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Impact of Foreign Direct Investment (FDI) on Economic Growth: The panel approach from 1990 to 2018 in East Africa countries

Salum Bakari Khamis

Abstract

The panel approach was used in this research to explore the effect of foreign direct investment (FDI) on the economic development of the East African Community, involving five countries that are the founders of the EAC, including Tanzania, Kenya, Uganda, Burundi, and Rwanda. This study used a dynamic ordinary least square (DOLS) from 1990 to 2018 to examine the influence of FDI on economic growth. According to the result of this research, FDI has a favorable and considerable impact on economic development in EAC nations. In addition to that, a Granger causality test supported the relationships between economic growth measured in GDP and FDI inflow in the EAC. The study implies that FDI has been a significant stimulator of economic growth in the region for the past three decades.

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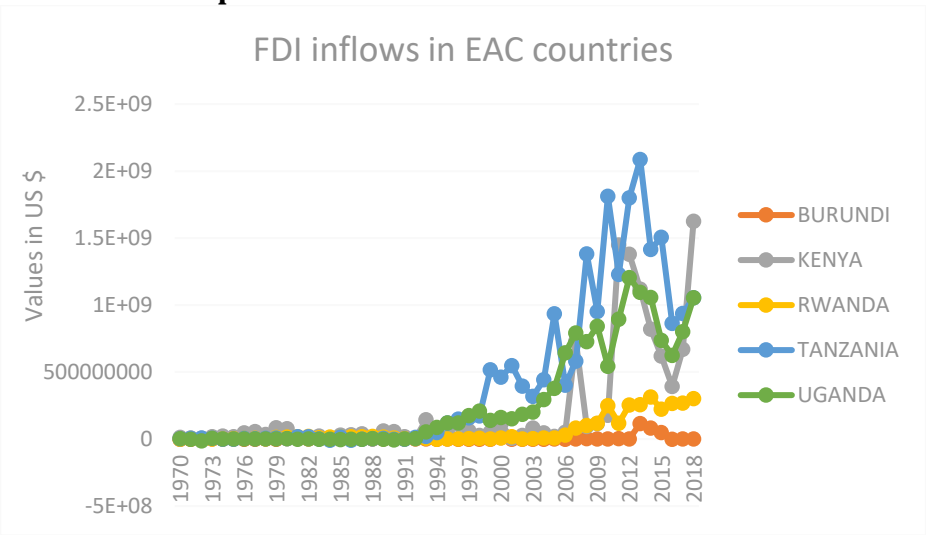
1.0 Introduction

East Africa's real GDP increased by 4.8 percent in 2021, subsequent a decline of 0.7 percent in 2020 due to the COVID-19 pandemic (Africa Outlook, 2022). FDI to East Africa decreased by 16% in 2019 to $6.5 billion. More than one-third of foreign investment in the subregion went to Ethiopia, despite a 6% decline in inflows to $2.4 billion. Despite the pandemic's negative effects on the Ethiopian economy, particularly in the hotel, aviation, and other service sectors, it nonetheless expanded by a respectable 6.1%. The industries that attracted the most investment in 2020 were manufacturing, agriculture, and hospitality. FDI is regarded as the primary driver of economic development in the EAC region (Zekarias, 2016).According to Adom and Amuakwa-Mensah (2016), FDI is the primary source of improvement and growth in the manufacturing and trade sectors, resulting in technology transfer, increased domestic production and exports, the availability of decent jobs, and the improvement of country infrastructure in developing countries. Despite a rise in FDI inflows into the EAC and Sub-Saharan Africa as a whole, more effort is needed to improve investment and boost regional economic development (Aust et al., 2020). A substantial amount of data suggests a significant relationship between FDI inflows and economic development in developing nations. (Sahu, 2021). Despite an increase in empirical studies using panel data to determine the impact of FDI inflows in developing countries, few studies use the EAC. The goal of this study is to provide empirical and analytical evidence using five EAC countries to examine the influence of FDI inflow on economic growth from 1990 to 2018. An ample amount of past literature exists that investigates the influence of FDI inflow on the economic growth of emerging nations and comes up with mixed findings (Mahmoodi & Mahmoodi, 2016). For instance, Bekere and Bersisa (2018) Using panel data, discover a negative relationship between FDI and economic growth. In that case, this study aims to fill a research vacuum by investigating the impact of FDI inflows in EAC nations such as Rwanda, Tanzania, Uganda, Burundi, and Kenya.

1.1 FDI inflows in EAC countries

The inflow of FDI to EAC countries has been gradually increasing since the beginning of the 1990s. For example, the average inflow during the 1990s was $ 2.3 billion; however, it remained lower when compared to other regions, such as Asia (UNCTAD, 2019). In the period between 2000 and 2010, FDI inflows in the eastern part of Africa have increased, implying that investment in the EAC region has also increased. Recently, FDI inflows into the EAC have changed over time due to the global financial crisis. During the 1990s, FDI into EAC nations was almost negligible. The surge in FDI occurred in the early 2000s, when average yearly inflows reached 623 million USD, nearly tripling. As the influence of the global economic crisis on FDI inflows to this region was limited during the past ten years, FDI inflows have nearly always increased. In 2010, the region's FDI level reached a pre-crisis level. It then continued to expand, reaching a peak of USD 3650 million in 2013 (Penev and Belgarde, 2014).

Graph 1: FDI inflows in EAC Countries

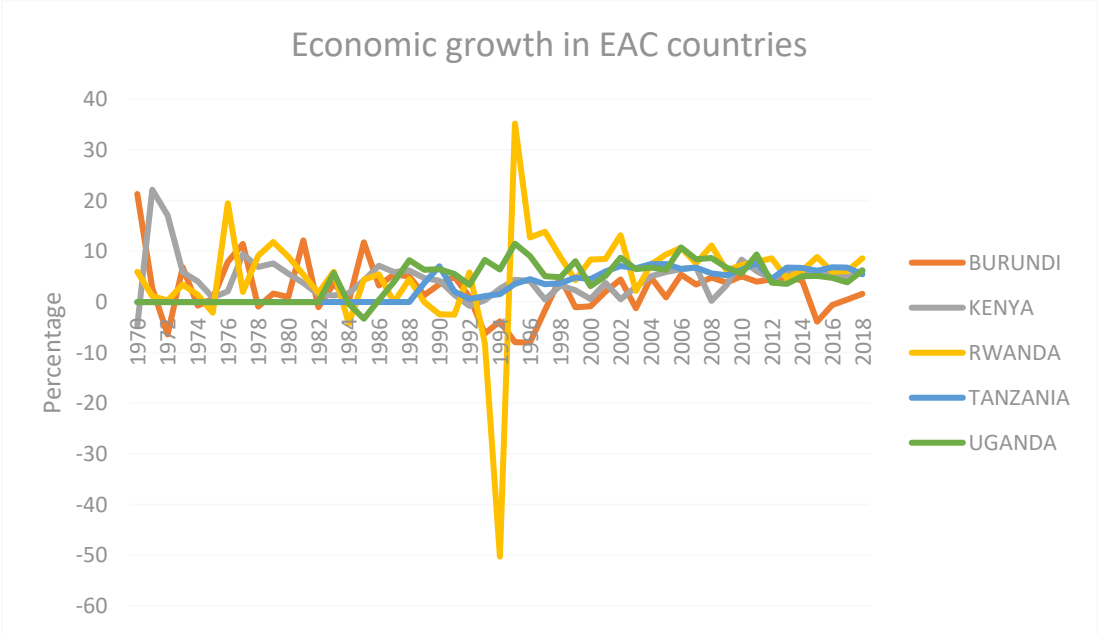


Source: Word Bank Database

1.2 Economic Growth in EAC Countries

The current EAC, also known as the "new" EAC, was established in 1999 as a resuscitation of the "old" EAC, which was established in 1967 and disbanded ten years later for a number of political and economic factors. The headquarters of the new EAC are in Arusha, Tanzania. The EAC is made up of five countries, including Tanzania, Burundi, Rwanda, Kenya, and Uganda. Although the EAC has recently expanded to include countries such as the Democratic Republic of the Congo and the South Sudan, this study focuses on the five key founders of the EAC.The region is considered to have 158 million people and a GDP of $169.5 billion. The region is made up of 2.42 million square kilometers. The trend of economic growth from 1970 to 2018 is summarized in figure 1.1.

Graph 2: Economic growth in EAC countries



Source: Word Bank Database

2.0 Literature Review

Using data from 1975 to 2010, prior study (Fadhil and Almsafir, 2014) Malaysia's economic growth has been evaluated in relation to the influence of FDI inflows. The study employed a diverse approach, including the hierarchical multiple regressions, the unit root test, Johansen co-integration test, and and discovered that FDI has a considerable impact on a country's human capital development. Urgaia (2017) conducted a research to investigate the link between FDI and economic growth measured in GDP from 1970 to 2015, involving seven countries in the EAC. The random effect approach and panel auto-regressive distributed lag are used in the study. The research concludes that FDI has a short- and long-term impact on particular nations' economic growth. According to Bhavish et al. (2016), the contribution of FDI was seen to be considerably larger than domestic investment throughout the period 2008-2014, based on both static panel data regression and dynamic panel estimates by performing VECM-based multivariate causality tests. For the vast majority of the economies studied, the results show a two-way causal relationship between four variables. According to Li and Liu (2005), Through ties with regional human resources and technical infrastructure, FDI and economic development are linked both indirectly and directly. Both developed and developing countries can clearly see the immediate benefits. Johansen cointegration test, Panel-based unit root test, Vector Error Correction Model (VECM) and Fully Modified OLS (FMOLS) were used by Liu et al. (2011) to analyze data from 2000 to 2014. FDI has long-term favorable effects on economic growth, but a short-term negative effect. Addissie Melak (2018) investigated the role of FDI in Ethiopia's economic growth from 1981 to 2013. The OLS technique of time series analysis is usedd to analyze the data. The study relied on the Augmented Dickey Fuller (ADF) unit root test technique. Through the Granger causality model, Jafar Ghasemi Varnamkhasti 1, Nader Mehregan (2014) show a positive and significant impact on FDI inflows in developing countries from 1996 to 2006 for 62 countries. Political stability, a working legal and institutional system, and a positive FDI-growth nexus are necessary (Prüfer and Tondl, 2008). Haussmann and Fernandez-Arias (2000) came to the conclusion that nations with weak institutions and low financial development see higher levels of FDI inflow. Using ordinary least squares and a generalized technique for the data from 1980 to 2013, Olawumi et al., (2016) clearly highlighted that FDI has little or no impact on economic progress in African nations. According to Michalowski's analysis (2012), Inflows of foreign direct investment and their implications on economic development in Sub-Saharan Africa are measured in absolute terms. De Mello (1999) also discovered that the amount of trained labor in the host country, in particular, has a significant impact on whether FDI promotes economic growth. Ronald and Wakyereza (2017) measured the impact of FDI on economic growth using the data from 1985 to 2014 by employing OLS with NLLS and ARMA and adopting the Gauss-Newton-Marquardt steps approach. A cross-country investigation conducted by Alfaro (2003) overall FDI had a hazy influence on host nation economic development; FDI inflows into the primary sector tended to have a negative impact on GDP. Given the modest contributions of neoclassical growth theory, the endogenous growth literature posits that FDI contributes to economic development through technology transfers, labor training, and capital accumulation. (Blomstrom et al., 1996; De-Mello, 1999; Lucas, 1988; Merican, 2009; Solow, 1956). According to Onyimadu and Chukwuemeka (2015), the existence of diminishing returns in capital is the reason why the neoclassical growth model is unable to explain long-term economic growth. Additionally, FDI boosts GDP by creating jobs in the host nation and sharing management and knowledge through forward and backward integration (Brecher and Findlay, 1983). Makki (2004) provided evidence that trade and FDI have a positive influence on economic growth. Growth occurs when FDI interacts with trade and domestic investment. Durham (2004) noted that, although FDI may drive economic development in the majority of developing countries,

the scale of the benefits is dependent on trade policies, the ability of local enterprises to absorb foreign capital, and labor force capabilities (Felipe, 1997; Durham, 2004). 3.0 Data and variable.

3.1 Data Sources

The current study used secondary data retrieved from the Word Bank database. The data used is from the period of 1990–2018 and comes from five East African countries, including Rwanda, Uganda, Tanzania, Burundi, and Kenya. In order to come up with appropriate findings, the Stata application is used as a tool for data analysis. Economic growth, as measured by GDP as a dependent variable, FDI as an independent variable, population, general government final consumption expenditure, and inflation-adjusted consumer prices are the main variables.

3.2 Empirical Methodology

To estimate co-integration in order to observe the relationship between FDI and economic growth in EAC countries, the current study involved four important step techniques, namely the unit root test, Granger causality, cointegration, and dynamic ordinary least square (DOLS).

3.2.1 Dynamic Ordinary least square (DOLS)

For panel analysis, Saikkonen (1991), Stock and Watson (1993), and Kao and Chiang (1997) introduced dynamic ordinary least square (DOLS). Endogenous feedback effects from the dependent variable to the regressors are absorbed by the initial differences of the regressors, which comprise leads and lags. The DOLS estimator is hence consistent, in contrast to OLS, even when the regressors are endogenous. Due to the following factors, this method was preferred over the Johansen and Juselius methodology and static OLS. First off, it is more reliable and suitable for tiny samples, implying accurate and effective estimations (Singh, 2010; Suleiman and Suleiman, 2017). Second, the approach is more suited when there is an endogenous relationship between the variables, as in our situation. The following is a formulation for the DOLS equations: -

$$LGDP_t = \alpha + \beta_1 LFDI_{it} + \beta_2 LCONS_{it} + \beta_3 LINF_{it} + \beta_4 LK_{it} + \beta_5 LPOP_t + \sum_{j=-q}^{p} \phi \Delta FDI_{it}$$

$$+ \sum_{j=-q}^{p} \partial \Delta LCONS_{it} + \sum_{j=-q}^{p} \omega \Delta LINF_{it} + \sum_{j=-q}^{p} \varphi \Delta LK_{it} + \sum_{j=-q}^{p} \delta \Delta POP_{it} + \varepsilon_{it}$$

4.0 Analysis and results

4.1 Descriptive statistics

The descriptive statistics for the study's major variables are shown in Table 3. The total number of observations in the analysis is 145. The average FDI inflows annually, real GDP, consumption is 18.099,22.95 and 20.66 respectively. Inflation rate, gross fixed capital formation and population growth in average are 2.418, 20.99 and 2.366 respectively.

Table 1: Descriptive Statistics for Key Variables

	LRGDP	LFDI	LCONS	LINF	LK	LPOPG
Mean	22.95206	18.09924	20.66942	2.418754	20.91212	2.317956
Median	23.25990	18.55681	20.71926	2.421647	20.99378	2.366317
Maximum	24.84687	21.46195	23.15270	3.907886	23.66282	2.765322
Minimum	20.92937	0.000000	18.25473	0.000000	17.00225	0.000000
Std. Dev.	1.179648	2.458920	1.169864	0.620542	1.617231	0.285414
Jarque-Bera	12.56777	2163.834	3.691558	25.24471	4.720230	9552.098
Probability	0.101866	0.200000	0.157902	0.300003	0.494409	1.300001
Observations	145	145	145	145	145	145

The standard deviation of each individual series is low in comparison to its mean, indicating a low coefficient of variation for the series. The Jarque-Bera test statistics fail to reject the null hypothesis of each variable's normal distribution, confirming that the series are normally distributed.

4.2 Correlation analysis

Table 4 demonstrations the pairwise correlation matrix for the key variables involved in the analysis. All independent variables depict a positive linear association with economic growth. Furthermore, all independents have small correlation which showed that there is no perfect multicollinearity problems. Hence, this study showed the normality of distribution.

Table 2: Correlation Matrix for Key Variables

Correlation	LRGDP	LFDI	LCONS	LINF	LK	LPOPG
LRGDP	1.000000					
LFDI	0.652952	1.000000				
LCONS	0.937440	0.679032	1.000000			
LINF	0.096219	0.043999	0.043406	1.000000		
LK	0.946546	0.711275	0.652026	0.015271	1.000000	
LPOPG	0.224886	0.134038	0.231214	-0.030126	0.205499	1.000000

4.3 Regression Result

4.3.1 Panel Unit roots

The unit root test is used to assess if a time series is stationary or non-stationary. The mean, variance, and autocovariance of a time series are considered stationary if they all equalize at the measurement point. A time series, on the other hand, is nonstationary if its mean, variance, and autocovariance are not the same at every point in time. This indicates that the time series data has a unit root issue. Time series must be stable because correlation may remain in non-stationary time series even if the sample size is extremely high, resulting in misleading or nonsensical regression. Panel unit root testing was performed in this investigation. The panel unit test can accommodate a large number of observations while accounting for both cross-sectional and time-series variance in data. To reject the null hypothesis, 5% and 10% statistically significant levels were utilized in this investigation.

Table 0.1: Panel unit root results (level)

Variables	Constant ADF test at Level Statistics	P-value	ADF test at First Difference Statistics	P-value
LGDP	5.04564	1.0000	-4.54320	0.0000
LFDI	-0.42627	0.3350	-4.72433	0.0000
LCONS	2.13911	0.9838	-9.03556	0.0000
LINF	-1.27167	0.1017	-1.97187	0.0243
LK	2.78906	0.9974	-7.07200	0.0000
POP	-1.23467	0.1085	-0.62127	0.0039

Table 4.1 shows the results of the unit root test (ADF). The data indicate that the null hypothesis of unit root at level cannot be discarded. However, if the first difference is taken into account, the null hypothesis of unit root may be rejected. As a result, the data strongly imply that at initial difference I, all variables are stationary (1).

4.3.2 Panel Cointegration Test

In the literature, there has been a lot of discussion on the use of panel cointegration approaches to check for the existence of long-term links among integrated variables that have both a time series dimension, T, and a cross-section dimension, N. This study used Padreni co-integration

to examine whether there was a long-term link among the non-stationary variables after determining that all series were I (1). Table 4.3 displays the results of the co-integration tests.

Table 0.2: Padreni Panel cointegration results

Dependent Variable = LRGDP
Independent Variables = LFDI LCONS LINF LK LPOP

	Statistic	Prob.
Panel v-Statistic	6.548391**	0.0000
Panel rho-Statistic	1.949624	0.9744
Panel PP-Statistic	0.702277	0.7587
Panel ADF-Statistic	0.958212	0.8310
Group rho-Statistic	2.233372	0.9872
Group PP-Statistic	-1.396943*	0.0812
Group ADF-Statistic	0.448992*	0.0733

Note: *; ** represent statistical significance at 10% and 5%

Constant uses four panel statistics and three group statistics to test the null hypothesis of no cointegration versus the alternative hypothesis of cointegration. Table 4.3 displays the within-group and panel cointegration test statistics for the cointegration between the variables. Group ADF, The Panel v-Statistic and Group PP statistic statistic results reject the null hypothesis of no cointegration at the 5% and 10% levels of significance. It is believable to assert that the variables in the growth model are cointegrated because there is significance in the majority of group and statistic panels.4.2.3 Relationship between FDI and Economic growth.

Relationship between FDI and Economic Growth

The results of the FDI and economic growth model for the EAC countries based on the DOLS estimator are shown in Table 4.4. To prevent the autocorrelation issue and take into account the endogeneity of the independent variables, leads and lags must be included in the estimation. To obtain reliable findings, the estimator employed a set of lags and leads with one-year lags and one-year leads DOLS (1, 1). According to the projected results, there is a correlation between FDI and economic growth in the EAC countries, however it is only statistically significant at 10%. This suggests that FDI has a favorable impact on these countries' economic development. This outcome is in line with what Hemed and Suleiman found (2017). In practice, these findings corroborate the new growth theory, which holds that growing FDI has an impact on the economy's long-term growth through its influences on technical transformation. The outcome also demonstrates a positive relationship between stock market value and economic growth, which is statistically significant at 5%. This indicates that raising capital stock will improve the area's economic performance. A study by Suleiman and Suleiman (2017) that emphasized the fact that economic growth will rise if there is an increase in the capital stock lends weight to this conclusion.

Table 0.1: DOLS estimates of the long run effect of FDI on economic growth for EAC Countries

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LFDI	0.089600	0.046470	1.928099	0.0602**
LCONS	-0.161663	0.101552	-1.591922	0.1184
LINF	0.081973	0.069745	1.175320	0.2460
LK	0.447456	0.098188	4.557116	0.0000*
LPOPG	0.302889	0.091573	3.307628	0.0019*

Note: *; ** reject the null of no cointegration at 5% and 10% level respectively

The results also show a 5% statistically significant positive link between population increase and economic growth. This indicates that a rise in population will boost the area's economic performance. However, for the case of EAC countries, neither consumption nor inflation are statistically significant.

4.3.4. Granger Causality

Based on the co-integration findings, it is feasible to conclude that variables are co-integrated and hence causally connected. To explore the direction of causation between variables, the Granger causality technique is utilized. The Granger causality test findings, shown in Table 4.5, demonstrate that there is a one-way relationship between economic growth and foreign direct investment, with only an increase in economic growth driving an increase in FDI. The results, however, show that there is no link between consumption and economic progress among EAC members.

Table 0.2: Granger causality Test

Null Hypothesis:	Observation	F-Statistic	Prob.
LFDI does not Granger Cause LRGDP	120	1.26486	0.2844
LRGDP does not Granger Cause LFDI		2.12141	0.0682*
LCONS does not Granger Cause LRGDP	120	1.43098	0.2188
LRGDP does not Granger Cause LCONS		1.26860	0.2827
LINF does not Granger Cause LRGDP	120	4.53951	0.0008**
LRGDP does not Granger Cause LINF		1.58977	0.1690
LK does not Granger Cause LRGDP	120	2.80899	0.0200**
LRGDP does not Granger Cause LK		1.07326	0.3793
LPOPG does not Granger Cause LRGDP	120	32.9820	2.E-20**
LRGDP does not Granger Cause LPOPG		9.66499	1.E-07**

Note: *; ** represent statistical significance at $p < 0.01$ and $p < 0.05$.

The results, on the other hand, demonstrates a one-way causal relationship between capital stock and economic development. The outcomes back up the neoclassical growth theory. However, the outcome demonstrates a bidirectional causal relationship between population growth and economic expansion at a 1% significant level in EAC countries during the study period.

5.0 Conclusion

This research examined the impacts of FDI inflows in EAC nations using panel data analysis, the DOLS as the primary approach, and data from 1990 to 2018. According to the report, FDI has a favorable impact on economic development in the EAC. Based on the findings, this shows that marketing seeking is what is driving FDI into SADC nations. According to the report, the country's sizable market is advantageous for foreign investment because it has grown as a result of the acceptance and liberalization of free trade among the African nations. Last but not least, the member state should reduce or remove the investment and trade barriers to allow free trade, which will expand the market by reducing transportation costs, taxes, and other duties.

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