

Offshore Financial Centres and the Determinants of India's outward FDI

The paper analyses the factors behind the trend of India's outward investment flows to a few top destination-countries during the years 2008 to 2013. India's investment decisions are not of the same kind, and hence the results of analysis showed interesting insights on offshore financial centres (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. hold good even when the host destination is an OFC. A significant fraction of global capital flows through these jurisdictions, but it has not 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 OFC, traditional factors are rendered insignificant.

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

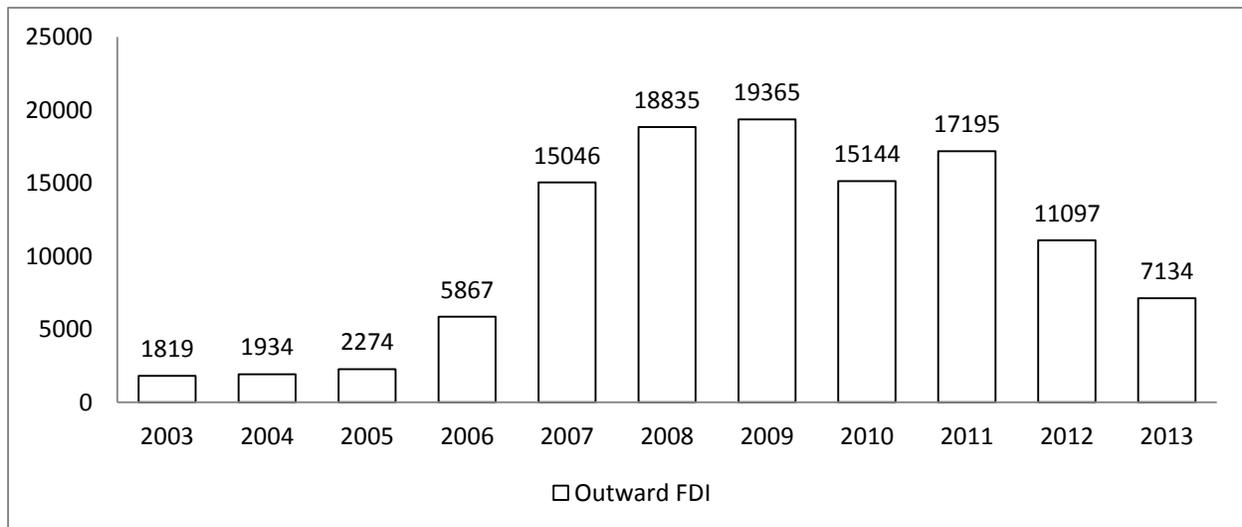
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Introduction

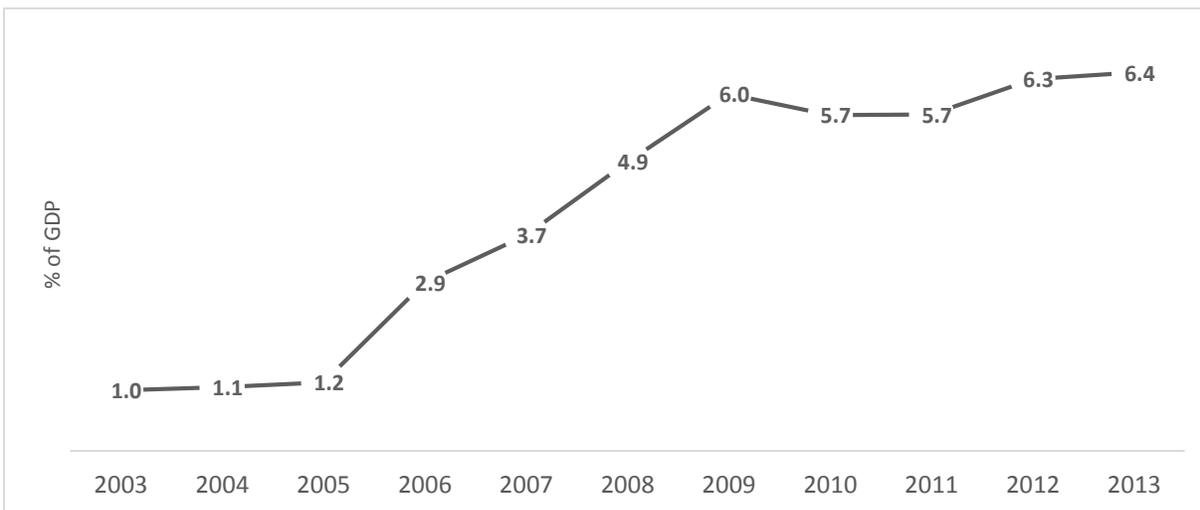
The first overseas Indian venture was a textile mill set up in Ethiopia in 1959 by the Birla Group of companies, India's second largest business conglomerate at the time. Investment fosters economic cooperation between countries through technology transfer, access to a global market, employment generation etc. India, being an income-poor country, needs robust domestic investment, and a big reason for its current slowdown is 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 shows the trends in India's OFDI flows between the years 2003 and 2013.

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)

Figure 2 shows the percentage of India's overseas investment as a % of GDP. Before 2005, this percentage was quite trivial. However, after liberalisation 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.

According to the Reserve Bank of India (RBI), in 2009, 43% of India's outward FDI was in the 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.² 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.³ This puts a question mark as to why Indian

² "When outward FDI exceeds inward FDI", *Economic Times*, January 18, 2014. Available at: http://articles.economictimes.indiatimes.com/2014-01-18/news/46324905_1_outward-fdi-foreign-direct-investment-fdi-equity-inflows

³ "Outward FDI Investment by India", Care Ratings, March 14, 2014. Available at: <http://www.careratings.com/upload/NewsFiles/Studies/Outward%20FDI%20Investment%20by%20India.pdf>

companies prefer to invest abroad to access new technology and R&D capabilities, instead of domestically. This paper tries to gauge the determinants that help Indian companies choose their 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 generate more such flows. With a relatively new government in place 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 receive 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 that is 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 a main component of this paper: a host country's emergence as an offshore financial centre (OFC). There is no consensus among scholars on what precisely constitutes an OFC, though there have been many attempts to define it. 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 other sovereign governments, attempting to regulate capital flows, started imposing restrictive domestic regulations. These regulations were imposed so that governments could have greater 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 1990s, there were attempts by the United States and the OECD countries to retard the growing significance of these OFCs. Even the Group of 20 (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 labour (over 12% of the labour force) and their 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 cannot be ignored, and the move towards a more systematic exchange of client information cannot be reversed.⁴ 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 has limitations, this indicates how huge the offshore banking business is.

The current literature revolves around the definition of OFCs or the study of their operations, functions, policies and politics. Studies so far show both positive and negative implications of OFCs, and it is essential to build a better understanding of the national-level characteristics that drive firms and investors to utilise OFCs. For e.g., Evans (2009) found that Seagate pays only a 5% effective tax rate, in large part by shifting income towards its OFC subsidiary. But Rose and Spiegel (2007) found a greater competition between onshore and offshore banks in tax havens, resulting in lower interest rates. Much of the existing literature is in still taking shape; dealing with the definition of OFCs and the issue of which countries become OFCs and their economic impact.

This paper seeks to empirically introduce OFC as a FDI-determinant and study how it interacts with FDI flows as well as the other traditional determinants. The OFCs are fast developing and challenge the existing economic models on the determinants of investment flows. This paper hypothesises that OFC as a determinant (host country being a certified OFC nation) would have a direct positive relationship with FDI inflows into a country. Section 2 reviews the existing literature 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 draws conclusions.

⁴ Special report: Offshore finance, "Sunshine and Shadows", *The Economist*. 16 February, 2013. Available at: <http://www.economist.com/news/special-report/21571559-offshore-financial-centres-will-always-be-controversial-they-will-stay>

Literature Review

Macroeconomic determinants

The literature on the macroeconomic 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 characteristics of being an offshore financial centre and hypothesises the effect on overseas investment.

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 translates into more opportunities and higher profits due to its greater economic development and greater demand potential. Empirical literature has quantified this characteristic as GDP, GDP growth rate and per capita income of the host country. Artige and Nicolini (2005) have found that market size, as measured by GDP or GDP per capita, seems to be the most robust FDI-determinant in econometric studies; mainly for horizontal FDI. Schenider & Frey (1985), Chakraborti (2001), Bevan and Estrin (2001) have found market size to be statistically significant to FDI flows. Hence, we can expect the GDP growth rate of the host country to have a positive relationship with investing country's OFDI flows.

Trade

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

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, profits will be reaped in home country's currency. So, if exchange rate increases (defined as host country's against the Indian rupee), then it means a depreciation of the Rupee; hence India's OFDI should decrease. Therefore, we can expect the exchange rate to have a negative relationship with India's OFDI flows.

Institutional quality

Literature shows that poor institutions retard growth and investment. This could be in the form of poor infrastructure 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 the FDI flow into that country. Similarly, Globerman and Shapiro (2002) show that good governance positively influences both inward and outward flows. Hence, we can expect that good institutions will positively influence OFDI flows.

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 to invest for export purposes. In this paper, we quantify it as a ratio between a country's total international trade (export + import) and its GDP. Hence, given that most investment projects are directed towards the tradable sector, a host country's degree of openness to international trade should have a positive relationship with India's OFDI flows.

Offshore Financial Centre

There are relatively few well-established empirical works on OFCs, given the lack of theory behind it and the lack of data. As mentioned earlier, Rose and Spiegel (2007) establish that proximity to an OFC is likely to competitive OFDI. Foad (2012) claims that a country with more economic freedom and low levels of corruption tends to invest less in OFCs. However, it has not been tested

as to how OFCs 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 International Monetary Fund, these are centres with low- or zero-taxation, low regulation and banking secrecy and anonymity. All these three characteristics work in favour of investment inflows into OFCs. In fact, 50% of the countries chosen in our sample data are IMF-certified OFCs. 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.⁵

Firm-Level Determinants

Apart from macroeconomic factors of a host country, there are many firm-specific characteristics that spawn multi-national corporations.

Productivity of firm

Extensive analyses have found that only the most productive firms will establish plants in foreign countries. Grossman, et. al. (2006) said that less-productive firms serve only the local market, while most productive firms are able to bear the high cost of establishing plants abroad and produce goods close to customers in order to minimise transportation costs. Hence, we would expect a positive relationship between productivity of a firm and OFDI.

Patented knowledge

A firm possessing a patented technology is more likely to manufacture products at its own domestic plants than to share knowledge with partner companies abroad. Hence, another reason for companies to invest in foreign companies is to take advantage of unique and diversified products

⁵ Forecast by a United Kingdom financial consultant, Wealth Insight.

since they are not possible in any other way. This was shown by Dunning (1988) as well as Rugman (1981). Hence, companies are more likely to seek out countries which have a better track record of intellectual-property creation in order to benefit directly or indirectly from the transfer of technology and know-how.

Incentive policies

Incentive policies can take various forms; developed countries generally offer payments for each job created, loan guarantees, access to cheap finances etc. Many countries offer duty-free access for inputs, and reduced rates of corporation tax to investors. One example is China; it has provided foreign investors with special favourable policies on taxation, land use etc. Zhang (2002) found that this was an important factor in the country's overwhelming performance in attracting FDI.

Size of firm

A firm's size is, broadly, determined by the volume of resources it possesses, number of employees, impact in the market etc. It is also linked to economies of scale, where larger firms have lower production costs and can apply more efficient technologies. Markusen and Maskus (2001) found that a larger firm is more likely to have foreign operations due to the lesser risk of failure in the field, compared to a smaller firm.

Methodology and Data

Zhang and Daly (2011) constructed a model based on the macroeconomic determinants' effect on China's outward FDI. Their paper used bilateral trade, GDP per capita, GDP growth rate, openness to foreign investment (ratio of inward FDI stock to GDP of host country), exchange rate, inflation rate, and natural-resource endowments. Chiappini (2014), Kolstad and Arne (2010), Demirhan and Masca (2008) also use similar models to show the relationship between these determinants and the OFDIs of Japan and China respectively. I try to develop this model further by including the determinant of how OFC affects foreign investments into a country. I would not be including the firm-level determinants as I am focusing on the macroeconomic factors of the host country.

Based on the discussions above, the following economic model was built, relating outward FDI to independent variables:

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

OFDI is the sum of logarithm values of India's outward FDI flow to a host country. It is a total of loan, equity and guarantee issued investments in foreign countries. Due to the inaccessibility of FDI data (country-wise) before 2007, the period of regression for this paper is confined to 2008-2013. The unit is in US\$, and it has been taken from the RBI database.

Trade measures the logarithm values of total bilateral trade. Measured in US\$, it has been taken from the RBI database. It is the sum of India's exports to the host country and imports from it.

g is one-year-lagged nominal GDP growth rate of the host country (as a measure of its market size), and has been taken from the CEIC database (the unit is in percentage).

Exrate is the annual exchange rate of the host country's currency against the Indian Rupee. It is the ratio of the quarterly average value of the host country's currency divided by the Indian Rupee. It has been taken from the CEIC database and has no unit.

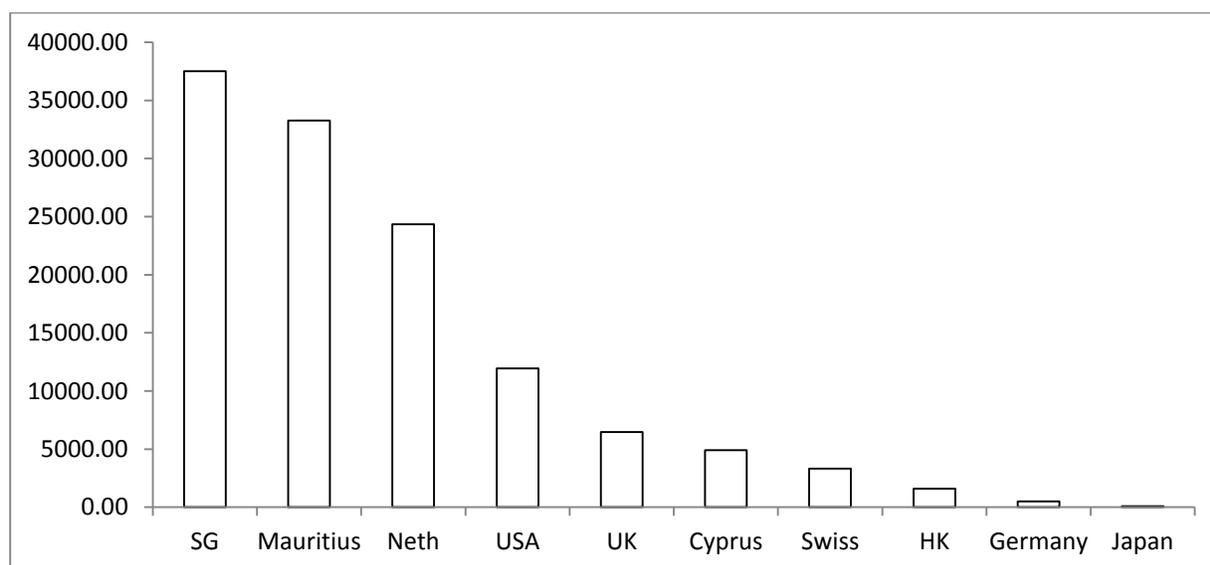
Openness is a measure of the trade-openness of the host country's market. It is obtained by dividing the total trade of the host country by the GDP of the country. This ratio has been used as a dummy variable in this equation; if the ratio is more than 100%, then the variable assumes the value of 1, and it assumes the value of 0 if this ratio is less than 100%. The data source is CEIC database.

OFC is a dummy variable which is 1, if the host country is an IMF-certified offshore financial centre and 0 otherwise.

Inst is a weighted index that measures the institutional quality of the host country based on three indicators taken from the World Bank database: 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/economies are Singapore, USA, Netherlands, Switzerland, Mauritius, United Kingdom, Germany, Hong Kong, Cyprus and Japan. 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 has not 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 outflows (in US\$ Million)



Source: Reserve Bank of India

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/economies known to be dedicated offshore financial centres (Mauritius, Cyprus, Singapore and Hong Kong).

In Regression 1, we can see that only trade is highly significant. This is in accord with the existing literature that shows 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 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	0.17	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/economies, on an average, increased, though the GDP of the host was falling. Though unique to this time period, this can explain the negative sign for the GDP growth rate among 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. 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 is an offshore financial centre. 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 favourable 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 be why foreign investment into the country has not reached the potential 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/economies that are OFCs. Now, other than exchange rate, none of the determinants is significant. This means that, for Indian firms, when dealing with an OFC, trade and institutional qualities are no longer important determining factors. For e.g. Mauritius and Cyprus have the poorest ranking of institutional quality in our sample data, and 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 that, even though the currency of the host country was appreciating against the rupee, it did not deter investment flowing to it. These highlight the lucrative characteristics and importance of an OFC; with low-tax and regulations, these centres are fast becoming conduits for global trade and capital flows. Hence, in such cases, the need for good trade relations as well as for other established determinants of FDI flows become irrelevant.

A regression was also run, dropping four countries/economies 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 the IMF's longstanding argument that such centres 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 trade and openness were found to be highly significant.

The low values of the R-squared are probably because I have not taken into account all the variables that influence outward FDI from India; I have left firm-level determinants, as I wanted to focus on the main macroeconomic factors and the OFC variable and their behaviour with reference to OFDI. As shown in the Literature Review section, there are many variables that influence the OFDI; omitting them could explain the low R-squared values. Kolstad and Arne (2010), with a similar independent variable, had similar R-squared values, but the important point to note is that the variables are statistically significant in both the cases.

Conclusion

The main reason for undertaking this exercise was to test the established investment models on studying India's overseas investment flows, when the host country/economy is an offshore financial centre. 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 participation in regional and global trade agreements/negotiations such as RCEP, ASEAN-India Free Trade Agreement (AIFTA) as well as various bilateral FTAs, provides a favourable trade platform for Indian firms to strengthen their presence in the host country and vice versa. The contributing factor for Singapore and Mauritius receiving high FDI from India may also be the fact that India has signed Double Taxation Avoidance Agreements (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 inefficiencies in India, is the biggest concern for investors from Singapore. Advancement in these areas will be instrumental in generating the FDI inflows that India greatly needs to revive the relative slowdown in its GDP growth rate.

This paper supports the reality that OFCs remain attractive destinations for FDI, due to their tax- and legal-protection advantages, despite significant developments in trade, institutions or on the growth front. As long as there are differences in national tax rates, regulatory standards and confidentiality laws, OFCs will exist.

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Appendix

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/Economy	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