FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH:
EMPIRICAL STUDY IN THE BRIC COUNTRIES

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FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH: EMPIRICAL STUDY IN THE BRIC COUNTRIES

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APPROVAL PAGE

I certify that I have supervised and read this study and in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate in scope and quality as a research paper for the degree of Corporate Master in Business Administration.

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This research paper was submitted to the Faculty of Economics and Business, UNIMAS and is accepted as partial fulfillment of the requirements for the degree of Corporate Master in Business Administration.

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STATEMENT OF ORIGINALLITY

The work described in this Research Paper, entitled
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where due reference is made.

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ABSTRACT

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(The capital flows such as direct and portfolio flows has significant impact to countries economic growth. Foreign Direct Investment (FDI) has huge influence in create healthy financial markets with the positive impact towards the economic growth. The size of the capital flows become critical issues especially at the time liberalizing the capital account.)

The study attempts to examine empirically FDI and economic growth in the Brazil, Russia, India, and China (BRIC) countries. By using annual time series data for the period 1980 to 2011, FDI is positively affecting the economic growth direct contribution. The empirical analysis shows that FDI plays unambiguous role in contributing to economic growth in BRIC countries.
ABSTRAK

PELABURAN LANGSUNG ASING DAN PERKEMBANGAN EKONOMI: KAJIAN EMPIRIKAL DI NEGARA BRIC

Oleh

LING FOO SIEN

Aliran modal seperti aliran langsung dan aliran combinasi mempunyaipengaruh yang jelas kepada perkembangan ekonomi negara. Pelaburan langsung asing penting dalam mewujudkan pasaran kewangan yang sihat dengan kesan positive yang dibawa kepada perkembangan ekonomi. Saiz aliran modal biasanya menjadi isu kritikal terutamanya semasa mengimbangkan akaun modal. Kajian ini dijalankan untuk mengkaji empirikal tentang pelaburan langsung asing dan perkembangan ekonomi di Negara Brazil, Russia, India, dan China (BRIC). Dengan menggunakan data tahunan dari tahun 1980 hingga 2011, pelaburan langsung asing mempunyai kesan positive langsung terhadap perkembangan ekonomi negara. Kajian empirikal ini menunjukkan pelaburan langsung asing memainkan peranan yang amat penting dalam usaha memangunkan ekonomi di Negara BRIC.
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CHAPTER ONE
INTRODUCTION

1.0 Introduction

The capital flow such as direct and portfolio flows has huge contribution to influence the economic behavior of the countries positively. Countries can gain significantly from Foreign Direct Investment (FDI) through a well developed financial market. The understanding of the behaviors of the capital flows become curious issues especially at the time in liberalizing the capital account when given the huge volume of capital flows and their impact on the domestic financial markets is significant. Capital flows have significant potential benefits for economies around the world. Countries with sound macroeconomic policies and well-functioning institutions are in the best position to reap the benefits of capital flows and minimize the risks. Countries that allow free capital flows have to choose between the stability provided by fixed exchange rates and the flexibility afforded by an independent monetary policy. Liquidity and contribute to financial market volatility will be affected when capital flows expose the potential vulnerability of the economy to sudden withdrawals of foreign investor from the financial market.

The relationship between capital flows and economy growth need to be strengthened over time. Capital flows play an important role in countries where a developed physical infrastructure, a strong business environment, and open trade regimes have facilitated the
absorption of those flows, but not otherwise through the transfer of technology and management techniques as well as the stimulation of financial sector development. The economy growth of countries depends to a large extent on the opportunity of making profitable investments and accumulating capital. Having access to foreign capital and investments allow a country to invest in both human and physical capital and to exploit opportunities that otherwise could not be used. Recent experiences with opening capital accounts in emerging and developing economies, however, have proved to be a mixed blessing, as it is becoming increasingly clear that not all types of capital imports are equally desired. Short-term credits and portfolio investments run the risk of sudden reversal, if the economic environment or even just an investor’s perception changes, giving rise to financial and economic crises. It is therefore frequently advised that such countries should primarily try to attract FDI and be very careful about accepting other sources of finance (Prasad, 2003).

FDI is one of the capital flows that drive the economic growth and a healthy economies environment in turn motivates FDI. After the advent of globalization, FDI have particularly become prominent that has led to widespread implementation of liberalization program and financial reforms in various countries across years. Hence, the integration of global financial markets has been created which enable capital started flowing freely across national border seeking out the highest return. During 1991 to 1996 there was a spectacular rise in net capital flows from industrial countries to developing countries and transition economies. This development was associated with greatly increased interest by international asset holders in the emerging market economies to find
trend toward the globalization of financial markets (Singh, 1998). A virtuous circle in which developing and transitional economies can be created gradually through global financial markets where the markets discipline had been strengthening to enhance financial system soundness.

Since the 1997 East Asian financial crisis, the relationship between FDI, exports and economic growth has gained importance and attention among policy makers and researchers. The concept of ‘Investment led Economic Development’ has promoted the idea that the outward and inward FDI position of a country is linked to its economic development relative to the rest of the world. The idea of ‘Investment led Economic Development’ has creates an argument that the FDI flows of a country is related to its economic development and it also relative to the rest of the world. The idea suggested there are five different stages of development that the countries have to go through if it desired a change in economic development. These stages are being classified according to the propensity of the countries to the outward and/or inward investors (Dunning and Narula, 1999). However, the development depends on the extent and pattern of the ownership-specific advantages of domestic firms, its location advantages and the degree of utilization of the ownership-specific advantages by the domestic and foreign firms in the internationalization of markets.

FDI plays an extraordinary and leading role in global economies and the regions. Most of the policymakers believe that FDI plays an important role in enhancing the productivity of host countries and promotes development. FDI creates a new medium for investing
firms with new markets and marketing channels, cheaper production facilities, access to new technology, products, skills, and financing. In return, the host country which receives the investment can provide a strong impetus to economic development which may favor the investors. FDI had been defined as a company from one country making a physical investment into building a factory in another country. FDI flows comprise capital provided by foreign investors, directly or indirectly to enterprises in another economy with an expectation of obtaining profits derived from the capital participation in the management of the enterprise in which they invest. The foreign investors acquire ownership of assets in the host country firms in proportion to their equity holdings. This is the empirical definition of FDI adopted by many countries to distinguish it from portfolio flows. According to International Monetary Fund (IMF), FDI is defined as “an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor”. The investor’s purpose is to have an effective voice in the management of the enterprise (IMF, 1977). FDI can be viewed as a process by which the residents of the source country acquire the ownership of assets for the purpose of controlling the production, distribution and other productive activities of a firm in the host country.

As the main aim to provide developing countries with their desired growth and development, FDI is focused to encourage the complement domestic investment. As a growth enhancing component, FDI has received great attention in both developed and developing countries in recent decade. FDI influence on economic growth of the host country has been a matter of great concern for many economists. Country investment is
financed solely from domestic savings in a closed economy such as China before 1980s, with no access to foreign saving where FDI is not performing at all. However, in open economy, investment is financed both through domestic savings and FDI where the capital flows enable investment-receiving (host) countries to achieve investment levels beyond their capacity to save. Since the previous few decades, FDI has remained the largest form of capital flow in the developing countries far surpassing portfolio equity investment, private loans, and official assistance. In 1997, FDI accounted for 45 percent of net foreign resource flows to developing countries, compared with 16 percent in 1986 (Perkins, 2001). The World Bank (2002) reported that in 1997 developing countries received 36 percent of total FDI flows. Lately, most of the developing countries view FDI as most crucial source of development, but its economic effects is almost impossible to either predict or measure with precision.

FDI has come to play a major role in the recent internationalization of business. Changes have occurred in the size, scope and methods of FDI analysis as a result of reacting to changes in technology, growing liberalization of the national regulatory framework governing investment in enterprises, and changes in capital markets. Management of foreign investment is now far easier than in the past due to the new information technology systems, as well as decline in global communication costs have made. The role of FDI had been most significantly catalyst due to the change in trade and investment policies and the regulatory environment globally currently, including trade and tariff liberalization, reduce of restrictions on foreign investment and acquisition in most nations, and the deregulation and privatization of lots industries.
In most developing and developed countries, the role of FDI in the growth process has been a hot issue. In the globalization efforts of the world, FDI can be a vital ingredient of economy. The economic and technological forces are the key drivers to the growth of international production. Besides, ongoing liberalization of FDI and trade policies is another important driver. Since 1990s, one outstanding feature of the present-day world has been the circulation of private capital flow in the form of FDI in developing countries. Multinational Corporations (MNCs) have come out as major actors in the globalization context since 1980s. Governments all around the world have been attracting MNCs to come to the respective countries with their FDI. Most developing and transition countries have moved to market-oriented strategies which can be related to broader context of liberalization. Globalization can offer an unparalleled opportunity for developing countries to attain amazing economic growth through trade and investment. In 1970s, international trade was by far than most other important international economic activities due international trade grew more rapidly than FDI. When world FDI started to increase sharply in the middle of the 1980s, this situation changed radically. At this era, the world FDI has increased its importance by transferring technologies and establishing marketing and procuring networks for efficient production and sales internationally (Shujiro Urata, 1998).

FDI has become the most significant source of external resource flows to developing countries over the years. Despite their share in global distribution of FDI continuing to remain small or even declining, FDI also become an important part of capital formation in developing countries. FDI are usually believed to have most impact in the
employment rate, augment in the productivity, boost in exports and amplified pace of
transfer of technology which may facilitates the utilization and exploitation of local raw
materials, introduces modern techniques of management and marketing, eases the access
to new technologies. Foreign inflows can be used for financing current account deficits.
Finance flows in form of FDI do not generate repayment of principal and interests (as
opposed to external debt) and increases the stock of human capital via on the job training.
FDI can be promoted purely by external factors which may tend to be less sustainable
than those induced by domestic factors. Both foreign capital inflows and outflows have
important implication for economies when they are large and sudden. When FDI flows
are large, they can lead to an appreciation of real exchange rate. Until 1997 a market shift
in Asia countries, in the composition of capital flows to domestic financial market with a
significant increase in net private capital inflows to financial markets and a decline in the
share of official flows. FDI remains as the most stable capital where as net portfolio
investment and banking flows were volatile. Portfolio flows are rendering the financial
markets more volatile through increased linkage between the domestic and foreign
financial markets (Kohli, 2001; 2003).

The most profound effect has been seen in developing countries, where yearly FDI flows
have increased from an average of less than $10 billion in the 1970's to a yearly average
of less than $20 billion in the 1980's, to explode in the 1990s from $27 billion in 1990 to
$179 billion in 1998 and $208 billion in 1999 and now comprise a large portion of global
FDI. Driven by mergers and acquisitions and internationalization of production in a
range of industries, FDI into developed countries rose to $636 billion, from $481 billion

1 Source of data: Databank, World Bank 2012.
in 2008 (UNCTAD, 2008). Most governments, especially in industrialized and developed nations, pay very close attention to FDI because the investment flows into and out of their economies can and does have a significant effect to their economy. In the United States, the Bureau of Economic Analysis, a section of the U.S. Department of Commerce is responsible for collecting economic data about the economy including information about foreign direct investment flows. This data monitoring is very useful in the effect of determine the investment on the overall economy, especially in evaluating industry segments. State and local governments watch closely because they want to track their foreign investment attraction programs for successful outcomes (Jeffrey P. Graham and R. Barry Spaulding, 2004).

With the existence of diminishing returns of physical capital, the impact of FDI on economic growth was restricted. Hence FDI could only exert an effect on the level of output per capita, but not on the growth rate. This means FDI unable to alter the growth of output in the long run. FDI is considered as an engine of growth of mainstream economies in the context of the new theory of Economic Growth. Several recent studies concluded that FDI can promote the Economic Development of the Host Country by promoting productivity growth and export (World Bank, 2002). However, the exact relationship between foreign MNCs and their host countries varies considerably between countries and among industries. Net benefit of FDI is highly depending on the determinant of the characteristics of the host country and the policy. The role of FDI in the growth process has been a topic of discussion in several countries which provide insights into the relationship between FDI and growth.
1.1 BRIC Countries Background

The world has experienced a massive transformation in terms of economics, geopolitics, and distribution of production. For several reasons, global economic leadership is progressively shifting from the G7\(^2\) to some large economies such as Brazil, Russia, India, and China which popular as BRIC countries\(^3\). BRIC countries have acquired important role in the world economy. The BRIC economies have been identified as some of the fastest growing countries and the engines of the global recovery process.

Due to their larger potential consumer market having the common characteristic of large population, BRIC countries prominently attract larger capital. BRIC countries as a whole do not have any trade or integrated economic union but they are listed as emerging economies. BRIC have emerged as major destination for FDI inflows, resulting in BRIC - a strong constructive term which was prominently coined by the ‘Goldman Sachs Investment Bank’ (Wilson and Purushothaman, 2003) to represent Brazil, Russia, India, and China as an economic Block. Global competition for FDI had given the bargaining power to MNCs and their allies (Boros Torstila, 1999). The important of FDI creates competition forces which forced the countries to lower their entry regulations, taxes, environmental clearances, and stipulations on working conditions for attracting more FDI. Goldman Sachs predicted that China and India are likely to emerge as dominant global suppliers of manufactured goods and services, while Brazil and Russia to dominate in supply of raw materials. In the recent days BRIC countries have exhibit economic

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\(^2\) G7 was formed by Canada, France, Germany, Italy, Japan, United Kingdom and United State.

\(^3\) BRIC is an acronym for the four largest developing countries Brazil, Russia, India and China that was introduced by Goldman Sachs chairman Jim O’Neil in 2001. Goldman Sachs has taken these four countries together because they expect that all four countries will belong to the largest ten economies in the world in 2050.
strength as emerging economies in the face of the US credit turmoil and growth slowdown.

China, India, and Russia had gone through deregulation and the ‘opening-up’ towards the global economy marked the start of economic acceleration which transformed their countries economy towards a market-based economy. With the introduction of the ‘opening-up’ policy by its leader Deng Xiaoping, China had gradual reform process started in 1978. However, China is still far off from a well-functioning market economy if compare to western standards at that time. The process of liberalization has been gradually continued under the leadership of President Hu Jin Tao and Prime Minister Wen Jia Bao since 2005. In contrast to Russia, China experienced an interesting feature of the liberalization process which the liberalization process occurred without a thorough attempt to democratization. China growth in the early years was led by an export-oriented policy, and later the inflow of foreign capital whereas recent growth is increasingly driven by domestic demand. In the latter, there is a large similarity with the earlier success of other Asian economies, like Japan, South Korea and Taiwan (see Young, 1994, 1995).

Indian economy started to accelerate in the early 1980s. However, substantial policy reform did not occur until a decade later. Rodrik and Subramanian (2005) attribute the growth during the first decade of India’s ‘take-off’ to a change in the political approach towards private businesses. In the early 1980s, this economic environment abruptly changed towards business friendly whereas before 1980s, it could best be
characterized as downright hostility. Indian economy still remained relatively closed, and economic growth was mainly driven by domestic factors during 1980s. India is only start drastic market-based economic reform in 1991. Investment decisions in most industries did no longer require government approval and many areas of economic activity were opened to private firms. However, banking was still mostly restricted to government operated firms until 1990s. Therefore, investment decisions were often politically rather than economically motivated. Trade restrictions were gradually removed, from the late 1990s onwards. Since that, the integration of India into the world economy has begun. This transformation resulted in the inflow of foreign capital as the case in China.

Following the collapse of the Soviet Union, economic reform in Russia occurred in a ‘big bang’ fashion rather than gradual. Under Michail Gorbatsjov, the reforms started in 1987, with the decision to allow firms to determine output levels based on demand. The transfer of funds from profitable to unprofitable companies came to an end and companies became financially independent and were allowed to negotiate prices. After the reform, foreign investment became legal. With the aim of rapid and radical transformation towards a market economy, Russia implemented what was known as the ‘shock therapy’ led by Jegor Gaidar in 1991, the first year of the presidency of Boris Yeltsin. However, this policy is a disastrous. A full economic collapse occurred between 1991 and 1995, with GDP declining by about 50 per cent. Hyperinflation had been created result of the sudden removal of price controls. Unfortunately, the 1998 financial crisis resulted in a new recession and hyperinflation after a short period of recovery in

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4 Sources: World Development Indicators (World Bank, 2012).
Russia. The economy was then started to recover after the financial crisis in 1998. The economic growth in Russia has been continuously high, attractive sums of foreign direct investments have been attracted, and inflation has remained relatively low after the recovery from the crisis.

Brazil had experienced a period of economic crisis in the early 1980s which was the result of bad governance and a high dependency on foreign debt. The economy entered a deep recession in 1981, as the government attempted to reduce indebtedness by reducing imports and economic growth and the introduction of an import substitution program. This program had resulted in a trade surplus. However, the domestic public debt had become problematic at that period and a loose monetary policy had resulted in hyperinflation. Before fiscal stabilization was achieved in early 1990s, the improvement of macroeconomic stability relied on a price freeze. While supply was reduced and many goods became scarce, the policy shown initial successful upon introduction in 1986. However, Brazil returned to hyperinflation in the late 1980s. In 1990, a new attempt was made to ensure macroeconomic stability under the presidency of Fernando Collor de Mello. Most financial assets were frozen, and fiscal reforms were carried out results of the implementation of new prize freeze. Economy entered a new period of recession as the plan failed as well. The crisis came to an end when the Brazil currency was pegged to the US dollar in 1994. Brazil economic growth has remained generally high since that period and it has succeeded to attract high levels of FDI.
Thus, if these countries (BRIC) form a formal union like European Union, NAFTA, ASEAN, G7 and G8, and pool their resources, the BRIC countries could appear to have prosperity of economic and social development in the forthcoming decades. The economic growth will be tremendous and the BRIC countries can have the ability to compete and challenge towards the developed countries. The overall macroeconomic fundamentals are expected to remain strong in China, India and Russia and to improve in Brazil in the short term. BRIC countries have the potential to continue attract substantial flows of foreign investment through their currently stable external environments which will further boosting potentials for the future output growth. However, risks related to the unwinding of global economic imbalances will continue to weight on the outlook for BRIC countries and especially Brazil.

1.2 FDI Flows in BRIC

Economically, BRIC countries are highly related to the world in terms of capital flows, international trade, and market interdependence. The BRIC countries have been grown substantially as a destination share for global FDI in the past decade. The combined annual inward FDI flows to the BRIC in 2011 was almost five times the flows in 2001 (refer Table 1.2). According to UNCTAD (2011) statistics, the BRIC countries attracted more than $1.5 trillion or about 12 per cent of world FDI flows during the period from 2000 to 2010. At the end of 2010, the stock of FDI in the BRIC was valued at about $1.7 trillion, almost one-quarter of that of G7. Meanwhile, the BRIC outward FDI also picked up sharply to reach more than 4 per cent of the world as more and more companies

5 Source: own calculations based on IMF-IFS data.