FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH: A CROSS COUNTRY ANALYSIS

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ABSTRACT

FDI is most preferred type of foreign capital by countries all over the world both by developed and developing countries alike. According to some it is an engine of growth and development and for others it is a universal remedy for all the ills. But what is FDI? According to IMF definition, "FDI is the category of International investment that reflects the objective of a resident entity in one economy obtaining a lasting interest and control in an enterprise in another economy". FDI is universally accepted as an essential element for achieving sustainable development. FDI provide a strong stimulus to income growth in host country. Developing countries are strongly advised these days to rely on FDI in order to supplement national savings by capital inflows and thereby promote economic development.

INTRODUCTION

Since Independence India started with planned economic development for the overall and balanced development of the country but Indian planners were apprehensive of foreign capital. Foreign capital was looked upon with suspicion. The aim of planning was to achieve a Socialistic pattern of society. Public sector expanded by leaps and bounds and private sector was supposed to play a limited role. The push towards liberalization, privatization and globalization in India came in eighties when India faced severe balance of payments crisis. To this crisis fuel was added by oil shocks, which pushed up import bill significantly while exports lagged behind. This led to considerable increase in trade deficits. Remittances from gulf countries also flattened out. The problems multiplied by gulf war in 1990-91. FOREX reserves declined to $1.1 billion in June 1991, which was hardly sufficient for two weeks of import requirement. During this period government had no option but to take loan from IMF, which comes with its conditionality's. One of the condition was external sector liberalization and relaxing restrictions on international flow of goods, services, technology and capital, which is considered as globalization. Thus we started with giving increasing emphasis to foreign capital. The foreign direct investment was allowed under the new regime in almost all sectors of the economy. The economy was opened up to bring it in tune with the global economy. And changes were effected in industrial and trade policies which were substantially liberalized .In the liberalized atmosphere the change in the attitude of the government was inevitable.

The change in the policy of government brought about huge inflows of foreign investment in the country. Researchers are of divergent opinions on the impact of foreign capital in the country. Foreign Investment inflows are considered as wonder pill for all the underdeveloped and developing economies. It is expected to increase employment, percapita income, exports and it brings with it much needed foreign exchange.

LITERATURE REVIEW

Sethi (2006) Capital flows are most helpful when the magnitude of those flows is steady and stable. The international capital flow such as direct and portfolio flows has huge contribution to influence the economic behavior of the countries positively. He attempts to explain the effects of private capital inflows (FINV) on some macroeconomic variables in India using the time series data between April 1995 to Dec. 2006.The study also examines the impact of international capital flows on economic growth, trends and composition and suggest policy implication thereof. Co-integration test confirms the presence of long-run equilibrium relationships between a few pair of variables like private capital inflows (FINV) and economic growth (IIP as proxy of GDP) and FINV and Exchange Rate (EXR). The Granger causality test shows unidirectional causality from FINV to Exchange Rate (EXR) and bi-directional causality from FINV and growth (IIP). Finally study found that Foreign Direct Investment (FDI) is positively affecting the economic growth, while Foreign Institutional Investment (FII) is negatively affecting the growth. The empirical analysis shows that FDI plays unambiguous role in contributing to economic growth. It concludes that capital inflows have not contributed much towards industrial production or economic growth. There are two reasons for this, one the amount of capital inflows to the country has not been enough. Two, the amount of capital that does flow in, is not utilized to its full potential

Kohli Renu (2001) has examined the impact of capital flows on money supply in the Indian Economy. According to her the short experience with liberalization of capital inflows highlights the pressures of a capital surge upon domestic monetary management. It also reveals fiscal led monetary expansion in India, which raises aggregate demand and aggravates the inflationary impact of capital inflows. She has also examined the use of sterilization to limit the impact of foreign currency inflows upon domestic money supply. One reservation about sterilization is its effects upon interest rates. High interest rates would serve to attract further capital inflows, which could be potentially destabilizing. Sterilization also increases public debt and this also involves costs.

According to Kohli Renu (2001) the experience of liberalization of controls on inward capital flows in India shows close similarities with other liberalizing economies of Latin America and Asia. A striking difference between India and these economies is that the magnitude of capital inflows has not been very large in India, as a result of which the challenges to macro and micro economic management has been far less. According to her as the Indian Economy gets increasingly integrated with the rest of the world there is distinct tilt towards portfolio rather than direct investment. According to her the short experience with liberalization of capital inflows highlights the pressures of a capital surge upon domestic monetary management. It also reveals fiscal led monetary expansion in India, which raises aggregate demand and aggravates the inflationary impact of capital inflows. A popularly suggested macroeconomic policy during capital surge according to her is fiscal constraint. But this option is also rarely exercised.

According to Kohli Renu (2001) India has gradually opened up its capital account as a part of broader financial liberalization strategy. Before 1991 India had a closed capital account with capital mobility being restricted through administrative controls and outright prohibition. In the aftermath of Balance of Payments crisis in 1991, India embarked upon transforming the controlled economy into a market driven economy. Following the liberalization of capital flows there was spurt in capital flows into the country between 1992-93 to 1997-98. The article documents trends in capital flows into India in a comparative perspective. She finds volatility in the flows and more tilt towards portfolio investments.

James and Halit estimates of the effects of capital restrictions on growth, especially for developed countries. Capital restrictions reduce the benefits of foreign direct investment (FDI) on growth in developing countries. Estimation results for long-term capital flows demonstrate that countries with higher flows grow faster, challenging the belief that countries must attain a threshold level of development or human capital to benefit from capital inflows. Moreover, findings show that trade with developed countries and FDI inflows are substitutes in developing countries. Overall, the results support capital account liberalization in developed and developing countries.

The paper investigates the relation between capital account liberalization and growth using two groups of capital account openness measures for a larger number of countries than in most previous studies. First, the estimated results for capital controls for the full sample support capital account liberalization. Further regression results indicate that the adverse growth effects of capital controls are more evident for developed countries, but the negative effect of capital controls is weakened by robustness checks for simultaneity.

Using interaction terms between capital controls and capital flows, they find that capital restrictions are more likely to reduce the benefits of FDI inflows on growth in developing countries. These results are invariant to different robustness checks. Second, the estimated results for FDI and portfolio investment flows suggest that countries receiving higher inflows tend to grow faster than countries with lower inflows, controlling for a wide set of other growth determinants, and after robustness checks. The results also suggest that foreign portfolio equity investment likely deepens host-country equity markets, thereby increasing capital accumulation and growth in host countries. Whereas the estimated results are generally consistent with previous studies of the direct effects of FDI on growth, the results contradict earlier studies' findings that for countries to benefit from capital flows, they must have attained a threshold level of development or human capital. Their results demonstrate that FDI inflows have contributed to the growth of developing and developed countries similarly, regardless of their level of economic or political development. The interrelation between international trade, capital flows, and growth is also explored. The results suggest a substitute relation between trade with developed countries and FDI inflows. Overall, the results of this study support capital account liberalization for both developed and developing countries. Capital controls reduce growth through a variety of channels in both developed and developing countries. Capital inflows, especially FDI, increase growth in all countries, regardless of their level of development.

According to Matthieu and Marcel (2008) there is no empirical evidence has yet emerged for the existence of a robust positive relationship between financial openness and economic growth. While some countries have benefited from financial liberalization, others have not enjoyed higher economic growth or have even experienced severe crises and recessions in the years following liberalization. The paper analyzes the openness–growth nexus for a set of 45 developed countries and emerging market economies: 11 OECD, 12 Asian, 8 Latin American, 9 of the new European Union (EU) member states,5 plus Bulgaria, Romania, Russia, South Africa, and Turkey. The time period analyzed is from 1980 to 2002. Many of the 45 countries opened up their capital accounts between 1985 and 1995, while most of the OECD countries in the sample liberalized in the 1960s and 1970s. the paper looks at seven different flow variables, four based on FDI and portfolio flows—combined FDI and portfolio net flows, combined FDI and portfolio *in*flows, FDI inflows, portfolio inflows—two proxies related to the size and composition of foreign debt—total foreign debt, and short-term foreign debt—and trade openness—defined as the sum of exports and imports. Moreover, two proxies are employed for stock variables—combined FDI and portfolio net stocks, combined FDI and portfolio in-stocks. Net flows and stocks refer to the difference between the asset and liability sides of the balance of payments (b.o.p.) in a particular period. The starting point of the empirical modeling is a simple growth model that is standard in the literature (e.g. Barro and Sala-i-Martin, 1995 cited in Mathieu and Marcel, 2008). The dependent variable is the growth rate of real per capita GDP. The control variables are the log of real per capita income at the beginning of the period, the investment to GDP ratio, the population growth rate, and government expenditure over GDP. They have used five-year averages of the variables to reduce the volatility and to avoid the drawback of having strong cyclical factors in the data. A first interesting stylized fact is that real per capita GDP growth in the sample of 45 countries indeed increased immediately following liberalization—indicated by period $t = 0$ in the figures—but then falls back roughly to its pre-liberalization levels thereafter. In addition, the investment to GDP ratio undergoes a similar trend as the growth rate. Secondly, concerning capital flow variables, portfolio inflows and short-term debt inflows seem to accelerate relatively quickly after liberalization. By contrast, FDI inflows rise more gradually over time. Thirdly, about 40% of the countries had liberalized either their domestic financial markets, or their domestic equity markets or both prior to opening up their capital account. The other countries liberalized their financial and equity markets at the same time or later than the capital account. This point relates to the sequencing of reforms, poorer economies—proxies by the initial income per capita—gain more from financial liberalization than richer ones in the immediate aftermath of liberalization, but not afterwards. Secondly, investment is positively related to growth only in the years immediately after liberalization, but not significantly related to growth in the medium to long term.

NEED AND IMPORTANCE OF THE STUDY

The relationship between FDI and Economic growth has been studied many researchers, but the results are mixed and not conclusive. Moreover, the analysis is confined to one particular country. With country specific annual analysis, numbers of observations are bound to be small and for time series econometric modelling we need large number of observations. Therefore, in the present paper we propose to take a panel data of approximately 100 countries over a period of almost 13 years.

OBJECTIVES:

1) To study the impact of foreign investment inflows on economic development (measured by National Income) of the countries of the world.
2) To study the impact of increase in National income of the countries of the world on their FDI inflows i.e. to study if there exists any reverse causation.

METHODOLOGY

Data on approximately all the countries is collected from UNCTAD Data base for the period of 1991-2012.

Using the panel data of approximately 2925 observations after adjustments an attempt is made to study the relationship between FDI and Economic growth in the world. Econometric technique of panel data regression is used for the purpose. In order to pre-empt with the problem of stationarity both the variables are converted to logarithms.

The paper has investigated whether capital account liberalization creates an inter temporal tradeoff, i.e. whether countries experience a short-run gain at the expense of a medium- to long-run pain due to opening up their capital account. Evidence in favour of the existence of such a tradeoff was presented for a broad set of 45 emerging and advanced economies. The opening of the capital account led to a 1.5% higher growth during the first five years after liberalization. Growth subsequently returned to or even below its pre-liberalization rate for the overall average of the countries. However, the results also point to significant regional differences. In particular, many Asian and Latin American economies have gone through such a cycle of faster short run growth but lower medium-run growth in the 1980s and 1990s, whereas EU acceding countries have so far unambiguously gained from financial liberalization. An important caveat, however, is that acceding countries have liberalized much more recently and have not experienced as many severe economic contractions as other emerging markets.

It therefore remains to be seen whether acceding countries can continue to reap benefits from liberalization without experiencing any setbacks in terms of economic growth.

The main implication of the paper is that the presences of such inter -temporal tradeoffs may be one of the key reasons why the literature so far has not found a compelling link between openness and growth. The findings of the paper also suggest that there are strong time-varying relationships between openness, several economic determinants and economic growth. In particular, the paper has presented evidence that economic growth immediately after liberalization is often driven by an investment boom and a surge in portfolio and debt inflows, which then become detrimental to economic growth in the medium to long run.

By contrast, the factors that lead to higher growth in the longer term tend to be the quality of domestic institutions, the size of FDI inflows, and the sequencing of the liberalization process. These findings point to three areas where policy measures can usefully accompany capital account opening: the quality of institutions, the composition of capital flows (in particular with regard to FDI inflows as compared to portfolio inflows), and the sequencing of reforms (with a focus on domestic financial market liberalization).

They finally conclude that there seems to be no simple answer to the provocative question they asked in the title of the paper. On the one hand, they documented the fact that many episodes of capital account liberalization were followed by a growth boom in the short run and a downturn in the longer run and presented ample evidence for this tradeoff.

This paper argues that a key reason for the elusive evidence is the presence of a time-varying relationship between openness and growth: countries tend to gain in the short term, immediately following capital account liberalization, but may not grow faster or even experience temporary growth reversals in the medium to long term. The paper finds substantial empirical evidence for the existence of such inters temporal tradeoff for 45 industrialized and emerging market economies.

The acceleration of growth immediately after liberalization is found to be often driven by an investment boom and a surge in portfolio and debt inflows. By contrast, the quality of domestic institutions, the size of FDI inflows and the sequencing of the liberalization process are found to be important driving forces for growth in the medium to longer term.

RESULTS AND DISCUSSION

In order to study the impact of FDI on GDP first a panel data regression was fitted with GDP as dependent variable and FDI as independent variable.

The results are given in the table below:

Dependent Variable: LOG_GDP				
Method: Least Squares				
Date: 03/13/14 Time: 15:28				
Sample (adjusted): 2 3190				
Included observations: 2925 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	5.625540	0.056891	98.88341	0.0000
LOG_FDI	0.691611	0.008916	77.57346	0.0000
R-squared	0.673066	Mean dependent var		9.559030
Adjusted R-squared	0.672954	S.D. dependent var		2.439459
S.E. of regression	1.395076	Akaike info criterion		3.504459
Sum squared resid	5688.853	Schwarz criterion		3.508548
Log likelihood	-5123.271	Hannan-Quinn criter.		3.505932
F-statistic	6017.641	Durbin-Watson stat		1.798782
Prob(F-statistic)	0.000000			

The results show that LOG_FDI is highly significant and R square is 67%. It implies that FDI helps in economic growth and countries with high FDI also have higher economic growth. There are also the chances of reverse causation i.e. countries with high GDP may be attracting high FDI and therefore one more equation was fitted with FDI as independent variable and GDP as dependent variable. The results are given in table below:

Dependent Variable: LOG_FDI				
Method: Least Squares				
Date: 03/13/14 Time: 15:29				
Sample (adjusted): 2 3190				
Included observations: 2925 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-3.615278	0.123763	-29.21121	0.0000
LOG_GDP	0.973185	0.012545	77.57346	0.0000
R-squared	0.673066	Mean dependent var		5.687427
Adjusted R-squared	0.672954	S.D. dependent var		2.893745
S.E. of regression	1.654873	Akaike info criterion		3.846009
Sum squared resid	8004.938	Schwarz criterion		3.850098
Log likelihood	-5622.788	Hannan-Quinn criter.		3.847482
F-statistic	6017.641	Durbin-Watson stat		1.726257
Prob(F-statistic)	0.000000			

The t-value is highly significant and R square is again 67%. It implies that countries with higher growth have more FDI inlows.

CONCLUSIONS

Thus to conclude that the causation between FDI and economic growth is both the ways and both are equally influencing each other. This also explains the reason why in India even after opening up of retail sector foreign retail giants are not motivated to invest because of declining growth in the last few years.

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