

DOES POLITICAL RISK AFFECT THE FLOW OF FOREIGN DIRECT INVESTMENT INTO THE MIDDLE EAST NORTH AFRICAN REGION?

Ritab Al-Khouri and M. Umaima Abdul Khalik

ABSTRACT

Given the political risk in the Middle East North African (MENA) region, this research aimed to unveil the importance of the different components of political risk on the change in foreign direct investment (FDI), controlling for other types of risks and macroeconomic factors. Furthermore, we look at whether there are differences in the factors that affect FDI between rich and poor countries in the region. Fixed effect and random effect dynamic models are applied on a sample of 16 MENA countries over the period 1984 - 2011. Taking all countries together, we find, as hypothesized, that agglomeration, market size, and political risk are significant and positively related to FDI. Additionally, among the 12 political risk components, the level of corruption and the level of external conflict have close association with FDI flows. FDI motives, however, vary greatly between rich countries and the non-rich countries in the MENA region.

Key words: Foreign Direct Investment, fixed and random effect models, political risk, MENA

INTRODUCTION

Trade and investment has become an important path to foreign markets. As business becomes more global, and the level of competition between firms increases, managers in multinational firms face strategic decisions which are more complex in nature than those decisions taken by national firms. Managers in multinational firms find it compelling to study the different political risks indicators that could face them in the countries they decide to make business in. Lately, managers in multinational firms encountered a change in the political environment, and hence, a change in the conditions for doing business in the MENA region. Foreign investors in the MENA region face many kinds of political risks due partly to the lack of stability in the political risk indicators as, among others, corruption, military in politics, and ethnic tension.

Butler & Joaquin (1998) defined political risk as the risk that host countries' governments might unexpectedly alter the institutional environment within which enterprises operate. Many researchers suggest that political risk has a negative effect on the MNE's decisions to invest in a foreign country. The reason behind that lies on the negative effect that political risk and institutional instability have on the firm cost of making business in a foreign country. A MNE can hedge against political risk in different ways through insurances and through prior negotiations with governments. Although MNE can reduce their political risk still we believe that this risk might hinder the flow of FDI to the country.

Ritab Al-Khouri has been a professor of Finance in the Faculty of Economics and Administrative Sciences at Qatar University since 2006. Ritab graduated in 1989 from the University of Wisconsin at Madison and worked at Yarmouk University in Jordan until 2006. Her research interests are in the areas of capital markets, financial institutions, corporate finance and corporate governance.

M. Umaima Abdul Khalik recently graduated from Qatar University.

POLITICAL RISK AFFECT OF FDI IN MIDDLE EAST & NORTH AFRICAN?

Literature on FDI determinants in the last two decades have shown that in addition to stable macroeconomic policies, political stability, and institutional quality are crucial in attracting FDI. However, previous empirical research did not reach to a consensus about the effect of political risk on FDI flow (Grosse & Trevino, 1996; Kobrin, 1979; Tallman, 1988). Evidence shows that political instability and the level of corruption significantly affects FDI flows in the MENA region (see, Kamaly (2002), Eid and Paua (2002), Rivlin (2001), and Richards and Waterbury (1996) Batra, et al (2000), Onyeiwu (2004)). While Wheeler and Mody (1992), find political risk to be insignificant in determining the production location decision of U.S. firms. In addition, Steiner (2010) investigated the relationship between FDI flows and political stability in MENA countries especially Egypt, was unable to find a clear relationship between FDI and political instability.

In addition, some researchers found political risk indicators including internal armed conflict, political strikes, riots, terrorism, and external conflicts to prevent the flow of FDI (see Nigh, 1985; Tuman and Emmet, 1999; and Schneider and Frey, 1985). A negative effect of terrorism on FDI inflows, for example, seems to be more damaging in low-income and less developed nations (Gaibullov & Sandler, 2009; Lee, 2011; Skaperdas, 2011). This result was supported by Khan, et.al. (2013) who found a negative effect of most of the political risk indicators on FDI for the world as a whole; however, they found that the relationship was the strongest for the upper middle-income countries.

On the other hand, Busse and Hefeker (2005), was unable to find a significant effect of internal and external conflicts on FDI into developing economies.

Furthermore, institutional quality which is considered as part of political risk indicators found to significantly reduces the FDI inflows. Researchers find that corruption negatively affect FDI since it adds significantly to firm costs (Wei, 2000, and Asiedu, 2006). On the other hand, Kolstad and Villanger (2004) find that corruption increases FDI inflows, while Wheeler and Mody (1992) find no significant relationship between corruption and quality of the legal system on U.S. FDI. In addition, researchers find that regulatory framework, bureaucratic hurdles and red tape, judicial transparency, and the extent of corruption in the host country are insignificant (see Wheeler and Mody (1992)).

The differences in results in the literature related to the effect of political risk indicators and institutional quality could be related to the use of different types of data, different methodologies, different measures of institutional quality, the application on developed vs. emerging countries, and the application on rich vs. poor countries.

The aim of this research is, therefore, to examine the political risk indicators and to identify the relative importance of these indicators for FDI inflows, controlling for other relevant determinants of observed changes in FDI flows. In particular, given the importance of FDI, the aim of this study is threefold. First; given the political instability in the region this research will unveil the importance of the different indicators of political risk on the change in FDI. These indicators are; the effects of government stability, socio-economic conditions, investment profile, internal and external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and the quality of bureaucracy. Second, in addition to political risk indicators, this study controls for the relationship between FDI and other types of risks, which are associated with the macroeconomic environment in the MENA region, including the financial and the economic risks, financial liberalization, and openness to try to understand the controversy over these relationships documented in the literature. Finally, the study looks at whether there are differences between the factors that affect rich and poor resource countries in the region in attracting FDI.

To reach to our goals, we apply two methodologies, the fixed effect (FE) and the random effect (RE) dynamic models on a sample of sixteen MENA countries over the period 1984 to 2011. The results of this study will unveil the instrumental factors that help promoting FDI in the region. It points what and where measures may need to be employed by countries to enhance business environment, which is favorable to foreign investors, especially those seeking FDI.

This research is structured as follows. Section two sets out and discusses our variables. Section three describes the data and the econometric methods employed. Section four contains the regression results and the last section concludes.

FOREIGN DIRECT INVESTMENT DETERMINANTS

According to the International Monetary Fund (IMF, 2003), determinants of investment locations differ among countries and across the economic sectors. They concur, however, that certain general factors consistently determine which countries attract the most FDI. This paper identifies the following indicators that affect the capital flows to the MENA region.

Political Risk (PR)

It refers to the probability that a sovereign state will be unwilling or unable to guarantee an environment which is favorable to investors, either because of policies pursued by the state or policies which are outside its control (like social unrest, and instability). It could affect economic uncertainty, safety of invested capital and economic prospects of the host economy. Often political risk refers to the quality of institutional environment. Political instability ranges from political restrictions to the probability of revolutions and violent uprising of the population. Inefficient institutions and high political risk can adversely affect operating costs. Therefore, multinational firms usually require a higher return to undertake FDI in countries with high political risk (Butler and Joaquin 1998).

This study expects a negative relationship between political risk and foreign direct investment. We will use political risk index, where higher values indicate less risk associated with specific country. Information on political risk and institutions are taken from the International Country Risk Guide (ICRG), provided by the Political Risk Services (PRS) Group. Risk ratings range from a high of 100 (least risk) to a low of 0 (highest risk), though ratings generally range in the 30s and 40s. Note that when considering political risk scores, a higher political risk score is “better” (i.e. would be associated with lower levels of political risk).

In addition to the aggregate level of political risk, the following components of political risk, as defined in ICRG are considered separately:

Government stability, (GOS), which measures the ability of the government to carry out its policies and to stay in office.

Socio Economic Pressure (SOCIO) that might restrain government action or promote social unrest due to dissatisfaction and thus destabilize the political regime.

Investment profile (INVP), relates to any investment risks, which are not covered by financial and economic risk components, like expropriation and risk of profits repatriation.

Internal conflict (INCON) relates to political violence within the country and its impact on governance, like the risk of civil war, terrorism, political violence or civil disorder.

External conflict (EXCON) relates to risk to the existing government from foreign action, like non-violent external pressure, such as diplomatic pressures, withholding aid or trade sanctions, to violent external pressures, ranging from cross-border conflicts to war.

Corruption (CORR) measures the level of corruption.

POLITICAL RISK AFFECT OF FDI IN MIDDLE EAST & NORTH AFRICAN?

Military influence (MLTINF) represents the influence of the military in politics, which could lead to an unfavorable environment for foreign businesses.

Religious Tensions (RELT) stemming from the domination of society and/or governance by a single religious group seeking, for instance, to replace civil by religious law or to exclude other religions from the political and social process.

Law and order (LAWO) measures the strength, independence and fairness of the legal system.

Ethnic Tension (ETT) relates to the degree of tensions among different ethnic groups related to racial, nationality or language divisions.

Democratic accountability (DEMO) measures how responsive the government to its citizens, fundamental civil liberties and political rights.

Bureaucracy (BUR) reflects the institutional strength and quality of the bureaucracy.

H1: An increase in the political risk of host country environment will result in a negative impact on foreign direct investment. A positive coefficient will show a negative relationship between political risk and foreign direct investment.

Economic risk (ER)

It is related to changes concerning market, competitive, and technological factors that reduces a firm's effectiveness and expected profit. Previous research shows that the macroeconomic environment affects the level of a country's productivity. Therefore, risk adverse investors would require higher return the higher the riskiness of their investment associated with high volatility of return. According to Iqbal (2001), Countries in the MENA region was struggling to maintain macroeconomic stability.

The ICRG assesses risk points for each of the component factors of GDP per head of population, real annual GDP growth, annual inflation rate, budget balance as a percentage of GDP, and current account balance as a percentage of GDP. Risk ratings range from a high of 50 (least risk) to a low of 0 (highest risk), though lowest ratings are generally near 15.

H2: High economic risk in a host country will have a negative impact on FDI.

Financial Risk (FR)

It refers to the risk of the inability of the country to repay its foreign liabilities. Countries with high financial risk are more likely to face financial crisis, since FDI cannot be easily liquidated when financial situation of the host country deteriorates. Therefore, multinational firms might be very sensitive to financial risk. As the amount of foreign debt grows the ability to pay debt obligations by the host country decreases, and consequently financial risk increases. As a result multinationals find countries with too much foreign debt to be less attractive for investments.

In addition, the instability in the country exchange rate may reduce the FDI since it would increase the level of uncertainty of the multinational firm. A high inflation rate may also affect foreign investment through its effect on future return and the level of competition by foreign firms. Risk rating from ICRG is used to test our hypothesis, which ranges from a high of 50 (least risk) to a low of 0 (highest risk).

H3: High financial risk will have a negative impact on FDI

Macroeconomic performance and the size of the economy (Size)

This paper uses the change in GDP per capital growth to proxy for the growth of the economy. A higher economic growth captures the change in demand for goods and services, and indicates rising productivity and profitability. This represents the market size hypothesis (eg. Hubert et al (2004) Abdul-Mottaleb (2007); Jana (2008)).

H4: The higher the growth in real GDP per capita, and the GDP per capita the higher the FDI.

The previous period FDI to GDP (a pull factor for new FDI) (lagFDI)

The higher the previous period's FDI, the higher the prospective FDI. Hisarciklilar et al. (2006) study the determinants of FDI into the MENA region shows a positive feedback effect of FDI (agglomeration). Foreign investors may be attracted to a host country that has large existing FDI stocks. It may be viewed as a signal for good investment environment. Thus, we use the lag in FDI stocks as a percentage of GDP in the host country as a proxy for agglomeration effects (AGGLO).

1. The act or process of gathering into a mass.
2. A confused or jumbled mass

H5: Countries that attracted FDI in the past is more likely to attract additional FDI

Trade openness (TO)

The openness of the economy, or the degree of liberalization of trade of the host country, is also regarded as a very crucial for foreign investors' decisions to allocate their capital. A positive relationship between FDI and openness is well established in the literature (see Asiedu, 2002; Morisset, 2000). In a host economy, the absence of an environment characterized by an open trade and investment regime and macroeconomic stability, FDI may impede rather than promote growth by enhancing the private rate of return to investment for foreign firms while exerting little impact on social rates of return in the recipient economy (Balasubramanyam et al. (1996)). The degree of trade openness is measured by the home country's trade (i.e. the sum of exports and imports) as a proportion of its GDP.

H6: Trade openness is expected to be positively associated with FDI.

Inflation volatility (IV)

Inflation is used to proxy for macroeconomic stability. It reveals the shocks suffered by the economy over the study period and, consequently, could affect FDI. A high and/or variable rate of inflation signals an internal economic uncertainty and of the host government's inability to maintain reliable monetary policy. It also may increase costs, and reduce the ability for multinationals to compete in the international markets (Grosse & Treviño, 2005). Therefore, inflation is an important source of uncertainty for foreign investors (see Rogoff and Reinhart, 2003) and is expected to have a negative effect on FDI. Addison and Heshmati (2003), on their study of the FDI into 182 countries, find a weak impact of inflation variance in the pooled model,

while it exhibits a negative effect on FDI for Europe, Central Asia and for MENA countries. Economic stability is controlled for by the volatility in inflation rate in the host countries.

H7: We would expect a negative relationship between inflation volatility and FDI.

DATA AND METHODOLOGY

The study uses a sample comprises annual panel data from 1984 to 2011 for 16 Middle East and North African Countries: 11 Middle Eastern countries and 6 North African countries. Our sample include GCC countries (Kingdom of Saudi Arabia; United Arab Emirates; Oman; Bahrain; Qatar; Kuwait), other middle eastern countries (Jordan; Syria; Turkey; Lebanon; Yemen), and North African countries (Egypt; Morocco; Tunisia; Libya; and Algeria). Capital flow data (i.e. FDI and FPI) is drawn from the IMF's International Financial Statistics database and the World Bank's World Development Indicators. FDI refers to net inflows—that is, gross inflows minus repatriation. Capital inflows are characterized as FDI if the investor acquires a lasting management interest (10 percent or more of the voting stock) in the foreign enterprise. The dependent variables are the ratio of FDI inflows to GDP, and the FPI to GDP. Normalizing capital inflows in terms of GDP allow us to avoid a dependent variable non-stationary problem. Information on political, financial and economic risks is taken from the International Country Risk Guide (ICRG), provided by the Political Risk Services (PRS) Group. Trade openness data is from OECD publication.

Empirically, the level of capital flows appears to have high persistence that is likely to generate a unit root in the series.

We assume that capital flows as a percentage of GDP follow the following data generating process:

$$Y_{it} = \alpha + \beta Y_{it-1} + \delta X_{it} + \varepsilon_{it} \quad (1)$$

$$\varepsilon_{it} = \mu_i + v_{it} \quad (2)$$

$$v_{it} \sim \text{iid} (0, \sigma^2 \varepsilon)$$

Where:

y_{it} : is the dependent variable (the ratio of FDI inflows to GDP)

X_{it} : denotes a $1 \times k$ vector of explanatory variables that vary in the cross-section in time t .

N : total number of countries

The subscript “ i ” denotes a particular country and “ t ” indicates particular time.

ε_{it} : country specific effect. Error component structure where μ_i models the time-invariant country specific effects and v_{it} is a stochastic error term, which is assumed to be uncorrelated over all t and i .

β : reflects persistence in the process of adjustment towards equilibrium.

δ measures the short-run effect of x_{it} on y_{it} given $y_{i,t-1}$. The long-run effect is calculated as $\alpha / (1 - \beta)$.

α, β, δ : parameters to be estimated

v_{it} : iid residuals with zero mean and constant variance.

The model assumes that the slope is homogeneous across countries, and assumes that unobservable characteristics are invariant over time. Therefore, this model specification assumes country-specific unobservable. Panel data allows one to control for unobserved time invariant country specific effects resulting from omitted variable biases (Ravallion, 1995). Using lagged dependent variable help us to capture capital flow agglomeration effects and to correct for residual autocorrelation present in panel data specifications. The analysis is conducted by employing two econometric methods namely, Random Effect (REM) and Fixed Effect (FEM) Models.

Our choice of suitable panel data econometric technique depends on whether there is likely correlation between the individual and, cross-section specific i.e. error component and the explanatory variables. In FE model, each cross-sectional unit has its own (fixed) intercept value. Implementing FE within regression model is expected to remove potential heteroscedasticity problems resulting from possible differences across countries (Greene, 1997). This study first tests panel data by running FE model. Second, this study runs the RE model, in which the intercept correspond to the average value of all the country specific intercepts and the unobserved error components to the (random) deviation of individual intercept from this average value.

If it is assumed that the error term and the independent variables are uncorrelated, RE may be appropriate, whereas if the error term and the independent variables are correlated, FE may be a better model to use (Gujarati, 2003).

To choose between fixed and random effect models we run a Hausman test (1978). The Hausman test checks a more efficient model (RE) against a less efficient but consistent model (FE) to ensure that the more efficient model will also give consistent results.

EMPIRICAL RESULTS

This paper analyzes the factors that affect FDI to 16 Middle East North African countries. Table 1 provides summary statistics and the correlation matrix of all the variables under study for the panel data over the period 1984-2011.

Table 1. Summary statistics and correlation matrix.

Variable	Mean	Std. Dev.	Min	Max
FDI/GDP	2.598304	3.419454	-2.5	15.75
FPI/GDP	-0.01297	0.071313	-0.4322	0.326002
Size	0.225179	0.299931	-0.32	1.29
TO	21.48536	19.17344	0	69.56
ER	35.38089	6.540251	19.75	48.75
PR	60.79437	11.55326	19.5	78.75
FR	34.73786	8.473405	10.75	48.5
IV	6.355815	21.1246	0	215.5526
ROI	0.250407	2.168708	-0.3556	22.87875

Correlation Matrix

	FDI	FPI	Size	TO	ER	PR	FR	IV	ROI	Mcap
FDI/GDP	1.0000									
FPI/GDP	-0.1224	1.0000								
Size	0.3723	-0.1141	1.0000							
TO	0.3374	0.1749	0.1580	1.0000						
ER	-0.0185	-0.2547	0.1635	-0.3775	1.0000					
PR	0.0431	-0.2167	0.2347	-0.1876	0.5844	1.0000				
FR	0.0534	-0.2853	0.3028	-0.1518	0.6926	0.7889	1.0000			
IV	0.2747	0.0773	0.2407	0.1709	-0.2471	-0.4560	-0.3283	1.0000		
ROI	-0.0591	0.0428	0.0107	0.0218	0.0182	0.0900	0.0454	-0.0224	1.0000	
Mcap	0.3948	-0.3374	0.1527	-0.2884	0.4861	0.3920	0.3572	-0.1377	0.0095	1.0000

Where: FDI/GDP: is foreign direct investment as a percent of gross domestic product, FPI/GDP: is foreign portfolio investment as a percent of GDP, Size: measured as the growth per capita gross domestic product, TO: is the trade openness measured as the sum of import and export as a percent of GDP, ER: refer to economic risk, PR: refer to political risk, FR: refer to financial risk, IV: is inflation volatility, ROI: is the return on investment.

We apply our data to both fixed effect and random effect dynamic panel models. The fixed effect estimation includes the country-specific effects as regressors rather than assigning them to the error term, thereby reducing omitted variable bias. Fixed effects always give consistent results; therefore, it is reasonable to employ them with panel data. Fixed effect model, however, may not be efficient to run. Random effects give better P-values as they are a more efficient estimator, so we will check our data to see which model is statistically justified.

To choose between fixed and random effect models we run a Hausman test. The Hausman test checks a more efficient model (RE) against a less efficient but consistent model (FE) to ensure that the more efficient model will also give consistent results.

First, we ran the first set of regressions for all MENA countries. We used the lag of change in the variables, FDI and size. The results of fixed effect model, random effect model and Hausman test for all countries in MENA region are outlined in table 2. Panel A of table 2 runs the fixed effect regression of our explanatory variables on the first difference in FDI as a percent of GDP. The model was significant at 5 percent level. Results show that political risk and the lag of difference in FDI are the only significant determinants of FDI. Panel B shows the results of the Random Effect regression model. The model was significant at 5 percent level as indicated by Chi square value. Results, however, indicate that lag FDI, political risk, size of the economy and financial risk are main determinants of FDI in the MENA region over the period 1984-2011. In the case of MENA the Hausman test was insignificant with p value equals to 0.99, at 5 percent significant level, and thus, we use the results of the random effects model. The results of the random effect model are consistent with the results in the literature for the variables lag FDI, market size, and political risk. All these variables are significant and positively related to the change in FDI as we hypothesized previously. As political risk increases in the host country, inward foreign direct investment is affected negatively. A positive coefficient is associated with lower levels of political risk, since a higher political score is better. Therefore, political risk affects economic uncertainty, safety of invested capital and economic prospects of the countries in MENA region. Our results show that the lagged change of FDI affects positively the current change in FDI. This is consistent with the literature, where FDI tends to cluster in particular location, in what is known in the literature by the “agglomeration” effect (Kamaly, 2002). Therefore, FDI flows depend on a country’s past stock of FDI. Market size and growth opportunities, proxied by the change in the GDP per capita growth are proved to be important determinants of FDI in the MENA region. Finally the financial risk index is significant, with a negative coefficient. This result seems surprising, however, is consistent with what has been found in the literature on developing countries (Hayakawa, Kimura and Lee, 2011). This result, however, could be explained by looking more closely to the different type of FDI attracted to the MENA countries. Or we can say that foreign investors do not give too much attention to financial risk when deciding to invest in MENA countries.

In panels C and D of table 2, the 12 indicators for political risk from ICRG have been added in addition to the control variables. First we test our pooled data using fixed effect model (C) and then (Panel D) using the Random effect regression. Results of Hausman test gives support to the Random Effect model as indicated by the insignificant p value of .996. Therefore, we will give more attention to explain the results from the Random effect model. The results show as before market size and the agglomeration effect are significant determinant of FDI. As for the components of political risk, results show that the level of corruption and the level of external conflict have positive impact on FDI inflows. The coefficients on these determinants are positive and statistically significant at the 5 or 10 percent level. Therefore, countries with low level of corruption, and less external conflict were more able to attract FDI to the MENA region in the period 1984-2011. However, countries with less democracy attract more FDI than otherwise. The level of democracy and socioeconomic conditions are significant, however have negative signs indicating that countries with less democracy and more socio economic pressure attracted more FDI. This could be explained by the amount of FDI that enters the GCC market representing the large amount of investments in the oil industry. In addition, given a high correlation between democracy and socio economic pressure might explain the results. Countries with low democracy use its political power to suppress people and consequently reduce the effect of socio-economic pressure.

Table 2. Fixed and Random Effect Regression Results for the period 1984-2011

FDI/GDP	FEM (A)	REM (B)	FEM (C)	REM (D)
Lag FDI	.498 (29.88)*	.498 (31.04)*	.507 (30.19)*	.507 (31.3)*
Lag size	1.257 (1.59)	1.26 (1.65)**	1.34 (1.70)**	1.32 (1.78)**
IV	.0036 (.72)	.0028 (.62)	.0003 (.05)	.00099 (.22)
TO	.0027 (.32)	-.0002 (-.03)	-.0043 (.42)	.001 (.11)
RE	-.0412 (.04)	-.003 (-.12)	-.0098 (.33)	-.0088 (.32)
FR	-.0412 (1.18)	-.048 (1.90)**	-.072 (2.19)*	-.0655 (2.50)*
PR	.045 (2.33)*	.039 (2.35)*		
CORR			.823 (3.31)*	.642 (3.28)*
BER			.395 (1.43)	.403 (1.57)
DEMO			-.261 (2.36)*	-.243 (2.21)*
ETT			-.095 (.68)	-.1005 (.76)
EXTCON			.1698 (1.68)**	.1360 (1.64)**
GOST			.1448 (1.54)	.1161 (1.39)
INCON			-.091 (-.94)	-.101 (.98)
LAWO			.176 (.91)	.176 (1.05)
MILTE			.182 (1.37)	.178 (1.46)
RELT			-.145 (1.05)	-.077 (.60)
SOCIO			-.166 (1.96)*	-.135 (1.85)**
INVP			.078 (.87)	.101 (1.26)
Const	-1.413 (.99)	-.691 (.76)	-.751 (.50)	-1.31 (1.24)
F. Value	131.7 (000)*		57.5 (000)*	
Wald X ²		988 (000)*		1090.8
R ² (within)	.72	.72	.75	.75
between	.036	.43	.49	.471
Hausman test X ²	0.55 P = .99		3.27 P=.996	

In order to see if there is any significant difference between the results for GCC countries and those of the other countries in the MENA region, Table 3 shows the results for a sample of 6 GCC countries, while table 4 outlines the results for other countries in the MENA region other than the GCC.

Results of Housman test for the GCC countries are significant at 5 percent level as indicated by the p value. Therefore, the Fixed Effect regression model is more efficient. Results show that Market size and growth, agglomeration, and openness are positively and significantly related to FDI. However, as before, financial risk is significant however, has the wrong sign.

Including the components of political risk, we find economic risk become insignificant determinant of FDI. The level of Bureaucracy and ethnic tension affects FDI negatively. However, surprisingly, the level of corruption, internal conflict and the level of democracy are significant, however, enter with the wrong sign. This result indicates that the GCC countries that have high level of corruption, with low democracy and with high internal conflicts, ceteris paribus, are more able to attract FDI over the period 1984-2011.

The results on democratic rights are inconsistent with our hypothesis and with the results reported in the literature (see Harms and Ursprung (2002), Jensen (2003), and Busse (2004)), who all find a statistically significant link between fundamental democratic rights, such as civil liberties and political rights, and foreign investment inflows. Moreover, our results on quality (and institutional strength) of the bureaucracy supports what has been found in the literature (eg. Gastanaga et al. (1998), Busse et. al. (2005) who established a statistically significant (negative) link between FDI flows and bureaucratic delays (that is, lower bureaucratic quality is associated with lower FDI inflows)

Table 3. Fixed and Random Effect Regression Results for the period 1984-2011 For GCC

FDI/GDP	FE (Panel A)	RE (B)	FE (C)	RE (D)
Lag FDI	.424 (19.58)*	.448 (20.97)*	.42 (17.95)*	.453 (19.05)*
Lag size	4.003 (3.20)*	3.69 (2.95)*	2.313 (2.03)*	2.54 (2.08)*
IV	.076 (.81)	-.106 (1.72)**	.246 (2.70)*	-.076 (1.26)
TO	2.51 (11.42)*	2.03 (10.79)*	3.126 (12.94)*	2.15 (9.96)*
RE	.041 (.64)	-.0354 (.75)	.054 (.66)	-.078 (1.19)
FR	-.140 (2.20)*	-.1001 (1.75)**	-.073 (1.02)	-.065 (.98)
PR	-.029 (.51)	.016 (.45)		
CORR			-1.87 (3.36)*	-.976 (1.83)**
BER			1.89 (2.42)*	2.23 (2.82)*
DEMO			-1.115 (3.76)*	-.732 (2.58)*
ETT			.948 (1.65)**	2.04 (3.57)*
EXTCON			.517 (2.15)*	.236 (1.21)
GOST			-.129 (.49)	-.199 (1.07)
INCON			.186 (.53)	-.518 (1.70)**
LAWO			-.167 (.27)	-.794 (1.34)
MILTE			.703 (1.96)*	.388 (1.09)
RELT			-.745 (1.34)	-.655 (1.42)
SOCIO			-.247 (.98)	-.244 (.97)
INVP			-.218 (1.19)	.052 (.32)
Const	1.856 (.39)	1.52 (.81)	-6.26 (1.34)	3.08 (1.33)
F. Value	116.02 (000)*		70.72(000)*	
Wald X ²		988 (000)*		938.43 (000)*
R ² (within)	.91	.72	.95	.93
between	.0077	.43	.09	.21
Hausman test X ²	35.91 P = 0.000		86.01 P= 0.000 Use FE	

Table 4 shows the result on countries in the MENA region excluding GCC region. Housman test was insignificant indicates that the random effect model is more efficient than the fixed effect model. Panel B shows positive and significant effect of agglomeration, and political stability on FDI. However, open countries were not able to attract foreign direct investment as compares to countries, which are less open. This result could indicate an omitted variable, which is highly correlated with openness that masks the actual results. To see which political risk elements affect more the FDI, paned D shows the results of regressing the various elements of political risk along with our control variables, on FDI. Results show that government structure and military tension play a significant role in attracting FDI. Ethnic tension and socio economic pressures are significant however enter at the wrong sign, which might mean that foreigners do not consider socioeconomic pressure and ethnic tension as important factors that affect their decision to invest in the MENA countries other than the GCC.

Table 4. Fixed and Random Effect Regression Results for the period 1984-2011 For NON GCC

FDI/GDP	FE (panel A)	RE (B)	FE (C)	RE (D)
Lag FDI	.445 (20.02)*	.440 (21.33)*	.469 (19.26)*	.467 (20.81)*
Lag size	.831 (1.12)	.815 (1.17)	.009 (1.50)	1.10 (1.68)**
IV	.0054 (1.54)	.0046 (1.45)	.0019 (.53)	.002 (.61)
TO	-.043 (3.78)*	-.042 (4.56)*	-.033 (2.42)*	-.085 (2.49)*
RE	.042 (1.32)	.0398 (1.41)	.0338 (1.02)	.0158 (.57)
FR	-.028 (.88)	-.032 (1.48)	-.068 (2.03)	-.030 (1.35)
PR	.035 (2.22)*	.029 (2.09)*		
CORR			.3596(1.60)	.237 (1.20)
BER			.154 (.54)	.129 (.50)
DEMO			-.043(.35)	-.068 (.64)
ETT			-.216 (1.78)**	-.238 (2.18)*
EXTCON			.027 (.30)	.034 (.47)
GOST			.119 (1.15)	.123 (1.65)**
INCON			.059 (.56)	.092 (.66)
LAWO			-.072 (.39)	.028(.18)
MILTE			.278 (1.96)*	.221 (1.63)**
RELT			.129 (.93)	.078 (.74)
SOCIO			-.138 (1.36)	-.151 (1.78)**
INVP			-.212 (1.68)**	-.152 (1.59)
Const	-1.42 (1.21)	-.916 (1.13)	.49 (.38)	-.187 (.19)
F. Value	61.77 (.000)*		27.10(0.000)*	
Wald X ²		480.51 (.000)*		541.17 (.000)
R ² (within)	.70	.70	.74	.73
between	.21	.32	.39	.40
Hausman test X ²	.95 P = 0.99		4.12 P= 0.98 Use RE	

CONCLUSIONS

In this paper, we study the factors affecting the level and change of FDI inflows among 16 economies comprising the MENA region using panel data for the period 1984-2011. Given the constant political risk in the region, this research aimed to unveil the importance of the different components of political risk on the change in FDI. Other types of risks are also considered, including financial risk, economic risks, and trade openness, which are associated with the macroeconomic environment in the MENA region. Finally, the study looks at whether there are differences between the factors that affect rich and poor resource countries in the region in attracting FDI.

Taking all countries together, our results are, as hypothesized, consistent with the results in the literature for the variables lag difference of FDI (agglomeration), market size, and political risk. All these variables are significant and positively related to the change in FDI at a 5 percent significance level. We also find that among the 12 political risk components, the level of corruption and the level of external conflict have close association with FDI flows.

FDI motives vary greatly between the GCC and the non-GCC countries. Results for the GCC countries show that market size and growth, agglomeration, and openness are positively and significantly related to FDI. Including the components of political risk, we find that the poor quality of bureaucracy and ethnic tension affects FDI negatively. However, surprisingly, the level of corruption, internal conflict and the level of democracy are significant, however, enter with the wrong sign. This implies that countries with high level of corruption, with low democracy and with high internal conflicts, ceteris paribus, are more able to attract FDI in the GCC region over the period 1984-2011.

The main findings on countries in the MENA region excluding GCC region show positive and significant effect of agglomeration, and political stability on FDI. However, open countries were not able to attract foreign direct investment as compares to countries, which are less open. Results of political risk components show that government structure and military tension play a significant role in attracting FDI.

ACKNOWLEDGMENT

This research was made possible by a UREP award [UREP: 12 - 095 - 5 - 026] from the Qatar National Research Fund (a member of The Qatar Foundation). The researchers thank QNRF for their support and would like to mention that the statements made herein are solely the responsibility of the author[s].”

REFERENCES

- Abdul-Muttalib (2007). “Determinants of Foreign Direct Investment and Its Impact on Economic Growth in Developing Countries”. *MPRA Paper No. 9457*, posted 7. July 2008 02:28 UTC.
- Addison, T. and Heshmati, A. (2003). “The New Global Determinants of FDI Flows to Developing Countries”, World Institute for Development Economics Research *WIDER, Discussion Paper*, No. 2003/45.
- Asiedu E. (2002) “On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different?” *World Development*, 30 (1) pp. 107-119.
- Asiedu E. (2006). “Foreign Direct Investment in Africa: The Role of Government Policy, Institutions and Political Instability”, *World Economy*, 29 (1) 63-77.
- Balasubramanyam, V. N., Salisu, M., and Sapsford, D., 1996. Foreign direct investment and growth in EP and IS countries, *Economic Journal*, 106, 92–105.
- Batra G, Kaufmann, D. and A., (2000). “The Investment Climate Around the World: Voices of firms from the World Business Environment Survey”, *The World Bank Technical Report*, Washington DC.
- Busse, Matthias (2004). Transnational Corporations and Repression of Political Rights and Civil Liberties: An Empirical Analysis, *Kyklos*, Vol. 57, No. 1, pp. 45-66.
- Busse, Carsten Hefeker (2005) Political Risk, Institutions and Foreign Direct Investment: *HWWA DISCUSSION PAPER* , 315 Hamburgisches Welt-Wirtschafts-Archiv (HWWA) Hamburg Institute of International Economics. ISSN 1616-4814
- Butler, K. C., and D. C. Joaquin (1998). A note on political risk and the required return on foreign direct investment. *Journal of International Business Studies* 29 (3):599–606.
- Eid F. and F. Paua (2002). “Foreign Direct Investment in the Arab World: The Changing Investment Landscape”, *Working Paper Series*. Beirut: School of Business, The American University.
- Gaibullov, K., & Sandler, T. (2009). The Impact of Terrorism and Conflicts on Growth in Asia. *Economics & Politics*, 21(3) 359-383.
- Gastanaga, Victor, Jeffrey B. Nugent and Bistra Pashamova (1998). “Host Country Reforms and FDI Inflows: How Much Difference Do They Make?” *World Development*, 26 (7) 1299-1314.
- Greene, William, (1997). *Econometric Analysis*, Third Edition, NJ: Prentice-Hall.
- Grosse, R. & Treviño, L. (2005). New institutional economics and FDI location in Central and Eastern Europe,” *Management International Review*, 45(2): 123-146.
- Guisinger, S., (1992). "Rehortic and Reality in International Business: A note on the Effectiveness of Incentives", *Transnational Corporations*, 1, pp. 111-23.
- Gujarati, N Damodar, (2003). *Basic Econometrics*, 4th Edition, McGraw Hill.
- Harms, Philipp, and Heinrich Ursprung, (2002). “Do Civil and Political Repression Really Boost Foreign Direct Investments?” *Economic Inquiry* 40 (4): 651–663.
- Hausman, Jerry, (1978). "Specification Tests in Econometrics," *Econometrica*, 46, pp.1251-1271.
- Hayakawa, K. Kimura, F. And Lee, H. (2011). How Does Country Risk Matter for Foreign Direct Investment? *Institute of Developing Economies*, Discussion Paper.
- Hisarciklilar, M., Kayam, S. and Kayalica, O. (2006) “Locational Drivers of FDI in MENA Countries: A

- Spatial Attempt”, Department of Management Engineering, Istanbul Technical University, *MPRA Paper*, no. 2085.
- Hubert P. Janicki and P. V. Wunnava (2004). “Determinants of Foreign Direct Investment: Empirical Evidence from EU Accession Candidates”. *Applied Economics*, 36: 505-509.
- IMF (2003). “Foreign Direct Investment in Emerging Market Countries”. <http://www.imf.org/external/np/cm/cg/2003/eng/091803.pdf>
- International Country Risk Guide (ICRG) online, The PRS Group.
- Iqbal, Z. (2001). "Economic Challenges in the Middle East and North Africa: Overview," Macroeconomic Issues and Policies in the Middle East and North Africa, *International Monetary Fund*.
- Jana P. (2008). “The Determinants of Foreign Direct Investment: A Regional Analysis with Focus on Belarus, Lund University Department of Economics” <http://www.essays.se/about/Jana+P%C3%84rletun/>
- Jensen, Nathan M. (2003). “Democratic Governance and Multinational Corporations.” *International Organization* 57 (3): 587–616.
- Kamaly, A (2002). “Evaluation of FDI Flows into the MENA Region”, *Working Paper Series*. Cairo, Egypt: Economic Research Forum.
- Khan, Mashrur M. and Akbar M. Ibne (2013). The Impact of Political Risk on Foreign Direct Investment“ <http://mpa.ub.uni-muenchen.de/47283/>.
- Kobrin, S. (1979). “Political risk: a review and reconsideration,” *Journal of International Business Studies*, 10 (Spring):67-80.
- Kolstad, I. and Villanger, E. (2004). How does social development affect FDI and domestic investment, *CMI report 2004:2*, Bergen: Chr Michelsen Institute.
- Lee, C. (2011). *Political risks, terrorism, and foreign direct investment*. Paper presented at the Midwest Political Science Association Meeting, 2011.
- Morisset, J. (2000) Foreign direct investment in Africa: policies also matter, *Transnational Corporations*, 9, 107–25.
- Nigh, Douglas (1985). The effect of political events on United States direct foreign investment: A pooled time-series cross-sectional analysis. *Journal of International Business Studies*, 16(1): 1-17.
- OECD, World Economic Forum, Arab World Competitiveness Report 2011-2012.
- Onyeiwu, S (2004). “Analysis of FDI Flows in Developing Countries: Is the MENA Region Different?” Selected Published Papers From the Tenth Annual Conference of the Economic Research Forum, Cairo, Egypt, pp. 165-182, 2004.
- Ravallion, Martin and Datt, Gaurav, (1995). “Growth and Poverty in Rural India,” *Policy Research Working Paper Series* 1405, The World Bank,
- Richards, A. and J. Waterbury (1996). *A Political Economy of the Middle East*. Boulder, CO: Westview Press.
- Rivlin, P (2001). *Economic Policy and Performance in the Arab World*. Boulder, CO: Lynne Rienner.
- Rogoff, K. and Reinhart, C. (2003). FDI to Africa: The role of price stability and currency instability. *IMF Working Paper* 03/10 (Washington, D. C: International Monetary Fund).
- Schneider, F., & Frey, B. (1985). “Economic and political determinants of foreign direct investment,” *World Development*, 13(2):161-175.
- Skaperdas, S. (2011). The costs of organized violence: a review of the evidence. *Economics of Governance*, 12(1) 1-23.
- Steiner, C. (2010). “An overestimated relationship? Violent political unrest and tourism foreign direct investment in the Middle East. *International Journal of Tourism Research*, vol. 12, issue 6, pp. 726-738.
- Tallman, S. B., (1988). Home Country Political Risk and Foreign Direct Investment in the United States, *Journal of International Business Studies*, pp. 219-34.
- Tuman, John P., and Craig F. Emmert (1999) “Explaining Japanese Foreign Direct Investment in Latin America, 1979–1992.” *Social Science Quarterly* 80 (3): 539–55.
- Wei, Shang-Jin, (2000). "How Taxing is Corruption on International Investors?" *Review of Economics and Statistics*. 82 (1): 1-11.
- Wheeler, David, and Ashoka Mody,(1992). “International Investment Location Decisions: The Case of U.S. firms,” *Journal of International Economics*, Vol. 33, pp. 57–76.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.