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

We wish to express our thanks to the reviewer for his/her thorough reading of the paper and extensive comments which we will incorporate in another draft. Below, the comments of the reviewer are reproduced in italics and our responses are added in red.

Comment 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.

→ **Thank you very much for the interest that you bring to the importance of this issue in the case of the MENA region.**

Comment 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Starting the paper with the out of date (2004) figures on the volumes of cross-border capital flows is not a very enticing start.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.

→ **We absolutely agree with the reviewer and we will remove the first sentence of the introduction to start by the share of the MENA region in global FDI flows comparing to other region.**

Comment 3

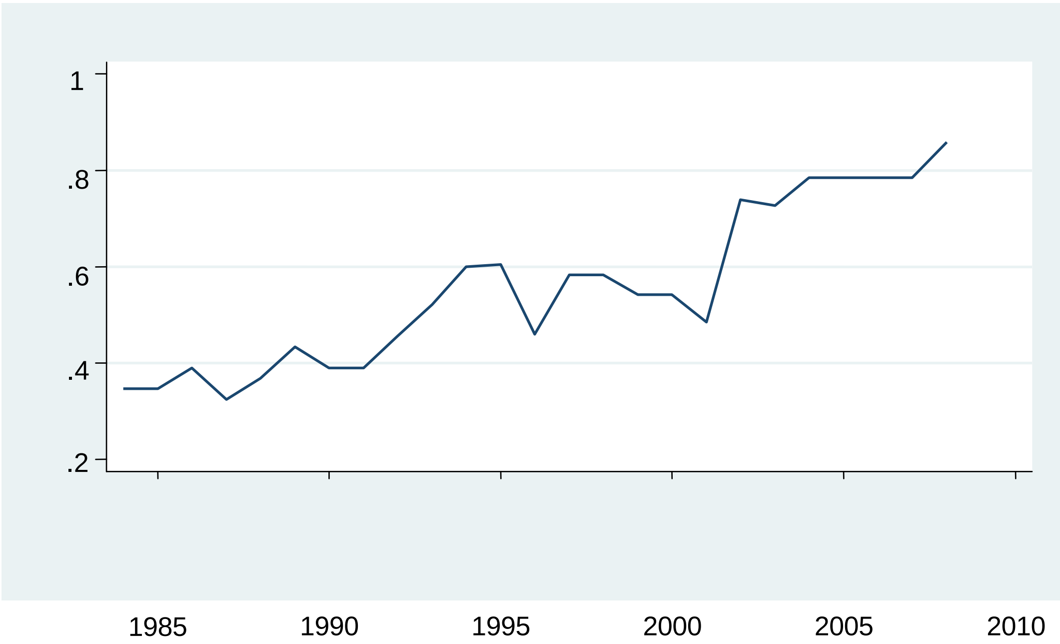
Throughout the paper, there is no discussion of the degree of capital liberalization or the performance of political institutions in each of the 17 MENA countries. The MENA countries are specified too late in Figure 2 in the paper.

→ **We totally agree with the reviewer, it will be suitable to mentioned the definition of MENA countries in the introduction or as footnote. The discussion about the degree of capital account liberalization and political institutions in the MENA region is already done in the others old versions. However, in this version we have chosen to remove it.**

MENA countries

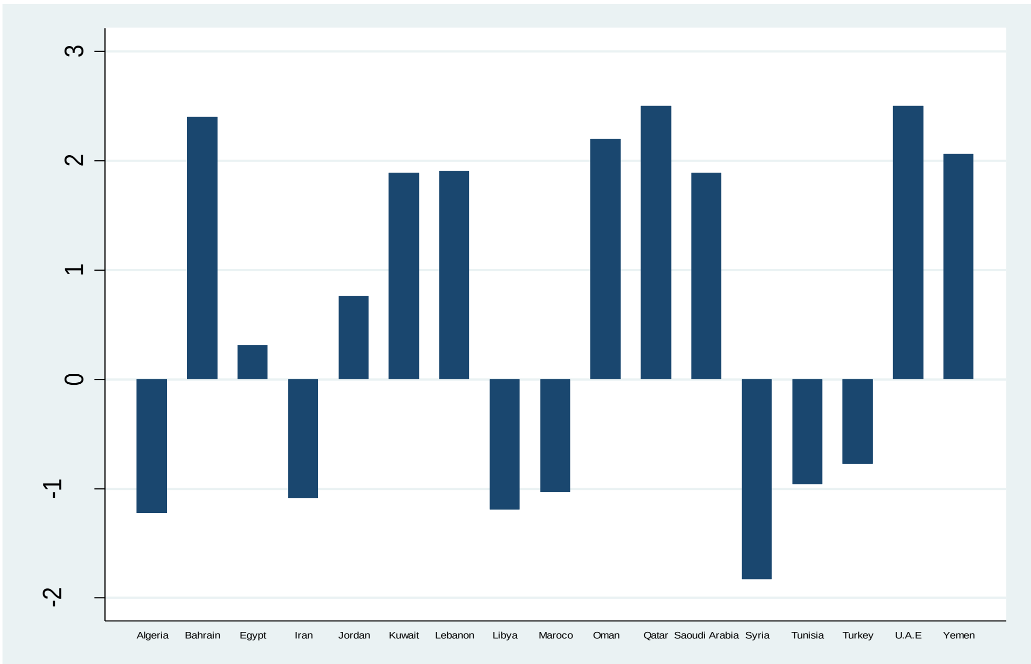
According to the World Bank's geographic classification, the MENA Region includes: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia, Syria Tunisia, United Arab Emirates, West Bank and Gaza and Yemen. For the purpose of this study, Djibouti, Iraq, Israel, Malta and West Bank and Gaza are all excluded from the sample due to severe issues of data availability. Turkey is on the periphery of the region, is located in southeastern Europe and southwestern Asia, between Bulgaria and Georgia, between Greece and Syria. It is included by several study in definitions of MENA region (Ben Naceur and Ghazouani, 2006). Then, in our study, the MENA region refers to the following 17 countries: Algeria, Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, Turkey, United Arab Emirates and Yemen.

Capital account liberalization in the MENA region



Evolution of KAOPEN Index in the MENA region from 1985 to 2008

Note: KAOPEN is an index of capital account liberalization. The data were given from the Chinn and Ito (2010) dataset. Source: Chinn and Ito (2010) dataset and author's calculations.



KAOPEN Index in the MENA region from 1985 to 2008

Note: KAOPEN is an index of capital account liberalization. The data were given from the Chinn and Ito (2010) dataset.Source: Chinn and Ito (2010) dataset and author's calculations.

Governments in MENA countries have initiated policies of financial liberalization to attract capital flows. According to Edison et al., (2002), capital account liberalization is considered an important precursor of financial liberalization. Capital openness can bring significant benefits to the host country include, increase of capital accumulation, access to international capital markets, enhancement of FDI inflows, promotion of productivity growth through technology transfer and thus, economic growth. Using a sample of 17 MENA countries **Erreur ! Source du renvoi introuvable.**, illustrates the average evolution of CAL index (namely, KAOPEN) as created by Chinn and Ito, (2010) from 1985 to 2008. It shows that the financial openness experienced an expansion starting in 1985, and attaining a score of 0.6 in 1995. By the mid 2000s, most of the countries in the MENA region had moved from having a closed financial system to a more open one. However, Despite the growth of capital account liberalization in the MENA region in the period under investigation (from 1985 to 2008), notable differences persist in terms of the degree of openness between countries of the region, while some countries have seen considerable liberalization such as Bahrain, Oman, Egypt, Lebanon, Yemen, Qatar, Jordan, Saudi Arabia and U.A.E, others like Algeria, Libya, Tunisia, Iran, Turkey, Morocco, and Syria retain significant restrictions.

Instituions in the MENA region

we have conducted an analysis of the institution in the MENA countries by using different indices that include the International Country Risk Guide (ICRG) indices, governance indicator, Eutomoney's Country Risk Survey, heritage foundation's index and Corruption perception index. Unfortunality we don't includ it in our paper.

Comment 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.

The objective of our paper is to investigate whether capital account liberalization (CAL) on net FDI inflows depends on factors linked to institutional quality. We find that countries with low levels of institutional quality receive less net FDI inflows when they open up their capital account, but higher levels of institutional quality/ political stability make the impact of higher openness on net FDI inflows more positive. In practice, for a country with an open capital account, a perceived deterioration in its policy environment/ political stability could be punished by foreign investors, who could suddenly take capital out of the country.The Arab spring offers a clear example of how political instability has impacted FDI in transition MENA countries (Egypt, Lybia, Tunisia and Syria), Overall FDI dropped by more than a quarter (UNCTAD, 2011). For example, in Egypt it plunged from $6.4 billion in 2010 to $500m 2011; in Libya it dropped from $3.8 billion to almost nothing.

Comment 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).

Noy and Vu (2007) and Okada (2013) studies are considered as "influential" given the low level of empirical studies how have towards to examine this issue by introducing the iterraction of financial openness and political stability in booting 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. The first one is given by Noy and Vu, (2007) and the second on proposed by Okada, (2013).
Okada (2013) uses a sample of 112 countries (developed and developing countries). However, Blonigen and Wang (2005) argue that pooling developed and developing countries is inappropriate in empirical FDI studies. Besides other differences, they find that the factors that affect FDI inflows are different across the two groups. In our study, we choose MENA countries to carry out our empirical study, because although large disparities exist between and within these countries in terms of resource endowments, economic evolution, geographical size, population, and standard of living, they share common in term of the determinants factor of FDI and business environment.
In term of empirical results, although, we have reached the same result of okada (2013) concerning the role of coupled effect of higher levels of institutional development (law and order, Socioeconomic conditions,) or political stability and capital account openness in attracting FDI. our result reveal however, that the effect of capital account liberalization on FDI inflows is higher when corruption and bureaucracy level is high.
Furthermore, we have underline the role of the low level of religion tension in attracting FDI in open financially countries, this factor is considered as important in the region, well-known by the religious conflicts and which is neglecde by okada(2013).

Comment 8

The selection of macroeconomic variables needs to be clarified.

→We agree with the reviewer's comment. We added this detail to the revision paper.

Bulding on Dunning's (1981) location advantage[1] hypothesis who proposed the most comprehensive theoretical framework of FDI determinants in his electric theory (OLI paradigm). However, one of the main criticisms of the eclectic paradigm is that it includes so many variables that it loses any operational practicality. Another criticism is that these variables are correlated with others.
Empirically Moosa and Cardak (2006) show that market size, trade openness and infrastructure quality are the most robust determinants of FDI, thus, these variables form part of our macroeconomic variables that appear in all model specifications. Furthermore, a high

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[1] The location advantage 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

rate of inflation is a sign of economic instability for foreign investors and a host government's inability to keep healthy monetary policies. Schneider and Frey, (1985) find that transnational companies invest less in developing countries with higher levels of inflation. Literature suggests that countries, which are endowed with natural resources, would receive more FDI. We therefore include the share of fuel in total merchandise exports to capture the availability of natural resource endowments. This measure of natural resources has been employed in several studies, including Jeffrey and Andrew (1997) and Asiedu and Lien (2011) among others and was available from World Development Indicators.

The rationale for the inclusion of the lagged dependent variable is to capture the clustering effects. That is, a larger existing FDI inflows in the previous period is regarded as a signal of a benign business climate for foreign investors. Multinationals may also see the considerable FDI inflows in the previous period as the success of other multinationals and hence may be attracted to the countries for further investment (Asiedu and Lien, 2011 and Okada, 2013).

Comment 13

Is the sample period 1985-2009 or 1985-2010?

→ ***The sample period is from 1985 to 2009***

Comment 14

What is the difference between ICRG's and Euromoney's political risk indexes?

→For our analysis we used two different composite indexes for political risk, the first is given from the International Country Risk Guide (ICRG) provided by the Political Risk Services (PRS) group. ICRG is ranges from zero to hundred, with higher index numbers reflecting lower overall risk. we choose the ICRG index because it has been consistently from 1984 to 2008, which allows cross-country and time comparisons. The second composite index used as a robustness check is taken from Euromoney and it is a 100 point scale. The highest overall rating (theoretically, 100) indicates the lowest risk, and the lowest score (theoretically, 0) indicates the highest risk.

The political risk index of ICRG comprising 12 components which are government stability, socioeconomic conditions, investment profile, internal and external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability. However, the composite index may be too aggregated to capture the appropriate effects on FDI. Then we examined each unbundling factor separately. It is worth noting that in this study, monthly data are averaged to obtain annual scores for the ICRG index for this period[2].

Euromoney's political risk index evaluates the investment risk of a country, such as the risk of default on a bond, risk of losing direct investment, risk to global business relations, etc. Factors included in the ranking of countries by risk: political risk economic performance/projections, structural assessment, debt indicators, credit ratings, access to bank finance and access to capital markets.

References

Ben Naceur, Ghazouani, S., 2007. Stock markets, banks, and economic growth: Empirical evidence from the MENA region. Research in International Business and Finance 21, 297–315.

[2]To ensure an easier interpretation of the results, all indicators have been re-scaled to 0-1.

Blonigen, B., & M. G. Wang, (2005). Inappropriate Pooling of Wealthy and Poor Countries in Empirical FDI Studies. In T. H. Moran, E. M. Graham & M. Blomström (Eds.), Does Foreign Direct Investment Promote Development? Washington D.C.: Institute of International Economics Press

Moosa, I.A., and Cardak, B.A. 2006. “The determinants of foreign direct investment: An extreme bounds analysis.” Journal of Multinational Financial Management 16: 199–211.