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W07:02

May 2007

Talking Trade or Talking Aid? Does Investment
Substitute for Aid in the Developing Countries?

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Talking Trade or Talking Aid? Does Investment Substitute for Aid in the Developing Countries?*

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May 2007

Abstract

This paper looks at the correlation between aid inflow and foreign direct investment inflow to the heavily indebted poor countries Malawi, Mozambique and Ghana. I analyze data running from 1970 through 2004, using a simultaneous equation system to determine the interrelation. Due to the occasional small scale of flow, the inverse hyperbolic sine function is used, rather than a logarithmic function. Results indicate that when the sample countries experience a higher income per capita, complementary effects diminish at the cost of supplementary effects.

Keywords: Foreign Direct Investment, Aid, Developing Countries
JEL Classifications Codes: F21, F23

*This paper was presented in May 2006 at a NOITS conference in Iceland. I very much appreciate comments received from conference participants. I also wish to thank for helpful comments by Ronald B. Davies, Thorvaldur Gylfason, Gian Maria Milesi-Ferretti and Carl-Johan Dalgaard.

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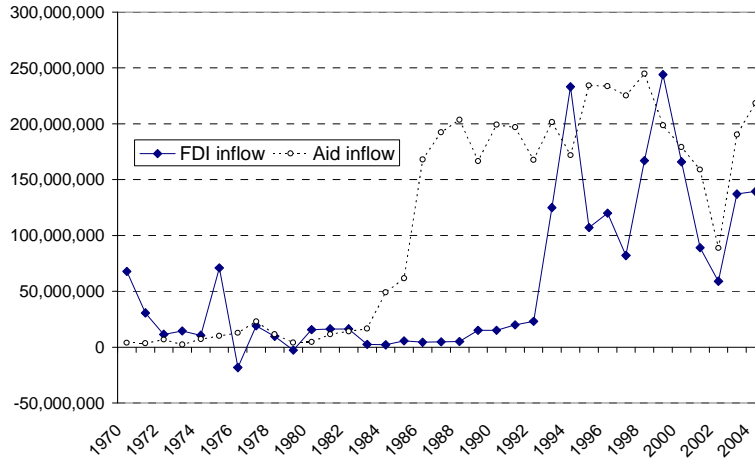
1 Introduction

The general belief has historically been that the recipients of foreign direct investment (FDI) from wealthy countries has been poorer countries. However, Markusen (2002) showed that the wealthy countries tend to invest in each other, so the flow of investment is primarily between the west and east, rather than from north to south, leaving the poorer African countries in an FDI wasteland. So what happens in the poorer countries? Many receive foreign aid, but is it doing its job? Does the aid improve the conditions in the countries to the extent that the country becomes able to attract FDI on its own? Can self-sufficiency be achieved for these chronic aid recipients? This paper aims to answer these questions, by looking at data from 1970 to 2004 for three African countries that are classified as heavily indebted poor countries (HIPC). All three have been receiving aid for the whole period studied, but all three have managed to attract some level of FDI in more recent years. What is the connection between the aid and the FDI? This is a challenging question, given the marginality of FDI inflow for the countries, because most functions to analyze FDI are really only designed for positive values. In this case, the zeros are also interesting and do have meaning, so a zero-friendly function is required. I therefore choose to use the Inverse Hyperbolic Sine functional format so the zeros in the data can be used productively, unlike an logarithmic function that simply ignores them. Furthermore, since the FDI and aid are so intertwined, I use the simultaneous equation system in order to explore the interrelation.

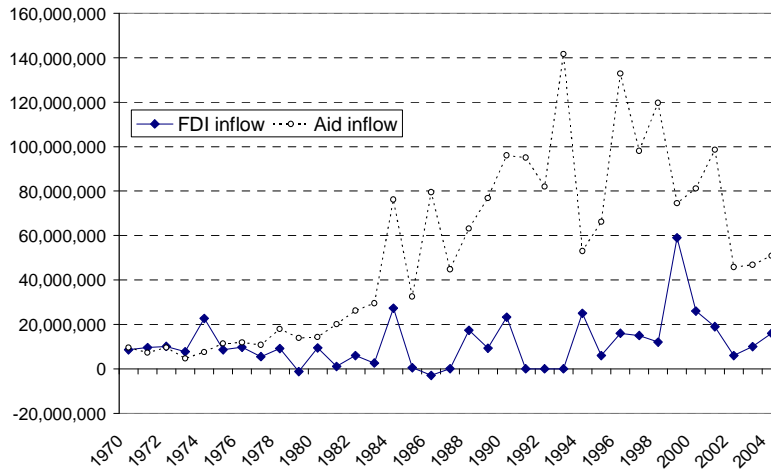
In the developing countries, FDI investment tends to be greenfield rather than brownfield, meaning that it's less likely to be in the form of joint ventures or mergers and acquisitions (M&As). This means that FDI data is less convoluted in developing countries and the flow data can be applied directly rather than proxied by affiliate sales figures as done by Brainard (1997), Ekholm et al. (2003) or Markusen (2002). The paper is organized as follows. Section 2 sets out the literature and Section 3 explains the modelling strategy used and data. In Section 4 estimation results are presented. Finally, Section 5 provides summary and conclusions.

Figure 1: FDI inflow and Aid inflow to the sample countries.

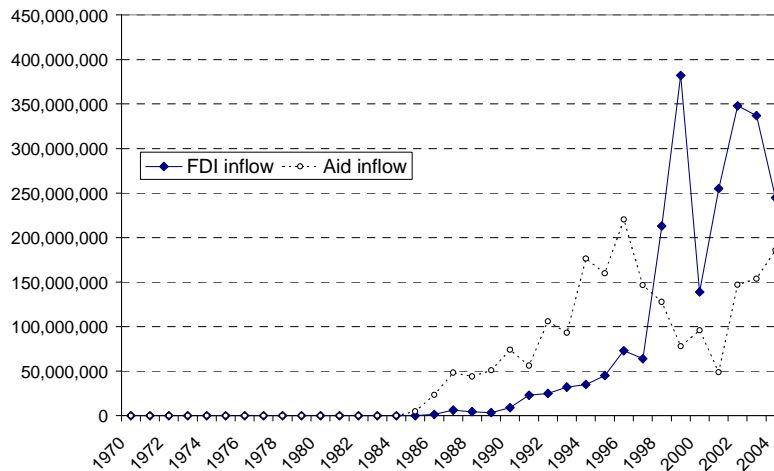
Ghana: FDI inflow and Aid inflow.



Malawi: FDI inflow and Aid inflow.



Mozambique: FDI inflow and Aid inflow.



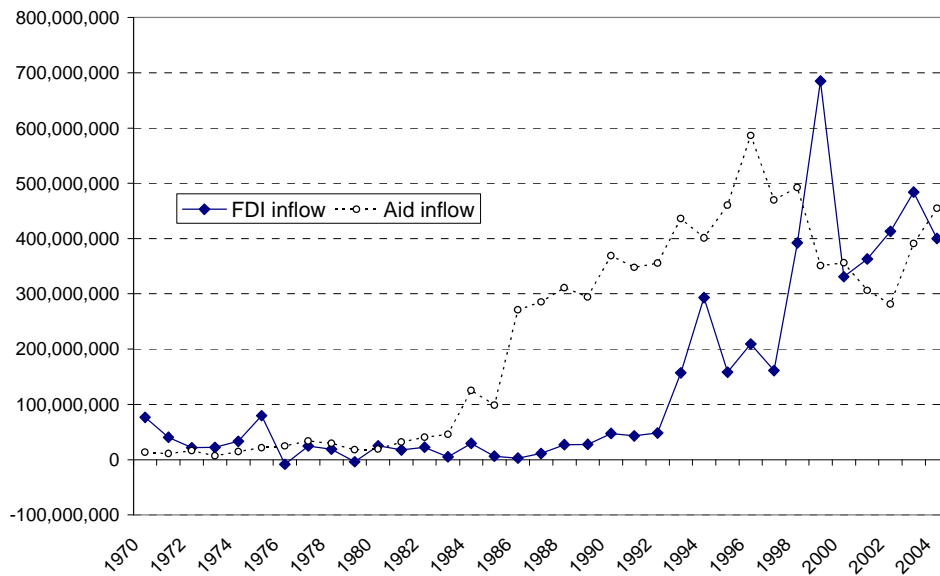
Source: World Bank (2006B).

2 Literature

Available literature on FDI in the developing countries often tends to consider the contribution of FDI to growth, as shown in papers by De Mello (1997), Balasubramanyam et al. (1996) and Borensztein et al. (1998). Borensztein et al. (1998) suggest that the host country of FDI needs to have a minimum threshold of human capital, to experience higher productivity of FDI. Some papers have looked at how FDI affects domestic firms in the local market, these would be papers like Aitken and Harrison (1999), and Aitken et al. (1997). Also, a paper by Edwards (1990) looks at debt-equity swaps in the developing countries.

Moreover, when considering aid flows and their contribution to shifting the economy into a higher equilibrium, a paper by Dalgaard et al. (2004) provides some interesting insights on how growth is impacted by aid flows, based on literature of some Burnside and Dollar papers. The variables selected in my paper somewhat correspond to the Dalgaard et al. (2004) paper.

Figure 2: Total FDI inflow and Aid inflow to Ghana, Malawi and Mozambique.



Source: World Bank (2006B).

Finding useful way to capture FDI has proven to be a difficult task, and therefore

some researchers have chosen to look specifically into issues regarding that. In a paper by Lane and Milesi-Ferretti (2003) the concentration is set on the composition of FDI and possible ways of correcting for M&As in the sample when estimating FDI.

In most of the recent literature, affiliate sales are commonly used as a proxy for FDI in a particular host country. With the objective of determining the shift between trade and multinational sales, Brainard (1997) analyzes multinational activities. In this well known paper, Brainard (1997) chooses to capture outward and inward FDI with separate measures as the share of affiliate sales in total exports, or to put it differently, share of overall foreign sales. More specifically, Brainard (1997) chooses to apply data on multinational activities in the United States, and countries trading with the United States. In her research, Brainard seeks to find ways to determine the willingness multinational enterprises have for entering into export, rather than overcoming the threshold of making foreign direct investment in a particular country. In her analysis, Brainard applies the proportion of export volume in overall corporate sales as the dependent variable, and this is measure is applied rather than applying sales of foreign affiliates in overall sales. The findings obtained by Brainard indicate that multinationals are more interested in entering into foreign production in the form of foreign direct investment, than seeking to export to markets in other countries, following an increase in the cost of transporting and with an increase in barriers to invest. It also stimulates investment when conditions are such that foreign plant scale economies are increasing relative to scale economies of the firm.

Another more recent example of a share measure can be found in a paper by Slaughter (2000). Slaughter seeks to proxy foreign direct investment by using the share of majority owned affiliates in the total of investment made by multinationals. On one hand Slaughter (2000) uses share of skilled labor in overall wage cost as the dependent variable of the equation, and the other hand he uses share of capital stocks an explanatory variable.

3 Model and Data

When choosing variables for the regressions, I use some of the variables Dalgaard et al. (2001) for estimating the connection between aid and growth. Since some of the sample data turn out to be negative, these are transformed by the inverse hyperbolic sine (IHS) procedure rather than the logarithm function.

A simultaneous equation model is applied here, which allows for simultaneous estimation of aid as function of foreign direct investment and investment as function of aid. More specifically, this procedure allows me to avoid the possible simultaneity which might exist among explanatory variables. I base the choice of variables somewhat on a paper by Dalgaard et al. (2004). In their paper Dalgaard et al. (2004) use GDP, population, fraction of land in tropic, and budget surplus among other variables when estimating the interaction of aid and growth.

The basic equation, Equation (1) goes as follows:

$$\begin{aligned} AID_inflow_{i,t} &= \alpha_0 + \alpha_1 FDI_inflow_{i,t} + \alpha_2 POP_{i,t} & (1) \\ &+ \alpha_3 GDP_{i,t} + \epsilon_{1,i,t} \\ FDI_inflow_{i,t} &= \alpha_4 + \alpha_5 AID_inflow_{i,t} + \alpha_6 CROP_{i,t} \\ &+ \alpha_7 CA_balance_{i,t} + \epsilon_{2,i,t} \end{aligned}$$

In Equation (1) the endogenous variables aid and FDI are functions of each other, as well as being function of other relevant variables for aid and FDI. The recipient country of FDI or aid, is denoted with (i), with the recipient countries being Ghana, Malawi and Mozambique.

Since I prefer to estimate the equation in a linear format, and change the notation, I now present it in a log-linear format as show in Equation (2). The model specification for the three-stage least-squares regression estimation for systems of simultaneous equations, for a linear regression format, can be presented as follows:

$$\begin{aligned}
\sinh^{-1}(AID_inflow_{i,t}) &= \beta_0 + \beta_1 \sinh^{-1}(FDI_inflow_{i,t}) & (2) \\
&\quad + \beta_2 \sinh^{-1}(POP_{i,t}) + \beta_3 \sinh^{-1}(GDP_{i,t}) + \zeta_{1,i,t} \\
\sinh^{-1}(FDI_inflow_{i,t}) &= \beta_4 + \beta_5 \sinh^{-1}(AID_inflow_{i,t}) + \beta_6 \sinh^{-1}(CROP_{i,t}) \\
&\quad + \beta_7 \sinh^{-1}(CA_balance_{i,t}) + \zeta_{2,i,t}
\end{aligned}$$

The simultaneous equation system presents AID inflow to the sample countries over time (t) by ($AID_inflow_{i,t}$) in Equation (2a), and FDI inflow over time (t) by ($FDI_inflow_{i,t}$) in Equation (2b).

Table 1. Variable Definition

Variable	
FDI INFLOW $_{i,t}$	The foreign direct investment data net inflows (BoP, current USD) into host country (i), over time (t).
AID INFLOW $_{i,t}$	International Development Association (IDA) loans, which are defined as long-term no interest loans provided to the poorest developing countries. IDA has the role of supporting anti-poverty programs in the host country (i), over time (t).
CROP $_{i,t}$	Crop production index (1999-2001 = 100) in host country (i), over time (t).
CA BALANCE $_{i,t}$	Current account balance (BoP, current USD) for country (i), over time (t).
POP $_{i,t}$	Population, total in the host country (i), over time (t).
GDP $_{i,t}$	Gross domestic product, current USD in the host country (i), over time (t).

The Aid, that is IDA financial flows into individual countries are defined by the World Bank (2006B) as net financial flows, AID (current US\$). World Bank (2006B) defines net financial flows as the disbursements of loans and credits less repayments of principal.

Table 2. Summary Statistics

VARIABLE	UNITS	OBS	MEAN	STD.	MIN	MAX
FDI INFLOW _{<i>i,t</i>}	current US\$	35	5.79e+07	6.94e+07	-1.83e+07	2.44e+08
AID INFLOW _{<i>i,t</i>}	current US\$	35	1.11e+08	9.35e+07	2200000	2.45e+08
CROP _{<i>i,t</i>}	prod. index	35	61.69143	26.97556	32.9	121.2
CA BALANCE _{<i>i,t</i>}	current US\$	30	-1.99e+08	2.35e+08	-9.64e+08	2.55e+08
POP _{<i>i,t</i>}	total	35	1.46e+07	3975582	8982592	2.17e+07
GDP _{<i>i,t</i>}	current US\$	35	4.98e+09	1.76e+09	2.13e+09	8.87e+09
INVERSE HYPERBOLIC SINE VARIABLE FORMAT						
FDI INFLOW _{<i>i,t</i>}		35	15.89859	8.207922	-17.46221	20.00583
AID INFLOW _{<i>i,t</i>}		35	18.39193	1.625021	15.29712	20.0091
CROP _{<i>i,t</i>}		35	4.730745	.4081998	4.186851	5.490606
CA BALANCE _{<i>i,t</i>}		30	37.66874	1.967186	33.36388	41.37383
POP _{<i>i,t</i>}		35	17.15251	.2763898	16.70395	17.58433
GDP _{<i>i,t</i>}		35	22.95303	.3880803	22.17026	23.599

Foreign Direct Investment is obtained from the World Bank (2006B), and these are foreign direct investment data net inflows (BoP, current US\$).

During the period estimated, FDI flows, aid flows and the current account occasionally turn negative, within particular years. This can happen if dividend payment from the host country to the source country is higher than the investments made in a particular year.

As to deal with these cases of zeros and negatives, the dependent variables of FDI and aid are estimated by using the so-called inverse hyperbolic sine (IHS) procedure, rather than a logarithm transformation¹.

Generally FDI is believed to give an indication of the long-term incentives of an investor, and can therefore potentially be considered to be a substitute for the International Development Association (IDA) loans, which are defined as long-term no interest loans provided to the poorest developing countries. IDA has the role of supporting anti-poverty programs.

¹The difference between the two functional forms is clearly visible for zeros and negative values.

In this paper the aggregate FDI World Bank (2006B) data is used together with IDA aid flow data from the World Bank (2006B). The other variables are defined by the World Bank (2006B) as follows: GDP (current US\$), Population (total), current account balance (BoP, current US\$), Crop production index (1999-2001 = 100). I use data running from 1970 to 2004.

I use World Bank data for all the variables estimated, all estimates are received using STATA 8.0.

4 Estimation Results

The regression results from estimating level data Equation (1a) and Equation (1b) simultaneously for aid and FDI, are presented in Table 3.

Table 3. Empirical Findings for the Basic Model Specification

Regressors	Ghana	Ghana, Moz., Malawi
	Equation 1a	Equation 1a
<i>AID_inflow_{i,t}</i>		
<i>FDI_inflow_{i,t}</i>	-.202 (-0.64)	.120 (0.91)
<i>POP_{i,t}</i>	9.954 (1.49)	6.049** (1.96)
<i>GDP_{i,t}</i>	.034*** (3.07)	.010** (2.25)
OBS.	30	77
R-SQ.	0.7018	0.4897
χ^2	72.75	77.98
	Equation 1b	Equation 1b
<i>FDI_inflow_{i,t}</i>		
<i>AID_inflow_{i,t}</i>	-.176 (-1.08)	.393** (2.15)
<i>CROP_{i,t}</i>	2041060*** (4.95)	1363558*** (3.43)
<i>CA_balance_{i,t}</i>	-.1088126** (-2.79)	-.154*** (-5.30)
OBS.	30	77
R-SQ.	0.6298	0.5968
χ^2	57.06	126.48

Note: t-statistics are in parentheses below the coefficients. ***, ** and * denote significance levels of 1%, 5% and 10%, respectively.

The results from estimating Equation (1a) first present aid inflow (*AID_inflow_{i,t}*) to the sample countries (Malawi, Mozambique and Ghana) as function of FDI inflow (*FDI_inflow_{i,t}*), Population (*POP_{i,t}*) and gross domestic product, GDP (*GDP_{i,t}*).

Then the results from estimating Equation (1b) are presented with FDI inflow as function of aid inflow, crop production and the current account balance.

The simultaneous equations for Ghana are somewhat as could be expected. Taken together, in the case of Ghana, FDI and aid are not found to complement each other, that is they are found to be substitutes rather than complements. However, when Mozambique and Malawi are also included in the sample, FDI flows and aid flows are found to complement, rather than substitute, each other. Increase in aid inflows is found to significantly positively affect FDI inflow. These results can be found to support the hypothesis implying that when the HIPC countries experience a higher income per capita, as is the case for Ghana in comparison with Malawi and Mozambique², then complementary effects diminish, while supplementary effect increase with FDI inflows increasingly substituting for aid inflows.

Furthermore, as the estimates reported in Table 3 show, aid inflows are estimated to be positively affected by an increase in population and GDP. FDI is estimated to be positively affected by crop production, however negatively affected by the current account balance, these results are as could be expected.

Let us next look at the regression results obtained from estimating Equation (2), when using an inverse hyperbolic sine functional format (\sinh^{-1}) for all the variables. These results are presented in Table 4. Before interpreting the results for Table 4, the historical development of the sample countries Ghana, Malawi and Mozambique deserves more attention. Ghana is sometimes viewed by international institutions as having a development success story, whereas Mozambique had civil war during the period analyzed, and Malawi suffered from dictatorship.

In Table 4, the logarithm equations represent elasticity coefficients, indicating the percentage change in dependent variable following a one percentage increase in one of the explanatory variables. The main conclusion to be drawn from Table 4 is that on the margin, aid inflow appears to complement FDI. Also, population is

²In 1990 Ghana had GDP 211, Malawi 131 and Mozambique 163, and in 2000 Ghana had GDP 251, Malawi 151 and Mozambique 211, these are GDPs (constant 2000 US\$), World Bank (2006B).

found to have more significant positive effects on aid than GDP, and crop less effect. As for the whole sample, variables are found to be less significant than before.

Table 4. Inverse Hyperbolic Sine Function Estimation

Regressors	Ghana	Ghana, Moz., Malawi
	Equation 2a	Equation 2a
$\sinh^{-1}(AID_inflow_{i,t})$		
$\sinh^{-1}(FDI_inflow_{i,t})$.067 (1.02)	.289 (1.07)
$\sinh^{-1}(POP_{i,t})$	2.988 (2.47)	-1.430 (-0.34)
$\sinh^{-1}(GDP_{i,t})$.565 (0.86)	.307 (0.30)
OBS.	30	77
R-SQ.	0.6598	-0.3232
χ^2	67.43	5.96
	Equation 2b	Equation 2b
$\sinh^{-1}(FDI_inflow_{i,t})$		
$\sinh^{-1}(AID_inflow_{i,t})$	6.663 (2.53)	5.622 (1.43)
$\sinh^{-1}(CROP_{i,t})$	-7.485 (-1.29)	-2.273 (-0.27)
$\sinh^{-1}(CA_balance_{i,t})$	-.382 (-0.52)	.302 (0.32)
OBS.	30	77
R-SQ.	0.1528	-1.3301
χ^2	12.71	5.16

Note: t-statistics are in parentheses below the coefficients. ***, ** and * denote significance levels of 1%, 5% and 10%, respectively.

5 Summary and conclusions

This research has the objective of determining whether aid flows and FDI inflows in some of the HIPC countries can be found to be supplements or complements, when analyzed over a period of time. Generally FDI is believed to give an indication of the long-term incentives of an investor, and can therefore be considered to be substitute for International Development Association (IDA) loans, which are defined as long-term no interest loans to the poorest developing countries.

An important issue of concern is whether there is a shift from financial aid flows to FDI flows, when the economies move to a higher equilibrium, as reflected in higher income per capita. Estimates are obtained for the HIPC countries Ghana, Malawi and Mozambique, with Ghana having higher GDP than the other two countries. These countries are estimated together in one sample, and Ghana is also estimated individually as to provide a comparison to the other two countries. One of the concerns to be considered in this context is that HIPC data may be somewhat troublesome. Flows may have zero values, or turn negative. Therefore I choose to apply an inverse hyperbolic sine function in order as to deal with these countries, since that functional form allows for estimation of negative flows and zeros.

In conclusion, in the case of Ghana, FDI and aid are found to substitute, rather than complement each other. However, when Mozambique and Malawi are included in the sample, FDI flows and aid flows are found to complement each other.

Overall, the results can be found to support the theory that when the HIPC countries experience a higher income per capita, as in the case for Ghana in comparison with Malawi and Mozambique, complementary effects diminish at the cost of supplementary effects. With FDI inflows increasingly substituting for aid flows.

6 Appendix A

I use the definition by World Bank (2006A) on the Heavily indebted poor countries (HIPC) countries³.

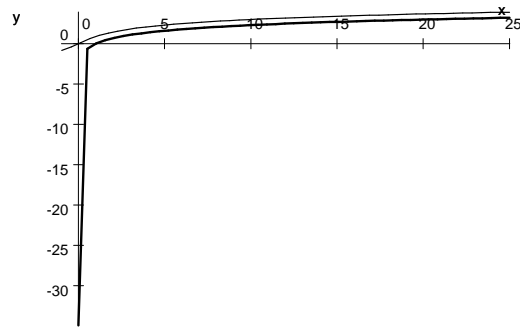
³These countries are:

Benin
Bolivia
Burkina Faso
Burundi
Cameroon
Central African Republic
Chad
Comoros
Congo, Dem. Rep.
Congo, Rep.
Côte d'Ivoire
Ethiopia
Gambia, The
Ghana
Guinea
Guinea-Bissau
Guyana
Honduras
Lao PDR
Liberia
Madagascar
Malawi
Mali
Mauritania
Mozambique
Myanmar
Nicaragua
Niger
Rwanda
São Tomé and Príncipe
Senegal
Sierra Leone
Somalia
Sudan
Tanzania
Togo
Uganda
Zambia

7 Appendix B

The Inverse Hyperbolic Sine function has a similar functional shape as the logarithm function for positive values as Figure 3 exhibits. The Inverse Hyperbolic Sine Function can be presented as $\sinh^{-1}(x) = \ln(x + (1 + x^2)^{0.5})$

Figure 3. Inverse Hyperbolic Sine and Natural Logarithm Functions



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W06:01: Eyjolfur Sigurdsson, Kristin Siggeirsdottir, Halldor Jonsson jr , Vilmundur Gudnason, Thorolfur Matthiasson, Brynjolfur Y Jonsson: Early discharge and home intervention reduces unit costs after total hip replacement: Results of a cost analysis in a randomized study.

W05:14 Gylfi Zoega and J Michael Orszag: Are Risky Workers More Valuable to Firms?

W05:13 Friðrik Már Baldursson: Fairness and pressure group competition.

W05:12 Marias H. Gestsson and Tryggvi Thor Herbertsson: Fiscal Policy as a Stabilizing Tool.

W05:11 Tryggvi Thor Herbertsson and Gylfi Zoega: On the Adverse Effects of Development Aid.

W05:10 Thráinn Eggertsson and Tryggvi Thor Herbertsson: Evolution of Financial Institutions: Iceland's Path from Repression to Eruption.

W05:09 Tryggvi Thor Herbertsson: The Icelandic Pension System in 2004.

- W05:08 Ron Smith and Gylfi Zoega: Unemployment, investment and global expected returns: A panel FAVAR approach.
- W05:07 Gylfi Zoega and Thorlaktur Karlsson: Does Wage Compression Explain Rigid Money Wages?
- W05:06 Thorvaldur Gylfason: India and China
- W05:05 Edmund S. Phelps: Can Capitalism Survive?
- W05:04 Thorvaldur Gylfason: Institutions, Human Capital, and Diversification of Rentier Economies
- W05:03 Jón Daníelsson and Ásgeir Jónsson: Countercyclical Capital and Currency Dependence
- W05:02 Alison L. Booth and Gylfi Zoega: Worker Heterogeneity, Intra-firm Externalities and Wage Compression
- W05:01 Tryggvi Thor Herbertsson and Martin Paldam: Does development aid help poor countries catch up?
- W04:12 Tryggvi Thor Herbertsson: Personal Pensions and Markets
- W04:11 Fridrik M. Baldursson and Sigurdur Johannesson: Countervailing Power in the Icelandic Cement Industry
- W04:10 Fridrik M. Baldursson: Property by ultimatum: The case of the Reykjavik Savings Bank
- W04:09 Ingólfur Arnarson: Analyzing Behavior of Agents of Economic Processes in Time
- W04:08 Otto Biering Ottosson and Thorolfur Matthiasson: Subsidizing the Icelandic Fisheries
- W04:07 Niels Vestergaard and Ragnar Arnason: On the Relationship between Greenland's Gross Domestic Product and her Fish Exports: Empirical Estimates
- W04:06 Ingolfur Arnarson: Modelling Fishery Management Schemes with an Olympic System Application
- W04:05 Ingolfur Arnarson and Pall Jensson: Adding the Sales Markets Dimension to Bio-Economic Models. The Case of Fishery Management
- W04:04 Edmund S. Phelps: Changing Prospects, Speculative Swings: Structuralist Links through Real Asset Prices and Exchange Rates
- W04:03 Ingolfur Arnarson: Analysing Behavior of Agents of Economic Processes in Time
- W04:02 Ron Smith and Gylfi Zoega: Global Shocks and Unemployment Adjustment
- W04:01 Fridrik M. Baldursson and Nils-Henrik M von der Fehr: Prices vs. quantities: public finance and the choice of regulatory instruments
- W03:07 Sveinn Agnarsson and Ragnar Arnason: The Role of the Fishing Industry in the Icelandic Economy. A historical Examination
- W03:06 Thorolfur Matthiasson: Paying paper by paper, the wage system of Icelandic University teachers explained
- W03:05 Gur Ofur and Ilana Grau: Bringing the Government hospitals into line: The next step of reform in the healthcare sector
- W03:04 Ingolfur Arnarson and Pall Jensson: The Impact of the Cost of the Time Resource on the Efficiency of Economic Processes

W03:03 Torben M. Andersen and Tryggvi Thor Herbertsson: Measuring Globalization

W03:02 Tryggvi Thor Herbertsson and J. Michael Orszag: The Early Retirement Burden: Assessing the Costs of the Continued Prevalence of Early Retirement in OECD Countries

W03:01 Eirik S. Amundsen, Fridrik M. Baldursson and Jørgen Birk Mortensen: Price Volatility and Banking in Green Certificate Markets

W02:10 Tryggvi Thor Herbertsson and Gylfi Zoega: A Microstate with Scale Economies: The Case of Iceland

W02:09 Alison, L. Booth and Gylfi Zoega: Is Wage Compression a Necessary Condition for Firm-Financed General Training

W02:08 Asgeir Jonsson: Exchange rate interventions in centralized labor markets

W02:07 Alison, L. Booth, Marco Francesconi and Gylfi Zoega: Oligopsony, Institutions and the Efficiency of General Training

W02:06 Alison L. Booth and Gylfi Zoega: If you're so smart, why aren't you rich? Wage inequality with heterogeneous workers