

The Effect Of Foreign Direct Investments On Developing Countries

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Abstract

The primary aim of this research is to analyze the effect of Foreign Direct Investment on the economic growth and development of Sri Lanka. Statistical analyses of local foreign investment and selected economic indicators, including Balance of Trade, the rate of inflation, and Gross Domestic Product, have been conducted. Time-series evidence of 15 years (1998-2012) has been examined. Multiple regression methods were used in measuring the relationship between FDI (independent variable) and the economic indicators (dependent variables). Results from the following research exhibit a relationship between economic development and FDI and should alert the government of Sri Lanka.

Background

Most less developed countries (LDCs), especially in Asia, Africa, and South America, have over the years preferred Foreign Direct Investments in pursuit of growth and development. In many developing countries, FDI provides additional external resources contributing to their economic performance. Foreign investors have an industrial effect by increasing production levels, promoting the competitiveness of host nations' products in the international market, and transferring cost-effective technology. FDI has helped narrow the technological gap in LDCs through direct and indirect transmission (world development report 2011).

In less developed countries, increases in corporate returns and high prices of commodities have assisted in boosting inflows due to increased demand. In 2006, FDI to LDCs was \$281 billion, compared to \$235 billion in 2005, which was as a result of the reduced restriction on foreign ownership and privatization of banking and telecommunication sectors. Sub-Saharan Africa absorbed only 4% of the global FDI. Sri Lanka is a developing nation with low-paid workers and low imports (Li & Liu, 2005). Foreign investment is essential in reducing unemployment rates, public deficits and poverty levels.

The objective of this study

To determine the effects of FDI in Sri Lanka

Research hypothesis and literature review

Researchers do not agree on the impacts of FDI on economic growth and development in host countries. The analysis is meant to focus on this difference concerning empirical evidence from Sri Lanka. This research examines:

H1: shows the existence of a healthy relationship between foreign domestic investment and GDP growth in Sri Lanka

H2: indicates a negative correlation between foreign domestic investment and the rate of inflation in Sri Lanka

H3: indicates a healthy positive relationship between external local placement and balance of trade in Sri Lanka

Foreign direct investments: According to World Bank 2013, FDIs are the sum inflows of investments to gain a long-term management interest in a business running in a different nation other than the investors'. It is the summation of short-term equity, re-investment of earnings, equity capital, and other long-term investments.

FDIs result from globalization involving the integration of domestic economies with international markets. It involves opening up the local economy and domestic capital so that foreign investors can establish a business. Technological growth has played a great role in the advancement of transport and communication, which in turn has allowed investors to move past their political boundaries. Developed nations have helped less developed countries acquire materials and tools for the extraction and utilization of natural resources for economic growth and development. With less developed nations owning most raw materials, foreign investors tapped into these economies with their skills and technology.

Benefits Of Foreign Direct Investment

Less developed countries, developing economies and countries undergoing transition, as a result of merits related to foreign direct investment, have adopted policies allowing foreign investors. Research shows that the benefits of foreign investment can be significant, including contributions to international trade, creation of a competitive business environment, human capital formation, technological spillovers and improved enterprise growth. All these benefits contribute to economic growth and development, which help alleviate poverty levels in the host countries. It is, however, difficult to accurately determine the exact economic impact of FDI. Benefits relating to FDIs are different in developing countries, and it's difficult to separate and measure them. Assessing development associated with FDI requires analyzing the econometrics of the relationship between local economies' performance and inward foreign investment and the ways in which TNCs interact with host countries (Gorg & Greenway, 2004).

Transfer Effects Of Resources

Foreign direct investment contributes positively to host economies by providing technology, capital and management resources that would otherwise be unavailable. Resource transfer stimulates economic growth and development in host countries.

Economic Growth

According to Shearer 1961, economic growth is the increase in production and assimilation of services and products. It is the increase in per capita consumption, increase in population and an increasing gross domestic product. It alludes to an economy that's getting bigger and not an economy that is improving. Economic development, on the other hand, refers to improvement in a country's national income and increase in per capita income. It involves changes in the rate of equity formation, resource supplies, and demography of a nation, institutional organization, and technology. It also implies changes in demand, level, and pattern of revenue distribution, in consumption habits and living standards, religious dogmas, and social relationships. Economic development is a process consisting of related changes in demand and supply that lead to an increase in the net national product of a country.

Effect Of FDI On Economic Growth

Empirical literature displays many results on the existence of favorable productivity externalities as a result of foreign investment. Host nations need to adopt a mechanism emphasizing the role played by local financial markets to allow foreign direct investors to promote economic development. Production of goods in developing economies is conducted by domestic and international industries that compete for intermediate goods, skilled and unskilled labor. To run a business in the intermediate goods sectors, investors need to come up with varieties of intermediate products. The developed financial market will allow credit-constrained entrepreneurs to start their businesses. An increase in intermediate goods leads to positive spillovers to the final goods sector. Financial markets will then enable backward linkages between local and foreign firms to turn into FDI spillovers (Makki & Somwaru, 2004).

Our calibrating exercises show that, with an international presence at a constant, financially developed markets have a growth rate that is double that of underdeveloped economies. An increase in FDI results in financial growth in developed financial markets unlike economically undeveloped economies, and conditions such as human resources contribute to generating positive effects of FDI on economic growth. Least developed countries have come up with policies to allow foreign investors. Such strategies include tax holidays, monopolies and lower taxes. FDI not only provides capital for local investments but it also allows the creation of job opportunities, technology transfers and managerial skills, all of which contribute to economic growth and development (Alfaro & Johnson,

2012).

Negative Impacts Of Foreign Domestic Investment On Economic Growth

According to Dutt 1977, the theory of dependence has an adverse effect on the host country. Diaz Alejandro 1977 supports this theory with the argument that foreign domestic investment may negatively affect the economic growth of a developing nation if foreign companies send excess profits to home countries. FDI increases host nations' imports since foreign firms need modern technology and intermediate goods unavailable in host countries. Increased imports may negatively impact the host nations' economic growth as a result of trade deficits (Prasad et al., 2005).

Types Of Fdis

Vertical FDI: Consists of two types. Backward vertical foreign domestic investment involves investing in a country that provides inputs to the foreign firms' production activities, and forward vertical foreign domestic investment involves setting up firms in a state that sells the end products of the foreign firms.

Horizontal foreign domestic investment: It refers to a situation in which a firm invests in a similar industry in the host nation as it is involved in the parent country.

Greenfield investment: A firm that would like to invest in another country may do so by expanding existing amenities or building new ones.

Foreign Direct Investments In Sri Lanka

As a developing country, Sri Lanka has realized the importance of FDI to her economy. After independence, Sri Lanka started attracting FDI for technology and knowledge transfers and capital formation. The inflow of foreign domestic investment improved from 1999 when the government adopted the industrial policy. Export and import facilities, infrastructure and dispute resolution have allowed foreign investors to set up firms.

During the last 15 years, foreign domestic investment flow into Sri Lanka went up from \$394 in 1999 to \$1.73 billion in 2013, compared to India with \$28 billion in foreign investment. Corruption, political instability, and poor infrastructure are some of the reasons Sri Lanka received lower FDI as compared to India.

Methodology

Below are time-series data over 15 years. Multiple regression has been used, with foreign domestic investment inflow as an independent variable and gross domestic product, CPI inflation, and Balance of Trade as dependent variables. The figures were obtained from secondary sources because this saves time and is free from bias as compared to data from primary sources.

Time series of Sri Lanka (1999-2013) inflow of FDI and chosen economic indicators FDI inflow in US \$ GDP % CPI % BOT US\$

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1998	394000	4.90	7.10	-1934000
1999	383000	5.90	2.80	-1865000
2000	564000	5.30	1.90	-2011000
2001	401000	4.40	2.80	-1768000
2002	379000	5.30	4.40	-2215000
2003	284000	6.30	5.80	-2319000
2004	804000	6.60	6.50	-3297000
2005	745000	6.60	7.20	-2889000
2006	793000	6.50	7.20	-3458000
2007	769000	6.20	9.90	-5330000
2008	961000	5.70	6.70	-4710000
2009	913000	6.10	7.30	-5155000

2010	779000	6.70	8.80	-9935000
2011	11195	6.20	10.60	-9320000
2012	1731000	6.00	7.70	-7010000

Statistical Interpretation

Foreign domestic investment and gross domestic product growth: A Pearson correlation described the strength of the linear relationship between GDP and FDI. A Pearson correlation of 0.38 shows a fair, positive relation between GDP and FDI. A significance level of 0.08 indicates that the relationship between GDP and FDI is insignificant.

FDI and the rate of inflation: A correlation coefficient of 0.573 shows a healthy relationship between FDI and the rate of inflation. R-square for variance in foreign domestic investment inflow is 0.238, indicating 32.80% variance in the rate of inflation.

FDI and Balance of Trade: The coefficient of correlation of 0.6970 shows a strong negative relationship between BOT and FDI. An R-square of 0.486 means that variance in the amount of FDI inflow explains 48.60% of the difference in BOT.

Discussion

Statistical results displayed an insignificant healthy correlation between GDP growth and FDI, a favorable relationship between the inflation rate and FDI, and a healthy interdependence between BOT and FDI. Growth in foreign domestic investment has no association with economic development in Sri Lanka. FDI led to an increased rate of inflation and an unfavorable balance of trade.

Recommendations

Results from this study would provide viable information to an organization and foreign entrepreneurs with the need to comprehend the role played by foreign domestic investment in Sri Lanka. Negative impacts of foreign domestic investment raise concerns, especially with the World Bank, UN (United Nations) and IMF (International Monetary Fund), which work to promote economic development in developing countries. Future research should focus on other economic indicators such as purchasing power, foreign exchange rate and gross national product that will broadly illustrate the effects of FDI on economic growth in Sri Lanka.

Conclusion

Foreign domestic investment in a host nation has its positive and negative effects. In Sri Lanka, the negative correlation between foreign domestic investment and economic indicators should alert the government. Factors such as unskilled labor, political instability, and poor infrastructure may be hindering foreign investors. To realize the benefits of FDI, the government may improve its infrastructure, investment-friendly policies, and available skilled personnel.

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