

CHAPTER 1

INTRODUCTION

1.1 Statement of the problem

During the past two decades, Foreign Direct Investment (FDI) has become an increasingly important part in the developing world, with a growing number of developing countries succeeding in attracting substantial and rising amounts of inward FDI. According to International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) definitions, FDI is an investment in a foreign company where the foreign investor owns at least 10% of the ordinary shares, undertaken with the objective of establishing a “lasting interest” in the country, a long-term relationship and a significant influence on the management of the firm. FDI is done by Multinational Enterprises (MNEs) whom are defined as firms that own a significant equity share (typically 50% or more) of another company (subsidiary or affiliate) operating in a foreign country. FDI can have an impact on many aspects of a host country’s economy such as output, the balance of payments, and market structure. However, it is believed that bridging the gap in technology between the foreign country and the host country is the main effect of FDI, which in turn improves the productivity and growth of the host country

Economic growth refers to the expansion of the national income - the total production of goods and services of a country over a given period. Economic growth is usually measured by the pace of change of Gross Domestic Product (GDP). Economic growth has important implications for the welfare of individuals. According to Sala-i-Martin, aggregate growth is probably the single most important factor affecting individual levels of income. Understanding the determinant of aggregate economic growth is the key to understanding how to increase the standards of living of individuals in the world.

The relationship between FDI and economic growth has been an exciting and controversial topic for economists, which continues to be widely debated. Theoretically as well as practically, there are still inconclusive arguments for and against the role of FDI inflows in enhancing economic growth in a country. Whether FDI inflows are beneficial or not to economic growth, and what governments should do to attract and use FDI inflows effectively, are still a matter of considerable debate. In recent literature, much attention has been devoted to the impact of FDI on economic growth in host countries.

Theoretically, FDI in neoclassical growth model promotes economic growth by increasing the volume of investment and its efficiency. In the endogenous growth model, FDI raises economic growth by generating technological diffusion from the developed world to the host countries (Borensztein, Gregorio, & Lee, 1998). As summarized in Balasubramanyam, Salisu and Sapsford (1996) and De Mello (1999), FDI is a composite bundle of capital stock, know-how, and technology, and can augment the existing stock of knowledge in the recipient economy through labor training, skill acquisition and diffusion, and the introduction of alternative management practices and organizational arrangement.

However, recent researches have stressed the role of technology as one of the crucial drive engines of growth. Not every country, however, has the same possibilities to access advanced technology. Many Less Developed Countries (LDCs) lack the necessary social infrastructure in order to innovate and must often recur to technology invented elsewhere. One of the channels whereby technology may diffuse from developed to developing countries is FDI.

Since Doi Moi policy in 2006, Vietnam has experienced high economic growth rate and changed from a backward and underdeveloped nation in 1980s to a developing economy increasingly converging to the regional fast growing economies. The adoption of market orientation and open door policy has connected the country to international economies which have brought in a lot of structural transformation. Together with exports, FDI has been considered one of the elements to contribute to recent growth in Vietnam. In 1987, the Law on Foreign Investment has been issued as the framework for the business activities of foreign partners in Vietnam. This law has

been amended four times since then and the new law has been applied since 2006. These changes are toward a more convenient and equitable environment for both domestic and foreign enterprises operating in Vietnam.

FDI inflows to Vietnam have increased rapidly both in the number of projects and the amount of funds since then. FDI inflows have played an important role as providing investment capital, stimulating export activities, introducing new labor and management skills, transferring technologies and generating job opportunities. However, Vietnam has still some typical weaknesses of developing countries in order to absorb FDI efficiently such as poor infrastructure, shortages of physical and human capital, and weak institutions...

Although many studies on FDI and growth in developing economies exist, few studies on this subject have been done for Vietnam, especially for time series data since the lack of some data for the period before 1990s. It is therefore impossible to undertake researches in a long-term perspective. This paper employs an endogenous growth model in which the technological progress is the primary determinant of GDP growth rate. The growth model is then empirically tested to examine the effects of FDI on economic growth. We also examine the nature of the relationship between FDI and domestic investment in Vietnam, we expect that FDI supplement domestic investment and the effect of FDI on economic growth is significantly positive.

1.2 Objectives of the study

The purpose is to study the role of FDI on Economic growth in Vietnam using endogenous growth model for the period 1986-2006. The period includes the 1990s, when Vietnam launched economic reform – Doi Moi and the financial liberalization process.

In addition, in order to strengthen our estimation results about impact of FDI on economic growth, the role of FDI in domestic investment is also tested to consider whether FDI stimulate or substitute domestic investment and thus contribute to economic growth.

1.3 Scopes of the study

We construct an endogenous growth model in which the rate of technological progress is the primary determinant of long term growth rate of income. Neoclassical investment theory is employed to test the effect of FDI on domestic investment.

The unit root test and cointegration technique are utilized to verify the adoption of endogenous growth model and investment model for Vietnam. Employing the Error Correction Model (ECM), we examine the speed of adjustment toward the long run equilibrium.

A time series macro data set of Vietnam collected from many sources, period from 1986 to 2006, is employed to test our hypothesis.

1.4 Organization of the study

This study is organized into six chapters. Chapter 1 is the introduction which includes statement of the problem, the objective and scope of the study. Chapter 2 reviews the theoretical and empirical studies of FDI and economic growth and the relationship between FDI and domestic investment. Chapter 3 introduces the recent trend of FDI and economic growth in Vietnam. Chapter 4 presents the theoretical framework, methodology and data sources. In chapter 5, we report our econometric estimation results. Finally, Chapter 6 gives out the conclusion and policy implication as well as the suggestion for further studies.