



Growth and Foreign Direct Investment in the Pacific Island countries^{☆,☆☆}

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ARTICLE INFO

Article history:

Accepted 15 November 2013

JEL classification:

F21
O11

Keywords:

Foreign Direct Investment
Economic growth
Pacific

ABSTRACT

Achieving sustained high rates of economic growth in Pacific countries has proved incredibly challenging. Despite many being rich in natural resources, receiving high levels of foreign aid and being open to external trade, the economic growth rates of Pacific Island countries are the lowest and most volatile for all groups of developing countries. This paper examines the impact of Foreign Direct Investment (FDI) to the Pacific region. Results from the estimation of a number of empirical models suggest that the impact of FDI is lower in Pacific countries than it is in host countries on average. A 10% increase in the ratio of FDI to host Gross Domestic Product (GDP) is associated with higher growth of about 2% in all countries on average. The impact in Pacific countries falls to between 0.1 and 0.4%. A number of explanations for this finding are provided including some empirical evidence that FDI displaces domestic investment in the region.

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1. Introduction

Pacific Island countries (PICs) face many tremendous challenges. These include small domestic markets, limited resource bases, great distances from major markets, vulnerability to external shocks such as hikes in the prices of key international commodities and natural disasters, often inadequate governance and political instability. Western governments seemingly recognise this to the extent that PICs receive some of the highest levels of foreign development aid in the world relative to the size of their economies. In 2009, Official Development Assistance (ODA) accounted for as much as 34% of GDP in the Solomon Islands and 68% of GDP in Tuvalu. On average ODA accounted for over 25% of recipient GDP in PICs. Despite these aid levels, PICs have experienced the lowest and most volatile economic growth of any region of developing countries, including sub-Saharan Africa (McGillivray et al., 2010). Partly due to these growth rates, poverty is increasing in the region. Approximately 2.7 million people, one-third of the region's population, live in poverty, without the income to satisfy their basic human needs. More than 400,000 children are not enrolled in

primary school and seven out of every 100 children die before their fifth birthday. At least 80,000 adults have HIV and the rate of infection is growing by more than 40% per year, the fastest of any region of the world (AusAID, 2009).

Despite the immense challenges faced by the Pacific, the region remains startlingly under-researched. There is a small literature examining the economic growth impact of foreign aid and remittances to the region. For example, Pavlov and Sugden (2006), Feeny (2007) and Feeny and McGillivray (2010) provide positive assessments of foreign aid to Pacific countries, while Connell and Brown (2005), Browne and Mineshema (2007) and Brown (2008) examine the impact of remittances. Yet, surprisingly, the impact of Foreign Direct Investment (FDI) has been neglected.¹ This is despite FDI accounting for a greater share of Gross Domestic Product (GDP) in Pacific countries than for developing countries on average. The main objective of the paper is therefore to help fill the void in development related research for the PICs by providing the first study to comprehensively examine the growth impact of FDI to the region. It is, to the knowledge of the authors, the first study to look at the impact of FDI in these countries. A fundamental premise of this paper is that the behavioural relationship between growth and FDI in Pacific countries cannot be assumed to be the same as that for other countries, observed either from cross country, panel or time series datasets. It would therefore be inappropriate to rely

[☆] This paper is an output from an Australian Research Council funded linkage project with Sustineo Pty Ltd entitled Supporting Pacific Development (LP110200746).

^{☆☆} The authors are grateful for helpful comments and suggestions from two anonymous referees.

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¹ Jayaraman and Singh (2007) provide the only exception, finding that FDI contributes to employment creation and economic growth in the case of Fiji. See Read (2007) for an examination of the determinants of FDI flows to Small Island Developing States (SIDS).

on the findings of previous studies to draw inferences about the impact of FDI in PICs. The main reason for expecting that the incremental impact of FDI will be different in the Pacific is the widely acknowledged difficulty of doing business in these countries. As noted in AusAID (2008) and World Bank (2011), doing business in these countries is becoming increasingly difficult. This is likely to retard the productivity of FDI in the region. It is also recognised that FDI might displace domestic investment in PICs, thereby limiting its effectiveness with respect to growth. FDI is particularly likely to displace domestic investment if foreign firms have superior managerial and technical expertise than their domestic counterparts.

FDI can play a crucial role in contributing to growth and poverty reduction in host countries, particularly in small countries located a long way from major markets. These countries often lack the resources to develop their own technology and suffer from technical and institutional constraints to the accumulation of physical and human capital. Domestic financing for investment projects can be limited and unprotected property rights, corruption, and civil and political instability may either hinder capital accumulation, or become obstacles for using already existing resources. FDI should, therefore, be an attractive source of development financing for these countries. A number of positive externalities are associated with FDI inflows, such as advanced technology, managerial expertise, R&D, employment, productivity and efficiency gains in the domestic economy.²

Support for FDI is not universal despite its potential benefits. Critics argue that the policies to attract FDI can distort domestic incentives and as noted above, can displace domestic investment, crowding out employment and domestic firms. The impact of FDI on the host country is therefore an empirical issue and one that has been examined by a voluminous (cross-country) empirical literature. The consensus of this literature is that the impact of FDI has been favourable, by contributing to the economic growth rates of host countries. It is also clear from a review of this literature that the impact of FDI varies across host countries.

Little is known of the impact of FDI on Pacific Island countries. There is anecdotal evidence to suggest that FDI has provided little benefit to some of these countries. FDI to Papua New Guinea (PNG) and the Solomon Islands, for example, has been characterised by large capital intensive projects in the extractive industries (mining and logging) of these economies. These industries have been plagued by corruption, widespread concerns over environmental damage and the exploitation of domestic landowners. FDI has focused on agriculture and tourism in other Pacific countries, sectors which (directly and indirectly) provide employment to a substantial proportion of their populations.

The paper finds that FDI is associated with higher rates of economic growth in the Pacific. Yet it also finds that the impact of FDI is lower in the region than it is for countries on average. Further evidence is presented which indicates that FDI has displaced domestic investment in the Pacific which sets this region apart. One of the recommendations emanating from this finding is for donor governments to shift the nature of their assistance to the region. There are limits to what aid can achieve to the region and instead of providing additional assistance, a change in the focus of aid is appropriate. More specifically, donors should examine ways of improving the growth (and other) impacts of FDI in the Pacific. This is likely to require a greater focus on improvements in human capital and private sector development.

2. An overview of FDI to the Pacific

Pacific countries suffer from a number of factors which might limit the desire of international firms to invest in them. These include their

small size, remoteness, insecure land rights, high cost and low availability of skilled labour and unfavourable business environments (Nathan Associates Inc., 2007). Yet to varying extents, Pacific countries have overcome these obstacles. Outside of the extractive industries, FDI in the Pacific has flowed to agriculture (the palm oil, copra, sugar and live-stock industries), forestry, fishing, banking and finance, real estate and tourism. There has been less FDI to the manufacturing sector. A notable exception is the Yazaki automobile wiring harness plant in Samoa.

While flows of FDI to the Pacific are small in absolute terms, levels of FDI (relative to the size of host country GDP) are actually higher (on average) in PICs than they are in other low and middle income countries. This is demonstrated by Table 1 which provides net FDI inflows relative to GDP for selected Pacific countries and country groups during the last three decades.

Fiji and Vanuatu have received far higher levels of FDI (relative to low and middle income countries on average) in each of the last three decades. The same is true for Kiribati and the Solomon Islands in the 1990s and 2000s. Levels of FDI to Samoa and Tonga have been lower and fluctuated widely. While PNG has received a lower level of FDI in the 2000s, the level is starting to increase dramatically with the construction of a large Liquid Nitrogen Gas (LNG) plant.

3. Data and methods

Empirical studies examining economic growth have specified models to include measures of human capital, institutional factors, policy related factors, and conditional convergence in addition to domestic and foreign investment (recent examples include Azman-Saini et al., 2010; Basu and Guariglia, 2007; Li and Liu, 2005). The current study follows this approach in examining the relationship between FDI flows and economic growth in 209 countries covering the period 1971 to 2010.³ Cross country data are averaged over five-year periods, as is standard practice. To examine whether the FDI–growth relationship is different in Pacific countries, the paper includes a FDI–Pacific interaction term. The Pacific variable is a dummy variable taking the value of 1 if the country is located in the Pacific and zero otherwise.⁴ The model is specified as follows:

$$g_{it} = \alpha_0 + \beta_1 P_i + \beta_2 FDI_{it} + \beta_3 FDI_{it} * P_i + \beta_4' Z_{it} + \mu_{it} \quad i = 1, \dots, n \quad (1)$$

where g_i is a real growth in GDP per capita, P_i is the Pacific dummy variable, FDI_i is the percentage of FDI relative to GDP, $FDI_i * P_i$ is the FDI–Pacific multiplicative interaction term and Z_i is a vector of control variables. Subscript i represents recipient country and t represents time. The vector of additional variables (Z_i) contains the initial level of GDP per capita (to capture convergence), the secondary school enrolment rate (as a measure of human capital), the ratios of imports and exports relative to GDP, the rate of inflation (logged), domestic investment, a measure of economic freedom and the coefficient of variation for the FDI variable. It also includes interactions of FDI with other region dummy variables. The data include 42 observations for the seven Pacific countries provided in Table 1. Data are sourced from the World Bank's *World Development Indicators* (WDI) online database. The exception is the economic freedom variable which is obtained from the Freedom House database.

The choice of the explanatory variables included in the model warrants some discussion. This is especially the case with the FDI variable

² In the context of the neoclassical growth framework, FDI affects only the level of income. Long-run economic growth will be unchanged unless FDI influences technological progress (see de Mello, 1997; Solow, 1957). In endogenous growth models, however, economic growth will be generated if FDI increases productivity via externalities and spillover effects such as know-how and improvements in human capital (Lucas, 1988; Rebelo, 1991; Romer, 1986).

³ The specific choice of the empirical model is motivated by maximising the number of observations for PICs to be included in the analysis.

⁴ An alternative approach is to estimate models for Pacific countries only. This option is not pursued by the current paper on the grounds of data availability and sample size. If annual data are employed, there are just 95 FDI observations for Pacific countries over the period 1971 to 2010. Moreover, there is a greater chance of estimating spurious regressions using annual data for just Pacific countries and therefore a greater need to address the time-series properties of the data. Time-series properties are less of a concern with data averaged within countries over five-year periods.

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