

Chapter 14

Bivariate Causality between FDI Inflows and Economic Growth in India Since 1990

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ABSTRACT

Nowadays, most of the countries in the world mostly concentrate on the flow of FDI, because it has direct relationship with economic development. The present study attempts to make a contribution in this context, by analyzing the existence and nature of causalities, if any, between FDI and economic growth in India since 1990, where growth of economic activities and FDI has been one of the most pronounced. The results indicate that there is a strong correlation between FDI inflows and GDP in India. And also there is unidirectional causal relation between FDI and GDP. Finally as co-integration shows there is no long run relationship between FDI and economic growth in India.

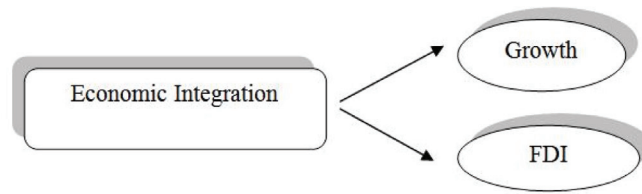
INTRODUCTION

The name Foreign Direct Investment (FDI) usually brings to mind a significant contribution of FDI to domestic investment. However, there has been a lot of skepticism concerning the contribution of inward FDI to domestic investment. It is considered as the most powerful driver of the economic development. Nowadays, most of the countries in the world mostly concentrate on the flow of FDI, because it has direct relationship with economic development.

Over the past two decades, many countries around the world have experienced substantial growth in their economies, with even faster growth in international transactions, especially in the form of FDI. The share of net FDI in world GDP has grown five-fold through the eighties and the nineties, making the causes and consequences of FDI and economic growth a subject of ever growing interest. This study attempts to make a contribution in this context, by analyzing the existence and nature of causalities, if any between FDI and economic growth, where growth of economic activities and FDI has been one of the most pronounced.

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Figure 1.



FDI has a major role to play in the economic development of the host country. Over the year it has helped the economies of the host countries to obtain a launching pad from where they can make further improvements. This trend has manifested itself in the last twenty years. Any form of FDI pumps in a lot of capital knowledge and technological resources into the economy of a country.

This is where the foreign direct investment can come in handy. It can also assist in helping economically under developed countries build their own researches and development bases that can contribute to the technological development of the country. This is a very crucial contribution as most of these countries are not able to perform these functions on their own. These assistances come in handy, especially in the context of the manufacturing and services sector of the particular country, that are able to enhance their productivity and ultimately advance from an economic point of view.

Today attracting FDI has become an integral part of the economic strategies for developing countries like India. FDI ensures a huge amount of domestic capital, production level and employment opportunities in the developing countries, which is a major step towards the economic growth of the countries. FDI has been a booming factor that has bolstered the economic life.

By contrast, according to the bulk of the literature on FDI and growth, causation would run from FDI to growth. Economic integration could then also be accommodated in either of two ways, as shown in Figure 1.

There is a general theoretical consequences ensure among development economists that FDI inflow is likely to play a crucial role in explaining growth of recipient countries. FDI inflows in fact represent additional resources a country needs to improve its economic performance and provides both physical capital and employment possibilities that may not be available in the host market while many studies observe positive impacts of FDI on economic growth.

FDI has been proved in the literature to be an important promoter of growth in its own right. In fact, FDI is argued to increase the level of domestic capital formation. This also implies producing on large scale which in turn results in benefits of economies of scale and specialization and also increasing export and employment opportunities. These are likely to result in positive economic impacts.

In general, economists agree that FDI inflows lead to an increased rate of economic growth. A major growth enhancing characteristic of FDI is the advanced technology that often accompanies foreign capital investment. In addition, domestic investors can also adopt this advanced technology. In other words, FDI generates positive externalities through technology spill over. At the same time, increased foreign capital can help to narrow the savings gap i.e. the gap between the domestic savings ratio and the desired level of investment ratio. In short, FDI should exert positive effects on economic growth. Particularly in developing countries which suffer from low productivity and capital stock delicacies.

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