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Foreign Direct Investment and Exports in India: A Cointegration Analysis

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Abstract:

There has been a long debate in the literature on how host country's exports respond to inward FDI. A crucial issue in this debate is whether FDI is a means of stimulating export performance of the host countries. The theories and the literature related to FDI-exports linkages suggest that FDI impacts host countries' growth and development in general through its direct, indirect and spill-over effects and exports in particular. Moreover, the literature on the topic provides both significant and insignificant effects of FDI on host countries' exports across countries. The dynamics of the influence of FDI on exports is far more complex in case of India. Against this complexity,the aim of the study is to specifically re-examine the impact of FDI inflows on exports in India with an extended period from 1970-2015.

Keywords: FDI, Exports, India, Cointegration.

Introduction:

There has been a long debate in the literature on how host country's exports respond to inward FDI. A crucial issue in this debate is whether FDI is a means of stimulating export performance of the host countries. FDI is widely regarded as an important resource for accelerating industrial development of a developing country since it is supposed to bring a bundle of capital, technology, skills and foreign market access (Kumar, 2005; Nagraj, 2003; DIPP); and it helps in raising productivity and uplift economic growth. FDI has also been playing an important role in promoting the exports of many South East Asian countries and countries from other region viz., Latin American and Caribbean countries (Sharma, 2000; Pantin, 1990). Moreover, the direct and indirect effects of FDI provide a starting-point that FDI is likely to have a positive influence on the host country's export performance (Zhang and Song; 2000).Given these advantages of FDI on host countries production and exports, the developing countries have significantly eased their retractions towards FDI since the early 1980s and the trend became wider in the 1990s (Barrell and Pain, 1996). Some commonly observed growth impact of FDI inflows have been well documented in recent studies (De Mello, 1996; Borensztein,et. al, 1998, Balasubramanyam, 1999).

Apart fromthis hypothesis of FDI's positive impact on host country's production and exports, the debate continues with respect to various countries and regions of the world in different time periods.

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Inward FDI positively affected export in Cameroon over the period 1980-2003 (Njong and Raymond, 2001). In line with this, a significant and positive relationship between exports and FDI is found for 49 developing countries over the period 1970-2004using a sample of panel observations (Majeed and Ahmed, 2007). Similarly, AbuAl-Foul and Soliman (2008) using 29 years data spanning 1975-2003 for four MENA countries and applying gravity equation found positive effect of FDI on both merchandise and manufacturing exports.Against these studies, Pain and Wakelin (1998) found that there is no systematic relationship between FDI and exports across countries. They derive this conclusion from the empirical evidences of 11 OECD countries from 1971 to 1992 and used panel data on manufacturing exports.

The debate continues in causal relationship between FDI and exports also. The study of Penélope Pacheco-López (2005) suggests that FDI inflows encourage exports and also performance of exports stimulates more FDI inflows. Moreover, Kutan and Vuksic (2007) in their empirical study estimated the potential effects of FDI inflows in 12 Central and Eastern European economies for the period 1996-2004. Their result suggests that the capital inflows cannot be expected to have significant and positive effect on local companies in comparison to investment by some MNCs. Against these studies;Asli and Ucal (2003) investigated the causality between export, FDI and domestic performance of Turkey by using VAR methodology. Their results are in line with the export led growth strategy but they have not found significant positive spill-overs from FDI. Furthermore, the findings do not suggest a kind of FDI led export growth linkage, hence only with more foreign capital investments flowing to Turkey FDI may have a powerful effect over output.

In the Asian context, Athukorala and Menon (1996) examined the role of MNE participation towards export-led industrialization in developing (host) countries. They found that the spread effects of FDI through backward linkage and direct technology transfer seemed limited, but increasing. Moreover, the evidence suggests that high import-intensity and limited linkages were not intrinsic features of FDI-led export expansion. Similar to this study, Xuan and Xing (2008) in their empirical analysis showed that FDI has substantially enhanced the Vietnam's exports to its source countries.

In the Indian context, Prasanna (2010) tried to explore the impact of FDI on export performance in India. Collecting data from the Reserve Bank of India his empirical finding was that inward FDI has significantly contributed to better the export performance of India and the Indian manufacturing has not contributed significantly in enhancing the export performance. But Sharma (2000) found FDI's contribution to India's export growth is insignificant. For this study, he used annual data for 1970-98 and investigated the issue in a simultaneous equation framework. The results suggest that the demand for Indian exports increased when its export prices fall in relation with the world prices.

Thus, FDI impacts host countries' growth and development in general through its direct, indirect and spill-over effects and exports in particular. Moreover, the literature on the topic provides both significant and insignificant effects of FDI on host countries' exports across countries. The dynamics of the influence of FDI on exports is far more complex in case of India because of the following features of the economy: India has a growing developing market economy, relatively higher tariff structure, relying significantly on agricultural activities for its growth, and infrastructure bottlenecks. Against this complexity of Indian economy, the aim of the study is to specifically re-examine the impact of FDI inflows on exports in India with an extended period from 1970-2015.

The rest of the paper has been organized in the following way: theoretical background in the second sectionis followed bydata source and methodology in the third section. Fourth section deals with the Results and discussion of the studyand the paper ends with the conclusion in the fifth section.

Theoretical Background:

The theory of multinational enterprise explains the reasons of a firm undertaking FDI and thus become a multinational enterprise (MNE). The theory also indicates that positive exports from the host country can be expected when the factor intensities of home and host countries are different (Kutan and Vuksic, 2007). Based on this, the theoretical explanation of the relationship between FDI and exports have been described through three theories *viz.*, product cycle theory, flying gees paradigm and new growth theory as studied by Njong (2008).

The product cycle theory suggests that a cycle emerges where a product is produced by a parent firm (or a developed country) then its foreign subsidiaries and then anywhere in the world where the cost of production of the product is the lowest (Vernon, 1966, 1971; Wells, 1968, 1969).The flying gees paradigm of KanameAkamatsuprovides somewhat different view. It was a view of Japanese scholars upon the technological development in South-East Asia viewing Japan as the leader. It is often claimed that the flying gees paradigm of comparative advantage has accurately depicted the catching-up process of regional hierarchy consisting Japan, the first-tier of Newly Industrialized Economies (NIEs), the second tier of NIEs , China and other countries in the region (Kasahara, 2004). Moreover, the new growth theory provides the theoretical basis for the positive relationship between international trade and long run economic growth and development. The theory suggests that lowering trade barriers would speed up the rate of economic growth by allowing the developing countries to absorb the advanced country's technology at a faster rate, raising the benefits from research and development, encouraging economies of scale; reducing price distortions which leads to more efficient use of domestic resources; encouraging specialization and efficiency in the production of intermediate products, and rapid introduction of new goods and services (Salvator, 2012).

Data Source and Methodology:

Annual data from 1970 to 2015 for aggregate exports and total FDI inflows to India are used for the study. These data are collected from United Nations Conference on Trade and Development (UNCTAD) that are used for international best practices. The values of the variables in current prices are converted into constant prices taking 2005 as the base year. This is done to avoid the effects of prices and biases. Moreover, the data are transformed into the logarithmic (natural logarithm) values so that changes in the variables represent the relative changes or percentage changes after multiplication by 100 (Gujarati, 2011).

The first step in multivariate time series is to determine if the series under consideration are stationary or non-stationary. To check the stationarity of the time series, two popular unit root tests *viz.*, Augmented Dickey Fuller (ADF) and Phillip-Perron (PP) tests have been used. Since we have found the two time series under consideration are non-stationary at level but stationary at first difference, we applied Engle-Granger (1987) residual based cointegration test to examine long run relationship. Then to examine the short run relationship and Granger causality between the two time series, Error Correction Mechanism (ECM) is used.

We have two time series, one is exports and the other is FDI:

$$X_t = \alpha_1 + \beta_1 T + \varrho_1 X_{t-1} + u_{1t} \quad (1)$$

$$F_t = \alpha_2 + \beta_2 T + \varrho_2 F_{t-1} + u_{2t} \quad (2)$$

Where, X is exports and F stands for FDI. The constant and trend terms are shown through α and T respectively and u_{1t} and u_{2t} represents the random disturbance terms for the two time series. For ADF test, the following regressions are estimated:

$$\Delta X_t = \alpha_1 + \beta_1 T + \delta_1 X_{t-1} + \theta_1 i \sum \Delta X_{t-i} + \epsilon_{1t} \quad (3)$$

$$\Delta F_t = \alpha_2 + \beta_2 T + \delta_2 F_{t-1} + \Theta_2 i \sum \Delta F_{t-i} + \epsilon_{2t} \quad (4)$$

In equation (3) and (4), Δ represents one-time differenced term; ϵ represents white noise error term. The null hypothesis is that $\delta_1=\delta_2=0$, *i.e.*, both the series have unit root. ADF test is a better test than the DF test because it takes into account the presence of the correlation between the error terms by adjusting one time differenced terms of the dependent variable (Ali, 2013).

The lag length of ADF is selected on the basis of Akaike Information Criteria (AIC) taking maximum lags equal to the cube root of the number of observations. AIC provides a superior lag length in case of small sample in the manners that it minimizes the chance of under estimation while maximizing the chance of true lag length (Khim and Liew, 2004). Further, we followed a step by step procedure to include whether both trend and intercept or only intercept or no trend and no intercept in the concerned time series. First, we check both trend and intercept, if the trend is insignificant, then we check it with only intercept. If again intercept is found insignificant, then we check the unit root test without intercept and trend.

The Phillips-Perron (PP) procedure considers the following regression equation:

$$\Delta X_t = \alpha_1 + \beta_1 T + \pi_1 X_{t-1} + u_{1t} \quad (5)$$

$$\Delta F_t = \alpha_2 + \beta_2 T + \pi_2 F_{t-1} + u_{2t} \quad (6)$$

Where u is the error term and may be heteroskedastic. 'T' is the trend term. Under the null hypothesis that $\pi_1 = \pi_2 = 0$, the PP statistics gives the same asymptotic distribution as ADF statistics. The advantages of PP over ADF are, it is robust to general forms of heteroskedasticity in the error term and the user does not have to specify the lag length to test the regression (Zivot, 2006).

Given these two non-stationary time series and stationary at first difference as suggested by the ADF and PP unit root tests, we applied cointegration test to examine the long run relationship between these two time series. That is, in the long run, whether these two time series move together or not. According to Engle-Granger procedure, if the linear combination of these two non-stationary time series gives us a stationary series then there will be a long run relationship between them. The basic equation for the cointegration test is

$$X_t = \alpha_{1t} + \alpha_2 F_t + u_t \quad (7)$$

$$i.e., \; u_t = X_t - \alpha_{1t} - \alpha_2 F_t. \quad (8)$$

Where X and F imply exports and FDI respectively; α is the intercept term and u is the random disturbance term; t implies the time period. According to the Engle-Granger approach, u_t in equation (8) should be stationary at level if there is cointegration relationship between X and F.

After examining cointegration, the next step is to examine the short run relationship and causality between the variables. To examine the short run relationship and causality, ECM is used. Taking into account the Exports-FDI series, the following basic equation is estimated to examine the long run equilibrium relationship and short run causality together:

$$\Delta X_t = \beta_1 + \beta_2 \Delta F_t + \beta_3 u_{t-1} + \varepsilon_t \quad (9)$$

Where Δ is the first difference operator, ε is the random error term and u_{t-1} is the one period lagged value represents the cointegrating equation (*i.e.*, $u_{t-1} = X_{t-1} - \alpha_1 - \alpha_2 F_{t-1}$). Change in exports ($\Delta X$) depends on change in FDI (ΔF) and equilibrium error term. According to EG approach, β_3 in equation (9) should be negative and significant if there is causal relationship between the two in the long run.

Results and Discussion:

Unit Root Test:

To check the stationarity of the series, two unit root test methods have been used—Augmented Dickey Fuller (ADF) and Phillips-Perron (PP) Test. The null hypothesis for both the variables is that the series has a unit root for both the unit root test method. If the series has unit root then the series is non-stationary, and if the series has no unit root then the series is stationary. The guidelines for rejection of the null hypotheses are that if the estimated value of the variable is greater than the critical value or if the 'p' value is less than 5 per cent (*i.e.* 0.05), we can reject the null hypothesis. Here, for ADF test MacKinnon one sided 'p'-values and for PP test MacKinnon (1996) one-sided 'p'-values are used for the rejection of null hypothesis.

The sample has been divided into three parts—one part named as sub-sample I (which represents pre-liberalization period, *i.e.* 1970-1991), second part named as sub-sample II (which represents post-liberalization period, *i.e.*, 1992-2015) and the last part named as full-sample covering the period 1970-2015.

Table 1: Unit Root Test Results

	ADF		Phillips-Perron		Decision
Variable	**Level**	**1st Diff.**	**Level**	**1st Diff.**	
Sub-sample I (1970-1991)					
Exports	-1.65 (0.44)	-3.32 (0.03*)	-1.55 (0.49)	-3.42 (0.02*)	I(1)
FDI	-3.50 (0.07)	-3.95 (0.03*)	-2.94 (0.17)	-5.90 (0.00*)	I(1)
Sub-sample II (1992-2015)					
Exports	-0.81 (0.80)	-3.56 (0.02*)	-0.81 (0.80)	-3.56 (0.02*)	I(1)
FDI	-2.38 (0.15)	-3.94 (0.01*)	-2.31 (0.18)	-3.94 (0.01*)	I(1)
Full Sample (1970-2015)					
Exports	-2.87 (0.18)	-5.14 (0.00*)	-2.00 (0.58)	-5.33 (0.00*)	I(1)
FDI	-3.29 (0.08)	-5.62 (0.00*)	-3.13 (0.11)	-11.99 (0.00*)	I(1)

Note:

1. Figures in the brackets ( ) indicates (in ADF Test) the Mackinnon one sided 'p'-values for rejection of null hypothesis.
2. Figures in the brackets ( ) indicate (in PP Test) MacKinnon (1996) one-sided 'p'-values for rejection of null hypothesis.
3. * represents rejection of null hypothesis at 0.05 per cent or less level of significance.

From Table 1, it is obvious that the 'p' values for both the series in all samples are greater than 5 per cent at level and the estimated values are also less than the critical values. This implies that we cannot reject the series at level. Therefore all the series have unit root at level *i.e.*, non-stationary at level. When we take first difference of all the series, then the results show that the 'p' values are less than 5 per cent and the estimated values are also greater than the critical values indicating rejection of null hypothesis. The results are same for the ADF and PP unit root tests. Thus, we can declare that all the time series are non-stationary at level but stationary at first difference, thus all the time series are integrated of order one *i.e.*, I(1).

Cointegration:

To examine the long run relationship under Engle-Granger (1987) residual based cointegration procedure; we derive residuals by regressing FDI inflows on exports and then check the stationarity of the derived residuals. We applied ADF unit root test to check the stationarity of the derived residuals and the ADF test statistics is compared with the critical values given by Engle and Granger (1987) as cited by Mamun and Nath (2005). Because residuals are generated from a regression equation, we can not use the standard ADF critical values. Moreover, the lag length is chosen on the basis of AIC's automatic lag selection procedure taking maximum lags equal to the cube root of the number of observations (Mamun and Nath, 2005). The cointegration results are presented in Table 2.

Table 2: Engle-Granger Cointegration Results

Sample	Long Run Equation	ADF test statistics for the Residuals (ECT)	Lag Length
Sub-sample I (1970-1991)	$X_t = 6.44 + 0.31F + u_t$ (0.00) (0.05)	-1.64	1
Sub-sample II (1992-2015)	$X_t = 5.66 + 0.62F + u_t$ (0.00) (0.00)	-2.49	1
Full Sample (1970-2015)	$X_t = 6.57 + 0.52F + u_t$ (0.00) (0.00)	--3.64*	1

Note:

1. indicates significant levels at 5 per cent.
2. Figures within the brackets show the probability values.
3. The Engle-Granger Critical value at 5 per cent level of significance is (–3.37).
4. Lag length has been chosen on the basis of AIC's automatic lag selection procedure taking maximum lags equal to the cube root of the number of observations.

From Table 2 it is seen that there is no cointegration relationship between exports and FDI when we checked it separately for pre and post liberalization period. Because the ADF test statistics of residuals of the two sub-samples are smaller than the critical values given by Engle and Granger at 5 per cent level of significance. While the ADF test statistics of the residuals for the full sample is greater than the Engle-Granger critical values at 5 per cent level of significance. Therefore, we found a cointegrating relationship between the two for the full sample. Therefore, there is long run relationship between exports and FDI in India during 1970 to 2015.

Error Correction Mechanism (ECM):

ECM for Full Sample (1970-2015):

Since we found a long run relationship between exports and FDI for the period 1970-2015, we can examine the short run relationship and Granger causality using error correction mechanism (ECM)[1]. Before presenting the ECM results, the residual diagnostics results have been shown in Table 3 which shows the validity of the regression equation.

[1] We have not applied ECM for pre and post liberalization period since there is no cointegration relationship between exports and FDI in the same periods.

Table 3: Residual Diagnostics

Sl No	Test	H_0	P value	Decision
1	Normality	Normally Distributed	0.37	Cannot reject the H_0
2	Serial Correlation	No Serial Correlation	0.83	Cannot reject the H_0
3	Heteroskedasticity	No Heteroskedasticity	0.95	Cannot reject the H_0

The 'p' values in Table 3 for all the least square assumptions are greater than 5 per cent which indicates that our model satisfies all the least square assumptions. We have applied the Jarque-Berra probability values, Breusch-Godfrey serial correlation LM test and Breusch-Pagan-Godfrey test for Normality, serial correlation and heteroskedasticity test respectively. The ECM results are presented in Table 4.

Before applying the ECM, it is necessary to choose the optimum lag length. From VAR lag length criteria we find that all the lag length selection criteria *viz*., LR, FPE, AIC, SIC, HQ[2] suggests lag 1 as the optimum lag for ECM. Therefore, we estimate the ECM result taking lag 1.

Table 4: ECM Results

Sl No	Coefficient	Coefficient Values	Probability
1	Constant	0.19	0.00***
2	D(lnX(-1))	0.12	0.42
3	D(lnF)	0.06	0.02**
4	D(lnF(-1))	0.05	0.06*
5	ECT(-1)	-0.13	0.00***
6	R^2	0.28	NA
6	F	3.80	0.01***

Note:***, ** and * denotes significant at 1 per cent, 5 per cent and 10 per cent respectively.

Table 4 represents the ECM results. Since the series are non-stationary at level, we take the differenced form of the variables to apply least square. If there is causality from FDI to exports the Error Correction Term (ECT) should be negative and significant. When it so, it means that the change in dependent variable is Granger caused by the change in independent variable. From Table 4, it is observed that the ECT is negative and significant at 1 per cent significant level. Thus, there is long run causality from FDI to exports. The coefficient value of ECT is -0.13 which indicates that it corrects the previous year's disequilibrium by only 13 per cent. Moreover, the change in lag exports corrects disequilibrium in current exports by 12 per cent but it is not statistically significant. Furthermore, the short run relationship between exports and FDI shows that change in FDI corrects change in exports by 6 per cent and change in lag FDI corrects by 5 per cent which are significant at 5 per cent and 10 per cent significant level respectively. The smaller value of the coefficients indicates weak relationship between the two in the short run.

[2]LR= sequential modified LR test statistic, FPE=Final prediction error, AIC= Akaike information criterion, SC= Schwarz information criterion, and HQ= Hannan-Quinn information criterion

Table 5 : Wald Test

Test Statistic	Value	Df	Probability
F-statistics	4.56	(2, 39)	0.02
Chi Square	9.11	2	0.01

Table 5 shows the results of short run Granger causality from FDI to exports. Here the null hypothesis is that the coefficient ofD(*ln*FDI) and D(*ln*F(-1)) is zero. It means, current year FDI and one year lagged FDI together do not Granger cause exports. The probability value of F-statistics is less than 5 per cent. We can reject the null hypothesis at 5 per cent level of significance. Hence, FDI granger causes exports at 5 per cent level of significance.

Conclusion

The study is an attempt to investigate the influence of FDI on exports in India and find an answer to whether FDI stimulates Indian exports. To examine the short run and long run relationship, time series analysis has been adopted and bivariate time series analysis have been applied. Having non-stationary series at level and stationary at same order (i.e. I(1)), there is long run relationship between aggregate exports and FDI in India during the period from 1970 to 2015. But we find no long run relationship between the two when we divided the data in to pre and post liberalization period. Moreover, the ECM for the full sample suggests the presence of causal relationship from FDI to exports, although the relationship is weak. The Wald test for short run causality shows that there is short run causality from FDI to exports. Therefore, further removal of restrictive policies towards foreign investment and opening up the economy will be more conducive for FDI inflows to realize it as a driving force for exports of the country.

The relationship between exports and FDI is not straight forward. There are many other determinants of exports besides FDI. Granger himself had warned that studies conducted through strictlybivariate framework and omitting relevant variables could result in spurious causality (Maddala and Kim 1998). Therefore, to address these issues, further research can be carry out taking multivariate framework by including more variables that affects export behavior of a country.

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