
# THE DETERMINANTS OF FDI IN SMALL DEVELOPING NATION STATES: AN EXPLORATAORY STUDY

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**ABSTRACT**

Since the decade of the eighties, developing countries began to implement more liberalized trade and investment policies in an effort to attract greater inflows of Foreign Direct Investment (FDI). Many of these countries were successful in attracting considerable amounts of foreign investments. Unfortunately the bulk of FDI inflows were concentrated in a small group of East Asian and Latin American countries with China emerging as the main beneficiary. Many small developing states, however, have failed to benefit from the explosive growth in FDI which occurred during this period. The paucity of FDI flows is linked to the weak regulatory reform system that currently exists in many of these countries. Using cross sectional data, the paper seeks to identify some of the factors that would help to increase the inflows of FDI into these nation states. Tourism, infrastructure, economic growth and openness were found to be the principal variables that attract FDI to these countries. Contrary to expectation the role of market size as a determinant was found to be insignificant.

***Keywords:*** FDI, size, openness, market size, infrastructure, economic growth, openness, cross sectional analysis.

## Introduction

Over the last two decades most developing countries have moved away from a state driven and inwardly focused to a free market oriented development strategy (Kobrin, 2005). This shift in policy position has seen greater emphasis being placed on attracting Foreign Direct Investment (FDI) because it was anticipated that such inflows would help to alleviate the financial, technological and skill deficits that existed in many of these countries (Balasubramanyam, 2001). In this regard many developing countries, starting from the decade of the eighties, begun to replace laws and regulations that had inhibited the flows of FDI with more liberal investment regimes as part of an outward oriented trade reform package (Athukorala and Sharma, 2004).

Data published by the United Nations showed a dramatic increase in FDI inflows to developing countries, jumping from US$ 24b in 1990 to US$ 178b in 2000(UNCTAD, 2003). Although there was a decline to US$ 159b in 2002 (World Bank, 2003) it continued to remain a major and reliable source of investment funding for many of these countries. In spite of this massive inflow, over the period, FDI has been concentrated in a small group of ten developing countries accounting for approximately three quarter of all flows in 2000 (World Bank, 2001). Of this small group, China alone was able to attract some 39% of total FDI to the developing world (World Bank, 2004).

Without a doubt the distribution pattern of FDI has been lopsided as the inflows to small developing states (defined as one with a population of 5 million or less persons) have remained consistently low over the decade of the $90^{s}$ (South Centre, 2005). To a large measure this problem has been linked to the prevalence of cumbersome administrative processes i.e, foreign exchange controls, repressive tax regimes etc., which acted as a major deterrent to foreign investment (Jenkins and Kuo, 2000).

In spite of this apparent lopsided allocation very few empirical studies have been concerned with identifying the determinants of FDI inflows into these capital starved nation states. This paper represents an attempt at identifying some of the determining factors of FDI flows to a group of 29 small developing countries. It is believed that by identifying and trying to understand these

factors would provide policy makers with better insights as to how future FDI policies must be tailored.

The paper, however, begins with a brief survey of the theories which is then followed by a review of the empirical literature on the determinants of FDI and the issue of size. The next two sections provide a brief analysis of the population of and the FDI inflows to, these countries. This is, then, followed by a discussion of the research focus and methodology, as well as, the data used by the study. The empirical results, comments on the results obtained and conclusions are presented in the final section of the paper.

**Theories of Multinationalization**

One of the major inadequacies of neoclassical financial theory has been its failure to adequately explain the phenomena of foreign direct investment (FDI). This to a large extent has been linked to the inability of Neo-classical economists to differentiate foreign direct investments from portfolio investments and to spell out the impact that each has on a country's development (Fan, 2002). By lumping together the two types of investments multinationals were seen by the Neo-classical literature as arbitrageurs of capital and, as a consequence, the flow of capital was influenced principally by differences in interest rates (Aoyama, 1996).

Hymer (1976), whose work represented a radical departure from the Neo-classical perspective, saw multinationals emerging as global industrial organizations in response to an imperfect global market environment whether imposed by government to protect indigenous industry, i.e. the imposition of tariffs and foreign exchange control, etc. or occurring naturally, i.e., uncertainty about the behaviour of suppliers and quality of inputs (Rugman et al., 1985) In this regard, he argued that Multinational Corporations engage in FDI in order to expand their market power either by controlling or eliminating competition through the transfer of capital, management and technology.

The suggestion that FDI is a product of market imperfections has been further extended by Caves (1971) and Buckley and Casson (1976) into what is described, today, as the internalization

theory. The central thesis of this theory is that for a firm to engage in FDI it must possess some specific advantage(s), whether in the form of superior technology, management know how or marketing and distribution skills which would enable it to compete successfully with domestic competitors (Helpman, 1984).

FDI involves a transfer of several resources across national borders, and, one, in particular, is technological skill. Vernon (1996), put forward his product life cycle hypothesis to explain at what stage in the development of a product would a multinational firm undertake foreign direct investment. This will occur when the product enters its mature phase because at this point the firm begins to loose it competitive advantage and will be seeking to minimize cost by relocating production facilities to locations where labour is cheaper( Vernon, 1971) Accordingly, it is argued that FDI occurs at this stage because increasing standardization and price competition tended to eliminate the first mover advantage enjoyed by an innovative firm. In the interest of lowering production cost and protecting existing markets, firms would locate production facilities overseas (Vernon, 1971).

Because of the inability of any of these theories to systematically explain the behaviour of MNCs and their reasons for engaging in FDI the eclectic paradigm theory was put forward by Dunning (1988) and is credited as a comprehensive tool for analyzing the multi-nationalization of firms (McDermott, 1989). The eclectic framework identified three broad set of factors, i.e., transaction cost/ internalization advantages, ownership advantages and location advantages that would influence the decision of the firm to engage in multi-nationalization activities. The internalization advantages are linked to factors, such as transaction and co-ordination costs, which would induce a firm to engage in overseas production (Schaefer, 2002). Location advantages require that the foreign country must be more profitable to operate in because of the availability of raw materials, cheaper factor inputs or where transportation cost is prohibitive (Andersen, 1997). Ownership advantages would include firm specific assets, which could be tangible ones, e.g., a unique product, a patent or a product process, as well as, intangible ones such as a trade mark or a good reputation (Kumar, 1996)

**Literature Review: Empirical Determinants of FDI and the Issue of Size**

The enormous growth coupled with huge differentials in FDI inflows to developing countries, particularly in the post 1990s period (Chakrabarti, 2001), has spawned an extensive body of empirical studies seeking to explain "why some countries were more successful than others in attracting FDI" (Moosa & Cardak, 2003). A preponderance of these studies have tested and analyzed the effect of a variety of macro-economic determinants, such as GDP, exchange rate policy, openness of the economy, physical infrastructure, etc., while others have explored the impact of socio-political factors, such as, political stability (country risk), corruption, education, political freedom, etc, on FDI inflows , (Dar et al., 2004).

Many studies, including Root and Ahmed (1979), Singh and Jun (1995), Kaufmann et al., (1999 a,b), Kolstad and Villanger (2004), Dar et al (2004). and Cho (2004) were concerned with identifying and explaining the socio-political determinants, while others, Dunning (1973), Culem (1988), Tsai(1994), Sin and Leung (2001), Asiedu (1994), Moosa and Cardak (2003) and Wei (2000), gave attention to the macro-economic factors of FDI flows.

The vast majority of these studies, however, grouped together large and small states, thereby, treating them as a homogenous group. The literature has long recognized that the production opportunities available to small states ***(defined as one with a population of 5 million or less people)*** are relatively limited because of severe economic disadvantages which are associated with their smallness (Briguglio, 1995). These limitations not only exposed them to the adverse influences of exogenous shocks but quite often threatened their economic viability (Shareef, 2003). To reduce their vulnerability many of these countries are forced, more so than their larger counterparts, to engage in policies that would attract FDI in order to promote economic diversification and by extension augment their capacities to withstand exogenous shocks (Armstrong & Read, 2000).

A limited number of studies have sought to identify some of the explanatory variables that could explain the inflows of FDI into small states. Collier and Dollar (1999) examined, among other issues, the influence of policy measures, such as macro policy, rule of law, the CPIA (Country Policy and Institutional Assessment) index and risk assessment on FDI and found that risk

measure exhibited a strong relationship with FDI. In addition, the study argued that because of adverse risk ratings small countries are at a distinct disadvantage when seeking to attract foreign investment. It is suggested that this perceived riskiness have seriously impaired their abilities to pull in adequate levels of foreign investments.

As part of a larger study, covering 135 countries and including 13 Caribbean states for the panel period, Kolstad and Villanger (2004) investigated why Caribbean countries were able to generate more FDI inflows than other comparable states and found trade openness and inflation to be statistically significant.

Using a qualitative approach, Hunya (2004) explored some of the possible factors that would have influenced the inward flows of FDI into the three small Baltic states of Estonia, Latvia and Lithuania. Although small in absolute terms, he argued that the inflows, relative to the size of these economies, were considerable. Two factors, a favourable macro-economic environment and a sound privatization policy, were advanced as the primary reasons for the level of success achieved by these countries.

The literature on small economies has, so far, failed to reach a consensus as an appropriate definition of size. In an attempt to quantify country size several variables such as population, gross domestic product and land area have been used (Shareef, 2003). There is a growing recognition by some experts that an appropriate definition would have to include several quantifiable variables. Srinivasan (1996) argued that a definition of size should include factors such as population, per capita income and income distribution while Downes (1986) suggested combining population, gross national income and land area. In contrast Davenport (2001) advocated the use of trade flows to represent size. As he argued small countries account for a very small percentage of world trade and once a country falls below a predetermined threshold it should be automatically classified as a small state.

These ideas, however, are in their formative stages and, as a result, no composite measure is currently available. For this reason, much of the literature continues to rely on population as a measure of size. The issue of size and the use of population as a measurement of size were first

raised by Kuznets (1960) who suggested a cut off point of 10 million as a definition of a small country. Demas (1965), Kaminardes and Nissan (1993) and Wint (2003), on the other hand, described a small state as one with a population of less than 5 million. Using the World Bank, World Development Indicators (2002) listing of countries, this threshold would cover 160 (out of 207) states.

**Population and FDI Inflows of Targeted States**

The 29 countries covered by this study (see, Table I) have populations ranging from a low of 42(000) in St. Kitts and Nevis to a high of approximately 4.1 million in Costa Rica Of this group 14 have a population of less than 1 million and are usually described as micro states or micro economies. Another 8 have population ranging between 1 and 2 million while 5 have population varying between 2 and 3 million. Although the study used 5 million as the bench mark to define a small country none of the states in the sample was close to the defined limit. It should be quite obvious that when population is used, size becomes a relative concept and any threshold decided on to define smallness will be arbitrary.

**Table I Population by Country**

| Country | Population | Country | Population | Country | Population |
|---|---|---|---|---|---|
| St. Kitts and Nevis | 42000 | Qatar | 601000 | Lesotho | 1800000 |
| Antigua and Barbuda | 73000 | Djibouti | 693000 | Namibia | 1961000 |
| Dominica | 78000 | Bahrain | 709000 | Jamaica | 2627000 |
| Seychelles | 80000 | Guyana | 764000 | Oman | 2768000 |
| Grenada | 80000 | Swaziland | 1069000 | United Arab Emirates | 2937000 |
| St. Lucia | 148000 | Mauritius | 1210000 | Panama | 3064000 |
| Belize | 251000 | Trinidad and Tobago | 1298000 | Lebanon | 3596000 |
| Barbados | 269000 | Gabon | 1306000 | Eritrea | 3991000 |
| Bahamas | 310000 | Gambia | 1388000 | Costa Rica | 4094000 |
| Cape Verde | 454000 | Botswana | 1770000 | | |

Source: World Population Prospects (2002 revision)

According to UNCTAD (2005) world wide FDI flows, except for some short periods of intermittent declines, registered strong and persistent growth up to 2000 when it peaked at approximately $1.3 trillion. Global FDI flows, partly because of the anemic growth experienced by many economies and partly as a result of a sharp contraction of stocks markets around the world, recorded a dramatic reduction in 2001- 2002 as it plummeted to $787 and $651 billion, respectively. As in the past developed countries continued to be the main beneficiaries accounting for approximately 71% or $462 billion in FDI while developing countries managed to pull in only 25% or about $162 billion, in 2002.

In 2002, the subset of countries targeted by this study received only $6.3 billion in FDI. Six states, United Arab Emirates, Trinidad & Tobago, Qatar, Jamaica, Costa Rica and Botswana accounted for $ 4.3 billion or 68%, while the remaining 23 countries received $ 1.9 billion or 32%, of these inflows. Within the group of 29, thirteen were recipients of $50 million or less while, except in the case of Lebanon, the remaining nine states had inflows ranging from $55 to $181 million.

**Table II – FDI Inflows**

| **Country** | **FDI (millions of dollar)** | **Country** | **FDI (millions of dollar)** | **Country** | **FDI (millions of dollar)** |
|---|---|---|---|---|---|
| Djibouti | 4 | Guyana | 44 | Namibia | 181 |
| Cape Verde | 12 | Seychelles | 48 | Bahrain | 181 |
| Dominica | 12 | Belize | 50 | Lebanon | 217 |
| Barbados | 17 | St. Lucia | 55 | Botswana | 257 |
| Eritrea | 20 | Grenada | 61 | Jamaica | 405 |
| Oman | 26 | Antigua and Barbuda | 80 | Qatar | 624 |
| Lesotho | 27 | St. Kitts and Nevis | 81 | Costa Rica | 658 |
| Gabon | 30 | Swaziland | 90 | Trinidad and Tobago | 791 |
| Mauritius | 33 | Panama | 99 | United Arab Emirates | 1307 |
| Gambia | 43 | Bahamas | 153 | Total FDI | $ 6, 292 |

Source: UNCTAD (2002)

At a broader level, these countries received just below 0.009% of world wide flows and just about 3.9% of inflows into developing countries.

**Research Focus**

This section begins with the principal research question: what factors are likely to influence the inflow of FDI into the subset of small countries targeted by this study. To explore this research issue the study will rely on a set of hypotheses that would provide the framework for the statistical analysis. These hypotheses are outlined below:

***Market Size***

The market size theory has long established that the size of the host country market is an important determinant of FDI (Tsai, 1994). The theory argues that FDI is attracted to a large market in order to exploit economies of scale and to earn higher returns on investment (Wang and Swain, 1995). As a consequence, small states, like those targeted by this study, are severely disadvantaged because the smallness of their markets constitutes a major disincentive to FDI. The corollary of the size hypothesis is that larger countries with larger markets are able to attract more FDI because larger markets make it possible to exploit economies of scale and earn higher returns ( Hara & Razafimahefa, 2003).

*Hypothesis I: Market size and the inflow of FDI are positively correlated*.

***Tourism***

The economic literature has long recognized that the production opportunities available to small countries are relatively limited because of major economic disadvantage, e.g., limited natural resource endowment, high degree of openness, overt reliance on few export commodities, etc., which are intrinsic to their smallness (Commonwealth Secretariat/ World Bank, 2000). Because of these limitations, the production base of most small countries has remained relatively undiversified in their export activities. As a consequence, most small states were forced to pursue

policies that would promote economic diversification (Tisdell, 2003). Because of the perceived economic benefits and the possibility of stimulating economic growth tourism was seen as a diversification strategy. Today, tourism is not only one of the main engines of growth for most small nation states but, also, a major source of FDI inflows (Benavides, 2001).

*Hypothesis II: The inflow of FDI into a small nation state is, in part, directly related to the size of its tourism industry*

***Infrastructure***

Physical infrastructure is not only an important pillar of economic development but, also, impacts on the ability of businesses to operate successfully from a small economy (Wint, 2002). A well developed domestic infrastructure is expected to improve the production possibilities of the domestic industries, develop greater intersectoral linkages within the economy and provide a platform for the efficient distribution of goods and services. This aspect of national development is critical to the efforts of small states to attract foreign investment (Spar, 1998).

*Hypothesis III: The quality of infrastructural development is a significant factor in determining the inflow of FDI to a small nation state*

***Economic Growth***

The debate, relating to direction of causality between FDI and economic growth in developing countries, continues. At the center of this debate is whether FDI causes economic growth or economic growth is a catalyst for FDI. There is substantial support, in the literature for the FDI and economic growth causal relationship (Borensztein, De Gregorio and Lee, 1995; Nyatepe-Coo, 1998; De Mello, 1999, etc.) as well as, the economic growth and FDI causality (Billet, 1991; Horisaka, 1993; BajoRubio and Sosvilla-Rivero, 1994; Chowdhury and Mavrotas, 2003, etc.). The latter has its genesis in the market size thesis which argues that large economies with rapid economic growth provide MNC with opportunities to generate greater profits which, then, becomes an inducement to FDI inflow. Similarly, it could be suggested that small economies

with weak growth rates are unable to attract significant amounts of FDI. Or put differently, small states with strong growth economic growth would able to attract larger inflows of FDI.

*Hypothesis IV: The economic growth rates of small states are directly related to the inflows of FDI inflows*

***OPENNESS***

Several studies have established that open economies encourage the inflows of FDI. For example, studies by (Culem (1988), Edwards (19990) and Singh and Jun (1995) have show that a significant positive relationship exists between openness and FDI inflows. Easterly and Kraay (2000), also, argued that small economies do not have lower growth rates than their larger counterparts because of their openness. In the literature the openness of a country to trade is measured as the ratio of trade (exports + imports) to the country's GDP.

*Hypothesis V: Openness of a small economy would promote greater FDI inflows*

**Research Methodology and Data**

This paper used a linear cross sectional regression model to test for the statistical significance of the determinants of FDI, as outlined in the above hypotheses, for the subset of 29 small countries which are listed in Tables I and II. In particular, the study used several variations of the general semi log model which is spelt out below in order to arrive at a subset of robust variables which could, at least, partially explain the inflows of FDI into small nation states:

$$\text{Ln (FDI)} = b_0 + b_1 \text{(country size)} + b_2 \text{ (size of tourism industry)} + b_3 \text{ (infrastructure)} + b_4 \text{ (economic growth rates)} + b_5 \text{ (openness)} + \text{error}$$

The study attempted to include other variables such as the control of corruption, country risk, human development index, existing regulatory framework and political freedom. but had to be excluded them from the model because the relevant data/ index was not available for all

countries included in the sample. For this reason the model had to limit its focus to the five explanatory variables that are spelt out in the above regression equation.

Given the nature of the variables listed in the regression equation it is critical that suitable proxies be identified and used to estimate the regression model. Table III lists each of the five variables being considered, their proxies, expected signs and data sources.

**Table III: Variables for Cross Sectional Model**

| **Variable** | **Proxy** | **Expected Sign** | **Data Source** |
|---|---|---|---|
| Dependent Variable | FDI | | UNCTAD(2002) |
| Market Size | Population | Positive | World Population Prospects (2002) |
| Size of Tourism Industry | Tourist Arrivals | Positive | World Tourism Organization (2002) & Country Profiles |
| Infrastructure | Digital Access | Positive | International Tele-Communication Development Report -2003- |
| Economic Growth | Growth Rate | Positive | UN Statistical Division (2002) |
| Openness | Export + Import as Percentage of GDP | Positive | UN Statistical Division (2002) |

**Regression Findings**

The results of the semi log model which includes the independent variables, market size, infrastructure, growth rates, tourism and openness are presented in table IV. These explanatory variables explained some 59 percent of the variations in FDI inflows to the 29 countries under consideration with all variables having the hypothesized signs but only market size, infrastructure and economic growth being statistically significant at the 5% level while tourism and openness were significant at the 17% and 20%, respectively. The large F value suggested that at least one of these variables is linearly related to the FDI inflows while the DW statistic suggested that there was no evidence of autocorrelation.

**Table IV: Regression Results**

| Model 1 | | T | Sig. | Collinearity Statistics | |
|---|---|---|---|---|---|
| | Variable | | | Tolerance | VIF |
| | (Constant) | 1.052 | .304 | | |
| | Market Size | 2.620 | .015 | .646 | 1.549 |
| | Infrastructure | 2.313 | .030 | .531 | 1.883 |
| | Economic Growth | 2.463 | .022 | .811 | 1.234 |
| | Openness*** | 1.324 | .198 | .665 | 1.504 |
| | Tourism** | 1.434 | .165 | .548 | 1.825 |

Dependent Variable: Ln FDI

R square = 0.665; Adj. $R^2$ = 0.592; F = 9.128; n = 29; DW = 1.845; * Significant at the 5% level; ** significant at the 17% level and *** Significant at the 20% level; Standard error of the estimate is 0.913

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However, upon closer examination of the results the associated tolerance (0.531) and VIF (variance inflated factor) (1.883) levels (see, Table IV) for the infrastructure variable were found to be the lowest and highest, respectively, among all variables. This would suggest that multicollinearity existed and hence, the decision was taken to eliminate the infrastructure variable and rerun the regression equation with the remaining four independent variables. Table V lists the outcomes of this modified version of the model.

**Table V**

| Model II | | T | Sig. | Collinearity Statistics | |
|---|---|---|---|---|---|
| | | | | Tolerance | VIF |
| | (Constant) | 3.545 | .002 | | |
| | Market Size*** | 1.689 | .104 | .775 | 1.291 |
| | Economic Growth* | 2.739 | .011 | .843 | 1.186 |
| | Openness** | 2.020 | .055 | .744 | 1.345 |
| | Tourism* | 2.776 | .011 | .736 | 1.359 |

Dependent Variable: LNFDI

$R^2 = 0.77$; adj. $R^2 = 0.59$; F = 8.53; n = 29; DW = 1.89; * significant at 1%; ** significant at 5%; *** significant at 10%

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A cursory examination would reveal an overall improvement in the results when compared to the findings of the previous model. Firstly, the tolerance and VIF levels for all variables have improved. And, secondly, all variables have the predicted signs with economic growth and tourism being statistically significant at the 1% level while openness and market size were significant at the 5% and 10% level, respectively.

To test for the significance of infrastructure on FDI a separate regression analysis was conducted and the results are presented in table VI. Infrastructure not only has the specified sign but is, also, statistically significant at the 1% level. The large F statistics confirms the existence

**Table VI**

| Model III | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| | Constant | 2.057 | .773 | | 2.660 | .013 |
| | Infrastructure | .051 | .016 | .519 | 3.151 | .004 |

a Dependent Variable: LNFDI

$R^2 = 0.27$; adj. $R^2 = 0.24$; F = 9.28; DW = 2.1; * significant at 1%

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of linear relationship between FDI inflows and infrastructure. The DW statistics supported the hypothesis that there is no serial correlation.

**Comments**

The research focus of this study was to identify some of the determinants that could explain the differences in FDI inflows in a subset of small countries. The results obtained, firstly, conflicted with hypothesis I which argued that market size has a strong influence on the inflow of FDI into a particular country. The implication of this hypothesis is that small countries with small markets are unable to attract significant level of FDI. The size of the FDI recipient market is one of the most often used variables in the literature. Many studies including Wheeler and Moody (1992), Kreinin, Plummer and Abe (1997), Billington (1999) and others have advanced empirical evidence to support this thesis.

The problem is that the market size theory only holds for local market and less relevant to export market or extractive oriented FDI (Contractor and Raghunathan, 2004). Many small countries, such as Singapore, Ireland, Costa Rica, Jordan, Latvia, etc., have found ways to attract relatively large amounts of export oriented FDI. The success of these states has three common threads which assisted in overcoming the limitations of size. These include:

- The creation of a competitive policy framework
- The creation of domestic advantages that allow investors to compete successfully in international markets, and
- Actively promoting export oriented investment

(Foreign Investment Advisory Service, 2001)

For these countries though the most salient results of the analysis pointed to the overriding influences of tourism, infrastructure, economic growth and openness to foreign trade, spelt out in hypotheses II, III, IV and V, respectively, on the inflow of FDI.

Most small economies have long been characterized as open dependent structures in which agriculture was, initially, the most dominant form of export activity (Commonwealth Secretariat / World Bank, 2000). This export focus over the decades has failed to provide the stimulus needed to promote and achieve sustained economic growth and development (Armstrong et al, 1998). As those export industries continued to stagnate many of these countries and, in particular small island economies, partly because of their inherent competitive advantage and partly because of the potential economic benefits that the industry has to offer, began to view tourism as an instrument of growth and development (Benavides, 2001).

Today, the industry is not only a dominant source of export activity, but also plays an integral role in the economic well being of these countries (Brau et al, 2003). In many of these countries, however, the industry is characterized by a high level of foreign ownership and foreign capital. For example, in the Caribbean region 63% of hotel rooms are foreign owned (Barberia, 2004) and some 40% of FDI inflows have been channeled to the tourism sector (CARICOM, 2000) while in sub-Sahara Africa the tourism and travel sector accounted for an estimated US $7b in capital investment or approximately 11% of total investment in the region (Courage, 2003).

It is important to point out that although in absolute terms the FDI inflows into these economies may be described as small for many of them the amount of FDI received represented a sizeable portion of their GDP. For the period, 1997-2000, the net FDI to GDP ratios ranged from a high of 21.8% (Lesotho) to a low of 4.3% (The Bahamas) while the rates for St. Kitts & Nevis, Trinidad & Tobago, Panama and St. Lucia varied between 17.1 to 10.3% and those for Seychelles, Guyana, Dominica, Eritrea and Jamaica fluctuated between 9.3-5.3%.

A recently published UNCTAD-Corporate Location Survey (2004) revealed that tourism would continue to remain a very attractive sector for foreign investments and a key factor of economic development among small countries in different regions of the world. According to Saunders (2006) the industry is expected to attract some US $700 billion in new capital (domestic and foreign), annually, representing approximately 12% of the worldwide capital investment.

The implied inference of hypothesis III is that the provision of an adequate and reliable infrastructure is critical for small countries if they wish to attract FDI. Infrastructure has many dimensions and would include the availability of quality road network, telecommunication systems, air and sea transport and information technology (Sun, 2002). As argued by Asiedu (2002) excellent infrastructure improves the productivity of investments and, as a consequence, encourages FDI flows.

One of the most controversial issues in the FDI literature is the direction of causality between FDI and economic growth (Johnson, 2005). As indicated earlier two schools of thought have emerged, one arguing that FDI because of its spillover effects enhances economic growth while the other is suggesting a reverse causal relationship. Results from the vast body of empirical studies that was spawned around this issue, at best, could be described as ambiguous (see, Johnson, 2005 for an overview of several of these studies) as no coherent and unified positon has been established.

FDI is becoming critical to developing countries because it is the most reliable source of foreign investment and knowing the direction of causality is important in the formulation of an appropriate policy framework. Chowdhury and Mavoratas (2003) using the Toda and Yamamoto (1995) methodology sought to trace the direction of causality between FDI and economic growth for three developing countries, Chile, Malaysia and Thailand, which have been three leading beneficiaries of FDI, over the period, 1969-2000. In the case of Chile the results of the study did not support the Neo-classical proposition that FDI is critical for the promotion of economic growth. Put differently, the study showed that it was economic growth which promoted FDI and not the other way around. For the other two countries, Malaysia and Thailand, the conclusions were that the causality was bi-directional. As the authors argued, as a matter of policy greater attention should be placed by developing countries on economic growth as a critical determinant of FDI.

Because of their narrow production base small countries had to rely, also, on foreign trade to stimulate economic activities and growth (Jansen, 2004). As a consequence their average openness ratio is much higher – 111.5%- compared to other developing – 60.3%- and

industrialized countries – 60.3% (Kose and Prasad, 2002). Although the study provides evidence of a positive and significant relationship between a country's openness to international trade and FDI (Hypothesis V) , yet these nation states have attracted very little investment flows over the years. As Kobrin (2005) explained the statistical significance of the trade openness variable must be seen as "an indicator of policy makers' perceptions that linkages to the world economy have a positive effect on growth and development and that additional FDI would be beneficial (page 11)". Hence, FDI and trade, as suggested by Markusen (1977), must be seen as complements.

**Conclusion**

This paper has attempted to present empirical evidence in order to ascertain some of the factors that would influence the flow of FDI into small developing countries. The results of our analysis revealed that several of the traditional variables, i.e., infrastructure, economic growth and openness to trade, do promote the flow of FDI to small developing nation states. The paper, further, revealed that the size of a country's market is not a major constraint in attracting FDI because this limitation can be overcome by actively promoting the inflow of export or extractive oriented FDI, through the creation of a competitive policy framework and provide a domestic environment that will allow local firms to compete in international markets. The study, also, brings into focus the importance of tourism, among small countries, as an important source of FDI.

The results of this analysis, however, must be seen as an exploratory one. There is little doubt that the paper has not accounted for all the determinants that would impact on FDI flows Further research is required to fill this gap.

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