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## FOREIGN DIRECT INVESTMENT: ECONOMIC GROWTH AND ISLAMIC BANKING INDUSTRY

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**ABSTRACT**

The purpose of this paper is to investigate the effect of FDI and Islamic banking on the increase of economic growth in Islamic countries in the 1990-2010 periods. The IPS unit root test indicates that variables are stationary in level and Hausman test suggests that we should apply the fixed effects model. The estimation of the model parameters leads us to conclude that FDI and the Islamic banking industry have a positive and significant effect on economic growth and variables such as human capital, economic infrastructure and capital formation have also positive effect on GDP. On the other hand, GDP, human capital and infrastructure attract FDI but Islamic banking has a weak positive effect on FDI attraction.

**JEL CLASSIFICATION**

F21, O16, D24.

**KEYWORDS**

Foreign Direct Investment; Economic Growth; Islamic Banking.

**INTRODUCTION**

The Islamic banking is a type of banking versus conventional banking. The different between conventional and Islamic banking is on interest rate: in conventional banking interest rate is fixed but in Islamic banking one isn't fixed. In Islamic banking the interest rate varies depend on the profit of project. There are many Islamic contracts that Islamic banks apply for the loans. According to these contracts (such as Mozareba, Moshareka,..) the interest rate isn't fixed inverse of capitalism banks.

Nowadays, Islamic financial markets were developed around the World even in Europe continent. There are more than 400 institutions spread over 51 countries (Dubai Islamic Bank 2009). The first modern Islamic bank was opened in Egypt. Then this type of banking was developed in the countries such as Malaysia, Pakistan and so on.

In Islamic countries there is other phenomenon that affects on economic activities. There are three dedicates that foreign direct investment was spread in these countries. The developing and certain Islamic countries usually have the problems about physical capital; foreign direct investment could comprise the lack of capital in these countries. Both, foreign direct investment and banking activities are the important variable in economy of these countries and the impact of these factors is different in each country, therefore the aim of this paper is the study of foreign direct investment and Islamic banking on economic growth in Islamic countries.

Borensztein and Gregorie & Lee (1978) show that foreign direct investment in an endogenous model cause of economic growth in developed countries. Blomstorm et al. (1996) indicate that foreign direct investment improves economic growth in developing countries. On the other hand, Balasubramanyam et al. (1996) show that foreign direct investment, plays more important role in economic growth as compared to export. Carkevic and Levine (2005) also showed that foreign direct investment leads to the increase of economic performance. However, Gory and Greenaway (2004) proved that FDI does not have any influence on economic growth. Tajardo, Behname and Noormohamadi (2012) have showed that there is a bidirectional relationship between Islamic banking and FDI (the feedback relationship). It means that FDI reinforce Islamic banking and Islamic banking attracts foreign direct investment. Behname (2008, 2011) has shown that economic growth is a determinant of foreign direct investment.

**FOREIGN DIRECT INVESTMENT, ISLAMIC BANKING AND ECONOMIC GROWTH**

Romer (1986) has developed a framework for the effect of foreign direct investment on economic growth. Fedderke and Romm (2006) by the spirit of De Mello (1997) and Ramirez (2000) develop a model for the study of impact of foreign direct investment on economic growth. They apply an augmented Cobb –Douglas function

$$Y=Af(L, K_p, E)=AL^\alpha K_p^\beta E^{1-\alpha-\beta} \quad (1)$$

where Y stands for real output, K<sub>p</sub> apply for the domestic capital stock, L shows labor, and E is stock of FDI.

$$E=(L, K_p, K_f)^\rho \quad (2)$$

where K<sub>f</sub> stands for foreign capital. Combining Eqs. (1) and (2) they obtain

$$Y=AL^{\alpha+\theta(1-\alpha-\beta)} K_p^{\beta+\theta(1-\alpha-\beta)} K_f^{\rho(1-\alpha-\beta)} \quad (3)$$

Finally they can generate the dynamic production function by taking logarithms and tim derivatives of Eq. (3):

$$g_y = g_A + (\alpha + \theta(1 - \alpha - \beta))g_L + (\beta + \theta(1 - \alpha - \beta))g_{K_p} + (\rho(1 - \alpha - \beta))g_{K_f}$$

where g<sub>i</sub> is the growth rate of i=Y, A, L, K<sub>p</sub> and K<sub>f</sub>. By assumption  $\alpha + \beta < 1$ , we can result that foreign direct investment has a positive effect on economic growth g<sub>y</sub>.

On the other hand, the credit of bank is an important factor in economy. The banks by development of credit system improve domestic and foreign investment and increase production, then the activity of banks could be cause of the economic growth. When the banks decrease the interest rate or increase the credit, investors rise investment by increasing investment aggregate demand would increase, increasing aggregate demand augments real output and so on. After a period, economic growth would increase.

**DATA AND METHODOLOGY**

Before estimation of the model, we should be ensured of the stationarity of the series. Dickey-Fuller, Augmented Dickey and Phillips-Perron tests are used to measure the stationarity of time-series variables, however, for panel data which have higher power in comparison to the time-series, other tests are applied. These tests are: Im, Pasavan and Shin (1997, 2002), Levin, Lin and Chu (1992). Among different unit root tests in econometrics literature, the LLC and IPS are more conventional than others. Both of these tests have been made based on ADF.

Assuming that data are homogeneous, LLC test has been made for dynamics of autoregressive coefficients for all panel data. However, IPS more generally considers heterogeneity for these dynamics.

The benchmark model of autoregressive is as follows:

$$Y_{it} = \rho_i Y_{it-1} + \delta_i X_{it} + \varepsilon_{it} \quad (1)$$

where shows  $i = 1, 2, \dots, N$  of the countries from the times of  $t = 1, 2, \dots, T$ .  $X_{it}$  are exogenous variables in the model.  $\rho_i$  is the autoregressive coefficient and  $\varepsilon_{it}$  is the error term. If  $\rho_i < 1$ ,  $Y_i$  is weak stationary and if  $\rho_i = 1$ , then  $Y_i$  has a unit root. In this paper, IPS test was used for the unit root, as the different economic structures for the respective countries. Behname (2011a,b)

**TABLE 1: UNIT ROOT TEST AND PANEL DATA**

GDP	INF	BAN	HUM	GCF	FDI	EX
-2.21*	-1.55*	-6.77*	-2.43*	-2.53*	-4.64*	-2.96*

The variables are stationary at the 5% confidence level.

As defined in Table 1, all the variables were significant in the 5% level of confidence. It means the variables are stationary, and so, spurious regression is avoided. The Hausman test is used to select the fixed effects or random effects models. This test shows that the fixed effects model is appropriate.

**DATA AND METHODS**

The main variables for economic growth in this study include investment, banking sector (credits of Islamic bank in the host economy), GDP per capita, infrastructure (telephone line), inflation, productivity, human capital and foreign direct investment.

We apply a linear panel data model for analysis of FDI and Islamic banking effects on economic growth. The basic specification for the model is as following:

$$GDP_{it} = \beta_0 + \beta_1 INF_{it} + \beta_2 BAN_{it} + \beta_3 HUM_{it} + \beta_4 GCF_{it} + \beta_5 FDI_{it} + BX_{it} + \varepsilon_{it}$$

where GDP is the real gross domestic product per capita growth of country  $i$ , INF stands for infrastructure, BAN is a proxy for Islamic banking sector and HUM stands for human capital in the host economy. FDI is the foreign direct investment and GCF is gross capital formation as a percentage of GDP. The group of  $X$  includes a group of variables to test the robustness of results (e.g. dummy variables, interaction of FDI with other variables, inflation...). We could consider the endogenous form of the model i.e. FDI to be a dependent variable.

The sources of variables are UNdata, World Development Indicators, FMI and Growth Data Resources. To calculate the Credits to Private Sector allocated by Islamic banks we follow two steps:

1. We made an exhaustive list of Islamic banks in selected Asian countries.
2. Assuming that all credits provided by Islamic banks are allocated to private sector as, the main selection criteria of projects in Islamic banks are the productivity. So we aggregate different total of credits from bank balance sheets to get the overall credits to private sectors by Islamic banks for each country. Data source is Bankscope database compiled by IFIS (Islamic Finance Information Service) dataset. (Tajgardoon, Behname, Noormohamadi 2003)

The data set used covers Islamic countries over the period of 1990-2010. The countries contain: Bahrain, Iran, Malaysia, United Arab Emirates, Pakistan, Kuwait, Saudi Arabia, Qatar, Iraq, Oman, Turkey, and Yemen. The limitation of date and countries is for the lack of certain sufficient data.

**EMPIRICAL RESULTS**

The Table 2 shows the results of estimation of our equation. In the column 2.1 we introduce the main variables: FDI, HUM and BAN. The results show the effect of Islamic banking sector, human capital and foreign investment variables on economic growth are positive and also significant. This result shows that the Islamic banking increases economic growth because nowadays, goods and services transfer through the money and banking system and an efficient bank system accelerate economic growth. Tajgardoon, Behname and Noormohamadi (2012) with a Granger causality test have shown that the Islamic banking causes of economic growth in the home countries. On the other hand, in production function, foreign direct investment considers as capital. Human and physical capitals are the essential variables in production function which affect positively GDP. Foreign direct investment the same as domestic investment increase aggregate demand and aggregate demand augment real domestic output. A high human capital level shows that the workers adopt easily the new technology and this process accelerates economic growth. Heir, the coefficients correspond on the theory. Behname (2008, 2011) and Borensztein et al (1998) indicate these results are confirmed for the many countries.

We add GCF to the column 2.2. This equation shows that capital formation could increase economic growth. In this column, human capital is insignificant but other variables have the same sign that the first column. Fnag (2011) and Apergis and Payne (2011) have also shown that capital formation could rise economic growth.

In equation 2.3 the infrastructure was also add. The proxy variable for infrastructure is the fixed telephone line per 10000. For our example the infrastructure has not any effect on economic growth, but other variables are the same that in second column. In the most researches that infrastructure was considered the effect of this variable on GDP is positive because with a good infrastructure inputs and outputs would transfer very easily. In the third column this variable is positive. In the fourth column, capital formation was deleted and by this change, the result has been varied. In this column, the banking sector isn't significant but infrastructure increase economic growth. In column 2.5, we include INFR inflation rate, as a systematic risk, into the equation which has positive effect on economic growth. Increasing in price general level is a motivation for producer because they consider this augmentation as increasing in their profit. Behname (2011b) shows that inflation rate could increase national income.



TABLE 2: IMPACT OF FDI ON PER CAPITA GDP GROWTH

	2.1	2.2	2.3	2.4	2.5
Constant	5.13** (2.12)	2.41* (2.99)	2.43*** (1.09)	1.33 (1.22)	2.22
BAN	0.14** (2.11)	0.22** (2.09)	0.21** (2.13)	0.13 (1.12)	0.26** (2.23)
HUM	0.92* (1.85)	0.37 (1.01)	0.89** (2.09)	0.81** (2.04)	0.43** (2.22)
FDI	0.101** (2.31)	0.39** (2.10)	0.21* (1.89)	0.12** (2.09)	0.25** (2.11)
GCF		0.14*** (4.12)	0.13** (2.04)		0.15* (2.12)
INF			0.51 (1.23)	0.34** (2.08)	0.43* (1.88)
INFR					0.09** (2.15)

Notes: t-values reported in parentheses; \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level.

Table 3 indicates the estimation of equation for foreign direct investment. In general, we consider that the effects of economic growth and human capital on FDI are positive, and the results show this fact. But for banking sector only in the first and the last model is positive and significant and its effect is weak. Based on this table, economic growth, human capital, trade, capital formation and economic infrastructure have positive sign and mainly significant effect on attracting foreign capital, while economic risk, (inflation), leads to the decrease of foreign investment. Aitken & Harrison (1999) and De Mello (1997) show the same results.

TABLE 3: IMPACT OF GROWTH ON FDI INFLOW

	3.1	3.2	3.3	3.4	3.5
Constant	-2.43** (-2.21)	-4.19** (-2.01)	-3.22** (-2.09)	-2.11** (-2.14)	-2.05 (-1.34)
GDP	0.03** (2.22)	0.02** (2.13)	0.06 (1.12)	0.03** (2.41)	0.03** (2.22)
HUM	0.23** (2.31)	0.33* (1.88)	0.21** (2.13)	0.23 (1.41)	0.32 (2.09)
BAN	0.03** (2.21)	0.65 (1.11)	-0.14 (-1.31)	0.32 (1.12)	0.03** (2.14)
EX		0.03* (1.91)	0.03** (2.12)	0.04** (2.17)	0.06** (2.14)
GCF			0.32** (2.09)	0.32** (2.09)	0.05** (2.03)
INFR				-0.14** (-2.04)	-0.08** (-2.11)
INF					0.31** (2.16)

Notes: t-values reported in parentheses; \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level.

## CONCLUSION

The aim of this paper is the survey of foreign direct investment (FDI) and Islamic banking effects on economic growth in the Islamic countries for the period 1990-2010. For avoid from spurious regression the unit root test was applied, and the results reveal that all the variables are stationary in level. The Hausman (1978) test is used to select the fixed effects or random effects models. This test shows that the fixed effects model is appropriate. We studied the effects of FDI and Islamic banking on economic growth, and the effect of GDP and Islamic banking on FDI. In each column, in order to compare the models we have included different variables. In general, the estimation shows that foreign direct investment could increase economic growth, this conclude corresponds on the theory that was developed by Fedderke and Romm (2006). Capital is the main variable in production function, marginal production of capital is positive that's mean augmentation of capital would increase real income. In this table we have also shown that Islamic banking can increase strongly economic growth. When Islamic banks develop their activities, the firms easily achieve the credit and they can extend their outputs. In this paper was cleared that human capital, trade and infrastructure increase economic growth.

The first estimation of our research reveals that economic growth and Islamic banks could attract foreign direct investment. A potential market is very important for foreign investors. The level of national income and its growth shows this market. A high level of educated labor force could increase productivity and efficiency in the firms. Therefore, Islamic countries could attract foreign capital by focus on these variables, but we should consider that Islamic banking effect on FDI attraction is weak.

For the second estimation we show the effective factors on economic growth, we could mention economic infrastructure, human capital and capital formation which increase the growth. Based on the obtained results, the Islamic countries should devote their most attention to economic infrastructure and capital formation, since it directly increases GDP and affects it indirectly through attracting FDI.

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