Do Absorptive Capacities Matter for FPI-Growth Nexus? Evidence from Cross-Country Analysis

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Abstract

Since the 1990s, there has been an increase in the volume of Foreign Portfolio Investments (FPI) flowing to developing economies. Theoretically, FPI inflows are supposed to promote economic growth by lowering cost of capital, increasing investment, diversifying risk and developing the financial sector. However, FPI—being short-term investments—may lead to boom and bust cycle affecting growth and stability. In this context, we empirically examine the impact of FPI on the economic growth for 82 countries for the period 2000–2017. We try to capture the differential effects of FPI across different categories of countries and transmission channels. Results reveal a positive relationship between FPI and economic growth for all sets of developing countries, with the magnitude of benefits being the highest for emerging economies. Moreover, domestic factors such as human capital, financial sector and external debt are found to influence the impact of FPI on growth. Therefore, there is a need to push for pro-FPI policies and develop the absorptive capacities of developing countries to promote and sustain their economic growth.

***Keywords*:** FPI, Economic Growth, Developing country, Panel data, GMM Model

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