

Financial Development, FDI and Governance in Mena Region

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Abstract: The aim of this study was to investigate the role of the relationship between financial development (FD), foreign direct investment (FDI) and governance in the Middle East and North Africa (MENA). The survey is done by using the Dynamic panel data model within the years 2002-2011. The result of this estimation indicates that governance stability is highly significant determinants of financial development into the MENA countries. In addition each level of financial development is now associated with higher level of FDI inflow. Therefore, policies to improve Furthermore inflowing the foreign good and capital and making competition in the countries of sample, reduce the negative impact of governance on financial development in the region are suggested.

Key words: Financial Development • Foreign Direct Investment • MENA Region • Dynamic Panel Data Model

INTRODUCTION

Foreign direct investment (FDI) is a key element of the global economy. FDI is an engine of employment, technological progress, productivity improvements and ultimately economic growth. FDI provides both physical capital and employment possibilities that may not be available in the host market. More importantly, FDI is a mechanism of technology transfer between countries, particularly to the less-developed nations. Because of these significant benefits, attracting FDI has become one of the integral parts of economic development strategies in many countries.

The role of foreign direct investment (FDI) in the last decade became more important even the political speech often stressed the attraction of FDI as a key component of the claim for development and particularly the fight against poverty. On the other hand argue that a stable political scenario is critical to attract FDI even in the presence of an Efficient Financial sector.

In the presence of the corporate control by the financial elite, many economists believe that the inflow of foreign goods and capital can play a crucial role to develop financial markets. To survive under vigorous foreign competition, the entrenched elite have no choice

other than to eliminate unnecessary financial regulations and support the institutions necessary for a more competitive domestic market. Financial markets have been held back, because of its reliance on political goodwill for its infrastructure. The threat primarily comes from incumbents, those who already have an established position in the marketplace and would prefer to see it remain exclusive. The identity of the most dangerous incumbents depends on the country and the time period, but the part has been played at various times by the landed aristocracy, the owners and managers of large corporations, their financiers and organized labor.

In an early review of studies on political risk, [1] concluded that the empirical evidence is inconsistent and mixed regarding the effect of political instability on FDI stocks or flows. Later econometrics studies continued to produce mixed finding. For example, [2] found that political instability had a negative effect on FDI flows [3]. failed to find statistical association between political stability and FDI. First attempt was made by Jun and Singh (1996), who regressed an aggregated indicator for political risk, based on a number of sub-components and several control variables on the value of foreign direct investment inflows. For their data sample of 31 developing countries, the political risk index is statistically significant and the

coefficient implies that countries with higher political risk attract less FDI. Likewise, Gastanaga *et al.* (1998) examined the link between various political variables and foreign investment inflows. They found that lower corruption and nationalization risk levels and better contract enforcement are associated with higher FDI inflows. Yet they state that their findings do not always hold up, which may be due to the relatively small country sample of 22 developing countries.

More recently, several studies have analyzed the relationship between fundamental democratic rights and FDI: Using different econometric techniques and periods, Harms and Ursprung (2002), [4] and [5] found that multinational corporations are more likely to be attracted by countries in which democracy is respected. Li and Resnick(2003), on the other hand, argue that competing causal linkages are at work. They found that democratic rights lead, above all, to improved property rights protection, which in turn boosts foreign investment. Apart from this indirect impact on FDI, increases in democracy may reduce FDI. These studies use pooled time-series analysis, but not all of them account for possible endogenous entity of the independent variables. Moreover, they often concentrate their analysis on very specific indicators, such as democratic rights, leaving out a broader range of other elements of policy-related variables.

In this paper, we focus on the experience of countries in Middle East and North of Africa. We test the effect of foreign direct investment, financial development and governance in 10 MENA's countries from 2000 to 2011. We use panel estimators from Arellano and Bond (1991) and Blundell and Bond (1998) to confront potential econometric pitfalls like country specific effects and reverse causation. The paper proceeds as follows: section two comprises a brief survey of related literature and it addresses mainly the theoretical and empirical issues. Section three considers methodology and data while the fourth section is discussion of empirical results. Section five is the last section and is made of conclusion and discussion.

Literature Review: Some literatures have investigated the effect of FDI on economic growth and financial development on economic growth. However a few studies have examined the interaction between FDI and financial development. More importantly, previous studies rarely examine how FDI and financial development would interact in the presence of political corruption and corporate control by a entrenched elite.

[6] study the role of financial intermediaries to economic growth and legal issues facing intermediaries and accounting system of companies to use services of intermediaries. The obtained results is that reducing legal restrictions to financial intermediaries and using electronic accounting systems increase foreign trade and therefore, causes to economic growth. Studies by Glaeser *et al* (2000) on Asian countries and Barca and Becht (2001) and Faccio and Lang (2002) on European countries support detrimental effect of financial elite on financial development. Thus La Porta *et al* (2000) stress that development of financial markets need some outside stimulus from courts, governmental agencies or other market participants. They point out that the integration of world capital markets cause to reform financial markets more likely. [7] used a panel of 97 countries; their study showed the relationship to be strictly non-linear. The impact of FD on FDI becomes negative beyond a threshold level of FD. However, their find political risk factors to be affecting the relationship by altering the threshold level of financial development.

[6] admits that financial markets work in conjunction with institutions and that the latter has an important role to play in the performance of the former. Using cross country regressions, Kapuria-Foreman (2007) finds that certain components of economic freedom are positively affected with foreign direct investment. Keeping such observations in mind, we delve deeper into the role played by political risks in enhancing or degrading the association between financial development and foreign direct investment inflows. There have been several cross country studies based on international data regarding the impact of policy-related variables like intellectual property protection, corruption and institutional uncertainty on FDI inflows (Lee and Mansfield, 1996; Brunetti and Weder, 1998; Wei, 2000).

[8] study tries to findout the relationship FDI and domestic investment. FDI, financial market development and GDP growth rate are taken as independent variables and domestic investment as independent variable in the model. ADF, PP,Ng-Perron and Zivot-Andrews unit root tests are applied to find the level of integration. ARDL cointegration technique and its error correction model are applied to check the long run and short run relationships. The study finds that long run and short run relationships exist in the model. FDI, financial market development and economic growth have the positive and significant impact on the domestic investment.

Recently, several studies have studied the impact of democratic institutions on FDI inflows. While one strand of thought shows the relationship to be positive (Harms and Ursprung, 2002; Jensen, 2003; Busse, 2004), [9] argue that there is more to the relationship. Though democratic right has an indirect boosting impact on FDI inflows by improving property rights protection, the direct impact on FDI is negative.

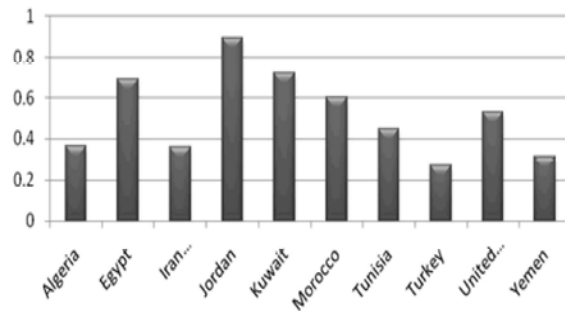
According to the law and finance literature, institutions that provide investor protection have been proved crucial for financial development. According to Roe and Siegel (2007), an economy's capacity to develop and foster investor protection is largely dependent on the political stability scenario. They argue that unstable governments cannot credibly commit to policies that can encourage and foster entrepreneurial functions, saving and functioning of the financial markets. They, further, argue that political instability can bring about poor macroeconomic policy and, thus, can hamper the development of financial infrastructure. Thus, the role of political stability cannot be ignored while investigating the association between financial development and FDI inflows. Political risk seems to be crucial from the aspects of both financial development and inflows of foreign capital.

[10] attempted to examine the impacts of corruption, foreign direct investment (FDI) and workers remittances on economic growth in a set of five South and South East Asian countries during the period ranging from 1985 to 2011. By using of panel data, fixed effects and random effects models, the study obtained evidence of the positive and statistically significant effects of FDI and workers remittances on economic growth. Empirical results also show negative and statistically significant impact of endemic corruption on economic growth during the study period.

MATERIALS AND METHODS

This paper employs panel data for 10 countries over the period 2002-2011. All countries (MENA)¹ for which data are available over this period are included in this study. We measure the degree of financial development in a country using the Private Credit variable. This variable is defined as the amount of credit issued by financial intermediaries to the private sector.

Private Sector is the most commonly used measure of financial development in the literature (Levine, 2005). It accounts for credit issued by bank and non-bank



Source: Financial Structure Dataset (2012)

Fig. 1: Average Private Credit by Deposit Money Banks / GDP in MENA

financial institutions, but excludes credit issued by central banks and development banks. Data on FDI inflows measured in current U.S. dollars collected from the UNCTAD

Handbook of Statistics on-line (United Nations Conference on Trade and Development, 2012). The dependent variable is rate of Growth of Foreign Direct Investment. Our independent variables include Financial Development, Political stability, Rule of law and Control of corruption. As shown in Fig (1), the average of Financial Development in Jordan is higher than other countries for the period under consideration.

Importance of financial development indexes defined by Levine *et al* is different in some countries and there is no same indicator to measure financial development of the countries. So this study prioritize the indicators that Levine *et al* proposed by Shannon Entropy approached the weight of them is got. Then the weighted average of these indicators is computed.

The Fixed Effects Approach: The fixed effects model (FEM) assumes that the slope coefficients are constant for all cross-section units and the intercept varies over individual cross-section units but does not vary over time. For this application, the FEM can be written as follows:

$$y_{it} = a_i + x_{it}\beta + u_{it} \quad (1)$$

Where y_{it} can be one of the three endogenous variables, i is the i th cross-section unit and t is the time of observation. The intercept, a_i , takes into account of the heterogeneity influence from unobserved variables which may differ across the cross-section units. The x_{it} is a row vector of all lag endogenous variable. The β is a column

¹Algeria, Egypt, Iran, Jordan, Kuwait, Morocco, Tunisia, Turkey, United Arab Emirates, Yemen.

vector of the common slope coefficients for the group of economies. The error term follows the classical assumptions that $\sim N(0, \sigma_U^2)$.

We follow the basic regression specification from the based on the findings of the Panel (EGLS) Method to find the impact of governance indicators and financial development influencing Foreign Direct Investment in MENA countries. The general form of the model is shown in the following equation.

$$FDI_{i,t} = \alpha_0 + \alpha_1 X_{i,t} + \alpha_2 FD_{i,t} + U_{i,t} \quad (2)$$

In this model, $FDI_{i,t}$ is the rate of the Foreign Direct Investment in country i and year t . The level of financial development, $FD_{i,t}$, is the key explanatory variable that we are interested in. The hypothesis to be tested is whether $FD_{i,t}$ is positive and significantly different from zero. The vector $X_{i,t}$ includes a number of control variables; political stability, control of corruption and rule of law values. α_2 Is a zero-mean error term that allows for heterogeneous variance structure across cross-section units, but assumes no cross– correlations.

Empirical Results: To estimate Equation 1, panel data of n countries (individuals) was used over T time periods. In order to test the null hypothesis that the (fixed) country effects and the time effects are absent, we use a restricted F test (Baltagi, 2005, pp. 34) which is shown in Table (1).

Im, Pesaran and Shin (2003) begin by specifying a separate ADF regression for each cross section

$$\Delta y_{it} = \alpha y_{it-1} + \sum_{i=1}^{pi} \beta_{ij} \Delta y_{it-j} + \epsilon_{it} \quad (3)$$

The null hypothesis may be written as: $H_0 : \alpha_i = 0, \text{ for all } i$

While the alternative hypothesis is given by:

$$H_1 : \left\{ \begin{array}{l} \alpha_i = 0 \quad \text{for } i = 1, 2, \dots, N_1 \\ \alpha_i < 0 \quad \text{for } i = N + 1, N + 2, \dots, N \end{array} \right\}$$

(Where the i may be reordered as necessary) which may be interpreted as a non-zero fraction of the individual processes is stationary. The results from the IPS panel unit root test are presented in Table 2 and are reported with an intercept. All of the variables are tested in levels. As it can be inferred from this table 2, we can reject the unit-root hypothesis at the 3 percent level of significance. Therefore, our series are well characterized as an $I(0)$

Table 1: Redundant Fixed Effects Tests Test cross-section and period fixed effects

Effects Test	Statistic	d.f.	Prob.
Cross-section F	10.410279	(9,77)	0.0000
Cross-section Chi-square	79.605836	9	0.0000
Period F	5.005402	(9,77)	0.0000
Period Chi-square	46.061405	9	0.0000
Cross-Section/Period F	7.678294	(18,77)	0.0000
Cross-Section/Period Chi-square	102.780555	18	0.0000

Table 2: IPS panel unit root test

Variables	level
FDI	-3.36444 (0.0004)
FD	-4.90650 (0.0000)
PS	-2.36960 (0.0089)
SS	-3.09803 (0.0010)
RL	-3.66562 (0.0001)

The p-value is reported in parenthesis

Table 3: The results of estimations (sample 2002-2011)

Dependent variable	Regression
C	3.585* (15.811)
FD	1.673 * (2.227)
PS	0.76* (2.157)
CC	1.585*(2.824)
RL	2.801* (3.817)
R ²	0.75
\bar{R}^2	0.72
N.O.	40

Notes: FD: financial development; PS: political stability

CC: control corruption; RL: rule of law.

* Significant at the 5% level

process. We can reject the problem of spurious regression. These results allow us to use fixed and random effects models for estimation equation (2).

The estimation results using Eviews 6 are shown in Table 3. As seen from Table 3, Financial Development, Control Corruption, Political Stability and Rule of Law have positive and significance impact on Foreign Direct Investment. According to the results in regression, that financial development contributes to the improvement FDI in MENA region.

CONCLUSION

In this paper we investigated the impact of governance indicators and Financial Development on FDI in MENA Region for which the necessary data were available for the period 2002-2011. The results based on the panel regression model show that Financial Development, Control of Corruption, political stability and rule of law are important to Foreign Direct Investment. Therefore, policies to improve financial development indicators in the region are suggested.

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