Chapter 12

Effects of Economic and Political Risks on Foreign Direct Investment: A Panel Data Analysis in MENA Region

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ABSTRACT

The chapter identifies the main determinants of FDI and the factors that constitute the main obstacles to foreign investment attractiveness in a region affected by economic and political instability and even conflict and where investors may face a multitude of political, economic, and security risks. The sample includes 14 Arab countries over the period of 2003-2017. To determine the factors that explain the probability of attracting investment inflows in MENA countries, the study uses a multiple regression model to estimate data in a time series. The authors also use the World Bank’s governance indicators to assess the quality of the Arab institutional framework. The results of the panel data estimates through three different regressions reveal that macroeconomic instability combined with political instability constitutes an obstacle to investment. On practical implications, the study suggests that, in general, economic managers should take some economic policy measures to reduce or mitigate risks to encourage foreign investors to invest in MENA countries.

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Effects of Economic and Political Risks on Foreign Direct Investment

INTRODUCTION

Since the 1980s, foreign direct investment (FDI) flows have become a key growth driver for developing countries. In this context, several studies have focused on the determinants of foreign direct investment and several questions have arisen to provide some clarification on this matter.

Many researches on the subject show that FDI has a positive overall effect on the economy (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004; Borensztein, De Gregorio, & Lee, 1998; Erokhin, 2016a, 2016b, 2017; Prabhakar, 2016, 2017, 2018; Gupta, Kangur, Papageorgiou, & Wane, 2014; Li & Liu, 2005). Indeed, the role of FDI is becoming increasingly important, since it contributes significantly to host countries’ economic growth and development. Large flows of FDI are now a feature of the globalized economy and policymakers are competing to attract long-term investment. In recent decades, FDI flows to host countries have increased, particularly, in countries that have undertaken economic and political reforms and have seen their economies become more open to international trade. More specifically, FDI provides recipient countries with the capital flows, technological know-how, human capital development, and management skills necessary for sustainable economic development. FDI provides valuable capital to stimulate economic growth and development and thus enables the transfer of technology and knowledge to host countries.

Nevertheless, if several researchers have explained the determinants of FDI in stable and developing countries, only few studies have examined the relationship between FDI and macroeconomic aggregates in a context of political uncertainty, an issue which remains underexplored. In this context, some scholars have shown that there is a negative correlation between incoming FDI flows and the number of strikes, corruption, political stability and the quality of legislation (Schneider & Frey, 1985; Wheeler & Mody, 1992). Further, other studies have shown that political uncertainty has negative effects for some countries by discouraging savings and foreign direct investment by destroying trade with other countries (Ades & Chua, 1997). From the perspective of Arunatilake, Jayasuriya, and Kelegama (2001), political instability has economic costs such as lost income due to reduced domestic and foreign investment. Fosu (1992) also studied the effect of political instability on growth in Sub-Saharan African countries and the results of the study confirmed that political instability has a negative impact on economic growth. In the Franco-Prussian example of Devereux and Smith (2007), the effect of wars on production and consumption movements was considered mandatory to adapt to German and French macroeconomic history between 1871 and 1873.

Some other studies such as Abu-Bader and Abu-Qarn (2003), Aizenman and Glick (2006), and Deger (1986) have provided evidence of the negative effect of military spending on economic growth. Political uncertainty can lead to increased military spending, lower investment and also savings, which can hinder economic growth (Abu-Bader & Abu-Qarn, 2003; Arunatilake et al., 2001; Deger, 1986). In the Arab context, Ades and Chua (1997) noted that there were several countries that had suffered economic consequences due to political uncertainty, such as Jordan. Faced with political instability, the country suffered during the Gulf War (1990-1991) from the loss of tourism, falling exports, and a decline in gross domestic product (GDP). As a result, excessive government consumption reduces economic growth in the country (Barro, 1990; Grier & Tullock, 1989; Landau, 1983) and also excludes private investment (Argimón, González, & Roldán, 1997). FDI has increased significantly worldwide and that some emerging economies have been successful in attracting more FDI. Their empirical results confirm that a favorable institutional environment plays a key role in attracting foreign investment. In this context, such research on the economic, political, and institutional determinants of FDI is all the more