

Literature review on foreign direct investment



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The theory of the determinants of private investment, irrespective of whether it originates domestically or from abroad, is relevant for an understanding of what drives FDI. This has become increasingly true with the globalisation of world markets, although there remain additional factors which may inhibit or encourage FDI that would not affect domestic investment.

Much of the research on the determinants of investment is based on the neoclassical theory of optimal capital accumulation pioneered by Jorgenson (1963, 1971). In this framework, a firm's desired capital stock is determined by factor prices and technology, assuming profit maximisation, perfect competition and neoclassical production functions. This theory was a deliberate alternative to views expressed initially by Keynes (1936) and Kalecki (1937), that fixed capital investment

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depends on firms' expectations of demand relative to existing capacity and on their ability to generate investment funds (Fazzari and Athey, 1987: 481; Fazzari and Mott, 1986: 171). Several studies have challenged the neoclassical assumption that any desired investment project can be

financed². Asymmetric information³ about the quality of a loan could lead to credit rationing, implying that not all borrowers seeking loans at the prevailing cost of capital may be able to obtain financing (e. g, Greenwald, Stiglitz and Weiss, 1984). Consequently, firms tend to rely on internal sources of funds to finance investment, and to prefer debt to equity if external financing is required⁴. A further theoretical development was the introduction of irreversibility and uncertainty in explaining investment behaviour. This literature demonstrates that the ability to delay an irreversible investment expenditure can profoundly affect the decision to invest (Dixit, 1989; Pindyck, 1991: 1110). Firms have an incentive to postpone irreversible investment while they wait for new information which makes the future less uncertain (Bernanke, 1983; Cukierman, 1980).

The development literature has long been concerned with investment, because of its importance for the rate of growth of per capita output in the economy (Dornbusch and Reynoso, 1989: 204; Fei and Ranis, 1963: 283; IMF, 1988). Although empirical models of the determinants of investment in developing countries are in broad agreement with results obtained for industrialised countries, there are additional factors which have been found to constrain capital accumulation.

Most of these are related to the problem of uncertainty and/or risk, which acts as a disincentive to private investment, because of the irreversible nature of most investment expenditures (Pindyck, 1991).

Inflation reduces private investment by increasing risk, reducing average lending maturities, distorting the informational content of relative prices, and

indicating macroeconomic instability (Dornbusch and Reynoso, 1989: 206-208; Oshikoya, 1994: 585, 590). Empirical studies show that the variability of inflation has a stronger negative effect on private investment than does the level (Serven and Solimano, 1993: 137).

Large external debt burdens also have a strong disincentive effect on private investment, especially short-term debt (Faruquee, 1992: 52). Debt-service payments reduce the domestic resources available for investment, and poor international creditworthiness reduces access to foreign savings⁵. For domestic investors, the existence of a large debt overhang reduces the future returns to investment because a high proportion of the forthcoming returns must be used to repay existing debt (Borensztein, 1990: 315). A debt overhang is also a major source of uncertainty: the size of future transfers to creditors is uncertain; macroeconomic policy is uncertain; and the exchange rate is uncertain. The combined risks of changes in relative prices, taxation and aggregate demand reduces investment by both domestic and foreign entrepreneurs. Whatever the cause, the irreversibility of real capital expenditures can result in underinvestment if the future is uncertain, even when current conditions are right (Tornell, 1990). During macroeconomic adjustment, the credibility of policy changes is an added problem (Rodrik, 1989), and the possibility of policy reversal can have serious consequences for real private capital expenditures. Investors prefer to hold financial capital, which is easier to realise if conditions turn out to be adverse, and which retains the option to purchase real capital if optimism continues. For this reason, there are frequently long lags in the investment response to adjustment (Serven and Solimano, 1993: 131, 137).

Several studies report the effects of changes in the real exchange rate⁶ and the terms of trade⁷ on investment. These studies generally find that the variability of the real exchange rate is usually

Some researchers support the notion that FDI contributes to the productivity and growth of local enterprises. Blomstrom and Sjöholm (1998) are of the opinion that the productivity and growth of local enterprises could be achieved through spill over effects/externalities from FDI.

This is achieved as the Multinational Enterprises (MNE's) either introduce superior technology or through the marketing activities of MNE's that affect the market equilibrium - forcing local operators to act in such way that they can retain their original market shares. Graham and Krugman (1995) indicates that competitive enterprises (MNE's) contribute to productivity and growth of the host nation by infusing technology, labour skills, management methods, and training into the host economy.

Empirical research shows that FDI affects the economy of a host country in a variety of ways. Firstly, it provides the required capital and state-of-the-art technology that enhances economic growth in the host country (Caves, 1996; Dunning, 1993; Blomstrom and Sjöholm, 1998; Smarzynska, 2002; Akinkugbe, 2005).

Secondly, it augments the skills of the host nations and thus stimulates growth through the infusion of managerial, labour skills and training (de Mello, 1999). Thirdly it promotes the technological upgrading, regarding start-up, marketing, and licensing arrangements (de Mello and Sinclair, 1995; Markusen and Venables, 1999). FDI is thus seen as a catalyst to the

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host nation's economic growth and development as it enhances technological process and promotes industrial development (Asheghian, 2004).

In addition, FDI can be expected to encourage economic growth of the host nation, given the prevailing view that MNE's can complement the local industry and stimulate growth and welfare in the host nations (Grossman and Helpman, 1991; Barro and Sala-i-Martin, 1995).

The major determinant's of the host country's economic development and growth is the economic environment portrayed by it's rate of economic growth , trade policy, political stability, legislation , domestic market size and balance of payments constraints (Caves, 1996; de Mello, 1999; Dunning, 1993)- the political economy of the nation . These factors may inevitably influence the decision of foreign investors (MNEs) on the possible choice of a viable investment location (Akinkugbe, 2005).

Dunning's (1981, 1988) ' electric theory' provides a flexible and popular framework where it is argued that Foreign Direct Investment (FDI) is determined by three sets of advantages which direct investment should have over the other institutional mechanisms available for a firm in satisfying the needs of its customers at home and abroad. The first of the advantages is the ownership specific one which includes the advantage that the firm has over its rivals in terms of its brand name, patent or knowledge of technology and marketing. This allows firms to compete with the other firms in the markets it serves regardless of the disadvantages of being foreign. The second is the internationalisation advantage, that is why a ' bundled' FDI

approach is preferred to ' unbundled' product licensing, capital lending or technical assistance (Wheeler and Mody, 1992).

The location-specific advantages relate to the importance for the firm to operate and invest in the host country and are those advantages that make the chosen foreign country a more attractive site for FDI than the others. For instance firms may invest in production facilities in foreign markets because transportation costs are too high to serve these markets through exports. This could either be directly related to the actual nature of the good, either being a high bulk item or a service that needs to be provided on site, or due to policy factors such as tariff rates, import restrictions, or issues of market access that makes physical investment advantageous over serving the market through exports. Location advantage also embodies other characteristic (economic, institutional and political) such as large domestic markets, availability of natural resources, an educated labor force, low labor cost, good institutions (the clarity of country's law, efficiency of bureaucracy and the absence of corruption), political stability, corporate and other tax rates among others.

Bende-Nabende and Slater (1998) investigate both the short-run and long-run locational determinants of FDI under the broad categories of cost-related, investment environment improving and other macroeconomic factors. The short-run dynamics indicate that European investment in the Thai manufacturing sector has been more responsive to the macroeconomic factors. The long-run dynamics on the other hand suggest that European investment has been more responsive to the investment environment

improving factors. In particular, there is evidence to suggest that the Thai manufacturing sector is losing its cost-related comparative advantage.

Dar, Presley and Malik (2004) studied the causality and long-term relationship between Foreign Direct Investment (FDI), economic growth and other socio-political determinants. Although a considerable literature gives the evidence of relationship between FDI and economic growth. Their paper considers economic growth, exchange rate and level of interest rates, unemployment, and political stability as determinants of the level of FDI inflows for Pakistan over the period 1970-2002. Almost all variables are found to have the theoretically expected signs with two-way causality relationship. The present study also estimates an error correction model by ordinary least squares, based on cointegrating VAR (2).

Nunnenen (2002) argues that there is a startling gap between, allegedly, globalization-induced changes in international competition for foreign direct investment (FDI) and recent empirical evidence on the relative importance of determinants of FDI in developing countries. He shows that surprisingly little has changed since the late 1980s. Traditional market-related determinants are still dominant factors. Among non-traditional FDI determinants, only the availability of local skills has clearly gained importance. As concerns the interface between trade policy and FDI, he finds that the tariff jumping motive for FDI had lost much of its relevance well before globalization became a hotly debated issue.

Artige and Nicolini (2005) analyse the determinants of FDI (foreign direct investment) inflows for a group of European regions. The originality of their

approach lies in the use of disaggregated regional data. First, they develop a qualitative description of their database and discuss the importance of the macroeconomic determinants in attracting FDI. Then, they provide an econometric exercise to identify the potential determinants of FDI. In spite of choosing regions presenting economic similarities, they show that regional FDI inflows rely on a combination of factors that differs from one region to another.

Bénassy-Quéré, Coupet and Mayer (2007) re-examine the role of institutions in the host and in the source country by estimating a gravity equation for bilateral FDI stocks that includes governance indicators for the two countries. Second, they tackle multicollinearity and endogeneity bias by implementing a three-stage procedure for instrumentation and orthogonalisation. Third, they look further into the detail of institutions by using a new database constructed by the French Ministry of Finance network in 52 foreign countries. This database is used to point out in some detail the relevant institutional features. Its country coverage, which focuses on developing countries, is very helpful for studying the impact of the institutional environment of the host country. It does not allow, however, going deeply into the impact of the institutional environment in the source country as well as into the impact of institutional distance. Hence they complement our analysis with estimations based on the Fraser database, which provides fewer details on institutions, albeit on a more balanced country coverage between industrial and developing countries. Finally, they study the impact of institutional distance on bilateral FDI.

Onyeiwu and Shrestha (2004) argues that despite economic and institutional reform in Africa during the past decade, the flow of Foreign Direct Investment (FDI) to the region continues to be disappointing and uneven. In their study they use the fixed and random effects models to explore whether the stylized determinants of FDI affect FDI flows to Africa in conventional ways. Based on a panel dataset for 29 African countries over the period 1975 to 1999, their paper identifies the following factors as significant for FDI flows to Africa: economic growth, inflation, openness of the economy, international reserves, and natural resource availability. Contrary to conventional wisdom, political rights and infrastructures were found to be unimportant for FDI flows to Africa. The significance of a variable for FDI flows to Africa was found to be dependent on whether country- and time-specific effects are fixed or stochastic.

Nakamura and Oyama (1998) studied the macroeconomic determinants of FDI from Japan and the United States into East Asian countries, and the linkage between FDI and trade, and other macroeconomic variables. Their analysis focuses on the structural differences among East Asian countries and classifies them based on statistical tests of fixed effects models using panel data. This examination helps to clarify how Japanese and American multinational firms position their production bases in East Asian countries within their world marketing strategies. In order to avoid the problem of simultaneity among variables, they examine simultaneous equation models to confirm the validity of panel regression results. In their study they find that East Asian countries can be classified into four groups depending on FDI from Japan and other elasticities to macroeconomic variables, and this

grouping almost coincides with their economic development stages.

Moreover, they confirm that FDI from Japan into all the groups are strongly affected by changes in real bilateral exchange rates, but this is not always the case for FDI from the United States. Among different country groups, FDI into group 1 (Taiwan and Korea) responds positively to the Japanese capacity utilization, indicating their industries' integration with the Japanese economy. Group 3 (Indonesia and the Philippines) shows that Japanese FDI is buoyed up by the yen's appreciation against the U. S. dollar. FDI into group 4 (China and Malaysia) and, to a lesser extent, group 2 (Singapore and Thailand) is oriented more toward capturing local markets compared to the other groups. They also find that Japanese FDI has strong trade expansion effects, which is rarely seen for U. S. FDI.

With regards to research on the determinants of FDI to Africa there appears to be a dearth of literature. A Search on the Econlit database using ' Foreign Direct Investment' and ' Africa' as keywords yielded the other two referred journal articles on the Determinants of FDI to Africa. One of the papers, Schoeman et al (2000), analyses how government policy (mainly deficits and taxes) affects FDI. However, their analysis focuses on one country, South Africa. The Second paper , Asiedu (2002) examines whether the factors that drive FDI in developing countries have a different impact on for countries in Sub Sahara Africa (SSA). However, the analysis focuses only on three variables --- the return on investment, infrastructure availability and openness to trade, and does not take into account the natural resource availability , which is an important determinant of FDI to Africa. Another paper that focuses exclusively on Africa is Morisset (2000). Unlike Asiedu

(2002), Morisset (2000) controls for natural resource availability , measured by the sum of primary and secondary sectors , minus manufacturing.

However, this measure of natural resources is too broad and does not accurately capture the availability of minerals and oil, the most important types of natural resources relevant for FDI to SSA. In addition none of the studies examine the impact of some of the important variables that feature predominantly in investor surveys, such as corruption and regulatory framework in the host country.

This research extends the limited to empirical literature on the determinants of FDI to Africa by examining the extent to which the economic, political, institutional characteristics of a country, as well as the policy environment affect FDI flows.

Nunnekamp (2002) sought to assess whether determinants of FDI have changed with globalisation i. e whether traditional determinants are losing importance whilst non traditional ones are increasingly gaining importance. Two approaches were adopted, namely survey data from European Round Table of Industrialists (ERT 2000) and simple correlation for 28 developing countries.

Market size (proxied by host country's population and level of GDP) as a traditional determinant of FDI is said to have declined in importance over time. Other factors such as location, cost differences, qualities of infrastructure, ease of doing business and the availability of skills measured by average years of schooling have become increasingly important as non-traditional determinants of FDI (Nunnekamp 2002: 16)

The survey results were supplemented by World Bank Data on variables that are considered important FDI determinants. Results show that traditional market related determinants still dominate determinants of FDI distribution among the countries considered (Nunnekamp 2002: 24). Non traditional determinants such as cost factors, and trade openness , measured by ratio of exports plus imports to GDP, have typically not become more important with globalisation. Of importance is the availability of skills which is proxied by average years of schooling, which has become a relevant pull factor of FDI in the process of globalisation (Nunnekamp 2002: 35).

An analysis of a developing country by (Tsai 1991) focused on Taiwan by providing demand size determinants of FDI using time series data. Tsai (1991: 279) employed OLS method using equations in logarithm form. Two equations were specified, i. e first on the demand size determinants and the second using variables as ratio of GDP to eliminate possible side of influences. A dummy variable was used to assess the impact of government incentive polices on FDI in different periods.

Tsai (1991: 276) suggests that for Taiwan only labour cost, market size and government incentive policies are important demand size determinants. Although FDI is seen to exploit cheap labour in developing countries, the case of Taiwan seems to show that growth in FDI with rising labour costs indicates the cheap labour may not be as important as expected.

No clear evidence was found to support the expectation that government incentive policies were effective in attracting FDI to Taiwan. An interesting finding in Tsai (1991: 279) is that Taiwan's relatively outstanding economic

performance as reflected in the expanding domestic market and ever increasing per capita GDP during 1965-1985 was not particularly attractive to foreign investors. As Tsai argues, this could be attributed to FDI being used supply side determined rather than demand side or perhaps non-economic factors outweigh the investment incentives.

It is generally believed that factors determine FDI inflow in developing countries could have a different impact on SSA countries in particular . This is because developing countries outside Africa seem to attract huge FDI inflow while SSA attracts low levels of FDI as discussed by Asiedu (2002).

Another study in Africa by Obwona (2001) investigated the FDI-growth linkage for Uganda. Obwona used the investor surveys approach and econometric tests. Using investor surveys, both local and foreign investors were directly questioned regarding their decisions and decision making processes when investing in Uganda (Obwona 2001: 55). The focus was on productive investment, as such purely commercial and consulting activities were excluded. For econometric tests , time series data was used for the period 1975-1991 to estimate the determinants of FDI and growth.

Findings from the survey showed that increased foreign investment was a result of a conducive investment environment provided by government though it's policies and institutions (Obwona 2001: 56). The author concludes that from the investors surveyed, foreign investors are primarily concerned with fundamental factors, i. e a stable macroeconomic and political situation and credible policy reforms.

For Uganda , Obwona considered pull factors such as growth factors , liberalised exchange rate, low inflation and fiscal discipline. The major determinants are availability and cost of natural and human resources, adequacy of infrastructure , market size, trade policies, macro stability, economic growth and political stability (Obwona 2001: 62). The importance of each of these variables , however depends on the type of investment and motivations or strategy of investors. Obwona (2001: 62) agrees with other researchers, such as Nunnekamp (2002) that given the shifts in the type of investment, the availability of low cost unskilled labour in location decisions has declined over time. This has meant more emphasis on skilled labour or the trainability of workers.

Furthermore, two notable studies by Moolman et al (2006) and Fedderke and Romm (2004) have focused on determinants of Inward FDI to South Africa.

Moolman et al (2006) sought to examine the macroeconomic link between FDI in South Africa and its resultant impact on output for the period 1970-2003. In so doing, they initially identified supply side determinants of FDI before analysing their impact on output. Their research method follows the supply side macro econometric framework, which does not take into account the demand side determinants that are equally important as well. On Model specification , five variables were explored as explanatory variables for FDI in the empirical estimation, namely, market size measured by real GDP, exchange rate proxied by the rand-dollar exchange rate , infrastructure, openness and a dummy variable for sanctions.

The empirical results of Moolman et al (2006: 3) indicate that market size, openness, infrastructure and the nominal exchange rate are factors which South African policy makers should focus on when seeking to attract FDI. The FDI output link does not take other factors such as increased employment , improved skills and new management techniques into account (Moolman et al 2006: 29).

After thorough investigation and studies, it was found out that only market size and openness are common factor determining FDI. The role of exchange rate is an important determinant of foreign investment in most countries. Particularly for South Africa, it should be considered whether it could be an important FDI determinant. Studies from developing countries have also identified other factors that should be considered as in the case of South Africa as those of Loots (2000) and Ahmed et al (2005).