IMPACT OF FOREIGN DIRECT INVESTMENT ON DOMESTIC INVESTMENT IN DEVELOPING COUNTRIES

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ВЛИЯНИЕ ПРЯМЫХ ИНОСТРАННЫХ ИНВЕСТИЦИЙ НА ВНУТРЕННИЕ ИНВЕСТИЦИИ В РАЗВИВАЮЩИХСЯ СТРАНАХ

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Abstract. Author analyzes the impact of foreign direct investment on domestic investment in host developing countries and checks whether a foreign direct investment has a "positive" or "negative" impact on domestic investment, as well as evaluating the impact of selected variables on this relationship. Using a full sample, the main conclusion of this study is that FDI does have a positive (crowding out) effect on domestic investment in this sample of developing economies. In the short term, an increase in FDI by one percentage point as a percentage of GDP leads to an increase in total investment as a percentage of the host country's GDP of about 10.7%, while in the long term this effect is about 31% dollar terms, one US dollar represents us 1.7$ of total investment in the short term and us 3.1$ in the long term. Based on the results of this study, it was once again proved that inflation hinders domestic investment in host countries by 0.04% and 0.12% in the short and long term, respectively.

Аннотация. Работа посвящена анализу влияния прямых иностранных инвестиций на внутренние инвестиции в принимающих развивающихся странах и проверке того, оказывают ли прямые иностранные инвестиции «положительное» или «негативное» воздействие на внутренние инвестиции, а также оценке влияния выбранных переменных на эту взаимосвязь. Основным выводом данного исследования с использованием полной выборки является то, что прямые иностранные инвестиции действительно оказывают положительное (вытесняющее) влияние на внутренние инвестиции в этой выборке из развивающихся стран. В краткосрочной перспективе увеличение прямых иностранных инвестиций на один процентный пункт в процентах от ВВП приводит к увеличению общих инвестиций в процентах от ВВП принимающей страны примерно на 10,7%, в то время как в долгосрочном плане этот эффект составляет примерно 31% долларов. Таким образом, один доллар США представляет собой 1,7$ США от общих инвестиций в краткосрочной перспективе и 3,1$ США в долгосрочной перспективе. По результатам этого исследования было еще раз доказано, что инфляция препятствует внутренним инвестициям в принимающих странах на 0,04% и 0,12% в краткосрочной и долгосрочной перспективе, соответственно.

Keywords: transnational enterprises, domestic investment, aggregate capital accumulation, crowd effect, displacement effect, real domestic interest rate.

Ключевые слова: транснациональные предприятия, внутренние инвестиции, совокупное накопление капитала, эффект толпы, эффект вытеснения, реальная внутренняя процентная ставка.

Introduction

Developing countries to obtain a package of assets that multinational enterprises (MNEs) deploy with their investments have attracted foreign direct investment (FDI). Most of these assets are intangible in nature and are particularly rare in developing countries. These include technology, management skills, international sales channels, product design, quality characteristics, brand names, and so on. However, when assessing the impact of FDI on development, the key question is whether MNEs contribute to the growth of domestic investment (such as when their presence encourages new downstream or upstream investment that would not have occurred in their absence), or whether they have the opposite effect, displacing domestic producers or outstripping their investment opportunities.

The domestic investment is one of the most reliable determinants of economic growth, which was also supported by Levine and Renelt and Mishra et al. The empirical literature also notes that foreign capital inflows positively affect domestic investment in host countries, rather than displace it [1]. A number of studies in this area have shown that foreign capital inflows have a positive impact on domestic investment [2]. If FDI displaces domestic investment or does not contribute to capital accumulation, there is every reason to doubt its benefits for recipient developing countries. In addition, given the lack of domestic entrepreneurship and the need to develop existing entrepreneurial talent, the conclusion that MNEs are replacing domestic firms will also cast doubt on the development impact of FDI. These issues become even more important when we consider that FDI is far from marginal. FDI contributes significantly and increasingly to total gross capital formation in developing countries. FDI accounts for a much larger share of investment in developing countries than in developed countries, especially in Latin America in recent years. The phenomenal growth of FDI inflows to developing countries in the 1990s sparked considerable debate about the impact of FDI on host economies. Although the relationship between FDI and host country economic growth has been the subject of many recent empirical studies, including the previous Chapter of this study, the relationship between FDI and domestic investment has been relatively ignored.

A typical question was asked about whether FDI is "mass" domestic investment. In theory, FDI can have both positive and negative effects on domestic investment. FDI can stimulate domestic investment in host countries through production links between foreign and domestic firms, through the introduction of new products and services into the host economy, and through the transfer of technology and knowledge. On the other hand, it can discourage domestic investment by raising real domestic interest rates or raising the real domestic exchange rate [3].

Most empirical studies examining the relationship between domestic investment and economic growth suggest that high growth rates are associated with high rates of domestic investment [4–5]. Since domestic investment is a key driver of economic growth, if FDI does have a negative impact on domestic investment, host country policy makers should review the various forms of investment incentives they offer to attract more FDI.

Since, in theory, FDI can have a positive or negative impact on domestic investment in host countries, an empirical study is indeed needed to determine the overall effect of FDI. Therefore, the main purpose of this study is to contribute to the empirical literature on investment by examining the impact of FDI inflows on domestic investment in host countries. In particular, it aimed to answer the following main question: whether the overall inflow of FDI pushes domestic investment or displaces it.

Material and methods

Due to the lack of data on private investment, this study used total gross domestic investment, which is the sum of private and public investment. It is extremely important to note that, according to al-Sadig (2013), the problem with using this variable of gross domestic investment is that it can lead to biased estimates of coefficients, and the bias can be in any direction [6]. Since public investment can play a positive role in improving the productivity of private firms by investing in physical and human infrastructure, the assessment of the impact of FDI on total domestic investment will be skewed upward. That is if a private investment has increased due to increased public investment, the effect of FDI will be overestimated. On the other hand, when public investment is replaced by FDI through the privatization of state-owned companies, this will reduce the level of domestic investment, since some of the public investment has been sold to foreign investors. Thus, if FDI displaces private investment, the displacement effect will be shifted downward. In addition, first, since foreign investors expect to invest in the private sector, mainly in the manufacturing sector, it is very important to be able to assess how private investment is determined by the difference between total and gross domestic investment and public investment. This Chapter used a panel analysis of 53 developing host countries for the period 1997–2011. Second, most existing empirical studies do not fully control the simultaneous flow of FDI and domestic investment, and therefore this lack may lead to distortion of coefficient estimates. Domestic monetary policies that raise domestic interest rates can increase FDI inflows while discouraging domestic investment. On the other hand, an internal shock that improves a country's location advantage can encourage both domestic and foreign investment. Thus, there is a two-way relationship between FDI and domestic investment. Therefore, there is an econometric model, namely the system generalized method of moments (GMM), which eliminates this potential bias.

Results and discussion

Whether FDI will displace domestic investment, especially in developing countries, has been the subject of academic debate for many years. These studies used two different methods: macroeconomics and microeconomics. Macro-economic research usually uses aggregate investment indicators for a specific host country or group of countries, while micro-economic research uses firm-level data. In addition, empirical data on the impact of FDI on domestic investment vary. In General, three prevailing views can be identified from the above literature: displacement [2, 7], displacement [8–9], and lack of effect [10].

Table illustrates the results of selected previous studies on the crowding-out effect of FDI in developing countries and countries with economies in transition. It should be noted that, according to previous studies, crowding and side effects are closely related to each other. Side effects can, on the one hand, stimulate domestic investment to the extent that new knowledge has been applied and new technologies introduced; on the other hand, they complement domestic investment, which can create the necessary prerequisites for implementing side effects in the first place. Thus, crowding in effects is usually accompanied by side effects in domestic investment. In addition, Graham and

Krugman (1993) suggested that domestic firms have better knowledge and access to domestic markets, and if a foreign firm decides to enter the market, it should do so with lower costs and higher production efficiency than its domestic competitors. It is likely that a combination of advanced technologies and management skills will lead to the higher efficiency of FDI, especially in the case of developing countries. Thus, FDI can be seen as the main channel through which advanced technologies can be transferred to developing countries [11].

Van Loo (1977) also used the time series method to test the impact of FDI inflows on total investment in Canada, using data for the period 1948-1966 [12]. Van Loo found that 1$ of FDI led to an increase of about 1.4$ in total Canadian investment. However, Fry (1993) found negative effects on the correlation between FDI and PI by studying 16 developing countries between 1966 and 1988 [2]. In addition, by disaggregating data, the FRY found that FDI is significant in only three countries. It is significantly negative in Chile, but significantly positive in Indonesia and Malaysia. This split the data sample into two groups: five market economies in the Pacific and 11 developing countries. FDI has reduced domestic investment in these 11 developing countries, but it has stimulated PI in five market-oriented developing countries in the Pacific [12–13].

In addition, again and Machado (2005) investigated the impact of FDI on population movement on domestic investment in developing countries over a 26-year period since 1970 [9]. They looked at data for three developing regions-Africa, Asia and Latin America. Their results show strong displacement of FDI in Asia and displacement in Latin America. In Africa, FDI increased overall investment by a one-to-one ratio, which means that it does not have a noticeable impact on domestic investment. In addition, when the sample period was divided into two sub-periods (1976–1985 and 1986–1996), the results varied only for Africa, which appears to have a crowding effect rather than no effect. Similar studies have been conducted by other researchers, such as fry (1993) and Misun and Tomsik (2002) [14]. Agosin and Mayer (2009) studied the impact of FDI on domestic investment using panel data for the period 1970–1996 for three developing regions-Africa, Asia and Latin America [15]. They found a neutral impact of FDI on total investment in Africa, displacement in Asia, and displacement in Latin America between 1970 and 1996. Dividing this period into two sub-periods, 1976–1985 and 1985–1996, their results differed only for Africa, which showed that it had a displacing rather than neutral effect.

Razin (2003) found that FDI contributes positively to economic growth more than other types of foreign capital flows [16]. Wang and Li (2004) quantified the impact of FDI on domestic investment using a large sample of panel data and compared different estimates for "absolute" and "relative" models. Wang and Li did not find any significant displacement or displacement effects in China at the country level [17]. However, further analysis in this study revealed significant regional differences, with the displacement effect dominating in Eastern China and the displacement effect dominating in middle China, and no significant effect was found in Western China. Mileva (2008) analyzed the impact of FDI, portfolio investment, and long-term Bank loans on PI for 22 transition economies, taking into account the financial market and institutional development. The results showed that FDI tends to increase PI by more than one additional us dollar [17].

FDI can negatively affect domestic investment by raising the domestic interest rate if foreign investors intend to borrow domestically. The same argument applies to government borrowing. In other words, if the government borrows funds from domestic financial markets to finance its budget deficit, it can raise the domestic interest rate, which in turn displaces domestic investment. Thus, a high budget deficit can negatively affect domestic investment either by raising the interest rate or by reducing loans to domestic sectors [18–21]. In the literature, the interest rate is usually considered as a representative indicator of the cost of capital. However, as suggested by Jorgenson (1963), the

real interest rate may harm the desired capital stock, but not on investment flows. Therefore, it is not clear whether the real interest rate should be included in the investment function [22–23]. Due to the lack of data on the real interest rate, the study did not take this variable into account in the analysis.

In particular, there are several channels for open economy factors to influence domestic investment. The first channel is the degree of openness that positively affects domestic investment [19, 23–24]. In this case, you can expect an ambiguous effect. According to Balasubrahmanyam et al. (1996), an economy highly integrated in the world is expected to attract investment in tradable sectors to increase productivity and competitiveness [23]. However, a sharp increase in exposure to external competition in some sectors may make these sectors less attractive as destinations for new capital flows [25].

Foreign capital inflows, especially FDI, can affect domestic investment by lowering the interest rate or increasing the credit available to Finance new domestic investment, given a favorable business environment, strong institutions, and financial development in host countries [22, 24, 26]. In this way, enabling institutions encourage domestic investment by providing a return on all investments made by foreign and local investors. This variable has been measured by various proxies in various literature sources, such as the index of corruption, property rights, and political freedom [17, 21, 25].

Economic freedom can be defined as "the absence of government coercion or restrictions on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain freedom" [19]. Economists agree that economic freedom, along with political freedom and civil liberties, is one of the pillars of the country's institutional structure. Since the time of Adam Smith, economists have recognized that free choice and supply of resources, competition in business, free trade with others, and guaranteed property rights are key elements of economic development. Economic freedoms are a reflection of an institutional structure that facilitates entrepreneurial activity and the implementation of business ideas for entrepreneurs and managers. A large number of papers suggest that economic freedom plays an important role in explaining cross-country differences in economic performance [21]. However, this effect may differ depending on the various components of economic freedom [19, 26].

In addition, external debt has a negative impact on domestic investment through the debt overhang channel and the credit rationing channel [7]. The idea behind this hypothesis is that debt overhang theory assumes that if a country's external debts are expected to exceed its solvency in the future, then the expected debt service is likely to be an increasing function of the country's level of production. Thus, part of the income from domestic investment is actually " taxed" by existing foreign creditors, and therefore domestic investment will be reduced [11, 24]. Data on this variable is also not available for some sample countries, and therefore the article does not consider the role of this factor in the study.

The analysis was based on a dynamic investment equation that includes FDI in the host country along with a set of control variables. A dynamic feature of the model arises from the inclusion of a lagging dependent variable in the number of explanatory variables discussed below. Thus, in the light of this discussion, the basic investment equation can be expressed in the following linear form:

$$DI_{i,t} = \beta_0 + \beta_1 DI_{i,t-1} + \beta_2 FDI_{i,t} + \beta_3 GDPG_{i,t} + \beta_5 INF_{i,t} +$$
$$+\beta_6 OPEN_{i,t} + \beta_8 FIN_{i,t} + B_9 INSTITUT_{I,t} + \varepsilon_{i,t}$$
$$\varepsilon_{i,t} = \eta_i + v_{i,t} \; i = 1, \, 2 \ldots N \; and \; t = 1, \, 2, \ldots T$$

Where (i) is the host country index, (t) is the time index, (β) s is the unknown parameters to be evaluated, and (ε) is the usual term for random perturbation. The dependent variable (DI) is domestic investment as a percentage of GDP. The main interest of this empirical study is the sign and value (β2) (i. e. the impact of FDI inflows on domestic investment in the host country).

The choice of control variables was motivated by the relevant existing empirical work mentioned above and the availability of data. The past value of domestic investment was expected to encourage domestic investors to invest more, as this could be a sign of a good investment climate (positive feedback effect). The growth rate of real GDP was used to capture the traditional acceleration effect, and it was expected to have a positive effect, as the increase in income would stimulate domestic investment. In addition, as investors look ahead, the fast-growing economy is expected to drive future expectations and hence domestic investment. Macroeconomic instability is controlled by the rate of inflation (INF), and it is expected to have a negative impact on domestic investment. The degree of trade openness of the host country (OPEN) was measured by the sum of exports and imports as a percentage of GDP, and it was expected that a high degree of trade openness would lead to increased domestic investment. Credit provided to the private sector as a percentage of GDP (FIN) was used as an indirect indicator of financial development, and the effect was expected to be positive. Finally, Feng (2001) found that political freedom encourages domestic investment through improved human capital formation, and so it was expected that democracy had a positive impact on domestic investment. Thus, democratic institutions are controlled by the index of economic freedom (INSTITUT).

The model above assumes that FDI is an exogenous variable. However, a particular problem in assessing the impact of FDI on domestic investment is the endogeneity of FDI inflows. In other words, there is a possible two-way link between FDI and domestic investment. For example, an internal shock that can have a positive impact on the return on capital, and this may increase both domestic investment and FDI inflows. In addition, any monetary policy that affects the level of the domestic interest rate can affect both types of investments. For example, if policies are aimed at raising domestic interest rates, FDI will be attracted to that country while deterring domestic investment [2]. Ignoring the problem of endogeneity would lead to biased estimates of coefficients that can be in any direction [17].

This study used balanced panel data for 53 developing countries for the period 1997–2011. Domestic investment is measured by gross capital formation as a percentage of GDP. FDI is measured by foreign direct investment inflows as a percentage of GDP. Data on the growth rate of real GDP, FDI inflows, the level of inflation, the amount of exports and imports to GDP as an indicator of the degree of openness and availability of credit to the private sector are received as an indicator of financial development from the world Bank, World Development Indicators (WDI). With the exception of inflation and real growth rates, all variables were measured as a percentage of GDP. Finally, there are two main sources of economic freedom index (INSTITUT) data that are widely used in the literature, namely the Fraser Institute and the heritage Foundation. They are similar in many aspects [20], BUT the heritage Foundation includes data for most of the countries of the Commonwealth of Independent States (CIS), especially those in Central Asia. Therefore, it is preferable to use data from the heritage Foundation in this work. Since most of the components of the economic freedom index were covered by the control variables in the model, only two of the nine economic freedom variables (composed of two indicators: property rights and freedom from corruption indices) were used to assess the quality of institutions.

The main goal of this paper is to empirically test the relationship between FDI and aggregate investment in the long term. The corresponding coefficient for the LR effect of FDI was obtained from equation (1) as follows:

$$\beta_{LR} = \frac{\beta_2}{1 - \beta_1}$$

1. If $\beta_{LR} = 1$, this means that in the long run, one unit of FDI inflows will increase total investment by the same amount, which indicates that FDI does not affect domestic investment;

2. If $\beta_{LR} > 1$, this means that in the long run, one unit of FDI inflows will increase total investment by more than one unit, meaning that FDI inflows will have a positive (crowding out) effect on domestic investment;

3. If $\beta_{LR} < 1$, this means that in the long run, one unit of FDI inflows will increase (or even negatively change) the total investment volume by less than one unit, meaning that FDI will have a negative (crowding out) effect on domestic investment.

Table.

THE IMPACT OF FDI ON DOMESTIC INVESTMENT; 1997-2011 YEARS (MODEL A TWO-STEP SYSTEM GMM, DEPENDENT VARIABLE: DOMESTIC INVESTMENT)

	1	2
Stragglers DI	0.660*** (0.039)	0.724*** (0.041)
FDI	0.107*** (0.030)	0.171*** (0.054)
Height RGDP	0.583*** (0.049)	0.658*** (0.056)
Inflation	−0.00043** (0.00017)	−0.00045** (0.00022)
Openness	0.008* (0.010)	0.025* (0.014)
Finance	0.031* (0.017)	0.020 (0.017)
Institutions	0.033 (0.035)	
• Freedom from corruption		0.032** (0.015)
• The rights of the owners		−0.015 (0.031)
Constant	5.681* (2.983)	2.157* (3.563)
Observations	794	794
tool variables	60	66
P-Arellano-Bond test for AR (2) in first diff.	0.348	0.549
P-Hansen test for over id. Restriction	0.728	0.924
Diff. in Hansen test of echtgenote instr. subsets	0.781	0.778

Standard errors are shown in parentheses. The system includes a dummy time variable to account for period-specific effects. * ,**, * * * denote significance at 10%, 5%, and 1%, respectively. Mannequins of the region and time were used in the analysis.

The results showed that domestic investment is a function of past domestic investment. Since lagging dependent variables are included in the right side of the equation, the dynamic panel data model is an appropriate econometric model that takes into account the constancy of the dependent

variable. Instrumental variables were used to solve the problem of endogeneity within explanatory variables. That is, a large and significant coefficient of the lagging dependent variable indicates high inertia of domestic investment, which confirms the conclusions of Borenzsteinet al. [2, 17, 21].

Conclusion

The article's empirical conclusions can be summarized as follows. The results to some extent confirmed the results of the empirical studies given above, even the estimated effects of some independent variables were less. Using a full sample, the main conclusion of this study is that FDI does have a positive (crowding out) effect on domestic investment in this sample of developing economies. In the short term, an increase in FDI by one percentage point as a percentage of GDP leads to an increase in total investment as a percentage of the host country's GDP of about 10.7%, while in the long term this effect is about 31 percent In dollar terms, one US dollar represents us 1.7$ of total investment in the short term and us 3.1$ in the long term. Investments made in the past have given a positive incentive to existing investors to invest more and encourage other local investors to enter the domestic market. The basis for this statement is a large and significant coefficient of the lagging dependent variable. According to the accelerator theory, production growth plays an important role in the investment function and is supported by a positive and very significant correlation between GDP growth and domestic investment. Based on the results of this study, it was once again proved that inflation hinders domestic investment in host countries by 0.04% and 0.12% in the short and long term, respectively. Financial development was seen as another incentive as a stock of domestic investment factors to attract local investors to domestic business. The correlation of financial development is consistent with the argument that the more loans to private sectors, the higher the level of domestic investment in the economy. The openness coefficient showed that there is a positive significant relationship between the openness of host economies to trade and domestic investment.

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