic indicators on industrialization in Asia's developed and developing economies.

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1. Introduction

Foreign direct investment is the investment done by the person or a qualified organization of one country in to the business intersects/ models of another country. It generally happens when investors in the host country does investment or established business operations in the investment recipients' country. The motives of the host country are clearly to utilize profit making opportunities and earn revenues where as for the recipient country, it is a source of foreign exchange that is being transferred to them, the investment helps them in expanding and establishing new industrialized units (Dunning & Lundan, 2008). The benefits to the recipient's country are: due to industrialization more output is produced, results higher GDP and GDP per capita, more jobs are created and it helps them in overcoming problem of unemployment

(Borensztein, De Gregorio, & Lee, 1998). Foreign direct investment might have a bi-directional impact i.e., positive or negative depending on how the nation utilizes it. In developing nations although it is source of finance but political instability, 3poor structural reforms, and inefficient management may result in further exploitation of developing nations by the foreign investors (Acemoglu & Robinson, 2000). Where as in developed nations outcomes may vary as there can be higher capital outflows and instead of opting further domestic investments in the host countries, individuals will look for better revenue generating opportunities abroad which will discourage host investment culture (Alfaro et al., 2004).

Investment, whether developed or developing, plays a crucial part in the development of an economy and technology. Developed economies in general or developing economies in particular sometimes faces domestic saving to investment gap to finance the revenue generation activities in the economy. In order to overcome this gap, economies mostly rely on foreign direct investment. Tsai (1994) highlighted this relationship and stated in his research that foreign direct investment can be helpful in achieving a reasonable rate of economic development. Over the years foreign direct investment has been considered to be a significant determinant that can helps the country in achieving better terms of trade, improvement in exchange rate and reducing the investment to saving gap in an economy. Foreign direct investment provides the needed resources that are required for the expansion or setting up of industrial units that can help in overcoming unemployment issue i.e., a macroeconomic problem, by creating more jobs and achieving a higher labor force participation rate and increase in outputs that can reduce the burden on imports and the surplus are exported, results in improvement of terms of trade, current account deficit and exchange rate (Tsai, 1994; United Nations Conference on Trade and Development, 1999). According to World investment report in 1999, United Nations conference on trade and development stated that foreign direct investment is one of the very important determinants of economic growth because it provides the optimal financial resource which can help to both technical and structural growth. The report further stated that foreign direct investment may trigger industrialization in developing countries (United Nations Conference on Trade and Development, 1999). United Nations conference on trade and development (2011), 2020 E-book is still stating that the main host region of foreign direct investment in developing world is Asia. In 2019, 13 of the top 20 host countries were developed countries, in 2019 foreign direct investment to developing nations was amounted to $685 Billion (United Nations Conference on Trade and Development, 2020).

The sharp expansion in the flow of foreign direct investment was evident from 1990, and the analysts begins researching effect of this determinant. A few specialists accepts that there is a positive and effective connection between the monetary development and foreign direct investment that can prompt financial development and industrial development while other research argued with the contradictory findings that this determinant does not have the same applicable results as the people believes (Alfaro et al., 2004). This research is to check the effect of foreign direct investment on industrialization as economy grows when the output of an economy increases and GDP per capita increase. In the past number of researches have carried out to check and interpret the foreign direct investment relation with economic growth. Majority studies have focused on an individual country, results varies country to country, region to region. Instead of restricting the area to research to just one country, this research area has been extended to selected developing and developed countries of Asia. The effect and association of industrialization through foreign direct investment in developed and developing economies can be measured and interpreted in concurrence of four other control variables that are further introduced in the research to enhance the internal validity of the study by limiting the effects of confounding variables. The controlled variables have added to this research are gross domestic investment, trade, inflation and labor. The discussion on hypothetical and empirical relationship between foreign direct investment and industrialization in developed and developing economies is carried out in review of literature. Variable description, model specification, and econometric approaches are discussed in methodology section. Findings and discussions of the research are elaborated in outcomes and discussion section. Last section, however, concludes the findings and provides policy recommendations.

2. Literature Review

FDI is regarded as one of the main ingredients for the economic production and industrial revolution in all most all developed and developing economies though few researcher

contradicted this theory by citing dependency theory i.e., if a nation mainly relies on investment from abroad to fulfill its saving to investment gap then its growth could have a negative impact as foreign investment will create monopolies in the industrial sector which will discourage competition and leaves underutilization of resources as they are profit seekers they don't keep welfare as an objective, so this proposes that although the association exists between growth, foreign direct investment and industrialization however the effect can be negative too. Although researchers have a consensus on existence of theoretical but have a contradictory view in the empirical findings i.e., empirical findings consist of both the research results that have a positive and negative relationships. In their published research, Zhang (2001) investigated the relationship between foreign direct investment and economic development in developing countries. The study was based on empirical research covering 11 developing economies in East Asia and Latin America. The analyst inferred that foreign direct investment emphatically affects the development of developing economies yet the degree to which foreign investment is growth enhancing depends upon countries conditions and policies i.e., foreign investment is more like to promote and enhance growth and output in the recipients' countries that are more trade liberalized, that have improved health care and better education conditions and supports exports orientated foreign investment.

Mishal and Abulaila (2007) through their research featured the connection using a time series data and the outcomes features the occurrence of bi-directional connection between the output and foreign direct investment. The other relationship they concentrate in their study were of imports and output and results produced supporting evidence of import led growth. Mottaleb (2007) analyzed factors that influence foreign direct investments and the effects of foreign direct investment on growth in developing countries. Mottaleb (2007) analyzed the impact through panel data of over 60 developing countries out of which 28 were lower middle-income countries and the rest were low-income countries. There were 20 countries from Asia's region, 30 countries from Africa region and 10 from Latin America region. The research inferred that foreign direct investment can assume significant part in the industrial expansion and advancement in the developing countries, the researcher further concluded that developed countries that have business friendly environment with abundant resources attracts more foreign direct investment and that investment positively affects increase in growth and output of the economy. The other variables that were added to the research were GDP per capita, internet users, telephone mainline, industrialization as a percentage of GDP, and time required to enforce an agreement. Zheyi (2008) examined the foreign direct investment impact on China industrial agglomeration and industrial development. They found the long run relationship to be positive and impactful while the short run relationship proved none is existent. They further concluded in their paper that foreign direct investment can be used to narrow the investment gaps in the region and it can help in the development of local industries.

Sen (2008) estimated trade and foreign direct investment relationship of India's manufacturing sector. Sen (2008) found that both trade and foreign direct investment positively influence the manufacturing sector of India. The study reviewed industrial reforms and their economic impact in 1970, 1980 and 1990 and highlighted that there has been a consistent growth in the manufacturing sector. On the contrary, the study said that there has been a huge growth in the FDI which resulted in capital intensive manufacturing. Also, MNC's are more productively efficient and exhibits higher export orientation in comparison to domestic firms. Falki (2009) evaluated the relationship between foreign direct investment and economic growth in Pakistan. The period covered by the research data was (1980-2006). Falki (2009) stated FDI has not helped much to the financial development in Pakistan for the years. It is further stated in his research that FDI has been found adversely impacting Pakistan economic performance. Adams (2009) analyzed domestic investment and foreign direct investment in Sub-Saharan Africa. A time series data covering the period of 1990 to 2003 was similarly used to analyze the positive and negative relationships between foreign direct investment and economic growth. OLS and Fixed estimation methods were used to test this relation. The researcher conclude that the FDI initially has negative impact and then turn out to be positive in the later time period for the panel of MENA countries studied. The researcher also pointed out that sign and magnitude of foreign direct investment suggests a net crowding out effect.

Adegbite and Ayadi (2011) assessed the role of foreign direct investment through time series data that Nigeria being a developing country has benefited from the FDI in term of country performance and output. Additionally, the study featured the significance of human capital and

expressed the outcome of FDI on development and output can be limited if human capital is not growing or transforming. The researcher also highlights the positive and simultaneous impact of FDI and human capital on output. Choong and Lam (2011) analyzed the connection between the FDI and output in developed and developing countries using yearly data from 1988 to 2002, a data of 70 developed and developing countries were included. The research concluded that FDI has an adverse effect in developing economies and a constructive effect in developed economies. The research also highlighted that foreign investment negative effect is due to weak policy framework, lack of information and misallocation reduces or even reverses the economic performance. Using time series data from 1960 to 2011, Umer and Alam (2013) looked at the relationship between foreign direct investment and trade openness on growth of the industrial sector in Pakistan. They also analyzed the impact on Johansen and Juselius co-integration technique. On the other hand, the results showed that those foreign direct investment is positively correlated with industrial sector growth but trade and inflation negatively affected.

SULEIMAN, KALIAPPAN and ISMAIL (2015) estimated factors of FDI and analyzes the relationship through Endogenous Growth model which is considered to be more appropriate and relevant in explaining the growth according to the researcher. The time span of data used in this research is (1980-2010). Using OLS regression method the analyst found constructive connection between FDI and output of the Southern Africa Customs Union countries (SACU). The researcher further suggests that (SACU) Countries should put more efforts to attract more Foreign direct investment especially in their manufacturing sector. The researcher suggested to maintain political social and economic stability to attract more foreign investment to guarantee more growth and productive efficiency. Control variables added to this research are Capital stock, Trade, Labor force. Maitah et al. (2015) analyzed the FDI relation with Palestine's Economic growth. Researchers states from their findings that FDI causes negative impact on Palestine's Economic growth. Researcher uses OLS method to test the influence of foreign investment on Palestine's Growth. The time span of data used in this research is (1995-2011). Researchers also included other controlled variables in their research i.e., local investment, labor (measure through total number of employees) and imports. Nilofer and Qayyum (2018) explored adverse consequence of FDI on growth of Pakistan using ADRL approach to analyze the relationship using time series data from 1970 to 2015. Other control variables added to this research were private and public investment which have a positive impact on growth according to concluded results. The researcher further suggested to create business friend environment for investors both domestic and foreign, to introduce investment friendly policies and frame work, ease of doing business to be promoted. Sohail and Mirza (2020) analyzed constructive connection between FDI and GDP Pakistan. Correlation and regression analysis was used by the researcher to test relationship and effect. This has been done at (1996–2015) time span of data for this research. Other controlled variables added to research by authors were domestic capital, exports, number of terrorist attacks, and index of human capital). Researcher further stated in his findings that controlled variables too have an impact on economic growth of Pakistan.

3. Data and Methodology

The study has used Ex-post facto research design as this help us to predict the consequences and origins based on acts that have already transpired, whereas the already occurred actions and their behavior cannot be manipulated. This ex-post facto investigation approach assists investigators in analyzing how explanatory variables influence the dependent variable. The data was mainly extracted from a reliable source i.e., World Bank database. The data was extracted Asia's Developed and Developing Countries. A total of five developed countries (Brunei, Cyprus, Japan, Saudi Arabia, and Singapore) and 5 developing countries (Bangladesh, India, Sri Lanka, Pakistan, China) were included in this research study from the Asian countries pool. Developed countries here are classified as higher income group countries whereas developing countries are classified as middle and lower- income group countries. The data time span used in this research study was of 29 years (1990-2018). Table 1 shows the description of all the data under consideration.

To achieve the study's objective of assessing the influence of FDI and industrialization, a linear regression method is employed to evaluate the response and significance of factors that explain on dependent variables in both developing and developed nations in Asia.

Table 1: Determinants of Industrialization, Panel data of Asia's Developed & Developing Counties

Variables	Proxy	Data Source
Dependent Variable:		
Industrialization	Manufacturing as a Percentage of GDP	World Bank Data Bank
Explanatory Variable:		
Foreign Direct Investment	FDI as a Percentage of GDP	World Bank Data Bank
Inflation	Annual growth rate of GDP implicit Deflator	World Bank Data Bank
Labour Force Participation	Labour force as a Percentage of total population 15+ (ILO)	World Bank Data Bank
Gross Capital Formation	GCF as a percentage of GDP	World Bank Data Bank
Trade	Trade as a Percentage of GDP	World Bank Data Bank

The model developed to estimate the relationship in both developed and developing countries is stated as,

$$MANUFACT = f(FDI, INF, LABRT, GCF, TRD) \quad (1)$$

The functional relationship for the hypothesis for both Asia's developed and developing nations is stated as,

$$MANUFACTt = \beta 0 + \beta 1FDIt + \beta 2INFt + \beta 3LBARTt + \beta 4GCFt + \beta 5TRDt + \mu t \quad (2)$$

3.1. Technique of Analysis

Across Asia's developed and developing nations, the response and significance of explanatory factors on dependent variables have been investigated by estimating regression by way of the panel least squares model. To be more explicit, which model is more correct for this model: the Fixed Effect Model (FEM) or the Random Effect Model (REM)? The analysis is based on the impact of independent variables on the dependent variable, by panel data, utilizing FEM and REM. The general econometric model can be expressed as:

$$y_{it} = \alpha + \beta X_{it} + u_i + \epsilon_{it}$$

Here y_{it} is a dependent variable for the entity i at a point of time t, X_{it} is the vector of independent variables, α is the intercept, β is the coefficient vector, u_i is the unobserved individual specific-effect, ε_{it} is an idiosyncratic error term. The assumption of the FE model is that u_i is correlated with X_{it} capturing unobserved heterogeneity, whereas the RE model assumes u_i is uncorrelated with X_{it}, thus suitable to randomly sampled entities. The rudimentary model assumptions--fixed or random effects--were exogeneity of regressors, homoscedasticity of errors in the random-effects model, absence of multicollinearity among regressors, and stationarity of panel data. In addressing such an issue, the choice of one model or the other is taken from the Hausman test which probes if random effects would have provided inconsistent estimates as opposed to fixed effects.

4. Results and Discussion

As outlined in the preceding section, following the implementation of the regression analysis, REM is employed. Subsequently, the Hausman test is administered to ascertain the appropriateness of the REM or to determine whether the FEM should be adopted. Thus, according to the results of the Hausman test and the best suitable model is chosen and executed for the final part of the analysis.

Table 2: Hausman test, Panel Series data of Asia's Developing Counties

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	96.250828	4	0.0000

Source: Authors' Estimation

The regression was first executed with REM. To assess the suitability of this model for the current study, the Hausman test was conducted. The p-value, as exhibited in Table 2, is found to be below the 0.05 threshold, signaling that FEM is more fitting for this analysis and should, therefore, be utilized.

Table 3: Summary of the Results, Panel Series data of Asia's Developing Counties 1990 – 2018

Variables	Coefficients	t-Statistics	P-Value
Constant	11.36305	2.278819	0.0243
FDI	0.650734	3.576568	0.0005
Inflation	0.064839	2.289280	0.0237
Labor Participation Rate	0.061777	0.853236	0.3951
Gross Capital formation	0.088157	2.145155	0.0338
Trade	-0.010996	-0.741157	0.4599
Adjusted R^2	0.945673		
F-statistic	269.8437		
Probability (F-statistic)	0.000000		

Source: Authors' Estimation

The final results of the FEM analysis are shown in Table 3. The results reveal a significant and positive relationship of FDI with industrialization in developing countries. Specifically, the coefficient for FDI is 0.650734, suggesting that a 1% rise in FDI results in a 0.65% rise in industrialization within these economies. These results resonate with the tenets of modernization theory, which posits that economic growth and development necessitate capital investment, with FDI helping as a critical foundation of financial support for fostering industrial expansion in developing nations. Moreover, gross capital formation and inflation also exhibit positive and noteworthy impacts on industrialization. Conversely, the labor participation rate exerts a positive yet statistically insignificant influence, while trade demonstrates a negative and insignificant relationship with industrialization.

Table 4: Hausman Test, Panel data of Asia's Developed Counties

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	783.695906	4	0.0000

Source: Authors' Estimation

Following the initial regression analysis, the Random Effects Model (REM) was employed. To ensure the accuracy of this model's application, the Hausman test was performed. The results of this test, displayed in Table 4, indicate a p-value below 0.05, affirming that the Fixed Effects Model (FEM) is the more suitable framework for this study. Consequently, the study proceeds with FEM to guarantee the robustness and validity of the analytical results.

Table 5: Summary of the Results, Panel Series data of Asia's Developed Counties 1990 – 2018

Variables	Coefficients	t-statistics	P-value
Constant	29.47646	5.047937	0.0000
FDI	-0.016391	-3.493309	0.0006
Inflation	0.033421	1.333991	0.1845
Labor Participation Rate	-0.292799	-3.200152	0.0017
Gross Capital formation	0.111704	3.773531	0.0002
Trade	0.008247	0.907181	0.3659
Adjusted R^2	0.909588		
F-statistic	150.9079		
Probability (F-statistic)	0.000000		

Source: Authors' Estimation

In Table 5, the final results are derived using the FEM. The data reveals a significant and negative relationship between FDI and industrialization in developed economies. More precisely, the FDI coefficient is -0.016391, indicating that a 1% increase in FDI correlates with a 0.016% decline in industrialization. This outcome is consistent with the dependency theory, which argues that an overreliance on foreign capital investment can have detrimental effects on domestic growth and development. According to this theory, local industries may face difficulties in competing with multinational corporations (MNCs), potentially leading to deindustrialization and monopolization by these external entities. Moreover, results on other variables show that inflation has a positive but not statistically significant relationship, labor participation is negative and

significant while gross capital formation is positive and significant in the industrialization of developed economies. By contrast, trade is found to have a positive but insignificant effect.

These findings are consistent with modernization theory that highlights the significance of foreign investment for economic growth and structural transformation in developing countries. Historically, Rostow (1959) suggested that tight resources in developing economies can lead to industrialization and that FDI is one of the essential mechanisms to fill gaps in industrialization. In underdeveloped economies, they accelerate modernization and stimulate industrial growth by bringing in financial resources, advanced technologies and managerial expertise (Hsu et al., 2016). There is empirical evidence that supports this positive association. Borensztein, De Gregorio and Lee (1998), that FDIs not only increases capital in domestic countries, but also allows for transfer of tech, specifically benefiting economies with a 'threshold' level of human capital. Similarly, according to the study conducted by Alfaro et al. (2004), FDI improves productivity and linkage of foreign and local industries which causes industrialization. The impact of inflation and gross capital formation is significant and positive, reinforcing the idea that macroeconomic stability and capital accumulation are important determinants of industrial growth (Solow, 1956). The effect of labor participation is statistically insignificant, suggesting a structural problem in which a large labor force due to skill mismatches or underemployment in low-income economies limits its contribution to industrialisation. The negative and insignificant trade impact could also suggest that trade is based on commodity rather than industrial goods exports, a point raised by Prebisch (1962) during his unequal exchange theory.

FDI can also lead to deindustrialization if we become too dependent upon it; according to Dos (1970) and Frank (1967), through dominating local markets, MNCs crowd out domestic industries and resources are diverted to profit repatriation instead of reinvestment in the host economy. FDI also comes with its own set of risks, as highlighted by Rodrik (2016) in relation to developed economies where foreign firms may pursue efficiency gains through (western economy friendly) automation or outsourcing, reducing industrial jobs or local productive capacities (Rodrik, 2016). This is consistent with existing research, for example Herzer et al. (the case from 2008 suggests that inflows of FDI can be dampened even at economic fronts such as industrial growth as long as market power is skewed against that of domestic producers against these foreign enterprises). As a consequence, the negative and significant effect of labor participation in developed economies could be attributed to the upgrading and industrialization process observed, resulting in the gradual decline of traditional labor-intensive activities in favor of higher-skill sectors (Acemoglu, 2018). The positive and significant effect of gross capital formation should be read in light of the importance of the domestic investment in maintaining the process of industrialization, according to the Harrod-Domar growth models (Domar, 1946).

5. Conclusion, Policy Recommendation and Future Research Direction

In this regard, the aim of this study was to investigate how foreign direct investment affects the industrialization of developing and developed economies across Asia during the period 1990–2018. Alongside FDI, the analysis considered inflation, labor participation rate, gross capital formation, and trade as key variables. The results were analyzed using panel regression techniques and FEM to understand the relationships of dependent and independent variables under various economic environment. The results indicate that while FDI contributes positively to industrialization in developing economies, it has a detrimental effect in developed economies. In developing nations, inflation and gross capital formation further stimulate industrialization, while in developed economies, gross capital formation plays a similar positive role, and labor participation exhibits a negative influence on industrial development. In light of these findings, policymakers are encouraged to adopt differentiated strategies based on the distinct economic contexts. For developing economies, FDI can be strategically leveraged to accelerate industrialization and stimulate growth. Conversely, in developed economies, excessive dependence on foreign investment may impede local industrial progress. Therefore, policy measures should focus on balancing FDI inflows with support for domestic industries to foster sustainable industrialization across varying economic landscapes.

Future studies may investigate the various sectoral-level impacts of FDI on industrialisation to ascertain which industries in developing and developed economies benefit most from FDI. Investigating the impact of technological spillovers, including skill formation as well as innovation, would help to capture the wider contributions of FDI. Studies could also limit the analysis to years after 2018 to analyze the effect of global economic change on the impact

of FDI. This includes the interaction between governance quality and FDI outcomes, as well as the implications for employment and the environment. Cross-regional studies within Asia might provide insights into how different cultural and economic contexts impact the effectiveness of RKT in attracting FDI. Research could also work to model policy scenarios — e.g. more balanced FDI and domestic support — to assess which pathways are more conducive to sustainable industrialization. Such directions would help improve understanding of the nuanced role of FDI in economic development in different contexts.

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