Chapter 7: Conclusion and Policy Recommendations

7.1 Introduction

FDI flows, particularly into emerging markets, have taken off particularly after 1991, as most of the emerging economies undertake structural and economic reforms, including the reduction of restrictions on international capital flows, removal of trade barriers, etc. The major policy changes relating to FDI since 1991 include relaxing the limits of foreign investment in high priority industries, liberalizing the procedures and mechanisms, bringing in transparency in the decision making process, lessening of bureaucratic controls, expanding the list of industries/activities eligible for automatic route of FDI. The new policy framework for investment coupled with trade and competition related policy changes have led to significant increase in FDI inflows in the recent years. Today emerging markets are one of the most attractive destinations for the foreign investor, and it is expected that they will continue to remain amongst the attractive destinations in near future.

However, distribution of FDI inflows is not symmetric across the countries; instead there exist wide-range of variations in FDI inflows in countries as well as in major sectors in emerging Markets. Top five countries in emerging market economies attracting more than 66% of total FDI inflows during 2002-2012 comprise of China followed by Brazil, Russia, Chile and India. Countries like Romania Estonia, Latvia, Pakistan and Lithuania found to have only a very small share in total FDI inflows in Emerging Markets. In this perspective, the present study aims at understanding the country specific and sector specific trends, variations and determinants of FDI inflows across the Emerging Market.

Addressing the dynamics of such inter-country and inter-sector variance in FDI inflows is very important for balanced regional and sectoral development in Emerging markets, as skewed distribution of FDI inflows towards some specific country and states increase the
imbalance and unequal development in the emerging markets which have serious consequences on socio-economic and political stability in the emerging markets.

Thus, this study considers a model to underline the FDI determinants in emerging markets, and empirically investigate how economic and institutional variables from the host markets affect its inward FDI stocks using a sample of 24 emerging countries. SUR model is used to evaluate the applicability of the results found in the case of BRICS. This study also examines the sector-specific determinants of FDI.

7.2 Major Findings

Overall trends of FDI inflows into emerging markets indicate that FDI inflow into emerging markets is increasing with wide inter-sectoral variation in FDI inflow that have made the distribution highly skewed towards manufacturing and service sector. It has been observed that at country level determinants including Market size, Labor cost, Infrastructure, Governance, Trade cost, corruption have significant impact on total FDI inflows in emerging markets. Market Size, Infrastructure, governance is positively associated with FDI while labor cost; trade cost and freedom from corruption are negatively associated with FDI. Although corruption level is high in emerging economies but FDI is flowing positively in emerging markets as it is generally driven by market seeking purpose with better infrastructure. Labor cost measured by hiring regulation and Minimum wage and countries with greater difficulty of hiring are given lower ratings and it indicates that though the hiring regulation and minimum wage was not supportive in emerging markets FDI flows into these markets. The findings from overall results from the analysis yield a number of insights about attracting foreign direct investment into emerging markets. Market size measured by Real GDP, better quality of infrastructure with better governance can attract greater additional FDI inflow in emerging markets. An unexpected finding is that macroeconomic stability measured by inflation rate does not appear to have a strong influence in emerging markets.

Country-wise results for BRICS indicate that the macroeconomic factors determining FDI inflows differ from country to country. In Brazil, China and Russia market size is
found to have exerted positive impact of Market size on FDI inflow while for India and South Africa it is not statistically significant. Trade openness is positively related in Russia. Macroeconomic stability measured by inflation rate is positively related in China and Russia which is unexpected. Higher level of inflation rate is not impacting negatively in China and Russia. Tax rate is impacting negatively in Russia. In Brazil and South Africa FDI appears to be drawn with more depreciated real exchange rates, the opposite is true for Russia. Labor cost is negatively related to FDI. Natural resource availability is found impacting positively with FDI inflow in Brazil while it is negatively related in Russia. Qualitative variables in BRICS also differ from country to country. Infrastructure is positively associated with all countries except South Africa. Control on Corruption is positively associated with FDI in India and Russia while it is opposite for South Africa. Effective business environment is attracting more FDI in Russia and South Africa. Trade cost is positively related with FDI in Brazil while the relationship is negative in Russia. Good governance is positively related with FDI in India and Russia and negative with South Africa.

Results from sector-level analysis show that there is a difference between determinants of FDI among sectors. FDI inflow in Primary sector is mainly influenced by market size, trade openness, macroeconomic stability and exchange rate while there are no strong linkages with labor cost. Market size, Macroeconomic stability, Tax Rate is positively associated with FDI, while trade openness and exchange rate is negatively related to FDI. FDI inflow in primary sector appears to be drawn with more depreciated exchange rate. Higher inflation and tax rate is not impacting negatively for primary sector. FDI inflow in primary sector is negatively associated with Trade openness and trade cost, which is intuitive, MNC’s FDI decision in primary sector is mainly determined by locality of those resources as trade cost is higher compared to FDI. Infrastructure quality in the host government is positively associated with Primary FDI. High level of corruption is positively related to FDI in primary sector which confirms that though the corruption level in emerging markets is higher, FDI tends to flow into these markets as other factors like natural resource availability increases the profitability rate into these markets.
FDI inflow in secondary sector are mainly influenced by Economic factors like Market Size, Macroeconomic stability, Tax Rate, Labor cost and qualitative factors like Infrastructure, Governance, Business Environment and Trade cost. Market size, Macroeconomic stability, Infrastructure, Tax Rate and infrastructure are factors that are positively related to FDI while labor cost, Governance, Business Environment and Trade cost are negatively related to FDI.

Trade cost is negatively related to FDI in secondary sector which supports “tariff jumping” hypothesis which indicates that less open economy with trade restrictions can have a positive impact on horizontal FDI inflow which is particularly motivated by market-seeking purpose as trade restrictions increases the overall cost.

In the tertiary sector, FDI has no strong linkages with Economic and qualitative factors like Macroeconomic stability, Exchange Rate, labor cost, natural resource availability and qualitative factors like infrastructure, governance, business environment and corruption. It is observed that infrastructure does not have significant impact on tertiary sector as service sector does not require road or railway related infrastructure to attract FDI. FDI inflows in tertiary sector are observed to be influenced positively by Market size, Trade openness, trade cost and negatively by Tax Rate.

The empirical result has some policy implications towards the improvement of investment climate to attract higher FDI inflows into emerging countries. Overall findings indicate that using macro-level FDI inflows in emerging economies is likely give rise to biased results, given the statistical noise provided by sectoral differences in determinants of FDI inflow in emerging markets. Hence it can be concluded that emerging markets can develop different sector level policies to attract FDI inflows into specific sectors. Although overall institutional and governance factor do not impact on FDI inflow in emerging markets significantly but in the long-run these market need to improve institutional and governance quality to attract additional inflow of FDI into these markets. Thus, emerging countries as developing nations have to address themselves on the path of institutional and governance reforms to attract additional inflow of FDI in the long-run.
7.3 Policy Implication

This study has implications for both academic researchers to understand FDI flows as well as policy to encourage augmented inward FDI flows in emerging markets. The findings of the present study raise the following important policy issues:

1) This study has found that higher market size attracts more FDI while macroeconomic stability, trade openness and exchange rate found statistically insignificant. This result provides a hint of the significance of internal market dynamism in attracting FDI in emerging markets. This indicates that MNCs might be less concerned with short-term fluctuations in the variables like macroeconomic stability, exchange rate but more guided by the internal market growth that pays off greater opportunities for a more intensive use of the their resources to achieve economies of scale and scope. Thus, policy planners in the emerging markets may try to stimulate their internal markets by undertaking efforts to trim down transaction costs rather than monetary policies to attract more FDI.

2) It is found that good governance can attract greater FDI inflow in emerging markets. Hence, efforts should be made towards improvement of governance by redefining role of government to improve efficiency in the governance creating an efficient rule of law, regulatory quality, and creating a sound political stability with effective government quality to attract more FDI in emerging markets. This must go together with single window clearance for foreign investors where they can get assistance on for setting up the business into host country location. This also implies that countries must decrease transaction costs and corruption level and provide efficient and effective institutions with good administrative capabilities and political stability to support MNCs. Government stability draws larger investment inflows. It is therefore, necessary to maintain stability in the countries by avoiding frequent elections.

3) Availability of infrastructure facilities measured by electricity consumption, air transport and Internet availability attract larger FDI inflow in emerging markets. Hence, efforts should be made towards development of electricity availability,
internet connectivity and air transport availability to attract more FDI in EMEs. Infrastructure can be developed in the form of Industrial clusters like Special Economic Zones (SEZs) and Export Processing Zones (EPZs) to explore the economies of scale and thereby to enhance business performance by making available common infrastructure facilities to MNCs. Governments in EMEs can increase the infrastructure related FDI by creating changes in the current policies.

4) Macroeconomic stability measured by inflation rate indicates that it does not appear to have a strong effect on overall FDI and in Service sector. For primary and secondary sector it is positively related to FDI, this result indicates that the benefit of policies towards reducing inflation from moderate to low level is minimal in terms of attracting extra FDI into EMEs and in Service Sector.

5) Labor cost is negatively related to FDI in emerging markets. Hence, emerging market economies need to focus on the development of sound labor market regulations that include effective minimum wages and regulation on procedures for the settlement of hiring and firing regulation which will reduce the overall cost of production and make these locations more attractive for MNCs.

6) Trade openness measured by trade to GDP ratio and Trade cost supports tariff-jumping hypothesis, which indicates that as tariff and non-tariff barriers are higher, as a result MNCs serve host markets by FDI instead of undertaking trade through horizontal FDI in emerging markets. Government should decline the tariff and non-tariff barriers if they want to attract more vertical FDI so that MNCs can subdivide a manufacturing procedure into different stages, locating each stage in a country where that particular part of the process can be done efficiently with less production cost, and then linking all the various stages through trade, MNCs can supply efficiently produced goods and services to buyers worldwide. This process will increase FDI as well as Trade from emerging markets.

7) There is significant difference between country-level and sector-level determinants of FDI in emerging markets. Hence, respective governments need to undertake different policies to attract FDI into particular sector. Further, respective government should create the priority list of the sectors where they are lacking and undertake policy initiative specific to that sector.
7.2 Contribution of the Present Study

Firstly, the study contributes to the exiting literature and provides empirical support to the determinants of FDI by analyzing economic, policy related and institutional variables for both the aggregate as well as country and sector levels. Besides, an analysis of the determinants of FDI in emerging markets suggest for necessary actions on macroeconomic fundamentals which may enhance FDI inflow in emerging markets.

Secondly, the present study also contributes to the existing literature in terms of analytical framework, methodologies applied, definition and measurement of the variables and data used at the aggregate as well as at the country and sector levels. In exploring the FDI-location relationships, the present study considers the Economic factor like Market Size, Trade openness, Macroeconomic Stability, Tax Rate, Exchange Rate, Labor Cost, Natural Resource availability and institutional factors like governance, and policy factors like infrastructure quality, business environment which determines the FDI inflow in emerging markets.

Thirdly, while many exiting studies apply simple OLS regression or logistic regression with time-series and cross-sectional data, use of panel data in the present study helps not only raising efficiency of the estimators, it also helps in capturing the changing dimension of FDI-location relationship across the countries and sectors.

Fourthly, by using panel regression this study identifies the role and scale of macroeconomic environment on determining the foreign investment flows in emerging markets and creates room for necessary policy interventions.

Fifth, unlike many of the earlier studies, the present study uses data on actual inflows of FDI, not on approved foreign investment.

7.4 Limitation of the Study

1) As the study covers only the period from 2002-2012, the number of observations are less. This limits the efficiency of the estimated models and hence of the
analysis. Hence, future research can be carried out by extending the time frame of the study.

2) The study addresses the sector-specific determinants of FDI using data on FDI inflows broken into broad three sectors namely Primary, Secondary and Tertiary sectors. While an ideal analysis would use investment-level data classified by industry, such dataset is not readily available and there is no continuity in the industry level data across the emerging markets. Another perception for future researchers is to test the model based on firm level data.

3) The study does not include the sector-specific factors responsible for determining FDI inflow in each country due to the non-availability of requisite datasets.

4) This study considers only location-specific determinants of FDI, not considering how elements from the home country may have affected the location-specific determinants of the FDI. Hence further research needs to undertake considering the factors showing impact of home country circumstance on FDI inflow into particular location.