Chapter 1: Introduction

1.1 Introduction

Foreign Direct Investment (FDI) plays a significant role in the development process of an economy especially in the case of Emerging Market Economies (EMEs) \(^1\). FDI inflow bridges the gap between the desired and the actual level of investment, particularly when domestic investment is not adequate enough to push the actual capital stock up to the desired level (Noorbakhsh et.al, 2001; Hayami, 2001). There are a large number of research (Annexure A) studies which empirically investigate the positive relationship between FDI and Economic Growth\(^2\). FDI not only brings non-debt creating capital flows but also transfer the technology, generates employment opportunities in host economy, and has spin off effects through backward and forward linkages within the host economy by Greenfield investment (Javorcik 2004; Alfaro and Rodriguez-Clare 2004; Ho and Rashid 2011, NCAER 2009). There is a belief among policymakers that FDI enhances productivity of host countries by promoting competition in to the market. (Caves, 1974).

In addition, FDI also brings in best management practices to the host country, and spillover effects make the economy more competitive. A number of studies (e.g., Caves, 1974; Globerman, 1979; Blomström and Persson; 1983, Basant and Fikkert, 1996; Kathuria, 1998; Pradhan, 2006) find significant evidence of such knowledge spillovers from foreign enterprises.

FDI is becoming a key component of the world’s growth engine; hence countries try to create favorable conditions to attract more FDI inflows into their economies. (Adhikary

---

\(^1\)The IMF World Economic Outlook Database is more precise and classifies countries as advanced economies or emerging market and developing economies based on the per capita income level, export diversification, and level of integration into the global financial system.

\(^2\) There is a wide empirical literature that has explored relationship between FDI and Economic Growth. Although there is no consistently strong evidence that FDI inflows promote growth but most of the recent research papers found positive relationship between Economic Growth and FDI. (Kose et al., 2009)
FDI also increases tax revenue to the host economies which turn into higher spending from the government on different development schemes like building infrastructure for the growth of industries. All of these benefits discussed above lead to higher economic growth and employment growth in emerging markets which is an effective tool for achieving enhancement in the reduction of poverty. (Hung, 2005). Empirical studies have also found strong evidence that FDI flows are less volatile compared to other capital flows like FII (IMF, 2007). There is also common notion that FDI is somehow better for growth and development than other capital flows. Moreover, FDI can also be considered as a substitute of international trade and an instrument to hedge the risks of exposure to foreign exchange. The World Trade Organization’s (WTO) General Agreement on Trade in Services recognizes FDI as a prerequisite for exporting many services. The keen interest in FDI is a part of a broader interest in the forces that are driven towards the integration of the world economy or what is popularly described as ‘Globalization’ (WTO, 1996).

As discussed above, FDI plays the crucial role in Economic Growth in host country; hence countries try to attract a substantial quantum of the FDI which can accelerate the process of economic growth by bringing in more capital, technology, new management practices, and employment generation. Therefore, policy focus should be on determinants of FDI as it can play an important role to enable policy makers to understand the scale and direction of FDI flows. It enables them in formulating a foreign investment policy that is most conducive in attracting FDI.

However, some empirical studies have indicated lack of association between FDI inflow and Economic Growth in the host country (Aggarwal, 2005; Pradhan, 2002; Bajpai and Sachs, 2000; Morris, 2004; Nunnenkamp & Stracke, 2008; Pal and Ghosh, 2007; Majumdar, 2005). The economic growth is depending on the nature of FDI and host countries situation to convert the FDI inflow in the growth of the economy, e.g. whether the FDI inflow is Greenfield or it follows the route of Mergers and Acquisition (M & A). Generally it is believed that the impact of FDI through M & A is complex as it may lead to organizational complexity and favor organizational structure with stricter financial control which leads to lower R & D activities. Hence the government’s role is important.
to put a lot of efforts in attracting Greenfield Investment particularly in high innovation intensity industries. On the other hand, FDI following the route of M & A may help in more efficient use of resources, international diffusion of technology, rationalization of R&D activities, and increase in efficiency of R&D activities through complementarities.

The macro empirical literature has also found that a country’s capacity to draw maximum benefit from FDI inflow might be limited by local conditions, such as progress of host countries financial markets or the educational level of country. (Alfaro et.al 2006), (Durham 2004), and (Hermes and Lensink 2003) empirically investigate that developed financial markets in host economy gain considerably from growth effects of FDI. According to (Borensztein et.al 1998) and (Xu 2000) the impact of technology transfer in host country brought by MNCs\(^3\) dependent on minimum threshold of stock of human capital in host economy. Hence absorptive capacities of the host economy are important for creating positive effect of FDI on Economic Growth.

The micro level empirical studies with respect to FDI and Economic Growth investigate that result for the effect of FDI on firm’s productivity is unclear. Firstly, (Caves 1974) found positive relationship between productivity of foreign firms and average value added per employee of the domestic firm in the same sector. Secondly, some studies have found negative productivity spillover effects from the foreign firms to the emerging economies whereas for developed countries it has been found that there are positive spillover effect from foreign firms. Thirdly, some studies have found that foreign multinationals would like to avoid risk of information leakage from potential domestic competitors; hence it is believed that horizontal FDI inflow is not much impacting on growth as it is not creating much backward and forward linkage to the host economy where capital is flowing. Vertical FDI inflow is recognized as a supportive factor for

\(^3\) A multinational corporation (MNCs) is a firm that owns and controls production facilities or other income-generating assets in at least two countries. When a foreign investor begins a green-field operation (i.e., constructs new production facilities) or acquires control of an existing local firm, that investment is regarded as a direct investment in the balance of payments statistics. An investment tends to be classified as direct if a foreign investor holds at least 10 percent of a local firm’s equity. This arbitrary threshold is meant to reflect the notion that large stockholders, even if they do not hold a majority stake, will have a strong say in a company’s decisions and participate in and influence its Management. Hence, to create, acquire or expand a foreign subsidiary, MNCs undertake FDI. In this thesis, we often refer to the MNCs and FDI interchangeably.
Economic Growth as it makes linkages between domestic supplier of intermediate inputs and foreign clients in downstream sector or between foreign suppliers of intermediate inputs and their domestic supplier in upstream sector. (Alfaro, 2006)

The impact of the FDI on Economic Growth is also dependent on the sector. According to Walsh & Yu, (2010), countries are normally concerned about attracting FDI into the primary sector (petroleum, mining, and agriculture) for revenue purposes and a small number of policymakers believe that investment in the primary sector is conducive to creating employment. Moreover, policymakers tend to focus on secondary and tertiary sector investment; believing that manufacturing investment can bring jobs to absorb labor from lower-productivity sectors, which is especially important among emerging markets where agricultural employment remains important. Thus, understanding the sector level determinants of FDI is crucial to attract more FDI into particular sector which is important to accelerate the growth in the host economy.

1.2 FDI inflow in Emerging Market Economies

FDI inflow in EMEs has been phenomenal and has contributed to the overall economic growth of these countries. The economic slowdown during 1980's forced EMEs to execute economic reforms by restructuring the economies from planned to even more market driven economies. The main reforms undertaken in this period are to transmit enterprise from the state ownership to private ownership in order to increase efficiency of production and reduce the dependence of the overall economy on inefficient state owned enterprises. In this course of action, FDI has played a central role in creating an “imported” private sector and strengthening the competitiveness of the emerging economies.

There was a drastic change in economic and political structure in most of the EMEs including the countries like China and Latin America after 1990s. Emerging Markets reduced trade barriers and restrictions on international capital flows after 1990s. As a result of these reforms there was a considerable increment in trade and international capital flows in EMEs. In this reform process EMEs opened up many sectors like
telecommunication and transportation which were earlier restricted for FDI. To attract more FDI and for improving the climate for FDI most of the EMEs have undertaken institutional reforms to address managerial, regulatory, legal, and institutional barriers to investment. Recently, FDI inflow in EMEs is mostly motivated for efficiency seeking purpose as most of the EMEs have less production cost as labor cost is less in these countries. As a result, efficiency-seeking trade from these locations also increased in recent years as MNCs are serving other countries by operating in a location where they get less production cost. Hence in EMEs, FDI is generally considered as complementary to trade.

Cautious optimism increased global FDI inflow by 9 percent in 2013 to $1.45 trillion compared to 2012’s decline into global FDI inflow. According to UNCTAD projections, FDI inflows could increase by $1.6 trillion in 2014, $1.7 trillion in 2015 and $1.8 trillion in 2016, with comparatively larger surges in developed countries. Global FDI flows grew nearly four -fold and FDI inflows to EMEs grew by about three-fold from 2003 to 2007. Global FDI flows touched a peak of US$ 2.1 trillion in 2007, but there was drastic decline in FDI flows over the next two years and it touched to US$ 1.1 trillion in 2009, following the global financial crisis. On the other hand, FDI flows to developing countries increased from US$ 565 billion in 2007 to US$ 630 billion in 2008 before moderating to US$ 478 billion in 2009.

The decline in global FDI during 2009 was mainly attributed to restrained Mergers and Acquisition (M&A) activities and weaker return projections for foreign affiliates, which impacted negatively on equity investments, Greenfield investment as well as reinvested earnings particularly in services related to business and financial. As the world economic recovery continued to be ambiguous and insubstantial, global FDI flows remained stagnant at US $ 1.1 trillion in 2010, also there was uneven pattern in FDI inflow across regions e.g. FDI inflow in advanced economies declined by 7 per cent while there was 10 per cent recovery in developing economies which confirms that there is difference in FDI inflow in advanced and developing economies. Recovery in FDI inflows particularly in emerging markets is largely driven by improved macroeconomic conditions, corporate profitability and some improvement in M&A activities with improved valuations of
assets in the stock markets and rising business confidence which augurs well for global FDI prospects. However, currency volatility, sovereign debt problems and potential protectionist policies may pose some risks to this positive outlook in EMEs.

According to UNCTAD’s World Investment Report (2014), FDI flows to emerging markets reached a new high at $778 billion, accounting for 54 per cent of global inflows. EMEs attracted largest share of international investments made by businesses for the year 2012 and 2013. Developing Asia continues to be the region with the highest FDI inflows, significantly above the EU, traditionally the region with the highest share of global FDI. In spite of lower growth rate in these locations, US and EU crisis, political uncertainty and turbulence in their financial markets it is expected that in 2014 also these market can attract largest FDI inflow. As international consumption and international production has shifted to emerging economies, MNCs are increasingly investing in both efficiency-seeking and market-seeking projects in these emerging countries.

But the overall growth in FDI inflow to EMEs declined to 6 percent from 17 percent in 2014 which is lower than last 10 years average growth rate. There is also a concern that the circulation of global economic growth seems to be shifting back towards developed economies, making them more attractive to foreign investors. Foreign investors are becoming increasingly anxious about the political uncertainty, regional instability and economic challenges in some emerging economies, which may negatively affect overall inflow of FDI in these markets. FDI in EMEs is expected to remain flat in 2014 and then increase slightly in 2015 and 2016. Hence EMEs need to develop proactive strategies in near future to increase the inflow of FDI. Therefore understanding of factors contributing to FDI inflows in these locations is of crucial importance.

Sectoral distribution of FDI inflows into emerging markets indicates that FDI inflow into emerging markets are increasing but a wide inter sectoral variation in FDI inflows which has made the distribution highly skewed towards manufacturing and service sector. Potentials for continuous growth of an emerging middle class consumer has attracted FDI in consumer-oriented industries, including food, IT, tourism, finance and retail (WIR, 2014). Overall trends of FDI inflow in primary sector reveal that, Brazil tops the list
among the emerging countries in attracting the FDI in Primary sector. It is followed by Colombia, Russia and others. India ranks at 15th position and attracts only 1.5 billion of FDI in the primary sector. Here, it is pertinent to mention that only a few activities are permitted for foreign direct investment in the primary sector in India and other EMEs. China tops the list among the emerging countries in attracting the FDI in Secondary sector & Tertiary sector. China is followed by Mexico and Brazil in both the categories. India received FDI of 23.9 and 67.7 billion US $ in the secondary and tertiary sector respectively. China also received highest amount of FDI among all the Asian countries. Thus, it is also evident that there is skewed distribution of FDI inflow in different sectors and different countries. Hence, understanding of determinants of FDI for each sector is crucial for formulating Sectoral policy in EMEs.

Empirical studies on FDI in EMEs illustrate that MNCs are mainly attracted to these countries due to higher market size, cheap labor costs and favorable policies toward FDI (Meyer, 1998; Cheng and Kwan, 2000; Bevan and Estrin, 2002). FDI is perceived as one of the most effective ways by which EMEs can be integrated to the global economy as FDI inflow in these economies transfer large number of benefits to a host economy, especially transfer of capital, knowledge, best management practices, technology know-how and the latest production technology. Further, the entries of MNCs are expected to create competition, economic reforms and promote the development of private sector. FDI inflows in EMEs also facilitate exports from home country to other markets through MNCs knowledge and experience of the relevant markets as well as access to distribution networks (Girma et al., 2005; Meyer, 1998; Nguyen and Xing, 2006).

Besides advantages that MNCs gain from investing in EMEs, they, however, have to face several complexities in these markets which arise from un-skilled labor forces, infrastructure bottlenecks, and especially from the bad institutional frameworks and governance such as higher level of corruption, ineffective rule of law and bureaucratic inefficiency (Bevan et al., 2004; Meyer, 2001). In addition, EMEs are deficient in the knowledge and experience to use market mechanism and these economies fail to identify potential partners and competitors. These drawbacks add to overall production costs as well as transaction costs associated with EMEs. MNCs therefore, have to act strategically
about how to limit disadvantages to obtain the highest benefits when entering in EMEs. In order to recognize the interface between foreign firms and the local economy, it is first of all necessary to understand what motivates MNCs to invest abroad, why they prefer FDI over other investment routes such as exporting or licensing, and which factors influence their location decisions. Review of literature on FDI in the next chapter enables us to understand the firm’s strategies and builds up the theoretical background for empirical studies in the next chapters.

FDI is considered as an important source of finance for emerging markets but unfortunately most of the FDI inflows are concentrated within the developed countries. FDI literature indicates that there are differences between the FDI inflows to the developed countries and those to emerging market economies (Marakusen et al., 1996; Carr et al., 1998). FDI inflow in EMEs is mostly associated with vertical investments. The vertical FDI takes place in a location where cost of overall production is less and MNCs undertake only a part of its production process for which production cost is less instead of total production. Mostly, labor intensive activities by MNCs are re-located to EMEs as labor cost in these locations is low compared to home location. FDI inflow in particular location is motivated by the difference in factors of production e.g. low labor cost, natural resource availability, skilled labor and availability of infrastructure. However, FDI inflows in advanced economies are motivated by market seeking strategies involving horizontal investment. As there is difference between determinants of FDI inflow in developed markets and emerging markets there, is a need to understand the factors behind FDI inflows in emerging markets.

1.3 Problem Statement

It is clear from the preceding discussions that empirical evidence for relationship between FDI and Economic growth is mixed but there is evidence that given certain country prerequisites, FDI leads to better growth outcomes (e.g., Alfaro 2004; Borensztein and Lee 1998). As FDI plays important role in economic growth there is a substantial interest among policymakers on the factors that might attract FDI flows. Therefore, it is imperative to identify factors contributing to foreign capital to a particular location.
These factors can play an important role to enable policy makers to understand the scale and direction of FDI flows. It enables them in formulating a foreign investment policy that is most conducive in attracting FDI to a particular location. In the face of the challenges of globalization, there are also new questions about absorptive ability of the country from FDI inflow. Hence EMEs need to adjust to structural changes and to foster a more dynamic and competitive environment that encourage enhanced productivity for FDI.

There are also evidences of inter-sectoral and inter-country inequalities in the FDI inflow in EMEs. Addressing the dynamics of such inter-country and inter-sector inequalities in FDI inflows is very significant for balanced regional and sectoral development in EMEs, as skewed distribution of FDI inflows towards some specific country and sector leads to increase in imbalance and unequal development in the emerging markets which have serious consequences on socio-economic and political stability in the 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 in EMEs. It is also equally pertinent to comprehend the ability of different sectors to adjust to structural changes to attract more FDI into particular sector. The present study, thus, aims to examine the macroeconomic determinants of FDI at the aggregate level and across three main economic sectors (primary, secondary and tertiary) in EMEs.

The factors that attract FDI to developed countries are not necessarily the same as those that attract FDI to EMEs. EMEs tend to have relatively higher level of macroeconomic instability in terms of higher inflation rate, bad institutional quality and lower development indicators compared to their developed counterparts. Since many EMEs are attracting more FDI and are considered as important destinations for FDI in recent years, it is clear that firms investing in EMEs enter at a different balance of considerations than those investing in developed economies, trading off better macroeconomic stability and a skilled labor force, for example, in exchange for lower wages or access to a profitable but protected EMEs. This study attempts to find out the major factors that contribute to higher level of FDI in emerging markets.
FDI inflows into particular location depend on several factors whose relative significance changes as economic environment for that location changes over time. Even though traditional determinants of FDI are important but some new factors contribute more compared to traditional factors. For example, market size is one of the traditional determinants of FDI but now FDI inflow in emerging markets is not only determined by market size but factors like Institutional Quality, Business Environment, the quality of infrastructure etc. (UNCTAD, 1996). This indicates that the motivations of foreign investor are changing; hence countries must seek new ways to attract the FDI. However, this might not be true for all the countries and all the sectors.

The findings of the study would help to develop suitable policy implications for probable solutions for attracting more FDI into particular location as well as particular sector. From the policy perspective, this study not only takes into consideration economic factors but also the institutional and qualitative factors which are impacting on FDI inflow in EMEs.

1.4 Organization of the Thesis

The remaining part of the thesis is organized as follows. Chapter Two reviews the theoretical and empirical literature on FDI determinants at macro level and sector level. In chapter three, concepts related to the issue are defined and econometric models used to analyze the data are presented. Chapter four examines the trends of FDI inflow at the aggregate level as well as for the three broad sectors in emerging markets to trace out the pattern of the FDI inflow and structural patterns over the years and accordingly, draws implications thereon. The relationship between macroeconomic determinants of FDI in emerging markets is examined in Chapter five. Chapter six examines the determinants of FDI at three broad sectors level. Chapter seven summarizes the findings and concludes the study drawing implications and policy recommendation thereon. It also outlines the major contributions of the work and scope for future work.