

THE IMPACT OF COUNTRY RISK ON FOREIGN DIRECT INVESTMENTS IN THE MENA REGION

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ABSTRACT

This paper attempts to study the impact of country risk on foreign direct investment in the MENA region. FDI operations, in the rest of the world have increased after 2010, while flows to the MENA region continued their downward trend as is exacerbating the economic, political and social conditions. In the wake of the "Arab Spring", the level and composition of FDI flows had been severely affected. In the current international context, especially in MENA region, the understanding of country risk by international investors is extremely important. This paper will firstly present the literature review related to different aspects of FDI and country risk. Secondly, principal concepts on traditional and non-traditional FDI determinants will be presented. Thirdly, an in-depth analysis on FDI in the MENA region will be carried out. Finally, a set of suggestions and recommendations will be presented in order to develop potential strategies attracting and enhancing FDI in the MENA region.

KEYWORDS

Flow of Direct Investment- MENA region- Country risk- Political risk- FDI attractiveness.

1. INTRODUCTION

If during the early 2000s, foreign direct investments flows to the MENA region followed the world trend, the situation has changed in the wake of the "Arab Spring". Indeed, FDI for the rest of the world increased after 2010, while flows to the MENA region continued their downward trend as is exacerbating the economic, political and social conditions. The political and social turmoil affected the level and composition of FDI flows.

Despite the significant increase in FDI during the last decades, the MENA region has disappointing performance in attracting FDI compared to other developing and emerging countries. This lack of performance raises serious concerns with regards to economic reforms that have been implemented by several MENA countries. In addition, the region is expected to attract less FDI inflows in the next coming few years due to current turmoil and instable political and social conditions.

The aim of this paper is, to explain the relationship between the risk of a country and its ability to attract FDI, to examine FDI determinants in the MENA region in order to define and determine the main factors affecting FDI and how a country or region characteristics matters in attracting FDI. The current transition phase in the MENA region goes along with relevant political, social and economic transformations. What would be the immediate and/or the next coming years' repercussions on foreign direct investment in the MENA region?

The main problematic of this study is with regards to the FDI flows to the MENA region after the Arab awakening. The scope of the problem increases during this period of time where the MENA countries are suffering from the political instability and the economic recession.

In this study, we will firstly present the literature review related to different aspects of FDI and country risk, Secondly, principal concepts on traditional and non-traditional FDI determinants will be presented. Thirdly, an in-depth analysis on FDI in the MENA region will be carried out. Finally, a set of suggestions and recommendations will be presented in order to develop potential strategies attracting and enhancing FDI in the MENA region.

1.1 Literature review

Foreign Direct Investment (FDI) is perceived as an important source of investment particularly in developing countries. According to the literature review, the amount of FDI depends on a number of determining factors. The population from which we can determine the market size as well as the growth prospect of the economy is the most important determinant of FDI. It is commonly assumed that, a country with a big market, can grow quickly from an economic point of view and it is further assumed that the country would be able to attract more investors and thus contribute to economic growth¹.

Several conceptual as well as empirical studies carried out in order to clarify and explain the principal economic determinants of FDI. In the eclectic paradigm, Dunning (as cited in Hauser, 2005) summarized the principal reasons why corporations take the initiatives to invest in other countries and expand their market internationally in three categories; Ownership, Location and Internationalization factors (also known as OLI model). Based on OECD and IMF definition for FDI and in light of Dunning classification for the location specific factors, the UNCTAD (2006) categorized the factors affecting FDI into the following determinants: market-seeking, efficiency-seeking, resource-seeking, and created assets-seeking determinants.

¹ZENASNI Soumia and BENHABIB Abderrezzak, The Determinants of Foreign Direct Investment and Their Impact on Growth: Panel Data Analysis for AMU Countries, International Journal of Innovation and Applied Studies ISSN 2028-9324 Vol. 2 No. 3 Mar. 2013, pp. 300-313

Market-seeking determinants are related to the mode of penetration of local market in host countries. Determinants, such as, market size, growth potential and structure of the market help companies expand in international markets. For the measurement of the market size, we usually use GDP and population, while GDP per capita and population growth are used as measures for market trend and potential.

Efficiency-seeking determines the ability of companies to improve their efficiency and creating new comparative advantages in order to enhance their competitiveness, through the international integration of production. Labor productivity, cost of the production factors, manufacturing value added, trade openness, and cost reduction are potential measures for efficiency-seeking determinants. Then, by taking into consideration the efficiency determinants, companies chose to go and invest where the production costs are the lowest.

The most common elements for resource-seeking determinants are the natural resources and the availability of raw materials. However, other resources might help companies to secure their production elements, such as, natural resources and cheap labor forces. Finally, the assets-seeking creation motives enable companies to acquire new assets in the host country.

As any investment decision, FDI is subjected to the risk-return relationship. In the FDI case, country risk analysis is becoming vital for international investors. Different categories of risks are being taken into consideration such as, economic, political, sovereign, capital transfer and exchange rate (Hauser, 2005; Meldrum, 2000; Nordal, 2001; Daniels et al., 2007). These categories of risks are major concern for companies when selecting host countries for investments. On the other hand, better returns, enhancing performances and increasing competitiveness are being used to explain and justify why some international investors are ready to take more risks by investing in countries with high risk. Indeed, international investors may be interested in higher risk investments if they expect higher returns (Brigham & Ehrhardt, 2005).²

Also, there are number of empirical studies that have found that institutional quality (political risk) has a positive relationship with FDI flows. With a sample of 22 developing countries, Gastanaga and al (2006) found that lower corruption and nationalization risk levels and better contract enforcement, associated with a greater FDI flows. Kolstad and Tondel (2004) found that FDI are affected by ethnic tension, internal conflicts and democracy but not by instability of government, bureaucracy, external conflicts, law and order, and military in politics. Lee and Rajan (2009) found that APEC member countries with lower country risk, appear to attract more FDI flows, particularly, they found that political risk is more important component of country risk witch impact FDI more than economic and financial risks.

²Busse, M., & Hefeker, C. (2005). Political Risk, Institutions and Foreign Direct Investment *Hamburg Institute of International Economics Discussion Paper 315*. 26

³The MENA region is comprised 16 countries: Algeria, Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, Yemen

⁴ Burger, M., Ianchovichina, E., and Rijkers, B. (2013) "Risky Business: Political Instability and Greenfield Foreign Direct Investment in the Arab World" Policy Research Working Paper No. 6716, World Bank.

Most previous studies focused on the impact of political risk on FDI flows. However, country risk includes not only political risk but also financial and economic risks, which refers to the ability of a country to repay its foreign liabilities and respect its international engagements.

Several studies addressed multiple determinants of FDI flows, either in the MENA region³ as a whole or in specific parts of the region. Chan & Gemayel (2004) analyzed the role of risk and the instability risk on FDI inflows. They concluded that there is a high correlation between the stability of risk and FDI flows in the MENA region. By comparing the role of risk in MENA countries to a set of developed economies, they also found that the role of risk in attracting FDI is greater in developing countries than in developed countries. In other words, risk analysis is an important determinant of FDI in developing countries rather than in developed countries. Moosa and Cardak (2002), using an extreme bounds analysis, concluded that FDI in the Middle East could be explained in terms of GDP growth rate, spending on research and development enrolment in tertiary education, country risk and domestic investment.⁴

Mina (2007) investigated the determinants of FDI in the six GCC countries and found that oil reserves and oil prices were negatively associated with FDI. He also found a positive role played by measures of institutional quality, trade openness and infrastructure. Chakrabarti (2001) concluded that market size, as measured by GDP per capita is the only determinant of FDI in the MENA region that is not highly sensitive to small changes in the conditioning information set.

2. GLOBAL VISION OF FDI IN THE WORLD

In 2012, FDI inflows decreased in all three major economic groups, developed, developing and as well as in transition economies. In *developed countries*, FDI flows fell by 32% to \$561 billion a level last seen almost ten years ago. The majority of European Union countries (EU) and the United States of America experienced significant drops in their FDI inflows due to the last crisis from 2007 to 2013. FDI flows to *developing economies* remained relatively resilient and stable, declining by only 4%, accounting for 52% of global inflows in 2012. Flows to developing Asia and Latin America and the Caribbean lost some momentum, although they remained at historically high levels. All sub-regions in developing Asia witnessed a decline of FDI inflows in 2012 compared with the previous year. Africa was the only major region to enjoy a year on-year increase in FDI inflows in 2012. FDI flows to *transition economies* declined by 9%.⁵

Table 1: FDI flows by regions between 2010-2012 in Billions of dollars

Region	FDI inflows			FDI outflows		
	2010	2011	2012	2010	2011	2012
World	1409	1652	1351	1505	1678	1391
Developed economies	960	820	561	1030	1183	909
Developing economies	637	735	703	413	422	426
Africa	44	48	50	9	5	14
Asia	401	436	407	284	311	308
Latin America	190	249	244	119	105	103
Transition economies	75	69	87	62	73	55

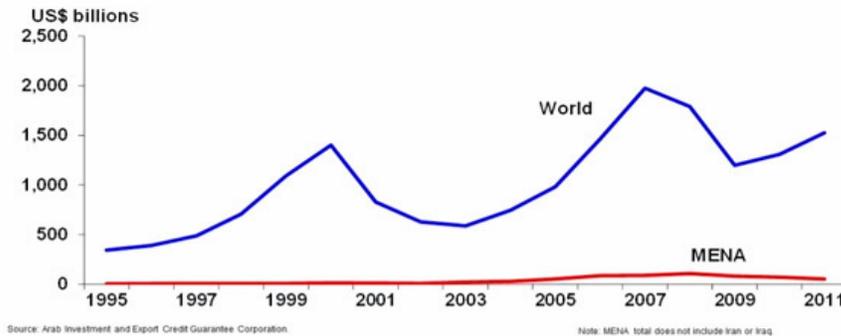
Source: Regional trends of FDI, World Investment Report 2013: Global value chains, investment and trade for development, Page 3.

3. FLOW OF FOREIGN DIRECT INVESTMENT TO MENA REGION

The political and social upheavals that followed the Arab Spring of 2011 continue to threaten the economic activities and near term prospects of the MENA region. Although, political transitions together with promises of greater political and economic freedom in MENA region, the process remains far from complete and has been accompanied with increasing political and macroeconomic instability. Following to the overthrow of the Egyptian government (Morsi government) in 2013, the reluctance is becoming more important, and the international investors considered the country very instable. This situation weighed heavily on confidence in the Arab Republic of Egypt, causing investment and industrial output to plummet in the second quarter of 2013. The escalation of violence and the civil war in the Syrian Arab Republic impacted heavy economic and human toll, with spillovers to neighboring Lebanon, Jordan, and Iraq. Oil production in developing MENA oil exporters – accounting for nearly a third of the region's oil output – has fallen over the past year by slightly more than 5%⁶, reflecting security setbacks, infrastructure problems, strikes, and economic sanctions (embargo) in the case of the Islamic Republic of Iran. Meanwhile, the GCC oil exporters continued to accumulate losses in oil market, while providing financial support to the region's transition economies.

⁵ Regional trends of FDI, World Investment Report 2013: Global value chains, investment and trade for development Page 02.

Figure 1: FDI in MENA region comparative to World



Source: <http://www.divergingmarkets.com/2013/05/08/>

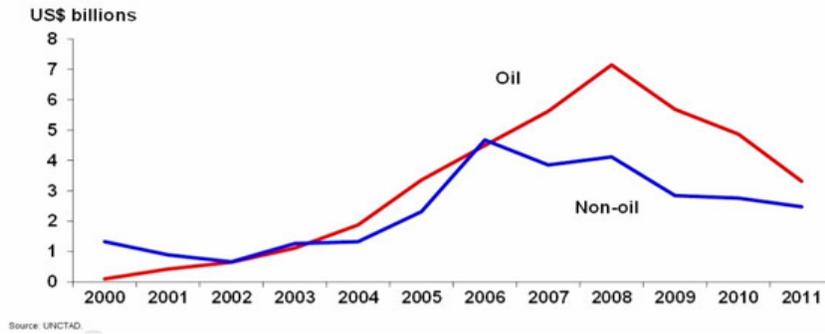
The figure 1 shows that FDI flows to MENA region are so weak comparative to world performance: It can be noticed that, in this region, FDI could not exceed 500 billion USD between 1995 and 2011, while it reached 1500 billion USD in the world in 2011.

Countries in the MENA region do have some similarities in terms of history, culture, language, business practices and governance systems. However, in terms of economic profile, there is a clear difference between MENA countries in terms of countries' gas and oil resources. The region contains seven OPEC members and nine non-OPEC members. For OPEC members, oil and gas remain the largest source of wealth and growth, indeed, they obtain at least 25% of their GDP from oil and gas revenues and have large oil reserves which might last for over than 85 years at current production rates (BP, 2009).

Although, several non-OPEC members such as Bahrain, Egypt, Oman, Syria and Yemen have some oil reserves, these are much smaller and are forecasted to run out within the next 15 years. The other countries (Jordan, Lebanon, Morocco and Tunisia) have no proven reserves of oil and gas that are currently being exploited.

⁶ Economic developments and prospects, World Bank MENA region, October 2013; P 11.

Figure 2: FDI flows for oil and non-oil countries in MENA region



Source: <http://www.divergingmarkets.com/05/08/2013>

The figure 2 illustrates FDI inflows to oil and non-oil countries in MENA region. In this region, we ought not be surprised to find that more of FDI is directed to the oil producers than to the non-oil producers:

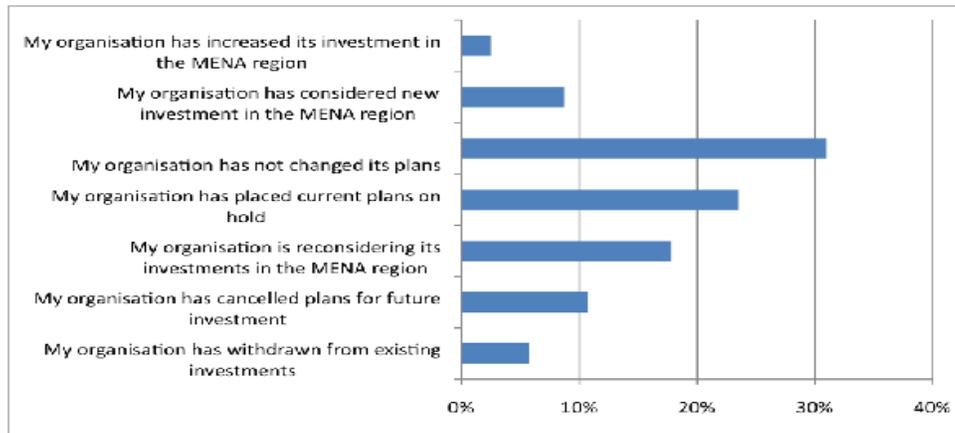
The findings of a foreign investor survey, jointly undertaken in 2011 by the World Bank's MIGA and the Economist Intelligence Unit⁷, that the upheavals did have direct and significant impact on corporate investors' investment intentions concerning MENA: `a quarter of investors put their investment plans on hold, 18% reconsidered their investments, while 11% canceled and 6% withdrew their investments. Whereas, almost a third did not alter their investment plans⁸.

Despite heterogeneity and differences among countries in MENA region, on balance the turmoil has stressed existing investments and dampened plans for expansions and/or new investments. While, there are differences between investors in extractive industries, these differences do not affect the overall results from a representative sample of investors worldwide.

⁷ MIGA, World Investment and Political Risk 2011 (World Bank, Washington DC),

⁸ The survey covered a representative sample of 316 senior executives from MNEs investing in developing countries. The survey was conducted in June-August of 2011. Therefore, the particular questions on MENA involved a self-selection of firms active or intending to invest in MENA; however, these were compared with the global questionnaire for consistency of overall findings

Figure 3: Effect of the recent turmoil in MENA on investment plans in the region (% of respondents)



Source: MIGA, World Investment and Political Risk 2011, World Bank, Washington DC, Report world bank Washington page 23 ISBN:978-0-8213-8850-1 (<http://www.miga.org/documents/WIPR11.pdf>)

For the most part, international investors in the MENA region continue to hold back, following a “wait and see” approach. Growth forecasts, coupled with concerns about security, political violence, and government instability have clearly affected their willingness to boost investments. In response to the developments in the MENA region over the past year, the majority of respondents in the MIGA-EIU Political Risk Survey 2013 expect to make no changes to planned investments across all countries⁹.

The same study found, not surprisingly, that political violence (war, civil disturbance, and terrorism) was the risk of most concern in the MENA region, with almost two third (2/3) of the survey’s respondents citing it as the most important constraint (see figure 4). Interestingly, breach of contract also ranked high. Changes in governments as electoral processes unfold, the emergence of new political actors and the shake-up of the status-quo, coupled with rising public spending, fiscal deficits and economic concerns to have shaken confidence in governments’ willingness to honor their contractual obligations with foreign investors.

⁹ World investment trends and corporate perspectives, Report Multilateral Investment Guarantee Agency (MIGA), 2013, Pages 23- 24.

As illustrated above, the MENA region as a whole witnessed a rebound of 43% in inward investment in 2012, especially in Egypt, before declining by 15% amidst renewed uncertainty. Despite the stated concerns, it seems that international investors were willing to return quickly to this anchor market. This raises questions as to whether such behavior could be repeated once the dust settles in the region as a whole. Do these surveys understate the preparedness of investors to return?; with the resurgence of uncertainty in Egypt, would international investors likely to jump back again so suddenly a second time?; breach of contract and adverse regulatory changes were also cited as the most important risks in the GCC countries by survey respondents. Given that, these countries were not undergoing political transitions in the same manner or magnitude as other countries in the MENA region. The findings suggest that such perceptions have not been triggered by recent events. The majority of the survey respondents did not see an increase in the breach of contract risk for this group of countries, which suggests that it may have been present for some time.

Table 2: Ranking of the most important political risks in MENA (percent)

Risks	North Africa	Middle East	GCC
Expropriation	7	4	9
Terrorism	14	11	10
NHFO(Non-honoring of financial obligations)	5	6	10
War	51	55	13
T&C restrictions	4	10	15
Breach of contracts	13	10	17
Adverse regulatory changes	6	9	26

Source: World investment Trends and corporate perspectives, Report Multilateral Investment Guarantee Agency (MIGA), 2013, Page 24

The perception that breach of contract risk in developing economies in the MENA region has been increasing is noteworthy, since most of the focus to-date has been on the risk of political violence. Governments are treating new and/or existing contractual obligations, and are most concerned that this risk may be on the rise. This is especially evident in North African countries, where the majority of respondents indicated a significant increase in this risk. Nevertheless, it might be more likely in reference to specific countries.

An important feature of FDI flows to MENA region is that, they are mostly focalized on the natural resource and non renewable energy sectors. During the period 2003-2012, these two sectors received nearly 50% more FDI flows than tradable non-resource manufacturing and commercial services¹⁰. Furthermore, countries with strong R&D capabilities did not invest in the non-resource manufacturing sectors but they concentrated their investment in natural resource sectors. Thus, the MENA region missed opportunities and largely failed to attract the high quality FDI extremely necessary for sustainable economic growth and development, export upgrading and fighting unemployment.

3.1 The impact of the political instability on macroeconomic fundamentals

Macroeconomic indicators are very sensitive to political and social instability. To respond to social demands, governments increase current public spending, including subsidies, wages, pensions and public sector employment. The increased spending stoked inflationary pressures, while weaker currencies exacerbated the situation, especially in the Islamic Republic of Iran, Syria, and Egypt. In 2012, the Islamic Republic of Iran had one of the highest inflation rates in the world, and flirted with hyperinflation in October 2012. Inflationary pressures persisted due to trade sanctions and currency depreciation. Cash transfers also stoked consumption and prices hiked. In Syria, inflation continued to rise as the civil conflict deepened, the economy contracted and the government monetized its large fiscal deficits.

In Egypt, inflation has risen since the end of 2012, as food and energy prices increased, the currency depressed in the context of growing macroeconomic and political instability. In Morocco, inflation has been moderate, but rising more and more. Despite generous price subsidies and a decline in world prices of imported basic commodities, inflationary pressures in Morocco rose in the first half of 2013. Thus, put further pressure on price increases in education and transport services, food, and restaurants.

Tunisia, the recent upward inflationary pressures resulted from the increase in food and fuel prices and amplified by the currency depreciation. The tightening of monetary policy in late 2012 has managed to slow the upward trend. Inflationary pressure subsided in Jordan as the effects and results of the fuel subsidy reform dissipated. Despite the government policy on wage increase, in order to increase workers' purchasing power, inflation remains relatively low in Algeria. Nevertheless, inflationary pressure has been rising recently. To alleviate and counter the pressure, Bank of Algeria implemented various measures by raising reserve requirements and absorbing liquidity¹¹.

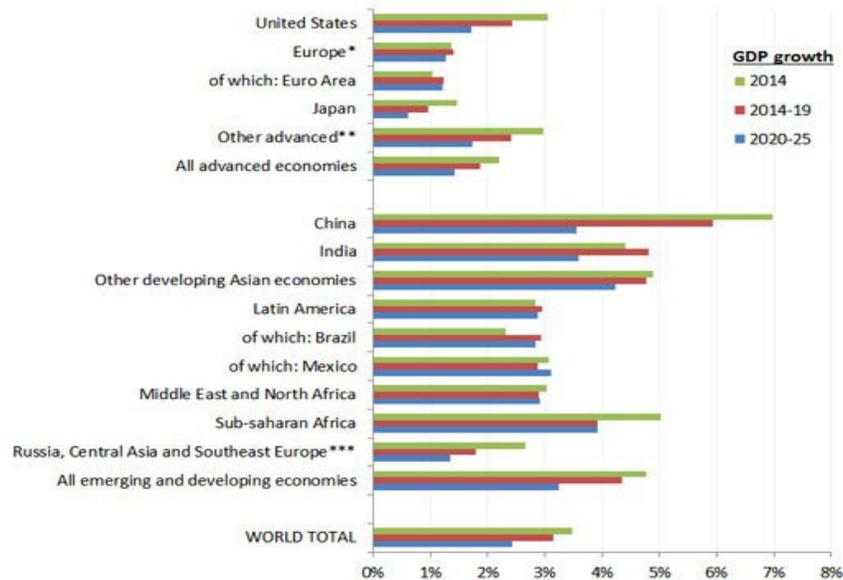
Credit rating agencies have exacerbated the economic instability of MENA countries. Indeed, they have given low sovereign credit rating to most MENA countries. Thus, most MENA countries face difficulties to access to international capital markets. As a result, macroeconomic conditions deteriorate and persistent political instability and policy uncertainty resulted in rising risks, and hence foreign borrowing costs, especially for Egypt and Tunisia.

During the 2000s, corruption and taxes were most widely cited as major constraints to private sector growth in the region. After the Arab Spring, the constraints were the same, concerns about corruption have become even more pronounced, while political instability has become the second most cited problem impacting the business environment. Nearly 65% of business owners in MENA region complained about political instability and institutional weaknesses¹².

¹⁰ Regional Economic Outlook report: Middle East and Central Asia, World Economic and Financial Surveys, International Monetary Fund, November 2013

The Conference Board, Global Economic Outlook 2014, is a prestigious conference that provides projections for the output growth of the world economy for 2014-2019, and 2020-2025, including 11 major regions and over fifty individual mature and emerging economies. For the MENA region, the conference projections confirm that Global Outlook for the GDP growth for the period 2014-2025. For this period, the GDP expected not to exceed 2.9%¹³ as illustrated in figure 4.

Figure 4: Global Outlook for Growth of Gross Domestic Product (2014-2025)



¹¹ Regional Economic Outlook report: Middle East and Central Asia, World Economic and Financial Surveys, International Monetary Fund, November 2013

¹² Regional Economic Outlook report: Middle East and Central Asia, World Economic and Financial Surveys, International Monetary Fund, November 2013

¹³ <https://www.conference-board.org/data/globaloutlook.cfm> (The Conference Board Global Economic Outlook 2014)

Source: <https://www.conference-board.org/data/globaloutlook.cfm> (The Conference Board Global Economic Outlook 2014).

MENA countries might get into a resource trap unless if they manage to strengthen public institutions, improve business and investment climate, especially political and macroeconomic stability.

To encourage and attract international investment, it would be a priority to protect the rule of law, property rights and ensure transparent policies, especially international investment in the labor-intensive, non-oil sector, industrial and manufacturing, as well as the service sectors. Hence, job creation, economic growth and social development, and structural reforms. Political reforms are a necessary pre-requisite for sustainable high level of growth in developing MENA region.

4. CONCLUSION

Political risk and uncertainty are characterizing the global market, especially in the MENA region. The majority of governments in MENA countries (in Tunisia, Libya, Egypt, and Yemen) have been overturned. While Syria, Lebanon, Iraq, and Bahrain still are in turmoil. In addition, the Israeli–Palestinian conflict and the confrontation over Iran’s nuclear program are far from settled. These developments and transitions have a large impact on the business environment and investment activities throughout the region, as old trading routes are no longer safe and international investors and tourists avoid the instable regions.

MENA countries seem to be facing several economic challenges such as, high unemployment rates, volatile economic growth, inefficient public sector and under-developed financial sector.

To overcome the challenges motioned above, FDI is considered as one of the main options to establish economic growth and improve the quality of business environment. Reforms will be necessary to undertake in order to move from monopoly state and massive public sector to efficient private sector.

Serious competition seems to be rude from developing and emerging countries, especially from Latin American and Asian economies. Comparatively to those countries, the current performance of the MENA region to attract FDI is not impressive. In addition, the current revolutions and political changes that are taking place in MENA region would be more important and may affect FDI inflows to the region in the coming few years and that might highlight the importance of such study. In this context, studying and analyzing the impact of country risk on foreign direct investment and the relationship between risks and international investment especially in MENA region will certainly be of interest. It will certainly contribute to better understanding and further academic research in the area.

To deal with the various challenges, MENA countries should take into consideration some reforms and long medium strategies such as: promoting and encouraging regional trade, integration and intraregional FDI, expanding investment protection instruments and political risk insurance mechanisms that guarantee business and investment activities and cover reimbursement in case of claims. Formulating policy frameworks to improve investment climate, emphasizing the rule of law and the independence of regulators, reducing restrictions on capital and profit transfers, fighting corruption, ensuring transparency, and setting appropriate dispute resolution bodies.

Diversify economic activities is vital for the majority of MENA countries. Indeed, the dependence mostly on the energy sector increases the fragility of their economies. Furthermore, multiply investment agreements would promote sector-specific awareness programs, encouraging regional and international economic and trade integration.

Experienced international investors have learned that political risk is an inherent characteristic of the MENA region and of emerging markets in general, and it is unlikely to change and improve in the foreseeable future. Therefore, rather than waiting for some indefinite political endgame to materialize, these companies analyze the specific political and regulatory risks they might face in various markets and adapt their strategy to suit the circumstances ¹⁴.

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