DETERMINANTS OF FOREIGN DIRECT INVESTMENT INFLOWS: EVIDENCE FROM A PANEL ANALYSIS OF SOUTH ASIAN COUNTRIES

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Abstract

The aim of this study is to examine the variables that derive FDI inflows in five major countries of South Asia. The results from the past empirical studies about this subject matter have been controversial, which has created a gap in the literature. Data was collected from the United Nations Conference on Trade and Development and World Bank Indicator from 1990 to 2017, and various Panel Techniques were estimated to simultaneously address the objective of this study and counter heterogeneity problem associated with cross countries analysis. Consequently, the findings that originated from this work established the following among others; the prominent variables that determine the inflows of FDI in South Asia are the market size and GDP per capita. However, growth rate of these economies are identified as a factor that could discourage the inflows of cross border investment in this region. Furthermore, as result of these important findings, this paper makes the following recommendations. The policy makers in South Asia should embark on further policy measures that will expand the market size and GDP per capita in this region. Also the policy makers in South Asia should implement policies that will boost competitive growth rate in the individual country.

Keywords: FDI, Market Size, GDP per Capita, Growth Rate, Panel Analysis, South Asia

JEL Classification: F21, F23, F36

1. INTRODUCTION

In the last decade, there has been a paradigm shift in the direction and trend of global foreign direct investment inflows. The G7 and the European countries occupied the fore front of FDI recipients in 1970s to early 2000. Specifically before the global economic crisis of 2008, the European Union Countries were the major destination of FDI inflows. This region of the world has consistently received the lion share of global FDI inflows. In 2008, FDI inflows in European countries dwindled by approximated 63%. Between 2008 and 2017 the stock of FDI inflows in this region has dropped by 0.62%. Meanwhile, reverse was the case of developing countries of Asian Continent. Year 2008 marked sporadic inflows of FDI in this region of the world. In this same year FDI inflows increased by 7.2%. Between 2008 and 2017, the stock of FDI inflows has risen by approximately 25%. (UNCTADstat, 2018).

However, the South Asian countries are among countries to be recon with when it comes to FDI destination in the continent among the developing economies. In this Asian sub region, India and Pakistan are the principal recipients of the global foreign direct. UNCTAD investment report in 2012 indicated that India and Pakistan jointly attracted about 52% of the Asian continent (India 46% and Pakistan 6%). Recently, among the major developing countries of the world, South and Southeast Asia sub regions have been selected and declared as the largest FDI recipient (UNCTAD, 2016, UNCTAD, 2018). It is worth of note that the performances of Bangladesh, India, Pakistan, and Sri Lanka in attracting FDI cannot be overemphasized in the recent times. This has made these countries to occupy a strategic position regarding cross border investment in the sub region of the Asian Continent. Succinctly put, the exceptionally performance of South Asia in attracting FDI inflows among other developing countries of the world has sparked off researches among scholars and policy makers to establish the major deriving variables behind sporadic FDI inflows in these countries. However, it has been observed that the results of the past studies have been mixed and controversial. See Aderemi *et al.* (2019), Azam (2010), Sahoo (2006), Minhas and Ahsan (2015), Tiwari and Mutasque (2011) and Mottaleb and Kalirajan (2010) Olaoye *et al.* (2020). This means there is no yet a consensus in the literature about the variables that derive FDI in South Asia. Similarly, South Asian sub region has not received enough discussion regarding FDI among researchers like other developing regions of the world (Bimal, 2017). In view of the above, this study will examine the factors that derive FDI inflows in these economies.

In addition to introductory aspect, the rest of this paper is arranged thus; section two examines the review of relevant literature and overview of economic performance indicators of countries under study and section three presents methodology, discussion of results, conclusion and policy recommendation.

2. REVIEW OF EMPIRICAL LITERATURE

This section presents the past empirical studies on FDI inflows in developed countries, emerging and developing countries.

Aderemi *et al*. (2018:1) employed OLS technique to examine a comparative analysis of performance of FDI inflows in BRICS countries alongside two emerging economies in Asia, namely Singapore and Hong Kong between 1990 and 2017. The study concluded that the key determinants of FDI inflows in China are large market size, growth rate and GDP per capita growth. But only the market size is the key determining factor of FDI inflows in Brazil, India, South Africa, Singapore and Hong Kong. Meanwhile, GDP per capita growth is an insignificant factor that determines FDI inflows in both Russia and South Africa. While investigating the impact of FDI on the Chinese and Indiana economies` growth between 1993 and 2009, Agrawal et al. (2011) utilized the modified growth model alongside OLS model to argue that FDI affected Chinese economic growth more than India's. The authors asserted that the majority of the foreign investors preferred to invest in china more than India because the market size of china is bigger than India`s. In another perspective, Frenkel et al (2004) examined FDI flow between major industrialized economies and twenty-two emerging countries with the aid of a gravity model and panel data. The author submitted that the distance and characteristics of both home and host country are the significant factors that determine how FDI flows within these countries.

Wei (2005) examined the factors that derive inward FDI in China and India. It was discovered that the causes of the wide difference between the two countries is that China attracted much higher FDI from OECD countries as a result of its larger market size and higher external trade relation with OECD countries whereas cheaper cost of labour, lower country risk, geographic closeness to OECD countries, and cultural similarity are the deriving factors behind the inflows of FDI in India.

Meanwhile, Xing (2006) investigated the important role played by the Chinese currency against Japanese`s in FDI inflows in the country. It was discovered that both devaluation of the Yuan and the pegged exchange rate of Yuan to the Dollar served as factors that increased the competitiveness the China's economy in attracting FDI. Furthermore, one of the key variables that determine the Japanese direct investment in China is the difference between the real exchange rates of the two countries.

However, Aderemi *et al.* (2018:2) adopted OLS modelling to estimate the variables that derive FDI inflows in China and the US between 2002 and 2017. It was established from the study that the principal deriver of FDI inflows in the USA is GDP, whereas GDP per capita growth is the key determining variable of FDI inflows in China. In testing the causality between FDI inflows and economic growth in 11 high-income and low-income developing countries in East Asia and Latin America, Zhang (2001) used Johansen cointegration test, the error-correlation model and the Granger causality test to posit that the effect of FDI on

host economies is country-specific. The finding from the study also submitted that FDI inflows have tendency to catalyse economic growth in East Asian countries if the host countries open their economy through international trade, improving education and embarking on human capital development.

In the same vein, Falki, (2009) utilized Ordinary Least Square technique to analyse effect of FDI on economic growth in Pakistan between 1980 and 2006. The researcher found out that insignificant inverse relationship existed between FDI and GDP in this country. In another perspective, Mallick and Moore (2008) made use of panel data for 60 developing economies during 1970-2003. The authors discovered that FDI inflows and economic growth have a direct significant relationship in all income groups. Whereas the reverse was the case of the lower income group countries. In another study, Chang (2007) employed the Johansen cointegration test, the multivariate error correction model, and the Granger causality to assert that no causal relationship existed between FDI inflows and economic growth in Taiwan. While investigating the relationship between FDI and economic growth and domestic investment in Korean economy in 1959-1999, Kim and Seo (2003) utilized vector auto regression models to corroborate that FDI and economic growth have insignificant direct relationship with each other, and domestic investment was not crowded out by FDI inflows as well. In an attempt to investigate the relationship between foreign direct investment and economic growth of Pakistan in between 1970 and 2001, Atique *et al.* (2004) adopted Eangle Granger and Hansen techniques to argue that FDI contributed significantly to the economy more than exports in the country. However, Hudea and Stancu (2012) applied a panel data analysis to investigate the nexus between foreign direct investments, technology transfer and economic growth in seven East European countries between 1993 and 2009. It was discovered from the paper that that FDI and economic growth had a positive relationship in both short run and long run in the countries selected for the analysis.

Consequently, Carcovic and Levin, (2000) used Ordinary Least Square approach to estimate the impact of FDI on economic growth in seventy-two developing countries between 1960 and 1995. The estimated results submitted that FDI did not affect economic growth in those countries. In another study, Matiur Rehman (2007) estimated the relationship between FDI, exports and remittances Bangladesh, India, Pakistan and Sri Lanka during the periods of 1976-2006 with the aid of the autoregressive distributed lag (ARDL) model. The results from the estimated model showed that India and Bangladesh were similar in both short run and long run. However, the results of the estimated relationship for Sri Lanka and Pakistan were identical as well in the short run but otherwise in the long run. Also, Azam and Lukman (2010) investigated economic variables that derive FDI inflows in Pakistan, India and Indonesia. The author applied OLS and Log Linear Regression Models to analyse the annual data between 1971 and 2005. It was revealed that the major determinants of FDI inflows in these countries were market size, external debt, domestic investment, trade openness, and physical infrastructure. Meanwhile, it was observed that the estimated results showed

similarity for Pakistan and India when these two variables, trade openness and government consumption were isolated but the results from Indonesian economy was not in correlation with the estimated factors that derive FDI India and Pakistan.

In the same vein, Yousaf *et al.* (2008) employed a co integration technique and error correction model to examine the impact in which FDI has on economic growth of Pakistan. He attempted to analyse the impact of FDI on exports and imports of Pakistan between the periods of 1973 to 2002. The findings from the estimated model corroborated that FDI had both short run and long run on the economy of the country. In another perspective, Tiwari and Mutasque (2011) applied a panel data analysis to evaluate the nexus between FDI and GDP of 23 countries in Asian continent within the period of 1986 to 2008. It was discovered that FDI, Labour, capital and exports led to an increment in the growth of these countries.

However, it could be pinpointed that from the empirical literature above that studies on FDI inflows in emerging economies of Asia are ongoing, and there is no consensus about the variables that derive this cross border investment in these. Hence, results the importance of this study.

2.1. AN OVERVIEW OF FDI INFLOWS IN SOUTH ASIAN COUNTRIES

India

The country commenced its economic reforms in the early 80s. The balance of payment and foreign exchange liquidity crisis experienced by the country compelled it to embark on aggressive privatization and liberalization policies in July 1991. Since then, India has made some impressive policy measures to integrate its economy with the rest of the global community. Some of these policies can be highlighted as follows: quantitative restrictions removal, reduction in tariffs, and introduction of exchange rate flexibility.

Consequently, in 2002, India embarked on its second-generation reforms with a view to improving infrastructure, reducing the fiscal deficit, reforming labour laws and invigorating the states to be actively involved in catalysing the pace at which the reforms should achieve their objectives. As a result of this India raised its FDI limits in majority of crucial sectors of the economy such as banking and insurance, telecommunication and civil aviation.

However, from 1991 to 2002 the average growth rate of Indian economy rose from 5.92% to 5.6%. Interestingly, the average growth rate of this country in the last decade, precisely from 2007 to 2017 is 7.3% which has surpassed the average growth rate of the developed economies like the US, UK, Germany etc. In the same vein, the FDI in India rose by 45.5% from 2010 to 2017.

Bangladesh:

The country implemented structural adjustment programme sponsored by the World Bank and the IMF in the 1980s and early 1990s as part of its major economic reforms. In 1980, the World Bank structural and sectoral adjustment loans (SALs and SECLs) were implemented in the country, after which a three-year structural adjustment facility (SAF) was equally, introduced 1986 under the sponsorship of the IMF. The scenario above sparked off the implementation of major reform initiatives in the country. In 1990s, agricultural policy, trade and industrial policy, privatization and public enterprise reforms, fiscal policy reform and financial sector reform were implemented in the country. From 2010 to 2017, FDI inflows increased by 135.6% in Bangladesh.

Pakistan:

In 1984, Pakistan took its first step in liberalizing its investment policies through the announcement of the industrial policy statement which gave an equal opportunity to the public and private sectors. Consequently, in order to encourage foreign private investment, joint equity participation of foreign and local investors in the areas of managerial and technical skills, marketing expertise and advanced technology was introduced by the policy makers in the country. In order to facilitate the inflows of foreign capital in this economy, a new industrial policy package came on board in 1989 with a view to recognizing the pertinent role the private sector plays in the country`s investment. As a result of this, a series of regulatory measures were put in place to generally improve the business environment so that FDI could be attracted in the country. Within the period, the Board of Investment (BOI) was set up in conjunction with the PM's secretariat, with a mandate to create platforms that will serve as attraction to foreign investors in the economy. Within the period Pakistan had signed bilateral agreements on the promotion and protection of investment with 46 countries which later caused sporadic inflows of FDI in the country. FDI rose by 38.8% from 2010 to 2017.

Sri Lanka:

Sri Lanka was the first country in South Asian sub region to open up its economy to the outside world in 1977. The country adopted a number of the policy measures such as liberalization of trade policy and exchange rate system, export promotion and incentives to investment, and the rationalization of public expenditure. From that time till now, the country has remained one of the most outward oriented economies in the sub region. FDI increased by 187.8% from 2010 to 2017

Maldives

Tourism is life wire of the Maldivian economy. Maldives started opening its border to foreign investors in 1980s. Currently the country attracts average of 1.2 million tourists annually and this accounts for about 70% of its GDP. Consequently, most foreign direct investment (FDI) in this country is geared towards the tourism sector. In order to widen the scope of investment of foreign capital, in 2015 the Maldivian government organized the second annual investor forum in Beijing, China with a view to increasing the participation of foreign

investors in the Maldivian banking and financial sector, renewable energy, real estate, logistics, transport, healthcare, education and construction. From 2010 to 2017, the inflows of FDI in this country has increased by 139%

Islamic Republic of Iran

The Iranian government liberalized its investment its investment regulation in 2000s. FDI inflows in this country has been skewed towards few strategic industries of the economy such as oil and gas industries, vehicle manufacturing industries, petrochemical and pharmaceutical industries and copper and mining industries. Between 1992 and 2009, approximated 485 projects with values of US$34.6 billion of cross border investment has been received by the Iranian economy. Similarly, from 2010 to 2017, FDI inflows in this country grew by 37.5%

In summary, in the last decade the South Asian countries have been opening up their economies continuously with competitive FDI policies, aggressive policy changes in their macroeconomic and trade policies with a view to creating a friendly investment environment to foreign investors.

2.2. AN OVERVIEW OF SOME ECONOMIC INDICATORS IN SOUTH ASIAN COUNTRIES
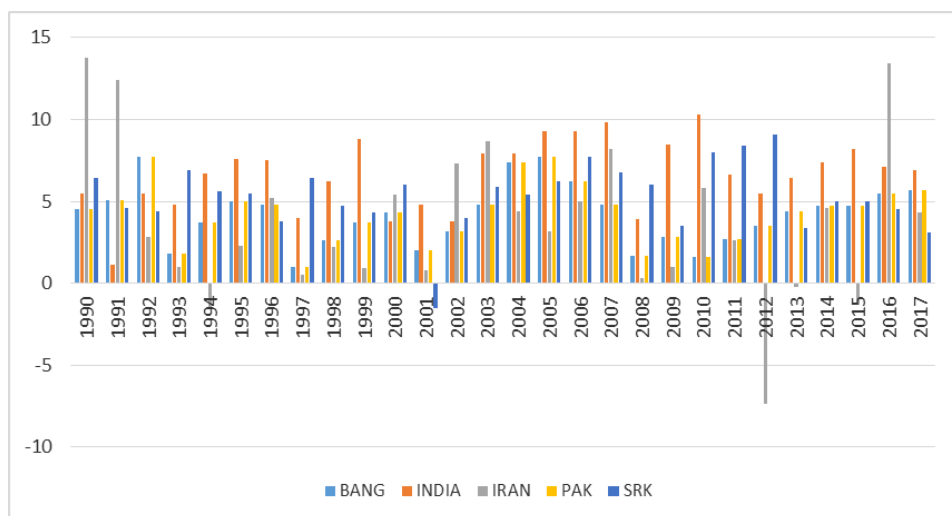

Figure 1. Growth Rate of Economies in South Asian Countries
Source: Authors' Computation (2020) from WDI, 2018.

Figure 1 shows the economy performance indicator in term of growth rate of South Asian countries from 1990 to 2017. It could be viewed from the graph above that in 1990 and 1991 growth rate in Iran was the fastest, followed by Sri Lanka and India in 1990 and Pakistan in1991 respectively. In 1993 Sri Lanka became the fastest growing economy followed by India and Pakistan simultaneously. However, there was a paradigm shift in 1994 in which Indian

economy became the fastest growing economy in South Asia. From that period till 2017, Indian economy has registered the highest rate of growth except few years like 1997, 200, 2003, 2011 and 2016. On average basis, India is the fastest growing economy in the region. It is worth of note that Iran registered negative growth in 1994, ditto for Sri Lanka in 2001 and Iran 2012 and 2015 respectively. However, Iran economy recovered in 2016 with the highest growth in the region in that year.
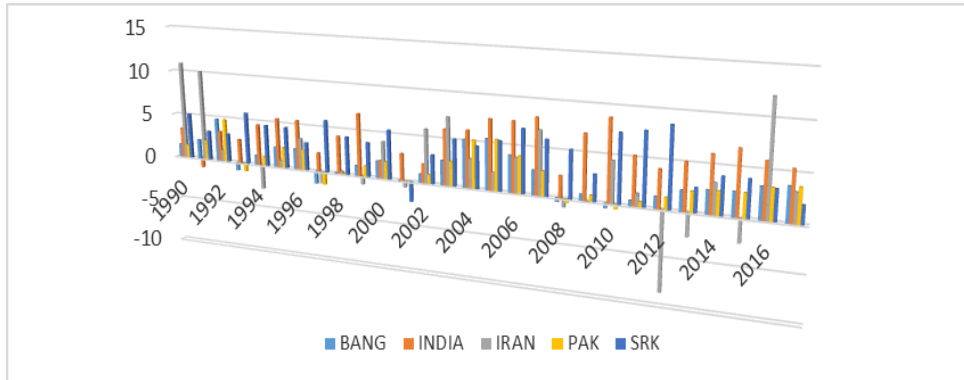

Figure 2. *GDP per Capita in South Asian Countries*
Source: Authors' Computation (2020) from WDI, 2018.

Figure 2 shows the GDP per capita growth which measures the standard of living in South Asian countries from 1990 to 2017. It could be pinpointed from the figure above that Iran had the best living standard in 1990 and 1991, followed by Sri Lanka and Pakistan respectively. In 1993 Sri Lanka came to the first position followed by India and Pakistan simultaneously. Meanwhile, 1994 marked the paradigm shift among the countries in this region with Indian economy becoming the best in terms of standard of living of people from that period till 2017 except few years like 1997, 200, 2003, 2011 and 2016. On average basis, India is the best growing economy in the region. It is worth of note standard of living became worse in 1994, ditto for Sri Lanka in 2001 and Iran 2012 and 2015 respectively. However, Iran economy recovered in 2016 with the best living standard in the region in that year.

3. METHODOLOGY

Secondary data from 1990 to 2017 would be used for this study. However, FDI inflows data are sourced from UNCTAD investment report of the World Bank. In the same vein, data on other macroeconomic variables such as market size, growth rate of the economy, growth per capita, per capita output and wage rate are extracted from World Bank Development Indicator.

3.1 MODEL SPECIFICATION

FDIinfl = F (MkT, GrT, GDP/CA) (1)

Log linearizing model one leads to model two as follows:

$$LnFDIinfl_{it} = \propto_i + \beta 0 LnMkT_{it} + \beta 1 GrT_{it} + \beta 2 GDP/CA_{it} + U_{it} \text{ (2)}$$

Where MkT represents the market size of the economy and the real GDP is used to proxy it and is measured in US dollars, FDIinfl is FDI inflows means foreign direct investment inflows which is measured in the millions US dollars in constant prices, GrT denotes the annual growth rate is measured in percentage. GDP/CA symbolizes annual GDP per capita growth is measured in percentage. This measures the standard of living of people and U captures error term. Moreover, i accommodates five countries selected for the panel analysis, which are Bangladesh, India, Islamic Republic of Iran, Pakistan and Sri Lanka. The remaining four countries namely Afghanistan, Maldives, Bhutan and Nepal were excluded from the analysis due to the FDI data problem associated with these countries.

t = 1990-2017.

$\propto$ is an intercept and $\beta 1, \beta 2$ and $\beta 3$ are slope parameters.

The estimation of model 2 would give the results of the variables that derive FDI inflows in the selected countries as evidenced from the panel analysis.

The apriori expectation is β_1, β_2 and $\beta_3 > 0$.

3.2. ESTIMATION TECHNIQUE

It is important for this study to make allowance for the control of variables that are unobservable or immeasurable. As a result of this, the study utilizes a panel data analysis with the mechanism of the fixed and random effects models to address the heterogeneity effect normally associated with panel data analysis. However, the Hausman test would be used to test the validity of fixed or random effects in the study.

3.3 RESULT AND DISCUSSION

Table 1. Descriptive Statistics of Annual Data Series (1990-2017)

Descriptive Statistics	LRGDP	LFDI	GDP/CA	GRT
Mean	29.59257	15.41232	1.860714	4.200000
Median	29.56776	15.39124	2.050000	4.450000
Maximum	30.15081	18.95013	5.500000	7.700000
Minimum	29.04709	11.51293	-1.400000	1.000000
Std. Deviation	0.321983	1.891229	1.776817	1.783820
Skewness	0.031153	-0.294274	0.211076	0.203622
Kurtosis	1.764180	2.273569	2.455198	2.481602
Jargue-Bera	8.931613	5.098864	2.770960	2.535082
Probability	0.011495	0.078126	0.250204	0.281523
Sum	4142.960	2157.725	260.5000	588.0000
Sum. Sq.	14.41054	497.1680	438.8339	442.3000

Deviation				
Observation	140	140	140	140

Source: Authors` Computation (2020)

The table above shows descriptive statistics of dataset employed for the analysis. The number of observations for each of the data is 140, which implies that the data set is a balanced panel data analysis. The mean and median values of the variables are very close. This shows that the data series are normally distributed. Real GDP has the highest maximum and minimum values of 30.15081 and 29.04709 respectively. The normal distribution of the data series could also be established by the values of Kurtosis which is not far from 3.

Table 2. *Correlation between variables*

Variables	LRGDP	GRT	GDP/CA
LRGDP	1.00000	0.056570	0.195288
GRT	0.056570	1.00000	0.987485
GDP/CA	0.195288	0.987485	1.000000

Source: Authors` Computation (2020)

GDP/Ca has a very strong positive correlation with growth rate but weak with real GDP. However, the presence of high correlation among the regressors will bring about the multicollinearity problem in the model estimation. Yet the variables can still be used for the analysis because the mechanism of panel data estimation takes care of the potential collinearity problems in the model.

Table 3. *Hausman Test*

Test summary	Chi sq. statistic	Chi-sq. d.f.	Probability
Cross-section random	11.3406	3	0.0000

Source: Authors` Computation (2020)

From the results shown in the table above, it could be pinpointed that the fixed effects model is more appropriate for the analysis of the data set because the probability value of the test is 0.00. As a result of this, the study prefers the fixed effects model because the probability value for Hausman, test is 0.00 which is less than 0.05. Therefore, we can reject the null hypothesis and accept alternative that fixed effect model is more appropriate.

Table 4. *Determinants of FDI Inflows Using Fixed Effects and Random Effects Models*

Dependent variable: LFDI			
Variables	FE Estimation	RE Estimation	Pooled Estimation
LGDP	3.539*** (6.1)	3.539** (3.5)	1.000*** (8.3)

GRT	-1.874** (2.8)	-1.874* (1.7)	-9.280*** (11.4)
GDP/CA	1.822** (2.7)	1.822* (1.6)	9.310*** (11.5)
Hausman test (prob> chi^2)			

a. The asterix *** indicates 1% level of significance ** indicates 5% level of significance * indicates 10% level of significance

b. *Figures in the parenthesis represent t- value*

c. *A constant term is included but not reported*

Source: Authors` Computation (2020)

In table 3, the panel data analysis of Fixed effects method and Random effects method for the selected countries is presented. It is worth of note that both techniques show similar result. However, the difference between the models emanated in their t- values and p-values which indicate the significance or otherwise of the parameter coefficients of the models. Meanwhile, the robustness of parameter coefficients would be used in explaining the relationship between FDI inflows and the selected regressors. The estimated results of the pooled regression, Fixed effects and Random effects parameter coefficients are similar in terms of sign and significance levels. However, The Fixed effects model is accepted in this study based on the analysis of Hausman specification test (1978). It is paramount to present the estimated results of both Fixed effects and Random effects models in the table above. But the results of Fixed effects are discussed thereof.

Consequently, the coefficient of LRGDP has a significant positive relationship with FDI inflows in the selected countries. The coefficient 3.539 shows that a unit change in RGDP would bring about more than proportionate increase in FDI inflows by 1.9325, though statistically significant at 1 percent level of significance. This means that market size is a significant variable that propels FDI inflows in the selected countries in the South Asia. In other words, FDI inflows in South Asian countries is market seeking. This study is confirmed by the submissions of Arfan (2018), Aderemi et al (2018:1), Azam (2010), Sahoo (2006), Atique et al, (2004) and Chakrabarti (2001) in related studies despite the adoption of different methodology. Similarly, FDI inflows and GDP per capita have a significant direct relationship. A unit change in GDP/CA causes an increment in FDI inflows by 1.822. This implies that FDI inflows in this region of the world is sensitive to the living standard of the people. However, the growth rate has a significant negative relationship with FDI inflow in the region. This contracts the expected result. This means that FDI inflows is not propelled by the growth rate of the economies of South Asia.

4. CONCLUSION AND RECOMMENDATION

In this paper, we have examined the potential variables such as market size, growth rate and GDP per capita that could derive inflows of FDI in South Asian countries during the period of 1990 to 2017 with the adoption of various panel data

techniques estimation. Consequently, the findings that originated from this work established the following among others that the market size and GDP per capita are the significant variables that determine the inflows of FDI in South economies. However, growth rate of these economies are identified as a factor that could discourage the inflows of cross border investment in this region. Furthermore, as result of these important findings, this paper makes the following recommendations for the policy makers, investors, financial institutions regulators and future researchers. Firstly, the policy makers in South Asian countries should embark on further policy measures that will expand the market size and GDP per capita in this region. This will facilitate further attraction of FDI inflows into this region. Also, special attention should be paid to the rate at which the economies are growing in these regions. Policy makers in South Asia should implement policies that will boost competitive growth rate in individual country. This will cause an improvement in the rate at which the economies of the region are growing. This study can also serve as a viable platform for other researcher to build upon in the nearest future.

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