

Role of Institutional Quality as a Key Determinant of FDI Flows in Developing Asian Economies

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Abstract : In the wake of the phenomenal surge in international business in the last decades or more, both the developed and developing economies around the world are in massive competition to attract more and more FDI flows. While the developed countries have marched ahead in the race, the developing countries, especially those of Asian economies, have followed them at a rapid pace. While most of the previous studies have analysed the role of institutional quality in the promotion of FDI flows in developing countries, very few studies have taken an integrated approach of examining the comprehensive impact of institutional quality, globalization pattern and domestic financial development on FDI flows. In this context, the paper contributes to the literature in two important ways. Firstly, two composite indices of institutional quality and domestic financial development for the Asian countries are constructed in comparison to earlier studies that resort to a single variable for indicating the institutional quality and domestic financial development. Secondly, the impact of these variables on FDI flows through their interaction with geographical region is investigated. The study uses panel data covering the time period of 1996 to 2012 by selecting twenty Asian developing countries by emphasizing the quality of institutions from the geographical regions of eastern, south-eastern, southern and western Asia. Control of corruption, better rule of law, regulatory quality, effectiveness of the government, political stability and voice and accountability are used as indicators of institutional quality. Besides these, the study takes into account the domestic credits in the hands of public, private sectors and in stock markets as domestic financial indicators. First in the specification of model, a factor analysis is performed to reduce the vast determinants, which are highly correlated with each other, to a manageable size. Afterwards, a reduced version of the model is estimated with the extracted factors in the form of index as independent variables along with a set of control variables. It is found that the institutional quality index and index of globalization exert a significant effect on FDI inflows of the host countries; in contrast, the domestic financial index does not seem to play much worthy role. Finally, some robustness tests are performed to make sure that the results are not sensitive to temporal and spatial unobserved heterogeneity. On the basis of the above study, one general inference can be drawn from the policy prescription point of view that the government of these developing countries should strengthen their domestic institution, both financial and non-financial. In addition to these, welfare policies should also target for rapid globalization. If the financial and non-financial institutions of these developing countries become sound and grow more globalized in the economic, social and political domain, then they can appeal to more amounts of FDI inflows that will subsequently result in advancement of these economies.

Keywords : Asian developing economies, FDI, institutional quality, panel data

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