

Dr. Muhammad Ayub¹, Hafiz Muhammad Ilyas², Hafiza Hira Jabbar³, Muhammad Mubeen Alam⁴, Dilawar Hayat⁵**Abstract**

The present research aims mainly investigated various elements responsible to FDI & trade openness including impact on growth rate, as well as quality of institutions in a group of selected developing countries. We test this hypothesis using a linear interaction model applied to 70 developing countries between 1984 and 2022. The FDI growth effect and trade openness is positive, but its monotonic increase with the quality of institution is revealed in the estimation by GMM. Empirical studies suggest that FDI and trade openness can obviously bring positive effects if they were channelled through a high level of political stability and full pledged democracy for promoting economic growth (Hadri & Pane, 2008).

Keywords: foreign direct investment, trade, developing countries

1. Introduction

World Bank including many other international institutions and financial supporting organisations for disadvantaged countries pay abundant attention to the formulation of good international economic policies because, in this way, they are trying to increase their national economies. The necessity of FDI and trade need not be overemphasised; they are beneficial for job creation, tax revenue, human capital increase, export promotion/market access, commerce expansion, and domestic investment complement (Jenkins & Thomas, 2002; Todaro & Smith, 2020).

During the last few years, and as a response to a deceleration in economic growth, financial turbulence, and escalating economic uncertainty inside various alters over the earth, many national authorities internationally have engaged in foreign direct investment promotion and liberalisation policies with the purpose of stimulating development and increasing economic efficiency. Many countries have relaxed from constraints variety that enable FDI flows with minimal impediments, given the spillover effects that may create additional economic opportunities referring to multinational corporations (MNCs). Trade and foreign direct investment (FDI) are viewed as vital tools to promote development and economic wellbeing. To this end, states approved measures that encourage foreign direct investment and trade.

The contingent actual regional relationships concerning FDI, trade, and growth patterns in developing countries have also largely been neglected by scholars and policymakers. During the last two decades, globalisation has intensified dramatically, especially in foreign capital globalization era, chiefly in foreign direct investment (FDI) spreading all over poor regions around the globe. For policymakers, especially in the developing countries, FDI is important since it is not only the biggest growing but also the most stable category of capital flows. As a result, thousands of international agency reports have highlighted FDI as an alternative factor that promotes economic growth in the development finance process.

There are substantial barriers to development such as chronic fiscal deficits, high levels of investment-saving gaps, and low savings rates in many developing areas (Feltenstein & Iwata, 2002; Ndikumana, 2017). These negatives give many difficulties to developing nations, familiarising FDI and trade, both of which intensify competitiveness, technology stripes, and work creatures (Kobrin, 2005; Khan, 2019; Nasir, 2022; Sadashiv, 2023).

2. Literature Review

Empirical evidence provides some support that FDI has positively influence economic growth; emphasis is laid on how the favourable externalities and spillover effects FDI influence country's economic growth. However, numerous researches proved that institutional environment & macroeconomic stability in host countries are more important to attracting FDI to stimulate economic development (Jalilian, 1998/99; Carkovic & Levine, 2005). Azman-Saini et al. study analysis analysed question of whether the relationship between FDI and economic growth depends on the economic freedom of host countries with a panel data set for 85 countries over the period 1975–2004. The empirical study arrived at three main results: On one side, FDI does not have a direct influence over the economic growth of host countries; on the other hand, as De Haan and Sturm (2000) have shown, freedom in their activities is investigated as the main engine for economic development on its long-run impact. FDI is, in fact, good for the economic development of host countries only if these countries allow freedom to economic activities.

Also, a study by Prüfer and Tondl (2008) determined that host country macroeconomic instability increases overall risk for foreign capital, which in return inhibits effect FDI enhancement on economic growth in developing countries. The results of the study published by Alguacil et al. show that macroeconomic instability harms economic growth not only in high-indebted and hyperinflationary countries with high unemployment (Racha, 2011), but also acts as a tax on the capital formation of the recipients (Chenery et al.).

There are many studies that highlighted the threshold level of financial development in host countries to boost economic growth through foreign direct investment (FDI) (Azman-Saini et al., 2010; Choong et al., 2010). Findings from some of these studies showed that foreign direct investment (FDI) creates positive externalities and spillover effects, which lead to financial development exceeding benchmark levels through efficient resource allocation and technical diffusion within host economies. To put it simply, a well-developed and structurally sound financial sector magnifies the positive effects of FDI on technological diffusion, which then makes it possible for recipient countries to prolong high levels of economic growth.

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The empirical study by Khan and Khan (2011) indicates that an efficient banking sector in the host nation claims to support economic growth that leads as a channel for reduced transaction costs, domestic capital accumulation, and return on capital. Similarly, other research emphasised the importance of openness for economic development, which could attract more foreign direct investment (FDI) than a closed economy and was necessary to harvest the growth effects of FDI (Balasubramanyam et al., 1996; Yol and Teng, 2012). However, a number of studies examining the relationship between FDI and economic growth have emphasised the importance of human capital, arguing that training and education investments in host countries improve their human resource development. Accordingly, foreign direct investment not only supports productivity of domestic capital and labour and other manufacturing factors but also the human capital in the host countries (Atique et al., 2004). Yet an adequate level of schooling among host countries, passing a threshold, attracts more inward foreign direct investment (FDI) that has a large effect on economic growth (Blomström et al. 2001).

On the other hand, conventional wisdom posits that recipient human capital together with its institutions enhances growth and attracts more FDI; some cross-sectional work provides support to this view, with reversed signs reported elsewhere regarding the role of human capital and slightly different stories for financial development, macroeconomic stability, trade openness, investment climate policy, and technology in recipient countries. Carkovic and Levine's (2005) research found that the effect of foreign direct investment (FDI) on economic growth only works in rich receiving countries, while it has no positive and significant impact in recipient countries with higher education. As a result, low-income countries fail to reap the benefits of foreign direct investment (FDI). On the other hand, some studies yield surprising results; for example, Egger and Winner (2005), using panel data of 73 rich and poor countries between 1995 and 1999, showed that foreign direct investment (FDI) inflows are higher in high-corruption countries. Greater FDI flows may be attracted by more lift of corruption in the recipient nations.

Higher marginal productivity of capital in LDCs induces more FDI and trade, but there are also other considerations, such as political (which would mean democratic) stability, cheap labour, proximity to raw materials, low transportation costs, and it is a market with purchasing power for foreign capital. Over the past two decades (and particularly since 2000), foreign money has entered developing countries with FDI inflows. Again, this is an empirical question—the historical record for developing countries shows whether or not such foreign capital does actually cause economic growth.

According to Azman-Saini et al. (2010), foreign direct investment (FDI) has a welfare-enhancing effect on economic growth in recipient countries if the financial development of these countries exceeds a critical threshold. The study also contributes to the existing literature by highlighting that the government policies of host countries merely encourage FDI inflow and they remain silent on other important factors that determine positive externalities and spillovers linked with FDI. Hence, this implies that in order to acquire the entire benefits of FDI, it is essential for other sectors, especially in host countries, to be improved with the help of technology and new banking system establishments.

3. Methodology

3.1. Empirical Model, Data and Econometric Technique

The research purpose empirically tests this hypothesis using the model developed by Falkis (2009); Balasubramanian et al. (1996); etc.

$$Growth_{it} = \alpha_0 + \alpha_1 FDI_{it} + \alpha_2 INS_{it} + \gamma Z_{it} + \varepsilon_{it} \quad (1)$$

$$Growth_{it} = \alpha_0 + \alpha_1 FDI_{it} + \alpha_2 INS_{it} + \alpha_3 (FDI_{it} * INS_{it}) + \gamma Z_{it} + \varepsilon_{it} \quad (2)$$

$$Growth_{it} = \alpha_0 + \alpha_1 TRP_{it} + \alpha_2 INS_{it} + \alpha_3 (TRP_{it} * INS_{it}) + \gamma Z_{it} + \varepsilon_{it} \quad (3)$$

Where INS= institutional quality,

TRP=trade openness,

Z= control variables vector

Growth= real GDP per capita growth rate,

FDI= foreign direct investment net inflows.

It calls life expectancy as measure of human capital helped through World Bank. Furthermore, investment rate presented is gross fixed capital formation to GDP. Here, α_0 is fixed, unobserved country-specific effect and ε_{it} is the stochastic (random) error term. Like the control variables of the model, the respective coefficient is denoted by the symbol γ . This is represented by the slopes 1 and 2, respectively, where one of them represents the coefficients of foreign direct investment (FDI) (for model 3) or trade openness (for model 4) and the other one represents the coefficient for regime durability. The interaction term provides the slope coefficient (α_3), which measures in model 1 and model 2 are evidencing the direct effect of FDI and trade, then in model 3 and mode 4 are demonstrating the indirect impact economic growth through regime durability.

To achieve the research objective set in this paper, Generalised-Method of Moments (GMMs) applied depend via empirical models explained above.

3.2. Data Sources and Sample Countries

An appendix lists the data sources for each of the described variables. For models 2 and 3, the present analysis uses data from 1984 to 2022. To achieve the desired outcome, the analysis included seventy (70) developing countries. It chose these countries because of the unique circumstances in which developing countries grow and develop. Although these regions are a major attraction for foreign capital (foreign direct investment, FDI, and commerce), it is highly unlikely to improve the economic growth rates of the least developed. Similarly, the social and economic indices of both types of sample countries do not improve significantly. Half the population, for instance, lives below the poverty line, while sanitation practices are poor; malnourishment and starvation levels are high; and infant deaths number some of the highest in the world. Over the last decade, each of the sample countries has made significant efforts through institutional reforms and various policy measures to boost FDI inflows and trade flows, improve development (such as basic infrastructure), and promote economic growth within those countries.

Table 1 presents the empirical results obtained by estimating equations 3 and 5. We do so in terms of several proxies for regime durability: durable (from Polity IV) and government stability (from ICRG), along with the multiple measures of institutional quality used. Moreover, the models incorporate several indicators for regime type, such as democracy from Polity IV, democracy from ICRG, and democracy from Freedom House and Polity IV, which serve as proxies for regime type. The estimates further show that composite trade openness proxies are significant and positively correlated overall (Table 1). These results allow one to conclude that additional trade openness is indeed a growth-promoting matter. In addition, results suggest that some democratic institutions are more important for their impact on fostering growth. By contrast, the democracy measure of Polity IV in Model 3 is substantively more important for growth when compared with other measures of democracy. Political stability also shows a significant negative impact on growth (Model 4), which again points to the notion that political instability could be directly associated with poor economic performance. However, in model 4, the political stability component (ICRG measure of political stability) has a somewhat positive and statistically significant effect on growth. Overall, regime type and durability—including those featured in Table 1—have robust positive effects on economic growth (net of their other effects), except for the Polity IV political stability score. The findings align with those of Adams and Klobodu (2016), Malikane and Chitambara (2017), and Radu (2015). The results show that while a Polity IV-derived measure of political stability has a negative impact on economic growth, other indices of political stability and democracy have a positive impact. Similarly, with respect to economic progress, inflation and the gross fixed capital formation rate are also relevant. The most significant finding is that all models pass both specification tests, indicating that the specification is correct.

Table 1 lists approximations of the Equation (4). It does so to assess the moderating role pes hardships in averting the escalation of violence or in finding a peaceful solution to the friction between the two countries. These models included interaction terms for political stability, democracy, and foreign direct investment. Therefore, from Table 1, the coefficients of the interaction have a positive sign and are statistically significant. In the case of the growth effect of FD as mentioned earlier, political stability and democracy are necessary conditions for the growth effect of FD hence their improvement enhances it (G30). This result is consistent with earlier research by Radu (2015). Two examples are Malkane and Chitambara (2017) or Adams and Klobodeau. flatMap (Package code (Dasari, Gaurav). More generally, the results suggest that receivers can better exploit trade and FDI when political stability remains high and democracy is more established.

Table 1
(N =70 countries; T =8; Sample Period = 1984– 2022).

	Polity -IV			ICRG		Freedom
	Model-1	Model-2	Model-3	Model-4	Model-5	Model-6
GDPI	0.149*** (0.032)	0.127*** (0.048)	0.203*** (0.021)	0.298*** (0.039)	0.241*** (0.078)	0.232*** (0.065)
TRP	0.392*** (0.128)	-0.256*** (0.095)	0.378*** (0.118)	0.294*** (0.129)	0.245*** (0.068)	0.232* (0.075)
FDI	0.821*** (0.239)	-0.315*** (0.121)	-0.498*** (0.134)	-0.446** (0.148)	-0.682** (0.234)	-0.538*** (0.159)
INSQD		-0.594** (0.128)	-0.649*** (0.194)		-0.389** (0.137)	0.397*** (0.197)
INSQR	-0.529** (0.176)			-0.468*** (0.149)		
IEFFECT	0.379*** (0.096)	0.249*** (0.069)	0.692*** (0.169)	0.789** (0.186)	0.539*** (0.156)	0.247*** (0.0896)
HUMANC	-0.754*** (0.145)	0.369*** (0.032)	0.549*** (0.217)	0.359*** (0.024)	0.346*** (0.094)	-0.137*** (0.048)
GRC	0.359** (0.092)	0.269*** (0.043)	0.598*** (0.136)	0.326*** (0.116)	0.489*** (0.064)	0.349*** (0.023)
Constant	5.249** (2.489)	-3.249*** (1.297)	-6.297*** (2.698)	-5.987*** (2.049)	-7.158*** (3.121)	5.297* (1.689)
Sargan test	9.564 (0.968)	12.489 (0.259)	11.987 (0.184)	14.329 (0.245)	15.397 (0.524)	9.489 (0.215)
AR(1)	1.259 (0.239)	-1.458 (0.489)	-1.7894 (0.326)	-1.249 (0.224)	-1.371 (0.458)	-1.187 (0.964)
AR(2)	1.487 (0.192)	2.468 (0.218)	1.874 (0.289)	-2.478 (0.427)	-2.497 (0.397)	1.489(0.348)
Instruments	36	32	39	34	37	35
Observation	560	560	560	560	560	560

As a result, these findings corroborate the view that there must be some rationale in host countries to attract and absorb emerging commerce- and FDI-related technologies. Also, there is evidence for the statistical significance of all control factors but human capital. These variables may include the initial income, gross domestic fixed capital formation, foreign direct investment, and HE. In conclusion, none of the specification tests can reject the null values, indicating a well-articulated null hypothesis model. In this regard, AR(2) and Sargon's overall test results do not rule out all forms of model falsification. Model estimation conducted via Blundell and Bond's (1998), three-step dynamic panel system GMM estimations implemented as the Stata xtdpdsys command. In

square brackets, standard errors are reported, while p-values placed for Sargan test, AR(1), & AR(2). For simplicity, model definition includes a few time dummies but does not display the results. IEFFECT refers to the interaction variable that exists between political stability, democracy, and trade openness.

4. Conclusion

In some developing countries, this study focusses on investigating how the factors affecting FDI & trade openness determine economic growth via institutional quality. Special attention is paid to institutional quality moderating role. More broadly, our results indicate institutional-quality significant crucial role in reinforcing positive & growth effect of FDI inflows and trade openness. While FDI & trade openness has positively impact on economic growth, strength of these effects is contingent upon domestic political stability and democracy, as evidenced by empirical findings. The preceding analysis implies that reforms aimed at improved democratic institutions and good governance would not only yield positive economic results for both forward and backward linkages but would also stimulate more FDI inflows and greater trade openness.

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