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THE DYNAMIC RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT INFLOWS AND INTEREST RATE IN SRI LANKA

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Abstract

Foreign direct investment acts as an engine of rapid growth and development of developing and emerging countries. It helps to promote the host nation's economic growth, financial inflows and markets, technology, and skills. This study aims to identify the dynamic influence and relationship between Foreign Direct Investment (FDI) and interest rate in Sri Lanka over the period 1978 to 2020. Foreign direct investment inflow has been used as the dependent variable while gross domestic products, interest rate, inflation rate, trade openness and exchange rate are the independent variables. This study used the ARDL model for the analysis. According to the bound test, F statistics is greater than the upper bound value. Therefore, this study confirmed that there is a cointegration relationship between foreign direct investment inflows and other explanatory variables. A negative and significant error correction coefficient of FDI inflows reveals that 128% disequilibrium is corrected each year which implies that FDI moves downward towards long-run equilibrium. This study found that there is no substantial relationship between the interest rate and FDI inflows in the long run and a negative and substantial relationship in the short run. Therefore, this study suggests that the government of Sri Lanka has to reflect on developing a monetary policy and maintaining the balance of interest rate and exchange rate. Because of the currency depreciation, the exchange rate negatively influences FDI.

Keywords: Exchange Rate, Foreign Direct Investment, GDP Growth, Interest Rate

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1. INTRODUCTION

According to the World Investment Report, Foreign direct investments (FDIs) are defined as investments made by an investor, a company and a government into another nation (Hayes, 2022). For a country, foreign investments come in numerous systems such as foreign loans, portfolio investment, and foreign direct investment. Therefore, FDI acts as an engine of rapid growth and development of developing and emerging countries. It helps to promote the host nation's economic growth, markets, financial inflows, technology, and skills. As well, it can eliminate the deficiencies of financial resources and knowledge and supports human skill progress which leads to economic growth (Faroh & Shen, 2015).

Interest rate refers to the percentage charged by the creditor for the usage of its money (Kimberly Amadeo, 2019). An interest rate is a key tool in the monetary policy of a nation and it is the most related variable to inflation and investment. As well as the interest rate is determined in the money market by the demand for money and money supply. Keynes emphasized that a rise in income has a positive impact on interest rates due to a rise in money demand. But, given the demand for money, a rise in the money supply causes a decrease in the interest rate and vice versa (Dwivedi, 2005).

Moreover, the interest rate is one of the key determinant factors of FDI. Generally, lower interest rates induce investors to invest more in economies. Because lower interest rates minimize the cost of production and maximize the higher returns. Consequently, good investment revenues, security through lower interest rates and an improved business atmosphere create an opportunity for high investment in an economy.

Nowadays, FDI is seen as the main key to the global economy and an essential source of socio-economic development. Still, advanced industrialized countries attract 59 percent of FDI inflows like the US and UK, while developing countries attract only 14 percent share of FDI, even though it supports sustainable growth in developing countries. FDI inflows to ASIAN countries improved from $123 billion in 2016 to $137 billion in 2017. Inflows from Indonesia increased from $3.9 billion to $23.1 billion in 2016, to Thailand to $9.1 billion and to the Philippines grew by 21 percent (Asean, 2021).

In recent years, FDI arrivals to Sri Lanka have risen gradually. Inflows to Sri Lanka reached USD 1.6 billion in 2018 by the ASEAN countries including India, China, and Singapore. According to the World Bank's Doing Business Index Report, Sri Lanka was ranked 100th out of 190 countries. The country has aimed to achieve the 70th rank by 2020. FDI stock exceeds USD 12.7% billion in 2018. As well, China, Hong Kong, India, and Singapore have invested a large amount in 2018. Hence, the government assumes to increase FDI to more than USD 4 billion by 2022.

Even Though, nowadays Sri Lanka faces some struggles in attracting FDI inflows. Now, there is peace and security. However, these are not sufficient conditions to attract the FDI inflows to Sri Lanka. But, confirming an attractive investment, good governance, macroeconomic policies, rule of law, economic stability, the guarantee

of property rights, and absence of corruption are preconditions to attract FDI (Sanderatne, 2011). As well as the real interest rate also determines the investment level. Because, changes in interest rates directly affect investment, output, and employment. Consequently, real GDP decreases and creates inflation through price changes.

Unsustainable external debt has increased. This is because of the absence of enough exports and FDI. Attracting more FDI requires several ingredients such as political stability, a reasonable tax regime, ensuring property rights, less corruption and interest rate. Further, most of the FDI inflows are coming from infrastructure development projects. Hence, Sri Lanka must attract FDI inflows to the manufacturing and service sectors. Because that only improves the tradable sectors, helps to increase the exports and leads to creating job opportunities (Daily Mirror - Sl's Foreign Direct Investment Conundrum, 2019).

High interest rates discourage FDI inflows. Because a high interest rate rises the cost of investment. Therefore, investors need more funds over their funds to invest in new projects. Therefore, lending interest rates of a country are very complex and cost for external investors. Hence, high lending interest rates may raise the cost of principal investment in all projects. Finally, it discourages FDI inflows (Jayasekara, 2014). According to the CEIC report, the Sri Lanka Bank Lending Rate was at 16.380 % in April 2022. This lending rate increased from 9.710 % in Mar 2022.

Even, though there is some empirical literature which has been published on determinant factors of FDI in many developing countries, there is only considerable literature related to the interest rate and FDI in Sri Lanka (Albert & Stuart, 2008; Amarasinghe, 2019; Jayasekara, 2014; Muraleetharan et al., 2018; Thilakaweera, 2012). In this context, it is well-intentioned to explore the relationship between FDI inflows and interest rates in Sri Lanka. Because this study can help to identify potential risks and vulnerabilities in the economy due to the fluctuations in interest rates which may affect the attractiveness for foreign investors. Sometimes, unstable interest rates may prevent foreign investors and affect the stability of the financial system. Hence, to fill this research gap, this study discovers the relationship between FDI inflows and interest rates in Sri Lanka by using ARDL-Bounds testing approach.

Further, the COVID-19 pandemic employed a substantial downward burden on international trade and the international economy. It leads to a decline in trade, FDI flows, and tourism. The Sri Lankan economy is affected by the fluctuation of external sector performance. FDI flows indicate a downward trend in 2020 by 42% 2020 compared to 2019. It affects capital flows such as migration, tourism, and remittance flows.

Therefore, this study intends to investigate the association and influence of interest rates on FDI inflows in Sri Lanka and to make some policy suggestions to improve the FDI inflows.

2. LITERATURE REVIEW

Thilakaweera (2012) identified the long-run connection and causality between FDI, real per capita GDP, and the level of infrastructure in Sri Lanka. These empirical results confirmed the unidirectional causality between the level of infrastructure and FDI. (Jayasekara, 2014) discovered that GDP growth rate, inflation, infrastructure quality, exchange rate, lending interest rate, corporate income tax, and labour force were significant factors of FDI in Sri Lanka from 1975 to 2012. Further, they are related to the cost of production for investors.

Amarasinghe (2019) investigated the determinants of FDI inflows in Sri Lanka for the period from 1977 to 2016. In this study, two regression models were established. The first model suggested that the growth rate of GDP, inflation, exchange rate and military expenses have a significant impact on FDI inflows and trade openness has an impact on FDI inflows in the second model. This study concluded that a considerable increase in FDI inflows has not taken place since the victory of the war in 2009.

This study found the positive and significant impact of real gross domestic product, interest rate, exchange rate and infrastructure quality on FDI. Inflation rate and international trade volume do not have a significant impact. Moreover, FDI and trade are measured as vital elements to enhance the FDI inflows (Muraleetharan et al., 2018). The findings of this study indicated that the wage rate is the most significant determinant of FDI in Sri Lanka. However, GDP, exchange rates, interest rates, and the level of external trade should be more considered in making policies to attract FDI inflows (Albert & Stuart, 2008).

Bett (2017) identified the connection between foreign direct investment and GDP, interest rate, exchange rate and inflation in Kenya by employing the multiple linear regression model. This study found that economic growth, inflation rate, interest rate, and exchange rate had a strong correlation with FDI. Thus, the model implied the effects of interest rates on FDI inflows. However, this result exposed that interest rate, economic growth, exchange rate and inflation rate are not determined by FDI inflows at a significant level in Kenya.

The influence of interest rates on FDI was investigated by using the Ordinary Least Square method in Sierra Leone for the years 1990-2016. The results indicated that interest rates significantly influence FDI inflows and revealed that GDP growth and trade openness are the major determinants of FDI (Fornah & Yuehua, 2017).

The connection between the FDI inflows and interest rate is examined using the Vector Auto Regression technique over the period 1986 to 2012. This study proposes that the interest rates of Thailand, Indonesia, and Malaysia have a negative correlation to FDI (Siddiqui & Aumeboonsuke, 2014). Quazi & Mahmud (2014), identified that economic openness, economic freedom, economic prosperity, incremental-legged changes, and human capital in FDI raise FDI inflows significantly in South Asia whereas political uncertainty significantly declines from 1995 to 2000.

Exchange rates and trade openness are the vital causes of FDI inflows that have been positively significant in the Sierra Leone economy found by using econometrics techniques from 1985 to 2012. Further, this study found that inflation, GDP and interest rate are insignificant variables causing the variability of FDI flows. Hence, based on the acceptance of the null hypothesis of this study, this study concluded that interest rate does not affect FDI inflows in Sierra Leone (Faroh & Shen, 2015).

Anna & Karambakuwa (2012) verified that a high interest rate positively affects the FDI inflows in Zimbabwe by using the OLS approach. This paper identified that interest rate is not significantly impacted on FDI inflows. And, this study discovered that the GDP, exchange rate, and inflation are also determinants of FDI inflows and revealed that political uncertainty, war, and observed domestic rights failures are the major determinants of FDI in Zimbabwe. These studies indicated the determinants of FDI. However, very few literatures only found the interest rate as the determinant of FDI even in Sri Lanka. Therefore, this study analyses the relationship between interest rate and FDI inflows.

3. METHODOLOGY AND DATA ANALYSIS

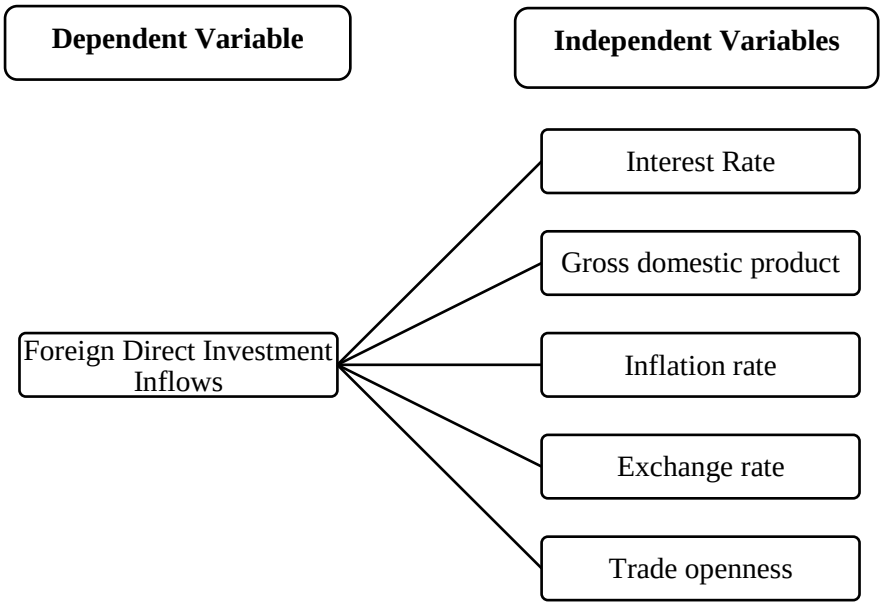
3.1 Data Collection

This study is enlightened through the secondary data which are gathered from secondary sources. In this study, the annual time series data are used for the period from 1980 to 2017. The exchange rate, GDP growth rate, and foreign direct investment data were directly gained from the annual report of the Central Bank of Sri Lanka. The data on interest rates were collected from the International Monetary Fund e-library and a popular statistics database website called Knoema. The inflation rate data was attained from the International Financial Statistics and International Monetary Fund e-library.

Table 01: Variable Operationalization

Variable	Description	Measurement
FDI	Foreign direct investment inflows	Net FDI inflows as a percentage of GDP
GDP	Gross domestic product	GDP growth rate (annual % change)
INF	Inflation rate	Consumer price index (annual % change)
IR	Interest rate	Lending Interest rate
EXR	Exchange rate	Local Currency Unit per US $, (period average)
TOP	Trade openness	Exports plus imports as percentage of GDP

3.2 Conceptual Framework



3.3 Econometric Models

To obtain reliable regression results, it is required to examine the stationarity or non-stationary of the time series variables to avoid spurious regression in the model. Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests were employed to find whether the data were stationary or not. Once time-series variables are non-stationary and used to analyze the findings, it may produce spurious results. ADF and PP tests were performed on variables to distinguish if these variables were stationary or non-stationary at the level. The first difference is used When variables are non-stationary at the level.

Auto-Regressive Distributed Lags (ARDL) Bounds test was employed to invent cointegration among variables in this study. The ARDL bounds testing method for cointegration was projected by Pesaran et al. (2001). The long-run association is examined using the values of bounds test. ARDL test is performed when all variables are not in the same order of integration. That means variables are combined in mixed order [*I (0), I (1)*] or a combination of both orders. The ARDL method allows the variables to have different levels of optimal lags.

Therefore, the ARDL model was performed to investigate long-run relations and short-run dynamics between foreign direct investment, interest rate, exchange rate, trade openness, and gross domestic product in Sri Lanka. Further, CUSUM and CUSUM OF SQUARES tests were employed to find the stability.

3.4 Model Specification

This study analytically observes the association between foreign direct investment and interest rates in Sri Lanka from 1978 to 2020. Where, FDI is the dependent variable and gross domestic product, inflation, interest rate, exchange rate and trade openness are independent variables. Hence, the econometric model is specified as:

$$FDI_t = \beta_0 + \beta_1 GDP_t + \beta_2 INF_t + \beta_3 IR_t + \beta_4 EXR_t + \beta_4 TOP_t + \varepsilon_t \ldots\ldots\ldots\ldots \textit{Equation (01)}$$

Where FDI represent the foreign direct investment, GDP shows the gross domestic product, INF denotes the inflation rate, IR represents the interest rate and EXR and TOP denote the exchange rate and trade openness. β_0 is an intercept coefficient, β_1 to β_4 are coefficient parameters to be appraised. Eviews version 10.0 was used to estimate the econometric models.

$$\Delta FDI_t = \alpha_0 + \sum_{i=1}^{n} \alpha_1 \Delta FDI_{t-i} + \sum_{i=1}^{n} \alpha_2 \Delta GDP_{t-i} + \sum_{i=1}^{n} \alpha_3 \Delta INF_{t-i} + \sum_{i=1}^{n} \alpha_4 \Delta IR_{t-i} + \sum_{i=1}^{n} \alpha_5 \Delta EXR_{t-i} + \sum_{i=1}^{n} \alpha_6 \Delta TOP_{t-i} + \delta_1 FDI_{t-i} + \delta_2 GDP_{t-i} + \delta_3 INF_{t-i} + \delta_4 IR_{t-i} + \delta_5 EXR_{t-i} + \delta_6 TOP_{t-i} + ECM_{t-i} + \varepsilon_{ti} \ldots\ldots\ldots\ldots \textit{Equation (02)}$$

Where: Δ indicates the first variance operator. α0 is constant. α1 to α6 show the short-run dynamic coefficients. $\delta 1$ to $\delta 6$ are the long-run multipliers. ECM is an error correction model. εt denotes white noise errors. 'n' is the optimal lag length which is designated by the model Schwarz information criterion (SIC) and Akaike Information Criterion (AIC).

The null hypothesis of no cointegration (H0:α1 =α2 =α3 =α4 = α5 =α6) is tested against the alternative hypothesis of co-integration (H1: $\delta\ 1 \neq \delta\ 2 \neq \delta\ 3 \neq \delta\ 4 \neq \delta\ 5 \neq \delta\ 6$). The bound test is used to fix the long-run association. The calculated F-statistic value is linked with critical bound values [lower bound I (0) and upper bounds I (1)]. If the calculated value of F statistics is better than the upper bound value, the null hypothesis of no cointegration will be rejected against the alternative hypotheses of cointegration. The null hypothesis of no cointegration will be accepted when the estimated value of the F – statistic is lesser than the lower bound. Where the values of the F – statistics are within upper and lower bound values then the null hypothesis may either reject or accept.

4. RESULT AND DISCUSSION

Table 02, results show that trade openness, exchange rate and interest rate lie non-stationary in their level in both ADF and PP tests. But, they become stationary in the first difference at 5 percent significance level. In the meantime, FDI, GDP and inflation are stationary at 5 percent significant level in both their level of ADF and PP tests and the first difference.

Thus, this study adopts that FDI, GDP and inflation are also non-stationary in their level and they become stationary in the first difference. Since the order of integration variables is I(0) and I(1), the cointegration Johansen method is not performed. Consequently, the ARDL bound test is performed to examine the short and long-run vitality of the dependent and independent variables.

Table 02: Stationary Test Result: Augmented Dickey-Fuller (ADF) Test and Phillips Perron (PP) Test

Variables	ADF Test (Trend)		PP Test (Trend)		Order of Integration
	Levels	First Difference	Levels	First Difference	
FDI	-4.600986 (0.0007)***		-4.582612 (0.0007)		I(0)
EXR	1.557990 (0.9992)	-6.261590 (0.0000)***	1.789825 (0.9996)	-6.260909 (0.0000)***	I(1)
IR	-2.179076 (0.2169)	-6.239919 (0.0000)***	-2.286780 (0.1814)	-7.130068 (0.0000)***	I(1)
GDP	-4.820639 (0.0003)***		-4.820639 (0.0003***		I(0)
INF	-4.612867 (0.0006)***		-5.635895 (0.0002)***		I(0)
TOP	-0.924574 (0.7697)	-5.618687 (0.0000)***	-1.012733 (0.7393)	-5.604481 (0.0000)***	I(1)

Note: *, **, *** indicate 10%, 5% and 1% significant levels respectively

Source: Computed in E-Views Software

Table 03 indicates the critical values of the bound test. Estimated F – statistic (4.954134) is more than the critical value at 1 percent, 5 percent and 10 percent for the upper bound I(1). Therefore, this study confirmed that there is cointegration. This suggests that there is a long-run association between GDP,FDI, interest rate, inflation, trade openness and exchange rate in Sri Lanka.

Table 03: Bound Test

Critical Value	Lower Bond Value – I(0)	Upper Bound Value – I(1)
1%	3.06	4.15
5%	2.39	3.38
10%	2.08	3
F-Statistics	4.954134	
K	5	

Source: Computed in E-Views Software

The coefficient of interest rate (-0.174389) has a negative and statistically significant impact on FDI inflows (in Table 04). In this study, there is a negative association between interest rates and FDI inflows. This finding indicates that a 1 percent rise in the interest rate primes to an almost 17 percent decrease in FDI inflows in Sri Lanka. The negative consequence of interest rate on FDI advocates the view of (Bett, 2017; Faroh & Shen, 2015; Jayasekara, 2014) that a decrease in interest rate typically increases the FDI. Hence, by decreasing the interest rate, the Sri Lankan government can increase the FDI inflow into the country. Unfortunately, exchange rate depreciation against the US dollar in Sri Lanka supports an increase in interest rates.

Consequently, FDI inflows are affected. But, in the long run, the interest rate has no significant connection between the interest rate and FDI inflows.

Table 04: Long Run Coefficients

Constant	GDP	INF	IR	EXR	TOP
-1.139028	0.089156	0.013213	0.020724	0.006402	0.016439
(0.1409)	(0.0581)*	(0.4890)	(0.6987)	(0.0279)**	(0.0925)*

Note: *, **, *** indicate 10%, 5% and 1% significant levels respectively

Source: Computed in E-Views Software

Similarly, the coefficient of economic growth (0.076043) has a positive and significant impact on Foreign Direct Investment inflows in both the short run and long run. This implies that a 1% percent increase in GDP can lead to an approximately 7 percent increase in FDI inflows to Sri Lanka.

The coefficient of the exchange rate (-0.000399) has a negative and statistically significant impact on FDI inflows. There is an inverse association between exchange rate and FDI inflows. This suggests that a 1 percent increase in the exchange rate can lead to nearly a 0.03 percent decrease in FDI inflows. Sri Lanka has a long exchange rate depreciation against foreign currencies which negatively influences the inflow of FDI. This result has been found in previous empirical studies by (Anna & Karambakuwa, 2012; Siddiqui & Aumeboonsuke, 2014). Trade openness and inflation have no significant influence on FDI inflows.

Table 05: Results of Error Correction Model (ECM)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.022957	0.094056	0.244075	0.8090
ΔFDI (-1)	0.511290	0.165670	3.086192	0.0045
ΔGDP	0.076043	0.032638	2.329844	0.0272**
ΔINF	0.000422	0.011510	0.036662	0.9710
ΔIR (-1))	-0.174389	0.053251	3.274867	0.0028***
ΔEXR	-0.000399	0.018154	-0.022001	0.0826*
ΔTOP	0.015985	0.016144	0.990139	0.3306
ECT(-1)	-1.289023	0.241859	-5.329648	0.0000***
R-squared	0.613071			
Adjusted R-squared	0.516338			
F-statistic	6.337803			
Durbin-Watson stat	1.943738			

Note: *, **, *** indicate 10%, 5% and 1% significant levels respectively

Source: Computed in E-Views Software

Table 06: Diagnostic Test Results

Diagnostic	P-value	Results
Normality: Jarque- Bera	10.65487	Error is normally distributed
Serial correlation: Bruesch- Godfrey serial correlation LM test	0.1284	No Serial correlation
Omitted Variable: Ramsey RESET Test	0.1114	No Omitted Variables
Heteroscedasticity: White Test	0.5139	No Heteroscedasticity

Source: Computed in E-Views Software

The Error Correction Term [ECT(-1)] calculates the speediness of change between the short-run volatility and the long-run equilibrium. It has a negative sign and is statistically significant at 1 percent. The speed of 128 percent volatility in the short run will be adjusted in the long run through the exact policy reforms.

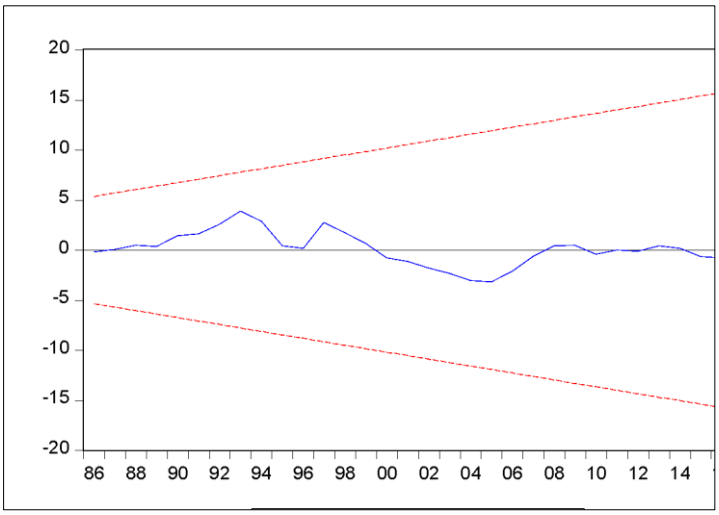


Figure 01: CUSUM Test Results

The constancy of the model was analyzed using statistics of the Cumulative Sum of Recursive Residuals (CUSUM). Statistics lie between boundary lines shown as two separate lines. Thus the null hypothesis will not be rejected. Therefore, this model was stable in 5 percent critical bounds.

5. CONCLUSION

This study intends to identify the relationships and influence of interest rates on FDI inflows in Sri Lanka by using data from 1978 to 2020. Based on the literature review this study identified that the GDP, exchange rate, interest rate, trade openness and inflation rate are five significant indicators which mostly affect the FDI inflows in Sri Lanka. In this study, ADF unit root tests proved that all the variables are stationary at the level and their first difference. It suggests that all variables are integrated with order zero and one and all lag length selection tests. Therefore, this study used the ARDL model for the analysis.

According to the bound test, F-statistics is more than the upper bound value. Therefore, this study confirmed that there is a cointegration relationship between the FDI and other explanatory variables. Long-run results show that GDP growth, trade openness and exchange rate have a significant influence on foreign direct investment inflow in Sri Lanka whereas inflation and interest rate do not affect FDI inflows. There is a positive and significant association between GDP and FDI inflows. Whereas interest rate and exchange rate have a negative and significant relationship with the FDI inflows. A negative and significant error correction coefficient (-1.289) of FDI inflows reveals that 128 percent disequilibrium is adjusted each year which implies that FDI transfers downward towards long-run equilibrium. Eventually, this study concluded long-run equilibrium among the FDI and five explanatory variables.

6. RECOMMENDATION AND SUGGESTIONS FOR FURTHER RESEARCH

This study suggests that the government of Sri Lanka has to reflect on developing a monetary policy and maintaining the balance of interest rate and exchange rate. Because of the currency depreciation, the exchange rate negatively influences FDI. The government should encourage the private sector to organize and utilize domestic resources for creative investment. Trade openness and reduction in trade barriers are significant economic policies in emerging countries like Sri Lanka, to stimulate domestic economic growth, produce employment opportunities and invent new technology through foreign direct investment. Therefore, the Sri Lankan government should implement more liberalization policies to attract foreign investment into the country.

This study contributes to the literature due to the few kinds of literature available in the Sri Lankan context. Further, this study contributes to the researcher in the way of exposing the relationship between the FDI inflows, interest rates and other control variables. This study suggests that further research be directed to incorporate human capital, innovation and technologies, political stability, money supply and so on. This will support policymakers to know the most suitable determinant to attract the FDI inflows. Researchers can perform the Granger causality test to analyze the various relationships between FDI and other macroeconomic variables.

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