Abstract

The present study attempts to examine the macro-level and sector level determinants of foreign direct investment (FDI) inflows in emerging economies, with special emphasis on the role of various macroeconomic, institutional/qualitative determinants of FDI in emerging markets. This study uses annual panel data with observation from 2002-2012 for macro level and 2003-2012 for sector level for 24 emerging economies. Identification of possible determinants of FDI has been done by analyzing existing theoretical and empirical literature developed with respect to determinants of FDI. Data for determinates and other related information has been collected from a variety of secondary sources like World Bank, UNCTAD, Heritage foundation etc. Infrastructure and governance index has been developed for estimating the results. For sector-specific analysis, this study uses a dataset which breaks FDI flows into primary, secondary and tertiary sector. The study uses Generalized Methods of Movement (GMM) dynamic estimator based on Arellano-Bond methodology to solve endogeneity concern in qualitative variables for sectoral analysis. Panel data model helps to increase the number of observations and degree of freedom. It helps to incorporate the dynamics of FDI inflow into different countries and sectors.

Before reporting the results obtained by panel least square regression this study presents various hypothesis testing results to know the significance of the unobservable individual country specific effects in the data set and to find out suitable panel data method for the estimation of the static model. Lagrange Multiplier (LM) test has been used to test the acceptability of panel data model over classical regression model. Hausman specification test has been carried out to choose a suitable panel data model (fixed effect model vs random effects model). Test for selection of appropriate model supports fixed effect model in all regression models. Final results have been drawn from fixed effect model.

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- Market size, Labor cost, Infrastructure, Governance, Trade cost, corruption have significant impact on determinants of total FDI inflow 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 higher in emerging economies but FDI is flowing positively in emerging markets as it is generally driven by market seeking purpose having better infrastructure. Labor cost measured by hiring regulation and Minimum wage and countries with greater difficulty of hiring are given lower ratings. This indicates that though the hiring regulation and minimum wage is 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 (Brazil, Russia, India, China and South Africa) 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 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 to be associated positively with FDI inflow in Brazil while it is negatively related in Russia.

Results from sector-level analysis show that there is a difference between determinants of FDI among sectors. FDI inflow in Primary is positively associated with Market size, Macroeconomic stability, Tax Rate, while trade openness and exchange rate is negatively related to FDI. FDI inflow in primary sector positively associated 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 are essentially 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 confirm that though the corruption level in emerging markets are higher, FDI tends to flow into that market as other factors like natural resource availability increases the profitability rate into these markets.

FDI inflows in secondary sector are mainly influenced positively by Market size, Macroeconomic stability, Infrastructure and Tax Rate while labor cost, governance, business environment and trade cost are negatively associated with 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 to result in 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 inflow into specific sector.

It is also observed that the EMEs with better infrastructure have greater FDI inflows. Hence, efforts should be made towards development of industrial clusters in the form of Special Economic Zones (SEZs), Export Processing Zones (EPZs) to explore the economies of scale and thereby to enhance business performance by making common infrastructure facilities to MNCs. Government can increase the infrastructure related FDI by creating changes in the current policies. MNCs in EMEs 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 pay off greater opportunities for a more intensive use of 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.

Although overall institutional and governance factor do not impact on FDI inflow in emerging markets significantly but in the long-run these markets 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 in the path of institutional and governance reforms to attract additional inflow of FDI in the long run.