Factors Affecting The Investment Climate For An International Financial Center In Kuwait

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ABSTRACT

In recent years, an increasing worldwide interest in developing a competitive international financial center (IFC) raises the important issue of identifying the factors or elements of the investment climate of an IFC. Drawing on the theories and literature of financial intermediation, innovation, governance, social relationships, and information in IFCs, the authors develop five hypotheses and examine them using a survey of 200 MBA students at a private university in Kuwait. The findings obtained from conducting a hierarchical linear regression indicate that finance and innovation are positively and significantly related to the investment climate in an IFC. Implications for theory and practice, and areas of further research are made.

Keywords: International Financial Centers; Investment Climate for International Financial Centers in Kuwait

INTRODUCTION

A growing financial interdependence in the global economy is intensifying, and internationalization has accelerated (Grant and Venzin, 2009), especially in the financial industry, where there is a close interdependence of markets and institutions in the functioning and resilience of the financial system (BIS, 2008). The globalization of the financial services industry and markets, and the intensification of international financial integration create opportunities and present challenges to the participants in the financial intermediation process, in the development of global strategies for the provision of value. Given the importance of financial services for organizing the world economy, these activities create significant opportunities for value creation and capture (White, 2005). Increasingly, offshore financial centers are becoming key players in the “race” (Sikka, 2008), capturing a large share of global financial flows (Gonzalez and Schipke, 2011). A major type of offshore financial center is the international financial centers (IFCs) that are playing a dominant role in the international financial intermediation process (IMF, 2005). The theory of financial intermediation originated with Adam Smith’s work *On the Principles of Political Economy and Taxation* (1817), however, it provided a ‘passive’ view on intermediation which is inadequate in explaining the reality of the finance industry (Lihui and Whinston, 2001). The traditional financial intermediation theory suggests the provision of basic value elements, such as liquidity and risk management (Allen and Douglas, 2004), and the allocation of resources (Woodford, 2010). However, no account is given to the value added elements as major outcomes of the process of financial intermediation. The challenge facing IFCs is developing a sound investment climate for the delivery of the elements or factors of value and value added to the agglomeration or cluster of financial institutions operating in it.

The definitions of an international financial center (IFC) (Gehrig, 1998., Goldberg and Levi, 2001., Zorome, 2007; IMF, 1994; Bhattacharya, 2011), share a common element of the provision of international financial transactions and services. In this study, an IFC represents an agglomeration of financial institutions that provide value competitively in the global financial marketplace. However, the existing definitions of investment climate in an IFC have a narrow and focus on institutional and regulatory elements. One definition of investment climate is: “The institutional, policy, regulatory environment in which firms operate: It is the collective set of incentives that establish the “rules of the game” to which economic actors must adhere”. (Fan, Guillerme, and Jarvis, 2007).

Another definition of investment climate is: “The policy, institutional, and behavioral environment, both present and expected, that influences the returns and risks associated with investment. The notion of investment climate focuses on questions of institutions, governance, policies, stability, and infrastructure that affect not just the level of capital investment but also the productivity of existing investments indeed, of all factors of production and the willingness to make productive investments for the longer term”, (Stern, 2002). In this study, we define investment climate to capture more elements of value provided as: “the factors or elements of value provided by an IFC to the agglomeration of financial institutions operating in it”.

The studies on investment climate, which is synonymous to the business environment (Morisset and Kelly, 2003, Hallward- Driemeier, Wallsten, and Xu, 2006) focus on its positive outcomes in terms of stimulating economic growth and development. (Hallberg, 2006, Kose et al. 2009, Weiss, 2008). However, most of the studies describe or prescribe the required institutional, governance, and infrastructure elements in an IFC (Negishi, 2007, DeFerranti, Jacinto, and Ody, 2009, Bhattacharya, 2011, Bindemann, 1999). In addition, they have a narrow geographic focus on Asia (Schenk, 2002, Jarvis, 2011, Laurenceson and Tang, 2005, Garcia-Herrera and Wooldridge, 2007) or Europe (Engelen, 2009, White, 2005), while African and Middle Eastern countries are understudied. The emergence of the Middle East as a global financial center is fueled by its oil revenues and equities (UNCTAD, 2008, IMF, 2009). The Arab World, especially the Gulf Cooperation Council (GCC) countries seek to establish an international presence by developing IFCs (Goetz, 2007). The limited nature of the studies on investment climate represent a gap in knowledge that needs to be addressed in an empirical study on an IFC located in a GCC country. The study comes in six parts. The first part is an introductory section indicating the growth of offshore finance with international financial centers playing an important role in the provision of value in the global financial marketplace. The second part is a literature review of factors of investment climate and five hypotheses, each relating to a relevant factor in the investment climate. The third part deals, with methodology, scales used, sampling, and the procedures conducted to implement the research design. The fourth part presents the results of the study, while in the fifth and sixth parts; we present conclusions, limitations, and future research needs.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

In our literature review we will deal with the factors or elements of value affecting the investment climate in an international financial center. Based on an extensive review of the extant literature, we found that these factors might be classified as: finance, innovation, governance, social relationships, and information.

Finance

A modern economic system depends on a reliable and efficient flow of finance through the financial system comprising both financial markets and financial intermediaries. Financial resources are required to achieve the objectives set by organizations. The efficient allocation of risks and resources is the primary function of a financial system (Allen and Douglas, 2004). Financial institutions make the capital formation process more efficient and more attractive by providing services to the investors, creditors, and shareholders; managing risk is where real value is added in financial services. (Oldfield and Santomero, 1997, McDonough, 2002). Financial institutions bear and manage risk on behalf of their customers through the pooling of risks and the sale of their services as risk specialists (Saunders, 1997). A stream of research has found that the provision of liquidity and risk management are important basic factors of the investment climate in an IFC. A paper (Poon, 2003) examined the spatial organization and evolution of capital markets in forty- three world cities from 1980 to 1998, and concluded that the task of financial and capital centers is to mediate between surpluses and deficits of financial savings that are best matched in a central place. An empirical study (Gehrig, 1998) found that the future development of cities as financial centers depends on the relative importance and magnitude of “centrifugal and centripetal forces” in international financial markets, and the most important centripetal force derives from market liquidity. Risk adverse investors prefer to trade in liquid markets because the risk of price changes caused by liquidity shocks of individual traders is lower. In addition to liquidity provision in an IFC, risk management is important. IFCs add value to companies by minimizing it in offshore outsourcing (Weerakoddy and Irani, 2010). The discussion above suggests the following:

H1: The provision of finance (liquidity) is positively related to the investment climate in an IFC.

Innovation

The positive impact of innovation on investment climate exists at both firm and country levels. Innovation may be the key for financial institutions to provide value-added products and services and differentiate themselves (Lihui and Winston, 2001). Key institutions besides factor endowments that can influence the location of production include national and regional systems of innovation, flexibility, and willingness to embrace innovation (Schneider and Susman, 2008). A paper (Walter, 1989) concluded that innovation is particularly important to players with a substantial presence in the offshore markets. These are typically markets where there are few barriers to competitive behavior, and where the relative absence of regulation allows each of the players far more degrees of freedom in terms of innovative behavior than is true in many onshore markets.

The discussion above suggests the following:

H2: Innovation is expected to be positively related to the investment climate in an IFC.

Governance

Adequate governance systems are essential to the development of a sound investment climate in an IFC. It includes several integrated elements: legal and regulatory systems, transparency, institutions, infrastructure, a stable political and macroeconomic environment, and capital account liberalization. A paper (Negishi, 2007) on East Asia and other emerging markets attempts to empirically answer what matters in the investment climate when a country wants to attract more long-term, stable foreign investment. A good investment climate includes sound macroeconomic policies, open regimes toward foreign investment, and non-discriminatory frameworks for business facilitation. An empirical study (Outreville, 2007) examined where financial firms are expanding their operations and documented some of the factors that may explain the most-favored locations of these financial groups. The results of the study indicated that location-specific advantages such as size, education, and cultural distance, do provide an explication for the establishment of foreign affiliates by the largest financial TNCs in specific locations. Second, that good governance has as strong impact on the choice of countries. A policy implication is that improving the functioning of markets and the institutional framework is critical for boosting long-run economic growth. Also, a theoretical study (Budd, 1995) prescribed the elements of a sound investment climate, in the form of systems of corporate governance, financial regulations, and general business environment as the means of maintaining a national interest as they become sites across which international transactions flow. The discussion presented above suggests the following:

H3: The presence of an adequate governance system is expected to be positively related to the investment climate of an IFC.

Social Relationships

Social relationships generate opportunities (Alderson and Beckfield, 2004., Polodny, Stuart, and Hannan, 1996). Relationships in the financial industry are long-term in nature and come to possess important attributes for the parties involved: reliability, trust, confidence, and security, which are critical to success (Maas and Graf, 2008), and economic growth rates (Beugelsdijk, 2006). Networked relations can also enhance certainty by enabling collaborative problem-solving, innovation, learning, and institutional change (Pistor, 2009; DePropris and Driffield, 2006). A study (Faulconbridge, et al., 2007) examined the factors affecting the competitiveness of a financial center, with a focus on Amsterdam as an IFC, and found evidence that even virtual financial markets have a “social underpinning” The process of knowledge creation and dispersion is facilitated by the relatively “tight spatial matrix” within which financial institutions locate themselves in leading IFCs, and the “dense social interactions” between traders within these matrices. The discussion above suggests the following:

H4: The development of social relationships is positively related to the investment climate in an IFC.

Information

At the conceptual level, a study (Oldfield and Santomero, 1997) found that financial institutions provide more efficient discovery, evaluation, and dissemination of information about legitimate investment opportunities. It is considered a focal point in the field of entrepreneurship (Gaglio, 2004, Vaghely and Julien, 2010).

In a similar vein, agglomeration of financial institutions may result in a faster, more reliable information flow (Bindemann, 1999). A study (Faulconbridge, et al. 2007) on the competitiveness of Amsterdam as an IFC found that the clustering of financial institutions within IFCs leads to what has been described as “information spillovers”. This is the process of knowledge creation and dispersion that is facilitated by the relatively tight spatial matrix within which financial institutions locate themselves in leading IFCs. Being embedded within such “spaces of knowledge” production and dispersion appears to be essential for conducting profitable trades. An empirical study (Gehrig, 1998) found that to the extent that the presence of other financial intermediaries stimulates communication among agents, more information can be exchanged among agents, and correspondingly exploited. Communication can help to generate new ideas but it also allows agents to benefit from information of others. The above discussion suggests the following:

H5: The production of information on entrepreneurial opportunities is positively related to the investment climate in an IFC.

METHODOLOGY

Sample

The surveyed participants were full and part-time MBA students at a large private university in Kuwait. There was a fairly close split between male (55%) and female (45%) participants. Furthermore, 48.3% of respondents had been in their position for five years and above, and 18.3% of respondents had been working in the present organization for over five years. In terms of positions, 65% of respondents were non-managerial; the remaining respondents were managerial (35%). A total of 200 questionnaires were distributed. Each questionnaire included a covering letter explaining the aim of the study. For the purpose of maintaining confidentiality and anonymity, names of respondents were not solicited. In total, 90 students responded, generating an effective usable response rate of 45%

Measures

Empirical studies on IFCs were the sources of the factors of the investment climate: finance, innovation, governance, social relationships and information. The factors were assessed on a five-point likert scale (1= strongly disagree to 5= strongly agree). The first factor labeled “finance” included two items measuring the provision of liquidity and risk management systems (Poon, 2003, Gehrig, 1998, Weerakoddy and Irani, 2010). The second factor, labeled “innovation” included one item to measure the production of financial production and organization innovation (Faulconbridge, et al. 2007), and innovation conditions (Klein and HadjiMichael, 2003). The third factor labeled “social relationships” included three items to measure the development of social relationships for coordination, control, and problem- solving efforts, (Faulconbridge, et al. 2007, Pistor, 2009). The fourth factor labeled “governance” included nine items to measure the various aspects of governance. These elements include good governance elements (Deferrant, Jacinto, and Oday, 2009), infrastructure (Sekka and Vezanzones-Varoudakis, 2007), financial institutions (Kose, Prasad, and Taylor, 2011), investment climate and regulations (Negishi, 2007), educated manpower (Kinda, 2010), and the protection of investor rights (Iarossi, Mousley, and Radwan, 2009). The fifth factor labeled “information” included five items measuring the provision of information about investment opportunities, entrepreneurship, and innovation (Oldfield and Santomero, 1997., Gehrig, 1998), profitable trades (Faulconbridge et al. 2007), and future alliance decisions (Walter, 1989).

Procedures

Since the scales had not previously been validated in an Arab non-Western context, the calculation of item-total correlations for the pooled data was first used as a basis for detecting poor items. Items with item-total correlation of 0.35 or less were eliminated from the analysis. Following recommendations by Anderson and Gerbing (1988), the retained items were subjected to an exploratory principal component analysis, separately for each scale, to further investigate the unidimensionality of the scales. We chose the oblique rotation since the survey dimensions are expected to be correlated. Advocates of the oblique rotation assert that in the real world important factors are likely to be correlated; thus searching for unrelated factors is unrealistic (Dixon, 1993). Finally, the retained items were combined into sum scales and reliabilities and means were calculated. The reliabilities, measured with Cronbach's alpha, ranged from 0.62 to 0.81. Cronbach's alpha is considered for the most part to be a conservative estimate of a construct's reliability (Carmines & Zeller, 1983).

RESULTS

Product-moment correlations

Though it does not prove causation, correlation can serve as predictor of causation (Sekaran, 2000). The product moment correlations between the variables are shown in Table 2. This table was constructed to get a feel for the associations among the six constructs constituting the model. Most of the correlation coefficients were significant and had the expected sign. Thus the constructs, in general, are highly related. (Table 1: Product Moment Correlations).

Table1. Product-moment correlations

		FIN	INV	GOV	INT	INF	INOV
FIN	Pearson Correlation	1	.670**	.741**	.653**	.706**	.564**
	Sig. (2-tailed)		.000	.000	.000	.000	.000
	N	90	88	90	89	89	88
INV	Pearson Correlation	.670**	1	.615**	.589**	.552**	.555**
	Sig. (2-tailed)	.000		.000	.000	.000	.000
	N	88	88	88	87	87	86
GOV	Pearson Correlation	.741**	.615**	1	.674**	.706**	.531**
	Sig. (2-tailed)	.000	.000		.000	.000	.000
	N	90	88	90	89	89	88
INT	Pearson Correlation	.653**	.589**	.674**	1	.734**	.722**
	Sig. (2-tailed)	.000	.000	.000		.000	.000
	N	89	87	89	89	88	87
INF	Pearson Correlation	.706**	.552**	.706**	.734**	1	.639**
	Sig. (2-tailed)	.000	.000	.000	.000		.000
	N	89	87	89	88	89	87
INOV	Pearson Correlation	.564**	.555**	.531**	.722**	.639**	1
	Sig. (2-tailed)	.000	.000	.000	.000	.000	
	N	88	86	88	87	87	88
**. Correlation is significant at the 0.01 level (2-tailed).							

Table 2 Hierarchical regression results

Model Summary^f

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.081 ^a	.007	-.018	.77937	.007	.266	2	80	.767	
2	.581 ^b	.338	.312	.64046	.331	39.467	1	79	.000	
3	.707 ^c	.500	.475	.55976	.163	25.418	1	78	.000	
4	.713 ^d	.509	.477	.55875	.008	1.283	1	77	.261	
5	.714 ^e	.509	.470	.56204	.001	.100	1	76	.752	1.893

a. Predictors: (Constant), GENDER, AGE

b. Predictors: (Constant), GENDER, AGE, INOV

c. Predictors: (Constant), GENDER, AGE, INOV, FIN

d. Predictors: (Constant), GENDER, AGE, INOV, FIN, GOV

e. Predictors: (Constant), GENDER, AGE, INOV, FIN, GOV, INF

f. Dependent Variable: INV

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	3.331	.659		5.055	.000		
	AGE	.018	.026	.082	.721	.473	.956	1.046
	GENDER	-.009	.179	-.006	-.049	.961	.956	1.046
2	(Constant)	.939	.662		1.418	.160		
	AGE	.005	.021	.023	.241	.810	.947	1.056
	GENDER	.258	.153	.164	1.686	.096	.883	1.133
	INOV	.685	.109	.599	6.282	.000	.922	1.085
3	(Constant)	.091	.603		.151	.880		
	AGE	.000	.018	.001	.007	.995	.944	1.059
	GENDER	.169	.135	.108	1.257	.213	.868	1.152
	INOV	.353	.116	.309	3.048	.003	.624	1.603
	FIN	.567	.113	.493	5.042	.000	.669	1.494
4	(Constant)	.051	.603		.085	.933		
	AGE	.001	.018	.005	.062	.950	.942	1.062
	GENDER	.154	.135	.098	1.135	.260	.859	1.165
	INOV	.318	.120	.278	2.659	.010	.583	1.717
	FIN	.466	.144	.405	3.248	.002	.410	2.439
	GOV	.136	.120	.140	1.133	.261	.416	2.402
5	(Constant)	.036	.608		.060	.953		
	AGE	.001	.019	.005	.060	.953	.942	1.062
	GENDER	.157	.137	.100	1.152	.253	.852	1.174
	INOV	.305	.127	.267	2.400	.019	.522	1.917
	FIN	.453	.151	.393	3.006	.004	.377	2.653
	GOV	.119	.132	.123	.899	.371	.347	2.880
	INF	.048	.152	.044	.317	.752	.336	2.978

a. Dependent Variable: INV

Hierarchical regression analysis

Hierarchical regression analysis was used to formally test the research hypotheses. This method is also known as incremental variance partitioning (Pedhazur, 1982). This approach allows us to focus on the variables forming the hypotheses, and at the same time sieve out the influence of the control variables that might have a moderating effect on affective commitment. Also this method allows the researcher to control the order of the variables entered into the regression model, allowing us to assess the incremental predictive ability of any variable of interest (McQuarrie, 1985).

Table -2- Hierarchical Regression Results shows the results of the hierarchical regression analysis used to test factors influencing international financial centers' investment climate. Following Geldern et al. (2008), gender and age were used as control variables in the first step of the regression. As shown in Table 1, the two variables were not significant at the 0.05 level. Both variables do not virtually explain any change in investment climate as indicated by the R-squared in model 1. This result corroborates previous research conducted in similar settings (e.g. Davey, Plewa & Struwig, 2011). In fact, some authors argue that the explanations offered by demographic and personality factors are all distal in nature (e.g. Rauch & Frese, 2000) since these explanations merely apply to broad classes of behaviour, which makes it difficult to formulate guidelines for intervention. In the second step, innovation variable was entered because previous research found a positive relationship between innovation and investment climate (Tate, Wendy, et al. 2009., Walter, 1989). The inclusion of this variable increased the explanatory power of the model to 33.8% (a change of around 39 % in the R-squared). This change was found to be significant at the 0.001 level as shown in Table 2. In the third step, the finance variable was entered in the hierarchical regression analysis. This variable was entered based on previous research reporting a positive relationship between finance and investment climate (Gehrig, 1998). The inclusion of this variable increased the explanatory power of the model to 50% (a change of around 16 % in the R-squared). This change was found to be significant at the 0.001 level as shown in Table 2.

In the fourth step, the governance variable was entered and this variable explained almost nothing of the change in explanatory power of the model. In the fifth step, the information variable was entered and this variable also did not add anything to the explanatory power of the model. Taken together our results seem to confirm that the investment climate of international financial centers in Kuwait might be affected by innovation and finance. Diagnostic checks shown in Figure 1 showed that the hierarchical regression assumptions are not violated.

Figure1. Hierarchical regression standardized residuals

IMPLICATIONS, LIMITATIONS, AND FURTHER RESEARCH

In this paper, we have attempted to suggest a more comprehensive group of factors, or value elements, of the investment climate in an IFC. As we mentioned in the introduction, most of the empirical studies on these factors have been narrow in scope. The focus of the studies is mostly on basic factors, such as finance, governance, infrastructure, and institutions, with little attention paid to other factors, of a value added nature, such as innovation, information, social relationships and entrepreneurship. This empirical study has attempted to fill this gap by testing five hypotheses relating to these factors: finance, innovation, information, social relationships, and entrepreneurship. On the basis of the results from the study, we have demonstrated the importance of finance, and innovation (value added) in the investment climate of an IFC. Also, with the increased interest in developing an IFC in many parts of the world, most of the studies on IFCs have a narrow geographic focus on Europe and the U.S.A. In order to cover more countries, the study was conducted in Kuwait, a member of the Gulf Cooperation Council (GCC).

The study has important implications for research and managerial practice; first, the realities and developments in the international financial market place show the inadequacy of the traditional view of financial intermediation, with its stress on basic factors or value elements. Hence, there is a need to broaden the scope of intermediation theory to consider more factors of a value added nature, such as innovation. In terms of practice, managers can enhance the effectiveness of an IFC by developing and implementing a comprehensive framework of factors, or value elements of the investment climate, in order to exploit its full potential. International marketers can develop better positioning strategies of IFCs as attractive sites for financial intermediation.

This study has limitations that could be extended in several ways. First, the data was collected from a sample of MBA students at a private university in Kuwait. The students do not necessarily have a full familiarity with or awareness of the investment climate of an IFC. Therefore, it is difficult to generalize the findings of the study to the working members of the financial and business community. Thus, additional research is needed to confirm the results of the study. Further research should focus on extending the generalizability of the findings by conducting a replication study on financial service employees in a diverse group of countries in the world. Second, the sample size of 90 observations is smaller than a normal sample size. A third limitation in the study is the language of the questionnaire, which was in English, administered to Arab students. Their understanding of the questions posed in the questionnaires could lead to a different understanding of what is being asked in the questions, which raises issues of the validity and reliability of the findings. Further research might focus on the existence of moderating effects of language differences in survey questionnaires.

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APPENDIX: RESEARCH INSTRUMENT

1. An international financial center should provide a reliable flow of financing and liquidity
2. An international financial center should provide effective and efficient risk management systems
3. An international financial center should be located in country that enjoys an attractive Investment climate.
4. An international financial center should be located in country that enjoys macroeconomic and political stability.
5. An international financial center should have a well-functioning financial system, institutions, and capital markets.
6. An international financial center should have appropriately-designed governance structures (stable, transparent and predictable regulatory conditions).
7. An international financial center should provide adequate financial market infrastructures (tax regimes, procedures, and laws).
8. An international financial center should provide protection of investors' rights.
9. An international financial center should have talented and skilled labor and educated manpower.
10. An international financial center should provide knowledge and information about market and investment opportunities.
11. An international financial center should provide Information on competitors.
12. An international financial center should provide adequate information on future alliance decisions.
13. An international financial center should have a well-established IT-infrastructure.
14. An international financial center should be located in country that enjoys financial liberalization.
15. An international financial center should promote the production and innovation of financial and intellectual capital.
16. An international financial center should provide a well-established opportunity identification system.
17. An international financial center should provide opportunities for engaging in entrepreneurial activities.
18. An international financial center should follow the evolution of social networks (Facebook, Twitter).
19. An international financial center should provide an inter-firm coordination and collaboration system to enable collaborative problem-solving efforts.
20. An international financial center should develop trust and interpersonal relations in a global workplace for coordination and control purposes.