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Saving, Foreign Inflows and Economic Growth: Evidence from Selected Developing Countries

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ABSTRACT

The current study seeks to investigate the impact of saving and foreign inflows on economic growth of selected developing economies such as Pakistan, India, Bangladesh, and Sri Lanka by utilizing yearly panel data for 1990-2020. Long run results of panel ARDL indicate that trade openness and capital investment have positive and significant effects on services sector whereas, government - household consumption expenditure, labor force and inflation have inverse relation with services growth. In order to enhance the economic growth, the Governments are required to improve the education sector along with the tax rebates for the business sector so that target of excelling economic growth be accomplished.

1. Introduction

Saving is an important determinant of economic growth. Higher saving results in a higher level of investment over time, which allows the economy to produce more goods and services (Sajid & Sarfraz, 2008). Thus, saving plays a significant role in financing development and growth (Agrawal, Sahoo, & Dash, 2009; Sekantsi & Kalebe, 2015). According to Solow (1956), savings increase the availability of funds for investment which helps a country to achieve faster economic growth. However, developing economies are continuously struggling to bring prosperity to their countries. Poverty, unemployment, low levels of savings and investment, and high inflation rates are the common issues of such countries (Iqbal, Ahmad, & Hussain, 2012). In order to achieve economic growth and to tackle the problems prevailing in developing countries, investments in various sectors such as agriculture, industry, and services are very important (Soli, Harvey, & Hagan, 2008). Similarly, foreign inflows are very important for economic growth because they bring new capital into an economy and, in addition, also improve relationships with other countries (Baharumshah & Thanoon, 2006). Likewise, McKinnon (1973) and Shaw (1973) argued that an increase in investment through increased savings enables high economic growth. When a new business setup starts in a country that is connected with different markets, it increases export opportunities and, at the same time, brings improvement in the country's export performance (Shahbaz & Rahman, 2014). In addition, foreign trade for any nation works as an engine of growth because national income increases with the increase in exports. With a good level of national income, a country can improve its production units, which, as a result, increases the employment opportunities for the people of the country. Keeping in view the available facts, the objective of the present study is to examine the effects of savings and foreign capital inflows on the economic growth of selected developing countries.

This paper is divided into six sections. Section 1 presents the introduction, and Section 2 reviews the relevant literature. Section 3 explains the theoretical framework of the study. Similarly, Section 4 describes the data and methodology, while Section 5 presents the results and discussion. Finally, Section 6 provides the conclusion and policy recommendations.

2 Literature Review

Anoruo and Ahmad (2001) investigated the presence of a long-term relationship between economic growth and domestic savings in seven African countries from 1960 to 1997. For this purpose, they used the Johansen and Juselius cointegration technique. According to the study, there is a positive relationship between domestic savings and economic growth. Therefore, they suggested that the involvement of the government is very important in order to encourage domestic savings for the growth of the economy. Alfaro (2003) examined the relationship between foreign inflows and economic growth in developing countries from 1981 to 1999. The study revealed that foreign inflows had a positive impact on the growth of the manufacturing sector, a negative impact on the growth of the agriculture sector, and a mixed impact on the growth of the services sector, which can be positive or negative depending on the government's policies. Baharumshah and Thanoon (2006) used data from 1991 to 2001 to examine the relationship between foreign capital inflows and economic growth in East Asian countries. The study used the Augmented Dickey-Fuller and Phillips-Perron unit root tests along with the dynamic generalized least squares technique for the analysis. The findings showed that FDI had a positive impact on economic growth both in the short and long run. Moreover, the study suggested that the government should take initiatives in order to improve FDI inflows in the country.

Yasmin (2005) investigated the association between foreign capital inflows and the economic growth of Pakistan. She used data from 1970 to 2001. By using a simultaneous equation model, the study predicted that developing countries like Pakistan are heavily dependent on foreign capital inflows in order to bring improvement to the economy. In particular, FDI plays a significant role in economic growth. Fatima (2013) and Jawaid and Saleem (2017) studied the effect of foreign capital inflows on the economic growth of Pakistan. For this purpose, time series data from 1972 to 2015 were used. According to their analysis, both developed and underdeveloped countries are usually dependent on different kinds of foreign capital inflows, such as FDI, remittances, and loans, for economic growth. The OLS and cointegration techniques, respectively, were used to examine the impact of these foreign capital inflows on economic growth. The results showed that FDI had a greater impact than the other foreign capital inflows on a country's economic growth. Therefore, these studies suggested that effective government policies can accelerate foreign capital inflows into a country. Similarly, Tahir et al. (2020) used the same variables with the addition of more years of data, verified the results of Fatima (2013) and Jawaid and Saleem (2017), and suggested that the government should encourage liberalized trade policies to bring growth to the country.

Najarzadeh, Reed, and Tasan (2014) observed the association between saving and total economic growth, as well as between saving and non-oil economic growth, in Iran. The analysis used data from 1972 to 2010 and the autoregressive distributed lag (ARDL) model. According to the results, in the long run, savings had a positive and significant impact on total economic growth as well as on non-oil economic growth. In addition, the study suggested that the Government of Iran should implement effective policies to increase savings to support the country's economic growth. Chigbu, Ubah, and Chigbu (2015) studied the impact of capital inflows on the growth of Nigeria, India, and Ghana from 1986 to 2012. The results of the analysis showed that foreign inflows in form of investments and remittances had a positive effect on the growth of each country. Therefore, the study suggested that developing countries should create a friendly environment with other countries to increase investment and remittances.

Rehman and Ahmad (2016) examined the relationship between foreign inflow and the economic development of 21 developing countries from 1990 to 2013. Using the pooled mean group estimation and unit root tests, the study predicted that external debt had a negative impact on economic growth

while FDI and remittances had a positive impact on the economic growth of a country. The study also suggested that FDI should be utilized properly and efficiently.

Tahir, Estrada, and Afridi (2019) studied the impact of foreign inflows on the economic growth of SAARC countries. Due to the unavailability of data, countries such as Afghanistan, Bhutan and Maldives were ignored during the analysis. Panel data techniques were applied to data from 2008 to 2015. The results show that FDI and foreign aid had a positive impact on economic growth, while foreign debt was negatively associated with economic growth. Moreover, the study found that no relationship exists between economic growth and remittances. Therefore, the study suggested that SAARC countries should liberalize trade policies to increase foreign inflows from developed countries. According to Karahan and Çolak (2019), developing countries need financial funds from other countries to enhance the level of investment and bring economic growth to a country. They used data from Turkey from 2002 to 2018 to see the impact of capital inflows on the savings of a country. According to the study, the impact of capital inflows on total savings was not as large as it was expected. In addition, the study suggested that policymakers should focus on the management of foreign inflow to bring prosperity to a country in the form of economic growth and financial stability.

Ribaj and Mexhuani (2021) measured the extent to which saving and economic growth are correlated with each other. Time series data from 2010 to 2017 were used for the measurement. According to the results, savings in Kosovo had a positive and significant impact on economic growth because investments, employment, and production are the results of savings. Moreover, it was noticed that countries with high saving rates are less dependent on FDI. Similarly, several other studies have documented the role of savings in the growth process. Sajid and Sarfraz (2008) examined the causal relationship between saving and economic growth in Pakistan, while Ahmad and Asghar (2004) estimated the saving behavior of Pakistani households by using micro data. Agrawal, Sahoo, and Dash (2009) analyzed the saving behavior of South Asian economies, whereas Alomar (2013) applied cointegration and causality analysis to explore the link between savings and economic growth in GCC countries. In addition, Verma and Saleh (2011) investigated the relationship between saving and investment in Saudi Arabia, and Sekantsi and Kalebe (2015) studied the connections among saving, investment, and economic growth in Lesotho. These studies indicate that domestic savings remain an important source of capital accumulation in developing economies.

On the other hand, Khan and Rahim (1993) and Basnet (2013) highlighted the role of foreign aid and domestic savings in the economic growth of Pakistan and South Asia, respectively. Likewise, a large body of literature links financial development with economic growth, since a well-functioning financial system mobilizes savings and channels them toward productive investment (Odedokun, 1998; Ahmed & Wahid, 2011; Grassa & Gazdar, 2014; Nyasha & Odhiambo, 2015; Rehman, Ali, & Nasir, 2015). Sehrawat and Giri (2016) also examined financial development and economic growth in SAARC countries and found that both of them cause rural-urban income inequality in the region. Similarly, the growth process has been associated with income distribution (Nissim, 2007; Shahbaz, 2010), wage pacts (Zagler, 2005), human capital in the form of health and education (Li & Liang, 2010), private housing investment (Rasheed, Alirat, Agboola, & Musa, 2016), and the role of the state (Reinert, 1999).

The major objective of the study is to investigate the impact of savings and foreign inflows on the growth of developing countries. However, the reviewed literature shows that most of the earlier studies have examined savings and foreign inflows separately or have focused on a single country. Therefore, the present study attempts to fill this gap by analyzing savings, foreign direct investment, remittances, and trade jointly within a panel framework for selected developing countries, which provides more comprehensive evidence for policymakers in these economies.

3 Theoretical Framework

According to classical economists, saving is always equal to investment because the situation of full employment always exists in the economy. They believed that savings in a country increase with an increase in the interest rate. However, Keynes believed that the equality between saving and investment was possible due to changes in income, not due to changes in interest rates. According to the Keynesian view, saving is equal to investment even below the full employment level. As far as growth is concerned, according to Solow (1956), a country's growth depends essentially on the accumulation of capital, the growth of labor or population, and productivity increases largely stimulated by technological advances. In addition, McKinnon (1973) and Shaw (1973) emphasized that financial liberalization raises savings and, therefore, the volume and efficiency of investment, which in turn accelerates economic growth.

4 Data and Methodology

The current study is based on a secondary source of data which is taken from World Development Indicators (WDI) of the World Bank. For the analysis, annual panel data are taken from 1995 to 2020 for the selected developing countries, namely Pakistan, India, Bangladesh, and Sri Lanka. There are two common ways to handle panel data, namely the random effects and fixed effects models. Therefore, the Hausman test is used in the analysis to select the appropriate model. When the value of the chi-square statistic in the Hausman test is small and insignificant, the random effects model is applied; however, when its value is large and significant, the fixed effects model is applied (Rehman & Ahmad, 2016; Tahir et al., 2019).

The functional form of the model is given below:

$$Y = \alpha_o + \beta_1 xi + \beta_2 xi + ... + \mu i$$

where Y is the dependent variable, Xi represents the explanatory variables, α_0 is the intercept term and β_1, β_2 are coefficients and μi is the error term.

Based upon the above-suggested methodology, the operational model of the study is given below:

GDPG = f (LFG, GFCF, FDI, REM, TRA, GS) (1)

$GDPG_{it} = \beta_0 + \beta 1(LFG)_{it} + \beta_2(GFCF)_{it} + \beta_3(FDI)_{it} + \beta_4(REM)_{it} + \beta_5(TRA)_{it} + \beta_6(GS)_{it} + \mu_{it}$ (2)

Where,

GDPG = Gross Domestic Product Growth (annual percentage)

LFG = Labor Force Growth (annual percentage)

GFCF = Gross Fixed Capital Formation Percentage of GDP

FDI = Foreign Direct Investment Percentage of GDP

REM = Remittances Percentage of GDP

TRA = Trade Percentage of GDP

GS = Gross Saving Percentage of GDP

i and t denote the country and time period, respectively

5 Results and Discussion

The results of the descriptive statistics of the variables are shown in Table 1 below.

Table 1

Descriptive Statistics (1995 to 2020)

	GDPG	FDI	LFG	GFCF	REM	TRADE	GS
Mean	4.85	4.70	10.96	23.30	5.63	41.64	19.12
Median	4.77	3.04	4.74	21.85	3.25	41.91	17.16
Maximum	34.48	89.48	57.44	145.75	31.75	321.63	83.29
Minimum	-30.59	-5.01	-16.94	1.10	0.00	-42.13	-34.03
Std. Dev.	4.65	7.00	12.01	9.96	6.14	42.32	15.22
Skewness	0.14	5.50	1.48	3.92	1.45	1.38	0.57
Kurtosis	15.89	49.53	4.62	39.44	4.70	7.86	4.13
Jarque-Bera	7913.68	108887.50	544.30	66166.99	535.60	1488.00	122.52
Prob.	0.00	0.00	0.00	0.00	0.00	0.00	0.00

According to Table 1, the average value of GDPG is 4.85 percent, while its measure of dispersion, the standard deviation, is 4.65 percent. This indicates that, on average, individual observations are 4.65 percentage points from the data's central value. The mean value of LFG is 10.96 percent, while the value of its standard deviation is 12.01 percent. It means that the actual values of LFG deviate from their mean value by 12.01 percentage points. Moreover, the average values of GFCF, FDI, REM, TRA, and GS are 23.30, 4.70, 5.63, 41.64, and 19.12 percent of GDP, respectively. In addition, the Jarque-Bera statistics are significant for all variables, which indicates that the series are not normally distributed. The correlation matrix examines the strength of the association between two variables. In other words, it shows the direction and strength of the relationship between variables. Correlation values always lie between -1 and 1. If the value is greater than zero, the variables are positively correlated; otherwise, they are negatively correlated.

Table 2

Correlation Matrix of Developing Countries (1995-2020)

	GDPG	FDI	LFG	GFCF	REM	TRA	GS
GDPG	1						
FDI	0.1	1					
LFG	0.2	0.1	1				
GFCF	0.1	0.3	0.2	1			
REM	-0.1	0.1	-0.3	-0.1	1		
TRA	0.1	0.1	-0.1	-0.1	0.2	1	
GS	0.2	-0.1	0.5	0.4	-0.3	-0.2	1

From Table 2, it is visible that LFG and GDPG are positively and weakly correlated with each other, while GFCF is positively and weakly correlated with GDPG and LFG. FDI is also positively and weakly correlated with GDPG and LFG but has a positive and moderate correlation with GFCF. REM is negatively and weakly correlated with GDPG and GFCF, while the connection between REM and LFG is negative and moderate. On the other hand, REM is positively and weakly correlated with FDI.

TRA has a positive and weak correlation with GDPG, FDI, and REM, while it has a negative and weak correlation with both LFG and GFCF. Similarly, GS is positively and weakly correlated with GDPG. LFG and GFCF are also positively correlated with GS, but the extent to which they are correlated with each other is moderate. However, GS is negatively and weakly correlated with TRA. The connection between REM and GS is negative and moderate.

Table 3

Hausman Test for Correlated Random Effects

Models	Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.
Developing Countries	Random Cross-section	26.9*	7

Note: * shows that the statistic is significant at the 1 percent level, and ** shows that it is significant at the 5 percent level

The results of the Hausman test (Random or Fixed Effect) are given in Table 3. The choice of methodology depends on the probability values. If the probability value is greater than five percent, the random effects method is suitable; however, if the probability value is less than five percent then the fixed effects method is more appropriate. From the above table, it has been noticed that the chi-square statistic is significant and the probability value is less than 0.05. Therefore, the fixed effects method is used for the analysis.

Table 4

Panel Estimates of GDPG Models in Developing Countries

Variables	Coefficient
FDI	0.025*
LFG	0.067**
GFCF	0.022
REM	0.100**
TRA	0.040*
GS	0.131*

Note: * shows that the coefficient is significant at the 1 percent level, and ** shows that the coefficient is significant at the 5 percent level.

Table 4 shows the results for the selected developing countries. It is found that the coefficient value of labor force growth is 0.067, which means that it has a positive and significant impact on GDP growth, because when employment rises, the income of the people of the country rises and, as a result, output rises. The coefficient of gross fixed capital formation is 0.022; however, it is not significant even at the 5 percent level of significance. It has a positive but insignificant impact on GDP growth. It means that fixed capital formation is not an important factor to bring economic growth in the developing countries under study.

It has been observed that the coefficient value of FDI is not only positively related to gross domestic product growth but is also highly significant. This finding is consistent with Baharumshah and Thanoon (2006), Jawaid and Saleem (2017), and Tahir et al. (2019). As investment increases, the economy's productive capacity increases. As a result, the standard of living of the people improves. In addition, remittances are a major source of income in developing countries (Chigbu et al., 2015). We find that the coefficient on remittances is about 0.10, meaning that a one-percentage-point increase in remittances (as a share of GDP) is associated with a 0.10 percentage-point increase in gross domestic product growth. A country with more capital has more to invest in business. As a result, output rises. When output rises, the income of the people of the country rises. Therefore, people with more income will save more. Similarly, trade has a positive and significant impact on gross domestic product growth, which supports the findings of Shahbaz and Rahman (2014) and Tahir et al. (2020). Most developing countries are agrarian economies; therefore, they produce more than domestic demand. The countries with excess output export those goods to other countries. In return, these countries earn income, which is responsible for savings and investment in a country. Gross savings is also one of the most important factors that influence GDP growth in developing economies. A high rate of saving would result in a high rate of investment, which is associated with higher GDP growth (Solow, 1956; Najarzadeh et al., 2014; Ribaj & Mexhuani, 2021). The results in Table 4 show that a 1

percentage point increase in gross savings is associated with a 0.13 percentage point rise in GDP growth.

6 Conclusion

The study aims to investigate the relationship among saving, foreign inflows, and GDP growth in selected developing countries. For this purpose, panel data from 1995 to 2020 for several variables were gathered from the WDI. GDP growth rate is taken as a dependent variable, while labour force growth, gross fixed capital formation, foreign direct investment, remittances, trade, and gross savings are used as independent variables. The results show that, in developing countries, foreign direct investment, the growth rate of the labour force, remittances, trade and gross savings have a positive and significant relationship with GDP growth; however, the result of gross fixed capital formation is insignificant, even though a positive relationship exists between gross fixed capital formation and GDP growth. Based on these findings, the concerned governments are advised to take adequate measures, such as tax cuts and rebates, and to provide education and employment opportunities to accelerate economic growth in developing countries (Reinert, 1999; Li & Liang, 2010). In addition, political stability is needed to overcome policy mismanagement by different governments in developing countries. Therefore, this stability will increase foreign capital inflows and attract foreign direct investment into different sectors of the economy. Similarly, separate authorities or departments should be established to facilitate foreign investors to invest in these countries. However, the present study is limited to a few explanatory variables and a fixed effects framework; therefore, future studies may extend the analysis by including institutional quality and financial development and by applying dynamic panel techniques.

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