

A Critical Analysis of Economic, Political, and Financial Determinants Influencing Location Choices of Foreign Direct Investments

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Abstract

This paper critically examines the determinants influencing the location choices of foreign direct investments (FDI), focusing on economic, political, and financial risks. The research explores how country risks—political stability, corruption levels, and democratic accountability—affect multinational corporations' (MNCs) decisions to invest. It also investigates financial risks, particularly exchange rate volatility, and its impact on FDI, finding that higher volatility deters investment. Additionally, the paper evaluates economic risks such as inflation, GDP, and unemployment rates, revealing their dual role in both attracting and deterring FDI. Using data from various countries, the study concludes that countries with stable governments, low corruption, democratic accountability, stable exchange rates, and healthy economic indicators are more attractive to FDI. This analysis helps MNCs make informed decisions about investing in different international markets.

Keywords

Foreign direct investment, Multinational corporations, Location Choices

1. Introduction

Foreign Direct Investment (FDI) is important for every country and some multinational corporation (MNC). In recent year, a significant increase of FDI can be observed from developed country to developing country, with investment in Asia gradually overtaking that in Africa and Latin America according to the World Bank (World Bank, 2021). Scholars argued that there are multiple influencing factors for the location choice of FDI, such as high potential for economic development, cheaper labor cost and so on (Dabla-Norris et al., 2010). Through surveying the influencing factors on location determinants for FDI, it appears that country risks are at the center of research. This paper will discuss and examine the influences of country risks, more specifically, the political, financial and economic risk on FDI location decision.

2. Country Risk

Country risk refers to the additional risks that arise when business transactions are conducted across international borders. These risks are distinct from those typically encountered in domestic transactions, where the regulatory, economic, and political environments are more familiar and stable for businesses (Meldrum, 2000). When multinational corporations (MNCs) contemplate investing in or expanding

operations within a new country, they must carefully evaluate the level of country risk involved. This evaluation is crucial because a higher level of country risk can significantly impact the ease and cost of conducting business within that country. For instance, businesses may face challenges such as regulatory changes, political instability, or economic volatility, all of which can disrupt operations and lead to unforeseen expenses. As a result, countries with higher levels of risk may be less attractive to investors, or investors may demand higher returns as compensation for taking on these additional uncertainties.

Investors generally expect a higher rate of return when investing in countries perceived to have a high level of risk. This expectation serves as a form of compensation for the potential difficulties and expenses that may arise from the uncertain political, financial, or economic conditions in such countries. The rationale behind this expectation is that in a high-risk environment, the probability of encountering obstacles that could reduce profitability is greater, thus necessitating a higher return to justify the investment. For example, in countries with unstable governments or volatile economies, the risk of expropriation, currency fluctuations, or economic downturns can be higher, requiring investors to seek additional returns to offset these potential losses.

To assess country risk, tools such as the International Country Risk Guide (ICRG), developed by the Political Risk Services (PRS) Group, are widely used. The ICRG provides a comprehensive measure of country risk by evaluating three primary aspects: political risk, financial risk, and economic risk. Political risk includes factors such as government stability, the presence of internal or external conflict, and the level of corruption. Financial risk assesses a country's ability to meet its debt obligations, which includes evaluating factors like foreign debt levels, exchange rate stability, and the soundness of the financial system. Economic risk, on the other hand, focuses on the overall health of the country's economy, taking into account indicators such as GDP growth, inflation rates, and unemployment levels. By analyzing these three aspects, the ICRG offers investors a detailed picture of the risks they might face when investing in a particular country, thereby aiding them in making more informed decisions.

3. Political Risk

Political risk encompasses any form of government intervention or influence that could potentially impact business transactions (Kobrin, 1978; Rafat and Farahani, 2017). This broad category of risk is particularly significant in the context of foreign direct investment (FDI) because the actions or policies of a government can directly affect the profitability and viability of investments made by multinational corporations (MNCs). The concept of political risk has been widely studied, with a focus on several key factors that are critical in determining the level of risk in a given country. Among these, government stability, corruption, and democratic accountability are frequently highlighted as crucial determinants that influence FDI decisions (Busse et al,2007). The International Country Risk Guide (ICRG) provides a framework for assessing these factors, and this paper will delve into how each of these elements contributes to the overall political risk profile of a country.

Firstly, government stability is a critical measure of a country's political risk. It reflects the government's ability to implement its policies effectively and maintain power over time, which is essential for creating a predictable and secure environment for business operations. The ICRG considers government stability as a key indicator when assessing the risk level in a country. Historical data from the 1980s, particularly from studies focusing on developing countries, suggest that political instability can significantly deter FDI. For example, research by Schneider et al. (1985) demonstrated that political instability in developing nations during this period led to a marked reduction in the inflow of foreign direct investment. This finding underscores the importance of a stable political environment in attracting and retaining foreign investment. Empirical research further supports this notion, with studies on countries such as South Korea and Cambodia concluding that political stability plays a pivotal role in determining the location preferences of foreign investors (Linclon, 1996). In regions where political instability is prevalent, such as those prone to ethnic violence or terrorist attacks, the risks to FDI are heightened. These events can lead to the destruction of assets and disrupt the regular supply chains of multinational companies, ultimately threatening the safety of employees and consumers alike. A pertinent example of the impact of political instability is the Russia-Ukraine conflict in 2022, where Russia's subsequent nationalization of "foreign" assets in Crimea, including those with Ukrainian-linked titles, exemplifies how government actions can severely impact

business operations (The Moscow Times, 2023). Therefore, MNCs tend to favor countries where a stable government and policies promoting economic growth are in place, as these conditions provide a more secure environment for business.

Secondly, corruption is another significant component of political risk that influences the decisions of MNCs when choosing where to invest. Corruption can manifest in various forms, such as bribery, embezzlement, or the manipulation of regulations, and it can have a profound effect on the business environment. Research conducted on a sample of 22 developing countries in the 1980s highlighted the negative impact of corruption on FDI inflows, showing that higher levels of corruption tend to deter foreign investors (Gastanaga et al., 1998). The rationale behind this is straightforward: corruption increases the uncertainty and costs associated with doing business, making the investment less attractive. However, there is also a counterargument that suggests corruption might, in some cases, facilitate business operations by allowing companies to circumvent cumbersome regulations and administrative barriers. For instance, some MNCs may exploit corrupt practices to gain competitive advantages or to expedite business processes that would otherwise be slowed by bureaucratic red tape (Egger et al., 2005). Despite this, the overall impact of corruption is generally negative, as it introduces hidden costs that can accumulate over time. These additional expenses, often referred to as a "hidden tax," are paid to those who benefit from corrupt practices, leading to an uneven playing field where certain companies may be unfairly disadvantaged. Consequently, regions with high levels of corruption are often avoided by foreign investors, as the risks and costs associated with such environments can outweigh the potential benefits.

Lastly, democratic accountability is a crucial factor in the assessment of political risk, as indicated by the ICRG. It refers to the degree to which government actions are held accountable to the public and how responsive they are to the needs and demands of their citizens. The impact of democratic accountability on FDI is complex and has been the subject of much debate. Empirical studies have shown that the hypothesis that FDI prefers non-democratic countries is not strongly supported. For example, Harms et al. (2002) found little evidence to suggest that foreign investors are more likely to choose non-democratic regimes over democratic ones. However, this finding is not without controversy. Some scholars argue that democratic institutions, by promoting transparency and accountability, might actually discourage FDI by limiting the ability of MNCs to engage in monopolistic or oligopolistic behaviors and by restricting the capacity of host governments to offer generous fiscal incentives to attract foreign investment (Li et al., 2003). Furthermore, the relationship between democratic accountability and FDI has been shown to vary over time. For instance, in the 1990s, an increase in democratic accountability was associated with a rise in foreign investment, whereas in the 1970s and 1980s, a significant portion of FDI was directed towards countries with repressive governments (Busse, 2004). This indicates that while democratic accountability can enhance the attractiveness of a country by ensuring better governance, legal protection, and respect for human rights, its effect on FDI is not straightforward and can depend on the broader global economic and political context at any given time.

In conclusion, political risk is a multifaceted concept that encompasses various elements such as government stability, corruption, and democratic accountability, all of which play a significant role in shaping the decisions of multinational corporations regarding where to invest. By understanding these factors, businesses can better navigate the complexities of international markets and make more informed investment choices.

4. Financial Risk

Financial risk is a critical aspect of political risk that pertains to the uncertainty surrounding a host government's ability to finance its official and trade debt obligations. This type of risk is particularly relevant for multinational corporations (MNCs) considering foreign direct investment (FDI), as it directly impacts the financial environment in which these businesses operate. One key component of financial risk, as identified by the International Country Risk Guide (ICRG), is exchange rate stability. The stability of a country's exchange rate can have profound implications for FDI, influencing both the location of investments and the overall success of business operations in the host country.

Exchange rate stability is crucial because it affects the predictability of returns on investment. When the exchange rate is stable, businesses can more accurately forecast their revenue streams and costs, leading to

more informed decision-making regarding investments. Conversely, when the exchange rate is volatile, it introduces a level of uncertainty that can deter FDI. For example, significant fluctuations in the exchange rate can impact the profitability of MNCs by altering the costs of imports and exports. If the exchange rate moves unfavorably, the cost of importing goods could rise, or the revenue from exports could fall, thereby squeezing profit margins. This added financial uncertainty can make it difficult for businesses to plan effectively, potentially leading to reduced investment in markets with high exchange rate volatility.

Empirical research supports the idea that exchange rate stability is a key determinant of FDI location. Studies using data from Japan between 1990 and 2000, as well as from 1980 to 1996, have demonstrated a negative relationship between exchange rate volatility and FDI (Kiyota et al., 2004; Urata et al., 2000). These studies suggest that as exchange rate volatility increases, the level of FDI decreases, indicating that MNCs are likely to avoid investing in countries where currency values are highly unpredictable. This negative relationship highlights the importance of a stable exchange rate environment in attracting foreign investment. MNCs, seeking to minimize risk, prefer to operate in countries where currency fluctuations are limited, allowing for more stable and predictable financial planning.

However, the relationship between exchange rate stability and FDI is not always straightforward. Some researchers have identified a threshold effect in this relationship, where the impact of exchange rate volatility on FDI is minimal when currency movements are relatively small, but becomes significant when volatility is excessive (Crowley et al., 2003). This threshold effect suggests that MNCs may tolerate a certain level of exchange rate fluctuation without significantly altering their investment strategies. It is only when exchange rate movements exceed a certain level of volatility that the relationship becomes strong, and the negative effects on FDI become more pronounced. In such cases, the instability in currency values can create substantial challenges for businesses, particularly in terms of financial planning and cost management.

Large fluctuations in exchange rates can lead to significant uncertainties in the settlement of import and export trades, further complicating the financial operations of multinational companies. For instance, when a company is dealing with frequent and unpredictable changes in exchange rates, the process of converting between different currencies becomes more complex and risk-laden. This can affect the company's overall profitability and cost structure, as unexpected changes in exchange rates can lead to losses that were not accounted for in initial business projections. Consequently, companies may face difficulties in maintaining consistent pricing strategies, managing cash flows, and securing favorable terms in international contracts. All of these factors underscore the importance of exchange rate stability as a critical factor in the decision-making process for FDI.

In conclusion, while exchange rate stability is undoubtedly a significant determinant of FDI location, its importance is highly contingent on the degree of exchange rate volatility in the host country. When exchange rate movements are moderate, their impact on FDI may be limited. However, in environments where exchange rate fluctuations are severe, the associated financial risks can become a major deterrent to foreign investment. Thus, for MNCs looking to invest abroad, a stable exchange rate environment is often a key consideration, as it provides a foundation for more reliable financial planning and reduces the risks associated with currency conversion and international trade.

5. Economic Risk

Economic risk refers to the assessment of a country's current economic strengths and weaknesses, which plays a crucial role in determining the attractiveness of that country for FDI (Erb et al., 2019). Understanding economic risk is essential for multinational corporations (MNCs) as they evaluate potential markets for expansion or investment. Various economic indicators, such as inflation, gross domestic product (GDP), and unemployment rates, are commonly used to assess economic risk. These indicators provide insights into the stability and potential growth of an economy, which are critical factors in the decision-making process for FDI. In this context, the International Country Risk Guide (ICRG) includes these economic indicators as part of its evaluation framework, helping businesses to gauge the level of risk associated with investing in a particular country.

Firstly, inflation is a significant measure within the ICRG framework and is widely recognized as a key determinant of FDI location. Inflation reflects the rate at which the general level of prices for goods and

services is rising, and subsequently, how it erodes the purchasing power of a nation's currency. When inflation is high, it indicates that the cost of living is increasing rapidly, which can deter investment. The negative impact of inflation on FDI inflow has been confirmed in various empirical studies. For instance, research conducted using data from Malaysia and South Africa demonstrated that high inflation rates led to a decrease in FDI inflows, highlighting the adverse effects of an unstable economic environment on investment (Kiat, 2010; Yol et al., 2009). High inflation can be problematic for investors because it often leads to increased costs associated with doing business, such as higher shoe leather costs (the cost of time and effort people spend trying to counteract the effects of inflation) and menu costs (the costs to a firm resulting from changing its prices). Moreover, inflation can lead to instability in the exchange rate, further complicating financial planning for MNCs and reducing the predictability of returns on investment. This makes regions with high inflation less attractive to foreign investors, as the risks associated with such economic conditions can outweigh potential benefits. However, it is also important to note that the impact of inflation on FDI can vary depending on the specific economic context. For example, research in the United Arab Emirates (UAE) suggested that inflation did not have a significant impact on FDI inflows (Alshamsi, 2015), indicating that in some cases, other factors may mitigate the negative effects of inflation or that inflation is less of a concern in economies with different structures or levels of economic development.

Secondly, the gross domestic product (GDP) of a region is another crucial factor that influences the decision-making process for FDI. GDP represents the total value of all goods and services produced over a specific time period and is often used as an indicator of the economic health of a country. High GDP is generally associated with a robust economy, which can provide a favorable environment for business and investment. Research has consistently shown that higher GDP levels are correlated with increased FDI inflows. For instance, studies in Chile and Poland have concluded that higher GDP leads to greater FDI, as these countries offer strong market demand and economic stability, which are attractive to foreign investors (Kosztowniak, 2016; Chowdhury and Mavrotas, 2006). In high GDP countries, businesses can expect to find a larger customer base, better infrastructure, and a more favorable regulatory environment, all of which contribute to the potential success of foreign investments. Additionally, a high GDP often reflects positive expectations about future economic growth, which further enhances the attractiveness of the region to investors. This optimism about the region's economic prospects can lead to greater returns on investment, making high GDP countries the top choice for FDI when deciding where to locate. However, the relationship between GDP and FDI is not always one-way. For instance, in Malaysia and Thailand, there is strong evidence of a two-way causal relationship between GDP and FDI, meaning that not only does high GDP attract FDI, but FDI itself also contributes to GDP growth (Chowdhury and Mavrotas, 2006). This mutually reinforcing relationship underscores the importance of a thriving economy in attracting and sustaining foreign investment.

Thirdly, the unemployment rate is another significant determinant in FDI location selection that cannot be overlooked. Unemployment rates provide insight into the labor market conditions of a country, which can have both positive and negative implications for FDI. High unemployment rates are often seen as a sign of economic distress, suggesting that a country may be experiencing a recession or economic instability. This perception can deter FDI, as investors may be concerned about the long-term economic prospects of the country and the potential for reduced consumer spending power. For example, a high unemployment rate might indicate that the local population has less disposable income, which could translate into lower demand for goods and services, thereby reducing the potential market for MNCs. However, the impact of unemployment on FDI is complex and can vary depending on the specific circumstances of the country in question. In some cases, higher unemployment rates may actually attract FDI, particularly in industries that are labor-intensive and seek to take advantage of lower labor costs. For instance, research on EU member states has confirmed that higher unemployment rates in countries like Romania, the Czech Republic, and Slovakia have led to increased inflows of FDI (Alecsandru Strat, 2015). This is because higher unemployment can lead to an abundance of available labor, which might allow companies to reduce variable costs and increase profitability. Additionally, in regions with high unemployment, governments may offer incentives to attract foreign investment as a way to stimulate economic growth and create jobs. These incentives, combined with the potential for reduced labor costs, can make high-unemployment regions appealing to certain types of FDI. Thus, while high unemployment is often associated with economic challenges, it can also present opportunities for MNCs, depending on the broader economic context and the specific needs of the investing companies.

In conclusion, economic risk is a multifaceted concept that plays a critical role in determining the attractiveness of a location for FDI. Inflation, GDP, and unemployment rates are key economic indicators that provide valuable insights into the potential risks and rewards associated with investing in a particular country. While high inflation generally deters FDI due to increased costs and economic instability, high GDP levels are typically associated with greater investment opportunities due to a stronger economy and better business environment. The impact of unemployment on FDI is more nuanced, as it can either deter or attract investment depending on the specific circumstances and the nature of the industry involved. By carefully analyzing these economic indicators, MNCs can make more informed decisions about where to invest, balancing potential risks with the opportunities presented by different markets.

6. Conclusion

Country risks including political, financial and economic risks have significant influence on FDI location selection. For political risk, regions with more stable governments, less corruption and more democratic accountability are generally more attractive to FDI. As a component of financial risk, a stable exchange rate result in more FDI. In terms of economic risk, inflation, GDP and unemployment rates are all important determinants when choosing a location for FDI.

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