Lecture 13: Foreign Investment (2)

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Today’s Plan

• Housekeeping

• Reading Quiz

• Today’s topic:
  • Foreign Investment (continued)
  • A little bit about my research
Housekeeping

• Midterms and Homework 2 back at the end of class
• Paper Topics will go up on my website tonight
  • Thesis and 3 articles
  • Don’t waste the opportunity
Creeping Expropriation

• Creeping Expropriation: Adverse changes in tax rates or regulations that reduce the value of a firm’s invested assets

• This is a REALLY broad category
  • Includes transfer risk

• In my research, I look at 3 categories of political risk
  • Policy risk
  • Bureaucratic risk
  • Risk of Political Violence
Policy Risk

• Risk of adverse policy change at the national level
  • Increased taxes, new regulations, changes to government contracts, outright expropriations

• What kind of countries:
  • Countries with unconstrained executives are risky
    • Elections, legislatures, independent courts
  • More “veto players” = more stability
Veto players

• Critical social science concept

• Veto player = someone who can veto a change to the status quo

• Simple logic: more veto players = more stable status quo

• Firms love stability, predictability
  • Without it, long-term investment is not possible
  • Many projects have high costs up front, pay out over a long time period. Not possible without stability -- too risky.
Bureaucratic Risk

• Risk imposed by bureaucrats and local officials
  • Corruption (e.g. bribe demands), inefficient civil courts, inefficient customs processing, excessive red tape

• What kind of countries:
  • Countries with low government capacity
    • Civil servants that are undertrained, underpaid, and/or unaccountable
Risk of Political Violence

• Risks imposed on firms by violence in the host country
  • Interstate wars, civil wars, government violations of human rights
• Wars destroy assets, disrupt transport, tank the domestic economy, kill employees
• Violence by governments against civilians puts employees at risk

• Foreign wars don’t pose a lot of risk -- its wars fought at home
Transfer Risks

- Risks associated with trying to repatriate your profits
  - Capital controls, exchange rate volatility
- Can fit either with policy risk or bureaucratic risk
  - Central banks OR policymakers can induce it
- Type of countries:
  - No independent central bank
  - Large government debt & deficits
  - Large current account deficit
  - Unconstrained executive
**Political Risk Around the World**

<table>
<thead>
<tr>
<th>Country</th>
<th>Composite Risk Rating (100 point maximum)</th>
<th>Risk Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>91.8</td>
<td>Very Low Risk</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>89.3</td>
<td></td>
</tr>
<tr>
<td>Brunei</td>
<td>88.5</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>88.5</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>86.0</td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>85.0</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>76.5</td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>65.8</td>
<td></td>
</tr>
<tr>
<td>Iraq</td>
<td>53.0</td>
<td></td>
</tr>
<tr>
<td>Somalia</td>
<td>39.3</td>
<td>Very High Risk</td>
</tr>
</tbody>
</table>
FDI and Development (The Good)

• Higher wages
  • Increases capital per worker
• Spillovers: Local firms learn from foreign firms
  • Demonstration effects and competition effects
  • Foreign firms hire and train local workers
    • These workers then leave
• Joint ventures are sometimes required by law to increase spillovers
  • May have explicit “technology transfer” provisions
## Wages Paid by Multinationals

<table>
<thead>
<tr>
<th></th>
<th>All Countries</th>
<th>High-Income</th>
<th>Middle-Income</th>
<th>Low-Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average wage paid by affiliates/ thousands of Dollars</td>
<td>15.1</td>
<td>32.4</td>
<td>9.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Average domestic manufacturing wage/thousands of dollars</td>
<td>9.9</td>
<td>22.6</td>
<td>5.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Ratio</td>
<td>1.5</td>
<td>1.4</td>
<td>1.8</td>
<td>2.0</td>
</tr>
</tbody>
</table>

*Calculations exclude wages of the multinationals’ expatriate employees*
GE in China

• GE had dominated the Chinese market for power generation equipment
• To access the Chinese market, GE was required to enter a joint venture with a Chinese state-owned enterprise (SOE)
  • And to share their technology
• Tradeoff: Sales now, but competition later
FDI and Development (The Bad)

- Sovereignty concerns: MNEs meddle in local politics
  - Case of Allende in Chile (International Telephone and Telegraph)
  - United Brands in Honduras ($1.25 million bribe)
- Powerful MNCs may extract cushy deals from governments
- Race to the bottom concerns
  - Lax regulations
  - Over-generous tax breaks and land-usage rights
  - Labor rights violations
The Foreign Corrupt Practices Act

- Makes it a crime for American companies (and foreign companies publicly traded in the U.S.) to bribe foreign officials
  - Covers actions taken by foreign partners on a firm’s behalf
- The benefits are obvious, but...
  - Some argue it places U.S. firms at a disadvantage
  - Especially vis-a-vis Chinese firms
MNEs and Competitive Advantage

• To survive, you have to be better than the local competition
• “Liability of Foreignness”
  • Lack language skills, cultural familiarity
  • Lack relevant social networks
    • Access to information, ability to enforce contracts
• Possess knowledge (technology, management expertise)
  • Economies of scale
Midterm Grades

Kernel density estimate

Density

kernel = epanechnikov, bandwidth = 3.6984