The Effect of Political Risk on Foreign Direct Investment: The Case of Algeria

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Abstract : Both political risk and financial risk represent a great loss of profitable opportunities in the host countries and a serious threat on the attractiveness of foreign direct investments (FDI)in almost all developing countries among them Algeria .

Methods & results: This paper attempts to study the significant relationship between political risk, financial risk and their effects on Foreign Direct Investment (FDI) in Algeria during 1990 to 2012.In fact, our analysis revealed that political has a negative relationship with (FDI) however financial risk was strong.

Key words: Political risk, financial risk, foreign direct investments.

JEL classification: C23 ;F21 ;F23.

1. Introduction

Most important determinants of FDI have been studied and analysed deeply among them the size and growth of the host country, high natural resource, sufficient economic development, foreign exchange reserves Beugelsdijk, S., Smeets, R., & Zwinkels, R. (2008) · However, the effect of both political risk and financial components didn't receive a great care in the analysis of their role as determinants on the attractiveness of foreign direct investments which play a main role in the analysis of any foreign direct investments decision. This paper aware and provide the policy makers about the importance of the political environment and the financial risk in developing countries in general and in Algeria in Particular in order to build a favorable political stability which attract more and more foreign direct investments. Foreign direct investment (FDI) plays a major role in influencing the level of economic activity in industrialized countries, as well as in the developing world. No doubt, that Non-government channel such as strikes, terrorism, ethnic revolutions, intolerance and social instability produce a bad influence on the business environment. Besides, the Government is guilty by generating unfair and discriminatory law that affects foreign investors and multinational firms.

The financial risk which represent any changes in the current financial climate that could either cause the increase in value or cause the option to drop. According to Beck, T., & Levine, R. (2002) the financial structure has a serious impact on FDI and gave the host country a comparative advantage. As a matter of fact, it is important to reduce the financial risk. King and Levine(1993) analyzed how important are financial market and countries with a high financial risk which occurs with any type of financial investment.

2. Literature review

One of the main concerns of policy maker is to attract enough foreign direct investments but this remains a difficult task in developing countries such as Algeria where the political stability is still uncertain. (Buckley and Casson, (1976)[(4)] argued that location and ownership advantages are the most important determinants for firms to undertake FDI. The relationship between either political risk or FDI or between Financial risk and FDI must be well studied to contribute in the world trade growth.

Busse, M., & Hefeker, C. (2007) studied the linkage between political risk ,institution and their impact on FDI For a data sample of 83 developing countries . They found that government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government, and quality of bureaucracy are highly significant determinants of foreign investment inflows.

The political risk varies from a country to another and according to Loikas, A(2003) the paradigm of political risk was developed by dividing risks into micro- and macro levels depending on whether they affected a specific company or all the companies in a host country,Krifa-Schneider, H., & Matei, I. (2010).

Foreign investors in developing countries such as Algeria face many kinds of political risks due to the lack of political stability and to the effect of the Arabic spring which inflected this part of the world and which is often ranked as a risky Zone.

Examining the determinants of FDI attractiveness to Algeria Sissani, M., & Belkacem, P. Z. (2014) found a positive relationship between foreign exchange reserves and foreign direct investments. They didn't include the effect of political risk although Algeria stayed dependent on the hydrocarbon sector policy. However political risk remain as a main factor that may attract or deter foreign Investment to Algeria.

3. Theoretical frame

As the level of competition continued to rise, foreign direct investments has become quite essential for lot countries in the world especially with the international business expansion and the recent world foreign direct investments trends. Numerous political and financial risks have become a real threat for international firms in host countries, affect FDI and lead to different investments pattern which make some countries more attractive than others.

3.1 Definition of Risk

Risk effect decision in most economic situation because of its uncertainty .Therefore First, its necessary to know what is meant by risk .The concept of risk refers to the loss, potential or possibility of danger, adverse consequences which may occur towards someone or something. Thompson, Simon G., et al(1995). However we distinguish between risk and uncertainty although both deal with likelihood. According to Henrich, J., & McElreath(2002) R. (2002).The risk may even pay off and not lead to a loss, it can be also calculated and it may lead to a gain however, Uncertainty involves choices with unknown probabilities , on the other hand, is unpredictable.

3.2 Definition of political risk

The most popular commercial publisher of political risk were Coplin and O' Leary's(*) Coplin, W. D., & O'Leary, M. K. (1990) and Dirick T Haner's attempted to assess the political risk climate in a set of countries using a Delphi method and a panel of experts .Now experts with high diploma in political science and experts in sociopolitical conditions and include scenarios for future in the political climate.

Political risk is not a new phenomenon, the concept goes back to the deep past but it emerged strongly in economic literature with events of 1960's by new independent countries tried to overcome their lack of capital by simply taking over the foreign subsidiaries of multinationals. This concept was clearly used by some researchers after 1970 and this period was called the Nationalism period. According to Kobrin, S. (1979) political risk is the probability of occurrence of some political events in the host country which may occur and change the prospects for the profitability of a given investment. This risk occurs when investing in a host country with changes in its political structure or policies happen suddenly, such as tax laws, tariffs, expropriation of assets, or restriction in repatriation of profits.

3.3 Definition of Financial Risk

The interaction between risk and reward was known by the financial theoryDe Giorgi, E. (2005). However, in this paper we focus on the financial risk which encompasses the risk of cash insolvency according to Gabriel, S. C., & Baker, C. B. (1980). It is the probability of loss inherent in financing methods which may provide adequate return. It also refers to the possibility of a government or firms defaulting on its bonds, which would cause the bondholders a loss.

3.4 Foreign direct investments

Foreign Direct Investment (FDI) has increased between 1980 and 1990 and globalization was its channel towards developed and developing countries in the whole world .FDI reinforce international finance and trade on the micro-economic macro-economic level. By International Monetary Fund (IMF) standards, (FDI) is defined as new equity purchased or acquired by parent companies in overseas firms beside reinvestment of earnings by controlled firms, and Finally intra-company loans from parent companies to controlled firmsBitzenis, A. (2006).

4. Analysing investment climate and FDI trends in Algeria

Algeria has made a great progress to reach a market economy. Everything started with the application of the law 90/10 which allowed Central Bank the authority to formulate and implement monetary and foreign-exchange policies. The law allowed full foreign ownership of new investment projects, encouraged unrestricted joint ventures between foreign companies and Algerian private concerns too. The government introduced a major liberalization of external trade and devaluated the dinar value to 100 % between 1990 and 1991.Although, the positive macroeconomic outlook, there are still vulnerabilities especially the great dependence on hydrocarbon revenue, risks posed by rising inflation which climbed to 8.9% in 2012. No Doubt that, Algeria with its hydrocarbon wealth, foreign exchange reserves which reached 193.4 billion dollars at the end of December 2012 against 181.5 billion dollars in December 2011, expanding infrastructure needs, growing consumer product demand, is really attracting interest from foreign investors and companies around the world.

Algeria has made a great performance in its macroeconomic results where its real GDP Grew at 3.3% in 2010 and decreased to 3.1 in 2012 due to the oil sector and in a total absence a diversification and a higher unemployment which reached 8.9% in2012.

Table 1: Macroeconomic indicators: 2009-2012

	2009	2010	2011	2012
Nominal GDP	138.0	160.8	190.7	206.5
Real GDP Growth (%)	2.4	3.3	2.5	3.1
Oil GDP Growth (%)	-6.0	-2.6	-2.1	-0.7
Fiscal Balance (% GDP)	-6.4	-2.4	-3.6	-1.0
Reserves (US $ B)	148.9	162.2	181.5	193.4
Population (M)	34.9	35.5	36.0	36.5
Unemployment (Labour forece%)	10.4	11.1	9.9	8.9

***Source**: IMF , Staff Country report 2011.Report 12/20,P9.*

The restrictive foreign investment rules enacted in 2009 and 2010, which imposed a requirement of at least 51/49 % Algerian ownership of foreign investments, have created a sort of threat and uncertainty to foreign Investors. The private sector remained weak with 1.07 % and incapable to contribute in the local economy where the public sector is dominant with almost 98.81%.

Table2 : Development of FDI by legal sectors in Algeria 2002 -2011.

Legal sectors	Nb of Project	%	Employment
Private	47028	98.81%	656817
public	509	1.07 %	80934
Mixed	56	0.12 %	17419
Total	47593	100 %	755170

***Source**: Andi. From: http://www.andi.dz/index.php/ar/secteurs*

Algeria has also expanded more than 286 USA billion in infrastructure development, making the local market sufficiently profitable for firms to explore opportunity especially in the different sectors such as energy, Trade, water, health, telecommunications and transportation. The 2012 Finance Law included measures to ease tax and customs procedures for companies. The political environment was stable, but not successfully strong to attracting FDI flows during this period. The world economic and financial indicators in 2012 revealed that Algeria rank remained Under Performers and suggested an economy diversification to avoid economic crisis.

Table 3: International Rankings and indicators of Algeria in 2012

Measure	Year	Index/Ranking
Corruption Index (CPI)	2012	105 (out of 176)
Heritage Economic Freedom	2012	140 (out of 183)
World Bank Doing Business	2012	152 (out of 185)
Global Peace Index (GPI)	2012	118 (out of 156)

***Source** : According to : Corruption perception index 2012 report - Heritage Economic Freedom 2012 report- Doing Business & (GPI) 2012 reports.*

5.Methodology

5.1 Source of data

The data source are provided by (PRS Group) and Unctad covering 23 years from 1990 to 2012. The methodology part consisted of two independent variables cited above and FDI as the unique dependent variable. The basic model is algebraically expressed as follows:

$$Y_j = \beta_0 + \beta_1 x_1 + \beta_2 x_{2j} + \varepsilon_j \qquad (1)$$

Where β0 is called the intercept and the (ß 1, ß 2, ß 3, ß4) are called the coefficients however is the estimated errors. The multiple linear regression will be as fellow:

FDI = ß 0 + ß 1Poli Risk + ß 2 Fin risk + (2)

Where,

FDI = Foreign direct investments

Poli Risk = Political risk

Fin Risk = Financial risk

Using multiple regression techniques for the period (1990 to 2012), assess the relationship between political risk, financial risk and their effects on the attractiveness of foreign direct investments in Algeria as a host country.

Table 4 :The Algerian data as listed by(ICRG)

Date	FDI	Financial Risk	Political Risk
1990	40	26,5	60,42
1991	80	30,5	56,17
1992	30	32,42	45,25
1993	90	31	47,5
1994	150	31,92	49,08
1995	210	34,17	45
1996	270	36,42	49,17
1997	260	36,25	47,67
1998	607	36,67	42,25
1999	292	31,63	41,42
2000	280	33,21	44,25
2001	1108	39,25	45,13
2002	1065	38,71	46,42
2003	634	42,58	45,08
2004	882	44,92	53,71
2005	1081	46,63	63,21
2006	1795	47,46	63,29
2007	1662	48,78	62,42
2008	2594	49	61,71
2009	2746	47,58	60,96
2010	2264	47,58	60,96
2011	2571	48,21	57,21
2012	1484	47	58

6. Results

The results of our estimation were quite different from what we were expecting .We do agree that low levels of financial and political risks leads to a high and better business climate. In the Model Summary table 5, the value of the correlation coefficient R = 0.89 and the Adjusted R-Square is about 0.80 which is quite very high. The R-square coefficient specifies how data used independent variables in the estimation of the dependent variable and note that the estimated model expresses the (independent variables together) 80% of the data is explained and that the proposed model adequately.

Table 5: Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics	
					R Square Change	F Change
1	0,895[a]	0,801	0,781	426,04643	,801	40,244

As we can see From ANOVA table 6, we find that Sig.=000which is less than the specified significance level of 0.05 ,so we will reject the null hypothesis .As a matter of fact ,The regression is significant and of course, the relationship between the independent variables and the dependent variable is confirmed .

Table 6. ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	14609670,743	2	7304835,372	40,244	,000[b]
	Residual	3630311,257	20	181515,563		
	Total	18239982,000	22			

The central question is which component risk matter most and affects the attractiveness of FDI. The analysis in the coefficients table7 revealed that the regression equation and the amount of errors in the estimation which are in the reasonable limits (std.Error 14.98 and 15.77).We also notice that the financial risk has the greatest coefficient (96.92) and sig = 0.000.So, we conclude that the financial component is the component which matters most for the attractiveness of FDI inflows to Algeria. However, we were astonished to find that the political risk was not *statistically significant.*

Table 7 **Coefficients[a]**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3915,575	638,731		-6,130	0,000
	Poli Risk	20,069	14,980	,170	1,340	0,195
	Fin Risk	96,924	15,778	,780	6,143	0,000

From table 7 : We concluded the regression equation as follow :

FDI= 3915.57+ 96.92 fin risk

7. Conclusion

The purpose of this paper was to analysis the linkage between the political risk, financial risk and foreign direct investment .Our main results can be summarized as fellow. First, the results show that the political risk doesn't have a real impact on the foreign direct investments since the government in Algeria give political guarantees to the petroleum firms and the coefficients is positive but not statistically significant at the 5 to the 10 percent level. The findings regarding the financial risk was in the line with King and Levine(1993)and

Beck, T., & Levine, R. (2002) who found a statistical relationship between financial risk and FDI .

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