

Chapter 15

The Nexus Between Institutional Quality and Foreign Direct Investments (FDI) in South Asia: Dynamic Heterogeneous Panel Approach

Mohammad Ashraful Ferdous Chowdhury
Shahjalal University of Science and Technology, Bangladesh

ABSTRACT

South Asia is one of the world's fastest growing regions, averaging 6.7 percent annual increases in real GDP over the past decade. However, South Asia's FDI inflows as a share of GDP are the lowest of all developing regions, averaging less than 2 percent in 2000-11 (World Bank, 2013). Institutional quality is one of the factors that determine the volume of FDI inflow in any country. This study covers the data of three sampled countries of South Asia provided by the World Bank for the period 2003-2014. By using both static and dynamic models, this study reveals that regulatory quality and the political stability have significantly positive impact on the FDI inflow into each of the three countries. For Robustness, this study also employs dynamic heterogeneous panel approaches like Pool Mean Group (PMG) and found that institutional quality factors are significantly relevant to the FDI. As a policy implication, the regression results indicate that during the process of reform, the relation between FDI and institutional quality warrants a certain amount of attention.

INTRODUCTION

The role of foreign direct investment (FDI) as a key driver of economic development has been proved by many researchers (Borensztein et al., 1995). It contributes to economic development through raising capital accumulation, increasing production capacity, enhancing technology, transferring knowledge, creating employment opportunities, improving management practices, enhancing competitiveness and fostering macroeconomic stability. The United Nations Conference on Trade & Development (UNCTAD) in their 2013 World Investment Report states that developing countries take the lead in foreign

DOI: 10.4018/978-1-5225-2345-1.ch015

direct investment (FDI). In 2012 developing economies received a higher inflow of FDI than developed countries. Also, Aizenmann, J. (2003) sees an increase in FDI in emerging economies. Thus, based on the increase of FDI it seems like companies are more interested in investing in emerging markets. However, investing in developing economies is not without risk. Ghemawat & Khanna (1998) argue that doing business in emerging economies is challenging due to information asymmetry and uncertainties. Political and economic risks are also significant risks. Institutions, both formal and informal, provide rules and procedures that reduce uncertainties involved in economic exchange. Informal institutions such as codes of conduct or conventions can trim down these uncertainties. Formal institutions via rules and regulations, laws, effective judicial systems and other institutions can reduce the uncertainties and provide effective enforcement mechanism. Codes of Institutional quality can be helpful by creating a more stable environment and accordingly reduce risks for multinationals associated with investing in developing countries.

However, for most of the countries, success in attracting sufficient amount of FDI inflows is not an easy job. Because of diversity in nature of factors affecting FDI inflows between countries, it is difficult to assess all these factors provided some of them are related to government political system. Governance indicators are identified by many researchers as significant determinants of FDI. The research acknowledges the gap in literature on the relationship between Institutional quality indicators and FDI flows particularly with respect to the Sub continental countries namely Bangladesh, India, and Pakistan.

Due to deep-rooted corruption, weak political and institutional structure, subcontinent is a very interesting region for case studies. Sahoo (2006) believes that there is a gap between policies and their implementations in this regions due to its dysfunctional institutional quality. Therefore, it may be worthwhile to provide strong foundation for a policy formulation through exploring the relationship between FDI and institutions based on country specific analysis. Subcontinent is a very interesting case study, because it is one of those regions which has experienced political turmoil in one form or the other, wide spread corruption, worse law and order situations, etc., which seem to be hurdles in attracting FDI in this region. The objective of the study is to find the impact of institutional quality on FDI(both inward and outward) of these three south Asian countries.

PRESENT STATUS OF FDI IN SELECTED SOUTH ASIAN COUNTRIES

Like many other developing countries, South Asian nations have been experiencing increased FDI inflows over the past decade as developing countries get a larger share of cross-border investments once sent to developed countries. Nonetheless, South Asia's FDI inflows remain the lowest relative to GDP among developing country regions. Of the inflows that do reach South Asia, India dominates, with much of the inflow reaching the service sector and very little going into industry, agriculture, or mining.

This series shows in Figure 1 net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors, and is divided by GDP. Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.

Foreign direct investment refers to direct investment equity flows in the reporting economy. Broadly, It is the sum of equity capital, reinvestment of earnings, and other capital. Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant

16 more pages are available in the full version of this document, which may be purchased using the "Add to Cart" button on the publisher's webpage:

www.igi-global.com/chapter/the-nexus-between-institutional-quality-and-foreign-direct-investments-fdi-in-south-asia/177681

Related Content

Globalization: Reshaping the World Economy in the 21st Century

Akhilesh Chandra Prabhakar and Vasilii Erokhin (2020). *Regional Trade and Development Strategies in the Era of Globalization* (pp. 1-24).

www.irma-international.org/chapter/globalization/249643

Implementation Concerns of Scholar-Practitioners: A Pilot Study of the Link between Research and Practice

Claretha Hughes, Jai Wang, Wei Zheng and Laird McLean (2010). *International Journal of Asian Business and Information Management* (pp. 32-46).

www.irma-international.org/article/implementation-concerns-scholar-practitioners/46019

An Analysis of Factors Influencing Green Purchase Intention in Airlines: An Interpretive Structural Modeling Approach

Mahmut Bakrand Nadjim Mkedder (2023). *Challenges and Opportunities for Aviation Stakeholders in a Post-Pandemic World* (pp. 218-234).

www.irma-international.org/chapter/an-analysis-of-factors-influencing-green-purchase-intention-in-airlines/319904

Local Milieu in Developing China's Cultural and Creative Industry: The Case of Nanluoguxiang in Beijing

Jici Wang, Chun Zhang, Ching-Ning Wang and Ping Chen (2012). *Advancing Technologies for Asian Business and Economics: Information Management Developments* (pp. 1-12).

www.irma-international.org/chapter/local-milieu-developing-china-cultural/63732

Fallacies in Decision Making From an Asian Perspective

Michael Sony and Neeta Baporikar (2021). *International Journal of Asian Business and Information Management* (pp. 117-132).

www.irma-international.org/article/fallacies-in-decision-making-from-an-asian-perspective/279814