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DETERMINANTS OF FOREIGN DIRECT INVESTMENTS IN SRILANKA

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Abstract

Foreign Direct Investment (FDI) has become an engine of growth and vital for economic development. Sri Lanka has also been entertaining FDI seeking acceleration of economic growth through various channels such as employment generation, poverty alleviation and creating foreign exchange. However, the factors that are likely influence on the FDI inflow has been varied country to country in terms of their Institutional and socio-economic characteristics. In that line, this study investigates the determinants of FDI in Sri Lanka during the time period from 1990 to 2017, using annual time series data extracted from the World Bank, and Central Bank database. As determinants, the study incorporates six variables such as gross domestic product, inflation, trade openness, labor force and tourism income. The study employs ADF unit root test, Johansen's Cointegration analysis and Error correction model based on the Vector error correction model (VECM) to ascertain the significance of macroeconomic and country specific factors on FDI inflow in Sri Lanka. The results derived from this study suggest that all variables are significantly influencing on the FDI in the long run. Gross domestic product and labor force have positive impact, whereas inflation, trade openness, and tourism income are found to have a negative impact on FDI.

Keywords: Sri Lanka, Foreign Direct Investment, Gross Domestic Product, Inflation, Trade Openness, Co-integration, Vector Error Correction,

Introduction

As far as the acceleration of the Global economic growth is concerned the growth in flow and stocks of FDI has been vital. It has been revealed that the Foreign Direct Investments (FDI) serves as an engine of economic growth through various channels such as enhancing employment opportunities, increasing per capita income, trade promotion and poverty alleviation. However, the distribution and the size of FDI are unequal as various factors determine the flow of FDI from home country to host country. Especially, the less-developing countries face difficulties in attracting FDI despite the fact that FDI is immensely important to these countries. A numerous factor possibly determines the FDI in host as well as in home countries that can be classified as pushing and pulling factors. Pushing factors are responsible to move the FDI from the home countries whereas pulling factors in host country side are responsible to attract the FDI. The direction and magnitude of the influence of these factors are depending on the socio-economic, demographic, institutional and environmental factors of home and host countries.

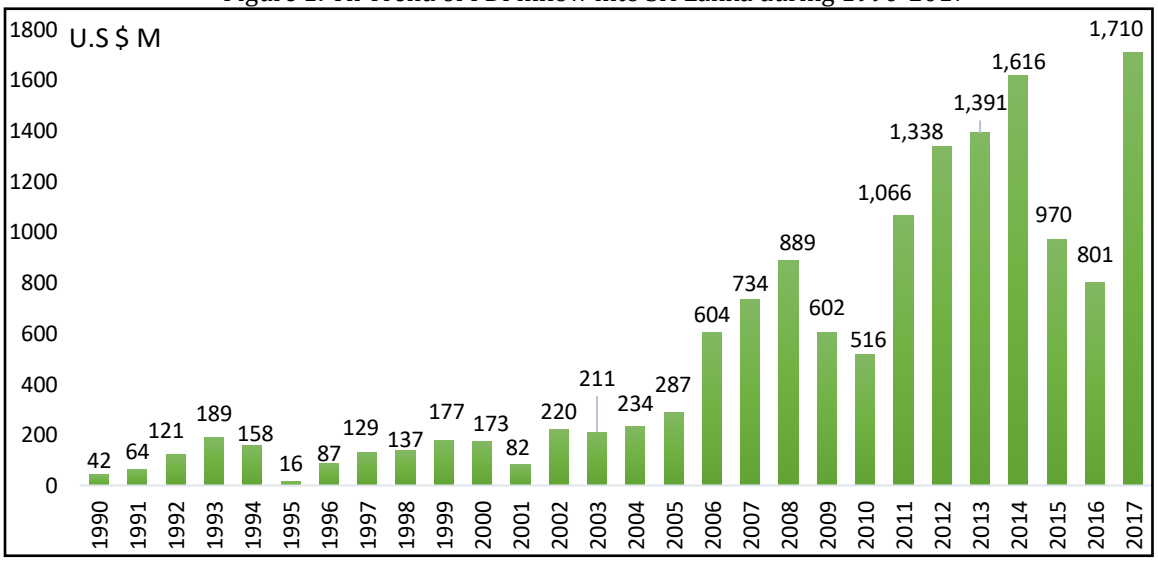
Sri Lanka is also in the line of entertaining FDI after the trade liberalization which was introduced in 1977 in, since then the country has been in success in receiving FDI into the economic system,

especially after 2009 where the civil war ended. The successive measures in government policies have also been addressed all the ways to attract FDI in such a way that creating free trade and investment zones, reduction of food subsidies, development projects to improve tourism potentials, developing infrastructure, transportation and so on. Contrarily, political instability, terrorists' attacks, the level of corruption, poor policies in property rights, outdated transportation, such as railway are possibly hindering the inflow of FDI. Therefore, the inflow and utilization of foreign direct investment in Sri Lanka is at a very low level compared to other developing countries. Therefore, it is imperative to increase the foreign direct and private investment of Sri Lanka rather than relying solely on the income of the government to facilitate development in the country.

Though Sri Lanka has implemented all the ways to attract FDI inflows, as shown in Figure 1, its overall trend shows an increasing trend with major fluctuations indicate that possible development in uncertainty in economic contribution of FDI. Therefore, this study selects some factors theoretically and empirically to investigate whether these variables are significantly contributing to attract FDI into Sri Lanka.

Source: Central Bank Report – 2017

Figure 1: Th Trend of FDI inflow into Sri Lanka during 1990-2017



Literature Review

Asiedu (2002) analyzed the determinants of FDI inflows in developing countries with the aim of establishing whether or not Africa was different during 1970 to 2000. This was a comparative analysis between non-sub-Saharan African and Sub-Saharan African countries. The results indicate that, firstly, a higher return on investment and infrastructure have a positive impact on FDI in non-sub-Saharan African countries, but no significant impact on FDI in sub-Saharan Africa. Secondly, the openness to trade promotes FDI in sub-Saharan African and non-Sub-Saharan African countries. Ravinthirakumaran et al. (2015) investigated the factors that could influence FDI inflows in Sri Lanka using annual data for the period 1978-2013. The results prove that market size, trade openness and level of infrastructure have a positive impact while political instability and wage have a negative impact on FDI inflows to Sri Lanka. Further suggested that, Sri Lanka should develop and introduce policies that would lead to an improvement on the level of trade openness, market size, political stability and infrastructure. But, the cost of labor should be reduced.

Sahoo (2006) examined the impact and determinants of FDI in South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal). The results from the panel co-integration showed that all potential determinants such as market size, growth prospects and positive country conditions, labor cost and availability of skilled labor, infrastructure facilities, openness and export promotion, human capital, policy measures and the rate of return on investment have a long-run equilibrium relationship. The major determinants of FDI in South Asia were labor force growth, market size, infrastructure index and openness. The most significant factors were market size and labor force growth. Rebecca Penn (2017) analyzed the determinants of foreign direct investment in India by incorporating GDP, Inflation, Economy Openness and Real Effective Exchange rate as determining variables. The study used time series data running from 1978 to 2014 and applied the Vector Error Correction Model (VECM). Their results suggest that GDP and Real Effective Exchange rate have a positive impact while inflation and Trade openness have a negative impact on FDI inflows to India.

Enisan (2017) examined the dynamics of FDI in Nigeria and used the Markov Regime Switching approach (MRSA). This researcher used quarterly data for growth rates of FDI, GDP, export, import, macroeconomic uncertainty, inflation, discount rate, exchange rate, financial development and oil reserves for the period 1986 to 2012. The major determinants of FDI in Nigeria were GDP, macroeconomic uncertainty, financial development inflation, discount rate, exchange rate. Demirhan and Masca (2008) analyzed the determining factors of foreign direct investment (FDI) inflows in developing countries over the period of 2000-2004 and used the cross-sectional econometric model. These researchers used sample of cross-sectional data on 38 developing countries and FDI as dependent variable. Independent variables are growth rate of per capita GDP, inflation rate, telephone main lines per 1,000 people measured in logs, labor cost per worker in manufacturing industry measured in logs, degree of openness, risk and corporate top tax rate. The results suggest that growth rate of per capita, telephone main lines and degree of openness have positive impact and statistically significant. Inflation rate and tax rate have negative impact and statistically significant and, labor cost and risk are found to have statistically insignificant

Majavu and Kapingura (2016) identified the determinants of FDI inflows into South Africa using quarterly data for the period from 1980 to 2012 and employed the Johansen co - integration test and fund that GDP, openness, inflation, exchange rate, corporate tax and the financial crises are important determinants of FDI inflows in South Africa.

Ranjan and Agrawal (2011) examined the Foreign Direct Investment (FDI) inflow determinants in Brazil, Russia Federation, India and China; collectively known as BRIC countries. The study used random effect model using panel data consisting of annual frequency data of 35 years ranging from 1975 to 2009 to identify the determinants of FDI inflow. This result shows that market size, trade openness, labor cost, infrastructure facilities and macroeconomic stability and growth prospects are potential determinants of FDI inflow in BRIC whereas gross capital formation and labor force are insignificant, although macroeconomic stability and growth prospects have very little impact.

Leitao and Faustino (2010) examined the Foreign Direct Investment (FDI) inflow determinants in Portugal over the period of 1995-2007 and used the Static and Dynamic Panel Data Approach model. Independent variables are market size, labor wage, trade openness and economic stability. The major determinants of FDI in Portugal were market size, labor wage and trade openness. Mustafa (2019) examined the Contribution of Tourism and Foreign Direct Investment to Gross

Domestic Product in case of Sri Lanka using annual time series data for the period from 1978 to 2016, and employed the Co-integration analysis found that there is a positive relationship between the variables.

Selva and Saroja (2012) investigated the causal link between FDI and tourist arrivals in India by employing the Granger causality test under a VAR framework. These researchers used quarterly data for the period from 1995 to 2007. A two-way Causality link is found between FDI and tourist arrivals in India. This explains the rapid growth in the tourism sector as well as FDI in India during the last decade. This result proved that two-way causality results in relation to India are similar to the findings of a number of small Islands developing states (SIDS).

Methodology

This study uses annual time series data for 27 years for the period 1990 - 2017. The data were extracted from the World Bank database and annual report of the Central Bank of Sri Lanka. As the first step, the Augmented Dickey Fuller Analysis is employed to test the stationary properties of time series data because miss-conducting econometric analysis avoiding time stationary properties would give a spurious result and leading to inappropriate conclusion. As the second step, the Johansen's Cointegration analysis and Error correction model based on the Vector error correction model (VECM) are employed to investigate the short and long run relationship among the variables. Foreign direct investment is treated as the dependent variable whereas GDP, Inflation, Trade Openness, labor force and tourism income has been used as independent variables to analyze the factors that determine foreign direct investment.

The econometric model used for this study is specified as follows:

$$\boldsymbol{lnFDI}t = \boldsymbol{\alpha}0 + \boldsymbol{\alpha}1\,\boldsymbol{lnGDP}t + \boldsymbol{\alpha}2\boldsymbol{lnCPI}t + \boldsymbol{\alpha}3\boldsymbol{lnTOP}t + \boldsymbol{\alpha}4\,\boldsymbol{lnLAB}t + \boldsymbol{\alpha}5\,\boldsymbol{lnTOU}t + \boldsymbol{\varepsilon}t$$

Where:

lnfdi= logarithm of foreign direct investment (in US dollars)

$\alpha 0$ = constant

lngdp= logarithm of gross domestic product (in US dollars)

lncpi= logarithm of consumer price index (in US dollars)

lntop= logarithm of trade openness (Defined as the sum of exports and imports over GDP)

lnlab = logarithm of labor force

lntou = logarithm of tourism income (in US dollars)

ε = error term

Results and Discussion

Table 1: Augmented Dickey Fuller Unit Root Test Results

Variables	ADF Test	Intercept	Trend & Intercept	None	Order Of Integration
Lnfdi	Level	-0.912722	-6.142251	1.918440	Non -Stationary
	First difference	-6.958219**	-6.736598**	-6.299420**	Stationary I(1)
Lngdp	level	0.389087	-1.503541	13.55243	Non- Stationary
	First difference	-4.136596**	-4.047198**	-1.244742	Stationary I(1)
Lncpi	Level	-2.074401	-0.699294	2.467056	Non -Stationary
	First difference	-3.725422**	-4.026939**	-1.479469	Stationary I(1)
Lnlab	Level	-0.505059	-2.611157	1.651624	Non- Stationary
	First difference	-5.651063**	-5.518378**	-5.017438**	Stationary I(1)
Lntop	Level	-0.497667	-2.249510	-0.767857	Non -Stationary
	First difference	-4.314070**	-4.441636**	-4.479553**	Stationary I(1)
Lntour	Level	1.334900	-0.549292	5.202628	Non –Stationary
	First difference	-3.429492**	-3.666751**	--2.312454**	Stationary I(1)
*, **, *** indicate 10%, 5% and 1% significant levels, respectively.					

Unit Root Test

When analyzing time series data, it is necessary to evaluate the trend and stationary of the variables. Most of the macroeconomic variables are non – Stationary. Thus, invariance and parallel invariance of the time series data are not consistent with time. The problem with non -stationary time series is that the OLS can simply lead to spurious sequences. Then the variables will have no real connections. The dependent variable and the independent variables used in this case are converted to logarithmic form. The Unit root test for each of the time series variable used in this study is based on the test equations of Intercept, Trend & Intercept, None.

Table 1 shows the results of the ADF test of each variable. The results suggest that the null hypothesis that all variables to be non-stationary at level cannot be rejected leading to conclude

Maximum rank (r)	Eigen value	Max-Eigen Statistic	5% Critical Value	Probability Value
0	0.904544	61.07626	40.07757	0.0001
1	0.704873	31.72910	33.87687	0.0883
2	0.564360	21.60441	27.58434	0.2414
3	0.477323	16.86859	21.13162	0.1783
4	0.282713	8.639255	14.26460	0.3174
5	0.085464	2.322800	3.841466	0.1275
Max-eigenvalue test indicates 1cointegrating eqn(s) at the 0.05 level				

that all variables consist of unit root characteristics and become stationary at first difference denoted as integrated order, *I (1).* The results further suggest to employing the Johansen's Co - Integration analysis.

Table – 2: Johansen Tests for Co – integration

Unrestricted Co - integration Rank Test (Trace)

Maximum Rank (r)	Eigen Value	Trace Statistic	5% Critical Value	Probability Value
0	0.904544	142.2404	95.75366	0.0000
1	0.704873	81.16416	69.81889	0.0047
2	0.564360	49.43505	47.85613	0.0353
3	0.477323	27.83065	29.79707	0.0829
4	0.282713	10.96206	15.49471	0.2138
5	0.085464	2.322800	3.841466	0.1275
Trace test indicates 3 co- integrating eqn (s) at the 0.05 level				

Unrestricted Co - integration Rank Test (Max-Eigen value)

Table – 3: Normalized Co - integration Coefficients Results			
Variables	coefficients	Standard Error	t-value
lnfdi (-1)	1	.	.
lngdp (-1)	-3.795508***	1.13914	-3.33191
Lncpi(-1)	1.226325**	0.53997	2.27108
lntop (-1)	1.321235***	0.28952	4.56350
Lnlab(-1)	-4.972501***	1.40590	-3.53688
lntou (-1)	0.296955**	0.12278	2.41854
cons	138.6612	.	.
*, **, *** indicate 10%, 5% and 1% significant levels, respectively.			

Table – 2 shows that, Trace test and the maximum Eigen value test evidently generate conflicting results. The trace test indicates at least three co- integrating equations at 5 percent level of the model. On the other hand, the maximum Eigen value test indicates at least one co- integrating equations at 5 percent level of the model. The results reveal the existence of a long-run equilibrium relationship between the variables.

However, the study's main aim is to establish if there is a long-term relationship between the variables and not necessarily the number of co -integrating vectors, so the null hypothesis of no co-integration was rejected at 0.05 percent level of significance from both the trace statistic and the maximal-Eigen value. This indicated that there is a co-integrating relationship among the variables,

Table 3 shows the results of normalized co – integrations coefficients. According to the results, all the variables taken in the study for determining FDI in Sri Lanka are statistically significant at the 1% and 5% level having a long run relationship. The model is followed by the long term equation of FDI as follow:

$$\boldsymbol{lnfdi}t = \boldsymbol{\alpha}0 + \boldsymbol{\alpha}1\,\boldsymbol{lngdp}t + \boldsymbol{\alpha}2\boldsymbol{lncpi}t + \boldsymbol{\alpha}3\,\boldsymbol{lntop}t + \boldsymbol{\alpha}4\,\boldsymbol{lnlab}t + \boldsymbol{\alpha}5\,\boldsymbol{lntou}t + \boldsymbol{\varepsilon}t$$

$$\boldsymbol{lnfdi}t = -138.6612 + 3.795508\,\boldsymbol{lngdp}t - \mathbf{1.226325}\boldsymbol{lncpi}t - 1.321235\boldsymbol{lntop}t + \mathbf{4.972501}\,\boldsymbol{lnlab}t - 0.296955\boldsymbol{lntou}t$$

The results suggest that GDP and labor force have a positive impact on FDI inflows in Sri Lanka. However, CPI, trade openness and tourism income have a negative effect on FDI inflows in Sri Lanka. The results are explained in detail below.

Gross Domestic Product (GDP)

The positive co - integrating coefficient of 3.795508 illustrates a positive relationship between GDP and the FDI inflows. According to the coefficient for GDP a 1% increase in GDP would cause FDI to be increased by 3.8 %. The results confirm the priori expectations, and are in line with the findings of Enisan (2017) in Nigeria. GDP is statistically significant in explaining changes in FDI inflows, suggesting that GDP is an important factor in attracting FDI inflows into Sri Lanka.

Inflation

The Consumer Price Index (CPI) is used as a proxy variable for inflation. The negative co - integrating coefficient of 1.226325 as a measure of economic stability shows a negative relationship between CPI and FDI inflows into Sri Lanka. FDI reveals that a 1.2 % decrease in FDI performance is explained by a 1% increase in CPI. The results agree with a prior expectation that macroeconomic instability discourages FDI inflows and is consistent with Demirhan and Masca (2008) in Developing Countries. The variable is statistically significant explaining that any macroeconomic instability brings with its economic uncertainty.

Trade Openness

The empirical results show that the co – integrating coefficient for trade openness is 1.321235, illustrating a negative relationship between trade openness and FDI inflows into Sri Lanka. FDI reveals that a 1.3% decrease in FDI performance is explained by a 1% increase in trade openness. These results are consistent with Rebecca Penn (2017) in India, correspond to the priori expectations.

Labor force

According to the results, the co - integrating coefficient for labor force is 4.972501, illustrating a positive relationship between the labor force and FDI inflows denoting a 1% increase in labor force would translate to a 5% increase in FDI inflows. labor force is statistically significant in explaining changes in FDI inflows. The results are consistent with Leitao and Faustino (2010) in Portugal.

Tourism income

A negative coefficient of 0.296955 indicates a negative relationship between FDI inflows and tourism income with statistically significant at 5% level, implying that a 1% change in tourism income will render a 0.3% decrease in FDI inflows.

This section seeks to analyze the short-run effects of the explanatory variables on the FDI inflows. The persistence of the analysis is to determine whether the short run dynamics are influenced by long-run equilibrium co - integrating vectors.

Table – 4 Vector Error Correction Model

Variables	D_lnfdi	D_lngdp	D_lncpi	D_lntop	D_lnlab	D_lntou
α Coefficients	-0.395553***	-0.006754	0.002879	-0.087112	0.027744*	-0.217754*
Standard Errors	0.06470	0.01539	0.02833	0.05256	0.01305	0.11452
T-Statistics	-6.11329	-0.43881	0.10164	-1.65730	2.12576	-1.90146

*, **, *** indicate 10%, 5% and 1% significant levels, respectively.

Table 5 shows the results of the Error Correction Model. In the results, the technique of speed adjustment parameters explores how quickly the system returns to equilibrium after a random shock. According to the results, the error correction term of foreign direct investment is -0.395553 and it is statistically significant at 1% level. Labor force and tourism income are statistically significant at 10% level, whereas the coefficients for Gross Domestic Product, Inflation and Trade Openness are insignificant. The coefficient for D_lnfdi indicates that the speed of adjustment to the long run equilibrium is significant and can be concluded that 39% of deviation would be eliminated annually.

Table – 5 : Short Run Testing

Variables	D_lnfdi (-1)	D_lngdp (-1)	D_lncpi (-1)	D_lntop (-1)	D_lnlab (-1)	D_lntou (-1)
α Coefficients	0.651068***	2.916790	2.324601	0.491593	2.092066	-0.548656
Standard Errors	0.18737	3.54333	2.33383	0.89900	3.63365	0.46719
T-Statistics	3.47471	0.82318	0.99605	0.54682	0.57575	-1.17437

*, **, *** indicate 10%, 5% and 1% significant levels, respectively.

Last year's FDI was statistically Positive significant at 1% level in the current FDI inflows, meaning that when other factors don't change, 1% increase in last year FDI would translate to a 0.651068

increase in current year FDI inflows. At the same time, independent variables weren't statistically significant.

Residual Diagnostic Test

The residuals were examined for the Serial Correlation test employing Historam normality and Heterosckedasticity Test. The results are reported in detail below in Table 6.

1. Serial Correlation Problem

Table - 6

Breusch - Godfrey Serial Correlation LM Test

F-statistic	0.696358	Prob. F(1,21)	0.4134
Obs*R-squared	0.898677	Prob. Chi-Square(1)	0.3431

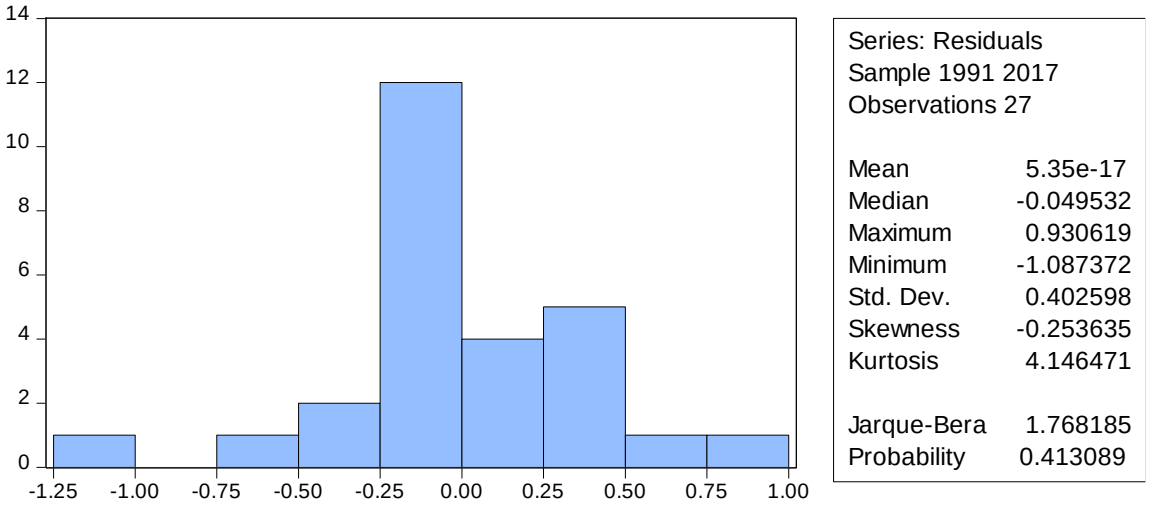
Source : survey data - 2019

According to the results as can be seen in the LM test for serial correlation, the test statistic is 0.898677 with a probability of 0.3431. Thus, the model is significant at all levels of significance; hence the null hypothesis which states that the error terms are independent is cannot be rejected.

2. Historam normality Test

Graph -1

Jarque – Bera Test



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According to the results, Jarque – Bera statistic is 1.768185 with a probability of 0.413089, thus the null hypothesis of normality in the residuals cannot be rejected at 5% significance level. All the variables follow the normal distribution and from the graph. Thus, it enabled the research to carry out further analysis because variables show consistency and therefore will give results that are consistence. Thus, it is a best model.

Heteroscedasticity Problem

Table – 7

Heteroskedasticity Test: ARCH

F-statistic	0.168861	Prob. F(1,25)	0.6846
Obs*R-squared	0.181146	Prob. Chi-Square(1)	0.6704

The Obs*R-squared statistic is 0.181146 with a probability of 0.6704. Therefore, we fail to reject the null hypothesis that there is no heteroskedasticity.

Conclusion

The main aim of this study was to analyze the determinants of FDI in Sri Lanka by incorporating GDP, Inflation, Trade Openness, Labor force and Tourism income as determining variables using time series data from 1990 - 2017. Firstly, using Unit root analysis the stationary properties of time series data were tested, and accordingly, as a second step, the Johansen's Co - integration analysis was employed in order to investigate the long run relationship among the variables. Thirdly, Vector Error Correction model was employed to study the dynamic relationship between the variables. GDP and Trade openness were found to have a positive relationship with FDI inflows in Sri Lanka. Further, inflation, trade openness and tourism income were found to have a negative relationship with FDI inflows into Sri Lanka.

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