

THE IMPACT OF FDI INFLOWS ON ECONOMIC GROWTH: EVIDENCE FROM LANDLOCKED COUNTRIES IN SUB- SAHARAN AFRICA

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ABSTRACT

The effects of Foreign Direct Investment (FDI) on economic growth in Sub-Saharan Africa (SSA) have become a pertinent issue in recent times. The premise of this study is to carefully analyse the impacts of FDI inflows on the economic growth of landlocked countries in Sub-Saharan Africa for the period 1995-2013. With the total of 234 panel observations, the results of the study revealed that while controlling host countries' characteristics (trade openness, inflation rate, government expenditure, natural resources endowment, and human capital.), FDI positively and significantly affects current economic growth in landlocked countries of SSA. There is also a significant relationship between domestic investment and economic growth which suggests that FDI has no crowding out effect on current domestic investment. Instead FDI and domestic investment are substitutes in landlocked countries of SSA while a negative relationship was revealed between trade openness and economic growth in the sample countries. Our study contributes to existing literatures on FDI-led growth by investigating landlocked countries of SSA for the first time and the role natural resources endowment play for FDI attraction for the stipulated period.

Keywords: FDI, Economic Growth, Natural Resources Endowment, SSA.

Introduction

Globally, FDI is seen as a key driver of an international economic integration and has the propensity to provide financial stability, promote economic development and enhance the well beings of societies (OECD, 2008). This presupposes that although for the past couple of years FDI inflows into developing economies have experienced a tremendous increase (Adams, 2009), it has not been sufficient enough to spur development. For FDI to yield any accrued benefits to the host countries, the host countries must endeavour to remove any bureaucratic factors that may limit the relationship between foreign firms and their local host and also pay attention to the

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resources that attract foreign investors to their countries. Clearly it is envisaged that, FDI is desirable particularly for developing countries (Yusufu, 2013), but quiet a substantial literatures are still questioning its potential ability to lead to economic growth of the recipient countries. In an attempt to substantiate the impacts of FDI – led Growth, most studies have focused on countries that are in high need of FDI (developing world) to boost the development of their emerging economies with few considered in SSA neglecting the more deprived countries (landlocked countries). This paper seeks to investigate the impact of FDI on economic growth of thirteen out of fourteen landlocked countries in Africa ¹for the period 1995–2013. This study contributes to existing literatures on FDI-led growth by investigating landlocked countries of SSA for the first time and the role natural resources endowment play for FDI attraction for the stipulated period. The subsequent structure of the study is as follows: the beneath sections evoke a critical review of theoretical and empirical evidence of FDI on economic growth; methodology deployed for the study, discussion of the empirical results and findings, conclusion and policy implications.

Literature Review

Different theoretical explanations exist on how FDI can influence economic growth (Yusufu, 2013). Even though the impact of FDI on economic growth is not clearly established; as some studies emphasized on financial development (Alfaro et al., 2006) others point to human capital (Borensztein & Gregorio et al., 1995). Contributing to the discussion of this challenge, (Yusufu, 2013) was of two strands, the first according him was the needs of FDI to the developing countries and emphasized on the various factors that increase their inflow and the question of whether FDI leads to growth and development in the recipient country.

FDI has a positive direct and indirect impact on economic growth (De Mello, 1999) especially in developing countries but attributed such effects to host country's factors that facilitate growth since the FDI itself does not necessary lead to growth (Yusufu,2013). First, following the neoclassical growth theory, FDI increases the stock of physical capital in the recipient economy and therefore directly affects economic growth. Secondly, following endogenous growth theory, FDI encourages human capital development, brings about technological upgrading and affects economic growth indirectly (De Mello, 1999). Regardless of the positive impacts of

¹ The sample countries are Botswana, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Lesotho, Malawi, Mali, Rwanda, Swaziland, Uganda, and Zambia. Zimbabwe, Niger and South Sudan were excluded from the sample because of data availability.

FDI flows on the growth of the recipient economy, several arguments have been levelled against FDI led Growth effect. For instance, according to the dependency theory, FDI leads to inefficient market structures like monopoly (Bornschier and Chase-Dunn, 1985). Furthermore, FDI creates a disarticulated growth pattern in economies or industries dominated by foreign firms (Amin, 1974). To have a better understanding of the impact of FDI on growth, it is necessary to take into consideration factors like the host country characteristics or the assumptions on which growth models were built.

Considering the diminishing returns of capital in the neoclassical growth model of (Solow, 1956), FDI inflows will only lead to short term growth (De Mello, 1999) since increasing inflows will be needed to induce decreasing variations in output growth. Furthermore, under the assumption of exogenous technical progress as professed by this neoclassical theory, the indirect effects of FDI (technology spill over) are not taken into consideration and the overall positive impact of FDI on growth is reduced.

Romer (1986, 1990) and the economists of endogenous growth offer another framework to analyse the impact of FDI on growth. First, they postulate that the returns of capital are no more diminishing but they are constant over time. Thus, as mentioned by (De Mello, 1999), FDI has a positive impact on long-run growth. Secondly, the theorists of endogenous growth postulate that technical progress, knowledge, and human capital are endogenous determinants of growth and may explain its cumulative aspect. Following this view, (De Mello, 1999) and (Mehic et al., 2013) argue that FDI promotes technological and knowledge spillovers that *in fine* lead to growth.

Considering other factors, (Mehic et al, 2013) argue that the impact of FDI on growth depends on the extent to which it complements or substitutes domestic investment. In a case where FDI is a “perfect substitute” for domestic investment as in the neoclassical approach, it will increase the stock of capital and lead to growth. Meanwhile, if FDI and domestic investments are investment alternatives, there would be a crowding out effect and FDI would not affect growth permanently. Taking into consideration the host country characteristics, the impact of FDI on growth depends on factors like sound institutional environment, natural resources endowment, telecommunication infrastructures. There are some controversies in the empirical literature related to the effect of FDI on economic growth. As a matter of fact, a group of studies finds that FDI has a positive impact on economic growth, while a second group reveals a negative impact of FDI on growth; the third group

demonstrates that the effect of FDI on growth is neither positive nor negative, depending on the host country characteristics.

In the first group of studies, (De Gregorio, 1992) investigated the effect of FDI on growth in 12 Latin American countries between 1950 and 1985. He found that FDI has a positive and significant effect on economic growth. Furthermore, he reveals that FDI has a greater impact on growth than domestic investment. He also discovered that FDI has a greater effect on growth when the level of education is high in the host country. In another work, (De Gregorio, 1998) used panel data analysis to study 69 developing countries and revealed that 1% increase in the FDI ratio on GDP will boost the growth rate of GDP per capita by about 0.8%.

Adams (2009) studied the impact of FDI and domestic investment on growth in 42 Sub-Saharan Africa (SSA) countries from 1990 to 2003 using OLS and fixed effect estimations. He found that domestic investment positively and significantly affects growth in both OLS and fixed effect estimations, and further asserted that FDI has a positive and significant impact on growth in OLS estimation only. Furthermore, the author revealed that FDI initially has a crowding out effect on domestic investment but the effect evolves and becomes positive over time.

Barrell and Pain (1999) investigated the effect of FDI by US multinational companies in 4 European countries. They found that FDI-led growth in the cases where it came with technology and knowledge transfers. Campos et al. (2002) came to similar results by studying 25 transition economies from Central and Eastern Europe and former Soviet Union. The study was carried out for 1990-1998 periods and the authors found that because FDI is bringing about technology transfer, it has a positive effect on growth in each of the host countries.

In a study of governance, FDI and economic growth, (Yosra et al., 2014) built a sample of 17 Middle East and North Africa (MENA) countries over the period 1996-2011. They used the Generalized Method of Moments (GMM) on a dynamic panel and found a positive and significant impact of FDI on growth. Zhang (2001) also used time series analysis and studied 11 developing countries from East Asia and Latin America during 1990-1998 periods. He found that FDI has a positive effect on growth but contended that the magnitude of this effect depends on the host country's characteristics (liberalized trade policy, level of education, macroeconomic stability).

Bengoa et al. (2003) studied 18 Latin American countries between 1970 and

1999 using panel data analysis. They compared the fixed and the random effect regressions and concluded that FDI leads to growth but the magnitude of this relationship depends on the host country's conditions. Mehic et al. (2013) took into consideration 7 Southeast European countries during the period 1998-2007. They used Prais-Winstern regression with panel corrected standard errors and found that FDI positively and significantly affects growth. Furthermore, FDI is still statistically significant and robust when they include domestic investment into the model and even when they take into consideration endogeneity issues.

In the second group of studies, (Bos et al., 1974) found that FDI by US companies has a negative effect on the host country growth. They explained this relationship by the fact that the outflows due to profit repatriation are greater than the level of new investments. Saltz (1992) found similar results in a study of third world countries between 1970 and 1980. He concluded that FDI will harm growth in the host country if it leads to monopolization and pricing transfers.

Alfaro et al. (2002) took into consideration the level of development of the domestic financial market in the relationship between FDI and growth. They studied 71 developing countries and found that FDI negatively affects growth in most of the countries of their sample. They postulated that a poor level of financial development reduces the ability of the host economy to take advantage of the potential spillover effects of FDI.

In the third group of studies, (Carkovic and Levine, 2002) investigated the effect of FDI on growth in 72 countries over 1960-1995. They used cross sectional Ordinary Least Square(OLS) analysis and GMM estimator on a dynamic panel and found that FDI do not have any effect on growth, even taking into consideration the level of education, economic development, financial development and trade openness. Lyrroudi et al. (2004) used Bayesian analysis on panel data for the period 1995-1998 to investigate the relationship between FDI and economic growth in 17 Eastern European and Balkan countries and did not find any relationship between the two variables too.

Borensztein et al. (1998) found a positive impact of FDI on economic growth but argued that the main way by which FDI affects growth is through technology transfer instead of capital accumulation. Therefore, the host economy can take advantage of the technology transfer effect of FDI and boost its growth only if it has a minimum threshold stock of human capital. The magnitude of FDI effect on growth is higher in countries with high level of human capital and lower elsewhere.

As to (Olofsdotter, 1998), he worked on 50 developing and developed countries using OLS regressions over 1980-1990. He found a positive effect of FDI on growth but stipulated that the magnitude of this effect depends on the institutional framework of the host country. He mentioned the degree of property rights protection as a variable of that institutional framework.

Balasubramanyan et al. (1996) studied 46 developing countries from 1970 to 1985 using cross sectional data and OLS regressions and found that FDI positively affects growth in countries implementing export promoting strategies and negatively affects growth in countries using import substitution strategies.

De Mello (1999) used panel data and time series to study 32 developing and developed countries from 1970 to 1990 and found weak evidence related to the effect of FDI on the host country's growth. Choe (2003), used panel data and analysed 80 developing and developed countries from 1971 to 1995 and found that FDI Granger causes growth and vice versa but the causality is stronger on the direction of growth to FDI.

Johnson (2006) studied 90 countries including both developing and developed ones and found that FDI positively affects growth in developing countries but not in developed countries. He attributed his findings to the technology spillover of FDI in the first group of countries. He went further and analysed the impact of FDI on each sector of the host country. Alfaro (2003) also analyzed the impact of FDI on economic sectors and found that the effect of FDI is negative on the primary sector, positive on the manufacturing sector and ambiguous on services.

Econometric Methodology

As a basic question, before using any data series, the stationary issue should be addressed. In this section tests for the stationary of variables of interest and decide whether the data are stationary at level or stationary at first difference is discussed. For this, in this research three different panel unit root tests had been applied, LLC (2002), IPS (2003) and Fished ADF, to confirm the findings about the data nature.

In order to investigate the determinants of Foreign Direct Investment (FDI) for the "landlocked countries" in Sub- Saharan Africa, the present research is conducted using panel data analysis which is seen as a powerful research technique that can be used to measure the effect of any variables of interest over a period of time (time-series) and across countries (cross-sectional Panel) data methodology is

used to reduce the time-varying and multicollinearity between endogenous and exogenous variables. After verifying the Heterogeneity of panel time series, as follow:

$$Y_{it} = \varphi_i + x'_{it}\beta_i + \varepsilon_{it}, \quad i = 1, \dots, N,$$

Where, assumed that $\varepsilon_{it} \sim IID(0, \sigma_{\varepsilon,i}^2)$. In order to pool the data or not depends on whether the data could be imposed on the homogeneity of slope coefficients; if $\beta_i = \beta$ and $\sigma_{\varepsilon,i}^2 = \sigma_{\varepsilon}^2$ for all i , upon assuming ε_{it} and φ_i are independent across units. Therefore, the model reduces to the fixed or random effects model. In order to determine the model specification, the fixed effects model should outperform the pooled OLS by using F-test and Pagan Lagrange multiplier (LM) test to determine the random effect model*52/8.7 outperforming the pooled OLS. Hausman test is used to contrast the random effects model compare with fixed effects model. For diagnostic purposes by applying Baltag LM-test for autocorrelation and Erlat LM-test for heteroskedasticity.

To investigate the effects of Foreign Direct Investment (FDI) on the GDP growth of the “landlocked countries” in Sub- Saharan Africa, the following model was estimated:

$$GDPg_{it} = \beta_0 + \beta_1 \log FDI_{it-1} + \beta_2 DIg_{it} + \beta_3 \log(OPENg)_{it} + \beta_4 \log(GDPpc)_{it} + \beta_5 INF_{it} + \beta_6 GEg_{it-1} + \beta_7 HC_{it} + \beta_8 NRE_{it-1} + \varepsilon_{it}$$

The data set of this research consisting of 234 observations made from a sample of 13 countries out of 16 landlocked Sub-Saharan Africa countries excluding Zimbabwe, Niger and South Sudan due to lack of data over the period of January 1995 to December 2013, (t time period) . Where, GDPg: GDP growth; FDI: foreign direct investment; DIg: Domestic investment percent of GDP; OPENg: openness of trade percent of GDP, GDPpc: GDP per capita, INF: inflation rate (consumer price index), GEg: Government Expenditure percent of GDP, HC: Human Capital (Secondary school enrolment as a proxy), and NRE: natural resources endowment. ε_{it} : is the random error. We had employed Hausman test to compare fixed effect versus random effect panel.

Empirical Results

The results reported in table 2 indicates that all the variables of interest are not stationary at level while they documented to be stationary at first difference I (1).

Table 1: Panel Unit-Root Test Results

| Panel A: Level | | | | | | | |
|----------------------------|---|------------|-----------|-----------|----------|-----------|-----------|
| VARIABLES | K | FISHER ADF | | LLC | | IPS | |
| | | A | B | A | B | A | B |
| GDP | 2 | -1.513 | -1.041 | 1.166 | 1.994 | -1,878** | -1,751** |
| FDI | 3 | -1.043 | -2.841** | 2.070 | 2.534 | 0.546 | -0.374 |
| DIG | 2 | 1.058 | 1.013 | 0.122 | 3.403 | 0.470 | 0.391 |
| OPENG | 4 | 2.344 | 3.288 | 2.690 | 3.188 | 5.725 | 1.377 |
| GDPPC | 4 | 3.747 | -0.373 | 1.540 | -1.449 | 2.056 | -1.245 |
| INF | 3 | -1.432 | 0.447 | 2.754 | 11.247 | -1.668 | -0.246 |
| GEG | 2 | 0.083 | -1.224 | -0.372 | -2.040 | -0.317 | -1.825 |
| HC | 3 | 5.513 | 0.970 | 3.817 | 4.217 | 4.590 | 0.237 |
| NRE | 2 | -0.549 | 0.208 | -0.154 | 0.199 | -0.887 | -0.249 |
| Panel B : First Difference | | | | | | | |
| GDP | 2 | -6.248*** | -4.442*** | -1.383*** | 0.773** | -7.153*** | -5.532*** |
| FDI | 3 | -12.299*** | -9.874*** | 2.499** | 6.330* | -4.877*** | -2.790*** |
| DIG | 2 | -3.328*** | -2.212*** | 5.941** | 8.315** | -3.544*** | -2.745*** |
| OPENG | 4 | 1.594*** | -0.356*** | 6.531** | 12.086** | 0.382*** | -1.089*** |
| GDPPC | 4 | -0.298*** | 4.422*** | -0.097** | 11.548** | -1.028*** | 1.925*** |
| INF | 3 | -4.218*** | -1.950** | 13.908** | 17.532** | -4.023*** | -1.910*** |
| GEG | 2 | -3.469*** | -1.905** | -0.758** | 0.854** | -3.576*** | -2.264*** |
| HC | 3 | -0.635*** | 0.559*** | 2.246** | 3.739** | -0.998*** | -0.479** |
| NRE | 2 | -4.152*** | -3.312 | -3.425** | -3.724** | -4.289** | -3.659*** |

** and ***, denotes the stationary of the variables at 5% and 1% respectively based on test critical values. K: is the lag length, it is been determined via applying general to specific method. Column A: Intercept, column B: Intercept and Trend.

As presented in Table 2, our empirical results revealed that while controlling host countries' characteristics (trade openness, inflation rate, government expenditure, natural resources endowment, and human capital, etc.), lagged FDI positively and significantly affects current economic growth in landlocked SSA countries. A 10% increase in current FDI will lead to an increase of GDP growth to about 5.05% in the next period. This finding is consistent with what Adams (2009) found in his fixed effect regression, using 42 SSA countries. It is also consistent with FDI-led growth school of thought who suggested that FDI increasing the stock of capital and brings technological upgrading, and therefore boosts economic growth in the host countries.

The results also revealed that domestic investment is positively and significantly correlated with economic growth. This positive correlation suggests that lagged FDI has no crowding out effect on current domestic investment. Instead, FDI and domestic investment are substitutes in landlocked SSA countries. These findings support Mehic

et al.'s (2013) argument that the impact of FDI on growth depends on the extent to which it complements or substitutes domestic investment.

As to trade openness, it negatively and significantly correlates with economic growth in our sample countries. This finding is also in consistent with Adams (2009). Furthermore, the impact of trade openness is even greater than the one of lagged FDI. A 10% increase in the trade between these countries and the rest of the world will reduce their GDP by almost 37.82%. This unusual correlation may be due to the fact that these countries are landlocked which have some peculiar characteristics. Firstly, their imports and exports may suffer from high costs because they have to transit through other countries before getting to their final destination. Secondly, these landlocked African countries may experience huge trade deficits because they are net importers. The combination of these two effects may explain why trade openness negatively affects economic growth in these countries.

Pushing this argument further, one should expect these landlocked countries to experience imported inflation since they are net importers and their imports are overpriced. Our results confirmed that in these countries, inflation is negatively associated with economic growth, although the correlation is not significant.

Table 2: The GDP Growth Estimation Results, Panel with Fixed Effect

| Independent Variables | Coefficients |
|--------------------------|----------------------------|
| $\text{Log}(FDI)_{it-1}$ | 0.505436*** (0.180729) |
| DIg_{it} | 0.105877*** (0.039552) |
| $\text{log}(OPENg)_{it}$ | -3.781903*** (1.058327) |
| $\text{log}(GDPpc)_{it}$ | 7.847276*** (1.906682) |
| INF_{it} | -0.021441 (0.041717) |
| GEg_{it-1} | 0.176818* (0.095536) |
| HC_{it} | -0.072713** (0.036487) |
| NRE_{it-1} | 0.223024*** (0.077576) |

| | |
|-----------------------------------|---|
| Intercept | 31.13485*** (12.28099) |
| S.E of country Fixed Effect | 4.273157 |
| R-squared | 0.337454 |
| Adjusted R-squared | 0.275243 |
| F-statistic Prob(F-statistic) | 5.424355 0.000000 |
| Durbin-Watson | 1.691025 |
| Hausman test Random Effect | $\chi^2 = 45.774077$ P-value 0.0000*** |
| Total panel observation | 234 |
| Diagnostic test | |
| Autocorrelation: Baltagi LM-test | $\chi^2 = 0.629139$ P-value 0.427617 |
| Heteroskedasticity: Emlat LM-test | $\chi^2 = 1.274867$ P-value 0.198802 |

*, ** and *** denotes significant level at 10%, 5% and 1% respectively. Standard errors are in parentheses.

Note: the Null hypotheses of residuals tests are that the residuals don't display any Serial correlation, and are homoscedastic.

Looking at the other characteristics of our sample countries, our results revealed that government expenditures, as well as natural resources endowments of the past period have a positive and significant effect on economic growth. Indeed, most of our sample countries are endowed with huge reserves of raw material that they export. These natural resources generate the foreign currencies used in financing imports. On the other hand, they may act as incentives for FDI and indirectly boost economic growth. The positive relationship between natural resources endowment and FDI has been underlined in Africa by Anyanwu (2011).

Finally, our results revealed that human capital has a negative and significant impact on economic growth in landlocked SSA countries. This finding is against De Gregorio (1998) view's that FDI has a greater effect on growth when the level of education is high in the host country. It may be explained by the fact that in most of our host countries, FDI is allocated to extractive industries. In these industries, most of the managers positions are occupied by foreigners while local people are used as "blue collars" and do not really develop and express their skills in tasks that create value added.

Conclusion and Policy Implications

In as much as the sample countries are highly in need of the FDI which makes its effects inseparable from their economic growth, it is envisaged that certain contingent factors play pivotal role to facilitate their attraction. As mentioned by UNIDA (2008), a particular attention should be paid to improve the investment climate and the legal framework of those countries because it is crucial for sound investment. Moreover, these countries should encourage domestic investment and implement strategies to transform their natural resources in order to gain more value added. The transformation of those natural resources will generate employment for their population and may modify the contribution of human capital to economic growth. Our sample countries should also implement imports substitution strategies in order to reduce their trade balance deficit and modify its contribution to economic growth. They can also create Custom unions with their neighbouring countries or joint such organizations if they already exist. This decision will reduce the cost of their imports and exports, especially if the neighbouring countries have access to the sea. Custom unions will also allow these landlocked countries to generate more benefits from international trade.

Over the years, researchers have highlighted that the flow of FDI into SSA is exclusive resource driven and this have not impacted on the overall economies (Dupasquier and Osakwe; Asiedu, 2002, 2006). Therefore it has become imperative for policy makers in Africa to formulate the right policies that can attract the right FDI that can stimulate economic diversification and growth. Our study was motivated by the lack of attention to the landlocked Sub-Saharan Africa countries. Our study identified and investigated some variables that should be given policy attention.

Furthermore, the study concluded that FDI have a positive impact on economic growth and development in the landlocked countries of Africa. However, trade openness and human capital has a negative relationship on FDI growth, which implies that the result of this study have implications.

First, human capital development is pivotal to the economic development of any nation. Thus for a nation to succeed, the capabilities and competences of her citizens must be developed through sound education and skills acquisition. In addition, it is important for policy makers in the landlocked countries of Africa to formulate policies that can developed an educated workforce with a view of positioning them to absorb the technology spill over and technical know how that

comes with FDI. The above statement is in consistent with (Cohen and Levinthal, 1990; Marcin, 2007) assertion which highlighted that Africa can fully exploit the impact of FDI if they have a trained workforce and other basic capacities that can drive and sustain FDI growth in their economies.

Secondly, openness to trade has a significantly negative impact on FDI growth in the landlocked countries of SSA. Our results indicated that 10% openness to trade with other parts of the world would lead to a 37.82% decline in GDP. This huge decline will have an adverse effect on the economy. Tandon (2002) contended that an average investor is in business for the returns on investment and not for the development of the host economy. Giving the fact that SSA is one of the least developed regions in the world; it is important for policy makers to develop strategic policies that will focus on creating an investment atmosphere for foreign investment to thrive and in turn boost the absorption of local actors. And these can be achieved when joint venture is stimulated between domestic firms and foreign investors as well as building capacity to absorb spill over. Finally, policy makers should develop a robust framework to facilitate the upgrade of domestic firms.

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