

IMPACT OF FOREIGN DIRECT INVESTMENT ON KAZAKHSTAN'S ECONOMY: A Boon or a Curse

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Abstract

The Republic of Kazakhstan has received large amounts of Foreign Direct Investment (FDI) relative to other countries within the Commonwealth of Independent States since its independence in 1991 from the Soviet Union. Kazakhstan expects to continue to attract FDI primarily because of its significant oil reserves. Simple regression analyses were employed to determine the impact of FDI on GDP, per-capita income and on individual sectors of the economy. Our analyses showed that FDI generally had a positive, although moderate, effect on Kazakhstan's economic growth and per-capita income. The study also indicated that FDI had an adverse impact in some sectors, especially agriculture and manufacturing, crowding-out domestic investment. The largest share of FDI is directed towards the energy sector. We concluded that FDI alone may not be relied upon to promote sustainable growth of the Kazakhstan economy, but their commitment to more economic freedom should promote an improving economy.

Key Words: Foreign Direct Investment, Economic Growth, Economic Freedom.

Introduction

Foreign Direct Investment (FDI) is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset.

This investment involves a long-term relationship between the investor and the recipient and reflects a lasting interest and control by the resident entity. In the last few decades many countries, especially developing countries, have recognized foreign direct investment as a vital external source for capital spending on the development of cutting edge technology and human capital, both of which contribute immensely to the growth of host economies (Christiansen, 2002). The positive impact of human capital and technological advances on countries' economic growth is also reported by international organizations such as the World Bank, the International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD), Organization for Economic Co-Operation and Development (OECD) which undertake to share knowledge by collecting and distributing statistical data and conducting research studies.

UNCTAD statistics indicate that worldwide FDI inflows were about US \$200 billion in 1990 and began rapidly increasing in the late 1990's to \$1.4 trillion in 2000. From 2001 to 2005 FDI inflows fell back below the trillion dollar level (World Investment Report, 2010). Indeed, competitive pressures and searches for new growth opportunities led to an FDI outflow from developed countries consisting of \$745 billion in 2005. Firms from developed countries accounted for about 87 percent of these outflows. The strongest explanations for the renewed surge in FDI are competition and price appreciation for natural resources. According to UNCTAD, FDI still remains the primary source of capital for developing countries. FDI "continues to surpass other private capital flows to developing countries as well as flows of official development assistance programs" that accounts "for more than half of all resource flows to developing countries" (UNCTAD, 2005). Earlier issues of the World Investment Report suggested that FDI flows would continue to increase and indeed they peaked in 2007 at \$2.1 trillion before the financial crisis led to reductions in 2008 and 2009 (World Investment Report, 2010).

Kazakhstan is rich in oil and mineral deposits (Teal, et al, 2011). As a result, Kazakhstan's FDI inflows are similar to the global trend. Between 1994 and 2002 FDI inflows to Kazakhstan increased in most years. In 2008 FDI inflows to Kazakhstan peaked at \$14.3 billion (World Investment Report, 2010). In total, since its independence in 1991, Kazakhstan received over \$40 billion of FDI inflows (National Bank of Kazakhstan, 2009). As seen in Table 1, from 2000 to 2004 FDI inflows averaged just less than 10 percent of GDP. The purpose of this paper was to analyze the relationship between Foreign Direct Investment inflows to Kazakhstan and Kazakhstan's economic growth since its independence from the Soviet Union in 1991. The next section discusses background information on FDI inflows to Kazakhstan, then we present our methodology and data in the following section, and in the last two sections we present results from our empirical analyses and then provide a discussion.

Background: What Kazakhstan offers foreign investors

Since the fall of the Soviet Union there has been a significant increase in foreign direct investment (FDI) flows around the world. Kazakhstan is an interesting example of an emerging economy in which to study FDI as it has become more integrated into the world economy. A primary reason for interest of the investors in Kazakhstan is its natural resources especially oil and natural gas. Also, the Kazakhstan government has significantly increased economic freedom. Its *Index of Economic Freedom* score has increased to about 60 (the world average which is "moderately free") from a "mostly unfree" score of about 50 (Heritage Foundaton, 2011). Other Central Asian countries such as Uzbekistan and Turkmenistan have remained "mostly unfree" and have attracted significantly less FDI (Barry, 2009). Teal, et al (2011) report also that "Kazakhstan has made great progress in the transformation...into a market-based economy" based on growing entrepreneurial development presumably from both foreign and domestic investors.

Since FDI, especially inward FDI to a particular country, is influenced by various factors such as business friendliness, economic and political stability, the presence of natural resources, infrastructure, and opportunities for participating in privatization, Kazakhstan's *Inward FDI Performance Index* is summarized in Table 2. The index captures the influence on the inward FDI to Kazakhstan of those factors for attracting investment, and is measured as the ratio of Kazakhstan's share in global FDI inflows to its share in global GDP as follows:

$$IND_K = \frac{FDI_K / FDI_W}{GDP_K / GDP_W}$$

where IND_K = the inward FDI performance index of Kazakhstan, FDI_K = the FDI inflows to Kazakhstan, FDI_W = world FDI inflows, GDP_K = GDP of Kazakhstan, and GDP_W = world GDP.

For this index, a value greater than one indicates that more FDI has flowed inward to a country than its economic size would suggest compared to other countries. As shown in the table, three-year moving averages of the index from 1993 to 2006 for Kazakhstan were substantially greater than one, indicating that the inward FDI has been a primary source of private investments in the country.

In addition, Kazakhstan has a well-developed financial sector that is effective at fostering productive investment. The physical infrastructure of Kazakhstan is also better than other CIS countries in the area which helps firms expand their productive capacity.¹ These efforts have resulted in strong economic growth in Kazakhstan in the 21st century, as real GDP growth averaged 10.3 percent annually from 2000 to 2005.² The country's economic performance *and* management has been strong enough to allow the leaders of Kazakhstan to repay all its debt to the IMF seven years ahead of schedule.

FDI inflows are far more likely to positively impact the economic growth of Kazakhstan if the investments are used to develop productive resources in the country such as human and industrial capital. In fact, FDI inflows as a percentage of gross fixed capital formation grew from less than 20 per cent in 1993 to over 50 percent in 2001 (UNCTAD 2004). Overall, inward FDI stock as a percentage of GDP grew from about 15 percent in 1995 to 63 percent in 2002 (UNCTAD 2004). Also, Table 1 (fifth column) shows that high-technology exports, as a percent of manufactured exports, have increased from 4.5 percent in 1995 to 11.3 percent in 2005. These statistics indicate that FDI inflows are being invested to develop the country's resources and not just oil and gas. The UNCTAD Brief also indicates that the top investment partners are the United States and the United Kingdom, who constituted 54% of inward FDI stocks in 2002. Nevertheless, the question remains whether these FDI inflows to Kazakhstan are a net benefit to their domestic economy.

Economic Status of Kazakhstan

Oil exports have driven much of Kazakhstan's economic growth in the 21st century, rising from approximately \$2.5 billion in 1999 to over \$16 billion in 2005 (IMF 2006). The Economic Cooperation Organization (2002) estimates indicate that about 90 percent of the country's growth derives from oil and oil-related businesses. Rising production and oil prices have helped cause oil revenues to increase. Being naturally endowed in mineral resources, Kazakhstan is ranked as the second largest exporter of oil after Russia in the Commonwealth of Independent States (CIS) region. Moreover, estimates of proven oil reserves in the country make Kazakhstan one of the largest non-OPEC sources. According to the U.S. Energy Information Administration, non-OPEC countries produced 60 percent of world's oil in 2004. Given GDP growth and geological estimates of proven oil reserves, it can be expected that Kazakhstan will continue to attract FDI into its economy in the future.

Foreign Direct Investment has significantly helped Kazakhstan to increase oil production. From 2000 to 2004 oil production in Kazakhstan increased an average of 15 percent annually and Kazakhstan's oil exports rose from 524,000 barrels per day (bpd) to 997,000 bpd (USAID 2005). During this time period the IMF (2005) estimates that on average, 59.8 percent of FDI went into oil and natural gas extraction. Although relying on oil revenues makes Kazakhstan vulnerable to a downturn in oil prices, Kazakhstan has established the National Fund of the Republic of Kazakhstan (NFRK) in order to accumulate assets and thus protect future generations from time periods of low commodity prices. Also, the President of Kazakhstan clearly indicated the goals for the country's future development in two documents, "Kazakhstan 2030" and "Strategic Plan of Development," which place great emphasis on the development of priority non-oil sectors such as agriculture, timber, construction, and tourism.

Reason for this study

Usually the source of FDI is transnational corporations (TNCs) or multinational enterprises (MNEs). These corporations invest funds that are accompanied with a bundle of assets. Lall (2000) identified five major values that TNCs bring: *capital, technology, skills and management, market access and environment*. For developing countries the capital may be scarce (Moran, 2002) and can act as a much needed "shot in the arm". In contrast to commercial debt and portfolio investments, FDI inflows offer a stable source of capital when TNCs invest in long-term projects, taking risks and repatriating profits only when the projects yield returns (Lall, 2000).

¹ Although insufficient capacity in oil pipelines limits their oil exports and communications networks need substantial improvement.

² Based on authors' calculations from the World Development Indicators

Since developing countries usually lag in progressive processes, they may use outdated technologies. Lall (2000) describes positive spillovers from FDI as follows: TNCs can bring modern technologies that may not be available without FDI and raise the efficiency with which technologies are used. Technical inefficiency and obsolescence affect the quality of products and handicap the ability to cope with new market demands. Moreover, TNCs can adapt technologies to local conditions, drawing on their experience in other developing countries. They may, in some cases, set up local R&D facilities. They can upgrade technologies as innovations emerge and consumption patterns change. They can stimulate technical efficiency in local firms, both suppliers and competitors, by providing assistance, acting as role models and intensifying competition (Lall, 2000). Moreover, Lall (2000) argued that skills are transferred when TNCs bring in experts and set up training facilities for the indigenous work force. TNCs also possess management techniques that offer enormous competitive benefits. Given these favorable values that FDI creates, some argue that FDI positively correlates to growth (Lim, 2001).

Yet, there are studies that show little or no effect of FDI on the growth of the host economy. For instance, Singh (1988) analyzed data from 73 countries for two time periods: from 1960-70 and from 1970-80. The data was subdivided into two groups: low-income and middle-income developing countries. The author concluded that there was little or insignificant effect of FDI on the economy or the industrialization of the host economy. Also, Hein (1992) reported an insignificant effect of FDI on economic growth for a sample of 41 countries. A sector analysis of FDI indicates why there have been inconsistent results. Alfaro (2003) showed that FDI can have a positive effect in some sectors, principally manufacturing, while having a negative effect in others, primary and agricultural sectors. The detrimental effects appear to be from the lack of spillover effects in some sectors and crowding out of domestic investment by indigenous firms. Fry (1992) examined a sample of 16 developing countries. He found that in general the contribution of FDI to the rate of economic growth is not significantly different from that of domestic investment. Moreover, domestic investment had a negative sign which meant FDI had an adverse effect on the domestic investment climate. Yet, the results varied from country to country.

As seen above, the available research provides conflicting predictions concerning the growth effects of FDI on the economy of the host countries. A study by Klaus (2001) of FDI in Commonwealth Independent States (CIS) investigated the effect of FDI using data for Kazakhstan. Yet, his study included data until 1997 with a time span of ten years when Kazakhstan was one of the republics of the former Soviet Union. Another study on Kazakhstan concerned export orientation of the Kazakhstan government and its effect on growth (Kuralbayeva, Kutan and Wyzan, 2001). This study only included data from 1995 to 2001. Therefore, given the mixed results on the effect of FDI and lack of studies concerning impact of FDI on the economy in Kazakhstan since its independence, it was considered important to examine these issues. Thus, the study focused on analyzing the effects of FDI on key economic indicators of Kazakhstan, especially GDP.

Methodology and Data

Our goal was to analyze the relationship between Foreign Direct Investment and economic growth in Kazakhstan since its independence in 1991. For the empirical analyses we used simple regression analyses on secondary data of Kazakhstan's economy from 1993 to 2005. The growth rate of GDP and GDP per capita are analyzed in relation with FDI as well as export volumes. Moreover, GDP per sector were analyzed with inflowing FDI to see whether there is any correlation.

Our simple linear regression model for the empirical analyses is:

$$Y = \beta_0 + \beta_1 X + \varepsilon$$

where Y is the dependent variable such as the growth rate of real GDP or real GDP per capita, and X is an independent variable such as Foreign Direct Investment as a percentage of GDP.-The regression tests used in this research included such economic variables as Gross Domestic Product (GDP), GDP per economic sector, population, foreign direct investment inflows, employment and export volumes. Excel statistical software from Microsoft Office was used to run regression analyses. In the regression analyses the null hypothesis that the slope of the regression line equals zero was rejected if the p-value is smaller than the significance level of $\alpha=0.10$.

Data on GDP, GDP per sector, FDI, aggregate employment, employment per sector and export volume were collected from the following sources:

- IMF's International Financial Statistics March 2006 CD ROM version for world oil prices from 1995 to 2004 and real GDP growth from 1993-2005.

- Statistical Agency of Kazakhstan - from yearly statistical prints and electronic database for GDP in 1993 constant prices from 1995-2003, GDP in current market prices from 1993-2005, export volumes from 1995-2004, aggregate employment data from 1993-2005.
- Ernst & Young's business and investment guide for Kazakhstan. The guide included employment data per sector of the economy from 1999-2003.
- Electronic database of the National Bank of Kazakhstan for inflows of foreign direct investment aggregated as well as individual inflows of FDI per sector.

The industrial classification code adopted by the statistical agency in Kazakhstan is compatible with Standard Industrial Code in the United States. The last three columns in Table 1 show how economic growth has occurred at different rate among the three major sectors of the economy (this is for illustrative purposes, as this is not the actual data used in the regression analyses below). Upon gaining independence in 1991, the agricultural sector was almost 30 percent of the economy, but it was plagued by low productivity (National Bank of Kazakhstan, 2009). Since independence, the agricultural sector has decreased to only about 7 percent of the economy whereas the services sector has grown substantially.

The data that was used for statistical tests have some limitations. The time span of the data is not consistent across all data. The longest time span included 13 observations and the shortest time span included 8 observations. Additionally, some variables in some tests may draw data from different sources, e.g. the National Bank of Kazakhstan and the IMF. Although the data came from different sources, data compatibility was not violated. The time span of data is short and thus limits the underlying research from employing growth models that require large sample data. Reliability of the data is influenced by some factors. First, in 1998 the Statistical Agency of Kazakhstan changed the methodology of data collection. Second, electronic data has slight deviations from the printed data published by the Statistical Agency.

Results

GDP, employment and average earnings are some of the main variables that are used in many studies on FDI to run the statistical tests to find the impact of FDI on the growth of the host economy. GDP per capita is one of the economic indicators of nation's wealth and was therefore included in the analysis in this study. Thus, in this study, the following main relationships were analyzed. We also attempted to determine whether foreign direct investments have any impact on the individual sectors of the economy. As discussed previously, FDI has a positive correlation to GDP growth. Although the coefficient of determination was not high, the test was statistically significant. For sector-level analyses, the ratio of FDI to GDP was used as the independent variable and the ratio of the output per sector to total GDP was used as a dependent variable. Results of our analyses showed that FDI had a negative effect on GDP of the agricultural sector which includes forestry, hunting and fishing. FDI also had a negative effect on the construction sector, trade sector, and services sector. However, FDI had a positive effect on output of the Industry sector which includes mining, manufacturing and utilities. FDI also showed a slight positive effect on the Transportation and Communication sector. However, the relationship was not statistically significant at a 10% level of significance.

Discussion and Conclusions

Since 1993 Kazakhstan has on average received FDI amounting to about 7.5% of GDP and peaked over 12% in years 2001 and 2009. The FDI inflows seemed to be volatile in nature and a large share of FDI inflows are directed towards the energy sector. In the analysis period, exports also increased and exports seemed to positively influence the growth of the economy as measured by GDP. Kazakhstan's export volume in 1995 accounted for 31 percent of gross domestic product. This share increased to 50 percent over a ten year period. The export composite includes durable and non-durable goods. Out of the non-durable share of exports, mineral products made up 29 percent in 1995 and increased to 74 percent in 2005. From this we can infer that Kazakhstan tends to be an exporter of primary products that mostly include petroleum and gas condensate. Thus, given large proved petroleum reserves, these exports may help Kazakhstan to sustain economic growth in the long run. Exports did not help the manufacturing, agriculture, construction and other mining sectors where employment opportunities actually declined. In contrast, in other sectors such as trade, transportation, communications, finance and services the overall employment increased during the observed period. This evidence seems to indicate an economy that is growing by exploiting its comparative advantage in mineral deposits as well as building its transportation and communications infrastructure with much of this growth funded by FDI.

As mentioned earlier, Kazakhstan has improved its rank as a “moderately free” country on the *Index of Economic Freedom*. However, according to USAID (2005), the Corruption Perception Index score for Kazakhstan is 2.6, which indicates rampant corruption. Kazakhstan also ranks poorly (86th of 155 countries) in the World Bank’s Ease of Doing Business ranking and on the Rule of Law index. According to the USAID (2005) report, “Corruption in Kazakhstan is widespread and serves as an impediment to doing business. The purpose of these indexes is to emphasize key factors that have been demonstrated to contribute significantly to sustained economic growth and attract more investment both foreign and domestic.

The good news is that although corruption is still pervasive in Kazakhstan, the country’s leaders are focused on promoting economic growth and are continuing to make efforts towards structural reform in order to attract investment and to diversify the economy’s production activities. These efforts are likely to be a root cause of both continued FDI inflows and GDP growth in Kazakhstan. However, the pace of structural reforms has been slow, making Kazakhstan less attractive than other transition economies as a place to conduct business.” In 2003 the political leaders signed a new investment law (Law of the Republic of Kazakhstan “On Investments” No. 373-II 3PK) which ensures the government will create a favorable investment climate. A friendly business environment would help attract foreign direct investment.

Overall, in the case of Kazakhstan, FDI had a positive influence on the growth of their macro-economy. However, analyses of the impact of FDI on individual sectors showed that FDI is negatively influencing some sectors or had no significant relationship to other sectors as expected with more intensive focus in its areas of comparative advantage. Since FDI is mostly directed to the energy sector which constitutes a large share of exports, and due to volatility of oil prices, it may be concluded that FDI may not be promoting a sustainable growth of the Kazakhstan economy. It is vital that Kazakhstan enhance market reforms and promote more economic freedom. These policies will allow it to take advantage of FDI in its natural resources and also encourage continued domestic entrepreneurial investment to balance development toward a sustainable future.

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Year	GDP growth (annual %)	Foreign direct investment, net inflows (% of GDP)	Gross capital formation (% of GDP)	High-technology exports (% of manufactured exports)	Agriculture, value added (% of GDP)	Industry, value added (% of GDP)	Services, value added (% of GDP)
1991	-9.2	0.0	20.03				
1992	-12.6	0.4	28.7		26.7	44.6	28.7
1993	-8.2	5.4	19.89		17.5	39.4	43.1
1994	0.5	3.1	20.53		15.5	40.0	44.5
1995	1.7	4.7	19.63	4.5	12.9	31.4	55.7
1996	-1.9	5.4	20.46	5.2	12.8	26.9	60.3
1997	2.7	6.0	13.7	5.7	12.0	26.8	61.2
1998	9.8	5.2	18.53	9.3	9.1	31.2	59.7
1999	13.5	9.4	29.73	9.7	10.5	34.9	54.6
2000	9.8	7.0	33.84	3.6	8.7	40.5	50.9
2001	9.3	12.8	28.89	3.2	9.4	38.8	51.8
2002	9.6	10.5	26.26	11.2	8.6	38.6	52.8
2003	9.7	6.8	30.08	8.7	8.4	37.6	53.9
2004	-9.2	9.6	20.03	8.8	7.6	37.6	54.8
2005	-12.6	3.5	28.7	11.3	6.8	40.1	53.1

Source: World Development Indicators (WDI) & Global Development Finance (GDF)

Period	Inward FDI Performance Index	World Rank
1993-1995	4.561	16
1994-1996	3.977	21
1995-1997	4.004	17
1996-1998	3.167	23
1997-1999	2.575	24
1998-2000	1.947	23
1999-2001	2.805	15
2000-2002	3.456	12
2001-2003	4.897	8
2002-2004	5.324	11
2003-2005	3.514	28
2004-2006	3.050	26

Source: United Nations Conference on Trade and Development (UNCTAD)

Independent Variable	Dependent Variable	p-value	Coefficient of Determination
FDI (% of GDP)	GDP Growth Rate	0.0269*	0.5852
Time	GDP Growth Rate	0.0153*	0.6518
Exports (% of GDP)	GDP Growth Rate	0.0027*	0.8000
Exports (% of GDP)	FDI (% of GDP)	0.0002*	0.8600
FDI (% of GDP)	GDP per capita	0.0020*	0.7988
FDI (% of GDP)	Employment	0.4200	-

* significance level of $\alpha=0.10$