Vol.6 Issue.2 June 2021

RSEP Review of Socio - Economic Perspectives
ISSN: 2149 - 9276
E-ISSN: 2547-9385

The nexus between foreign direct investment, domestic investment and economic growth: Evidence from Ethiopia

Garedew Aweke Gizaw[1,•], **Negash Haile Dedeho**[2,∂], **Tariku Lorato Lodamo**[3,α]
[1] Lecturer of Economics, Dilla University, Ethiopia
[2] Ph.D Candidate, Maastricht University, Netherland
[3] Lecturer of Economics, Dilla University, Ethiopia

Article History

Received: 18 March 2021 Revised: 20 May 2021 Accepted: 31 May 2021 Available Online: 6 June 2021

Keywords: Investment, Economic growth, ARDL Approach.
JEL classification: F21

Citation: Gizaw, G. A., Dedeho, N. H., Lodamo, T. L. (2021). The nexus between foreign direct investment, domestic investment and economic growth: Evidence from Ethiopia, *Review of Socio-Economic Perspectives, Vol 6(2)*, 47-57.

Abstract

This study is an effort to show the long-run effects of foreign direct investment and domestic investment on economic growth of Ethiopia and tested the hypotheses that whether foreign direct investment crowds-in or crowds-out domestic investment in Ethiopia. A macroeconomic annual basis data covering 1981 up to 2019 is used and an auto regressive distributive lag (ARDL) econometric regression technique is employed. The result from domestic investment equation shows that foreign direct investment crowd-in domestic investment in Ethiopia. The implication is that in order to increase more domestic investment activity in the country, the government and policy makers have to harmonize the countries investment policy by bringing more FDI inflow from the rest of the world. This might be done by securing peace and political stability in the country, reducing the existing problems of access in electricity, transportation and telecommunication services, reasonable devaluation of domestic currency and by decreasing import tariff on intermediate products. Besides, GDP growth rate of the country can increase the domestic investment activity of the country. But, FDI is found to be insignificant in affecting economic growth of the country rather its positive effect is witnessed only on domestic investment of the country. Domestic public investment and private investment are found to be significant in affecting real GDP growth rate of the country. This might induce the government to liberalization of the goods and factor markets for the private sector, public sector and tax reform and diversifying the economy in order to generate more revenue for investment and so as to achieve long run economic growth in the country.

1. Introduction

Many economic growth theories such as Solow (1956), Barro (1990) and Romer (1996) highly acknowledged about the positive effect of investment or capital accumulation on economic growth. To be more specific, the positive contribution of capital formation on economic growth is undeniable. Capital formation or investment has the wide and deep effect on economic growth under two channels. These channels are through aggregate demand and aggregate supply. Investment affects aggregate demand through government expenditure and aggregate supply through productivity and thereby it can increase economic growth (Nguyen and Trinh, 2018).

The relationship between foreign direct investment and domestic investment has been a hot debatable issue in macroeconomics for decades. Literatures such as Ndikumana and Verick (2008), Hooi and Wah (2010) and Lasbrey et,al. (2018), forwarded that an increase of FDI will bring positive impact to the domestic investment

[•] **E-mail:** Garedewa@du.edu.et & awekegar8@gmail.com & **ORCID:** https://orcid.org/0000-0002-8888-2241
[∂] **E-mail:** negh2009@gmail.com **ORCID:** https://orcid.org/0000-0003-0975-5111
[α] **E-mail:** tarikulorato@gmail.com

DOI: https://doi.org/10.19275/RSEP114
Article Type: Original Paper