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The effect of macroeconomic instability on FDI flows: A gravity estimation of the impact of regional integration in the case of Euro-Mediterranean agreements

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In order to diversify their risks, firms facing uncertainty in their domestic market may choose to increase their investment abroad by transferring production to more stable host economies. By estimating a gravity model of foreign direct investment (FDI) flows from Europe and the Mediterranean region to the four main recipients of FDI in the Middle East and North Africa (MENA) region from 1985 to 2009, this article tests (1) the extent to which FDI inflows are affected by macroeconomic volatility in the source country and (2) whether regional trade and investment agreements could have increased this FDI sensitivity to external macroeconomic volatility. We find that the incidence of FDI between two countries increases with source GDP instability and with host GDP stability. Moreover, FDI to MENA countries tends to be countercyclical with respect to the source country's business cycle. We also find that although FDI reactivity to host country's uncertainty is not conditioned by North–South trade and investment agreements, it becomes negative for South–South regional integration. Last, we show that although the source country's instability certainly matters when explaining bilateral FDI flows in our sample, its impact may be less important when investments are driven by cost differentials, that is, for vertical investment.

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1. Introduction

Foreign investment is supposed to convey positive effects, such as technological upgrading and trade expansion, to developing economies. Attracting FDI from multinational corporations (hereafter MNCs) has therefore become a priority goal of most developing countries. Nonetheless, although labor-abundant Middle East and North African (MENA) countries have made significant efforts, since the mid-1990s, to increase their attractiveness through adjustment, stabilization, and liberalization policies, they still receive few FDI flows when compared to other low- and middle-income economies.[1] Weak institutional governance and limited market size have been pointed by many studies as good candidate explanations for these disappointing outcomes (Malik and Awadallah, 2013; Chenaf-Nicet and Rougier, 2011). However, during the 1990s, MENA countries deeply reformed their institutions and opened up their economies to foreign trade and investment notably via various South–South (GAFTA, AMU) and North–South (Euro-Mediterranean) trade agreements (Alaya et al., 2009; Mina, 2012). As a result, although FDI inflows have been significantly augmented for the four main MENA recipient countries during the two last decades, FDI instability has simultaneously been amplified (UNCTAD, 2009).

We argue in this article that source countries' macroeconomic conditions influencing the decision of MNCs to invest abroad should be more closely investigated to understand the patterns of FDI flows to the Arab region. Over the last three decades, MENA economies, especially the labor-abundant ones, have become increasingly dependent on the European MNCs investment to modernize their productive structures and provide jobs to their educated workers.[2] Like all MNCs, European firms partially determine their investment decision by considering the demand conditions on their domestic market, with horizontal investment being stimulated by a more unstable demand home. Moreover, this dependence of FDI inflows to MENA on European demand instability has probably gone stronger as trade integration between the two regions got deeper over the last two decades. As a direct effect, the size and steadiness of European FDI flows to the MENA region have become increasingly dependent on the source countries' macroeconomic volatility.

Our aim in this article is to test this assumption by identifying the determinants of FDI flows going to MENA economies, not from the point of view of their own factors of attraction but rather by focusing our analysis on the way macroeconomic instability in source countries may condition them. In other words, we seek to identify how FDI reacts to the source country's macroeconomic conditions, which may increase uncertainty for their MNCs, and to the synchronization of business cycles in home and foreign economies. We also address the conditioning impact of regional trade integration, between European and MENA economies and between MENA economies, on this reaction.

In our article, macroeconomic uncertainty is assessed by the three-year GDP volatility measuring short-term demand instability. Demand instability is supposed to have either a positive or a negative impact on FDI flows.[3] On the one hand, firms facing increasing demand uncertainty at home may be willing to invest abroad in order to diversify their portfolio of consumption markets and to limit their exposure to the risk of instability of their revenue on their domestic market. On the other hand, seeking lower production costs abroad through

[1] Moreover, they still fail to experience the technological spillovers they initially expected. Sadik and Bolbol (2001) explained this fact by the nature of FDI inflows, mostly resource-based, during the 1990s. Chenaf-Nicet and Rougier (2011) have provided evidence based on more recent data that this failure could be because of the low absorption capacities of poorly innovative MENA economies.

[2] FDI sourced in Gulf countries has also become increasingly strategic for MENA countries. However, we do not introduce it into our estimations since it is a more recent phenomenon on which we lack of a sufficiently long time perspective.

[3] Productivity shock may also spur GDP trend instability over the longer run, but we do not measure and address this dimension in our article. Moreover, we also control for the productivity shocks that may condition vertical investment by introducing a proxy for the cost differential between the source and the host countries.

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