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The impact of Foreign Direct Investment in Arab countries

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Although the growth of per capita real income in the Arab world has markedly improved since the mid-1990s, it remains much lower than in many East Asia and Pacific countries. The lack of diversification of production and exports is seen by many observers as a major reason of the poor performance of the Region. From an economic point of view, specialization has the advantage of exploiting economies of scale and generating learning by doing. However, it induces the risk of a heavy dependence on shocks to the demand of a specific good. The resulting high uncertainty is detrimental to factor accumulation and growth. Since the pioneering studies of development economics, rich empirical evidence confirms that production and exports diversification are integral parts of the development process.

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The Issue

While the lack of diversification is, in general, associated with natural resources rich countries such as Algeria, Kuwait, Saudi Arabia, and United Arab Emirates (UAE), it is also an issue for many natural resources poor countries like Morocco, Tunisia, Yemen, and to some extent Egypt. These countries have low or very low shares of sophisticated manufactures in total exports. They are still highly specialized in few "traditional" manufacturing industries such as textiles, wearing apparel and food. This makes them vulnerable to external shocks, such as the termination of MFA and to fierce competition from other emerging economies, like China and India.

Since economic growth and the diversity of exports drive the development process, a natural question is how to boost them. The literature points to Foreign Direct Investment (FDI) as a potentially important culprit. Therefore, the ERF launched an ambitious research that focused on the impacts of FDI in the Arab world. The research addressed two questions. One concerns the impact of FDI on growth while the other focused on the impact on exports diversification.

About the authors

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General Background

Among the channels through which FDI inflows to a given country can affect its economic growth, the literature has emphasized three mechanisms: an increase in productivity; an increase in domestic investment; and the development and dispersion of new technologies. FDI is supposed to increase a country's productivity through a more efficient use of capital, the absorption of unemployed resources, and a better combination of foreign management skills with domestic labor and inputs. Empirical evidence suggests that FDI could be about three times more efficient than domestic investment. FDI is also expected to act as a catalyst for local investment by complementing local resources and providing a signal of confidence in investment opportunities. However, FDI can crowd in or crowd out domestic investment depending on the domestic economy's context. Finally, FDI can stimulate the development and dispersion of technological skills through transnational corporations' internal transfers and through linkages and spillovers among firms. The empirical evidence reveals a strong complementarity between FDI and human capital. FDI has an overall positive effect on the diffusion of technology, the magnitude of diffusion depends on the stock of human capital available in the host country. FDI can even have a negative effect on growth in countries with low levels of human capital.

Regarding Arab countries, little research has been conducted. It focused mainly on quantifying the influence on growth and the spillover effect. Some scholars found a positive but non-significant effect of FDI on growth while others showed that FDI's positive impact on growth in the Arab world depends on financial development. Finally, a meta-study analysis of the literature on FDI and growth has shown that in the Region the impact of FDI on growth is the lowest compared to the rest of the world.

The impact of FDI on exports diversification has received little attention in the literature. Existing results allow pointing to some channels through which FDI inflows to a given country can affect exports diversification. First, foreign firms may target sectors that are not yet developed in the host country, as for FDI from the US to India. Second, foreign firms are more likely to engage in exports than their domestic counterparts, as has been observed in the UK. Third, the presence of foreign firms may reduce the cost of exporting through their participation in international production and commercialization networks, as in the case in China.

As far as Arab countries are concerned, we found only study on the effect of FDI on the concentration of exports. However, the estimated relation is not robust and depends on the method and the index used.

For completeness, note that fears were also expressed about the possible negative effects of FDI on developing countries. FDI was sometimes seen as a danger for national industries as it would entail the closing of national companies, thereby increasing unemployment; aggravate the weaknesses of the capital account; and prevent internally led growth. It has also been subject to political criticism, because it has been seen in developing countries as a colonial relic aimed at taking control of national resources. As a consequence, many developing countries passed series of legislations restricting foreign ownership, repatriation of capital, conditioning FDI on performance

requirements and transfers of technology, among others. The official aim was to maximize the benefits of foreign participation in national economies using public policy as a tool to channel investments to critical sectors, gather knowledge and protect the economy from international competition.

FDI Inflows to Arab Countries

The above discussed potential positive effects of FDI on the host economy have widely served as a basis for policies recommending opening up 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 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. Arab countries were not exceptions to this trend. Examples include Algeria, Libya, Egypt, Jordan, Morocco, and Tunisia, among others.

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 have 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 period.

In terms of sector of destination of FDI, available data show that since 2000 the bulk of FDI to Morocco, Saudi Arabia and Tunisia is going to the tertiary sector. The primary sector is receiving no FDI in Saudi Arabia, very little in Morocco, but an important share in Tunisia.

The Research Findings

FDI and growth

Given the above discussed fragility of the relationship between FDI and growth in Arab countries, the research went further to see whether such a relationship depends on the components of FDI. The official benchmark definition of foreign direct investment specifies that a financial-account transaction is counted as FDI if a company's stake in a subsidiary exceeds ten percent. However, this definition pools together two very different forms of foreign investment: Greenfield investment, whereby foreign investors build a new productive unit from scratch, and mergers and acquisitions (M&A), whereby foreign investors acquire existing assets. While the former implies an accumulation of capital, the latter is essentially a transfer of ownership. These two forms of foreign investment are fundamentally different, and there is no reason to a priori think that their effects on host countries' capital stock, productivity, and growth are the same. Hence, accounting for the composition of FDI flows may improve our understanding of the relationship with a country's growth performance.

The results of the econometric analysis confirm that the impact of total FDI on growth is predominantly driven by its Greenfield component. The impact of M&A sales do not have a significant effect on growth. These results resist various robustness checks.

Using the estimation results, scenarios were simulated to better assess the impact of Greenfield FDI on the growth rates of Arab countries for which the data are available. Two scenarios were considered. In the first one, it is assumed that these countries increase their Greenfield FDI inflows by one standard deviation. The second scenario assumes that each country increases its Greenfield FDI inflows by 50%. The difference with the first scenario is that countries that receive more FDI initially should be affected more.

The results show that a standard deviation increase in the Greenfield FDI to GP ratio should lead to an additional percentage point in growth in all countries. The simulation suggests that Lebanon could have added 1.96 percentage points to its growth rate by increasing its volume of Greenfield investment by 50 percent. Jordan and Tunisia could have raised their growth rates by 0.81 and 0.47 percentage points, while Morocco's growth rate would have been 0.21 percentage point higher.

FDI and diversification

As explained above, except for one study (by the World Bank) that suffers from various shortcomings, we are aware of no research investigating the relation between FDI and export diversification. To address the impact of FDI on diversification, we computed and discussed three indicators of the diversity of exports. We, then, tackled the issue of the relation between the two variables.

We measure the diversity of exports using a database of 1345 products and three diversification indexes (Gini, Herfindahl and Theil). The results are broadly similar across indexes. The exports of Arab countries appear as the second most concentrated (least diversified) as compared to other region of the World. Among Arab countries the level of concentration remains very high in Algeria, Bahrain, Qatar, and the United Arab Emirates. Lebanon, Morocco and Tunisia have the least concentrated exports in the Region. Most countries for which data is available for the whole period display a decreasing trend in concentration. The only exceptions are Kuwait, Oman, and Qatar. Overall, in many Arab countries the specialization of exports is much higher than those of emerging countries. Since 1995, diversification has not significantly improved, especially relative to countries like Turkey.

Given the lack of studies on the relation between FDI and diversification, the econometric analysis went deep to examine whether the relation exists in general or depends on the existence of some conditions. To examine the generality of the phenomenon, we used the concept of Granger causality. Overall, the null of no causality cannot be rejected. FDI does not cause diversification. The phenomenon is not general.

To examine whether the relation between the diversification of exports and FDI inflows is conditional, we rely on multiple regression analysis. The change in the diversity of exports, as measured by the three above indexes of diversification, is explained by the host country's lagged value of the relevant index of diversification, degree of freedom of international trade, quality of institutions, availability of infrastructure, human capital and FDI inflows.

Overall, the results are consistent across estimations: Diversity seems to be persistent; improving a country's institutions results in larger diversity of exports; and a better skilled workforce allows a country to diversify its exports. More importantly, the coefficient of FDI is never significant, i.e. regardless of the statistical technique and the measure of diversity used, there is no relation between FDI inflows and the diversity of exports.

Conclusion and Policy Recommendations

The finding that the impact of total FDI on growth is predominantly driven by its greenfield component, while M&A sales do not have a significant effect on growth, has an important policy implication. It simply implies that public policies should target Greenfield FDI instead of M&As.

The finding that no relation exists between FDI inflows and the diversity of exports notwithstanding, our analysis provides interesting results on the determinants of the diversity of exports. We thus find evidence that education and the quality of institutions are robustly correlated with the diversity of exports. Developing education and improving the country's institutional framework may thus contribute to diversifying a country's exports.

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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