FOREIGN DIRECT INVESTMENT QUALITY AND ITS INTERACTION EFFECTS ON ECONOMIC GROWTH IN EMERGING ECONOMIES: A DYNAMIC PANEL MODEL

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Abstract: *In many developing countries, Foreign Direct Investment (FDI) was and remain an important driver for economic growth. However, the contribution of FDI to the country's economic growth is still inconclusive. Economist argued that the impact of FDI on growth is depend on the type of FDI inflowed to the economy. Another reason for the mixture result could be the different condition of the host country which are the human capital stock, financial openness and trade openness. Hence, the interaction effect of these three conditions with FDI quality have also examined. Therefore, this study intends to examine the impact of the different type of FDI inflowed on the economic growth. This is a cross-country study using annual panel data from 55 emerging economies. The data have been anaysed using dynamic panel model. The estimation results found that the model did not show encouraging result, the insignificant and / or negative results may due to the unavailability of the data from few important emerging economies especially China as this is the largest emerging economy in terms of the GDP. The results might be better if other variables were used as the dependent variable.*
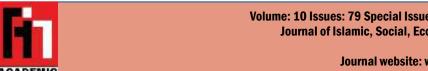
Keywords: *FDI quality, dynamic panel model, entry mode, interaction effects, emerging economies*

Introduction

The impact of Foreign Direct Investment (FDI) on economic growth have been studied extensively and the results are mixture. Most of the studies, however, focusing on the total FDI instead of FDI quality. Not many studies were focusing on FDI quality; brownfield FDI or greenfield FDI. Generally, greenfield FDI is more quality than brownfield FDI as it enters a host country via setting a new firm which will form a net capital to the host country. In contrast, brownfield FDI only involved merging and acquisition, hence no new capital were added to the economy.

Empirical study by Wang and Wong (2004) found that greenfield FDI boosts economic growth while brownfield investment only benefits the host countries when the host achieve a certain threshold of human capital. Luu (2016), however, concludes that both significantly promote economic growth. This is due to the stronger theoretical support on this dimension compared to other dimensions besides data availability. According to Assignment Theory (Nocke & Yeaple, 2004), firms enter the host country with greenfield investment are more efficient than the brownfields. The level of technology transfer from greenfield FDI is expected to be higher as compared to the brownfield FDI and it provides more impact to the employment market in the host country (Pradhan, 2006). In an empirical study, Olha (2024) found that in 21 Eastern European countries, FDI quality scale (direct investment inflow) and FDI quality efficiency (employment numbers in foreign-funded and joint venture enterprises) having significant impact in promoting economic growth

Many argued that FDI can only improve economic growth of the host country when the development of the host country achieved certain threshold level. For example, the impacts of FDI on economic growth is depend on the level of human capital factors (Borensztein et al., 1998; Balasubramanyam, Salisu & Sapsoford, 1999). A developed financial market could provide source of capital to the MNCs to expend their business activities in the host country, which would improve the technological spillover to the local firms, hence economic growth (Sghaier & Abida, 2013).

Number of previous researches have studied the impact of aggregate FDI on economic growth. However, only few were embed FDI quality in their models, and the result were mixed. Therefore, the objective of this paper is to investigates the effect of FDI quality and its interaction with human capital, financial development and trade openness on the economic growth of the emerging economies. This is due to the fact that FDI quality alone may not sufficient to improve the economic growth, but by its interaction with other variables, FDI quality maybe able to significantly improve the economic growth.

Literature Review

The effects of FDI on economic growth has been recognised by economists and the policy makers, not only from theoretical points of view but also supported by number of empirical studies. For instance, Hansen and Rand (2006) the empirically examined the links between FDI and GDP found that FDI has a lasting impact on GDP. While Nguyen, Pham, Tran, and Nguyen (2021) confirmed the positive and significant relationship of FDI on economic growth. Ali (2014) in his study for Pakistan found in long run, the impact of FDI on economic growth is negative, while in short run, the impact is positive. In a study in East Asian, Baharumshah and Thanoon (2006) found that impact of FDI on economic growth is significant in both short run

and long run. While Tan and Tang (2016) confirmed the finding in most of ASEAN-5 countries that FDI is enhancing economic growth in both short-run and long-run.
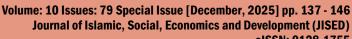
There is an argument that the impact of FDI on growth depends on the type of FDI projects and the level of economic development of the host country. The greenfield FDI that can be classified as FDI quality may provide more benefit to the economy as compared to others. Regarding this, previous studies have identified seven dimensions of FDI quality; entry mode, sectoral dimension, origin of FDI, localization level, market orientation, research and development, preference of the host country. Despotovic, Dimitrijevic and Savicevic (2024) classified FDI based on sectoral difference and studied the impact of it on the economic development (economic growth) in European Developing Countries.

In practice, an MNC can enter a host country by acquiring a local company (brownfield) or by establishing a brand-new company (greenfield). Therefore, greenfield FDI is presumed to be a high quality of FDI as compared to brownfield, because the greenfield FDI gives a net addition to the production capacity in the host country. The level of technology transfer is also higher as compared to the brownfield FDI and this give a more favourable impact to the employment market of the host country (Pradhan, 2006).

As different FDI projects will affect the economy differently, thus, to treat all FDI projects equally could provide misleading result. Pradhan (2006) argued that entry mode, localization level, market orientation, research and development, preference of the host country will distinguish the quality of the FDI and its impact on economic growth. This is supported by Neto, Brandao and Cerqueira (2008) study which found the effect of greenfield FDI on economic growth is significant and positive in developed and developing countries. Similarly, Nunnenkamp and Spatz (2004) argued FDI characteristics and the conditions of host countries are important for the effect of FDI on economic growth. Olha (2024) found that in 21 Eastern European countries, FDI quality scale (direct investment inflow) and FDI quality efficiency (employment numbers in foreign-funded and joint venture enterprises) having significant impact in promoting economic growth.

Studies also found the interaction effect between FDI and human capital in spurring economic growth of the host country. For example, Balasubramanyam et al. (1999) in their study found the significant impact of the interaction between FDI and human capital on economic growth. Similarly, Berthelemy and Demurger (2000) found human capital contributes to the economic growth in adopting the technology by the MNCs. Azam and Ahmed (2015) concluded that the human capital development is essential for economic growth.

Meanwhile, a developed financial market could provide source of capital to the MNCs to expend their business activities in the host country (Sghaier & Abida, 2013). This would generate more profit in their business and eventually boost the economic growth. Hermes and Lensink (2003) suggested that out of 67 countries, 37 have a well-developed financial system to absorb the benefit of FDI toward improvement of economic growth. Alfaro, Chanda, Kalemli-Ozcan and Sayek, (2004) argued that the development of financial markets in host countries is significant for the effect of FDI on economic growth to take place. This is supported by Choong et al. (2010) which stated that private capital flow (inclusive FDI) positively affects economic growth in countries with well-developed financial system but have a negative impact

on the economic growth in the countries with poor financial system. Study also found a positive and significant interaction effects of financial development and FDI on economic growth (Sghaier & Abida, 2013).

Besides financial development, different trade policy could also affect the growth rates differently (Kawai, 1994). FDI increases the trade volume of host country if the MNCs' strategy is focusing on export-oriented, and consequently boost the economic growth (Hisarciklilar, Kayam, Kayalica & Ozkale, 2006). In the other words, trade openness accelerates FDI and economic growth relationship. For the countries with higher trade openness, FDI inflow will affect economic growth significantly. Nair-Reichert and Weinhold (2001) proposed that there is some evidence that the FDI presence will raising future growth rates, although different across countries, the growth rate is higher in more open economies. Meanwhile, Makki and Somwaru (2004) found that the interaction effect between FDI with trade openness significantly and positively improve economic growth in developing countries.

Economist argued that the impact of FDI on growth is depend on the type of FDI inflowed to the economy as some FDI are more quality than others, therefore, consensus is lacking. Another reason for the mixture result could be the different condition of the host country which are the human capital stock, financial openness and trade openness. Hence, the interaction effect of these three conditions with FDI quality have also examined.

Research Methodology

This is an econometric dynamic panel model study that used Endogenous Growth Model (EGM) as a basis for a model specification. The model is used to examine the impact of FDI quality (QTY), and its interaction with human capital (HDI), financial development (FD) and trade openness (TO) on economic growth (GWH). In addition, two control variables also were included in the model; government expenditure (GOV) and institutional quality (IQU). The model that used in the estimation can be written as follow:

$$LNGWH_{ij} = \alpha_0 + \beta_1 LNFDI_{it-i} + \beta_2 QTY_{it-i} + \beta_3 (HDI * QTY)_{it-i}$$
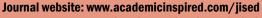
$$+\beta_4 (FD * QTY)_{it-i} + \beta_5 (TO * QTY)_{it-i} + \beta_6 LNGOV_{it-i} + \beta_7 LNIQU_{it-i}$$

$$+\beta_8 LNK_{it-i} + \beta_9 LNHDI_{it-i} + \beta_{10} LNFD_{it-i} + \beta_{11} TO_{it-i} + u_t$$

where, *i* denotes the countries, *t* denotes the time dimension, * is the interaction between the two variables, *u* is the error term and the subscript *t-i* is the dynamic effect under dynamic panel model, *LN* denotes natural logarithm. The description of the notations used are in Table 1.

In this study, panel data have used in the estimation process. This is a cross-countries study focusing on emerging economies. The emerging economies has been defined by IMF as the developing countries that opens their financial market to encourage capital flow and are easily accessible to MNCs. As of April 2024, a total of 96 countries have been categorized as emerging economies (International Monetary Fund, April 2024) (International Monetary Fund) However, due to the data availability, some economies were excluded, Taiwan also excluded due to different data gathering method thus to make the total number of economies involved in this study become 55.

The panel data of this study were generated from annual data of 55 economies from 2003 to 2017, with the total observations of 825 (i.e. 15 observations per economy) for each variable. The period of study (starting from 2003 to 2017) is determine based on the availability of the data. Another reason being this period is free from the pandemic effect. The time span is sufficient to capture the relationship between the independent variables and outcome variable due to the property of the dynamic panel model and plenty of cross-sectional unit in the data.

Table 1: Description of Variables

Notation	Variable	Description
LNGWH	Economic Growth	Natural logarithm of Percentage change of real GDP per capita
LNFDI	Foreign Direct Investment	Natural logarithm of Percentage of inward FDI to GDP
QTY	FDI Quality	Ratio of greenfield FDI to GDP
LNHDI	Human Capital	Natural logarithm of Human Development Index
LNFD	Financial Development	Natural logarithm of Ratio of private credit by deposit money banks to GDP
TO	Trade Openness	The ratio of total trade to GDP
LNGOV	Government Expenditure	Natural logarithm of Percentage of government expenditure to GDP
LNIQU	Institutional Quality	Natural logarithm of Worldwide Governance Indicators (WGI)

The data on FDI and economic growth have been collected from World Bank Development Indicator database, FDI in greenfield have been gathered from World Investment Report (various issues). Human Development Index by UNDP have been used as the proxy for human capital. The other data has collected from World Bank Indicator and International Financial Statistics.

For estimation, this study used generalized method of moments (GMM) proposed by Arellano and Bond (1991). The method is capable to overcome the endogeneity problem that causes inconsistency to the OLS estimates by using instrumental variable. In this case, the instrumental variable is a proxy variable for Y_{t-1} which is highly correlated with Y_{t-1} but is uncorrelated with u_t (Gujarati and Porter, 2009).

The instrumental variables used in the dynamic panel model will generate moment conditions. In addition, to examine either the instrumental variables are valid (they are not correlated with the errors in the first-differenced equation), the Sargan test for overidentifying restrictions have been conducted. The null hypothesis indicates the instrumental variables (IV) estimators are not biased and consistent.

Estimation Results and Findings

As the data points are too huge, logarithm transformation is considered. Nevertheless, based on the performed descriptive statistics in Table 2, there are few variables contain negative values which are economic growth (GWH), foreign direct investment (FDI) and manufacturing growth (MG). As logarithm of negative value is not defined, inverse hyperbolic sine (IHS) transformation is used to ensure that logarithm transformation is feasible (Abramova, Artemenko & Krinichansky, 2022 and Aihounton & Henningsen, 2021)

Table 2: Selected Descriptive Statistics

	GWH	FDI	MG
Mean	3.0609	5.1036	3.8432
Median	3.0141	3.2625	3.8739
Maximum	33.0305	58.5188	29.6750
Minimum	**-14.5599**	**-15.9892**	**-23.0016**

Following the procedure used by Abramova et al (2022), all variables in the dataset that do not contain negative values or do not turn to zero are log transformed using the natural logarithm function. Meanwhile, variables whose series contain negative values or zero values are transformed according to the IHS transformation. The HIS transformation equation as followings:

$$\widetilde{z_t} = log\left(z_t + \sqrt{z_t^2 + 1}\right)$$

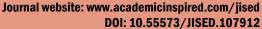Where z_t is the value of the variable to be transformed for the year t.

Four models have been identified according to the lag length of the independent variable and instrumental variables, as shown in Table 3. Two variables did not perform logarithm transformation to avoid multicollinearity problem which are trade openness (TO) and FDI quality (QTY). Using the criterions of Root Mean Square Error (Root MSE) and Standard Error of Regression (SE of Regression) where the smaller values indicate better model, Model A has been selected as the more optimal economic growth model where one lag specified for the independent variables and lag 2 for the instrumental variable.

Table 3: Model Selection

Growth Model	Model Specification	Root MSE	SE of Regression
A	*Lag 1 Instrumental Variable -2*	*0.034*	*0.035*
B	Lag 1 Instrumental Variable -2 till -3	0.049	0.050
C	Lag 2 Instrumental Variable -2	0.039	0.041
D	Lag 2 Instrumental Variable -2 till -3	0.042	0.043

The estimation of the dynamic panel model is performed with Model A which is one lag specified in the independent variable, instrumental variable lag 2 with economic growth as the dependent variable. The result is shown in Table 4.

The result shown that all the interactions terms are insignificant, whether it is for level or lag one as the p-values are greater than 0.1. To test on the serial correlation which are the autoregressive (AR) terms, the Arellano-Bond Serial Correlation test is performed, the result is shown in the last two rows in Table 4. If the result rejected the null hypothesis of the absence of first-order serial correlation with negative autocorrelation coefficient and do not reject the absence of second-order serial correlation, it implies that there is no problem of endogeneity in the model and therefore the result should be consistent. Based on the result, the model showing that the it is free from endogeneity problem at 1% significant level.

Another requirement for the dynamic panel model is Sargan test which is performed to test the overidentification restrictions. Based on Baltagi (2008), there is convincing evidence that too many moment conditions introduce bias while increasing efficiency, so Sargan test is aimed to examine if the instrumental variables are valid. If the Sargan test rejects the null hypothesis, the instrumental variables (IV) estimators are biased and inconsistent. Below is the hypothesis for Sargan's test:

Ho: there is no correlation between the IV estimators and error terms.
H1: there is correlation between the IV estimators and error terms.

Table 4 Result of Dynamic Panel Model

Variables	Coefficient	p-value
LNGWH(-1)	0.283	0.000
LNFDI	0.001	0.880
QTY	589991	0.570
HDI*QTY	-221	0.986
FD*QTY	-5790	0.458
TO*QTY	-191634	0.671
LNGOV	0.034	0.476
LNIQU	-0.053	0.546
LNK	0.119	0.001
LNHDI	2.644	0.001
LNFD	0.002	0.960
TO	0.017	0.790
LNFDI(-1)	0.001	0.844
QTY(-1)	-1111386	0.383
HDI*QTY(-1)	9005	0.577
FD*QTY(-1)	-214	0.971
TO*QTY(-1)	460421	0.381
LNGOV(-1)	-0.000	0.997
LNIQU(-1)	-0.080	0.516
LNK(-1)	-0.098	0.090
LNHDI(-1)	-2.415	0.004
LNFD(-1)	-0.034	0.202
TO(-1)	-0.086	0.046
J-Stats	82.592	0.110
AR(1)	-5.552	0.000
AR(2)	-1.085	0.278

The result of the Sargan's test is shown in Table 4 which is reflected in the J-Statistics. The result showing not rejecting the null hypothesis even at 10% significant level, so there is no correlation between the instrumental variables and the error terms. Hence, the parameters in the model do not overidentified.

Discussion and conclusion

Many researchers have studied the impact of Foreign Direct Investment (FDI) on economic growth and the results are mixture. Most of the studies, however, focusing on the total FDI instead of FDI quality. This study focusing on one of the important dimensions of FDI quality which is the entry mode in 55 emerging economies. Firms enter the host country with greenfield investment are believed to be more efficient than the brownfields. The secondary data were collected from ILO, UNDP, World Bank Development Indicator database, World Investment Report and International Financial Statistics.
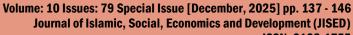
Besides FDI quality, many researchers argued that FDI can only improve economic growth of the host country when the development of the host country achieved certain threshold level. For example, the impacts of FDI on economic growth is depend on the level of capital stock; a highly developed financial market could improve the technological spillover from MNCs to the local firms, hence economic growth; while, trade openness accelerates FDI and economic growth relationship. As such, the impact of the interaction effect between the FDI quality with human capital, financial development and trade openness on economic growth was examined using the dynamic panel model.

However, the model did not show encouraging result which indicates that the interaction effects between the FDI quality with the human capital, financial development and trade openness do not affecting the economic growth for the sample economies. The result is inconsistent with the previous studies, where Balasubramanyam et al. (1999), Berthelemy and Demurger (2000) and Azam and Ahmed (2015) have proposed the positive interaction effect of human capital and FDI on the economic growth. In terms of interaction effects between FDI quality and financial development, the result of this study also inconsistent with previous studies. As some previous studies showed that FDI affects economic growth in the host countries with more developed financial market (Hermes & Lensink, 2003; Alfaro, Chanda, Kalemli-Ozcan & Sayek, 2004, Choong et al., 2010, Sghaier & Abida, 2013). The result of this study also shown inconsistent result with previous studies on the interaction effect between FDI quality and trade openness, As studies shown that the countries with higher trade openness, FDI inflow will affect economic growth significantly (Nair-Reichert & Weinhold, 2001; Makki & Somwaru, 2004; Zhang, 2001).

The insignificant and / or negative results may due to the unavailability of the data from few important emerging economies including China as this is the largest emerging economy in terms of the GDP. As for the policy implication, the policy makers should not have any preferences in attracting FDI as the impact of all types of FDI on economics are similar. The results might be better if other variables were used as the dependent variable.

Acknowledgement

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