Country Risk Factors: An Empirical Study of FDI Determinants in SSA

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ABSTRACT

Foreign Direct Investment (FDI) plays an important role in the development of emerging economies and it has recently been considered a force for the integration of countries, particularly developing ones, into the global economy. However FDI flows into Sub-Saharan Africa (SSA) has been dismally low compared to flows into other parts of the world (UNCTAD, 2002). This study examines the effects of country-risk factors—economic, financial and political risks—on FDI flows into SSA countries during 1990-2002. Using rigorous regression analyses, study results indicate low levels of FDI flows into SSA are attributable to a risky business/investment climate. Specifically, the capacity of SSA countries to attract FDI is a function of economic, financial and political risk factors, with political risk exacting the most significant influence in the joint determination of FDI inflows.

INTRODUCTION

Theories on the growth of foreign direct investment (FDI) have generated different explanations for why FDI occurs. Kindleberger (1969), Hymer (1972), and Horaguchi and Toyne (1990) argue that FDI is the direct result of an imperfect global market environment. The internalization theory, for instance, postulates that FDI takes place as multinationals replace external markets with more efficient internal ones (Rugman 1985 and 1986), and when internalization of such imperfect markets occurs across national boundaries, it leads to the creation of multinational corporations (Rugman, 2002). Dunning (1986, 1988), in his eclectic theory of international production, states that FDI emerges because of ownership, internalization, and location advantages. Most empirical studies classify FDI determinants into demand- and supply-side determinants (Root and Ahmed, 1978 and 1979; Agarwal, 1980). They posit that the demand determinants of FDI are aggregate variables classifiable into three main categories: economic or marketing, social, and political. Some studies have given limited attention to social and political influences (Root and Ahmed, 1979; Dunning, 1981; Schneider and Frey, 1985) while others have focused largely on economic factors (Dunning, 1973; Lunn, 1980 and 1983; Scaperlanda and Balough, 1983; and Culem, 1988). Few studies have examined the financial aspects of the FDI-demand view point; usually such host-country allure studies inappropriately subsume financial market environment in the economic.

This study uses a comprehensive theoretical model that takes into account all country-risk factors such as economic, financial, and political risk factors—separately and collectively—to better explain FDI determinants for the SSA (i.e., the location advantage perspective). By analyzing FDI inflows into the SSA countries over the last thirteen years, the study provides further and reliable empirical evidence on macro-economic factors that affect FDI inflows, in addition to the following significance of the study.

First, the SSA countries are chosen for this study because they possess characteristics that are common to the vast majority of under-developed countries: SSA countries still face huge economic, social, and political challenges; living standards still remain at low levels for much of the population. Therefore, the study contributes to the growing literature on FDI and country-specific risks in the SSA region in general.

Second, understanding FDI determinants for the SSA countries is of interest to both policy makers and investors because FDI is particularly driven by globalization of markets, which has become pervasive (World Bank, 1997). FDI can be an important and stable source of foreign capital flows for the SSA countries, which will appreciate highly any additional external investment capital and the popularly curveted FDI spillovers. These spillovers occur because multinational firms possess numerous proprietary advantages and can, for instance, provide needed high-level

managerial skills and contemporary technology (Meyer, 1998). Further, environmental factors such as marketing, social, host-country economic performance and country risks have been found to affect investment decisions (Agarwal, 1980). Therefore, a study of FDI determinants is additionally important for the SSA countries because FDI serves as a powerful force for competitively integrating developing economies into the global economy (UNCTAD, 1997 and 2000); it can influence a host-country's prosperity as well as improve its absorptive capacity.

Third, given that country-risk factors of developing countries and particularly SSA countries are often cited as major reasons for their dismal record for attracting foreign investment funds, it is important to ascertain which of the country specific risks is most influential in determining FDI inflows. Such knowledge would inform the appropriate mix of policies for attracting more FDIs than is currently in vogue, and in the process increase the attendant benefits of FDI—which are vital ingredients to development-needing SSA economies.

Foreign Direct Investment (FDI)

FDI is defined as activities that are controlled and organized by firms in different nations or host countries (Dunning, 1988), or when the parent company has branch plants or subsidiary operations in another country. World Bank (2004) defines FDI as the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. FDI is also defined as the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments (WDR, 2004). As Dunning (1988) points out, there is a clear distinction between FDI and portfolio investment. In the case of FDI, the parent company has direct and ultimate control over the scope and nature of daily operations, and is transferring not just capital to the host countries, but also technology and management skills. On the other hand, portfolio investment is simply the supply of capital from a lender to a borrower; it is motivated by the rate of return on capita, and requires borrowers to pay back the loan plus interest. Additionally, portfolio investment can involve the purchase of foreign stocks, bonds, or other securities, and has no controlling interest in the investment.

Host-Country Factors that Affect FDI Inflows

All business transactions involve some degree of risk, but international business transactions carry additional political, economic, and financial risks not present in domestic transactions. Country risk relates to the possibility of changes in the business environment, and to the possibility that these changes can adversely affect operating profits as well as the value of assets of foreign investors. The risks arise from country environmental factors such as legal and regulatory changes, government transitions, human rights issues, currency crises, and terrorism, just to mention a few. For multinational companies, these instabilities (political risks) can threaten corporate financial positions, as the costs of doing businesses in an unpredictable, volatile, politically unstable country are usually substantial. Most country-risk measurements are a multidimensional construct that include political, financial, and socio-economic indicators. For many of these constructs, analysts reduce risks to some type of index or relative measure. To measure risk-based environmental factors that affect FDI (e.g., political, economic and financial risk factors), we use the international country risk rating (ICRG) as in Coplin and O'Leary (1994). Political, economic, and financial factors are of interest to investors, businesses, and individuals. A number of influential studies have employed ICRG data, as country-risk ratings are reported to have a high correlation with actual future equity returns (Harvey et al., 1996; Hall and Jones, 1999).

The crux of focusing on risk-based environmental factors of FDI is that countries that have transparent political institutions and governance structure in addition to promoting and improving their economic and financial institutions and structures attract more FDI in particular and investment funds in general. That is, foreign investors are less likely to invest in risky countries. Therefore, the study seeks to answer the following questions:

1. Does country-risk matter in influencing inward-bound FDI decisions for the SSA countries?
2. Can we estimate the impact of specific country-risk components—political, economic and financial risks—on FDI flows into SSA?
3. What, therefore, are the apparent development and growth policy recommendations from answers to these two questions?

Alternatively, these research questions can be encapsulated in one broad question: What country-risk factors influence FDI flows into Sub-Saharan African (SSA) countries?

Political Risk

Multinational firms are very concerned with the political stability of any country in which they plan to do business. Naturally, they prefer to operate in countries with a stable and friendly government. Investors continually monitor government policies in countries in which they operate for political changes that could adversely affect their operations. International firms may face restrictions in terms of percentage of ownership, the number of non-host staff and executives they are allowed to employ, the amount of profits they are allowed to take out, the types of industries in which they can invest, and their overall conduct of the business. Many other national laws such as tax laws, labor laws, product liability laws, trade restrictions, expropriations laws, and anti-trust laws, also affect an international firm. International business firms are also affected by such international laws as property rights which involve rights to patents, designs, copyrights, and trademarks.

Moran (1998) argues that the host country investment climate is an important determinant of the magnitude of spillovers which a host country experiences. He suggests that a liberal investment climate attracts more dynamic FDI that exhibits some of the best and highly efficient management practices. He further suggests that a stable and friendly investment climate encourages export-oriented operations that are integrally tied into the MNEs' global sourcing and operations. Clearly, this will serve the interest of a developing country that seeks to be competitively integrated into the global markets.

On the other hand, restrictive regimes impose mandatory conditions such as joint partnership, licensing, or domestic local content requirements. Consequently, these restrictive investment climate regimes attract FDIs that exhibit older technology and lags behind in the utilization of management and best practices. In this case, FDI is oriented towards producing for the local market, and may be under joint partnership or other types of licensing restrictions that are less likely to be integrated into the global sourcing and production network. Under domestic local content requirements, foreign investors are forced to substitute poor quality local inputs for better quality imports. This consequently leads to production for the noncompetitive host market, and often limits the achievement of economies of scale (UNCTAD, 1991). Kokko and Blomstrom (1998) argue that the imposition of host country restrictions on the production activities of multinational affiliates is negatively correlated with technology inflows into the host country.

Robock (1971) defines political risk as the likelihood that political forces will cause drastic changes in a country's business environment. He defines political risk as the change in political institutions due to changes in government control, and in social and economic factors. In this study, political risk refers to the host government's policies or decisions that constrain the business activities of foreign investors, and/or affect the business climate in such a way that foreign investors may lose the investment or suffer a decline in their investment value. Political risk includes potential risks that arise from internal and external conflicts in the host country, expropriations, and other traditional political problems. Given its perceived importance, several empirical analyses have been conducted and the findings on political risk as an influential determinant of FDI are largely in the affirmative. Smarzynska and Wei (2000) find that extent of corruption in a country reduce inward-bound FDI into Eastern Europe and the former Soviet Union. Lehmann (1999) argues that country-specific risks coming from political and macroeconomic uncertainty have a significant impact on U.S. multinational firms' FDI decisions in developing countries. In partial support for Lehmann's argument, Jun and Singh (1996) find that political risk is a significant determinant among the countries that receive high levels of FDI but not among the countries with low FDI inflows. In the same supportive vein, Ojah et al (1997) document that political risk is a significant determinant of excess returns to investors of US MNCs that extended manufacturing to foreign markets via joint ventures.

This study assumes that a political risk measure that encompasses government policies and their implied credibility is likely to determine FDI inflows into the SSA economies. The study empirically examines the relationship between political risk and FDI in these countries at the cross-national level. The study hypothesizes a negative relationship between political risk and FDI, thus suggesting a positive relationship between FDI inflow and political risk points. High scores mean that the legislature's decision- and law-making processes are transparent, efficient,

trustworthy, and reasonably democratic; that policies are implemented transparently, efficiently, and consistently to ensure equitable treatment of all subjects under the law. High scores are expected to increase FDI by decreasing instability and, thus, decreasing investment risk.

Table 1 Classification of Composite Risk Rating

Risk Classification	Risk Points (%)		Risk Classification	Risk Points (%)
Very High Risk	00.0 to 49.9 percent		Low Risk	70.0 to 79.9 percent
High Risk	50.0 to 59.9 percent		Very Low Risk	80.0 to 100 percent
Moderate Risk	60.0 to 69.9 percent			

Financial Risk

The financial risk measure reflects a country's ability to finance its official, commercial and trade debt obligations as well as provides a means of assessing a country's financial markets' capacity and stability. For instance, the larger the proportion of debt to total capital that economic units in the country hold, the greater the likelihood of the units' inability to service debt contracts (financial distress/risk). Feder and Just (1997), Cline (1984), and Callier (1985) argue that a country's financial state (equity and credit markets' depth and breadth) plays an important role in attracting foreign capital and in economic development. That is, in addition to the advantage of FDI-bearing MNC's ability to source capital from diverse national financial markets, MNCs are further encouraged to locate production in foreign markets they believe will provide them with working capital funding at affording capital cost, for instance. Similarly, were they to source equity funds in host countries, FDI companies would like to list their stocks in relatively efficient national stock markets that maintain the value of their equity shares as well as allow them to raise equity capital with minimal dilution of ownership. In other words, low financial risk economies have credit markets in which financial services firms seek savings competitively and thus provide credits at affordable interest costs; and their stock exchanges are well run to the extent that many local firms list their stocks there and that shares are traded with minimal discounting (high liquidity in the secondary market).

Therefore, countries that are characterized by low financial risks would attract more FDI inflows than countries characterized by high financial risks. Table 2 shows the financial risk measure's classification used in this study.

Table 2 Financial Risk Classification

Risk Classification	Risk Points (%)		Risk Classification	Risk Points (%)
Very High Risk	0.00 to 24.9		Low Risk	35.0 to 39.9
High Risk	25.0 to 29.9		Very Low Risk	40.0 to 50.0
Moderate Risk	30.0 to 34.9			

Economic Risks

The level of economic activity of a country sets the stage for business operations. A growing economy enables an established business to prosper and offers new entrants a greater chance to succeed. International firms constantly monitor economic activities of countries in which they operate and of countries they wish to enter. Generally, the following elements reflect the economic conditions of a country: gross domestic product (GDP), annual/periodic increases in GDP (rate of economic growth), level of GDP per capita, rate of inflation, stability of local currency, rate of unemployment and balance of payments. The monitoring and evaluation of these activities permit multinational firms to assess the macroeconomic viability of target FDI recipient countries. The review of economic activities also helps firms to consider further expansion (more investments) or plan a pullback (divestment) in a country they already conduct business.

Economic risk deals with factors associated with traditional indicators of fiscal policy effectiveness such as inflation, per capita GDP, GDP growth rate, fiscal budget and current account balances. The economic risks reflected in these indicators arise from adverse shifts in fundamental macroeconomic policy goals or from a significant change in a country's comparative advantage. The overall purpose of the economic risk measure is to provide a means of assessing

a country's current economic strengths and weaknesses. In general, where strengths outweigh weaknesses it indicates a low economic risk, and where weaknesses outweigh strengths it indicates a high economic risk. The minimum number of points that can be assigned to each component of the measure is zero while the maximum number of points depends on the fixed weight each component is given in the overall economic risk assessment. For this measure, the lower the risk points total, the higher the risk; and the higher the risk points total, the lower the risk. Examples of the economic risk measure components are GDP per capita, real annual GDP growth, annual inflation rate, budget balance as a percentage of GDP, and current account balance as a percentage of GDP (PRS Group, 2004). One can see that these components individually reflect growth policy- and/or institutional-factors that can affect a firm's ability to carry out production successfully (profitably).

EMPIRICAL TESTS METHODOLOGY

This section describes the data, states the hypotheses and discusses the methodology employed to test the hypotheses. Let's begin with description of the data:

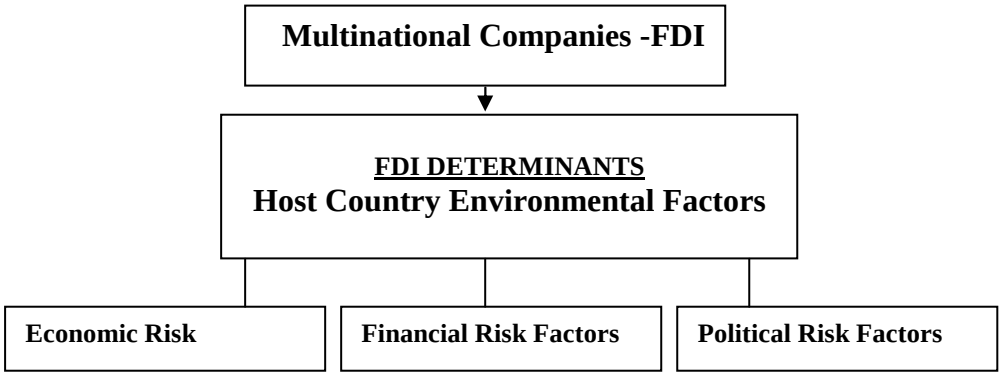
The Data

In seeking to ascertain the determinants of FDI inflows into SSA countries, the study articulates the Country-Risk theoretical model (figure 1). The model states that FDI is determined by country-risk factors such as economic, financial and political risk factors. To validate the model, hypotheses are empirically tested using quantitative data. The data sets are compiled from several sources for the estimation of the model. Data on FDI is obtained from the best source of world development indicators, the World Bank's data bases. Quantitative data on political, economic, and financial risks are obtained from the Political Risk Services (PRS) group database.

The Concept Model and Hypothesis

The theoretical model is consistent with the existing theories of international production, where the demand for inward-bound FDI is said to depend on a variety of characteristics of the recipient country. The analysis starts from the notion that the location advantage point of view of FDI is influenced by host-country environmental factors. Therefore, the dependent variable represents the host-country demand for FDI while the independent variables are comprised of political, economic, and financial risk components—important constituents of a host-country's environmental terrain.

Figure 1: Schematic Illustration of the Country-Risk Theoretical Model



The key hypothesis of the study is based on the Country Risk Model, presented schematically in Figure 1. This theoretical model posits that FDI inflows into a country (here expressed as FDI amount as a percent of the country's GDP) is a function of three major country-risk factors of the host-country—economic, financial and political (express as risk points per the ICRG's measurement scheme).

The World Bank (2004) define FDI as the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is also

expressed as the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as reported in the balance of payments. We use FDI as a percent of GDP because it adjusts foreign investment flows for size of the host-country's economy. This normalization is necessary because the size of a country's GDP can influence the amount of FDI it attracts. We group the location-based determinants of FDI into major category forms the literature has dubbed country-risks factors. The dependent variable (FDI) represents the host country demand for FDI, and we expect a direct relationship between it (FDI inflows as percent GDP) and the location-based FDI determinants (country risk characteristics).

In sum, the hypothesis is that FDI inflows into the SSA countries depend on the degree of economic, financial, and political risks in these host-countries. Alternatively, the hypothesis can be stated as follows: FDI inflow into country I (I = a SSA), is a function of economic, financial, and political risk points. It can be expressed mathematically as:

FDI (I=) = $\beta_0 + \beta_1$(ECONOMIC RISK) + β_2(POLITICAL RISK) + β_3 (FINANCIAL RISK) + ε, (1)

where, ECONONOMIC RISK, FINANCIAL RISK, POLITICAL RISK represent, accordingly, economic, financial and political risk-points; β_0, β_1, β_2, β_3 are regression coefficients, and ε is a random error term. We expect economic, financial, and political risk-points to be positively related to FDI inflows. In fact,all risk-points (per ICRG measurement scheme) are expected to be positively associated with FDI inflows.

Empirical Estimation

Empirical tests were conducted using both the Pearson Product Correlation and Ordinary Least Squares (OLS) regression methods. Regression analysis on FDI determinants is performed for the SSA countries for the period 1990-2002. Specifically, the study tests the relationship between the dependent and independent variables, which encompass each country's economic, financial, and political risk measures. Country risk factors were chosen because they interact among themselves in a number of ways, and they largely overlap with other FDI determinants (e.g., social and marketing factors). Furthermore, investors focus on political, economic, and financial institutions as the primary source of actions and policies that determine the success and viability of FDI (Wilhems, 1998). Thus, the objective is to investigate whether country risk factors are indeed important determinants of FDI inflows into SSA countries.

Analysis of Results

The interpretation and discussion of empirical estimates and other tests are discussed in this section. OLS regression methods was used to determine the estimated regression line and to predict the value of the response variable for any value or combination of values of the predictor variables. Goodness-of-fit statistics, such as R-square, adjusted R-square, and standard error of the estimate, were used to determine whether or not the overall model provides information for the prediction of the dependent variable. For the test statistics, we adopt the conventional benchmark that coefficients with p-values less than 0.10 (p-value < 0.10) are statistically significant, and can thus reject the null hypothesis and conclude that the coefficient is significantly different from zero, 0. Two- tailed t-test p-values are reported in the regression tables, indicating each individual independent variable's predictability of the dependent variable.

Regression Results

SPSS software was used to perform the OLS regression analysis and to estimate the effects of the hypothesized variable and the control variables on FDI inflows, and especially to check if the changes in FDI can be explained by country risk factors. Recall that high risk points correlate with desirable properties for private investors, and indicate that institutions are transparent and trustworthy. Consequently, FDI inflows depend on the economic, financial, and political risks in the host country. Also recall that the country risk model specifies the following relationship:

FDI (I =) = $\beta_0 + \beta_1$ (POLITICAL RISK) + β_2 (FINANCIAL RISK) + β_3 (ECONOMIC RISK) + ε

Regression results show that the country risk model significantly predicted FDI inflows for only 12 countries. That means, R-square values were statistical significant at 90% confidence for only 12 cases (countries). In this case we can argue that the group of country risk factors (economic, financial, and political risk) reliably predicted the dependent variable (FDI) for only 12 countries out of 47. The overall strength of association was weak for the other 35 countries, meaning that the information on country risk points did not provide sufficient evidence to predict FDI inflows.

Table 3 Example of Multiple Regression Results of Country-Risk Factors on FDI Inflows

	Kenya	**Tanzania**	**Uganda**
Constant	1.501 (0.323) [1.045]	-10.835 (0.075) [-2.013]*	-5.986 (0.000) [-6.639] ***
POLITICAL RISK	-0.023 (0.290) [-1.123]	0.182(0.063) [2.121]*	0.155 (0.001) [5.194] ***
FINANCIAL RISK	-0.021 (0.762) [-0.312]	-0.135 (0.179) [-1.457]	0.020 (0.332) [1.026]
ECONOMIC RISK	0.020 (0.792) [0.272]	0.179 (0.126) [1.688]	-0.023 (0.286) [-1.135]
R-Square	0.203	0.884	0.955
Adjusted R-Square	-0.063	0.781	0.940
Std. Error Estimate	0.387	1.068	0.291
No. of Observations	13	13	13
Degrees of Freedom	12	12	12
F-statistic	0.765	10.703***	63.588***
Significance	(0.542)	(0.003)	(0.000)

p-values are in parenthesis; t-statistics are in brackets

*** = Significant at 99% confidence interval

** = Significant at 95% confidence interval

* = Significant at 90% confidence interval

CONCLUSION

The study confirms that the ability to attract FDI inflows depends on the host country's institutions and policies (Wilhelms, 1998; Pigato, 2001). Thus by working on improving environmental factors that influence FDI, such as minimizing country risks, developing countries can experience more FDI inflows, which in turn would contribute to sustainable economic growth and development. Specifically, regression analyses reveal that political, economic, and financial factors influence FDI inflows in the SSA. Though results for some countries did not fully support the country-risk model, overall results generally support observations long made by Gilpin (1975) that it is the host country's environmental factors and implementation of policies that determine inflows of FDI; and recently by Whilelms (1998) that the ability of a country to attract FDIs is determined more by its economic, financial, and political policies than by its inherent characteristics.

The theoretical model is based on the notion that country-risk factors play a critically huge role in determining FDI flows into SSA countries. The results indeed confirm the importance of country-risk factors in attracting FDI for SSA, and show that investors prefer to invest in a relatively stable business environment characterized by low economic, financial and particularly political risks. Thus, the study highlights the importance of government institutions that are responsible for making and implementing policies that affect a country's business/investment climate.

Therefore, to attract more FDIs, SSA governments must importantly establish favorable political conditions such as democratic, transparent and stable governance in a state free of internal and external conflicts. Their financial markets should be characterized by low volatility, efficient transfer of claims and appreciable depth and breadth. A credible judiciary and legal infrastructure that facilitate entry into and exit from business and timely enforcement of contracts are vital. All these (per components of country-risk measures used in this study) alongside an effective regulatory framework would be tremendous in creating an environment conducive to all manner of investments.

FURTHER WORK

By establishing the importance of country-risk factors in predicting FDI inflows, this research encourages further use of the ICRG data for FDI studies at both industry and firm levels. Establishing that country-risk variables correlate with FDI inflows partly validates Schneider and Frey's (1985) findings that a combination of political and economic variables works best in explaining FDI decision. A fuller validation can include additional consideration of social, cultural and other host-country environmental factors' effects on FDI decision in SSA countries.

Africa is divided into five economic trading blocs, and the study of FDI determinants can be extended to a particular region: Southern, Central, Eastern, Western and Northern blocs.

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