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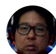

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Economics Bulletin

Volume 29, Issue 3

Impact of foreign direct investment volatility on economic growth of asean-5 countries

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Abstract

This study examines the impact of volatility of FDI, rather than its level on the economic growth of ASEAN-5 countries. Using bounds testing approach, we show that FDI volatility retards long-run economic growth in Indonesia, Malaysia, the Philippines and Thailand. Our results suggest that the economic growth of Indonesia is the most susceptible to the adverse effect of FDI volatility. These findings, which are robust to different measures of FDI volatility, are of concern in dealing with the economic growth of developing countries in the ASEAN region, which rely heavily on FDI.

Citation: Chee-keong Choong Ph.D and Venus khim-sen Liew Ph.D, (2009) "Impact of foreign direct investment volatility on economic growth of asean-5 countries ", *Economics Bulletin*, Vol. 29 no.3 pp. 1829-1841.
Submitted: Mar 11 2009.   **Published:** July 29, 2009.

1. Introduction

There exists a vast empirical literature on the impacts of foreign investment (FDI) on economic growth of developing countries. Among them, a great number of studies have reported a positive relationship between FDI and economic growth rates, although others have shown that FDI and economic growth are not related to each other. In general, those studies that provide positive evidence found that FDI tends to have significant effect on economic growth by stimulating capital accumulation, enhancing and enabling more efficient use of existing resources such as human capital (knowledge and skill), or/and through positive externalities such as technology transfer and spillover. De Mello (1997) and Ozturk (2007), for instance, provide a comprehensive review on the nexus on FDI and economic growth.

Whilst much has been done on the level of FDI and economic growth, the issue volatility of FDI and its impact on economic growth is less researched. It should be noted that not only the level of FDI, but also its volatility can have significant effect on the economic growth of a country. The mechanism underlying the link among FDI, its volatility and economic growth can be illustrated as follows: Higher level of investment leads to higher levels of output and thereby greater profit, ceteris paribus. Greater profit improves creditworthiness and intensifies borrowing that in turn results in higher investment, and subsequently FDI flows into the economy to finance this demand or boom. At the same time, an increase in investment level raises the demand for the country-specific factor as well as increases the aggregate price relative to the aggregate output. Increases in input prices, on the other hand, reduces profits and hence, trims down creditworthiness and investment, which will eventually transmit into a fall in aggregate output. Thus, endogenous volatility causes adverse shock to have permanent and persistent negative impacts on economic growth.

Volatility of FDI in recipient countries may be harmful to economic growth since it causes FDI to be less effective because foreign investors, when confronted with risks, may postpone or even withdraw the investments. As a result, the sudden fluctuations in the FDI flows may have a destabilizing effect on the economic performance (Lensink and Morrissey, 2006). Besides, FDI volatility may reflect political and economic instability in a country. A high level of instability or uncertainty may be a potential disincentive to FDI, which may further discourage higher level of domestic investments and economic performance (Lensink and Morrissey, 2000; Guillaumont and Chauvet, 2001). Subsequently, FDI volatility is expected to have a negative impact on economic growth. See Lensink and Morrissey (2002, 2006) who present an interesting and provocative view on the nexus between FDI volatility and economic growth. Empirically, Guillaumont and Chauvet (2001) find that volatility of FDI is robustly and negatively correlated with growth. In addition, Lensink and Morrissey (2002, 2006) report that the different measures of FDI volatility have a significantly negative impact on economic growth.