INTERNATIONAL CAPITAL FLOWS
A MODIFIED GRAVITY EQUATION APPROACH

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ABSTRACT

The gravity model has historically been used in determining bilateral trade flows among a pair of countries. Using the concept in explaining bilateral capital flows, especially FDI, has been only recently adopted by various economists. This paper estimates the determinants of foreign direct investment flows using the gravity equation, controlling for the importance of both the traditional gravity variables (size, distance, common language) and other business environment variables such as openness to the rest of the world and ICT penetration. Simultaneously the purpose of this paper is to identify the important determinants of FDI inflows. A pooled regression as well as random effects estimation method has been used for the purpose. It has been found that apart from the traditional gravity variables other variables affecting business environment are also instrumental in determining capital flows, though these variables do differ in case of developing countries when compared to their developed counterparts.