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The Effects of Financial Development on Foreign Direct Investment[‡]

Rodolphe Desbordes[§] Shang-Jin Wei[¶]

Abstract

This paper empirically investigates the various effects that source and destination countries' financial development (SFD and DFD respectively) have on foreign direct investment (FDI). We establish causality by exploiting variations in both country-specific financial development and sector-specific financial vulnerability. This approach is made possible by our use of detailed databases on real manufacturing FDI projects worldwide. We find that both SFD and DFD have a large positive influence on greenfield, expansion, and mergers & acquisitions FDI, by directly increasing access to external finance and indirectly promoting manufacturing activity. The overall economic impacts of SFD and DFD tend to be similar but their direct and indirect effects vary across margins and types of FDI.

Keywords: Financial constraints; financial development; foreign direct investment; greenfield; mergers and acquisitions. JEL: F23; O16.

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