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## Research Article

# Foreign Capital Dynamics and Macroeconomic Performance in South Asia

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## ABSTRACT

Foreign capital is regarded as a vital resource for raising a developing nation's standard of living and wellbeing. Researchers and academics are concentrating on analyzing how foreign capital affects emerging nations. This study examines how foreign capital affects the economic growth of six South Asian nations between 2001 and 2020. The primary measures of foreign capital utilized in this study are official development assistance, foreign direct investment, and migrant remittances. The GDP growth rate is a measure of macroeconomic performance. The empirical analysis is conducted using sophisticated panel data estimate methods, Fully Modified Ordinary Least Square (FMOLS), and Dynamic Ordinary Least Square (DOLS). The study concludes that official development assistance has a negative impact on economic growth, whereas remittances and foreign direct investment have a beneficial effect.

**Key Words:** Foreign Direct Investment, Macroeconomic Performance, Official Development Assistance, Remittances

## INTRODUCTION

It is widely acknowledged that emerging economies require foreign capital inflows to meet their developmental goals. Developing economies can thrive and maintain their prosperity with the help of foreign investments. South Asia gets a significant amount of foreign investment in the form of foreign direct investment (FDI), official development assistance (ODA), and migrant remittances. But in the context of South Asia, it becomes more crucial to comprehend the problem of how much the increasing capital inflows into emerging nations over the past few decades have contributed to economic growth.

Foreign capital resources enable host countries to attain investment levels greater than their levels of domestic saving while also promoting economic growth in developing nations (Domar, 1946; Harrod, 1939). Capital resources were previously attributed to internal changes such as policies and the greater economic performance of a growing country. Stagnant economies require a big push in the form of foreign capital to bring revolution toward economic progress (Rosenstein-Rodan, 1961). Official development assistance (ODA), sometimes known as foreign aid is the transfer of financial resources from developed to developing countries. The proponents of foreign aid hold that the influx of outside funding is crucial for developing nations to achieve their development goals since more resources enable them to meet growth rate targets (Bowen, 2010; Burnside & Dollar, 1997, 2000; Karras, 2006). Remittances remained a crucial financial flow and a key source of foreign exchange for several South Asian countries. The remittances are transfers of money or goods that migrants send back to their family members or communities back home.



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According to data compiled by the World Bank on international remittances, remittance flows to South Asia are increasing faster than anticipated (International Organization for Migration, 2024). However, the phrase is currently most often used to describe a sum of money sent home by an individual working abroad. One of the most beneficial ways to obtain advanced technology and managerially advanced human resources is through foreign direct investment (FDI). Foreign direct investment is becoming a more significant factor in the growth of developing nations with low levels of capital. This is because it not only provides a consistent supply of foreign investment but also fosters the transfer of technology and the creation of jobs.

Financial resources are a major source for developing nations to achieve macroeconomic stability. Over the last two decades, foreign capital flows have increased dramatically in South Asia. Despite this, economists have never taken into account how each of these factors affects macroeconomic performance. Many theoretical frameworks were developed to emphasize the significance of foreign capital flows. Two gap theory, three gap theory, and big push theory of revolution, all have provided sound conceptual understanding to understand the nexus of foreign capital inflows and economic growth. Many theories have provided sound theoretical links between remittances and economic growth such as human capital theory, structural transformation theory, and investment and capital formation theory. Furthermore, FDI can enhance economic growth through various channels, such as capital formation, technological advancement, skill development, and wide market access. Despite all this, empirical research indicated the adverse impact of capital flows on developing economies due to many factors. Literature indicated many factors such as volatility in capital flows, corruption, lack of institutional stability, and currency devaluation (H. Ali et al., 2022; Mouneer, 2023). This study particularly emphasizes the role of capital inflows to enhance macroeconomic performance in South Asia. The study has focused on the link between capital flows and economic growth in South Asia. It adds to the body of knowledge by probing several aspects of capital inflows and the sporadic connections between these elements and South Asia's macroeconomic performance. Additionally, South Asia was specifically chosen for this study because it had previously been overlooked.

## LITERATURE REVIEW

The influence of foreign capital on economic growth is complex, showing both beneficial and detrimental effects based on the host nation's circumstances. Foreign direct investment (FDI) is recognized as a vital factor in economic progress, promoting technology transfer, job generation, and productivity gains. Nonetheless, this relationship exhibits considerable variability across regions and timeframes.

Numerous studies illustrate a positive relationship between FDI and GDP growth, particularly in Algeria and India, where FDI significantly fuelled economic growth. FDI frequently introduces advanced technologies and methodologies, thereby improving local productivity and human capital (Kaddouri et al., 2024). Conversely, some research indicates that FDI may yield negative outcomes in specific scenarios, especially in developing nations with inadequate institutional frameworks for effectively utilizing foreign capital (Herzer, 2012). The efficacy of FDI fluctuates across regions, as demonstrated in Southeastern Europe, where certain countries reaped substantial benefits while others did not (Shkodra et al., 2022). The effectiveness of foreign capital in promoting economic growth is contingent upon the economic policies, institutional integrity, and pre-existing infrastructure of the host country. This complexity raises the possibility that maximizing foreign investment to promote economic growth may not be possible with a single, all-encompassing strategy. Li and Liu (2005) evaluated the beneficial impact of foreign direct investment (FDI) on economic growth in the presence of human capital across 84 nations from 1970 to 1999. However, FDI has a detrimental impact on economic growth with technological limitations in economies.

Oli (2024) looked into how capital inflows, both local and foreign, affected employment and economic growth in low- and middle-income countries. The study, which used panel data from 1990 to 2021, found that both forms of capital had a positive impact on growth, but that foreign capital inflows significantly increased employment. According to the study, domestic capital is more important in promoting employment and growth in low- and middle-income nations.

An analysis of the effects of foreign capital flows, including foreign direct investment (FDI), external loans, foreign aid, and migrant remittances, was carried out by Madani et al. (2023) between 1990 and 2021. The study found a long-term correlation between these factors and Algeria's real GDP. The results showed that while foreign loans hurt GDP because they were misallocated to non-productive sectors, foreign direct investment and migrant remittances had a favorable impact. Policymakers may find the study's conclusions useful in maximizing foreign capital flows and supporting Algeria's economic growth. Khurshid et al. (2023) found that an external debt considerably destabilizes growth, whereas remittances and FDI are positively linked with economic advancement.

According to Mohammed (2024), when accompanied by robust institutional frameworks, remittances can serve as important sources of capital investment and income, promoting economic growth. On the other hand, increased levels of corruption would hinder the possible advantages of remittances.

CHIJOKE (2024) found that while the exchange rate has a negative impact on Nigeria's economic growth, remittances and foreign direct investment have a positive impact. Governments must reduce transaction costs, promote remittances, improve the climate for foreign investment, and reduce foreign exchange rate fluctuation.

Mostafa and Wadud (2024) found a strong long-term relationship between remittances, foreign direct investment, and GDP in South Asia. FDI has a negative impact on GDP, remittances show an advantageous association. Countries must have a main concern about the export of skilled labor and maximize the use of remittances to promote sustainable economic growth.

A thorough examination of the impact of remittances on economic growth in 113 developing countries between 1990 and 2015 was carried out by Azizi et al. (2024). According to their findings, countries with higher human capital experienced more significant labor supply and investment, whereas those with lower human capital had less growth. The study carefully examined how remittances impact economic expansion. Rehman et al. (2023) recognized that remittances play a dynamic role in the enlargement of Pakistan's GDP and the mitigation of impoverishment by augmenting income, investment, credit accessibility, and human development. After examining data from 1981 to 2020, the study concluded that long-term GDP growth is positively impacted by exports, foreign direct investment, capital formation, labor force participation, and secondary school enrolment.

## DATA AND METHODOLOGY

The main aim of this paper is to explore the impact of foreign capital flow on economic growth in South Asian developing countries. To serve this purpose, this study relies on the secondary source of data for the years 2001 to 2020. It is very important to collect the data from an authentic source to get reliable estimates. The main data source for all indicators used in this study is World Development Indicator (WDI).

Our model of empirical analysis is based on endogenous growth theory which suggests that foreign capital flow indicates the growth of the economy in the long run by the mean of the equipment allocation and impact of macroeconomic performance development. Oluwaseyi et al. (2017) and Orji et al. (2014) also followed the same model. The Cob-Douglas production function following the endogenous growth theory is:

$$Y_t = AO_tR_t^aK_t^{1-a}$$

In the above equation Y refers to the output, O represents the Official development assistant, R refers to the remittances K refers to the physical capital (inflows of direct foreign investments), and A represents the coefficient that affects the growth of the economy. Foreign capital flow is a big source of progress and macroeconomic performance, when foreign firms make direct investments in a country they bring new varieties of goods and new advanced technologies to produce these goods. It is less expensive for a domestic company to duplicate new technology than it is to import advanced technology. Therefore, the economy of the host country will expand the more goods that foreign companies produce there. In this regard, macroeconomic performance is crucial because it determines the host country's ability to absorb positive foreign direct investment (Onyinye et al., 2018).

By following, the Oluwaseyi et al. (2017) and Orji et al. (2014) econometric model which stands on the endogenous theory of growth, the following Model is developed to empirically analyze the impact of foreign assistance, remittances, and FDI on economic growth in South Asia.

$$PGDP_{i,t} = \beta_0 + \beta_1 ODA_{i,t} + \beta_2 FDI_{i,t} + \beta_3 REM_{i,t} + \beta_4 TOP_{i,t} + \beta_5 CPI_{i,t} + \beta_6 M2_{i,t} + \beta_7 GFCF_{i,t} + \mu_t$$

Where PGDP stands for per capita gross domestic product (% of GDP), FDI for foreign direct investment, net inflow (% of GDP), REM for Remittances (annual %), ODA for official development assistant (% of GDP), TOP for Trade openness (% OF GDP), M2 for Money supply (annual %), CPI for Consumer price index (annual %) and GFCF for Gross fixed capital formation (% of GDP). The variable description is given in the present section. These are variables that we have chosen for our research work. We have selected these variables according to their most importance in literature and theoretical framework and availability of comparable data of all the countries under the study.

Table 1. Description of Variables

Variable/symbol	Symbol	Definition	Unit	of Measurement
GDP per capita	PGDP	Value of ultimate goods and services manufactured in an economy	Growth	Rate

			by utilizing all resources within one year divided by its total population.	Annual
Foreign Investment	Direct	FDI	Investment from one company to another country (host country).	% of GDP
Official Assistance	Development	ODA	Transfer of Foreign capital from developed countries to developing countries. It may be bilateral or multilateral foreign aid.	% of GNI
Remittances		REM	Remittances are the source of capital that households transfer from abroad to their own country in return for their services abroad.	% of GDP
Trade Openness		TOP	The sum of exports and imports as a share of GDP.	% of GDP
Consumer Price Index	Price	CPI	The average price of goods and services which are utilized by consumers.	Index
Gross Fixed Capital Formation	Capital	GFCF	It includes all investments in an economy within one year.	% of GDP
Broad Money Supply		M2	Amount of money circulated in an economy within one year. It includes demand deposits and actual currency in circulation.	% of GDP

### Econometric Methodology

Foreign capital inflows play a significant role in emerging economies theoretically. The goal of the study is to empirically probe the impact of foreign capital inflows, including official development assistance, foreign direct investment, and migrant remittances, on the economic growth of South Asian developing countries. To serve this purpose, empirical analysis is carried out. This analysis includes two steps.

1. Statistical analysis: It includes descriptive statistics and a correlation matrix. Descriptive statistics provide summary statistics for the data that includes mean, median, skewness, and Kurtosis, whereas correlation matrix provides association among all variables.

2. Econometric Analysis: Levin-Lin-Chu (LLC) and Im Pesaran Shin (IPS) panel unit root tests are employed to check the stationarity of the series. The existence of the unit root should be checked to proceed further. Kao cointegration test is employed to check the long run link among dependent and independent variables. Advanced panel data econometric techniques are utilized to quantify the  $\beta$ -coefficients. Two techniques called Fully Modified Ordinary Least Square (FMOLS) and Dynamic Ordinary Least Square (DOLS) are employed for empirical analysis. Both techniques are suitable to evaluate the influence of foreign capital on economic growth in South Asia.

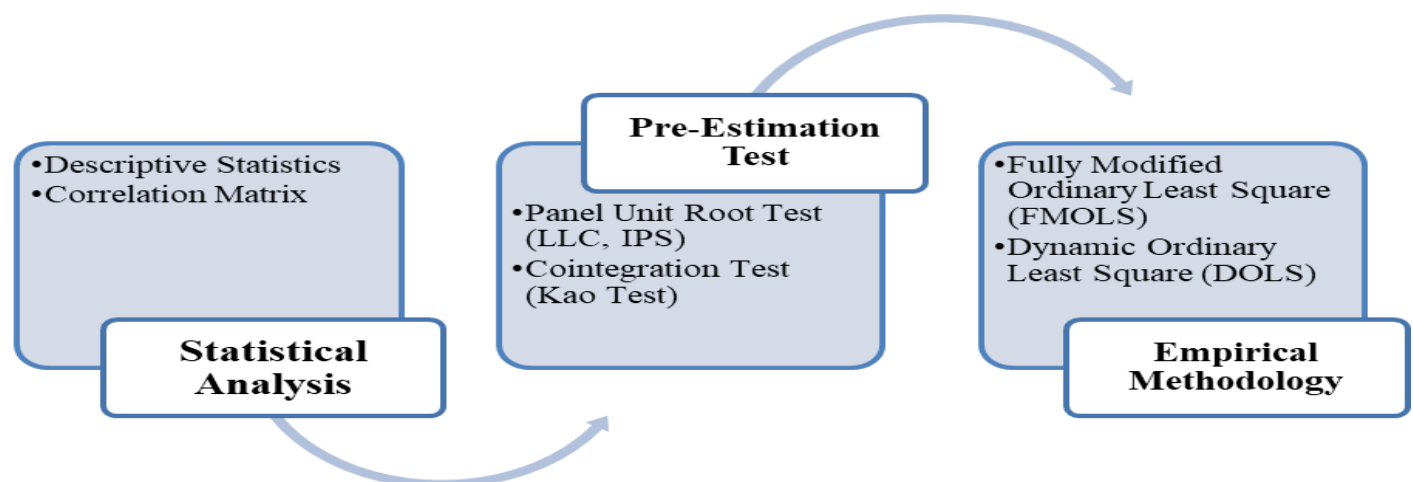


Figure. 1. Methodological Framework

Figure 1 provides a methodological framework to give a glance at methodology.

### RESULTS AND DISCUSSION

The following section presents an empirical analysis to explore the impact of foreign capital flows on macroeconomic performance in South Asian countries. First of all, statistical analysis is carried out. Statistical analysis comprised of correlation and descriptive analysis of under consideration variable.

### Statistical Analysis

Descriptive analysis describes the quantitative description of the data set. This study covers the period of 2001-2020. Table 2 presents the descriptive analysis of all variables used in the study.

Table 2. Descriptive statistics (Dependent variable: per capita GDP)

Variable	Mean	Medians	Skewness	Kurtosis
PGDP (annual %)	5.19	5.55	-1.008	9.33
REM ( % of GDP)	7.49	6.18	1.54	4.73
ODA(% of GNI)	2.84	1.54	1.38	1.14
FDI(% of GDP)	1.09	0.92	2.34	11.9
TOP(% of GDP)	51.9	54.75	1.35	3.79
CPI (annual %)	3.43	3.10	1.044	3.62
M <sub>2</sub> (% of GDP)	61.1	60.41	0.69	3.62
GFCF(annual% growth)	5.72	6.87	-0.14	6.27

The correlation matrix shows that each variable in the matrix is correlated to another variable in the matrix. It also tells the degree and direction of correlation among the set of two variables.

Table 3. Correlation Matrix

Variables	PGDP	GFCF	FDI	CPI	M2	ODA	REM	TOP
PGDP	1							
GFCF	0.45	1						
FDI	0.35	0.09	1					
CPI	0.05	-0.09	0.09	1				
M2	-0.15	0.03	0.04	0.28	1			
ODA	0.14	0.03	-0.17	0.58	0.12	1		
REM	-0.19	0.02	-0.37	-0.39	0.33	-0.03	1	
TOP	0.24	0.08	0.21	0.81	0.07	0.69	-0.33	1

In the table, the diagonal is 1 which indicates that the correlation between the variable with itself is 1, like the correlation between per capita GDP and per capita GDP is 1. The correlation matrix illustrates that foreign direct investment is strongly correlated with GDP per capita. Final trade openness official development assistant, gross fixed capital formations are weakly correlated with GDP per capita. Remittance and money supply are negatively correlated with per capita GDP.

### Econometrics Analysis

The study started by checking the level of integration of all variables in the panel data of 6 developing countries. The table shows the stationary result of Lavin, Lin Chu Im, Pesaran, and Shin W-stat unit root tests for all variables in panel data at a five percent significance level. The result shows that FDI, ODA, and CPI are stationary at this level. The remaining variables GDP, REM GFCF TRADE, and M<sub>2</sub> are stationary at first difference. For FDI both tests of the unit root show conflicting results at a 5 % level of significance at the level it is stationer in Levin, Lin, and Chu test 5 % level of significance but in the Im, Pesaran, and Shin W-test it stationary at the level on 10 % level of significance. GFCF is stationary at first neither difference having neither intercepted nor trend. The result of Panel unit root tests shows all variables of the selected six developing countries under the study are a mixture of 1(0) and 1 (1).

Table 4. Panel Unit Root Checks

Variables	Levin, lin and Chu				Im , Pesaran and Shin W-Test				Result
	Level		1 <sup>st</sup> difference		Level		1 <sup>st</sup> difference		
	Stat	Prob	Stat	Prob	Stat	Prob	Stat	Prob	
GDP	0.68	0.9313	2.46	0.0068	1.82	0.0348	5.56	0.0000	1(1)
FDI	3.45	0.0003	9.81	0.0000	4.25	0.0000	10.03	0.0000	1(0)
REM	0.24	0.5941	6.20	0.0000	4.53	0.0000	10.10	0.0000	1(1)

ODA	3.98	0.0000	10.73	0.0000	2.63	0.0018	9.34	0.0000	1(0)
GFCF	1.43	0.0773	9.94	0.0000	1.94	0.1389	8.82	0.0000	1(1)
TRADE	0.78	0.2204	9.64	0.0000	0.66	0.2507	4.98	0.0000	1(1)
CPI	3.31	0.0005	9.58	0.0000	0.66	0.2568	5.08	0.0000	1(0)
M2	0.28	0.898	2.52	0.0059	0.72	0.9831	3.101	0.0000	1(1)

Table 5. Result for Kao Panel Cointegration test (Engle-Granger based)

Statistic	t-stat	p-value
ADF	-5.954	0.000

The result rejects the null hypothesis that there is no cointegration between variables and accepts the alternative hypothesis that there exists cointegration between variables. Following the cointegration determination, panel FMOLS and panel DOLS techniques are used to estimate the coefficients. Once the existence of cointegration has been established, these tests can be used. This allows us to determine the direction and strength of the link between our explanatory variables, FDI, CPI, ODA, REM, TRADE, M2, and GFCF, and our dependent variable, GDP. FMOLS and panel DOLS are employed because the typical pooled least squares method may produce biased estimates when a cointegration connection exists because of issues with serial correlation and endogeneity.

Table 6. Dynamic Ordinary Least Square (DOLS) Results

Variable	Coefficient	S. Er.	t-Stat	P-value
FDI	0.64	0.28	2.19	0.0300***
CPI	0.48	0.65	0.75	0.4581
GFCF	0.10	0.03	4.29	0.0000***
M2	-0.12	0.04	-3.53	0.0006***
ODA	-0.23	0.22	-1.00	0.3174
REM	0.20	0.10	1.98	0.0513**
TOP	0.08	0.02	2.49	0.0142***

Note: \*\* and \*\*\* show significance at 5% and 1%.

Table 7. Fully Modified Ordinary Least Square (FMOLS) Results

Variable	Coefficient	S. Er.	t-Stat	P-value
FDI	0.41	0.27	1.52	0.1301
CPI	0.62	0.65	0.94	0.3479
GFCF	0.12	0.02	5.39	0.0000***
M2	-0.10	0.03	-3.45	0.0008***
ODA	-0.10	0.21	-0.49	0.6200
REM	0.16	0.11	1.39	0.1682
TOP	0.06	0.02	2.29	0.0238***

Note: \*\* and \*\*\* show significance at 5% and 1%

Table 6 indicates panel DOLS results for the South Asian countries while Table 7 presents results for FMOLS. According to the panel DOLS results, FDI, GFCF, CPI, and TOP are significant at a 1% level in 6 developing countries. In DOLS M2 and ODA coefficients are negative signs and in other variables are coefficient is positive. Table 6 indicates panel FMOLS results for the six South Asian developing countries.

This study looked at the inflow of foreign capital and the macroeconomic performance of South Asian nations from 2001 to 2020. According to the findings, there is a long-term relationship between economic growth and foreign direct investment, official development assistance, remittances, the consumer price index, gross fixed capital formation, and money supply.

The primary contribution of this study is to highlight inflow characteristics that are more effective at spurring economic growth and directing the economy in the right direction. Estimated results show that foreign aid has an insignificant impact on economic growth in South Asia. These findings are theoretically consistent (Mouneer et al., 2022; Mouneer & Khan, 2019) and many studies have pointed out reasons for aid ineffectiveness in developing economies. South Asia has to face political instability, corruption, and weak institutional and regulatory frameworks. These all factors cause aid ineffectiveness in developing economies (Lensink & Morrissey, 2000; MacGillivray & Morrissey, 2001; Mouneer, 2023; Pallage & Robe, 2001).

Furthermore, the study also highlighted the fact that FDI and migrant remittances contribute positively to enhancing economic growth in South Asia. The foreign direct investment and remittances have beneficial and noteworthy long-term effects on economic growth. The error correction term's negative sign indicates the dynamics' long-term convergence to equilibrium. The error correction coefficient's value provides important information about the rate of convergence towards equilibrium. These findings are useful for policy analysis to develop plans for utilizing foreign capital inflows effectively in the correct sound macroeconomic policies, including fiscal and monetary policies. The influx of foreign capital can stimulate economic growth in South Asian countries.

According to the neoclassical growth theory, foreign capital inflows can enhance investment levels, leading to increased productivity, job creation, and overall economic expansion (Adamu, 2013). This can be particularly beneficial for countries that lack sufficient domestic savings and investment capabilities.

FDI has a predicted positive and considerable influence on GDP at the 5% level. This is consistent with several earlier research (Adam, 2018; Balasubramanyam et al., 1996; Mehic et al., 2013; Tasneem & Aziz, 2011). It follows that FDI favorably influences both direct and indirect economic growth in South Asia.

Because millions of migrants send money back home, remittances are a substantial source of income for many South Asian nations. These inflows may help recipient nations reduce poverty and increase household spending and investment. Remittances have a favorable effect on economic growth in South Asian nations including India, Bangladesh, and Sri Lanka (Ratha & Shaw, 2007). According to the study, remittances can boost local savings, investment, and the growth of human capital.

The results show that inflation has an insignificant impact on economic growth in South Asia. However, gross fixed capital formation and trade openness are growth enhancing factors in South Asia. High levels of gross fixed capital formation (GFCF) lead to more investments, employment, and production and in turn boost the economic development in developing economies (G. Ali, 2015; Edwards, 1992; Meyer & Sanusi, 2019). Trade openness leads to faster growth and can reduce poverty in developing countries, particularly when supported by sound policies (Dollar & Kraay, 2004). Melitz's model shows that trade increases productivity through the reallocation of resources from less efficient to more efficient firms, driving overall economic growth in developing countries. This is a key theoretical explanation of how trade fosters economic improvement (Melitz, 2003).

Money supply has a negative and insignificant impact on economic growth. The negative impact of money supply on economic growth in developing economies is often linked to inflationary pressures, currency depreciation, and the distortion of economic incentives (Barro, 1995; Ghosh & Phillips, 1998; Mishkin, 2007). An excessive increase in money supply without any growth in real output can undermine economic stability and growth.

## CONCLUSIONS AND POLICY RECOMMENDATION

To investigate the impact of foreign capital flows and the economic growth performance of developing countries the study used six developing countries. The study runs the growth model for six developing countries in the period of 2001-2020.

The study uses the fully modified ordinary least squares (FMOLS) and dynamic ordinary least squares (DOLS) for estimation. The econometric technique is based on the nature of variables. Levin Lin and Chu and Im, pesaran and Shin tests are used to test the stationary of variables. The study concludes that foreign capital is necessary to boost economic growth in South Asia. Furthermore, the study indicates that FDI and remittances have a positive and significant impact on economic growth but official development assistance has adverse effects on economic growth. Excessive money supply and inflation hinder economic growth in South Asia. The study also highlights that trade openness and gross fixed capital formation lead to an increase in economic growth by increasing investment, production, and employment. Based on the findings, the study recommends some policies:

1. Foreign capital inflows can provide South Asian developing countries with much-needed investment, which can contribute to economic growth. These inflows can finance infrastructure projects, stimulate productivity, create jobs, and enhance technology transfer.
2. Sudden outflows of capital have the potential to cause financial instability; therefore developing nations need to be mindful of this risk. Unexpected changes in capital flows have the potential to devalue currencies, raise deriving rates, and undermine macroeconomic stability. The specific framework should be designed to utilize foreign aid in South Asia.

3. Policymakers should strive for policy coordination between monetary, fiscal, and exchange rate policies to effectively manage foreign capital flows. A coherent policy framework can help maintain macroeconomic stability and minimize the risks associated with capital flows

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