Assessing the Catalytic Role of Foreign Direct Investment in Sri Lanka: 1977- 2020

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Abstract

Foreign Direct Investment (FDI) is an important factor in promoting the economic growth of a country. It transfers advanced-technology from developed to developing countries, stimulates domestic investment, and develops new skills and techniques. This study investigates whether FDI induces economic growth in Sri Lanka using timeseries data over the study period of 1977 to 2020. In this study the Autoregressive Distributed Lag (ARDL) Bounds cointegration technique was employed as an analytical tool. Despite all variables being in first difference (I(1)), the ARDL approach was selected given the limited sample size and the focus on short- and long-run dynamics. The ARDL Bounds cointegration technique confirms that there is a long-run relationship between the variables used in this study. The estimated coefficient of FDI reveals that Foreign Direct Investment induces economic growth in Sri Lanka. Further, the estimated coefficient of error correction term illustrates that the response variable of economic growth moves towards the long-run equilibrium path with correcting 22 percent of error every year. Therefore, government should create a supportive environment for FDI, while maximizing its benefits and mitigating any potential negative impacts.

Keyword: *ARDL Bounds test, Economic Growth, Foreign Direct Investment, Sri Lanka*

Introduction

Foreign Direct Investment (FDI) is identified as one of the most important determinants in a country's macro-economic progress. It transfers advanced technology from developed to developing countries, stimulates domestic investment, and develops new skills and techniques (Samantha, 2017; Ghaith *et al.,* 2017). FDI inspires technology, high-tech knowledge, and managerial skills from guest

companies to host companies to improve the productivity of local firms. Aiming at accelerated economic growth, Sri Lanka announced a liberalized economic policy in 1977, upholding the subsequent government policy on the same and international trade and international investment as economic growth tools. The Sri Lankan government intends to utilize these investment funds to create high-quality employment opportunities while enhancing income levels of the Sri Lankan workforce. Moreover, it also intends to boost productivity and make Sri Lanka's economy more competitive. Over the past several decades, Foreign Direct Investment (FDI) has emerged as a pivotal driver of economic growth, especially in emerging economies such as Sri Lanka Fernando and Perera (2017) Jayasuriya and Gunawardana (2019). Nunnenkamp *et al.* (2003) enumerated FDI as superior capital inflows in stimulating economic growth, less volatile and access to modern technology and know-how to the host country. According to Herzer *et al.* (2006), FDI has a typically favorable influence on economic growth in developing countries.

Theoretical literature predicts that FDI benefits the host country considerably because it provides a pathway for transferring new technology from one country to another, stimulating the economy and GDP in the host country; nevertheless, empirical investigations have reported mixed consequences. Some research indicated the positive impact of the FDI on economic growth (Khun, 2018; Bouchoucha *et al.*, 2019; Silajdzic & Mehic, 2015), while certain revelations contradicted (Alvarado *et al.*, 2017; Jorge et al., 2018) or showed zero impact on the country's economic growth (Herzer *et al.*, 2006). Rita (2021) explored the relationship between FDI and Nepal's economic growth from 1990/91 to 2019/20 using the Ordinary Least Square (OLS) model. He posited that FDI and economic growth in Nepal have a long-term association.

FDI has an essential source that directly supports the industrial sector's high requirements for technology and value-added products, such as machinery manufacturing, energy, computers and telephones. Similarly, Shahzad *et al.* (2013) found that FDI in a country is often the subject of many economic benefits such as technology transfer, organizational framework, managerial skills, the balance of payments and employment promotion, and the export of these countries UNCTAD (2011). Sri Lanka faces many challenges since independence, moving toward a debt trap due to a high fiscal deficit, inability to service foreign loans, and limited foreign currency reserves (ADB, 2016). The prolonged civil war in Sri Lanka gravely impeded its FDI flow. The conflict led to an unstable environment, causing potential investors to be deterred by concerns about safety, political instability, and the business climate. While the civil war ended in 2009, Sri Lanka’s efforts to attract FDI remained challenging. The relatively weak FDI attraction after the war can be attributed to a number of factors.

According to the World Bank Development Report, FDI inflows declined from 955.91 million USD to 681.24 million USD between 2010 and 2015. Further, inflows to Sri Lanka declined from a high of USD 1.6 billion in 2018 to USD 758 million in 2019 (UNCTAD, 2020). FDI into Sri Lanka dropped from USD 793 million in 2019 to USD 528 million in the 2020 third quarter, owing to the COVID-19 and the Easter attacks occurred in 2019 (Central Bank Report, 2020). Sethi and Sahoo (2016) observe that due to a lack of domestic capital generation, Sri Lanka has become more reliant on foreign investment to boost its economic development. According to the theoretical framework, FDI encourages production growth, resulting in an increase in GDP in a country. The trajectory of FDI net inflows (% of GDP) and GDP growth in Sri Lanka, as shown in Figure 1, have experienced significant fluctuations. One illustration is the decrease in FDI during the 2000s, while GDP growth remained fairly consistent. In a comparable manner, FDI witnessed a substantial decline in 2017, a slight uptick in GDP growth is witnessed. Further, theoretical evidences argued that only FDI positively contributed to the economic growth of a country (Li and Tanna, 2019). Therefore, the objective of this study is to examine if FDI has played a significant role in Sri Lanka's economic growth from 1977 to 2020. The relationship between FDI and economic growth in Sri Lanka is explored using the ARDL technique in this analysis.

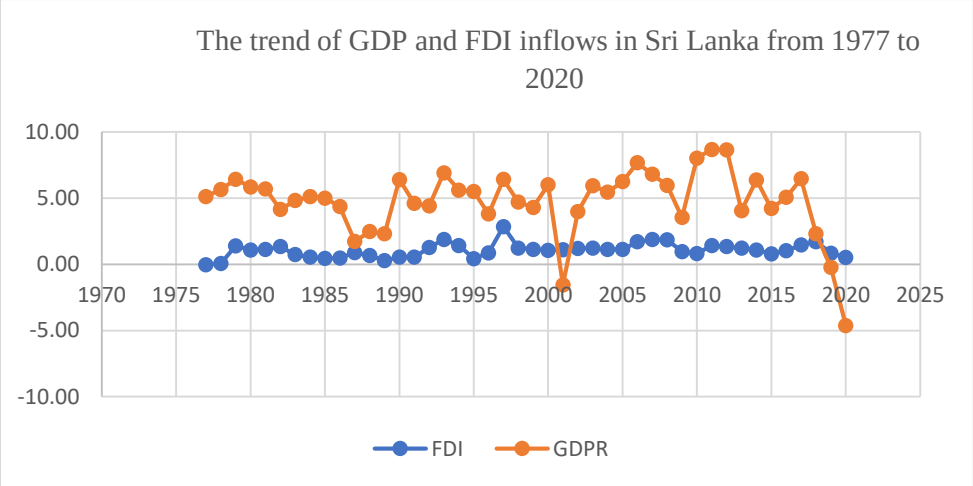


Figure 1. The trend of GDP and FDI inflows in Sri Lanka from 1977 to 2020

The following section examines literature on the influence of FDI on economic growth. The study's methodology is examined in the next section. Lastly, the study presents empirical findings and conclusions.

Theoretical framework

A number of theories have been developed by different viewpoint for introducing FDI - growth. In order to establish the empirical model, this study relied on the neoclassical theory and endogenous growth theory to analyze the long-run relationship between economic growth and FDI, as these theories are widely employed in empirical research. In line with neoclassical growth theory, FDI is believed to have only a small role in driving economic growth. The theory emphasizes accumulation of physical capital and technological progress as the primary catalysts for long-term economic growth, grounding this perspective. According to neoclassical theory, FDI has potential to improve productivity and efficiency in the receiving economy by introducing new technologies and managerial practices. Nevertheless, FDI's contribution to growth is seen as less significant when compared to domestic investment in physical capital and technological advancements.

On the other hand, the endogenous growth model established by Lucas (1988), Rebelo (1991), and Romer (1986) asserts that FDI contributes to economic growth by generating capital, transferring technology, and enhancing knowledge through training and skills acquisition. De Mello (1997) showed that FDI improved long-run economic development through technical advancement, capital accumulation, and human capital augmentation. It may also stimulate economic growth endogenously if it creates productivity. Borensztein *et al.* (1998) examine the influence of FDI on economic growth, concluding that FDI is a critical vehicle for adopting new technologies, contributing greatly to growth than domestic investment. Therefore, foreign direct investment contributes to promoting economic growth in developing nations.

Literature Review

A sufficient amount of previous literature by using single and cross-country data sets examines the relationship between foreign direct investment and economic growth. Accordingly, using the Padroni cointegration test, Victor and Christopher (2018) investigated the relationship between FDI and economic growth in a panel of 10 South American countries. They found that FDI has a strong positive impact on the economic growth in these countries with bidirectional causality between FDI and economic growth. The same findings were obtained by Mehdi (2012) with regard to South Asia. Trang *et al.* (2019) concluded that FDI helps stimulate the economy. When considering a single country study, Khun's (2018) found that FDI had a positive impact on Cambodia's economic growth. As for China, Tang *et al.* (2008) stated that FDI has not only helped overcome capital shortages but also boosted the economic growth. Silajdzic and Mehic (2015) concluded that foreign direct investment has a beneficial impact on economic growth in transition economies due to knowledge

spillovers; technological and inventive initiatives. Similar findings were reported by Najabat and Hamid in Pakistan. The empirical findings of Bouchoucha *et al.* (2019) confirmed that FDI positively influences economic growth in Tunisia. Further, in Bangladesh, Hussain and Haque (2016) discovered that FDI has a considerable impact on per capita GDP. In Eurozone countries, Pegkas (2015) concluded that FDI has a considerable effect on economic growth. Another study was done by Chakraborty and Nunnenkamp (2008) who concluded that FDI has a long-standing relationship with Indian economic growth, while Choi and Baek, (2017) found that FDI inflows to India boost Total Factor Productivity. Similarly, Ghaith *et al.* (2017) found that FDI promotes economic growth. Another analytical technique is the ordinary least squares approach which was widely used in the previous studies examining the relationship between FDI and economic growth. Accordingly, Alvarado *et al.* (2017) studied the impact of FDI on economic growth in 19 Latin American nations. The findings reveal that FDI has no statistically significant influence on economic growth and that FDI is not an adequate strategy for accelerating economic growth in Latin America. Similarly, Jorge *et al.* (2018) found that FDI creates no impact in Spain. Laura (2003) confirmed that FDI improves economic growth. Further, Nilofer *et al.* (2018) concluded that FDI negatively impacted the economic growth in Pakistan. Herzer *et al.* (2006) used cointegration techniques to investigate the FDI-led growth hypothesis for 28 developing nations and found that FDI has no statistical significance on the economic growth. Few countries have recognized the long- and short-term favorable association between FDI and economic growth.

Research methods

Empirical model derivation

Equation (1) is the empirical model used in this study which includes per-capita GDP ($PCGDP_t$) at constant form of 2015 US$ considered as economic growth, which is consistent with the study of Ibhagui (2019) and Osei and Kim (2020), per-capita gross fixed capital formation ($PCFCF_t$) at constant form of 2015 US$ applied with the study of Hammed *et al.*, (2020), FDI (FDI_t) is quantified by the net inflows of foreign direct investment as a percentage of GDP which bring direct and sustainable advantages for the host country. Most of the previous studies, such as Alfaro *et al.* (2004), Ibhagui (2019), and Osei and Kim (2020), have employed FDI in their studies and Consumer Price Index (2013=100) (CPI_t) which were considered in the study of Adeniyi and Omisakin (2010) and Zia (2014). All the data sets for the variables used in this study were time series, covering the period 1977-2020, collected from the FDI annual report of the Central Bank of Sri Lanka published in various years. Therefore, econometric model of this study is written as:

$$PCGDP_t = \beta_0 + \beta_1 PCFCF_t + \beta_2 FDI_t + \beta_3 CPI_t + \epsilon_t \quad (1)$$

Where, β_0 is intercept and $\beta_1 - \beta_3$ are the coefficent of per-capita fixed capital formation, foreign direct investment, consumer price index, respectively. ϵ_t is random error term.

Analytical technique

As for this study, two analytical techniques were employed. They are exploratory data analysis and inferential data analysis, respectively. The exploratory data analysis consists of scatter plots, confidence ellipse with kernel fit, whereas the inferential data analysis includes unit root test, cointegration and Pairwise Granger causality test.

Since this study used the time series data, confirming the order of integration of the variables is important. To test the order of integration of the variables, a number of unit root tests were used in empirical studies. The Augmented Dickey-Fuller (ADF) and Philips-Perron (PP) unit root tests were more commonly used. The use of these tests in econometrics and time series analysis is common for assessing variable stationary, a vital step in developing reliable models and accurate forecasts. As a result, this study employed the ADF and PP unit root test to analyze the integration order of the variables.

The variables in this study were found to be integrated of order 1 according to the unit root tests. Still, the study contains less than 50 sample observations. As a result, the Johansen cointegration approach is not appropriate. To test for cointegration, the recommended technique is the autoregressive distributed lag (ARDL) approach. Moreover, there are no variables called I(2) either. This study used the ARDL technique to examine if foreign direct investment promotes economic growth. The ARDL model specification in this study is known as the unrestricted error correction model. Overall, the ARDL approach is a reliable method for analyzing time series data, especially when variables have different orders of integration or when cointegration testing is not possible.

$$\Delta PCGDP_t = \beta_0 + \sum_{i=1}^{p} \beta_1 \Delta PCGDP_{t-i} + \sum_{i=0}^{p} \beta_2 \Delta PCFCF_{t-i} + \sum_{i=0}^{p} \beta_3 \Delta FDI_{t-i} + \sum_{i=0}^{p} \beta_4 \Delta CPI_{t-i} + \beta_5 PCGDP_{t-1} + \beta_6 PCFCF_{t-1} + \beta_7 FDI_{t-1} + \beta_8 CPI_t + \epsilon_t \quad (2)$$

Where, Δ is 1st difference indicator, p is optimal lag length for each variable given in equation (8), $\beta_1 - \beta_4$ are short-run coefficnets of the variables, $\beta_5 - \beta_8$ are the long-run coefficnets of variables.

The long-run relationship between the variables used in this study was tested by using the following joint hypothesis. In that respect, the joint null hypothesis ($H_0: \beta_5 \neq \beta_6 \neq \beta_7 \neq \beta_8 = 0$) being no long-run relationship between the variables

was tested against the alternative joint hypothesis ($H_1 = \beta_5 \neq \beta_6 \neq \beta_7 \neq \beta_8 = 0$) of having had a long-run relationship between the variables.

By comparing calculated *F*-statistic with the set of critical values, decision on the presence of a long-run relationship between the variables used in this study was made. As for the critical values, Pasaran *et al.* (2001) introduced both lower and upper-bound critical values, respectively. Set of lower bound critical values to assume that all the regressors are *I* (0) whereas, the set of upper-bound critical values assume that the regressors are *I* (1). Accordingly, if the calculated *F*-statistic is greater than the upper bound critical value, the null hypothesis will be rejected, if the calculated F-statistic is less than the upper bound critical value, the null hypothesis will not be rejected. On the other hand, if the calculated *F*-statistic is located between lower and upper bound critical values, it cannot be concluded about the long-run relationship between the variables used in this study. Further, once confirmed the long-run relationship between the variables used in this study, the following error correction model was employed to estimate both the short-run dynamics of the variables and coefficient of the error correction term.

$$\Delta PCGDP_t = \beta_0 + \sum_{i=1}^{p} \beta_1 \Delta PCGDP_{t-i} + \sum_{i=0}^{p} \beta_2 \Delta PCFCF_{t-i} + \sum_{i=0}^{p} \beta_3 \Delta FDI_{t-i} + \sum_{i=0}^{p} \beta_4 \Delta CPI_{t-i} + \Psi ECT_{t-1} + \epsilon_t \quad (3)$$

Where Ψ is coefficent of error correction term which is theoretically expected to be negative, less than one and significantly different from zero to move towards the long-run equilibrium path.

In order to confirm whether the estimated ARDL model of this study is robust, the Breusch-Godfrey serial correlation LM test for serial correlation, the Breusch–Pagan Godfrey test for Heteroskedasticity, the Jarque-Bera test for normality, the sum of recursive residuals (CUSUM) test, and the cumulative sum of recursive residuals square (CUSUMSQ) test were employed.

Empirical findings and discussion

As mentioned in research methods here the empirical findings are presented in two ways. One is empirical findings of exploratory data analysis whereas, others are empirical findings of inferential data analysis. Exploratory data analysis which is given in Figure 3 shows that foreign direct investment in Sri Lanka has a positive relationship with per capita gross domestic product at 95% confidence region.

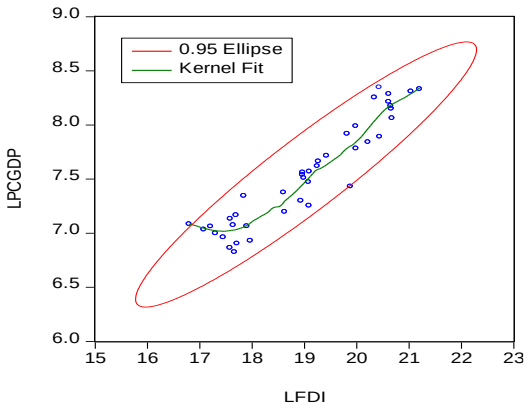


Figure 3. Association between Foreign Direct Investment and Economic Growth
Source: Authors' Derivation

Next to exploratory data analysis, the study starts inferential data analysis by conducting ADF and PP unit root tests for all variables used in this study. The ADF and PP unit root tests which are summarized in Table 1 show that all the variables used in this study are unit root at their level I (1). Therefore, the null hypothesis that the variables are non-stationary cannot be rejected at a 5 percent significance level. Since all the variables used in this study are stationary at their 1st difference, the Johansen cointegration procedure is appropriate. However, due to the small sample (N<50), this study recommends the ARDL cointegration procedure.

Table 1. Unit root tests results

Variable	ADF Test		PP Test		Order
	Level	1st difference	Level	1st difference	
$\boldsymbol{LPCGDP_t}$	-0.606	-3.244	-0.176	-3.228	*I*(1)
	(0.858)	(0.024)	(0.933)	(0.025)	
$\boldsymbol{LPCFCF_t}$	-1.493	-5.596	-1.441	-7.778	*I*(1)
	(0.526)	(0.000)	(0.552)	(0.000)	
$\boldsymbol{CPI_t}$	-0.350	-5.444	-0.427	-5.422	*I*(1)
	(0.986)	(0.000)	(0.981)	(0.000)	
$\boldsymbol{FDI_t}$	-1.139	-6.358	-2.315	-4.519	*I*(1)
	(0.690)	(0.000)	(0.172)	(0.000)	

Source: Authors' Estimation

Note: p-values are in parentheses

Once the suitable cointegration procedure is selected, the next step is to find the optimal lag length for estimating the long-run model. Asteriou and Agiomirgianakis (2001) note that when use annual time series data and the variables achieve stationary at 1st difference, lag two can be considered to suitable cointegration model of this study. However, use the present study lag four to select the ARDL model for this study because the Eviews 9 software automatically considers the lag four under Akaike Information Criterion. Thus, Figure 2 shows the possible ARDL model of lag four under the AIC. As per the figure, the ARDL (1, 2, 0, 0) model has optimal lag then other ARDL models given in Figure 2. Therefore, this study selects the ARDL (1, 2, 0, 0) model for testing the objective.

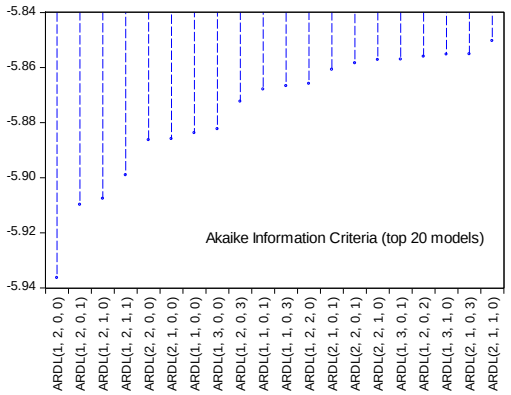


Figure 2. Appropriate ARDL model of lag four

Once the appropriate ARDL model for this study has been selected, the next step is to confirm whether the key variable has a long-run relationship with economic growth. In order to do that, the bounds procedure is employed. Table 2 illustrates the test results of long-run relationship between explanatory and explained variables. The calculated F-statistic in Table 2 is 5.49 which is greater than the upper bound critical value of 4.35 at 5 percent significance level. Therefore, the null hypothesis that there is no long-run relationship between the variables can be rejected at 5 percent significance level, meaning that the variable of foreign direct investment has a long-run relationship with economic growth in Sri Lanka over the study period.

Table 2. Cointegration test results

Test statistic	Value	
F- Statistic	**5.49**	
K	3	
Significance	*I*(0) Bound	*I*(1) Bound
10%	2.72	3.77
5%	3.23	**4.35**
2.5%	3.69	4.89

Source: Authors' derivation

Diagnostic tests result of the Breusch-Godfrey serial correlation LM test for serial correlation, the Breusch–Pagan Godfrey test for Heteroskedasticity, the Jarque-Bera test for normality are given in Table 3. Since the corresponding p-value of all three tests given in Table 3 are greater than 5 percent significance level, the residuals of estimated ARDL (1, 2, 0, 0) model is robust.

Table 3: Findings of Diagnostic tests

ARDL (1, 2, 0, 0)	**F-Statistic**	**Prob.**
Breusch-Godfrey Serial Correlation LM Test	0.6017	0.5542
Heteroskedasticity ARCH Test	0.8655	0.5303
J-B test statistic	1.0401	10.594

Source(s): Authors' calculation.

Both Figure 3 and Figure 4 show the plots of the cumulative sum of recursive residuals (CUSUM) and the cumulative sum of recursive residuals squared (CUSUMSQ) for the estimated ARDL (1, 2, 0, 0) model, respectively. These figures indicate that the CUSUM and CUSUMSQ plots are within the critical bounds at 5 percent significance level. Thus, the null hypothesis of parameter of coefficient constancy cannot be rejected, meaning that the empirical model of this study is stable over the study period.

Figure 3. CUSUM plot for ARDL (1, 2, 0, 0) model

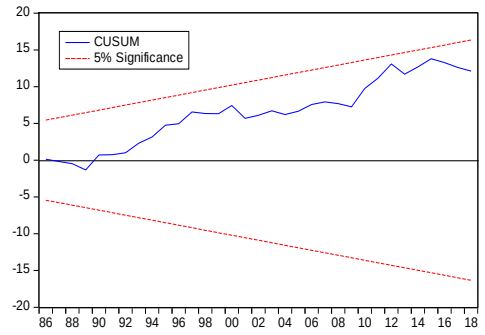
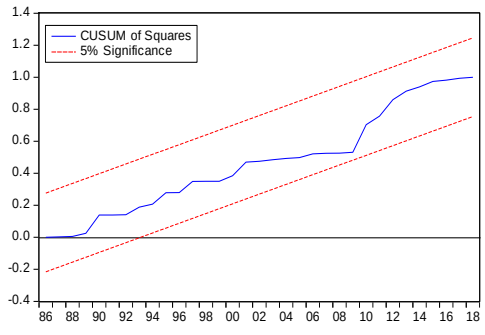


Figure 4. CUSUMSQ plot for ARDL (1, 2, 0, 0) model



Source: Developed by the author

Table 4 illustrates the estimated coefficients of explanatory variables used in this study. All the variables given in Table 4 are significant at 1 percent level. In that respect, the estimated coefficient of Per-capita fixed capital formation implies that 1 percent increases in per-capita fixed capital formation raises the per-capita GDP by 0.46 percent. This finding is consistent with the study of Onyinye *et al.,* (2017); the estimated coefficient of consumer price index notes that 1 percent increases in consumer price index promotes per-capita GDP by 0.19 percent. This finding is in line with the study of Boujelbene (2021), whereas the estimated coefficient of foreign direct investment indicates that 1 percent increases in foreign direct investment upsurge per-capita GDP by 0.15%, this result is consistent with the studies of Alvarado *et. al.,* (2017); Raza, *et al.,* (2021); Halliru *et. al.,* (2021).

Table 4. Long – run coefficient of variables

Dependent Variables: $\boldsymbol{lnPCGDP_t}$

Variable	Coefficient	*t*-statistic	*p*-value
$\boldsymbol{lnPCFCF_t}$	0.460	8.239	0.006*
$\boldsymbol{CPI_t}$	0.190	6.133	0.000*
$\boldsymbol{FDI_t}$	0.151	5.367	0.000*
$\boldsymbol{C}$	3.948	11.056	0.000*

Source: Authors' calculation. *$p<0.01$*

The estimated coefficient of error correction term is shown in Table 5 satisfying theoretical requirement such as negative sign, statistically, and less than one. The negative sign indicates that the response variable of per-capita GDP moves towards the long-run equilibrium path. Accordingly, the test results of error correction term show that 22 percent of errors will be adjusted every year. Further, the estimated coefficient of error correction term indicates that there is a long-run causality between the variables.

Table 5. Coefficient of Error correction

Dependent Variables: $\boldsymbol{lnPCGDP_t}$			
Variable	Coefficient	*t*-statistic	*p*-value
$\boldsymbol{ECT_{t-1}}$	-0.223	-4.036	0.000*

Source: Authors' calculation. *$p<0.01$*

Conclusion

In this study, the relationship between foreign direct investment and economic growth in Sri Lanka was examined by using some important proxy variables. The study period of this study covers the period of 1977 to 2020. The exploratory data analysis confirms that FDI has a positive relationship with per-capita GDP. As for the inferential analysis, the ADF and PP unit root test results indicate that all the variables used in this study are order one. The ARDL Bounds cointegration test confirms that there is a long-run relationship between the variables used in this study. All the diagnostic tests confirm that the estimated model is robust. Further, it is confirmed that the interest variable of FDI positively pushes economic growth in Sri Lanka. The estimated coefficient of error correction term reveals that the response variable moves towards the long-run equilibrium path. Based on the findings of this study, there is compelling evidence to suggest that FDI plays a significant role in promoting economic growth in Sri Lanka throughout the study period. Therefore, it is recommended that policymakers in Sri Lanka adopt measures to attract FDI more effectively.

Specifically, policymakers should focus on creating a more favorable investment climate by implementing policies that reduce bureaucratic hurdles, develop infrastructure, ensure political stability, and provide incentives for foreign investors. Moreover, efforts to improve education and skills of the local workforce could further promote Sri Lanka as an investment destination, facilitating technology transfer and increasing the overall productivity of the economy.

In conclusion, the findings of this study underscore the importance of FDI as a catalyst for economic growth in Sri Lanka. By prioritizing policies that attract and retain foreign investment, policymakers can stimulate economic growth, create employment opportunities, and enhance the country's overall development prospects.

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