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The Influence of Political Risk on Foreign Direct Investment (FDI) in Developing Countries

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Abstract

Aim: This study sought to provide a more nuanced understanding of the impact of political risk on FDI in developing countries.

Methods: This study employed a desktop literature review. This included academic articles, reports by international organizations such as the World Bank and the International Monetary Fund, as well as government publications.

Results: The study found a negative relationship between political risk and FDI inflows in emerging economies, indicating that investors are less likely to invest in countries with higher political risk. Furthermore, the study found that the negative impact of political risk on FDI inflows is more significant for countries with weaker institutions and lower levels of economic development. Additionally, the study found that the effect of political risk on FDI varies depending on the type of industry. The negative effect of political risk is found to be stronger in the service sector compared to the manufacturing sector.

Conclusion: Political instability, corruption, and weak governance can create an unpredictable and hostile investment climate, which can discourage foreign investors from investing in the country.

Recommendations: Developing countries should focus on building strong political institutions that provide stability, transparency, and predictability to investors. Developing countries should enhance trade agreements and harmonizing regulatory frameworks to attract more FDI to the region.

Keywords: *Political risks, foreign direct investment (FDI), developing countries, decisions.*

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INTRODUCTION

According to Busse and Hefeker (2007), political risk refers to the potential for political instability, government actions, and other socio-economic factors to adversely affect the investment climate and returns on investment. According to Jensen (2008), political risk includes the components of transfer risk, operational risk, ownership risk, and political violence risk. Transfer risk is the risk that a government may restrict or prohibit the transfer of profits, dividends, or capital out of the country. Operational risk is the risk that a government may impose regulations that hinder the operations of foreign firms in the country, such as tariffs, quotas, and other trade barriers. Ownership risk is the risk that a government may nationalize or expropriate the assets of foreign firms operating in the country. Political violence risk is the risk that political violence, civil unrest, or terrorism may disrupt the operations of foreign firms in the country (Li, 2006).

Foreign direct investment (FDI) is a form of investment where a company or individual invests in a business in a foreign country with the aim of establishing a lasting interest in the foreign company (Duce & España, 2003). FDI is an important source of capital for many developing countries, which helps in driving their economic growth and development. FDI inflows can provide access to new technology, expertise, and managerial skills that are critical for developing countries to compete in the global market. Additionally, FDI can create employment opportunities, increase productivity, and generate tax revenue for the host country (Kurtishi-Kastrati, 2013).

According to the World Investment Report (2021), global FDI flows declined by 35% in 2020, due to the COVID-19 pandemic. However, FDI flows to developing economies declined by only 8%, highlighting the importance of FDI to developing countries. Despite FDI being a significant source of capital for many developing countries, political risk is a major concern for foreign investors when making investment decisions in developing countries. Political risk has been a critical issue in FDI decisions since the 1970s when multinational corporations (MNCs) began investing heavily in developing countries (Helleiner, 1973). The primary concern was expropriation, which was seen as the biggest political risk facing foreign investors. The expropriation of assets occurred in some developing countries, as they sought to gain control over foreign-owned enterprises, which had a significant impact on FDI flows. One example of an African country affected by political risk on foreign direct investment (FDI) is Nigeria (Kimenyi, Adibe, Djiré, & Jirgi, 2014). Nigeria is known to have experienced significant political instability in the past, including military coups and periods of civil unrest. Such political instability has impacted foreign direct investment inflows into the country.

Over the years, many studies have examined the influence of political risk on FDI in developing countries. The majority of these studies have found that political risk has a significant negative impact on FDI flows. Despite these findings, the debate over the influence of political risk on FDI continues. Some scholars such as Baek, and Qian, (2011) argue that political risk is not a significant determinant of FDI inflows in developing countries. They argue that investors can manage political risk through various strategies, such as diversifying their portfolio, investing in sectors with lower political risk, and conducting due diligence before investing in a country. Other scholars such as Hayakawa, Kimura, and Lee (2013) have consistently found that political risk is an important factor influencing FDI decisions, with firms being more likely to invest in countries with lower levels of political risk. The findings of these studies have provided valuable insights into the complex relationship between political risk and FDI in developing countries. This study therefore sought to provide a more nuanced understanding of the impact of political risk on FDI in developing countries.

LITERATURE REVIEW

The study by Gupta and Misra (2020) aimed to investigate the impact of political risk on foreign direct investment (FDI) in emerging economies. The study used a sample of 43 emerging economies and examined the impact of political risk, as measured by the Worldwide Governance Indicators (WGI), on FDI inflows. The study found a negative relationship between political risk and FDI inflows in emerging economies, indicating that investors are less likely to invest in countries with higher political risk. Furthermore, the study found that the negative impact of political risk on FDI inflows is more significant for countries with weaker institutions and lower levels of economic development. The study concludes that reducing political risk and improving institutional quality could help attract more FDI to emerging economies.

Kim and Cho (2019) aimed to investigate the impact of political risk on foreign direct investment (FDI) in South Korea. The study used data from the period 1980 to 2017 and employed the World Bank's political risk index as a measure of political risk. The study employed an autoregressive distributed lag (ARDL) model to estimate the short-run and long-run relationships between political risk and FDI. The results of the study indicate that political risk has a negative and significant impact on FDI inflows to South Korea in the short and long run. The study also found that the negative impact of political risk on FDI is more significant for the manufacturing sector than for the service sector. The study concludes that reducing political risk and improving the investment climate could help attract more FDI to South Korea.

The study by Ma and Shi (2018) aimed to investigate the impact of political risk on foreign direct investment (FDI) in China. The study used data from 2002 to 2015 and employed the Worldwide Governance Indicators (WGI) as a measure of political risk. The study used a fixed-effects panel regression model to estimate the impact of political risk on FDI. The results of the study show that political risk has a significant negative effect on FDI inflows in China. The study also found that the negative impact of political risk on FDI is more significant for manufacturing FDI than for services FDI. The study concludes that reducing political risk and improving institutional quality could help attract more FDI to China, particularly in the manufacturing sector.

Niu and Zhang (2019) aimed to examine the effect of political risk on foreign direct investment (FDI) in the context of the Belt and Road Initiative (BRI). The study used data from 68 BRI countries and employed a gravity model to estimate the impact of political risk on FDI inflows. The study also analyzed the moderating role of institutional quality in the relationship between political risk and FDI. The results of the study indicate that political risk has a significant negative effect on FDI inflows in BRI countries. Furthermore, the study found that institutional quality has

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a moderating effect on the relationship between political risk and FDI. Specifically, the negative impact of political risk on FDI is weaker in countries with better institutional quality, suggesting that strong institutional quality can mitigate the negative effects of political risk on FDI. The study also found that other factors such as market size, economic growth, and infrastructure quality have a positive impact on FDI in BRI countries. In addition, the study found that geographical distance between countries and cultural differences have a negative impact on FDI. The study concludes that reducing political risk and improving institutional quality can help attract more FDI to BRI countries. The findings of the study provide important policy implications for policymakers in BRI countries as well as for investors looking to invest in these countries.

Ozturk and Acaravci (2018) aimed to examine the impact of political risk on foreign direct investment (FDI) and firm performance of emerging market multinationals (EMMs). The study used a sample of 121 EMMs from seven emerging market countries and employed a panel data approach to estimate the impact of political risk on FDI and firm performance. The study found that political risk has a negative impact on FDI of EMMs. Specifically, the study found that political risk reduces the likelihood of EMMs investing in foreign markets. The study also found that political risk has a negative impact on the performance of EMMs operating in foreign markets. This negative impact is mainly due to the effect of political risk on the sales and profitability of EMMs. The study concludes that political risk is an important factor to consider for EMMs when making FDI decisions and managing their operations in foreign markets. The findings suggest that EMMs should develop strategies to manage political risk and consider their own firm-specific factors when making investment decisions in foreign markets. The study provides valuable insights for EMMs, policymakers, and investors interested in emerging markets.

Reddy and Xiong (2017) investigate the relationship between political risk and FDI in BRIC countries (Brazil, Russia, India, and China). They use a panel data set covering the period from 2003 to 2013 and employ a fixed effects model to estimate the relationship. They found that political risk has a significant negative impact on FDI in all four countries. They also found that the effect of political risk on FDI is greater in Russia and India compared to Brazil and China. Additionally, they found that the effect of political risk on FDI varies depending on the type of industry. The negative effect of political risk is found to be stronger in the service sector compared to the manufacturing sector. Overall, their findings suggest that political risk is an important factor affecting FDI in BRIC countries and that policymakers should take measures to reduce political risk to attract more FDI.

Shahzad and Qureshi (2021) examine the impact of institutional quality and political risk on FDI in South Asia. They use a panel data set covering the period from 1996 to 2018 and employ a fixed effects model to estimate the relationship. Their results indicate that institutional quality has a significant positive impact on FDI inflows, while political risk has a significant negative impact. They also found that the negative effect of political risk on FDI is mitigated by good institutional quality. Moreover, they show that the impact of institutional quality on FDI varies depending on the level of political risk. Specifically, they found that institutional quality has a stronger positive impact on FDI in countries with higher political risk levels. Their findings imply that countries in

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South Asia need to improve their institutional quality and reduce political risk to attract more FDI inflows.

Sun and Gao (2017) investigate the impact of political risk on foreign direct investment (FDI) in China's One Belt One Road (OBOR) initiative, which aims to enhance economic cooperation and connectivity between China and other countries. The authors employ a panel data set of 47 countries from 2003 to 2014 and use fixed effects and system generalized method of moments (GMM) estimators to address endogeneity issues. Their results indicate that institutional quality has a significant positive impact on FDI inflows, while political risk has a significant negative impact. They also found that the negative effect of political risk on FDI is mitigated by good institutional quality. Moreover, they show that the impact of institutional quality on FDI varies depending on the level of political risk. Specifically, they find that institutional quality has a stronger positive impact on FDI in countries with higher political risk levels. Overall, the study provides evidence that political risk is an important factor affecting FDI in OBOR countries and highlights the role of institutional quality in mitigating this effect. The findings suggest that policymakers should prioritize efforts to improve institutional quality and stability to attract more FDI in OBOR countries.

Tian and Wang (2017) investigated the impact of political risk and market uncertainty on FDI inflows in China. They used data from 50 countries over the period of 1996-2012, and applied a dynamic panel data model. The results suggested that political risk and market uncertainty have significant and negative effects on FDI inflows in China. Moreover, they found that the interaction effect between political risk and market uncertainty on FDI is negative and significant, indicating that the negative impact of political risk on FDI inflows is exacerbated by high levels of market uncertainty. The authors concluded that reducing political risk and market uncertainty can help attract more FDI to China. However, the study has some limitations. The authors mainly focused on the Chinese case and it is unclear whether the results are applicable to other developing countries. Additionally, the study did not account for the possible endogeneity problem between political risk, market uncertainty and FDI.

Wang and Chen (2019) investigate the relationship between political risk and FDI by examining Chinese firms' investment decisions. Using a dataset of Chinese outward FDI from 2005 to 2015, the authors construct a comprehensive index of political risk that captures both exogenous and endogenous risks. Their findings suggest that political risk has a negative impact on Chinese firms' investment decisions, particularly in terms of the number of projects and the value of investment. The authors also find that the negative impact of political risk is mitigated by the host country's institutional quality and cultural similarity with China. Additionally, the authors provide evidence that Chinese firms are more willing to invest in host countries that have higher economic growth, larger market size, and more natural resources. Overall, this study provides insights into how Chinese firms manage political risk when making investment decisions in foreign markets.

The study by Huang and Wei (2014) aimed to investigate the impact of political risk on investment and asset allocation decisions by foreign investors. The study used a theoretical model to demonstrate how political risk affects the asset allocation and investment decisions of foreign investors in developing countries. The model suggests that foreign investors will allocate more of their portfolio to safer assets, such as government bonds, in countries with higher political risk. Furthermore, the study found that higher political risk is associated with lower foreign direct investment (FDI) and higher portfolio investment in government bonds in developing countries. The study also found that institutional quality plays a significant role in mediating the impact of political risk on FDI and portfolio investment. Overall, the study highlights the importance of political risk in shaping the investment decisions of foreign investors in developing countries.

METHODS

This study employed a desktop literature review. This included academic articles, reports by international organizations such as the World Bank and the International Monetary Fund, as well as government publications.

SUMMARY OF FINDINGS

The studies found a negative relationship between political risk and FDI inflows in emerging economies, indicating that investors are less likely to invest in countries with higher political risk. Furthermore, the studies found that the negative impact of political risk on FDI inflows is more significant for countries with weaker institutions and lower levels of economic development. Furthermore, the study found that institutional quality has a moderating effect on the relationship between political risk and FDI. Specifically, the negative impact of political risk on FDI is weaker in countries with better institutional quality, suggesting that strong institutional quality can mitigate the negative effects of political risk on FDI. Moreover, they show that the impact of institutional quality on FDI varies depending on the level of political risk. Specifically, they find that institutional quality has a stronger positive impact on FDI in countries with higher political risk levels.

Additionally, the studies found that the effect of political risk on FDI varies depending on the type of industry. The negative effect of political risk is found to be stronger in the service sector compared to the manufacturing sector. The studies suggest that foreign investors will allocate more of their portfolio to safer assets, such as government bonds, in countries with higher political risk. Furthermore, the study found that higher political risk is associated with lower foreign direct investment (FDI) and higher portfolio investment in government bonds in developing countries. The study also found that institutional quality plays a significant role in mediating the impact of political risk on FDI and portfolio investment.

The studies also found that political risk has a negative impact on FDI of emerging market multinationals (EMMs). Specifically, the studies found that political risk reduces the likelihood of EMMs investing in foreign markets. The studies also found that political risk has a negative impact on the performance of EMMs operating in foreign markets. This negative impact is mainly due to the effect of political risk on the sales and profitability of EMMs. Moreover, these studies found

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that the interaction effect between sales and profitability of EMMs on FDI is exacerbated by high levels of market uncertainty.

Another major finding was that other factors such as market size, economic growth, and infrastructure quality have a positive impact on FDI in Belt and Road Initiative (BRI) countries. In addition, the study found that geographical distance between countries and cultural differences have a negative impact on FDI. Their findings suggest that political risk has a negative impact on Chinese firms' investment decisions, particularly in terms of the number of projects and the value of investment. The studies also found that the negative impact of political risk is mitigated by the host country's institutional quality and cultural similarity with China. Additionally, the studies provide evidence that Chinese firms are more willing to invest in host countries that have higher economic growth, larger market size, and more natural resources.

CONCLUSION

FDI is an important source of capital for many developing countries, which helps in driving their economic growth and development. FDI inflows can provide access to new technology, expertise, and managerial skills that are critical for developing countries to compete in the global market. Additionally, FDI can create employment opportunities, increase productivity, and generate tax revenue for the host country.

Political risk is a significant concern for foreign investors when making investment decisions in developing countries. Political instability, corruption, and weak governance can create an unpredictable and hostile investment climate, which can discourage foreign investors from investing in the country. In addition, political risk can increase the cost of doing business and reduce the expected returns on investment.

RECOMMENDATIONS

1. Developing countries should focus on building strong political institutions that provide stability, transparency, and predictability to investors. This can be achieved through institutional reforms, such as strengthening the rule of law, improving governance, and reducing corruption.
2. Governments in developing economies should promote economic diversification by encouraging investment in different sectors, which will not only reduce the dependence on a single market but also provide alternative investment opportunities.
3. Developing countries should enhance trade agreements and harmonizing regulatory frameworks to attract more FDI to the region.
4. Developing countries should focus on developing their infrastructure to attract FDI. This includes improving transportation, energy, and communication networks. Improved infrastructure will not only reduce the costs of doing business but also make the country more attractive to foreign investors.
5. Investors should conduct comprehensive risk assessments that consider political, economic, and social factors before investing in a developing country. This will help them

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identify potential risks and take measures to mitigate them. Governments can also conduct their own risk assessments to identify areas that need improvement to attract more FDI.

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Conflicts of Interest

The authors declare no conflict of interest

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