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FDI, Productivity, and Financial Development

by Laura Alfaro, Sebnem Kalemli-Ozcan and Selin Sayek

Abstract

This paper examines the effect of foreign direct investment (FDI) on growth by focusing on the complementarities between FDI inflows and financial markets. In our earlier work, we found that FDI is beneficial for growth only if the host country has well-developed financial institutions. In this paper, we investigate whether this effect operates through factor accumulation and/or improvements in total factor productivity (TFP). Factor accumulation—physical and human capital—does not seem to be the main channel through which countries benefit from FDI. Instead, we find that countries with well-developed financial markets gain significantly from FDI via TFP improvements. These results are consistent with the recent findings in the growth literature that shows the important role of TFP over factors in explaining cross-country income differences.

Keywords: Human Capital; Income; Performance Productivity; Financial Markets; Foreign Direct Investment; Financial Institutions; Cross-Cultural and Cross-Border Issues;

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