



An Empirical Study on Country Risk as A Predictor of Market Entry Decisions: Impact of Political, Economic and Financial Risks on FDI Inflows of Horn of Africa and Middle East North Africa Region (MENA)

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ABSTRACT

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This study examines how risks affect firm's entry to the market and operations in foreign countries. Based on a critical literature review, key risks were identified which compromise focus area of current study. We have conceptualized the decision of firms to enter foreign market and attractiveness of Mena and Horn region as a country risk- FDI inflow relationship. The analysis was performed on a macroeconomic level. The country risks include political risks, financial risks and economic risks. A quantitative study encompassing inferential statistical analysis was utilized. The Country risks data was sourced from International Country Risk Guide (ICRG), whereas the FDI data has been collected from World Bank database. The results derived by using multiple regression analysis showed there are significant relationship between the country risks, and FDI inflows. The findings therefore imply that FDI levels in countries, and decision of market entry as well as business operations are significantly affected by political, financial, and economic risks of the host country. Moreover, the study suggests that firms need to increase the risk awareness and prepare risk management plans to minimize the occurrence of risks. There is a real need for companies to recognize, plan for and manage risks as a part of their strategic planning and everyday business operations. This becomes particularly evident in unfamiliar environments with increased risks, such as foreign markets. The problem still exists as managers of companies do not spend sufficient time on risk preparation and only deal with the consequences after risk occurs. Our study findings have implications for entrepreneurs, firms, and governments.

1. Introduction

1.1 Introduction

The topic of FDI and decision making on locations in the case of emerging economies is regarded as one of the strongly debated topics among the scholars, policymakers and executives of company. Particularly, there is a strong need for the research in the area of FDI for Mena and Horn of Africa region. This can be explained by the fact that there is a high level of environmental risk in this region and it has huge reserves of oil and gas. The literature shows that strategic decision making is often made based on the Transaction cost framework and OLI (Ownership, Location, Internalisation) paradigm (Buckley et al., 2007; Makino et al., 2002).

Entry and ownership of decision making is closely related to the research of FDI. Entry modes is often classified as ranging from low control to high control. Low control modes involve licensing and franchising. Medium control is explained by joint ventures type of business ownership. High control is described by the presence of wholly owned subsidiary.

1.2 Research Questions and Objectives

The purpose of the paper is to explain the main roots of FDI. Research objectives are focused on describing the types of risks of international operation of firms and FDI inflows. Moreover, the paper covers the main factors which influence the realization of FDI in the case of Mena and Horn firms. Precisely, the types of relationships such as political risks, financial risks and economic risks and FDI inflows are investigated in this paper.

2. Literature Review

There are four types of factors that stimulate the FDI which involve natural resource seeking, efficiency seeking, market seeking and strategic asset seeking (Dunning & Lundan, 2008). Understanding the main differences among these type of FDI motives is critical as each type of FDI fulfill different competitive and growth objectives. Many theories have been proposed to explain the determinants of FDI. According to Chin (2016) and Charkabarti (2001) understanding the underlying motives of these theories can play an important role in exploiting more determinants of FDI. From the perspective of the investing firm, there are

two main categories of FDI. The first is known as market seeking FDI which focuses on local markets. Market seeking type of FDI is also considered as horizontal FDI. Export substitution and tariff jumping is regarded as examples of horizontal FDI. Increase in local production and market size as well as its growth is considered as main motives behind the FDI which focuses on improving the economic condition of the host country (Bruton, 2008). Market seeking FDI is also popular due to the low tariffs and transportation costs (Zahra, Nielsen, & Bogner, 1999). Another type of FDI is considered as resource-seeking FDI. In this regard, it is important to mention that export oriented FDI is often stimulated by a cheap labor cost. Countries which are full of natural resources are the main targets of the resource-seeking FDI. Market seeking FDI is often concerned with improving the firm's presence especially in foreign markets (Li et al., 2012). Market seeking FDI often involves the acquisition of assets of host country which will help companies to achieve a competitive advantage in a specific market. In the majority of cases, the market seeking objectives are limited too. Efficiency seeking often involves using competitive advantage as a short to medium term goal instead of transforming core competence of the firm to long term competitiveness. In general, above mentioned FDI types are not sufficient to reach to the superior strategic assets of the global leaders. In this regard, firm's strategic asset seeking is regarded as another important type of FDI (Luo & Tung, 2007). Strategic asset seeking is considered to be different from other types of FDI in many different ways. First of all, based on its asset exploring nature it aims to transform investors core competency into its strong competitive position. Precisely, strategic asset seeking is more about the acquisition of knowledge based resources that are considered to be outside of the areas such as technology and brands (Agarwal, J., & Feils, D., 2007). Moreover, strategic asset seeking provides learning experiment for the firm which can be critical for its success in future.

(Blomberg et al., 2004). Furthermore, government institutions and organizations often lead to emergence of political risk since they create various obstacles for companies intending starting a business in other country. In contrast to political risks, political stability can attract attention of foreign investors and impact positively on their operations.

The review of the previous literature showed that political, economic and financial risks are strongly related to each other. It should be mentioned that one type of risk can not be analyzed without consideration of another one (Kungwani, 2014). Consequently, it can be said that financial risks are used to evaluate the future market. Financial risks are taken into consideration since they are mainly about identifying whether the invested money will be returned or they lose it. The outcomes of this type of decisions are used further to either increase or decrease the amount of future investments according to their rates of return. In this regard, the country's debt is taken into consideration to GDP on macro-level. This indicator is mainly used to ensure the economic stability of the country (Herndon et al., 2014).

The relationship between country's economic growth and FDI has been studied in the literature for quite a long period of time. In this regard, the indicator of GDP is used as a main indicator of country's economic growth. The literature related to macroeconomic determinants of FDI is considered to be vast and review of number of studies for this study. The research conducted by Mercereau (2005) under the Overseas Development Institute considered various determinants of FDI inflow to various countries. These determinants include relevance of openness, market size, productivity of labor, stability of political system. Market size is regarded as an important macroeconomic determinant. It helps companies to make important strategic decisions such as growing or staying competitive by getting an access to new markets locally and internationally and to increase market share. In this regard, it is important to mention that market size is often measured by GDP. Moreover, it can be measured by the per capita income or size of the middle class. Market size is believed to make local sourcing more feasible and it is considered as a potential FDI variable which leads to the greater profitability of the local sales. Thus, it is believed that the larger the market size, the more profit will be generated by the company increasing more sales. Researchers identified that market size and growth effect change based on the circumstances. The real life example which supports the findings of the studies can be given in the case of China. China has significantly large market size and it has been able to attract large amount of FDI inflow. However, Bangladesh, India and Pakistan received relatively less FDI. Some analysts mention that this indicates that in future the FDI inflow will increase in these countries while others mention that certain obstacles exist which prevent it from happening. Small market size of most of the low-income countries is given as a reason for the less amount of FDI. Growth rate, along with the market size, is believed to be another important determinant of the FDI and it has a positive impact on FDI inflow. In this regard, it can be mentioned countries which have high growth rates is believed to receive more FDI inflow compared to volatile economies

Variable	Effect of FDI	Countries	Authors
GDP	Positive	38 countries	Nonnenberg <i>et al.</i> (2004)
GDP growth rate	Negative	29 countries	Mathur and Singh (2007)
Level of schooling	Positive	38 countries	Nonnenberg <i>et al.</i> (2004)
Degree of Openness	Negative	29 countries	Mathur and Singh (2007)
Inflation	Negative	38 countries	Nonnenberg <i>et al.</i> (2004)
Country's risk rating	Negative	38 countries	Nonnenberg <i>et al.</i> (2004)
Capital market growth	Outflows	38 countries	Nonnenberg <i>et al.</i> (2004)
Corruption	Not significant	12 sources to 45 countries	Wheeler and Moody (1992)
	Not negative	29 countries	Hines' (1996)
	Negative (but not if the source is OECD or US investors)		Wei (2000)
	Negative (especially in presence of interdependence of FI in the same region)		Mathur and Singh (2007)
Trade/GDP	Positive	29 countries	Mathur and Singh (2007)
Value added per person	Positive	12 sources to 45 countries	Wei (2000)
Telephone lines	Positive		
Capital controls	Negative		
Regional dummy	Negative		
Legal and Property rights	Positive		
Left government	Positive		
Democracy (political rights and civil liberties)	Negative		
Tax	Negative		
Regional FDI	Significant interdependence among these Asian countries	China, Malaysia, Indonesia, Thailand and Vietnam	Hansen <i>et al.</i> (2003)
Bilateral FDI	Developments making China a more attractive destination for FDI also make other Asian countries more attractive destination for FDI		Eichengreen and Tong (2005)

Table 1
Summary of FDI literature

Source: Cull (2013)

Internationalization of firms can take place based on different stages and it is important for the company to identify whether they want to deal with FDI or export to the host country. The outcomes of this type of decisions are critical as they play crucial role in understanding the elements of political risks. Particularly, the countries which are intending to invest in other countries are more prone to face challenges from political risk

3. Research Methodology

3.1 Research Methodologies

Table 1: Environmental risk components - ICRG risk ratings

Composite risk		
Political risk (50%)	Economic risk (25%)	Financial risk (25%)
Bureaucracy Quality	Budget Balances as % of GDP	Exchange rate stability
Corruption	Current Account as % of GDP	Foreign Debt as % of GDP
Democratic Accountability	GDP growth	Foreign Debt Service as % of Exports
Ethnic Tensions	GDP Per Capita	Current Account Balance as % of Exports
External Conflict	Inflation	International Liquidity
Government Stability		
Internal Conflict		
Investment Profile		
Law and Order		
Military in Politics		
Religious Tensions		
Socio Economic Tensions		

3.2 Research Model and The Hypotheses

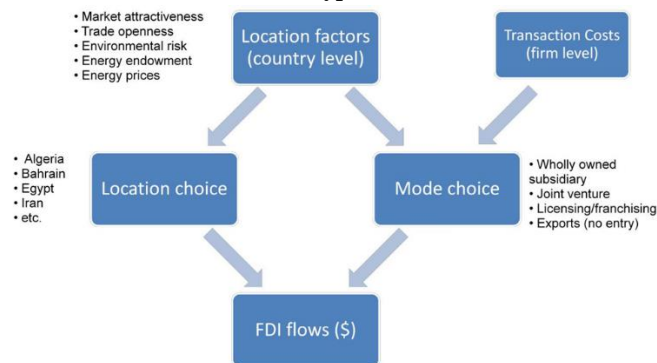


Figure 1. Research model

Overall determinants of FDI in the Mena and Horn of Africa region

Hypothesis 1a: FDI inflow in the Mena and Horn of Africa region positively impacts on a country's GDP.

Hypothesis 1b: FDI inflow in the Mena and Horn of Africa region positively impacts on a country's GDP per capita.

Hypothesis 2: FDI inflow positively impacts on country's manufacturing exports.

Country's openness to trade is often measured by the amount of manufacturing exports as a proportion of GDP in a particular year. It is important to mention that the impact of trade openness on FDI can be either positive or negative (De Maeseeneire, W., & Claeys, T., (2006). Openness is regarded as important variable to attract FDI and while tariff protection often represents a lack of openness. Generally, it is critical to consider that openness to trade and FDI is positively associated and the relationship between these two variables are worth considering.

Hypothesis 3: FDI inflows in the Mena and Horn of Africa region negatively impacts country's level of environmental risk.

This study proposes that high level of environmental is believed to discourage the intentions of investors (Alfaro et al., 2004, Busse, M., & Hefeker, C., 2007). The nature of this hypothesis can be explained by several reasons. For example, the company may have strategic decisions not to invest to economically unstable countries, particularly, countries with civil strife and external conflict. Another reason is that while choosing regional hubs for their businesses, investing countries may be reluctant to invest in countries with high levels of environmental risk.

Hypothesis 4: FDI inflows in the Mena and Horn of Africa region and world energy prices during previous years have the positive relationship.

The review of the literature shows that there is no available theoretical basis to support positive relationship between FDI inflows in the Mena and Horn of Africa region and world energy prices. However, it can be mentioned that high energy prices make investment in energy exploring countries more attractive and it may attract resource seeking FDI. Moreover, high energy prices increase the amount of funds available to OPEC governments.

Table 2: Construct Operationalization Table

Construct Name	Construct Definition	Source
Political Risks	Regulative Institutional Constraints Which Can Affect Fdi (Kang & Jiang, 2011 And Quer Et Al., 2012).	Icrg, 2014.
Financial Risks	Obstacles For A Country Which Effect On Its Ability To Pay Her Obligations (Kungwani, 2014).	Icrg, 2014
Economic Risks	Undesirable Obstacles for Economic Stability and Economic Growth. (Bhagwati, 1978). Means Of Assessing A Country's Current Economic Strengths And Weaknesses ¹	Icrg, 2014
Foreign Direct Investment (Fdi)	Ownership Relies On Control And Capital From Abroad By Its Nature And Depends On The Development Of Host Country's And Domestic Financial Markets. (Alfaro At Al., 2004).	Worldbank, 2014

¹ <https://www.prsgroup.com/wp-content/uploads/2014/08/icrgmethodology.pdf>

Manufactures exports (% of merchandise exports)	0.0005***	0.0008***	0.0005**	0.0007***	0.0007***	0.0008***
	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0002)
Trade (% of GDP)	0.0004***	0.0005***	0.0005***	0.0005***	0.0004***	0.0005***
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0002)	(0.0001)
Inflation, GDP deflator (annual %)	0.0000	-0.0002	0.0000	-0.0001	-0.0001	-0.0001
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
Oil Price (in US\$ per barrel)	0.0002***	0.0002**	0.0001	0.0002**	0.0002**	0.0001*
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
Government Stability	0.0037***					
	(0.0010)					
Socioeconomic Conditions		0.0008				
		(0.0016)				
Investment Profile			0.0045***			
			(0.0011)			
Internal Conflict				0.0019**		
				(0.0009)		
External Conflict					0.0015	
					(0.0011)	
Corruption						-0.0048*
						(0.0026)
Constant	-0.0530***	-0.0388**	-0.0548***	-0.0434***	-0.0383***	-0.0220
	(0.0132)	(0.0161)	(0.0132)	(0.0132)	(0.0130)	(0.0140)

Observations	270	270	270	270	270	270
R-squared	0.3062	0.2639	0.3127	0.2770	0.2686	0.2733
Standard errors in parentheses						

p<0.01, **						
p<0.05, *						
p<0.1						

The results of sub categories of political risk show that government stability has significant positive impact on FDI inflow. This can be explained by the fact that politically stable countries with present stable government is more likely to receive the more FDI. The relationship between government stability and FDI is found to be significant at 1%. Moreover, the investment profile, another political risk sub category, is found to have a significant positive impact on FDI inflow which is significant at the level of 1%. Another important finding of the research is the significant positive relationship between internal conflict and FDI. It can be mentioned that countries with less levels of internal conflict is found to have less inflow of FDI. Besides that, another interesting findings of the research is significant which is a negative relationship between the corruption and FDI inflow. FDI inflow is found to be lower in countries with decreased levels of corruption.

Table 4b: Political risk and FDI

	(1)	(2)	(3)	(4)	(5)	(6)
Variables	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)
GNI per capita growth (annual %)	0.0011***	0.0011***	0.0011***	0.0010***	0.0011***	0.0011***
	(0.0003)	(0.0003)	(0.0003)	(0.0003)	(0.0003)	(0.0003)
GDP per capita (current US\$)	-0.0000***	-0.0000***	-0.0000***	-0.0000***	-0.0000***	-0.0000***
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)
Manufactures exports (% of merchandise exports)	0.0007***	0.0008***	0.0008***	0.0008***	0.0008***	0.0008***
	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0002)
Trade (% of GDP)	0.0005***	0.0005***	0.0005***	0.0005***	0.0005***	0.0005***
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0002)	(0.0001)

Inflation, GDP deflator (annual %)	-0.0001	-0.0001	-0.0001	-0.0001	-0.0001	-0.0001
Oil Price (in US\$ per barrel)	0.0002**	0.0002**	0.0002**	0.0002**	0.0002**	0.0002**
Military in Politics	0.0036					
Religion in Politics		0.0014				
Law and Order			0.0004			
Ethnic Tensions				0.0038*		
Democratic Accountability					0.0021	
Bureaucracy Quality						-0.0032
Constant	-0.0406***	-0.0352***	-0.0345***	-0.0483***	-0.0350***	-0.0275
Observations	270	270	270	270	270	270
R-squared	0.2705	0.2651	0.2633	0.2737	0.2666	0.2641
Standard errors in parentheses						
*** p<0.01, ** p<0.05, * p<0.1						

4.3.2 Economic Risk and FDI

Table 5: Economic Risk and FDI

Variables	(1)	(2)	(3)	(4)	(5)
GNI per capita growth (annual %)	0.0010**	0.0010**	0.0006*	0.0010**	0.0008*
GDP per capita (current US\$)	-0.0000**	-0.0000**	-0.0000**	-0.0000**	-0.0000**
Manufactures exports (% of merchandise exports)	0.0008**	0.0006**	0.0005*	0.0008**	0.0006**
Trade (% of GDP)	0.0005**	0.0005**	0.0004**	0.0004**	0.0004**
Inflation, GDP deflator (annual %)	-0.0000	-0.0001	0.0001	-0.0001	0.0000
Oil Price (in US\$ per barrel)	0.0001*	0.0001*	0.0001	0.0002*	0.0001
Risk Points for Inflation	0.0023*				
Risk Points for GDP per Head		-0.0050*			
Risk Points for GDP Growth			0.0048**		
Risk Points for Budget Balance				0.0017*	
Risk Points for					0.0031**

Current Account as % of GDP					
					(0.0007)
Constant	-0.0481* **	-0.0169	-0.0506* **	-0.0393* **	-0.0487* **
	(0.0143)	(0.0147)	(0.0123)	(0.0129)	(0.0127)
Observations	270	270	270	270	270
R-squared	0.2757	0.2774	0.3431	0.2718	0.3119
Standard errors in parentheses					
*** p<0.01, ** p<0.05, * p<0.1					

The findings of the study show that there is a both positive and negative relationship between economic risk sub categories and FDI inflow. Particularly, there is a significant positive influence of inflation, GDP growth, budget balance and current account as % of GDP on FDI inflow while GDP per head has negative influence on FDI inflow. This indicates that inflation, increasing GDP growth, budget balance and current account is considered to control the level of economic risk, thus providing accessible environment for FDI inflow.

4.3.3 Financial Risk and FDI

Table 7: Financial Risk and FDI

	(1)	(2)	(3)	(4)	(5)
Variables	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)	FDI (% of GDP)
GNI per capita growth (annual %)	0.0010* **	0.0009* **	0.0011* **	0.0011* **	0.0011* **
	(0.0003)	(0.0003)	(0.0003)	(0.0003)	(0.0003)
GDP per capita (current US\$)	-0.0000* **	-0.0000* **	-0.0000* **	-0.0000* **	-0.0000* **
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)
Manufactures exports (% of merchandise exports)	0.0008* **	0.0006* **	0.0008* **	0.0008* **	0.0009* **
	(0.0002)	(0.0002)	(0.0002)	(0.0002)	(0.0002)
Trade (% of GDP)	0.0005* **	0.0005* **	0.0005* **	0.0005* **	0.0005* **
	(0.0001)	(0.0001)	(0.0001)	(0.0002)	(0.0001)
Inflation, GDP	-0.0002	-0.0000	-0.0002	-0.0001	-0.0002*

deflator (annual %)					
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
Oil Price (in US\$ per barrel)	0.0002* **	0.0001	0.0002* **	0.0002* *	0.0002* **
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
Risk Points for Foreign Debt as a % of GDP	-0.0026* *				
	(0.0011)				
Risk Points for Exchange Rate Stability		0.0024* *			
		(0.0009)			
Risk Points for Debt Service as a % of XGS			-0.0020		
			(0.0016)		
Risk Points for Current Account as % of XGS				0.0008	
				(0.0012)	
Risk Points for International Liquidity					-0.0026
					(0.0016)
Constant	-0.0194	-0.0427* **	-0.0203	-0.0398* *	-0.0331* **
	(0.0138)	(0.0129)	(0.0165)	(0.0155)	(0.0125)
Observations	270	270	270	270	270
R-squared	0.2799	0.2827	0.2679	0.2645	0.2707
Standard errors in parentheses					
*** p<0.01, ** p<0.05, * p<0.1					

The findings of the study show that there is a significant negative association between foreign debt and FDI inflow. It indicates that increasing levels of foreign debt is more likely to decrease the inflow of

FDI. It implies that foreign investors may have less trust and more risk while receiving their return on their investment. Moreover, exchange rate stability is found to have significant positive influence on FDI inflow. This indicates that more stable the exchange rate in the country, there will be increased inflow of FDI.

5. Discussion and Conclusion

5.1 Impacts of Oil and Gas Reserves on FDI

The findings of the study provide several insights into the determinants of FDI in Mena and Horn of Africa region. First of all, it is important to mention that there is a positive association between country's oil, gas reserves and FDI performance. The findings of the research are similar to several researchers including Dunning (1980) who found that countries with natural resource endowments are more likely to attract resource seeking FDI. Moreover, it is worth considering that countries which have natural resource endowments such as oil and gas are less likely to receive FDI when they do not possess natural resource endowments especially when there is a control for the other explanatory variables.

5.2 Market attractiveness and exports impact on FDI

When we take a look at the full country sample, we can see that role of GDP per capita as a proxy for market attractiveness by considering the other dependent variables. This can be explained by the fact that OPEC countries have high average GDP per capita compared to non-OPEC countries. Additionally, it is important to mention that when we consider the case of OPEC and non-OPEC countries together, we can see that GDP per capita is found to be a determinant even if OPEC countries have large reserves of oil and gas and poor FDI inflow (Berry, et al, 2010). However, when we consider these countries separately, it can be discovered that GDP per capita acts as a strong determinant.

5.3 Political, Economical and Financial Risks and FDI

The findings show that Bureaucracy Quality, Law and Order (ICRG) and Legal Risk (Global Insight) scores play an important role in ensuring institutional quality and attracting Foreign Direct Investment, especially in the case of non-OPEC countries. However, in OPEC countries, institutional quality may not be so important since they are going to deal directly with rules of host country, particularly if there is a low democratic accountability (Brown, 2006).

It should be mentioned that despite the high level of environmental risk in the Mena and Horn of Africa region, FDI has significantly grown. It can be proposed that future research can take into consideration the comparison between Mena and Horn of Africa countries and other regions. This can be done as it will be useful to compare the FDI determinants between the regions and check the generalizability of the resource curse theory and its application to FDI. Another limitation of the study can be explained by the absence of Iraq and Palestinian territories although these regions constitute the small proportion of Mena and Horn of Africa economy.

The study has provided a detailed view of the determinants of FDI in the Mena and Horn of Africa region. Mena and Horn of Africa region has not been studied in terms of FDI attractiveness for a long period of time especially in terms of FDI location decision making and ownership modes. The findings of the research show that aggregate measures of environmental risk are not considered to be drivers of FDI flows in the Mena and Horn of Africa region. The research has made a strong contribution to existing theory by providing insights on the role of energy endowments, energy prices and various types of specific environmental risk and institutional factors.

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