

# Country Analysis: Understanding Economic and Political Performance (Gower Applied Research)

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## An Analysis of Host Country Characteristics that Determine FDI in Developing Countries: Recent Panel Data Evidence

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### Abstract

*This paper analyzes a range of host country characteristics that determine foreign direct investment (FDI) flows to developing countries, using panel data on 72 countries for the period 1970-2008. Keeping in view the endogeneity problem of the chosen host country's characteristics, the model is estimated using the General Method of Moments (GMM) technique. The analysis shows that gross domestic product (GDP), economic growth, and per capita income positively affect FDI—a result consistent with the market-seeking behavior of multinational corporations (MNCs). Furthermore, we find that remittances have a significant and positive impact on FDI. On the other hand, inflation and the balance of payments deficit have negative effects on FDI. MNCs are attracted to host countries that are outward looking and follow trade-promoting policies. This is confirmed by the positive effect of openness on FDI flows to developing countries. The study also finds that the effect of military expenditures on FDI is negative and significant. Finally, our analysis finds that the real exchange rate has a significantly negative impact on FDI.*

**Keywords:** Investment, panel data, developing countries, FDI, GMM.

**JEL Classification:** F21.

### 1. Introduction

Most developing countries experience a shortage of capital, which is reflected in their respective savings-investment and import-export gaps. This implies that developing countries have insufficient savings/foreign exchange to finance their investment needs. To bridge this gap, they need an inflow of foreign capital. Foreign direct investment (FDI) is thus an important source of capital for growth in developing countries.

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