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Does Foreign Direct Investment Promotes Economic Growth in India? Evidence from Simple Regression Model

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Abstract

Foreign Direct investment (FDI) and its impact on economic growth has been the interesting subject in recent financial literature because it is an important implication for policy makers and academicians. FDI is vital source of capital formation and it brings new technology, modern business practices, new ideas and generation of employment in emerging market economies namely India. This paper empirically explores the impact of FDI on the economic growth in India. It also examined the short and long run association of economic growth and FDI. Finally, trends in FDI inflows into India analyzed. Time series techniques namely the Augmented Dickey–Fuller test, Granger causality test, Engle-Granger co-integration test and simple regression model were applied. The annul data of sectors wise FDI, country wise FDI, yearly wise GDP and FDI from 2009 to 2020 sourced from RBI website for analysis and discussions. According to Reserve Bank of India report, there has been a significant increase in FDI inflows into India from 2010 onwards. The total FDI inflows into India was $42 billion in 2010-11 and had consistently gone up from $ 46 billion in 2012-13 to $ 81 billion in 2020-21. In case of sector wise

FDI, manufacturing sector in India received the of maximum amount of FDI equity inflows when it was compared to other sectors. The FDI inflow in manufacturing sector had increased to $ 9.61 billion in 2018-19 from $ 7. 91 billion in 2014-15.The result from regression suggests that FDI has positively impacts the economic growth in India. The results of Granger causality results show a feedback relationship exists between FDI and economic growth. The result from the residual-based co-integration test reveals that existence of a co-integrating relationship between these two variables and tend to move together the same direction in long run. Although the several studies on same issue has been examined in emerging market economies namely India, the present study was mainly focused to this issue fairly large set of data and it covers during Covid 19 outbreak pandemic to bride research gap in literature and also suggests the suitable policies implications and recommendations.

Key words: FDI, Economic Growth, Co-integration, Granger Causality test and Regression.

1. Introduction

Foreign Direct Investment is an investment made by a foreign company in India for the business operations in the form of joint venture, establishment of a subsidiary and merger and acquisitions. India is one of the emerging economies most attractive destinations of foreign direct investment in the world due to lower labour cost, subsidies, large market size, liberalization of policy, market diversification and tax incentives. FDI plays a vital role in accelerating economic growth and development in India through introduction of foreign technology, enhancement of industrial output and creation of employment opportunities. The foreign companies mainly were used to invest in emerging industries in India namely energy, infrastructure, software, banking, and insurance that were the critical drivers of India's economic growth as it helps enhancement of employment, tax collections, wages and foreign exchange reserves. Availability of foreign exchange reserves helps central bank to intervene in the currency market and control any adverse movement in order to reduce fluctuations in foreign exchange rates. Further, country like India has been lacking in saving and investment which leads to lower GDP growth rate and employment. FDI not only bridge the gap of domestic saving constrains and also provides the alternative sources of domestic capital, promotes efficiency and productivity. As a result, it offers a more advantageous economic environment for the growth and development of Indian economy. Therefore it was imperative to study FDI and its effects on economic growth in India.

After the introduction of LPG Policy in 1991, the government of India had permitted 100 percent FDI in many industries. In recent times, India's FDI inflow has been increasing trend over a period of time. India's FDI inflows had increased to $ 81 billion in 2020-21 from $ 74 billion in 2019-20 and it was 10.5 % higher as compared previous financial year, despite global FDI decline to $ 845 billion during Covid 19 pandemic outbreak. India emerged as the third largest recipients of foreign direct investment in the world according to United Nations Conference on Trade and Development (UNCTD). In 2015, India had received highest FDI inflows of $ 31 billion when it was compared with China and US which received only $28 billion and $27 billion respectively. This was

because of inclusive efforts and initiatives of Government of India undertaken to boost the higher FDI inflows namely relaxation FDI norms across industries. In 2021, Government of India had permitted to hike FDI limit in insurance sector from 49 % to 74% and also permitted 100 % FDI in various sectors namely telecommunication, petroleum and natural gas, retail and automobile. After government initiatives, Amazon India invested more than $ 1 billion in Indian small and medium enterprises in 2021 for generating one million jobs. For the same year, French oil and gas giant acquired 34 percent stake in Adani Gas Ltd for worth of $ 810 million making it the highest foreign capital inflows in India's gas distribution sector.

Many studies have explored the impact of FDI on economic growth in developed and developing economies namely India. However, these studies have found with inconclusive results. Few empirical results revealed that FDI had a negative impact on economic growth in both advanced and developing economies due to exploitation of human and natural resources by multinational companies, discouragement of domestic investment, large imports of inputs which greatly affects balance of payments and outflows of profit. However, other studies argued that the result of increase in FDI leads to an improvement in output productivity which promotes industrial output and even economic growth in host countries. They supports that FDI influences host country's GDP growth rate in many channels. . Therefore, this research paper contributes to the existing literature by reexamining the effects of FDI on economic growth of host country namely India. Further to best of our knowledge, there are no studies on short run and long run interaction between FDI and economic growth in case of India. This paper also intend to test the short run and long run relationship between FDI and economic growth by applying the Granger causality and Engle-Granger (1987) co-integration tests.

FDI is consider to be important source of capital formation and external finance, transfer of innovative ideas and technology in host country like Nigeria. This spillover effect allows the improvement in productivity, industrial output and even economic growth in host countries Applying the simple regression model, their result advocates that FDI had a positive impact of Nigeria's economic growth (Oyegoke & Aras (2021). Keerti Kulkarni et al (2021) analyzed the FDI and its impact on economic growth in India by employing the ARDL co-integration test. They find that presence of co-integration relationship among FDI and GDP series. Their results show that an increase in FDI promotes economics growth in India.

Minti Sinha (2021) examined the trends in FDI and its effect on India's GDP growth rate by using annual data from 2014 -2018. The study reveals that growth in FDI inflows contributes India's GDP growth rate. The study finally concluded the FDI inflows has been upward trend after commencement of Make in India. Saswata Chaudhary et al (2020) revealed that FDI inflows had a positive effect on manufacturing sector and economic growth in south Asian countries through generation of employment, transfer of technology and international management practices. This spillover effect leads to enhancement in efficiency and productivity in domestic firms which promotes the industrial output and economic growth. Their study also identified effects of the factors other than FDI on economic growth in south Asian countries by applying panel data from 1990-2014. Their study

confirms that factors like domestic investment and Human Development Index also greatly influences the economic growth of these countries.

Vlatka Bilas (2020) explored the dynamic short and long run interaction between FDI and economic growth in Croatia by using annual data of over the period- 2000-2019. Time series techniques namely Granger causality test, Engle granger co-integration test and Johanshan co-integration test were applied for analysis and discussions. The results suggest that there was no co-integration relationship between quarterly FDI and GDP series. Finally result reveals that FDI had no impact on economic growth in Croatia. Sharil Sharma et al (2020) revealed that there was no significant relationship between FDI and economic growth in India. By applying simple regression model, they find the FDI had no influences the economic growth in India.

However, Benjamin Odei Appiah,(2020) found that an increase in FDI inflows leads to boost the India's GDP growth rate. The study concluded that FDI one important factors that drive the economic growth in India. Tamar Baiashvili and Luca Gattini (2020) applied Panel GMM model to study FDI and its impact on economic growth and their effects mediated by income level in 111 countries. The result shows U shape relationship between size of FDI effect on economic growth and income level. The result also suggests the effect of FDI on economic growth was larger in case of middle income countries. Sasidharan Subash (2020) studied the whether the foreign companies technology spillover to domestic firms exits or not by employing panel data techniques. The study found that technology spillover from foreign companies to domestic companies offers the inconclusive results.

Trang Thi et al (2019) employed the various panel data techniques namely panel unit root tests, fully Modified OLS and Johansen co-integration to test the FDI and its effect on economic growth in both short and long run in developed and developing economies. Using panel data from 2004- 2014, result shows that FDI influences the economic growth only in long run in most of countries, but it had a negative impact on economic growth in short run. Their results finally advocate that there was co-integrating relationship exists among economic growth and FDI and trend to move together the same direction in long run. Ali et al (2018) explored foreign direct investment and its effects on economic growth of Pakistan by employing Ordinary Least Square Method (OLS). The annual data has been collected from 1966 to 2014 for the purpose of analysis. The result shows that the FDI had a positive an impact on economic growth in Pakistan.

Melnyk et al (2014) revealed that the FDI had negatively impacts the economic growth of communism transition European economies namely Hungary, Poland etc. Further, empirical study results shows that FDI does not impacts economic growth in few central European counties. FDI inflows is supplementary to domestic capital that encourages new innovation and technology, new ideas and development of skills which leads to establish new business firms. All these contribute to the growth and development of a country like India (Malhotra (2014).

Driffield, N., & Chris (2013) examined the impact of FDI on economic growth in selected developing countries. The result discovers that FDI had a positive an impact of economic growth in selected developing countries namely India and China. The results also suggest that a positive relationship exists between FDI and economic growth in developed as well as in developing countries. Applying co-integration, error correction and simple regression models, they find that FDI had positively influences the economic growth in Jordan. They had collected annual data from 1999 to 2020 and used for analysis and discussions. Their results suggest that the existence of short and long run association among FDI and economic growth. Obiamaka and Onwumere (2011) analyzed the Foreign Direct Investment (FDI) and its effect on Nigeria's economic growth by using annual data from 1999 to 2006. The results suggest that FDI growth the major determinates of economic growth in Nigeria. The result also shows that both FDI and economic growth were co-integrated and tend to move together in long run.

Sasidharan Subash (2006) used the statistical techniques such as Karl Pearson's correlation and percentage analysis to examine Foreign Direct Investment (FDI) and its effect on industrial growth in India. The study has been collected annual data from 2013 to 2019 for purpose of analysis. The study also reveals that FDI positively impacts industrial growth in India. Johnson, Andreas, (2006) explored the effect of FDI inflows on host country economic growth in 90 countries by using cross sectional panel data from 1980 to 2002. The results show that FDI increases the economic growth in developing countries but not in developed countries. Pradeep Agrawal (2005) argued that the FDI had a negligible influence on economic growth in south Asian countries. Applying panel data from 1965 to 1996, study found that that FDI had no impact on economic growth in Bhutan and Nepal.

The above empirical studies relating to FDI and its effects on economic growth in developing and developed countries does not offer clear cut findings and conclusions. Therefore, the study re-examines the how does FDI impacts economic growth in India, in addition with the study intend to investigates the short and long run association between FDI and country's economic growth by using the Granger causality and Engle-Granger (1987) co-integration tests.

2. Objectives of the Study

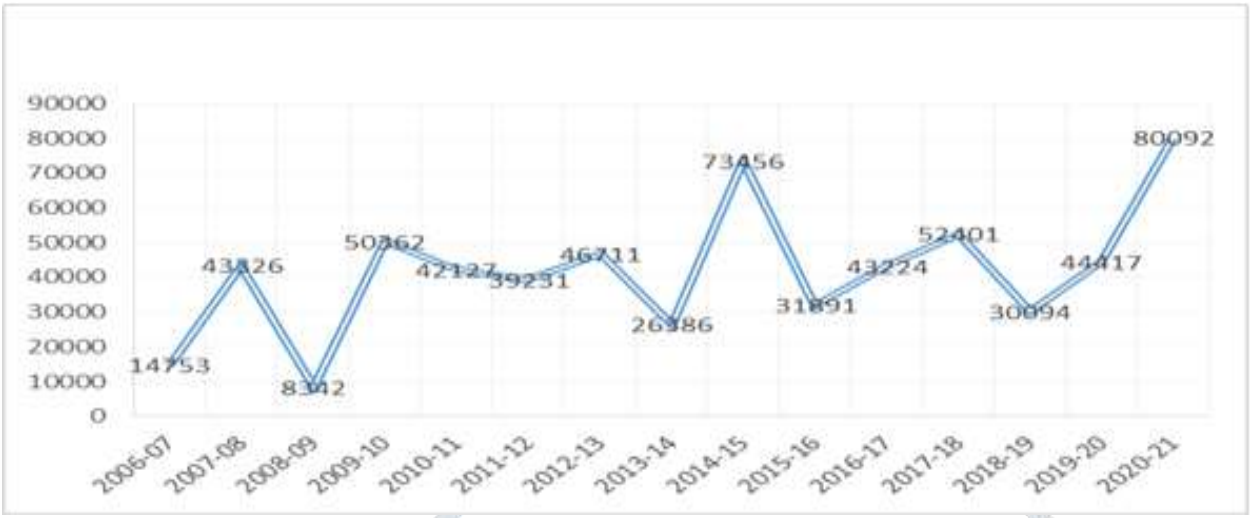
Considering conceptual review, following objectives were framed for the study.

1. To analyze the trends in FDI inflows in India.
2. To examine the impact of FDI on economic growth in India.
3. To investigate the short and long relationships between FDI and economic growth.

3. Data Sources and Methodology

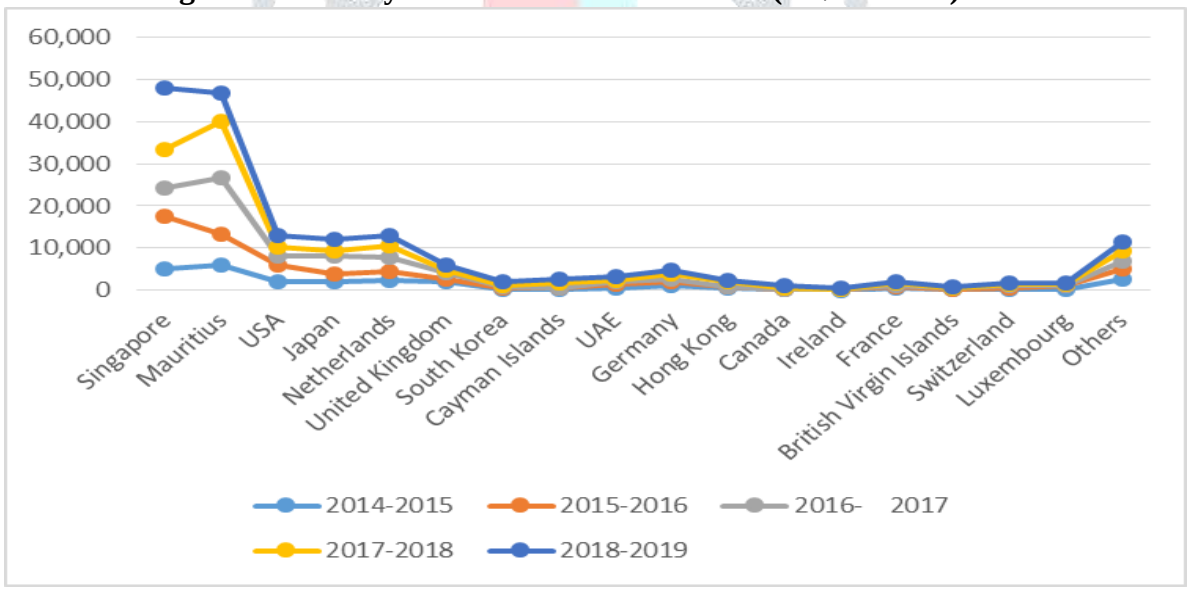
To investigate the impact of FDI on economic growth in India, present study sourced annual data of county wise FDI inflows, yearly wise total FDI inflows, sector wise FDI inflows and GDP from RBI website for a period of 11 years from 2009 to 2020 and used in analysis. The study was taken GDP proxy for economic growth. All variables were transformed into natural logarithms to avoid spurious regression results. Diagram 1, 2 and 3 present's yearly wise total FDI, county wise FDI and sector wise FDI respectively.

Figure 1: Total FDI inflows in India



The figure shows 1 the total inflows of FDI in India had witnessed fluctuations during period of study. However, overall total FDI inflows into India shown upward trend the over a period of time. The yearly wise total FDI inflows was $ 42127 million in 2010-11 and had gone up to $ 46711 million in 2012-13, which was declined to $ 30094 in 2018-19 and again it had increased to $ 80092 million in 2020-21.

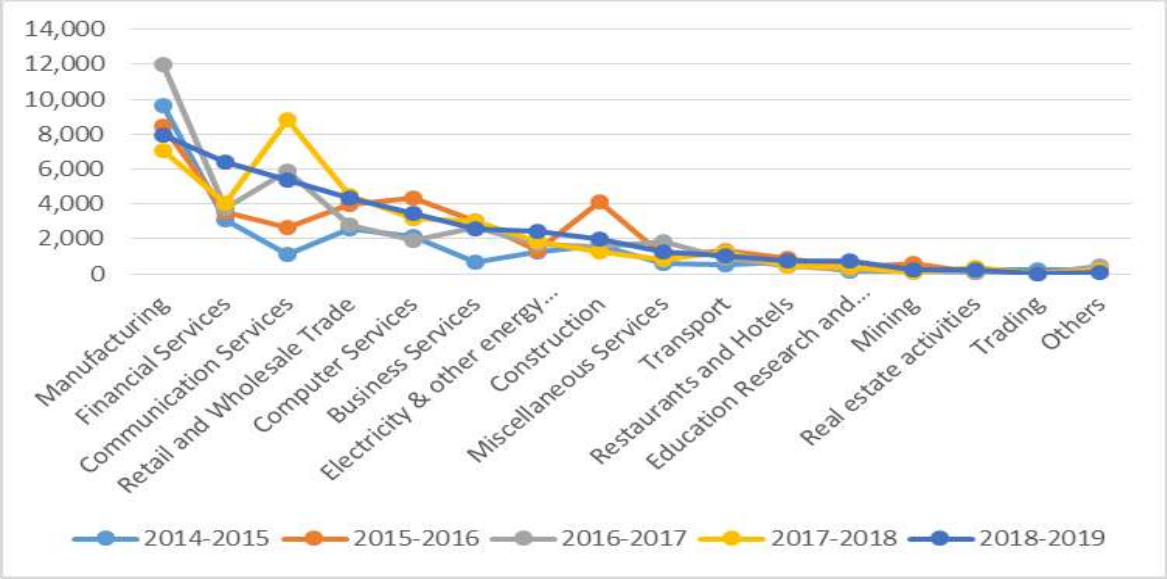
Figure 2: Country Wise FDI Inflows to India (in $ millions)



The figure 2 show that the county wise FDI inflows April 2008 to June 2019. Initial period of economic labialization, there were only 15 countries contributed FDI inflow to India namely USA, Japan, UK, Netherlands etc., the number of investing countries had increased to 120 after during post globalization era. It shows Singapore was first among top five investing countries investing in India. The share of FDI inflow from Singapore had increased from $ 12,479 million in 2015-16 to $ 14,632 million in 2018-19. Mauritius was occupied the second position and received highest amount of FDI from that country. The third position was occupied by USA and share

of FDI inflow from USA also gone up from $ 1,981 million in 2014-15 to $ 2,823 million in 2018-18 followed by Japan, Netherlands, etc.

Figure– 3: Sector Wise FDI Inflows to India (in $ millions)



The figure 3 shows that the sectors wise FDI inflows April 2008 to June 2019. In India, there were more than 60 sectors that attract FDI inflows particularly during post liberalization era. It was observed that manufacturing sector in India attracts the highest amount of FDI equity inflows among top ten sectors. The share of FDI inflow in manufacturing sector jumped to $ 9,613millon in 2018-19 from $ 7,919 million in 2014-15. The unambiguous evidence from the figure suggests that the manufacturing sector dominates FDI inflow followed by financial services sector. The service sector was occupied second position and largest recipient FDI inflow as compared to other sectors. The FDI inflow in the service sector had gone up significantly from $ 3,075 million in 2014-15 to $ 6,372 million 2018-19. The top ten sectors in India that attracts highest FDI inflows namely manufacturing, service sector, communication services, retail and wholesale trade, and the computer Services.

To verify whether the series of FDI and GDP are stationary or not and also find out the order of integration, we employ unit root test namely augmented Dickey fuller test. The equation of Augmented Dickey–Fuller is specified as follows.

$$\Delta x_t = \delta_0 + \theta_1 x_{t-1} + \sum_{i=1}^{p} \gamma_i \Delta x_{t-i} + \varepsilon_t$$

Where p is lag, Δx first difference series, θ,δ and γ are parameters to be estimated.

We also apply Granger causality test to explore the short run association between FDI and economic growth. The equation of Granger Causality test is specified as follows.

$$EG_t = \alpha_1 + \sum_{i=1}^{n} \lambda_{i_1} FDI_{t-i} + \sum_{j=1}^{m} \phi_{j_1} EG_{t-j} + \varepsilon_{1t}$$

$$FDI_t = \alpha_2 + \sum_{i=1}^{n} \lambda_{i2} FDI_{t-i} + \sum_{j=1}^{m} \phi_{j2} EG_{t-j} + \varepsilon_{2t}$$

Where EG and FDI are economic growth and foreign direct investment, respectively. α, ϕ and λ are parameters to be estimated. The Granger Causality test attempts to find out whether FDI Granger cause economic growth or economic growth Granger cause FDI or a feedback causality relationship between FDI and economic growth or not.

Engle-Granger (1987) co-integration test has been applied to examine whether these two series have long run relationship exits or not. In Engle-Granger co-integration (1987), there were two-step procedures involved. In step one, estimate regression model and obtained residuals from it and in second step, to check whether residuals are stationary or not. The residuals are found to be stationary implies that a long run relationship exists among FDI and economic growth in India. If residuals are non-stationary indicates that there were no co-integrating relationship among them. Finally, we employed the Ordinary Least Square Method (OLS) to analyze the impact of FDI on economic growth in India.

4. Results and Discussion

Before discussing about the estimation of simple regression model and Engle granger two step-co integration tests, we employed the unit root test such as Augmented Dickey Fuller (ADF) test to verify whether series are stationary or not.. Results of ADF were given table 1. The results suggest that log series of GDP and FDI were found to be non-stationary in level form. However, these series became stationary at first difference and integrated order one since null hypothesis has been rejected at 1 % level of significance. Since all series found to be integrated order one and possibility of long run relationship among them examined by Engle granger two step-co integration tests.

Table 1: Results of Unit Root Test

Variable	ADF in level	ADF in Fist difference
FDI	-0.452 (0.589)	-22.983* (0.000)
GDP	-0.779 (0.725)	45.976* (0.000)

*Indicates 1 percent level of significance

The study also intends to test the short-run and long run association between FDI and economic growth by applying Granger causality test and Engle granger two step-co integration test. The tables 2 and 3 present results of Granger causality and co integration tests. The results of Granger causality test show that a feedback or bidirectional relationship exists between economic growth and FDI since the null hypothesis has been rejected. The result confirms that short run relationship exists between economic growth and FDI. The results from co-integration test reveals that residuals from co-integration regression were stationary implying that the existence of co-integrating relationship between FDI and economic growth. This result suggests that two variables tend to move together the same direction in long run. This empirical finding is in line with Kulkarni et al (2021) for India, Trang Thi et al (2020) for developing countries, Louzi, and Abadi, (2011) for Jordon. Their empirical finding also

confirms these two variables have both short and long run relationships. However, Vlatka Bilas (2020) found that there was not co-integrating relationship exists among economic growth and FDI.

Table 2: Results of Granger Causality Test

Hypothesis	F-Stat	P value	Inference
FDI does not granger cause Economic growth	12.774*	0.000	FDI→EG
Economic growth does not granger FDI	18.630*	0.000	EG→ FDI

*Indicates 1% percent level of significance.

Table 3: Results of Co-integration Regression and Residuals based Engle Granger Test

Co-integration regression between Economic growth and FDI $GDP_t= \alpha_0+\beta_1 FDI_t+\mu_t$			
Variables	Co-efficient	t-Statistics	P. value
Constant	0.4743	2.8943*	0.0134
FDI	0.5892	4.8960*	0.0000
$R^2 = 0.9356$	DW Statistics = 0.853		
Residuals based Co-integration test $\Delta\hat{u} = \alpha\hat{u}_{t-1}+\nu_t$			
Variables	ADF Statistics	p. value	
$\Delta\hat{u}$	-28.4520*	0.000	

*Indicates 1% percent level of significance

The Ordinary Least Squared (OLS) method has been applied to examine the impact of FDI on economic growth in India. The table 4 shows that co-efficient of FDI was positive and significant. It indicates that the existence of positive relationship between FDI and economic growth in India. The results also show that one percent increase in FDI leads to 0.57 percent increase in economic growth. The result finally suggests that FDI had positively significant impacts the economic growth in India. The overall result shows that FDI stimulates economic growth and development in India. The high R value indicates 92 % variations in economic growth explain by FDI. This results corroborates with those of Keerti Kulkarni et al (2021) for India, Oyegoke et al (2021) for Nigeria and Driffield et al (2013) for developing countries. These studies also confirms the FDI not only simulates country's economic growth and had a positive an impact on it. The above studies have not incorporated the short and long run interaction between FDI and economic growth for their analysis and they mainly devoted to FDI and its effect on economic growth. However, our research study also focused to examine the short run and long run relationship between FDI and economic growth by applying the Granger causality and Engle-Granger (1987) co-integration tests. Our research study was mainly devoted to this issue fairly large set of data and it covers during Covid 19 outbreak pandemic to bride research gap in literature. The study also intends to test the following hypotheses.

H_{o1}: There is no significant relationship between FDI and Economic growth in India.

Based on regression results, the null hypothesis was rejected and accepted alternative hypothesis. It indicates that the significant relationship exists between FDI and economic growth in India.

Table 4: Results of Simple Regression Model

Variables	Co-efficient	t-Statistics	P. value
Constant	0.4643	2.7943*	0.0121
FDI	0.57793	4.8960*	0.0000
R^2 = 0.9254	DW Statistics = 0.853		

*Indicates 1 percent level of significance

5. Conclusion

The impact of FDI of economic growth has been interesting subject in recent financial literature because it is an important implications for policy makers and academicians. The FDI plays a crucial role in promotion of economic growth and development in emerging market economies namely India through transfer of innovative technology, innovative ideas, and generation of employment. The main objective of study was to examine the impact of FDI on economic growth in India by using simple regression model. Granger causality and Engle-Granger co-integration tests have been also employed to explore the short run and long run interaction between FDI and economic growth. Finally, the trends in FDI inflows to India analyzed. The annul data was sourced from RBI website and obtained sectors wise FDI, country wise FDI, yearly GDP from 2009 to 2020 and used for analysis and discussions. According to Reserve Bank of India report, there has been a significant increase in FDI inflows into India from 2010 onwards. The total FDI inflows to India was $42 billion in 2010-11 and had consistently gone up from $ 46 billion in 2012-13 to $ 80 billion in 2020-21. In case of sector wise FDI, manufacturing sector in India received the maximum amount of FDI equity inflows when it was compared to other sectors. The FDI inflow in manufacturing sector had increased to $ 9.61 billion in 2018-19 from $ 7. 91 billion in 2014-15. The service sector was occupied second position and FDI inflows said sector had jumped significantly from $ 3.075 billion in 2014-15 to $ 6.372 billion 2018-19. The result from regression suggests that FDI had a positive significant impact on the economic growth in India. The results of Granger causality results show that a feedback relationship exists between FDI and economic growth. It indicates that the existence of short run relationship among economic growth and FDI. The result from residual-based co-integration reveals that existence of a co-integrating relationship between these two variables and tend to move together the same direction in long run.

The overall results suggests that in such competitive environment, government of India urgent need to undertake the various measures namely relaxation of FDI norms across industries, removal of state government level

obstacles, relaxation of registration requirements, development of technology and infrastructure, improvement in education and skills to attract more FDI inflows into India in order to boost the economic growth.

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