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TERM-STRUCTURE OF FOREIGN DIRECT INVESTMENT INTO VIETNAM ECONOMY

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Abstract

Objective:

The paper investigates the term structure of foreign direct investment into Vietnam economy by dividing the short-term, medium-term and long-term contribution on the domestic economic growth. The data is an annual sample of Vietnam economy over 2007-2021.

Methodology:

The research methodology is first based on the recent literature review on the impact of foreign direct investment on the economic growth rate of the host economy. Then, the paper examines the contribution of foreign direct investment into the Vietnam's economic growth by the term structure.

Findings:

The empirical evidence records that the foreign direct investment stimulates the domestic economic growth by promoting the net exports in the medium-term and by the capital accumulation process in the long-term. In the short-term, the foreign direct investment also provides the foreign currency, which affect directly the equilibrium foreign exchange rate. Therefore, the foreign direct investment is a crucial growth engine for the Vietnam economy.

Implications:

The evidence suggests that the foreign direct investment can be a priority for the public policy to enhance the domestic economic growth rate. Beside the domestic sector, including the state-owned firms and private firms, the foreign direct investment needs to be managed so that its contribution to domestic economic growth is maximized.

Keywords: Foreign Direct Investment; Term-Structure; Qualitative Analysis; Quantitative Analysis; Vietnam Economy.

1. INTRODUCTION

The foreign direct investment (FDI) is the main driver of cross-border capital flows in the recent financial globalization over last decades. This type of capital flows contributes significantly on the economic growth in the host countries, and also entails the allocation of trading value chain around the world. The current context of high inflation rate and low economic growth prospects (World Bank, 2022) also stresses the importance of FDI capital flows as the connection channel across economies to solve the global stagflation prospect.

The current paper investigates the contribution of foreign direct investment on the economic growth by considering the term-structure of this capital inflows. The long-term analysis examines the contribution of FDI capital inflows into domestic capital accumulation; The medium-term analysis explores the contribution of FDI capital inflows into exports and imports; And the short-term analysis focuses on the contribution of FDI capital inflows into domestic currency stability.

The empirical evidence records that the foreign direct investment stimulates the domestic economic growth by promoting the net exports in the medium-term and by the capital accumulation process in the long-term. In the short-term, the FDI also contributes to more stable domestic currency. Therefore, the foreign direct investment is a crucial growth engine for the Vietnam economy.

The paper belongs to the literature on the foreign capital inflows. The capital inflows exert positive impact on the economic growth, but only when the financial development level of the host country is high enough (Prasad et al, 2007). The FDI also generates one dynamic sector which accounts for a significant share on the exports and imports of the host country. By that mechanism, the FDI can also affect the trade-offs between the output and inflation in an economy (Hung, 2021). In the short-run, an economy facing the policy trilemma in the international finance would have to deal with the foreign currency supply originated from the FDI

inflows. The fluctuation of foreign exchange rate can be an absorber of the fluctuation on the foreign capital inflows (Obsfeld et al, 2019).

Our result synthesizes the impact of FDI inflows on an economy by three terms, including the short-term, medium-term and long-term. Therefore, the paper provides a multi-aspect impact of FDI inflows on the economic growth of the host economy.

The paper is structured as follows. The first section on Introduction would briefly describe the main results. Then, the second section on Framework analyzes the theory and data, while the third section on Evidence investigates the term-structure of foreign direct investment. Finally, the fourth section on Conclusion would summarize the paper and discuss the public policy.

2. FRAMEWORK

2.1. Theory

In the long-term, the foreign direct investment (FDI) contributes on the economic growth by enhancing the domestic capital accumulation process. According to the neoclassical growth model (Solow, 1956; Swan, 1956), an economy tends to converge to one long-run equilibrium in which the capital stock per effective unit of labor is constant. Along this convergence path, the economy needs to accumulate the capital, both from domestic and foreign sources, to attain the long-run equilibrium. Thus, the convergence to the steady state economic growth rate is determined by the capital accumulation, then, depending on the foreign capital.

By the long-term aspect of foreign direct investment, the contribution of FDI can be captured by the share of FDI sector over domestic output, measured by the gross domestic product (GDP). Another indicator can be the share of FDI sector over domestic government revenue, which illustrates the significance of FDI sector on the domestic fiscal space. In both theory and practice, a larger fiscal space supports the intervention of government on the domestic economy, such as the

stimulus package for aggregate demand, especially on the economic recession period.

In the medium-term, the foreign direct investment contributes on the economic growth by stimulating the foreign trade of goods and services. The foreign trade, in fact, illustrates the foreign demand for domestic goods and services. Thus, according to the identity equation of aggregate demand, the net exports, which is equal to the exports subtracting by the imports, contributes to domestic demand, then, economic growth.

By the medium-term aspect of foreign direct investment, the contribution of FDI works through the establishment of one dynamic sector which contributes on the domestic exports and imports. Thus, the medium-term role of FDI can be illustrated by the share of FDI sector over exports, imports, and the relative comparison of net exports by FDI sector with that by domestic sector.

In the short-term, the foreign direct investment contributes on the economic growth by providing the additional source of foreign currency. In the foreign exchange market, the equilibrium exchange rate is jointly determined by the supply and demand for foreign currency. The supply of foreign currency comes from the capital inflows such as the foreign direct and indirect investment, foreign-currency debts, aid flows and even remittances from domestic workers in foreign economies.

By the short-term aspect of foreign direct investment, the contribution of FDI is captured by the supply of foreign currency, which affects the foreign exchange rate between domestic and foreign currency. Then, one way to examine this channel is to analyze the co-movement of the growth rate of FDI disbursed value with the depreciation rate of domestic currency.

2.2. Data

The data is a time-series annual sample of Vietnam economy covering the 1990-2021 period. The starting point is 1990 when the Vietnam economy stimulates the international integration into the world economy with some breakthrough laws such as the Law of Firm, Law of Foreign Investment. And the

ending point is 2021 when the Vietnam economy is recovering from the recent Covid-19 pandemic. With a long time period of over 30 years, the data sample is useful to shed a new light into the term-structure of the foreign direct investment into the Vietnam economy.

The foreign direct investment (FDI) is measured by the disbursed values in billion USD in current price. And the long-term contribution of FDI into the economic growth is measured by the share of FDI sector over the gross domestic product in percentage. The medium-term contribution of FDI into the foreign trade is measured by the share of FDI sector over the exports, imports and total exports and imports value. The short-term contribution of FDI into the foreign exchange market is measured by the fluctuation of official VND/USD exchange rate over time.

The data on the foreign direct investment, economic growth, exports and imports are all from the Vietnam General Statistic Office (GSO, 2022). And the data on the official exchange rate is from the World Bank Macroeconomic Monitoring Database (WB, 2022).

3. EVIDENCE

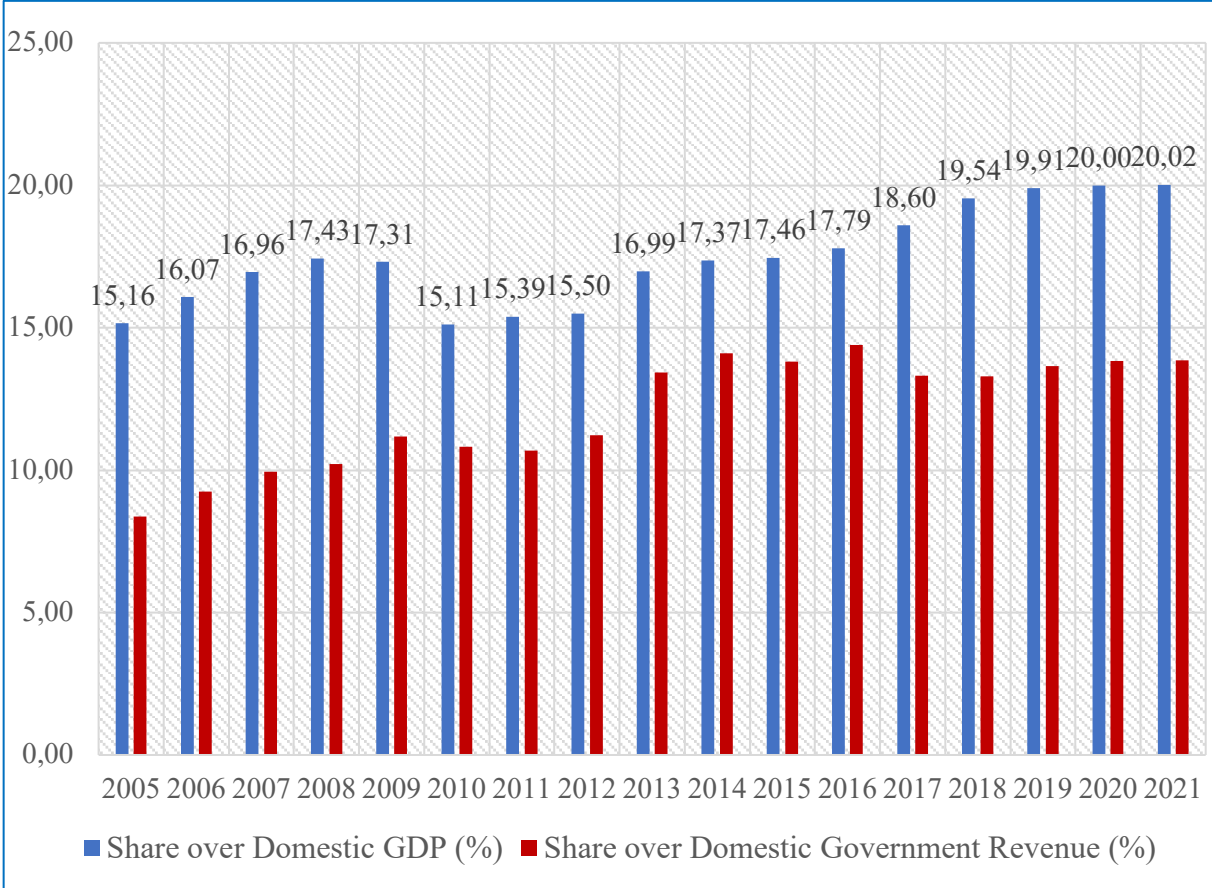
3.1. Long-Term

Figure 1 shows the long-term contribution of FDI on the economic growth. The share of FDI sector raises from 15,16% in 2005 to 20,02% in 2021, with only a slight decrease over 2010-2012. The increase of GDP share by the FDI sector proves the significant role of this sector toward the domestic growth rate. As recent theory and evidence, the positive contribution of FDI into domestic GDP can work through the domestic capital accumulation process. An economy needs the foreign capital inflows to build up domestic capital stock in the convergence pathway to its long-run equilibrium, or steady state.

Another aspect of the long-term contribution by FDI is the share of FDI sector over domestic government revenue. In theory, a huger government revenue can support more space for the fiscal policy implementation. In the Vietnam

economy, as Figure 1 shows, the share of FDI sector over government revenue raises from 9% in 2005 to 18% in 2021. On other hand, the share by FDI sector doubles over a period of 16 years.

Figure 1: Foreign Direct Investment and Economic Growth



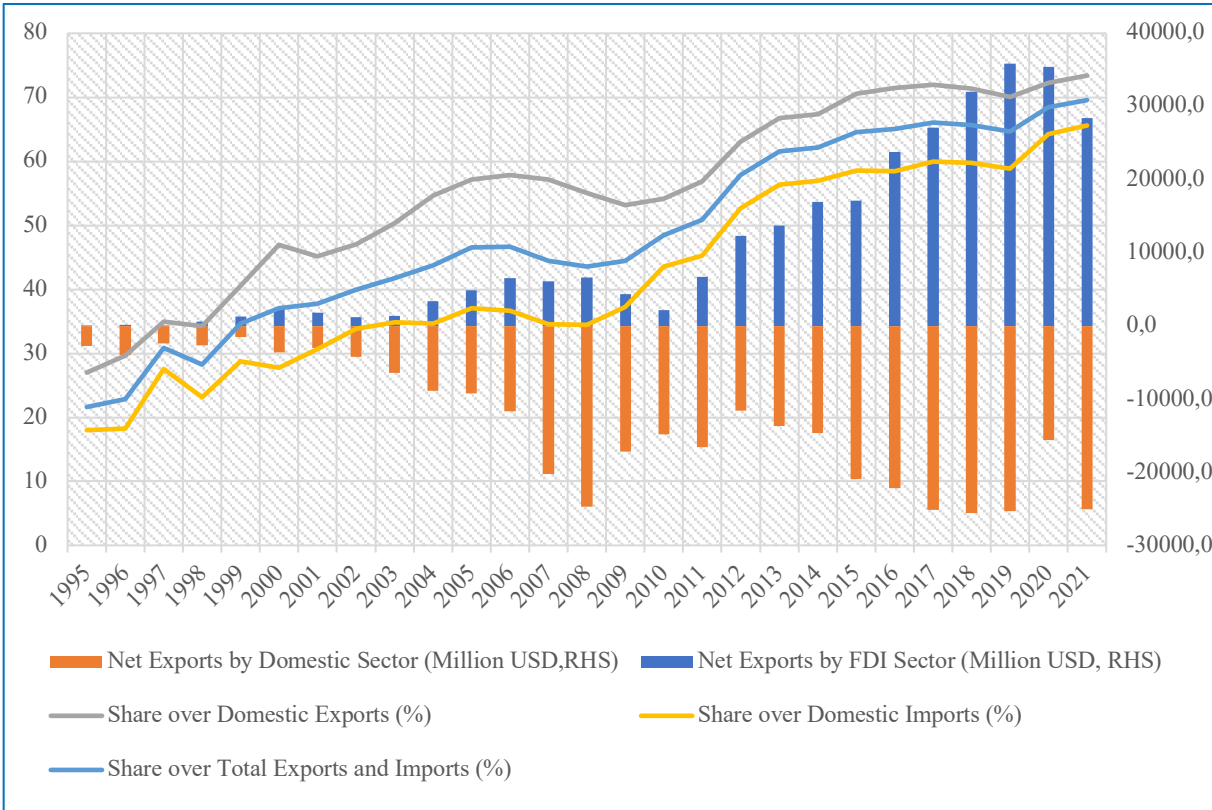
Source: Vietnam General Statistic Office.

3.2. Medium-Term

Figure 2 recors the medium-term contribution of foreign direct investment into the domestic economy. The line figures show that the share of FDI sector over both exports and imports tends to increase over time. The share of FDI sector over exports raises from 28% in 1995 to 73% in 2021, while its share over imports also goes up from 18% in 1995 to 65% in 2021. Overall, the share of FDI sector over total exports and imports increases from 21% in 1995 to 70% in 2021, which means a 3,5-folds increase over a period of 26 years.

Another indicator of FDI contribution on the foreign trade is revealed by the comparison of the net exports by the FDI sector with that by the domestic sector. By the identity equation of GDP, the net exports are one component of GDP. According to the view point by Vietnam government, the net exports together with private consumption and investment jointly compose the three-horse vehicle which drive the domestic economic growth rate. As Figure 2 shows, while the domestic sector continuously runs the deficit trade balance, the FDI sector has the surplus trade balance. For example, in 2021, the domestic sector has a deficit trade balance of 25 billion USD while the foreign sector has a surplus trade balance of 28 billion USD. This results in an overall surplus trade balance of about 3 billion USD in 2021. Therefore, the trade surplus by the FDI sector is strong enough to counteract the trade deficit by the domestic sector.

Figure 2: Foreign Direct Investment and Foreign Trade

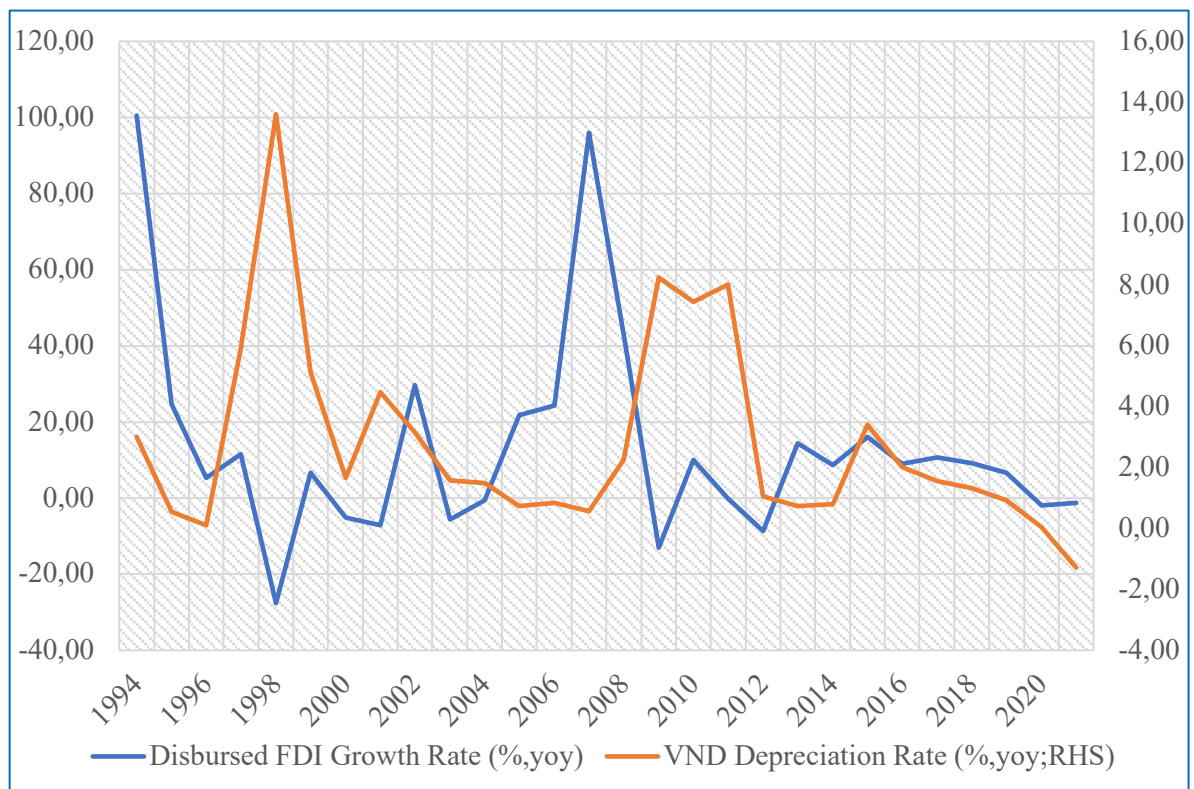


Source: Vietnam General Statistic Office.

3.3. Short-Term

Figure 3 shows the correlation between the foreign direct investment inflows and the domestic currency. In details, we compute the annual growth rate of disbursed FDI on percentage and the depreciation rate of domestic currency on percentage. The disburse FDI illustrates the absorption capacity of an economy toward the foreign capital. And its growth rate shows the change of absorption capacity over time. Moreover, the value of domestic currency is illustrated by the foreign exchange rate of domestic currency, VND, over the foreign currency, USD. We also employ the official nominal exchange rate rather than the real rate or effective rate for the reason that the official nominal rate is the common reference for the foreign trade and banking activities, while the real or effective exchange rate is more useful in accessing the strength of one currency.

Figure 3: Foreign Direct Investment and Domestic Currency



Source: Vietnam General Statistic Office.

The data records a high correlation between these two variables: when the disbursed FDI growth rate reduces over time, the VND depreciation rate also goes down. The reduction of disbursed FDI growth rate proves the inflows of FDI tends to approach the absorption capacity of an economy. And the decrease of VND depreciation rate proves that the domestic currency tends to enter a stable zone, in which, its value has less standard deviation around the mean. Therefore, the combination of low disbursed FDI growth rate and low VND depreciation rate shows that the FDI inflows are associated with more stable domestic currency.

4. CONCLUSION

The paper investigates the term structure of foreign direct investment into Vietnam economy by dividing the short-term, medium-term with long-term contribution on the domestic economic growth. The data is an annual sample of Vietnam economy over 2007-2021.

The empirical evidence records that the foreign direct investment stimulates the domestic economic growth by promoting the net exports in the medium-term and by the capital accumulation process in the long-term. In the short-term, the FDI also contributes to more stable domestic currency. Therefore, the foreign direct investment is a crucial growth engine for the Vietnam economy.

The evidence suggests that the foreign direct investment can be a priority for the public policy to enhance the domestic economic growth rate. Beside the domestic sector, including the state-owned firms and private firms, the foreign direct investment needs to be managed so that its contribution to domestic economic growth is maximized.

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