

Home Bias in Foreign Direct Investments

Gulnur Muradoglu & Kristina Vasileva
ESDS International Annual Conference, London, 01.12.2008

Introduction

The purpose of this research is to investigate familiarity bias in foreign direct investments (FDI). We are investigating the influence of several familiarity factors in the corporate decision making regarding FDIs. Huberman (2001) explains that familiarity is associated with the general sense of comfort with the known and discomfort with the distant and unfamiliar. We find that investors prefer to invest in countries with which they share a border, certain historical ties, or even a common past as parts of the same country in the past.

Table 1. Home Bias in FDI flows - panel regression		
[Dependant variable is log (FDI flows)]		
	FDI inflows	FDI outflows
C	4.8 ***	-11.45***
L [GDP of FDI receiving country]	-0.16***	0.81***
L [GDP of FDI sending country]	-0.18***	0.43***
L [Net Exports of FDI rec. count.]	0.02***	0.000444
L [Distance]	-0.3***	-0.54***
Economic Union Dummy	0.08*	0.28***
Same Legal Origin Dummy	-0.015	0.12***
N	25638	23880
R ²	0.43	0.23

Table 1: estimation model: $FDI_{i,j,t} = \alpha + \beta_1 L(GDP \text{ of FDI receiving country})_{i,t} + \beta_2 L(GDP \text{ of FDI sending country})_{j,t} + \beta_3 L(\text{Net Exports of FDI rec. count.})_{i,t} + \beta_4 L(\text{Distance})_{i,j} + \beta_5 (\text{Economic Union Dummy}) + \beta_6 (\text{Same Legal Origin Dummy}) + u$

Literature Background

1. **FDI Literature** - assumes investors are rational and evaluate investment destinations using traditional economics determinants [Kinoshita and Campos (2005); Botic and Skuflic (2005); Bevan and Estrin (2000); Bandelj (2003); Hara and Razafimahera (2003); Mayer (1998, 2001, 2004), Brada et al. (2004), Van de Laar De Neubourg (2007)]
2. **Psychology of decision making** - Economics and finance models should account for the human behaviour that influences the way people make decisions. E.g. people prefer the familiar and this tends to influence their choices. [Clark (1918); Kahneman, Slovic, Tversky (1982); De Bondt and Thaler (1994); Gigerenzer (1999); Oberlechner (2004); Lucey and Dowling (2005); Dalal et al. (2006); Preda (2007); Kuhnen and Knutson (2008);]
3. **Home Bias Literature** - asset management literature finds that individual and institutional investors are prone to home bias in the equity markets. [French and Potreba (1991, 1995); Lewis (1999); Ivkovich and Weisbenner (2003); Warnock (2001); Vannieuwerburgh, Veldkamp (2007); Tesar and Werner (1992); Suh (2001); Ng et al. (2007); McQueen (2007); Liljeblom and Löflund (2000); Foad (2006, 2008); Ahearne et al (2004);]

Data

- Data on FDI is from OECD's direct investment database
- Data includes all 30 OECD member countries
- 5755 different bilateral country pairs
- Data period is 25 years (1981-2005)
- Number of observations:
 - 28935 for inflows
 - 26490 for outflows
- Separate consideration of inflows and outflows
- Unbalanced panel data

Model

The general model is:

$$FDI_{i,j,t} = \alpha + \beta_1(\gamma_1)_{i,t} + \beta_2(\gamma_2)_{j,t} + \beta_3(\gamma_3)_{i,j,t} + \beta_4(\gamma_4)_{i,j,t} + u$$

Where:

$FDI_{i,j,t}$ is FDI inflows or outflows;

γ_1 - macroeconomic variables (GDP, GDP per capita, GDP growth rate, population, country trade openness);

γ_2 - is for geographic proximity (distances, shared border, same continent);

γ_3 - familiarity variables (common language, shared legal system origin, economic/political union membership, colonial relationship)

Conclusion

Foreign direct investors prefer to invest in countries that are geographically closer to their home countries. We test familiarity variables to test whether physical proximity and cultural similarity between the countries from the FDI flows country pairs influence FDI flows. Physical proximity is an indicator of cultural and linguistic familiarity in most instances. We find that investors prefer to invest in countries whose economic and legal systems are similar to their own. Institutional similarities are important indicators of business climate familiarity. We also find the size of the economy to be more important for the FDI outflows sending country while country openness for the FDI receiving countries.

Table 2. Home Bias in FDI flows – panel regression

[Dependant variable is log (FDI flows / GDP/10⁹)]

	FDI inflows	FDI outflows
C	4.41***	(-4.88)**
L [GDP per capita of FDI receiving country]	0.08	0.75***
L [GDP per capita of FDI sending country]	0.38***	2.11***
L [Net Exports / GDP]	0.00	-0.01
L [Distance]	(-1.6)***	(-1.69)***
Economic Union Dummy	0.65***	0.27*
Same Legal Origin Dummy	0.59*	0.18
N	28823	26456
R ²	0.0041	0.0063

Table 2: estimation model: $FDI_{i,j,t} = \alpha + \beta_1 L(GDP \text{ per capita of FDI receiving country})_{i,t} + \beta_2 L(GDP \text{ per capita of FDI sending country})_{j,t} + \beta_3 L(\text{Net Exports / GDP})_{i,t} + \beta_4 L(\text{Distance})_{i,j} + \beta_5 (\text{Economic Union Dummy}) + \beta_6 (\text{Same Legal Origin Dummy}) + u$