

The Role Foreign Direct Investment, Financial Development and Institutions Quality of Economic Growth: Empirical Evidence From WANA Countries

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ABSTRACT

Research Aims: The study investigates the impact of foreign direct investment, financial development, and institution quality on economic growth in nations located in western Asia and North Africa

Methodology: This study methodology employs a panel data regression model using a fixed effect model (FEM) strategy. The study data is collected using the information that was available between the years 2000 and 2022. The WANA nations include Saudi Arabia, Iran, Israel, Jordan, Kuwait, Lebanon, Morocco, Egypt, Oman, Qatar, Tunisia, and the United Arab Emirates.

Research Findings: The findings indicated that foreign direct investment (FDI), financial development (FD), and intellectual quotient (IQ) had an impact on economic growth. Specifically, foreign direct investment (FDI) has a beneficial and statistically substantial impact on economic development, but the quality of institutions has an adverse and statistically substantial impact on economic growth. However, financial development does not affect economic growth.

Originality: The grand theory used in this research Economic Growth, Foreign Direct Investment, Institutions Quality, Financial Development, and Export and population growth variables are controlled. variables in this study by testing three variables consisting of independent variables, dependent variables and control variables.

Research limitation and implication: The findings in this study suggest that policies implemented by governments, public institutions and academics aimed at increasing FDI, FD, and institutional quality can help improve economic growth in WANA countries.

Keywords: *Foreign Direct Investment, Financial Development, Institution Quality and WANA Countries*

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INTRODUCTION

Economic growth is the long-term increase in a nation's ability to create products and services to satisfy the demands of its population (Jhingan, 2011). Throughout the history of economic growth, it has been influenced by several factors, such as natural resources, human resources, macro- and microeconomics, investment, financial development, and non-

economic factors, such as the institutional system of each country. Each country has different economic conditions, so income and economic growth between countries are also different. Some of these indicators are considered important in creating a conducive environment for sustainable economic development and growth (Abaidoo & Agyapong, 2022). Continuous economic oscillations pose a significant risk to global economic development, particularly in the Western Asia and North Africa area. This can be seen from the gross domestic product (GDP) per capita of WANA for 2000–2022.

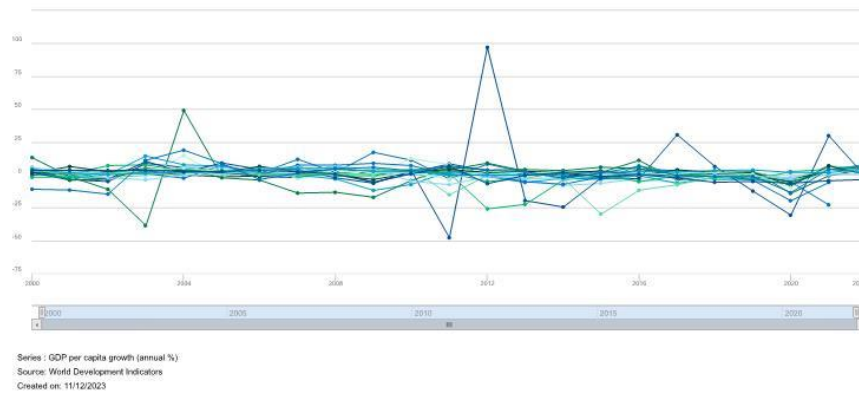


Figure 1. Gross Domestic Product (GDP) for the period 2000-2022
Source: World Development Indicators, 2023

Significant divergence is seen in Figure 1, which shows the economic growth data of several countries in Western Asia and North Africa (WANA). Afghanistan has significant variation, characterized by alternating periods of growth and decline, suggesting that economic volatility may be influenced by variables such as violence and political uncertainty. Saudi Arabia shows consistent economic growth, but Bahrain and Iraq experience significant fluctuations over time. Iran experienced significant economic expansion, while Israel, Qatar, and Jordan also reported fairly strong growth rates. Kuwait experienced a large economic expansion, while Lebanon and Libya faced difficulties with negative growth rates, which may be due to domestic and foreign instability.

Gulf countries such as Qatar and Oman showed consistent economic expansion, but the United Arab Emirates (UAE) experienced significant volatility. It is important to recognize that economic conditions in the region can be affected by factors such as political changes, conflicts, economic performance, and oil price volatility. However, many countries in the WANA region continue to demonstrate resilience and growth capacity. In order to conduct a comprehensive evaluation of the economic conditions in the region, it is necessary to conduct a more detailed analysis and gain a deeper understanding of the specific elements that impact each country.

Investment is a crucial factor in assessing a country's economic progress since it is closely linked to the share of GDP that is saved and put into productive use. Increased levels of savings and investment directly correlate with a larger potential for economic development. FDI is a kind of investment that involves a significant amount of capital. Foreign FDI starts with the continuous influx of foreign money over an extended time, demonstrating a level of durability in the face of economic fluctuations. According to Jhingan (2004), FDI is the culpable investment of foreign private enterprises in other countries. The level of FDI shows variability and generally shows an increasing trend in the absence of a global economic crisis.

In addition, the impact of FDI on a country's GDP has been widely studied in the academic literature (Aslam & Rudatin, 2022; Edwards et al., 2017; Kamrunnahar et al., 2015) Demonstrating the correlation between the amount of FDI and a nation's overall GDP. This is in line with neoclassical theory Solow (1956), FDI can be seen as a significant contributor to capital, thus adding to or supplementing domestic capital reserves. In accordance with this assumption, the economy will expand in the short run, but when diminishing returns occur, the economy will stabilize and have no long-term effect on growth (Mello, 1997).

A viewpoint that also explains economic growth is not influenced by FDI (Nadzir & Kenda, 2023; Shabbir et al., 2020; Uwubanmwun & Omorose, 2016) According to the study, FDI has a negative and little impact on economic development. The study mentioned above indicates a lack of information on the influence of FDI on economic development. This result is what raises the most concern among economists. The need to explain these results gives rise to three viewpoints: the positive impact view, the negative impact view, and the dependency impact view.

Additional research suggests that foreign direct investment (FDI) can enhance the productiveness of nearby firms by appearing as a source of fresh capital for industrial growth, helping to improve their management systems, giving them access to global markets, encouraging innovation, and facilitating technology transfer to domestic firms (Bigliardi et al., 2021; Li & Tanna, 2019; Ni et al., 2017). However, previous studies have yet to uncover the exact mechanism that causes the spillover impact of FDI on efficiency and productivity (Wulan et al., 2016). The findings Assadzadeh & Pourqoly (2013) Demonstrate the correlation between FDI and institutional quality with a substantial, beneficial influence on poverty reduction and enhancement of welfare. Likewise, (Ullah & Khan, 2017) FDI and governance are considered to contribute to capital for investment and increase employment opportunities for local workers, as well as access to technological improvements.

The subsequent determinant that impacts the pace of economic expansion is the advancement of the finance industry. According to (Orji et al., 2019), their research demonstrates that enhancing financial development via human resources leads to a favorable effect on economic growth. The study conducted by (Guru & Yadav, 2019; Ibrahim & Alagidede, 2018), emphasizes how important a nation's financial system's effectiveness, complexity, structure, and efficacy on driving economic performance and growth. The financial system plays a significant role in facilitating the transfer of capital resources to essential productive sectors, thereby promoting economic growth and development. The financial system facilitates investment activity and fosters a conducive environment for productivity and development via the provision of essential funds (Abaidoo & Agyapong, 2023). An extensive examination of this empirical study reveals that several studies establish a positive link or interaction between a nation's degree of financial development and its economic success (Durusu-ciftci et al., 2016; Herwartz & Walle, 2014; Muhammad et al., 2016; Pradhan et al., 2017).

Furthermore, a country's economic can also be assessed by the quality of its institutions or governance. If a country has good governance, a safe political climate, and institutions that work effectively, then this situation will help create productive economic conditions. Thus, the country's economy experiences a considerable rate of growth and development (Aziz & Sundarasan, 2015; Ogbuabor et al., 2020). Nevertheless, economies characterized by inadequate leadership, political instability, weak institutions, and sluggish

governance systems may need a more active pace of development (Assadzadeh & Pourqoly, 2013; Ghardallou & Sridi, 2020; Yu & Jong-a-pin, 2019). Competition rules have a favorable influence on investment choices and businesses with inadequate governance. Countries with inadequate investor protection and ineffective enforcement have significant implications for market competition, especially in terms of how different institutional frameworks impact competitive outcomes (Xede et al., 2023).

Later research Pham (2023) It is hypothesized that the existence of robust institutional quality reduces the extent of the informal sector. This phenomenon may be explained by policies that have been developed about the relationship between the informal economy and institutional quality, suggesting that limiting the informal sector requires improving institutional quality (IQ). This aligns with the discoveries made by Barra & Falcone (2023) Strengthening the quality of institutions is crucial for boosting economies in high-income nations. However, research by (Addi & Abubakar, 2022) States that enhancing institutional quality is a very effective method for stimulating investment. The promotion of investment and economic development is the outcome of the correlation between the rise in economic freedom and the quality of institutions. Indirectly, this study explains that IQ can improve the economy through investment because high investment will foster a good economy. Research (Abuzayed & Al-Fayoumi, 2016) also indicates that there is a substantial and positive correlation IQ and economic development.

This research is predicated on the premise that the caliber of institutions quality, The establishment of robust financial institutions and the influx of foreign direct investment are critical factors in enabling substantial growth and progress. This empirical study's main goal is to evaluate how financial development, foreign direct investment, and the caliber of institutions affect economic growth and development. The methodology used in this research is informed by the continuous discourse that often designates the Western Asia and North Africa (WANA) area as possessing the biggest reserves of oil and natural gas worldwide, hence making it a significant contributor to global economic stability. Moreover, a number of nations in the WANA area are members of the Organization of the petroleum exporting countries (OPEC). In addition, Some countries in the region, such as Iran, are always in the conversation of the world community because they have special policies and different ownership and legal structures in the economic environment (Zimon et al., 2022). The application of sanctions has created significant financial constraints for these companies (Heydarian et al., 2021), They has the capacity to affect competitiveness and shape investor behavior. Hence, scholars are intrigued by the impact of IQ, FD, and FDI on economic growth in the Western Asia and North Africa. The goal of this study is to make a major contribution to developing countries' economic development, particularly in the western Asia and north Africa region. This study was undertaken due to the observed deficiencies and limitations in existing studies examining this study examines the role of financial development (FD), foreign direct investment (FDI), and institutional quality (IQ) on economic growth in the regions of Western Asia and North Africa.

LITERATURE REVIEW

Economic Growth

Gross Domestic Product (GDP) is a metric used to measure the overall value of finished products and services within an economy. In addition, GDP simultaneously quantifies the aggregate income of all individuals in the economy and the overall government spending to purchase goods and services from the economy (Mankiw, 2010). According to Mankiw (2010) outlines the components of GDP: consumption refers to spending by households on goods and services; investment is purchases made with the aim of producing more goods and services in the future; government spending includes government employee salaries and public interest spending; and net exports are calculated by subtracting imports (purchases of foreign products by citizens) from exports (purchases of domestic products by foreigners).

Foreign Direct Investment

FDI is a real investment in the form of building factories, roads and other infrastructure, buying land for manufacturing, setting up factories, acquiring various capital goods, buying inventory equipment, and so on (Salvatore, 1997). FDI exerts a substantial impact on the economy through its facilitation of gross domestic product (GDP) expansion. FDI plays a crucial role and serves as a potent instrument for the comprehensive development of developing nations. Industrial growth is a crucial need for the economic advancement of a growing nation. FDI inflows contribute to an increase in the capital account surplus, thereby improving the balance of payments and strengthening the macroeconomic stability of the economy (Akhter & Hasan, 2018). The relationship between gross domestic product and foreign direct investment suggests that a rise in GDP will serve as a catalyst for increased investment within a given nation. Conversely, countries with low GDP will experience a decrease in investment levels. So, the hypothesis of this study.

H1 : Foreign direct investment (FDI) has a positive effect on economic growth.

Institutions Quality

According to (Acemoglu & Robinson, 2010), The development gaps between nations may be attributed to institutions, which also determine economic growth. Inadequate institutions can impede economic progress by allowing economic actors to focus on redistributive policies rather than engaging in growth-promoting activities, thus hindering economic development (North, 1990). In growth theory, Economic growth is seen to be fundamentally determined by the quality of institutions (North & Thomas, 1973). The view on institutions and growth is that institutions supporting effective rule-of-law markets can promote strong economic growth (Acemoglu et al., 2005; Porta et al., 1998; Uddin et al., 2021). In addition, empirical evidence shows that the financial sector contributes to the economy of each country (Adeel-farooq et al., 2020; Bayar et al., 2020; Maciejewski & Głodowska, 2020). This research posits that the financial sector has a significant role in contributing to the economy of each nation.

H2: Institution quality has a positive effect on Economic Growth.

Financial Development

According to Levine (1997), Financial growth has a crucial role in stimulating economic advancement. The connection between the two has been the focus of theoretical and empirical scrutiny ever since the publication of his groundbreaking book (Schumpeter, 1911). Moreover, empirical evidence consistently shows a positive and strong relationship

over time between several indicators of financial development and economic growth (Hook & Singh, 2014). So, the hypothesis of this study.

H3: Financial Development has a positive effect on Economic Growth

RESEARCH METHOD

This study employs a quantitative research technique, specifically using panel data. The cross-sectional units that were assessed included the nations of Western Asia and North Africa (WANA) throughout the time frame of 2000 to 2022. The study sample comprises typical nations chosen based on the accessibility of information during the research period. The nations included in the list include Saudi Arabia, Iran, Israel, Jordan, Qatar, Kuwait, Lebanon, Morocco, Egypt, Oman, Tunisia, and the United Arab Emirates. The project will use data obtained from:

Tabel 1. Gross Domestic Product (GDP)

Gross Domestic Product (GDP)	GDP per capital, PPP (current international \$)	World Bank
Foreign Direct Investment	FDI Net Inflows (BoP, current US\$)	World Bank
Quality Institutions	Control of corruption: Percentile Rank Government Effectiveness Absence of violence/ Terrorisme: Percentile Rank Regulatory Quality: Percentile Rank Rule of Law: Percentile Rank Voice and Accountability: Percentile Rank	World Bank
Financial Development	Financial Development index Financial Institutions Access Index Financial Institutions Depth Index Financial Institutions Efficiency Index Financial Institutions Index Financial Market Access Index Financial Markets Depth Index Financial Markets Efficiency Index Financial Market Index	International Monetary Fund
Economic Policy & Debt	Exports of goods and services (% of GDP)	World Bank
Population	Population growth (annual %)	World Bank

This research used a panel data regression analysis model as its technique. The panel data regression technique used is the Ordinal Least Square (OLS) approach. However, before using OLS, the researchers used the Principal Component Analysis (PCA) approach to construct two indices: institutional quality and financial development. PCA is used to substitute a multitude of strongly correlated independent variables with a limited set of uncorrelated variables, while retaining the utmost quantity of information. PCA is also referred to as data transformation into a new set of variables (Jolliffe, 2002). The research model is:

$$\text{LogGDP}_{it} = \alpha + \beta_1 \text{LogFDI}_{it} + \beta_2 \text{LogIQ}_{it} + \beta_3 \text{LogFD}_{it} + \beta_4 \text{LogEks}_{it} + \beta_5 \text{LogPG}_{it} + w_{it}$$

$$w_{it} = \mu_i + v_{it} \quad I = 1, \dots, N; \quad t = 1, \dots, T$$

Where GDP stands for Gross Domestic Product expressed as (current international \$), FDI is foreign direct investment expressed as FDI inflows in current US dollars, IQ is institution quality expressed as worldwide governance indicators, and FD is financial development expressed as Financial Development Index. Ex stands for export, The term "PG"

represents population growth, which is measured as an annual percentage. Similarly, the term "GDP" Gross Domestic Product (GDP) is a measure of the overall economic output, expressed as a percentage. Export and population growth variables are control variables in this study. In the research model, it represents the cross-section unit, and t shows the period. W_{it} is a combined error term that includes unobservable country elements μ_i and v_{it} errors.

RESULTS AND DISCUSSIONS

The research was conducted from 2000 to 2022, with 276 observations. To be able to obtain research results, researchers determined the best models used in this study: The three often used models in statistical analysis are the common effect model (CEM), the fixed effect model (FEM), and the random effect model (REM). Furthermore, the researchers used the Chow test to ascertain the most suitable model estimation between the common effect model and the fixed effect model.

Table 2. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	255.352891	(11,259)	0.0000
Cross-section Chi-square	682.248422	11	0.0000

The estimated results shown in Table 2 have a probability value of 0.0000. By using a significance threshold of 5% (0.05), The probability value is below the alpha threshold of 5% (0.05), indicating statistical significance. Therefore, it may be deduced that the null hypothesis (H_0) is rejected and the fixed effect model is considered appropriate. The fixed effect model is preferable for estimating panel data in comparison to the common effect model. Afterwards, determine the better model, either the fixed effect model or the random effect model, via the use of the Hausman test.

Table 3. Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	25.847432	5	0.0001

The estimated findings reported in Table 3 yielded a probability value of 0.0000. With a significance threshold of 5% (0.05), It has been discovered that the probability value is lower than the alpha value of 5%. (0.05), indicating that the findings are statistically significant. Consequently, the null hypothesis (H_0) may be refuted, and the fixed effect model can be deemed appropriate.

Based on the aforementioned stages, the fixed effect model is the most appropriate model for the variables being studied, as shown in the table below.

Table 4. Fixed Effect Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	11.16518	0.436704	25.56695	0.0000
LOG(FDI)	0.036977	0.009890	3.738893	0.0002
LOG(FD)	-0.063008	0.094581	-0.666173	0.5059
LOG(IQ)	-0.563849	0.086832	-6.493556	0.0000
LOG(EKS)	0.047726	0.063876	0.747169	0.4556
LOG(PG)	0.046723	0.017354	2.692384	0.0076
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.965040	Mean dependent var		10.08731
Adjusted R-squared	0.962880	S.D. dependent var		0.971546
S.E. of regression	0.187183	Akaike info criterion		-0.453841
Sum squared resid	9.074736	Schwarz criterion		-0.230845
Log likelihood	79.63007	Hannan-Quinn criter.		-0.364357
F-statistic	446.8384	Durbin-Watson stat		0.253759
Prob(F-statistic)	0.000000			

The methodology for analysing panel data regression using a fixed effect model is elucidated, drawing upon the results shown in Table 4. The FDI value is 0.036977, with a probability of 0.0002. A probability value < 0.05 indicates that the FDI variable has a statistically significant and positive effect on economic growth, namely GDP. The FD coefficient has a value of -0.063008, with a probability of 0.5059. If the probability value is greater than 0.05, it indicates that the FD variable does not have a significant influence on economic growth (GDP). The coefficient values for the IQ and PG variables are -0.563849 and 0.046723, respectively. The corresponding probabilities are 0.0000 and 0.0076. These findings suggest that the IQ variable has a substantial negative impact on GDP, whereas the PG variable has a notable positive influence on GDP. Regarding the eksport variable, its coefficient value is 0.047726, and the probability is 0.4556. This variable has no impact on economic growth (GDP). The R-squared value for the cross-section fixed model findings is 0.965040. This suggests that FDI, FD, IQ, exports, and population growth (PG) all account for 96.5% of the effect on the GDP variable. The remaining 3.5% represents the contribution of other factors, which are not addressed in this research, to the GDP.

The findings on the FDI has a favourable impact on the expansion of the economy. This is because FDI can encourage economic growth by creating new jobs, increasing productivity, and helping transfer new technology and knowledge to WANA countries. FDI can also help diversify the economy by investing in new sectors and industries, thus making the economy in WANA countries more resilient to shocks and reducing dependence on oil and gas. Although FDI has increased in WANA countries in recent years, governments should still work to control foreign investment in a conducive manner, such as improving political stability, reducing bureaucracy and fighting corruption. Thus, WANA countries can achieve sustainable and inclusive economic growth. The findings of this research corroborate other prior studies that elucidate the substantial advantages of FDI (Paweenawat, 2019). In research Amighini et al. (2017) Stated that studying the distribution of foreign direct investment (FDI) in developing nations is enhanced by the influx of FDI, which contributes to the accumulation of capital and positively affects the host country's balance of payments (BoP). Thus, FDI inflows to developing countries will increase capital flows and increase production and exports. Moreover, the influx of foreign investment from multinational

corporations fosters international commerce by establishing novel global connections between the host and home nations (Gammeltoft & Cuervo-Cazurra, 2021). Several research elucidate that Foreign Direct Investment (FDI) has a favourable influence on nations with highly globalised economy and those that exhibit less reliance on agriculture (Lee & Shin, 2020).

However, in contrast to the findings on the Financial Development (FD) variable has not affect Economic Growth, the quality of FD in WANA countries is generally still of poor quality, such as the lack of adequate regulations to oversee financial institutions, low management quality, lack of transparency and accountability, while in terms of macroeconomics in WANA countries is still unstable, it can be seen from political conflict and uncertainty, high inflation and interest rates, The suboptimal quality of human resources and infrastructure, coupled with government policies that inadequately promote economic development. This research is not in line with the findings (Levine, 1997) that financial development plays an important role in encouraging economic goals. The relationship between the two indicates a long-term positive influence (Hook & Singh, 2014). On the other hand, investigations carried out by Beck et al. (2017) suggests that the results of financial development research do not affect economic growth in countries that have poor institutions. The same thing was also conveyed by (Acharya et al., 2014; Mian et al., 2013), high financial development can increase systemic risk so that it can reduce economic growth.

However, in contrast to the findings on the Financial Development (FD) variable which does not affect Economic Growth, the quality of FD in WANA countries is generally still of poor quality, such as the lack of adequate regulations to oversee financial institutions, low management quality, lack of transparency and accountability, while in terms of macroeconomics in WANA countries is still unstable, it can be seen from political conflict and uncertainty, high inflation and interest rates, the quality of human resources and infrastructure and government policies that generally do not fully support economic growth. This research is not in line with the findings (Levine, 1997) The function of financial development in promoting economic objectives is significant. The relationship between the two indicates a long-term positive influence (Hook & Singh, 2014). In contrast, research conducted by Beck et al. (2017) suggests that the results of financial development research do not affect economic growth in countries that have poor institutions. The same thing was also conveyed by (Acharya et al., 2014; Mian et al., 2013), high financial development can increase systemic risk so that it can reduce economic growth.

Institution Quality has a negative effect on Economic Growth in WANA countries due to various factors, including corruption, legal uncertainty, inequality and lack of inclusiveness, which reduce people's perception of government and public institutions, increase production and investment costs and exacerbate social strife and trigger social discontent. So, the government needs to address institutional deficiencies to promote sustainable economic growth in WANA countries. This research is in line with Uddin et al. (2021), showing the results that human and institutional development have a large and favourable impact on economic growth. However, the relationship between institutions and human development has a negative impact on the economic progress of developing countries. This study posits that in the presence of weak and malfunctioning institutions, the influx of investment assistance intended for human development would have a detrimental influence on economic growth. This is due to the fact that more resources are often allocated

towards activities that prioritize profit and have negative societal consequences. According to the research conducted by Nawaz et al. (2014), institutions have a role in enhancing long-term economic development in Asian nations. Nevertheless, the impact of institutions on economic growth is contingent upon the degree of economic development inside a nation. Furthermore, institutions exhibit greater efficacy in industrialized Asian countries compared to emerging Asian countries. The aforementioned research indicates that diverse nations need distinct institutions in order to enhance economic development over an extended period of time. Nevertheless, this perspective contradicts the economic growth theory, which views institutions as a crucial factor in determining economic development. According to this theory, high-quality institutions may foster robust economic growth (Acemoglu et al., 2005; North & Thomas, 1973; Porta et al., 1998). Similarly, the research conducted by Salman et al. (2019) demonstrates that characteristics related to the quality of institutions have a favorable and substantial influence on the rate of economic development.

CONCLUSION AND RECOMMENDATION

The findings from the analysis and discussion indicate that the variables of foreign direct investment, financial development, and institution quality, together with the control variables of exports and population growth, may collectively influence the variable of economic growth. Foreign direct investment has a somewhat beneficial impact on economic growth. This suggests that Foreign Direct Investment (FDI) may serve as a significant financial resource to stimulate economic development in nations located in the Western Asia and North Africa (WANA) region. Nevertheless, there is no correlation between financial progress and economic growth. This demonstrates that FD must enhance its resource allocation and innovation capabilities in order to drive growth in WANA nations. Therefore, policy enhancements are necessary to foster FD's development and expansion. Conversely, the quality of institutions has a detrimental impact on economic development. Low institutional quality may impede economic development via factors such as corruption, legal ambiguity, inequality, and a lack of inclusivity. Overall, foreign direct investment, financial development, and institution quality are important factors that can affect growth in WANA countries. Therefore, governments, public institutions, and economists in WANA countries need to work together to implement policies to increase FDI, FD, and IQ to promote a sustainable economy.

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