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TRACK 2: INTERNATIONAL BUSINESS AND LOCAL DEVELOPMENT

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EXPLORING ECONOMIC AND POLICY DETERMINANTS OF FDI. A PANEL DATA ANALYSIS

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Abstract

During the past decades, the world economy has witnessed a dramatic surge in foreign direct investment. There is increasing competition among economies in attracting inflows of FDI. There has been renewed research interest in trying to detect what are the economic and political conditions that make a local economy an attractive destination for FDI inflows. Hence, in this paper we investigate macroeconomic and locational variables that may influence the level of FDI in a group of countries as a whole. In this paper we explore not only economic but also policy variables in terms of trade policy and regulation, and their effects on foreign direct investment. The evidence is captured by panel data analysis, which pools together 29 countries over the period 1990-2005. Overall our research shows that the distribution of FDI across countries is strongly determined by economic fundamentals and broad policies affecting foreign owned and domestic firms alike. Strategic and endurable horizontal policies, education and training in particular, can do much for the latter. There is scope for policies that are costless in the sense of having no immediate budgetary implications, namely the reduction of remaining impediments to trade.

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Exploring economic and policy determinants of FDI. A Panel Data Analysis.

1. Introduction

During the past decades, the world economy has witnessed a dramatic surge in foreign direct investment (FDI). High rates of growth of both inflows and outflows, however, have not spread evenly across countries. Developing countries in East Asia witnessed an explosive growth in capital flows, but developed countries together still account for over 70% global FDI. There is increasing competition among economies in attracting inflows of FDI. There has been renewed research interest in trying to detect what are the economic and political conditions that make a local economy an attractive destination for FDI inflows.

There has been renewed research interest in this area particularly in trying to detect the underlying determinants of FDI. A search conducted in the database EconLit with the Terminology 'Determinants and FDI': 331 results. 223 journal articles, 40 Books/Monographs, 6 Collective Volume Articles and 56 working papers, 6 dissertations. Another search with the terms 'Foreign direct investment and determinants' collected 482 results. 279 journal articles, 79 books and monographs, 32 Collective Volume Articles, 73 working papers, 14 dissertations.

With these and other contributed, ideally, FDI literature would have already an established model and empirical testing laying out the primary determinants of FDI location. In this ideal world, one could analyse how worldwide FDI patterns would change by government intervention (taxes and tariffs), when controlling for other determinants of FDI. However, MNE and FDI behaviour is highly complicated to model. First, it is difficult to build a model that accounts for general equilibrium features that is tied back to microeconomic decision making, and, second, there are very distinct motivations for FDI: access markets; access low wages, export platform FDI, processing trade, and so (Dunning, 1993). Not surprisingly the literature focuses on partial equilibrium, examining time series data, assuming that omitted variables reflecting long-run determinants are not changing significantly over the time period of the sample, i.e. focus is on short-run factors , assuming that long-run factors are constant. Moreover, the increase in empirical research is often determined by the data available. These studies have been conducted to identify the determinants of FDI inflows but no consensus view has emerged, in a sense that there is not a set of explanatory variables that can be regarded as the 'true' determinants of FDI. Different perspectives, methodologies, sample-selection and analytical tools contribute to the lack of consensus between studies (Chakrabarti, 2001, Moosa and Cardak, 2006).

In a survey of the literature, Blonigen (2005) concludes that the literature on the determinants of MNE decisions and FDI is quite substantial, tough arguably still in its infancy. Understanding the determinants of FDI inflows and unveiling the reasons why some countries are more successful than others in attracting FDI may provide policy markets with useful guidance for future policy prescription.

Hence, in this paper we investigate macroeconomic and locational variables that may influence the level of FDI in a group of countries as a whole. Recent empirical research uses predominantly time series studies that attempt to capture the effects of various economic variables in attracting FDI inflows. Some of these studies are based on instances of FDI in the host countries or states, and therefore, the empirical results measure only the impact of various control variables on the likelihood of an FDI to happen. The large proportion of empirical studies emphasise the role of economic variables such as relative labour cost, cost of capital, and so on. The role of policy related variables received relatively less attention. In this paper we explore not only economic but also policy variables in terms of trade policy and regulation, and their effects on foreign direct investment. The use of policy data follows the suggestions and an earlier paper by Lee (2005).

The paper is organized as follows. We will first look at the locational determinants of FDI, i.e. once a firm has decided to conduct FDI, the second question is where to go. These determinants of FDI consist of both economic fundamentals and policy variables, and are investigated empirically in section 3. The evidence is captured by panel data analysis, which pools together 29 countries over the period 1990-2005. Section 4 discusses our results and contains some concluding remarks.

2. FDI determinants

There is substantial research on the determinants of FDI across countries, in developed, transition and developing economies alike (e.g. Chakrabarti, 2001, Crowley and Lee, 2003, Janicki and Wunnava, 2004, Baniak et al., 2005, Nonnenberg and Mendonça, 2005,.and Blonigen, 2005, Moosa and Cardak, 2006). These literature shows that the determinants consist of both economic fundamentals and policy variables. Next we focus on a selection of variables that are typically advanced in the literature as determinants for FDI inflows in a certain economy. The variables reviewed are related to market growth and size, labour costs, labour productivity, exchange rates, to trade openness and regulation. These variables are then empirically tested on FDI inflows of twenty nine countries over the period 1990-2005.

Market size and growth prospects. Existing and future expected host market size is one of the strongest and most unambiguous drivers of FDI inflows, especially for horizontal FDI. Foreign investors are attracted by large markets in order to exploit economies of scale and revenue opportunities. A growing aggregate demand, despite its relative size, calls for new investments, and, consequently, also stimulates FDI. The impact of host market size and growth rate as locational determinants for FDI among industrialized countries has been empirically tested among others by Culem (1988). He found both, host market size measured by GDP per capita and GDP growth rate a significant locational determinant of inward foreign investments among industrialized countries. Lee (2005) finds market size statistically significant for explaining FDI inflows into 153 countries over the period 1995-2001. Yet, Lee (2005) found a negative correlation between FDI and economic growth, while Giullietti et al. (2004) found that growth was not statistically significant for explaining FDI in the UK food sector for the period 1982-1991. Lee (2005) stress that the estimate depends on other attainments in the host country.

Other things being equal, firms are expected to prefer lower *labour costs* locations. The relatively low unit labour cost is widely perceived as the main rationale for multinational firms to relocate production to less developed economies. The study of Janicki and Wunnava (2004) demonstrates this for the case of Eastern European countries. Culem (1988) also showed that FDI is attracted to locations of lower wages. However, in the Lee's (2005) study the wage rate was not qualitatively meaningful as explanatory variable for FDI inflows in 153 countries over the period 1995-2001. The relative unit labour cost was neither statistically significant in Giulietti at al.'s (2004) study on FDI in the UK food sector for the period 1982-1991.

Other features of the labor market may also be important in influencing inflows of foreign investment. A lower unit labour cost is attractive insofar as it is not compensated by a lesser productivity. However, very few studies include labor productivity among the factors that attract inward FDI, since they mostly depend on aggregate data that usually hides important productivity variations either across industries or across locations. Productivity is related to Physical, financial and technological infrastructure, Natural and human resource endowments. In the literature on FDI, productivity is more often analysed as a consequence of than as a determinant of FDI.

A number of articles explore the effect of *FDI* on *productivity,* demonstrating that the effects depends on local absorptive capacity (Girma, 2005) or, as Cantwell and Narula (2001) that the nature of the externalities associated with FDI depend upon the foreign firm's motivation for undertaking it. Friedman et al. (1992) found that higher labor productivity attracts Japanese FDI inflows in the United States but not necessarily European FDI inflows, while Hatzius (2000) showed that high labor productivity increases FDI inflows in Germany and the UK. In Axarloglou

(2005) study on What Attracts Foreign Direct Investment Inflows in The United States. Real wages and unit labor cost appear to depress the share of inward FDI flows allocated to a specific state, while higher labor productivity boosts this share. Giulietti et al. (2004) found lagged (-1) productivity a significant variable in explaing FDI in UK food sector.

Changes in *exchange rate* may also influence FDI as discussed by Blonigen (2005). Clearly if purchasing power parity held, there would be not relationship between exchange rate and FDI; exchange rate would reflect relative inflation. However, deviations from purchasing power parity breaks the link, so exchange rate fluctuations may influence investment decisions. Following Froot and Stein (1991), a fall in the value of host country's currency will raise the value of investor's wealth allowing foreign investors to raise their bids for host country firms.

Giulietti et al. (2004) study on the FDI investment in the UK food sector and Lee (2005) found that the exchange rate was not statistically significant as determinant for FDI. Cushman's firm-level model of international investment shows that if firms are heterogeneous in their financing options and trade linkages, then examination of aggregate data may very well show ambiguous results that hide these very real firm-level effects (Cushman, 1985). The topic of exchange rate effects on FDI is a rich area for future work. Hence, as Cushman (1985) argues, the direction of the linkage is indeterminate as the effect of the exchange rate and its expected movements varies considerably across models.

One country's policy in terms of trade is fairly accepted as linked to FDI. Tariff and other trade barriers can be such that exports are not competitive with respect to domestic goods in a foreign market and FDI must be undertaken to gain access to it. This event is commonly termed tariff-jumping FDI. Yet, in spite of the general agreement on the subject, it is not relatively tested in the literature, probably due to data-driven (Blonigen. 2005). In his review of the literature, Blonigen (2005) concludes that the studies on tariff-jumping have been mixed, probably because trade protection may explicitly target import sources where FDI is less likely.

The institutional, regulatory, and policy framework and policy coherence when applied well, reduces uncertainty and the risks of doing business in an economy. Bureaucracy and restrictive administrative practices, are found to incur additional transaction costs that impede FDI inflows. Proper investment protection such as transparent and consistently enforced dispute settlement procedures is a sort of minimum requirement for FDI. While these hypotheses are readily accepted Blonigen (2005), more difficult is to estimate and prove the magnitude of the relationship. It is difficult to find appropriate measures for institutions and for regulations.

It is difficult to evaluate the effectiveness of government policies toward foreign investment activity. Lee (2005) overcomes this difficulty employing an index compiled by the Heritage

Foundation that reflects a country's general regulatory environment and treatment of foreign business. He uses a panel regression model, with a cross-section of 153 countries over the period 1995-2001. His results support the proposition that restrictive government policies are crucial impediments to FDI inflows.

Above we have briefly surveyed a number of variables commonly advanced in the literature as determinants for FDI. It is cleat that no consensus view has emerged, in a sense that there is not a set of explanatory variables that can be regarded as the 'true' determinants of FDI. In the next section we contribute to literature by testing a number of economic and policy variables through an unbalanced panel data.

3. ECONOMETRIC ANALYSIS

3.1 Data description and methodology

The sample comprises eight indicators over the period 1990 to 2005. Data was collected for 29 countries. However, this panel data study uses an unbalanced dataset because not all countries have observations to all years, and for the two policy variables we have data just for 1990, 1995 and 2000-2005. Hence, the evidence is captured by an unbalanced panel data of 29 countries, as listed in Appendix A.

Table 1. List of Variables

FDI_{it}	Foreign direct investments inflows of country i in time t.
$GDPg_{it}$	Gross Domestic Product growth rate of country I in time t.
$GDPc_{it}$	GDP per capita valued at constant prices (2000=100) of country i in time t.
ULC_{it} :	Unit labour costs valued at constant prices (2000=100) of country i in time t.
$PROD_{it}$	Labour productivity per person engaged valued at constant prices (2000=100) of country i in time t.
lag $PROD_{it}$ (-1)	Labour productivity per person engaged valued at constant prices (2000=100) of country i in time t.
RER_{it}	Real exchange rate valued at constant prices (2000=100) of country i in time t.
$FREE_{it}$	Freedom to trade internationally index of country i in time t.
REG_{it}	Regulation index of country i in time t.

The dependent variable is foreign direct investments inflows. The conditioning variables include a number of economic variables widely considered in the literature as potential determinants for FDI, such dross domestic product growth rate, GDP per capita, unit labour costs, labour productivity, real exchange rate, and other policy variables less explored in the literature, i.e. index of Freedom to trade and a regulation index.

FDI inflows were obtained from various issues of Economic Outlook published by the Organization for Economic Cooperation and Development (OECD). In the econometric analysis FDI inflows are valued in real terms, i.e. at constant prices (2000=100) and expressed in natural logarithms.

The GDP data come from the World Bank (World Development Indicators). The Labour productivity data were obtained from Labour Productivity per Person Engaged from the Groningen Growth and Development Center. Real exchange rate measured as the nominal exchange rate against the dollar were obtained from International Financial Statistics (IMF). The Unit Labour Costs is a index measuring the change in the total amount of wage and salary payments per unit of output (OECD). The data were converted into indexes (2000=100). Freedom to Trade and Regulation correspond at two categories of the Economic Freedom of the World (EFW) index constructed by Gwartney and Lawson (2005) and retrieved from the economic freedom of the world database of the Fraser Institute, freedom to trade internationally and regulation of credit labour and business. The use of compositive indexes is also subject to criticisms (see Blonigen, 2005). For example, it can be argued that institutions are quite persistent over time, so there is little variation over time within a country.

The index related to freedom to trade and regulation index are obtained from the Economic Freedom of the World Index[2]. One of the most valuable aspects of this index is that, for many countries, it can be calculated back to 1970 for 53 countries, and for over 113 countries since 1995. Appendix B indicates the structure of the EFW index, and its five main areas:

1. Size of government
2. Legal structure and security of property rights
3. Access to sound money
4. Freedom to trade internationally
5. Regulation of credit, labour and business

In our paper we focused on the components four and five that capture a government's trade

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[2] Complete methodological details are found in Appendix 1 of the Economic Freedom of the World: 2006 Annual Report. It is arguably the best measure of economic freedom available and it provides a reliable measure of cross-country differences in economic freedom.

policy and regulation for credit, labour and business activities.

Table 2: shows the summary statistics for all sample countries (1990-2005)

Table 2: Summary Statistics for all sample countries (1990-2005)

Variable	Observations	Mean	Std.Deviation	Min	Max
FDI inflows	457	45.60	68.05	-158	873
GDP growth	455	2.83	2.64	-12	11
GDP pc	464	93.28	11.72	53	124
Productivity	420	70.36	36.65	1	118
Real exchange. Rate	389	59.43	49.33	0	272
Unit labour costs	452	74.99	45.53	1	219
Freedom to trade	202	7.73	0.97	0	10
Regulation	195	6.45	1.04	3	9

As preliminary analysis Table 3 displays the correlation among the variables.

Table 3 Table of correlation among the variables

	FDIIN	GDPg	GDPc	PROD	RER	ULC	FREE	REG
FDIIN	1							
GDPg	0.0068	1						
GDPc	0.0141	0.1557**	1					
PROD	0.3216*	0.3903*	-0.1716*	1				
RER	0.2638*	0.2087	-0.1011	0.2989	1			
ULC	0.1210	0.1477**	0.0115	0.2108*	0.3304*	1		
FREE	-0.0984	0.1515**	0.0365	0.0327	-0.0014	0.1110	1	
REG	-0.0356	0.1670*	0.0414	-0.0470	0.2005*	0.1590*	0.2580*	1

Note: *, ** 5% and 10% significance level, respectively

The dependent variable is correlated to productivity and real exchange rate. There is correlation between GDP growth and all the other explanatory variables.

The standard model of FDI is the starting point of this analysis. It is specified in equation (1) which estimates the determinants of FDI inflows for a set of countries over time. It takes the

following form:

$$FDI_{it} = \alpha + \beta_0 GDPg_{it} + \beta_1 GDPc_{it} + \beta_2 PROD_{it} + \beta_3 RER_{it} + \beta_4 ULC_{it} + \beta_5 FREE_{it} + \beta_6 REG_{it} + \varepsilon_{it} \quad (1)$$

where ε_{it} refers to the disturbance term for the unit i (country) at time (year) t.

We do not report the OLS results as we want to estimate individual effects among the determinants of FDI. Furthermore, the OLS regression is not considering for the panel nature of the dataset. It does not consider that there are different countries across time periods. In the simple OLS case, we would assume that the disturbances are not correlated through time and units, and conditioned to the explanatory variables which are identically distributed with a zero mean. It is not our intention to estimate a pooled regression model which could be consistently and efficiently estimated through Ordinary Least Squares.

Following the panel data literature, it is necessary to determine the individual effects. In order to take into account the country-specific and time-varying effects, a choice has to be made between two alternative regressions. The econometric literature has offered two estimators to handle with variations across and time simultaneously. The fixed effects estimator, which handles both time and individual effects. The second estimator is the random effects. There are advantages and disadvantages of using each of the alternative estimators. The Hausman's specification sheds light on the relative reliability of the alternative estimators. Under the null hypothesis, there is no correlation between the error terms and the explanatory variables, implying that the random effects estimators is applicable. If we reject the null hypothesis, the estimator is inconsistent. If we obtain insignificant a P-value, that is to say, if Prob>chi2 larger than 0.05, then we do not reject the null hypothesis and we are safe to use random effects. If we get a significant P-value, however, we use fixed effects. The fixed effects estimator is consistent under both the null and the alternative.

Subsequent investigation is therefore concerned with choosing the correct specification. Therefore, the following equation is estimated:

$$FDI_{it} = \alpha + \beta_0 GDPg_{it} + \beta_1 GDPc_{it} + \beta_2 PROD_{it} + \beta_3 RER_{it} + \beta_4 ULC_{it} + \beta_5 FREE_{it} + \beta_6 REG_{it} + \varepsilon_{it} \quad (2)$$

where ε_{it} refers to the disturbance term for the unit i (country) at time (year) t. It is defined as $\varepsilon_{it} = \alpha_i + \eta_{it}$, with the η_{it} zero mean, constant variance uncorrelated across time and units, and

the α_{it} , being the unknown individual effects to be estimated for each unit *i*.

First we run a fixed effects regression, then a random effects regression and after that we test for which model to use. We performed the Hausman's specification tests to shed light on the relative reliability of the alternative estimators. The Hausman test statistic, which tests the hypothesis that the (random) effects are uncorrelated with the explanatory variables. It assumes as true the null hypothesis of a random effects model against the alternative of a fixed effects model. We reject the random effects model if the p-value of the Hausman test is lower than 10% which is evidence to choose the fixed effects model. All the Haussman's specification tests choose the fixed effects models over the random ones. The fixed effects give consistent results. Thus, here we present the results from the fixed effects estimator.

To investigate the determinants of FDI, four econometric models were tested. The estimation results are grouped in table 4.

3.2 Estimation results

Table 4 displays the panel regression results for four alternative specifications defined by the inclusion of different explanatory variables. The first specification (1) includes all the explanatory variables except the policy indexes; the second specification (2) includes the same variables as model, but productivity is replaced by lagged (-1) productivity; specification (3) includes all the explanatory variables of model 2 and includes one policy variable; specification 4 includes all variables, with lagged (-1) productivity.

The models report a low overall $R^{2.}$, which is common in these type of studies. As noted by Hatzuis (2000), these type of studies often report low 'goodness-pf-fit' statistics due to the fact that a large part of the FDI being presumably due to firm-specific factors and inter-sectoral variation in FDI which are hard to capture in an aggregate equation. Recall here in support of these arguments that Giulietti et al. (2004) study on the FDI investment in the UK food sector confirms the importance of ownership characteristics and industry structure relative to the macroeconomic variables.

We look whether the predictors are statistically significant and, if so, the direction of the relationship between the independent variables and the dependent variable.

Table 4: Fixed-effects Models (FDI as dependent variable)

	Model 1	Model 2	Model 3	Model 4
Constant	-16.13* (2.59)	-16.42* (0.11)	-14.48* (4.70)	-14.63* (4.73)
GDP growth	0.05 (0.11)	0.04 (0.11)	0.08 (0.18)	0.05* (0.19)
GDP pc	4.14* (0.55)	4.11* (0.50)	2.98* (1.00)	2.91* (1.02)
Productivity	0.07 (0.05)			
Lag Productivity		0.14* (0.05)	0.14* (0.07)	0.14* (0.07)
Real Exchange rate	0.1* (0.05)	0.10* (0.04)	0.28* (0.08)	0.27* (0.08)
Unit labour cost	-0.01 (0.05)	-0.01 (0.05)	-0.14** (0.08)	-0.14** (0.08)
Freedom to trade			0.41** (0.22)	0.41** (0.22)
Regulation				0.09 (0.19)
$R^{2 \, overall}$	0.21	0.22	0.07	0.05

Note: *, ** 5% and 10% significance level, respectively

Regarding the market dimension, the regression results shown in the Table are consistent with Lee (2005) findings. The market size is statistically significant in all specifications. GDP pc is consistently significant in all models, confirming that the size of the markets is a significant determinant of foreign. GDPg has a positive sign but it is not significant. As for GDP growth the results are not consistent as it is significant only in model 4.

Productivity is not significant, and we have replaced this variable by productivity if the previous year. As in Giulietti et al (2004), lagged productivity appears positive and significantly correlated to FDI. Higher productivity may also be important in influencing inflows of foreign investment insofar they affect costs to employers.

Surprisingly, real exchange rate appears significant in all models and with a positive sign. Apparently, currency evaluation is positive related to FDI inflows.

As expected, for unit labour cost we found a negative and significant sign, meaning that investors prefer low labour cost foreign locations.

For the policy variables, note that when they are included, the overall R^2 falls considerably, probably due to the fact that we have many missing values for these indexes up to 1999.

Among the policy variables, the freedom to trade internationally index displays a positive sign and is significant at the level of 5%, meaning that more freedom to trade effectively increases

FDI inflows and vice-versa. Recall that in Lee (2005) openness was significant and positive related to FDI. The regulation index is not significant. Such a result seems to indicate that trade liberalization policy has a much stronger effect on FDI then the regulation policy.

3.3 Conclusion

There is a vast literature on the determinants of FDI. However, empirical evidence to ascertain the significance of factors that determine global capital flows remain controversial (Lee, 2005). In this paper we have considered typical economic determinants and two additional variables that capture policy options over which governments have some degree of control. The study is a work in progress, and the results must be understood purely as preliminary.

Overall our research shows that the distribution of FDI across countries is strongly determined by economic fundamentals and the broad policy environment affecting foreign-owned and indigenous firms alike.

We found a significant number of FDI determinants that lie largely outside the direct control of national policy, such as the size of the domestic market, labour costs and productivity. Nevertheless, strategic and endurable horizontal policies, education and training in particular, can do much for the latter.

The significance of the exchange rate variable came to us as a surprise and deserves further investigation about the meaning.

The preliminary results imply that while a country's macroeconomics are crucial factors for FDII, trade policy also plays an important role. There is scope for policies that are costless in the sense of having no immediate budgetary implications, namely the reduction if not removal of remaining impediments to trade.

Finally, the arguments that regulation and institutional design are paramount determinants for FDI are not supported by the data.

There are a number of limitations to the present results reported here. First, it is necessary to complete and collect more data to create a balanced panel for a higher number of countries. Second, the policy indexes in particular can be ameliorated. More refined data on government regulations and policies can be added using other type of variables (e.g. Goodspeed et al., 2006, Lee, 2005). The next step is to include policies specifically targeting FDI. Analysing the period 1980-2000, the OECD has estimated that border barriers and labour market arrangements account for almost half of the differences in bilateral outward FDI positions between OECD members (OECD 2003). While FDI restrictions have been reduced considerably in recent years, obstacles remain, notably

obligatory screening and approval procedures and limits on the share that foreign investors can hold in domestic enterprises and barriers to cross-border M&As and labour market arrangements. Recall that Blomström and Kokko (2003) argue that policies specifically targeting FDI can still affect the location choice of TNCs in the case when underlying economic fundamentals are similar across countries. The issue deserves further investigation.

Further considerations regarding the specification of the FDI model are necessary given the nature of the dependent variable. Past as well as present values of the explanatory variables may eventually influence FDI_{it}. To account for this attempts can be make to carry out a dynamic analysis of FDI, in addition to the static models described by equations 1 and 2, by considering the potential effect of past economic conditions on the current level of FDI. However, the scope for a dynamic analysis is limited by the unbalanced dataset and by the limited number of time observations.

Finally, after correcting for data shortcomings, we need further ascertain the robustness of our findings.

Appendix 1: List of countries

Australia
Austria
Belgium/Luxembourg
Canada
Czech Republic
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
Ireland
Italy
Japan
Korea
Mexico
Netherlands
New Zealand
Norway
Poland
Portugal
Slovak Republic
Spain
Sweden
Switzerland
Turkey
United Kingdom
United States

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