


Chapter 10

The Relationship Between Foreign Direct Investment and Financial Development in OECD Countries

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ABSTRACT

This chapter investigates the relationship between the OECD-FRRI issued by OECD and IMF-FDI issued by IMF for 36 OECD member countries. Cross-section data (CSD) analysis and panel data (PD) analysis consisting of random and fixed effects estimations were used in the study to investigate the relationship between Foreign Direct Investment (FDI) and Financial Development for OECD countries for the years 1997, 2003, and 2006 and the 7-year period of 2010-2016. Granger Causality Test (GCT) is also applied to test the direction of causality between two indicators. According to the Random Effects Model (RAM) and Fixed Effects Model (FEM) with PD analysis in the study OECD-FRRI is found as one of the determinants of IMF-FDI and IMF-FDI is found as one of the determinants of OECD-FRRI in OECD member countries. For CSD analysis, there is no significant proof to say OECD-FRRI is one of the main determinants of IMF-FDI and IMF-FDI is one of the determinants of OECD-FRRI in OECD member countries. For CSD, OECD-FRRI does not cause IMF-FDI whereas IMF-FDI causes OECD-FRRI.

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Table 1. Financial development index pyramid

Financial Development (FD)					
Financial Institutions (FI)			Financial Markets (FM)		
Depth (FID)	Access (FIA)	Efficiency (FIE)	Depth (FMD)	Access (FMA)	Efficiency (FME)

Source: Sahay et al. (2015). 12.

INTRODUCTION

FDI provides many positive gains to the host economy, such as employment, production, income and export growth. This situation has been effective in increasing the competition of countries to attract FDI in recent years and with their efforts to make their countries attractive for investment. Due to the possible negative effects of indirect foreign capital investments, investing directly in other countries is extremely important for supporting the sustainable growth of especially developing countries.

The effectiveness of the financial system comes to the forefront in the success of the economic performance of the countries. Financial stability has become a prerequisite for economic stability. Therefore, the soundness of the financial system, which is important for the foreign investor, is a matter that needs to be paid attention.

The basis of this study is to examine the relationship between FDI and financial development in 36 OECD countries (Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea Republic, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States).

For this purpose, the relationship between the International Monetary Fund’s (IMF) Financial Development Index (IMF-FDI) and Foreign Direct Investment Regulatory Restrictiveness Index (OECD-FRRI) measured by the OECD has been examined for 36 OECD member countries. Financial Development Index (IMF-FDI) is a relative ranking of countries on the depth, access, and efficiency of their financial institutions and financial markets. It is an aggregate of the Financial Institutions Index and the Financial Markets Index (IMF, <https://data.imf.org/>).

Financial development is identified as a combination of depth (size and liquidity of markets), access (ability of individuals and companies to access financial services), and efficiency (ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets). (Table 1) These indices were originally developed in the context of the IMF’s “Rethinking Financial Deepening: Stability and Growth in Emerging Markets” (Sahay et al., 2015).

The FDI Regulatory Restrictiveness Index (OECD-FRRI) measures statutory restrictions on foreign direct investment in 22 economic sectors across 69 countries, including all OECD and G20 countries. The FDI Index gauges the restrictiveness of a country’s FDI rules by looking at the four main types of restrictions on FDI: (OECD, <https://www.oecd.org/>).

- Foreign equity limitations.
- Screening or approval mechanisms.
- Restrictions on the employment of foreigners as key personnel.
- Operational restrictions, e.g. restrictions on branching and capital repatriation or land ownership.

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