Interaction of Economic Systems in the World under the Influence of Global Trends: The Role of International Trade and Investment

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Abstract

This study explores that how Foreign Direct Investment and trade openness impact the economic interaction by considering economic globalization, as assessed by the KOF index. The basic idea endogenous growth theory is applied globally from 2001 and 2021. The study utilizes the econometric techniques of three-stage least squares and seemingly unrelated regression. The findings suggest that foreign direct investment play a significant role in fostering economic interaction inside specific countries. There is a strong and positive relationship between foreign direct investment and economic interaction. Foreign Direct Investment often serves as the main channel via which advanced technology are transferred to countries. The results indicates that the advantages of this venture would be greatly upgraded in the host country with a more grounded and more skilled labor force. Furthermore, the results suggest that foreign direct investment promotes domestic investment. For FDI-driven growth to occur, it is necessary to have institutional stability and sound macroeconomic policies in place. Our findings indicate that global economic connection can be promoted by reducing the inflation rate, tax collection problem, and government consumption.

Keywords: Economic Interaction, Economic Development, FDI, International Economy, Trade Openness, Economic Globalization.

Introduction

The economic interaction that occurs across international borders is a fundamental component of global prosperity (Zreik, 2024). Economic interaction considers many factors like exchange of goods and services, cultural exchange, exchange of financial matters and exchange of assets and wealth. The process of economic interaction is a statistical measurement that find out the scale and scope of all economic activities on global level. Furthermore, economic interaction act as channel that looks after the activities of different economic issues of different nations during different time (Si et al., 2023). International trade and investment are the major part of the economic interaction and has crucial role for the development of domestic capital and productivity in the economies.

There are a many other variables that are driving economic interaction, including improved competition and the interchange of investments (Banmairuroy et al., 2022).

Globalization is commonly known as the successive phase in the progression of humanity, presenting concerns with novel prospects for economic progress (Kibik et al., 2022). The KOF Index of Globalization is a renowned index to measure the level of economic globalization along with social and political globalization (Awan et al., 2020). The KOF index propose a data to measure the trade openness and foreign direct investment (FDI) constraints and trade flow, so that it can be approachable to understand the economic condition and activities of any nation. A high level of economic globalization index indicates that that economy has high achievements in growth. Anyhow, lower scores show that the nation is facing the constraint in progressing and development (Gygli et al., 2019).

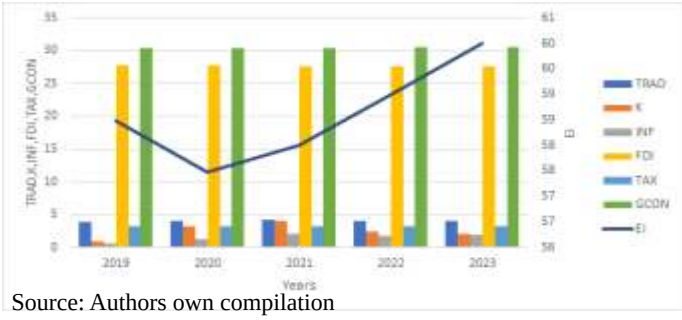
International trade is considered as booster for growth and development. Trade enhances production efficiency by reallocating activities to countries that excel in specific services or products. Different factors like Infrastructure development, investments, human capital levels, and trade policies play a crucial role in shaping economic structure. These factors can play a positive role when efficient and rational policies of FDI and trade openness are formulated (Kumari et al., 2023). Policy makers are still working to find the way that can promote FDI and trade openness. The dispute over trade liberalization and FDI on economic interactions makes it difficult to create policies that boost economic growth (Muzuva, 2023). Economies have difficult relations with one another, as demonstrated by the spectacle of economic globalization. These factors have a foremost influence on the development of the global economic framework.

The importance of Human Capital Investment (HCI) stems from its ability to promote connectivity and enhance productivity, innovation, and affordability in nations. Understanding the importance of a informed and skilled labor goes beyond just driving technological improvements. It also plays a crucial role in boosting a country's competitiveness in the global market, leading to a rise in business transactions (Kyriakopoulos, 2021). Another key aspect in economic growth is domestic capital investment. Investing in local commodity producers boosts industrial capacity and attracts foreign investment, which boosts global economic integration (Amade et al., 2022).

Understanding a gross domestic production(GDP) is crucial as it forms the foundation of any economy. Countries having larger GDP tend to attract international trade and investment due to their developed markets, strong economies, and stable financial systems. These factors are highly required after for international trade and investment. Considering the starting GDP is crucial when conveying international economic terms, as it serves as a significant indicator of a economic interaction with other nations (Zamfir & Iordache, 2022).

Government expenditure, inflation rate, and taxation affect economic interaction and the macroeconomic policies. High inflation decreases the purchasing power of the consumer and also the investors loss the interest to invest more that can be harmful for the economy. Tax rules and its implementation policies influence trade and international investment, which affects the economy both positive or adversely. Government consumption precisely shows the trends of economic conditions of the society. Government consumption can discourage the investors and traders to invest in the economy (Mihu, 2023). Globally there are many factors including, organizations, substructure, investment, global trade, FDI, and regional integration that may affect the economy variables (Lukianykhin et al., 2024). Figure 1 shows that primary Y-axis contains all the independent variables studied in this paper, whereas, secondary axis economic interaction (EI) of the global data of last five years (2019-2023.

Figure 1: Relationship of dependent variable with independent variable



Source: Authors own compilation

Since the beginning of the 21st century, there has been a significant growth in the level of economic globalization (Ortiz-Ospina & Roser, 2024). International investment and trade openness substitute "globalization for economic growth"—the growing interconnection of economies worldwide. This nexus has potential for economic development and growth hence its consequences are being discussed worldwide. Despite many research studies on economic globalization and its causes, there is still a lack of understanding regarding the relationship between various factors such as human capital, domestic capital investment, initial GDP, inflation, tax rate and government consumption.

Implementation oflegislative amendments in old policies and laws in any sector of the economy are always helpful to drive the economy (Koller et al., 2023) and easy to establish the economy according to new demands of the population. Researchers often overlooks various factors that influence economic interaction, instead choosing to focus on specific aspects. The careful and comprehensive analysis is required to conclude the practical aspects and integrate all of these diverse elements into a coherent structure. Therefore, it is crucial to study the relationship between economic globalization, FDI and trade openness globally.

This research consists of cross-sectional data from different groups of income so that whole conclusion can be drawn for policy makers. Endogenous growth theory is considered and the factors of human capital, domestic capital investment, macroeconomic stability, and trade openness and FDI are considered to examine their impact on economic interaction. The findings provided above enrich economic development literature. Our results show that FDI, human capital index, and domestic investment have significant relationship and can affect economic interaction, positively. Inflation, tax rates and government consumption damaged the FDI. The FDI, together, with trade and domestic investments increased the economic globalization, promoting economic integration. Also, results show that FDI and government consumption boost the domestic capital investment.

In Chapter two, a literature review is presented. The third chapter describes the methodology and data, whereas the fourth chapter is devoted to a discussion of the results. The conclusion to the research is presented in Chapter 5.

Literature Review

Do et al. (2023) analyzed how the national economy, international commerce, and FDI influenced the living standards of individuals inthe Association of Southeast Asian Nations(ASEAN) member states between 2012 and 2020. The findings indicated that both the domestic economy and global trade exerted influence on the quality of life in the area. However, the impact of FDI compared trusting upon the degree of improvement of the nation getting it. Regarding the impact of FDI, it is significant to emphasize that developed countries experienced negative repercussions, while developing nations experienced minimal effects.

Sun et al. (2023) analyzed the interplay between investment risk, globalization, public and private capital investment, and economic development in 34 Asian economies spanning the years 2001 to 2019. It was resolute using the two-step generalized method of moments(GMM) method that, comparative with laid out economies, monetary globalization sprays the extension of creating, emanant, and low-pay Asian economies. Additionally, the research indicated that private capital is attracted to low-risk investment strategies, which increases institutional capacity, productivity, and the appeal to foreign investors.

Islam et al. (2022) analyzed the association between the extent of trade liberalization and the level of growth and development in Saudi Arabia. The investigation included control factors such as labor force participation and government spending. The study utilized Autoregressive Distributed Lag(ARDL) cointegration regression and the T-Y Granger causality test from 1985-2019. The expansion of the economy was driven by both a larger work force and more trade openness, which had positive effects in long-term relationship. The immediate benefits of government consumption on economic development were offset by minimal long-term repercussions. The T-Y Granger causality test has discovered numerous feedback loops, including "economic growth-government consumption," "trade openness-labor force," and "government consumption-labor force." The linkages between labor

force and economic growth, trade openness and government consumption, and trade force and trade openness were found to have unidirectional causal links. Legislators should encourage an increase in income, reduce public expenditures to buttress the business sector, and strengthen trade liberalization.

Hassane et al. (2021) examined the relationship of FDI, human capital, and economic growth. The data of the study was concluded form fifty research survey. The study found that FDI had significant impact on the factor of economic interaction. The study concluded that for the betterment of the economy, it is important to have a skilled labor and understand the aspects that can affect outcome through FDI and human capital. These suggestions include technology formations, FDI, and economic progress of the economy.

Charaia et al. (2020) studied that that FDI and other global economic forces have diverse effects on economic activities in Georgia. The study found that the incentives that drive economies features that explain FDI had consequences on the Georgian economy.

Methodology and Data

This study applied a production function to analyze the effects of various factors on an economic interaction worldwide. The main idea is extract form endogenous growth theory based on the study of Balasubramanyam et al. (2001) and Borensztein et al. (1998). These factors included FDI, trade openness, domestic capital investment and human capital. FDI has potential to influence the economies globally. It has the capacity for inventions and innovations. Additionally, it works to rebuilt the economy in many indirect manners (Borensztein et al., 1998). Here is a fundamental equation that this study has formulated for economic interaction (EI).

$$EI = \beta_0 + \beta_1 FDI_{it} + \beta_1 TRD_{it} + \beta_1 HCI_{it} + \beta_1 K_{it} + \beta_1 G_{0_{it}} + \lambda_1 FDI_{it} * TRD_{it} + \lambda_2 FDI_{it} * HCI_{it} + \lambda_3 FDI_{it} * K_{it} + \delta_1 INF_{it} + \delta_2 TAX_{it} + \delta_3 GCON_{it} + \mu_{it} \quad (1)$$

In equation (1), EI is the economic interaction proxied by economic globalization retrieved from KOF Globalization index (Gygli et al., 2019). FDI is the foreign direct investment (inflows) measured by percentage of GDP. TRD is the abbreviation of trade (exports plus imports) of goods and services measured as a share of gross domestic product. HCI, the stock of human capital index accumulated of education, health to worker productivity. K, the domestic capital investment measured in stocks traded, turnover ratio of domestic shares in percentage; G0, is the initial stock of GDP. INF is the in?ation rate measured by annual percentage of consumer prices. TAX is the tax on pro?ts, and capital expansions expressed in ratio of revenue and GCON is government consumption taken in current US dollar. The analysis utilized independent variables obtained from the World Development Indicators, (WDI, 2023), spanning from 2001 to 2022.

The investigation encompassed a total of forty countries from various regions across the globe. Countries are selected depending on the availability of data, with ten countries chosen from each category: high- income, middle-income, lower-middle-income, and low-income. This study's model expands on the research undertaken by Borensztein et al. (1998), incorporating data from the 1990s. The current decade is particularly noteworthy since it has witnessed a substantial increase in FDI and commerce in developing countries. The analysis also considers the relationship between FDI and trade, as well as domestic investment. In addition, the influence of human capital is also taken into consideration.

Prior empirical studies have established that FDI, trade, human capital, and domestic investment venture decidedly affect economic interaction (Zhang & De Beule, 2024). It is anticipated that the coefficients for these factors will be positive. It is expected that there will be positive correlations of FDI with both economic interaction and domestic investments. These correlations are expected to contribute to the progress of economic globalization. The assessment of human capital is of utmost importance in the process of incorporating foreign knowledge and has a substantial impact on the likelihood of achieving anticipated spillover effects.

It is conjectured that FDI and economic interaction had some relationship (Lu et al., 2021). Furthermore, it is suggested that a positive relationship between FDI and domestic investments is facilitating economic interaction. Host countries must possess a appropriate level of human capital to effectively leverage innovative technology

introduced through FDI. The correlation between the human capital index and the impact of FDI on the nation's economic growth is positive and directly proportional. When the degree of human capital rises, the influence of FDI on economic interaction intensifies (Liobikienė & Butkus, 2019).

The inquiry of "What is the interaction between FDI and domestic investment?" is a fundamental question regarding the relationship between FDI and economic interaction. The response to this inquiry may seem less contentious in theory than it actually is in practice. The FDI plays a vital role in facilitating the transfer of capital, technology, and knowledge to the host countries (Sultana & Turkina, 2023). This, in turn, leads to the emergence of opportunities for accelerated economic growth, as has been previously discussed. However, in practical applications, the impact of FDI on economic interaction is to a great extent subject to the absorptive of host country limits and the expected uprooting of domestic capital investment caused by FDI. The question that should be tended to is: "What is the extent to which FDI acts as a substitute for or complement to domestic investment?"

In empirical model, this study included an interaction term (FDI - K) between FDI and domestic investment. This is in addition to separately including FDI and domestic investment. The interaction term represents the nature of the relationship between FDI and domestic investment by quantifying their collective influence on interaction. The positive coefficient of the interaction term suggests that domestic investment (K) and FDI work together to promote economic growth. The initial GDP considers the institutional and economic circumstances that were in place prior to the examination, and is expressed in constant U.S. dollars. There is an expectation that the field of globalization economics will exhibit a negative correlation with the initial GDP, which will be presented in logarithmic format. The inflation rate is a crucial metric when evaluating a nation's monetary and fiscal policy. It is expected that the decline in the inflation rate will have a positive impact on trade, investment, and overall economic growth. Public funds are allocated for spending and income, capital gains, and profit taxes are levied instead of investing in institutions and infrastructure. The primary objective of this study is to measure the impact of trade and FDI on economic interaction.

Econometric Techniques

The most accurate econometric technique may have more clear and understandable results (Awan et al., 2024). The panel data of this study is analyzed by using the methodology of the seemingly unrelated regression (SUR) method and the instrumental variable (three-stage least squares, TSLS) approach simultaneously. The SUR estimation method is designed to tackle situations where there are different error variances in each of the equation, while also allowing for the arrangement of these errors across each of the equation. The SUR model is designed to tackle different dependent and independent variables for each equation. This method considers the potential correlation among error terms. This econometric framework a strong statistical approach in econometrics (Pan et al., 2020). The mathematical equation of SUR is given as under.

$$Y_{it} = \beta_0 + \beta(c_{it,m} - c^*_{it,m}) + \sum_{i=1}^{N}\sum_{h=-p}^{q} \lambda_{it}\Delta z_{it-h} + \mu_{it} \quad (2)$$

Where, $\Delta z_{it} = c_{it,m} - c^*_{it,m}$, is formulated to look after the issue of endogeneity and serial correlation. The second method is used to check the robustness of the panel data. The instrumental variable method is highly advantageous in mitigating biases that may arise from endogeneity difficulties between the studied variables (Liu et al., 2024; Kosova et al., 2019).

Results and Discussion

This study analyzes an investigation that how trade and FDI have impact on economic interaction, globally. Secondly, how FDI interrelates along with trade openness, human capital, and initial GDP effect the domestic investments. In return, domestic investments have also influence on economic interaction. The findings of the study are presented in Table 1.

Table 1: Results of SUR Regression

	Dependent variable = economic interaction (EI)			Dependent variable=Domestic investments (K)
Series	1.1	1.2	1.3	1.4
FDI_{it}	0.1856[a] (0.0697)	0.0475 (0.0942)	0.0792 (0.0793)	0.0716[a] (0.0238)
TRD_{it}	0.0126 (0.0115)	0.0111 (0.0111)	0.0059 (0.0096)	0.0031 (0.0038)
HCI_{it}	0.0079[c] (0.0045)	0.0096[c] (0.0063)	0.0085[b] (0.0037)	-0.0020 (0.0023)
K_{it}	-0.0364 (0.0938)	-0.0937 (0.0975)	0.0419[b] (0.2013)	
G_{oit}	0.0187 (0.0213)	-0.0005 (0.0195)	-0.0184 (0.0167)	0.0087 (0.0081)
FDI_{it} *TRD_{it}		0.0053[a] (0.0018)	0.0044[a] (0.0012)	0.0018[c] (0.0009)
FDI_{it} * HCI_{it}		-0.0035 (0.0109)	0.0058 (0.0106)	-0.0016 (0.0034)
FDI_{it} * K_{it}		0.0569[c] (0.0368)	0.0036 (0.0225)	
INF_{it}			-0.0047[a] (0.0009)	-0.0001 (0.0003)
TAX_{it}			- 0.0050 [b] (0.0031)	- 0.0001 (0.0007)
$GCON_{it}$			-0.0574 [a] (0.1932)	0.9018 [a] (0.0299)
Constant	0.5444 (0.4844)	0.6232 (0.4654)	1.0360 [a] (0.4293)	0.7005 [a] (0.1757)
System R	0.0698	0.1175	0.2560	0.8903

Note: a =99% significant level, b =95% significant level and c =90% significant level.

The SUR approach is employed to estimate the fluctuations of equation (1) in regressions 1.1, 1.2, and 1.3. The explanatory variables in Regression 1.1 consist of FDI, trade openness, HCI, initial GDP and domestic investment. Regression 1.2 enhances FDI estimation by including the interaction terms. Regression 1.3 incorporates the factors of inflation, tax burden, and government consumption, expanding upon the discoveries made in regression 1.2. Although the majority of coefficients, especially in specification 1.3, are consistent with expectations, certain coefficients may differ among specifications due to the use of cross-sectional data. R2 levels are generally characterized by being moderate and rational.

Regression analysis 1.1 demonstrates that FDI and HCI have a beneficial effect on economic interaction. The coefficient value of FDI is statistically positive effect, whereas the coefficient value of trade does not have a significant effect. The presence of a positive link between economic interaction and human capital is deceptive, however it is statistically significant only at an 90% confidence level. The outcomes of this study are similar to the result of Kamal et al. (2022) and Olagunju et al. (2019).

Regression 1.2 improves the accuracy of estimation and enables the consideration of interaction effects between FDI with trade, HCI and domestic capital investment. Regression 1.2 demonstrates a direct relationship between FDI and domestic investment in indorsing economic integration. The domestic investment coefficient exhibits a significantly positive relationship with the outcome variable, with a confidence level of 90%. Host nations

derive advantages from FDI and the mutually beneficial relationship between FDI, trade, and domestic investment. However, the relationship between FDI and economic interaction index does not show statistical significance. These results are in line with Radmehr et al. (2022) and She and Mabrouk (2023).

The findings from regression 1.3 indicate that HCI and domestic investments have positive impacts on economic interaction, further supporting these beneficial effects. The only interaction that shows statistical significance is the interaction between FDI and trade, and FDI and domestic investments. This suggests that there is a synergistic effect on income growth in emerging nations. For growth led by FDI to occur, it is necessary to have stable institutions and effective macroeconomic policies. This is supported by the presence of statistically significant negative coefficients for inflation, government consumption, and tax burden. Reducing these uncertainties can promote economic engagement by showcasing stability, boosting investment returns, and redirecting cash towards investments. Results are similar to the findings of Sun et al. (2023) and Yurioputra (2022). Regression 1.4 in table 1 shows that FDI alone, and FDI together with trade have positive impact on K.

FDI "Crowds-In" Domestic Investment

A crucial topic of discussion in research discourse concerns whether FDI serves as a complement to or a substitute for indigenous investment in host countries. Regression 1.4 shows that FDI boosts domestic investment, suggesting that domestic investment is improbable to be replaced in the chosen countries. The application of the SUR technique strengthens the validity of these findings. The link suggests that FDI has a favorable effect on domestic investment, leading to increased investment activity. This is consistent with the findings presented by Borensztein et al. (1998). The statistical significance of trade alone may not be substantial, but when paired with FDI, it demonstrates a positive and significant correlation with domestic investment. The coefficient for the interaction term of FDI and trade is found to be positive, with a confidence level of 90%.

Issues related to endogeneity

There could be a correlation between FDI and economic interaction that stems from internal incentives to engage in FDI. Borensztein et al. (1998) conducted a study to analyze how changes in the stochastic process affect growth rates and their relationship with FDI. By implementing market reforms in host nations, it is feasible to enhance economic interaction rates and attract greater foreign direct investment. If a correlation exists between variables and error term, it could potentially affect the calculated coefficients.

Table 2: Results of TSLS Regression

	Dependent variable= Economic interaction (EI)		
Series	2.1	2.2	2.3
FDI_{it}	0.1704[b] (0.0698)	0.0427 (0.0946)	0.0805 (0.0564)
TRD_{it}	0.0215 (0.0216)	0.0098 (0.0112)	0.0066 (0.0076)
HCI_{it}	0.0086 (0.0047)	0.0084[c] (0.0042)	0.0064[b] (0.0032)
K_{it}	-0.0261 (0.0842)	-0.0612 (0.0380)	0.0666[b] (0.2345)
G_{oit}	0.0195 (0.0215)	0.0008 (0.0197)	-0.0188 (0.0169)
FDI_{it} *TRD_{it}		0.0049 (0.0018)	0.0053[a] (0.0023)

	Dependent variable= Economic interaction (EI)		
Series	2.1	2.2	2.3
FDI_{it} * HCI_{it}		0.0036 (0.0110)	0.0065 (0.0105)
FDI_{it} * K_{it}		0.0456 (0.0259)	0.0027[c] (0.0225)
INF_{it}			-0.0043[a] (0.0009)
TAX_{it}			-0.0052[b] (0.0031)
$GCON_{it}$			0.0700[a] (0.1850)
Constant	0.5490 (0.4873)	0.6271 (0.4690)	0.9965 b (0.4321)
System R	0.0704	0.1274	0.3421

Note: a =99% significant level, b =95% significant level and c =90% significant level.

Instrumental variables are employed to tackle the problem of endogeneity. An obstacle in instrumental variable estimation is the identification of instruments that exhibit a substantial correlation with FDI while being uncorrelated with the residual. The Two-Stage Least Squares (TSLS) method employs past values of FDI, trade, and the logarithm of economic globalization as instrumental variables. The findings from the Two-Stage Least Squares (TSLS) model, notably from regressions 2.1-2.3 in Table 2, show that the results obtained using both the SUR technique and instrumental variable estimate agree in terms of quality. The coefficients for trade openness and FDI exhibit a positive correlation, albeit they lack statistical significance. There exists a distinct and robust association between commerce and FDI. This research underscores the robustness and reliability of our findings.

Conclusions and Policy Recommendations

This study inspects the influence of FDI and trade openness on economic interaction, with a specific emphasis on the KOF index for economic globalization. The analysis is carried out using the framework of endogenous growth theory. The analysis utilizes cross-sectional data from forty nations, spanning the time frame of 2001 to 2021. Our research emphasizes the momentous impact of FDI and trade openness on economic involvement in specific nations. Trade and FDI have a robust and significant relationship. FDI frequently serves as a pivotal factor in enabling countries to acquire innovative technology. The analysis of this study indicates that in nations with a greater degree of human capital, the advantages of this kind of expenditure would be significantly amplified. Furthermore, this study demonstrates that FDI promotes domestic expenditure. FDI has the capacity to formulate the solid policies by allocating the reasonable budget to the institutes. This study found that low inflation rate, developed system of tax collection, and rational government spending can promote economic interaction in some countries.

To get the most out of FDI, the study stresses how important it is to build a highly qualified workforce. Labor is the back bone of any economy. So, it is essential to educate them as well as trained them efficiently. It is also important to make the economy stable by lowering the inflation rates, tax subsidies to encourage investment, and being careful with investments. Better implementation of rule of law, code of conduct, timely response of the government to business issues can make the situation better and more controlled. FDI can help any economy to take these steps properly and can get fruitful economic results for long-term.

Governments should not tolerate illegal business activities. More efforts are required to tackle the undocumented business activities by using updated and secure technology.

FDI can help to mange all the monetary expenses and can enhance the economy worldwide. Develop strategies to promote and stimulate investment: In order to attract FDI, it is crucial to ensure that your investment policies and practices are transparent and easily comprehensible. Discuss the process of transferring technology: Establish regulations that facilitate the transfer of technology and information from overseas corporations to American companies.

By optimizing the utilization of the available pool of skilled individuals, implementing policies that promote women's education, providing opportunities for leadership positions, and ensuring equitable participation in the labor market, the benefits of FDI can be further enhanced (Rezvorovych, 2023). Financial technology policies may be revisited and digital development policies may be implemented efficiently (Buzaubayeva et al., 2023).

Enhancing the availability of essential pharmaceuticals and medical technology can be accomplished through cooperation with global pharmaceutical businesses. This medical technology will helpful for the human labor to maintain their health and get treated in time and can participate in economic activities efficiently (Volodymyrovych et al., 2021; Volodymyrovych et al., 2021). Improvement in small and medium business in any economy can enhance the development and economic integration and can get stable figures by producing through small and medium businesses for export purposes (Mura, 2022).

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