Foreign Direct Investment flows from Southern Europe to developing countries:

The political capabilities of Multinational Enterprises as a determinant of

investments in North Africa and the New Member States of the European Union.

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Abstract: *This study analyzes foreign direct investment flows from Southern European countries to one of two nearby developing regions: North African countries and new European Union Member States in Central and Eastern Europe. As expected, the results show that good economic perspectives, higher level of human capital and appropriate development of infrastructures attract greater investment flows. However, the same is also true for greater levels of political risk measured on scales of political discretionality, corruption and economic freedoms. Despite the fact that one might expect global investment flows to fall as a consequence of political risk, those from the countries in the sample increase, because they come from multinational enterprises that are searching for a market niche where they can take advantage of their political capabilities to obtain competitive advantages.*

Keywords: *foreign direct investment, political risk, multinational enterprise, corruption, developing countries, Africa, Central and Eastern Europe, panel data.*

1. INTRODUCTION

Structural change entailed in economic development is systematically related to direct investments received and paid out by a country or a geographical area (Lall, 1996). At present, these investment inflows are, on the whole, made by multinational enterprises (MNEs); justifying their study to occupy a central role in academic research.

Such is the situation that at present almost all countries, especially developing countries, so as not to lag behind in the current process of regionalization and globalization, take steps to attract Foreign Direct Investment (FDI) through financial or other types of incentives that paint a favourable picture for foreign investors; something which was not done some decades ago.

However, not all regions have managed to attract equal amounts of FDI inflows, despite having begun to open up their economies, to develop infrastructure and to improve the quality of their institutions. In particular, Africa is one of the least attractive destinations for FDI worldwide. According to UNCTAD data (2003), only 1.4% of global FDI between 1994 and 2001 was localized in Africa, whereas 14% went to Asia and the Pacific and 10% to Latin America and the Caribbean. Moreover, as pointed out by Akinkugbe (2005), these inward flows were concentrated in a few developed countries (e.g. South Africa), or those rich in mineral resources (e.g. Angola and Nigeria). These three countries, for example, absorbed 65% of all investments localized in Africa between 2000 and 2002 (World Bank, 2004).

Central and Eastern European countries, on the contrary, reflect a totally different evolution, due especially to investments received from other European Member States at the start of their negotiations over adhesion to the European Union (EU). Spanish investments centred on Latin America in the second half of the 1990s, but having covered the greater part of all possible investments, switched to the EU at the start of the millennium. However, as from 2005, Spanish MNEs began to invest in new EU Member States, attentive to the new opportunities offered by the Common Market and the free movement of goods, capital, services and persons (although with some safeguards). Thus, having received only 5.4% in 2003 and a mere 2.6% in 2004, the region came to represent 25.9% of all foreign Spanish investment throughout the world, which amounted to a growth rate of 626% with respect to the previous year (Durán et al. 2008).

Rather than analyzing global flows influenced by MNEs from the main investor countries, this work aims to analyze the determining factors behind flows of FDI from Southern European countries, given the interesting dilemmas they face over investment

decisions in two nearby developing regions. On the one hand, North Africa is made up of neighbouring countries with historical links but with a deeper psychological gulf and a lower level of development, which provokes migratory movements that are hardly free from social unrest. These could, to a certain extent, be mitigated, insofar as FDI can influence economic growth positively and improve the quality of life. These countries may be contrasted with the recent EU Members States, whose adhesion to a supranational European entity has a played a crucial role in economic, social and institutional development, increasing their attraction for international investors, but at the same time the level of competition.

The rest of this paper is structured as follows: section 2 reviews the academic literature on determinants of FDI in North Africa as well as in Central and Eastern European countries that have recently jointed the EU, lending special attention to variables relating to political risk and the institutional setting of the investment host countries. Section 3 describes the dependent, independent and control variables, as well as the model used and the diagnosis of multicollinearity. Section 4 describes the results obtained with the selected panel data techniques. Section 5 sets out the conclusions and finally, the article ends with the bibliography and annexes.

2. LITERATURE REVIEW

The literature on direct investments in Africa is, in fact, not very abundant, as pointed out by Naudé and Krugell (2007), and the literature on North African countries in the Mediterranean basin is even thinner on the ground. In line with Dunning's eclectic theory of FDI (1981, 1988), works may be highlighted that analyze the specific advantages of localization in the host country based on its economic, institutional and political characteristics which make it more attractive than other alternative localizations.

Morisset (2000) underlines the importance of an attractive environment for investments, liberalization and economic growth as factors that attract investments above and beyond the size of the domestic market or the natural resources. Despite accepting that opening up to international trade favoured the attraction of investments, Asiedu (2002) highlights that it does so in Africa to a lesser extent than in countries

from other continents. Jenkins and Thomas (2002) also hold this same view that African countries suffer from lower investment levels due to the perception of endemic instability on this continent that is shared by investing MNEs.

Naudé and Krugell (2007) raise precisely the same point about the importance of institutions and initiatives working for political stability and good governance, as higher FDI inflows can stimulate economic growth given the low level of domestic investments and savings, as well as the decreasing contributions from development aid.

For his part, Akinkugbe (2005) carries out a two-step study, which firstly studies the decision over whether or not to invest in the region, so as to investigate which determinants influence the magnitude of the inflows. His results reveal that per-capita income, a highly developed infrastructures and favourable policies towards foreign trade are the most significant variables for investors. Similar conclusions are obtained by Wahid et al. (2009) who also underline the positive effect of the size of the domestic market and of human capital, as well as the negative effect of salary costs.

In another study, Asiedu (2004) points out that despite having witnessed unyielding progress towards the fulfilment of traditional recommendations on improvements to opening up and liberalizing the economy, infrastructural development and institutional quality, the reforms pale in comparison with those undertaken by other developing countries (among which the new EU Member States from Central and Eastern Europe following the enlargements in 2004 and 2007), which explains why investment inflows into Africa as a total of all investment inflows into developing countries have dropped. Along these same lines, Richards and Nwankwo (2005) argue that the attractions of Africa as a viable alternative to the emerging economies of Eastern Europe and Southeast Asia depend crucially on the guarantees and harmonization of the different legal systems as, despite recently introduced improvements, the lack of uniformity and difficulties over compliance with contractual obligations and property rights are repeatedly cited as two of the major factors that deter investors.

This leads one to think of the possibility, especially since the start of the new century, that investments originating from Southern European countries, which it might

have been thought would be destined for Mediterranean countries because of their geographical proximity, have been channelled towards the new EU members states which are making progress towards legal harmonization within the framework of the community acquis.

Some authors have studied the possibility that MNEs might be switching investments to the new member states of the EU, which would otherwise have been destined for the South of Europe (Spain, Portugal, or Greece), although the empirical evidence they found ran contrary to their opinion. Thus, both Buch et al. (2003) and Galego et al. (2004) showed that this was not taking place, and that the reduction in investment inflows received by countries in Southern Europe, even before the incorporation of new members, was due to the fact that a balance had been reached with regard to the accumulated stock of FDI.

In fact, academic literature that focuses on investment received by the new European partners, although relatively scarce, is more abundant than the literature that analyzes investment determinants in the Mediterranean basin. As well as the articles by Buch et al. (2003) and Galego et al. (2004) cited above, Meyer (1995) indicates that the political, economic and legal setting since the mid 1990s constitutes one of the fundamental factors, alongside the local market, that is needed to attract investments to the region, especially in the manufacturing sector. Lankes and Venables (1996) distinguish between investments directed at these economies in transition which target local markets, where consumer proximity is essential and associations are usually formed with local agents, as against those that target exports, where the advantages of factor costs are of importance and the type of control is usually total ownership. Oxley (1999) and Smarzynska (2002) point out that greater protection of intellectual property rights also incentivize investments made through total ownership.

Holland and Pain (1998) used panel data techniques to analyze the importance of privatizations as determinants of FDI flows, while Resmini (2000) found that those flows are influenced by specific sectorial factors, although aspects of a strategic or market-related nature usually prevail. Pennings and Altomonte (2003) demonstrated that uncertainty has a negative influence, due to its effect on expected profitability, although not as a delayed investment option, on the countries of Central and Eastern

Europe. Various authors contend that FDI has led to increased productivity through the localization of MNE subsidiaries, but that the "spillovers" towards the domestic firms have been limited, inexistent or even negative (Meyer, 1998; Holland et al. 2000; Hunya, 2000; Rojec, 2000; Konings, 2001; Damijan et al. 2008).

Disdier and Mayer (2004) uphold the idea that as these countries have been passing through transitional phases while joining the EU and have developed in economic, social and institutional terms, the determining factors driving the decision to set up in Western Europe and Eastern Europe have followed a convergent tendency. Nevertheless, there is still evidence to demonstrate the existence of relevant differences, which suggests an East-West structure in the localization decisions of MNEs

Bevan and Estrin (2004), as previously Wheeler and Mody (1992) and Brenton et al. (1999) insist on the importance of institutional determinants, pointing out that progress during negotiations over the entry of those countries now in the EU had a positive effect on FDI receipts.

Recognizing that markets operate in a political, administrative judicial and social context, recent research belonging to the "New Institutional Economy" has analyzed the organisation of public sector institutions and its interactions with private sector (De Figueiredo, 1997; Henisz, 1998; Levy and Spiller, 1994; Zelner, 1999). Indeed, new theoretical frameworks and methodological tools have been developed to analyze the influence of this institutional environment in the competitive strategy of the firm and the methods used by the private sector to try to influence public agents (Holburn, 2001).

Consequently, this work seeks to analyze the principal determinants of direct investments towards new members of the European Union and developing countries in North Africa. It does so by examining outflows originating from countries in the Mediterranean basin. Special attention is also given to the variables relating to institutions, specifically corruption, political restrictions and protection of property rights, in view of the great relevance attached to them by researchers (Gastanaga et al. 1998; Henisz, 1998; Campos et al. 1999; Asiedu and Villamil, 2000; Wei, 2000;) as well as by the MNEs themselves.

On the one hand, it may be thought that a lower corruption index score in the host country would have a positive relation with investment inflows, as perceived corruption levels would be lower. In addition, greater political restrictions imposed by the government add to the credibility of its commitments, which favours investments by foreign MNEs (Henisz and Zelner 2001 and 2002a), whilst demands by stakeholder and pressure groups that run contrary to the interests of MNEs are given less attention (Henisz and Zelner, 2002b). Finally, greater assurances to ensure compliance with contracts, respect for property rights and greater economic freedom may all be held to attract more foreign investments.

However, results obtained by García-Canal and Guillén (2008) and De la Fuente et al. (2008) show that, on some occasions, certain MNEs display a preferential bias towards countries whose governments may exercise discretionality or have high corruption levels, which would allow them to obtain competitive advantages over their competitors thanks to their negotiating skills gained from their experience of negotiating with governments in their country of origin, or the ease with which they might be able to benefit from corrupt systems. Precisely by including French and Italian investments in the sample, countries which Laporta et al. (1998) include in the same legal sub-group within the wider category of countries with civil-law legal systems, it may be seen whether this situation also occurs in the MNEs of other developed Mediterranean countries, accustomed to negotiating with authorities whose presence in the business environment is greater than others, such as those found in countries with "*common-law*" legal systems.

For their part, Durán et al. (2008) point out that in certain regions where the risk is considered tolerable, MNEs are prepared to undergo greater political risk in exchange for other advantages (such as for example physical and cultural proximity). Moreover, Jiménez (2008) points out that Spanish MNEs implement their internationalization strategies by investing in countries where political risk is very different, aiming to maximize the opportunities of acquiring knowledge, renewing their skills in order to compete and to access managerial talent, at the same time as they diversify their foreign direct investment portfolios so as to protect themselves against local fluctuations in offer and demand. Although it is true that in recent decades Spanish FDI has gradually followed an upward trend, in recent years and thanks to cost reductions and

developments in Information and Communications Technologies (ICTs), MNEs and especially the younger ones, attempt to obtain competitive advantages by investing in countries where their political capabilities may be used to good effect (Hillman y Hitt, 1999; Holburn, 2001; McWilliams et al. 2002; Henisz, 2003).

Drawing on the concepts developed under the Resource-Based View of the firm (Wernerfelt, 1984; Barney, 1991) related to the divergences between firms in the ability to implement given strategies depending on their different tacit knowledge and skills, political capabilities are shaped by two mechanism: organizational learning derived from the experience in identifying and attempting to influence political powers and mental models from cognitive imprinting (Stinchcombe, 1965) which provoke that managers and employees develop skills and routines, based on their mental models from their home country, to asses and manage political risk in an uncertain environment from another country (Holburn and Zelner, 2008)

Differences in organizational attributes (such as size, age or industry), external linkages with other organizations, reference groups or information that the company already possesses causes these political capabilities and they can be classified into the ability to identify the relevant institutional configurations that pose hazards or opportunities for the investing firm, the ability to block adverse and/or promote favourable policy changes and the ability to enhance the previous two abilities (Henisz, 2003).

This strategy is, moreover, consistent with the conceptual framework drawn up by Wan (2005) who suggests that the political capabilities of MNEs allows them to obtain competitive advantages and to guarantee success in the face of potential competitors due to their friendly relations with local government, especially in the so-called "*factor-driven economies*", which is to say, emerging economies where institutional development is more limited and transaction costs are still high due to fragile political stability and bureaucratic inefficiency. In this type of countries, MNEs usually develop what the author calls "*non-market capabilities*", especially those of a political nature over the internal market, such that they can seek access to resources that are controlled and allocated by local government through close relations that can even lead, on occasions, to scandals related to corruption and influence pedalling.

Furthermore, Boddewyn and Brewer (1994) claim that rent generation, in markets where the government plays an active role, will depend on the ability to secure favourable exemptions from or changes to existing policy, in addition to the ability to innovate (Buckley and Casson, 1976).

In both senses, these arguments mean that, *ex-ante*, it is not possible to predict the signs of the relations between these variables that relate to political risk and FDI inflows in the countries of North Africa and Central and Eastern Europe. The study seeks to obtain evidence on the relevance and the sign of the relation between the variables of political risk and investment in these regions, enlarging the analysis not only to include investments originating in Spain, such as those in the referenced works, but also those originating in France and Italy, which are two other Southern European FDI investor countries.

3. METHOD AND VARIABLES

3.1 SAMPLE AND DATA COLLECTION

The sample is made up of outflows of FDI from Spain, France and Italy invested in countries on which reliable data could be found in North Africa and Central and Eastern Europe. More specifically, Algeria, Bulgaria, Egypt, Czechoslovakia, Slovenia, Estonia, Hungary, Latvia, Lithuania, Morocco, Poland, the Czech Republic, Romania, and Tunisia were included in the study.

The timeline for this study runs from 1999 up until 2006 for all the combinations of investor country-recipient country, which generated a sample composed of 336 observations.

In those cases where the sources consulted failed to provide data on the explanatory variables for a specific year, it was decided to estimate that value as the average of the adjacent years, so as not to lose observations given that the size of the panel was not excessively large.

3.2 DEPENDENT VARIABLE

The dependent variable is direct investment flow in the corresponding host country from each of the investor countries included in the sample. It was decided to use measurement units of millions of Euros instead of the more commonly used Neperian logarithm in thousands of Euros. This is because in some cases investments made by an investor country in a recipient country equal zero, which makes it impossible to calculate with the Neperian logarithm.

The sources that were consulted to collect the information were the United Nations Conference on Trade and Development (UNCTAD) and the DATAINVEX database of the Ministry of Industry, Tourism and Trade of Spain. Annex 1 shows the descriptive statistics of both the dependent variable and the independent and control variables included in the model.

3.3 INDEPENDENT AND CONTROL VARIABLES

A range of variables have been described in the literature as determinants in the attraction of FDI. Thus, three indices will be used in order to measure the political risk faced by MNEs in their FDI projects, in an attempt to cover all aspects encompassed by this concept.

The first of the variables that is used is the **Corruption Index** prepared by Transparency International (www.transparency.org)[2] The second variable taken into consideration will be the **Political Constraint Index (POLCON)**[3] by W. J. Henisz (1998). Finally, the **Index of Economic Freedom** prepared by the Heritage Foundation

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[2]Transparency International's Corruption Perceptions Index measures perceived corruption based on surveys of business people and country analysts. This index ranges from 0, which represents an absolutely corrupt state, to 10 for a state that is totally free from corruption (Pournarakis and Varsakelis, 2004; DiRienzo et al, 2007).

[3]The index takes into account the number of independent branches of government able to veto government policy in each country, modifying the scores as a function of the alignments that may occur between these authorities in such a way as to affect the actual constraints to which the government is subjected. Additional modifications are also made for legislative branches of government that are neither totally aligned nor totally opposed to policy decisions by the executive branch, in such a way that the extent of their alignment is relevant when determining the degree of political constraint.

(www.heritage.org)[4] is also included. As pointed out in the latter section, the sign of the relation can not be predicted *ex-ante*, as although political risk has traditionally been thought of as an obstacle to global outflows of FDI, a line of research has recently indicated that MNEs from certain countries actively use their political capabilities to obtain competitive advantages, by selecting those countries as a destination for their investments in which they can benefit from the discretionality and even the corruptability of the system.

Along with the variables that relate to political risk, different macroeconomic indicators of the host countries are also included such as the GDP growth rates and GDP per-capita income as indicators of their economic attractiveness. It is expected that the sign of these variables will be positive, should their relation with the dependent variable be significant. In the case of the unemployment rate, the relation cannot be determined *ex-ante* as high unemployment rates may indicate to MNEs that workers can be contracted without difficulty, but it may also point to inflexibility in the labour marker (Disdier and Mayer 2004).

Furthermore, as Galego et al. (2004) has done, the GDP growth rate is included as a macroeconomic indicator on the country of origin, to take the macroeconomic conditions of the FDI investor countries into consideration.

Better infrastructure may be expected to increase investment receipts given greater transport and communications facilities. To do so, however, not only should infrastructural availability be taken into account, but so should its reliability, without which the infrastructures are of little use (Asiedu, 2002). Thus, in line with the recommendation made by Asiedu (2004), electricity losses during transmission and distribution as a percentage of total production, and percentage GDP expended on fixed capital (which covers road and railway construction, schools and other investments in infrastructural development) are also included, the sign of which is expected to be positive if the results are significant,.

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[4] This index ranges from 0 to 100 and consists of variables that measure the independence of the judicial system, the capabilities of firms and individuals to ensure that contracts are met, the degree to which the government protects property rights and the degree of freedom existing between business, trade and investors (Fernández and González, 2005).

In the same way as Naudé and Krugell (2007), urban population levels are applied in the model and, as suggested by Wahid et al (2009), enrolment rates in secondary education, as a higher level of human capital is a good indicator of an available, qualified, more productive workforce trained to adapt more rapidly to new technologies, which plays a positive role in the attraction of FDI (Root and Ahmed, 1979; Schneider and Frey, 1985; Borensztein et al. 1998; Noorbakhsh et al. 2001; Asiedu, 2002).

Openness to FDI in the host country is measured by its percentage of total GDP, the source of which, as for all the aforementioned variables, is the World Development Indicator published by the World Bank.

Finally, a group of "*dummy*" temporal variables are included to control for the effects of economic and business cycles (Galego et al. 2004; García, 2008).

3.4 MULTICOLLINEARITY DIAGNOSIS

Annex 2 shows the matrix of correlation coefficients for the independent variables and their Variance Inflation Factor (VIFs). Given that all the values are under the limit of 10 recommended by Neter et al. (1985), Kennedy (1992) and Studenmund (1992) and also under the stricter limit of 5.3 proposed by Hair et al. (1999), it may be affirmed that no serious multicollinearity problems exist.

3.5 MODEL

The panel data technique chosen for the analysis overcomes certain limitations associated with Ordinary Least Square cross sectional regressions which have been noted by various authors. Temple (1999) affirms that these types of regressions can imply measurement errors, parametric heterogeneity and loss of relevant dynamic information. Even in studies that centre on direct investment in Africa, authors such as Gyimah-Brempong and Traynor (1999) and Tsangarides (2001) point out that the results can be inconsistent and biased if no consideration is given to the possibilities of regressor endogeneity, and bias due to omitted variables. Like Naudé and Krugell

(2007), they therefore recommend the use of panel data techniques to overcome these limitations.

In particular, the dynamic panel data estimator proposed by Arellano and Bond (1991) was used as an econometric technique, also known as the Generalized Method of Moments (GMM) as the possible endogeneity of the variables, including the dependent variable is satisfactorily resolved in this way. In order to get consistent estimates with this technique, all control variables are instrumented with suitable lags. I use the two-step estimator with standard error adjusted to the potential heteroskedasticity proposed by Arellano and Bond (1998) since in addition to correct possible issues of simultaneity and measure, it deals with the problems of self-correlation and heteroskedasticity while increasing the efficiency of the original one-step estimator (De Andrés and Rodríguez, 2009).

The proposed model is estimated by first differences of the variables, which means taking account of the increases (Δ) in the explanatory variables, with the exception of the temporal dummies. That implies, in precisely the same way as for Buch et al. (2003), not being able to include geographical distance between the countries in the set of explanatory variables as they do not vary over the years. Galego et al. (2004) choose to include it, which prevents them from using a technique that controls for possible endogeneity. These authors, however, measure the distance between the capitals of each country, which might introduce error whenever economic activity is concentrated in regions that are far away from the capital.

Econometric calculations were performed using the STATA 9.0 statistical programme for Windows.

4. RESULTS AND DISCUSSION

The results obtained in the model are shown in Annex 3. The majority of the control variables show the expected sign. Thus, investment flows are negatively

influenced by FDI received in the preceding year (which reinforces the need to use a technique that takes account of any possible endogeneity of the dependent variable), indicating that, although the low coefficient shows that the impact is not too relevant, companies try to invest in markets not previously exploited, and positively by the enrolment rate in secondary education, economic growth in the host country and fixed-capital educational expenditure.

All the variables related to political risk are highly significant and have a negative sign. This reinforces the idea that investor MNEs actively use their political capabilities to the full to obtain competitive advantages through negotiations with local authorities that have wide discretional powers and/or are easily bribed. In addition, the somewhat unexpected negative sign of the variables measuring the opening up of the host country economy to foreign investment and the GDP per capita (although the coefficient of the latter indicates that the impact is not very relevant) show that the investments are concentrated in less attractive countries for the international investors. At localizations where high-levels of political risk prompt a majority of MNEs from the rest of the world to reduce their investments, other MNEs, seeking to take advantage of such circumstances, increase them, in spite of the limited constraints on the host country government, greater difficulties over ensuring compliance with contractual conditions and the negative consequences of corruption (institutional practices that are damaging for the economic and social development of the country and which translate into lower per-capita income).

Thus, although FDI inflows usually increase whenever there is greater openness and less political risk in the host country, the opposite occurs in our sample. This is because it tracks FDI outflows from investor countries in which the MNEs, aware that competitive superiority in all areas is not necessary to achieve international success (Erramilli et al. 1997), seek to benefit from overseas expansion, despite not being the most powerful global competitors. They can do so because they possess resources or capabilities, in this case of a political nature, which are useful in certain environments (Wan, 2005).

Finally, it is worth highlighting the high global significativity of the model as reflected by the Wald Test, as well as the coefficients of the Sargan Test, which confirm

the absence of correlation between the instruments and the error term, and those of first-and second-order autocorrelation of first difference residuals, which allow their respective null hypotheses to be rejected. This means that both the instruments as well as the treatment of the different variables is correct, thereby confirming the validity of the model.

As robustness tests, the model was tested interacting all variables related to political risk with each region analyzed in this research, in order to control if the effects are exclusive to only one of them. However, as shown in Annex 4, all of them keep the negative relation, while five out of the six are significant, two at the 0.01 level and even four of them at the strictest limit of 0.001.

Also, a further data panel was formed exclusively of the countries from Central and Eastern Europe. The results, included in Annex 5, only show slight differences in the significant control variables. With respect to the independent variables relating to political risk, all of them maintained their negative relation with inward FDI flows.

5. CONCLUSIONS

This analysis has sought to identify the determining factors that influence FDI flows from three countries in the Mediterranean basin (Spain, France and Italy) towards two regions, which are up to a certain point competitors, in order to win their support given their geographic proximity: on the one hand, the countries that have recently joined the EU following the enlargements of 2004 and 2007 and, on the other, countries in North Africa.

To do so, panel data methods have been used as, unlike other methods, they treat the possible endogeneity of the variables and include the dynamic information that is obtained when including data from various years. The results have shown that the investment flows under study are not negatively affected by greater political risk in the host country. Instead, they are due to the particular characteristics of the investor MNEs, which are to a certain extent (although not exclusively) based on competitive advantages obtained because of their political capabilities, which is why they select niches in the market as their destinations where global investment flows are lower due

to their higher levels of risk, but where these MNEs can apply their political capabilities more easily and to greater effect.

This does not mean to say that MNEs from these countries do not positively value low levels of political risk when deciding to localize their investment in a particular region of the world. De la Fuente et al. (2008) point out that Spanish MNEs take this into consideration when planning investments in Europe, in North America and to a certain extent in Asia. However, Durán et al. (2008) obtained evidence that having selected a region that is considered "safe", MNEs are willing to tolerate greater levels of political risk in exchange for other advantages. In much the same way, the results obtained here indicate that having taken a decision to invest in a region that is considered "risky", MNEs are also willing to assume a little more risk if, by doing so, they are able to exploit their competitive advantages more fully. Thus, it appears that the positive assessment of localizations with low levels of risk found by De la Fuente et al. (2008) are limited to a preliminary decision-making stage in which the geographical region is selected, whereas the maximization of competitive advantages prevails in the second stage when a specific country is selected in which to site the subsidiary.

The results for the control variables introduced in the model show that the host country should have good economic perspectives, high levels of human capital and develop satisfactory infrastructure to attract higher inflows of FDI. The acquisitive power of the population was not relevant, which suggests that these investments target exports, resources and lower salaries rather than local markets.

Certainly, there is no reason why direct investment should necessarily lead to greater economic growth. Asiedu (2006) refers to somewhat discordant results in the literature, with authors that find a positive relation (De Gregorio, 1992 and Oliva and Rivera-Batiz, 2002), whereas others argue that this only happens under certain conditions that are linked to education (Borenzstein et al. 1998), domestic capital (De Mello, 1999), investments (Blomstrom et al. 1994), openness (Balasubramanyan et al. 1996) or the development of the financial sector (Alfaro et al. 2004). However, Naudé (2004) showed that in the case of Africa, FDI inflows, along with illiteracy rates, maritime access and improvements in sanitation (especially to combat malaria) constitute some of the determinants for the growth of per-capita income. In addition,

FDI serves as a source of capital, stimulates domestic investment, creates employment, assists the revitalization of local industry through technological transfer and the creation of clusters, as well as introducing codes of behaviour and good practice to the host country that can, on occasions, improve those at a national level (Mudambi, 2003; Asiedu, 2006).

According to Cecchini and Lai-Tong (2008), FDI inflows are not only more stable than portfolio investments, but also contribute to improved productivity, insofar as they use resources that were either being used less efficiently or not at all. In turn, greater levels of competition reinforce the need for a good allocation of resources. However, these authors stress the vital role of human capital in the host country, as this determines the absorption capacity of the economy, without which many potential advantages of FDI are undone.

Thus, given the numerous advantages cited earlier on, it is advisable that host countries which need to increase inward investment flows lend special attention, in the first place, to strengthening vital aspects, as has been demonstrated, such as infrastructure, the investment climate or the reduction of restrictions on capital market transactions; but also to the inherent characteristics of investment flows and the MNEs of the most relevant partner countries, especially in North Africa, where the high differences in the standards of living compared to European countries might be reduced, alleviating, partially at least, the important problems of migration, given the human drama that imply, that are affecting both countries where immigrant flows are originated as well as developed countries that receive them.

The majority of research papers analyze global flows, usually between developed countries, or from those countries to developing countries; however, some governments might need to boost inflows received from particular countries, which may have specific determinants that differ from those of the global set of investor countries. In those cases it is necessary to analyze, as in this research, which variables are positively associated with investment flows from that particular investing country or set of countries.

Even so, and despite the results indicating that Southern European MNEs positively value being able to use their negotiating skills to obtain competitive advantages, host countries must place an appropriate value on the importance of FDI inflows from these countries in comparison with the potential increases they would receive from other investor countries that are attracted by political stability, systems with low levels of corruption and a degree of security that comes from there not being any unexpected changes in the "rules of the game". Moreover, it should not be forgotten that, according to the World Bank, corruption is one of the greatest obstacles to economic and social development (World Bank 2001). It implies worsening future perspectives that will attract fewer investors, even from those countries that benefit in the short term from these characteristics but which, as is also reflected in the results, positively value good economic perspectives.

For their part, MNEs that base their strategy on political capabilities, should take account of the assumed risks when taking full advantage for their own benefit of the discretionality of local government and corruption in the host country, as in the medium and long-term it could be used against them. In addition, those MNEs that sacrifice social legitimacy when employing practices related to corruption, risk losing influence and effectiveness as a consequence of the negative impact on their status in the world community (Ghosal and Moran 2005).

As a limitation of this study, the impossibility of including other European FDI investor countries in the Mediterranean basin (Greece and Portugal), as well as recipient countries in North Africa (Libya) due to the inexistence of reliable data should be pointed out. The same may be said for variables such as the effective tax rate to which the MNE is subject, or salaries in the host country, despite a mean average salary for the manufacturing sectors of each country being included in the referenced source (World Development Indicators), but only with data up to 1999. The preparation, on the part of national and international bodies, of reliable sources of information on such countries and omitted variables would facilitate research that could broaden our understanding of FDI inflows in developing countries.

Finally, the need for research centred on countries that are economically less developed should be stressed, as in the words of Ricart et al. (p. 197, 2004): *"...we as*

scholars in International Business, face the great challenge of bringing prosperity everywhere and not just to a small privileged group. It is the challenge of developing strategies and business models to serve the majority of humanity that is currently excluded from world trade. It is the challenge of doing so in a profitable way but also in a way that is socially and environmentally feasible given limited world resources".

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ANNEX 1 DESCRIPTIVE STATISTICS

	N	Minimum	Maximum	Average	Std. Dev.
Investment received (millions of Euros)	336	-607	4635	161.82	505.62
Unemployment	336	5	30	12.85	5.813
Enrolment in secondary education (%)	333	30	96	79.01	15.86
Urban Population	336	42	75	61.52	8.245
Electricity Losses	336	3	27	11.38	4.884
GDP Growth Host Country	336	-4.789	10.596	4.563	2.448
Gross Fixed-Capital Formation (% of GDP)	336	16.078	35.377	25.32	4.314
GDP Growth in country of origin	336	.037	5.05	2.468	1.44
Corruption index	336	26	64	41.36	9.977
POLCONV Index	336	.00	78.8	68.33	19.55
Economic Freedom Index	336	45.7	77.7	60.825	6.755
FDI/GGDP	336	.286	20.476	4.5	3.422
Per-capita GDP	336	1101.96	17556.78	4652.54	3417.41

ANNEX 2 CORRELATIONS MATRIX AND VIFs

	1	2	3	4	5	6	7	8	9	10	11	12	VIFs
1. Unemployment	1												1,71
2. Enrolment in Secondary Education (%)	-,424	1											2,25
3. Urban Population	,021	,200	1										1,92
4. Electricity Losses	,111	-,075	,112	1									1,55
5. GDP Growth in Host Country	-,020	,121	,147	,189	1								1,30
6. Gross Fixed-Capital Formation (% of GDP)	,055	-,138	,293	-,021	,339	1							2,23
7. GDP Growth Country of Origin	,039	-,074	,029	,034	-,145	-,036	1						1,09
8. Corruption Index	-,399	,301	,211	-,354	,173	,352	-,003	1					3,04
9. POLCONV Index	-,389	,319	-,073	-,090	,029	-,067	,009	-,011	1				1,75
10. Economic Freedom Index	-,132	,212	,500	-,071	,323	,543	-,070	,586	,143	1			2,79
11. FDI/GDP	-,186	,238	,476	-,071	,146	,255	-,009	,230	,247	,310	1		1,67
12. Per-capita GDP	-,419	,544	,072	-,426	,115	,314	-,143	,613	,281	,387	,123	1	3,38

ANNEX 3 RESULTS OF THE ARELLANO AND BOND DYNAMIC PANEL DATA ESTIMATION

Two-step results   Number of groups: 42

VARIABLES

1. Δ **FDI received previous year**	-.0495363** (.0201206)
2. Δ **Unemployment**	-5.650629 (8.016718)
3. Δ **Enrolment Secondary Education (%)**	15.25624** (7.608557)
4. Δ **Urban Population**	-.1071958 (4.041277)
5. Δ **Electricity losses**	-7.926122 (6.787112)
6. Δ **Host Country GDP Growth**	25.21672*** (6.740312)
7. Δ **Gross Fixed-Capital Formation (% of GDP)**	21.16896** (9.095827)
8. Δ **GDP Growth Country of Origin**	-23.43183 (20.35731)
9. Δ **Corruption Index**	-21.09358*** (3.392054)
10. Δ **POLCONV Index**	-47.30001*** (8.932868)
11. Δ **Index of Economic Freedom**	-26.87632*** (5.28111)
12. Δ **FDI/PIB**	-13.1611*** (3.34974)
13. Δ **Per-capital GDP**	-.0169492** (.0075378)
14. **Constant**	7.259463 (11.7363)

Sargan test of over-identifying restrictions:	chi2(20) = 27.85 Prob > chi2 = 1
Arellano-Bond test that average autocovariance in residuals of order 1 is 0:	z = -1.64 Pr > z = 0.1009
Arellano-Bond test that average autocovariance in residuals of order 2 is 0:	z = -1.15 Pr > z = 0.2521
Wald chi2(18)	155408.04

The results of the temporal *dummies* are not included in the table

Standard errors between brackets

* p < 0.10 ;   ** p < 0.05;   *** p < 0.01

ANNEX 4 RESULTS OF THE ARELLANO AND BOND DYNAMIC PANEL DATA ESTIMATION (INTERACTED VARIABLES)

Two-step results	Number of groups: 42
VARIABLES	
1. Δ FDI received previous year	-.070015***
	(.0187785)
2. Δ Unemployment	-.7538498
	(8.005006)
3. Δ Enrolment Secondary Education (%)	8.059025*
	(4.897335)
4. Δ Urban Population	-.5395161
	(4.558146)
5. Δ Electricity losses	-6.791892
	(7.641309)
6. Δ Host Country GDP Growth	37.50088***
	(8.725089)
7. Δ Gross Fixed-Capital Formation (% of GDP)	17.60693**
	(8.48452)
8. Δ GDP Growth Country of Origin	-37.95265
	(33.35658)
9. Δ FDI/PIB	-17.14895***
	(3.121309)
10. Δ Per-capital GDP	-.035087**
	(.0121378)
11. Δ Corruption Index*Africa	-18.14938
	(15.60451)
12. Δ Corruption Index*Central and Eastern Europe	-22.24351***
	(3.177354)
13. Δ POLCONV index*Africa	-40.7123**
	(15.89955)
14. Δ POLCONV index* Central and Eastern Europe	-94.3423***
	(15.57822)
15. Δ Index of Economic Freedom*Africa	-39.29581***
	(19.54428)
16. Δ Index of Economic Freedom*Central and Eastern Europe	-31.79698***
	(5.992508)
17. Constant	-70.59124**
	(34.129)
Sargan test of over-identifying restrictions:	chi2(20) = 29.32 Prob > chi2 = 1
Arellano-Bond test that average autocovariance in residuals of order 1 is 0:	z = -1.65 Pr > z = 0.0987
Arellano-Bond test that average autocovariance in residuals of order 2 is 0:	z = -1.10 Pr > z = 0.2708
Wald chi2(21)	265305.87

The results of the temporal *dummies* are not included in the table

Standard errors between brackets

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

ANNEX 5 RESULTS OF THE ARELLANO AND BOND DYNAMIC PANEL DATA ESTIMATION (EUROPEAN HOST COUNTRIES SUBSAMPLE)

Two-step results   Number of groups: 30

VARIABLES

1. Δ **FDI received previous year**	-.0623933** (.025445)
2. Δ **Unemployment**	.1209516 (12.8918)
3. Δ **Enrolment Secondary Education (%)**	-9.821758 (17.15523)
4. Δ **Urban Population**	-9.838249 (9.654665)
5. Δ **Electricity losses**	32.69636 (20.22665)
6. Δ **Host Country GDP Growth**	48.00291** (22.758)
7. Δ **Gross Fixed-Capital Formation (% of GDP)**	29.28085** (9.85232)
8. Δ **GDP Growth Country of Origin**	127.6174 (109.3922)
9. Δ **Corruption Index**	-30.60975*** (7.016383)
10. Δ **POLCONV Index**	-157.6015** (81.68434)
11. Δ **Index of Economic Freedom**	-42.55223*** (11.38403)
12. Δ **FDI/PIB**	-6.981067 (5.380019)
13. Δ **Per-capital GDP**	-.0028405*** (.0447633)
14. **Constant**	-246.5077 (92.47508)

Sargan test of over-identifying restrictions:	chi2(20) = 8.26 Prob > chi2 = 1
Arellano-Bond test that average autocovariance in residuals of order 1 is 0:	z = -1.65 Pr > z = 0.1037
Arellano-Bond test that average autocovariance in residuals of order 2 is 0:	z = -1.01 Pr > z = 0.3112
Wald chi2(18)	15299.23

The results of the temporal *dummies* are not included in the table

Standard errors between brackets

* $p < 0.10$;   ** $p < 0.05$;   *** $p < 0.01$