

What Are the Impact of FDI to Economic Growth?

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Abstract

FDI has been perceived as important factor for economic growth in the African countries. FDI seems to contribute in the economic growth through the following channels. (a) Firms spills over effect (b) introducing new technology (c) enhancing R& D services (d) increasing employment opportunities (e) enhancing trade development. However, the empirical literatures has not clear consensus in believing that FDI has positive contribution to the economic growth. Furthermore, the causal relation between FDI and economic growth has still remained as country specific results. Unfortunately, most of these researches have been conducted in developed and middle income countries especially East Asian countries.

1.0 Theoretical Literatures On Relationship Between Foreign Direct Investment And Economic Growth

Under neo classical growth theories capital accumulation was seems as important driving factors towards steady state level of economic growth. Technological progress, capital and labor productivity was the main forces for economic growth. The efficiency of these factors increase total productivity function through higher investment in economy. In this model, FDI seems to improve technological progress. Furthermore, due to increase higher investment thereby increases productivity level and per capita income. However, under neo classical growth theory, total factor productivity which is highly affected by FDI determined by the external factors. From this fact, could not guarantee long run steady state impact (Hsiao and Hsiao, 2006). On top of that, this models failed to interact (endogenise) economic growth with advantage of foreign technologies from developed countries, that are introduced through FDI (Yao and Wei, 2007).

In addition to that, in late 1970s neo classical economic theories of FDI came to support the idea of positive relationship between FDI and economic growth. This neo classical theory of FDI has shown a way in which FDI can operate. Kojima (1975) argued that, transfer of capital is not only influenced with the marginal productivity, but it is influenced with the differences in technology gaps. Thus FDI rise from low technology to higher technology areas.

From these facts, neo classical theories for FDI have shown the following advantages that rise from FDI. (a) It introduces new technology from developed countries to developing countries. Moreover, introduce new managerial skills training of workers (b) generate employment (c) foreign exchange and (d) improve balance of payment (e) rise competition which lead to proper utilization of resources and increase productivity (Bergten et al, 1978; Kojima, 1978; Kojima 1975; Reuber et al, 1973). However, neo classical theories of FDI give less attention to whole macroeconomic relationship with economic growth factors in their analysis.

From this weakness, led to the rise of endogenous growth in 1980s. This theory emphasized endogenous relationship among technological progress, human capital spills over effect and economic growth. FDI was seems as a permanent driving factor to growth of host country economy through technological spillovers and technology transfer (Romer, 1986; Lucas, 1988; Barro and Sala -I- Martin, 1995). Endogenous growth theory, argued that developing countries through FDI can absorbs technologies from advanced economies (Li and Liu, 2005).

From these theories it was believed that FDI had a positive role in the host country. In general, FDI increase capital accumulation in host country's economy. This is achieved through introduction of new inputs to firms and new technologies in productions (Esso, 2010; Li and Liu, 2005; De Mello, 1997). In this respect, we can say new inputs and technology which introduced through FDI allow domestic firms to have variety of intermediate goods and more efficiency technology. This will help to improve domestic production thus economic growth.

1.1 Empirical Literatures On Relationship Between Foreign Direct Investment And Economic Growth

The empirical literatures for FDI and economic growth have been extensively documented especially in late 1980s. The results are still mixed due to the different type of method, sample and time trend of the observations.

a. Positive Impact

In mid 1990s many literatures argued that, FDI has positive impact to economic growth. Most of these studies used cross section and panel methods in their analysis. These studies include, De gregorio (1992), Fry (1992), Blomstorm et al (1994), Balasubramany et al (1996), Blomstorm et al (1998). In general, they argued that FDI is more productive rather than domestic investment for developing countries. They insisted on the role of macroeconomic policies, trade openness and level of economic growth to ensure the spills over effect from FDI efficiently utilized. For example Fry (1992) and Blomstorm et al (1994) found that, FDI play important role for

higher income countries with more human capital and good macroeconomic policies. However, they found that, FDI fails to transmit spillover effect to low income countries.

Furthermore, most of the studies during 2000s had found that FDI has positive impact to economic growth. Li and Liu (2005), Wan Azman Saini et al (2010a,b). Instead of cross section analysis, these literatures used panel methods such as GMM methods. Yet, most of these literatures continued to insist role of macroeconomic policies as to ensure that, FDI has positive impact to economic growth. These factors were economic freedom, human capital development, financial development and trade openness.

For example, Yao and Wei (2007), Apergis et al (2008) and Wan Azman Saini et al (2010a, b) found that FDI has no direct impact to economic growth, however the results are positive and significant when there is financial development or economic freedom. In contrast, Alguacil (2011) using GMM method suggested that FDI has more significant role to low and middle income countries, rather than developed countries. Low income countries has shortage of domestic investment as a results, FDI play more important role. These results were supported by Li and Liu (2005). However, the results contradict with Apergis et al (2008) and Blomstorm et al (1994)

b. FDI has no impact to economic growth.

Most of these studies used OLS or panel method yet, they argued that FDI do not have impact to economic growth .For example, Ghebreyesus and Cordel (1998) Using OLS method they found that, FDI had no significant positive impact to economic growth in Sub Saharan African countries. They argue that aid does not support capital formation in these countries. In addition to that, Carkovic and Levine (2002) used OLS and GMM methods, they found that FDI has no impact to economic growth.

Furthermore, Carcovic and Levine (2003) and Hanson (2001) had supported the idea that, there is no relationship between the economic growth and FDI. They stress that, inflow of FDI did not have any significant impact in economic growth, since it fails to accelerate spills over effect in domestic firms.

Certain groups of studies continue to have mixed results, however, they stressed that, FDI in primary sectors are less effective compare to FDI in manufacturing sectors. It has empirically been found that, those inflows of FDI in primary sectors cannot guarantee benefits of FDI. This is common to most of African countries. For example, Akinlo (2004) using Error correction model found that private capital and FDI had only small but insignificant effect in promoting economic growth in Nigeria.

Most of FDI inflows are directed to extractive sectors (primary sectors) like oil sectors which had no close relationship with the overall macroeconomic sectors. Furthermore, Wan Azman Saini et al (2010a, b) found that FDI has no direct impact to economic growth instead, it depends on financial development or economic freedom policies in the host country. Moreover, Alguacil et al (2011) using GMM method suggested that FDI has no impact to developed countries.

c. Causality relation between FDI and Economic growth

Instead of long run relationship, some of the literatures investigated short run relationship between FDI and Economic growth .For example, Magnus and Oteng-Abayie (2008), suggested that there was no causality relationship between FDI and growth for the entire period from 1970 to 2002 in Ghana. Furthermore, for the period of pre Structural Adjustment Programme (SAPs) from 1970-1983, there was no causality relations between FDI and Growth. Furthermore, during post structural adjustment programme (SAPs) period 1984-2002, their results was different .They found that FDI cause growth and not vice versa.

On the other hand, Chakraborty and Nunnenkamp (2008) using panel co integration frame work found that, in India there is long run relationship between FDI and output. Furthermore, argued that the effects of FDI are varying across sectors. They found feedback Granger causality relationship in short and long run between FDI stock and output in manufacturing sectors. However, in primary sectors there were no any causal relationships. In general, both literatures Magnus and Oteng Abayie and Chakraborty and Nunnenkamp suggested that, major reasons for the failure of FDI to stimulate economic growth are due to the higher concentration to primary sectors. They argue that, primary sectors do not have close relationship with the economic growth. From this facts, suggested that it is better to direct FDI in manufacturing sectors or agricultural sectors.

Moreover, several studies also found that FDI Granger cause economic growth and long run relationship with economic growth, trade and capital formation. For example, Esso (2010) in 10 Sub Saharan countries, Yaoxing and Serge(2010), Jayachandran and Seilan(2010), Adhikary (2011) in Bangladesh, Feridun and Sissoko(2011) in Singapore. Common method used was Bound test, Toda and Yamamoto and VAR. However, Esso (2010) found that, economic growth cause FDI inflows in 3 Sub Saharan countries.

2.0 CONCLUSION AND RECOMMENDATIONS.

Furthermore, the relationship between FDI and growth are still mixed. In fact, the following matters has been outlined as important policies to ensure that host country can absorbs positive impact of FDI . (a) Human capital (b) political stability (c) good economic policies in host country including (d) openness of economy (e) good monetary policies (f) export oriented regime (g) financial development. Furthermore, some of the studies have

suggested the importance of FDI inflows in manufacturing sectors rather than primary sectors. It has been suggested that most of the primary sectors, especially, mining activities have found to have low linkage with the overall macroeconomic performance, especially for the developing countries.

Generally, commonly used methods are panel methods that are mainly used for cross country analysis and panel co integration framework under Pedroni (1999). On other hand time series methods such as Toda and Yamamoto (1995), ARDL bound test under Pesaran et al (2001) and Johansen and Juselius (1988.) However, these methods have been argued that, they face several limitations. For examples, they not give information of the single country, but only give the average in all cross observations. In panel and cross section studies they use few data that can accelerate the biasness.

On top of that most of time series studies rely mainly on bivaried analysis. The use of bivaried analysis has several weaknesses. It can cause the invalid inferences, faces the problem of mis-specification, and cannot make analysis of interaction with more than one variable. In this case, these studies had not considered the VECM test which differentiates short run and long run co integration and causality relationship.

Moreover, many studies during 2000s to the current, have investigated only the relationship of FDI and growth .Furthermore, they are only directed to developed and the East Asian countries .Very few studies have been conducted in African countries. There are very few studies, especially for the Sub Saharan countries that that used the time series analysis, especially Dynamic Ordinary Least Square (DOLS). Most of studies conducted in Africa used OLS methods that can create the problem of spurious results.

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