Impact of Selected Macro-Economic Variables on Foreign Direct Investments (FDI) in Sri Lanka

Hapuhinna, H.K.D.W.M.N.A.H.
Department of Accountancy & Finance
Faculty of Management Studies
Sabaragamuwa University of Sri Lanka
navo256@gmail.com

Dayarathna, D.A.I.
Department of Accountancy & Finance
Faculty of Management Studies
Sabaragamuwa University of Sri Lanka
indunildaya@gmail.com

Introduction

Foreign Direct Investment (FDI) is one of the major sources of external finance sources for all countries, especially for developing countries. Therefore, FDI is regarded as, an investment involving, acquiring or creation of assets that is undertaken by foreign investors or a joint venture with local governments with the main aim of creating a long-term relationship. In simple terms, FDI is international capital flow from one country to another country in order to get advantage from investment opportunities and to deliver positive production effect for the recipient country. Moreover, FDI has become one of the significant players in economic growth of a country. One of the main economic problems faced by developing economies is the insufficiency of national savings to finance their potential investments. Therefore, governments are in constant look out for foreign capital investments. In view of addressing this issue, most governments seek loans from international commercial banks. However, this further aggravates the debt burden to the economy. Therefore, along with the benefits, it also brings more liabilities to the country. As a result governments prefer a comparatively easier source of financing; which is FDI. The realization of the benefit package that tags along with the capital inflow has made FDIs more attractive. Infrastructural developments, employment opportunities, new technology and knowledge, are few of the positive inflows to the host country from FDI inflows. In recent years governments have made changes to their policies and regulations to encourage more foreigners to invest in their countries. However, the sustainability of these amendments is still questionable and open to discussion. What drives FDI needs to be addressed objectively for the policy implications to be effective. Many researchers have focused their studies to find the determinants of FDI inflow to a country. The literature shows that there is no conclusive argument on factors determining FDI. Furthermore, there are several theories which attempt to explain the determinants of FDI. According to Lipsey (2001) Macro-economic theories explain what motivates investors to invest in foreign countries, explain the phenomena associated with the macro-economy. Macro-economic factors such as gross domestic production, exchange rate, inflation, population, labor force, economic growth and interest rate affects the host country's FDI flows. Researchers have found varying relationships among these variables and FDI inflow. Adding to that literature pool, this study investigates the determinants of FDI, more specifically and the impact of selected macro-economic variables on FDI with reference to Sri Lankan context.

Research Problem

Sri Lanka being an island, where there are ample natural resources that have not yet been utilized fully and with a high growth potential for the market, should have attracted foreign investors. However, in practice when making their investment decisions foreign investors consider a wide range of other factors too. Therefore, what actually attract FDIs to a country yet to be scientifically, explored. This is an important question that should be answered by every government if the governments wish to attract FDIs. In simple terms what determines FDI flow to a country? By identifying the determinants and managing them properly, may assist in attracting more FDIs to host countries. The relationship between these variables and FDI has not been clearly stated yet and not clearly identified in the Sri Lankan context. It is critical for all governments to identify the determinants of FDIs in order to manage them in an effective manner to attract FDIs to their home countries. Therefore, the factors that determine FDIs to the host country still needs to be identified in Sri Lankan context

Objectives

To examine the impact of selected macro-economic variables on foreign direct investments in Sri Lanka.

To explain the long-run association between selected macro-economic variables and foreign direct investment in Sri Lanka.

To analyze the causal11 relationship between selected macro-economic variables and foreign direct investment in Sri Lanka.

To explore the perception of foreign investors who have already invested in Sri Lanka.

Theoretical and Empirical Review

FDI has become one of the most demanded sources of finance by countries. As cited by Parvin (2013), Kok (2009) has demonstrated that the main purpose of FDI inflow to a country is to have access to natural resources, host countries market size and geographic locations, low labor cost. Dunning (1993) and Kosekahyaoglu (2006) pointed out that FDIs increase total demand for domestic goods and initiate technology overflow. Aremu (2005) identified the growing interest in FDI being driven by the perceived opportunities that can be derived from utilization of foreign capital injection into the economy to add to domestic savings and promote economic growth in most developing countries. Arbatili (2011) states that as well as it provides many development options for the host country, FDIs inflow stability also creates a barrier against reversals in portfolio inflows during crisis periods.

Moreover, Pradhan (2001) stated that Sri Lanka has great potential to become an international business hub with the wealth of human capital and geographical location. Trade liberalization policy adapted in 1977 has created an enabling environment for the foreign investors to invest in Sri Lanka. The intention of this move has been to bring the country as one of the most open economies in South Asia.

Data and Sample

The study employed both primary and secondary data. Based on the type of data the research introduced two models; Model-A and Model-B.

Model-A consists of analysis of Secondary data (annual data) which have been obtained from the Central bank of Sri Lanka, the Sri Lanka National bureau of statistics and the World Bank (WDI) from 1985-2016.

Model-B consists of primary data which are collected through face to face semi-structured interviews with selected foreign investor sand this was aimed to enrich the findings of Model-A.

Methodology

Model-A; Firstly, Augmented Dicky Fuller test was applied to examine the spuriousness of the regression model. Johansen cointegration test has been used to find the long term association. Causality between variables was identified using Pair-wise two-way Granger Causality test. Karl Pearson's correlation was utilized to find the correlation between the macro-economic variables and FDIs.

Model-B; Feedback from ten foreign investors have been summarized and converted in to percentage values.

Findings

The results suggest that exchange rate was significant to determine FDIs in Sri Lanka and positive relationship was established. On the other hand other macro-economic variables; GDP, Inflation and Population were insignificant in determining FDIs. Interestingly, the results contend that there is a long run association between the macro-economic variables and FDIs.

It is also found that exchange rate Granger Cause with FDIs while other macro-economic factors; GDP, Inflation and Population does not Granger cause with FDIs. Vey importantly, the results with secondary data (Model – B) supported the findings of primary data (model – A.) analysis. The most influential factor for the foreign investors was exchange rate and inflation. This suggests that inflation and exchange rate determines FDIs movements in Sri Lanka. Furthermore, additional factors which investors had considered in their investment decisions were revealed through the interviews such as infrastructure, competitive advantage, skilled labor, geographical location and so on.

Conclusion

Early, researchers had initially identified four macro-economic variables to determine FDIs inflow to Sri Lanka as GDP, inflation, population and exchange rate. However, the findings of this study suggested only exchange rate as the significant variable in determining FDI in Sri Lanka. Importantly, Causal relationship was found only in exchange rate. Further results contend that war element has direct impact on FDI inflows in Sri Lanka. It is observed that there is a long run association within all four variables and all four variables move together in long run. Moreover, majority of foreign investors found exchange rate and inflation significant in determining their FDI decisions.

Keywords: Foreign Direct Investment; Gross Domestic Production; Inflation; Population; Macro-Economic Variables

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