The Political Economy of Governance in the Euro-Mediterranean Partnership

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Working Package II: The Political Economy of Euro-Med Investment

Summary of findings

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1. Introduction

Both developed and the developing countries struggle nowadays to strengthen their attractiveness towards foreign direct investment (FDI). This has become a new imperative for national policy in a globalized and nationalized world economy characterized by free movement of production factors. Liberalization is introduced according to a certain sequencing pattern – first industrial goods, followed by FDI, which will then lead to liberalization of flows of services and people.

FDI inflows have an overall positive impact on a country's development process and economic growth as well as, especially important for the MENA (Middle East and North Africa) states, creating jobs and accelerating exports. For all these reasons, competition between countries and regions in attracting FDI becomes more and more intense – giving trans-national companies a choice in case of their localization. While the growth performance in MENA region is encouraging (3,5% on a per capita basis in 2003-2004), it has been driven largely by the recent dramatic rise in oil prices and it can be argued that growth should remain a worrying factor to policy-makers in the region because of the problems posed by existing high unemployment rates and relatively strong growth in the labor force of the MENA region.

Considering the situation in the region and the measures implemented there to attract investors, especially in the Mediterranean Partner Countries (MPCs) which have already institutionalized relations with the EU, this study was aimed at answering following questions: Why do some regions lose and some win this competition as it is respectively in the case of the MENA region and NMS (new member states)? What factors determine the investors' decisions in both cases? What is the role of the investment climate, and the entire regulatory framework and economic policies introduced by the host countries in the Mediterranean comparing compared with the Central European region? Where does their these regions' experiences in attracting FDI converge and where does itdo they differ, as far as the scope of the EU's investors engagement is concerned, for example? How can the EU and MPCs work together to build better regional investment relations?

Each paper in this Investment Working Package attempts to give answers to the specific questions listed above. The Package consists of three papers written by Partners from Poland, Turkey and Jordan. Their titles are:

1. *FDI in the MENA Region and Jordan: Regional Experience and Causality Analysis* written by the University of Jordan team.

2. *Development and Determinants of the FDI in the MENA Countries* written by the Sabanci University team.
3. *FDI in Mediterranean Partnership Countries. How to improve the institutional environment in Mediterranean region in order to attract the FDI?* – written by the Warsaw School of Economics team.

2. Findings

One major difference between the texts is the fact that the Polish and Turkish texts take a general view relating to the region of our concern whereas the Jordanian paper predominantly characterizes Jordan's economy, as well as analyzing the impact of FDI on Jordan's growth and its exports and imports, being thus a one-country study in the large part. The Turkish work provides some empirical studies on the determinants of FDI in MPCs. It conducts a quantitative study, draws conclusions and then basic recommendations are made. The Polish paper draws a rather wide view on FDI determinants in MPCs. Each of the three sections concentrates on one group of FDI factors such as: internal arrangements, external arrangements (especially IIAs, agreements within WTO), and fiscal policy. The Polish part is descriptive and forms a basic framework for further empirical studies. When it comes to the main differences between the papers it is obvious that although all of them agree on FDI determinants, their interpretation or descriptions, they differ in applied methodology, which makes them compatible, complementary and able to be considered as a single entity. All papers complement one another and help to create a picture of MPCs' situation in relation to FDI attraction, reasons of their poor performance in this field as well as drawing certain recommendations on what should be done in these countries in order to attract more investment.

When it comes to major findings in the texts we should point to those related to analysis of FDI flows, stocks and the main determinants influencing those factors. And thus, the Jordanian text points out the fact that in 1998-2005 Arab countries managed to attract only 0.94% of the world FDI flows, although figures for inward FDI stock as % of GDP of the Arab countries are comparable to those in the CEECs. The text points at a strong sectoral specification of FDI in the MENA region (concentration on the telecommunication, service - banking and tourism - and energy sectors). Moreover, Arab countries have not managed to attract FDI flows in heavy industrial projects or in advanced technologies as some CEECs have. One of the main reasons for this situation, according to the authors, is a low level of

intra-Arab trade and thus the existing free trade agreements should enhance, facilitate and promote intra-regional trade. Otherwise European investors, for example, will not find it attractive to invest in the region (the hub and spoke argument). On the other hand, this paper tries to analyze the impact of FDI on trade. The results of that paper on Jordan's economy show the absence of short-run unidirectional causality from FDI to exports. According to the authors this should be a worrying factor since the Jordanian economy is small and needs export-oriented FDI because this is the only way that the economy can generate enough growth to meet its current and future development challenges. As the author points out: "if FDI does dot promote exports, the export-led economic growth, which is necessary given the economy's problems, is put into some serious doubt". One reason for this is the fact that most FDI inflows in case of Jordan (as well as in the whole region) are service-oriented. The authors, however, expect this trend to change in the future due to the increasing FDI flows in the Jordanian Qualified Industrial Zones (QIZs).

The Polish paper shows that FDI in the MENA region come from three main regions. The biggest one is the EU with its 49% (2005) share in total FDI. The second place is taken by the US (18%) and the third (15%) is formed by MPC – MPC reciprocal FDI. Despite Europe making such a large percentage of FDI in the region, this comprises less than 1% of total European FDI. However, the Jordanian paper stresses the fact that the share of European FDI in Jordan dropped from 54% in 1996 and 6% in 2005. The Polish paper gives possible reasons for this fact, which may be lack of European perspective for MENA countries and the even stronger economic involvement of the USA in the region in terms of building investment and trade relations through Free Trade Agreements.

The Turkish text shows that MPCs are improving their position in most variables, for example fiscal burden, monetary policy, informal market, GDP and others. For countries with strong attractiveness a trend on increasing FDI stock shares can be observed for i.e. trade and monetary policy, wages and prices, GDP and the opposite trend for foreign investment, banking and finance and property rights. A final observation on correlation coefficients in FDI inflows is that the traditional determinants are gaining importance in this region, while the non-traditional determinants are remaining the same. The paper draws a final conclusion from the empirical work as well as from the case studies for the individual MPCs that these countries, in order to increase inward FDI stocks, should decrease tariffs, reduce or remove non-tariff barriers, slow down the inflation rate, eliminate price controls, and extend the domestic market. Moreover, to increase inward FDI flows they should also decrease government intervention in the economy, decrease corporate tax rates, and increase the

incentives for investments. This list of determinants could be widened to creating institutionally safe solutions for foreign investors, embracing full convertibility, stable exchange rate policy, a well developed banking system, and predictable and transparent laws, amongst other measures. Most of these solutions can be achieved within WTO or MIA agreements.

Similar conclusions are drawn by the third text, which is prepared by the Polish group. It concludes that within the institutional arrangements much must be done, namely: overcoming the corruption problem and red tape, lowering transaction costs, and improving transparency. MPCs should accelerate the ratification process of BITs already signed and renegotiate the old treaties to make them more suitable to international law development as well as widen the scope of investment provisions of the future Euro-Med Association Agreements. So far there is more evidence of BITs serving as complements to sound domestic regulatory and institutional framework rather than as substitutes.

The Jordanian paper shows that Jordan has become aware of the need to integrate in the world economy and thus pays more attention to investment agreements. It has already signed the AA with the EU, the Jordan Free Trade Area Implementation Act with the US, and is a member of the WTO. Within fiscal and monetary policy, the Polish text also suggests lowering tax burdens – CIT, PIT, tax on dividends, facilitation of complicated, multi-layered tax systems (e.g. in Jordan). When we compare the findings and conclusions of all papers we see that similar recommendations are formulated in each of them, all papers seem to notice the bad performance of MPCs in attracting FDI compared to the economic potential of the whole region. All papers analyze only FDI inflows. They do not concentrate on FDI outflows from MENA countries and their results on the economy, such as limiting the scale of national currencies appreciation which attracts capital flows but at the same time can be considered as a factor counteracting the drive to increase exports.

The papers also cover the subject of NMSs' experience in attracting FDI flows. In the Polish text one chapter is devoted to the NMSs as a policy example for MPCs. Poland achieves the best performance in FDI attraction within CEECs and wins the competition for FDI competition with the Czech Republic and Hungary, and is here a good policy example. Poland gained such results thanks to the lowest inflation rates in the region, a relatively high rate of growth, relatively low corporate tax (19% compared with 35% in Morocco and Syria, for example), higher of interest rates than in the EU, access to big and rich markets, and a well developed labor market. The reforms in MPCs could follow the Polish pattern. The MPCs should more firmly reform their internal arrangements, policies and the regulatory framework,

which do actually influence the FDI flows to the host countries and therefore play a major role. Integration in the form of setting up new formal relations with other regions, such as the EU or the US does contribute to improvement of the regions attractiveness. Newly signed and ratified BITs and Association Agreements reassure potential investors that the region may be considered a safe target for investment. The Polish paper compares EU AAs and other BITs and states that AAs are of too narrow scope and that the liberalization process should be continued. This is a potential field for cooperation between the MPCs' governments and the EU.

As for the scope of the research there are not many missing links in the papers. However, no paper analyzes in detail particular reforms undertaken by MENA governments in order to attract more investments (for example privatization, or the Egyptian National Suppliers Development Programme). Detailed analysis of the reforms will be continued in next year's Package: Reforms. The process of European integration with the MENA region, the impact of the EU and the European Neighborhood Policy, although important and having great impact on the situation in the region and therefore directly on the FDI volume, are the subject of a different Package: Negotiation will be studied in next year's package on the impact of the EU enlargement on the MPCs.