

The Determinants of Foreign Direct Investment: An Analytical Survey

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Abstract Investments undertaken by multinational corporations (MNCs) can be regional or global. In the recent years, there has been spectacular growth in the flow of global capital in developing economies accompanied by a significant increase in capital outflows from the Global South. Though outward investment by emerging economies is not a new phenomenon, the past couple of decades have witnessed a surge in the quantity and also qualitative transformation in the pattern of their investment. The most important region among developing countries for foreign direct investment outflows is Asia, though there has been an increase in other developing regions as well. In this chapter, we present an analytical survey of the literature around the various issues that determine the location decision of global capital and also investigate the current changes in trends in these investment flows. We also explain the motivating factors behind the location decisions of southern multinationals, an area relatively new in the literature on foreign direct investment.

1 Introduction

International business activity in the form of multinational corporations (henceforth, MNCs) is not a recent phenomenon. These economic activities that have their roots in the nineteenth century included foreign direct investment (henceforth, FDI), joint ventures and strategic alliances, among other forms of internationalization. There is a long-standing notion among the policy makers that FDI is much more inductive to long run economic growth and development when compared to other forms of foreign capital flows. However, despite the presence of FDI, most of the foreign investments till late 1940s were in the form of portfolio investment. The volume of

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FDI grew substantially after the World War II and concentrated its activities towards knowledge-based production rather than in primary goods. In the early 1960s, the United States accounted for about three-fifth of the total FDI of the market economies and was followed by the United Kingdom and other OECD countries. However, changing patterns of industrial production was reflected in the declining shares of US and UK in FDI stocks and rise of Germany and Japan between 1967 and 1976. Big business houses shifted their interest from traditional locations such as Canada, Latin America, Ex-colonial territories to the newly industrialized areas such as South-East Asia along with a shift in the nature of international production. Rather than extracting natural resources overseas, MNCs started concentrating on production specialization (both horizontal and vertical) to take advantage of difference in endowment across nations, scale economies and integrated markets.

Past couple of decades have experienced spectacular growth in the flow of global capital into developing countries, including many of the debt-stricken Latin American countries. Figures 1 and 2 show per cent share of FDI inflows for different regions since 1970. With global capital flows growing at a faster rate than the

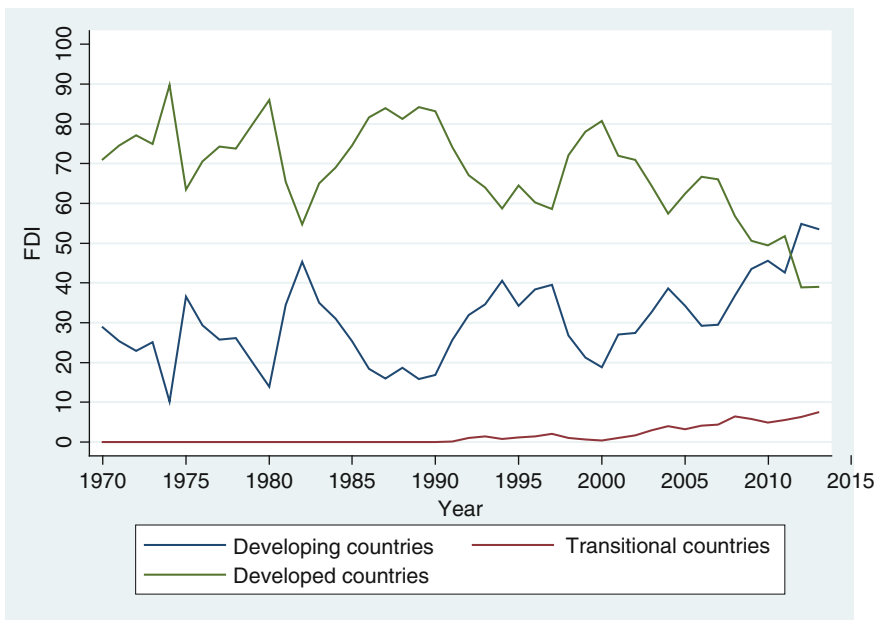


Fig. 1 Per cent share of world FDI inflows for developing, developed and transitional countries. *Source* UNCTAD and authors' calculation

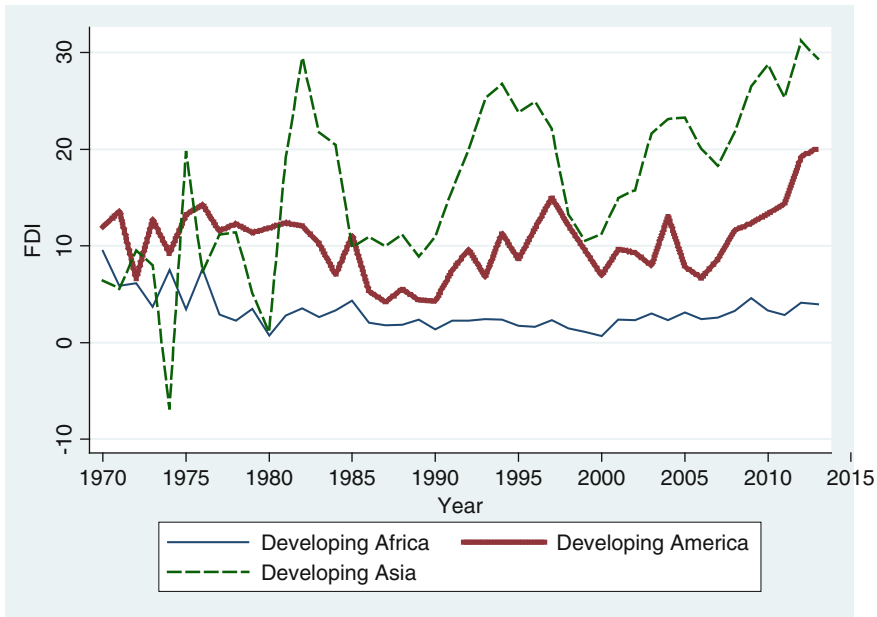


Fig. 2 Per cent share of world FDI inflows for developing Africa, developing Asia and developing America. *Source* UNCTAD and authors’ calculation

global trade, it remains an open question that what pulls FDI into the emerging economies that are often protected.

It is not difficult to understand that FDI will flow to the countries with relatively stable economic, political and social conditions accompanied with strong institutions. However, there is very little evidence to support this view.¹ Structurally weak economies like least developed countries (LDCs), landlocked developing countries (LLDCs) and small island developing states (SIDS) experienced increase in FDI inflows by 29, 54 and 32 %, respectively, in 2008 (Fig. 3). FDI outflows from developing countries have also experienced major increase. This surge in outward investment is mainly due to cross-border mergers and acquisitions (for example, Cemex, from Mexico has become the largest cement producer in US by acquisition; Italian company Wind was purchased by Egyptian EMNC Orascom, etc.). Flows from

¹Though, internal factors of FDI receiving country have received huge attention in the present literature (see Blonigen 2005), there exists a large body of work that examines the importance of external forces in driving foreign capital, mainly debt and portfolio flows to the rising economies (see Calvo et al. 1993; Fernandez-Arias 1996; Reinhart and Montiel 2001).

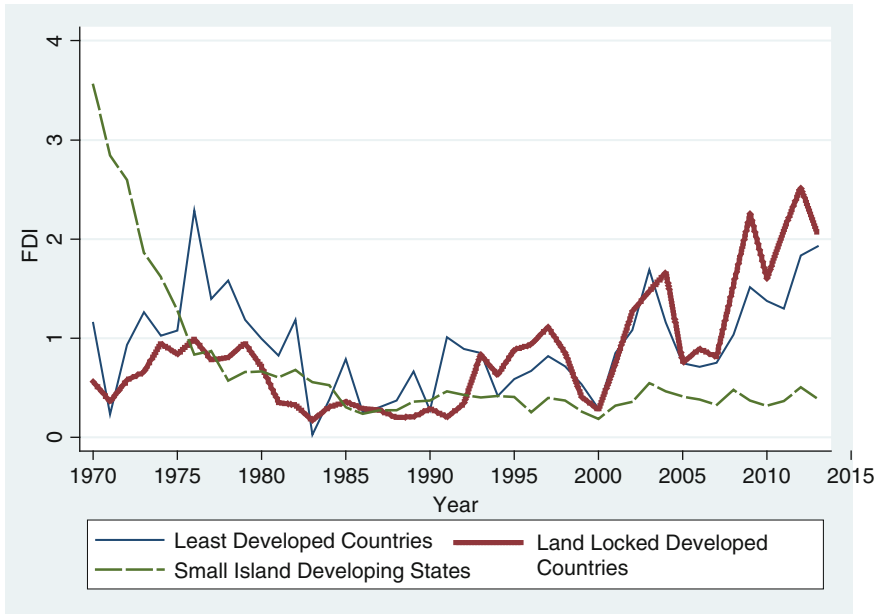


Fig. 3 Per cent share of world FDI inflows to LDCs, LLDC and SIDS. *Source* UNCTAD and authors' calculation

the developing countries have increased from 2.7 % of the total global outflows in 1989–1991 to 13 % of the total global outflows in 2007.²

However, flow of private capital has been both cyclical and inconsistent. Policies such as financial openness, adopted by many of the developing economies have significantly contributed to the surge in the inflow of foreign capital and have given greater exposure to the global financial shock. This inflow of private capital has been a cause of global liquidity, accompanied by growing commodity prices, declining interest rate, better economic fundamentals and market-oriented reforms adopted by many of the rising economies. However, economists are yet to reach a firm conclusion whether these capital inflows to the developing economies has been

²Investment by multinational corporations can be regional or global. Data on MNCs from emerging markets show that they are likely to invest in their own region or in other developing countries with whom they are familiar through trade, or have ethnic and cultural ties (for example initially Russia invested in other countries of former Soviet Union, India and China mainly invested in other Asian countries, South Africa's investment abroad was mostly to other countries of Southern Africa and Chile, Brazil and Argentina invested in other countries of their region). This surge in intraregional or South-South FDI flows since early 2000s was mainly due to availability of Petrobras in Argentina, Bolivia and Venezuela, giving access to oil and gas reserves; state policy of regional energy integration in Argentina, Brazil, and Cuba; and retreating some of the global MNCs from Latin America during the early 2000s that gave local firms the opportunity to increase their activities in the region.

a result of the deteriorating macroeconomic conditions of the developed world known as *pushed* factors or have been *pulled* by improving domestic conditions of the developing economies. There are many studies that come across the relationship between FDI and several macroeconomic variables such as market size of the host countries, economic and political stability, government policies, infrastructure, degree of openness of the host country, quality of institutions, absorptive capacity of the local firms, human capital, cost of labour, etc. However, increase in foreign assets and liabilities of many of the developing countries were results of improved current account balance that reduced their foreign debt and helped building international reserves. With the decline in the world interest rate, the debt servicing burden of the developing countries declined substantially. This unprecedented rise in the holding of foreign reserves by the developing countries (China showed a huge accumulation of reserve), commonly known as *self-insurance*, helped them to fight back the crisis of the late 1990s. However, this unparalleled rise in the flow of private capital to the developing countries that reached its peak during 2007–2008 came to a *sudden stop* or even reversed its direction and flew back to the developed countries where the epicentres of the global financial crisis existed. The world economy started recovering since spring 2009 with the help of the support laid by the central banks of the developed countries. However, developing countries saw another surge in the inflow of global capital after mid-2009 followed by another reversal of flows as an aftermath of worsening European crisis of 2011. Regional analysis of data shows, FDI flows to developing countries reached to \$778 billion, a share of 54 % of the total global inflows (UNCTAD 2014). Major developing areas such as developing Asia, Africa, Latin America and Caribbean experienced a major rise in the share of global flows. Africa experienced a growth of 4 % in inflow of foreign capital mostly due to intra-African flows. Developing Asia saw a rise of 3 % and the Latin America and the Caribbean experienced an overall positive growth.

With the increasing trend of foreign capital pouring in developing economies and outflows from developing economies rising, the obvious question arises is how the *push* and the *pull* factors operate to determine the location choice of FDI.

This chapter surveys the literature around the various factors that determine flow of FDI, investigates the motives and strategies of MNCs that determine the location decision of FDI and also investigates the current surge of outflows from the Global South.

2 Changing Map of FDI in the Recent Years

With the growing integration of the global capital markets, FDI grew significantly during the 1990s at a rate faster than global economic growth and trade. Data shows that world FDI flows that increased by an average of 13 % a year during 1990–1997, saw an average increase of 50 % during 1998–2000 due to mergers and acquisitions. Global inward FDI flows that rose from US\$54.1 billion in 1980,

reached US\$207.7 billion in 1990 and US\$1,401.5 billion in 2000 and felled to US \$0.7 trillion in 2001 as a result of sharp decline in mergers and acquisition. By 2003 it had fallen to US\$565.7 billion before rising again to US\$2100 billion in 2007. According to UNCTAD (2014), developing and transitional countries together invested 39 % of total global FDI outflows in 2013. Initially, Argentina, Brazil, Hong Kong, India, Korea, Singapore and Taiwan were the major sources of emerging country's FDI. However, since late 1980s these countries were joined by Chile, China, Egypt, Malaysia, Mexico, Russia, South Africa, Thailand and Turkey.

Three major economic groups, the developed, the developing and the transition economies of South-East Europe and Commonwealth of Independent States (CIS) were affected by the Global financial crisis of 2008 differently and this was reflected by the respective falls in their FDI inflows. The developed countries saw a 29 % decline in inward FDI flows in 2008 which was mostly due to drop in cross-border mergers and acquisition (M&A) sales. Most of them suffered a downfall as host economy due to the global crisis, except US. The developing countries survived the crisis of 2008 as they were not tightly interlinked with the banking system of US and Europe that were badly hit by the disaster. With their economic growth remaining robust and commodity prices rising, the developing countries continued to face growth in inward FDI, however, at a rate slower than the previous year. While the manufacturing and the service sectors were the worst hit, the primary sector saw a rise in FDI mainly due to participation of large companies from developing countries, especially from China. For the least developed countries, Africa received US\$88 billion in 2008 amid the global economic and financial crisis and most of these FDIs that were directed from developed countries were concentrated in natural resource-based industries (Fig. 4). Many of the African countries adopted policy measures to make environment favourable to FDI, however, the recent picture across different African regions remain mixed. On the other hand, though South, East and South-East Asia collectively experienced a huge growth in FDI inflow of 17 %, reaching a new high, in 2008, the picture varied significantly among different regions and for West Asia the picture was rather mixed³ (Fig. 5).

³Whereas, inflows slightly dropped in Malaysia and Thailand, it declined sharply in Singapore and Taiwan province of China. However, China, India, Republic of Korea and Hong Kong (China) experienced an increase in FDI inflow. Though in total, West Asia experienced a significant increase of 16 % in FDI inflows, this was mainly due to major growth experienced by real estate, petrochemicals and oil refinery industries of Saudi Arabia, as the major players like Turkey and United Arab Emirates received major set back. A similar picture was found in Latin America and the Caribbean where there was a 13 % increase in total FDI flows in 2008. With an unequal distribution of the inflows in different regions, natural resource-based industries were the main recipients, whereas manufacturing sector observed a drop due to sharp decline in the flows to Central America and the Caribbean. South-East Europe and Commonwealth of Island (CIS) received US\$114 billion in the year, with Russian Federation, Kazakhstan and Ukraine being the major players received nearly 84 % of the total inflow. This vast area received a record level of FDI inflows in spite of regional conflicts in some of its regions.

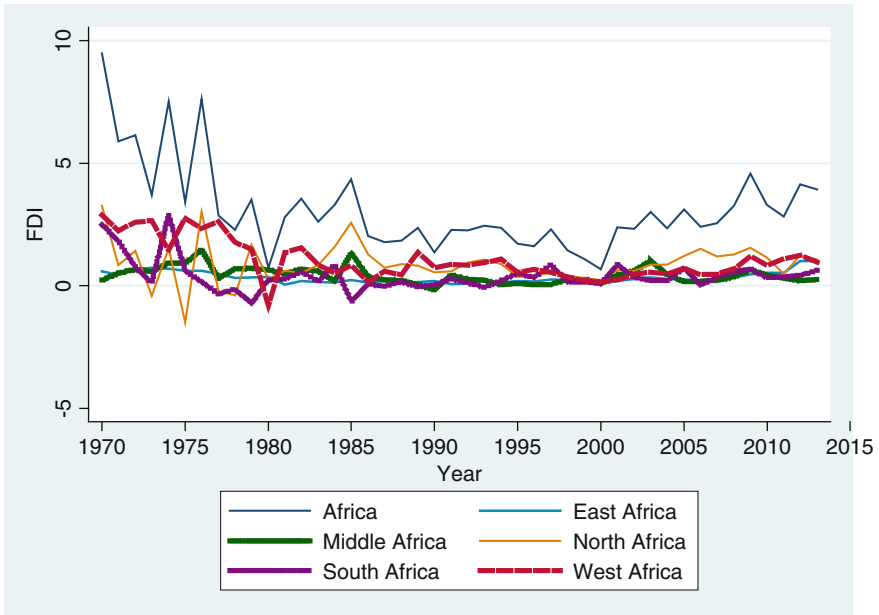


Fig. 4 Per cent share of world FDI inflows for different parts of developing Africa. *Source* UNCTAD and authors' calculation

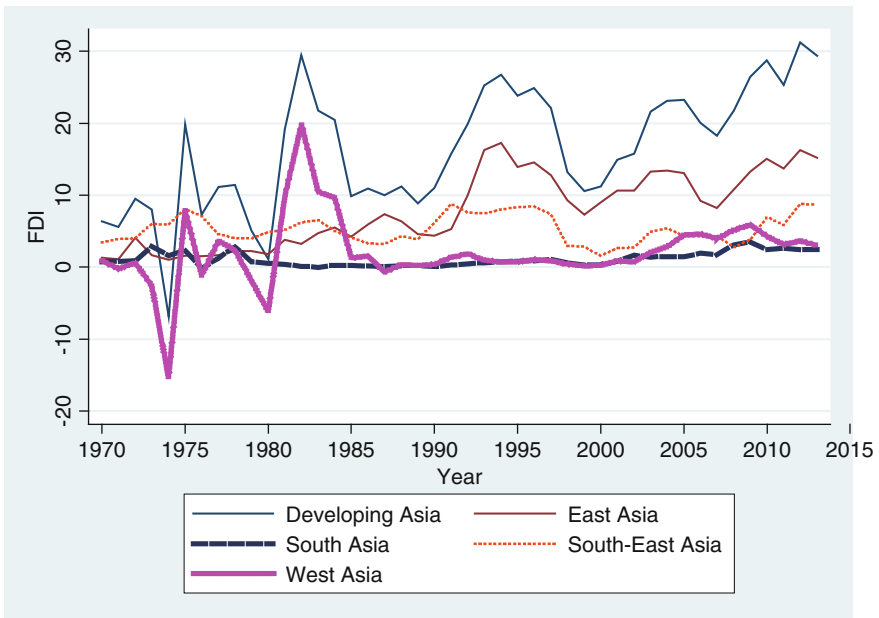


Fig. 5 Per cent share of world FDI inflows for different parts of developing Asia. *Source* UNCTAD and authors' calculation

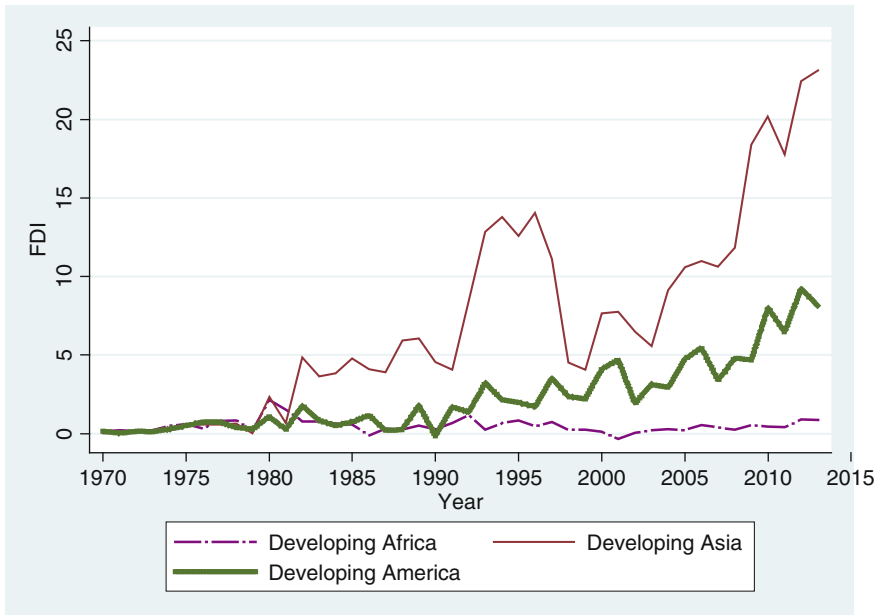


Fig. 6 Per cent share of world FDI outflow for developing Asia, developing America and developing Africa. *Source* UNCTAD and authors' calculation

As the world's major economies were badly affected by the increasing downturn in economic and financial crisis resulting in falling profits and declining reinvestments and rechanneling of loans from foreign affiliates to the headquarters of Transnational Corporations (henceforth, TNCs), FDI flows from developed countries fell by 17 % in 2008. These dramatic changes that occurred in 2008 changed the relative ranking of the host and the source countries in the world. While US maintained its top position both as a host and a source country, United Kingdom lost its position as the top host and source country in Europe. Japan improved its position in outward investment and many developing and transitional countries emerged as large recipients and investors of FDI in 2008. Figure 6 shows outflow of capital from developing Asia, Africa and America.

Outflows from West Asia declined by 30 % in 2008 mainly due to significant fall in the value of cross-border M&A purchases by West Asian TNCs. In contrast, FDI outflows from Latin America and the Caribbean increased by 22 %. This was mainly due to rising flow of FDI from South America that counterbalanced the decline in the outflows from Central America and the Caribbean. TNCs of Russian Federation continued to maintain their lead position. In addition, FDI flow from South, East and South-East Asia increased by 7 %, mainly due to huge outflow of FDI from China, though many of the countries of this region slowed down during 2009.

Most of these flows from the major economies of this region were due to relatively high economic growth and growing foreign reserves originated from trade surpluses and sovereign wealth funds (SWFs). Moreover, growing competition amongst the domestic firms; saturated or limited markets and improved institutional support contributed to the growth of FDI from this region. Most of the outward investment from this region is intraregional (for example in 2007, 40 % foreign investment by Temasek from Singapore were in Asia; Khazanah Malaysia, a Malaysian SWF, invested significantly in Malaysian companies such as UEM, Telecom Malaysia International, Opus Group Berhad and Bumiputra Commerce Bank). However, recently a growing number of developed countries are also receiving FDI from this region as a part of efforts of the Asian firms to get hold of strategic assets abroad. TNCs from East Asia are acquiring firms of the developed countries mainly which are based in United States because of weak dollar and lower asset prices of these companies.

Chinese overseas investment, mostly in extractive industries, has particularly focused on acquiring strategic assets outside Asia, mainly in developed countries, Africa and Latin America. Another major player, India, has been investing in both the developing and the developed countries, particularly in pharmaceuticals, extractive industries, information technology and other business services. Investment by Singapore firm Temasek Holdings in Merrill Lynch (United States), acquisition of Jaguar Cars Ltd. (United Kingdom) by Tata Motors Ltd. (India), overseas acquisition of Anglo-Dutch firm Corus by Tata group (India) are some of the largest deals carried out in the recent years. Outward investment by different Asian economies is shown in Fig. 7.

The year 2009 saw the Russian Federation to be the largest source of outward investor of FDI from the whole region. With rising number of Mexican and Brazilian companies expanding mainly in developed countries, the outward flow of FDI from Latin America and Caribbean increased to US\$48 billion in 2003–2009 annually. Per cent share of outward investment by some of the Latin American countries and Russian Federation and Kazakhstan in global FDI outflows is given in Fig. 8. Moreover, though outward investment from Africa as a whole suffered, investment from South Africa and North Africa continued to grow. Despite a gloomy picture throughout Asia, China maintained its outward investment mainly in non-financial sectors.

2.1 Recovery of Global Investment and New Trends in Outflows from the Global South

The first half of 2010 saw a modest, however, uneven recovery of global FDI from 2009 crisis. Amidst the increasing risk and uncertainties of post-crisis world, featured by the possibilities of sovereign debt crisis, rising inflation, fiscal and financial imbalance of many of the developed countries and overheating in emerging market

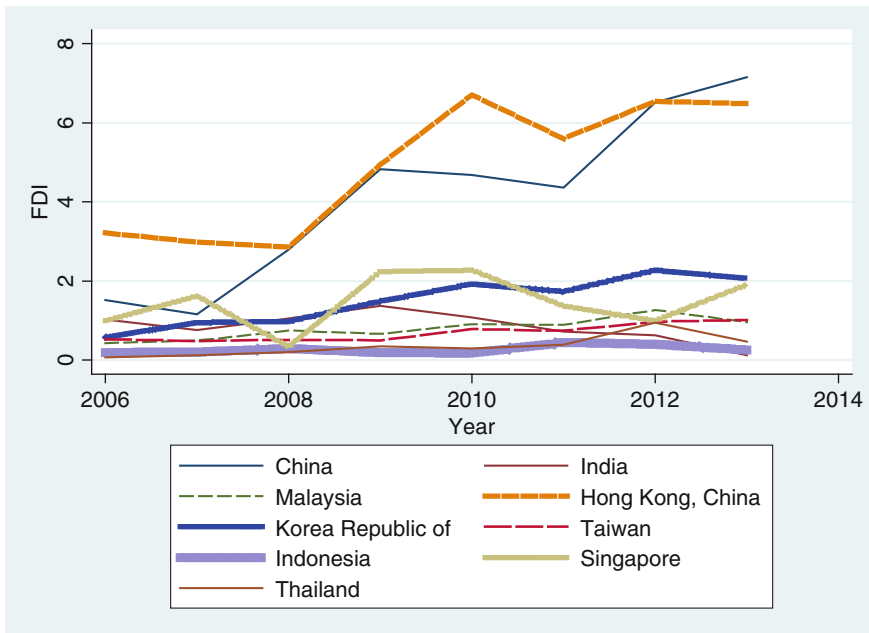


Fig. 7 Per cent share of different Asian economies in world FDI outflows. *Source* UNCTAD and authors’ calculation

economies, though industrial output and world trade reached their pre-crisis level, FDI flows in 2010 remained at 15 and 37 % below their 2008 and 2007 peaks, respectively. The post-crisis period of 2010 saw developing countries to maintain their lead both as global recipients and investors of FDI. FDI in services (business services, finance transport and communication services) continued its downfall though at different paces.⁴ 2010 also saw rise in FDI outflow by six developing and transitional countries that were among the top 20 investors.

Outflows from South-East Asia and West Asia saw a significant increase in 2011. While outflows from China and Hong Kong dropped; Singapore, Thailand and Indonesia saw a rise. Flows from India increased mainly due to increase in investment in overseas green field projects particularly in extractive industries;

⁴While FDI flows in the financial service sector declined the most, manufacturing industry backed most of the FDI investment. However, business-cycle-sensitive industries, for example metal and electronics sector suffered. Though chemical industry (including pharmaceutical industry) weathered away the crisis, others such as food, beverages, textile, tobacco and automobiles recovered in 2010. However, FDI in extractive services that were not affected by the crisis suffered a downfall in 2010.

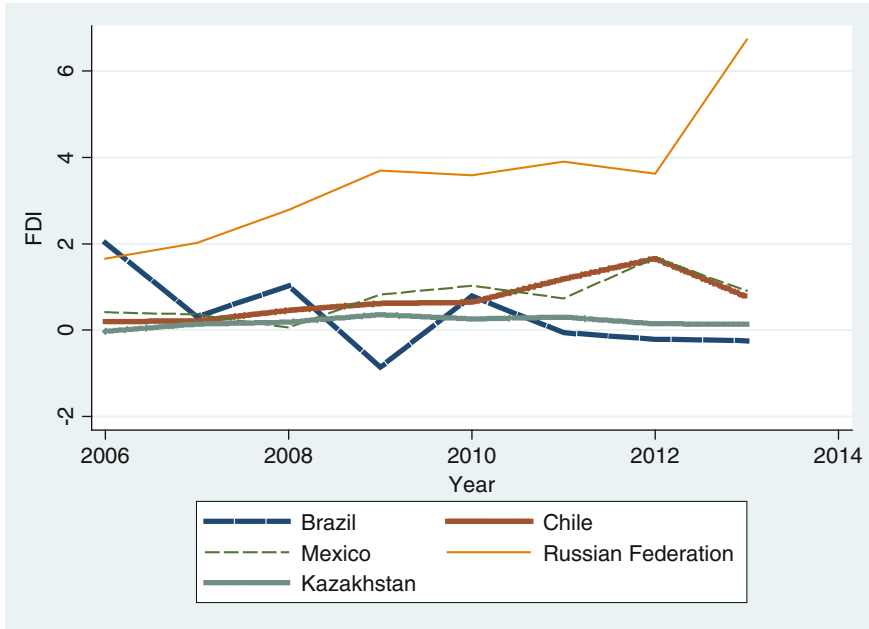


Fig. 8 Per cent share of world FDI outflows from Latin American and the Caribbean, Russian Federation and Kazakhstan. *Source* UNCTAD and authors' calculation

metal products and business services.⁵ Political instability of Egypt and Libya and cancellation of big construction projects in the midst of global crisis in the Gulf Cooperation Council (GCC) lead to a fall in inflow of investment in those respective areas in 2011. In addition, political and social unrest contributed significantly to the fall in global investment in different parts of West Asia. However, Central America, South America, the Caribbean and South Asia saw high FDI inflows during 2011. In addition, improving political relationship between India and Pakistan generated attractive investment climate in the region of South Asia.

Global FDI outflows in 2012 increased by 5 % mainly due to investment from developing regions (whereas outflows from developing Asia and Africa increased, it declined for Latin America and the Caribbean) and transitional economies who continued to increase their outlay with the increasing trend in economic liberalization, growth and growing commodity prices. China and Hong Kong strengthened their positions as the two important sources of global FDI investors in 2013. Other parts of developing Asia saw mixed trends in outward flow in 2013. While

⁵FDI flows in 2011 rebounded in all the three sectors (primary, secondary and tertiary), with slightly higher growth rate for the primary and the service sectors compared to the manufacturing industry. The industries that contributed mainly to the rise in FDI in 2011 were mining, quarrying, petroleum; electricity, gas and water and transportation and communication services.

investment by TNCs from Republic of Korea declined by 5 %, for Taiwan it increased by 9 %. FDI flows from transitional countries increased significantly mainly due to TNCs from Russian Federation, followed by Kazakhstan and Azerbaijan. Drop in FDI outflows from developed countries in 2012 (Europe and North America experienced large downfalls in their outflows and Japan who was still able to maintain its position grew by 14 %) was marginally improved in 2013. Whereas outflows from Europe (doubling of reinvested earnings abroad and increase in intracompany loans helped Switzerland to become the largest outward investor in Europe in 2013 and outward flows from Italy, Netherlands and Spain rebounded in 2013) and Japan continued to grow in 2013, North America saw a 10 % decline due to negative outflow of intracompany loans from US. France, Germany and United Kingdom also saw a significant decline in outward flows in 2013. Inflows increased in North America by 23 % in 2013 mainly due to acquisitions by Asian companies (e.g. Canadian upstream oil and gas company, Nexen, was taken over by CNOOC of China; Sprint Nextel of US was taken over by Japanese telecommunication group Softbank and Smithfield of US was taken over by Chinese Shuanghui).

3 The Theoretical Background

According to neoclassical trade theory location decision of multinational firms has been guided by the theory of *comparative advantage* of the host country highlighted under the Ricardian or Heckscher–Ohlin–Vanek theoretical framework. According to the theory of *market imperfection* (Kindlerberger 1969; Eitemann et al. 2007), MNCs locate their production activities in other countries to take advantage of market imperfection by exploiting economies of scale, ownership advantage and government incentives. Moreover, by taking the advantage of market imperfection, MNCs safeguard their intangible assets (Buckley and Casson 1976; Hennart 1982; Shapiro 2006). In addition, according to Vernon (1966), MNCs' exporting of goods or setting up of production house in the foreign market is influenced by product life-cycle theory. However, the literature on the activities of MNCs, which was mainly based on the observations of international firms from triad (i.e. US, EU and Japan) is best explained by the most influential study called *eclectic paradigm* that was first proposed by Dunning (1981). Accordingly, the decision of the firms to expand overseas depends on three advantages: *Ownership advantage* (representing firm's specific resources to be exploited externally), *Location advantage* (representing host country's characteristics say endowment of natural resources) and *Internalization* (representing the opportunity to internalize firm specific advantages). The *eclectic paradigm* theory is the most comprehensive theory to provide rationalization of MNCs behaviour to invest in foreign countries. However, the conventional Ownership–Location–Internalization (OLI) paradigm of Dunning has been criticized on the ground that:

- I. It could not explain internalization of the MNCs from the developing countries as these new firms do not possess the ownership advantage of superior technology or brand name that they can exploit in the foreign market. According to Mathews (2006, p. 17), “*Rather their international expansion has been undertaken as much for the search for new resources to underpin new strategic options, as it has been to exploit existing resources. This is why they have to expand quickly, to consolidate gains that are fleetingly won. This is why they tend to rely on partnerships and joint ventures, to reduce the high level of risk involved in their leveraged strategies*”. The *challenger firms* or the *newcomer firms* from the developing countries take a very different perspective compared to the *incumbent firm*. According to (Aulakh 2007, p. 237), the *newcomer firms* from developing countries get motivated by “...*learning objectives that allow these firms to overcome the initial resource hurdles arising due to technological gaps and late mover disadvantages in international markets*”. They acquire strategic assets like technologies and brands and raw materials that they lack by setting up linkages with the source firm overseas.
- II. The OLI framework has been further criticized on the ground that it is a static paradigm and fails to explain the dynamism that captures the advancement of a firm’s capabilities throughout time. The dynamic capability approach developed by Teece et al. (1997) is an extension of the resource-based view and is concerned with the knowledge-generating process at the firm level. Mathews (2002a, b) observed the dynamic behaviour of the *Dragon Multinationals* from the Asia Pacific region, and in a number of his successive works he has highlighted that the *resource-based approach* best fitted for this *newcomer firms* remains to be unexplained for quite a long time by the eclectic paradigm theory of Dunning.

This unexplained behaviour of the *newcomer/latecomer firms* were then best handled by an alternative framework called the *Linkage–Leverage–Learning* (LLL) developed by Mathews (2002a). Accordingly, *linkages*, formed by joint ventures or any other kind of collaboration with the *incumbent* or the foreign firms help the *latecomer firms* to access resources that they lack internally. After getting linked up these firms *leverage* their low production cost advantages and *learn* new foundation of competitive advantages and ways to operate them internationally.

However, the *LLL* approach has been criticized by Dunning (2006) and Narula (2006). Narula (2006) highlighted the fact that *LLL* approach focus mainly on the fast-growing economies of Asia Pacific region. Additionally, according to Dunning (2006), it has been found empirically that many of the *newcomer firms* possess some kind of competitive advantage with them that explains their process of internalization. However, Aykut and Goldstein (2006) and Mathews (2002b) have given another dimension to this view of Dunning by stating that enjoying some kind of competitive advantage by the *newcomer firms*, for example early awareness to plan their activities keeping in mind the global competition and partnership, would put them in the position to rapidly connect with the global world and *leverage* their resources for joint collaboration.

4 Empirical Findings

This section surveys the empirical literature around different *push* and *pull* factors behind FDI inflows; business cycles of the advanced countries as determinants of FDI inflows and also tries to identify the causes associated with emerging outflows from the Global South.

4.1 Domestic Pull Factors as Determinant of FDI Inflows

The vast empirical literature that focuses on the *pull* factors as the determinants of FDI use cross-country regressions to identify country-specific characteristics regarding market size, labour cost, political and institutional stability, government policies, etc., to attract FDI.

In this section, we discuss the literature around these factors that exhibit steady relationship with FDI in determining its location.

i. Market Size

Attractiveness of the host country's market, generally proxied by the country's GDP or per capita GDP, has been widely accepted in the empirical literature as a significant determinant of FDI flows (see Wafure and Nurudeen 2010; Artige and Nicolini 2006; Masayuki and Razafimahefa 2005; Jordaan 2004; Nonnenberg and Cardoso de Mendonça 2004; Chakrabarti 2001; Resmini 2000; Tsai 1994; Culem 1988; Schneider and Frey 1985; Schmitz and Bieri 1972; Bandera and White 1968 etc.). According to this hypothesis, larger size of the host country's market is associated with higher inflows of FDI as large markets are necessary for exploiting natural resources and economies of scale. Culem (1988) supported the market size hypothesis in a study of six industrialized countries, over the period 1969–1982. Similar results were reported by Papanastassiou and Pearce (1990), Swedenborg (1979) and Dunning (1980). Resmini (2000) found that for manufacturing FDI, countries of Central and Eastern Europe with huge population attract more FDI. Similar result was found by Bevan and Estrin (2000) where larger economies of the transitional countries attract more FDI. However, the relationship between market size and FDI is not unanimous. Whereas, Asiedu (2002); Jaspersen et al. (2000); Edwards (1990) found a negative relationship between real GDP per capita and FDI/GDP; Pistoresi (2000), Resmini (2000), Billington (1999), Shamsuddin (1994), Tsai (1994) and Schneider and Frey (1985) have found a positive relationship between market size and inward FDI.

However, there lie some conceptual problems with the market size variable (Chakrabarti 2001). Though most of the studies have used per capita real GDP as a measure of attractiveness of the host country's market and have shown significant positive relationship between market size and inward FDI; there exist some studies that have used absolute value of GDP as an alternative measure. Absolute value of

GDP of a developing country is a very poor measure of market attractiveness for the foreign investors as it really shows the size of the population rather than income. Moreover, use of GNP or GNP per capita as a measure of market size is also inappropriate in the context of foreign investment.

ii. Infrastructure Development

Another variable that attracts multinationals is good quality of infrastructure. Usually number of telephones per 1,000 population is taken as a measure of infrastructure development. Asiedu (2002); Loree and Guisinger (1995); Wheeler and Mody (1992) found that good quality infrastructure positively influences inflow of FDI.

iii. Wage or Labour Cost

One more important factor that determines FDI inflows, in spite of its controversial nature, is wages or labour cost (Chakrabarti 2001). Though, theoretically, cheap labour may be one of the most important causes of the multinationals venturing in the labour-abundant developing countries, no unanimity has been reached by the studies in exploring the role of wage in attracting FDI. Whereas, Wheeler and Mody (1992), Nankani (1979), Swedenborg (1979) found strong positive relationship between cheap labour and inflow of FDI; Pistorresi (2000), Shamsuddin (1994), Culem (1988), Schneider and Frey (1985), Flamm (1984), Saunders (1982), Goldsbrough (1979) found higher cost of labour to discourage inward FDI. Narula and Wakelin (2001) use unit labour cost in the manufacturing industry to show that cheap labour acts as an incentive for the US firms to invest in foreign countries. Lipsey (1999), Tsai (1994), Sader (1993), Lucas (1990); Gupta (1983) and Owen (1982) found statistically insignificant relationship between labour cost and inward FDI. Tsai (1994) got strong positive relationship between cheap labour and FDI for the period 1983–1986, but a very weak association during the period 1975–1978.

iv. Openness

Openness, generally measured by the ratio of trade to GDP, is an important factor affecting the location choice of FDI. According to the openness hypothesis, a country's openness in international trade is a determining factor for FDI flows and the standard hypothesis is that openness encourages FDI. However, the impact depends on the type of foreign investment. If the investment is of market-seeking type then restricted trade can have positive influence on inward FDI flows. On the contrary, export orientation investment on the part of the multinational corporations may encourage them to locate in a more open economy. Leitão (2010), Hailu (2010), Quazi (2007), Sekkat and Veganzones-Varoudakis (2007), Nonnenberg and Cardoso de Mendonça (2004), Anyanwu and Erhijakpor (2004), Asiedu (2002), Noorbakhsh et al. (2001), Hausman and Fernandez-Arias (2000), Pistorresi (2000), Morisset (2000), Gastanaga et al. (1998), Edwards (1990), Culem (1988), Kravis and Lipsey (1982) found significant positive relationship between trade openness and inward FDI flows. Singh and Jun (1995) found openness to be very important in attracting FDI and also focused on the complementary relationship between the

two. However, there are studies that show negative or weak association between the variables. For example, Wheeler and Mody (1992) and Schmitz and Bieri (1972) found weak link between trade openness and FDI. Yih Yun et al. (2000) reported negative relationship between the two variables.

v. Exchange Rate

According to the exchange rate hypothesis, weak currency discourages foreign investors to invest in that location. However, the findings in this area widely vary from being significantly positive to negative and insignificant. For example, Blonigen and Feenstra (1996), Blonigen (1995), Froot and Stein (1991) found strong negative relation between a country's exchange rate and FDI inflows; Tuman and Emmert (1999), Sader (1993) reported insignificant relationship between the two variables and Edwards (1990) found significant positive relationship.

vi. Taxes

Regarding the role of taxes in attracting FDI, there is no unanimity in the literature. Whereas, Swenson (1994) found positive significant relationship between the two variables; Billington (1999), Barrel and Pain (1998), Kemsley (1998), Cassou (1997), Loree and Guisinger (1995), Guisinger (1985), Hines and Rice (1994), Grubert and Mutti (1991), Hartman (1984) found significant negative association between corporate tax rate of the host country and inward FDI. Moreover, there are papers, for example Porcano and Price (1996), Jackson and Markowski (1995), Yulin and Reed (1995), Wheeler and Mody (1992) that found no significant relationship between the two variables.

vii. Human Capital

There is mixed evidence regarding the role played by human capital in an economy in attracting FDI. The relationship between MNCs and human capital is not straightforward. The relation follows two main directions. On the one hand, MNCs enter only when the critical level of human capital is high in the host country (see Head and Ries 2002; Greenaway and Nelson 2001; Xu 2000; Borensztein et al. 1998; Berman et al. 1998; Benhabib and Spiegel 1994; Nelson and Phelps 1966, etc., for surveys) and on the other, MNCs influence human capital through spillovers (see Blomström and Kokko 2003; Slaughter 2002; Gorg and Strobl 2001, 2003; Kokko et al. 2001, etc., for related discussion). Zhang and Markusen (1999); Lucas (1990) and Dunning (1988) observed that cheap labour may not be sufficient for attracting FDI, quality of the labour force is also crucial. Noorbakhsh et al. (2001) find the levels of human capital as one of the most important determinants of attracting FDI. Improvements in education and level of human capital increase the absorption capacity of foreign technology by the domestic firm. This view suits well for countries like Korea and Taiwan where a large amount of FDI flowed only after the countries were able to develop a workforce that was highly educated. This line of argument suggests that countries with high initial endowment of human capital attract foreign capital that subsequently brings about skill-biased adjustments in sectoral capital-labour ratios. Xu (2000) uses a multicountry study of technology

diffusion effect of multinational enterprises to show that for the LDCs US affiliates have positive productivity effect on the host country but the author found no evidence of relating positive productivity to technology transfer.⁶ Regression results of the model shows that positive effects depend on the threshold level of human capital which lies somewhere between 1.4 and 2.4 years of male secondary school attainment which was much higher than 0.52 as estimated by Borensztein et al. (1998).⁷ Most of this literature points on the existing ‘skill gap’ that MNCs face while investing in developing countries. However, the empirical studies suggest that this ‘skill gap’ is endogenous with FDI. Miyamoto (2003) emphasized that ‘skill gap’ and FDI reinforce each other through complementary channels. Kar and Sinha (2014) in a theoretical study develop an aggregate transmission mechanism to show that technology deepening through MNC activities in the advanced sectors affect economywide skill formation. Accordingly, deepening of technology unambiguously raises the aggregate skill formation of the economy when the MNCs are more skill intensive than the traditional sector of production.

viii. Institutional Quality

In the recent years, institutional quality of the developing countries has qualified as one of the most important factors to attract FDI (see, Bissoon 2011; Ali et al. 2010; Kinda 2010; Wernick et al. 2009; Busse and Hefeker 2007; Daude and Stein 2007; Anghel 2005; Stein and Daude 2001; Hausman and Fernandez-Arias 2000; Wei 1997, 2000; Shleifer and Vishny 1993; Wheeler and Mody 1992). Wheeler and Mody (1992) made an early attempt to investigate the role of good institutions on FDI by taking a composite measure of risk factors that included institutional variables like extent of bureaucratic red tape, political instability, corruption and quality of the legal system. These factors were then tied up together with other factors such as, attitudes towards private sector, living environment, inequality, risk of terrorism, etc., making it complex to identify the factors separately in the index. However, taking the first principal component of 13 risk factors of their composed index, Wheeler and Mody (1992) did not find any significant impact of good quality institutions on the location of US multinationals. Later studies done by Wei (1997, 2000) found negative association between corruption and FDI. Using a broader range of institutional variables, Stein and Daude (2001) showed that quality of institutions plays significantly in attracting FDI. Hausman and Fernandez-Arias (2000) found better institutions to play negative role in attracting FDI. Accordingly, foreign capital inflows other than FDI were much more sensitive to good

⁶The reason was that LDCs were not endowed with sufficient amount of human capital to absorb the technology diffusion of the MNEs.

⁷“This threshold value is much higher than the 0.52 years estimated by BGL (1998). BGL’s estimate is the human capital threshold to benefit from the presence of MNEs, while our estimate is the human capital threshold to benefit from technology transfer of MNEs. Most LDCs meet the first threshold but not the second. Our results are consistent with the findings of the previously mentioned single-country studies; technology spillover effects of MNEs are positive and significant in advanced countries but are insignificant in less developed countries” (Xu 2000, p. 479).

institutional quality. In another study, Globerman and Shapiro (2002) found good governance to have positive influence both on inflows and outflows of FDI, however, the influence on outflows was significant only for developed countries. Zheng (2006) found inverted U-shape relationship between institutional quality and FDI flows. Accordingly, strengthening of institutions simply created a downfall in the inflows of FDI after a period of high flows associated with low-quality institution. Intuitions may be that strengthening of political institutions was guided by new rules that did not suite the foreign investors.

4.2 Push Versus Pull Factors as Determinant of FDI Inflows

Importance of *push* versus *pull* factors in driving FDI has been discussed in the works of Calvo et al. (1993), Chuhan et al. (1993), Schadler et al. (1993), Hernandez and Rudolph (1994), Dooley, Fernandez-Arias, and Kletzer (1996) and Fernandez-Arias (1996). In Calvo et al. (1993) foreign exchange reserves were taken as a proxy to capital inflows in Latin America; Fernandez-Arias (1996) measured quarterly portfolio capital inflows for a panel of middle-income developing countries and the study by Dooley, Fernandez-Arias and Kletzer (1996) took price of commercial bank debt as a proxy of capital inflows. All these three studies found external factor to be the prime determinants of capital inflows in spite of their modelling differences. Dooley, Fernandez-Arias and Kletzer (1996) showed external factors to play the leading role in explaining rise in prices leaving no role for the domestic environment.

Foreign capital inflows to Latin America during the second half of 1980s that increased significantly during 1990 and 1991 was partly explained by external conditions such as continuing recession, falling of world interest rate and balance of payment developments in the US (Calvo et al. 1993). Calvo et al. (1993) used principal component analysis to show significant co-movement among foreign reserves and real exchange rates for ten Latin American countries for the time period 1990–1991. Structural VARs conducted in the model shows that foreign factors contribute significantly in accounting for movement in reserves and real exchange rate. According to Fernandez-Arias (1996), linkages and channels in his study have been discussed analytically and empirically, unlike the study of Calvo et al. (1993) where conclusions relied only on statistical analysis of common factors. In addition according to Fernandez-Arias (1996), findings of Calvo et al. (1993) were not in line with traditional portfolio models that are guided by return differentials. Importance of external factors supported in the above-mentioned works has been challenged by Schadler et al. (1993), where the authors have identified that in many cases timing of the change in external factors do not match the timing of internal flows. Moreover, country-specific factors played a huge role that was ignored by the above-mentioned studies. On the other hand, Hernandez

and Rudolph (1994) have shown how careful specification of domestic factors could explain long-term credit flows for a sample of 22 developing countries for the time period 1986–1993. They found statistical significance of domestic credit worthiness with no role of external factor.

4.3 Business Cycles in Advanced Economies and Flow of FDI to Emerging Markets

Cycles of economic development in United States are felt in many of the developed countries, and the same holds true for many emerging economies of Asia, Eastern Europe and Latin America. Central banks opt for easy monetary policy and lower down the interest rate to dampen the effect of business cycle during the recession and hike the interest rate with the signs of boom. Falling of US interest rate and accumulation of foreign exchange reserves in the banks of Latin American countries and associated currency appreciation highlighted in the works of Calvo et al. (1993) have been supported by subsequent studies. In another study conducted by Reinhart and Reinhart (2001) over the period 1970–1999, it was shown that FDI, which is more stable than other forms of capital outflows, shrank during US recession and short-term capital continued to grow. More specifically, outflow of FDI and portfolio capital to the emerging economies increased when there were economic expansions in the US coupled with falling interest rate (Reinhart and Reinhart 2001). On the contrary, other flows (bank lending) increased with US recession and falling interest rate. This disparity between FDI and other forms of capital flows owes to the lending operation of the banks abroad in the midst of falling domestic demand and declining interest rate during the recession. However, the study found that regionwise the composition of capital flows were different for different parts of the business cycle. Rising Asia, Middle East and Europe showed signs of slowing down with downturn in US economy, while for Africa and Western Hemisphere the picture was different (Reinhart and Reinhart 2001). Works done by Fernandez-Arias (1996), Frankel and Roubini (2000) and Kaminsky and Schmukler (2001) show evidence that as the cost of borrowing international capital falls more than fall in the international interest rate for many emerging countries, their country-risk premia moves with international interest rate in a manner that magnifies the interest rate cycles of the industrialized countries (Reinhart and Reinhart 2001). Most recently, Albuquerque et al. (2005) has shown negative relationship between rising interest rate in the advanced countries and outflow of FDI to the developing countries.

Studies of Calvo et al. (1993) and Reinhart and Reinhart (2001) focused on aggregate data on FDI flows and used US cycle as a proxy for source country cycle though US only accounted for nearly 30 % of the total outflow and inflow of FDI from the perspective of OECD countries. These limitations have been addressed in the work of Yeyati et al. (2007) where bilateral FDI flows for 22 OECD source

countries are taken and the cycles of both the source and host countries are identified separately. Findings of the paper confirm the conclusions of the previous studies. Interest rate cycles of the source countries again came out to be an important determinant of FDI flows. For Europe and US, outflow of FDI was countercyclical with the business cycle (for Japan the opposite was true) and the outflows declined with rising interest rate (Yeyati et al. 2007). However, the overall contribution of business cycles of the industrialized countries in outward FDI movement is not unanimous and eventually depends on empirical issues. In another paper, Norris et al. (2010) uses data on bilateral FDI outflows from G7 countries to low-income countries to document the role of economic conditions of the developed countries in explaining cross-country variations in FDI inflows in the recent period. Accordingly, economic conditions of the developed countries are found to be significant determinant of cross-country variations of FDI inflows in the recent years.

4.4 Internalization by the Global South

Though outward investment by the emerging economies is not a new phenomenon, the past couple of decades have witnessed a surge in the quantity and also qualitative transformation in the pattern of their investment. There has been a significant increase in the outward investment by the developing country multinationals since 1980. The figures increased from \$80 billion in 1980 to \$129 billion in 1990 to more than \$1 trillion in 2004 (UNCTAD 2004). The emergence of second wave of MNEs was quite different from the *first wave* or the *pre-globalization* success stories that were mainly driven by domestic *push* factors such as market restrictions and export difficulties. According to Yeung (2000), the rise of *second-wave* MNEs from emerging market economies, best known as *latecomers* “*is less driven by cost factors per se, but more by a search for markets and technological innovations to compete successfully in the global economy*”. The *latecomer firms* utilized these *pull* factors for their rapid internalization. However, the emergence of this *second-wave* firms was a paradox as their sudden appearance cannot be explained by conventional strategies adopted by MNCs.

It has been well recognized in the literature that flow of outward FDI has been a result of interaction between domestic *push* factors, e.g. internal policies, inadequateness of domestic market (in terms of scale and opportunities to expand), tough competition at home, export difficulties and external *pull* factors. There are a number of studies (see Aykut and Ratha 2004) that attempt to explain the relative importance of these factors that drive outward FDI from the developing countries.

Below we list the different factors responsible for outward FDI from developing countries and also highlight some of the respective studies dealing with them.

4.4.1 Drivers of Outward FDI for the Global South: Empirical Evidence

One of the most important domestic *push* factors that drive out FDI from developing countries is *market and trade related conditions*. According to UNCTAD (2006), internalization by the Chinese firms is mainly driven by poor domestic market opportunities and trade barriers. Moreover, rising *labour cost* has become a cause of concern for the MNCs from countries such as Malaysia, Republic of Korea, Singapore and Mauritius (see Schive and Chen 2004; Brooks and Mirza 2005). Inflationary pressure has been one of the main driving factors for countries like, India, China and Turkey during the 1990s (see Erdilek 2005; Banga 2006). According to Hymer (1976) and Athreye and Kapur (2009) firms often rush to invest abroad to increase their *competitiveness* vis-a-vis their domestic rivals (e.g. strong competitive element has been found in the overseas investment by the Indian MNCs). Moreover, pressure mounting due to competition from *low-cost production* (mainly from East and South-East Asian manufactures) in the international market has been the cause of internalization for many Latin American and African countries (see ECLAC 2006; Farrell et al. 2005; Gaulier et al. 2006). Moreover, in an integrated world, *opportunities of competition* from foreign companies have become another major source of internalisation by the firms from the developing economies. According to Nolan (2001), Jürgens and Rehbehn (2006), rapid increase in Chinese outward FDI is mainly attributed to competition from foreign companies. However, competition abroad also provides incentive for firms from developing countries to invest abroad. It has been shown by Fortanier and van Tulder (2009), in some sectors (e.g. chemicals and pharmaceuticals, oil and petroleum and telecommunications) MNCs from developing countries set up joint ventures with the existing MNCs from the developed countries to compete globally. In addition, home country *government policies* and *adverse business conditions* also play significant roles in outward FDI. Transparent governance, investment in infrastructure, property rights, minimal exchange rate regulations and other macroeconomic conditions of the home country determine the location choice of FDI. According to a survey conducted by UNCTAD, decision of the Chinese firms going global was mainly guided by home *government policies*. Moreover, *adverse business conditions* mainly generated from inadequate infrastructure, labour issues, or undeveloped input or component services push firms to invest in foreign countries (e.g. labour issues have played a significant role in South Africa in limiting domestic investment and in possible rise in foreign investment).

However, merely studying of *push* and *pull* factors may not be sufficient to understand the ultimate location choice of the developing country MNCs; understanding of their motives and strategies is also essential (UNCTAD 2006). A particular driver that affects different MNCs may lead to different motives and strategies thus ending up with different location choices by the firms. For example, competition faced in the domestic sphere may lead a firm to invest overseas, but it can respond to this pressure in a number of ways. For instance, the firm may go for searching new customers in a middle-income developing country by taking *market-*

seeking attitude; or it may go for *efficiency-seeking* by investing in a lower income developing country to lower its cost of production; or it may adopt *resource-seeking* behaviour in search for key inputs may be in a country with abundant supply of raw materials; or even it may go for *created asset-seeking* in developed economies; or may go for a *mixed strategy*. Therefore, whereas, *resource-seeking*, *market-seeking* and *efficiency-seeking* motives are to be found as the dominant factors driving out FDI to other developing countries; *strategic asset-seeking* has been the main motivation for FDI flying from developing countries to developed countries.

Below we discuss different motives of MNCs that lead to location choice of outward FDI from the developing economies.

4.4.2 Motivations

Coming to the *market-seeking* motive, accessing the global market has been one of the most important motives of outward FDI from the developing countries (see Aykut and Goldstein 2006; Athreye and Kapur 2009). Though evidence of *market-seeking* behaviour is very common in most of the industries, variations occur depending on the nature of the source country (e.g. outward FDI from South Africa is very common in industries such as chemicals, food and beverages, finance, and transport and communication). Though, developed country markets are very attractive due to their large market size and accessibility due to regional integration, especially, North America and Europe; theory and evidence suggest that most of the MNCs from developing countries, such as, Latin America, Africa, East and South-East Asia, initially invest in their neighbouring economies especially due to familiarity and common factors. Recently, market size has generated increasing interest in South-South investment and trade corridors by some of the Brazilian, Indian, Chinese and South African firms seeing prospects in each other's relatively large markets.⁸ However, according to UNCTAD (2006) greater relative importance is given to developed country markets than to developing country markets by a majority of firms from India, China, Korea and Russia. Moreover, apart from capturing the vast markets of the developed economies through exports, some of the affiliates were established to get proximity to their clients (for example Indian IT firms) and some to get access to the foreign markets against protectionist barriers (investment by Chinese firms).

Another motivation for the firms from the developing countries (mainly countries that lack natural resources, e.g. India, China and Turkey) to invest abroad is to get access to natural resources; especially raw materials (see Makino et al. 2002; Ariff and Pio Lopez 2007; Cuervo-Cazurra 2007; Buckley et al. 2007; Kumar and Chadha 2009 etc.). Buckley et al. (2007) found *resource-seeking* from developing countries to be an important motivation for Chinese outward FDI. In another study,

⁸See Kaplinsky and Morris (2006), Naidu (2005), Rios-Morales and Brennan (2006), Goldstein and Toulan (2005) for literature on trade corridors.

Kumar and Chadha (2009) find that most of the *resource-seeking* outward FDI from Chinese and Indian firms are driven by the motive to secure the supply of raw materials for the development of their respective homelands. State-owned enterprises namely, China National Petrol Corporation (CNPC), China National Offshore Oil Corporation (CNOOC), India's Oil and Natural Gas Corporation (ONGC), Turkish Petroleum Corporation (TPC), etc., are typical firms in this category. Most of these firms from countries with poor reserve of natural resources have invested in the areas determined not by regional proximity but by availability of resources. For example, ONGC from India has a vast area of operation that includes Algeria, Brazil, Côte d'Ivoire, Cuba, the Islamic Republic of Iran, Kazakhstan, Nepal, Nigeria, Qatar, the Russian Federation, Syrian Arab Republic, Sudan and Venezuela. In another study, Goldstein (2008) showed that outward FDI activities of Tata Chemicals and Tata Power have been guided by their access to natural resources required for their production process.

The *efficiency-seeking* outward FDI is an important purpose for companies mostly from Asia and for industries, namely, electrical and electronic products, garments and footwear and IT services (see Ariff and Pio Lopez 2007; Sim and Pandian 2007; Kazmi 2006; Chen and Lin 2005; Page and Velde 2004; Lim 2005; Moon 2005; Zainal 2005; Cherry 2001, etc.). MNCs for whom *efficiency-seeking* motive is very important mainly comes from Hong Kong (China), Malaysia, Mauritius, the Republic of Korea and Taiwan Province of China. Most of these countries nowadays face relatively high cost of labour that has forced them to invest in lower cost locations that has generated, in some cases, regional integrated production system (Samsung is a typical example as it has production facilities all over South-East Asia). For firms from Taiwan province of China efficiency means low-cost production and for the Indian firms efficiency represents synergies obtained from international integration in production and services. However, there are a few firms from China and Singapore that go for low-cost *efficiency-seeking* outward FDI.

There are some studies like Buckley et al. (2007); Cross and Voss (2008); Liu and Tian (2008) that focus on *strategic asset-seeking* motive together with *market-seeking*. Firms adopt *mixed motives* when they invest for more than one purpose simultaneously. Singapore Technologies Telemedia has ventured in a number of markets including Indonesia, United Kingdom, United States, and in many Latin American countries since 2002. According to UNCTAD (2006) all of its foreign affiliates are established to access the local market and at the same time secure strategic assets and create synergies. *Complementary motives* are found in many firms when they combine more than one motive to pursue their goal. Integrated Microelectronics Inc (IMI), a Philippines-based company has gone for *complementary motives* when it adopted two strategies such as *created asset-seeking* and *market-seeking* by acquiring its first foreign affiliate in US to improve its own R&D and at the same time buying a Singapore-based affiliate with manufacturing facilities in Singapore and China to improve its competitive position in China's electronics market. Regarding the *evolutionary motives* Pradhan (2007) has identified the evolution of motivations of the Indian MNCs that started mainly with *market-*

seeking activities in the pre-liberalization period aiming towards other developing countries. This strategy shifted to *resource-seeking* and more recently to *strategic asset-seeking* in developed countries.

5 Concluding Remarks

Increase in capital movement in different parts of Asia, Eastern Europe, Latin America, the Caribbean and the Russian Federation in the past couple of decades suggests that both the global factors and the favourable domestic conditions of the developing countries played important roles in driving FDI flows to these countries. The rush in global inflows to the middle-income and low-income countries before the global financial crisis of 2008 occurred in the strong background of global economic growth and strong terms of trade. Emerging economies continued to grow at a high rate with increasing South-South trade and FDI linkages. Moreover, favourable financial conditions accompanied by low world interest rates resulted in huge global liquidity and low borrowing costs. Though most of the related literature in this regard has focused on the relative importance of *push* and *pull* factors to drive global capital to the new set of countries, there is another strand of thought that focuses on the macroeconomic *countercyclical* policies adopted by the capital importing countries. According to World Bank, Latin America and the Caribbean were the least affected in the 2009 global economic meltdown compared to other regions. Accordingly, whereas weak currencies, fiscal processes and banking system magnified the degree of previous crisis in the region, improved macroeconomic and financial conditions helped the economy to stay balanced during 2009. In this case, effective implementation of *countercyclical* policies not only supported domestic demand for the large countries of the region but has also met the rising demand from fast growing emerging markets, e.g. China.

Moreover, business cycles in the industrialized countries also play an important role in determining capital flows to the rising economies. Interest rate cycles coupled with *countercyclical* monetary policy of the developed countries influence emerging economies' access to international capital. Regarding the outflow of FDI from the Global South, though outward investment by the emerging economies is not a new phenomenon, the past couple of decades have witnessed a surge in the quantity and also qualitative transformation in the pattern of their investment. Survey of the literature finds that besides studying the *push* and *pull* factors it is important to study the motives and the strategies of the developing country MNCs to know their location choice. These firms may be guided by *market-seeking*, *resource-seeking* or *efficiency-seeking* behaviour while investing in other countries. Clearly, further research is needed to understand the determinants of FDI outflows from the Global South, and the standard theories of the determinants of FDI may need to be revisited, in light of this very recent phenomenon, that is sharply increasing in significance in global capital flows.

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