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# Determinants of Foreign Direct Investment in GCC (Gulf Cooperation Council) Countries: Analysis of Economic Growth, Inflation, and Political Stability for the Period 2002-2018

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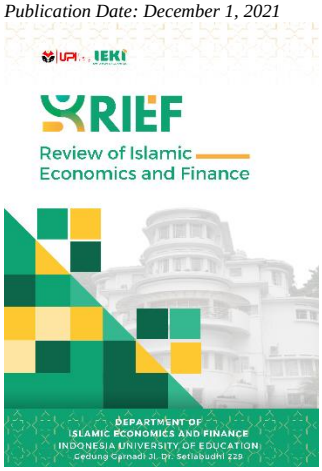


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***Abstract***

***Purpose*** *– This research investigates the factors of foreign investment inflows (PMA) that are encouraged in the member countries of the GCC (Gulf Cooperation Council).*

***Methodology*** *- The sample selection for observations was based on six countries, including the United Arab Emirates (UAE), Kuwait, Qatar, Oman, Bahrain, and Saudi Arabia. The data for this study were obtained from the World Bank and Asian Development Bank (ADB) database for the period 2002-2018. This study adopts panel regression analysis and uses the Random Effect Model.*

***Findings*** *- This research reveals that GDP and Inflation are positive and play a significant role in driving FDI inflows in GCC countries. Meanwhile, Political Stability (PSAV) does not have a substantial impact on FDI inflows in the GCC countries. This study shows that the GCC countries must provide a conducive investment environment that is represented by higher GDP growth and is involved in various international trade agreements as these factors have a higher likelihood of impacting inflows FDI. Other than that, rules describing investment priorities among members should be ratified immediately to reduce the percentage of FDI inflows out of GCC countries. Thus, this research provides significant insights for policymakers for the GCC countries to attract FDI inflows into the country.*

***Keywords:*** *Foreign Direct Investment, Gulf Cooperation Council Panel Regression.*

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## 1. INTRODUCTION

Several transformations of economic globalization have had an impact on strengthening the integration and connectivity of countries. Coulibaly et al. (2018) explained that this phenomenon resulted in the ease of doing business for foreign investors, foreign investment inside and outside, deregulation of trade barriers, the rapid mobilization of technology, goods, services, and physical and human capital. (Coulibaly, Erbao & Metuge, 2018). In addition, also explain that globalization increases the flow of global information and knowledge, leading to higher productivity and economic growth. Therefore, to maximize the advantages of globalization, several countries have formed cooperative organizations such as the GCC (Gulf Cooperation Council). The GCC (Gulf Cooperation Council) countries are regional intergovernmental political and economic unions made up of all Arab states in the Persian Gulf - Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates - except Iraq. The GCC Charter was signed on 25 May 1981, formally establishing the institution. All current member states are monarchies, including three constitutional monarchies (Qatar, Kuwait, and Bahrain), two absolute monarchies (Saudi Arabia and Oman) (see, https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/MT_Globalization_Report_2018.pdf ).

Various empirical studies show a positive relationship between FDI and Economic Growth. FDI is a critical component of the world growth engine; hence countries try to create favorable conditions to attract more FDI inflows to their economies (Adhikary, 2010). Todaro (2004) from some general economic growth factors can be told that one of the primary sources for economic growth is the existence of investments that can improve the quality of capital or human and physical resources, which turn will succeed in improving the quality of resources through discoveries, innovations, and technological advances. There is not a single country in the world whose economic growth is independent of the role of investment. Because the investment in a country experiences a shock, this will have a further impact on the national income of that country (Todaro, 2004).

Some observers considered foreign direct investment to be far more helpful than portfolios. This is because the state truly feels the effects provided by FDI in the capital, the transfer of knowledge and technology. Unlike a portfolio that is often referred to as bad cholesterol because of its fluctuating nature, not having a significant impact on development in the reeling sector, and vulnerable to economic stability (Lembong, 2013). Ibhagui (2020) states that FDI plays a vital role in financial independence because FDI offers investable capital and helps host countries access advanced technology, accelerating their total factor productivity. Therefore, an increase in production productivity will trigger production efficiency and effectiveness (Ibhagui, 2020).

In a broader view, Onafowora and Owoye (2019) explain that FDI can enlarge the market and increase the competitiveness of the domestic input market, which ultimately contributes to getting more tax revenue in the host country from corporate profits. In addition, FDI also assists in sharpening better social and environmental conditions in host countries by adopting `` greener " technologies. (Onafowora & Owoye, 2019).

Likewise, SESRIC (2019) describes international capital flows such as FDI assistance in encouraging international trade, creating jobs that reduce unemployment, and increasing people's income through taxes and household income through wages. (SESRIC, 2019). Furthermore, Akadiri et al. (2020) and Redmond and Nasir (2020) emphasize that FDI promotes technology

transfer from developed to developing countries, developing and underdeveloped countries, which simplifies domestic investment and improves the quality of institutions, and encourages increased human resources of the host country. (Akadiri, Gungor, Saint & Bamidele-Sadiq, 2020; Redmond & Nasir, 2020). In addition, Sahoo & Sethi (2020) describe FDI as an essential source due to the lower probability of capital flow reversal (Sahoo & Sethi, 2020). Iamsiraroj (2016) also supports this statement, which states that most developing countries are trying to attract FDI because they expect stable resources for long-term economic growth. (Iamsiraroj, 2016). In summary, Ridzuan et al. (2018) FDI significantly assists countries in achieving higher growth rates, improving income distribution, and intensifying environmental quality in Malaysia. Because of the importance of FDI, all countries globally, including OIC member countries, try to attract FDI to get sustainable growth (Ridzuan, Ismail & Hamat, 2018). Thus, the factors that influence FDI inflows become an essential research topic for analysts and policymakers (Economou, 2019) to boost FDI growth to a higher level and overcome barrier factors, leading to lower FDI growth. (Economou, 2019).

Research conducted by (Zaman, Shah, Khan & Ahmad, 2012) by looking at the relationship between macroeconomic factors and direct foreign direct investment on state growth in Pakistan produced surprising findings. Overall, the analysis shows a long-term relationship between growth and FDI, human capital, trade. Openness, government size, population growth rate, and consumer price index in Pakistan. Factors such as the low quality of human resources hurt economic growth. The cumulative impact of all aspects (human resources, trade openness, government size, population growth rate, and consumer price index) increases the effects of FDI on growth, whereas the independent impact is unfavorable. The article (Zaman, Shah, Khan & Ahmad, 2012) emphasizes that FDI alone is not enough; several other factors magnify or hinder the effects of FDI on growth. The extent to which a country will take advantage of FDI depends on human resource development, trade openness, government size, population growth rates, and the consumer price index (Zaman, Shah, Khan & Ahmad, 2012).

Depart from this. We want to examine the determinants of foreign direct investment (FDI) in the GCC (Gulf Cooperation Council) member countries by looking at the assumptions of influencing factors based on a review of previous research literature, namely projected economic growth through gross domestic product, inflation, and political stability. Another important finding is that FDI is a necessary means of achieving economic growth only in the presence of absorption created through increased exports, increased imports of capital goods, trade liberalization policies, and human resource development. The negative impact of human resource development on economic growth may reflect decreased public investment in education and training or over-specialization in the education system in Pakistan. With an inflexible labor market, companies cannot benefit from recent trade and institutional reforms (Permana & Rivani, 2013; Zaman, Shah, Khan & Ahmad, 2012).

## 2. LITERATURE REVIEW

### 2.1 Gross Domestic Product (GDP)

Rani and Kumar (2019) state that achieving high economic growth and developing the quality of life are the main goals of all developing and developed countries. FDI is one of the various ways to encourage economic growth (Rani & Kumar, 2019). Therefore, several empirical literature reviews have assessed the relationship between GDP and FDI. Maryam and Mittal (2020) show

that an increase in the market size of the host country, as measured by higher GDP, will lead to a rise in FDI inflows in the context of Brazil, Russia, India, China, and South Africa (BRIS) (Maryam & Mittal, 2020). In addition, this study also confirms that GDP is one of the potential factors in attracting FDI in the long term. Thus, this research shows that policymakers must create and adopt several changes to promote economic growth and increase technological progress. Logically, an increase in GDP reflects an increase in domestic consumption; the increasing demand for consumption, which is a crucial element in determining investment decisions, will attract the attention of investors, including FDI inflows. In a broader view, Sajilan et al. (2019) also illustrate that the size of the market, which GDP represents, reflects the total consumption of the host country in which foreign investors look up (Sajilan, Islam, Ali & Anwar, 2019).

In addition, Iamsiraroj (2016) found that FDI inflows and economic growth have a simultaneous and dynamic relationship. This result implies that the rapid expansion of economic growth will stimulate FDI inflows in 124 countries covering 1971-2010 (Iamsiraroj, 2016). This result is in line with the findings of Onafowora and Owoye (2019), Maryam and Mittal (2020), and Kishor and Singh (2015). They state that economic growth plays a significant and positive role in FDI. Moreover, Alfaro et al. (2004), Asiamah et al. (2019), explain that macroeconomic stability as represented by GDP has a positive impact on FDI inflows (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004; Asiamah, Ofori, & Afful, 2019; Kishor & Singh, 2015; Maryam & Mittal, 2020; Nijhof & Jeurissen, 2017; Onafowora & Owoye, 2019). Based on the theoretical framework above, the following hypotheses can be described:

H1: Gross Domestic Product positively and significantly affects FDI inflows in certain GCC (Gulf Cooperation Council) countries.

### 2.2 Inflation

Sajilan et al. (2019) explained that an increase in the inflation rate would lead to a decrease in FDI inflows due to decreasing consumer purchasing power parity in the host country, which implies a reduction in total demand. (Sajilan, Islam, Ali & Anwar, 2019). In addition, several researchers have described the relationship between Inflation and FDI inflows. Ibhagui (2020) reports that lower inflation rates will cause Sub-Saharan African (SSA) countries to enjoy higher rates of FDI inflows, leading to the most significant economic conditions. (Ibhagui, 2020). Thus, this study shows that to attract a sufficient FDI as their financial resource, SSA countries must maintain inflation stability. In addition, Onafowora and Owoye (2019) examined the Caribbean covering the period 1975-2015 and showed that higher inflation rates are a reflection of the weakness of liability in monetary policy, which directly affects reduced investment and business productivity through increased prices and total production cost (Onafowora & Owoye, 2019). Especially in the context of Ghana, Asiamah et al. (2019) found that the inflation rate has a negative and statistically significant impact on FDI (Asiamah, Ofori, & Afful, 2019). Therefore, the following hypothesis is formulated:

H2: Inflation negatively and significantly affects FDI inflows in certain GCC (Gulf Cooperation Council) countries.

### 2.3 Political Stability (PSAV)

Political stability is essential for the average macroeconomic balance and a conducive business environment in a country. Political risk is highly dependent on political stability and good governance. In a recent study, Shahzad et al. (2012) argue that political stability increases the likelihood of attracting more FDI inflows to developing countries. A country like Pakistan has been suffering from constant instability in the political system, thus, adversely affecting foreign and domestic investment. Of course, political instability is not good because it will have a negative impact on the country's economic development and growth process by its unhealthy dents on physical and human resources. (Shahzad, Mithani, Al-Swidi & Fadzil, 2012). When the conditions of the country's Political Stability are not good, foreign investors will hesitate to carry out any project until they are sure that the business environment will be conducive and profitable. (World Bank, 2011).

Furthermore, determinants of political risk such as regime change, government intervention in the economic situation, property rights laws, and red tape can adversely affect the foreign investment decision process. (Schneider, 1984). However, international investors and international organizations give high importance to their FDI decision processes on how well each country's governance indexes such as: fighting corruption; transparency of administrative functions; and a violence-free environment (World Bank, 2011). Shahzad et al. (2012) suggest that macroeconomic determinants can influence political stability (Shahzad, Mithani, Al-Swidi & Fadzil, 2012).

H3: Political stability positively and significantly affects FDI inflows in certain GCC (Gulf Cooperation Council) countries.

## 3. METHODOLOGY

The analysis method in this study uses panel data regression and is processed using the Stata 14.0 statistical application. Panel data consisted of a cross-section and time series with the period 2002 - 2018 with all the variables involved. The tabulated data is then converted into a natural logarithm (ln) for each variable to equalize the unit value with assistance program Stata 14.0. Furthermore, in panel regression to determine the best measurement model, the model specification test is carried out (Gujarati, 2004) where later when it meets the criteria for the best measurement model, then the statistical criteria test is continued, which is a procedure to test the truth and error of the hypothesized results from the sample, while the user is the coefficient of determination (R-square) simultaneously. The F statistical test interprets whether all the independent variables included in the model have a joint influence on the dependent variable with a significance level of 95% ($\alpha$ = 0.05). Then to partially do the t statistical test to see how far the influence between the dependent and independent variables is.

The analysis used in the study is a panel data regression test. This panel data regression test is used to determine the effect of GDP, Inflation, and political stability on Foreign Direct Investment. The multiple linear regression formula is as follows:

$$YFDIit = \alpha + \beta 1\ GDPit + \beta 2\ INFit + \beta 3\ PSAVit + \varepsilon it$$

Variable Dependent in this study is FDI inflows in billions of dollars, and the independent variables expected to determine FDI flows are carefully selected, based on previous literature and the availability of data sets for the selected period. The independent variables in our estimation include GDP, inflation rates for macroeconomic stability, value exchange rates, and political stability variables. Where, FDIit= Net FDI inflows in the State Gulf Cooperation Council (GCC) i & period t; GDPit= Gross domestic product of the Gulf Cooperation Council (GCC); PSAV variableit = StabilityPolitics in the State Gulf Cooperation Council (GCC). And from now on is the error term of the model based on a literature review discussed, our study predicts a set of potential determinant variables affecting FDI flows, and we classify the variables into the following broad categories:

Tabel 1. Descriptive Sample

| | Variable | Source |
|---|---|---|
| 1 | FDI | World Bank & Asia Development Bank |
| 2 | GDP | World Bank & Asia Development Bank |
| 3 | Inflation | World Bank & Asia Development Bank |
| 4 | PSAV | World Bank & Asia Development Bank |

Source: Author

The data set consists of annual datasets from 2002 - 2018 Gulf Cooperation Council (GCC) States. The required data sets for the selected countries were obtained from the World Bank and Asia Development Bank data set.

## 4. RESULTS AND DISCUSSION

### 4.1. Chow Test

This test aims to compare and select the best modeling between CEM and FEM models. The null hypothesis is not accepted if the p-value is less than α 5%. At the beginning of the test, the best model was determined to determine the most appropriate model through the Hausman test. The initial hypothesis is:

H0 = *common effect model*
H1 = *fixed effect model*

From the Hausman test, it is found that the chi-square probability is more than 0.05, so H1 is accepted. So that the best model in this study uses a fixed effect model (REM), from the results of the Hausman test, the probability value is obtained as follows:

Tabel 2. Chow Test Results

| Information | Probability |
|---|---|
| Prob> chi2 | 0.0018 |

Source: Stata 14.0 Data Processing

### 4.2. Hausman Test

In addition, by following the results of the chow test, the next step to ensure that the FEM model is the best model to be used in this study, the Hausman test was conducted to compare the FEM model with the REM model. At the beginning of the test, the best model was determined to determine the most appropriate model through the Hausman test. The initial hypothesis is:

H0 = *random effect model*

H1 = *fixed effect model*

From the Hausman test, it is found that the chi-square probability is more than 0.05, so H1 is rejected. So that the best model in this study uses a random effect model (REM), from the results of the Hausman test, the probability value is obtained as follows in table 3:

Table 3. Hausman Test Results

| Information | Probability |
|---|---|
| Prob> chi2 | 0.9616 |

Source: Stata 14.0 Data Processing

### 4.3. Breusch-Pagan Test

The final stage for selecting the best model is carried out by the Breusch-Pagan Test. This test is used to determine the best model between FEM and REM. At the beginning of the test, the best model was chosen to select the most appropriate model through the Breusch-pagan test. The initial hypothesis is:

H0 = *common effect model*

H1 = *random effect model*

From the Hausman test, it is found that the chi-square probability is more than 0.05, so H1 is accepted. So that the best model in this study uses the random effect model (REM), from the results of the Breusch- pagan test, the probability value is obtained as follows table 4:

Table 4. Breusch-pagan Test Results

| Information | Probability |
|---|---|
| Prob> chi2 | 0.0001 |

Source: Stata 14.0 Data Processing

The results of the three tests are described in the table above. The test results show that with table 2, in Chow's test, we can be sure that the fixed effect model (FEM) model is better than the common effect model (CEM). This result is expressed by the Chi-Square cross-section probability is 0.0018, which means it is lower than α 5%, and there are significant individual and time effects. In addition, according to table 3 of the Hausman test, we can clarify that the appropriate model between the two models is the random effect model (REM) model. The test probability value is higher than α 5% (0.9616> 0.005). Therefore, to test which equation is the best model for this result, the Breusch-pagan test is needed. In the last step measured by the Breusch-Pagan test, we

can conclude in table 4, that by using α 5%, the best model for this study is the random effect model (REM). Both p values are lower than α 5% (0.0001> 0.005).

It can be concluded that if the best model for this study is the random effect model (REM), there is a specific effect for each Gulf Cooperation Council (GCC) country. This objective is seen through the mean intercept of country data in a cross-section where a representative random deviation is seen. Both individual intercept of the mean value of the intercept. The random effect model uses generalized least square where the data used is free from multicollinearity, and the data characteristics are constant so that it is homoscedastic. Therefore, this model does not require the classical assumption test ondeviation rate (Gujarati & Porter, 2009; Gujarati, 2004).

### 4.4. Multicolinearity Test

This research involves using the Variance Inflation Factor (VIF) to test multicollinearity. The results are in table 5:

Table 5. Test results Multicollinearity Test - Variance Inflation Factors

| Variable | Centered VIF |
|---|---|
| GDP | 1.47 |
| INF | 1.27 |
| PSAV | 1.26 |

Source: Stata Data Processing

Table 5 shows that all VIFs are less than 10. This VIF value implies that none of the variables are highly collinear on each variable studied in the country Gulf Cooperation Council (GCC).

### 4.5. Panel Data Regression Test

Discussion and interpretation in table 6. Results of the Random Effect Model panel regression test:

Table 6. Random Effect Model – Estimation

| Variable | Coefficient | Probability |
|---|---|---|
| C | 1.883756 | 0.026 ** |
| GDP | 0.1468517 | 0.010 * |
| INF | 0.0316764 | 0.174 *** |
| PSAV | -0.2010278 | 0.793 |
| Descriptive Statistic | | |
| R-squared | | 0.0827 |
| Prob (F-stat) | | 0.0126 |

* significant on α = 1%
** significant on α = 5%
*** significant on α = 10%

Source: Stata Data Processing

The results of the research shown in Table 6 are interpreted to mean that simultaneously the probability F-Statistic = 0.0126 <0.050 with a significance level of 95% shows the results of the independent variable significantly influence the dependent variable, which shows the model has an impact on international trade flows influenced by the trading partners affiliated with the GCC (Gulf Cooperation Council) countries, this is due to the relationship between each other for the production process and the flow of imports in the territories of trading partner countries to countries that are members of the GCC (Gulf Cooperation Council)., then for the effect of variables simultaneously shown by R-Squared of 0.0827 means that these variables have an influence of 8% on the dependent variable.

And the last one is a partial interpretation of each variable, the gdpit variable has a significant positive effect on FDI, meaning that every 1% increase in the gross domestic product (GDP) in the GCC (Gulf Cooperation Council) country will cause an increase in the value of FDI on average. A coefficient of 14.68517% assuming other factors outside the model are considered constant, then the INFjt variable has a significant positive effect on FDI, meaning that if Inflation (INF) prices are constant in the GCC (Gulf Cooperation Council) country increases by 1% it will increase FDI to the destination country automatically. The average coefficient of 3.16764%. But on the one hand partially, the state political stability variable (PSAV) does not have a significant effect but has a negative value on FDI.

For the variable economic growth (GDP) and price increases, inflation has a significant and positive value. This analysis shows that foreign direct investment (FDI) in the determinant GCC (Gulf Cooperation Council) country can be influenced by economic growth (GDP) and price increases. (INF) in a GCC (Gulf Cooperation Council) country of a trading partner country, therefore parties with interest in policymakers must create a friendly environment for foreign direct investment, because it can increase the rate of foreign direct investment (FDI) in GCC countries (Gulf Cooperation Council). Besides that, this is also in line with the research conducted by (Gumilang, Mukhopadhyay & Thomassin, 2011) stated that the flow of foreign direct investment through domestic investment can incre ase production capacity in terms of raw materials and ready-to-use output products, of course from direct foreign investment can also increase employment in Indonesia and have an impact on the welfare of society, in One side that needs to be considered from direct foreign investment is creating fair regulations related to cooperation with foreign parties, so that collective collegial cooperation is based on mutually beneficial principles in bilateral relations in terms of national resilience in the trade economy sector.

Then, this is also confirmed by the research of Sajilan et al. (2019) found that the impact of Inflation on FDI, such as in OIC countries, is not robust for the fixed effect model (FEM) & random effect model (REM). Interestingly, a number of studies such as Ibhagui (2020), Asiamah et al. (2019), and Onafowora and Owoye (2019) explain that lower inflation rates indicate stable economic conditions and substantial parity of local consumer purchasing power. This, in turn, will bring FDI inflows to a higher level because of the small investment risk. (Asiamah, Ofori, & Afful,2019; Ibhagui, 2020; Onafowora & Owoye, 2019)

The Political Stability variable (PSAV) does not have a significant effect but has negative results. This is also confirmed by research conducted by Kurniati (2017), Political stability and security should not be carried out in authoritarian ways. Political stability must be based on performance and based democracy so that the state of a country is healthy. In a country, there must be a political element that is directly related to the potential for FDI inflows in several countries.

This political risk is related to potential uncertainty so that this potential for delay can reduce the decline in FDI in a country (Kurniati, 2007).

## 5. CONCLUSION

This paper investigates the factors that lead to the inflows of foreign investment (PMA) in 6 GCC member countries (Gulf Cooperation Council), which are among the top 6 hosts for FDI flows into countries, including Bahrain, United Arab Emirates (UAE), Iran, Kuwait, Qatar, and Oman covering the period 2002-2018. This study applies two variables, which are macroeconomic and political stability variables, as independent variables. Essential findings in this research reveal that economic growth (GDP) and rising inflation have a positive effect and significantly shape FDI inflows. Meanwhile, political stability (PSAV) does not have an essential role in influencing the inflow of FDI but has a negative value. In addition, this study also shows that the impact of the GDP variable on FDI is strong in three equation models, namely, the common effect model, the fix effect model, and the random effect model.

Furthermore, the results of this study indicate that GCC member countries should provide an investment environment that is conducive to getting investors' attention and multiplying the rate of FDI inflows. This environment is shown by higher GDP growth. Increasing GDP implies rapid growth in economic activity. In addition, it also reflects an expansion of domestic consumption and domestic spending. As such, this can be seen as a positive signal to investors that progressive returns on investment are promising.

Of course, even though the political stability variable of a country is not significant, it has a negative coefficient indicating that if the country can create a foreign investment ecosystem that is friendly to a country's policy and stability, it can increase production capacity so that GCC (Gulf Cooperation Council) countries independently can export which will then increase the surplus in the trade balance and have an impact on increasing GDP GCC (Gulf Cooperation Council) countries and its impact on improving the welfare of life and the resilience of the state in facing economic shocks, so that from the policy maker perspective, it can formulate collective, collegial policies so that a healthy bilateral relationship between parties with an interest in countries. And finally, the political stability of a country can be related to the potential entry of FDI within countries GCC (Gulf Cooperation Council).

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