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The Relationship between Foreign Capital Inflows and Economic Growth: Empirical Evidence from Vietnam

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Abstract

Foreign capital inflows play an essential role in each country's socio-economic growth, particularly for undeveloped and developing countries where capital accumulation is limited in the early stages of development, and Vietnam is no exception. The purpose of this article is to examine the impact of foreign capital inflows on economic growth in Vietnam. The empirical method employed secondary time-series data set during the period 1995–2018 to determine the impact of FDI, foreign aid, foreign loans, and exports on economic growth in Vietnam by using a linear approach. For this study, data was collected from the World Bank and relevant agencies in Vietnam. The results show that FDI (net inflows), foreign aid, foreign loans, exports, and GDP (current), have a positive effect at a 1% significance level on economic growth. Rather, an increase in FDI (net inflows), foreign aid, foreign loans, exports has beneficial effects on the Vietnamese economy in the study period. Based on the findings of this study, the article proposes several important policy implications for Vietnam in maintaining a high rate of economic growth via the contribution of FDI inflows, foreign aid, foreign loans, and exports.

Keywords: GDP, FDI, Foreign Aid, Foreign Loans, Exports

JEL Classification Code: F30, F35, F43, B17

1. Introduction

Each country's development necessitates an efficient and reciprocal combination of domestic and foreign resources. Starting with countries with no international relations, being fully reliant on domestic resources is inevitable; however, these countries' development is inevitably slow, with poor economic growth rates, low per capita income, and low living standards. If this situation continues, it will have ramifications when domestic resources are depleted. So, what exactly is economic growth? Why is every country's annual rate of economic growth so important? Economic growth is defined as an increase in the production of economic goods and services over time and can be measured in nominal or real (inflation-adjusted) terms (The Investopedia, 2020). Another definition from the perspective of national income is that economic growth is viewed as a macro-economic concept referring to the increase in real national income, sustained over two consecutive quarters of a year (The Economics Online, 2020).

According to the Intelligent Economist (2020), economic growth is an increase in the market value of the goods and services produced by an economy over time. These three definitions demonstrate the significance of economic growth for each country's socio-economic development, as well as the size of the economy between the current year and the previous year, or the current period and the previous period. Furthermore, the annual economic growth rate plays a crucial role in any country's prosperity. According to Chirwa and Odhiambo (2016), high and sustainable economic growth is a central feature and achievement in many economies, particularly in developing countries. A study on the relationship between gross domestic product

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and foreign direct investment showed that the GDP growth rate indicates the size of the economy in the future (Cung, 2019). Thus, gross domestic product (GDP) depicts the size of each country's economy, with the increase or decline indicating the scale of growth, and the rapid or gradual rise indicating the pace of growth. (2020, Nguyen).

Since 1986, Vietnam's economy has evolved from a planned and subsidized model to a market economy, in which all economic sectors are free to develop based on open policies for domestic market development and international economic integration, as well as foreign investment attractiveness. To bring Vietnam to its current stage of development, a combination of domestic and foreign resources is a proper and appropriate perspective. The development of the Vietnamese economy among the group of countries with the highest growth rates in the world is an outstanding achievement (Liu et al., 2012; Cung, 2020; Cung & Hung, 2020). Vietnam's economic growth model has been built on natural factors, exploitation of available resources, low labor prices, and the use of low and unskilled quality workers for over 30 years (Liu et al., 2012; Nguyen, 2020). According to economic growth theories and reality in countries, four main factors including human resources, natural resources, capital, and technology sustain the motivation for economic growth. Vietnam has two main motivations for economic growth – a young labor force and abundant natural resources (Nguyen, 2020).

Despite the fact that these two reasons have resulted in several achievements for the Vietnamese economy in terms of economic growth, foreign investment attraction, export, employment and income, and infrastructure, Vietnam is soon to face resource depletion and an aging workforce. This is regarded as evidence of the growth model's backwardness. The obsolescence of this growth model has become increasingly evident since the emergence of the global economic recession in 2007–2008 and the COVID-19 epidemic from 2019 to the present. Furthermore, according to the author's observations, the change of economic growth model has been mentioned in meetings of state agencies from central to local, and since then, economic domestic and international economic forums have been held to find the economic growth model suitable for Vietnam in the coming period.

Vietnam has had an effective and sustainable mix in using domestic and international capital flows through open development policies to achieve high economic growth over the years. Vietnam has adopted a new growth model in recent years, but it continues to exploit capital flows in the same way as before. The objective of this research is to use a time-series data set from 1995 to 2018 to examine the impact of foreign capital factors on economic growth in Vietnam. This is the author's second study using a linear model using regression and correlation analysis to differentiate foreign and domestic factors affecting economic growth in Vietnam. The author's previous study titled "The impact of foreign direct investment, aid, and exports on economic growth in Vietnam" was published in *The Journal of Asian Finance, Economics, and Business*. The difference between this article and the previous study is the addition of an independent variable - foreign loans (IBRD loans and IDA credits) and the inclusion of time period. With the expectation that by giving empirical evidence on the effects of FDI, aid, loans, and export on economic growth in Vietnam, this article will offer scientific and practical contributions. Based on empirical findings on the role of foreign capital inflows in affecting economic growth in Vietnam from 2015 to 2018, as well as changes in the new situation of the COVID-19 pandemic, policy recommendations will be made to improve the efficiency of attracting FDI, effectively exploiting and using aid and loan flows, and export promotion.

2. Literature Review

Whether a closed economy or an open economy, countries use a combination of four inputs (human resources, natural resources, financial capital, technology) to produce goods and services to meet the needs of the people and create a certain rate of economic growth to ensure the annual economic development plan. With an open economy, these four inputs are increased both quantitatively and qualitatively based on inflows from other countries. For less developed countries, the first stage of development is the exploitation of foreign inflows such as FDI, aid, and preferential loans, actively signing bilateral and multilateral relations to increase exports mainly through FDI companies, etc, to contribute to the economic growth and ensure safety. Therefore, to develop faster, these countries have been seeking effective solutions to attract foreign resources, especially foreign direct investment (Nguyen, 2021). An analysis of the relationship between foreign capital inflows and economic growth has been studied by many authors with empirical evidence in developed countries as well as developing countries at different time periods.

In developing countries, the role of external economic assistance on the socio-economic development of countries remains controversial. That controversy stems from positive as well as negative effects in each form of external economic assistance. Foreign capital inflows into countries include various forms such as FDI, external loans and credit, technical assistance, project, and non-project aid, etc. Moheyuddin (2006) built a multiple linear regression model with two independent variables (FDI, ODA) and one dependent variable (GDP). The empirical results showed a positive impact of foreign capital inflows on the GDP growth in Pakistan in the period 1975–2004. The results of empirical research in Cameroon on the relationship between foreign capital inflows and economic growth show that FDI has a positive and

significant impact on economic growth in the short and long terms for the period 1980–2008 (Fambon, 2013).

Erum et al. (2016) studied the impact of FDI, domestic capital, labor, and government expenditures on the economic growth of South Asian Association of Regional Cooperation countries by using the pooled data for the period 1990–2014, and the results showed that FDI has a positive effect on economic growth. Rehman and Ahmad (2016) used modern econometric techniques to examine the effect of foreign capital inflows on economic growth in 21 developing nations from 1990 to 2013. The findings showed that inflows, such as net external debt and net official development assistance, have a significant negative impact on developing country economic growth, whereas the net foreign direct investment and net remittances have a positive and significant effect on the economic growth. Mowlaei (2018) studied data of 26 top African countries on the relationship between foreign capital inflows and economic growth, the empirical results show that FDI, personal remittances, and ODA have a positive and significant impact on economic growth in the long and short run. An empirical study by Abouelfarag and Abed (2019) on the relationship between foreign capital flows and economic growth in Egypt, showed that foreign direct investment has a weak positive effect on economic growth, while external debt and economic growth have an insignificant effect.

Ehigiamusoe and Lean (2019) analyzed the impact of foreign capital inflows on economic growth in Nigeria for the period 1980–2015. The Autoregressive Distributed Lagged (ARDL)-bounds test was used, and a cointegration relationship between foreign capital inflows and economic growth was found. Empirical results showed that the relationship between foreign portfolio investment and economic growth is positive, while foreign loans and economic growth are negative. In addition, this study found that the effect of foreign direct investment and foreign aid on economic growth is insignificant. Nantharath and Kang (2019) found that FDI and trade openness has a positive impact on economic growth in the Lao People's Democratic Republic during the period 1993–2015, while human capital and institutional quality have a negative effect. Golder et al. (2021) studied the impact of foreign aid, trade openness, and domestic investment on economic growth in Bangladesh with annual data covering the 1989–2018 period. Foreign aid and domestic investment have a positive effect on economic growth in the long run, while trade openness has a positive effect on economic growth in the short term. Nguyen and Duong (2021) studied the impact of economy, corruption, public expenditure, inflation, tax revenue, FDI, and trade openness on economic growth in the BRICS countries, and the empirical findings suggested that the relationship between FDI, trade openness, and economic growth is positive.

FDI and other foreign capital inflows have helped Vietnam transition from an underdeveloped to a developing economy with a low-income level, contributing to economic growth, employment, income, and other factors. Given this significance, numerous research findings have been published to identify factors influencing economic growth in Vietnam, including factors affecting foreign capital flows. (Cung & Hua, 2013).

Ha et al. (2017) analyzed the factors affecting economic growth in Vietnam. Research results showed that FDI, gross fixed capital formation, real interest rate, and real exchange rate have a positive and significant effect on economic growth in Vietnam, while the relationship between inflation rate and economic growth is negative and significant. Chinh and Chi (2018) analyzed the relationship between FDI and economic growth in Vietnam, stating that FDI is an important source of capital for economic growth in Vietnam. Empirical results also showed that there is a positive linkage between FDI and GDP, and a significant impact of openness to trade and international crisis on economic growth in Vietnam for the 1986–2015 period. Tru (2018) investigated the factors influencing economic growth in Vietnam from 1977 to 2016, and the findings showed that the effect of export share, foreign direct investment, value-added in the agriculture, forestry, and fishery sector, and ASEAN participation on economic growth is positive, while imports have a negative effect.

Based on a study on the relationship between economic growth and FDI in Vietnam for the period 2003–2018, Cung (2019) found that real GDP and FDI have a positive and significant effect at 1% significant level on economic growth, and business freedom index and investment freedom index have a positive effect on FDI at 5% significant level. Cung (2020) used a secondary time-series data set from 1995 to 2018 to analyze the relationship between factors affecting economic growth in Vietnam. The results showed that the impact of FDI, exports, financial freedom index, and investment freedom index on economic growth is positive and significant, while the relationship between annual inflation and FDI is negative and insignificant. Nguyen (2020) found that FDI (net inflows), aid, exports, and GDP (current) have a positive and significant effect on economic growth. Le et al. (2021) analyzed the relationship between FDI and local economic growth in Binh Dinh Province (Vietnam) from 1997 to 2019, and the results showed that there is no evidence of the effect of FDI on economic growth in the condition of low capital implementation, and the impact of FDI on economic growth is influenced by infrastructure and human capital.

Based on the empirical results of different studies via the literature review above, there are many factors affecting economic growth in Vietnam and other countries such as FDI, exports, ODA, foreign aid, foreign loans, foreign credit, technical assistance, project & non-project aid, domestic capital, labor, remittances, external debt, foreign portfolio

investment, trade openness, human capital, corruption, public expenditure, inflation, tax revenue, gross fixed capital formation, real exchange rate, real interest rate, business freedom index, investment freedom index, financial freedom index, others. However, within the scope of the author's research, the purpose of this article is to analyze the effect of foreign capital inflows on economic growth in Vietnam in the period 1995–2018.

3. Data and Empirical Model

This study only evaluates the influence of factors indicating foreign capital flows on economic growth in Vietnam based on data collected from one dependent variable and four independent variables. An empirical model is used to determine the effect of FDI, foreign aid, foreign loans, exports of goods and services on economic growth in Vietnam. Within the scope of this article, a linear model is employed by the author to perform the regression and correlation analysis. To achieve the purpose of the study, the author employs a secondary time-series data set ranging from 1995 to 2018 collected from The World Bank. Like several previous articles of the author that have been published, The data in the article are presented, analyzed, and interpreted using descriptive statistics and inferential statistics such as regression and correlation. The regression results show that there is no serious problem to conclude for the model mismatch.

Figure 1 is a graph showing the relationship between five independent variables (FDI, foreign aid, foreign loans, and exports) and one dependent variable (GDP).

The relationship being tested is

$$GDP = F(FDI, AID, LOANS, EX)$$
$$GDP = \beta_0 + \beta_1 FDI + \beta_2 AID + \beta_3 LOANS + \beta_4 EX + \varepsilon_t \quad (1)$$

With the given data, this article performs a linear regression on the relationship between four independent variables (foreign direct investment net inflows, net official development assistance and official aid received, IBRD loans and IDA credits, exports of goods and services) and economic growth (real GDP) in Vietnam to analyze the role of each force on economic growth in Vietnam during the period 1995–2018, at the same time to compare the effect degree between factors on economic growth (see Table 1).

4. Results and Discussion

4.1. Descriptive Statistics

The author presents and analyzes the descriptive statistics on the relationship between FDI, aid, loans, export, and economic growth in Vietnam (see Table 2). Output data shows that the mean real GDP reached USD97.94004 billion; the maximum and minimum real GDP was USD244.9480 billion and USD20.73600 billion, respectively. For the period 1995–2018, it increased 11.8 times, with an average annual GDP growth rate of 6.76 percent. Since 1986, Vietnam has been implementing economic reforms, and this change has acted as a key motivator for promoting rapid economic growth and addressing social issues, transforming the country from

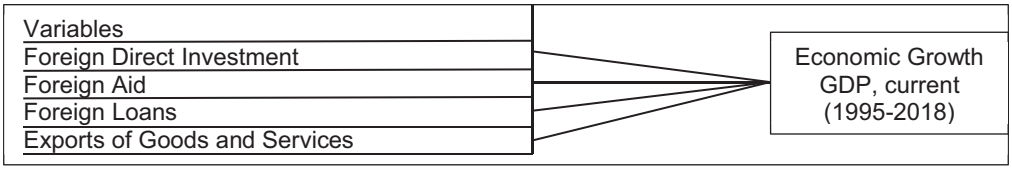

Figure1: The Relationship between Four Independent Variables and a Dependent Variable

Table 1: Meaning of Variables

Variables	Meaning	Unit
GDP	Gross domestic product	Current, Bill.US$
FDI	Foreign direct investment, net inflows	BoP, current, Bill.US$
AID	Net official development assistance and official aid received	Current, Bill.US$
LOANS	IBRD loans and IDA credits	DOD, current, Bill.US$
EX	Exports of goods and services	Current, Bill.US$
ε	Error variable	

Table 2: Descriptive Statistics

	GDP	FDI	AID	LOANS	EX
Mean	97.94004	5.861125	2.159708	5.903668	79.30292
Maximum	244.9480	15.50000	4.216000	14.96778	259.5140
Minimum	20.73600	1.298000	0.778000	0.286298	6.804000
Std. Dev.	73.55227	4.654614	1.096393	5.045057	76.35253
Observations	24	24	24	24	24

the world's poorest to a low-middle-income country. As a result, the average annual GDP growth rate was about 6.59% for the 1986–2018 period. However, if there is a comparison before the US lifting of the economic embargo and after the lifting of the economic embargo against Vietnam, there is a slight difference, meaning that the average annual GDP growth rate was about 6.16% for the 1986–1994 period and 6.76% for the 1995–2018 period. This data demonstrates a problem: the US lifted the embargo on Vietnam only as a result of Vietnam's aggressive economic reform process, with the goal of becoming a developed market economy and a key partner for all countries in the world. The benefits that the two nations have received from this relationship in terms of business, politics, diplomacy, culture, defense, and others have increased significantly since the US removed the embargo on Vietnam (on January 1, 1995).

Vietnam is a developing country with a highly open economy through the signing of several bilateral and multilateral agreements with countries and international economic organizations around the world. Furthermore, for many years, Vietnam has been a member of the group of countries with the highest economic growth rate in the world, and it is now classified as a low-middle-income country. Foreign variables such as FDI, aid, loans, and export are critical to these achievements, and they are a major source of motivation for Vietnam's economic growth, with FDI contributing the most. FDI inflows are still the most important foreign capital factor in Vietnam, despite the fact that the country's economic growth model is changing. The only change from the previous period is a greater focus on the quality of FDI projects to accomplish the objectives of modern technology, the utilization of highly qualified and productive workers, good product quality, and environmental sustainability. Therefore, Vietnam has issued new or revised legal documents in recent years, for example, the Investment Law 2014 stipulates 13 groups of fields and 3 types of areas to encourage investment, and assigns specific tax incentives to the fields and areas to be enjoyed. Accordingly, the specific level of tax incentives is specified in the tax law.

The regulations on incentives to attract FDI are concretized in the following legal documents: Law on Investment 2014, Law on Corporate Income Tax as amended in 2013, Law on Import and Export Tax 2016, Decree No. 118 /2015/ND-CP of the Government detailing and guiding the implementation of a number of articles of the Law on Investment, Decree No. 123/2017/ND-CP amending a number of articles on the collection of land use, land rental and water surface rent, etc. Important criteria to determine the type and scale of incentives. First, investment location (the project takes place in an area with difficult socio-economic conditions, industrial parks, economic zones, high-tech zones, etc). Second, Investment field (Investment in fields and industries that enjoy investment incentives or special investment incentives). Third, the number of jobs created (investment projects in rural areas employing 500 workers or more). Fourth, incentives according to the total investment capital (Invest in large production projects with a total investment capital of VND 6 trillion or more and meet a number of other conditions).

4.2. Correlation and Regression Analysis

Depending on each explanatory variable in different study periods and areas, the research results on foreign capital variables affecting economic growth in different countries could be a positive or negative sign, significant or insignificant. In this study, the correlation analysis undertaken between real GDP and four explanatory variables is shown in Table 3 below. The correlation results show that there is a positive and significant sign between real GDP and FDI, aid, loans, and exports. These correlation outputs demonstrate that measures attracting and enhancing foreign capital inflows into Vietnam, such as FDI, aid, loans, and exports, have had a positive impact on economic growth from 1995 to the present. Moreover, in recent years, in the process of transforming the economic growth model, Vietnam still attaches great importance to foreign capital flows via policies on land, administrative reform, tax, credit, and interest, etc.

Table 4 shows the regression results, which indicate that the model is consistent and statistically significant

Table 3: Correlation Matrix between GDP and Independent Variables

	FDI	AID	LOANS	EX	GDP
FDI	1				
AID	0.642391333372	1			
LOANS	0.944815863574	0.744100874627	1		
EX	0.951230757775	0.615464231447	0.981138043892	1	
GDP	0.960993751595	0.716429141688	0.996415953128	0.989446976179	1

Table 4: Regression Analysis Results for GDP and Explanatory Variables

Variable	Coefficient	Std. Error	*t*-statistic	Prob.
C	7.095545	1.512733	4.690548	0.0002
FDI	1.810658	0.363102	4.986637	0.0001
Aid	6.856225	1.514891	4.525886	0.0002
LOANS	3.892819	1.330049	2.926824	0.0087
EX	0.535197	0.078187	6.845100	0.0000
R-squared	0.999101	*F*-statistic		5277.864
Durbin-Watson stat	2.403129	Prob(*F*-statistic)		0.000000

at a 1% significance level (Prob(*F*-statistic) = 0.000000). Sign of β_1, β_2, β_3, β_4 shows a positive and statistically significant effect of four explanatory variables on the dependent variable. Sign of β_0 = 7.095545 shows that not only FDI, aid, loans, and exports affect economic growth but also other factors that are the driving force for Vietnam's economic growth in the period 1995–2018. Furthermore, *R*-squared = 0.999101, which represents a 99.91 percent explanatory level for the variables of real GDP in terms of $R^{2.}$ This means that around 99.91% of the variation in real GDP is explained by this model via explanatory variables such as FDI (net inflows), aid, loans, and exports of goods and services. The value *d* of Durbin-Watson test = 2.403129 while at 5% level significance (α = 5% = 0.05), sample numbers *n* = 24, independent variables in the model *k*' = 4, inferred d_L = 0.805 and d_U = 1.527. Due to $d_u = 1.527 < d = 2.403129 < 4 - d_u = 2.473$. This concludes that the model does not have autocorrelation. The author continues to study the regression findings of each factor to compare their importance (see Figure 2).

The empirical evidence in Table 4 shows, β_1 = 1.810658, which indicates that, while other factors remain constant, when FDI inflow increases to USD 1 billion, real GDP will increase to USD 1.810658 billion, and *p* = 0.0001 reflects the effect of FDI on economic growth at a 1% level of significance. Thus, the relationship between FDI and economic growth in Vietnam in the period 1995–2018 is positive and statistically significant, which means that policies to attract FDI inflows have been consistent with Vietnam's macroeconomic goals for many years. This result is consistent with the finding of Moheyuddin (2006), Fambon (2013), Erum et al. (2016), Rehman and Ahmad (2016), Ha et al. (2017), Mowlaei (2018), Chinh and Chi (2018), Tru (2018), Cung (2019), Ehigiamusoe and Lean (2019), Nantharath and Kang (2019), Cung (2020), Nguyen (2020), and Nguyen and Duong (2021).

For foreign aid, β_2 = 6.856225. which indicates that, while other factors remain constant when aid (Net official development assistance and official aid received) increases to USD 1 billion, real GDP increases to USD 6.856225 billion, and *p* = 0.0002 also implies the effect of foreign aid on economic growth at a 1% level of significance. This result is consistent with the finding of Rehman and Ahmad (2016), Mowlaei (2018), Nguyen (2020), and Golder et al. (2021).

For foreign loans, β_3 = 3.892819, which indicates that, while other factors remain constant, with an increase in loans (IBRD loans and IDA credits) of USD 1 billion, real GDP rises to USD 3.892819 billion, and *p* = 0.0087 indicates that the relationship between foreign loans and economic growth is significant at a 1% level. This result is consistent with the findings of Rehman and Ahmad (2016) and Abouelfarag and Abed (2019), but not consistent with the findings of Ehigiamusoe and Lean (2019) who showed that the relationship between loans and economic growth is negative.

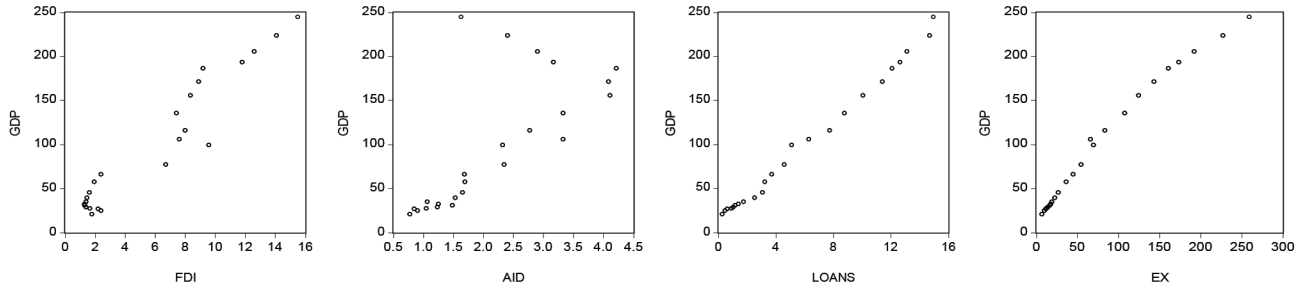

Figure 2: Correlation between an Independent Variable and a Dependent Variable

For exports of goods and services, $\beta_4 = 0.535197$, which shows that, while other factors remain constant, when exports rise to USD 1 billion, real GDP increases to USD 0.535197 billion, and $p = 0.0000$ indicates the effect of exports on economic growth at a 1% level of significance. This result is consistent with the finding of Chinh and Chi (2018), Nantharath and Kang (2019), Cung (2020), Nguyen (2020), Golder et al. (2021), and Nguyen and Duong (2021).

5. Conclusion and Policy Implication

The purpose of this paper is to analyze the relationship between four explanatory variables (FDI, foreign aid, foreign loans, exports) and economic growth in Vietnam for the 1995–2018 period. Not only that, from the research results in this article, the author also compares the impact of each factor on Vietnam's economic growth during the research period. The role of all four factors on economic growth is strong at a 1% significance level and has a positive causal relationship. Based on the findings of this article, the author proposes several policy implications as follows:

First, to transform the economic growth model to achieve socio-economic goals in the near future, in addition to improving the effectiveness of current FDI attraction policies, Vietnam should strive to achieve greater openness to improve the quality of FDI projects and continue to compete with other countries in the region. Besides issuing preferential policies in attracting FDI, Vietnam needs to prepare reciprocal resources, both directly and indirectly, such as enhancing the quality of human resources through innovation in training quality in the national education system, quality of physical and psychological health through capacity building of the national health system, clear and transparent planning of land use for different purposes, infrastructure development via public investment as a source of open capital to attract private investment, stronger administrative procedure reform, and rapid elimination of informal costs, others.

Second, since the time it became a low-middle-income country, Vietnam has been receiving preferential aids and loans from governments and international organizations, who provide such aids and loans at low or market interest rates. The pressure on Vietnam to repay its debts is increasing. To increase the efficiency of obtaining foreign aid and loans in the future, Vietnam will need to implement the following solutions in a synchronized manner: using foreign aid as committed, improving the efficiency of using foreign aids and loans, increasing reciprocal capital, especially reciprocal capital for site clearance and resettlement for construction investment projects, enhancing transparency in the management and use of foreign aids and loans, strengthening public-private partnership (PPP) in attracting investment and using foreign aids and loans effectively (a new way), enhancing the control and evaluation of the use of foreign aids and loans, and perfecting the legal system for attracting foreign aids and loans.

Third, among the four foreign capital factors, export is the strongest factor affecting Vietnam's economic growth with $p = 0.0000$ (see Table 4) for the 1995–2018 period. What policy implications does this result have for Vietnam? Vietnam must continue to promote goods and service exports in a sustainable manner by implementing the following strategies: maintaining available export markets through signed commitments and expanding new export markets through bilateral and multilateral agreements, enhancing competitiveness through the quality of exported goods and services, increasing total export value through the restructuring of export goods and services with high added value, and accelerating the digital transformation to find and diversify markets.

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