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FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN INDIA: AN EMPIRICAL ANALYSIS

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ABSTRACT

This paper is an attempt to analyze empirically the causal relationship between of Foreign Direct Investment (FDI) and economic growth of India. FDI in the general manner of speaking is defined as a multinational company from one country making a physical investment to set up its business in another country. FDI has assumed a crucial role in the internationalization of economic activities and plays a remarkable and growing part in global business. FDI is widely accepted as a major resource for the economic development of developing countries. Therefore, almost all the developing countries offer a welcoming attitude to foreign institutional investors, associated with FDI. After following to some extent restrictive policy towards FDI, India liberalized her FDI policy regime significantly since 1991. This liberalization has been accompanied by increasing inflows, changes in the sectoral composition, sources and entry modes of FDI. To assess the impact of FDI on economic growth of economy by using Engle-Granger co integration and Granger causality tests for India over the period 1991-2009, we find out causal relationship between FDI and economic growth. During the study it was causalities run both from GDP to FDI and FDI to GDP. The results show the long run positive relationship between FDI and GDP in India.

KEY WORDS
FDI, Economic Growth, Liberalization, GDP, Unit Root Test

I. INTRODUCTION

Foreign direct investment, in the general manner of speaking, is defined as a company from one country making a physical investment to structure of its business in another country. FDI has assumed a crucial role in the internationalization of economic activities and is playing a significant and always growing part in global business. For the country getting the investment, it provides source of capital, new technologies, processes, products, organizational techniques and management skills; in this way providing a strong momentum to economic development. FDI is also known as movement of capital across national frontiers in a way that grants the investor control over the acquired asset. FDI is different from portfolio investment which may cross borders, but does not offer such control over the business. Firms contributing to FDI are known as multinational enterprises and in this case control is defined as owning 10% or greater of the common shares of an incorporated firm. FDI is widely accepted as a major resource for the economic development of developing countries. Therefore, almost all the developing countries offer a welcoming attitude to foreign institutional investors, associated with FDI.

FDI increased rapidly during the late 1980s and the 1990s in almost every region of the world, stimulating the long and debate about the costs and benefits of FDI inflows. On the one hand, many would argue that, given appropriate policies and a basic level of development, FDI can play a key role in the process of creating a better economic environment. On the other hand, potential drawbacks do exist, including a worsening of the balance of payments. In 1991, India liberalized her FDI policy regime; this liberalization has been accompanied by increased inflows and changes in the sectoral composition, sources and entry modes of FDI. In 1991-92, FDI inflow in India was Rs. 409 crore, which increased up to Rs. 122219 crore in 2008-09. The trend shows that there is a positive relation between FDI and GDP. In first section of the paper, we present a brief overview of FDI inflows in India. The second section provides a brief review of literature. The third section of paper explains the description of data and methodology used. Section fourth will present the estimation of results and discussions and fifth section will conclude the paper.

II. REVIEW OF LITERATURE

FDI is considered beneficial not only because it brings in much needed capital, but generates employment and presumably contributes to enhanced economic growth as it provides access to advanced technologies and technology spillovers (Borensztein, De Gregorio and Lee, 1998; De Mello, 1999). Oteng-Abayie and Frimpong (2006) argue that FDI may have a negative impact on GDP growth. Aitken and Harrison (1999), in a seminal study of Venezuela, or Aitken, Harrison and Lipsey (1996) for Mexico and Venezuela, have shown negative productivity and wage effects for domestic firms and only small, if any, positive effects overall. On the other hand, Smarzynska (2004) has shown positive inter-

industry spillover effects from foreign firms in Lithuania. Liu (2008) documents a negative level, but a positive growth effect for China. While, the literature on the effects of foreign presence on productivity and wages in developing countries is growing, the evidence is decidedly mixed and varies greatly among countries and industries (Blomström and Kokko, 1998). Ozturk *et al*. (2007) viewed that there is a positive association between FDI inflows and growth provided receiving countries have reached a minimum level of educational, technological and/or infrastructure development. However, there is no universal agreement about the positive association between FDI inflows and economic growth. Research that focuses on data from only less developed countries (LDC's) has tended to find a clear positive relationship, while studies that have focused on data from only developed countries (DC's), have found no growth benefit for the recipient country. According to Chowdhury and Mavrotas (2005) studied the role of FDI in host countries and suggests that FDI is an important source of capital, complements domestic private investment which is usually associated with new job opportunities; enhances both technology transfer and spillover and human capital (knowledge and skill) enhancement boosts overall economic growth in host countries. Work on developing countries shows the FDI-economic growth relationship subject to a number of crucial factors, such as the trade regime, the human capital base in the host country, financial market regulations, banking system and the degree of openness in the economy has a positive impact on overall economic growth.

III. DATA SPECIFICATION AND METHODOLOGY

This paper used aggregate annual time series data at constant prices for Gross Domestic Product, GDP and total net inflows for foreign direct investment for the period of 1991-2009. The data is collected from the Reserve Bank of India, Handbook of Statistics on the Indian Economy 2008-09. The perusal of raw data indicates that FDI in terms of proportion of GDP increased over the time except during the period of 1997-98 to 2003-04 (Figure1).

The results of the present paper are estimated by using of standard statistical tools such as OLS, Unit-root tests, Granger causality test and Co-integration test with the help of popular statistical software i.e., SPSS (Version 17) and E-Views (Version 3.1). Ordinary Least Square test was applied to assess the dependency of GDP over the FDI by Equation 1.

$$GDP = \alpha + \beta * FDI \quad (1)$$

The unit root test is applied to examine empirically whether a series is stationary or non-stationary in nature. To assess the long-run relationship between FDI and GDP in India we have applied the Engle-Granger's (EG) residual-based ADF test. Moreover, to find out the causality between FDI and GDP (or GDP and FDI) Granger Causality Test has been used.

III. EMPIRICAL FINDINGS

In this part of study we are presenting the econometrically analyzed properties of time-series data of FDI and GDP. We have applied the Augmented Dickey-Fuller (ADF) unit root test and Phillip-Perron test (Gujrati, 2003). These unit-root tests are performed on both levels and first differences of all variables with the *null hypothesis i.e, the trends of variable is unit root (non-stationary) and with alternative hypothesis of stationary trend.* Table 1, reports the results of unit root tests.

The table 1 reveals the non-stationary tests for FDI and GDP series for India using Augmented Dickey-Fuller (ADF) test and PP test. We found a constant but no time trend result of tests. The results indicate that the hypothesis of a unit root in FDI and GDP cannot be rejected. While, the hypothesis of a unit root in FDI and GDP is rejected as a first difference at least at the 5 percent level of confidence.

To assess the long-run relationship between FDI and GDP in India we have applied the Engle-Granger's (EG) residual-based ADF test with the *null hypothesis that there is no long run relationship exists among the variables and vice-versa in context of alternative hypothesis*. The first step of the EG cointegration test, we estimated Equation (1) using the Ordinary Least Square Method (OLS). Further, in the second step we use the EG procedure is to check the stationary of residuals by using the ADF test. Table 2 presents the results from Engle-Granger (EG) cointegration test. These results indicate that long-run equilibrium exists between GDP and FDI for India since test statistics are above the 5 percent level of significance critical value. Therefore, we reject null hypothesis in this context. Our study supports the views of Ozturk *et al*. (2007) and Chowdhury and Mavrotas (2005), that there is a positive relationship between FDI inflows and growth.

The existence of the relationship among the variables indicates the possible causality between GDP and FDI. Further to assess the causality between GDP and FDI we apply the Granger Causality test. *It is hypothesized that GDP does not granger cause FDI and FDI does not granger cause GDP.* The Granger Test for causality is such a technique searching the direction of causality between the variables. There are four possible outcomes regarding causal relationships between GDP and FDI: uni-directional causality from GDP to FDI or vice versa; bi-directional causality between the two variables; and, finally, lack of any causal relationship. Table 3 reports the results of the Granger test. The probability values for F statistics are in the table 3 are less than any α level, then the hypothesis would be rejected at that level. We found that, the causality for both from GDP to FDI and from FDI to GDP in India over the time. The content of policy implications has been determined according to the direction of causality between these two variables.

IV. CONCLUSION

FDI is an important resource for the economic development in all over the world. All the developing countries offer a welcoming attitude to FDI. For the any economy FDI provides capital, new technologies, processes, products, organizational techniques and management skills and also provides a strong momentum to economic development. The paper examined the causal relationship between FDI and economic growth by using Engle-Granger co integration and Granger causality tests for India over the period 1991-2009. During the study it was causalities run both from GDP to FDI and FDI to GDP. The results show that there is positive long run relationship between FDI and GDP in India. However, there is no universal agreement about the positive association between FDI inflows and economic growth.

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Table 1: ADF unit roots test results

	Augmented Dicky Fuller		Philip-Perron	
INDIA	Level	First Difference	Level	First Difference
FDI	-2.012	-3.109*	-2.117*	-3.789*
GDP	-2.98	-3.075*	-2.631*	-3.012*

Note: * significant at the 5% level.

Table 2: Results for Engle-Granger's Cointegration Tests

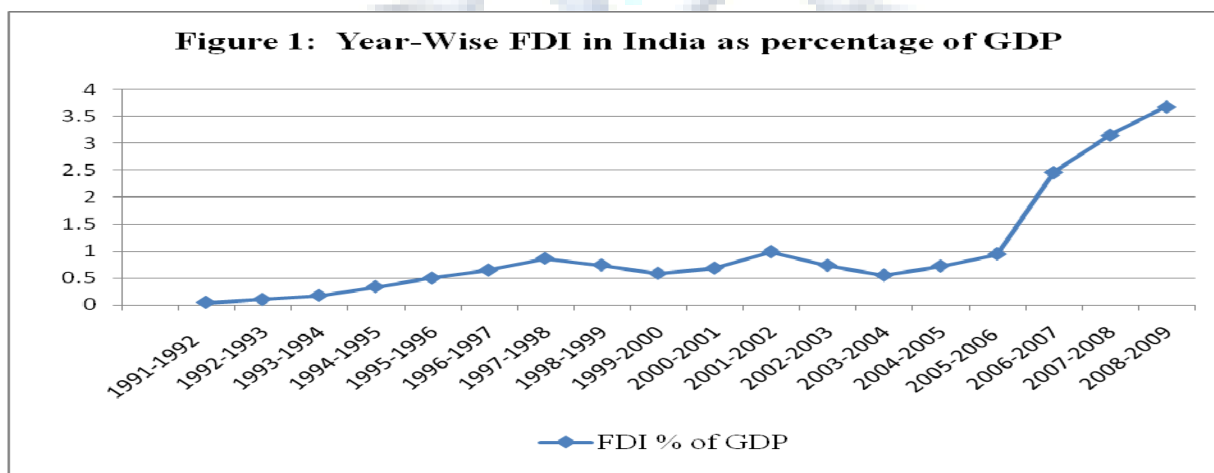
Country	**Modal**	**ADF**
India	GDP = 3.193 + 0.253* FDI	-3,089*

Notes: * significantly at the 5% level.
ADF: Augmented Dickey-Fuller

Table 3: Granger Causality Test Result

	FDI →GDP	GDP →FDI	F statistic.	P value
India	Yes		2.497*	0.119
		Yes	2.593**	0.117

*significance at 95% confidence level; ** significance at 99% confidence level



Source: RBI Handbook of Statistics on Indian Economy 2008-09 & Annual Report 2008-09, GOI, Ministry of Commerce & Industry

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