

Effects of FDI flows on Current Account Balances: Do Globalisation and Institutional Quality Matter?

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Abstract

This study examines the linkages between globalisation, institutional quality, foreign direct investment (FDI) and current account (CA) for twenty three Asian countries over the period of 1998 to 2013. Institutional reforms may motivate more FDI inflows, however, this may lead to deterioration of the current account by inducing imports as well as rising investment demand in the domestic economy. This study probes the nature of this relationship and try to examine whether it holds good for the Asian economies as well. After controlling for other exogenous variables, the study finds that FDI inflows and institutional reforms have negative and significant impact on the current account balances. The coefficients of exchange rate, globalisation, financial development and age dependency indicate an adverse relationship with current account. Further, while GDP per capita is having a positive relationship, GDP per capita square has a negative and significant impact on the current account balances. This implies the ‘stages of development hypothesis’ does not hold good in case of Asian countries.

Key Words: Current account, FDI, Productivity, Institutional Reform

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1. Introduction

Increasing current account deficit and its negative impact on economic activities have been a matter of policy debates both in developing as well as developed countries. In a liberalised economy with the presence of flexible capital flows, it is a great challenge for the policy makers to introduce proper policies in order to avoid discrepancies in the external sector balances. Further, in recent years, there is a move by many developing and emerging economies to seek more actively to attract foreign direct investment. This raises policy makers' concern that intensifying global competition among governments to attract FDI may have undesirable effects (Oman, 2000). Rising capital inflow which appreciates the domestic currency may worsen a country's current account by increasing more imports and reducing exports (Kim and Kim, 2006; Abell, 1990). For attracting more FDI into the country, better institutional quality plays a very important role (Du, Lu, & Tao, 2008; Dang, 2013). The countries having better institutional quality in terms of better legal system, good governance, quality of financial information, strong property rights and sound prudential regulation and supervision of banking system, motivates the foreign investors to increase their investments in these countries. Further, Mishkin (2009) argues that globalization is a key factor in stimulating institutional reforms in developing countries that promote financial development and economic growth. This shows that there can be a good linkage among globalisation, institutional quality, foreign direct investment and the current account for better explaining the external sector balance of an economy.

Though the existing studies have focused on the determinants (Chinn and Prasad, 2003; Sooreea and Wheeler, 2010; Batdelger and Kandil, 2012), role of capital flows (Cecen and Xiao, 2014; Garg and Prabheesh, 2014; Kim and Kim, 2011) and twin deficit hypothesis (Abell, 1990; Kim and Roubini, 2008) to explain the current account deficits, they have overlooked the nexus between globalisation, institutional quality, foreign direct investment (FDI), and the current account. Therefore, the present study is trying to examine such linkage in the context of the Asian economies. As proposed by Kaufmann et al. (2011), the study uses the aggregate indicators of the six broad dimensions of the governance such as Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption from the World Governance Indicators 2015 to measure the institutional quality (more about the measurement of the institution quality index shown in the data section).

In this study, we have used a panel of 23 Asian countries for the period from 1998 to 2013 and the study period consists of the post Asian crisis period. The justification for selecting these countries is that, most of the Asian countries like India and China are having competition to attract more and more of FDI into various sectors like agriculture and animal husbandry, plantation, defence, broadcasting, civil aviation and manufacturing etc. Therefore, it is important to test the impact of FDI flows on the external sector balance of these countries.

This study contributes to the existing literature in several ways. First, the study analyse the link between institutional quality, FDI and current account which has been overlooked by many of the existing studies. Second, it also considers the longer post liberalisation period when most of the Asian countries became more open to capital flows. Third, more robust techniques have used to confirm the econometric results.

The rest of the paper is organised as follows. Section 2 presents theoretical framework. Section 3 reviews the literature. Section 4 explains about the data and variables. Section 5 provides the empirical methodology. Section 6 reports the empirical results and discussions. The last section concludes.

2. Theoretical Framework

This section explains whether the institutional quality and net FDI flows appear related to the current account deficits experienced in many countries. It plots the cross section data of institutional quality, net FDI flows and the current account in two periods i.e. 1998 and the 2013, to show the changes in the movements of these variables over the years.

FDI plays a vital role in the development process of an economy in many ways such as through knowledge spill over and capital accumulation (De Mello, 1999). It is also considered as the main driver of the technological diffusion, which is beneficial for the developing economies (Borensztein et al., 1998). This leads to competition among the developing economies to attract more FDI in order to improve the productivity and the performance of the domestic industries (Holtz-Eakin, 1992). Considering the importance of the various macroeconomic factors in motivating greater FDI inflows, recent studies have emphasised the importance of the institutional development in creating more attractive investment destination (Du, Lu, & Tao, 2012; Fukumi & Nishijima, 2010 and Du, Lu, & Tao, 2008).

Many of the authors have linked the capital flows (in terms of FDI and FPI)⁴ with the current account deficits of a country through the exchange rate channels (Hobza & Zeugner, 2014; Cecen & Xiao, 2014; Abell, 1990). They argued that increasing capital inflows causes appreciation of the domestic currency, which makes the imports cheaper and the exports dearer. This results in increasing imports and reducing exports of goods and services, and thereby worsens the current account balances of the economy concerned. From the national income accounting, we can find that current account is the difference between saving and investment. So an increase in investment, saving remaining the same, reduces the current account surpluses. Therefore, an increase in the inflow of FDI may induce more investment in the domestic economy and thereby worsen the current account.

Further, in the context of the developing economies, greater openness to external flows allows importing technology to achieve faster accumulation of knowledge and higher total factor productivity due to the resource allocation from lower to higher productive activities (Amighini & Sanfilippo, 2014; Schiff & Wang, 2006 and Grossman & Helpman, 1991). This shows that rising FDI inflows lead to rising imports of technology, capital goods and the raw materials, which can deteriorates the current account balance of a country.

Figure 1 and 2 present the country wise plots of the values of institutional quality index, FDI and current account balances for the years 1998 and 2013, respectively. Both figures provide an interesting display of the relationship among these variables. It shows that as compared to Figure 1, the slope of the current account balances trend line is flatter and the slope of the FDI trend line is steeper in Figure 2. This shows that the countries having more institutional development, achieve more FDI inflows and less current account surplus in 2013 as compared to 1998. Therefore, we can infer that rising institutional quality attracts more FDI inflows and as a result, it may lead to the worsening of the current account balances of the respective countries by encouraging more imports as well as by motivating higher investment in these countries.

⁴ FPI shows foreign portfolio investment.

Figure 1

Institutional quality, FDI and current account balance by country for 1998

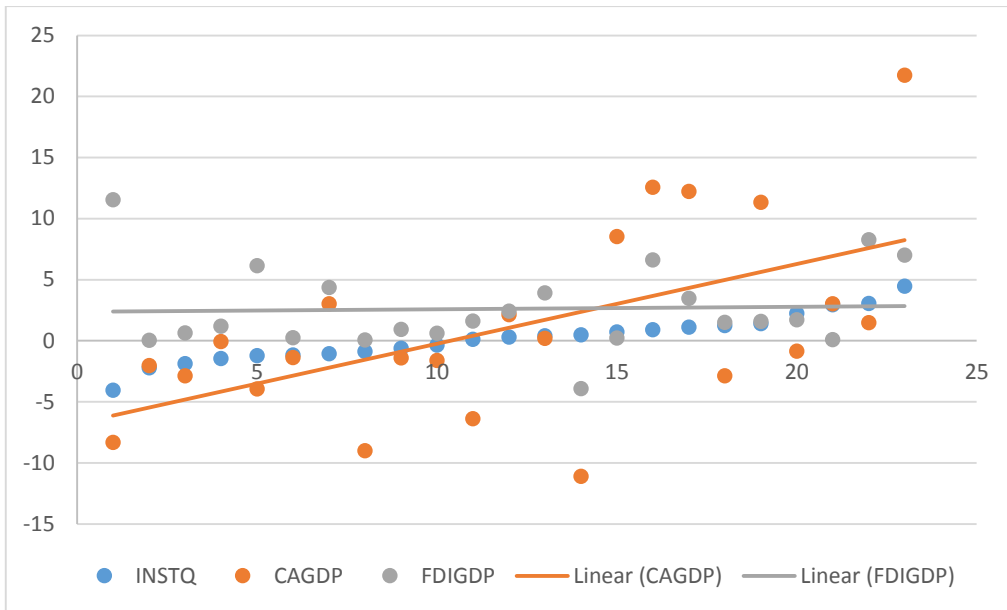
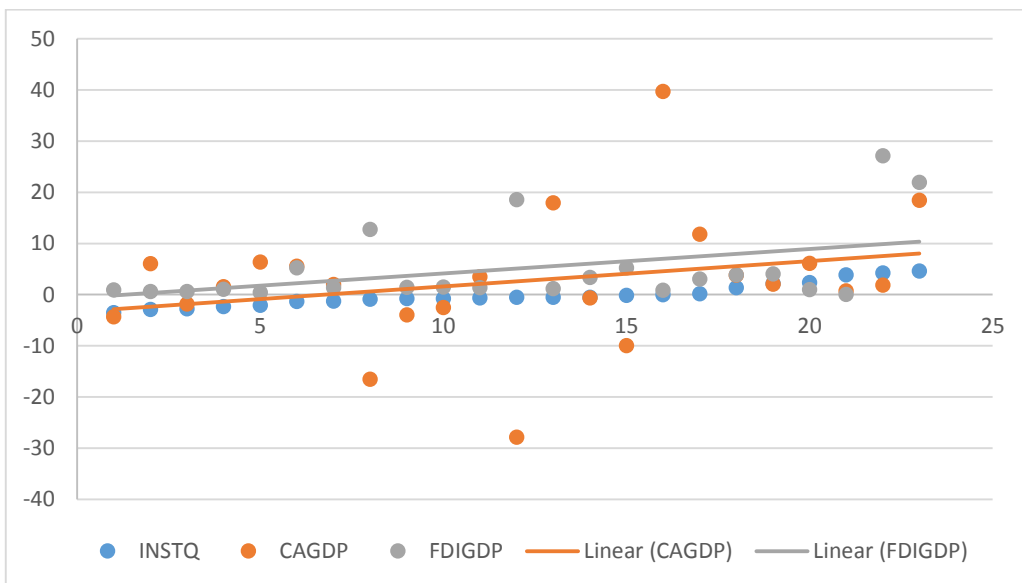


Figure 2

Institutional quality, FDI and current account balance by country for 2013



3. Literature Survey

A number of theoretical as well as empirical studies are available to explain the determinants of the current account deficits. According to the intertemporal approach, the current account deficit is the outcome of forward-looking dynamic saving and investment decisions driven by

expectations of productivity growth, government spending, interest rates, and several other factors (Calderón, Chong and Loayza, 1999). Within this framework, the current account balance behaves as a buffer against transitory shocks in productivity or demand (Sachs, 1981; Obstfeld and Rogoff, 1995, 1996; Ghosh, 1995; Razin, 1995).

In the context of a real business cycle model, the intertemporal approach has been widely used to evaluate the impact on the current account balance of fiscal policy (Leiderman and Razin, 1991; Frenkel and Razin, 1996), real exchange rate (Stockman, 1987), terms of trade fluctuations (Obstfeld, 1982; Svensson and Razin, 1983; Greenwood, 1983; Mendoza, 1995; Tornell and Lane, 1998; Mansoorian, 1998), capital controls (Mendoza, 1991) and global productivity shocks (Glick and Rogoff, 1995; Razin, 1995).

So far the empirical literature is trying to examine the factors determining the current account as well as measuring the sustainable level of the current account deficit in the developing and developed economies.

There exists no comprehensive conceptual model incorporating all possible transmission mechanisms explaining the trends in current accounts balances (Huntington, 2015). Experts differ on what factors lead to long-run periods of current account surpluses or deficits and how sustainable they can be (Mann, 2002). The studies including Debelle and Faruquee (1996), Chinn and Prasad (2003), Bussière et al. (2004), Chinn and Ito (2007) and Gruber and Kamin (2007, 2009), show that the major factors influencing the current account balances over mid to long run are associated with a country's propensity to save in both the public and the private sector. These studies include structural variables that explain saving and investment levels but exclude near-term fluctuations in the internal capital movements and its impact on the current account balance.

Government budget imbalances has been used as one of the major determinants of current account imbalances. Bernheim (1988) provides a better explanation about the "twin deficit hypothesis" where the author discusses the impact of budget deficit on the current account deficit. When the government increases and the domestic and the private saving become insufficient to meet the domestic investment and the government expenditure, then it puts upward pressure on the domestic interest rate. Rising interest rate strengthens the domestic currency and attracts more capital inflows. Both the effects shift the current account to the deficits, resulting in both government budget and trade imbalances.

Globalization plays an important role for the saving investment decision, as it influences the institutional reforms in the domestic market. [Mishkin \(2009\)](#) argued that globalization is a key factor in stimulating institutional reforms in developing countries that promote financial development and economic growth. While better institutions attract FDI into the region ([Fukumi & Nishijima, 2010](#)), financial development enhances saving and investment because it contributes to raising returns as well as lowering the cost of capital and the risk of investment by ameliorating information asymmetry, reducing information and transaction cost, improving corporate governance, and/or facilitating risk management ([King and Levine, 1993](#); [Rajan and Zingales, 1998](#); [Wurgler, 2000](#); [Chinn and Ito, 2007](#)).

Demographic variables should also be considered as they influence the savings rate and hence the current account imbalances ([Huntington, 2015](#)). The economy having more dependent population will have less saving capacity than the economy having more working group population. Accordingly, current account surpluses are more likely in countries with a greater share of workers in their population ([Higgins, 1998](#)).

GDP per capita also plays a major role for shaping the current account balances. Generally, an increase in the domestic income motivates more imports and thereby, reduces the current account surpluses. The “stages of development hypothesis” propounded by [Debelle and Faruquee \(1996\)](#) argues that at the low and intermediate stage of development a country requires more capital imports and thereby incurs higher current account deficits. On the other hand, once the country reaches the higher stages of development, it begins to develop current account surplus by exporting capital goods to the developing countries to reduce its past liabilities. Therefore, we can get a non-linear specification of income which requires to include both GDP per capita and GDP per capita square in the model. Hence, there should be a negative effect of income and positive effect of income square on the current account balances.

4. Data source and variable descriptions

This study uses panel data for 23 Asian countries (listed in Table 1) over the 1998-2013. The study period consists of the post Asian crisis period. The data used in this study are basically taken from the World Development Indicators (WDI) and the World Governance Indicators of World Bank, and the UNCTAD data bases. Most of the variables are selected on the basis of the earlier panel data works of [Chinn and Prasad \(2003\)](#), [Chinn and Ito \(2007\)](#) and [Gruber & Kamin \(2007, 2009\)](#). As our focus is on the intermediate run rather than the short run, we have used the annual data instead of quarterly data. For similar reasons, we depart from the approach

used by the above studies in which the time interval for each observation is the long run as measured by the average over a five year period. In these previous studies, averages were computed over a shorter period less than five years when there was missing values. In this study, have used the annual data, excluding countries with missing values for any of the study period concerned.

Table 1

Countries included in the study.

Bahrain	Jordan	Pakistan
Bangladesh	Korea	Philippines
China	Kuwait	Saudi Arabia
Hong Kong	Malaysia	Singapore
India	Maldives	Sri Lanka
Iran	Mongolia	Thailand
Israel	Myanmar	Viet Nam
Japan	Nepal	

The major variables of our study are current account balances as percent of GDP, globalisation, net FDI flows as percent of GDP, institutional quality, real effective exchange rate (REER), financial deepening/development, GDP per capita, GDP per capita square, and age dependency. The Chinn and Ito (2006) index of capital account openness (KAOPEN) is used as the proxy for the globalisation. We use the six aggregate indicators such as Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption to create the institutional quality index (See Mishkin, 2009 and Kaufmann et al. 2011). The data on these indicators have taken from the World Governance Indicators 2015. We use the principal component analysis (PCA) to prepare the institutional quality index from the above six indicators. The PCA gives the linear combination of the original variables, known as the principal components (PCs). After getting the PCs, we can use the most efficient one in our model.

Table 2 presents a short description about the variables as well as their expected signs. Current account is the sum of the trade balance and the return on a country's stock of net foreign assets

(NFA) or payment on its foreign liabilities position (Chinn and Prasad, 2003). FDI inflows should show a negative sign, because as discussed above increasing capital flows deteriorate the current account through the exchange rate channel by increasing more imports. The variables like real GDP per capita and the square of the real GDP per capita are used to explain the ‘stages of development hypotheses’. The ‘stages of development’ hypothesis for the balance of payments suggests that countries, as they move from a low to an intermediate stage of development, typically import capital and, therefore, run current account deficits (Roldos, 1996). As they reach an advanced stage of development, countries run current account surpluses in order to pay off accumulated external liabilities and also to export capital to less advanced economies (Chinn and Prasad, 2003). This shows that there can be a nonlinear relationship between current account and the GDP per capital, which necessitates the nonlinear specification that includes the level and the square of the per capita GDP. This may give a U-shaped relationship between the current account and the GDP per capita, which implies that the coefficient of GDP per capita and the GDP per capita square should be negative and positive, respectively.

Table 2 Description of the variables

Variables	Description	Expected sign	Source
CAGDP	Current account as % of GDP	-----	WDI
FDIGDP	FDI as % of GDP	-ve	UNCTAD
REER	Real effective exchange rate	-ve	WDI
GDPPC	Real per capita GDP (2005 \$)	-ve	WDI
GDPPCSQ	Real per capita GDP square (2005 \$)	+ve	WDI
INSTQ	Institutional Quality Index	-ve	The World Governance Indicators, 2015
KAOPEN	Capital account openness	-ve	Chinn-Ito 2013 Index
FINDIP	Financial deepening (measured as Ratio of M2 to GDP) ⁵	+ve/-ve	WDI
AGEDEPN	Dependent population as ratio to working population	-ve	WDI

⁵ See Chinn and Prasad (2003) for detail discussion.

Further, the age dependency which shows the ratio of the dependent population (population with age of 65 and above, and 0-14 years old) to the working group population. This indicates that increasing age dependency will reduce the savings and increase the consumption, and thereby will deteriorate the current account. So age dependency should carry a negative sign. Likewise, the institutional quality, KAOPEN and REER also should carry negative sign because better institutional quality may motivate more investment demand in the economy, whereas KAOPEN increases capital inflows and thereby increasing import demand through the appreciation of the exchange rate.

5. Empirical Methodology

In this study, our basic objective is to empirically examine the relationship between globalisation, institutional quality, FDI and current account balance by controlling the other explanatory variables such as exchange rate, GDP per capita, GDP per capita square, financial development, and age dependency. Our panel model is in the following form:

$$Y_{it} = \sum_i \beta_i + \sum_t \beta_t + \alpha X_{it} + \varepsilon_{it} \quad (1)$$

Where Y is the current account as the percentage of GDP, X is the vector of explanatory variables, ε is the disturbance term, and subscript i and t represent country and year, respectively. The model also includes the dummy variables (β_i) as fixed country effects to control for the time invariant factors associated with each individual country and the dummy variables (β_t) as fixed time effects to control for country invariant effect associated with each year.

6. Empirical results and discussion

The empirical results starts with the summary statistics shown in the Table 3, which explains the summary of all the variables included in our study. The unit root test results including IPS and ADF Fisher are explained in Table 4 and 5, respectively.

Table 3

Summary statistics for key variables, 1998-2013.

Variables	Mean	Max.	Min.	S.D.	Skewness	Kurtosis	J.B. Test
CAGDP	3.36	45.23	-32.58	10.61	0.75	6.33	203.68
FDIGDP	4.68	53.82	-3.93	7.19	2.96	13.8	2319.83
REER	108.43	204.09	68.83	15.79	2.16	11.95	1511.17
GDPPC	10.5	54.78	0.13	13.27	1.38	3.94	129.78
GDPPCSQ	129.78	3000.36	0.02	550.26	2.6	10.15	1196.31
INSTQ	0.01	1.78	-1.46	0.83	0.25	2.09	16.62
KAOPEN	0.4	2.39	-1.89	1.5	0.11	1.51	34.73
FINDIP	90.27	350.51	17.69	62.03	1.69	6.05	317.45
AGEDEPN	0.54	0.88	0.28	0.14	0.33	2.22	15.86

Both of the panel unit root test results show that while the variables like CAGDP, FDIGDP, INSTQ and KAOPEN are stationary at level, the other variables like REER, GDPPC, GDPPCSQ and AGEDEPN are stationary after taking the difference. After the unit root test, we use the panel regression in order to estimate the parameters of the model. As our study consists of the panel data model for several Asian countries, there is the possibility of the existence of the country specific effects which may give the biased results. Therefore, in this case, the fixed effect and the random effect models will be useful for tackling such problem. The Hausman test comparing the generalised random with the fixed effects model results in χ^2 statistics of 5.87 with probability 0.56 (i.e. not significant), resulting in the decision to use the random effect model instead of the fixed effect model.

Table 4

IPS panel unit root test results

Variables	With intercept		With intercept and trend	
	Statistic	P-values	Statistic	P-values
CAGDP	-3.55	0.00	-1.7	0.04
FDIGDP	-2.65	0.00	-4.97	0.00
REER	2.22	0.99	2.75	1.00

GDPPC	12.99	1.00	0.91	0.82
GDPPCSQ	17.21	1.00	7.45	1.00
INSTQ	-0.65	0.01	-1.42	0.08
KAOPEN	-2.97	0.00	-2.34	0.01
FINDIP	-0.22	0.41	-1.63	0.05
AGEDEPN	4.43	1.00	4.12	1.00
At Difference				
REER	-624	0.00	5.67	0.00
GDPPC	-5.31	0.00	-8.29	0.00
GDPPCSQ	-0.22	0.42	-7.85	0.00
FINDIP	-12.06	0.00	-10.2	0.00
AGEDEPN	-7.8	0.00	-5.81	0.00

Table 5

ADF Fisher panel unit root test results

Variables	With intercept		With intercept and trend	
	Statistic	P-values	Statistic	P-values
CAGDP	83.36	0.00	67.03	0.02
FDIGDP	93.20	0.00	101.95	0.00
REER	29.51	0.97	30.93	0.96
GDPPC	4.92	1.00	36.71	0.83
GDPPCSQ	4.83	1.00	21.35	0.99
INSTQ	74.68	0.00	63.64	0.04
KAOPEN	50.26	0.00	38.10	0.01
FINDIP	45.49	0.49	63.04	0.05
AGEDEPN	96.48	0.00	33.49	0.92
At Difference				
REER	124.50	0.00	112.16	0.00
GDPPC	113.86	0.00	147.99	0.00
GDPPCSQ	80.82	0.00	151.77	0.00
FINDIP	209.20	0.00	170.31	0.00
AGEDEPN	139.74	0.00	110.15	0.00

Table 6 carries the results of the random effect model, where we have estimated three models. Model 1 consists of all the variables including both GDPPC and GDPPCSQ. Model 2 consists of all the variables except GDPPCSQ whereas Model 3 consists of all variables except GDPPCSQ. As explained earlier, GDPPC and GDPPCSQ are used to explain the stages of the development hypothesis⁶ and this gives contradictory results while estimating Model 1 including both the variables. Therefore, in order to get more robust results we estimate the variables separately in the Model 2 and 3. Tables 6 presents the results of all the models (i.e. Model 1, Model 2 and Model 3) for explaining the impact of FDI and institutional quality along with the other explanatory variables on the current account balances in the 23 Asian economies.

Table 6

Results of the random effect model, 1998-2013.

VARIABLES	(Model 1) All variables	(Model 2) Income	(Model 3) Income square
FDIGDP	-0.411*** (0.0606)	-0.414*** (0.0604)	-0.425*** (0.0616)
REER	-0.0728*** (0.0242)	-0.0718*** (0.0242)	-0.0751*** (0.0246)
GDPPC	0.707*** (0.184)	0.558*** (0.0631)	
GDPPCSQ	-0.00246 (0.00284)		0.00775*** (0.000998)
PC2	-2.353** (0.975)	-2.339** (0.966)	-2.498** (0.996)
KAOPEN	-1.798*** (0.625)	-1.685*** (0.604)	-1.095* (0.611)
FINDIP	-0.0369** (0.0160)	-0.0351** (0.0158)	-0.0312* (0.0163)
AGEDEPN	-15.33** (6.302)	-17.35*** (5.823)	-23.37*** (6.071)
Time Dummies	Yes	Yes	Yes
Adjusted R-sqr	0.29	0.29	0.27
F-statistic	19.81***	22.65***	20.34***
Observations	368	368	368
Number of id	23	23	23

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

⁶ See Section 4 for the meaning and definition.

The random effect results in [Model 1](#) provide the coefficients with the correct sign for all variables except GDPPC and GDPPCSQ. The results indicate that greater FDI inflows, institutional development, exchange rate appreciation, globalisation, financial deepening and increasing age dependent population reduce the current account. The positive and significant response from the income level, and the negative and insignificant effect of income squared do not support the “stages of development hypothesis”. Therefore, we estimate the same separately in [Model 2](#) and [3](#). The [Model 2](#) estimates all the variables except squared income, while [Model 3](#) estimates all the variables except the GDPPC. The results from [Model 2](#) and [3](#) shows that both the income and income square are positive and significant separately in the respective models. On the other hand, taking both the variables together in the [Model 1](#), shows only income to be positive and significant.

However, the standard random effect equation’s residuals strongly suggest the presence of the heteroscedasticity in the model. Application of White’s general test of heteroscedasticity (which is a special case of Breusch-Pagan test) results in $\chi^2(43) = 142.5$, which rejects the null hypothesis of homoscedasticity at the 1% significance level. Moreover, the Wooldridge test for autocorrelation in panel data rejects the null hypothesis that there exists no first order autocorrelation at the 1% significance level with an F-statistic $(1, 22) = 73.018$. For this reason we apply the generalised least square (GLS) for obtaining more robust estimates. The results of the GLS formulation are presented in the Table 7.

Table 7

Generalised least squares (GLS) results, 1998-2013

VARIABLES	(Model 4) All variables	(Model 5) Income	(Model 6) Income square
FDIGDP	-0.253*** (0.0112)	-0.252*** (0.0164)	-0.327*** (0.0152)
REER	-0.0404*** (0.00534)	-0.0395*** (0.00574)	-0.0371*** (0.00481)
GDPPC	0.805*** (0.0272)	0.686*** (0.0115)	
GDPPCSQ	-0.00268*** (0.000529)		0.0125*** (0.000376)
PC2	-2.788*** (0.151)	-2.698*** (0.155)	-2.317*** (0.115)
KAOPEN	-3.037*** (0.147)	-2.868*** (0.106)	-1.513*** (0.0981)
FINDIP	-0.0228*** (0.00164)	-0.0231*** (0.00190)	-0.0143*** (0.00184)

AGEDEPN	-9.595*** (1.120)	-11.08*** (1.385)	-21.31*** (1.053)
Time	Yes	Yes	Yes
Adjusted R-sqr	0.57	0.62	0.76
F-statistic	58.94***	87.21***	166.56***
Observations	368	368	368
Number of id	23	23	23

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

The GLS results show that the coefficient of all the explanatory variables are significant with the similar signs like the results of the random effect model as explained in Table 6. The adjusted R^2 improves significantly after controlling for the heteroscedasticity and autocorrelation in the model. Further, the GDP per capita square which was showing negative and insignificant in the random effect model, we find it negative as well as significant in the GLS results. This finding is consistent with the robust results reported by [Chinn and Ito \(2007\)](#) for the industrial countries case. In all the cases, we find that FDI, institutional development, exchange rate, capital account openness, financial deepening and age dependency result worsen current account in these countries. While GDP per capita is having positive and significant impact on the current account in the Models 1, 2, 4, and 5, the GDP per capita square has negative and insignificant sign in Model 1 and 4, but positive significant sign in Model 3 and 6. All the results show that the net FDI inflow is having consistently negative and significant effect on the current account.

7. Conclusions and policy implications

Foreign direct investment provides a great opportunity for the developing economies to grow at a faster rate and thereby to catch up with the other developed countries of the world. Increasing inflows of FDI into the developing economies can be helpful for enhancing the manufacturing as well as the service sectors, improving the infrastructure, and creating the job opportunities in the domestic economy. From the theoretical and empirical point of view, there are some of the adverse impact of FDI on the home economy, some of which are discussed in this study. This study examines the impact of FDI inflows on the current account deficits and trying to analyse the role of institutional quality for better explaining such linkage.

In recent years, it has been seen that there is a huge competition among the developing countries to attract more and more FDI into the domestic economy. For doing so, institutional reforms in

in terms of better legal system, good governance, quality of financial information, strong property rights and sound prudential regulation and supervision of banking system etc. play an important role. Increasing inflows of FDI can also have adverse impact on the external sector of an economy in terms of appreciating the exchange rate and thereby increasing the imports and reducing the exports. This may lead to decline in the current account surplus of the respective economy.

In this study we examine the nexus between FDI, institutional quality and current account for 23 Asian countries for the period of 1998 to 2013. The countries are selected on the basis of the availability of data, and the study period consists of the post Asian crisis period. The results show that the increasing inflows of FDI, institutional development, exchange rate appreciation, capital account openness, income square and age dependency have negative and significant impact on the current account balances, whereas, the income shows positive and significant impact for improving the current account in these economies. Therefore, it is so much important to see the negative impact of FDI while inviting more and more inflows into the domestic economies. This also implies that there has to be proper policies for proper channelization of the capital flows towards the productive as well as the export oriented sectors rather than the consumption sector. As the increasing FDI inflows will enhance investment demand, therefore, it is more important to make policies to motivate more domestic saving, in order to avoid the external borrowing.

The major limitation of this study is the availability of data. The institutional quality data is available only from 1996, and also the FDI data as well as institutional quality data are not available for most of the Asian economies. Further, the data on the government budget balances⁷ is not available for the recent periods for most of the countries used in this study. Therefore, we exclude the government budget balance as an additional explanatory variable.

⁷ The government budget balance is used as an additional control variable in many of the studies on current account including Chinn and Prasad (2003) and Chinn and Ito (2007).

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