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Institutional quality, financial development and OFDI☆

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Abstract

Using a panel of 73 countries from 2000 to 2008, this study uses Investment Development Path theory as a framework that utilises institutional quality (IQ) as a threshold for the effect of economic development on OFDI. Using the dynamic threshold model, we find new evidence that the strong promoting effect is initiated when IQ is within a certain interval, which is supplementary to IDP theory. Finally, we propose the corresponding advice.

Keywords: Institutional quality; Financial development; OFDI; Dynamic threshold

Introduction

The OLI theory [6] determines that MNEs should have an ownership advantage, location advantage and internalisation advantage before OFDI and should become the theory that explains OFDI in emerging countries early in their development. The Investment Development Path theory [18] indicates that a country's FDI/OFDI depends on its level of economic development and summarises the characteristic five stages of FDI/OFDI; only if the GDP per capita reaches 3000—4000 US dollars (approximately 7000—8000 in US dollars today) will the OFDI begin to scale. However, the Investment Development Path theory is contrary to the fact that a large quantity of OFDI throughout the world comes from emerging markets, such as China and India, where the income level is low. The phenomenon may result from the promoting function of government and the financial advantage from excessive foreign exchange reserves under the condition of a domestic institutional void and the relative lag of economic development (large in gross but low on average), realising a leapfrog development path for its OFDI. In addition, some other emerging countries that have reached the required per capita income still strongly promote the OFDI, such as Brazil and Russia.

☆ Institutional quality was introduced as a dummy for policy liberalisation [5] and then extended into other detailed indicators, such as trade and foreign exchange liberalisation, privatisation reform, enterprise restructuring reforms, overall institutional reforms, and competition reforms [15]. The authors would like to thank the sponsorship from National Natural Science Funds (71473025).

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Most emerging markets experience a long term central economy and a short time market economy, so a large proportion of state-owned enterprise exists and the market mechanism is not perfect. Once OFDI is treated as a native economic strategy, the strong power and administrative methods from the government will still promote the international firms under the condition of a low level of economic development. However, in developed economies, because of the sound institutional quality (IQ), high economic development and core technology controlled in firms, the support from government declines into a secondary position. The dynamic process reminds us that a nonlinear influence of economic development on OFDI comes into being, which depends on a certain level of institutional quality in the economy, causing a first increased then decreased development path. The dynamic process is also a valid supplement to Dunning's IDP theory.

Based on this background, the paper integrates the institutional quality (including the strength of legal rights index, the overall institutional reform, the privatisation process and trade openness) into the economic development stage, extends the IDP theory effectively, and utilises a regression model based on the concept of dynamic panel threshold model (DPTM) and dynamic panel to test the nonlinear influence and leapfrog development characteristic of OFDI using country specific institutional quality as a threshold. Our fitted model allows the relationship between economic development and OFDI to be piecewise linear, with the IQ as a regime-switching trigger. Using cross-country data from 73 economies from 2000 to 2008, we find strong evidence of threshold effects in the economic-development-OFDI link. Specifically, we find that the strong promoting effect of economic development on OFDI begins only when the IQ is within a certain interval. At this time, the strong benefits of economic development exist.

The paper is structured as follows. Section 2 reviews the literature, and further development of our hypothesis is presented in Section 3. Section 4 discusses the results and performs a series of robustness tests, in which we explore alternative measures of IQ, while Section 5 provides some conclusions.

Review of the literature

The influence of institutional factors on OFDI

The OLI theory usually supposes that the MNEs should have ownership advantages before OFDI, while the IDP theory emphasises in which stage the MNEs from emerging economies may begin to invest abroad. However, for the characteristics of asset-seeking purpose and leapfrog development, the former theories appear to be lacking full explanatory power. The research in OFDI of Russia finds that we must augment the traditional OLI and IDP theory and must introduce the country specific institutional factors to the theories [11]. In addition, the theory should embed three types of explanatory variables into the MNE theories: imperfect capital markets, special ownership advantages, and institutional factors [5,17]. The research of Buckley [5] found that the liberalisation of government policy has a significant effect on Chinese OFDI, emphasising the importance of institutional factors. However, in this paper, only dummy variables are used to capture the change in institutions, so in later research, continuous, endogenous institutional variables are used to explain OFDI in emerging countries. All of the studies found important evidence that specific institutional reforms, such as the liberalisation of trade and foreign exchange, privatisation, competitive reform and overall institutional reform, will affect OFDI in emerging markets significantly. Further, the range of the study extends from emerging countries, such as China, India, and Russia, to Malaysia, Thailand, Latin America, Central Europe, East Europe and all emerging countries. The extant framework of theories also extend from traditional ideas (OLI, IDP, Natural-based view, and internationalisation theory) to LLL theory, the strategy tripod (resource, industry, and institution), imperfect capital markets, special ownership advantage and institutional factors embedded in traditional MNEs theories.

The influence of financial factors on OFDI

Froot [8] first proposed the question of low efficiency in financial markets and explored the effect of exchange rate on FDI. Later, many reports in the literature started to focus on effect of exchange rate on transnational M&A in the condition of financial inefficiency and then extended to other aspects for finance and FDI [1,12] or the financial development in country level [2]; subsequently, reports studied the influence of firm specific capital cost on FDI [7], constructed the relationship between financing and domestic OFDI on a theoretical basis [10,14], and combined country specific financial advantage and firm specific financial advantage to explore enterprises' foreign investment in the condition of financial constraints.