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Emerging economies' attraction of foreign direct investment

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ABSTRACT

This paper uses a composite measure to examine why some countries attract more foreign direct investment (FDI) than others. The measure considers all identified, measurable, and comparable socioeconomic aspects that affect FDI decisions on an aggregated country level. As a result, we can rank 127 countries with respect to their FDI attraction. The measure allows detailed strength and weakness analyses and enhances the discussion of why FDI flows are concentrated in advanced economies. Additionally, the findings reveal the areas in which emerging countries should improve in order to narrow existing gaps. Our robustness checks indicate that the composite measure accurately tracks real FDI activity.

1. Introduction

The United Nations Conference on Trade and Development (UNCTAD, 2008a) identifies that while Foreign Direct Investment (FDI) flows have risen steadily over recent decades, declines occurred in the early 1980s, 1990s, and 2000s. This trend was partly driven by increasing corporate profits worldwide and resulting higher stock prices, which raised the value of cross-border mergers and acquisitions. The Organization for Economic Co-operation and Development (OECD) claims that FDI is a key element in the quickly evolving international economic integration. In 2007, global FDI reached a new record high, with inflows of $1833 billion. According to UNCTAD (2008b), this surpasses the previous record by

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some $400 billion. OECD (2008) emphasizes that the growth in FDI flows reflect both an increase in size and the number of individual FDI transactions, which are typically a result of cross-border mergers and acquisitions or as green field investment. Although the flow to emerging countries has increased, developed countries still comprise about 75% of the world's inward FDI stocks (UNCTAD, 2008b).

FDI plays a significant role in the development of international trade, and it helps to establish direct, stable, and long-lasting links between economies. OECD (2008) discusses that FDI can serve as an important vehicle for local enterprise development, strengthening the competitiveness of both the recipient and investor.

The decision-making process of a foreign investor is complex and has been discussed in the literature at the macro and micro level. Many factors have been identified that influence FDI flows. Geographic patterns and the determinants of spatial FDI activity are complex, numerous, and site-specific. A sufficient set of parameters that drive FDI on a global scope has still not yet been detected. While there are certainly some factors that explain FDI from or towards certain countries, the same factors need not be relevant on a broad cross-sectional scale. This paper contributes to the problem of explaining inward FDI flows on a large sample of countries. We provide an indicator of country-specific FDI that reveals the strengths and weaknesses of economies and measures a host country's ability to attract FDI. This measure, henceforth referred to as the FDI Index, considers all identified, measurable, and comparable aspects that affect FDI decisions. As a result, we can rank 127 countries according to their attractiveness to foreign direct investors and contribute to the discussion of why some are more attractive to them than others. The index allows a better understanding of spatial FDI activity on a world-wide scale, which can help policymakers determine how to improve their country's attractiveness to foreign investors. We compare the strengths and weaknesses of advanced and emerging economies to identify the factors that explain why FDI flows remain concentrated in advanced economies. These factors are mainly related to the legal and political systems and to the infrastructure in the emerging countries. We conduct several robustness checks to determine the quality of the FDI Index. We benchmark the FDI Index with similar indicators (namely the FDI Inward Potential Index, the Global Competitiveness Index, and the Global Enabling Trade Index) that focus on different aspects of FDI attractiveness. The analyses prove that our composite score more accurately measures a country's ability to attract FDI than the other indicators. This is due to the inclusion of only criteria that are identified relevant in literature, to the chosen index structure and to the selection of quality data series. Finally, we confirm that no individual data series or combination thereof has a higher explanatory power for actual FDI activity and show that our index also allows classifying emerging and developed economies via a cut-off score.

Section 2 is a literature overview of the determinants for FDI decisions. Section 3 presents the data and methodology for our index and the sample countries, followed by a description of the construction technique of the composite measure. In Section 4, we discuss the results and several robustness checks. Concluding remarks are given in Section 5.

2. Literature review

The contributions on the criteria that determine FDI are exhaustive, and an ample consideration is beyond the scope of this paper.[1] Numerous papers focus on the micro level of FDI and examine how external factors affect firm-level decisions. Another body of the literature discusses the macro aspect; hence, the country-specific factors and how they affect aggregate country-level FDI. The latter strand is important for our perspective as we need to determine the criteria to assess the ability of a country to attract FDI. However, even this part of the FDI literature is extensive and we cannot completely cover it. Usually, the research on FDI is either bilateral or focuses on one country or region as the origin or recipient of capital flows. Our approach is broad: we examine 127 countries with our FDI Index and any country can be host and home of FDI. Therefore, we do not consider some of the aspects that have been deemed relevant for particular national or regional FDI activity. This is notably the case for natural resources that provide reasonable explanations for FDI in several emerging countries, but hardly qualify as drivers of investments

[1] Comprehensive literature overviews and can be found, for example, in Singh and Jun (1995), Markusen (2000), Chakrabarti (2001), Lim (2001), Chapman (2003), Bloningen (2005), Clausing and Dorobantu (2005), Moosa and Cardak (2006), and Franco et al. (2010).