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# Causal Interactions between FDI, and Economic Growth: Evidence from Dynamic Panel Co-Integration

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**Abstract**

In all countries, especially developing, foreign direct investment (FDI) plays a very important role, they are even considered as the engine of economic growth and development. Engaged in good conditions, foreign capital can help reduce the gap between capital requirements and national saving, raise skill levels in the host economy, improve market access and contribute to technology transfer and good governance. Foreign investment comes in many forms. In what follows, we will show through theoretical and empirical studies the effect of the investment on economic growth of countries. This study analyzes the relationship between foreign direct investment and economic growth in 65 countries, using co-integration and panel Granger causality tests in panel data. The results show a disparity in terms of the relationship between the co-integration of the panel study. The results also indicate a unidirectional causality from FDI to GDP, which could be a good tool to prioritize the allocation of resources across sectors to promote foreign direct investment.

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## 1. Introduction

In the 50s and 60s, Foreign Direct Investment (FDI) was regarded with great suspicion by most developing countries. He was considered a threat to national sovereignty and multinational companies were suspected of reducing social welfare by manipulating transfer prices and the formation of enclaves.

Faced with the current globalization of markets, globalization and internalization of production and monetary policies, there has been a radical change in the attitude of developing countries that are forced today to seek sources of non-traditional and non-generating investment in debt. That is why they have turned to FDI. They are stable and less susceptible to financial crises investments. They must be able to create additional funding opportunities, without increasing the external debt of a country.

Indeed, FDI is now increasingly sought both by developed countries by developing countries and are no longer considered as a factor of dominance, but as a major channel for technology transfer and innovation.

Thus, the global economy has been completely transformed in recent years. It operates in an environment increasingly Entangled as free trade, free movement of capital and goods become hallmarks, where FDI is increasingly qualified as a new way to finance economic growth.

In order to increase their investment capacity to positively affect the balance of the balance of payments, make up for the shortfall in national savings, create new opportunities for better jobs with better pay and better conditions work, several countries are trying to make IDE one of the most powerful in the economic development strategy pillars.

These countries have a significant production potential, they have everything for the effective take-off of their economy. These states have focused their actions on the economic and social recovery considering FDI as a by-product of economic development, which explains the great importance attached to the attractiveness of foreign investment flows, by implementing a series of measures to make these countries more attractive.

Beyond assessing the attractiveness of different regions in terms of FDI, the whole point of this study lies in the analysis of the causal link between foreign direct investment and their real impact on economic growth different countries. A major issue is, is there a long-term relationship between direct foreign investment and economic growth?

## 2. Literature review

The correlation between the FDI inflow into host countries and economic development has been subject to rigorous research for years. In theory, the causal relation between FDI and GDP growth can run in either direction. On the one hand, according to the “FDI-led growth hypothesis”, FDI inflows can stimulate growth for the host countries by increasing the capital stock, creating new job opportunities, and easing the transfer of technology (Borensztein et al., 1998; De Gregorio, 2003; de Mello, 1997). On the other hand, according to the “market size hypothesis”, a rapid GDP growth creating new investment opportunities in the host country can also cause larger inflows of FDI (Mah, 2010; Rodrik, 1999). In addition, although the existing studies generally suggest a positive impact of FDI on economic growth, it is also possible that FDI has negative effects on economic growth by crowding out domestic investment, increasing external vulnerability, and causing dependence (Aitken and Harrison, 1999; Lipsey, 2002). Last but not least, it is also possible that a causal relationship between FDI and economic growth does not exist, supporting the so-called “neutrality hypothesis”. The empirical studies in identifying the relationship between inward FDI and economic growth have been studied extensively. The work of Herzer (2008) found that outward FDI has positive long-run effects on domestic output in 14 industrialized countries over the period 1971 to 2005 using panel analysis. The results also pointed out that the long-run causality is bidirectional between outward FDI and domestic output.

Based on panel co-integration and causality tests, Basu et al. (2003) found that there is a bidirectional causality between economic growth and FDI in 23 developing countries over the period between 1978 and 1996. Basu et al. (2003) further argued that for relatively open economies causality runs in both directions, while for relatively closed economies long-run causality mainly runs from growth to FDI. Nair-Reichert and Weinhold (2001) have found that FDI on average has a significant and positive impact on economic growth in a sample of 24 developing countries. In

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