

Impact of FDI on Economic Development: A Causality Analysis for Singapore, 1976 – 2002

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Abstract

This study examines the relationship between economic growth as measured by GDP per capita and foreign direct investment for Singapore, using the methodology of Granger causality and vector auto regression (VAR). Evidence shows that there is a unidirectional Granger causation from foreign direct investment to economic growth.

Keywords: Granger Causality, Vector Auto Regression, Economic Growth

JEL classification: C22, F21, O47

1. Introduction

Singapore, an island between Indonesia and Malaysia, is the smallest country in Southeast Asia. Singapore is one of the world's most prosperous countries with strong international trading links. Gross Domestic Product (GDP) per capita PPP (Purchasing Power Parity) for Singapore was US\$24, 481 in 2003 while real GDP was growing at an average annual rate of 6 percent (Human Development Reports, 2005). This rapid economic growth in Singapore improves the social and economic welfare of the country. Most of this economic growth can be explained by an open trade policy promoting production and export and attracting foreign capital inflow into Singapore. Moreover, the government adopted upon independence in 1965 a pro-foreign investment and export-oriented economic policy to promote growth and development in Singapore.

This paper shows the causal relationship between Foreign Direct Investment (FDI) and economic growth in Singapore. In Figure 1, the annual growth rate of GDP and FDI-GDP ratio move closely together in Singapore with FDI-GDP ratio going down quickly as the growth rate of GDP declines. The decrease in the FDI-GDP ratio was even higher than negative 5% in 2001 when Singapore recorded a negative growth rate of GDP.

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