Reply to the Second Referee Report on "Capital Account Openness, Political Institutions and FDI in MENA region"

We thank the reviewer for carefully reading our paper and for pointing out some important points that we will take care of in preparing a revised version. Below, the comments of the reviewer are reproduced in italics and our responses are added in blue.

Comment 1

What makes the authors focus on the MENA region? The authors argue that it is meaningful to focus on the region because many of the countries in the region have implemented financial liberalization while they also tend to have weak institutions. However, the combination of relatively high levels of financial openness and weak institutions is quite commonly observed among many emerging market economies. Unfortunately, the paper has an impression that a methodology used in other papers is merely being reapplied to MENA countries. Is there any particular hypothesis, ideally pertaining to some characteristics of the MENA region, tested in this study?

→*We choose MENA countries to carry out our empirical investigations for the following reasons:*

1. Although FDI to developing countries has increased substantially in the nineties. The MENA countries have lagged behind and received a low FDI inflow compared to other developing countries. The share of FDI inflows to the MENA region as a share of the total FDI in the world is small compared to other region in the world. It attracts a smaller amount than all other regions except for Sub-Saharan Africa. The figure below shows that over the period between 2006 and 2010, the share of FDI inflows in MENA represented on average about 6.5 per cent of the world's total FDI inflows, against 23.62 per cent in East Asia and Pacific and 8.72 percent in Latin America and Caribbean, where Brazil and Mexico remained the leading recipients of inward FDI. The Europe central and Asia region has maintained the lion's share of global FDI flow (59 per cent). This distribution is not only particular to this period or one year, but also of the whole previous decades.**Therefore, the relevance of understanding the determinants of FDI inflow in the MENA region is important**

FDI net inflows in MENA compared to other world regions, 2006-2010 (In Million of current US$)					
	2006	**2007**	**2008**	**2009**	**2010**
World	1 594 554	2 352 054	1 905 578	1 345 874	1 343 624
East Asia & Pacific	264 706	372 069	373 095	251 347	371 443
Europe & Central Asia	807 917	1 351 718	814 716	654 829	448 965
Latin America & Caribbean	89 503	135 307	152 956	98 065	127 100
Middle East & North Africa	86 086	91 504	108 642	86 162	67 804
Sub-Saharan Africa	16 636	29 716	37 074	34 983	40 133

Source: UNCTAD, 2012

2. Another reason motivates our choice is explained by the fact that despite the immense challenges faced by the MENA in attracting FDI inflows, the region remains startlingly under-researched. **Very few studies have been devoted to study the determinant of FDI in the MENA region.**
3. In these studies some researchers have focused only on the macroeconomic variables as a determinant of FDI, while little examines the role institutional factors, However, most of them negleged the effect of interaction between them on FDI. The dual determinants of FDI, macroeconomics and institutions, are now know as the new institutional economics approach to FDI (Van Wyk and Lal, 2011). This approach can be defined as an expansion of macroeconomic determinants of FDI to include socio-political interactions and the evolution of institutions. **The important question that arises thus is that what is the role of institutions in MENA countries in world globalizing economic in attracting FDI?**
4. None of these studies have included the capital account liberalization as a determinant of FDI, our literature review outside the case of MENA countries reveal that only nine published articles which include financial openness as a potential determinant of FDI, and only two of the papers examine the relevance of institutional in determining the relationship between capital account openness and FDI inflows.

Throughout this paper, we will try to give an answer for each of the following questions:

- Does capital account liberalization affects FDI inflows in the MENA region?;

- Does political risk alter the relation between capital openness and FDI?
- Does the effect of capital openness on FDI depend on the interaction between capital account liberalization and institutional quality in the region.

Our study comes as a continuation of the research on the FDI determinant in MENA countries by focusing on the role of financial openness and institutional quality. ***Besides, the results stemming from MENA region could be of interest to other developing countries which have engaged in the process of capital account liberalization as part of their structural adjustment programs and economic integration agenda imposed by the International Monetary Fund and the World Bank, for instance like African countries.***

Comment 2

In addition to the above, even if the authors are interested in investigating on the MENA region, having a sample composed only of MENA countries would not let them get insights on the peculiarity of the regional economies. It is better to try to focus on the region in a cross-country or panel context. For example, showing the average effect of MENA countries or individual countries using the estimates based on the sample composed only of MENA countries is not greatly insightful.

→ ***In our empirical analysis, we have referred to the work of*** **Asiedu and Lien (2011).**

Comment 3

How are the correlations among all the institutional variables? One would instinctively imagine that they must be high. If that is the case, trying to identify which of the individual institutional variables is affecting the results of the composite index (Table 3) does not present so much information.

→ The objective behind the examination of the effect of the political risk index as well as its 12 sub-components is to identify if some institutional factors matter more than others. Among institutional factors, law and order, democratic accountability, religion tension and investment profile play an important role in promoting FDI in financial open economies. Result reveal also that the effect of capital account liberalization on FDI inflows is higher when corruption and bureaucracy level is high.

Comment 4

The explanations on the negative coefficient on the interaction terms between bureaucratic quality or anti-corruption measures and capital account openness (reported in columns 11 and 12 of Table 2) do not seem to make sense. What does "foreign investors value the quality of institutions more than the level of corruption in the location selection" mean? A country with higher levels of bureaucratic quality or anti-corruption measures tends to receive smaller volumes of FDI inflows when it opens its capital markets to foreign investors? Why so?

→ "Foreign investors value the quality of institutions more than the level of corruption in the location selection" means that, while law and order, democratic accountability, religion tension and investment profile appear to be important determinants for the location of FDI when country become more financially open, high level of corruption and bureaucracy appears to have positif effect on FDI inflows. Of course, our results should not be interpreted as support for corruption level or bureaucracy regimes in the MENA region. In fact, according to the ICRG, the greatest risk of corruption in the political system "is that at some time it will become so overweening, or some major scandal will be suddenly revealed, as to provoke a popular backlash, resulting in a fall or overthrow of the government, a major reorganizing or restructuring of the country's political institutions, or, at worst, a breakdown in law and order, rendering the country ungovernable". So, even if the corruption in political system appears to increase FDI inflows in Tunisia, Syria and Egypt in the period under investigation, it has helped trigger the Arab revolution in the end of 2010, which affected adversely the business environment and conducted to reduce FDI inflows in these region. Elbir, D., and Goaied, M. (2012) find that is the growth impact of improving financial liberalization is higher when the corruption level is high in the case of the MENA region.

Comment 5

The authors conclude that "high levels of democracy and property rights protections increase FDI inflows to the MENA region (p. 10)." While the positive (interactive) effect of property rights is understandable, why can a more democratic country receive more FDI when it opens itself financially? A more democratic developing country can often be more politically unstable (e.g., Latin American countries).

→We can illustrate the linkage between democratic countries, financial openness and FDI by focusing on the property rights which considered as determinant factors of FDI in the location specific advantage[1] of the OLI paradigm (Dunning, 1988). Despite autocratic countries may offer secure property rights, their credibility is weakened by the fact that their leaders are accountable merely to the ruling elite and exercise power out of their own volition, democratic institutions are on average more effective at securing private property rights than

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[1] The location-specific advantage in a host country relate to the importance for the firm to operate and invest in the host country and are those advantages that make the chosen foreign country a more attractive site for FDI than the others. These advantages may include, government policies, political stability, investment incentives and disincentives, infrastructure, institutional framework (low tax rate, institutions protecting property right, the clarity of country's law, efficiency of bureaucracy and the absence of corruption), cheap and skilled labor, market size and growth, macroeconomic conditions and natural resources.

autocratic institutions as argued by Persson and Tabellini (2006) and Jensen (2006) among others. Furthermore, the freedom to move capital across borders induces countries to secure property rights, because a failure to do so triggers a capital flight. In the eyes of foreign investors, democratic countries which become more financially open offer better property rights protection and reduce risks, this explain why more democratic country can attract more FDI when it opens itself financially.

References

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