KEY for POL 1005 Exam

SECTION I: Answers

Answer 1: (MANDATORY)

Traditionally, research on democracy and trade openness indicates that democracies prefer free trade because the abundant factor – labor – benefits from open markets. This is a staple view on economic integration based on Heckscher-Ohlin-Samuelson type models of international trade. Since the size of the ‘selectorate’ (i.e., those who have a say in policy formation) increases with democracy, a majority will prefer open markets. In authoritarian countries, the policy process is heavily dominated by local capital (a powerful but narrowly-based selectorate). Since capital is the scarce factor in poor countries, control of policy can mean supernormal profits for local capitalists (local industrialists). Under open-economy conditions, the scarce factor within poor countries will lose as local capitalists (local industrialists) are forced to compete with (both vertical and horizontal) FDI for domestic markets and for labor. New entrants, particularly MNCs, which generally offer higher wages than domestic firms, are likely to alter labor market conditions (such as paying high wages for example) in a way that works against monopoly-seeking domestic firms. This forces migration of labor from local firms to foreign firms, from rural areas to urban areas (where foreign firms are largely based) and from non-tradable sector to tradable sector to take advantage of higher wages offered by foreign capital. In order to retain the existing labor force, the local capitalist will also raise the wages. As wages tends to go up across the board, the labor (who is also the median voter in a democracy) stands to gain. As foreign capital is allowed into the country, the monopoly positions of state firms and domestic industrialists are also likely to erode, to the benefit of labor and larger segments of domestic society, or those who make up the ‘selectorate’ (i.e. the voters) in a democracy. Therefore, it is in the interest of democratic rulers to allow FDI which not only have positive effect on the economy in the medium to long run, but also benefits the labor, which form the electorate base for democratic leaders.
Answer 2: (MANDATORY)

a. FDI diversity index for the following countries:

- Norway = 5.56
- Peru = 2.63
- UK = 3.85
- Namibia = 1.72

b. The FDI diversity is very high in Norway compared to other countries suggesting that Norway has FD coming from various source countries. Namibia has the lowest FDI diversity.

c. These results suggest that the chances if political risk will be very high for foreign investors in Norway compared to Namibia. In other words, higher the FDI diversity index, higher is the political risk for foreign investors. That is because the governments will a higher FDI diversity have more options to expropriate or breach contracts with one or more investors.
Answer 3:

1. Direct effects:

As resource prices go up, chances for resource nationalism also goes up as it gives incentives for the regime to appropriate all the resource rents to itself either by changing the contracts or by outright expropriations.

2. Indirect effects:

Usually, in resource rich states (which are non-democracies) there is an unwritten social contract between the state and people. The contract implies that welfare spending is ensured in return for no accountability of the regime. In this backdrop, when oil prices go up it provides incentives for the regime to stoke up resource nationalism to expropriate oil companies. The public has incentives to support the expropriation because they assume that expropriation proceeds are shared with the masses in the form of increased welfare spending.

When oil prices are down, the governments’ welfare spending promises are strained because of the low oil revenues, which may stoke demonstrations, riots and political instability. In order to divert the public attention, the governments have incentives to revive resource nationalism to expropriate foreign firms (and lower the drilling rights in the future to attract FDI into resource sector in the future).

However, it is noteworthy that some resource rich states have started to save part of resource rents generated when oil prices are high in saving into Sovereign wealth funds and foreign exchange reserves. These reserves are used by the regime to finance its welfare spending on the people when oil prices are low. If this is the case, then in countries which follow this pattern the FDI will NOT experience any political risk when oil prices are low.
Answer 4:

(i) Bilateral Investment Treaties: Agreements that establish the terms and conditions for investments by nationals and companies of one country in the jurisdiction of another.

Typical BIT Guarantees:
- Fair and equitable treatment
- Protection from expropriation
- Free transfer of means
- Full protection and security

Effects of BITs
- Commitment device to sustain future government policy (time inconsistency problems), especially in the area of property rights, nationalization (+)

- Some BITs cover dispute resolution mechanisms, which can affect profitability of investments in case of legal problems (+)

- Can serve as a signal of unfavorable host environment (-)

(ii) Political Risk Insurance (PRI):
- PRI emanates from the fact that arbitration brings its own risks to MNCs!
- PRI help MNCs mitigate political risk by purchasing insurance contracts.
- PRI contracts are designed to insure against political events that affect, large, illiquid investment projects.
- Insurance can be provided to the investor/exporter, or to a financial institution.

Most insurers underwrite the following risks:
- Political risks: Expropriation, Transfer, War & Political Violence, Breach of Contract
- Sovereign obligor payment risk (“Contract Frustration”/”Non-Honouring of a Sovereign Obligation”)
- Commercial credit risk (“Credit Insurance”) – mostly as single transactions, rather than whole turnover

Types of coverages:
• **Expropriation:** protects against partial or total loss of investment as result of governmental actions…
  – Losses are assessed based on book value
  – *Currency inconvertibility:* protection against losses arising from an investor’s inability to convert local currency into the foreign currency specified in the policy
  – Devaluation is not covered

• **War and civil disturbance:** protects against losses resulting from damage, destruction or disappearance of assets due to war or civil disturbance
  – **Covers:** revolution, insurrection, sabotage, and terrorism
  – In case of war, firms do not have to loss property to file a claim, they do have to show interruption to business
  – Losses are assessed at book value

• **Breach of contract:** protects against a host country’s breach of investor’s contract
  – Covers losses on project investments not loss of profits

• Additional coverage: *Business interruptions, contract frustration*

(iii) **Restructuring Firms Operations:**

• Tailoring capital structure
  - reduce equity,
  - opt for JVs, local partnerships

• Structuring leverage
  - increase debt structure, i.e. Debt/Equity ratio;
  - minimizing the size of operations;
  - maximizing liquid operations, i.e. more Liquid Assets/Fixed Assets

• MNCs can engage in political activities to structure their operations
  - lobbying,
  - campaign contributions,
  - bribes, *quid-pro-quo* deals
  – BUT, MNCs face ‘Collective actions problem’
  – Campaign contribution promises *ex ante* elections become unenforceable *ex post* elections

• Align firm’s goals with politicians’ goals
  – eg. can generat job opportunities in politicians constituencies
Answer 5:

Initially proposed by Vernon (1971), the obsolescing bargain model states that investment deals involving the deployment of significant fixed assets will, almost unavoidably, be susceptible to later revisions by the host government. This is so mainly because investment, once undertaken, becomes a “hostage” in the custody of the host country. Large oil rigs, production plants or copper mines cannot easily be removed by the TNC. Consequently, the firm cannot, ex ante, credibly threaten to pack up and leave if the host government reneges on the agreed contract. All else being equal, the relative bargaining power of the firm decreases and that of the host government increases with time.

The pre-investment distribution of bargaining power tends to favour the TNC; hence, the initial deal is often relatively advantageous for the investor. Depending on the nature of the proposed investment, the foreign investor can offer the host much needed capital, management know-how, marketing skills, advanced technology and access to export market. The “bargaining chips” of the host country include its market size and growth prospects, access to cheap and/or highly skilled labour, natural resources, infrastructure, and an investor-friendly regulatory regime. The outcome of the bargaining is also influenced by the level of TNC and host country competition. While the TNC may succeed in working out a favourable initial agreement for itself, the point Vernon (1971) makes is that this deal might not last for long if immobile fixed assets are involved. In countries where the risk of expropriation (however defined) is substantial, the host government’s inclination to renege on contracts increases with the degree of asset specificity, which makes investments involving large sunk costs a particularly risky undertaking. Paradoxically, the size of the required investment, which in the pre-investment phase is a crucial bargaining chip for the TNC, becomes a liability in the post investment phase. This mechanism has proved particularly troublesome for companies in extractive industries, where fixed asset investments are substantial and the period required for recouping investment is long.

TNCs’ profits also constitute a double-edged sword. High initial returns may make an affiliate a more attractive target for government takeover or the imposition of regulation, and even more so if monopoly rents are extracted by the firms, as is often the case with infrastructure investments. Besides, once a foreigners’ project has proven commercially viable, the “risk premium” from the pre investment phase – a common feature of investments in natural resources – suddenly looks excessive and unfair; accordingly, both politicians and the public at large are inclined to demand a larger slice of the revenue as time passes.
Moreover, as technical and management skills spread to host country nationals, the government comes to realize that the project can - and perhaps should - be run by locals. The general outcome of these processes is the increased risk of government intervention.

While highlighting the bargaining relationship as a potential source of political risk is fairly uncontroversial, the notion that foreign investors prefer democracy over autocracy is not left uncontested in the literature. The benefits of democracy should nonetheless far outweigh the costs associated with its supposed lack of flexibility. Political institutions, first and foremost, enter into the consideration because the likelihood of policy reversal is such a major concern for investors. Democracies are more conducive to investment and growth than autocracies because an autocrat is unable to commit credibly to protect his citizens’ property rights. Citizens in autocracies will thus invest and produce less than the optimal level. Of course, an autocrat does have an incentive to promise property rights protection, but such a promise lacks credibility because it is not backed up by any independent sources of power. Sound political institutions, although they do not guarantee policy stability, do enhance the credibility of promises to protect investors’ assets. This is of utmost importance to TNCs, given that most FDI is undertaken with a long-term view. Having invested in immobile assets in the host country, the TNC’s financial viability will surely be under threat if foreigners are discriminated against; contracts are not upheld; or business laws are enforced in an arbitrary manner.

The credibility-enhancing nature of democracies is in no small part due to the existence of veto players and executive constraints, such as the parliament, opposition parties, independent courts and regional/local governments. These are actors of the political system that can block the adoption of a random policy changes. By definition, checks and balances favour the status quo, diminishing the scope for policy reversals, uncertainty and self-interested behaviour. Other things being equal, a low number of veto players increases policy risk.
Answer 6:

(1) Pro-market model (P-M hereafter). Features:

- P-M strategy supports new entrants & consumers; critical towards state intervention.
- Philosophy == free play of markets will lead to efficient allocation of resources and will promote competitiveness boosting productivity and growth.
- Based on “Washington consensus” with one of the focuses on “open to FDI” and “less regulations and less state intervention in the markets”.

(2) Pro-business model (P-B hereafter). Features:

- Growth success or failure == f {quality of state intervention}
- Cooperative relationship == state & private sector == common goals, ideas on economy.
- State is strongly committed to high growth + coincides with the profit maximising needs of private entrepreneurs.
- Narrow ruling coalition = (repression + profits) == higher growth rate (in the name of the nation) !
- State’s job is to ease “demand and supply constraints” faced by private sector.

Sate addresses the Demand side constraints faced by firms =

- Expansionary fiscal and monetary policies,
- Tariff and exchange rate policies to boost domestic demand
- If domestic demands are met, then boost exports by providing export incentives

Supply side (direct intervention) =

- State help facilitate capital, labor and technology at cheaper rates.
• Where required allow FDI and technology to come into the country
• Allowing FDI based joint ventures so that the spillovers happen.

Supply side (indirect intervention) =
• State invests in education, health and R&D spending in the long run.

(3) Import Substitution and Industrialization model (ISI hereafter). Features:

➢ State intervention in the economy
➢ Self-reliance on domestic factors of production is the key
➢ Replace imports with indigenous industrialization
➢ Anti-FDI and foreign trade regimes

✓ ISI is closed for FDI, while P-B model is moderately open to FDI; P-M is fully open to FDI
✓ State regulations and interventions in the economy are very high in ISI model, moderate in P-B model and low or very low in P-M model
✓ Thus, business opportunities are very high for FDI in P-M model, moderate to high in P-B model and low or none in ISI model.
✓ Therefore, political risks for foreign investors are very high in ISI model; moderate in P-B model and low in P-M model.
SECTION II: Answers

1 Answer:

a. Loss of ownership
b. No compensation
c. Involuntary in nature (or by force)
d. Should involve a cross-border transaction (i.e. an FDI project with foreign investor)

2 Answer:

a. FDI is investments with managerial controls; FPI has no managerial control 
b. FDI is investments in physical assets, FPI is investments only in financial assets 
c. FDI is investments with long term perspective; FPI with only short term perspective 
d. FDI is stable and predictable; FPI is volatile 
e. FDI is immobile and involve sunk cost; FPI is highly mobile

3. Answer:

a. Size of the assets or operations (post investment risk = sunk costs/’hostage effect’)
b. High (early) profit or monopoly rents (post investment risk = ’becomes object of takeover’) 
c. If commercially viable (post investment risk = ‘risk premium’ becomes unfair demands) 
d. Spillover / Diffusion of technology and knowledge (post investment risk = easy learning curve) 
e. Market concentration or Access to world markets ((post investment risk = lucrative for takeover)

4 Answer:

Extraterritoriality is the operation of laws upon persons existing beyond the limits of the enacting state but who are still amenable to its laws.

Examples of US firms facing this risk are:

- Foreign Corrupt Practices Act (FCPA)
- Alien Tort Claims Act (ATCA)

5 Answer:

Yes, size does make a difference.

a. Big firms don't go into conflict zones; small firms have nothing to lose from venturing into such danger zones.
b. Big firms are more concerned about reputation risk; small firms are less concerned.
c. Big firms have financial resources and hence unlikely to engage in corrupt practices, while small firms its ‘make or break’ situation and hence are more likely to not to care about CSR practices.
d. Big firms are answerable to their shareholders and hence are more likely to incorporate CSR policies, while small firms are often self-financed by loans or partners and hence are less likely to have CSR policies in place.

SECTION III: Answers

1. A
2. D
3. D
4. B
5. D
6. B
7. D
8. D
9. A
10. B
11. E
12. A
13. B
14. C
15. D