The Determinants of FDI flows between OECD and CARICOM countries
by

Preeya Mohan
Patrick Kent Watson

Outline of Paper

- Objective and Motivation of Study
- Literature Review
- Data and Methodology
- Results
- Conclusion

Objective of Study

- To determine factors which affect FDI flows between CARICOM and OECD countries.

- Investigation carried out using Gravity model applied to twenty countries - twelve CARICOM and eight OECD for period 2000-2007.

Importance of FDI

- Since the 1980s FDI flows have increased exponentially.
- World FDI flows to CARICOM countries have also increased.
- OECD countries are the main contributors of FDI to developing countries.

Benefits of FDI

- OECD (2002) lists the following benefits of FDI to developing economies:

  - technology spillovers
  - improved human capital formation
  - enhanced trade and integration
  - encourage enterprise development
  - higher growth and potential for poverty reduction

Benefits Cont’d

-environmental preservation through transfer of ‘cleaner’ technology

-improved social conditions by forcing host countries to adopt more socially responsible corporate policies

Factors Affecting FDI

- Firms undertake FDI for a myriad of reasons.

- The factors looked at in study :
  1. Macroeconomic
  2. Financial Conditions in acquirer country
  3. Trade
  4. Transactions cost
  5. Tax regimes

Macroeconomic Factors

1. Real GDP of acquirer and target countries

- GDP acts as a measure of market size.

- Firms in countries with large GDPs are expected to engage in more FDI and to move to countries with high GDPs.

Macroeconomic Factors Cont’d

2. Price level in target country

- High prices create uncertainty over real returns which can reduce FDI Flows

Financial Conditions

- Ease of access to long term financing would stimulate FDI.
- Firms can obtain investment financing form two sources:

  1. Stock market
  2. Private credit

Trade

- Trade can affect FDI positively or negatively.
- High export costs encourage firms to set up local production facilities-negative relationship between FDI and trade.
- Stylized fact : trade and FDI positively related.

Trade Cont'd

- Trade is further investigated by looking at trade agreements between investor and host countries.

1. Do both countries belong to a common Customs Union?
2. Do both countries share a common Free Free Trade Agreement?
3. Do both countries have a common Service Agreement?
4. Any Other Common Trade Agreement

Transactions Costs

- Transactions cost hamper FDI flows.
- Distance acts as a proxy for transactions cost.
- Further apart two countries the greater the information asymmetries between them.

Transactions Cost Cont'd

- Having a common language reduces transactions cost as information can be more easily communicated.

Taxes

- Taxes not a main determinant of FDI.
- High taxes in host countries can deter FDI.

Data and Methodology

- FDI data recorded in the Annual BOP reports.
- Lack of bilateral FDI flows among CARICOM countries pose challenges for study.
- CARICOM countries report gross FDI flows only, no data on source and destination.
- Trinidad and Tobago is only country that provided such data.

Methodology

- A Gravity Model was used.
- The study augments Standard gravity model to include macroeconomic, financial, trade, transactions cost and tax variables some of which takes the form of dummy variables.

Model

- $\ln(FDI_{ij,t}) = \beta_0 + \beta_1 \ln Y_{it} + \beta_2 \ln Y_{jt} + \beta_3 \ln P_{it} + \beta_4 \ln(MC/YN)_{jt} + \beta_5 \ln(Credit/YN)_{jt} + \beta_6 \ln Dist_{ij} + \beta_7 \ln Trade_{ij,t} + \beta_8 CU_{ij,t} + \beta_9 FT_{ij,t} + \beta_{10} SA_{ij,t} + \beta_{11} Other_{ij,t} + \beta_{12} Lang_{ij,t} + \beta_{13} \ln Tax_{i,t} + e_{ij,t}$

Estimation

- Estimation done by pooling data across the twenty countries.
- Method of estimation Pooled Ordinary Least Squares (OLS).

Results

Variable	Coefficient	p-value
Y_i	1.198126	0.0000
Y_j	1.100664	0.0000
P	-5.719124	0.0000
$(MC/Y^N)_j$	0.096901	0.0296
$(Credit/Y^N)_j$	1.317641	0.0000
Dist	-1.788559	0.0000
Trade	-0.027167	0.1844
CU	7.400023	0.0000
FT	15.00556	0.0000
SA	-7.941388	0.0000
Other	-8.793793	0.0009
Lang	-2.937632	0.0000
Tax	-0.245595	0.0000

Results Cont'd

- All coefficients except trade in goods highly significant.
- Coefficients of real GDP for target and investor countries are large.
- Credit market to GDP coefficient was larger than stock market to GDP coefficient.

Results Cont'd

- Coefficient for Price level and taxes negative.

- Trade agreement dummies all highly significant.

Conclusion

- FDI flows more freely from high income to high income countries.
- It is encouraged by vibrant stock exchange and credit market in acquirer countries with credit having a larger effect.
- High price levels and oppressive tax regimes in target countries discourage FDI.
- Trade in goods do not appear to affect FDI but Trade and Service agreements do.

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