DETERMINANTS OF FDI INFLOWS TO GCC COUNTRIES – AN EMPIRICAL INVESTIGATION

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Abstract

The GCC (Gulf Cooperation Council) is known for its distinct advantages including wealth, control of vast reserve of natural resources, and geopolitically strategic location. This block of nations commands a pervasive political-socio-economic influence in the Arab world and beyond. Despite of both needs for foreign direct investment (FDI) and integration into the world economy which are the necessary conditions for diversification from oil-based industries, the GCC countries have been host to a disproportionately insignificant share of the global FDI inflows. Within the above context, the purpose of this study was to empirically investigate the role that the five widely recognized macroeconomic determinants (independent variables) have played in attracting FDI inflows (dependent variables) to the GCC countries in the years 2002-2014. The study used a two-stage least squares (2SLS) regression model to test the research hypotheses. The empirical results, for the most part, did not support the hypothesized positive relations between four out of the five determinants (i.e., good governance, level of inflation, economic growth/market size, and ease of doing business) and the ability to generate FDI inflows. As for market openness, and with the exception of Kuwait, the hypothesized positive relationship could not be rejected.

Keywords: GCC Countries, Determinants of FDI, Foreign Direct Investment, Market Integration, Economic Diversification

INTRODUCTION

On the issue of moving away from an oil-based economy, Hvidt (2013) studied the efforts of the GCC countries. Applying content analysis and looking at the past records, he noted the existence of politically difficult economic reforms in implementing substitutive restructuring, though the whole issue of economic reforms was not new to the GCC states and had been on their political agenda since oil and gas industries had became their main (and virtually sole) sources of income in the past nearly three decades (Henry and Springborg 2001; Hvidt 2007; McBrierty and Al Zubair 2004; Niblock and Malik 2007; Rivlin 2009; and Seznec and Kirk 2011).

Hvidt's (2013) study noted the relative failure of the GCC's diversification attempts and expressed serious doubt regarding the prospects of future success of broad reforms to induce reinvigoration of the private sector. Hvidt (2013) characterized the GCC's current diversification plans as narrow in scope, piecemeal, and ad-hoc strategies to secure sustainability of income levels in near future, while avoiding politically difficult economic reforms. As barriers to a broad-based reform, the study noted the following reasons (Hvidt, 2013):

1. Reluctance to adopt broad reforms that might have negative social and political ramifications,
2. Duplication of economic activities,
3. Obstacles to interregional trade, and
4. Fallback on the predominant role of the public sector at the expense of deferring and/or abandoning well-argued and well-planned diversification policies.

Based on the above conclusions as well as the study's expressed concerns over the success of diversification, the approach that could ensure economic growth and prosperity for the GCC countries seems to be the integration in the world economy through attracting FDI inflows. According to Beblawi (2011), the direct investment of capital by foreign companies in the GCC countries (along with all the other benefits that FDI brings), can indeed be the beginning of a successful transition to a diverse economy that can fill the gap in revenue resulting from a scaled back reliance on oil exploration and exportation. In addition, Beblawi noted that integration into the world economy would limit the ability of oil revenues to quickly crowd out any other economic activity (Beblawi, 2011).

In view of the above observations, the purpose of this empirical research was to identify the impact of five determinants derived from Dunning's OLI advantages (i.e., good governance, inflation rate, economic growth/market size, market openness, and ease of doing business) on the level of FDI flows into the GCC countries. The results of this study should assist in

improving the position of GCC nations to more successfully attract FDI inflows. The study covered the years 2002-2014.

The selection of the years 2002 through 2014 was significant for two important reasons. First, this timeline covered some significant events that changed the political landscape of the region (e.g., September 11 attack on the US, the Arab Spring -- a popular political uprising in a number of Arab countries, and the war in Syria). Second, this timeline reflected the aftermath of the US financial crisis of 2007-2008 that led to the worldwide economic slowdown.

Both of the above events could have influenced the extent of FDI inflows due to the increased level of political risk in the region and the effect of global economic downturn. Furthermore, the twelve-year time span was sufficiently long to neutralize any possible random variations in FDI inflows and yield a more valid trend. Finally, and beginning with the year 2002, the yearly publishing of data provided access to a more complete information regarding the determinants of FDI (e.g. publishing yearly indicators of good governance).

With this introduction, the first part of this article presents an overview of the literature followed by the comparative trends of FDI internationally and among the GCC countries. An overview of the study and its theoretical framework, model specification, data analysis, and the analysis of results are presented in the subsequent sections of the paper, in that order. The article ends with offering suggestions for future research and a summary.

AN OVERVIEW OF LITERATURE

In a 2011 study, Anyanwu examined the determinants of FDI inflows to African countries covering the period of 1996-2008. Anyanwu's (2011) study found that while economic growth/market size, market openness, level of endowed natural resources (oil) and its exploitation had all had positive impacts on the ability of a country to attract FDI inflows, an increased level of financial development and excessive government operating budget were the two variables that negatively influenced FDI inflows (Anyanwu, 2011).

In line with Anyanwu's (2011) study, Jabri (2013) investigated the determinants of FDI inflows to Middle East and North Africa (MENA) region covering the period of 1970-2010. Using panel data to indicate long-term impact of macroeconomic determinants on FDI inflows, his study found that market openness and economic growth had a positive influence on FDI inflows and the reverse was true for two determinants of variation in foreign exchange rate and political instability -- i.e., these two determinants had a negative impact on FDI inflows (Jabri, 2013).

Along the same line, and for the first time, Kariuki (2015) investigated the economic performance of developed countries (i.e., investors) as the "necessary condition" for FDI outflows to the developing countries – an assertion with significant ramifications on FDI and its

determinants. Using the least squares dummy variable (also known as the fixed effects model), Kariuki also examined the determinants of FDI inflows to 35 African countries for the years 1984-2010. The following observations are based on the results of this study (Kariuki, 2015):

1. A strong performance of stock markets in the home country of the investor significantly increases the FDI outflows,

2. The infrastructure spending and high degree of market openness in the host country increases the FDI inflows,

3. The economic risk, political risk, and financial risk in the host country decreases FDI inflows, and

4. An FDI inflow to a country in any given year is positively correlated with that of the preceding year.

In a related line of research, and supported by findings of an extensive body of literature, the ability to attract FDI inflows plays an important role in the economic growth, especially in developing countries (e.g., Zekarias, 2016; Pegkas, 2015; and Tang, 2015), and for the most part, FDI is perceived as a favorite source of capital financing. In their studies, Feldstein (2000) and Razin and Sadka (2007), listed other benefits of FDI inflows which included the transfer of technology, competition in the domestic input market, and employee training in the course of operating new businesses (i.e., human capital development). Loungani and Razin (2001) added to the list of benefits the additional tax revenue being generated by the host country from the operation of foreign companies. The tax benefit equally applies to the otherwise "tax free" GCC countries, as incomes of foreign companies are subject to taxation.

Specific to GCC countries vis-à-vis FDI inflows, the extant literature is relatively scant. The noted exception to this is the study undertaken by Wasseem Mina (2007) which examined the location determinants of FDI inflows to the GCC countries for the years 1980-2002, using Dunning's 1981 Ownership, Location, and Internalization (OLI) Paradigm. Mina's (2007) findings, contrary to the widely held perceptions, showed that while oil production relative to oil reserves was positively related to FDI inflows, the reverse was true for both oil reserves and oil utilization.

Furthermore, Mina's (2007) findings, similar to the results of other studies, showed trade openness, institutional quality, and infrastructure development in the GCC countries to have a positive impact on FDI inflows. Mina's study concluded that FDI inflows will enable the GCC countries to diversify from an oil-based economy by developing non-oil industries that would lead to access of technology and innovation in variety of production-related processes in

manufacturing as well as upgrading the expertise in the other sectors of the economy like banking, insurance, finance, and alike (Mina, 2007).

TREND ANALYSIS OF FDI INTERNATIONALLY AND IN THE GCC COUNTRIES

As shown in Table 1, the increase of the FDI has continued throughout the years, though with some fluctuations, reaching $1.2 trillion in 2014.

Table 1.   Sample Trend of Global Foreign Direct Investment Inflows ($Millions)

Year	2000	2001	2007	2008	2010	2013	2014
Developed economies	1125227	460726	1254988	787761	673223	696770	497784
United State	314007	159461	215952	306366	198049	230768	92397
Canada	66795	27663	116821	61553	28400	62324	53864
Australia	14191	7825	41480	46896	36443	45239	51584
Developing economies	232216	215594	528536	585467	579891	670790	681387
Developing economies: Asia	142788	122807	360562	387838	40185	427879	465285
Developing economies: Eastern Asia	111790	86789	161264	186726	201825	221450	248180
Developing economies: South- eastern Asia	22515	21867	85975	50307	105151	126078	132867
Developing economies: Western Asia	3618	7315	78765	94149	59852	44718	43046
Developing economies: Africa	9624	19947	50206	57770	44072	53969	53912
Developing economies: Northern-Africa	3250	5352	23015	22206	15745	13658	12241
Developing economies: Western-Africa	2131	2075	9546	14220	12008	14208	12763
Total	1363215	684071	1871702	1489732	1328215	1467149	1228283

Source: UNCTAD, http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96740

A summary outline of the trend in global FDI inflows presented in Table 1 reveals the following:

1. Highest level of FDI inflows to developed countries,
2. Highest level of FDI inflows to the North American and the European countries, and
3. Highest level of FDI inflows to developing countries in Asia, South and South-East Asia, as compared with other typically poor developing countries, particularly those in Africa and the Middle East.

The above observations reflect a positive correlation between the stage of development and political stability of a country on the one hand and the country's ability to attract FDI inflows on the other hand. This is to say that due to their political stability and/or higher economic growth,

the developed countries (and some industrialized developing countries that enjoy political stability) have had more success in attracting FDI, while the need of poor developing countries for persistent FDI inflows is pronounced. While the disparity and inequality of FDI distribution is outside the scope of this study, it remains an issue of significance for global economy and policy makers.

As for the GCC, the member countries experienced a decline in the total FDI inflows in the five years leading to 2014 compared to the proceeding five years (please see Table 2). The data in Table 2 also reveal that the share of the GCC countries from global FDI in 2014 was a mere $22 billion from nearly $1.2 trillion (or less than 1.8 percent). This is evidence of the GCC lagging far behind developed countries or other rich developing countries to attract FDI inflows - - a serious impediment to the GCC's economic diversification and integration in the world economy.

THE STUDY AND THEORETICAL FRAMEWORK

As stated earlier, the aim of this study is to empirically investigate the reasons explaining the lack of success of the GCC countries to attract FDI inflows -- among the necessary conditions for moving in the direction of fuller integration of their economies into the global market. To that end, this study attempts to ascertain the impact of five widely accepted macroeconomic determinants of FDI (independent variables) which are derived from Dunning's 1979 OLI Paradigm, namely good governance, inflation, economic growth/market size, market openness, and ease of doing business (independent variables). The study excluded the foreign exchange rate as one of the determinants of FDI since all the member countries of the GCC use a de jour (fixed) exchange rate pegged to the US Dollar as opposed to using a de facto (dual) exchange rate (Daly, 2007). Therefore, any possible influence of this determinant was considered inconsequential.

Table 2. Trend of GCC Foreign Direct Investment Inflows ($Millions)

Year/ Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Bahrain	865	1048	2914	912	2638	257	155	780	891	988	957
Kuwait	23	233	121	111	-5	1113	1304	3259	2872	1433	485
Oman	111	1538	1597	3332	2952	1485	1243	874	1040	1625	1179
Qatar	1198	2500	3500	4700	3778	8124	4670	938	395	-840	1040
KSA	1942	12097	18293	24318	39455	36457	29232	16308	12182	8865	8012
UAE	10003	10899	12805	14186	13723	4002	5500	7678	9601	10487	10065
Total	14142	28315	39230	47559	62541	51438	42104	29837	26981	22558	21738

This research used Dunning's OLI (Ownership, Location, and Internalization) theory that was first published in 1979. Until Dunning's (1979) OLI theory, none of the empirical studies dealing with different dimensions of FDI had articulated a comprehensive theory which could explain the conditions and the determinants influencing FDI flows (e.g., Denisia, 2010; Donnelly, 2014; Cywiński and Harasym, 2012; Mengistu and Adhikary, 2011).

In his theory, Dunning (1979) identified three broad categories of advantages related to OLI and asserted that the presence of these advantages will lead to investing firms' propensity to engage in foreign production due to comparatively lower transaction costs (Dunning, 2000). Further, the OLI theory specified that in order for a company to build outside its home country, it must benefit from a series of advantages such as a firm's ownership of intangible assets and the host country's infrastructure and business friendliness (Mina, 2007).

In sum, Dunning has identified the following three conditions as necessary for FDI outflows from home country to the host country (Dunning, 1988):

1. Receiving certain privileges from the "host country" such as right to monopoly,
2. Possessing technological advantage new to the "host country," and
3. Benefiting from the "host country" abundant resources, including financial.

ANALYTICAL MODEL AND MODEL SPECIFICATION

Based on the research of Bajo-Rubio and Sosvilla-Rivero (1994), the study developed the analytical model depicted in Figure 1. The model illustrates the research variables and their proposed relations.

Figure 1. Analytical Model
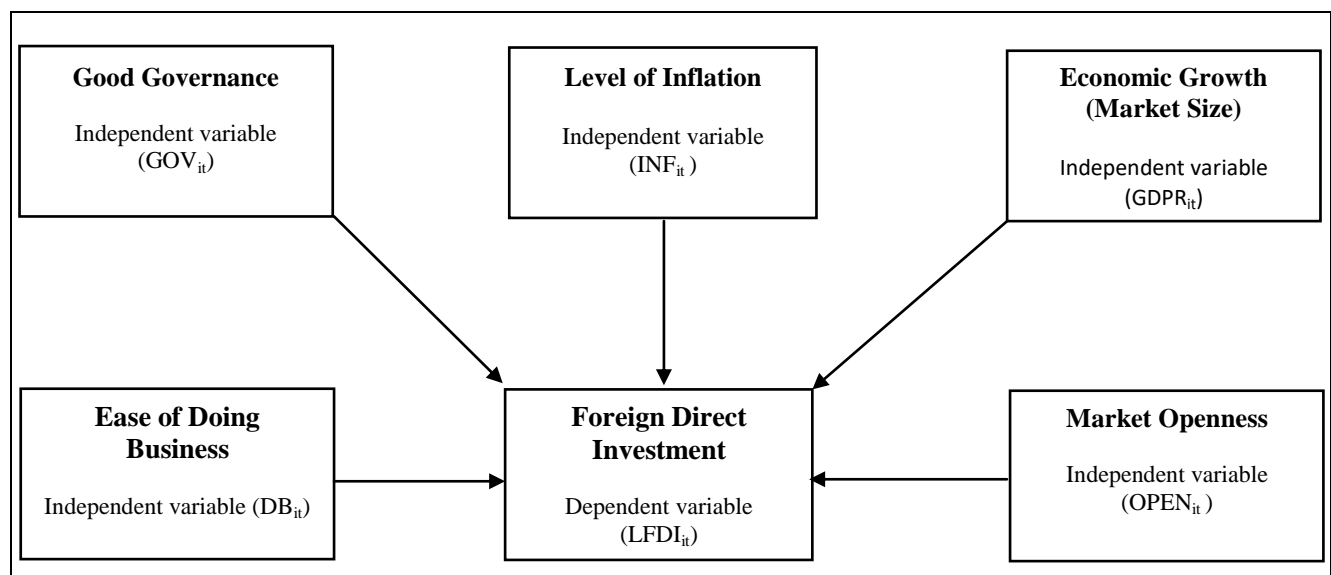
The mathematical expression of the model is as follow:

$$LFDI_{it} = \alpha + \lambda \, GOV_{it} + £ \, INF_{it} + \mu \, GDPR_{it} + \psi \, OPEN_{it} + € \, DB_{it} + U_{it}$$

Where:

$LFDI_{it} = \log(FDI)_{it}$ = Dependent variable

Gov_{it} = Good governance = Independent variable

INF_{it} = Inflation rate = Independent variable

$GDPR_{it}$ = Growth in domestic product as a surrogate for market size = Independent variable

$OPEN_{it}$ = Market openness measured by [(export + import) % GDP] = Independent variable

DB_{it} = Ease of doing business = Independent variable

$U_{it} =$ Residual term (stochastic error measuring the impact of other probable explanatory factors)

λ, £, μ, ψ, and € = Coefficients measuring the affect of independent variables on the dependent variable

$it = i$ refers to the cross section of countries under study and t refers to time series so there is i*t dataset available (i.e., data for 6 countries and 13 years of observations).

ANALYSIS AND RESULTS

This study used pooled data to test the relationship between the five eco-political determinants (independent variables) and FDI inflows (dependent variable) using E-Views version 9. To reduce any potential bias inherent in the quality of data (please see Arellano and Bond, 1990), the research model was estimated by applying a two-stage least squares regression (2SLS). A two-tailed probability T statistics was produced and is shown in Table 3. According to the results, the proposed model for this study provided a very strong fit to the data, as evidenced by R2 = 0.96799 (i.e., 96.7% of the variance in the dependent variable was explained by the model). As shown in Table 3, the adjusted R2 = of 0.919155 indicated that only 0.048835 (the difference between R and R-squared) of the variance of the model was due to chance or other explanatory factors.

The discussion of the results of tests of hypotheses dealing with the relationship between the five determinants (good governance, level of inflation, economic growth/market size, market openness, and ease of doing business) and the FDI inflows are presented in the following sections.

Table 3.   Results of Two-Tailed Regression Analysis (2SLS Estimates)*

Variable	t-Statistic	Prob.	Accept	Reject
Good Governance				
Bahrain	-0.67	0.51		✓
Kuwait	2.34	0.03	✓	
Oman	1.73	0.09		✓
Qatar	4.7	0.00	✓	
Saudi Arabia	-0.62	0.53		✓
UAE	0.52	0.60		✓
Level of Inflation				
Bahrain	0.03	0.97		✓
Kuwait	-2.03	0.05	✓	
Oman	-0.28	0.77		✓
Qatar	1.73	0.09		✓
Saudi Arabia	1.16	0.25		✓
UAE	0.000	0.99		✓
Economic Growth (Market Size)				
Bahrain	0.73	0.46		✓
Kuwait	0.88	0.38		✓
Oman	0.24	0.81		✓
Qatar	1.37	0.18		✓
Saudi Arabia	-2.81	0.01	✓	
UAE	2.92	0.00	✓	
Market Openness				
Bahrain	3.65	0.00	✓	
Kuwait	-0.51	0.61		✓
Oman	4.09	0.00	✓	
Qatar	-2.38	0.02	✓	
Saudi Arabia	6.51	0.00	✓	
UAE	1.95	0.05	✓	
Ease of Doing Business				
Bahrain	0.03	0.97		✓
Kuwait	-2.03	0.05	✓	
Oman	-0.28	0.77		✓
Qatar	1.73	0.09		✓
Saudi Arabia	1.16	0.25		✓
UAE	3.88	0.00		✓

R-squared	0.967999	Mean dependent variance	10.23350
Adjusted R-squared	0.919155	S.D. dependent variance	6.047125
S.E. of regression	0.638350	Sum squared residual	7.742332
Durbin-Watson stat	2.057020	Second-Stage SSR	7.742332

*   The research hypotheses were tested at 95% confidence level.

The discussion of the relationships of each of the five independent variables on FDI is presented as followed.

Good Governance: The study used indicators reported by the World Bank to measure the effectiveness of the system of governance in a country and the results obtained from the analysis of data revealed mixed results. While the hypothesized positive relations between FDI and good governance for Kuwait and Qatar could not be rejected, the opposite was true for Bahrain, Oman, Saudi Arabia, and the UAE. Prima facie, these findings are consistent with the negative perceptions of the governance in this part of the world and in line with the findings of Worldwide Governance Indicators (WGI), a project carried out by Kaufmann, et al. (2010).

In this ten-year global research project, Kaufmann, et al. (2010) reported aggregate and individual governance status for 215 countries over the period of 1996-2014. Depending on the quality, the project assigned values ranging from -2.5 representing "ineffective" to +2.5 representing "effective" to each of the six dimensions of governance – i.e., voice and accountability; political stability and absence of violence; government effectiveness and regulatory quality; rule of law; and control of corruption. As shown in Table 4, among the 6 countries in the GCC region, only about half received marginally positive indicators and the rest had, for the most part, negative indicators. This explanation can help to clarify the reason for the inability to reject the hypothesis for all the GCC countries, while the overwhelmingly perceptions of the quality of governance in this region is unfavorable.

Table 4. Worldwide Governance Indicators for Years 2002-2014*

No.	Country	Worldwide Governance Indicators	
		Range	Mean
1	Bahrain	-0.09 to 0.35	0.15
2	Kuwait	-0.16 to 0.35	0.16
3	Oman	0.09 to 0.45	0.26
4	Qatar	0.38 to 0.79	0.55
5	Saudi Arabia	-0.47 to -0.23	-0.33
6	United Arab Emirates	0.40 to 0.67	0.53

* Source: Worldwide Governance Indicators

Inflation Rate: The study used the Consumer Price Index (CPI) as a surrogate for inflation rate and the hypothesized positive relationship with FDI inflows was rejected for all the GCC countries, other than Kuwait. The rise in the GCC domestic spending after the 2003 upsurge in oil prices resulted in a persistent inflation, despite of a tighter integration of the GCC economies and a peg to a common currency – the U.S. dollar or in Kuwait a basket that closely follows the U.S. dollar (Mohaddes and Williams, 2011).

In view of rising prices in the GCC during the past decade, whether driven by external markets (spillover effects) or internally, the research finding is in line with the following:

1. The general economic theory's view that inflation discourages doing business in foreign countries (FDI) due to the uncertainty it creates in relation to future prices, interest rates, and exchange rates, and

2. The coincidence of high inflation and low FDI versus the low inflation and high FDI inflows into developing countries (Seyak, 2009).

Economic growth/Market size: The study used the Gross Domestic Product (GDP) as a measure of economic growth to test the hypothesis. The test results indicated the existence of a positive relationship between the economic growth and the level of FDI inflows only for Saudi Arabia and the UAE, two of the countries in the GCC that experienced the highest rate of growth over the past decade. As for the remaining four countries (Bahrain, Oman, Kuwait, and Qatar), the hypothesis was rejected.

These findings, for the most part, are consistent with Muawya Hussein's (2009) study that ascertained the degree to which the GCC countries have recognized the role and importance of FDI for their economic growth. Results obtained from the study indicated only a weak relationship between FDI and economic growth (Hussein, 2009).

Market openness: The study used the total export and import as a percentage of GDP to measure market openness. With the exception of Kuwait, the analysis of results supported a positive relationship between market openness and the ability of the GCC countries to attract FDI inflows.

This result is in line with the finding of a study by Douglas and Redvers (2011) that placed the UAE and Qatar at the top of the list of outward-oriented members of the GCC -- i.e., the countries that had illustrated propensity to relax restrictive mandates, regulations, or practices aimed at tighter integration into the global economy. On the same list, Douglas and Redvers (2011) ranked Saudi Arabia, Bahrain, and Oman in the middle, and Kuwait several tiers lower (Douglas and Redvers, 2011).

Ease of doing business: The final hypothesis asserting a positive relationship between doing business (DB) and ability to attract FDI inflows was rejected for all the GCC member countries, other than the UAE. This result is validated by the ranking of the World's Bank's 2017 index of DB for 190 countries, where a high ranking in the DB index means that the regulatory environment of the country is conducive to the operation of business. In this index, the UAE

was ranked 29, the only one in the GCC block on the list of top 30. The rest of the countries received scores between 66 (Oman) to 102 (Kuwait).

For the most part, this finding also depicts the restrictions being placed on foreign companies doing business in the GCC countries, especially the restriction on the right to maintain controlling interest through ownership of majority interest in the acquired companies (e.g., to open a company in virtually all countries in the GCC, and the region as a whole, a local partner must own the majority of the ownership of the enterprise). This condition is contrary to the very essence of FDI which requires an investor's majority ownership and controlling interest in the acquired company.

SUMMARY

In the past few decades, and compared to other rich developing countries, the GCC region has been host to a disproportionately insignificant share of FDI inflows, despite of its distinct advantages of geopolitically strategic location, the control of vast energy reserves, and the role it plays in both the regional and global economy. For a number of reasons, this can be considered a serious concern for the GCC countries (and the region) deserving both an investigation and constructive corrective measures.

In view of the above, the purpose of this empirical research was to identify the impact of five determinants of FDI inflows derived from Dunning's OLI advantages (i.e., good governance, inflation rate, economic growth/market size, market openness, and ease of doing business). The study used pooled data covering the years 2002-2014.

A two-stage least squares (2SLS) regression analysis was used to analyze the data producing two-tailed probability T statistics. The hypotheses stating positive relationships between the five determinants (independent variables) and the level of FDI inflows (dependent variable) were tested at 95% confidence level.

The test results, for the most part, did not support the hypothesized positive relations between good governance, level of inflation, economic growth/market size, and ease of doing business vis-à-vis the level of FDI inflows to the GCC countries. The noted exception among the determinants was market openness, where other than Kuwait, the hypothesized positive relationship could not be rejected.

Based on the findings of this study, and to attract FDI inflows, the GCC member countries implement policies aimed at the following:

1.   Easing restrictions on foreign entities interested in making direct investment,
2.   Improving the public's perceptions of governance structure,

3. Curbing raising inflation, whether induced internally or imported from the trading partners, and

4. Exercising control over the circumstances detrimental to direct investment by foreign firms.

Notwithstanding unexpected events (e.g., the Arab Spring or the war in Syria), the above actions along with targeted socio-economic, legal, and institutional reforms can lead to promoting GCC's position in attracting FDI inflows and pave the way for substitutive diversification of their economies and fuller integration in the global market.

SUGGESTIONS FOR FUTURE RESEARCH

The current research was the first of its kind in the GCC region. Due to the limited scope, whether in terms of geographic location or limitation on number of determinants of FDI inflows, two areas appear to be logical extensions of this study.

First, and due to the significance of the FDI inflows for economic growth, it is important to replicate this study for major developing countries in the Arab World. The findings of this line of research would assist in terms of providing the necessary country-specific conditions to attract FDI inflows. These findings would also enable comparative analysis of results among similar studies - a useful exercise that could facilitate attracting an improved level of FDI inflows.

Second, two determinants were identical among the GCC countries, and thus, their possible influence on FDI inflows to that region were considered inconsequential (e.g., foreign exchange rate regime and taxation of foreign entities). While considered inconsequential and excluded from this study, these determinants can have serious influence on FDI inflows to other Arab countries. Accordingly, any future studies should focus on the impact of these two, and any others determinants deemed relevant to a given country.

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