Political Risk (POL 1005) Examination Key

The final grade structure will be as follows:

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Section I

[04 × 15 = 60 points]

1. Discuss how Bilateral Investment Treaties (BITs) (5 points); Political Risk Insurance (5 points) and restructuring firms operations (5 points) can help Multi-National Companies (MNCs) to mitigate political risk (mandatory).

A: (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 (UNCTAD 2000)

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

2. According to Li and Resnick (2003) autocracies are more favourable to FDI because democracies cannot: (a) offer sweet deals; (b) monopoly profits to foreign firms; and (c) competing local interest groups in democracy hinder FDI. Please counter each of these arguments presented by Li and Resnick (mandatory).

A: Li and Resnick (2003) suggest a negative relationship between democracy and FDI inflows in three basic ways.

First, monopoly profits of MNCs are likely to be hampered by democracy because the electorate will be able to exert control over politicians – who grant such favors to MNCs – thereby deterring monopoly-seeking FDI. On closer examination, however, this argument may be self-defeating. If MNCs are allowed monopoly profits, then these companies can be expected to powerfully curtail further investments, thus lowering FDI inflows. Hence, monopoly-seeking MNCs and autocrats should go together with less – not more – FDI. Clearly, the rivalry between MNCs should not be disregarded. Such competition has apparently played a major role in spurring the growth of FDI in recent years. Taking as a
point of departure John Dunning’s eclectic view on why firms invest abroad, the ownership advantages of MNCs, which can be derived from specific technological and managerial skills, would likely be challenged by other MNCs with similar endowments. However, MNCs should be far less concerned about competition from domestic firms in poor countries. The supposition that monopolists and autocrats increase FDI flow is counterintuitive – monopolists should erect barriers to entry to keep out similarly endowed economic rivals.

Secondly, Li and Resnick (2003) contend that democracy reduces the propensity for governments to offer ‘sweet deals’ to FDI (at the expense of taxpayers), something which diminishes the incentives for MNCs to pick democratic investment locations. A democratic public will, according to this argument, monitor the actions of elected officials more closely than will autocracies. However, to our knowledge there is little if any evidence to suggest that FDI going to poor countries is attracted by incentive packages, despite that fact that most LDCs are instituting special investment promotion agencies to signal their desire for FDI. Neither do states seem to engage in any significant tax competition to attract FDI, nor do multinationals seem to prefer lower labor standards. In other words, even if democracies were less likely to ‘race to the bottom’, it seems to be largely an irrelevant consideration for MNCs, who evidently prefer to locate in relatively rich, high-tax countries rather than in the weak states in the Global South. Moreover, we are inclined to think that ‘sweet’ incentive packages are far more common within the rich countries that compete for high-technology FDI than among cash-strapped LDC governments, which are much more likely to give incentive packages to domestic capitalists.

Thirdly, Li and Resnick (2003) argue that indigenous business groups, who see FDI as a threat to their profits, are likelier under democracy to lobby their governments for protection, thus spurning FDI. A closer look at this argument suggests that this point does not conform to general theories explaining why democracies among the LDCs would favor FDI based on who controls the policy process. Specifically, it does not fit very well with factor-endowment theories that account for why governments have particular attitudes toward free trade. Recent 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 HeckscherOhlin-Samuelson, Ricardo-Viner 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 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. Under open-economy conditions, the scarce factor within poor countries will lose as local capitalists (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 in a way that works against monopoly-seeking domestic firms. As these countries democratize, the monopoly positions of state firms and domestic industrialists are likely to erode, to the benefit of labor and larger segments of domestic society, or those who make up the ‘selectorate’.

3. What is resource nationalism? Discuss the three forms of resource nationalism. How resource nationalism can pose direct and indirect political risk for MNCs.

A: It encompasses efforts by resource-rich nations to shift political and economic control of their energy and mining sectors from foreign and private interests to domestic and state controlled companies.

(1) Revolutionary resource nationalism
   - Objective = increased state ownership
     - Linked to broader social & political upheaval, not directed at oil sector
     - Significant threat to international resource firms (forced renegotiation of contracts etc.)
     - Actions are top-down, arbitrary & little compensation

(2) Economic resource nationalism
   - Objective = increased state income
     - Shifting commodity revenue from international to domestic hands
     - Actual control and political ownership LESS important than fiscal take

(3) Historic conditional resource nationalism
   - Objective = political-cultural identity
     - Direct effects
       - Setting high entry barriers
- *ex post facto* changes
- Renegotiate contract to divest ownership
- Extract fiscal take by changing laws (intention NOT to drive away MNCs)
- Corruption (remember China case study!)
- Direct ‘expropriation’ (eg. Argentina, Venezuela etc)
- Indirect effects
- Instability due to price shocks!

- Indirect effects
- Instability due to price shocks!

**4. Explain if democracy (as against autocracy) can moderate the obsolescing bargain mechanism risk.**

**A:** 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 renego 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.

5. What is expropriation? Discuss various types of expropriations. Explain why expropriations increased during 1960-1979 period and declined thereafter.

A: ‘Governmental action to transfer the ownership of private ... assets to the state, with or without compensation’

- Mass vs. Selective expropriations
- Direct vs. Indirect expropriations

Expropriation wave – causes

- Radical political change (eg. Coup/revolution/decolonization)
- Economic nationalism (as prime motive)
- Marxist ideology (anti pvt. property)
- New development strategy (selective targetting of industries which are of strategic in nature)
- Improved bargaining position for LDCs (strong belief that indegenous control was possible; OPEC in 1960 another reason)

Further causes:

(A) ‘Objective’ bargaining strength:
- Indirect regulation is not viable....
- Technology/innovation (in industry) is mature
- Vertical integration is limited
- Market concentration is high & market access is large

(B) ‘Subjective’ political factors:
- Determine timing and zeal of regime
- Economic nationalism/political ideology
- Political institutions and sociopolitical instability

Why the decrease 1975–1979?

Four hypotheses (Kobrin 1984):

1. Sensitive sectors were already taken...
2. MNCs’ reduced symbolic status as regimes became pragmatic...
3. Improved bargaining position...
4. Economic crises...

Causes for further decline Post-1980
6. Prepare causal chain analysis of political risk faced by the foreign companies as illustrated in the two case studies below. Prepare causal chain analysis for both case studies separately highlighting the actors involved; sources of political risk; political risk effects; parties affected; project specifics; and risk mitigation solutions.

A: 

**CASE 1 - China falls victim to Gabon’s expropriatory zeal**

**Actors involved** = Government of Gabon

**Sources of political risk** = improvement (increased confidence) in bargaining power of Gabon government.

**Political risk effects** = Expropriation, renegotiation of contracts / breach of contracts

**Parties affected** = Chinese oil firms (particularly, Addax oil and Sinopec)

**Project specifics** = petroleum industry with huge capital intensive investment with a risk of “sunk cost” in the event of political risk realization.

**Risk mitigation solutions** = Political Risk Insurance, joint ventures with local firms.

**CASE 2 - Indonesia Expropriation of Churchill mining’s East Kutai coal mine**

**Actors involved** = Indonesian Government

(5) SOEs dominance in sensitive sectors
(6) Instrumental elements in MNC–LDC relations (BITs, MIGA, Insurance)
(7) Improved administrative capacity in LDCs
(8) Poor results from expropriations
(9) Intensified economic crisis
(10) Pressure from multilateral organizations (like IMF and World Bank)
(11) ‘New’ development strategy  liberalization
Sources of political risk = political corruption, domestic firms lobbying against foreign firms

Political risk effects = Cancellation of contract arbitrarily without adequate compensation OR breach of contract (indirect expropriation)

Parties affected = Churchill Mining (UK based firm)

Project specifics = mining industry with capital intensive investment with a risk of “sunk cost” in the event of political risk realization.

Risk mitigation solutions = Political Risk Insurance, joint ventures with local firms.

Section II

[05 × 05 = 25 points]

1. List Five benefits and costs associated with FDI.

A: (i) Benefits of FDI (comprehensive list of benefits)

- FDI creates long-term growth and development
- FDI brings capital, technology, know-how
- FDI increases trade
- FDI generates spillover effects
- FDI increases competition and effectivity
- FDI boosts employment, workers’ wages/welfare
- FDI strengthens host-country institutions
- FDI supplants domestic special interests
- FDI finance balance of payments

(ii) Costs of FDI (comprehensive list of costs)

- FDI upholds and augments dependence
- FDI ‘expropriates’ added value ➔ lower growth
• FDI creates enclaves economies
• FDI supplants local capital
• FDI institutionalizes inequality
• FDI leads to a ‘race to the bottom’
• FDI harms environment
• FDI undermines state sovereignty

2. What is the difference between Foreign Direct Investments (FDI) and Foreign Portfolio Investments (FPI)?
A: FDI - Foreign Direct Investment refers to international investment in which the investor obtains a lasting interest in an enterprise in another country. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants, or equipment.

On the other hand, FPI (Foreign Portfolio Investment) represents passive holdings of securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities' issuer by the investor.

3. What is time inconsistency problem?
A: The problem that arises for MNCs in a host country when that host country government, prefers one policy in advance but a different policy when the time to implementation arrives (or change the course of the proposed policy over a period of time).

4. What is Extraterritoriality?
A: Extraterritoriality is the operation of laws upon persons existing beyond the limits of the enacting state but who are still amenable to its laws.
Some examples include:
(1) Foreign Corrupt Practices Act (FCPA)
(2) Alien Tort Claims Act (ATCA)
• Prosecution of MNCs in the U.S. if:
  • Complicit in human-rights violations
  • Responsible for environmental degradation
5. List four symptoms of ‘state capitalism’

A:

- Advocates ‘Protectionism’
- State-owned enterprises (SOEs)
- ‘National champions’ (pvt. owned)
- Sovereign wealth funds (SWFs)
- National oil companies (NOCs)

Section III

[15 × 01 = 15 points]

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