The Implications of Foreign Direct Investment on Economic Development in Egypt

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Abstract

Over time, foreign direct investment has become the most influential and important for economic growth. Foreign direct investment affects economic growth for several reasons. Therefore, countries, whether developed or developing, pay special attention to foreign direct investment in an effort to achieve high growth rates. Foreign direct investment is one of the main determinants of economic growth in the host countries. There is no agreement between studies about the direction of the impact of foreign direct investment on economic growth. The problem is that both directions of the relationship have economic theories to back them up. In this research, we discussed the impact of foreign direct investment on economic development and economic growth in developing countries in general and in Egypt in particular. We also clarified the difference between economic growth and economic development. According to previous studies, foreign direct

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investment affects economic growth positively because it plays a major role in advancing economic development, but it has some negative effects in some special cases.
This research focused on the revealed comparative advantage and its relationship to foreign direct investment and economic growth in Egypt. From this, we found that foreign direct investment is not directed to sectors that have a comparative advantage, so its impact on growth is weak. The sectors that contribute significantly to economic growth are service sectors, so despite the occurrence of economic growth, we did not find economic development and this growth occurs in the short term.

Keywords: Foreign direct investment, economic development, economic growth, revealed comparative advantage.

انعكاسات الاستثمار الأجنبي المباشر على التنمية الاقتصادية في مصر

ملخص

بمرور الوقت، أصبح الاستثمار الأجنبي المباشر هو الأكثر تأثيرًا وأهمية للنمو الاقتصادي. يؤثر الاستثمار الأجنبي المباشر على النمو الاقتصادي لعدة أسباب. لذلك، تولي الدول، سواء كانت متقدمة أو نامية، اهتمامًا خاصًا للاستثمار الأجنبي المباشر في محاولة لتحقيق معدلات نمو عالية. الاستثمار الأجنبي المباشر هو أحد المحددات الرئيسية للنمو الاقتصادي في البلدان المضيفة. لا يوجد اتفاق بين الدراسات حول اتجاه تأثير الاستثمار الأجنبي المباشر على النمو الاقتصادي. المشكلة هي أن كلا الاتجاهين للعلاقة لديهما نظريات اقتصادية لدعمها. ناقشنا في

هذا البحث تأثير الاستثمار الأجنبي المباشر على التنمية الاقتصادية والنمو الاقتصادي في الدول النامية بشكل عام وفي مصر بشكل خاص. كما أوضحنا الفرق بين النمو الاقتصادي والتنمية الاقتصادية. وبحسب دراسات سابقة، فإن الاستثمار الأجنبي المباشر يؤثر على النمو الاقتصادي بشكل إيجابي لأنه يلعب دورًا رئيسيًا في دفع عجلة التنمية الاقتصادية، إلا أن له بعض الآثار السلبية في بعض الحالات الخاصة.

ركز هذا البحث على الميزة النسبية المكشوفة وعلاقتها بالاستثمار الأجنبي المباشر والنمو الاقتصادي في مصر. من هنا وجدنا أن الاستثمار الأجنبي المباشر غير موجه إلى القطاعات التي تتمتع بميزة نسبية، وبالتالي فإن تأثيره على النمو ضعيف. القطاعات التي تساهم بشكل كبير في النمو الاقتصادي هي قطاعات خدمية، فعلى الرغم من حدوث نمو اقتصادي لم نجد تنمية اقتصادية وهذا النمو يحدث على المدى القصير.

الكلمات المفتاحية: الاستثمار الأجنبي المباشر، التنمية الاقتصادية، النمو الاقتصادي، الميزة النسبية المكشوفة.

Introduction:

Trade transactions and Foreign Direct Investment (FDI) are the most important in addressing the economic growth of a country. Market opening in economic growth is mostly due to natural capital accumulation and technology transfer. Exporters through competition will try to enter foreign markets by using investment and production technology. Foreign direct investment increases the export capacity of the host country and leads to foreign exchange earnings mostly in developing countries. They also increase the availability of funds for domestic investment, encourage the creation of new job opportunities, promote technology transfer, and increase overall economic growth.

Most political support to attract FDI does not take into account academic research indicating that there is no automatic link between foreign direct investment and development. Whether FDI has positive or negative effects depend on whether the right policies and regulation are in place and relates to factors such as the sector, the country, the company and the balance of cost and benefit for all stakeholder. it is rarely who actually benefit, endures the negative consequences and what the impacts of FDI on the local society.

Foreign direct investment has emerged as the most important foreign resource flow to developing countries over the years and has become an increasingly important part of capital formation in these countries, although there is a share in the global distribution of foreign direct investment that is still continuing or declining in this role. Foreign direct investment is widely used as a factor promoting growth in developing countries.

FDI is one of the most famous sources of investment in the world and its impact on economic growth is positive. for developing countries such as Egypt FDI is considered to be a way to transfer technology and capital from other countries special the development countries.

According to economic literature and theories, any investment in developing countries must cause economic growth that is based on structural change. However avoidable information in the Egyptian economic literature shows the FDIs might lead to shift in the comparative advantage, generate and / or some less foreign exchange and change industrial structure in forms of more concentration. economic growth is based on structural change such as the ability of FDIs to create foreign exchange and change in industrial structure, also change in trade pattern.

The research is based on the hypothesis that, " An increase of FDI helps achieve economic growth in Egypt by supporting positive structural changes.

The main objective is to test the research hypothesis to investigate the relationship between foreign direct investment and economic growth in Egypt and the role of capital and labor in this relationship.

To achieve this main objective the following sub-objectives will be targeted:

- Does FDI support the competitive advantage in Egypt?
- Is the impact of FDI on the industrial structure stronger than its impact on economic growth?

The research Methodology will depend on the Cobb Douglas function it would be relying on economic analysis to test the basic hypothesis of the study depending on the share of sectors in GDP, labor share in total employment and sector share in fixed capital formation CAPMAS databases published by The Annual Bulletin of Industrial Census and sector share in total foreign direct investment World bank database. In selecting for further analysis of foreign direct investment and its relation to growth, that indicate the variation in sector share in output is positively affected by the variation in sector share of FDI. However, the results show that the relationship between FDI and output is not significant.

Literature review:

The review of the literatures shows the theoretical assessment of the foreign direct investment on the economic development in Egypt.

There have been many developments in the global economy. One such development is the increase in capital flows across countries. Foreign direct investment (FDI) is a cross-border capital flow that countries use in order to boost their economic growth. This study focused on how foreign direct investment affected economic growth in Egypt for the period from 1980 to 2018. The study applied Johansen's co-integration, vector error correction model (VECM) and Junger causality in the methodology. Johansen's co-integration results showed a long-term relationship between the variables. In addition, VECM has shown that foreign direct investment exerts a significant positive impact on economic growth in Egypt. Finally, a two-way causal relationship between FDI and economic growth in Egypt emerged through the Granger causal relationship. Safwat Alaa (2021), This paper used annual balanced panel data to examine the causal relationship between foreign direct investment (FDI) and economic growth. Note the one-way causal relationship of FDI to GDP growth in Egypt. Mebratu, Renshui, and Jihong Lin (2015), In general, they found a mutually reinforcing two-way relationship between foreign direct investment and economic growth in Egypt. Using the Generalized Moments Method (GMM), they found that the two-way correlation between FDI inflows and economic growth in Egypt was verified, that is, the high level of FDI inflows has accelerated economic growth. Anis Omri & Amel Sassi-Tmar (2013), They found a positive link between foreign direct investment and economic growth. They also find that economic freedom appears to function as a complement to FDI and that the effect of FDI is more pronounced in the presence of the economic freedom variable. Nahed Zghidi, Imen Mohamed Sghaier and Zouheir Abida (2016), The main findings indicated that FDI has a positive effect on growth only in the countries acceding to the European Union while the effect of FDI on growth in the MENA and non-EU countries is negative. The candidacy for EU membership is an impetus for stronger commitment and more serious reforms that may have led to the positive impact of foreign direct investment on growth, Samer Kherfi and Mohamed Soliman (2005), The empirical results showed that increases in FDI inflows and capital balances enhance the process of economic growth in the countries of the Middle East and North Africa. On the other hand, their findings showed that economic growth in MENA countries interacts negatively with environmental degradation. Mohamed Abdouli and Sami Hammami (2017), This study used a data set for the Egyptian governorates for the period 1992-2007, which studied the effects of total and sectoral foreign direct investment on economic growth in Egypt. The study distinguished between foreign direct investment in industry, agriculture and the service sector. They found that neither total nor sectoral foreign direct investment had an unconditional effect on economic growth.

They also rejected human capital as a conduit for carrying capacity, but revealed an interesting effect of foreign direct investment in the service sector on economic growth in interaction with domestic private investment. Shimaa Hanafy and Marcus Marktanner (2019).

Foreign direct investment is lasting interest that the direct investor in one economy acquire of the direct investment enterprise in another economy. Lasting interest includes two things: the existence of a long-term relationship and involving degree of control when the direct investor has 10% at least as voting power for an enterprise abroad. Ibtessam Zayed Saleh (2009) pages 5,6.

There are also two concepts to be distinguished from FDI: Emam Khalil (2015) pages 332, 333.

Foreign indirect investment is investments by a resident entity in one economy in the debt and equity securities of an enterprise resident in another country which seek primarily capital gains and do not necessarily reflect a lasting and significant interest in the enterprise. The category includes investments which do not involve affiliated enterprises and are below the ten percent rule. Investment report (1999), page 4.

The narrow concept:

which means new investments would be created by the foreign investor (the comparative FDI)

the broad concept:

which is the ownership of part or all of an existing project with the transfer of resources and experiences in all field from the host country (the concentration FDI).

The importance of foreign direct investment for host country:

- It plays an important role in the economic development process so the world countries interest with attracting more and more of foreign investment.
- It is important source for foreign financing that contribute in many processes in the host country.
- It is the most important channel for technology transfer.
- It is important in improving the quality of production in the host country
- It is important in filling the gap between the domestic saving and investment in the host country

The importance of foreign direct investment for foreign country:

- The high cost of transportation pushes the foreign investor to shift his investment in the form of FDI.
- It occurs when the expected return in the host country is more than at home.
- When the foreign governments impose restrictions on trade
- When a foreign company faces a decline in its profits in the home country, it transfers its investments to another country in order to achieve higher profits.
- When a foreign company has a surplus, it invests it in another country, as this surplus if it is invested in the home country will lead to lower prices.

The differences among the foreign direct investment and the foreign indirect investment:

- The foreign indirect investment has not any influence on the management of the enterprise while the foreign direct investment has the right to exercise the management of the enterprise. Amal Mohamed Mahmoud, 2004, page 42
- The foreign indirect investment cover only the transfer of capital while the foreign direct investment in addition to the transfer of capital it covers the transfer of a package of resources and assets. Amal Mohamed Mahmoud, 2004, page 42

The foreign indirect investment interest with high and steady return while the foreign direct investment focus on technologically and dynamic advanced sectors in which firms enjoy competitiveness. Hala Sakr, 1998, page 7.

	FDI	FII
The relation	Long run	Short run
The goal	Achieving higher return and many other goals	Achieving higher return
The investment size	Large (more than 10%)	Small (lower than 10%)
The management participation	Yes	No
Shifting assets	Accompanied by the transfer of tangible and intangible assets	It is purely financial in nature
The nature	Stable	Unstable
The volatility	Lower volatility	Higher volatility

Prepared by the researcher

The types of foreign direct investment:

We will divide the types of FDI according to three aspects to:

- According to the host country.
- According to the home country.
- According to its relationship to trade.

The types of foreign direct investment according to host country: Johannes Voget, 2013, page 3:5,7**.**

Firms can expand their operations in another country either by acquiring another investment or engaging in new investment. Depending on the circumstances, a new investment is better because it allows for greater increase in productivity compared to a joint investment due to resources being idle. On the other hand, entries by acquisition may be especially desirable because they facilitate industry consolidation across borders necessary for an efficiently functioning common international market.

- The comparative FDI (the new investment)

It is foreign direct investment in which multinational corporations purchase capital goods to establish new production facilities abroad. The foreign source contributes only equity or debt to the foreign direct investment. Debt is not financed by local banks. It is also important to note that new investment only increases the capital stock of the host country to such an extent that it stimulates the host economy to supply more capital goods. But it may also crowd out domestic investment. Even then, new investment still involves a change in the ownership of capital goods which are used by the new foreign owner more productively.

- The concentration FDI (the joint investment)

It is foreign direct investment where the transaction is first and foremost a change of ownership. Changes in the capital stock may then occur follow-up or downsizing of investments - as a result of the change in ownership. In the case of acquisitions via stock swaps, the entire volume is recorded as a foreign direct investment flow from the buyer to the target country. In the case of cash acquisition, the amount of FDI may be much smaller than the total size of the acquisition.
The difference between the comparative FDI and concentration FDI:

- The comparative FDI add more to a country's productive capacity especially if there are idle resources.
- The comparative FDI also tends to increase the level of competition more than the concentration FDI.
- knowledge spillovers to the domestic sector are found to be larger in the case of concentration FDI than comparative FDI probably due to the target firm's pre-established linkages within the industry.

The types of foreign direct investment according to foreign country:

- The horizontal FDI:

It is type of the investment in which the foreign investor produces in the host country differentiated products that be identical for the products in the home country. The characteristics of this type of investment contribute to the reduction of trade relations among different countries where aims to serve foreign markets through local production rather than export, as well as prefer investment and production in external markets excessive size and this is to reduce total costs. This type of investment usually occurs among countries with a similar level of growth and is considered as a trade offset because of customs constraints. Yosr Medhat Mohamed Helmy, (2017), pages 42, 65, 101.

- The vertical foreign direct investment: Dalia Ramadan Mahmoud, 2009, page 7

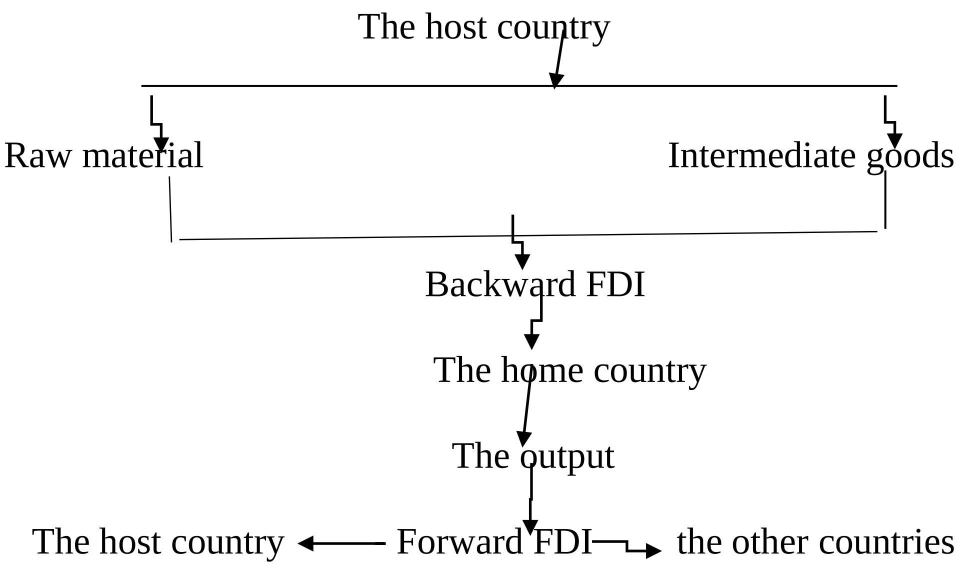
It consists of two types backward and forward FDI

Backward FDI:

It is the type of investment in which the foreign investor extracts raw material or manufacturing an intermediate good

Forward FDI:

It is the type of investment in which raw material or intermediate good are exported for the home country and using it in the production of output and reexported it for the host country.



Prepared by the researcher:

According this type each branch of foreign firms specializes in producing a portion of the production process, which is for export to the home country and is intended to exploit raw material and lower wages. Hussam Shehata Abdulghani, 2016, page 66

The difference between the horizontal FDI and vertical FDI: Nils H, Christos K, Steve McCorriston, pages 85,86

<u>The horizontal FDI</u>:

- It is seeking to access market by replicated production facilities overseas
- The horizontal FDI has been mostly associated with investment flows between developed countries
- The horizontal FDI would imply that foreign acquisitions involve a target firm in the same industry.

<u>The vertical FDI</u>:

- It desires to fragment the production chain with the production abroad leading to the intermediate goods export.
- The vertical FDI has been mostly associated with investment flows between developing countries

The vertical motive would imply that a foreign acquisition involves a target firm on a different stage of the value chain to out-source production stages.

The types of foreign direct investment according to its relationship to trade: Mary Amiti, 2000, page 4:6.

Whether trade and FDI are substitutes or complements depends on the nature of FDI. Trade costs influence the level of affiliate sales in a non-linear way. A symmetric increase in trade costs increases MNE sales if countries are similar in relative endowment and in size and (horizontal FDI). Whereas, when countries differ in relative endowments, with the skilled labor abundant country moderately smaller, higher trade costs reduce MNE affiliate sales higher trade costs bring some plants back home to the skilled labor abundant country (vertical FDI). This gives a straightforward hypothesis on how trade costs affect the relationship between trade and FDI.

Substituting to trade:

Horizontal multinational enterprise theories suggest that they are alternatives. Firms decide whether to serve a foreign market by setting up a factory abroad or exporting goods. When a firm decides to set up a foreign factory, it reduces its exports of goods to that market. As a result, an increase in sales of subsidiaries is associated with a decrease in exports of goods to this market.

Enhancing to trade:

Vertical FDI theories suggest that they are complementary. Here, firms geographically separate the different stages of production across countries to take advantage of lower factor prices. For example, the unskilled intensive stages of the production process are located in a low-wage country and the finished goods are re-exported to the mother country. The home country exports intermediate inputs, headquarters services, and imports final goods. Thus, the increase in the sales of the firm is associated with the increase in trade.
Vertical FDI is more likely to dominate when factor prices are very different between the two countries and trade costs are not too high because higher trade costs reduce sales of subsidiaries of multinational organizations and higher trade costs cause some factories to return to their labor-saving country skilled.
Here, there is an advantage in dividing the different stages of production. With two phases of production, the firm will determine its final production phase in a country abundant in unskilled labor and its headquarters in a country with relatively abundant skilled labor. It is important that the trade costs are not too high because the vertical multinationals are associated with large amounts of intra-company trade, with the home country exporting the headquarters services and importing the finished goods. Vertical MNC sales are particularly high when transportation costs are not too high, the home country is small, skilled labor is abundant, the host country is large, and unskilled labor is abundant.

Economic growth is the main result of any government effort on the national level and the central index of national welfare, as it is also a guarantee of the country's independence. Society with proper economic growth is protected from potential economic risks and threats, so in any country, economic growth will have priority to develop a macroeconomic policy. Economic growth includes changes in material production, expressing the rate of growth of the total national product during a short period of time usually a year. The rapid growth leads to the expansion of the total volume of the economy and it varies from one country to another because it is pre -determined by planning the international economy and the internal capabilities of the country itself, Prateep Wajeeton Gratana (2020) page 1.

Economic development is not only an increase in material production, but it is also all social and economic processes and a series of structural changes resulting from the impact of economic and other factors during a long period of time, which are achieved by increasing participation in the treatment of the industrial and service sector. These changes include many aspects, including changes in the Production structure and introduction of new products, new techniques and technologies, new energy sources, new processes of production, and raw materials. It is also not only at the local level, but it also means the participation of the economy of a country greater and more effective in the international economy, Mladen M. Ivic (2015) page 56.

The implications of foreign investment on economic development in Egypt:

Most developing countries trap in a low-level equilibrium, the low saving rate followed by the low investment rate and therefore the low-income growth rate. It may escape the trap by importing capital from abroad in the form of foreign direct investment. So, developing countries compete with each other to attract a large amount of Foreign direct investment through the adoption of various promotional policies such as liberalization of trade regulations, the establishment of special economic zones, and the provision of incentives to foreign investors. Mottaleb, Khondoker Abdul (2007) page 2

Foreign direct investment is an important indicator for stimulating economic growth. It is an important and indispensable element for development with the impact of different determinants that differ from one country to another. It has a mixed effect on economic growth in developing countries. Hafiz Muhammad Abubakar Siddique (2017) page 112.

In the fifties and sixties of the last century, many developing countries considered FDI a threat to national sovereignty and harmful to economic development. FDI was also seen as a dominant factor in economic development to reduce social welfare through the manipulation of transfers and prices. Galaye Ndiaye1 & Helian Xu (2016) page 33.

In the seventies, trade grew faster than the growth of foreign direct investment. This situation changed dramatically in the mid-1980s, when the increase in foreign direct investment began sharply. During this period, the importance of foreign direct investment increased through technology transfer and the establishment of marketing networks around the world. Dr. Sabah Noori Al-Mihyawi (2019) page 78.

The flow of foreign direct investment increased rapidly during the late eighties and early nineties all over the world, which confirms the positive impact of foreign direct investment on economic development through the transfer of capital, skills, technology, access to markets and the promotion of exports. Sarbapriya Ray, (2012) page 151.

While FDI is currently considered an important tool for economic development due to many factors such as the global context of economic liberalization and pressure on developing countries to solve their economic problems such as unemployment, lack of domestic investment and the need to own modern technologies. FDI also supports the transfer of production technology from developed countries to countries developing. Therefore, it would contribute to economic growth more than domestic private investment. Galaye Ndiaye1 & Helian Xu (2016) page 33.

The microeconomic effects of FDI on the economic growth:

- **The sectoral distribution of FDI in the years (2016:2018)**

According to data collected from the Egyptian central bank

we will rank the sectors according to the share of foreign direct investment for the years 2016 to 2018.

In 2016, the highest percentage of FDI contribution in the petroleum sector, which was 53.5%, followed by the financial sector with 3.8%, followed by the real estate sector with 3.6%, followed by the manufacturing sector with 4.3%, followed by the communications sector with .5%, then the tourism sector by .3%.

In 2017, the highest percentage of foreign direct investment contribution in the petroleum sector, which was 61.2%, followed by the manufacturing sector at 5.8%, followed by the real estate sector with 3.1%, followed by the financial sector

with 1.7%, followed by the construction sector with .9%, then the agricultural sector by .2%.
In 2018, the highest percentage of foreign direct investment contribution in the petroleum sector, which was 67.3%, followed by the manufacturing sector at 10%, followed by the construction sector with 4.5%, followed by the telecommunications with 3.4%, followed by real estate sector with 2.7%, followed by the financial sector with 1.9.

- **The contribution of different sectors to economic growth (2016:2018)**

According to data collected from world bank

will rank the sectors according to their contribution to economic growth.
In 2016, the decrease in tourism led to a decrease in the contribution of the tourism sector by 28.5% in economic growth, and the construction sector contributed with an increase of 11.2 % in economic growth, followed by the communication sector by 8.4%, followed by the electricity sector by 7.1%, followed by the wholesale sector by 5.3% and the extraction sector contribution fall with 5.3%.
In 2017, the contribution of the communication sector in economic growth is 12.5%, followed by the construction sector with 9.5%, transportation sector is 5.3%, real estate is 5.2%, wholesale sector with 5.2%, and the social service is 4%.
In 2018, the increase in tourism led to an increase in the contribution of the tourism sector by 37.7% in economic growth, followed by the communication sector by 10.4%, the construction sector contributed 10 % in economic growth, followed by the Suez Canal 9.6%, the wholesale sector by 8.7% and the extraction sector contributed with 7.7%.

We note that most of the sectors that contribute the most to economic growth are service sectors.

- **The revealed comparative advantage in the years (2016:2018)**

In this section, we will present the sectors with the highest comparative advantage in Egypt for three years

	2016	2017	2018
Fertilizers	44.9	36.05	31.49
The meal and flour	11.7	14.06	22.33
Vegetables	8.9	9.07	7.96
Fruits and nuts	7.45	7.78	6.98
Stone and gravel	7.12	7.15	6.84
Textile	7.1	5.84	8.433

Data collected from UNCTAD

We note from the table that the commodities that have a comparative advantage in Egypt are primary commodities

From this, we find that foreign direct investment is not directed to sectors that have a comparative advantage, so its impact on growth is weak. The sectors that contribute significantly to economic growth are service sectors, so despite the occurrence of economic growth, we do not find economic development and this growth occurs in the short term.

Methodology

$$Q = -1.798 + 0.765L + 0.286K + 0.53FDI$$

(-1.047) (3.923) (2.543) (1.654)

$$R^2 = 0.975$$

(Figures between parentheses are the value of the t ratio)

- Q is the share of sectors in GDP (data source: CAPMAS, The Annual Bulletin of Industrial Census, 2019).
- L is labor share in total employment (data source: CAPMAS, The Annual Bulletin of Industrial Census, 2019).
- K is sector share in fixed capital formation (data source: CAPMAS, The Annual Bulletin of Industrial Census, 2019).
- FDI is sector share in total foreign direct investment (data source World Bank)

Coefficients of labor and capital have positive sign and both are significantly different from zero. This implies that the variation in sector share of output is significantly explained by the variation in sector share of labor and capital. This result is consistent with the expectation of production theory as it is represented by the above production function.

As far as FDI is concerned, the results indicate that the variation in sector share in output is positively affected by the variation in sector share of FDI. However, the results show that the relationship between FDI and output is not significant.

The high value of the R^2 (0.975) indicates that more than 95% of the variation in output of different economic sectors in Egypt is explained by the variation in labor and capital inputs and FDI.

The conclusion

This research focused on the revealed comparative advantage and its relationship to foreign direct investment and economic growth in Egypt. From this, we found that foreign direct investment is not directed to sectors that have a comparative advantage, so its impact on growth is weak. The sectors that contribute significantly to economic growth are service sectors, so despite the occurrence of economic growth, we did not find economic development and this growth occurs in the short term.

Also, it included the role of capital and labor in influencing economic growth and foreign direct investment in various sectors.

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