

## Chapter 29

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

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### 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

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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 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.

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