Reviewer Report

"Capital Account Openness, Political Institutions and FDI in MENA Region: An Empirical Investigation"

This paper examines the influence of capital account liberalization on FDI flows to MENA countries using dynamic panel model and system GMM estimation methodology. The paper mainly finds that the positive influence of CAL on FDI flows depends on political stability in the host country, and that strengthening democratic institutions and reducing the risk of investment expropriation and religious tension encourage FDI inflows. The results have policy implications for CAL and institutional strengthening.

Comments:

1. The paper raises the interesting issue of the importance of political institutions in attracting FDI flows to the MENA countries, given the degree of capital account openness. This issue is very timely and has important policy reform implications for the MENA region.
2. Starting the paper with the out of date (2004) figures on the volumes of cross-border capital flows is not a very enticing start. A focus on the share of the MENA region in global FDI flows, relative to other regions, is perhaps a better start.
3. Throughout the paper, there is no discussion of the degree of capital liberalization or the performance of political institutions in each of the 17 MENA countries. The MENA countries are specified too late in Figure 2 in the paper.
4. The paper explains the low level of FDI inflows to the MENA region in terms of bad institutions and financial openness that imposes market discipline through capital flight. However, there is no lending support to either explanation.
5. The contribution claims of this paper to the literature is quite a stretch.
6. It is unclear how the paper defines "influential" when referring to Noy and Vu (2007) and Okada (2013), and very hard to see the difference from Okada (2013).
7. The use of GMM estimation methodology is becoming standard in the empirical literature now. However, the paper does not elaborate on the rationale for it in the MENA region context.
8. The selection of macroeconomic variables needs to be clarified.
9. Table 1 below provides summary statistics of the most of the variables used in the empirical mode for the period 1985-2009 for the 17 MENA countries reported in Figure 2. There are gaps in the number of observations reported below for the sample period and what the authors report. The authors need to review their dataset.
10. The specification of the error term in equations 1 and 3 presumes that there is only a country specific effect. Is this the main empirical issue? If it is, why use system GMM instead of fixed effects estimation methodology? This point should be clarified.
11. The paper does not address how it dealt with the "too many" instruments requirement of system GMM. The number of instruments should be reported.
12. The paper should specify the GMM and IV variables used in system GMM estimation.
13. Is the sample period 1985-2009 or 1985-2010?
14. What is the difference between ICRG's and Euromoney's political risk indexes?
15. Why discussing the positive coefficient of *KAOPEN* in specification 2, while leaving the negative coefficients in specifications 5 and 7? These results suggest that capital account openness yield negative results contrary to expectations, political risk has no influence, with positive influence of interaction term.
16. Comparison of one country to the other should be based on the level of FDI as opposed to capital account openness. Accordingly, the comparison should be either with Saudi

Arabia and Turkey, which have the highest 1985-2009 average FDI inflows level (US$ 6.3 billion and US$4.2 billion, respectively) or Lebanon, which has the highest average FDI inflows relative to GDP (11.9 percent).

17. Based on the results of table 2, most institutions have no statistically significant influence on FDI flows. Should we discard the positive influence of institutions on capital flows in the literature and focus instead on the indirect influence of institutions through capital account openness?
18. How do institutions actually exert an indirect influence through capital account openness and the three channels discussed in Brafu-Insaidoo and Biekpe (2014)? This should be explained clearly in the MENA region context. As mentioned above, Saudi Arabia and Turkey have the highest levels of FDI inflows and yet they do not have the highest level of capital account openness.
19. I would advise that robustness checks include: a) exclusion of outlier countries, and b) adoption of measures of capital account liberalization similar to those of Brafu-Insaidoo and Biekpe (2014) building on Kaminsky and Schmukler (2003) and Koyama and Golub (2006).

Table 1: Descriptive Statistics

	Mean	Obs.
KAOPEN	0.531	414
GDPGR	4.462	381
TO	78.199	382
INF	10.181	356
PC	55.407	410
Political (ICRG)*	0.5488	420

References:

Brafu-Insaidoo, W. G. and N. Biekpe (2014), “Determinants of Foreign Capital Flows: The Experience of Selected Sub-Saharan African Countries”, *Journal of Applied Economics* 17, 1, 63-88.

Kaminsky, G. L., and S. Schmukler (2003), “Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization”, IMF Working Paper 03/34, Washington, DC, IMF.

Koyama, T. and S. Golub (2006), “OECD’s FDI Regulatory Restrictiveness Index: Revision and Extension to More Economies”, OECD Working Papers on International Investment, 2006/4, OECD Publishing.

Noy, I., and T. B. Vu (2007). “Capital Account Liberalization and Foreign Direct Investment”, *The North American Journal of Economics and Finance* 18, 2, 175-194.

Okada, K. (2013). “The Interaction Effects of Financial Openness and Institutions on International Capital Flows”. *Journal of Macroeconomics* 35, 131–143.