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Foreign direct investment in MENA: Impact of institutional context*

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1. Summary

This policy brief summarizes the findings from a study on the determinants of greenfield investment in the Middle East and North Africa region (MENA). The results point out that institutional deficiencies deter foreign direct investment in the region and in particular, for the main oil producers within this region. Improvements in the areas of democratization, institutional quality and violence reduction would undoubtedly make the region more attractive to foreign investors.

2. Introduction

Foreign Direct Investment (FDI) can be broadly divided into greenfield investments (i.e. the creation of a new firm in the host country), and Merger and Acquisitions. In Middle East and North Africa (MENA) region1, greenfield investments represent more than 80% of the FDI projects during the period 2003-2012 in most countries of the region. According to data from FDIMarkets from Financial Times, these new foreign firms directly created more than 50,000 jobs in Algeria, Egypt, Morocco, Saudi Arabia, Tunisia and United Arab Emirates. In some MENA, greenfield investments represent more than 3% of the GDP, that is a larger weight than in other developing countries. However, Iran, Kuwait, Lebanon, Saudi Arabia, Syria and Yemen have not been able to reach this share. Moreover, in contrast with other developing countries, the beginning of the Western Economic crisis and the Arab Spring have significantly affected the inward FDI in the region and, in most countries, these investments no longer overpass the threshold of 3% of the GDP (see figure 1).

Overall, FDI might be an important source of development and welfare improvements for host countries by fostering economic growth, productivity, technology diffusion, global value chain participation and employment. In developing countries, the capacity to attract FDI can contribute to its economic and democratic development (Paniagua & Sapena, 2014). For instance, Syria's reconstruction and development after the war will most likely depend on foreign capital, and in particular FDI will be central on developing a productive structure that will ensure welfare. Additionally, in countries like Egypt, Tunisia, Oman or Morocco in which unemployment is particularly high, FDI could re-

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present a relevant source of employment. Similarly, FDI could play an important role in reducing unemployment within the youngsters which fluctuates around 30%.

The aim of this work is to outline how institutional factors affect the capacity of MENA countries to pull FDI. According to Méon and Sekkat (2004), institutional factors have limited a larger participation of the MENA region in the world economy. Moreover, this region is characterized by a strong local ruling power in which patronage networks are common and developed private sector is an exception (Malik & Awadallah, 2013). Institutions may impede the entrance of foreign firms that may challenge this status quo.

In comparison with previous works that focus on MENA (e.g. Helmy, 2013; Méon & Sekkat, 2004; Rogmans & Ebbers, 2013), the present study has several new aspects. First, it looks into the differences in the FDI determinants between those countries for which oil production plays a relevant role and those for which it does not. This distinction is of great relevance since oil production plays a prominent role in most MENA and there is evidence that indicates that it may alter the relationship between FDI and institutions (e.g. Asiedu & Lien, 2011). Secondly, the study does not rely on aggregate FDI inflows but on bilateral greenfield investments, the main source of FDI into the region. Thanks to these bilateral data, it is possible to estimate a gravity equation at the world level taking into account specificities of each country and of each pairs of countries. Besides, this dataset allows us to study the relevance of institutions on two complementary indicators: the multinationals' decision to invest and the volume of investment. Thirdly, the study considers several indicators of quality of institutions such as the impact of corruption, rule of law, instability, violence and ease of doing business.

As reported in tables 1 and 2, MENA'S level of democracy, political instability and degree of violence stand out from the rest. In fact, these countries suffered from 69% of the total number of terrorist attacks that took place between 2003 and 2012, and the region is also characterized by a high rate of violence in neighbor countries. However, the number of days needed to start a business is lower in MENA, on average, than in other developing countries but higher than developed countries. In terms of rule of law and lack corruption they also perform better than the rest of developing countries.

Figure 1: Greenfield investment as a percentage of GDP

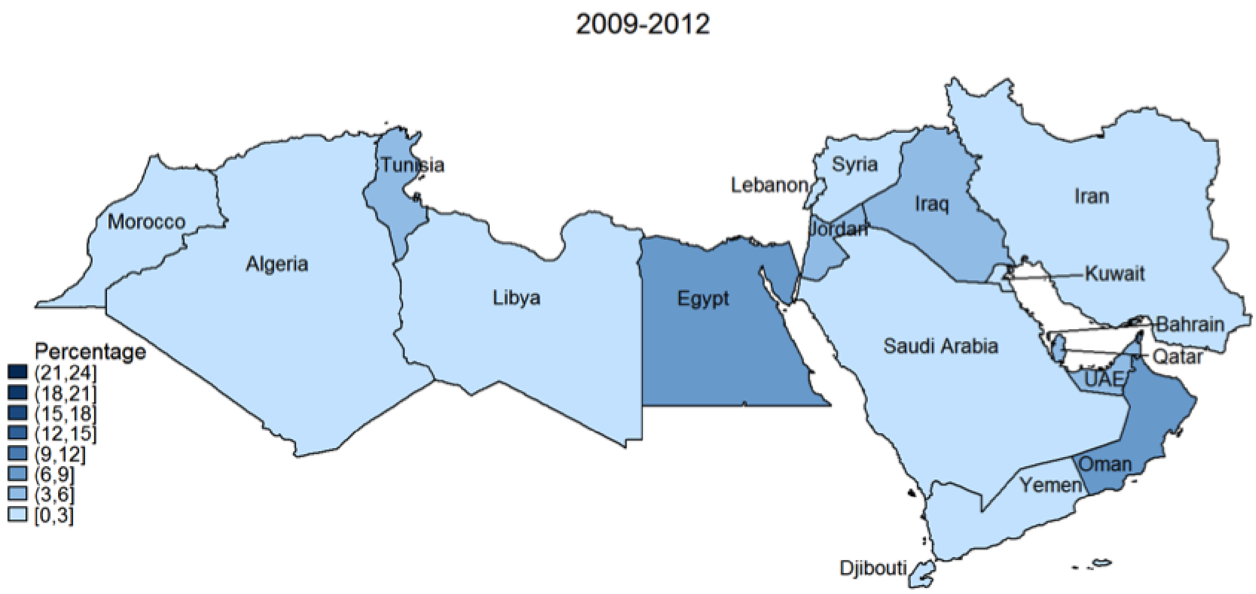

Table 1: Institutional indicators

	Democracy	Compliance with rule of law	Lack of corruption	Days for starting a business	Procedures for starting a business
MENA	-4.37	-0.23	-0.24	26.02	9.70
Rest of Developing countries	3.23	-0.47	-0.39	51.18	9.71
Developed countries	9.73	1.21	1.21	20.36	6.15

Sources: Democracy index is retrieved from Systemic Peace, it takes -10 for full autocracies and 10 for full democracies. Rule of law and corruption go from -2.5 to +2.5, going from less rule of law/more corruption to more rule of law/less corruption, together with days and procedures for starting a business are retrieved from the World Bank. Averages are calculated for the period 2003-2012, except for days and procedures for starting a business which are based on the 2004-2012 average.

Table 2: Political stability and violence

	Political stability	Total civil violence	Total violence	Terrorist attacks	Total violence from neighbor countries
MENA	-0.46	0.26	0.54	5.64	4.19
Rest of Developing countries	-0.34	0.55	0.58	0.41	2.47
Developed countries	0.78	0.06	0.13	0.04	0.63

Sources: Political stability is retrieved from the World Bank; it ranges from -2.5 to +2.5 (from instability to stability). The violence indicators are from Systemic Peace. The average is calculated for the period 2003-2012.

3. Methodology

We estimate an augmented gravity model in order to analyse the effect of several variables on the number and value of greenfield investment projects. In addition, we explore the impact of holding natural resources on the nexus between the institutions and FDI. In particular, we distinguish among MENA countries which produce few oil (Djibouti, Jordan, Lebanon, Morocco and Tunisia) and the MENA oil producers (Algeria, Bahrain, Egypt, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen). Following Silva and Tenreyro (2006), the following non-linear baseline equation is estimated:

$$FDI_{ijt} = e^{\left(\begin{array}{c}\beta_1 \ln(GDP_{it} x GDP_{jt}) + \beta_2 ln(D_{ij}) + \beta_3 contig_{ij} + \beta_4 colony_{ij} + \beta_6 lang_{ij} \\ + \beta_7 smctry_{ij} + \beta_8 rel_{ij} + \beta_8 FTA_{ijt} + \beta_{10} BIT_{ijt} + FE_i + FE_j\end{array}\right)} + \varepsilon_{ijt}$$

where FDI_{ijt} is the aggregate investment between home country i and host j in year t; GDP_{it} and GDP_{jt} are the GDPs of home and host countries, respectively; D_{ij} is the distance in kilometers between country capitals; $contig_{ij}$ (Contiguity) is a dummy that indicates whether a pair of countries share a common border; col_{ij} (Colony) is set to one if the two countries have ever had a colonial link; $lang_{ij}$ (Common Language) takes positive value if both countries share the same official language; rel_{ij} (Religion) is a composite index which measures the religious affinity between country pairs with values from zero to one; $smctry_{ij}$ (Same Country) indicates if both countries were part of the same country in the past; FTA_{ijt} (Free Trade Agreement) is a dummy that indicates if both countries have a free trade agreement in force; BIT_{ijt} (Bilateral Investment Treaty) is a dummy that takes a value of one if the country pair has a bilateral investment treaty in force; lastly FE stands for host and source country fixed effects, and year fixed effects and$\varepsilon_ij$trepresents an stochastic error term. In order to address the role of institutions and its different impact in MENA oil producers and non-producers, we add the institutional variable and we interact it with dummies which separately identify both group of countries.

The data on greenfield investments come from FDI Markets from Financial Times. This source is the official source of greenfield data used by UNCTAD's World Investment Report and the Economist Intelligence Unit. Moreover, a growing strand of research is also using it. Regarding institutions, we include in our analysis lack of corruption, rule of law and political stability which are retrieved from the World Bank Worldwide Governance Indicators. Ease of doing business is measured by the number of days and procedures for starting a business also retrieved from the World Bank. Then, the democracy, civil violence, total violence and terrorist attacks measures are from Systemic Peace. Our dataset covers 160 countries during 2003-2012.

4. Results

Our results show that greenfield investments in MENA are significantly more sensible to cultural ties between the investing country and the host country than other regions: religious and linguistic links foster investments in these countries more than in any other region. FTA appears to only have significant negative impact on MENA non-oil producers. Though, this results should be interpreted cautiously since the variable FTA may fail to capture the specificity of each Euromed agreements. Then, BIT appears to only foster FDI into non-oil producers.

As far as institutional context is concerned, democratization, lack of corruption, business freedom, compliance of rule of law, ease of doing business, political stability and reducing violence would foster FDI into the region. The positive effects from these reforms are particularly relevant for MENA oil producers. For instance, in the case of democracy, for the year 2012 if Algeria had increased its level of democracy to the one of Ecuador, greenfield investment inflows and projects would have increased by almost 44% and 28% respectively.

One percent improvement in rule of law would significantly foster MENA countries' capacity to captivate FDI by 4.5%, on average, the number of projects these countries receive, and reducing corruption would imply a 1.9%-2.1% increase. In terms of ease of doing business, one extra day would decrease the number of projects by approximately 0.4%. Furthermore, oil producers would particularly benefit from a reduction of the number of procedures necessary for opening a business: a country like Kuwait may increase the number of FDI projects by 7% by reducing the number of procedures from 12 to11.

Political stability and violence play a prominent role in MENA countries' capacity to attract greenfield FDI. For example, if Algeria were to improve its political stability to the level of Venezuela in 2012 the increase in terms of number of projects would be of approximately 14%. Violence is an important source of instability and deters FDI into the region regardless if it refers to civil violence, total violence or terrorists' attacks. However, this negative impact is not only limited to the violence suffered domestically. In contrast, to the rest of the world, FDI into MENA countries is also deterred by the level of violence in neighbor countries. In other words, FDI which fly away from violent countries do not plan to invest in the neighborhood, as they do in other part of the world, but choose to abandon the region.

5. Conclusion

The relationship between the considered institutional aspects appear to play a prominent role in shaping MENA countries' attractiveness for new FDI projects, while in terms of volume of investment they play a secondary role. Moreover, the institutions-FDI relationship also appears to depend on the natural resources hold by a country. Oil producers are more likely to gain from democratization and institutional quality improvements.

6. Implications and Recommendations

A low level of democratic political participation boosts social tensions, which in turn increase the likelihood of bringing severe political and social crisis to a country. Moreover, autocracies are more likely to be characterized by government's lack of transparency and a higher rent seeking behaviour. These aspects deter FDI. It would be advisable to gradually improve the plurality and political participation in MENA countries as part of a smooth transition; from autocracies towards democratic models which fit with each society particular characteristics.

Concerning the influence of quality institutions, relevant potential gains could be obtained in terms of foreign investments, particularly in MENA oil producers. It would be recommendable to improve the compliance of rule of law and to reduce corruption: the lack of a solid rule of law and the existence of systemic widely spread corruption severely hampers the willingness and capacity of Multinational firms investing in a given host country. These shortcomings not only represent an extra cost for multinationals, but also prevent them from developing high value added activities. Improving contract and law enforcement, property rights, safety of investments' guarantee, transparency and independence of the judicial system are some examples of measures that should deserve more attention of MENA policymakers.

Increasing the ease of doing business is a task that should be tackled by MENA: one of the options worth considering could be to reduce the cost and time necessary for starting a business by simplifying and unifying procedures, allowing making online registration, reducing the minimum capital requirement and reducing the time necessary between procedures. Moreover, governments should be advised to ensure that procedures necessary for starting a business do not become, or remain as, a method of enforcing corruption.

Political stability plays a central role in host countries' capacity to attract greenfield investment. This aspect should be taken into consideration by those countries currently going through transition: transition regimes would have to pay, in the short term, a high cost in terms of attracting foreign investments and political stability should be achieved as soon as possible. In terms of violence, campaigns are needed to inform on the situation of each country. Violence does not only have a negative impact on the host country, but also displaces investment out of the region. Investors consider more likely the contagion of violence to neighbor countries within MENA compared with other regions in the world. In order to attract FDI, regional, internal and external peace should occupy a central role in policy. MENA countries should dedicate larger efforts in positioning their selves as safe and stable, despite neighbors' instability. All in all, without peace in the region, accompanied by the positive expectative from investors, economic prosperity will be hampered and greenfield investment will decrease.

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