Antecedents of Foreign Direct Investment: A Review Study

David Boohene
University of Energy and
Natural Resources
Ghana, West Africa.

Joseph Asante Darkwah
Zhejiang Gongshang University
Hangzhou, Zhejiang
China, East Asia.

Abstract

This paper provides a narrative review of the factors that influence foreign direct investment (FDI) in an economy. The articles relied on to assist in this regard were from relevant literature gotten through the search of published studies in major databases, namely Scopus, Google Scholar, DOAJ, Science Direct, and Semantic Scholar, using keywords such as foreign direct investment determinant, economic growth, and development. Articles published after 2005 were mainly included in the study. The study identified some variables that determine FDI uptake and highlighted that factors influencing FDI differ as one moves from one place to another, especially when these areas are not at par in terms of development. Trade openness, gross domestic product (GDP) growth, natural resources, political stability, the regulatory framework, market size, corruption levels, human capital levels, and inflation appear to be the main factors influencing FDI inflows. Other factors are the exchange rate, corporate governance, and tax incentives, among others.

Keywords

Foreign direct investment, Trade openness, Political stability, GDP growth, and Market size.

1. Introduction

The factors that influence FDI inflows and the consequential growth of an economy are enormous, and they continue to increase as economists' day in and day out come out with new modules enabling them to compute variables that were previously neglected because of their ambiguity or unreliability. For instance, in developing and developed countries, researchers have documented that the presence of educational institutions influences the development and growth of a region (Boohene and Maxwell 2017). Human capital, on the other hand, as a whole influence economic growth (Pelinescu 2015; Hanushek & Woessmann 2010). In a broader perspective, Brooks et al. (2003) opine that FDI can promote development and generate jobs, particularly in the tertiary sector, increasing GDP. In this light, most emerging and developing countries rely on FDI for

developmental projects. It must be stressed that FDI is neither a new nor obsolete concept as a research topic. Also, attention has to be drawn to the fact that the factors that hinder or improve FDI location decisions have been widening over the years. For instance, early Sub-Saharan African and Asian scholars focused on the region's market access, natural resources, and political stability (DeGregorio, 2005). Most of the time, researchers have found a direct link between these factors and foreign direct investment. In that sense, the larger your natural resources, the more FDI you attract, or the better the country's political climate, the more attractive the country is to foreign investment, which could further lead to development and growth. Thus, understanding the antecedents or factors that influence FDI inflows into a region is essential for policymakers and stakeholders seeking to attract foreign investment for economic development and growth. Thus far, this paper reviews some variables that determine FDI inflows in recent years.

2. Review of the Literature

Researchers from developing economies have moved the investigation of FDI inflows to cover factors like trade openness, regulatory framework, infrastructure, and nations' inflation (Assa, 2018; Evans et al., 2018). Although current research on some of these earlier variables renders some inconclusive, the tendency to find a contrary relationship to the earlier research is possible, given that the way of doing business has evolved over the years. What used to scare investors yesterday are seen as an opportunity today by those accustomed to the ever-changing terrain in which businesses operate (Khodaei & Ortt, 2019).

Furthermore, researchers are concerned about finding out whether political stability, political institutions, and control of corruption matter when it comes to decisions for the siting of FDI in a region. For instance, a study by Asante Darkwah et al. (2023) shows a strong connection between FDI inflow, human development, and corruption control. Their study further revealed that while human development has a beneficial influence, controlling corruption has an uncomplimentary impact on the growth of FDI in sub-Saharan Africa. Again, researchers are concerned about what happens if the political stability of a country or region does not necessarily influence the attractiveness of a nation for FDI but rather the type and quantum of its natural resources? And what role will new variables like value added per worker, as well as control of corruption, play in the new world after Covid-19 (Asante Darkwah et al., 2023; Boohene & Darkwah, 2023)? Various studies prior to Covid-19 have shown that country-specific factors such as trade openness, regulatory framework, exchange rate, commercial interest

rate, and inflation heavily influence FDI determinants (Mikinis & Juozenaite 2015; Xaypanya et al. 2015; Asiamah et al. 2015).

Asiamah et al. (2019) examine the variables that determine FDI in Ghana from 1990 to 2015 and find a cointegrating relationship between FDI and its determinants. The research concludes that in both the long and short run, there is an adverse effect of interest rates, exchange rates, and inflation rates on FDI in Ghana. On the other hand, there is a positive effect of telephone usage, gross domestic product, and electricity production on FDI in Ghana. The paper employs a causal research design to ascertain the determinants of FDI and uses Johansen's approach to cointegration within the autoregressive vector framework for the data analysis. This work is similar to previous papers on FDI inflows in terms of the chosen study area and some variables, like GDP and inflation, to ascertain how they impact FDI. However, it differs because it concentrates on a single country; thus, the findings cannot be imposed on other countries. For example, according to a study by Agbokah et al. (2023), which relied on the Generalized Method of Moments (GMM), it turned out that sound corporate governance affects the inflow of FDI into a region. Further, according to Sahiti et al. (2018), the research on FDI is an everlasting argument of inconclusive factors that impact negatively or positively given a geographical area. Their stance is affirmed by Saini and Singhania (2018), who examined the determinants that affected FDI uptake in developed and developing nations from 2004-2013 and concluded that outcomes vary across regions and countries. They do, however, categorically state that FDI positively links economic determinants like trade openness, gross fixed capital formation, and efficiency variables in developing economies. In contrast, FDI seeks policy-related determinants like trade openness, GDP growth, and the freedom index in developed countries.

Maybe the most important question here is whether certain factors could affect the FDI influx in developed and developing nations. On this matter, further investigation into the literature found that most academics looking at FDI in various economic zones see some elements, including political stability, market size, trade openness, the FDI regulatory framework, and tax incentives, as potential drivers of high levels of FDI. This also demonstrates that the reasons that drive large-scale investment (FDI) in nations may not change if one moves from one region to another. This is supported by the fact that the factors affecting FDI in Bangladesh and Ethiopia are not wholly dissimilar, and a possible explanation for this is when economies share similar traits.

Anarfo et al.'s (2017) study implies that natural resources and infrastructure growth are important triggers or indicators of FDI inflows in the African

subregion. Several additional factors, including the loan interest rate, market size, and GDP growth rate, heavily influence FDI inflows in the SSA region. When applying regressions to series, Anarfo et al. use the Prais-Winsten regression estimation process, which is essential to overcoming autocorrelation and heteroscedasticity in the error terms in a model. The research was done between 1975 and 2014. In keeping with this line of reasoning, Ali (2020) examines the significant factors that influenced foreign direct investment (FDI) coming into Ethiopia between 1992 and 2015 and finds that FDI and market size, trade openness, exchange rate, and financial freedom are all significantly and positively correlated. Additionally, there was a strong and negative correlation between FDI and inflation. He concludes that while these variables have a long-term impact on FDI, the results did not show a long-term association between FDI and its motivating elements alone. Ali makes an educated guess on the link using the Ordinary Least Squares approach.

All this research attests to the fact that weak economic fundamentals will make an economy less favorable to attracting FDI. For instance, political stability has a non-significant negative association with FDI inflow, although it has a strong negative relationship with tax (Das & Das, 2017). Konchitchki (2011) documents that inflation reduces the purchasing power of a given unit of exchange for a period of time. Agudze & Ibhagui (2021) study the effects of inflation on FDI in 74 countries, divided into industrialized and non-industrialized markets, on the same reasoning. The study determined that there are threshold effects in both industrialized and non-industrialized economies in the link between inflation and FDI. According to the study’s findings, non-industrialized countries have an inflation threshold that is roughly five times higher than that of industrialized countries. While inflation tends to reduce FDI inflows only when it exceeds its edge in industrialized countries, it has a negative impact on FDI in non-industrialized countries even when its threshold is not exceeded.

Aigheyisi (2019) delivers novel evidence on the effect of trade openness on FDI inflows in the SSA region using data from 1981 to 2016. The study employs the FMOLS estimator. Aigheyisi concludes, "The more democratic the government is, the more FDI the country attracts." The problem, however, is that the sub-region is young in terms of democracy. The continent has had three coups’d’état in the past decade alone. This could be problematic for foreign investors. The researcher, however, adds that the expansion of the domestic market, acceptable levels of inflation, and infrastructural development augment the attractiveness of an economy to FDI. Xaypanya et al. (2015) investigate the momentous factors influencing foreign direct investment (FDI) in ASEAN3 and ASEAN5. ASEAN3

comprises Laos, Vietnam, and Cambodia, while ASEAN5 comprises Singapore, Indonesia, Thailand, Malaysia, and the Philippines. The researchers applied the first differencing technique to guesstimate the parameters on the built panel data studied from 2000 to 2011. In the findings of the paper, the researchers state categorically that because of the different stages of economic advancement amongst ASEAN3 and ASEAN5 countries, the determinants of FDI are not the same for all the countries. The paper documents that, for ASEAN3, there is a significantly positive effect on the level of openness and infrastructure facilities; however, inflation has a negative effect on FDI inflow. Also, net official development assistance, gross domestic product, and the real exchange rate have no impact on FDI. In the case of ASEAN5, infrastructure facilities, and market size are significant variables in attracting FDI. Furthermore, the paper states that, amid the high inflation rates and decrease in the level of openness measurement, the ASEAN-5 continues to attract foreign investors. Ultimately, the goal of this study is to provide a comprehensive understanding of the key influencers of FDI, which can inform policies and strategies aimed at attracting FDI into a region and promoting economic growth.

3. Research Methodology

Articles from relevant literature was identified through searches of published studies in major databases, namely Scopus, Google Scholar, DOAJ, Science Direct, Semantic Scholar, etc., using keywords such as foreign direct investment determinants, economic growth, and development. Only articles on influencers of FDI that were published after 2005 were included in the study.

4. Findings & Discussion

Foreign direct investment (FDI) is a significant driver of economic growth and development in many countries and regions around the world. FDI can provide several benefits, such as increased employment opportunities, technology transfer, and access to new markets. However, the factors influencing FDI are complex and vary depending on the region. Understanding the key determinants of FDI is crucial for policymakers and investors alike, as it can help them make informed decisions about where to invest and how to attract investment.

On trade openness, when a country embraces trade liberalization, removes barriers to international trade, and actively participates in global markets, it becomes an attractive destination for foreign investors. Trade openness provides foreign companies with access to larger consumer markets, increased export

opportunities, and potential cost efficiencies through global supply chains. As a result, FDI inflows tend to be higher in countries that are more open to trade.

A country's GDP tends to increase its appeal to international investors. Strong economic performance and solid growth patterns indicate a healthy business climate and possible market prospects. The possibility of greater investment returns attracts foreign investors more often in nations with rapid GDP development. The possibility of rising consumer demand, increasing markets, and increased profitability make a growing GDP appealing. Moreover, largely, there seems to be a positive relationship between the region's GDP and FDI inflows. The basic economic reasons for this stem from the fact that, with economic growth, comes the provision of some basic needs of livelihood, which include portable drinking water and electricity. These two are crucial for the production of goods and services too. With high economic growth, a more efficient, cheap, and fast transportation system is assured. In the absence of this, man hours from raw material to finished goods to the final consumer increase.

Natural resources have the potential to be used as inputs for many different businesses, luring in international investors looking to assure a steady supply. Manufacturing, energy, and construction sectors all rely largely on commodities and raw resources. Natural resource-rich nations can give foreign investors a competitive edge by supplying a reliable and affordable supply of inputs. By improving the competitiveness and profitability of foreign-owned industries, access to these resources can boost FDI inflow.

Political stability is also a crucial factor in FDI. Investors prefer regions with stable political environments because it gives them the assurance that their investment will not be at risk due to political instability. Regions with a history of political instability often discourage investors, as they fear that their investment may be lost due to government instability or political upheaval.

Further, the economic policies of a region are also important causes of FDI. Investors prefer regions with policies that are favourable to foreign investors, such as tax incentives, low tariffs, streamlined regulations, and investment-friendly laws. Countries and regions with well-developed infrastructure, such as good transportation systems, reliable telecommunications networks, and reliable energy supplies, also attract more FDI. Also, a transparent and predictable regulatory framework instils confidence in foreign investors. Clear and well-defined regulations provide certainty and reduce the perceived risks associated with investing in a foreign country. Investors prefer countries with stable and transparent legal systems that protect property rights, enforce contracts, and provide a level playing field for all market participants. A regulatory framework

that is consistent, transparent, and predictable fosters an environment of trust, which is crucial for attracting FDI.

The size of a region's market is another important element of FDI. Investors prefer regions with large markets because they provide a broader customer base, which can lead to increased profits. Additionally, regions that are strategically located and have access to other markets can also attract FDI, as investors can use these regions as a base to export to other countries. The study also highlights that factors influencing FDI differ as one moves from one place to another, especially when not at par in terms of development. That is, the proximity to key markets, access to resources, transportation networks, and regional integration opportunities are among the factors that make the geographical location an important determinant for foreign investors. Being located near major markets can significantly impact FDI inflow, as foreign investors often seek to establish a presence in countries that offer proximity to large consumer markets.

The level of corruption in a region is also an important determinant of FDI. Investors prefer regions with low levels of corruption because it can affect their investment by increasing the cost of doing business. Corruption can also create an uncertain business environment, which can deter investors from investing in a region.

The level of human capital in a region is also an essential factor in FDI. Investors prefer regions with a highly skilled and educated workforce. This is because a highly skilled workforce can provide the necessary talent to operate a business successfully. Regions that have a good education system and provide adequate training programs are more likely to attract FDI.

On the issue of inflation, it is interesting to note that the ability of consumers and businesses to make purchases can be reduced by high inflation rates. When inflation is high, costs of living and production rise, raising the price of products and services. Consumer demand and business profitability may therefore suffer as a result. Due to the reduced possibility of returns on investment caused by high inflation, foreign investors may be reluctant to make investments in certain nations. High inflation might further discourage foreign investors by causing economic instability and uncertainty.

Other critical factors that can influence FDI inflows include the exchange rate, corporate governance, and tax incentives in the local economy.

The attraction of FDI is significantly influenced by the currency rate (Lan Tan et al., 2021; Obgonna, 2019). A favourable exchange rate can make the goods and services of the host nation substantially less expensive for international investors, increasing the competitiveness and profitability of exports. A depreciated currency enhances the attractiveness of the host economy by reducing production costs and potentially increasing returns on investment. However, maintaining

investor trust and reducing the risks associated with currency changes require a stable exchange rate. Also, sound corporate governance practices play a crucial role in attracting FDI (Fazio & Chiara-Talamo, 2008). Investors prefer host economies with strong governance frameworks that protect shareholders' rights, ensure transparency, and minimize corruption. Effective corporate governance mechanisms, such as independent boards, clear disclosure requirements, and reliable accounting standards, instil confidence in foreign investors and reduce investment risks. Transparent and accountable corporate governance practices contribute to a stable business environment and attract long-term investments (Agbokah et al., 2022; Yung-Chih, 2005). Tax incentives offered by host economies are effective in attracting FDI (Abille and Mumuni, 2023). Governments often provide tax breaks, exemptions, or reduced tax rates to encourage investment in specific sectors or regions. These incentives can include tax holidays, investment allowances, or accelerated depreciation. By reducing the tax burden on foreign investors, host economies can enhance their competitiveness and create a more attractive investment environment (Etim et al., 2019).

5. Conclusion

The review showed that the factors that lead to the inflow of FDI into a region are multifaceted but differ as one move from one place to another, especially when not at par in terms of development. Trade openness, gross domestic product (GDP) growth, natural resources, political stability, regulatory framework, market size, corruption levels, human capital levels and inflation appears to be main factors influencing FDI inflows. Aside these, other critical factors that impact the decision of investors to invest in a region include but not limited to exchange rate, corporate governance and tax incentives. On the account of this, policymakers and investors are therefore advised to take these factors into consideration when making decisions about where to invest and how to attract investment. By creating an environment that is favourable to investors, including policies that are transparent, stable, and predictable, economies can attract FDI and promote economic growth.

6. References

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