Chapter 1

Introduction

1.1.Overview

One striking feature of the world economy in recent decades has been the growth of foreign direct investment (FDI). Since the early 1980s, world FDI flows, now attributable to almost 54,000 transnational corporations, have grown faster than either world trade or output. Developing countries' share in total FDI inflows rose from 26 percent in 1980 to 37 percent in 1997. FDI arises mainly from activities of the firms that operate across national boundaries.

Foreign direct investment had a very little place in economic development and the balance of payments problems until 1960s. On the whole FDI was not always sharply distinguished from the broader "long-term capital" item in the balance of payments statement. In 1914, 90 percent of international capital movements took the form of portfolio investment (**Dunning, 1964**). Under the gold standard operating system, capital normally moved across national boundaries in response to interest rate differentials. The balance of payments adjustment process of these capital movements and their affects on the money supply relative prices and the level of economic activity in the lending and borrowing countries were largely explained by the both classical and neo-classical theories of international investment.

During the interwar period, there was a paradigm shift and new approaches were introduced to deal with capital movements under a paper standard fixed exchange rates and controls on movements or goods as well as capital under this environment, new ideas, like the importance of the purchasing power than the amount of capital actually involved were come out. **Knapp (1942)** in his classic paper explains that when the elasticities of supply of the internationally traded goods are different, the terms of trade may change with fluctuations in the total income. And it may affect the outweighing influence on the balance of trade differences in the rate of investment or of the marginal propensity to import at given in various countries. Further **Knapp (1942)** states such changes in terms of trade as are due to changes in the relative changes in the relative rates of money earnings in different countries resulting from comparative inflation or deflation.

Some writers such as **Chakravarty (1956), Arndt (1954), Malach (1954), White (1966),** and **Romberg (1966)** attempt to explain why and how capital moves internationally. **Chakravarty's (1956)**, view is that the long-run pattern of international long-term capital movements was primarily determined by political influence, relative growth trends, and cultural similarity. According to Chakravarty, capital scarcity as measured by the stock of capital per head contributed very little in explaining the flow of long-term capital. **Arndt (1954)**, argued that the lack of external economies accounts for the low marginal productivity of capital, despite the relatively low level of capital stock in these areas. According to Arndt, for a given level of the MP, the marginal efficiency of capital is lower in under developed nations than in developed because of risk and uncertainty. That is MEC/MP of foreign investment industries in lower in capital poor countries. Hence these two factors act as brakes on the movement of capital from capital rich to capital poor nations. **Malach's Study (1954),** suggests that investors invest abroad when it is profitable than the home country. **White (1966)**, explains FDI distinguishing "supply case" and "demand case". According to White "supply case" of the direct investment is motivated for reasons other than the desire to sell into local markets. And according to the "demand case" direct investment primarily directed towards local market. **Romberg (1966)**, focuses on profitability conditions in the host country. In the case of foreign direct investment the exchange rates and the prices of the product and various inputs should be taken into account for the profits.

However most of the literature dealing with the theory of foreign direct investment has been more concerned with the determinants of such investments rather than its objectives. Studies so far undertaken on determinants of foreign direct investment can be divided into three categories. First the studies mainly evaluate the individual businesses to ascertain the key factors influencing their decision to invest in a particular country and/or industry **(Basi, 1966; Behrman, 1962; Robinson, 1961).**

The second type of approach is to establish some kind of functional relationship between direct capital flows to one country from various countries or in particular industries and possible determinants. **Bandera and White (1968)**, investigated US enterprises, which invested abroad to identify the reasons for such investments abroad. They summarize that the main motive of US enterprises invested abroad is the growing markets in the host countries. The potential of those markets can be judged in terms of the levels and growth of GNPs. According to them, the earnings from the capital are a precondition for the movement when the GNPs set the mood of foreign investors. **Mikesell (1962)**, identified many different reasons for US private investments abroad such as search for higher profits expanded foreign demand, nationalism and foreign trade restrictions, access to raw materials, lower labor costs abroad, the need to maintain supplier relationship with the customers, poor performance of local distributors, and the need to adapt product to foreign demand. The motive of foreign investments of US enterprises in this view can be considered as the desire to increase business profits by penetrating the foreign market. **Scaperlanda (1967)**, claims that the statistics cannot support the hypothesis that the dismantling of internal tariffs within the European Economic Commission induced US business to invest within the tariff walls of that customs union.

Kravis and Lipsey (1982), tested two opposing hypotheses, "market scanning hypothesis" and hypothesis related to firms as "market makers". According to the first hypothesis, transnational corporations use their superior knowledge to locate their activities in countries where they have market or cost advantages. The second hypothesis suggests that TNEs' large size, managerial and commercial strength and superior financial and capital resources permit them to develop new markets for their products. **Kravis and Lipsey (1982)** found that use of English language and the size of the host country's market the major factors caused to take place United States' firms.

The third approach is related to explanations why FDI is preferred to other forms of resource allocation. In this context the importance or advantages of FDI compared with foreign portfolio investment, other ways of exploiting a foreign market such as exports of licensing agreements and the comparison of advantages between FDI outflows and forgone investment opportunities at home are mainly investigated (example, **Kindleberger, 1969**).

A recent study on East Asian foreign direct investment in European Community (EC), done by **Balasubramanyam and Greenaway (1994)**, focuses on the determinants of FDI. Empirical evidence of this study suggests that the observed upsurge in East Asian investment in the EC is largely due to the potential market size of the EC, although some of it may have been undertaken toward of threats of trade restrictions. **Milner and Pentecost, (1994)**, analyzed the cross sectional regression to investigate the industrial pattern of US FDI in UK manufacturing sector. The results of this analysis indicated that inter-industry variations in industrial/market characteristics do systematically influence the extent of or scope for locational and internalization advantages for US investors in the UK economy. Further this study reveals US FDI is higher where there is access to sources of UK comparative advantage in general, and specifically where it provides access to local endowments in the case of relatively capital and non-manual labor-intensive activities. The results also support the hypothesis that US FDI is higher the lower is the scope for competition from other domestic firms and from imports. This study also shows that US FDI is positively related to the 'host' market size. **Lecraw's study (1991),** shows locational factors, such as the value of the natural resource base and the rate of the growth of the labor force, that are outside the control of government have influenced inward investment. And locational factors, such as the rate of growth of the consumption, the perceived risk of the country, and the real exchange rate, over which the government may exercise some degree of control also influenced the inward flow of investment. It further shows locational factors, such as the tariff rate, the tax rate and the "openness" of the country's foreign investment incentives system, which are under the direct and immediate control of the government, also influenced inward flows of investment.

Some recent studies attempted to investigate the major determinants of FDI inflows to some particular regions. For example **UNCTAD (1993)** used a time series econometric model to analyze the major determinants of FDI inflows to European Community, the regions of Africa, Asia, and so on. The major obstacle of such studies is that some variables, which serve as determinants of FDI are difficult to measure due to their nature and unavailability of relevant data. According to **Mallampally and Sauvant (1993)**, the most important determinants for the location of FDI are economic considerations and it comes into full play when FDI policy framework is in place. Mallampally and Sauvant present three groups of determinants; those related to the availability of location-bound resources or assets, those related to the size of markets for goods and services, and those related to cost advantages in production. They further argue that although many of the factors that attract investment to particular locations such as natural resources, large host country markets, low cost, flexible labor remain important, their relative importance is changing as transnational corporations, within the context of liberalizing and globalizing world economy, increasingly pursue new strategies to enhance their competitiveness.

1.2.Objectives of the study

The objectives of this study can be summarized as follows.

1) Examining the key factors, which determine foreign direct investment inflows in emerging Southeast Asian region.

2) Quantifying those forces in determining the behavior of foreign direct investment inflows in that region.
3) Investigation of future trend of inflows of foreign direct investment in that region, which may useful for policy purpose.

This study aims to address the question why foreign direct investment takes place in host countries. Various previous studies have concluded suggesting various different factors serve as determinants of FDI in host countries or host regions. These factors vary specifically from region to region. Hence studying of this area is still very important and it will very useful specifically for policy makers. The problem of this study is narrowed down to a particular region, five South East Asian countries namely Indonesia, Malaysia, Philippines, Singapore, and Thailand. It is widely accepted that the East Asian and South East Asian countries emerged FDI in past three decades and it helped rapid economic growth of these countries. During the time foreign direct investment and other kinds of foreign investments emerged in these countries, the economic growth of these countries rose changing the structure of GDP, and exports. And the significance of the primary sector in GDP reduced and it was replaced by manufacturing and services sectors. The importance of primary products in the export composition was reduced and importance of manufacturing products increased. This caused increase in export performance and positive change in the balance of payments. In this situation, many researchers focused on their studies on foreign direct investment in these countries recently. Many studies focused on impacts of FDI on the economic growth, on the balance of payments, on export performance, on savings, and sectoral changes etc. while some studies tried to analyze what factors influence to emerge FDI in these countries. This study tries to identify the major determinants of foreign direct investment analyzing data pertaining to Indonesia, Malaysia, Philippines, Singapore, and Thailand and to analyze how strong these factors in determining FDI in this region.

Previous studies relevant to determinants of FDI in some regions or countries have shown that some factors have strong effects while some factors have modest or weak effects on FDI inflows as determinants factors. This study attempts to quantify such effects of possible factors that serve as determinants of FDI in Southeast Asian region. Investigation of how strong the determinant factors by quantifying is very useful for policy making.

Forecasting of FDI inflows is very important for policy decisions. When the determinants are recognized, and if those are quantified, FDI inflows can be forecast for a period in near future using that information in terms of some assumptions.

Since these selected Southeast Asian countries follow a policy of promoting foreign direct investment, forecasting of FDI inflows using empirical evidence may useful for such policy making.

1.3.Scope of analysis

The scope of the analysis of this study is limit to selected five Southeast Asian countries namely Indonesia, Malaysia, Philippines, Singapore, and Thailand as these countries have some similar characteristics in economically and geographically.

Data available on foreign direct investment inflows in Southeast Asian region show that such inflows are not significant before 1970s. Collection of complete data on this subject relating to very recent period i.e. year 2000 and 2001 were found to be difficult. Therefore the scope of this study is limit to the period from 1970 to 1999.

1.4.Outline of the chapters

Introduction to this study is given in Chapter 1 of this paper. It consists of an overview that reviewed the subject matter to emphasize the necessity of studying on this subject, the objectives of this study, scope of the analysis of the study, and an outline of the chapters of the paper.

Chapter 2 presents review of literature pertaining to the subject area of this study. Some key theoretical views on foreign investments before foreign direct investment was distinguished as a separate subject were reviewed in this chapter first. Then the views on foreign direct investment in various aspects were reviewed. Finally, the literature on the area of determinants of FDI including recent studies on this subject was summarized. Chapter 2 elaborated the review of literature on this subject under the sub topics, introduction, the theories of capital movements, foreign direct investment as capital accumulation process, foreign direct investment as capital accumulation process, monopolistic or oligopolistic behavior of the firm, costs and benefits of foreign direct investment, determinants of foreign direct investment, and summary.

Chapter 3 is meant for the theoretical outline of determinants of FDI, which was used as a base to the model, analyzed empirically. Based on the theoretical background, specifications of the possible variables, which were used for the regression model of this study, were described in this chapter.

Chapter 4 of this paper describes the methodology, followed in this paper. This chapter explains the method that used to fulfill the objectives of this study under the subtitles, overview, model, research assumptions, data collection and analysis, stationarity tests, test for multicollinearity, test for heteroscedasticity, statistical analyses, forecasting, and conclusion.

The major part of this paper is chapter 5, which includes results and findings of analysis of the model. The way of analyzing data as required for the model, analyzing the model, results and findings of that analysis, and forecasting of FDI inflows are included in this chapter. This chapter is divided into five sections under the sub titles, introduction, an analysis of the selected variables, testing for stationarity of data series, testing for multicollinearity, testing for heteroscedasticity, estimation of the model: determinants of FDI, determinants of FDI and elasticities of FDI with respect to determinants, forecasts of inflows of foreign direct investment, and policy suggestions.

Finally, chapter 6 summarized the conclusion part of the study based on the results and findings of the study