How Different are FDI and FPI Flows?: Does Distance Alter the Composition of Capital Flows?

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March 2011

Summary

The availability of bilateral capital flows between countries has motivated a voluminous literature attempting to understand trends and determinants of capital flows between country pairs. Drawing on the more established trade literature, most of the papers apply some version of the gravity model to various types of international capital flows (foreign direct investments (FDI), foreign portfolio investments (FPI), Mergers and Acquisitions (M&As), banks flows, bonds, etc). Most studies find that distance stands out as consistently hindering all types of capital flows, while economic sizes of the host and source (measured by GDP, population, market capitalization, etc) appear to positively impact bilateral flows in most cases. This paper tries to answer an interesting question that arises – does distance affect the composition of cross-border equity flows? This issue has not been examined systematically. In particular, does greater distance hinder all types of bilateral flows equally or are some types of flows more impacted than others? To help us answer the questions, we have three hypotheses: First, FDI ought to be relatively more hindered by greater distance than FPI. Second, other things equal, FDI in the form of M&As should be less impacted by distance than total FDI as it is primarily a financial transaction. Third, since M&A and FPI are broadly similar types of investments, distance ought not to have any discernible difference between the two. Due to data availability, and consistent with the theory/hypotheses to be laid out, the paper focuses on equity flows only, limiting its attention to foreign portfolio (equity) flows and FDI, and also differentiates between total FDI and FDI is the form of M&As (the other type of FDI being of the Greenfield variety). Given data constraints and in order to maintain focus, the is limited to equity flows – FPI, FDI and M&As where the hypotheses are also clearer (compared to debt flows). We use a fairly large panel over the period 2000-2007. We find that the data fit our three priors quite well. Broadly, distance affects FDI relatively more than FPI. Consistent with the fact that FDI in the form of M&A does not involve as much sunk costs compared to Greenfield and is also much easier to liquidate, we find that distance seems to hinder Greenfield investment relatively more than M&A. Finally, we find that distance has an almost equal inhibiting impact on FDI in the form of M&A and FPI, consistent with the fact that they are broadly similar financial transactions with different ownership thresholds.