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Twisting Ties:

Analyzing the Impact of Shifting Diplomatic Relations on FDI in Egypt

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ECONOMIC RESEARCH FORUM
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Twisting Ties: Analyzing the Impact of Shifting Diplomatic Relations on FDI in Egypt

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Abstract

This study empirically examines the use of capital flows as a tool of economic statecraft by the Gulf Arab states in Egypt, with a particular focus on Qatar's investments from 2005 to 2023, encompassing phases of support, the suspension of diplomatic relations, and renewed diplomacy. While empirical research on the Gulf states' use of economic statecraft is growing, significant gaps remain. This study tests the hypothesis that Qatar/Gulf investments have been used as instruments of economic statecraft. It provides a seminal exploration of the impact of political frictions between Egypt and Qatar on FDI inflows from Qatar to Egypt. Using panel data on FDI flows to Egypt, the study employs a gravity model covering the period from 2005 to 2023. The analysis evaluates the effects of several political shocks, such as the Qatar blockade and the Al Ula Agreement, on capital flows. The findings reveal that Qatar's investment flows into Egypt, as well as those from other Gulf countries, hinge on the state of bilateral relations and the presence of like-minded administrations. This confirms that capital flows are part of the Gulf's economic statecraft. However, the manipulation of capital flows is comparatively less adaptable than economic aid and portfolio investments in responding to political tensions.

I. Introduction

Economic statecraft refers to leveraging economic tools to accomplish foreign policy objectives (Baldwin, 2020). Hillary Clinton, the former United States Secretary of State, described economic statecraft as having "two parts: first, how we harness the forces and use the tools of global economics to strengthen our diplomacy and presence abroad; and second, how we put that diplomacy and presence to work to strengthen our economy at home."[1]

There has been a prevailing view that globalization, along with market deregulation and the World Trade Organization's trade rules, could make economic statecraft obsolete and reduce the politicization of trade and investments, as governments increasingly respond to private interests. For example, Davis and Meunier (2011) suggested that in an era of multinational corporations and globalization, governments struggle to shape economic outcomes based on political interests and encounter higher costs for attempting to do so. Nevertheless, there is a concern that the rise of emerging economic powers, such as China and India, characterized by different types of institutions and economic systems, may increase the politicization of economic exchange and the use of economic statecraft (Van Veenstra, Yakop, & Van Bergeijk, 2011).

There have been many recent examples where governments have used economic statecraft to exert pressure on other countries including halting imports. In 2012, Argentina's official news agency, Telam, reported that ministry officials had requested companies to halt imports of materials from the UK due to diplomatic tensions concerning the Falkland Islands[2]. In 2012, China imposed restrictions on Norwegian salmon imports to penalize Norway after the Nobel Peace Prize was awarded to Chinese human rights activist Liu Xiaobo.

Davis, Fuchs, and Johnson (2019) delved deeper and explored the mechanisms through which governments employ economic statecraft. They suggested that governments with significant state ownership in the economy possess the means to engage in politicized trade, even under the World Trade Organization's trade rules. Using the cases of China and India, they investigated state ownership of firms as a tool of economic statecraft. Their findings suggest that imports controlled by state-owned enterprises (SOEs) are significantly more responsive to shifts in bilateral political relations than those controlled by private firms.

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[1] Clinton, H. (2011). Speech on Economic Statecraft. U.S. Department of State. Available at: https://www.state.gov

[2] "Falklands Dispute: Argentina Urges UK Import Ban," BBC News, February 28, 2012

Governments with significant levels of state ownership in their economies have the tools to engage in politicized trade and investments. In contrast, countries with low levels of state ownership are less equipped with such tools and are therefore less likely to display politicized trade and investment patterns. The politicization of economic interaction by SOEs and sovereign wealth funds (SWFs) can be explained by their objectives, which are not solely driven by commercial considerations but also by the need to fulfill government goals.

In contrast, the private sector primarily focuses on economic outcomes, and its involvement as a tool for economic pressure often leads to inefficiencies. Thus, countries with a greater reliance on the private sector to drive the economy tend to exhibit less politicization in trade and investment practices. Similarly, one could argue that a high degree of public sector involvement in the economy is likely to influence capital flows in comparable ways.

The recent decades have witnessed the emergence of the Gulf Arab states as practitioners of economic statecraft, enabled by windfalls from oil price booms and by their economic structure rooted in state-led economies (Alhasan & Lons, 2023; Flynn & Aldamer, 2024; K. Young, 2022; K. E. Young, 2017). The GCC economies are characterized by a high degree of public sector dominance. In Qatar, for example, hydrocarbons account for nearly half of its GDP as of 2022. Additionally, several sectors in the non-oil economy—such as postal services, minerals, manufacturing, telecommunications, civil aviation, transportation, and public utilities—are dominated by SOEs (Kularatne, Miyajima, & Muir, 2024).

The Arab Spring of 2011 significantly disrupted the political landscape of the region. This turmoil also overlapped with an oil price super cycle spanning from 2004 to 2014, which fueled Gulf states' use of economic statecraft to achieve their foreign policy objectives. The use of Arab Gulf economic statecraft during this period, also revealed a Gulf divide in foreign policy objectives. In Egypt, Qatar used its economic statecraft to support a regime aligned with political Islam. In contrast, other Gulf states focused on backing like-minded governments to counter extremism in the region. The Gulf divide culminated in a diplomatic crisis in 2017, which led to the Qatar blockade imposed by the Arab Quartet countries: Egypt, the UAE, Saudi Arabia, and Bahrain.

The turmoil during the decade from 2011 to 2021, spanning from revolutions to civil wars to the Qatar blockade, presents a quasi-natural experiment for studying the use of economic statecraft by Gulf Arab states to navigate the regional turmoil. This study focuses on Qatar's and the Gulf states' use of economic statecraft in Egypt, given its role as the cornerstone

of the region. The study explores how Qatar's and the Gulf's investments were used to support the like-minded administration in Egypt during the 2012-2013 period and examines the extent to which Qatar's and the Gull states' capital flows to Egypt were affected during the blockade period and in the aftermath of the Al Ula Agreement in 2021.

There is an emerging literature examining the Arab Gulf states use of economic statecraft in the past years (Alhasan & Lons, 2023; K. Young, 2022). However, this literature remains largely descriptive and less is known about the deployment of capital flows as a tool of economic statecraft. Other studies assessing the political friction between Qatar and its neighbors and the use of economic statecraft during the blockade, have mainly focused on financial markets reactions during the blockade period (Buigut & Kapar, 2020; Charfeddine & Al Refai, 2019; Kapar & Buigut, 2020; Selmi & Bouoiyour, 2020). This study goes beyond the blockade period and its consequences on financial markets. It aims to quantitatively analyze Qatar's foreign economic policy in Egypt by examining investment flows. The bilateral relations between Egypt and Qatar have fluctuated over time, shifting from political and economic support to a diplomatic crisis in 2017 and then back to diplomacy.

The contribution of this study to the literature is twofold. To the best of my knowledge, it is the first study to examine the use of Qatar\Gulf 's economic statecraft during the period of turmoil following the Arab Spring and during the Qatar blockade, with a particular focus on Qatar's FDI flows, Second, methodologically, the study advances the literature by moving from descriptive analysis and applying gravity models to evaluate the reaction of capital flows to political shocks.

The remainder of this study is organized as follows: Section 2 provides a background on the historical development of Egypt-Qatar relations and outlines Qatar's international investment strategy. Section 3 reviews the relevant literature on the relationship between political tensions and economic activities, focusing on trade and capital flows. Section 4 provides a conceptual framework and predictions for using game-theoretic analysis. Section 5 describes the data sources and methodology employed in the analysis. Section 6 presents the econometric results. Section 7 discusses the study findings. Finally, Section 8 concludes the study, highlighting the implications of the results and suggesting directions for future research.

II. Background

II.I Development of Egypt-Qatar Relations

Qatar is—a resource-based economy, and one of the wealthiest countries globally in terms of per capita income, with a sovereign wealth fund holding assets totalling $526 billion in 2024. The oil sector represents around 40% of its GDP and 80% of government revenue. Qatar's population in 2023 was 2.7 million with migrant workers constituting 95% of its labour force. The country holds the third largest proven gas reserves globally. It is a hereditary constitutional monarchy with executive power held by the Emir.

The relationship between Egypt and Qatar has been dynamic, influenced by regional politics and leadership changes (Islam, 2024). Qatar gained independence from Britain on September 3, 1971, after which Egypt supported Qatar's membership in the Arab League. The 1980s and 1990s were marked by increasing tensions, particularly in the early 1990s. A significant shift occurred in 1995 following Sheikh Hamad bin Khalifa's assumption of leadership, leading to policies that contrasted sharply with traditional Gulf norms, straining relations further. A breakthrough occurred in 2010 with President Mubarak's visit to Qatar, which eased long-standing tensions and opened discussions on economic cooperation.

However, the 2011 Arab Spring brought another shift. Qatar was one of the first supporters to Egypt after the revolution, and the Qatar's Emir visited Egypt and leveraged economic statecraft with promises of financial support. In 2011, the Egyptian Prime Minister Essam Sharaf's visit to Doha, further strengthened ties through planned joint economic and developmental projects. In 2011, Qatar's Crown Prince visited Egypt and pledged a $10 billion investment in Egypt (Al Arabiya, 2011), exercising economic statecraft to signal support. However, data on FDI suggests that this investment did not materialize.

Under President Mohamed Morsi (2012-2013), bilateral relations deepened. Emir Hamad and President Morsi met multiple times, focusing on enhancing economic cooperation and addressing regional issues. Qatar pledged significant financial aid and investments, reflecting robust support for the new Egyptian regime. Qatar's FDI flows witnessed a spike during this period (Figures 2 &3).

However, the bilateral relations soured following Morsi's ouster. Qatar initially hesitated to align with the new interim President Adly Mansour, contrasting with the support from other Gulf states. Tensions peaked in early 2014 when Qatar criticized Egypt's policies

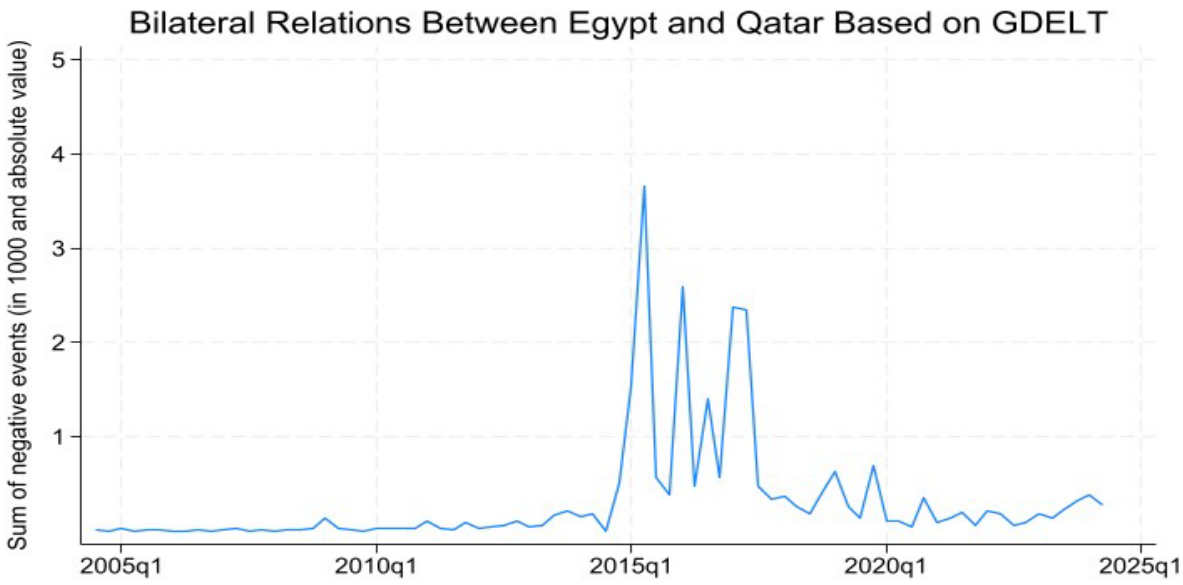
towards Morsi supporters, leading to a diplomatic fallout. In March 2014, Egypt, along with Saudi Arabia, the United Arab Emirates, and Bahrain—collectively known as the Arab Quartet—withdrew their ambassadors from Qatar in response to its regional policies.

Saudi King Abdullah bin Abdul Aziz's intervention in late 2014 led to a temporary reconciliation, but the relationship deteriorated again over differing stances. The situation worsened in 2016 after Morsi's trial, resulting in diplomatic retaliation, including Qatar's exclusion of Egyptian universities from its scholarship system. The tense diplomatic relations between Qatar and the Arab Quartet led to the Qatar blockade in June 2017, involving cutting off economic and diplomatic ties with Qatar and closing airspace between the Quartet and Qatar.

A significant improvement occurred in early 2021 with the Al-Ula Agreement during the 41st Gulf Summit, marking a major step towards reconciliation. This positive turn was further solidified in March 2021 when Egyptian Prime Minister Mostafa Madbouly met with Qatari Deputy Prime Minister to discuss the return of Qatari investments to Egypt, promising a new era of cooperation.

Using big data, Figure 1 summarizes the bilateral relations between Egypt and Qatar. In fact, quantifying bilateral relations between countries is a challenging task. The Global Database of Events, Language, and Tone (GDELT) database is a form of big data resource that allows analysis of the world’s news (Saz-Carranza, Maturana, & Quer, 2020). GDELT collects online news, machine-translates it into English, and codes each article by theme, sentiment, tone, location, and entity (organizations and persons). The GDELT can provide quantitative insights that summarizes the bilateral relations between Egypt and Qatar over time. Figure 1 focuses on negative actions initiated by Egypt, as the sender country, toward Qatar. We aggregated the severity-weighted count of negative diplomatic events based on Goldstein (1992)’s scale to create quarterly observations, then applied the log to its absolute value.

Figure 1



Source: GDELT Database

The upward movements and spikes in the graph indicate periods of heightened diplomatic tensions between Egypt and Qatar, as recorded by the GDELT dataset. These peaks represent intervals marked by a significant increase in negative bilateral events, suggesting episodes of intensified strain in their diplomatic relations. The graph reflects a period of heightened diplomatic tensions between Egypt and Qatar from 2014 to 2017, culminating in the withdrawal of ambassadors and subsequently escalating to the diplomatic crisis and blockade from 2017 to 2020. The later years display a trend toward reconciliation, with the line approaching zero, indicating an absence of negative events. This decline signifies improved diplomatic relations and sustained cooperation, particularly following the reconciliation efforts formalized in the Al-Ula Agreement

II.II Qatar's International Investments

Qatar, with its relatively small population and economy heavily reliant on energy resources, has recognized the importance of diversifying its economic resources. The outflow of investments abroad plays a crucial role in this diversification strategy.

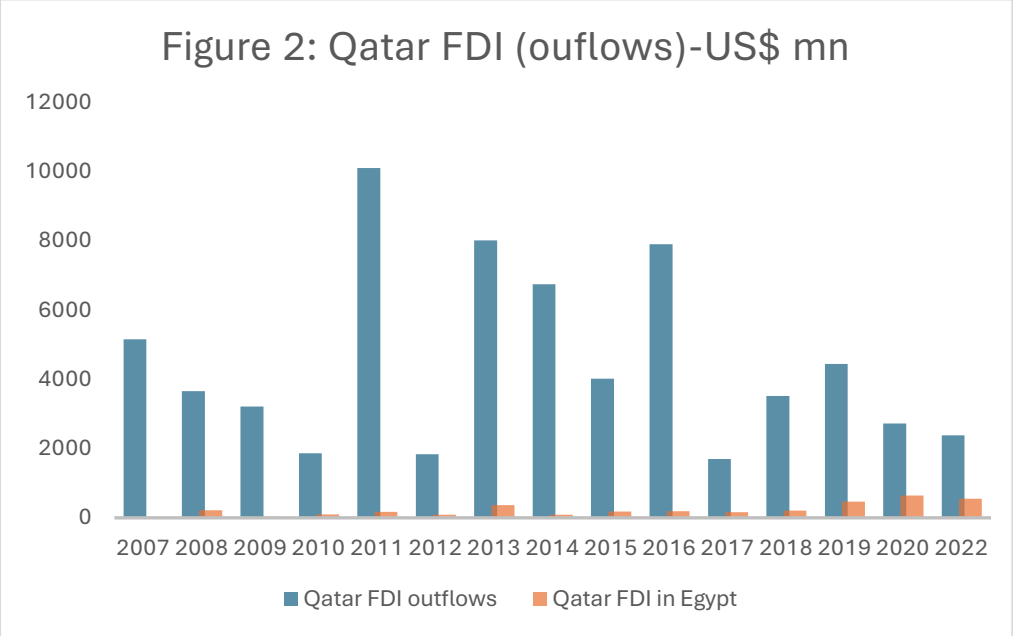
The primary motivation behind Qatar's investment abroad is twofold: economic diversification and strategic security. Qatar is actively seeking to reduce its reliance on hydrocarbons by investing in a wide range of sectors globally. These investments not only provide economic returns but also help in acquiring strategic assets crucial for national security. For instance, given Qatar's challenges with water scarcity and limited agricultural land, investing in

agricultural sectors abroad helps ensure food security. These investments thus serve dual purposes—yielding financial returns and securing essential resources.

Qatar's investments are managed by the Qatar Investment Authority (QIA) established in 2005 to invest the revenue of hydrocarbon resources. The QIA's assets are estimated to be around $526 billion in 2024. QIA manages a substantial and diverse portfolio, with significant holdings in various sectors globally. Notably, QIA possesses extensive real estate and hospitality assets in the United Kingdom. Additionally, it holds a 19% stake in the Russian state-owned oil company, Rosneft. Furthermore, QIA is one of the principal shareholders in Credit Suisse, a prominent but recently troubled Swiss financial institution.

The FDI outflows from Qatar have averaged approximately 4.7 billion dollars per year during the period from 2007 to 2019. Qatar's investments in Egypt represent a very limited proportion of Qatar's FDI (Figure 2). For instance, the FDI reached about 35 million dollars in the fiscal year 2011-2012 and peaked in the fiscal year 2019-2020 to 678.3 million dollars.

Interest Figure 2 about here



Source: Central Bank of Egypt and UNCTAD

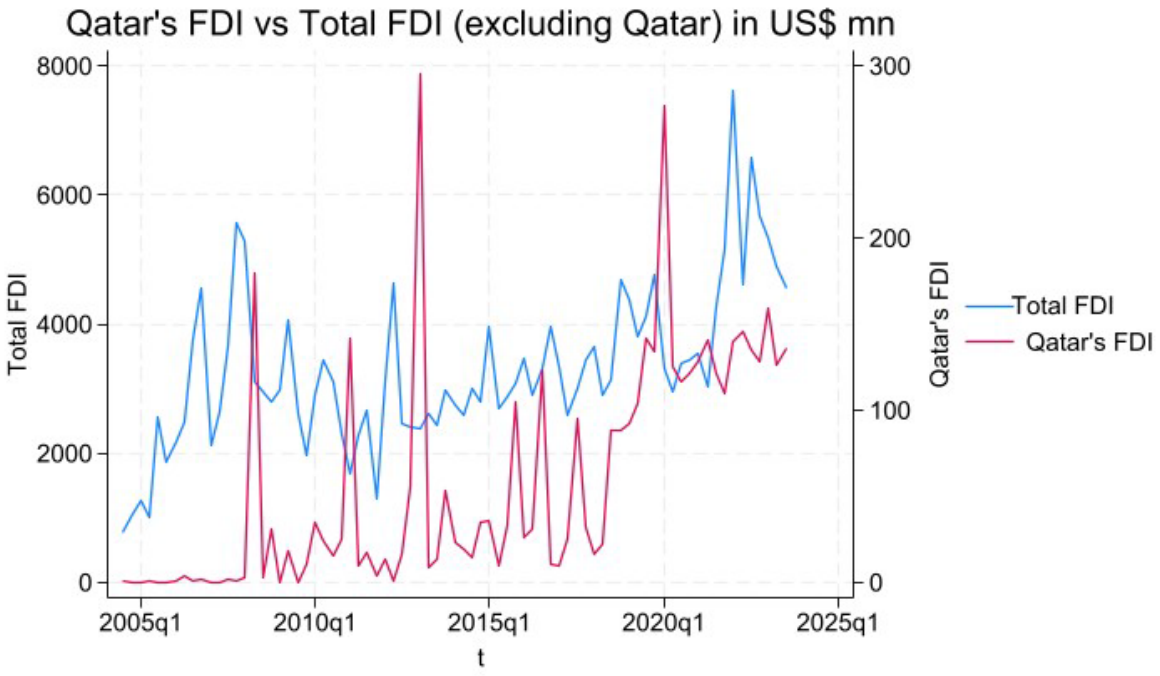
Looking at the trend of Qatar's FDI in Egypt (Figure 3), several key observations emerge. Initially, from 2005 to 2008, the FDI levels were relatively low, suggesting limited investment activities during this period. A significant rise occurred in 2010, marking the first notable peak. The peak in investment that occurred in 2010 followed President Mubarak's visit

to Qatar. In fact, the literature on diplomatic activity underscores the significant impact of visits by heads of state on economic relations (Aleksanyan, Hao, Vagenas-Nanos, & Verwijmeren, 2021; Fuchs & Klann, 2013; Kodila-Tedika & Khalifa, 2024; Nitsch, 2007, 2018).

The subsequent period from 2010 to 2015 exhibited high volatility, characterized by several peaks and troughs, including prominent peaks in 2012-2013. This second significant peak coincides with the presidency of Mohamed Morsi in Egypt, a period marked by political alignment. After the change in the Egyptian regime, there was a drop in FDI from Qatar that persisted until 2018. The FDI inflows began to pick up from 2019 and particularly after the Al-Ula agreement. There is a modest co-movement between Qatar's FDI and the total FDI flows (excluding Qatar) going to Egypt.

Interest Figure 3 about here

Figure 3



Source: Central Bank of Egypt

II.III The Economic Impact of the Blockade

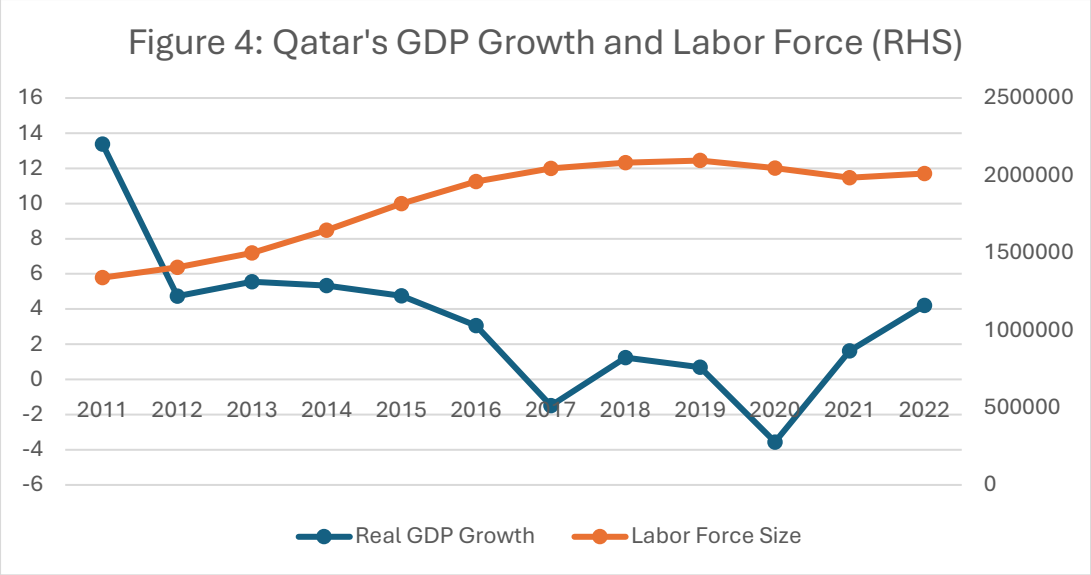
Historically, Qatar blockade is not the first incident in Arab regional politics where economic boycott or blockade and economic statecraft have been leveraged. A notable example occurred in 1979 when Egypt signed a peace treaty with Israel, that defied regional unity at that time. In

addition to its suspension from the Arab League, Egypt was subjected to economic sanctions, with Arab countries banning economic aid, cancelling loans, and halting public investments in Egypt. The impact of the embargo was notable regarding foreign aid and trade. However, a short-term impact in the areas of tourism and Egyptian workers aboard (Lavy, 1984).

There is a growing interest in examining the impact of Qatar blockade, particularly as more data become available. Selmi and Bouoiyour (2020) examined the stock markets' performance of Qatar and the Arab Quartet countries before and after the blockade. The study focused on the conditional volatility process of stock market returns and risks related to financial interconnectedness. Their findings suggested that the blockade had the most adverse impact on Qatar, Saudi Arabia, and the UAE, with Bahrain and Egypt also experiencing negative effects, albeit to a lesser extent. However, these effects were found to be transitory. They claimed that the availability of significant external and fiscal buffers allowed Qatar to withstand the diplomatic crisis effectively. Kapar and Buigut (2020) showed that stock market volatility responded significantly to the blockade. Likewise, Buigut and Kapar (2020) examined the effect of the Qatar blockade on GCC stock markets, and they suggested that Qatar's economy showed resilience despite short-term negative reactions in its stock indices. Meanwhile Saudi Arabia, Dubai, and Abu Dhabi markets experienced positive abnormal returns, suggesting limited economic strain.

On the banks' liquidity front, Standard & Poor's highlighted that Qatar injected $43 billion from its sovereign wealth fund to support banks after billions of deposits flowed out[3]. On the real economy front, Qatar's GDP growth has been significantly affected by the blockade's restrictions. Qatar's economy contracted in 2017 by -1.5% (Figure 4), the weakest performance in over two decades. The World Bank indicated that Qatar's economy managed to overcome the blockade restrictions and resumed its growth in 2018, albeit at a slower pace, by redirecting trade routes and establishing a new port (World Bank, 2019). Antoniades, Al-Jassim, and Gharatkar (2022) did a descriptive analysis of the short-term economic impact of the diplomatic crisis on the key economic measures suggesting a significant impact on economic activity.

[3] Qatar Injected $43 Billion to Help Banks after Boycott, S&P Says, Bloomberg News, February 20, 2018



Source: World Bank Statistics

III. Literature Review

III.I The relationship between trade and political tension.

The literature is abundant with studies that have examined the impact of bilateral political relations on trade flows (Davis et al., 2019; Du, Ju, Ramirez, & Yao, 2017; Fan & Lu, 2021; Gasiorowski, 1986; Gowa & Mansfield, 1993; Li, Jian, Tian, & Zhao, 2021; Morrow, Siverson, & Tabares, 1998; Pollins, 1989a, 1989b; Su, Song, Tao, & Hao, 2020; Wang & Tao, 2024; Whitten, Dai, Fan, & Pang, 2020). There is consistent evidence in the literature that positive diplomatic climate enhances trade although the effect can vary over time and context. On the other hand, Li et al. (2021) demonstrate that political frictions can reduce imports, particularly those of SOEs. They showed that political tensions primarily affect imports of intermediate goods, with a lesser impact on capital goods. Davis et al. (2019) examined the extent to which governments can leverage trade to reward or penalize partner countries. They showed that SOEs can be used as leverage for economic statecraft.

III.II The relationship between capital flows and political tensions.

Unlike trade, the literature exploring the impact of bilateral relations on capital flows is relatively limited. Che, Du, Lu, and Tao (2015) investigated the long-term impact of the Japanese invasion of China (1937-1945) on contemporary cross-border trade and investment between the two economies. Interestingly, they found that Japanese multinationals are less

likely to invest in Chinese regions that suffered greater civilian casualties during the invasion, suggesting that historical animosity continues to affect investment patterns. Similarly, Song, Chen, Tao, Su, and Peculea (2020) explored the time-varying relationship between bilateral political relations and FDI based on the Sino-Japanese relation. Using bootstrap Granger causality, the findings identified a one-way causal link from bilateral political relations to FDI, with bilateral relations having both positive and negative influences on FDI inflows in different sub-stages, and adverse impacts on FDI outflows. However, evidence of reverse causality has not been established. Likewise, Elmassah (2019) conducted a descriptive study on the UAE's investments in Egypt and the state of bilateral relations between the two countries. She suggested that FDI flows from the UAE to Egypt are sensitive to the political leadership, with ideologically opposing regime experiencing a 14% drop in FDI flows. On the other hand, President Abdel Fattah Al-Sisi's tenure has witnessed a surge in FDI flows.

Gawarkiewicz and Tang (2017) examined the interaction between political tension and capital flows, among ASEAN members and China, Japan, and the Republic of Korea. Using a gravity model, they found that short-term political tension impacts bilateral trade if either trading nation is not a member of the World Trade Organization (WTO). They also suggested that a short-term political tension does not significantly affect FDI either on the initial decision to invest or the subsequent decision regarding the amount of investment, while historical conflicts reduce the amount of FDI. They concluded that joint WTO membership positively influences both trade and FDI flows.

Davis and Meunier (2011) examined whether political tensions impact economic exchange. They explored the U.S.-Japanese trade and investment flows as well as specific incidents of tensions in U.S.-French. Despite varying levels of political tension, the study found that negative events did not significantly harm trade or investment flows between these countries. They argued that sunk costs in existing trade and investment relationships make it unlikely for firms, to alter their economic behavior in response to political disputes. Moreover, they suggested that firms have little motivation to connect political relations with economic interactions. This supports the hypothesis that the use of economic statecraft as a tool to influence investment and trade is declining, as firms in market-led economies do not mix political relations with economic exchanges.

The takeaway from the existing literature is that studies involving state-led economies, such as China, consistently suggest that bilateral political relations significantly influence

economic exchanges, underscoring the use of economic statecraft. In fact, it is not possible to separate between governments and SOEs when the state dominates the economy. In contrast, the literature examining economic relations in market-led economies tends to downplay the importance of bilateral political relations in affecting economic exchange.

IV. Conceptual Framework

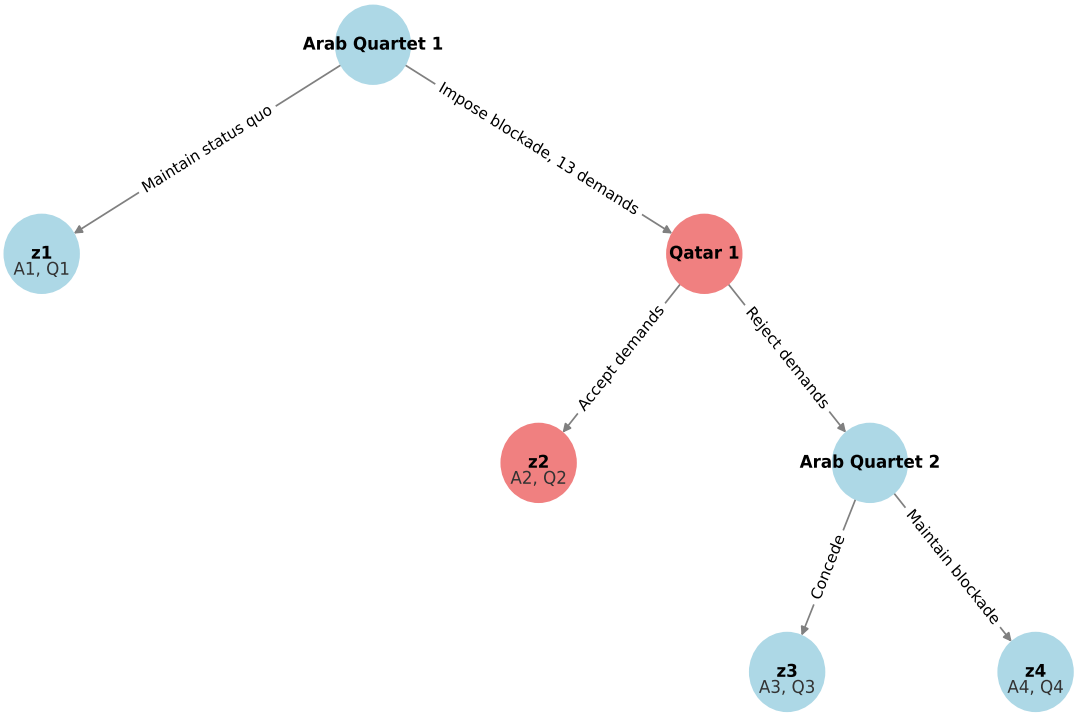
The relationship between the Arab Quartet- comprising Egypt, Saudi Arabia, the UAE, and Bahrain- and Qatar has historically been marked by complexities and frictions. These frictions eventually led the Arab Quartet to cut off diplomatic and economic ties with Qatar. I have developed a game-theoretic analysis as a conceptual framework to conceptualize and predict the potential reaction of Qatar's FDI flows to Egypt in response to the boycott. Thus, the game theoretic analysis seeks to theoretically anticipate the econometric model's coefficient of the blockade on the new Qatar's FDI flows.

In this game-theoretic model, there are two players: the Arab Quartet and Qatar. The payoff for the Arab Quartet is denoted by A, while, the payoff for Qatar is represented by Q. The game begins with the Arab Quartet, which faces a decision between maintaining the status quo and accepting policies from Qatar that conflict with their policies or escalating by cutting off diplomatic relations and issuing a list of thirteen demands that Qatar must meet for the blockade to be lifted. If the Arab Quartet chooses to impose the blockade, Qatar then decides how to respond. Qatar's options are either to accept the 13 demands or to reject them. If Qatar rejects the demands, the Arab Quartet has a final choice: They can either maintain their stance by continuing the blockade, or they can concede, restoring relations and lifting the blockade. In fact, the below game shares characteristics with the classical chicken game, where each player risks losing face or suffering reputational costs by backing down.

The game is solved using the subgame-perfect Nash equilibrium in pure strategies through backward induction. The Arab Quartet faces two main choices, each leading to different potential outcomes. Ranking these preferences, the ideal outcome for the Arab Quartet is $A2$, where they escalate, and Qatar concedes by accepting their demands. Conversely, the least favorable outcome is $A3$, where the Quartet concedes after escalating, resembling the "chicken" outcome. The remaining outcomes, $A4$ and $A1$, observing the choices made by the Arab Quartet suggests that $A4$ is a better outcome than $A1$ (maintaining the status quo). Thus, the outcomes can be ranked as $A3<A1<A4<A2$.

Turning to Qatar's payoffs, the most favorable outcome is *Q3*, where Qatar maintains its policies (as in *Q1*), refuses the Arab Quartet's demands, gains political leverage, and the Quartet ultimately backs down. Conversely, the least desirable outcome for Qatar is *Q2*, where the Quartet escalates, and Qatar concedes, taking on the "chicken" role in the game. Observing Qatar's decisions, we can assume that *Q4*, despite involving the economic blockade's costs, is preferable to *Q2*, as Qatar refused the thirteen requests. Therefore, Qatar's preferences in the game can be ranked as $Q2 < Q4 < Q1 < Q3$.

Figure 5: Game Tree of the Arab Quartet-Qatar Game



Source: Author's compilations

Considering the preference rankings above and applying backward induction to solve this sequential game, the Arab Quartet initially chooses to escalate. Qatar, aiming to avoid the "chicken" outcome, opts to reject the demands. At the next decision point, the Arab Quartet decides to maintain the blockade to avoid its own worst outcome. Consequently, the subgame-perfect Nash equilibrium is *Z4*, which aligns with the actual outcome observed.

Turning to the study's research question, given the predicted equilibrium (z4), Qatar's strategic response would be to make *A4* less attractive for the Arab Quartet by reducing the

Arab Quartet's payoff, thereby diminishing *A4*'s appeal as an equilibrium outcome. Game theory's rationale would suggest that Qatar would reduce payoffs so that A3 > A4 by employing economic statecraft instruments like cutting foreign aid, restricting FDI flows and labor flow restrictions in the case of Egypt, which could weaken the blockade sustainability. Qatar also filed a complaint with the WTO to dispute the trade boycott (News, 2017). Thus, the research hypothesis derived from the above game theory framework is that Qatar's FDI flows to Egypt will decline as the diplomatic bilateral relations deteriorate.

V. Data and Method

To examine the use of Gulf economic statecraft in Egypt during the post-Arab Spring, the study uses a gravity model to analyze FDI flows. The gravity model is a foundational framework in empirical trade analysis (Anderson & Van Wincoop, 2003; Tinbergen, 1962), and is also applied to FDI flows (Gawarkiewicz & Tang, 2017; Kahouli & Maktouf, 2015; Kox & Rojas-Romagosa, 2020; Mishra & Jena, 2019). The gravity framework is based on the hypothesis that the economic interaction (trade or investment flows) between countries is directly proportional to their economic mass (e.g., GDP) and inversely proportional to the distance between them. We adopt the Poisson Pseudo Maximum Likelihood (PPML) estimator over Ordinary Least Squares (OLS) because it overcomes the limitations of OLS in dealing with heteroscedasticity and zero flows (J. M. C. S. Silva & Tenreyro, 2006; J. S. Silva & Tenreyro, 2011). Hence, our baseline model is:

$$FDI_{i,t} = \exp\left(\beta_0 + \beta_1 \log\left(GDP_{i,t-1}\right) + \beta_2 \log\left(GDP_{EG,t-1}\right) + \beta_3\, relations + X_{i,t} + \alpha_i + \delta_i\right)$$

Where $FDI_{i,t}$ is the FDI by country i in time t to Egypt, measured in millions of US dollars from 2005 to 2023. It captures the FDI inflows from each of the five origin countries-Qatar, Kuwait, UAE, Saudi Arabia, and Bahrain- that played the main roles in the diplomatic crisis. By focusing on these countries, the model aims to explore how shifts in political relations influenced FDI to Egypt. Data on FDI flows are sourced from the Central Bank of Egypt for the period between 2005 and 2023.

The log of the origin country's GDP (lagged) is included in the model as well as the GDP of Egypt. Data for these current GDPs are obtained from the World Bank's World Development Indicators (WDI) database. The above model incorporates a set of independent variables, represented by vector X. Vector X captures the impact of political leadership

transitions in Egypt and their associated political tensions on Gulf's FDI flows. We introduce a set of dummy variables representing distinct political periods, as well as interaction terms to capture the heterogeneous impact of bilateral political relations on capital flows. The variables are defined as follows: A dummy variable equal to 1 for the period of Mohamed Morsi's presidency in Egypt and zero otherwise. A dummy variable equal to 1 for the phase that followed Morsi's presidency and precedes the Qatar blockade. A dummy variable equal to 1 for the blockade period (2017-2021). A dummy variable equal to 1 for the post-blockade reconciliation period in 2021 and Al Ula agreement. The period of Hosni Mubarak's presidency serves as the reference period.

Interaction term is included to capture the effect of the Morsi's tenure on Qatar's investments. Additionally, the interaction term *Qatar× Blockade Period* is included to measure the effect of the diplomatic crisis on Qatar's FDI. Interaction term *Qatar× Al Ula* is added to capture the impact of Al-Ula agreement and its impact on Qatar's FDI flows.

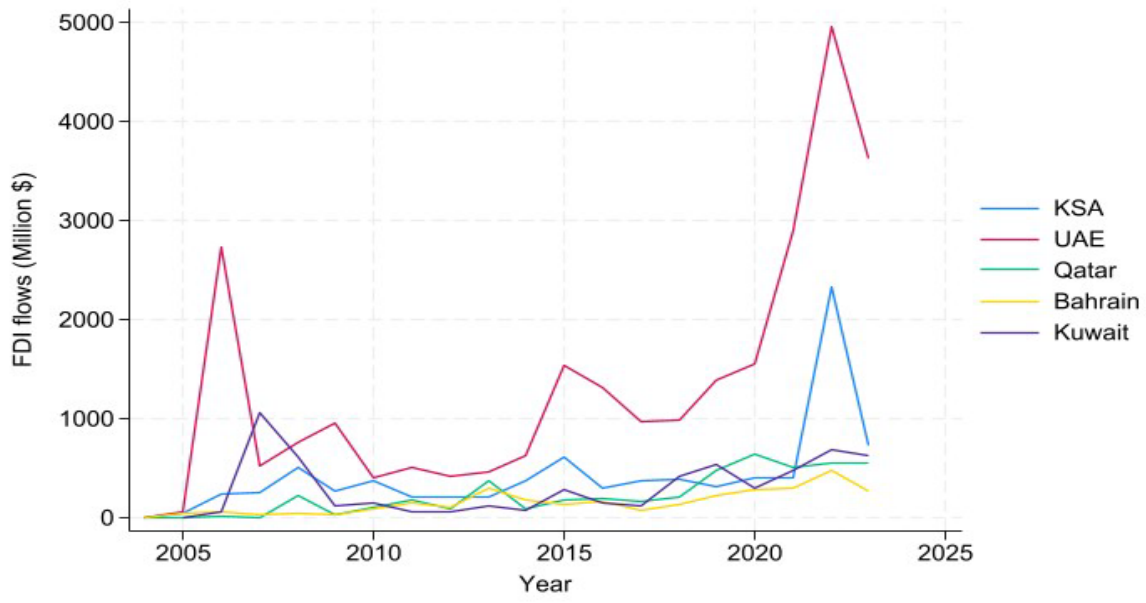
To account for broader macroeconomic factors that may influence FDI flows, the vector X also includes the log of oil price lagged by one year, as the Gulf's oil revenues (petrodollar) are channeled into investments abroad. A dummy variable for the COVID-19 pandemic period (2020-2021). A dummy variable equal to 1 during the global financial crisis of 2008-2009. α_i and δ_i are the country and time fixed effect. Time-invariant factors that are shared across this region such as language, geographic distance, religion, culture and colonial history are omitted from the model as their effects are absorbed by the fixed effect.

VI. Results

Descriptive Results

The below line chart exhibits the trends in FDI flows to Egypt from the Gulf countries between 2005 and 2023. Notably, the UAE has been the largest investor in Egypt in the recent years followed by Saudi Arabia. A striking observation is the spike in FDI flows from Qatar during the blockade period (2017–2020), particularly peaking around 2020, which deviates from the anticipated effects of strained political relations. This examined further by using box plot in Figure 7.

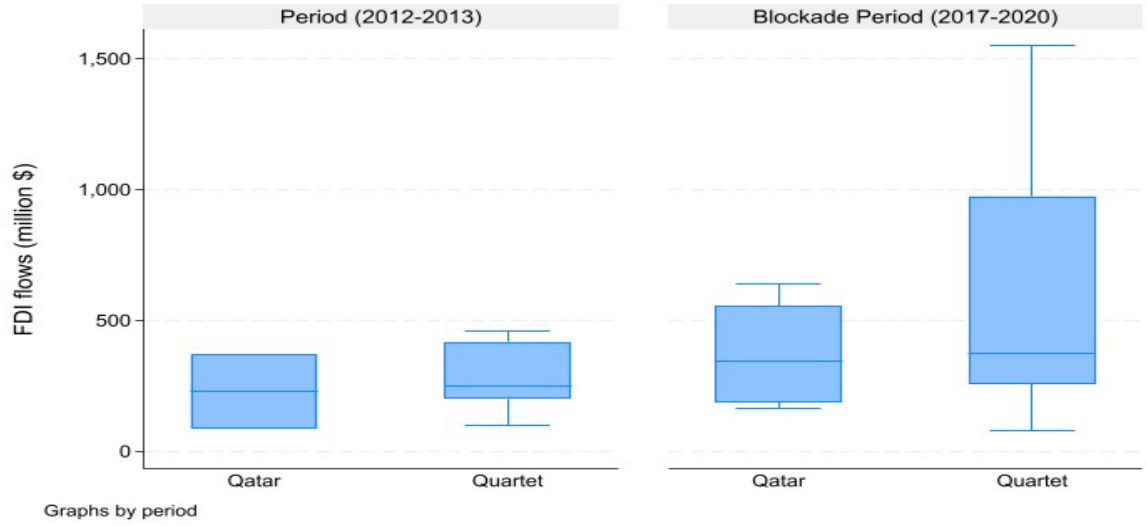
Figure 6: Trends in FDI flows



Source: Egypt's Central Bank

Figure 7 provides box plots illustrating the variation in FDI inflows to Egypt from Qatar, as well as from Saudi Arabia, the UAE, and Bahrain, during two distinct periods: the Morsi administration (2012–2013) and the blockade period (2017–2020). Qatar's FDI inflows remain steady, and there is no visible decline during the diplomatic crisis.

Figure 7: FDI Boxplots



Source: Author's compilations

Econometric Results

Table 1 presents the gravity model estimates for FDI flows to Egypt. The models start with no fixed effects in Model 1, add country fixed effects in Model 2, and include both country and time fixed effects in Model 3 to address any unobserved heterogeneity or omitted variable bias. The different specifications account for various sources of variation and ensure the robustness of the findings.

The *Blockade* variable exhibits a significant and negative effect on FDI flows in Models 1 and 2, indicating that the blockade generally reduced overall investment flows. However, the interaction term *Blockade* × *Qatar* shows a positive and significant relationship in Models 2 and 3, suggesting that the negative impact observed in the blockade period is not driven by Qatar. Instead, it reflects reduced FDI flows from other countries during this period. This finding is highly significant at 1% level of significance and consistent across the three different models, highlighting its robustness. The positive coefficient of 0.668 of *Blockade* × *Qatar* in model 3 indicates that Qatar's FDI flows during the blockade period increased by approximately 95% (exp(0.668)-1=0.95).

During the Morsi administration, FDI flows from the Gulf countries were significantly lower, as reflected in the negative coefficients across Models 1 and 2. With a coefficient of -1.027, FDI flows decreased by approximately 64% during the period 2012 and 2013. The decline is likely to reflect the political tension with the political leadership at this period, which is likely prompted these countries to withhold their investments. Interestingly, the interaction term *Morsi Presidency* × *Qatar* is positive and highly significant in Models 2, and 3 at the 1% level of significance, the Model 3 coefficient translates to an approximate 503% increase in FDI flows from Qatar during Morsi administration. A distinct investment behaviour compared to other Gulf countries during the same period. These divergent investment patterns may highlight underlying differences in Gulf foreign policy.

The interim period between 2013 and 2017 is not associated with a significant impact on overall FDI. However, the interaction term *Interim Period* × *Qatar* in Model 2 is significant and negative. The Al-Ula Agreement, which brought an end to the diplomatic rift, exhibits an insignificant effect on FDI flows across all models. Although positive, the interaction term *Al-Ula* × *Qatar* is statistically insignificant, suggesting limited immediate effects of reconciliation on Qatar's investment flows.

Moving to economic controls, the GDP of origin countries has a positive and significant effect on FDI flows in Models 1 and 3, emphasizing the role of economic mass in driving investment in line with the gravity model predictions. Additionally, the GDP of Egypt does not correlate positively with the FDI flows, which suggests that the FDI coming to Egypt may be more politically-driven than economically-motivated. The variable oil price has a positive and highly significant impact in models 1 and 3, suggesting that oil revenue can drive investment flows. Other control variables, including the COVID-19 pandemic and the 2008 financial crisis, do not significantly affect FDI flows. Overall, the models exhibit high Pseudo R^2 values, demonstrating strong explanatory power in modelling FDI flows.

To evaluate the sensitivity of the findings to different estimation techniques, the model has been re-estimated with OLS fixed effects instead of PPML and using bootstrap standard errors. Column 4 indicates that the results of Model 4 remain consistent across different specifications (see Table 1).

Insert Table 1 about here

Table 1: FDI and Political Events
Dependent variables: FDI flows in million $ and Log (FDI) in Model 4

	(1)	(2)	(3)	(4)
VARIABLES	PPML	PPML	PPML	OLS
Blockade	-0.477*	-0.686*		-1.649**
	(0.271)	(0.397)		(0.719)
Blockade× Qatar	-0.517***	0.967***	0.668***	0.960***
	(0.178)	(0.244)	(0.249)	(0.169)
GDP (Origin)	1.356***	0.626	1.455**	1.904***
	(0.335)	(0.762)	(0.693)	(0.562)
GDP (Egypt)	-1.603***	-1.435***		-0.483
	(0.466)	(0.547)		(0.553)
Morsi Tenure	-0.746*	-1.027***		-2.037***
	(0.440)	(0.389)		(0.716)
Morsi Tenure×Qatar	-0.458	2.516***	1.783***	2.040*
	(0.728)	(0.577)	(0.519)	(1.089)
COVID19	-0.0729	-0.0948		0.0766
	(0.151)	(0.173)		(0.113)
Financial Crisis	0.0552	0.141		0.272
	(0.0960)	(0.144)		(0.222)
Interim Period	0.126	-0.0414		-1.047**
	(0.104)	(0.276)		(0.456)
Interim Period×Qatar	-1.387***	0.131	-0.271	0.228
	(0.260)	(0.230)	(0.268)	(0.424)
Al Ula agreement	0.640*	0.293		-1.458
	(0.383)	(0.532)		(0.961)
Al Ula×Qatar	-1.248***	0.267	-0.0398	0.567*
	(0.228)	(0.231)	(0.274)	(0.314)
Oil Price	-0.197*	0.0466	0.284***	-0.140
	(0.118)	(0.104)	(0.0975)	(0.394)
Population (Origin)	-0.0764***	-0.0355	-0.0580*	-0.140
	(0.0127)	(0.0363)	(0.0300)	(0.393)
Population (Egypt)	0.0847***	0.0966***		0.116***
	(0.0262)	(0.0187)		(0.0378)
Constant	6.288	18.51**	-32.13*	-39.48**
	(8.729)	(8.528)	(18.34)	(18.49)
Country Fixed Effect	No	Yes	Yes	Yes
Time Fixed Effect	No	No	Yes	No
Observations	95	95	95	95
R-squared	0.73	0.79	0.87	0.63

Notes: Robust standard errors in parentheses (clustered by origin country level for columns 1, 2, and 3). Bootstrapped standard errors are in Column 4. GDP and oil price are in log form and lagged by one year. Population is measured in millions. In Model 3, omits variables absorbed by time fixed effect: blockade effect, Morsi dummy, Covid period, financial crisis, interim period, and Al Ula agreement

*** p<0.01, ** p<0.05, * p<0.1

VII. Discussion

The importance of economic statecraft has been perceived as diminishing in a globalized world increasingly characterized by market deregulation and reduced state involvement in firm-level decision-making. However, the rise of emerging economies characterized by state-capitalist economic models has revived the practice of economic statecraft. There is a growing literature claiming the emergence of the Gulf states in the recent decades as active practitioners of economic statecraft. They have leveraged their hundreds of billions of wealth derived from oil booms to position themselves as influential players in the region. With some of the largest sovereign wealth funds in the world and state enterprises, the Gulf states have the means to exert influence on the region via economic aid, investments, workers' remittances, and trade.

Egypt, as the largest Arab country and a regional linchpin, underwent political upheaval and a significant political transition following the Arab Spring. This study empirically explores the hypothesis that Gulf states engage in economic statecraft with Egypt, politicizing FDI. The study also focuses on the use of economic statecraft during the diplomatic crisis between Qatar and the Arab Quartet.

Our results suggest that Gulf investments are sensitive to the political leadership and political alliances, lending support to the study's hypothesis. During Morsi's presidency, there was a significant and robust increase in Qatari FDI, consistent with the Qatar's support for political Islam parties. In contrast, other Gulf states markedly decreased their FDI flows to Egypt during the same period. Additionally, Qatar's economic statecraft extended beyond FDI, as it deposited $6 billion in Egypt's Central Bank during Morsi's presidency (B. B. C. N. Arabic, 2016). This economic support was intended to aid the Egyptian administration in managing the economy during this period, in an attempt to stabilize the external position and the Egyptian pound.

The findings of the study indicated that there was an increase in Qatar's FDI during the blockade period- obviously an unexpected finding by the game-theoretic analysis. However, at least a portion of these investments, including oil refinery project (D. W. Arabic, 2019) and a 5 stars hotel in downtown Cairo (Bloomberg, 2012), primarily belong to projects announced during the Morsi administration, which is difficult to reverse without significant economic losses. Simultaneously, Egypt emphasized its commitment to protecting foreign investments, assuring that these projects would be safeguarded (Reuters, 2017). In addition, some of these investments may have originated from the private sector.

In fact, Qatar exerted economic pressure on Egypt in other areas. It withdrew the $6 billion deposit it had placed during the Morsi's period (Reuters, 2014), adding a pressure on the Egypt's external position. Qatar ceased economic aid between 2013 and 2022 and halted the in-kind natural gas support it had pledged in 2013. Thus, the use of economic statecraft is evident.

An important finding is that, unlike Central Bank deposits, which can be swiftly withdrawn, FDI tends to be more entrenched or sticky in the host country. FDI represents long-term commitments requiring deeper engagement and cannot be easily repatriated when political tensions arise. This characteristic makes FDI a less effective tool for economic statecraft in the short and intermediate term. While the *Al Ula* × *Qatar* coefficient was insignificant, indicating that FDI did not increase significantly, it is noteworthy that, for the first time since 2013, Qatar deposited $4 billion in Egypt's Central Bank in 2022 (Bloomberg, 2022)—a gesture of support while also ensuring financial flexibility.

According to our model, FDI from other Gulf countries did not show a significant increase during the interim period following 2013. However, these countries supported Egypt through other forms of financial assistance. For instance, between July 2013 and the end of that year, Gulf countries (excluding Qatar) deposited a total of $9 billion in the Central Bank of Egypt.

VIII. Conclusion

This study explored the hypothesis that Gulf countries, particularly Qatar, have been using capital flows as a tool of economic statecraft. It aims to understand how political leadership and diplomatic tensions influence capital flows. The study empirically examines the hypothesis in Egypt, a key arena for economic statecraft following the Arab Spring. Using a gravity model, the paper analysed the determinants of FDI flows to Egypt from five Gulf countries: Qatar, UAE, Saudi Arabic, Kuwait and Bahrain for the period between 2005 and 2023. The study explored the response of FDI flows to changes in Egypt's political leadership as well as Qatar blockade.

The main conclusion of this paper is that FDI flows to Egypt from the Gulf are sensitive to the political leadership in Egypt and its alignments. The political element continues to play a role in driving investments from Gulf countries in Egypt. This supports the hypothesis of economic statecraft. Capital flows tend to grow under politically aligned Egyptian administrations but diminish during periods of unaligned administrations. The state-capitalist

economic model facilitates this dynamic, enabling governments to use their financial resources and SOEs to align with foreign policy objectives. However, unlike economic aid and central bank deposits, which can be easily manipulated, FDI is a less flexible instrument of economic statecraft.

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