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HOW POLITICAL INSTABILITY AFFECT FOREIGN DIRECT INVESTMENT IN LEBANON

Foreign direct investment (FDI) is the main driver of economic growth in developing countries. Many studies and research have dealt with its determinants and characteristics. The political factor remains the strongest influence on attracting foreign investment in developing countries, especially if they suffer from instability. In this study, we will try to investigate the impact of political risks on foreign direct investment. Thus, we will address several indicators of political risks, after dividing them into three categories, and applying them and testing them on the Lebanese case. Through this study, we will provide clear physical and real evidence of the existence of an interdependent relationship in causes and effects between political risk and foreign direct investment flows. The «infrastructure», «inflation», «trade openness» and «wage rates» are among the most important determinants that have minimal effects on direct foreign investment.

One of the most important advantages provided by foreign direct investment and its flows to developing countries is that it promotes technology transfer, increases productivity levels, encourages innovation, and relaunches the growth of local companies. It also plays a major role in securing financial capital needs, thus creating new job opportunities that lead to economic growth. The countries of the Middle East and North Africa region have not performed well in taking advantage of the above advantages compared to developed countries, and the region is still lagging behind due to prolonged conflicts and regional wars. Thus, the instability in the political situation leads to a state of uncertainty that leads to the loss of investment opportunities, and thus impedes economic growth.

Howell considers political risks as «political and social events in a country that affect the business climate in such a way that investors lose their money or do not make as much money as they expected, as is the case of the host country in which they lose the opportunity to raise economic growth rates. Thus, the main reason for the economic downturn is the political risks that come from political instability like the change of power and governments, change in legislatures and military coups» [1].

The aim of this study is to approach the unclear relationship between political instability and foreign direct investment cash flows.

Lebanon is one of the countries in the Middle East that has not yet been able to attract foreign investment for several reasons, noting that it's an open economic location and system qualifies it to play this role. According to the UNCTAD World Investment Report, total FDI flows into developing countries decreased in Lebanon from 3,2 billion dollars to 2,8 billion dollars during the 2007-2018 period.

This decline is mainly attributed to political instability and the deterioration of the economy as a result of regional wars. In this regard, Lebanon continues to suffer today from the political, social and economic repercussions of the war in Syria, and internal political instability, as the country witnessed a presidential vacuum from 2014 until 2016, and a vacuum from 2021 until today, after which the country was unable to form a government for continuity of government. Once again, the political situation in Lebanon is unstable, inflation rates are very high, the local currency has lost 90% of its value, and the exchange rate of the local currency has collapsed to the worst.

All these factors contribute to investors' lack of confidence in the country. and thus justify the importance of research of the determinants of foreign direct investment.

We examine in the research [2] the determinants of FDI inflows in Lebanon for the period 2008 till 2018. The study considers a set of macroeconomic variables and political risk indicators as independent variables, and FDI inflows as the dependent variable.

The model uses the political risk index taken from the International Country Risk Guide (ICRG) that is provided by the PRS group to find the adverse effect of political risk on FDI inflows [3]. The PRS group supplies 12 risk indicators that tackle different components of political risk. To include them all in the same regression leads to massive multicollinearity, which jeopardizes the robustness of the results. The need for the Factor Analysis technique is necessary, given the large number of factors and the high multicollinearity they bring in a single regression. In addition, the 12 different indicators introduced by ICRG cover most of the aspects of political risk available in the literature. The Principal Component Factor Analysis technique is used to condense the 12 ICRG into a smaller set of highly correlated factors that reflect the more general dimensions.

Once factor analysis reveals a new set of components, OLS technique is then used to estimate the following [2]:

$$FDI = \beta 0 + \beta 1\ GROWTH + \beta 2\ OPENNESS + \beta 3\ INFRA +$$
$$+ \beta 4\ INFLATION + \beta 5\ LABOR + \beta i\ PRi + \varepsilon,$$

where FDI is foreign direct investment, millions of USD; GROWTH – economic growth, growth rate of real GDP; OPENNESS – trade openness, the ratio of the sum of imports and exports to GDP; INFRA – infrastructure, proxied by the quarterly average of the number of hours of electricity supplied per day; INFLATION – quarterly inflation rate; LABOR – labor cost, provided by the minimum wage rate in Lebanese Lira; PR – political risk, proxied by a vector of political risk variables; E – error term.

Following the literature, the expected signs of the estimated coefficients are positive for β1, β2, β3, and βi, and negative for β4, and β5.

Quarterly data covering the years 2008 until 2018 is collected from Banque Du Liban (FDI, GDP, Imports and Exports), from Electricite Du Liban (infrastructure), from IMF (CPI), from Central Administration for Statistics (CAS) (minimum wage), and from Political Risk Services group (political risk factors).

All political risk indicators can be united into three factors. By inspecting the factor loadings, «Bureaucracy Quality», «Democratic Accountability», «Law and Order», «Religious Tension», «Internal Conflict» and «Ethnic Tensions» belong to the first factor (F1). All six variables are related directly or indirectly to «Cohesion». As a result, F1 refers to «Cohesion». The second factor includes «Corruption» and «External Conflict», and these two indicators mostly represent the «Quality of Institutions». Well-functioning institutions curb corruption and resolve external conflicts peacefully. The third factor includes «Government Stability», «Military in Politics», «Investment Profile», and «Socioeconomic Conditions» which mostly represent «Governance». Accordingly, F3 refers to the «Governance» [3].

The estimated coefficients of all three political risk factors are positive, as expected, and statistically significant. In particular, as «cohesion» index increases by one unit, FDI inflows increase by 299 million USD; as the «quality of institutions» index increases by 1 unit, FDI increases by 139,7 million USD and as «governance» index increases by one unit, FDI inflows increases by 180,6 million USD [3].

Political stability stands out as the most important determinant of FDI inflows. Investors hesitate to invest in a Lebanon as long as it suffers from external and internal conflicts, corruption and ethnic tensions. The key to attract FDI is to provide a stable environment that investors can trust.

Conclusion. Through this study, we tried to move forward in studying the determinants of foreign direct investment in Lebanon, by examining

12 indicators of political risk from the ICRG, after removing the multiple linear relationship, and then grouping the variables into three categories [3]. The results of this important and useful research we can use in evaluation of country risks and correct the discount rate for investment projects in a process of finding the real model of attracting FDI to Lebanon.

Therefore, political stability is generally considered one of the most important determinants of foreign direct investment. First and foremost, investors are looking for countries with fewer conflicts that strictly enforce the rule of law and have fewer bureaucratic complications. This result is particularly important for the stagnant Lebanese economy, which needs foreign investment to stimulate economic growth and job creation.

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