Fdi Inflows and Host Country Institutions: Evidence from Leading Developing Economy Merchandise Exporters

Assist. Prof. Dr. Gülşah Kulalı

Anadolu University, Turkey

ABSTRACT

Foreign direct investments (FDIs) are one of the crucial elements in the industrialization and economic growth of developing countries. These countries' well-known problems in the areas of macroeconomy, business sector and institutional modernization are rendering them fragile to foreign investment inflows and vulnerable to declines in investments at the same time. Therefore, the question of how to sustain investment inflows is always in policymakers' agenda in developing economies, where incentives are part of foreign economic policy, and investment climate for incoming FDI is a consideration. Besides being a host for low-cost production on the supply side, most developing countries in fact are large markets themselves and at the same time, a hub for export in the demand side, especially for efficiency-seeking manufacturing multinational enterprises (MNEs). FDI inflows to developing economies out of global inflows fall from 52 percent to 44 percent from 2012 to 2019. In 2019, 685 of 1.540 billion of dollars' worth of global FDI flows directed to developing economies. It was 703 of 1.351 in 2012. (World Investment Reports 2013 and 2020). These flows to developing economies are mostly export-oriented and commodity-linked investments. In connection with this, compared to developed economies, developing economies are relatively downstream at global value chain (GVC) participation. 'GVC trends are towards shorter value chains, higher concentration of value added and declining international investment in physical productive assets' (World Investment Report 2020).

The main motivation of this study is to contribute to institution-based view of foreign direct investments in developing economies. We want to find out how economic, political, and social institutions influence the direct investment flows in institutionally underdeveloped, yet leading merchandise exporter host countries. As one of the above-mentioned problematic areas, institutions set the context that MNEs and their foreign affiliates, as key drivers of FDI, embedded in. Their operations are influenced by institutional factors in the host country (Dicken & Malmberg, 2001; McCann & Mudambi, 2005; Beugelsdijk, 2007; Chan et al., 2008; Dellestrand and Kappen, 2012). With weaker institutional structures, developing economies are characterized by scarcity of resources and turbulent environments where uncertainty is high (Kostova, 1999; Kiss and Danis, 2008).

Therefore, developing economies provide a good setting for establishing the following research question about effects of institutional quality on FDI inflows. Are foreign direct investment inflows being sensitive to changes in the quality of different institutional development aspects in leading 15 developing economy merchandise exporters? (Leading 15 developing economy merchandise exporters (non-fuel-exporters) in world merchandise trade in 2019, are extracted from World Trade Statistical Review 2020, WTO. These countries include China, Hong-Kong, Mexico, Singapore, India, Viet Nam, Thailand, Malaysia, Brazil, Turkey, South Africa, Philippines, Chile, Argentina and Israel). To answer this question, using country-level set of variables covering the eight-year period of 2011-2018, panel data regression estimation is made with 13x8=104 firm-year observations. Hong-Kong and Singapore are excluded in the analysis since they are tax havens. FDI data and other country-level economic data were obtained from The World Bank Database and data about institutions were obtained from Fraser Institute's Economic Freedom Measurements. Findings show that 'legal system and secure property rights' and 'regulation of business, labour and capital markets' are significant factors with positive sign in explaining the change in FDI flows, where 'sound money' is significant factor with a negative sign. These findings are consistent with the findings of empirical literature. The results of this study are expected to contribute policymakers in defining targets to improve (which aspects of institutional development are prominent in FDIs), to sustain the direct investment inflows.

Keywords: Foreign Direct Investment (FDI), Institutional Development, Developing Economies, Leading Merchandise Exporters, Panel Data