

Foreign Direct Investment in Emerging Markets

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Abstract

Foreign direct investment has been a prominent area of research since the liberalisation and privatisation wave that swept across the developing world in the last two decades. Although there is a large amount of empirical literature on the economics of FDI, there are unexplored and emerging areas due to the changing economic conditions and business cycles. The proposed research takes a positivist approach on the belief that reality can be objectively measured and is independent of the researcher, aiming to explore FDI in emerging markets through empirical experimentation by making use of quantitative techniques.

Key words: Foreign direct investment, emerging markets, multinational enterprises, South-North FDI, reverse causation, positivism.

1. Introduction

In the last two decades there has been great interest in the forces of liberalisation, privatisation and globalisation. There was an increase in international trade and international production through foreign direct and portfolio investment. The structure of the global financial system has undergone a sea change due to the integration resulting from globalisation. This has made it easier for multinational companies, governments and individuals to invest in any part of the world. A main form of international capital flow is FDI which can be defined as *“the category of international investment that reflects the objective of a resident entity in one economy (direct investor) obtaining a lasting interest in an enterprise resident in another economy (direct investment enterprise)”* (IMF, 1993). Multinational enterprises (MNEs) play an important role in the flow of FDI between countries. MNEs *“usually comprise companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways”* (OECD, 2008). Many developing countries liberalised their economies for investment in the post-1990 period which led to a surge in investment flow into them. This phenomenon has led to the rise of a group of nations known as emerging markets. Emerging markets or economies are *“those regions of the world that are experiencing rapid informationalisation under conditions of limited or partial industrialisation”* (Emerging Economy Report, 2008). These are countries that are in a transition phase from developing to developed status.

2. Purpose

During the pre-liberalisation period in developing economies, FDI and MNEs were treated with suspicion and were considered to exploit the developing and under-developed countries of its resources. However, once developing countries realised the potential for growth that comes along with FDI, there has been a change in attitude towards MNEs and FDI. “*FDI is now the most important form of external capital flow to emerging economies*” (UNCTAD, 2006). Another reason for the change in attitude towards FDI was the Asian financial crisis of the late 1990s which showed that FDI was more stable in crisis periods than other forms of capital inflows (Lall, 2002). The emergence of sovereign wealth funds as a means of direct investment (Truman, 2007) and commodity price boom (Humphreys, 2005) are recent phenomena that enhanced the inflow of FDI into emerging markets. In the current economic scenario, the sub-prime mortgage crisis that started in the United States in 2007 has had less effect on emerging markets compared to advanced economies such as the US and UK (IMF, 2008; UNCTAD, 2008). This has brought to forefront the importance of emerging markets and the role they can play as target markets for goods produced in industrialised countries, as manufacturing bases and as sourcing destinations. The general warming of attitude towards inward and outward FDI in developing and emerging economies have led to considerable debate in the fields of management, international trade and international investment, and as a result researchers, governments and policy makers are seeking a better understanding of the motives and drivers of FDI, and its impacts and implications. This underlines the need to examine the phenomenon of FDI in the context of emerging economies and provides scope for an empirical study in order to get a coherent picture of the ground realities in emerging markets.

The purpose of this research is to determine the factors that drive or attract FDI to emerging markets, to identify the extent, characteristics and motives of South-North¹ FDI flows and also to enquire whether reverse causality exists between growth and FDI in emerging markets. This study is expected to provide a better understanding of the factors that determine the inflow of FDI to emerging markets and the interrelationships between them, the nature and significance of South-North FDI flows and also prospects of growth resulting in increased FDI. The study is seen

¹ International investment literature uses the terms North and South for the developed and developing countries respectively.

as a means to enhance personal learning in the field of FDI and the outcome of the research is expected to contribute to the existing international investment literature. This study can be beneficial to governments and policymakers aiming to formulate policies to attract more investment into them. Companies can also benefit from this research while formulating investment strategies relating to different emerging markets.

3. Theoretical framework

An important prerequisite to obtain a clear understanding of the determinants and impacts of FDI is proof of the link between theory, empirical evidence and policy making. Since this research is quantitative in nature and makes use of econometric techniques, theory is expected to inform me what parameters or variables are important and how they can be measured. Theoretical finance and economics also gives a framework to establish relations between variables used in the quantitative techniques. Also, since this research is expected to have policy implications, theory can be used to defend the policy perspective and provide logical support to the same.

For the purpose of this research I propose an empirical evaluation of FDI on the basis of the presently available theoretical perspectives, mainly the eclectic/OLI paradigm (Dunning, 1977 & 1979) and the product life cycle model (Vernon, 1966). OLI paradigm encompasses the firm specific and country specific motives for FDI and the internalisation advantages. This perspective helps to evaluate the motive of an MNE in engaging in FDI and the location specific factors that attract investment and thus allows the use of macroeconomic variables in the empirical experimentation. Product life cycle model allows the evaluation of FDI from international trade and production perspective.

3.1 Eclectic paradigm

Dunning (1977, 1979) amalgamated the concepts of internalisation and trade theory to propound the eclectic paradigm, explaining reasons for the international operations of firms and the mode of entry into a foreign market. Dunning identified three types of advantages firms possess: ownership, location and internalisation (OLI) advantages. Ownership advantages are those aspects of the production process that give a competitive advantage for multinationals over its rival firms, and can be patents, advanced technology, managerial and organisational skills, or ownership of a

particular raw material. Location advantages are mainly features of the market in which a firm operates and may include favourable tax laws, lower transportation costs, lower risk, cultural similarities, protected markets and cheap labour. The public good nature of firms' ownership advantages force them to internalise which has the advantages of reduction in transaction costs and low possibility of technology imitation.

3.2 Product life cycle hypothesis

Vernon's (1966) product life cycle model seeks to bridge international trade theory and the individual firm's perspective of investment in product development. He identified different stages in the life cycle of a product, each with different implications for the internationalisation of the firm. The first stage is domestic in nature, the home country being the major market. Exports to other industrial countries support the goal of economies of scale. In the second stage, production is transferred to other countries where wages are lower and technically skilled workers are available, the production process no longer requires the highly skilled and innovative personnel involved in the original product development. Later again, in the mature stage, the production process becomes fully standardised and the market very competitive, the consequence of production technology diffusing to rival firms, manufacturing is transferred to countries with low labour costs.

The product cycle hypothesis shows that FDI is the result of fierce competition and standardisation of the product, and therefore the innovating firm decides to shift production facilities to lower cost developing markets. This model encompasses exporting and production in foreign locations in a single specification of foreign market entry.

4. Research questions

Although there is substantial amount of empirical literature on the economics of FDI in emerging markets, it is still in its infancy and most hypotheses are still up for testing (Blonigen, 2005). It is unclear why investors prefer to take advantage of the opportunities in emerging markets, in spite of the fact that many of the emerging markets are considered to be slow reformers and suffer from corruption and red-tapism.

Research question 1: What are the determinants of FDI in emerging markets?

The change in attitude towards MNEs and FDI accompanied by the liberalisation of markets in the developing world and the subsequent growth led to the emergence of southern transnationals, which are MNEs from the developing countries. Although most of the investment by these companies are concentrated in other developing countries (South-South), they have started investing heavily in the industrialised developed countries (South-North) as well, which is an unexplored area in the literature.

Research question 2: What are the characteristics and motives of South-North FDI flows?

FDI is considered to be positively correlated with economic growth. Emerging markets have experienced higher growth rates since they opened their economies to international investment (Duttaray et. al., 2008). However, there is a two way link between FDI and economic growth. On one hand, increase in FDI leads to higher growth rates in the recipient economies whereas the increased avenues for growth lead to more FDI being attracted into the emerging market. This aspect of reverse causation from growth to FDI has been ignored in the literature on emerging markets and offers prospects for research.

Research question 3: Is there any reverse causation from economic growth to FDI in emerging markets?

5. Philosophical approach

Research in finance, like most other social sciences, is methodologically diverse and researchers often make implicit but different methodological assumptions about the nature of reality, role of theory and the importance of empirical experimentation (Ryan et al, 2002). Therefore it is of utmost importance on the part of the researcher to be clear about the methodological assumptions and how they influence the research process. In spite of the fact that there has been much methodological advancement, positivism remains the dominant paradigm in research in finance. However, the nature of the phenomenon that is being researched also influences the methodological stance of the researcher. Therefore researchers should consider alternatives in order to ensure that their methodology and philosophical perspective is appropriate and aligns with the rest of the research process.

For the purpose of clarifying my ontological and epistemological standpoint, I will use a straight line with the two contrasting traditions of positivism and social constructionism on either side as shown in Figure 1. My approach to research is indicated by the dot on the left hand side. I opine that philosophical position in financial research is inbuilt and follows the positivist paradigm.

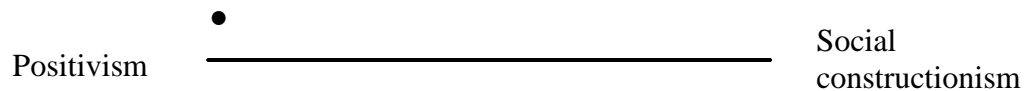


Figure 1: Philosophical position

Since I will be dealing with secondary data I believe that reality can be objectively measured and is independent of the researcher. Therefore my approach to research is based on the ontological assumption that reality is external and objective and the epistemological assumption that knowledge is only significant if it is based on observations of this external reality. Positivism encompasses these two aspects in its main tenets that reality exists externally and can be observed. It should be measured through objective methods rather than being interpreted subjectively. The other extreme of the continuum is the idea of social constructionism where reality is determined by people rather than by objective and external factors and the way people make sense of the world. The main aim of my research is exploration through empirical experimentation by making use of quantitative techniques on the basis of hypotheses and deductions. This determines the choice of research design and methods for my research.

6. Research design

For the purpose of this research I will be using secondary data and will be primarily testing theories. This involves formulating hypotheses and using statistical and econometric tools to test the hypotheses. Data will be collected from reputed databases such as Datastream, Bloomberg, International Financial Statistics, World Development Indicators, International Direct Investment Statistics, Foreign Direct Investment Statistics, Eurostat, International Country Risk Guide, etc. Majority of the data collected will be at the macroeconomic level such as GDP, inflation, interest

rates, and data on trade and investment variables. The period of study will be both the pre- and post-liberalisation in the emerging markets since it will provide the motives for investment in both the periods.

With respect to the econometric techniques, the study will make use of panel data analysis and Granger causality tests.

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