GO Green Research and Education
Journal of Business and Management Research
ISSN:2958-5074 pISSN:2958-5066
Volume No:3 Issue No:2(2024)

Factors Affecting Foreign Direct Investment In South Asian Countries

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Abstract

Foreign Direct Investment (FDI) plays a crucial role in the economic development of South Asian countries, contributing to their growth, employment generation, and overall stability. This study investigates the influence of FDI on south Asian countries. Secondary data of was collected World Asian Development Bank, World Development Indicator and Federal Bureau of Statistics. Fixed Effects Model has been recommended by the Chow and Hausman tests for the regression analysis in this study. The finding of the study revealed that GDP, Lending interest Rate, Trade openness, and political stability has a positive and inflation rate has a negative significant explanatory factor at 1%, 5 %, and 10% level that attract Foreign Investment in the emerging Asian economies. Based on the findings, the state should stabilize the exchange rate and adopt liberal policy to increase bilateral trade across the border. Furthermore political stability must be maintain to encourage the foreigner investor for investment in the Asia.

Keywords: FDI, South Asian Countries, Pooled data, Fixed Effect Model, GDP

Introduction

Foreign Direct Investment (FDI) plays a crucial role in the economic development of South Asian countries, contributing to their growth, employment generation, and overall stability (Sahoo et al., 2014). FDI is widely regarded as an excellent instrument for economic development and expansion. FDI can contribute to the host country's economic growth by providing additional capital for investment, leading to increased production and employment (Inekwe, 2013). Foreign Direct Investment (FDI) in South Asian countries has been a notable phenomenon, with varying degrees of success and challenges across the region (Qazi, 2014). Despite these challenges, South Asian countries continue to actively seek FDI to fuel economic growth, create jobs, and develop key sectors. Efforts to address infrastructure gaps, streamline regulations, and enhance the overall business environment are ongoing to attract and retain foreign

ISSN:2958-5074 pISSN:2958-5066
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investors in the region. The landscape of FDI in South Asia is dynamic, and policies are continually evolving to encourage sustainable economic development.

South Asia comprises countries such as India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan, and the Maldives. India has been one of the largest recipients of FDI in the region. The country has implemented economic reforms to attract foreign investors, especially in sectors like information technology, telecommunications, and manufacturing (Singh, 2019). The CPEC, a major infrastructure project, has significantly increased Chinese investment in Pakistan, covering areas such as transportation, energy, and industrial zones (Javed, & Ismail, 2021). Bangladesh has attracted significant FDI, particularly in the garment and textile industry. The country is known for its low-cost labor, making it an attractive destination for manufacturing (Sadique et al., 2018). Sri Lanka has sought FDI for infrastructure projects, including ports, airports, and tourism-related initiatives. The government has implemented policies to attract foreign investors.

These nations do not, however, have a good record of attracting FDI. Therefore, the key question facing South Asian policymakers is: What were the key factors that attracted foreign direct investment? Most people agree that national policy-oriented variables and broad economic fundamentals that are focused on policy are what drive FDI flows. Government incentives such as tax vacation facilities are crucial in drawing foreign direct investment (FDI), according to Hussain (2019). Additionally, Edame and Okoi (2014) stressed the importance of government policies that may have an impact on FDI flows directly or indirectly. However, research by Anyanwu (2011) and Albeit (2015) shows that FDI inflows are largely determined by economic fundamentals, negating the impact of national and international government policies on FDI inflows. Common economic fundamentals continue to be the primary determinants of foreign direct investment inflows since the 1980s, according to Nunnenkamp (2002).

Many studies were conducted in the beginning to look at the factors that influence FDI in various parts of the world. To learn more about the steadily rising amount of foreign capital being transferred to Asia's growing markets, research is still lacking. While the significance of political stability and institutional quality cannot be disputed, the majority of early studies place a strong emphasis primarily on economic considerations. Furthermore, there haven't been many recent studies that look at how

ISSN:2958-5074 pISSN:2958-5066
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the Global Financial Crisis has affected FDI influx into these economies. This study looks at the variables influencing FDI (foreign direct investment) inflows into South Asian economies between 2002 and 2018. Panel data and the random effect approach are used in the study to investigate the important FDI factors.

Literature Review

Sasana & Fathoni (2019) stated that Asian countries, notably those in the ASEAN region, have been considered viable destinations for FDI, which is regarded as one of the tools for spanning the poverty as well as health divide. This study's goal was to investigate the factors influencing FDI in ASEAN countries between 2007 and 2016. (Indonesia, Cambodia, Malaysia, Thailand, Philippines, and Vietnam). The study revealed that FDI was favorably impacted notably by Malaysia's economic crisis, negatively by salaries and exchange rates, and favorably by size of the market, government transparency, & infrastructure quality. Economic liberalization, taxation, or interest rates have no impact on the FDI inflow into ASEAN countries.

Ho & Rashid (2011) scrutinized the relationship between significant future macroeconomic as well as particular aspects of country in FDI in Malaysia, Thailand, the Philippines, Indonesia, Singapore, five ASEAN countries, from 1975 to 2009. The findings highlighted two significant macroeconomic variables: the openness degree and growth of economy had a substantial impression on FDI flows in most of the countries. Using data from Kazakhstan, Aizhan and Diana (2013) investigated the connection between FDI and economic growth. They argued that foreign direct investment (FDI) would stimulate domestic investment, help build human capital, advance technological levels through knowledge transfer, and pave the road for access to international markets. Using the vector error correction model (VECM) and Granger causality analysis, Uwubanmwen and Ajao (2012) examined the effects of foreign direct investments coming into Nigeria between 1970 and 2009 in relation to the exchange rate, interest rate, inflation, GDP, and openness.

They came to the conclusion that the gross domestic product and foreign direct investment have a long-term link. (2010) Lamine and Yang conducted research on a comparable nation. Granger causality analysis was used to examine the impact of foreign direct investments on economic growth in the Republic of Guinea using data from the years 1987 to 2009. They came to the conclusion that employment was a major

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factor in luring foreign direct investment, that educational attainment had a positive impact on both economic growth and foreign direct investment, and that the present influx of foreign direct investment had little bearing on economic growth.

Adnan and Riaz (2008) discovered short-term bidirectional causality in the instance of Pakistan, but long-term unidirectional statistical causality extending from economic growth to electricity consumption. The study's significant conclusion is that Pakistan should keep investing, especially in hydroelectricity, wind, coal, gas and nuclear power to lessen its reliance on imports. Using Hsiao's version of Granger's-Causality Test, Aqeel and Butt (2001) carried out a study to ascertain the causal relationship between economic development, energy consumption, and employment in Pakistan. They discovered unidirectional causality connecting total energy consumption, petroleum consumption, and economic development, as well as between electricity consumption and economic growth, but no causality was discovered for gas consumption.

The factors influencing foreign direct investment inflow into European Union countries were investigated by Zeren and Ergun (2010). The dynamic panel data model was employed by them from 1995 to 2007. They came to the conclusion that rising development levels, higher openness ratios, and faster GDP growth rates all encourage the influx of foreign direct investment. They also discovered that there is an inverse association between foreign direct investment and gross capital creation and the current account balance. Kar and Tatlısöz (2008) conducted a study that was comparable in nature in Turkey. Under the headings "investment-inviting factors" and "investment-uninviting factors," the variables influencing the movements of foreign direct investment between 1980 and 2003 were examined. Foreign direct investment was found to have a negative relationship with real foreign exchange and labour costs, while it had a positive relationship with net international reserves, gross domestic product, openness ratio, electric energy, production index, and investment incentives.

Meşiri and Kiyhanpor (2012) conducted a thorough investigation of the variables influencing foreign direct investments in 209 nations from 1980 to 2007. According to the model under study, infrastructure, human capital, the openness effect, and the rate of return on investment all significantly and favorably influence foreign direct investment. However, it was also determined that inflation, corruption, and

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variable costs have little bearing on foreign direct investment. Between 1960 and 2000, Bouoiyour (2007) investigated the variables influencing foreign direct investment in Morocco and other Middle Eastern and North African nations. According to the study's findings, market share influences FDI inflow positively but negatively affects economic growth, and rising FDI is correlated with rising import and export levels.

According to Basar and Zyck's (2012) report, corruption is a major barrier to foreign direct investment (FDI) in Afghanistan, and reducing corruption is key to attracting international investment. Furthermore, it was discovered that a major barrier to foreign direct investment is the insecurity present in many areas of the nation. All things considered, they came to the conclusion that Afghanistan's economy can benefit from decreased corruption and increased security. Conversely, Abasi and Ranjbardar (2011) examined the impact of Iran's financial assistance on Afghanistan's infrastructure and investment. They came to the conclusion that Iran's financial assistance had a favourable effect on the infrastructural investments undertaken in Afghanistan. Additionally, they gathered encouraging data suggesting that these supports have contributed to an increase in trade volume and foreign direct investment. Ali et al. (2015) conducted a second study in which they examined the connection between economic growth and foreign direct investment using data pertaining to Bangladesh.

In order to capture two-way links, they used time-series data covering the years 1973–2013 and applied the co-integration and error correction approach. Ultimately, they concluded that there isn't much of a relationship between FDI and growth. Dritsaki and Stiakakis (2014) looked into a related relationship. Between 1994 and 2012, they looked for a connection between Croatia's economic growth, exports, and foreign direct investment. They found a two-way causal association between FDI and export and growth, both in the short and long terms, using the ARDL and ECM-ARDL models.

The market size is the primary factor influencing the flow of foreign direct investments, according to the FDI literature. Many studies (Zeren & Ergun, 2010; 2006; Kar & Tatlısöz, 2008; Daly & Zhang, 2010; Liu, et al., 2012; Uwubanmwen & Ajao, 2012; Naguib, 2012; Al-Sadig, 2013; Lamine & Yang, 2010; Hoang et al., 2010) consider factors other than market size, such as market growth rate, ease of transportation, infrastructure facilities, natural resources, economic and political stability,

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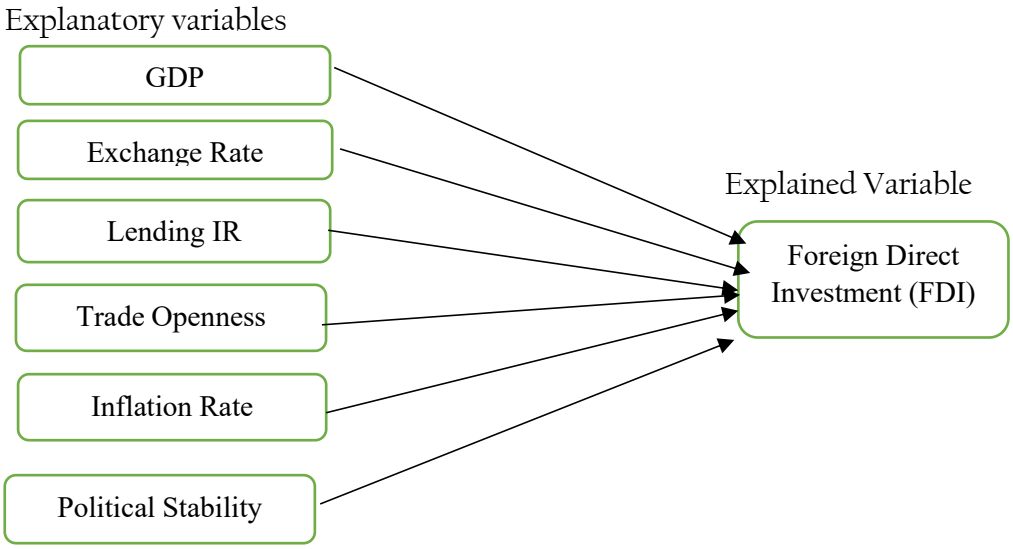
administrative and commercial obstacles, labour and labour costs, labour and labour costs, export opportunities, and trade openness, The Gross Domestic Product (GDP), Trade Openness, Inflation Rate, Exchange Rate, and Political Uncertainty have been used in this study to explain the FDI inflow in South Asian Countries.

1.1. Conceptual Framework



The following hypotheses was developed on the basis of above empirical review and conceptual framework

H_1: GDP of South Asian Countries has impact on FDI.

H_2: Exchange rate of South Asian Countries has an impact on FDI.

H_3: Lending Interest Rate of South Asian Countries has impact on FDI.

H_4: Trade Openness of South Asian Countries has an impact on FDI.

H_5: Inflation Rate of South Asian Countries has impact on FDI.

H_6: Political Stability of South Asian Countries has impact on FDI.

Data and Methodology

The methodology of current research endeavor has been based on the the research onion proposed by Saunders, Lewis and Thornhill (2009). The study in hand is quantitative in nature, explanatory type and deductive approach. The data used was secondary and collected from the world development indicators, World Bank, Asian development bank and federal statistics bureau of Pakistan. The statistical tools applied was descriptive statistics, to describe the data, correlation analysis to analyze the correlation among various variables under study. For hypothesis testing, the

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standard penel data analysis tools were used i.e. pooled regression, fixed effect and random effect models. For the model selection The Chow, Breusch Pagan, and Hausman tests are used. The test results are displayed in a table. Results indicates that the Fixed Effects Model is recommended by the Chow and Hausman tests. Nonetheless, the Pooled Ordinary Least Square is recommended by the Breusch Pagan Test. Therefore, based on the aforementioned findings, it can be said that the Fixed Effects Model is the best fit for this study's regression analysis. All these tests results are presented in next section.

$$FDI = \beta_0 + \beta_1(GDP) + \beta_2(Exc.\ R) + \beta 3(Trade\ Op.) + \beta 4(Inflation) + \beta 5(Pol.\ Instability) + \mu$$

Results and Discussion

Descriptive Analysis

Descriptive statistics above shows the number of observation, mean, Standard deviation, minimum and maximum value for all the dependent and explanatory variables. In this study foreign direct investment serves as the dependent variable, and GDP, lending interest rate, inflation rate, Trade Openness, and Political stability are the most important explanatory variables. Each variables have 150 observations for a panel of 5 South Asian countries. From the descriptive statistics table, it showed that the mean value of foreign direct investment (measured in million US$) in South Asian countries is1.76e+09. Similarly, the average value of the explanatory variables such as GDP is 1.159e+09, lending interest rate is 14.557, Trade Openness is 1.054, and inflation rate is 8.254.

Table:4.1 Descriptive Statistics

Variables	N	Mean	Max.	Min.	Std. Deviation
FDI	150	1.76e+09	6.959e+08	1.087e+13	1.701e+11
GDP	150	1.159e+09	4.341e+10	3.606e+07	5.012e+09
Lend. IR	150	14..557	21.521	5.671	2.874
Trade.Op	150	1.054	0.884	0.364	2.322
Inf.	150	8.254	23.638	3.045	5.715
Pol.St	150	0.942	1.945	2.502	1.451

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Model Selection Tests

Data from five Asian nations such as Pakistan, Bangladesh, India, Sri Lanka, and Nepal were examined in this study. The dynamic behavior of the parameters is taken into consideration while estimating panel data. Cross-sectional and time series data have been combined to create panel data. POOLED ordinary least square (OLS) estimation is the most straightforward estimate technique that enables pooling of observations throughout time and OLS computation, and it is the foundation of panel data analysis. The panel data approach has three distinct models. Random effect, Fixed effects and Common Constant (Pooled OLS). In addition, three distinct tests are included in the model selection process. The Chow, Breusch Pagan, and Hausman tests are among these. Therefore, these tests are conducted in order to choose the model for the regression analysis in this study. The test results are displayed in a table. Table results indicate that for dependent variable (FDI), the Fixed Effects Model is recommended by the Chow and Hausman tests. Nonetheless, the Pooled Ordinary Least Square is recommended by the Breusch Pagan Test. Therefore, based on the aforementioned findings, it can be said that the Fixed Effects Model is the best fit for this study's regression analysis. Thus, the Fixed Effects Model is used to do the regression analysis.

Table:4.2 Model Selection Tests (FDI)

Test	Models	Results		Conclusion
Chow Test	Between Pooled OLS & Fixed Effects	F-stat. = 34.12	Sig.= 0.000	Fixed
Breusch-Pagan	Between Pooled OLS & Random Effects	sigma_u sigma_e Rho	0.0 .005 0.00	Pooled
Hausman Test	Between Random Effects & Fixed Effects	Chi2 (6) Prob› Chi2	0.000 0.000	Fixed

1.2. Empirical Results

Table 4.3 Empirical Results of Fixed Effect Model

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Variables	Coeff.	t-value	Prob.
GDP	0.165	3.456	0.042**
Lending IR	0.027	6.451	0.084*
Trade.Op	0.011	2.376	0.009***
Inf.	-0.027	-0.2227083	0.014**
Pol.St.	0.142	0.12	0.001***

Table 4.3 summarizes the empirical results for the dependent variable FDI. This indicates how effectively a country is managing the various explanatory variables to generate its FDI. The model of the study comprises seven explanatory variables. The model for the FDI is selected based on strong diagnostics tests and a value of R-squared. The value of R-squared is 0.617, which means that approximately 62% variation in the dependent variable (FDI) is explained by the independent variables such as GDP, Lending Interest Rate, Trade Openness, Inflation Rate, and Political Stability and remaining 38% can be explained by the other variables which are not included in the model. The value of F-statistics is 24.25 indicating that the data is validate and relevant to model of the study.

From table above, we find that GDP, Lending interest Rate, Trade openness, and political stability has a positive and inflation rate has a negative significant explanatory factors at 1%, 5 %, and 10% level that attract Foreign Investment in the emerging Asian economies.

Based on the obtained results H_1, H_2, H_3 and H_4 has been accepted while H_5 and H_6 has been rejected.

Discussion

The study's findings can be derived from the data processing results and a discussion of the factors that affected foreign direct investment (FDI) in five South Asian nations between 2016 and 2020, including GDP, lending interest rates, trade openness, inflation, and political stability.

1. GDP significantly positively affects FDI in the five South Asian countries in general. This indicates that if GDP increases, the FDI of the five South Asian countries will also increase. The results are in line with Agrawal (2000).

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2. The Lending Interest Rate has a positive and significant effect on FDI in the five South Asian countries at 10% significance level. This indicates that the higher the Lending Interest Rate, the higher the will be FDI in South Asian countries. The findings are consistent with the previous finding of Kiplagat, (2016).
3. Trade Openness has a significant positive influence on the five South Asian countries. This indicates that the higher the level of economic openness in the, the higher will be FDI in the five South Asian countries. The results are in line with Saleem et al (2000).
4. Inflation has a significant negative effect on FDI in the five South Asian countries. This means that the lower the inflation rate, the higher FDI in the South Asian countries
5. The Political stability has a positive and significant effect on FDI in the five South Asian countries at 1% significance level. This indicates that the higher the perception of political stability, the higher will be FDI in South Asian countries.
6. Based on the results of the F test, it is obtained that the independent variables, GDP, Lending Interest Rate, Trade Openness, Inflation Rate, and Political Stability are simultaneously influencing the dependent variable (FDI).

We use a seventeen-year data for twenty-four countries to overcome any sample biased. Traditional economic variables such as market size, trade openness, gross capital formation, natural resource plays a dominating role in attracting foreign investors. The main policy implications are that the growing GDP per capita seems profitable for the investors. Moreover, sound trade policy is required for attracting continuous flow of capital. Though the political factors such as government effectiveness, political stability, and rule of law were expected to be significant, only the significant of political stability is established.

On the other hand, Business Disclosure Index is significant positive impact on FDI which suggests that multinational corporation emphasizes more cautious about business regulation, gauge regulatory outcomes, legal protection of property, the flexibility of employment regulation, and the tax burden in the emerging Asian countries. The world observed unprecedented economic shock-Global Financial Crisis-in 2008-09. It was one of the worst financial shocks after the Great Depression. Likewise rest of the world, most of the emerging country in Asia also faced low economic growth, downturn in FDI flow, high inflation, high rate of unemployment etc.

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However, the study does not find any negative significance of the GFC on FDI. Further study could be done to fine the reason.

Conclusion

The world investment scenario is changing constantly. According to (*UNCTAD*, World Investment Report, 2019), the Asia is renamed as the world's largest receiver of FDI gaining 39% of global inflows in 2018, which is 33% more than previous year. It was expected that the flow would be higher in coming years. In another study IMF estimated that the total GDP of the Asian economy would exceed the rest of the world in 2020(*WEF, 2019.*). However, the world currently going through a COVID-19 pandemic. The world health system is about to collapsed with growing number of case and mortality. At the same time, the economic growth becomes slow down, unemployment increased, transfer of capital not promising. Therefore, the future study could include impact of pandemic, technological progress, and other important variables on the FDI inflow in the emerging Asian markets.

Recommendation

Policy recommendations

1. Based on the obtained results and literature review the state should stabilize the exchange rate to motivate FDI.
2. The interest rate must be made competitive and lending terms should be relaxed to encourage industrialization and FDI inflow.
3. The government should adopt liberal policy to increase bilateral trade across the border.
4. Monetary policy must be device in such a manner to maintain balance between inflation and deflation to protect manufactures and traders.
5. The political stability must be maintain to encourage the foreigner investor for investment in Asia.

Further research directions

1. Further research should be conducted to analyze the impact on FDI in various sectors of the economy.
2. Future research should study the same variables in specific countries of Asia.
3. The current study has analyzed the linear relationship among variable under study there is a need to study the nonlinear relationship among these variables.

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4. Furthermore the causality analysis can be conducted to understand the direction of relationship among these variables.
5. Further research should focus on the institutional factor i.e. economic, social, governance and corruption.

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