The Impact of Foreign Direct Investment on Economic Growth: A Case Study in Vietnam 1990 – 2015

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Abstract

Over the past 20 years, the role of FDI in the Vietnamese economy has been important. FDI is one of the essential factors for the domestic economic growth. FDI not only increases the supply of investment capital but also promotes technology transfer, human capital accumulation, which promotes long-term economic growth. This paper employs time series techniques to analyses the effect of the foreign direct investment on economic growth in Viet Nam. The study uses annual data over the period 1990 - 2015. The gross domestic product (GDP) is the dependent variable, and foreign direct investment (FDI), gross fixed capital formation, real exchange rate, real interest rate, and inflation rate are the explanatory variables.

Keywords: Gross domestic product, foreign direct investment, gross fixed capital formation,

1. Introduction

According to the International Monetary Fund, foreign direct investment, commonly known as FDI, "... refers to an investment made to acquire a lasting or long-term interest in enterprises operating outside of the economy of the investor." The investment is direct because the investor, which could be a foreign person, company or group of entities, is seeking to control, manage, or have significant influence over the foreign enterprise.

Foreign direct investment (FDI) is a capital inflow which a company in one country expands or built a subsidiary in another country; it involves the acquisition of control and transfer of resources (Mun *et al*. 2008). Foreign direct investment (FDI) plays a significant role in the economic growth of developing countries. Economic and technological forces orient the growth of international production. The liberalization of trade policies and foreign direct investment also oriented it. In the context of globalization, this is an opportunity for developing countries to achieve faster economic growth through trade and investment (Makki & Somwaru 2004). The advantage for developing countries is that FDI provides the necessary resources for developing countries such as capital, technology, management skills, entrepreneurship, brand and market access (Hossain & Hossain 2012; Alshehry 2015). These factors affect employment, income, production, price, import and export, which are essential for developing countries to industrialize, develop, and reduce poverty in their country. Also, FDI stimulates the development of the local industry through the spillover effect of technology, enhancing the export competitiveness of the host country because goods produced by the foreign companies are the result of better technology, and then can be sold more easily abroad. Brands are more popular and satisfy the quality standards required by the international market. As a result, most developing countries recognize the potential value of FDI and have liberalized their investment regimes and participated in investment promotion activities to attract various sources of capital. Globalization and integration promote the liberalization of trade policies and foreign direct investment that reduce trade costs, change the level and pattern of FDI. Finally, the role of FDI deriving from better management and marketing strategies from foreign companies can be realized (Pacheco- Lopez 2005).

FDI inflows to Vietnam since 1988 have been considered as an important phenomenon of economic transition from a centrally planned economy to a socialist-oriented market economy (Nguyen and Nguyen 2007; Ohno and Le 2014). Specifically, FDI inflows have increased annually from the US $ 0.34 million in 1988 to the US $ 14,500 million by 2015, which has an important role in promoting the economic growth of Vietnam.

This paper employs time series techniques to analyses the effect of the foreign direct investment on economic growth in Vietnam. The study uses annual data over the period 1990 - 2015. The empirical analysis starts with run ordinary least square (OLS), which found that there is the statistically insignificant positive impact of foreign direct investment on gross domestic product (GDP) in Vietnam. Also, there is a significant as well as positive impact of gross fixed capital formation, real exchange rate, and real interest rate on economic growth; however, there is the negative and insignificant impact of inflation rate on economic growth. The result of Augmented Dickey-Fuller (ADF) test hence shows that the series are non-stationary in the level form, first difference and stationary in the second difference. This study uses Granger causality test to find the relationship between FDI and GDP. The result demonstrates that there is one-way causality between FDI and GDP in the context of Vietnam.

The remainder of the paper proceeds as follows: Section 2 focuses on literature review. Section 3 discusses methodology and sources of data. In Section 4 presents the empirical findings, and Section 5 presents

some concluding remarks.

2. Literature review

Foreign direct investment can be seen as a catalyst for productivity growth, capital accumulation and technological progress, job creation and productivity gains through knowledge and transfer skills. Delivery, application of new technology in the development of production capacity (De Mello 1997).

Over past two decades, FDI inflows to developing countries have increased considerably, globalization and trade liberalization have helped to rotated capital flows, production factors around the world. Backed up by the advancement of communication and information technology (Nair-Reichert & Weinhold 2001). Multinational Corporations (MNCs) refer to developing country indicators for investment choices, contributing to reducing inequalities among industrialized and underdeveloped countries. By the foreign direct investment, MNCs based on the most advanced production and organizational methods are seen as powerful means of transferring technology to poorer developing economies, allowing many developing countries to design policies to attract foreign investment from industrialized nations. To meet the demand for the use of advanced technologies in management and production, these companies need a well-trained workforce. Developing countries has a plentiful labor force, they need more advanced education and training methods to provide a skilled workforce, but they have to spend a high amount of investment (Ilgun *et al.*2010). MNCs have an active impact on human resources in host countries through the training that they provide to local workers by their subsidiaries. These training courses affect staff levels from simple skills, management skills to advanced technology. Research and development activities sponsored by MNCs also contribute to the development of the local workforce and thus allow their economies to develop in the long run (Blomström & Kokko 1998; Balasubramanyam *et al.* 1996).

In the range of factors such as infrastructure, market size, and skilled labor, these are considered fundamental determinants of foreign direct investment in developing countries. In addition, the impact of foreign investment on growth is positive when the recipient country has achieved a certain level of development measured by capital, income, or human capital (Borensztein 1998; Blomström 1992). The presence of multinational companies is positive externalities. "Characterized by differences in enterprise size and labor productivity spillovers (De Mello 1997).

Bahname (2012) studied the impact of FDI on economic growth in South Asia over 1977 - 2009. The results show that FDI along with other variables such as human resources, infrastructure, and gross fixed capital formation has a positive and significant impact on economic growth. Similarly, Abdullahi *et al*. (2012) conclude that FDI promotes economic growth in African and Asian countries period 1990 - 2009, he suggesting that the economy needs more expansion, more investment in infrastructure and greater political commitment to the fight against corruption. According to a study by Pardeep Agrawal (2000) on the "Economic impact of foreign direct investment in South Asia," a cross-sectional analysis of panel data from five South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal). The additional impact and linkage between foreign investment and growth were positive in the late 1980s and early 1990s. Mottaleb (2007) study on "determinants of foreign direct investment and its impact on economic growth in developing countries," suggesting that economic growth could be significantly affected by foreign direct investment. Li & Liu (2005) examined the relationship between FDI and economic growth on a data sheet for 84 countries between 1970 and 1999 and found the positive impact of FDI on economic growth. Through its interaction with human resources in developing countries, a negative impact of FDI on economic growth is through its interaction with technological distances. Influence of FDI inflows on economic growth of the host country through channels such as financial markets, absorption capacity, human resources, and technology (Carp 2012). However, de Mello emphasized that FDI led to growth depending on the level of complementarity and replacement between FDI and domestic investment.

By applying the theory of endogenous growth, Lucas (1988, 1990), Romer (1986, 1987) and Mankiw (1992) improved the exogenous growth model from the Solow growth model, using the growth rate of labor and capital to explain the presence of FDI in developing countries. Based on their model, it shows that the effects of FDI on economic growth can be through technology transfer. Technology diffusion plays a central role in promoting economic growth. FDI can contribute significantly to human capital such as management and research and development skills (R & D).

Based on location advantage, many empirical studies have shown that economic growth is an important determinant of FDI inflows. Moore (1993) argued that as economic growth accelerates, FDI inflows to host countries tend to be encouraged. Balasubramanyam, Salisu & Sapsford (1996) using data from 46 developing countries show that the effects of FDI growth are stronger in countries pursuing encourage export policy rather than substituting import. Their analysis shows that the output elasticity for FDI is greater than domestic investment, which implies that FDI is a driving force in growth. In an empirical study, Borensztein *et al*. (1998) examined the effects of FDI on economic growth in 69 developing countries in two phases, 1970-1979 and 1980-1989. In which economic growth rates are determined by FDI, human capital, government consumption,

domestic investment, the black market premium on foreign exchange, a measure of political instability (political assassinations and wars), a measure of political rights, a proxy for financial development, the inflation rate, and a measure of quality of institutions, they used the 2SLS estimation method to solve the endogenous issues and found that FDI inflows have a positive effect on economic growth. In addition, between FDI and domestic investment, there are additional relations, FDI is an important means of technology transfer, contributing to greater economic growth than domestic investment. Chakrabarti (2001) points out that larger FDI inflows result in higher economic growth as it is a measure of the attractiveness of host countries.

By using a datasheet for 18 Latin American countries between 1970 and 1999, Bengoa & Sancher - Robles (2002) showed that the impact of FDI on economic growth is positive only when the host country has enough human resources, economic stability, and market liberalization. Similarly, using the 84 country data, Wang & Wong (2009) showed that FDI promotes economic growth only when the host country has a sufficient level of human capital. Alfaro *et al.* (2002), using transnational data for the period 1975 - 1995, showed that FDI plays an important role in contributing to growth. However, countries with better - developed financial markets can exploit FDI more effectively. This finding was supported by Hermes & Lensink (2003) using a data sheet of 67 developing countries for the period 1970-1995, and Aghion *et al.* (2006) used a sample of 118 countries over 1960 - 2000. Moreover, they also emphasized that the first LDCs needed to reform their domestic financial system before liberalizing capital to allow FDI inflows. As a result, FDI inflows are very important to promote economic growth in these countries. Bende - Nabende *et al.* (2002) examine the two-way relationship between FDI and economic growth in ASEAN countries in the period 1970-1996. The results show that FDI promotes strong economic growth through human resources, learning effects, and economic growth affects FDI attraction.

Al - Ahdulrazaq & Bataineh (2007) used the ARIMA model to forecasting foreign direct investment inflows into Jordan over the coming period 2004-2025. Research showed that foreign direct investment tends to increase and had a positive impact from the inflows of foreign direct investment to the various macroeconomic variables in the Jordanian economy. However, there is no consensus on the stability or efficiency of FDI for growth. Adamu *et al.* (2015) using time series data from 1970 to 2012 found a positive and significant relationship between FDI and economic growth in Nigeria. In order to keep this positive linkage, it is necessary to continue to implement FDI attraction policies, especially in Nigeria's non-oil sectors. The positive effects of FDI on economic growth are also supported through experimental research by Ghatak & Halicioglu (2007).

In Vietnam, there have been many studies on the relationship between FDI and economic growth. FDI has a positive impact on economic growth, the addition of development investment capital, economic restructuring, job creation, commodity production, exports, and balance of payments and enhances the competitiveness of the economy (Doan 2004, Nguyen 2004). Similarly, using table data covering 61 provinces of Vietnam in 1995-2006, Hoang *et al.* (2010) shows that there is a strong and positive influence of FDI on Vietnam's economic growth as a channel for raising capital, human resources and trade, allowing for improved technology and knowledge contribution accelerate economic growth of Vietnam.

3. Methodology and Data

Based on the theoretical models of the neoclassical and endogenous growth as well as various empirical analysis models such as Borensztein *et al.* (1998), Adamu *et al.* (2015), Hoang *et al.* (2015), the econometric model is derived from a production function framework in which FDI is incorporated as one of the factor inputs, along with gross fixed capital formation, real exchange rate, real interest rate, and inflation rate. The model for this study is specified as follows:

$$GDP = f(FDI, GFCF, RER, IR, IFR)$$

This equation can be transformed into a linear function thus:

$$GDP_t = \alpha_0 + \alpha_1 FDI_t + \alpha_2 GFCF_t + \alpha_3 RER_t + \alpha_4 IR_t + \alpha_5 IFR_t + \varepsilon_t$$

Where dependent variable is GDP (gross domestic product), and the independent variables are FDI is foreign direct investment inflows in Vietnam, GFCF is gross fixed capital formation, RER is real exchange rate, IR: Real interest rate, IFR is inflation rate, α_0 is constant, $\alpha_1 - \alpha_5$ are the coefficients of the explanatory variables, and ε_t is error.

Due to the relationship between non-linear variables. Furthermore, the value of the variables is a unit, in the case of the ln model, the value of the coefficients can be expressed in terms of percentage or elasticity rather than a unit. For the purpose of estimation the equation to be tested was obtained by taking the ln on both sides, an equation that could be rewritten as follows:

$$lnGDP_t = \alpha_0 + \alpha_1 lnFDI_t + \alpha_2 lnGFCF_t + \alpha_3 lnRER_t + \alpha_4 lnIR_t + \alpha_5 lnIFR_t + \varepsilon_t \quad (1)$$

Where variable on the left side is dependent, variable and variables on the right side are the exogenous variables. In addition, we expect that FDI inflow, gross fixed capital formation, real exchange have a positive impact on economic growth, while the inflation rate will have a negative relationship with economic growth in Vietnam.

This article uses OLS multivariable regression to determine the effect of independent variables on

dependent variables. The choice of the OLS method gives the least squares the least squares and has some advantages such as zero deviation, consistency, minimal variance and minimum efficiency; It is widely used based on BLUE (Best, Linear, Unbias, Estimate) rules, simple and straightforward (Gujarati 2004). The Stata econometric software 13.0 was used for this analysis. Statistical testing of parametric estimators was conducted using standard errors, t-test, F-test, R, and R^2. Economic criteria show that the coefficients of the variable are consistent with predicted economic expectations, while the statistical criteria test is used to assess the magnitude of the overall regression.

This study using annual data for the period 1990 - 2015. The data were obtained from World Development Indicators published by the World Bank for Vietnam.

4. Results and Discussion

4.1. Ordinary Least Square Regression

The key idea of the Ordinary Least Square regression is that employing this model in order to estimate the coefficients and intercept through minimizing the sum of squared estimate errors in the multiple regression models.

Table 1. OLS regression

Variable	Coefficient	Std. Error	t-Statistic	p-value
lnFDI	0.2629375	0.0404822	6.50	0.000
lnGFCF	0.5177922	0.0559609	9.25	0.000
lnRER	0.9279649	0.1447892	6.41	0.000
lnIR	0.0346428	0.0883707	0.39	0.699
lnIFR	-0.0531581	0.0424955	-1.25	0.225
Constant	-2.186621	0.9548816	-2.29	0.033
R-squared	0.9954	F-statistic		865.15
Adjusted R-squared	0.9942	Prob(F-statistic)		0.0000
Durbin-Watson stat	1.440864	Observations		26

Source: Author's Computation

Estimated function:

$$GDP_t = -2.186621 + 0.2629375 FDI_t + 0.5177922 GFCF_t + 0.9279649 RER_t + 0.0346428 IR_t - 0.0531581 IFR_t$$

In the estimated regression line above, the value of α_0 (the constant term) is -2.186621, which means that holding the value of FDI and all other variables used in this regression constant, the value of GDP will be about -2.186621. The regression coefficient of FDI in the estimated regression line is 0.2629375 which implies that which shows that 1% rise in FDI would result in 0.2629% increase in GDP of Vietnam. The calculated t-statistics for the parameter estimates of foreign direct investment is 6.50 which is greater than the value of the tabulated t-statistics illustrates that the relationship between GDP and FDI is positive and statistically significant for the period under review.

Additionally, the regression coefficient of GFCF in the estimate regression lines is 0.5177922, which means that a 1% rise in GFCF would result 0.5177922% increase in GDP within the period under study was accounted for by changes in GFCF. The calculated t-statistics for GFCF is 9.25 which is greater than the value of the tabulated t-statistics indicates that the relationship between GDP and gross capital fixed formation is positive and statistically significant.

In the estimated regression line above, the regression coefficient of RER is 0.9279649 which implies that a 1% rise in RER may result 0.9279649% of the increase in GDP within the period under study was accounted for by the RER. The calculated t-statistics for RER is 6.410 which is greater than the value of the tabulated t-statistics implies that the relationship between Gross domestic product and RER is positive and statistically significant.

The real interest rate has a positive and statistically significant impact on Vietnam's GDP. With a 1% rise in interest rate may result in 0.0346428% of the increase in GDP.

On the contrary, the inflation rate has a negative and statistically significant influence on the economic growth. Particularly, a 1% increase in the rate of inflation will lead to around 0.0531581 decreases in GDP. High inflation rate causes relative price volatility and misallocates resources, reduce investment, raise economic instability, changes in exchange rate policy. It leads to the slowdown of economic development.

4.2. Unit Root Test

Since most of the economic time series data are unstable, the prerequisite of conducting regression approach is to ensure that the objective time series data is stabilized; otherwise, the obtained regression results would be susceptible. As Unit Root Tests is aimed to test the stationarity of time series data of interest, this section employed the Augmented Dickey-Fuller (ADF) Unit Root Testing approach by running Stata 13.0. The outputs

are provided in Table 2.

Table 2: Augmented Dickey-Fuller Unit Root Test

Variable	At level	First difference	2nd difference
lnGDP	-3.266	-5.786	-10.675*
lnFDI	-1.928	-3.167	-5.481*
lnGFCF	-2.002	-2.934	-5.449*
lnRER	-8.222	-8.836	-5.663*
lnIR	-1.804	-5.375	-8.233*
lnIFR	-2.687	-6.838	-9.077*

Source: Author's Computation

**, * Denotes rejection of the null hypothesis at the 5% and 1% levels of significance

   The test results show that all the data are found to be nonstationary at the level, I(0) and first difference, I(1). After second differencing, the null hypothesis (H0) for the existence of a unit root in the three variables is rejected, implying that the three variables used in the study are integrated at order two, I(2). The findings confirm that there is a possibility of having a co-integrating vector of which coefficient can directly be explained as the long term equilibrium.

4.3. The Granger Causality Test

The Granger causality test is conducted to check the existence of causality between FDI and economic growth. This model is in line with Engle and Granger (1987), Khan (2007) and Egbo (2010).

   The Granger causality test was used to explore the existence of a bi-directional causality between GDP and FDI for Vietnam for the proposed study period. If FDI can help to forecast GDP, then we can say that FDI Granger-causes GDP. However, if FDI causes GDP and not versa vice, then we say there is unidirectional causality exists from FDI and GDP. The Granger approach answers the question whether GDP causes FDI by finding how much of the current value of GDP can be explained by past values of GDP and lagged values of FDI. Thus, to test for causality between GDP and FDI, we shall estimate the following regression equations:

$$d(2)\_lnGDP_t = \gamma + \sum_{i=1}^{k} \alpha_i.d(2)\_lnGDP_{t-i} + \sum_{i=1}^{k} \beta_i.d(2)\_lnFDI_{t-i} + \mu_t \ (2)$$

$$d(2)\_lnFDI_t = \emptyset + \sum_{i=1}^{k} \delta_i.d(2)lnGDP_{t-i} + \sum_{i=1}^{k} \theta_i.d(2)\_lnFDI_{t-i} + \eta_t \ (3)$$

Where $d(2)\_lnGDP_t$ and $d(2)\_lnFDI_t$ are stationary time series sequences, μ_t and η_t are the respective intercepts, and are white noise error terms, and k is the maximum lag length used in each time series (decided by Akaike Information Criterion (AIC) or Bayesian Information Criterion (BIC)). FDI is said to Granger cause GDP if the β_i coefficients are jointly significantly different from zero. Similarly, GDP is said to Granger cause FDI if the δ_i coefficients are jointly significantly different from zero.

   According to our results we reject the null hypothesis and accept the alternative hypothesis is that FDI can cause GDP. In the case of GDP, we accept the null hypothesis that means GDP does not cause FDI.

Table 3. Granger causality Wald tests

Null Hypothesis		Lag 1	Lag 2	Lag 3
d(2)_lnFDI does not Granger - cause d(2)_lnGDP	F - statistic	12.75	3.5933	5.0144
	P - value	0.0019	0.0499	0.0144
d(2)_lnGDP does not Granger - cause d(2)_lnFDI	F - statistic	2.4726	.08575	0.1309
	P - value	0.1315	0.9182	0.9401

Source: Author's Computation

5. Conclusion

This paper has attempted to explore a relationship between foreign direct investment, gross fixed capital formation, real exchange rate, real interest rate and inflation rate with economic growth (GDP). It has employed annual data over the period of 1990 - 2015. The test result shows that all variable in this paper has a unit root problem in terms of level and first difference form by using Augmented Dickey Fuller (ADF) test. But, when the second difference is considered, all the series become stationary at one percent confidence levels. Furthermore, Granger causality test indicates that there is not a bi-directional causality on the FDI-GDP relationship for one, two and three year lags. This paper has argued that there is no Granger causal relationship between FDI and economic growth (GDP) in Vietnam. The current study's findings have further shown the fact that the FDI Granger causes with GDP because it can reject the hypothesis at 5% significance level. Besides that, by using OLS regression in terms of level form of series variables, the result of the analysis shows that FDI positively and insignificantly impact on GDP in Vietnam for the period under review. There is short run relationship between FDI and GDP. It has also illustrated that FDI helps in overcoming the lack of capital through implementing domestic investment whereby it substantiates Vietnam. This contradicts the conclusion of some existing studies reported in our literature (Borenztein *et al*. 1998). Based on the results of empirical research, we conclude that

the FDI inflow contributed to speed up the GDP growth into the Viet Nam economy for the period under consideration.

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