Policy Perspective
Economic Research Forum (ERF)

Policy Perspective No. 8
May , 2013

The determinants of Foreign Direct Investment to Arab countries

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This policy perspective examines the issue of attracting foreign direct investment (FDI) to the Arab countries. FDI enjoys a positive reputation among researchers and policymakers. It has been attributed a long list of virtues, among which being a vector of managerial and technological expertise, being a stable source of capital and being, at least under some conditions, conducive to growth. Determining why some countries attract more FDI than others has, therefore, become a major research and policy issue.

The Issue

The issue of attracting FDI is of prime importance to Arab countries. For a long time a majority of them has been attracting little FDI. In the late 1980s, the Region's ratio of FDI to GDP was the lowest (0.39%) compared to all other regions except South Asia (0.10%). However, recent figures show a significant improvement in terms of FDI inflows to the Region which is now doing better than many others. Between 2005 and 2010, the Region ranked first in terms of ratio of FDI to GDP (4.6%) just before Europe and Central Asia (4.31%). It also shows a steady increase of the ratio since 1990 with a notable acceleration since 2003. There are, however, notable differences between countries over the period. Kuwait is receiving almost no FDI (like during the preceding periods) and Algeria exhibits a ratio of FDI to GDP far below 2%. In contrast, FDI to Jordan and Lebanon amounts to around 16% and 13% of their GDP.

To explain those trends, and possibly leverage on them to foster growth, a natural question is how to attract more FDI. To answer this question one needs a better understanding of the drivers behind the good and bad performance in terms of FDI inflows. Therefore, the ERF launched an ambitious research which focused on the determinants of FDI to Arab countries. The research encompasses four dimensions. One dimension

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concerns the determinants of FDI to the Region and their contrast across Arab countries and with respect to Asian countries which have been successful in attracting important FDI flows. A second dimension focuses on a specificity of the Region; that is the coexistence of relatively capital rich and labor poor countries and of capital poor and labor abundant countries. Such specificity offers the possibility of mutual beneficial exchange of factors. The question here is what would make such exchange materialize, that is what determines intra-Arab FDI. The third dimension follows from recent development in the literature which gives a major role to formal and informal institutions in attracting FDI. The fourth dimension is motivated by the findings that the impacts of the two components of FDI, mergers and acquisitions (M&As) and Greenfield investment, on host countries' capital stock, productivity, and growth are very different. While greenfield investment consists in the creation of new production capacities, mergers and acquisitions only transfer the property of existing assets. Actually, inflows of Greenfield investment lead to much faster growth than M&A inflows. Hence, a country would be more interested in attracting Greenfield investment. The last dimension, therefore, concerns the empirical investigation of the determinants of the distribution of FDI between green-field investment and M&As.

General Background

Various motivations of FDI have been put forward in the literature. The eclectic theory of FDI groups them into three categories: Ownership-specific advantages, transaction costs and location advantages. Given the objective of the research, we focused on the third motivation. Country's advantages are grouped into three categories: basic economic factors; trade and foreign exchange policy; and other aspects of the business climate.

Basic economic factors include the difference in the rate of return on capital across countries, portfolio diversification strategy of investors and market size of the host country. The difference in the rate of return depends on incentives for foreign investors and supply of cheap labor. Studies that have focused on incentive policies such as grants, subsidies, tax abatement, loan's guarantees and interest subsidies, showed that their effect on FDI inflows is only marginal. The empirical evidence in favor of the portfolio diversification hypothesis is also weak. Finally, FDI was found to depend not only on sales on the host market but also on income in export markets.

The impact of trade policy on FDI inflows might be positive or negative. If the motive is only to serve the host market, the impact should be negative because higher openness means more competition on this market. This is known as the "tariff jumping" motivation for FDI. If the objective is to serve external markets, the coefficients should be positive since higher openness means easier access to foreign markets. Moreover, higher openness can allow cheaper access to imported inputs. Analyses of the relationship between FDI flows and exchange rate show that FDI inflows are negatively correlated with the value of the currency implying that a depreciated currency can stimulate the acquisition of control of productive corporate assets. However, exchange rate volatility contributes to the internationalization of production, thereby to more FDI inflows.

Other aspects of the business climate play an important role in a country's attractiveness to FDI. They include a large set of factors such as the availability of adequate infrastructure, the quality of the economic, political and institutional framework and the availability of human capital. By facilitating business, transport and communication, infrastructure quality is an important determinant of FDI inflows to LDCs. Foreign firms are also more likely to enter wealthier countries with large.

The role of institutions, being formal or informal, is crucial in terms of commitments to and enforcement of rules. Political instability can have a negative effect on FDI flows through its impact on profit uncertainty. Foreign firms are more likely to enter countries with credible political rules. Corruption is also generally put at the heart of the non-enforcement of rules in LDCs. It has repeatedly been found to depress inward foreign direct investment.

Finally and maybe related to the role of informal institution, very recent developments in the literature point to the importance of similarity between countries as another major determinant of FDI inflows. This means that after controlling for the above variables, FDI between two countries will be higher the more similar those countries. Similarity encompasses culture, language and institutions.

As regards Arab countries more specifically, FDI seems to react to GDP growth, to the enrolment in tertiary education, to research and development spending, to country risk and to domestic investment. Although tax incentives might increase investment because of higher after tax returns, the evidence shows that the positive effect of tax incentives on FDI is marginal. Other studies have shown that openness increases total FDI inflows and that a friendly investment climate complements openness in further attracting FDI. The availability of good telecommunication services also increases Arab countries attractiveness to FDI. Finally, corruption, the lack of government effectiveness, political risk, and a low respect for the rule of law and are severe impediments to FDI in the Region.

FDI Inflows to Arab Countries

The foreseen positive effects of FDI on the host economy have widely served as a basis for policies recommending the opening up of the economy to foreign investors. After the restrictive policies on foreign ownership pursued throughout the 1970's and the emergence of the Washington Consensus as a framework for development policies in the 1980's, FDI was seen by policymakers in developing countries as the best and fastest way to gain access to foreign technologies, markets, and increase foreign currency earnings. As it should serve as a support to the building of domestic production capabilities and exports, FDI required specific domestic policies.

Arab countries were no exceptions to this trend. Examples include Algeria, Libya, Egypt, Jordan, Morocco and Tunisia among others. Before 1990, Algeria allowed direct investments in the hydrocarbons sector only if foreign investors entered the country via joint ventures with the national hydrocarbon company Sonatrach. This illustrates the willingness of the authorities to keep the country's resources under control while gaining access to foreign technologies. Egypt, although not imposing controls on foreign investors' ownership, has used laws to channel foreign participation into targeted sectors. Libya allowed foreign participation on a minority basis. Jordan allowed only 50% of foreign ownership in a number of activities and FDI is subject to a minimum amount of funds. Before the 1980's, Morocco used the "moroccanization decree" to increase local ownership rather than foreign investments.

Today, most of the countries under study have adopted more liberal frameworks towards foreign investors. In 1995, Morocco abolished the restrictive framework and adopted a highly liberalized environment for foreign investors. Tunisia has set foreign investment promotion as a key target of the 11th Economic Development Plan. Inflows have slowly increased partly as a result of such less restrictive framework.

A regional perspective

As a result, while the ratio of FDI to GDP in the Arab countries was the lowest (less than 1%) as compared to all regions of the world until 2000, it climbed to very high levels afterwards (slightly below 5%) far ahead of many other regions. However, there are notable differences across countries. Since 2005, Jordan and Lebanon scored the highest ratio (on average 16.71% and 14.27% respectively), while Algeria scored the lowest ratio (1.37%). In terms of evolution, a similar picture emerges: Jordan and Lebanon show the highest increases (14 and 9 percentage points respectively) while Algeria shows the lowest increase (0.62 percentage point). Kuwait continued receiving very little FDI all over the periods.

There are, however, notable differences inside the Region which is often split in three sub-groups: Oil rich and labor poor countries (the Gulf countries and Libya); Oil rich and labor abundant countries (Iraq, Algeria, Syria, Sudan and Yemen); and Oil poor and labor abundant countries (Egypt, Morocco, Tunisia, Jordan and Lebanon). The data shows the same steady increase of the ratio of FDI to GDP for the three groups. However, the group of Oil poor and labor abundant countries exhibits the highest increase and the highest level of the ratio since 2005. The performance is impressive given that this group had the lowest ratio in the 1990s. The second group is the lowest performing.

A sub-regional perspective

The above analysis already suggested that the various groups of Arab countries did not perform similarly in terms of FDI inflows. This section shows that the differences show up even inside each group. Inside the first group, Bahrain is the country benefiting the most from FDI inflows given its GDP, and has maintained such a status since 1990. Qatar exhibits a similar performance although less pronounced. Only since 2005, Saudi Arabia, the United Arab Emirates, Oman and Libya have had a high ratio which is comparable to the rest of the group. Interestingly, Kuwait received very little FDI all over the periods. Kuwait received very little FDI all over the periods. The ratios inside the group of oil rich and labor abundant countries reveal that Syria is achieving the best all over the period although its ratios are much lower compared to countries in the other groups. During the last period, Yemen exhibits a relatively high ratio while Algeria and Iraq have received very little FDI over all periods. Finally, Lebanon and Jordan appear as the best performing in terms of attraction of FDI inside the group of oil poor and labor abundant countries. Actually, their scores since 2005 are much higher than any country in the other groups. Egypt and Tunisia are doing fairly, while Morocco has the lowest ratio.

Intra-Arab FDI

Given their share in World GDP, Arab countries receive more FDI from other Arab countries than they should. This is relatively high and stable over the whole period. Regarding individual Arab countries, Saudi-Arabia is benefiting much more than any other Arab country from Arab FDI (36%) followed by Lebanon (8%) over the period 2003-2009. The two countries held the reverse order between 1995 and 2002: Lebanon (32%) first and Saudi-Arabia (20%) second. In relative terms, Egypt and Lebanon are the countries that lost the most of Arab FDI between the two sub-periods.

Greenfield FDI and M&A

Arab countries seem to attract mainly Greenfield investment as opposed to M&As. In Libya and Iraq, the ratio of Greenfield investment over total FDI remains close to 100% over the whole period of study. In Bahrain and Algeria the ratio peaks down in the late 1990s, but never goes below 90%. More precisely, its minimum was 94% in Bahrain in the second half of the 1990s. Algeria reaches a minimum of 90% in the first half of the 1990s. The only two countries where the ratio went below 90% are Egypt and Morocco. In Egypt, the ratio already reaches 90% in the early 1990s and keeps on decreasing up to 46% in the early 2000s. It then goes up to 88% in the 2010. In Morocco, the ratio is below 80% in the second half of the 1990s, and reaches a minimum on 32% in the early 2000s. It stabilizes at 75% in the late 2000s.

The Research Findings

The research addressed four issues: i) What are the determinants of FDI to the Region and how they compare across Arab countries and with respect to

Asian countries? ii) What determines intra-Arab FDI? iii) How do formal and informal institutions interact in attracting FDI to the Region? And finally, iv) What are the determinants of the distribution of FDI between green-field investment and M&As?

Regarding the first issue, the results show first that the Arab world is different from the Asian world in terms of determinants of FDI, and that countries also differ within the Arab world. As compared to Asia, the Arab world as a whole can attract more FDI provided infrastructure availability, institutions quality and foreign exchange policies are improved. For the oil rich labor poor countries investors are mainly attracted towards countries with high real per capita income and human capital. For the oil rich labor rich countries, the main determinants are real per capita income, infrastructure and foreign exchange liberalization. For the oil poor labor rich countries the main driver of FDI inflows is the quality of institutions.

The analysis of intra-Arab FDI was conducted in comparison of FDI in Arab countries originating from by non-Arab countries. The results show first that Arab and non-Arab countries behave differently regarding their investments in the Arab world. Focusing on intra-Arab FDI, only the size of the receiving economy (GDP) and the total supply of FDI from the source country are significant determinants. With extra-Arab FDI, GDP, real per capita GDP, institutions, openness and total supply of FDI are significant determinants.

Given the above discussion about the potential complementarity between the capital-rich and labor-poor countries on the one hand and the capital-poor and labor-rich countries on the other hand, the analysis was deepened to see whether Arab countries actually invest "enough" in other Arab countries. To get rid of the influence of unobserved factors, a "difference in difference" method and two different approaches have been adopted. One simply compares the observed FDI inflows to those predicted by the model. It showed that both Arab and non-Arab investors send more FDI to Arab countries than predicted by the model and the difference is higher for Arab investors. Arab countries receive 17% more FDI from other Arab countries than predicted by the model. Another approach compares the observed intra-Arab FDI inflows to those predicted under the assumption that Arabs behave like non-Arabs as suppliers. It showed that Arab countries receive from other Arab countries almost twice the FDI they would have received if Arab investors behaved like on-Arab investors.

Overall, the literature suggests that implementing a stable legal and institutional environment increases FDI inflows. Yet, the bulk of this literature has emphasized the role of formal rules such as those improving creditor rights or protecting property rights. It later appeared that such rules where insubstantial if not upheld in courts. Actually, attempts at importing the same set of good practices everywhere may prove futile, if not counterproductive, if those practices do not take their environment into account. Evidence suggests that the effect of formal rules depends in the environment where they are applied. Recent work points out that the informal environment, which includes norms of behavior and trust, matters as much as the formal environment. Suggestive evidence supports the view that formal rules interact with their informal environment. Surprisingly, no attempt has been made at investigating the interaction of formal and informal rules on FDI. Hence, a part of the research project studies the impact of social trust and formal legal and institutional determinants of foreign direct investment inflows in a panel of countries. For formal institutions, the study focuses on the legal provisions protecting property right in each country. Regarding informal institutions an indicator of the degree of trust among citizens of a country is used. It is simply the share of survey respondents in a country who reply affirmatively to the standard question "In general, do you think most people can be trusted?", which has been asked in a number of surveys around the World since the late 1950's.

The results show that the legal protection of property right and trust among citizens are each conducive to larger FDI inflows. Hence, the quality of both formal and informal institutions induces larger FDI inflows. This is first time evidence of a positive effect of trust on FDI inflows. More interestingly, the results suggest an interaction between the impacts of formal and informal institutions. Namely, the impact of formal rules appears smaller in countries where trust is high, and vice versa. Formal institutions are less necessary when social trust is high. Taken together, those results therefore mean that an informal institution, trust, can substitute for the quality of formal institutions, and vice versa. Our results are therefore evidence that formal and informal institutions are substitutes when it comes to attracting foreign direct investment.

The distinction between M&A and Greenfield investment is important because the two forms of FDI fundamentally differ. Their effects on host countries' capital stock, productivity, and growth are bound to be different. Previous evidence found that larger inflows of Greenfield investment lead to faster growth, while larger M&A inflows have no effect. Hence, a country might find it more important to attract Greenfield investment instead of M&As. For this, it should identify the determinants of the distribution of FDI across Greenfield investment and mergers and acquisitions.

The study shows that the ratio of M&A to total FDI inflows increases with market capitalization and better civil rights, and decreases with openness to trade. Moreover, market capitalization, civil rights, and urbanization only affect the volume of M&A flows, but do not correlate with the volume of greenfield investment flows. Conversely, the impact of openness to trade on the ratio of M&A to FDI inflows runs almost entirely through its positive impact of greenfield investment. Openness is found to increase both Greenfield investment M&A flows. However, the impact of openness on M&A is one order of magnitude smaller than its impact on Greenfield investment. Its impact on growth is therefore unambiguous. In addition, in developing countries, urbanization increases the ratio, and corruption seems to reduce Greenfield investment, but has no impact on M&As.

Conclusion and Policy Recommendations

It appears that for the Arab world as a whole to attract or maintain as much FDI as Asia infrastructure availability, institutions quality and foreign exchange policies should be improved. Interestingly such improvements could affect all Arab countries. However, there may be differences among Arab countries. In the oil-rich labor-poor countries better availability of human capital is the key driver of FDI while in the oil-rich labor-rich countries sub-sample a better availability of infrastructure and sound foreign exchange policies are the most important. In the oil-poor labor-rich countries the main driver of FDI inflows is the quality of institutions.

Regarding intra-Arab FDI inflows, the results support the view that the determinants of FDI inflows to Arab countries differ across suppliers (Arab or non-Arab). More precisely, only the size of the receiving economy and the total supply of FDI by a sender determine intra-Arab FDI. In contrast, extra-Arab FDI depends on GDP, real per capita GDP, institutions and openness in the receiving countries and total supply of FDI from the sender. The results suggest that neither human capital, quality of institutions, infrastructure nor openness affect an Arab investor's decision to locate in a given Arab country. Hence, for an Arab country to attract more Arab FDI it does not necessarily need to comply with the literature and international organizations' recommendations regarding openness and institutions. The pessimistic side of the result is that this leaves it with no tool to attract Arab FDI, because GDP depends on too many other factors than government action. The optimistic side is that such a country can still try improving its openness and institutional records to attract non-Arab FDI without losing Arab's.

Some explanations of such "Arab specificity" could be put forward. One is that to the extent that a large share of intra Arab FDI is provided by government or government-related entities, such as those of the GCC, the driving force might be a 'regional' authoritarian bargain across the Arab world. In this case capital surplus Arab countries would invest in other Arab countries for strategic considerations, hence causing some standard FDI fundamentals, most notably institutional quality, to be relatively unimportant as determinants of FDI. Moreover, the same effect is also likely to obtain even if the FDI flows originated from the private sector, but are linked to politically connected business partners in the FDI-receiving countries. Alternatively the main influence of the cultural and language commonality across the Arab world might be operating through the information channel, where Arab investors are able to avoid informational and/or institutional impediments through their informal socio-cultural networks. Naturally this would allow them to be less sensitive than their non-Arab counterparts to some established FDI fundamentals, such as institutional quality, for example.

The findings that local informal factors may affect the impact of formal incentives to FDI imply that policy advisers have to take local culture into account before formulating recommendations. In other words, the same set of measures will not be relevant everywhere irrespective of the local context. The issue is of question particular relevance in the case of Arab countries. Some scholars observe that citizens of gulf countries are more reluctant than Westerners to trust others, and relate that discrepancy to the fact that trust is relation-based in the Gulf, while it is rule-based in the West. Although Gulf countries are only a sub-group of the Arab world, this finding suggests an important specificity of the region that hinge on its capacity to attract foreign investment. What the results imply is that countries with low levels of social trust must be particularly careful about their formal legal framework.

The research on the composition of FDI shows that the volume of greenfield investment and M&As are affected by different factors. Encouraging the development of financial markets and civil rights may increase M&As without hurting greenfield investment. However, to reap the full benefits of greenfield investment, a policy package conducive to more trade openness may be recommended.

ERF at a Glance

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The Economic Research Forum (ERF) is a regional network dedicated to promoting high quality economic research to contribute to sustainable development in the Arab countries, Iran and Turkey.

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Established in 1993, ERF's core objectives are to build strong regional research capacity; to encourage the production of independent, high quality economic research; and to disseminate research output to a wide and diverse audience.

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