# MEDIATING EFFECT OF FINANCIAL DEVELOPMENT ON RELATIONSHIP BETWEEN FOREIGN TRADE AND OUTWARD FOREIGN DIRECT INVESTMENT

**By**

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**Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfilment of the Requirements for the Degree of Doctor of Philosophy**

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**December 2023**

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This study analyzes the factors affecting outward foreign direct investment (OFDI) in 64 countries, comprising 53 developing and 11 developed nations, from 2010 to 2022. It underscores the importance of financial development in mediating the relationship between foreign trade and OFDI in developing countries. Trends in foreign trade are similar for both developing and developed countries, yet the patterns of OFDI differ. Compared to foreign trade, OFDI requires substantial capital and the capacity to manage overseas risks. Due to the lack of large capitalization in banking and financial systems, most firms in developing countries are unable to engage in extensive OFDI.

Considering the issue of endogeneity, this study analyzed all three research objectives using the System Generalized Method of Moments estimation method. The results indicated that foreign trade has a significant positive impact on OFDI. Moreover, when analyzing the 53 developing countries and the 11 developed countries separately, it was found that exports, imports, and openness have a positive effect on OFDI in both groups. This study delves into the influence of financial development on the generation of OFDI. The findings reveal that the scale, structure, and efficiency of financial development significantly positively affect OFDI. However, the impact varies between developed and developing countries. The third objective is to investigate whether financial development acts as a mediator in the relationship between foreign trade and OFDI using the Sobel test and Variance Accounted for (VAF). The findings demonstrate that only the structure of financial development mediates the relationship between foreign trade and OFDI. For developing countries, the scale and structure of financial development were found to mediate this relationship, while for developed countries, it was the efficiency of financial development that served as a mediator.

This study supports the theory by providing novel evidence on the growth of OFDI from developing countries. It encompasses multiple factors, such as exports, imports, and openness, and examines their contributions to OFDI. Furthermore, the study investigates the link between financial development and OFDI, and develops a dynamic panel model to analyze this relationship. Lastly, the study offers new insights into the mediating effects of financial development.

**Keywords:** Outward foreign direct investment; Foreign trade; Financial development; Mediating effect; GMM

**SDG:** Goal 8: Decent Work and Economy Growth

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**KESAN PENGANTARA PEMBANGUNAN KEWANGAN TERHADAP HUBUNGAN ANTARA PERDAGANGAN LUAR NEGERI DAN OFDI**

Oleh

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Kajian ini menganalisis faktor-faktor yang mempengaruhi pelaburan langsung asing keluar (OFDI) di 64 negara, yang terdiri daripada 53 negara membangun dan 11 negara maju, dari tahun 2010 hingga 2022. Ia menekankan kepentingan pembangunan kewangan dalam memediasi hubungan antara perdagangan asing dan OFDI di negara-negara membangun. Trend dalam perdagangan asing adalah serupa untuk kedua-dua negara membangun dan maju, namun corak OFDI berbeza. Berbanding dengan perdagangan asing, OFDI memerlukan modal yang besar dan keupayaan untuk mengurus risiko luar negara. Disebabkan kekurangan modalisasi besar dalam sistem perbankan dan kewangan, kebanyakan firma di negara-negara membangun tidak mampu untuk terlibat dalam OFDI yang meluas.

Mengambil kira isu endogeniti, kajian ini menganalisis ketiga-tiga objektif penyelidikan menggunakan kaedah anggaran Sistem Kaedah Momen Teritlak Umum. Hasilnya menunjukkan bahawa perdagangan asing mempunyai impak positif yang signifikan terhadap OFDI. Selain itu, apabila menganalisis 53 negara membangun dan 11 negara maju secara berasingan, didapati bahawa eksport, import, dan keterbukaan mempunyai kesan positif terhadap OFDI dalam kedua-dua kumpulan. Kajian ini mendalami pengaruh pembangunan kewangan terhadap generasi OFDI. Penemuan menunjukkan bahawa skala, struktur, dan kecekapan pembangunan kewangan mempengaruhi OFDI secara positif yang signifikan. Walau bagaimanapun, impaknya berbeza antara negara maju dan membangun. Objektif ketiga adalah untuk menyiasat sama ada pembangunan kewangan bertindak sebagai mediator dalam hubungan antara perdagangan asing dan OFDI menggunakan ujian Sobel dan Variance Accounted For (VAF). Penemuan menunjukkan bahawa hanya struktur pembangunan kewangan yang memediasi hubungan antara perdagangan asing dan OFDI. Bagi negara membangun, skala dan struktur pembangunan kewangan didapati memediasi hubungan ini, manakala bagi negara maju, kecekapan pembangunan kewangan yang bertindak sebagai mediator.

Kajian ini menyokong teori dengan menyediakan bukti baru mengenai pertumbuhan OFDI dari negara-negara membangun. Ia merangkumi pelbagai faktor, seperti eksport, import, dan keterbukaan, dan mengkaji sumbangan mereka terhadap OFDI. Selanjutnya, kajian ini menyelidiki hubungan antara pembangunan kewangan dan OFDI, dan mengembangkan model panel dinamik untuk menganalisis hubungan ini. Akhirnya, kajian ini menawarkan pandangan baru mengenai kesan mediasi pembangunan kewangan.

**Kata kunci**: pelaburan langsung asing keluar; perdagangan luar negeri; prmbangunan kewangan;kesan pengantara; GMM

**SDG:** Matlamat 8: Kerja Layak dan Pertumbuhan Ekonomi

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This thesis was submitted to the Senate of the Universiti Putra Malaysia and has been accepted as fulfilment of the requirement for the degree of Doctor of Philosophy. The members of the Supervisory Committee were as follows:

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Date: 13 June 2024

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| | |
|---|---|
| OFDI | Outward Foreign Direct Investment |
| BLUE | Breush and Pagan Langragian Multiplier |
| GDP | Gross Domestic Product |
| GMM | Generalized Moment Method |
| IMF | International Monetary Fund |
| OLS | Ordinary Least Square |
| US | United State |
| USD | United State Dollar |
| VIF | Variance inflation factor |
| VAF | Variance Accounted For |
| UNCTAD | United Nations Conference on Trade and Development |

# CHAPTER 1

# INTRODUCTION

## 1.1 Introduction

Chapter 1 primarily addresses the introduction, research background, problem statement, research questions, research objectives, research implications, and conclusion. This chapter details the relationship between foreign trade, OFDI and financial development, as well as the problems that exist in developing countries. It also offers a new perspective on the relationship between foreign trade, OFDI and financial development.

## 1.2 Background of the Study

Foreign trade principally involves economic and trade transactions between a country or region and other countries or regions. It encompasses the exchange of goods, technology, labor, and production materials such as equipment (Song, 2019; Kordos, 2019; Andrei et al., 2020), typically including both imports and exports (Li, 2020). According to traditional international trade theory studies, foreign trade allows countries to optimize the global allocation of scarce economic resources more efficiently, thereby promoting improvements in social output. Concurrently, it can enhance social welfare and utility by diversifying product supply and consumption choices (Xu, 2017; Kahouli & Chaaben, 2022; Cohen, 2019). The integration of competitive market incentives and information through foreign trade expedites the regional development of knowledge, technology, and human capital, subsequently fostering economic growth. Notably, foreign trade serves as an engine of economic growth in developed countries, operating somewhat more effectively than in developing countries (Das et al., 2023), and stands as a critical method for developing countries to achieve industrial upgrading, technological progress, and economic growth (Sun, 2020; Acharya, 2019). The international definition of foreign trade is fairly straightforward, adhering to the conventional definition which considers it the exchange of goods, labor, and technology via exports and imports. Various international organizations, such as the World Trade Organization, exist to monitor the trading activities between countries of differing economic statuses.

Figure 1.1 illustrates a comparison between the foreign trade and OFDI of developing and developed countries. The unexpected outbreak of COVID-19 in 2020 instigated a global public health crisis, leading many countries to implement isolation and lockdown policies that impeded industrial development and economic growth (Duan et al., 2020). The pandemic has significantly disrupted global production, trade, and OFDI (Kong et al., 2021; Zhang et al., 2020; Wong et al., 2022).

Referring to Figure 1.1, sourced from WTO data, developing countries have experienced a steady rise in both exports and imports over the past decade, with the disparity between developed and developing countries gradually diminishing. Nevertheless, developed countries maintain an edge due to their advanced economic development and greater production capabilities. Despite challenges in competing in foreign trade, some developing countries are proficient in goods production. Import trends for both developed and developing countries align with the global economy, increasing during periods of economic expansion and decreasing in downturns. Export trends are similarly consistent for both developed and developing countries, apart from an anomaly in 2018-2019. During this period, developed countries witnessed a reduction of 248 billion USD in exports, while developing countries observed a surge of 749 billion USD. This shift may be ascribed to several developed countries relocating their original export-oriented industries to low-wage, cost-effective developing countries through OFDI. For example, corporations such as Samsung and Foxconn have set up manufacturing facilities in countries like India and Vietnam, resulting in reduced exports from developed nations.

As indicated by Figure 1.1, the exports and imports of developed countries surpass those of developing countries, and the trends coincide. Consequently, the OFDI from developed countries also exceeds that of developing countries, suggesting that countries with more substantial foreign trade activity typically engage in more considerable OFDI. There is a discernible positive correlation between foreign trade and OFDI. According to the same figure, OFDI from developing countries diminished in 2019, largely attributable to a decline in China's merger and acquisition activities overseas, prompted by the ongoing restrictions on OFDI and geopolitical tensions.

(USD billion)

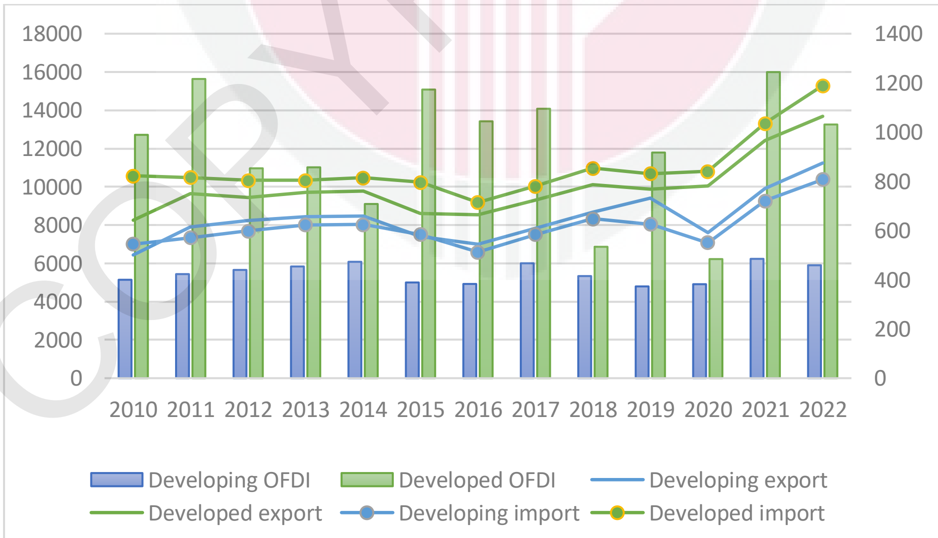


**Figure 1.1 : Comparison of Foreign Trade and OFDI between Developing and Developed Countries**
(Source : WTO Foresight Industry Research Institute)

The full name of OFDI is “outward foreign direct investment,” which refers to the outflow of international direct investment from a country, i.e., investment made by investors to directly organize and operate enterprises in foreign countries (Chen, 2023; Yang, 2021; Christofi et al., 2022). Investors allocate capital for OFDI to establish subsidiaries abroad, facilitating production operations and expanding profits (Xu, 2020; Fahad et al., 2022). OFDI is an essential strategy for a country to globalize, utilize both domestic and international resources and markets, circumvent foreign trade barriers, absorb advanced foreign technology and management expertise, and take proactive steps to grasp external information promptly (Cui, 2017; Li & Che, 2021; Guo et al., 2020). In the context of OFDI, the home country refers to the country where the company was originally incorporated and where the main operations of the company are located, while the host country is the country where the multinational corporation (MNC) is expanding its business. There are two main methods of OFDI: greenfield investment, where the parent company establishes new offices or branches to control the subsidiary, and cross-border acquisitions or mergers. This study posits that OFDI is a productive or service-oriented direct investment activity undertaken by firms within a country in countries and regions outside their own.

With globalization, economic trade between countries is becoming increasingly frequent, and in the trading process, countries export and import different products. Figures 1.2 and 1.3 showcase the most exported and imported products in the world in 2022. A minority of the world’s countries are developed, while the majority are developing. Western Europe has the highest concentration of developed countries, which include the United States and Canada in North America, Japan in Asia, Australia and New Zealand in Oceania, while most countries in Asia, South America, and Africa are developing countries. The main exports of developed and developing countries also differ significantly.

According to Figure 1.2, the principal exports of developed countries, such as those in Western Europe and Japan, include cars, aircraft, and medical products. Examples include cars made by Mercedes-Benz and BMW, and aircraft manufactured by Airbus, which are expensive high-tech products with a higher value. In contrast, the primary exports of developing countries, such as those in Africa, Asia, and South America, are mainly oil, ores, food, and clothing, which require less technology and have a lower value. Developing countries often produce primary products and face challenges in accessing knowledge and technology through foreign trade.

Figure 1.3 indicates that developed countries like Japan and Europe export high-tech products and import a considerable amount of primary products, such as oil and ores, most of which originate from developing countries. Developing countries not only export oil but also import cars, aircraft, medical, and electronic products, primarily from developed countries.

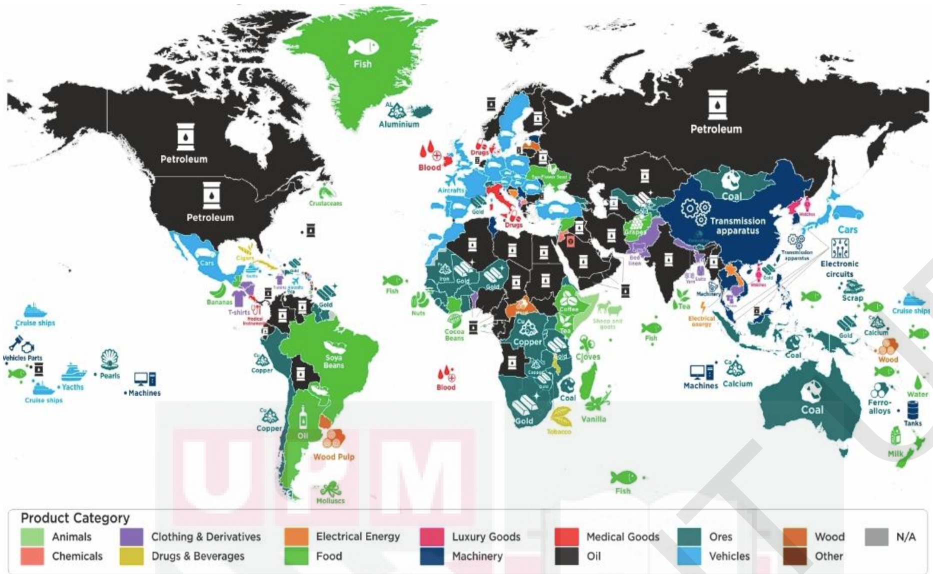


**Figure 1.2 : Each Country's Top Export in the World**
(Source: UN Comtrade Database; Centre for prospective studies and International Information)

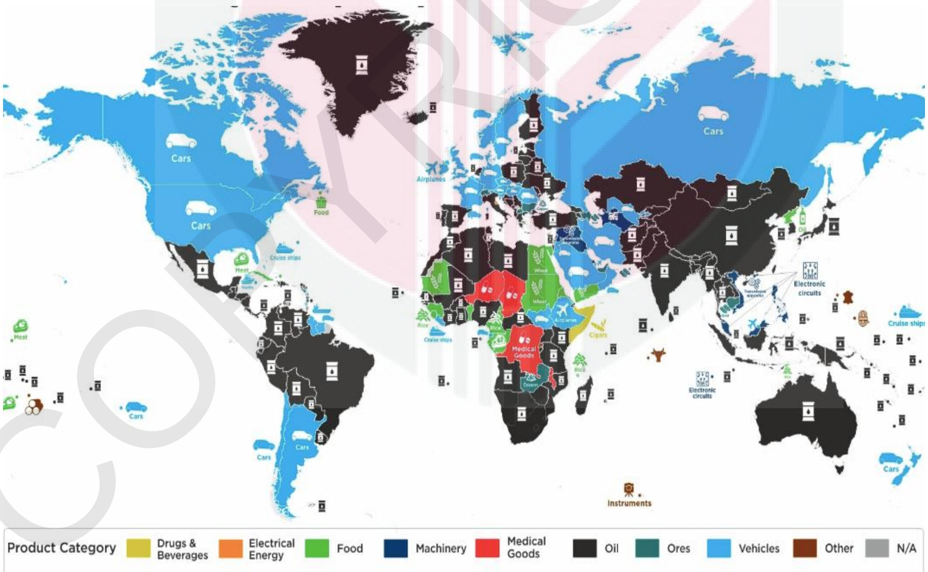


**Figure 1.3 : Each Country's Top Import in the World**
(Source: UN Comtrade Database; Centre for prospective studies and International Information)

Foreign trade creates many economic benefits for developing countries, but in today's world, developed countries still dominate. Developing countries have been exporting primary products and are unable to obtain the advanced technology of developed countries, making it difficult for them to occupy a dominant position in import and export trade (Wang, 2018). Therefore, the emergence of OFDI has provided a new opportunity for developing countries to turn the situation around.

For developing countries, OFDI enables these nations to access new markets, resources, technology transfer, knowledge, and skills, all of which can have positive effects that contribute to their economic growth (Pravakar & Ashwani, 2021). OFDI from developing countries is a phenomenon that has recently received increasing attention. Firms from these countries are making large-scale OFDI in today's business world (Han et al., 2018; Buckley & Tian, 2017). For example, following the successful acquisition of Volvo in August 2010, China's Geely established a European R&D center in Gothenburg, Sweden. In February 2018, Geely acquired a 9.69% stake in Germany's Daimler for $9 billion. If China relied solely on foreign trade, exporting primary products and importing transportation equipment such as cars, it would be impossible to acquire advanced knowledge and technology. However, through OFDI and greenfield investment, China can establish factories in host countries. Alternatively, through mergers and acquisitions, China can gain access to advanced skills and talented staff.

(USD billion)

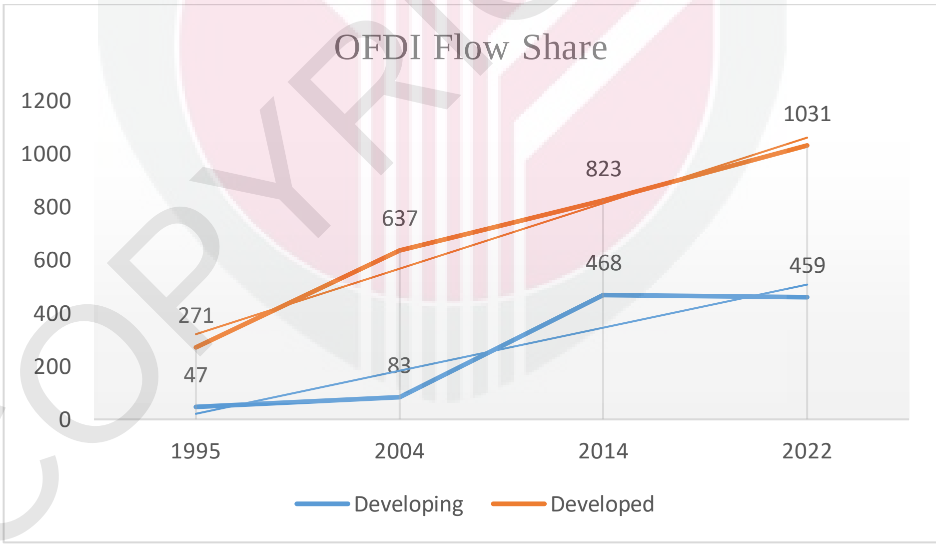


**Figure 1.4 : Comparison of OFDI in Developed Countries and Developing Countries from 1995 to 2022**
(Source: UNCTAD)

Based on Figure 1.4, there has been a steady increase in OFDI from both developed and developing countries from 1995 to 2022. While OFDI from developed countries has increased by 2.8 times from 1995 to 2022, OFDI from developing countries has surged by a significant 8.8 times during the same period. This suggests that cross-border investment activities by firms from developing countries across various industries have grown rapidly over the past two decades (Guo & Clougherty, 2020; Nayyar & Mukherjee, 2020). This phenomenon requires further empirical study. Hence, this study primarily focuses on developing countries as the main research subject, while developed countries are also included in the total sample to explore any differences in results.

Intuitively, OFDI may lead to a reduction in the capital stock of the home country, which in turn inhibits economic development. However, through such investment, transnational corporations are able to enhance their human resources and technological capabilities, especially in terms of upgrading knowledge, management and technology, thereby broadening the global perspective of productivity. At the same time, home-country firms can use OFDI to promote the upgrading of their industries, which can help secure a stable supply of resources and markets, improve the local environment, and further attract foreign investment. Through such indirect effects, OFDI is considered to be favorable to the growth of the home country's economy (Bhasin & Paul, 2016).

Increased home country OFDI activity may have a catalytic effect on domestic investment. Often, foreign affiliates utilize the resources of the home country to produce in the host country (He, 2019). This is because multinational companies combine domestic and foreign production to reduce costs, a strategy that boosts the profitability of domestic production and thus incentivizes more domestic investment. In addition, the internationalization of firms, especially in high-tech and low-tech sectors, helps to boost domestic R&D activities. An empirical study based on panel data of manufacturing firms in Taiwan, China, shows that OFDI significantly enhances firms' domestic R&D expenditures (Peng et al., 2023).

OFDI can expand domestic output by increasing access to global production networks, markets, technology transfer, and skills acquisition (Ameer et al., 2017; Kazemi et al., 2018). Moreover, inward and outward linkages can enhance a country's investment competitiveness, leading to a higher growth trajectory (Ameer et al., 2017; Kazemi et al., 2018; Badar et al., 2018).

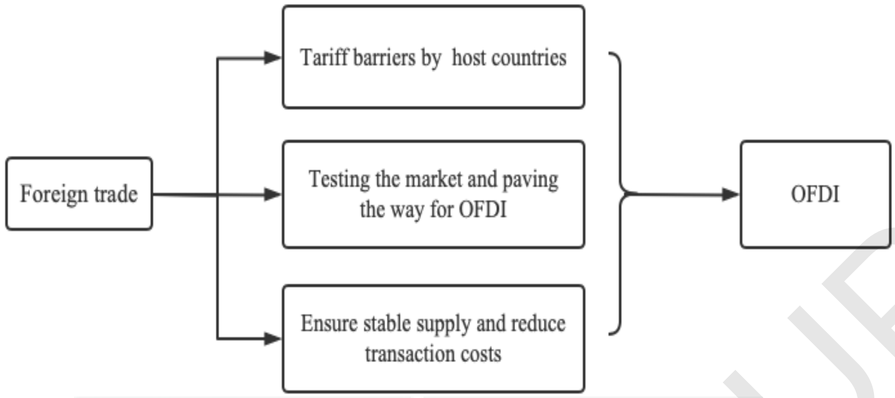


**Figure 1.5 : The Impact of Foreign Trade on OFDI**

With the deepening process of globalization, the negative impacts of foreign trade have become apparent, driving many countries to turn to OFDI. In the global market, a country's export activities are often hindered by a variety of trade and non-trade factors such as anti-dumping, technical and green barriers (Van, 2023). For example, in the trade conflict between the United States and China, the United States has taken several measures to restrict exports to China. However, these restrictions can be effectively circumvented through OFDI. OFDI allows goods to be sold freely without import and export controls, can enjoy national treatment, reduces the cost of international trade, and avoids trade barriers. In addition, the country's over-reliance on foreign trade may lead to extremely high foreign trade dependence (Foo et al., 2020). High foreign trade dependence means dependence on imports for important goods and services, which may threaten national economic security (Rokicki et al.,2023). For example, the Russia-Ukraine conflict led to the disruption of natural gas supply from Russia to Europe, which made Europe heavily dependent on imports. This situation has seriously affected the livelihood and heating of the European population, while research and development of technological products have been hampered by the lack of gas. In order to maintain the basic life, Europe needs to buy foreign natural gas at a high price, which brings economic losses.

The success of a country's foreign trade can promote the growth of OFDI. Initially, according to the history of international trade and OFDI, the development of international trade precedes OFDI. Compared to OFDI, foreign trade is less risky and more controllable in scale since it involves less capital, while OFDI requires more knowledge, capital, experience, and skills. Foreign trade establishes an information channel between home and host countries, providing market information support and a smoother platform for OFDI development, particularly in the initial stages, thus enhancing and facilitating the establishment of OFDI.

As the economy develops, if a country imports more strategic resources, such as mineral resources and advanced technologies, it may lead to resource-seeking OFDI to secure a long-term and stable supply of these resources (Yu et al., 2020; Liu, 2019; Eissa & Elgammal, 2020; Aizenman et al., 2018; Aybar, 2016). For example, in 2019, Tesla announced that it was building a factory in Germany. Tesla's production requires large amounts of copper and nickel, as well as advanced technology for its vehicles. Relying solely on imports would not guarantee a stable resource supply. Thus, the optimal strategy is to use OFDI to build factories in resource-rich regions.

OFDI is characterized by significant upfront investment amounts and extended capital return periods, meaning that a country needs to address financing constraints and investment risks associated with potential losses when engaging in OFDI, which reflects the role of financial development. Financial development involves expanding the scale of financial transactions and enhancing the financial industry, leading to a continuous improvement in financial efficiency. This is evident in the elimination of financial repression and the improvement of the financial structure, i.e., the innovation of financial instruments and the diversification of financial institutions to adapt to economic development (Huang & Huang, 2023; Behera et al., 2020; Wu, 2017; Yang, 2021). The advancement of the financial system is as significant as the growth of the real economy, and financial development is a driver of real economic development (Batool et al., 2022), particularly for developing countries. These countries have significant potential for further development of the real economy to achieve mature financial development, which, in this study, is defined as the increase in financial efficiency and the optimization of financial structure.

Financial development can affect OFDI in several ways. Undertaking OFDI requires rebuilding production plants and installing equipment in the host country, which entails higher fixed and sunk costs (Jiang & Zhang, 2016). The differing institutional environments across countries, cultural differences, and exchange rate fluctuations can increase costs. Financial development can aid multinational enterprises in resolving capital shortages through a financing effect, effectively easing the financing constraints of OFDI and reducing financing costs.

Financial development can enhance investment efficiency and reduce the risk of OFDI. It has intensified competition among financial institutions, enabling them to improve their information-gathering and processing capabilities. This competition makes it easier for financial institutions to evaluate enterprises and investment projects more accurately and invest credit funds in high-quality enterprises and projects with higher returns, thus improving the efficiency of OFDI investment (Liu & Manzoor, 2020). It has been found that financial development can mitigate the "moral hazard" and "adverse selection" in enterprises, thereby reducing information asymmetry caused by incomplete capital markets and decreasing the financing cost and risk of OFDI (Yang, 2021). The development of financial markets can foster greater transparency and disclosure requirements, helping to reduce information asymmetries. Companies are required to provide more comprehensive, accurate, and timely information, allowing investors to better understand their business conditions and risks. Financial developments can offer more efficient and intelligent financial services and risk management tools. These tools can assist companies in better managing risks and reducing the potential for adverse selection and moral hazard.

Improving financial development is beneficial for the diversification and transfer of OFDI risks. Firstly, financial-related departments in the country have introduced a series of policies favorable to the development of OFDI while focusing on the implementation of a loss reserve system for OFDI to provide more comprehensive protection; secondly, multinational enterprises can transfer part of their OFDI projects to financial institutions. Financial development enables financial institutions to exhibit high efficiency, transparency, and professionalism, so transferring OFDI projects to financial institutions is conducive to information collection and project evaluation, and can also transfer part of the investment risk to these institutions (Zhu et al., 2022; Guo & Wang, 2023). Moreover, the use of abundant financial products can effectively aid enterprises in preventing and transferring OFDI risks and in promoting OFDI.

Financial development has led to high efficiency, transparency, and professionalism, and funds have been allocated rationally, providing more financing opportunities for domestic investment. It is the driving force behind urbanization, promoting the optimization of urban industrial structures. In turn, it enhances the population distribution within cities, drives urban development, and improves the level of urbanization. Financial development creates more employment opportunities in cities, increasing productivity, which, in turn, promotes the level of economic development. It also leads to labor market saturation, prompting multinational companies to choose OFDI as a means to explore new markets and gain more profits. Therefore, this study selects the level of economic development, the urbanization rate, and labor abundance as control variables.

The relationship between financial development and foreign trade has become increasingly intertwined due to the continuous advancement of economic globalization and the optimization of trade structures. In 1966, Patrick proposed the concept of “demand following” in his study of the relationship between financial development and economic growth. This concept suggests that financial development is driven by economic development, which places greater demands on the financial system. This study builds upon Patrick’s research to examine the impact of trade on financial development. Foreign trade generates additional financial demand within the domestic financial sector. The research and development of products, as well as the construction of related facilities in the foreign trade industry, incur significant costs. To meet these demands and reap benefits, banks and other financial institutions are incentivized to expand their scale and promote the innovation of business models and financial products, thus fostering the rapid development of the financial industry. The expansion of a country’s financial scale can provide OFDI with the necessary investment capital and alleviate financial constraints. As the financial development grows, financial institutions become more competitive. In the midst of intense competition, the capabilities of financial institutions to identify and assess project risks and strengthen risk supervision are enhanced, reducing the risks associated with information asymmetry and thereby improving the investment efficiency of OFDI.

Foreign trade will increasingly rely on the financial sector, which will encourage the implementation of various domestic financial support policies. This will drive institutional reforms and innovations within the financial system, rendering it more comprehensive and better equipped to compete in the global market. By promoting the flow of capital in the international market, foreign trade will expand the degree of financial market openness. The implementation of financial openness can help bring domestic interest rates closer to market equilibrium levels, thereby improving the efficiency of resource allocation and promoting OFDI.

Foreign trade significantly impacts the development of financial institutions. It encourages innovation in financial products and optimizes the structure of financial development. This comprehensive financial development provides stable funding and multiple financing methods for OFDI, thereby reducing the risk of OFDI and enhancing investment efficiency. The study posits that foreign trade influences financial development, which, in turn, affects OFDI through financial development. Therefore, financial development may be a critical factor in OFDI, rather than foreign trade itself. This mediating role played by financial development is also the focal point of this study.

## 1.3 Statement of the Problem

Foreign trade and OFDI are the two main conduits through which countries engage in international business. From 2010 to 2022, foreign trade from both developing and developed countries has consistently grown. However, OFDI from these countries has exhibited divergent trends (as mentioned in the background of the study). Notably, OFDI from developing countries started to grow slowly in 2010 and then declined in 2019.

Developing countries, endowed with abundant resources and a large labor force, tend to focus their foreign trade on producing primary products required by developed countries, such as ores, oil, and textiles. This focus has led to the rapid expansion of developing countries' foreign trade. However, an overemphasis on primary products can also render their economies susceptible to the volatility of commodity prices, potentially impeding the development of more diversified economic sectors. Conversely, engaging in OFDI through greenfield and brownfield investments necessitates significant capital and the capacity to manage risks abroad. Developing countries may lack the robust financial systems required for substantial OFDI. Additionally, their limited access to advanced technology and knowledge can constrain their development. Both foreign trade and OFDI are instrumental to a country's economic growth, and neglecting the interplay between them can undermine their collective progress, potentially damaging the country's economy.

As mentioned above, OFDI requires a significant amount of stable capital and entails high fixed and sunk costs. A robust financial system is a necessary guarantee for conducting OFDI. Therefore, compared with countries with a high level of financial development, countries with a lower level will encounter more obstacles when trying to increase OFDI, particularly regarding the efficiency, professionalism, and transparency of financial environment preparation. A well-developed financial sector can provide the necessary capital, reduce investment risks, and support economic growth through more efficient international investment.

Foreign trade allows capital to flow into international markets, further promoting financial openness and affecting the scale, structure, and efficiency of financial development. The optimization of financial structure and the improvement of efficiency, in turn, provide stable financial support for OFDI and reduce investment risks. Thus, foreign trade affects financial development, and financial development affects OFDI. However, there is a significant gap between the financial development levels of developing and developed countries. This disparity impacts how foreign trade and OFDI operate and benefit these countries, potentially widening the economic gap between them. Consequently, different levels of financial development may influence foreign trade and OFDI differently.

## 1.4 Research Questions

1. What is the impact of foreign trade on OFDI in developing and developed countries?
2. What is the impact of financial development on OFDI in developing and developed countries?
3. What is the mediating effect of financial development on the relationship between foreign trade and OFDI in developing and developed countries?

## 1.5 Research Objectives

1. To identify the impact of foreign trade on OFDI in developing and developed countries.

   With the global integration of the economy, countries should integrate foreign trade and OFDI into their future cross-border operations to promote the joint growth of both and to maximize the role of OFDI, thereby creating a scenario where the overall function exceeds the sum of the individual functions.

2. To identify the impact of financial development on OFDI in developing and developed countries.

   In the context of globalization, both financial markets and OFDI are undergoing rapid development, and the development of OFDI is influenced by financial markets. However, there is no consensus on whether financial development plays a positive or negative role. This study aims to determine the optimal level of financial development and the extent to which further development may inhibit OFDI.

3. To identify the mediating effect of financial development between foreign trade and OFDI in developing and developed countries.

   This study seeks to provide new insights by empirically investigating whether financial development has a mediating effect in addition to its potential moderating role.

## 1.6 Significance of the Study

Driven by globalization, OFDI has become another key driver, in addition to international trade, for the economic development of countries. More and more business operators have begun to regard outward expansion as part of their corporate development strategy. According to the existing literature and theoretical analysis, the traditional economic theory explanations of OFDI are mainly based on the cases of developed countries in Europe and America. These explanations have a certain degree of relevance.Imbruno et al. (2022) and Bajgar and Javorcik (2020) analyze OFDI behavior from the micro perspective of multinational corporations and the macro perspective of host countries, respectively. Despite the lack of monopoly and unique comparative advantage, recent studies tend to ignore the key role of developing countries in the rapid growth of global OFDI.

The purpose of this study is to complement gaps in the existing literature and to expand the knowledge framework on OFDI, with particular emphasis on the need for a more in-depth exploration of investment activities in developing countries, given the continued growth in the volume of their investments. The results of the analysis provide insights and important information on the continued expansion of developing countries in the area of OFDI.

In recent times, the swift advancement of OFDI has underscored the necessity for its stable and sustainable growth. Foreign trade and OFDI serve as crucial mechanisms through which multinational corporations from various countries extend their operations. Research conducted by Liu (2016), Qiu (2021), and Chawla (2022) has examined the effects of foreign trade on OFDI, predominantly focusing on the export dimension while often overlooking other facets of trade. The presence of trade barriers can impede export activities, highlighting the importance of imports in the trade equation. Consequently, this study undertakes a holistic analysis by considering various elements such as exports, imports, and trade openness, to provide a comprehensive understanding of the topic.

Financial development impacts the business of multinational companies. In the context of economic globalization, it is vital for countries to improve the maturity of their financial development to integrate into globalization and carry out OFDI effectively. Multinational companies can choose the appropriate financing method according to their needs and the specific project situation. Although current academic research on the relationship between financial development and OFDI has yielded some enlightening results, there is still disagreement on whether financial development promotes or inhibits OFDI. Furthermore, the empirical methodology for measuring financial development indicators requires refinement, often overlooking the dynamic development between variables. Based on the characteristics of financial development in developing countries, this study selects variables applicable to each of the three dimensions of financial development—financial scale, financial structure, and financial efficiency—to estimate the impact of financial development on OFDI more accurately and fill the gaps in existing research.

The literature reviewed shows limited empirical studies on the interplay between foreign trade, OFDI, and financial development. Xu and Wan (2021) measured the level of foreign trade in four aspects: scale, structure, competitiveness, and sustainability. They also used a stepwise regression method to verify the mediating effect of technological progress between foreign trade and OFDI. However, the role of financial development as a mediator in this relationship has yet to be examined. This study aims to fill these gaps in scope, variable selection, and analytical methods.

## 1.7 Structure of the Thesis

The study comprises five chapters. The first chapter is the introduction; the second chapter reviews theoretical and literature backgrounds; the third chapter describes the data and research methodology; the fourth chapter presents the results and discussion; and the fifth chapter outlines the contributions.

## 1.8 Summary

OFDI, as an essential component of economic globalization, has long attracted widespread attention in academia, policy circles, and industry. OFDI can provide developing countries with access to technology, knowledge, and resources.

Foreign trade and OFDI in developing countries have shown different trends compared to the situation in developed countries. These two aspects have become important economic variables in a country's open economy and significantly affect a country's economy. Studying the relationship between foreign trade and OFDI is crucial for further driving a country's economic growth. Financial development is an important factor influencing OFDI, offering new insights into whether it acts as a mediating factor between foreign trade and OFDI.

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