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Offshore Financial Centers and India's Outward FDI Determinants

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The paper analyses the factors behind the trend of India's outward investments to its top destination countries during the years 2008-2013. India's investment decisions are not homogenous and hence the results showed interesting insights on offshore financial centers (OFCs). The main aim of the paper, apart from reiterating the robustness of traditional investment theories, is to test whether the traditional determinants of FDI flows; trade, institutions, exchange rate etc., work even when the host country is an OFC. A significant fraction of global capital flows though these jurisdictions but it hasn't received much research focus. A better understanding of their nature can help countries in policy decisions. The results confirm that for a host country to attract FDI from India, the traditional determinants remain significant, however, where the host country is an offshore financial center (OFC), traditional factors are rendered insignificant.

Keywords: India, foreign direct investment (FDI), determinants, gross domestic product (GDP), market, host country

Field of Research: Foreign direct investment

1. Introduction

The first overseas Indian venture was a textile mill set up in Ethiopia in 1959 by the Birla Group of companies, India's second largest business conglomerate at the time. Investment fosters economic co-operation between countries through technology transfer, access to a global market, employment generation etc. India being an income-poor country needs robust domestic investment and a big portion of its current slowdown is blamed on the drop in domestic investment. India's outward FDI (OFDI), on the other hand, has tremendously increased since 2007 and even peaked in 2009 despite the global downturn. Since 2012, though, it has shown a declining trend but it is still rising when seen as a percentage share of GDP. Figure 1 in the Appendix shows the trends in India's OFDI flows between the years 2003 to 2013.

Figure 2 (Appendix) shows the percentage of India's overseas investment as a % of GDP. Before 2005, this percentage was quite trivial. However, after liberalization of government policies and relaxation of regulations on OFDI in 2004, it grew significantly and is currently around 6.5% of GDP. Compared to other South Asian countries, it is by far the largest and almost at par with China, becoming the 21st largest outward investor.

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According to the Reserve Bank of India (RBI), in 2009, 43% of India's outward FDI was in manufacturing sector, 28% in finance, insurance and real estate and 7% in construction sector. However, while overseas investment is very important, India's OFDI has increased so drastically, that the amount of overseas direct investment is higher than foreign direct investment (FDI) flows into the country.[i] This is striking for a capital-scarce country. Hence, while India's own manufacturing industry was facing negative growth, a quarter of India's OFDI in 2014 (April to January) was related to manufacturing activities.[ii] This puts a question mark as to why Indian companies prefer to invest abroad to access new technology and R&D capabilities, instead of domestically. This paper tries to gauge at the determinants that help Indian companies choose its destinations. These are broadly classified into economic determinants like market size, trade, exchange rate as well as institutional qualities such as rule of law, corruption and government effectiveness. Studying the characteristics of the host country that are instrumental in attracting India's OFDI flows may help in improving their current domestic state. With the onset of the new government in India, there is renewed hope of an improved business environment, with many American and European companies looking to invest in India.

For example, the institutional quality of some countries that receives India's greatest proportion of FDI is given in Table 3 of the Appendix. India ranks poorer than all of them; which reiterates the urgency of proactive policy correction needed in India. This would not only reverse the trend of domestic corporates choosing to invest abroad but also make it easier for foreigners to invest in India and add to its growth.

This brings us to the main component of our paper which is becoming a key factor in attracting FDI inflows; a host country's emergence as an offshore financial center (OFC). There is no consensus among scholars on what precisely constitutes an OFC, though there have been many attempts to define one. According to the International Monetary Fund (IMF), an OFC is a "country or jurisdiction that provides financial services to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy".

The origin of OFCs can be traced back to the 1960s and 1970s when many developed nations and sovereign governments, attempting to regulate capital flows, started imposing restrictive domestic regulations. These regulations were imposed so that governments may have more control over the outcomes of their monetary policies. However, banks and other financial institutions started shifting their deposits and borrowing activities to less regulated offshore centres. These OFCs allow effective movement of capital and resources; provide legal protection against unjustified claims, have centralised group services and low tax jurisdictions. As a result, during the 1970s to 90s, there were attempts by the United States and the OECD countries to retard the growing significance of these OFCs. Even G20 in 2009, was determined to bring tax havens down. However, they seem much more robust and adaptable, finding new clients and products; with international private banking becoming the most significant OFC activity today. Nowadays, functional OFCs employ a significant proportion of local labor (over 12% of the labor force) and its activities constitute over 25% of GDP. This is not to say that governments' drive to push for transparency can be ignored. However, OFCs indispensability also can't be ignored and the move towards more systematic exchange of client information can't be reversed.[iii] In 2008, there was US$6.1 trillion of portfolio investment across 49 OFCs, nearly equal to the amount invested in the United Kingdom. Though the data collection relating to OFCs remains incomplete and with limitations, this indicates how huge the offshore banking business is.

The current literature revolves around the definition of OFCs or studying their operations, functions, policies and politics. Studies so far show both positive and negative implications of OFCs and it is essential to build up on a better understanding of the national level characteristics that drive firms and investors to utilize OFCs. For e.g., Evans (2009) found that Seagate pays only a 5% effective tax rate, in large part due to shifting income toward its OFC subsidiary. But Rose and Speigel (2007) found there is greater competition between onshore and offshore banks in tax haven regions, resulting in lower interest rates. Much of the existing literature is in nascent stages; dealing with definition of OFCs and which countries become OFCs and their economic impact.

This paper would contribute to existing literature by empirically introducing OFC as a FDI determinant and study how it interacts with FDI flows as well as the other traditional determinants. This has not been done so far and as OFCs are fast developing and challenge the existing economic models on the determinants of investment flows, as will be shown later in this paper, this paper aims at motivating more in-depth research on OFCs. Section 2 reviews the literature that exists so far on FDI flows in the world. Section 3 discusses the economic model that will be used in this paper as well as the data sources. Section 4 presents the results of the regression and Section 5 concludes.

2. Literature Review

The literature on the determinants of a country's overseas investment decisions is vast; empirical investigations suggest that characteristics such as host country's market size, trade relations, exchange rate, trade openness, institutional quality etc. determine FDI flows into that country. This section discusses the driving forces of FDI flows in the world, including the characteristic of being an offshore financial center and hypothesize its effect on overseas investment.

2.1 Market Size

A host country's market size is of vital significance when firms are deciding whether to invest. This is because a bigger market size is one that translates into more opportunities and higher profit due to greater economic development and demand. Empirical literature has quantified this characteristic as GDP, GDP growth rate and per capita income of the host country. Schenider & Frey (1985), Chakraborti (2001), Bevan and Estrin (2001) have found market size to be statistically significant to FDI flows. In this paper, we use one year lagged GDP growth rate as a measure of a country's market size and will confirm that GDP growth rate of the host country to have a positive relationship with OFDI flows.

2.2 Trade

Some of the largest trading partners of India; Singapore, USA, Switzerland, Germany are also the largest destinations of OFDI. Dritsaki, Adamopoulos (2004), Helpman (2006) confirm the causal relationship between two variables. Hence, greater the bilateral trade between the two countries, more investment should flow between them. Hence, through established literature, we can expect trade to have a strong positive relationship with OFDI flows.

2.3 Exchange Rate

Multinational Corporations (MNCs) will find it more profitable to invest if the host country's currency depreciates. This is because while the buying of asset will be in the foreign currency, the profits will be reaped in home country's currency. So, if exchange rate increases (defined as host country against Indian rupee), then it means a depreciation of the Rupee and hence OFDI should decrease. Therefore, we can expect the exchange rate to have a negative relation with OFDI flows.

2.4 Institutional Quality

Literature shows that poor institutions retard growth and investment. This could be in the form of poor infrastructures which increases the cost of doing business, expropriation of assets and profits etc. Wei (2000) shows that a rise in the level of corruption in the host country reduces inward FDI. Similarly, Globerman and Shapiro (2002) show that good governance positively influences both inward and outward flows. Hence, we can expect that good institutions with positively affect OFDI flows.

2.5 Trade Openness

Chakrabarti (2001) debates that a country's degree of trade openness is a relevant determinant of FDI decision by firms because most investment projects are related to the tradable sector. Greater trade openness, in the form of lower tariffs and barriers and overall better economic linkages, is seen as a platform by a country to invest in the host country for export purposes. In this paper, we quantify it as ratio of total international trade (export + import) of a country as a proportion of its GDP.

2.6 Off shore Financial Centre

There are relatively few well-established empirical work on OFCs given the lack of theory behind it and the lack of availability of data. As mentioned earlier, Rose and Speigel (2007) establish that proximity to an OFC is likely to be pro-competitive. Foad (2012) claims that a country with more economic freedom and low levels of corruption tend to invest less in outward OFC invest ents. However, literature has so far has not tested how OFC will perform as a regressor along with the other FDI determinants in an empirical model.

As mentioned earlier, an OFC is one that provides financial services to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy. In recent times, it has become a very important determinant of FDI flows. According to the IMF, these are centres with low or zero taxation, low regulation and banking secrecy and anonymity. All these three characteristics work in the favour of investment flows. 50% of the countries chosen in our sample data are certified OFC by the IMF. Among them, Singapore, which has the world's highest density of wealthy people, is said to overtake Switzerland as the world's largest offshore financial centre as early as 2015.[iv] Hence, one can expect a positive relationship between OFC and OFDI flows.

3. Methodology and Data

According to the discussion in Section 2, the following economic model was built, relating outward FDI and the independent variables:

$$OFDI = \alpha + \beta_1 Trade + \beta_3 g + \beta_4 Exrate + \beta_6 Openness + \beta_7 OFC + \beta_8 Inst + \varepsilon$$

$\boldsymbol{OFDI}$ is the logarithm values of India's outward FDI flow to a host country.

$\boldsymbol{Trade}$ measures the logarithm values of total bilateral trade between the countries.

$\boldsymbol{g}$ is one year lagged nominal GDP growth rate.

$\boldsymbol{Exrate}$ is the annual exchange rate of the host country currency against the Indian rupee.

$\boldsymbol{Openness}$ is a measure of the trade openness of the host country's market. This is a dummy variable which is 1 if a country's trade to GDP ratio is more than 100% and 0 if this ratio is less than 100%.

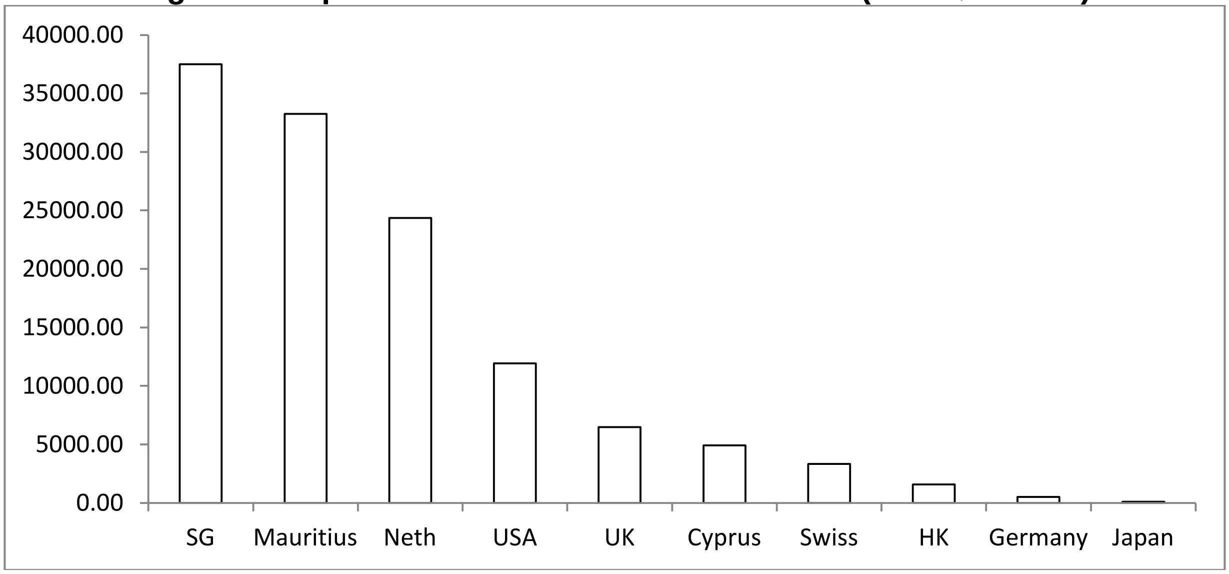
$\boldsymbol{OFC}$ is a dummy variable which is 1 if the host country is an IMF certified offshore financial centre and 0 otherwise.

$\boldsymbol{Inst}$ is an index that measures the institutional quality of the host country based on three World Bank governance indicators: Rule of law, Government effectiveness and Control of corruption.

For this paper, the top ten destinations of India's OFDI are chosen for the sample. These countries are Singapore, USA, Netherlands, Switzerland, Mauritius, United Kingdom, Germany, Hong Kong, Cyprus and Japan. Due to inaccessibility of FDI data (country-wise) before 2007, the period of regression for this paper is confined from 2008 to 2013. FDI and trade flow data have been compiled from the RBI database, Institutional quality data from the World Bank indicators, while data for all the other variables has been compiled from the CEIC database.

The following table shows the total FDI outflows from India to these countries over the time period 2008-2013. In general, India's outward FDI destinations are a mix of developed countries as well as OFCs and there hasn't been much change over the recent years in terms of the direction of outward FDI from India. The reason for these trends; which helps Indian companies make their overseas investment decisions, will become clearer in the next section.

Figure 3: Top destinations for India's FDI flows (in US$ Million)



Source: Reserve Bank of India

4. Results / Analysis

The correlation matrix of the dependent and independent variables is given in Table 2 of the Appendix. The highest correlation of OFDI can be seen with exchange rate and the lowest with institutional quality. Table 1, below, presents the main results of the regression on the panel data. Regression 1 uses the full sample. Regression 2 uses only data from the OECD countries (USA, UK, Germany, Japan, Netherlands and Switzerland) and Regression 3 uses the data from countries known to be dedicated offshore financial centers (Mauritius, Cyprus, Singapore and Hong Kong).

In Regression 1, we can see that only trade is highly significant. This is in accordance to the existing literature that says that trade and investment go hand-in-hand. OFC and exchange rate have the expected sign but are weakly significant and insignificant, respectively. Institutional quality and GDP growth rate have a negative sign (opposite to expectation) and are again weakly significant. This is contrary to existing empirical literature which confirms strong correlation between all the three determinants.

Table 1: Regression results

Independent variable	Regression 1	Regression 2	Regression 3
Trade	0.788*** (3.15)	1.33*** (2.00)	-0.562 (-1.33)
Exchange rate	-0.854 (-1.11)	-1.38*** (-2.36)	7.49** (1.97)
GDP growth rate	-0.021* (-1.84)	-0.34 (-1.16)	0.033 (1.04)
OFC	2.22* (1.77)	-2.26*** (-2.11)	NA
Institutional quality	-2.71* (-1.67)	6.45*** (2.27)	4.35 (1.54)
Observations	60	36	24
R-squared	0.2377	0.16	0.11

Note: Dependent variable is India's outward FDI 2008-2013. The t-values are given in the parenthesis. *** indicates significance at the 1% level. ** indicates significance at 5% level and * indicates significance at 10% level.

First of all, the time period of this regression coincides with the global recession. While OFDI flows from developed countries fell drastically, OFDI flows from emerging markets still saw an upward trend. In fact, India's OFDI flows to these ten countries, on an average, increased though the GDP of the host country was falling. Though unique to this time period, this can explain the negative sign for the GDP growth rate of all the regressions carried out in this paper. The insignificance of the determinants; exchange rate and institutions, can be explained by the fact that India's overseas investment decisions are very heterogeneous. It depends on different sets of economic and institutional characteristics for different countries. For some countries it may be highly important while for others, probably not at all. Overall, this results in their weak or insignificance. This becomes clearer when we look at Regression 2.

As mentioned above, Regression 2 is run only for OECD (Organization of Economic Co-operation and Development) countries. Now, all the important determinants, except growth rate, are highly significant with the expected sign; trade, exchange rate and institutional quality. OFC has a negative sign because, with the exception of Switzerland, none of them are offshore financial centers. This strongly supports the fact that when countries are not certified OFCs, the usual investment models apply for India; its OFDI flows depend on robust trade between India and the host country, good institutions and infrastructure in the host country and a favorable exchange rate. This may shed light on the reason why Indian companies are choosing to invest abroad due to the lack of clear-cut investment rule and time-bound project clearances by state institutions. This may also why foreign investment into the country hasn't reached the potential it should for a high-growth nation like India.

However, this scenario changes when the characteristic of an OFC is added to a country's profile. Regression 3 is run only with countries that are OFCs. Now, other than exchange rate, none of the determinants are significant. This means that for Indian firms, when dealing with an OFC, trade and institutional qualities are no longer an important determining factor. For e.g. Mauritius and Cyprus have the poorest ranking of institutional quality in our sample data and also their trade with India is minimal, yet Mauritius received the second largest FDI flows from India during this period. Also, exchange rate has a positive sign; that means even though the currency of the host country was appreciating against the rupee it did not deter investment flowing to them. These highlight the lucrative characteristics and importance of an OFC; with low tax and regulations, these centers are fast becoming conduits for global trade and capital flows. Hence, in such cases, the need for good trade relations as well as other established determinants of FDI flows become irrelevant.

A regression was also run dropping four countries with the highest ranking in institutional quality (Singapore, Netherlands, Switzerland and Hong Kong). Trade, exchange rate and OFC with their expected sign were highly significant. This means that in countries with relatively average institutions, trade and exchange rate are highly important determining factors of FDI flows into them. However, OFC was also highly significant (with $t = 3.79$) which may shed light on IMF's longstanding argument that such centers can be misused by some individuals for money laundering and tax evasions because of their high secrecy. However, this would require more in-depth research and hence is excluded in this paper. Openness and OFC variables are highly correlated and hence the annual data omitted openness from the regression. Hence, the same data was regressed on a quarterly basis, with a one quarter GDP growth rate, and found trade and openness to be highly significant.

5. Conclusion

The main motive of this paper was to test the established investment models on studying India's overseas investment flows, given the host country is an offshore financial centers. Apart from reconfirming the existing literature on traditional FDI determinants, it revealed some interesting results that can be practically seen globally. It is important to note that the lack of robustness of the results, when the entire sample is taken together, points to the fact that looking at India's OFDI flows in a homogenous manner would reveal insignificant results and might be misleading. This is because when looking at OFCs, all traditional FDI determinants become insignificant

Overall, these regression results show that individually all the variables are highly important in deciding India's OFDI flows. Trade universally is a very important factor for fostering investment relations between countries. India's membership in regional and global trade agreements such as RCEP, ASEAN-India Free Trade Agreement (AIFTA) as well as various bilateral FTAs provide a favorable trade platform for Indian firms to strengthen their presence in the host country and vice versa. The contributing factor for Singapore and Mauritius receiving highest FDI from India may also be the fact that India has signed Double Tax Avoidance Agreement (DTAA) with these nations. Further, having good institutions and infrastructure is something all countries strive for to attract FDI and our results confirm the strong relationship with all these factors. These same areas are where India lags behind relative to other countries; Azmul Haque, a consultant at Olswang in Singapore said that red tape by an unwieldy bureaucracy along with endemic corruption and working efficiencies in India are the biggest concerns for investors from Singapore. Advancement in these areas will be instrumental in generating the FDI inflows that India greatly needs to revive the slowdown in tis GDP growth rate.

The development of offshore financial centers that have attracted investment from all over the world and this paper supports the reality that they remain attractive destinations of FDI, due to their tax and legal protection advantages, despite significant development in the trade, institutions or growth front. As long as there will be differences in national tax rates, regulatory standards and confidentiality laws in the home country, OFCs will have an existence.

Endnotes

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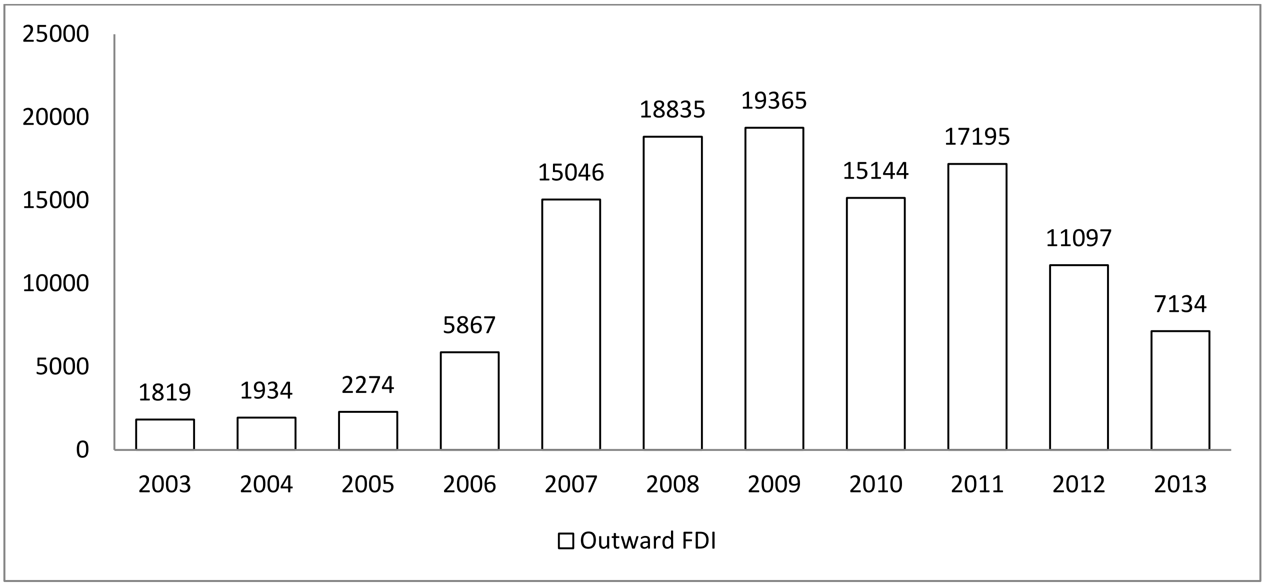
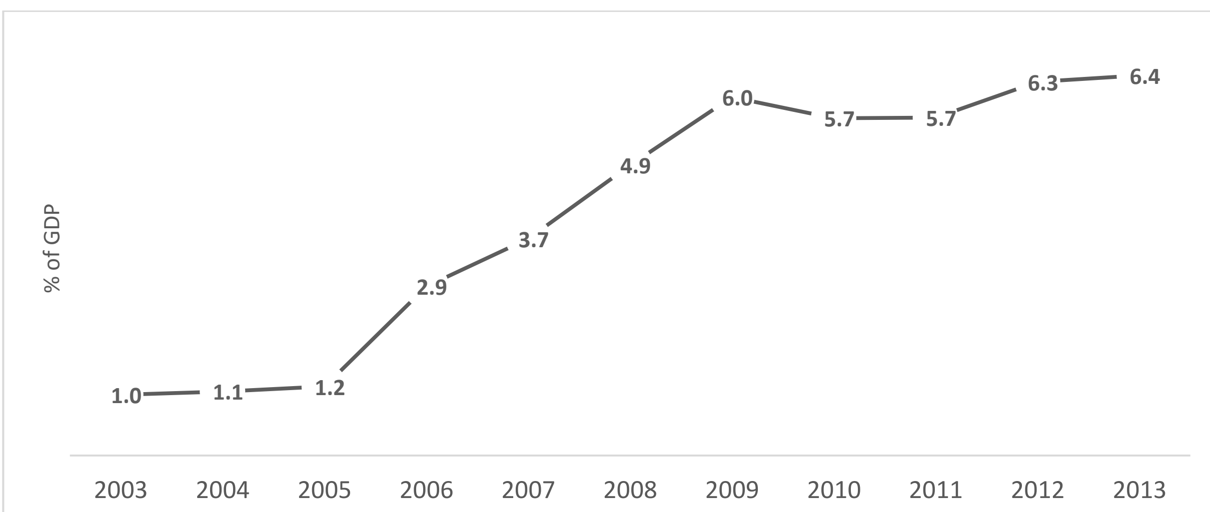
Appendix

Figure 1: India's outward FDI (in US$ million)



Source: Reserve Bank of India

Figure 2: India's outward FDI as percentage of GDP, 2003-2013



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics)

Table 2: Correlation matrix

	OFDI	Trade	Exchange rate	Growth rate	Openness	OFC	Institution
OFDI	1						
Trade	-0.1159	1					
Exchange rate	-0.5967	-0.0246	1				
Growth rate	0.0406	-0.0047	0.0475	1			
Openness	0.2987	0.2246	-0.2303	0.0708	1		
OFC	0.3029	-0.4475	-0.1892	0.2793	0.2589	1	
Institution	0.0195	0.6319	-0.3759	0.0044	0.5375	-0.1095	1

Table 3: Average Institutional quality of the countries

Country	Governance indicator
Singapore	2.05
Mauritius	0.76
Germany	1.65
USA	1.49
UK	1.63
Hong Kong	1.72
Cyprus	1.22
Netherlands	1.90
Switzerland	1.95
Japan	1.40
India	-0.17

Source: World Bank