Chapter 44
The Effect of Foreign Direct Investment on the Economic Development of Mongolia

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ABSTRACT

This article describes how foreign direct investment in Mongolia has reached 3.9 billion US$ mainly in the mining sector that amounted approximately 40% of the year's GDP. Even though FDI into Mongolia has been grown along with the country's economic development with trade openness to the world, a few studies have used regression analysis to analyze determinant factors of FDI. This article has estimated the determinants attracting FDI inflow into Mongolia by using two methods: applying single country (Mongolia) data using the determinants attracting FDI inflow into Mongolia from 1995-2014, and applying the determinants attracting FDI from the top investment countries using panel data, using random and fixed effects models from 2005-2013. The study results showed that GDP of Mongolia has a positive and significant effect on the FDI inflow. It was also revealed that the partner countries located either too far away from or too close to Mongolia pay little attention to and play a small investment role in Mongolian FDI.

1. INTRODUCTION

Foreign direct investment is generally seemed as a way through which technology can spread from developed countries to developing ones. Although the evidence of relationship of foreign direct investment(FDI) with economic growth is not clear, several studies agree that absorptive capacity of host country does an important role of explaining FDI. For instance, it is stated that FDI is positively related and significant

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only for higher income countries and has no impact in lower income countries. And it is asserted that contribution of FDI for economic growth is determined by its interaction to the human capital level in host country. Mungunzul and Chang (2016) showed that FDI does a different role in growth procedure because of differing trade policy regimes. Even though there are different shapes of overseas capital flows, FDI has been research topics. FDI is an investment done abroad through establishing a new company in host country or through acquiring shares to have full managerial power of existing foreign company.

This paper's goal is to determine the factors affecting the FDI flows into Mongolia through answering the following questions: Firstly, how FDI influences on economic development of Mongolia. Secondly, which factors can be identified with regard to FDI. Thirdly, what recommendations could be applied to induce FDI flows into the country.

2. METHODOLOGY AND DATA ANALYSIS

2.1. Research Model

A gravity model is a way of explaining FDI, not only the flow of FDI, but the effect of distance in FDI and relationship between FDI and trade of related countries by using econometric measure of distance. A gravity model can explain the relative market sizes of related countries and their distance each other. Mungunzul (2016) asserted that distance could be accepted as a measure of management cost in handling foreign activities, for example, cost of transportation and communications, cost of dealing with cultural and language gaps, costs of dispatching personnel overseas and the information cost of institutional and legal matters. Tinbergen (1962) and Pöyhönen (1963) suggested first version of the model. It has been argued that export is positively related to income of the related countries and the distance of the countries affects export. Several contributions have recently been made to this early version. A gravity model has been generally used for analyzing determinants of FDI inflows. In simple form, gravity model for FDI suggests that FDI has positive relationship with GDP levels in host and investing countries and negative relationship with the distance between countries. A number of empirical studies analyze bilateral FDI flows through the framework of the gravity model. The determinants of FDI flows to emerging economies was examined by Frenkel, Funke, & Stadtmann (2004).

Gravity model classic equation:

$$X_{ijt} = A\frac{Y_{it}^{B}Y_{jt}^{C}}{D_{ij}^{D}} \tag{1}$$

where Y_{it} is GDP of country *i* at time *t*, Y_{jt} GDP of country *j* at time *t*, D_{ij} distance between related two countries, and A, B, C, D constants. The left-hand side variable, X_{ijt}, is FDI flows country *i* to country *j* in time *t*. The gravity models have found application in the empirical literature for more than just inspecting FDI inflows. The relationship of gravity has been generally applied in trade flows area and similar relationship holds for large area of spatial economic interaction, for example, telecommunications, overseas equity holdings and technology transfer (Navaretti & Venables 2004).

Gravity type equation of the FDI study as follows: