The impact of fdi on gdp

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All the developing economies are entrapped by the vicious circle of poverty. These countries lack the basic capital resources. Income of the people is very low due to which savings are low and ultimately it ends in lower investments. In addition, due to the lower income levels the taxable capacity is low meaning that government's earning is also low. Under such circumstances these countries had to face saving-investment gap & Balance of payment gap. To fulfill these gaps these developing countries had to rely on Foreign Capital Investment to accelerate the growth process and to fill saving-investment gap & BOP gap. Foreign Capital Investment can come in many forms including; Foreign Aid, Official Development Assistance, Official Aid, FDI, Foreign Portfolio Investment and borrowing (Mohey-ud-din, 2006). Regardless of the fact that all the developing economies must rely on any of these sources to accelerate the process of growth, the amount and the form of FCI differs from country to country and depends on the individual economic condition of that particular country. In case of Pakistan, FCI plays a significant role in the economic development. On one side Pakistan lack basic capital investment, technology and human resource and on the other side country's political and economic condition forces it to rely on FCI.

During the period of 1950 Pakistan along with the other south Asian countries pursued a policy of import substitution. In 1970 Srilanka took a progressive step toward policy reforms in favor of progressive liberalization and globalization. These macro economic reforms were adopted by all south Asian courtiers due to the derived benefits. This Post reform period in all south Asian countries is characterized by high growth and economic development. Pakistan introduced these reforms in late 1980's. One of the

most important benefits of these economic reforms was the increased inflow of FDI (Mehta, 2006).

The current research only concentrates on foreign direct investment rather than capital flows in general because it is intimately connected to not only the transfer of capital but also helps in transfer of capital, management & marketing skills and advanced technologies between nations. And secondly, for the past 40 years and so the inflow of FDI specifically in South Asia has increased drastically.

FDI is the investment made by a company outside its home country. For the home country it is the outflow and for the host country it is the inflow of, long time investment based on long term profit sharing involved in international production. This definition is correct but not complete as the important issues of control and management are not included in it. International investment can take two forms. It could either be portfolio investment, where the investors buy some non-controlling portion of the stock, bond or any other financial security, or direct investment where the investor participates in the control and management of such business venture. This is the type of investment by multinational companies and it tends to contribute more to economic growth than the portfolio investment (Adewum, 2006).

FDI brings in costless capital and technology necessary for rapid growth as well as it provides access to global production and marketing networks. As noted above South Asian countries had a fairly restrictive regime and it is only in the last decade that the policies had opened up and became conducive to greater foreign investment. Initially, FDI was allowed in a

restrictive manner and on mutually advantageous terms where majority stake were to be held by domestic firms. However, South Asian countries tried to encourage FDI more aggressively in the nineties, by making changes in macroeconomic policies along with trade and FDI policies (Mehta, 2006).

The intensity to attract FDI for all the major South Asian countries in the era of 1990-2003 had more than doubled except for Pakistan. It can therefore be interpreted that although the macro economic reforms had been successful in attracting greater FDI inflows but the inflows were not significant when compared with other countries of the same region.

As per the information in the above table, Pakistan was not able to attract enough amount of FDI to accelerate the growth process because of the prevailing economic policies at that time. Sri Lanka had the largest intensity to attract FDI inflows (1. 25% of GDP) followed by India and Pakistan (Mehta, 2006).

This research will discuss whether the changes in those reforms bring any impact on the growth process or not. And if it does, then is it worthwhile for the government to modify those policies to attract more MNCs to bring FDI in Pakistan?

The purpose of this research is to demonstrate the role played by FDI in accelerating GDP growth, so as to know whether the call for more FDI is truly justified.

The flow of FDI has been drastically increased in the last couple of decades making it a key area for the further research. Increasing attention has been

paid in all developing countries in recent years to answer the question of " how to attract more FDI". This emphasis on one side has increased the flow of FDI in the host country and on the other side it gives rise to uncertainties regarding the profitability analysis of making such decision. Such as whether the impact of FDI on domestic employment pays more or costs more? So a lot of researches had been done on this topic so that these questions can be addressed (OECD, 2002).

The topic is of great importance because of the advantages that FDI brings to the home country. one of the main advantage of foreign direct investment is that it helps in the economic development of the host country where the investment is being made through; overcoming financial crisis, by permitting transfer of technology, human skills, intellectual property, enhancing skills of human capital, increasing government's revenue through taxation, by creating new jobs, by improving the quality of goods and services being produced, it boosts the exports sector etc plus there is also some scope for new research activities.

This research will help the government in formulating and modifying the right policy mix to attract the targeted level of FDI. It will also help the Central Bank in making the fiscal policy where it can set the tax targets, helps in determining the tax rates as well as in the making of monetary policy. The students can get the grip of FDI on GDP by understanding the importance of this research which will be a source for the future research, also making a think tank they can come up with new ideas and provide consultancy to the local firms and entrepreneurs so that they can merge with MNCs to gain the knowledge of advanced technologies and skills.

Considering the significance of the topic, this research has been planned. The core purpose of this research study is to examine the impact of the FDI on GDP growth of Pakistan. The organization of this thesis follows as: a detailed review of literature on the impact of FDI on GDP of the developing countries, the theoretical background of economic theories on FDI is presented in Section chapter II. Chapter III deals with the data and methodology. Chapter 1V discusses the results and interpretations while chapter V gives the conclusion and the policy recommendations.

CHAPTER 2: REVIEW OF THE RELATED LITERATURE

The literature review is divided in to two parts. The first part mainly focuses on the basic theories underlying the foreign direct investment and the second part emphasizes on the theoretical framework of FDI Flow and its impact on GDP growth of developing economies.

2. 1. THEORIES OF FOREIGN DIRECT INVESTMENT

Theories played a significant role in determining legal attitudes both nationally and internationally. Theories of FDI asserted that the basis for such investment lies in the transaction costs of transferring technical and other knowledge. Three important theories of FDI are discussed below:

2. 1. 1 Neoclassical Economic Theory of FDI

According to the Bergten, Horst & Moran (1978) the neoclassical economic theory stated that FDI positively contributed to the economic development of the host country and increased the level of public welfare. Some of the supporters of Neoclassical economic theory and the researchers who had

further worked in that field includes; Seid (2002), Kojima (1978), Antonelli (1991), Reuber (1973); Sornarajah (1994); Bergten, et al. (1978), Kennedy (1992), Chu (1989), Lall (1993).

The rationale behind this theory was that, that the MNC's by bringing FDI in to the host country influenced the quality and quantity of capital formation in that country. On one hand this inflow of capital from MNCs and its reinvestments of profits increase the total savings of the country, increases government's revenue via tax and other payments and on the other hand this infusion of capital reduces the BOP pressure of the host country (Seid, 2002).

The other argument that supported the neoclassical theory was that FDI did not only brings advanced technology but managerial skills, marketing skills, market information, organizational experience, and the training of workers as well (Kojima, 1978).

MNCs served as a primary channel for the transfer of technology from developed to developing countries. But the benefits derived from this transfer of technology depended on the extent to which these innovations are diffused locally. This cost of technology transfer got affected by a number of factors. And due to the general scarcity of these factors in developing countries, the cost of adoption of new technology remained high (Antonelli, 1991).

The proponents of neoclassical theory further argued that FDI raised competition in an industry with an ultimate improvement in productivity. This increased competition lead to better allocation of resources, better utilization

of capital, efficient management and increased in market efficiency. MNCs through Foreign direct investment provided local industry the exposure of international markets, which lead to greater competition, more opportunity of technology transfer and ultimately resulted in economic development (Kojima, 1978).

FDI helped in employment generation which ultimately influenced distribution of income. It also helped in generation foreign exchange which facilitated in filling balance of payment gap Reuber (1973); Sornarajah (1994); Bergten et al. (1978). FDI also helped in upgrading the local infrastructure facilities which resulted in economic development Sornarajah (1994). FDI accelerated the economic development by enhancing the administrative, technical and managerial capabilities of the host country (Kennedy, 1992).

The guiding principle on the Treatment of Foreign Direct Investment incorporated the neoclassical theory and stated that a larger flow of foreign direct investment brought significant benefits to the world economy in general and for the developing countries in specific in terms of technological advancement, greater competition, expansion of international trade, enhanced marketing & management skills and access to international market. The World Bank guiding principles on the Treatment of FDI demonstrated that a proper policy mix and openness to FDI had brought more benefits to the host country (Chu, 1989).

2. 1. 2 Dependency Theory of FDI

According to the Dependency school theory, the impact of foreign direct investment from developed countries through multinational corporations (MNCs) on developing countries was harmful for long term economic growth of the developing nations. Dependency theory's thoughts were based on Karl Marx's theory of development and underdevelopment; Paul Baran's analysis of economic backwardness and economic growth; Andre Gunder Frank's analysis of the development of underdevelopment; and the writings of Samir Amin on unequal development (Fan, 2003).

Dependency theory argued that FDI and MNCs were harmful for the long term economic development of the developing countries in specific. It believed that the rich countries becomes richer and exploits the labor and other natural resources of the developing nations. And the developing nations thereby put in to conditions of continuing poverty. It caused exploitation of labor, hindered growth and caused income inequality. So keeping in mind the above harmful affects, the developing nations must develop independently without depending on FDI or MNCs.

The influence of dependency theory peaked in 1970s. Various countries including East Asian and Latin American adopted this point of view and demonstrated a hostile attitude toward FDI. But after seeing the harmful affects of adopting these policies on the economy, these countries shifted the attention to more liberal policies to attract foreign direct investment. This theory is out of the scope for this research. Hence it's not discussed extensively.

2. 2. Theoretical Framework of FDI Flows and Growth

The role played by the Foreign Direct Investment in the economic development of developing countries remains debatable in the literature. Many researchers had proved that FDI is positively related to GDP growth and FDI enhances the process of GDP growth. The researchers that proved its significant and positive impact on economic development, includes; Chenery & Strout (1966), Bosworth, Collins & Reinhart (1999) , Loungani & Razin (2001), Moss, Ramachandran & Shah (2005), De Gregorio (2003), Feridunm (2004), Bornsztein, Gregorio & Lee (1998), Sanchez-Robles (1998), North (1956), Borensztein, De Gregario & Lee (1998), Glass & Saggi (1998), Blomstrom, Lipsey & Zegan (1994), Balasubramanyan, Mohammed, Salisu &Sapsford (1996), Bengos & Sanchez-Robles (2003), Nabenende, Ford, Sen & Slater (2002), Aluko (1961), Brown (1962), Obinna (1983), Oseghale & Amonkhienan (1987), Das (1987) , Din (1994), Balasubramanyam, Mohammad, Salisu & Sapsford (1996), Dees (1998), De Mello (1997), Adewumi (2006), Hasen & Giorgioni (2006), Athukorala (2003), Zhang (2004), Trevino & Upadhyaya (2003), Sjoholm (1999) & Agrawal (2000). While some researchers had highlighted its negative aspects as well.

On the basis of a research on least developed economies, it had been concluded that FDI had a significant and positive impact on GDP and it helped in raising the economic activity. The study also made an important statement, saying that FDI played a very vital role in rousing the economic growth (Chenery & Strout, 1966).

Bosworth et al. (1999) analyzed the impact of various form of FCI on GDP. The research proved that, out of various forms of FCI including loans,

borrowing, portfolio investment and other forms of FCI, FDI had a stronger positive impact on GDP in developing economies. It had a strong positive effect on investment and saving which eventually lead towards more economic development while other forms of FCI may had a negative impact on saving and investment, leading to a negative impact on GDP. This research concluded that FDI is the most effective form of FCI which helped in fastening the process of GDP growth.

It had been concluded that out of the different forms of capital flow (FDI, portfolio investment and primary bank loans) to the Least Developed Economies, FDI was discovered to be the most resilient. It greatly helped in accelerating the growth process of developing countries (Loungani & Razin, 2001).

A similar conclusion had been given in a study by Moss et al. (2005). The study revealed that FDI contributed more to GDP as compared to local investment. So rather than making efforts to increase local investment, the government must emphasize more on attracting Foreign Direct Investment because FDI not only bring capital but technology, management and international exposure which in combination resulted in more effective and efficient mix in accelerating the process of economic growth (GDP). It might end up in wiping local firms out of the market but for that the government had to make the right policy mix keeping in mind the cost and benefits of MNCs.

It had been proved that the contribution of FDI to GDP is three times more than that of local investment De Gregorio (2003). The study revealed that

FDI brings in new expertise in the local market with the benefit of having access to foreign markets. According to the analysis, the researcher found out that increasing aggregate investment by 1 percentage point of GDP increased economic growth of Latin American countries by 0. 1% to 0. 2% a year, but increasing FDI by the same amount increased growth by approximately 0. 6% a year during the period 1950-1985, proving that FDI is three times more efficient than local investment.

Feridunm (2004) conducted a study to examine the relationship between GDP and FDI in the economy of Cyprus. The study verified that there is a strong positive relationship between GDP and FDI and stated that if the economy of Cyprus manages to get the higher FDI, its GDP will increase and vice versa. Further the results of the research suggested that the economic development of the country resides on its ability to get more FDI. So the government must make policies that can help the country in attracting more FDI.

Bornsztein et al. (1998) also carried out a research to test the impact of Foreign Direct Investment on a country's economic development. The data on the FDI flow from 16 countries was taken and the cross country regression framework was applied. The analysis reported that FDI played a positive and significant role in boosting the economic growth through technology transmission. However, the analysis was based on an assumption that the host country must had minimum threshold of human capital so that new technology can be utilized more efficiently.

Robles (1998) also tested the relationship between FDI and GDP in Latin America in the period of 1975-1985 and reported that FDI and GDP had a very strong relation. Increase in FDI had caused a definite increase in GDP growth. And the impact of FDI on GDP was highly significant and positive for this particular region.

FDI had a positive impact on GDP and Foreign Direct Investment played an important role in supporting the import surplus and in enhancing total investment that helped in the economic development (North 1956).

Borensztein et al. (1998) & Glass & Saggi's (1998) research proved that FDI is assumed to enhance domestic capital which ultimately lead to stimulate the productivity of domestic investments which thereby had a significant positive impact on GDP. Therefore, FDI had empirically been found to stimulate economic growth.

Blomstrom et. al (1994) reported a positive impact of FDI on economic development with a condition that the host economy must have a threshold level of income above which Foreign Direct Investment seems to had a positive impact on GDP and below which it does not.

Balasubramanyan et al. (1996) reported positive impact of FDI on economic development.

The impact of FDI varied across countries. It largely depended on the trade policy of the host country. This study revealed that the impact of FDI on GDP is more in export promoting than import substituting countries. Therefore the

trade policy must be made in such a way that it can attract more FDI to support the country’s economic growth.

Bengos & Robles (2003) proved that FDI is significantly and positively correlated with economic growth. Minimum capital (human), economic stability and stable markets are the necessary preconditions that need to be met if the country wants to benefit from FDI.

Nabende et al. (2002) research proved that the long-term impact of FDI on GDP is significant and positive for comparatively economically less advanced economies but negative for the economically advanced countries.

Aluko (1961), Brown (1962) & Obinna (1983) reported positive linkages between FDI and economic growth in Nigeria. Oseghale & Amonkhienen (1987) and founded that FDI had been positively associated with GDP, concluding that greater inflow of FDI spelled a better economic performance for the country.

Das (1987); Din (1994); Balasubramanyam et al. (1996) and Borensztein et al. (1998) stated that FDI had been introduced as the factor explaining positive impact on GDP growth through technology transfer in addition to human capital. Dees (1998) submitted that FDI had been important in explaining China’s economic growth, while De Mello (1997) presented a positive correlation between FDI & GDP for selected Latin American countries. Findings of Xu (2000) for US FDI in 40 countries for the period 1966-94 also supported the finding of De Mello that the transfer of technology through FDI contributed more to the productivity of developed countries as compared to developing countries, which the research

attributed to lack of adequate human capital. The OECD (2002) simply stated that FDI increased efficiency of resources and raised factor productivity in the host country, so it affirmed positive influence of FDI on GDP growth as positive.

Adewumi (2006) examined the contribution of foreign direct investment in Africa's economic growth. Data for the entire continent and data for eleven countries within the continent were used for the analysis from 1970-2003. The countries used for the analysis includes; Angola, Botswana, Burkina Faso, Central African Republic, Cote d' Ivoire, Egypt, Mali, Nigeria, South Africa, Tunisia and Republic of Benin. Eleven countries were selected based on the following criteria: growth rate, strong currency value, population and Geographical spread. It was discovered that the contribution of FDI to growth is estimated to be positive in most of the countries but not significant. GDP growth rate was used as a dependent variable while FDI growth rate was used as independent variable. Other variables that were considered for the study include; gross capital formation and net exports. From the analysis it was proved that the impact of FDI on GDP is estimated to be positive for most of the countries. But in the other countries where the effect is not positive, did not indicate that FDI's impact on GDP is negative. The reason for this negative impact was that some impact of FDI in the host country can not be measured quantitatively, e. g. knowledge acquisition, technology, international image, and it may take a considerable time before these variables affect growth.

Hasen & Giorgioni's (2006) research had assessed the impact of FDI on GDP growth of four AMU countries including; Algeria, Libya, Morocco and Tunisia1

– between 1990 and 2006. The variables under analysis included; total output, total factor productivity, domestic capital, foreign capital, labor input and human skills. These countries were chosen for analysis because as most other developing countries these countries were the one which were transitioning toward the policies of attracting inflows of FDI. The research empirically proved that FDI and GDP had a strong relation. The FDI inflows were an important determinant of GDP growth. The research analyzed that the positive impact of FDI on the economy depended on its interaction with open trade policy, macroeconomic stability, better education level and filling of technology gap. The research suggested that AMU countries would do better by concentrating on human capital, developing domestic firms, creating a stable macroeconomic framework and providing productive investments to start up the process of economic development.

However, some economists had analyzed negative impacts of FDI on economic growth. Leff (1969) & Griffin (1970) had argued that the foreign investment could negatively affect the economic growth by substituting the domestic savings. One of the main argument against the inflow of FDI was that multinational companies (MNCs) replaced domestic firms, introduced unsuitable production technology and created BOP crisis through transfer of profits from the host country (Sahoo (2006).

MNCs bringing FDI generally had advanced technology, skills and resources through which the market share of the domestic firms get eroded and can crowd out the local investment Markusen & Venables, (1999); Agosin & Mayer, (2000) & Kumar & Prakash, (2002). These MNCs also made use of advanced technologies in the production process which lowerd the demand

of labour. These phenomenons lead to higher rates of unemployment which lowered the economic development.

Carkovic & Levine (2002) concluded that FDI did not had a positive impact on economic development. Mwlima (2003) also concluded that the incentives that most African countries were offering to attract the FDI ended up in adding to the economic problems leading to a situation where the incentives being offered offsite any gains from FDI. Zambia was the classic example which explained the proved this research. Findings of the research claimed that the aim of any MNC is to make profit rather than providing economic development, therefore the host countries must be very cautious in formulating any policies to attract FDI.