Foreign Direct Investment and Foreign Portfolio Investment in the contemporary globalized world: should they be still treated separately?

Marcin Humanicki[1], Robert Kelm[1,2], Krzysztof Olszewski[1]

April 2013

Preliminary draft – please do not quote

Abstract

Foreign direct investment (FDI) and foreign portfolio investment (FPI) have been long considered as distinct and independent forms of international capital flows, but in the globalized world there are reasons to treat them as interconnected phenomena. This paper analyzes the mutual relationship between FDI and FPI and attempts to answer the question whether they complement or substitute for each other from a foreign investor's point of view. Firstly, the paper describes the main characteristics of FDI and FPI in terms of a trade-off between their volatility and profitability. Secondly, it provides a literature review on the determinants of these two types of foreign investment. Finally, we analyse the long-run and short-run relationships between FDI and FPI running VECM regressions on data for Poland. Our research suggests that these two forms of foreign investment are rather substitutes. To be more specific, in stable periods of time FDI tends to dominate over FPI, but during insecurity and economic distress both in source and host countries, FPI starts to gain importance.

JEL codes: F21, F41, O1

Key words: capital flows, foreign direct investment, foreign portfolio investment, VECM

---

[1] Economic Institute, National Bank of Poland, Swietokrzyska Street 11/21, 00-919 Warsaw, Poland. *Corresponding author: Krzysztof.Olszewski@nbp.pl.*

[2] Łódź University

We would like to thank participants at the Warsaw Economic Seminar organized by the University of Warsaw and the Warsaw School of Economics for comments.

The paper presents the personal opinions of the authors and does not necessarily reflect the official position of the National Bank of Poland or the Łódź University.