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# **FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN SMALL ISLAND ECONOMIES: THE CASE OF SOLOMON ISLANDS**

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## ABSTRACT

The role of foreign direct investment (FDI) has been recognised as a catalyst in the growth of developing nations in that it brings additional sources of capital investment and foreign savings. In addition to its primary aim as a source of capital formation, FDI also brings productive benefits, which include employment creation, technology transfer and associated spillover effects; skills development; trade and competitiveness; and access to foreign markets. As such, FDI is viewed in many studies as a key driver of economic growth, since it enhances profitability of domestic investment; transforms the host country's ownership structure of total investment; complements funding for domestic investment and improves the productive sectors of the economy.

This study examines several hypotheses relating to the linkage between FDI inflows and economic growth in the case of Solomon Islands. First, the study investigates the contribution of FDI to economic growth (i.e. the FDI-led growth nexus) in Solomon Islands. Second, it examines the main determinants of FDI (i.e. the growth driven-led FDI nexus). Finally, the productivity effects of FDI (i.e. the FDI-productivity nexus) on the main sectors of primary, manufacturing and services are evaluated. The directions of causality between selected variables for these three hypotheses are also examined.

Using time series data for the period from 1970 to 2010, the autoregressive distributed lag approach to cointegration is utilised to evaluate the FDI-led growth nexus and the growth driven-led FDI nexus. The Granger causality approach is adopted to evaluate the direction of causality between the selected FDI and growth variables. The FDI-productivity nexus is analysed using the stepwise and Granger causality approaches for the period 1985-2010. The empirical findings of the FDI-growth nexus show that FDI inflows, domestic investment, trade openness and labour are major influential factors of economic growth in the Solomon Islands. For the growth driven-led FDI nexus, the empirical findings show that economic growth, domestic investment, openness, exports, and infrastructure are all important determinants of FDI inflows. However, the civil strife and political instability, and high inflation deter FDI inflows and are detrimental to economic growth. In the FDI-productivity nexus, the primary and services sectors benefit the most from the productivity effects of FDI inflows complemented by better institutions, education, infrastructure and a stable political environment. The findings not only have important policy implications for the Solomon Islands but also for other small island economies.

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## **LIST OF ABBREVIATIONS**

ADB	Asian Development Bank
ADF	Augmented Dicky- Fuller Tests
AIC	Akaike Information Criteria
ARDL	Autoregressive Distributed Lag to cointegration
ASEAN	Association of South East Asian Nations
CBSI	Central Bank of Solomon Islands
DBSI	Development Bank of Solomon Islands
DSF	Debt Sustainability Framework
ECM	Error Correctional Model
ECT	Error Correction Term
EU	European Union
FDI	Foreign Direct Investment
FIB	Foreign Investment Board
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GMM	Generalised Methods of Moments
HRPI	Honiara Retail Price Index
IFS	International Financial Statistics
IMF	International Monetary Fund
KPSS	Kwiatowski Philips Schmidt and Shin
LAR	Liquid Asset Ratio
LDC	Less Developed Country
LMIC	Lower Middle Income Country
MNCs	Multinational Corporations
NFD	National Fisheries Development
NPV	Net Present Value
OECD	Organisation for Economic Co-operation and Development
OLI	Ownership Location Internationalisation
OLS	Ordinary Least Square
OMO	Open Market Operations
PACER	Pacific Agreement on Closer Economic Relations
PP	Philips and Perron
RAMSI	Regional Assistance Mission to Solomon Islands
RGDP	Real Gross Domestic Product
SBDS	Solomon Islands Dollar
SIC	Schwarz Information Criterion
SIDS	Small Island Developing States
SINPF	Solomon Islands National Provident Fund
SINS	Solomon Islands National Statistics
SOE	State Owned Enterprises
SPICs	South Pacific Island Countries
TOT	Terms of Trade
UNCTAD	United Nations Conference on Trade and Development
VAR	Vector Autoregressive
WDI	World Development Indicators
VEC	Vector Error Correction
VECM	Vector Error Correction Model
WTO	World Trade Organisations

Map of Solomon Islands



Source: Ezilon Maps.