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8 January 2009

Online at <https://mpra.ub.uni-muenchen.de/65852/>  
MPRA Paper No. 65852, posted 30 Jul 2015 05:33 UTC

**FDI and economic growth:  
New evidence on the role of financial markets**

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**Abstract**

This study uses a threshold regression model and finds new evidence that the positive impact of FDI on growth “kicks in” only after financial market development exceeds a threshold level. Until then, the benefit of FDI is non-existent.

*JEL Classifications*                      F23; F36; F43; O16

*Keywords:*                                      FDI, economic growth, financial markets, threshold effects

*Words*    1928

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# **FDI and economic growth: New evidence on the role of financial markets**

## **I. INTRODUCTION**

There is a widespread view that the impact of foreign direct investment (FDI) on economic growth is ambiguous (Gorg and Greenaway, 2004).<sup>1</sup> One possible explanation for this mixed finding may be the failure to model contingency effects in the relationship between FDI and growth. A number of economic models suggest that the relationship between FDI and growth may be contingent on other intervening factors. For instance, the model by Hermes and Lensink (2003) predicts that the impact of FDI on economic growth is contingent on the development of financial markets of the host country. According to the authors, well-functioning financial markets reduce the risks inherent in the investment made by local firms that seek to imitate new technologies and thereby improve the absorptive capacity of a country with respect to FDI inflows.<sup>2</sup>

Unfortunately, the role of financial markets in the FDI-growth relation has been hardly investigated. An exception is the study by Alfaro et al. (2004), who, using a linear interaction model, find that the development of local financial markets is an important pre-condition for a positive impact of FDI on growth. A limitation with this modeling strategy is that the interaction term (constructed as a product of FDI and financial markets indicator) imposes à priori restriction that the impact of FDI on growth monotonically increasing (or decreasing) with financial development. However, it may be the case that a certain level of financial

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<sup>1</sup> Gorg and Greenaway (2004) review a number of firm-level studies on FDI spillovers. They reported only six out of 25 studies find some positive evidence of FDI spillovers.

<sup>2</sup> Absorptive capacity can be defined as the firm's ability to value, assimilate and apply new knowledge (Cohen and Levinthal 1989).

development is required before host countries can benefit from FDI-generated externalities.<sup>3</sup> This suggests the need for a more flexible specification that can accommodate different kind of FDI-growth-financial markets interactions.

In this paper, we use a different approach to examine the role local financial markets play in mediating FDI effects on output growth. We use a regression model based on the concept of threshold effects. Our fitted model allows the relationship between growth and FDI to be piecewise linear with the financial market indicator acting as a regime-switching trigger. Using cross country observations from 91 countries over the 1975-2005 period, we find strong evidence of threshold effects in FDI-growth link. Specifically, we find that the impact of FDI on growth ‘kicks in’ only after financial development exceeds a certain threshold level. Until then, the benefits of FDI are non-existent.

## II. MODEL SPECIFICATION

We argue that a model particularly well suited to capture the presence of contingency effects and to offer a rich way of modelling the influence of financial markets on the dynamics of FDI and growth is the following threshold specification:

$$GROWTH_i = \alpha X_i + \begin{cases} \beta_1 FDI_i + e_i, & FIN \leq \gamma \\ \beta_2 FDI_i + e_i, & FIN > \gamma \end{cases} \quad (1)$$

where *GROWTH* is the average growth rates of real GDP over the 1975-2005 period, FDI is foreign direct investment, and *X* is a vector of variables hypothesized to affect output growth, which includes initial income (log value of per

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<sup>3</sup> [World Bank \(2001\)](#) emphasizes that only countries with greatest absorptive capacity are likely to benefit from the presence of foreign capital. In countries with low absorptive capacity, the benefits of FDI are muted or non-existent.

capita income at the beginning of the sample period), population growth rates, investment-GDP ratio, human capital (defined as average years of secondary schooling), and government expenditure-GDP ratio. In this model, financial market indicators (*FIN*) act as sample-splitting (or threshold) variables and will be explained in the following section. The above specification allows the effects of FDI on growth to take two different values depending on whether the level of financial development is smaller or larger than the threshold level  $\gamma$ . The impact of FDI on growth will be  $\beta_1$  ( $\beta_2$ ) for countries in low (high) regime.

There are two issues that need to be addressed here. The first is to determine the estimate of  $\gamma$  and the slope parameters  $\alpha$  and  $\beta$ 's. We determine  $\hat{\gamma}$  by experimenting Equation (1) with all possible values of  $\gamma$ , and  $\hat{\gamma}$  is the minimiser of the residual sum of squares computed across all possible values of  $\gamma$  (see [Hansen, 2000](#)). Once  $\hat{\gamma}$  is identified, estimates of the slope parameters follows trivially as  $\hat{\alpha}(\hat{\gamma})$  and  $\hat{\beta}(\hat{\gamma})$ . The second issue is to test the significance of threshold parameter  $\gamma$ . Since  $\gamma$  is not identified under the null, inferences are conducted via a model-based bootstrap whose validity and properties have been established in [Hansen \(1996\)](#).

To sum up, our goal here is to first test for the presence of threshold effect and if it is supported by the data to estimate Equation (1) so as to assess the statistical significance of  $\beta_1$  and  $\beta_2$ .

### III. DATA AND EMPIRICAL RESULTS

The data set consists of cross-country observations for 91 countries over the 1975–2005 period. FDI data was extracted from the World Development Indicators (WDI) and expressed as FDI inflows over GDP. Average years of secondary schooling were taken from Barro and Lee dataset. Real GDP and other explanatory variables were extracted from WDI. In this paper, we focus only on the banking sector because (i) bank credits are the only feasible sources of financing for the majority of developing countries in our sample<sup>4</sup>, and (ii) the number of available observations for equity market indicators is insufficient to conduct sample-splitting regression.<sup>5</sup> Following [Alfaro et al. \(2004\)](#), we utilize four measures of banking sector development. The first is private sector credit (henceforth, PRC), which equals the value of credit issued by financial intermediaries to the private sector divided by GDP. This is the most preferred measure as it reflects more precisely the efficiency of the banking sector in credit provision ([Levine et al., 2000](#)). The second is bank credit (henceforth, BCR) defined as the credit by deposit money banks to the private sector as a share of GDP. The third is commercial bank assets (henceforth, CBA), defined as the ratio of commercial bank assets to commercial bank plus central bank assets. The final measure is the liquid liabilities of the financial system (henceforth, LLY). It measures the overall size of the financial system but may not accurately reflect the efficiency of the banking sector ([Demetriades and Hussein, 1996](#)). However, it is included for comparison purposes. The data were taken from the *Financial Structure Database* of the World Bank.

Table 1 presents the results of estimating Equation (1) using private sector credit as a threshold variable. The statistical significance of the threshold estimate

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<sup>4</sup> For developing countries, several studies find that banks are a more important source of financing than equity markets (refer to [Levine, 2005](#) and references therein).

<sup>5</sup> The restricted availability of equity markets indicators limit the sample to about 50 countries.

is evaluated by  $p$ -value calculated using bootstrap method with 10,000 replications and 10% trimming percentage. As shown in the table, the threshold estimate is 0.497 and the test of no threshold effect yields a  $p$ -value of 0.034. Thus, the sample can be split into two groups. Countries with private sector credits (over GDP) of more than 49.7 percent are classified into high-FIN group (i.e. more developed financial market) while the ones with smaller values are classified into low-FIN group (i.e. less developed financial markets). Additionally, the coefficient on FDI is positive and significant for the high-FIN group ( $\beta_2=0.0029$ ; s.e. =0.0013) but not for the low-FIN group ( $\beta_1=0.0001$ ; s.e. =0.0012). This suggests that the effects of FDI on growth are non-linear in nature and only 'kick in' after financial development exceeds a threshold level. [Insert Table 1]

Table 2 reports the results for models utilizing other bank indicators. The upshot of this analysis is that the threshold effects remain intact in models utilizing bank credits and bank assets. However, the same effect cannot be established in the model utilizing liquid liabilities. This is not a surprise because liquid liabilities are not accurate measure of banking sector efficiency. [Insert Table 2]

Several robustness checks are carried out for the main regression, i.e. private credit equation. Firstly, we assess the effect of outliers on the estimation results. Following a strategy advocated by [Belsley et al. \(1980\)](#), the so-called DFITS statistic is used to flag countries with high combinations of residuals and leverage statistics. The test results suggest Botswana, Guyana, and Lesotho as potential outliers. Interestingly, excluding these countries did not alter the results as the null of no threshold can be rejected at the usual level of significance ( $p$ -value = 0.011). Secondly, we check whether the high-FIN group can be split further into

sub-groups.<sup>6</sup> The split produced an insignificant  $p$ -value of 0.712 which suggests that a two-regime specification is adequate. Finally, we replicate the sample used by [Alfaro et al. \(2004\)](#) and find that the threshold effect remains valid (not reported).<sup>7</sup> Therefore, previous interpretation is unchanged.

#### **IV. CONCLUSIONS**

We present new evidence on the role financial market developments play in mediating the impact of FDI on growth, using data from 91 countries over the period 1975-2005. One major contribution of the paper is the adoption of the regression model based on the concept of threshold effects to capture rich dynamic in the relationship between FDI, output growth, and financial markets. We find that the positive effect of FDI on growth 'kick in' only after financial markets development exceeds a threshold level. This finding underlines the importance for government to emphasize on diffusion aspect in formulating FDI policies as knowledge diffusion is not sustained on welfare ground. Therefore, policies directed towards attracting FDI should go hand in hand with, not precede, policies that aims at promoting financial market developments.

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<sup>6</sup> We do not split the low-FIN group because of a small sample size.

<sup>7</sup> [Alfaro et al. \(2004\)](#) use a sample of 71 countries over the 1975-1995 period. For brevity, results are not reported but are available from the authors upon request.



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Table 1: Threshold regression using private sector credit as a threshold variable

	Coefficient	s.e.	t-test
Initial income	-0.0040	0.0017	-2.3550
Population Growth	-0.5472	0.2323	-2.3559
Investment /GDP	0.0015	0.0003	4.4672
Schooling	0.0051	0.0018	2.8186
Government spending/GDP	-0.0004	0.0003	-1.2297
FDI/GDP			
low-FIN ( $PRC \leq \gamma$ )	0.0001	0.0012	0.0856
High-FIN ( $PRC > \gamma$ )	0.0029	0.0013	2.2520
Threshold estimate	0.497		
LM-test for no threshold	30.707		
Bootstrap $p$ -value	0.034		

Notes: The dependent variable is average real GDP growth (1975–2005). Initial income is the log of per capita income at the beginning of 1975.  $p$ -value was bootstrapped with 10,000 replications and 10% trimming percentage. There are 31 and 60 countries in the high-FIN and low-FIN, respectively.

Table 2: Threshold regression using other indicators

	(i) BCR	(ii) CBA	(iii) LLY
Initial Income	-0.0043 (-2.52)	-0.0059 (-3.83)	-0.0045 (-2.57)
Population growth	-0.6116 (-2.78)	-0.6562 (-3.24)	-0.5366 (-2.16)
Investment/GDP	0.0014 (3.97)	0.0011 (3.92)	0.0014 (3.72)
Schooling	0.0031 (1.83)	0.0031 (1.66)	0.0047 (2.61)
Government spending/GDP	-0.0004 (-1.34)	-0.0004 (-1.60)	-0.0004 (-1.15)
FDI/GDP			
low-FIN ( $FIN \leq \gamma$ )	-0.0004 (-0.36)	-0.0005 (-0.50)	0.0001 (0.09)
high-FIN ( $FIN > \gamma$ )	0.0029 (2.41)	0.0021 (2.15)	0.0013 (0.61)
Threshold estimate	0.431	0.891	0.688
LM-test for no threshold	29.064	63.871	15.401
Bootstrap $p$ -values	0.048	0.000	0.631
Countries in low-FIN regime	59	58	76
Countries in high-FIN regime	32	33	15

Notes: BCR is credits allocated by commercial banks, CBA is commercial bank assets and LLY is liquid liabilities. Figures in parentheses are t-statistic.  $p$ -values were bootstrapped with 10,000 replications and 10% trimming percentage.