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The Determinants of Inward FDI in SAARC Countries: Evidence from a Time Series data Analysis

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Abstract
As South Asian Countries have location advantage, this study examines the impact of economic, social and political factors on inward foreign direct investment into Pakistan, India and Bangladesh using a time series data for the period 1991- 2010. The set of macro-economic determinants are *market size* measured by GDP and market potential measured by per capita GDP, *exchange rate* measured by real effective exchange rate, *macroeconomic stability* measured by inflation and *trade openness* measured by the ratio of trade to GDP, *political instability* measured by *political index* taken from polity IV. *Social determinants* are cost of capital measured by real interest rate and quality of physical infrastructure measured by internet users (per 100 people). The paper highlights the finding that *macroeconomic stability* is insignificant variable for Pakistan and Bangladesh. *Infrastructure* is statically and economically significant variable for India, while *market size* is a significant variable for India but not for Bangladesh. Political instability is insignificant variable for India and Bangladesh. This paper fills the gap by identifying the common location advantage variables for FDI inflows between Pakistan, India and Bangladesh.
Key words: *macroeconomic stability, trade openness, political index*

1. Introduction

Foreign direct investment is an important source of insertion of foreign capital. It refers as direct investment by a country or entity into another country by buying a company in a country or by intensifying operations of business in a country. The components of FDI are "equity capital, reinvested earning and intra-company loans". There are two types of FDI: inward foreign direct investment and outward foreign direct investment. Outward FDI refers to direct investment going abroad, while inward FDI refers to direct investment coming from abroad, where as other classifications of FDI exists as well. Vertical Foreign Direct Investment takes place when a multinational corporation owns some shares of a foreign enterprise, which supplies input for it or uses the output produced by the multinational corporations (MNCs). Horizontal foreign direct investments happen when a multinational company carries out a similar business operation in different countries.

South Asian countries are behind and receiving low FDI as compared to developed countries. Our study focuses on the inward FDI only, examines the different economic and institutional factors that encourage and discourage inward FDI because FDI is an important source of economic growth in lower income countries, like Pakistan, India, and Bangladesh. The Study also attempts to find common economically significant variables between the selected countries.

Figure 1: According to 2012 A.T. Kearney FDI Confidence Index, "**India** moves to 2nd place in 2012, passing the United States, as investors return to India after a few years of soft inflows". Pakistan and Bangladesh have no position in 2012 FDI confidence index." The 2012 A.T. Kearney FDI Confidence Index examines future prospects for FDI flows and assesses the impact of political, economic, and regulatory changes on the FDI intentions and preferences of the leaders of top companies around the world". The index is calculated on the basis of responses of participating firms about the FDI destinations and their intentions for FDI flows. Participating firms are resposible for 70% of global FDI flows and generate more than US $ 16 trillion in annual sales.

1.1Trends of FDI Inflows into Pakistan, India and Bangladesh

Figure 2: According to Ana Marr (1997) "incentives initiated in 1991 for India and subsequently more "open door" policies have brought a cumulative FDI flows of US $ 2.9 bn during 1991-5, most of it is going into infrastructure, particularly power, telecommunications, petroleum refining, petrochemicals and automobiles in the manufacturing sector." After that, increasing trend in FDI inflows in India and also a drastic change in FDI of India was observed from 2006 and in 2008 it touches the highest point.

FDI inflows in Bangladesh shows smooth pattern from 1991 to 2010. After 1991 reforms, establishment of 100% foreign owned subsidiaries were allowed, which led FDI to increase.

"In 1990s, government of Pakistan further liberalized trade policy for agriculture, telecommunication, energy and insurance sector, but due to political changes and inconsistency in policies the level of FDI remain low compared

to other developing countries" (Nishat, 2005). Increasing trend was observed from 2003 to 2007 in FDI, but after 2007 there was a declining trend due to political instability.
The remaining sections of study are organized as follows. Next part is the review of Literature on the determinants of FDI inflows. Then the methodology used in study and the empirical results are discussed. Finally, the conclusion is given, together with policy implications.

2.Literature Review

There are several studies and theories exist that tell us why foreign direct investment takes place and what are the determinants encourage and discourage foreign direct inflows. Dunning (1977, 1988, and 1993) explained OLI (Ownership, Location and Internalization advantages) paradigm, which is used by multinational firms to producing abroad. OLI paradigm explains three types of advantages "Ownership advantages, Location advantages and Internalization advantages.
With respect to supply of capital to particular location, South Asian countries have location advantages. According to Sahoo (2006), Location advantages are categorized into five groups "macro-economic fundamentals, infrastructural facilities, availability and cost of specific inputs, market size and growth prospects and FDI trade regulatory policies".
Existing literature explains variables that influence FDI categorize into three groups: economic, social and political factors. Economic factors includes: market size, growth prospects, exchange rate, inflation, trade openness. Social factors includes: real wage in manufacturing, cost of capital, quality of infrastructure, labor force growth and literacy rate. Political factors includes: perception about country risk, legal framework and quality of bureaucracy.
Chatterjee (2009) found for India that size of market indicated by GDP; Labor productivity measured by wage rate and economic stability measured by level of external debt; inflation and trade openness, all variables are statistically significant except infrastructure. M. Azam (2005) found that for Pakistan and India; market sizes, external debt, Infrastructure are significant with expected sign, and Inflation is insignificant with unexpected sign while trade openness is significant for Pakistan but insignificant for India. Quader (2009) found that for Bangladesh trade openness and wage rate are significant but exchange rate and interest rate are insignificant. Mushtaq-ur-rehman, Arshad, Shafiq-ur-Rehman, & ilyas were found that FDI growth and GDP growth rate is significant with positive relationship.Exchange rate is positive but insignificant with FDI.they tested the relationship between trade openness with FDI before and after liberalization.Shah and Ahmed (2003) also found that cost of capital, Tariff and infrastructure;which is measured by expenditure on transport and communication, are significant.
Agiomirgianakis, Asteriou and papathoma(2006) studied a panel data of OECD countries and found real GDP growth,GDP per capita , Trade openness, level of human capital, infrastructure are statistically significant and positively related to FDI. Ramjee singh, Mcdavid and Birch(2006) studied determinants in small developing countries and found that infrastructur,trade openness and economic growth help to promote FDI while size of country's market is not a constraint to attracting a FDI.
Wadhwa & S(2011) found significant and positive relationship between GDP and FDI. Internet users have negative and significant impact on FDI; Botric and Skuflic (2005) also found same results which could be due to the fact that the developing countries have started using internet widely after 2000.Inflation has negative impact on FDI.

According to Mottaleb (2007), "countries with large GDP and high GDP growth rate, business friendly environment and modern communication facilities such as internet, encourage FDI inflow in countries".

M.Azam(2011), took a set of panel data that consists of seven countries including Pakistan, Bangladesh, India, Afghanistan, Srilanka, Maldives and Bhutan for the period 1996 to 2007, which transpired that GDP per capita has positive and significant impact on FDI inflows, showing that large market size creates demand for goods and services which helps MNCs to attain economies of scale in host country. Trade openness has shown positive and significant effect in those countries where trade liberalization policy is consistent. The result of internet users (per 100 people) indicates communication facilities are available in host countries and showing positive effect on FDI. GDP deflator shows positive and significant effect on FDI.

3.FDI determinants and Hypotheses

Our research focus is what factors are like to influence the FDI inflows into Pakistan, India and Bangladesh. Therefore our dependent variable is FDI (as% of GDP) because this ratio of FDI to GDP indicates the attractiveness of an economy to draw FDI.

3.1Independent Variable

Market size and Market potential: market size is an important determinant of FDI location for horizontal market seeking FDI, because it is related to potential of local sales. Market size is measured by GDP and market potential is measured by GDP per capita.

Hypothesis I: *Market size and market potential both are positively correlated inward FDI.*

Real interest rate: Cost of capital is one of the determinants of investment decision, whereas interest rate affects the cost of capital in host country. Sokchea (2007) includes real interest rate as proxy of cost of capital host country.

Hypothesis II: *Cost of capital and FDI inflows are negatively correlated, because lower interest rate are expected to increase FDI inflows ,making firms easier to finance projects.* (Arbatli, August 2011)

Exchange rate: Investment in host country also affected by exchange rate. High exchange rate will grind down the profitability in foreign investment and increase the cost of production. Real effective exchange rate is used as a proxy because," Economics that have weak currencies will attract FDI inflows from strong currency economics, as this investment would enjoy higher purchasing power within the host country" (Zheng, P. ,2009).

Hypothesis III: *Exchange rate and FDI inflows are negatively correlated.*

Inflation: high inflation rate is a sign of macroeconomic instability in a country. GDP deflator is a proxy of inflation.

Hypothesis IV: *Inflation and FDI inflows are negatively correlated.*

Trade openness: Open economy is one of the important determinants of FDI inflows which have been studied in several studies, for example studies by [Culem (1988), Edwards (1990) and Singh and Jun (1995)] have found statistically positive relationship between trade openness and inward FDI. The variable is proxied by the ratio of trade to GDP (Import + export/GDP).

Hypothesis V: *Trade openness and FDI inflows are positively correlated.*

Quality of Infrastructure: Botric and Skuflic (2005) have used internet users as one of the proxies of infrastructure. Pazienza and Vecchione (2009) and Palit and Nawani (2007) have also used internet users to find out the determinants of FDI and found a positive relationship between internet users and FDI. On the basis of these studies, we have also taken internet users (per 100 people) as a proxy of infrastructure.

Hypothesis VI: *Infrastructure and FDI inflows are positively correlated.*

Political instability: This variable is taken from Integrated Network for Societal Conflict Research (INSCR) data page. "The variable is obtained by the difference between the democracy and the autocracy index. The democratic characteristics of a country are given by 10 points and the autocratic characteristics are given by -10" (Mushtaq-ur-rehman, Arshad, Shafiq-ur-Rehman, & ilyas).

Hypothesis VII*: political instability and FDI inflows are negatively correlated.*

4.Data and Methodology

This study analyze the determinants of FDI in Pakistan, India and Bangladesh for this study we use single country time series data of three countries for the period of 1991-2010.The data for all variables except political instability is taken from World Bank Development Indicators database while, political instability is taken from Integrated Network for Societal Conflict Research (INSCR) data page. Linear regression model would be used to analyze the explanatory variables on dependent variable into Pakistan, India and Bangladesh during the study period.

In this paper the general model which we have selected to show the impact of macroeconomic, political and social variables on inward FDI for Pakistan, India and Bangladesh is:

FDI = **βo + β1GDP+ β2GDPy + β3RIR + β4INF + β5REER+ β6INFRA+ β7IMEX+ β8 Polity+ ε (1)**

Where,

FDI= foreign direct investment as a percentage of GDP, GDP= GDP as percentage, GDP y = GDP per capita, RIR= real interest rate, INF= GDP deflator, INFRA= Infrastructure, IMEX= trade openness, Polity = Political instability, REER = Real effective exchange rate, ε= error term.

5. Empirical Results

The results are significant on the basis of adjusted R-squared. Multicollinearity problem is tested by VIF (Variance Inflated Factor) and Durbin Watson statistics is used to test autocorrelation.

The estimated equation of determinants of FDI for Pakistan is;

FDI = -3.73 + 0.050 GDP y + 0.027 INF + 0.262 IMEX – 0.084 REER + 0.015 INFRA

In case of Pakistan, results of the Table 1 shows that adjusted R-square value is 0.558 which tells us that five independent variables (GDP y, INF, IMEX, REER and INFRA) in our model account for 57% variance in the

dependent variable (FDI). Clearly this is a moderate model as there are factors which should be used to predict a Foreign Direct Investment (FDI).

Trade openness at one percent level of significance and real exchange rate at five percent level of significance are statistically significant with expected sign. Trade openness (0.379) and real exchange rate (-0.393) are weakly correlated with FDI. The result shows if 1% in trade openness increases FDI increases by 0.262% and if 1% in real exchange rate increases, FDI decreases by 0.084%. Market potential, infrastructure and Inflation are insignificant. Market potential and infrastructure have expected sign while inflation has unexpected sign. Market potential (0.258) and Inflation (-0.027) are weakly correlated with FDI while Infrastructure (0.570) is strongly correlated with FDI. The result shows if 1% in market potential increases, FDI increases by 0.050% FDI; if 1 internet user (per 100 people) increases, FDI increases by 0.015% and 1% inflation increases, FDI increases by 0.027%. Therefore we accept null hypothesis for market size, exchange rate, trade openness and infrastructure and we reject null hypothesis for inflation. F-test use to test overall significance of model. The result shows overall model is significant.

The estimated equation of determinants of FDI for India is;

FDI = -1.777 - 0.137 GDP – 0.012 RIR + 0.353 Polity + 0.526 INFRA

In case of India, results of the Table 2 shows that adjusted R-square value is 0.827 which tells us that four independent variables (GDP, RIR, Polity and INFRA) in our model account for 83% variance in the dependent variable (FDI). Clearly this is a good model as there are factors which should be used to predict a Foreign Direct Investment (FDI).

Infrastructure is statistically significant at one percent level of significance and strong (0.725) positively correlated with FDI. If one internet user (per 100 people) increases, the FDI increases by 0.526%. Market size has unexpected negative sign, statistically significant at five percent level of significance and has weak positive (0.325) correlation with FDI. If 1% increases in Market size, the FDI decreases by 0.137%. Political instability has unexpected positive sign; it could be the use of index instead of dummy variable, and real interest rate has expected negative sign both are statistically insignificant. Political instability has moderate positive (0.509) correlation with FDI, if increases in political instability, the FDI increases by 0.353%. Real interest rate has weak negative (-0.113) correlation with FDI, if 1% increases in RIR, the FDI decreases by 0.012%. Therefore, we accept null hypothesis for infrastructure and real interest rate, but rejects null hypothesis for market size and political instability. F-test use to test overall significance of model. The result shows overall model is significant.

The estimated equation of determinants of FDI for Bangladesh is;

FDI = - 2.318 +0.120 GDP + 0.026 Polity - 0.070 INF+ 0.467IMEX

In case of Bangladesh, results of the Table 3 shows that adjusted R-square value is 0.993 which tells us that four independent variables (GDP, Polity, IMEX and INF) in our model account for 99% variance in the dependent variable (FDI). Clearly this is a very good model as there are factors which should be used to predict a Foreign Direct Investment (FDI).

Inflation and Market size both have expected sign and statistically insignificant. Market size is strong positive (0.839) correlated with FDI, while Inflation is moderate positively (0.440) with FDI. The results show if one % in GDP increases, FDI increases by 0.120% and one % in inflation increases, FDI decreases by 0.070%. Political instability has unexpected positive sign and statistically insignificant; it could be the use of index instead of dummy variable, while has moderate negative (-0.539) correlation with FDI. If political instability increases, FDI increases by 0.026 %. Trade openness has expected positive sign and statistically significant at one percent level of significance. Trade openness is strongly positive (0.996) correlated with FDI. If one % in trade openness increases, FDI increases by 0.467 %. Therefore we accept null hypothesis for market size, trade openness and inflation but reject null hypothesis for political instability. F-test use to test overall significance of model. The result shows overall model is significant.

6.Conclusion and Implication

Our objective was to investigate the determinants of inward FDI in Pakistan, India and Bangladesh. The empirical results showed some similarities and differences between the selected countries. Trade openness is a positive and significant variable for affecting FDI inflows in Pakistan and Bangladesh, having economic significance on FDI. Infrastructure is statistically significant for India but insignificant for Pakistan and has strong positive correlation with FDI. As per result, Infrastructure has strong economic significance for India. Market size is significant with unexpected negative sign and has weak positive correlation with FDI for India, but insignificant with expected sign and has strong positive correlation with FDI for Bangladesh. In case of India, coefficient sign of market size is different from expected sign which may be due to the error in data. Macroeconomic stability is insignificant for Pakistan as well as for Bangladesh. In case of Bangladesh, macroeconomic stability is measured by inflation which shows moderate positive correlation with FDI, which is different from literature. This relation may exist due to

endogeniety, which means that if FDI inflow increases, money supply also increases which leads to increase in inflation. Political instability is insignificant variable for India and Bangladesh. It may be for the use of index instead of dummy variable. Real exchange rate is statistically significant at five percent level of significance for Pakistan.

Results are supportive in the policy making for enhancing FDI inflows, in order to amplify economic growth. To enhance more FDI into Pakistan, India and Bangladesh, the regulatory and policy making authorities of each respective country needs to ensure stable political, social and economic environment, because these all are the important factors for potential investors in making investment decisions.

This research paper has not considered all determinants due to data limitation that would impact on FDI inflows; the possibility for further research is imperative to fill this gap.

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Table 1: Results for Pakistan

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
market size	20	1.00	7.70	4.3000	1.98680
Macro stability	20	2.50	24.90	10.7300	5.31018
Trade openness	20	28.10	38.70	34.4450	3.08007
Political instability	20	-6.00	8.00	1.8500	6.22622
FDI	20	.42	3.90	1.3620	1.01120
Real exchange rate	20	97.09	122.80	1.0765E2	9.11034
GDP per capita	20	-1.63	5.78	2.0272	2.07171
Infrastructure	20	.00	16.80	4.3950	6.00495
Valid N (list wise)	20				

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.821[a]	.674	.558	.67265	1.810

a. Predictors: (Constant), Infrastructure, Trade openness, GDP per capita, Macro stability, Real exchange rate

b. Dependent Variable: FDI

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	13.094	5	2.619	5.788	.004[a]
	Residual	6.334	14	.452		
	Total	19.428	19			

a. Predictors: (Constant), Infrastructure, Trade openness, GDP per capita, Macro stability, Real exchange rate

b. Dependent Variable: FDI

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.883	2.605		.339	.740		
	GDP per capita	.050	.078	.103	.641	.532	.910	1.099
	Macro stability	.027	.035	.139	.755	.463	.684	1.461
	Trade openness	.262	.072	.798	3.657	.003	.490	2.042
	Real exchange rate	-.084	.034	-.753	-2.465	.027	.250	4.003
	Infrastructure	.015	.044	.090	.346	.734	.348	2.872

a. Dependent Variable: FDI

Table 2: Results for India

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FDI %	20	.03	3.57	1.0530	.90046
MKT size	20	1.06	9.82	6.5821	2.35840
GDP per capita	20	-.99	8.23	4.8015	2.46020
real interest rate	19	2.04	9.12	6.3189	1.95201
Trade openness	20	17.18	52.71	31.0199	11.09849
Infrastructure	19	.00	7.50	1.7415	2.14904
political instability	20	8.00	9.00	8.8000	.41039
Valid N (list wise)	18				

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.931[a]	.868	.827	.38044	1.813

a. Predictors: (Constant), political instability, real interest rate, MKT growth, Infrastructure

b. Dependent Variable: FDI %

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	12.327	4	3.082	21.293	.000[a]
	Residual	1.882	13	.145		
	Total	14.209	17			

a. Predictors: (Constant), political instability, real interest rate, MKT size, Infrastructure

b. Dependent Variable: FDI %

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-1.777	2.280		-.779	.450		
	MKT size	-.137	.055	-.302	-2.473	.028	.681	1.469
	real interest rate	-.012	.056	-.025	-.213	.835	.770	1.299
	Infrastructure	.526	.067	.967	7.789	.000	.661	1.514
	political instability	.353	.267	.148	1.321	.209	.810	1.235

a. Dependent Variable: FDI %

Table 3: Results for Bangladesh

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FDI %	20	6.66	20.34	13.9777	4.14375
Macroeconomic Stability	20	.29	8.79	4.6229	2.11627
trade openness	20	18.89	49.09	33.9513	8.92227
MKT Size	20	3.34	6.63	5.3121	.85537
Political instability	20	-6.00	6.00	4.7000	3.67209
Valid N (list wise)	20				

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.997[a]	.994	.993	.35741	1.774

a. Predictors: (Constant), political stability, MKT Size, Macroeconomic Stability, trade openness

b. Dependent Variable: FDI %

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	324.326	4	81.081	634.712	.000[a]
	Residual	1.916	15	.128		
	Total	326.242	19			

a. Predictors: (Constant), political stability, MKT Size, Macroeconomic Stability, trade openness

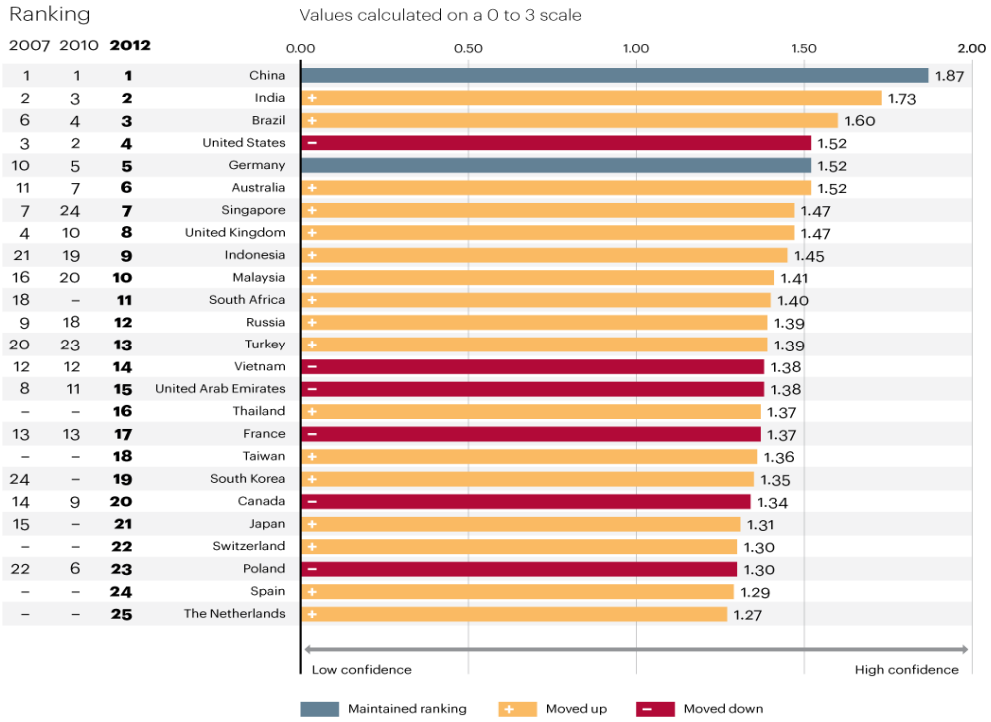
b. Dependent Variable: FDI %

Coefficients[a]

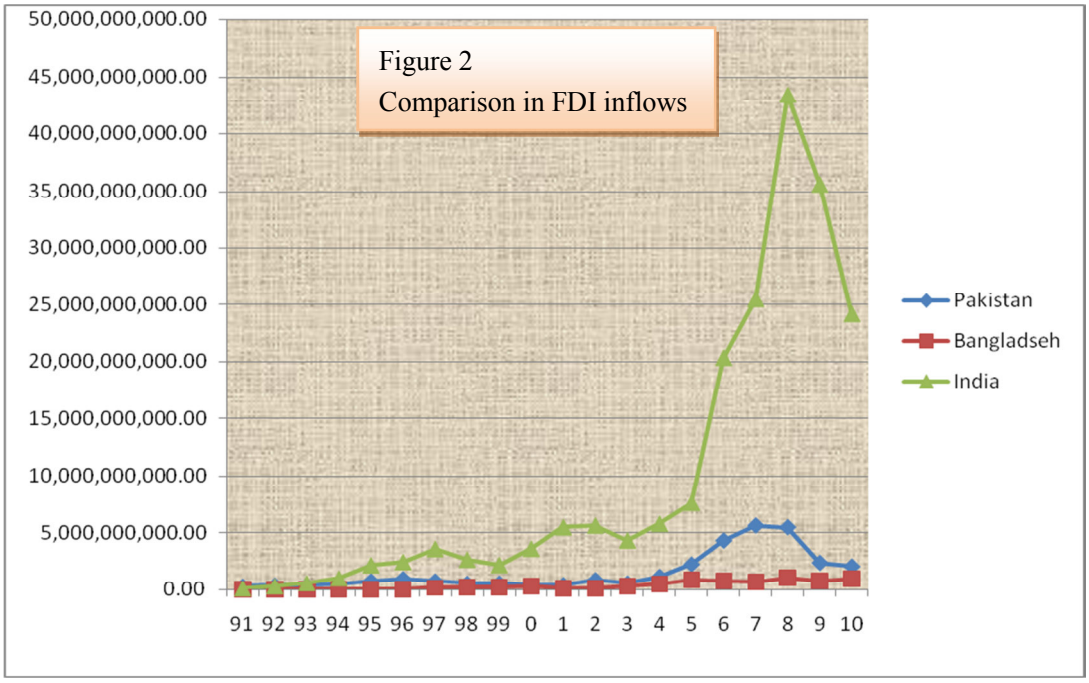
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	-2.318	.697		-3.325	.005		
MKT Size	.120	.180	.025	.668	.514	.285	3.515
Macroeconomic Stability	-.070	.050	-.036	-1.418	.177	.608	1.646
trade openness	.467	.020	1.006	23.829	.000	.220	4.551
political instability	.026	.029	.023	.899	.383	.585	1.711

a. Dependent Variable: FDI %

Figure 1
2012 FDI Confidence Index®



Source: A.T. Kearney Foreign Direct Investment Confidence Index®, 2012



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