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RESEARCH ARTICLE

The Role of Foreign Direct Investment in the Economic Transformation of Developing and Arab Countries

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ABSTRACT

This study examines the development of global foreign direct investment (FDI) flows and assesses the share and impact of FDI on developing and Arab countries. It explores how economic transformation, privatization programs, adoption of market economies, openness to foreign investments, and the emergence of regional economic blocs have influenced FDI flows. The research involves a comprehensive review of literature and analysis of statistical data regarding FDI trends, particularly focusing on developing and Arab countries. Findings indicate that despite significant increases in global FDI flows in recent years, developing countries receive less than a third of these investments, with considerable disparities among different regions and countries. The Arab region, in particular, attracts a minimal share of global FDI, not exceeding 1.5% at best, despite efforts to offer incentives and tax exemptions. Inter-Arab investments are also weak due to unfavorable investment climates. However, FDI in developing countries positively affects technology transfer, human capital development, and contributes more to economic development than local investments. The study highlights the need for developing and Arab countries to improve their investment climates to attract more FDI and to leverage the benefits associated with it for economic transformation. This paper provides valuable insights into the role of FDI in the economic transformation of developing and Arab countries, emphasizing the specific challenges and opportunities in these regions. Future research should focus on strategies to enhance the attractiveness of developing and Arab countries to FDI, including policy reforms, improving political and economic stability, and fostering regional cooperation.

INTRODUCTION

In recent years, the world has undergone fundamental transformations affecting various aspects of contemporary life across all countries, irrespective of their level of development (Matyushok, Vera Krasavina & Sendra García, 2021). The last two decades of the twentieth century were characterized by significant changes in politics, economics, and scientific development, leading to a new global reality (Hart, 2021). These changes have impacted the global economic system, presenting both opportunities and challenges, particularly for underdeveloped countries striving to emerge from underdevelopment and achieve economic development.

Economic development has been a central issue in economic thought since ancient times, occupying the attention of local, regional, and international institutions, especially after World War II. However, defining an accurate concept of economic development remains complex due to evolving development thought and the multifaceted nature of the development process (Fajardo, 2021). The interest in growth problems in advanced capitalist economies, efforts to overcome backwardness in underdeveloped economies, and challenges posed by planned socialist economies have intensified the focus on growth and development issues (De Paula & Jabbour, 2020). Furthermore, understanding the historical development of the concept of economic development is crucial for accurately and comprehensively grasping the development process. This understanding also helps in recognizing the significance of recent developments in its concept and content, particularly since the late twentieth century, aiding in formulating an appropriate definition of economic development suitable for current conditions in developing countries (Chen, & Huo, 2022).

The goal of this paper is to present a survey on theories related to foreign direct investment, synthesize recent literature on FDI's role in economic transformation, and suggest promising avenues for future research. The survey on the theory and evidence on FDI has important implications for capital markets since FDI offers investors critical insights into the intrinsic objectives and behavior of corporate entities. Because research on FDI is broad, we narrow the scope to empirical issues based on recent evidence. Although we discuss the empirical literature as it relates to the predictions of theory, the paper does not attempt to provide a comprehensive survey of this literature.

The paper is organized as follows: the first part (Section 1) introduces the study and outlines its goals. The second part (Section 2) examines conceptual clarifications related to economic development and FDI. The third part (Section 3) traces the historical development of the concept of economic development. The fourth part (Section 4) presents a literature review, discussing challenges of economic development in developing countries according to the Foreign Investment Index. The fifth part (Section 5) analyzes recent international trends in FDI. The sixth part (Section 6) discusses the benefits of FDI for developing countries. Finally, the last part (Section 7) concludes the study.

2. CONCEPTUAL CLARIFICATIONS

2.1. Economic Development and Growth

Economic development refers to the sustained, concerted actions of policymakers and communities to promote the standard of living and economic health of a specific area. It involves both qualitative and quantitative improvements in the economy, including advancements in infrastructure, education, healthcare, and reduction in poverty and inequality (Doussard & Yenigun, 2024). Economic growth, a subset of economic development, is the increase in the production of goods and services over a specific period, measured as the percentage increase in real gross domestic product (GDP) (Ebimobowei, 2022). While growth is necessary for development, development encompasses broader societal changes.

2.2. Foreign Direct Investment (FDI)

Foreign direct investment involves investment from a foreign entity into business interests located in another country, establishing lasting interest and control over business operations. FDI is a critical driver of economic growth, facilitating capital inflows, technology transfer, job creation, and integration into the global economy (Kanval et al., 2024; Shihata, 2023).

3. Historical Development of the Concept of Economic Development

3.1. Mercantilist Thought

Between the fifteenth and seventeenth centuries, mercantilist ideas emerged, emphasizing the accumulation of wealth through trade surplus and acquisition of precious metals. Mercantilists believed that a nation's wealth depended on its stock of gold and silver and that the economy needed strong state intervention to achieve a favorable balance of trade (Chijioke, Aloysius & Obi, 2021).

3.2. Classical Economists

Classical economists like Adam Smith and David Ricardo shifted focus towards free markets, specialization, and capital accumulation (Kurz, 2022). Smith introduced the concept of the 'invisible hand,' suggesting that individual self-interest inadvertently benefits society as a whole (Malook, 2024). In his study, emphasized the importance of division of labor, market size, and capital accumulation in driving economic growth.

3.3. Marxist Perspective

Siddiqui (2023), analyzed the capitalist system's inherent contradictions, focusing on how capitalism would eventually collapse due to internal conflicts. In his study, emphasized the role of class struggle and advocated for a socialist system where economic forces would be fully utilized for the benefit of all society members.

3.4. Neo-Classical and Keynesian Economics

Neo-classical economists emphasized market efficiency, resource allocation, and the importance of capital intensity in achieving growth. Keynesian economics emerged in response to economic downturns, highlighting government intervention's role in stabilizing the economy and achieving full employment through increased investment and demand (Juliyanto, Syafi, Fatkhurrozi & Abadi, 2023).

4. THEORETICAL REVIEW

4.1 Challenges of Economic Development in Developing Countries According to the Foreign Investment Index

The global flow of foreign direct investment (FDI) has experienced significant growth in recent years, driven by globalization, the emergence of regional economic blocs, the openness of global markets, and the proliferation of cross-border mergers and acquisitions (Okwu & Obiakor, 2020). This section analyzes the share of developing countries in global FDI, with a particular focus on the Arab region, and evaluates the benefits of such investments to these economies.

4.2. Analysis of Recent International Trends in Foreign Direct Investment

During the 1970s, the annual global flow of FDI was estimated at approximately $27.5 billion. This number rose to $50 billion during the first half of the 1980s and reached $155 billion between 1985 and 1990. By 1996, FDI flows escalated to $350 billion. The surge in globalization and the opening of world markets led to a significant increase in FDI flows to various regions worldwide. In 1997, the volume of FDI flows was estimated at about $364 billion, marking a 4% increase over 1996, with 84% of these investment flows originating from advanced industrial countries through mergers and acquisitions. FDI continued its upward trajectory, recording $648 billion in 1998, $800 billion in 1999, and peaking at $1.3 trillion in 2000 (UNCTAD, World Investment Report 2003).

Following the unprecedented levels of global financial flows recorded in 2000, global FDI flows declined in 2001 by $735 billion for the first time in a decade. Of this decline, $503 billion was in advanced economies, $250 billion in developing economies, and $27 billion in transition economies in Central and Eastern Europe. The decline was attributed to the weakness of the global economy, a decrease in the value of cross-border mergers and acquisitions, the impact of the events of September 11, 2001, and a concentration of the decline in advanced economies (World Investment Report 2002). It was observed that more than 95% of the global investment volume was hosted by only 30 countries, which also constituted the same number on the investment source side, justifying the emergence of new developing countries in FDI exports (UNCTAD, World Investment Report 2003).

In 2002, global FDI flows were estimated at $537 billion, down 27% from their level in 2001. The share of developed countries was $347 billion (65% of the total), developing countries $157 billion (30%), and transition economies $27 billion (5%). China ranked first in the world in 2002 in receiving foreign investment ($50 billion), with a sharp decline in FDI flows to the United States ($44 billion) and the United Kingdom ($112 billion) (UNCTAD, World Investment Report 2003).

Table.1 The share of regional economic blocs in foreign direct investment (1999-2002) in billion dollars.

Year	European Union	APEC Asia Pacific Economic Cooperation	NAFTA North American Free Trade Agreement	ASEAN Association of Southeast Asian Nations	Arab countries
1999	476 44.1%	445 41.2%	321 29.8%	60 5.6%	3,2 0.3%
2000	684 49.14%	554 39.8%	396 28.5%	94 6.7%	2,8 0.2%
2001	390 44.3%	303 36.7%	198 24.1%	45 5.5%	6,7 0.8%
2002	374 57.5%	171 26.2%	64 9.9%	30 4.6%	4,5 0.7%

Source: UNCTAD, World Investment Report (2003)

The data in Table 1 show that the European Union consistently ranked first in terms of global FDI value, accounting for 57.5% in 2002 with a value of $374 billion. The APEC bloc followed in second place, while NAFTA and ASEAN occupied third and fourth places, respectively. The Arab countries remained at the bottom of the list, highlighting their minimal share in global FDI.

Factors Contributing to the Increase in Global FDI

Several factors have contributed to the significant rise in global FDI in recent years:

Increased Need for External Financing: Developing countries have shown a large increase in the need for external financing amid declining savings rates.

Debt Dynamics: Many countries suffering from substantial debt have moved towards selling debt to investors at prices that encourage investment.

Avoidance of Customs Restrictions: FDI is used as a means to avoid customs restrictions resulting from the establishment of economic blocs.

Policy Reforms and Privatization: An increasing number of countries have begun to open up to FDI flows, especially those implementing privatization programs.

Economic Strategies in East Asia: East Asian countries have adopted open-minded strategies, flexible exchange rate policies, and minimal state interference in market forces regarding prices and wages, enhancing their attractiveness to foreign investors.

4.3. The Share of Developing Countries in Global Foreign Direct Investment

In the 1980s, developing countries accounted for 20% of total global investment. This share increased to 33% during the period 1991–1996, while developed countries held 64% in the same period. Specifically, the share of developing countries increased from $12.6 billion in the 1980s to $51.8 billion in the first half of the 1990s, reaching $70 billion in 1994. In that year, 11 developing countries received more than 76% of total global investment (World Investment Report 1996).

Between 1975/1980 and 1991/1996, the share of South, East, and Southeast Asian countries—including China and India—in FDI directed to developing countries increased from 26% to 62%. Concurrently, the share of Latin America and the Caribbean decreased from 53% to 34%. According to the World Investment Report, Latin American countries recovered in 1998/1999, receiving most of the increase in FDI with a share similar to East Asian countries before their financial crisis in 1997. In 1995, developing countries from East Asia and Latin America hosted 80% of FDI directed to developing countries. After the collapse of the Soviet Union, the opening of Eastern European markets created promising opportunities for FDI, especially from Western European countries. The World Investment Reports from 1995 to 2001 indicate that the share of these countries doubled every year, reaching $72 billion in 2001 due to liberalization policies, the availability of skilled and cheap labor, and geographical proximity to OECD countries (World Investment Reports 2001).

FDI flows to developing countries fell from $238 billion in 2000 to $205 billion in 2001. However, this decline was confined to a relatively small number of host countries, particularly Argentina, Brazil, and Hong Kong (China), which saw a combined decline of $57 billion. Africa remained a marginal recipient of FDI, although inflows rose from $9 billion in 2000 to over $17 billion in 2001. This increase was largely due to a few large FDI projects in South Africa and Morocco. Newly industrialized countries, such as China, Hong Kong, Singapore, and Taiwan, began to emerge with significant weight in FDI. As a result, the share of developing countries in total foreign investment flowing abroad increased from 5% in the early 1980s to 9% in 2000. However, the share of developing countries in inward foreign investment decreased from $173 billion in 1998 to $166 billion in 1999, primarily due to financial crises in Asia (since 1997), Brazil (1999), and Argentina (2000) (World Development Report 2005).

4.4. The Weakness of the Arab Region in Attracting Foreign Direct Investment

At the Arab level, despite efforts by Arab countries to attract FDI through incentives and tax exemptions, their share in global FDI remains small. In general, FDI in Arab countries did not exceed 1.5% of total global FDI in 1997 and remained around 1% in 1996, 1998, and 2001. The average percentage of FDI in total global investments during 1995–2001 was about 0.65%, while the average percentage of FDI to GDP in Arab countries during the same period was 0.7%. Between 1999 and 2002, the relative share of Arab countries in total global FDI ranged between 0.2% and 0.8%. In 1999, Arab countries received only about $3.2 billion out of $1,079 billion in global FDI. The percentage of the Arab countries' share of FDI fluctuated, declining to 0.2% in 2000, increasing to 0.8% in 2001, and declining again to 0.7% in 2002 (. Table 2 provides detailed figures of FDI inflows to selected Arab countries during this period (World Investment Report (wir), 2003).

Table.2 Share of Arab countries in global foreign direct investment during the period from 1999 to 2002 - in millions of dollars

Countries	**1999**	**2000**	**2001**	**2002**
Egypt	1065	1235	510	647
Sudan	731	392	574	681
Libya	118-	142-	101-	96-
Tunisia	368	779	486	821
Algeria	507	432	1196	1065
Morocco	1376	423	2808	428
Mauritania	1	9	6-	12
Djibouti	4	3	3	4
Somalia	00	00	00	00
Palestine	19	62	11	41
Lebanon	250	298	249	257
Syria	263	270	205	225
Jordan	158	787	100	56
Iraq	7-	3-	6-	9-
Saudi Arabia	780-	1884-	20	350-
Kuwait	72	16	147-	7
Oman	21	44	42	40
Qatar	113	252	296	326
Bahrain	454	364	81	218
Yemen	328-	6	136	64
UAE	985-	515-	257	95
Arab countries	3184	2834	6714	4532
Total World	1.079.083	1.392.957	823.825	651.188

***Source**: UNCTAD, United Nations conference on trade and development world investment report (wir), 2003*

The weakness of the Arab region and the Middle East and North Africa in attracting FDI is primarily due to prolong political, economic, and security instability. This instability has led to minimal investments in the region compared to other regions worldwide, including high-income economies, middle and low-income economies, Latin America and the Caribbean, and sub-Saharan Africa.

4.5. Weakness of Inter-Arab Investments

The Arab region is not only characterized by its weakness in attracting FDI but also by the weakness of inter-Arab investments (Young, 2022). The cumulative value of inter-Arab investments during 1985–2002 reached about $26.3 billion across 20 Arab countries, witnessing gradual spread among these countries. Between 1995 and 2002, these investments amounted to approximately $16.9 billion, involving 21 Arab countries (Winckler, 2011).

Table.2 Inter-Arab Investments (1995–2002) in Millions of Dollars

Countries	1995	1996	1997	1998	1999	2000	2001	2002	Total
Jordan	35,7	13,5	10,6	12,7	24,2	26,2	27,6	21,0	171,5
UAE	-	-	-	380	176	196	215	217,4	1184,5
Bahrain	13	-	-	16	14	-	217,4	159,6	420,00
Tunisia	54,7	70,2	135	290	506	49,1	69,1	75,0	1249,2
Algeria	3,5	-	-	122	85,8	347,5	350	54,6	963,4
Djibouti	-	-	-	-	-	-	-	-	-
Saudi Arabia	12,2	20,6	27	198	82	76,8	651,4	716,9	1784,9
Sudan	38,8	554	142,5	70,3	151,7	414,6	554,9	567,4	2494,3
Syria	333,5	303	328	212	224	8⍰7	43,5	46⍰5	1499,2
Somalia	-	-	-	-	-	-	-	-	-
Iraq	-	-	-	-	-	-	-	-	-
Oman	4,2	24	18,7	42	45,8	-	-	-	134,7
Palestine	250	-	24,8	56	-	-	-	-	330,8
Qatar	-	-	-	54,4	58	61,8	65,5	68,5	308,2
Kuwait	-	-	-	-	-	-	-	-	-
Lebanon	157,8	250	312	400	500	350	225	650	2844⍰8
Libya	-	-	-	-	-	80,4	85	82,7	248⍰1
Egypt	455	711	532	390	277	113	96,5	100,4	2675,0
Morocco	59,8	61,2	48	48,6	22,2	24,8	39,5	12,8	316,9
Mauritania	-	-	-	-	-	-	-	-	-
Yemen	11,9	86	11	22,2	16,7	68,5	6,5	139,4	362,2
Total	1430,1	2093,5	1589,6	2314,2	2183,4	1817,4	2646,9	2912,3	16987,6
Annual average for the period 1995-2002									**2123,45**

Source: Arab Investment Guarantee Corporation - Investment Climate Report in Arab Countries 2002, Kuwait, p. 68.

Statistical indicators of Arab inter-Arab investments show weak results despite abundant legislation and numerous bilateral and multilateral agreements. These investments are characterized by their small size, concentration in certain countries, and management using traditional governmental administrative methods.

Additionally, Arab countries still represent regions that repel their citizens' investments. The value of Arab investments outside the Arab world is estimated between $800 and $1,000 billion, sufficient to develop the Arab world and elevate it among developed nations. The migration of Arab capital outside the Arab world is primarily due to an encouraging investment climate in Arab countries. Factors include government interventions, loss of investor confidence due to multiple supervisory bodies, high transaction costs, and numerous restrictions compared to other regions.

4.6. The Benefit of Foreign Direct Investment for Developing Countries

While FDI is witnessing significant growth, other forms of capital flow have begun to fade. International aid, once an important source of external financing for developing countries in the 1960s, is now in continuous decline and represents less than one-quarter of international capital.

Commercial financial loans, the main source of capital flows during the 1970s, eroded after the global debt crisis of the 1980s, particularly in Latin America (Hung & Liu, 2022).

Indirect foreign investment in global stock exchanges, which experienced a revolution during the 1980s and until the mid-1990s, remains important but is unstable and carries a degree of risk, as seen in Mexico and East Asian countries during 1997–1998 (Cherrez, 2022). Even after the financial crisis in East Asian countries, FDI remained the only welcomed source of external financing.

4.7. Benefits of FDI to Developing Countries

Technology transfer, FDI enables the transfer of technology in the form of new capital inputs and stimulates competition in the local market for production requirements. It is also a source of capital flows needed to finance trade balance deficits (Razzaq & Delpachitra, 2021). Moreover, it contributes to the development of human capital in host countries through employee training for new projects and increases tax revenues for the host country (Xia, Qamruzzaman & Adow, 2022).

Compensation for Savings Shortfall: FDI compensates for the severe shortage in national savings suffered by developing countries to finance development operations. It contributes to the development of the export sector, as seen in East and Southeast Asian countries and China. Research and Development: FDI contributes to the development of research and development activities in the host country, exemplified by China's relationship with major companies like Microsoft and Motorola.

A comprehensive study by Bosworth and Collins (1999) showed the impact of capital flows on domestic investment in 58 developing countries during 1978–1995. The sample covered almost all of Latin America and Asia, along with many countries in Africa. They differentiated between three types of flows: FDI, portfolio investment, and loans. The study found that FDI has a stronger impact on domestic investment than loans and portfolio investments. For instance, in developing countries, each dollar of FDI leads to an increase in domestic investment by 80% of the FDI amount. Moreover, investment increases economic growth when the level of education in the host country is high.

4.8. Caution Regarding the Effects of FDI

Developing countries must be cautious about adopting an uncritical attitude towards FDI gains. Overreliance on FDI indicates the weakness of host countries, particularly in state institutions. Therefore, caution should be exercised regarding the potential effects of FDI on developing countries. Improving the investment climate for all types of capital, both domestic and foreign, is essential (Asongu, Efobi & Beecroft, 2021). This includes enhancing political and economic stability, reducing bureaucratic hurdles, and fostering a favorable environment for sustainable economic development.

5. EMPIRICAL REVIEW

This section presents a synthesis of recent empirical studies examining the role of Foreign Direct Investment (FDI) in the economic transformation of developing and Arab countries. The empirical evidence sheds light on the impact of FDI on economic growth, technology transfer, human capital development, and the challenges faced by host countries in maximizing the benefits of FDI. Several empirical studies have demonstrated a positive relationship between FDI and economic growth in developing countries. For instance, Borensztein et al. (1998) analyzed data from 69 developing countries and found that FDI contributes to economic growth more than domestic investment, particularly when the host country has a sufficient level of human capital. Similarly, Alfaro et al. (2004) examined the impact of FDI on growth in the primary, manufacturing, and services sectors, concluding that the growth effects of FDI vary by sector and that FDI in the manufacturing sector has the most significant positive impact on economic growth. In the context of Arab countries, Sadik and Bolbol (2003) assessed the effects of FDI on economic growth in six Arab economies and found that FDI had a limited impact due to factors such as inadequate absorptive capacity and less developed financial markets. Their study suggests that improving financial systems and human capital can enhance the positive effects of FDI.

Empirical evidence highlights the role of FDI in facilitating technology transfer and improving human capital in host countries. Fu et al. (2021) investigated U.S. multinational enterprises and found that technology diffusion from these firms to host countries is significant when the host country has a high level of human capital. Blomström and Kokko (1998) also emphasized that technology spillovers from FDI depend on the host country's capacity to absorb new technologies. Kammoun and Fakhfakh (2020), analyzed the determinants of FDI and its impact on economic growth in MENA countries, concluding that FDI positively affects growth when accompanied by human capital development and trade openness. Studies have shown that FDI can enhance the export performance of host countries by integrating them into global production networks. Khan (2023), examined data from the United Kingdom and found that FDI inflows are associated with increased export volumes. In developing countries, Sun (2001) observed that FDI in China significantly contributed to export growth and diversification.

While FDI brings numerous benefits, some empirical studies point out challenges and potential adverse effects. Kopiński (2023), questioned the universal positive impact of FDI on growth, suggesting that the benefits of FDI are contingent on the host country's economic conditions and policies. They argued that without sound economic policies and stable institutions, FDI might not lead to the desired growth outcomes. Asafo-Agyei and Kodongo (2022), examined Sub-Saharan African countries and found that FDI did not have a significant impact on economic growth, attributing this to factors such as political instability, inadequate infrastructure, and weak regulatory frameworks

6. CONCLUSION

In conclusion, the economic transformation of developing and Arab countries is significantly influenced by their ability to attract and effectively utilize FDI. While global FDI flows have increased substantially, these countries receive a disproportionately small share, with the Arab region attracting minimal investment. Despite efforts to provide incentives and tax exemptions, the lack of a conducive investment climate and political and economic instability continue to deter investors. FDI holds immense potential for technological advancement, human capital development, and economic growth, contributing more significantly than local investments to development processes.

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