Chapter 33
Economic and Political Factors Affecting Foreign Direct Investment in the MENA Region

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ABSTRACT

This study examines the relationship between variables thought to have an effect on foreign trade investment (FDI) including volume of trade, GDP growth rate, trade credit risk and political stability. Specifically, this study is concerned with the 1981-2012 period in the MENA region, made up of the Middle East and North African countries of Algeria, Bahrain, Egypt, Jordan, Morocco and Tunisia. Another objective of the study is to determine whether economic factors are more impactful than political factors on the FDI flow to MENA countries. In order to investigate long-term relationships between the variables, three cointegration analyses were used including Pedroni, Kao and Johansen, and Fisher. Coefficients were interpreted using the FMOLS and the DOLS methods. The Holtz-Eakin Causality Test was also applied. As a result of the analysis, volume of trade was found to be the most important factor determining FDI. Economic factors were found to be more influential for FDI than political factors.

INTRODUCTION

Changes in the world economy and politics in the last quarter of the twentieth century have brought new geographies to the fore. This study examines the Middle East and North Africa (MENA), where world politics and economy have been continuously shaped from the past to the present. In this region where changes are occurring and new balances are being sought, the main determinants of foreign direct investment (FDI) are analyzed. In addition, the hypothesis that economic factors are more impactful on the FDI flow to MENA countries than political factors is tested.

This empirical analysis explores the FDI flow to the MENA countries of Algeria, Bahrain, Egypt, Jordan, Morocco and Tunisia during the period 1981-2012. It investigates the effects of economic variables in conjunction with political stability, on FDI in these countries. Volume of trade, growth in gross

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domestic product (GDP) per capita, and trade credit risk are the economic variables in the study. In the framework of the results gathered from the analysis, the study gives solutions and recommendations and makes future assessments.

Importantly, the impact of trade credit risk on FDI is analyzed as an economic indicator for the first time in this discussion. A further contribution to the extant literature is that this is the first empirical study which considers the effects of the political stability factor on FDI inflows to the MENA countries together with political developments such as the Arab Spring. Against the backdrop of the MENA region, this study defines FDI and introduces its importance. The major factors that determine FDI inflows into a country are discussed accompanied by a thorough literature review. Information about the empirical methodology and data are given and the empirical analysis results are evaluated. Finally, solutions, recommendations, future trends and conclusions are mentioned.

BACKGROUND

FDI involves the establishment of a new company, the acquisition of an existing company, or the increase of one's capital in foreign countries. Foreign capital intends to achieve high profits. In making investment decisions, it considers the country's growth performance together with economic and political risks. Therefore, low risk countries with high growth rate or potential are expected to attract more foreign capital (Ağayev, 2010).

There are factors related to the economic, political, and investment climate which influence FDI: market size, openness index, tax burden, labor costs, skilled labor, natural resource stocks, technology level, exchange rate, inflation rate, population growth rate, unemployment, rate of growth, macroeconomic stability, trade risks, political stability, bureaucratic structure, institutional and social structures, transparency, transportation costs, and infrastructure are some of these factors.

Many studies point to the host country's market size as an important factor in FDI decisions. Alam and Shah (2013) investigate potential determinants for FDI in their panel data analysis of 10 OECD countries. They conclude that investors are influenced by variables such as market size, labor costs, and the quality of infrastructure, and that policies should be implemented to improve infrastructure and reduce labor costs. In the short term, there is a bi-directional relationship between market size and labor costs. Quality of infrastructure affects labor costs and market size in the short term. Zang and Markusen (1999) also conclude that market size and labor force are influential factors in FDI.

High population and a high population growth rate can be considered as factors encouraging FDI since they influence consumer demand in the domestic market and reflect the size of the market. However, they may have a weak effect on FDI depending upon purchasing power and GDP per capita. Resmini (2000) concludes that Central and Eastern European countries with a high population are able to attract more FDI flows than those with low population. According to Erçakar (2004), demographic factors of the countries are closely related to the degree of FDI that is likely to enter the country. It is generally accepted that FDI providers seek countries with a high rate of population growth, high unemployment, and low domestic investment, as labor costs tend to be cheaper.

According to Carr, Maskusen, and Maskus (2004), FDI providers from the United States choose countries with skilled labor while FDI providers from other countries choose developing countries with less skilled labor. This choice made by countries other than the United States shows that investment in other countries follows an approach based on low level of wages. Açıkalın, Gül, and Yaşar (2006),