



THE RELATIONSHIP BETWEEN FDI AND ECONOMIC GROWTH IN INDIA. A TIME SERIES APPROACH

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ABSTRACT

Foreign Direct Investment (FDI) has gained importance after the second world war. In broader sense Foreign Direct Investment incorporates the establishment of up to date and advanced facilities, mergers and acquisitions, investing the profits earned from other overseas business activities, providing loans to other companies etc. In narrow sense the Foreign Direct Investment means investment in the country other than the investors own country.

FDI can be better understood by studying the real reason that why the companies have shown interest in investing abroad rather than exporting and outsourcing their products to domestic firms.

In due course of time many theories and approaches were developed to explain FDI. Although several researchers have tried to explain the phenomenon of FDI, we cannot say there is a generally accepted theory, every new evidence added some new elements and criticism to the previous ones.

FDI in India is playing a noticeable role in the growth and development of the country. India is one of the important countries of the world which is able to receive substantial amount of FDI.

The present study has made an effort to see the relationship between the FDI and Economic growth in India. GDP has proxies for economic growth. First the Johansen cointegration test result shows the long run relationship between variables and the Granger causality test result exhibits that there is unidirectional Granger causality between FDI and GDP. Next the Multiple Regression model result presents that the estimated coefficients on FDI & exports have a positive relationship with GDP. Therefore, it is statistically revealed that FDI and Exports are instrumental in influencing the level of economic growth in India.

India is having certain drawbacks like Weak infrastructure, Complicated tax structure, Restrictive labor laws, Bureaucracy and Corruption. Unless and until these challenges are met with, India will never compete with China regarding FDI inflows.

KEYWORDS: Foreign Direct Investment, Gross Domestic Product, Economic Growth.

1. INTRODUCTION

Foreign Direct Investment (FDI) has gained importance after 1945. To have the full knowledge of FDI how it works and what is its' significance in the economic growth and development of any country we have to focus on the theory behind the development of this concept.

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In due course of time, many theories and approaches were developed to explain FDI. Although several researchers have tried to explain the phenomenon of FDI, we cannot say there is a generally accepted theory, every new piece of evidence adds some new elements and criticism to the previous ones.

1.1 The Theory Behind the Evolution of FDI

FDI theories can be put under the following four headings:

1) Production Cycle Theory of Vernon

Vernon developed the Production Cycle Theory in 1966. It explains the foreign direct investment by companies of the US which invested in manufacturing industries of Western

European countries after 1939 or during the Second World War.

According to Vernon, the production cycle has four different stages i.e. innovation, growth, maturity and decline stages. As per Vernon's explanation, in the innovation stage, the companies of US create the new products for the home market and whatever is left as surpluses are traded outside the country. The theory of the production cycle tells us that the demand for US-manufactured products in European markets has increased tremendously. Thus, the US companies having the edge on technological advancement started exporting and thus US export trade has increased.

As the technologies are raw in the first stage, they cannot remain new for a longer period and may be imitated by other foreign companies. The European companies started copying the US-exported products. The US companies were forced to open local manufacturing units in foreign lands to have market shares in those areas. Thus, the investments made by the US companies in Western Europe in 1950-1970 are well explained by this theory. The theory tells us how the monopoly of the US manufacturing trading companies in Western Europe ended and this was the actual beginning of the concept of Foreign Direct Investment.



2) The Theory of Exchange Rates on Imperfect Capital Markets

There is foreign exchange risk involved in the international trade. According to Itagaki (1981) and Cushman (1985), there is the presence of an uncertainty factor concerning FDI. Cushman has tried to explain this in the US context that there is the enhancement of FDI with the increase of real exchange rate and with the appreciation of the foreign exchange rate there is the reduction of FDI. He has coated US, that with the appreciation of the US dollar, there was a 25% reduction in US FDI.

This theory at the same time lacks an explanation of FDI between different countries and currencies. However, the followers of this theory believe that there are many cases which prove the authenticity of this theory.

3) The Internalisation Theory

This theory explains the reason why transnational companies grow and what are the reasons behind their active participation in the FDI. This theory was initiated by Coase in 1937 who tried to explain the theory in the national context. It was further developed by Buckley and Casson (1976), by Hennert (1982) and again by Cason (1983). It was Hymer (1976) who explained this theory in the international context. He says that there are two factors which majorly determine the FDI, first is the dismissal of competition and second, the advantage the firms enjoy while following a certain activity.

Buckley and Casson explain that transnational companies indulged in their internal activities for the development and exploitation of certain benefits. Dunning has also given importance to the Internalisation Theory. He has used this theory to explain his eclectic theory and maintains that this describes only a portion of the flow of FDI.

Hennart (1982) has expanded the concept of internalization and established the models which explain the vertical and horizontal integrations.

Hymer who was the main advocate of this theory explains that there is the possibility of FDI only when the advantage, the concerned firm is getting is more than the cost of its overseas activities. Hymer explains that the real reasons for the development of MNCs are the imperfections and distortions present in the market. Hymer has explained the problems of investing in transnational firms, regarding the costs indulged in getting information, the different governmental treatments and uncertainty related to foreign currencies. Hymer says that FDI should not be treated as the financial settlement of capital market but it can be treated as the policy decision at the firm level.

4) The Dunning's Eclectic Paradigm

Professor Dunning explains this theory as the mixture of three divergent theories of FDI. (OLI)

1) Ownership advantages:

This indicates the intangible assets which the company owns. The intangible assets are transferable among the transnational companies at nominal costs which may lead to an increase in

incomes or reduction in costs.

The TNCs operating in different countries accrue few extra costs. For operating abroad, they should possess some qualities that could reduce their operating costs abroad. These qualities may be related to their property advantage or some special advantage of the company. These advantages of the firm lead to its profit enhancement and reduction in marginal costs.

The following are the three specific advantages discussed by Dunning:

- a) Advantages related to Monopoly are seen as special rights in entering the markets because of owning limited natural resources, patents, and trademarks.
- b) Technology related to all kinds of innovations
- c) Economies of large size for example the economies related to learning, scale and scope and easy admission to capital related to finance.

2) Location is denoted by L: As soon as the initial situation is met it seems to be beneficial for the owner company to use them rather than either selling or renting them to foreign firms.

Locational benefits of different countries are the one which determines where the TNCs would perform their activities.

The specific benefit of each country has the following three classifications:

- a) The benefits related to economics comprise all types of factors of production, the size of the market and the costs containing transportation, telecommunications, etc.
- b) Benefits related to Politics: Both common and specific government policies which affect FDI flows.
- c) Social advantages: include distance between the home and foreign countries, cultural diversity, attitude towards strangers etc.

3) "I" from Internalisation:

Supposing the first two conditions are met, it must be profitable for the company to use these advantages, in collaboration with at least some factors outside the country of origin (Dunning, 1973, 1980, 1988).

The third feature of the eclectic paradigm OLI refers to a structure, with the help of which the company can assess different ways for exploiting its powers from the selling of goods and services, to different agreements that might be signed between the companies. The firm will not want to engage in foreign production rather it will offer this right under license, or franchise when the cross-border market Internalisation benefit is lower.

Eclectic paradigm OLI shows that OLI parameters differ from company to company and depend on different situations and also it exhibits the economic, political, and social features of the host country. The different countries provide different types of opportunities to TNCs and thus the production types and quantities and the objectives and policies of the TNCs depend on the same.

1.2 FDI fosters economic Growth:

All the countries of the world are vehemently aspiring for economic growth and for that, they are trying to attract large amounts of FDIs from foreign investors. There are many factors



which are responsible for promoting or obstructing the economic growth of the country and also act as catalysts for the growth of these countries. (World Investment Report UNCTAD, 1994) These factors are as follows: (1) Large amounts of investment capital, (2) Sophisticated Technological know-how (3) Highly trained and experienced labour force, (4) Proper and required infrastructure, (5) Stability in the political and social systems (6) Taxation rates should be low (7) Regulatory system should be conducive and supportive. Differences in the factor endowments show the extent of economic growth of the countries (Dondeti and Mohanty, 2007).

FDI has been accepted as the main source of technical knowledge for developing countries. FDI not only transfers the production techniques but also the management skills which makes it unique as compared to other types of investments. The foreign portfolio investments do accord for the capital accumulation in developing countries, but the transfer of capital through this is limited and also, they do not impart the technical know-how required to face the competition in the world markets.

FDI can speed up the growth process by creating employment opportunities in the host countries, satisfying the need for enormous investments and imparting managerial skills in the host countries. (Frenkel et al, 2004). To compete with the technologically advanced foreign firms the local firms start investing in technical gradation of their concerns, which boosts up the healthy competition between them. This again compels the foreign firms to introduce a high standard of technical skill and knowledge in the host country. FDI induces spillover effects on the productivity of the host country. (Blomstrom and Kokko 1998). The MNCs have higher-quality technical and managerial skills. Mostly some of these skills are transferred to or copied by the domestic firms. Thus, these stimulate the economic growth of the host country. (Wang and Blomstrom 1992). The spillover effects are caused by the forward and backward linkages of MNCs and domestic firms (Rodriguez-Clare 1996) and this happens because the MNCs render low-cost inputs to the domestic buyers or may increase their demand for the inputs supplied by domestic firms. (Ram and Zhang 2002) have considered the impression that FDI stimulates the growth of the host country after considering the following factors: 1) FDI is the provider of finance/capital required by the host economy. 2) Through FDI the advanced technical knowledge is transferred from the developed FDI-providing countries to economically less developed countries. 3) FDI enhances the competition in domestic countries' markets. 4) By export promotion FDI makes the host countries enlarge their foreign exchange reserves and thus improves their balance of payment positions. 5) It increases the management skills of the host countries. 6) FDI imparts training and skills to the people of the host countries and thus increases their employment options and possibilities 7) It also helps the host countries by reducing their import obligations. 8) FDI acts as a source of savings and investment in the host countries. FDI is the provider of admission to the host countries in world markets. FDI also acts as a channel of globalization for them. (Dondeti and Mohanty 2007). Although it is presumed that FDI acts as

the catalyst for the growth process in the host countries growth can be possible only when the incoming capital can be used properly. (Bezuidenhout 2009) The extent of the use of FDI depends on the presence of a positive economic environment in the host countries.

2. LITERATURE REVIEW

Foreign direct investment plays a very important role in the economic growth and development of the different economies of the world especially the developing economies which possess low capital, underdeveloped technology, unskilled human resource and entrepreneurship. FDI is the main source of getting the required capital, technical knowledge and skills. FDI ensures the economic growth, development and technical enhancement of the FDI-receiving country. FDI also improves the exports of the receiver country. It fosters the favourable spillover effects in the FDI-receiving country. According to UNCTAD, foreign direct investors have a huge influence on the economy of FDI-receiving countries. Therefore, in developing countries, FDI should be motivated because through capital and technology transfer the growth and development of these countries are possible. FDI also supports the countries in their globalization.

Various works have been done regarding the question of whether there exists an intense relationship between the FDI and the economic growth and development of the countries. The researches are carried out either on a particular type of economy or comparative studies are made across various countries. Many research studies have shown that there exists an affirmative relationship between FDI and the economic growth of various types of FDI-receiving countries.

Balasubramanyam et al. (1996) studied the contribution of foreign direct investments of the forty-six developing economies through using improved production functions and concluded that there exists a favourable impact of FDI in those developing economies where stress has been given on promoting exports in place of substituting imports. Therefore, trade-related policies are responsible for having a positive impact of FDI on the growth of the economy.

Chadee and Schlichting (1997) have studied the characteristic features of FDI involved in the Asia Pacific regional area and concluded that all the countries of this area have favourable contributions to FDI. The World Investment Report UNCTAD (1999) has also explained a few econometric models for judging the quantitative effect of FDI on the growth of the economy.

Borensztein et al. (1998) have adopted the endogenous growth model for studying the effects of FDI inflows from developed countries to the sixty-nine developing countries. They have emphasized the positive role of technical skill enhancement in the growth of the economy. They felt that FDI could boost the economic growth of the country only with the help of proper human resources present in the country.

Zhang (2001), after examining the data from 11 East Asian and Latin American countries and using unit root and cointegration



models concluded that FDI enhances the economic growth in those countries which have open trade policies and an educated and skilled workforce.

Nagesh Kumar (2001) has written about how the presence of good and required infrastructure positively attracts the FDI inflows in a particular country.

Chakraborty and Basu (2002) have used the error correction model and co-integration model to find the connection between the FDI and economic growth in India and emphasized that in India there is the Granger causality between GDP and FDI and not the other way round.

Hsiao and Shen (2003) have examined the two-way relationship between FDI and growth and confirmed the relationship between FDI and GDP.

Nunnenkamp and Spatz (2003) have adopted the multivariate regression model to see the effect of FDI inflows in developing countries and concluded that FDI inflows in the manufacturing sector which creates the technology spillover have an affirmative effect on the growth of their economies. As the foreign investment firms are not attached to internally produced goods or the internal labour market therefore the FDI inflows in the agriculture sector do not seem to be fruitful as it has no role in the growth process of the economy. The FDI inflows in the service sector will have a positive effect on the growth of the receiving country only with the launch of unconventional service types and enhancing healthy competition among the service providers. However, it is felt that the domestic service provider can't face the cutthroat competition for a longer period. Thus, the favourable effects of FDI inflows depend upon the chosen sector vis-à-vis the other conditions like favourable government policies, required infrastructure etc. They have also emphasized trade liberalization which is also one of the important conditions to be met for the favorable effect of FDI on the economic growth of the country.

Li and Liu (2004) with the help of the endogenous growth model and conducting a research study on eighty-four countries found the existence of a favourable FDI effect on the growth of the economy only in the presence of genuine human resources and proper absorption of technology.

Balasubramanyam and Mahambare (2003) as well as Fischer (2002) argue that the reforms implemented so far have not eliminated the distinct anti-export bias of India's trade policy. This may explain why, according to Arabi (2005) and Agarwal (2001), FDI in India has remained domestic market-seeking. It is widely believed that the type of FDI and its structural composition matter at least as much for economic growth effects as the overall volume of inward FDI.

Agrawal and Shahani (2005) reckon that it is the quality of FDI that matters for a country like India rather than its quantity. FDI is often supposed to be of higher quality if it is export-oriented, transfers foreign technologies to the host country, and induces economic spillovers benefiting local enterprises and workers (Enderwick 2005).

Agrawal (2005) estimates a fixed effects model based on pooled data for five South Asian host countries, among which India figures prominently, and the period 1965-1996. The coefficient of the FDI-to-GDP ratio turns out to be negative, though not significant. However, this approach ignores that FDI is endogenous. Moreover, the inclusion of exports as a right-hand side variable may bias the coefficient of the FDI variable downwards to the extent that the growth impact of FDI may run through export promotion.

Hansen and Rand (2006) through their publication, 'On the Causal Links Between FDI and Growth in Developing Countries' say that FDI does act as the promoter of growth in a country when that country has a proper trade policy, skilled labour force and is capable of absorbing the gains of FDI.

Baharumshah and Thanoon (2006) have studied the involvement of FDI in the growth of East Asian countries with the help of a dynamic panel model and concluded that FDI has contributed positively.

Chakraborty and Nunnenkamp (2008) have examined the impact of FDI on sector-wise growth in India and established that with the spillover effect across the sectors, the service sector has prompted the growth in the manufacturing sector and in turn has resulted in positive economic growth.

Whalley and Xin (2009) studied how the inflow of FDI contributed to the economic growth of China using a two-stage growth accounting model they emphasized that the export and overall economic growth of China depend predominantly on FDI inflow.

Adams (2009), has advocated liberalized trade and, the presence of a stable political, economic and social environment for the required FDI inflows. The countries differ in getting a favourable amount of FDI inflows because of the dissimilarity of political social and economic policies of their countries.

Wijeweera et al. (2010) by using the OLS panel research of 45 countries from 1997 to 2004 stated that the FDI inflows favourably effects the country's economic growth exclusively in the presence of highly trained human resources.

Egbo et al. (2011), studies based on the Granger causality test to see the effect of Foreign Direct Investment and Nigeria's economic growth using the time series (annual) and taking years 1981 to 2007 (27 years) tells that FDI increases the economic growth of the country.

Alkhasawneh (2013), had done the Granger causality test of GDP, FDI and Government Expenditure of Qatar from 1970 to 2010 and concluded that GDP and Government Expenditure Granger cause FDI in the short period. He has highlighted that to attract the required amount of FDI in the country the government should establish a favourable economic background in the country.

Moyo (2013) after applying the multiple regression model, concluded that a positive relationship exists between FDI and



the growth of the Zimbabwean economy. For calculation, he has taken the data of FDI, Government Expenditure, Private Savings and GDP.

Barua (2013) has studied the dynamics of co-integration of the factors of FDI, exports and the growth of the Indian economy during the period 2000 to 2012. Simple and multiple regression models have been used by the researcher. She concluded that there exists a favorable correlation between the three factors FDI, exports and GDP in the country.

Younus et al (2014) with the help of their research work concluded that trade liberalization is very much required to have a favourable effect on FDI in the FDI-receiving country.

3. METHODOLOGY

3.1 Data and its Sources

In the present research study, we have used the time series approach and annual data from 1970 to 2015 for our variables. We have taken the required data of Gross Domestic Product, Total Exports and foreign direct investment from the World Bank, To, see the long-term relations between variables we have used the Johansen cointegration test method. To see the short-run causality effect between variables we have conducted the Granger Causality test. In our study, the multiple regression method is used to see the effect of FDI on the Economic growth of India. Our multiple regression method is based on the Model used by Barua S. (2013) to see the quantitative relations between Foreign Direct Investment inflows, the country's Exports and Gross Domestic Products of the Indian economy. Barua (2013) takes two models, first, the simple regression model proves that there exists a positive relationship between the FDI and the country's Exports and second her multiple regression model analyses that the FDI and Exports have a favourable effect on the GDP of the country.

Our multiple Regression Method is based on the following function:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \mu$$

Y= Economic growth as shown by GDP X₁= Exports of the country X₂= Foreign direct investment inflows in the country β = Coefficient μ = the error term

The dependent variable in this study is economic growth measured as GDP. The independent variables are the Exports of the country and FDI the Foreign direct investment inflows in the country.

3.2 FORMULATION OF HYPOTHESES:

Null Hypothesis (H₀): There is no significant relationship between GDP, FDI and exports. Alternative Hypothesis (H₁): There is a significant relationship between GDP, FDI and exports.

4. TESTING OF HYPOTHESES AND DATA ANALYSIS

To investigate the magnitude of FDI and exports on growth, the Cointegration test is carried out first. The results are examined by taking into consideration the significant relationship between FDI inflows, exports of India and GDP. Data for the variables are taken from the period from 1975 to 2022.

4.1 Cointegration test

We have applied the Johansen cointegration test in our research study to identify the cointegration relationship of the variables used here. We have focused on the trace statistics test and the maximum Eigenvalue test. The two tests have been applied here to decide the presence of the numeric size of the cointegrating vectors. The null hypothesis for the trace statistics exhibits the absence of the existence of cointegrating vectors whereas, the alternative hypothesis shows the presence of ≤ 1 cointegrating vector. The null hypothesis of maximum Eigenvalue denotes the absence of the existence of cointegrating vectors but the alternative hypothesis confirms the presence of one cointegrating vector. The following Table 1 presents the calculative result of the Johansen cointegration test.

Table 1: The calculative result of the Johansen cointegration test

Hypothesized No of Ce(s)	Eigen Value	Trace Statistics	0.05 Critical Value	Max-Eigen Statistic	0.05 Critical Value
None	0.644291	77.52716	29.79707	45.48028	21.13162
At most 1	0.483670	32.04688	15.49471	29.08437	14.26460
At most 2	0.065113	2.962514	3.841466	2.962514	3.841466

Source: Authors' calculation results in E-views. The calculation shows the rejection of the null hypothesis at the 5% level.

The above Johansen cointegration test result confirms that the trace statistic and maximum Eigenvalue tests exhibit one ultimate cointegrating relationship at the 5% level of significance. Where there, is a rejection of the null hypothesis at the 5% level of significance. This means that there is a long-run relationship between all the variables.

4.2 Granger Causality Test

Johansen's cointegration test is followed by the Granger causality test in which the causal relationship between the variables is examined. For testing the causal links, the F-statistics and the P- values are considered.

Table 2: The Granger causality test results.

Null Hypothesis:	F-Statistics	Prob.
DX1 does not Granger Cause DY	22.5695	4.E-07
DY does not Granger Cause DX1	16.2322	9.E-06
DX2 does not Granger Cause DY	3.49993	0.0405
DY does not Granger Cause DX2	1.74303	0.1891
DX2 does not Granger Cause DX1	24.3138	2.E-07
DX1 does not Granger Cause DX2	3.19590	0.0521

Source: calculation conducted by the author by using E-views. The Decisive method: rejecting Ho if p-value < 5%.



The table displays the test results and verifies the requirement of rejecting the null hypothesis H_0 which says that FDI (X2) does not Granger cause GDP(Y). This means that the FDI remarkably Granger causes GDP or the economic growth of the country. The test results also show that GDP does not Granger cause FDI and therefore it can be concluded that the relation between FDI and GDP is unidirectional in the Indian context using the data from 1975 to 2022. Further, it can be observed that there is no causal relationship between FDI and Export because FDI does not Granger Cause Export and also Export does not Granger cause FDI. The result again verifies that there is no causal relationship between Export and GDP, which means that neither Export Granger Cause GDP nor the GDP Granger Cause FDI.

To study the relationship between the three variables namely GDP, Exports and FDI further the Multiple-Regression method is used.

4.3 Multiple-Regression Method

Here the Multiple-Regression Method is applied to observe that how much the dependable variable GDP relates to the independent variables Exports and FDI.

The functional form of the method is as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + e \dots\dots\dots (2)$$

Where, Y = Gross Domestic Product

X1 = Exports

X2 = Foreign Direct Investment

e = Error term

Multiple-Regression Result:

Dependent Variable: Y

Method: Least Squares

Sample: 1975 to 2022

Included observations: 46

Variable	Coefficient	Std. Error	t-Statistic	Prob.
c	156848.4	16582.11	9.458894	0.0000
X1	5.460196	0.350886	15.56119	0.0000
X2	6.015929	2.503540	2.402969	0.0206
R-squared	0.978979	Mean dependent var		579603.7
Adjusted R-squared	0.978001	S.D. dependent var		614623.7
S.E. of regression	91161.77	Akaike info criterion		25.74165
Sum squared resid	3.57E+11	Schwarz criterion		25.86091
Log likelihood	-589.0580	Hannan-Quinn criterion		25.78633
F-statistic	1001.264	Durbin-Watson stat		1.198807
Prob(F-statistic)	0.000000			

Source: calculation by author by using E-views.

In the above growth model, estimated coefficients on FDI & exports have a positive relationship with GDP. Therefore, it is statistically revealed that FDI and Exports are instrumental in influencing the level of economic growth in India. The coefficient of determination i.e., R^2 explains that 97% level of economic growth is being influenced by FDI and exports in India. The F-test also confirms the significant relationship between FDI, growth and exports. The D-W statistic is 1.19 which confirms that there is no autocorrelation problem in the analysis.

CONCLUSION

FDI inflows have continuously increased since the liberalization period. From the cointegration test and Granger causality, it is clear that there is a relation between FDI and GDP and also FDI Granger causes GDP. In multiple regression, it is seen that a % increase in FDI causes a 2% increase in GDP and the relation between FDI and GDP is significant. GDP is taken as a proxy for Economic Growth. Thus, India seems to be the profitable country for FDI but India is still lagging behind China and other popular Asian countries like Indonesia, Vietnam etc. India has certain drawbacks like Weak infrastructure, Complicated tax structure, Restrictive labour laws, Bureaucracy, regulations and corruption. Unless and until these challenges are met, India will never compete with China regarding FDI inflows. To attract the required amount of FDI

India needs to have flexible labour laws, FDI should be encouraged in the Education sector and R&D to strengthen the human resource and technological capabilities of the country. More sectors should be brought under the automatic route, the FDI cap should be increased and the procedural delays should be minimized.

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