

The FDI-political risk nexus: some new insights

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Abstract

Most of the existing literature in the FDI-political risk nexus has focused on the creation of economic models to assess foreign investment decisions in the presence of political risk. This is entirely legitimate and valuable as foreign investors are interested in assessing the political risk climate of their investment location. However, not much research has been done to assess how FDI could affect political risk. Globalization implies an increasing amount of cross-border investment and trade flows. For some countries, FDI is a huge component of their GDP. Since FDI is a composite bundle of capital stock, knowledge and technology (Balasubramanyam et al, 1996) and represents "International investment made with the objective of obtaining a lasting interest, by a resident entity in one economy in an enterprise resident in another economy" (OECD, 2000), we postulate that because of this stakeholder commitment, FDI could affect a country's political risk level.

The management literature has it that political risk measures the stability of individual countries based on factors grounded in government, society, security, and the economy (Bremmer, 2005). We expand on this notion to investigate whether, and if so, how FDI affects political risk? We believe that the contribution of our study is specifically in examining this reverse relationship running from FDI to political risk. In this preliminary paper we test this hypothesis for a sample of thirty countries in various stages of economic development and regime types over the 1984-2012 period. Preliminary results indicate that countries with increased FDI inflows demonstrate decreased levels of political risk. Although there are variations across countries, country groups that are considered developed and full democracies tend to exhibit the lowest levels of political risk. Our ongoing research is examining a sample of 140 countries using both time series and panel data techniques.

1. Introduction

Foreign investment and political stability have long been interconnected in a way that affects economic development in a vast majority of countries. Foreign direct investment (FDI) has been of particular interest among academics and economists since World War II, and has gained importance in the last few decades due to the proliferation of global businesses. Most studies, ranging from Kobrin (1979) and Lewandowski (1997) to Ekpenyong and Umoren's (2010), Baek and Qian (2011), Solomon and Ruiz (2012) and Ritab and Abdul (2013), that have looked at the FDI-political risk nexus have examined the problem from an investment perspective, that is, how political risk (broadly defined as the impact of politics on the market) affects FDI. Investors and economists mainly use these studies as ways to make informed foreign investment decisions based on the host-country's current or forecasted political standing.

However, the FDI arena is not only growing, but also changing drastically. The year 2012 marks the first time developing countries exceeded developed countries' FDI inflows, by \$130 billion (Zhan, 2013, p. 2). Moreover, countries are being put into new classifications such as "emerging markets" and political risk characteristics are an important factor in this determination. Bremmer (2005) notes that emerging markets are generally in the moderate to high political stability range, have high levels of openness and cross-border investment and trade flows. These economies are

experiencing not only a dramatic increase in FDI inflows but also a major transformation in their political structures and regimes. The FDI-political risk issue seems almost like the chicken-and-egg problem: Is it political stability leading to higher FDI or is it FDI helping to reduce political risk, or both? The growth in FDI, the change in political risk levels among nations, and the lack of studies on the impact of FDI on political risk demands that we take a more in-depth look at what kind of impacts FDI has on the country it flows into and the institutional effects it creates.

The purpose of this study is to specifically examine whether, and if so, how FDI impacts political risk. Few recent studies have begun to explore this relationship such as Addison and Murshed (2003), Schroeder (2008), Dutta and Roy (2009), Zaharia et al. (2011), Lautier and Moreaub (2011), Al Azzawi (2012) and Feng (2014). However, most of them only examine FDI's effect on specific components of political risk. Democratic accountability and conflict are two components that are mostly tested in the literature. In contrast, this study investigates FDI's effects on the overall level of political risk of a nation. This current study is a preliminary work that looks at a sample of 30 countries over the 1984-2012 period. Ongoing research is examining a total of 140 countries during the same time period. The study also categorizes countries by their regime types and stages of economic development and the results are clustered in bubble charts for easier interpretation. Overall, the results show that countries with increased FDI demonstrate decreased political risk levels. Although there are variations across specific countries, country groups that are considered developed and groups that are full democracies tend to exhibit the lowest levels of political risk indicating that FDI inflows could help countries to stabilize themselves politically. The rest of the paper is organized as follows. Section two reviews the literature. The data and methodology is explained in Section three. Results and discussions are provided in Section four. Section five provides the direction of future research and concludes.

2. Literature Review

Political Risk

Political risk assessment is often considered to have its origin in the United States right after World War II when the U.S. government needed language and tools for describing the international risks involved with investing in the rehabilitation of Europe. Since WWII, international investing and FDI have grown rapidly across the world making the need for assessing political risk increasingly pertinent. Because of this exponential growth in only a short period of time there were many different variations and methods for explaining political risk among academics and no conventional wisdom was or has been established. Therefore, the definition of political risk used for the current study comes from the World Bank, a widely used and accredited source, which considers the criticism from Kobrin (1979), Fitzpatrick (1983), and Frynas and Mellahi (2003). According to the Multilateral Investment Guarantee Agency (2011, p. 21):

“Political risk broadly defined is the probability of disruption of the operations of companies by political forces and events, whether they occur in host countries or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions not only of governments and political institutions, but also of minority groups and separatist movements”

Other studies such as Bremmer (2005) broadly defines political risk as the impacts of politics on the markets. He considers political risk to be any or all factors that might politically stabilize or destabilize a country, and argues that it measures the stability of countries based on factors grounded in government, society, security and the economy. The Political Risk Services Group (PRS), through their International Country Risk Guide (ICRG), commercially produces an overall index of political risk. This consists of 12 weighted components: (1) government stability; (2) socioeconomic conditions; (3) investment profile; (4) internal conflict; (5) external conflict; (6) corruption; (7) military in politics; (8) religious tensions; (9) law and order; (10) ethnic tensions; (11) democratic

accountability; and (12) bureaucracy quality. This is the most comprehensive index of political risk available in a consistent fashion for 140 countries over the 1984-2012 period.

Foreign Direct Investment

Just as the term political risk had its origin in the U.S. so did FDI. Dunning (1979, p. 269-270) notes that the U.S. held three-quarters of total accumulated FDI from 1945-1960 when FDI was being brought to the forefront. Since then, FDI has entered all parts of the world dictated by investors' interests in host-country economies and their resources. Even though FDI has hit a few crashes or on a large scale changed location multiple times, global FDI has shown a dramatic increase over the last few decades (UNCTAD, 2014). In 2013 alone, global FDI flows rose by 11 percent (\$1.46 trillion) and all countries grouped by stages of economic development increased (developed, developing and transition) (UNCTAD, 2014, p. 2).

It is important to note the changes in the FDI arena as it relates to the current study. First, FDI's largest (in relation to FDI flow amount) and most historically consistent source of inflows and outflows has been the developed countries. The key exceptions to this fact is that in 1913 (first showings of FDI) developing countries received two-thirds of global FDI and in 2012 and 2013 developing countries took the majority of FDI inflows again. In the year 2012, it was the first time developing countries exceeded developed countries' FDI inflows. This study uses the World Bank's (2014) most current definition of FDI as it is a commonly used source among academics and practitioners that encompasses the evolution of FDI's ownership quality aspects within the definition:

"Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments."

Unlike political risk, FDI has a more concrete measure and can be valued by the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital (World Bank, 2014).

How Political Risk Affects FDI

The literature on the relationship between FDI and political risk has been predominantly focused on the effect of political risk on determining the placement of FDI flows. Ekpenyong and Umoren's (2010, p. 28) study defines political risk as events that have "destabilizing effects on the polity, and distorts the functionality of an enterprise." They add other components that they found significant when evaluating political risk for that time period (remembering that political risk components are subject to change over time): "Increases in political terrorism, social inequalities, the North-South question, as well as poverty and disease" (Ekpenyong and Umoren, 2010, p. 30). Ekpenyong and Umoren (2010, p. 31) conclude that these sources of political risk "provide opportunities for wars, insurrections, government takeover of assets, bombings, and hostage takings amongst others; all of which are inimical to business success." This conclusion shows that political risk does have an effect on FDI, and arguably a negative effect since Ekpenyong and Umoren (2010) only describe adverse impacts on business when political risk is increasing.

Asiri and Hubail (2014) use the Eurom and Economic Intelligence Unit indices to measure political risk for their study examining political and economic factors that influence the determination of country risk ratings. Asiri and Hubail (2014) claim that, country risk (and therefore political risk, component of country risk) analysis is crucial for the profitability of overseas investments because it helps investors make rational decisions to limit the foreign risks.

Kobrin (1979, p. 69) states, "At least in the short term, politics determines economic activity and economics can determine politics [addressing his example of the distribution of money affecting the distribution of power]." Using the Spearman's Rank Correlation Coefficient, Lewandowski (1997) examined political risk as one of the four risk sources that determines FDI and the results showed

significance for emerging market countries. Using the Gravity Model, Baek and Qian (2011) find that political risk is a significant determinant of FDI in both industrialized and developing nations, but that the significance of it for developing countries has increased recently. Ritab and Abdul's (2013) study confirm the influence of political risk on FDI from their results that show agglomeration, market size, and political risk are all significant and positively related to FDI. Solomon and Ruiz (2012) claim that in general, political risk and exchange rate uncertainty reduce FDI.

How FDI Affects Political Risk

The majority of the previous literature explored how political risk affects FDI. Studies that analyze how FDI affects political risk are few and quite recent. One of the contributions of the current study is that it looks at whether FDI can have a bearing on political risk and the implications of such a relationship.

Schroeder's (2008) study finds that there is still a need for a theoretical framework to assess country risk (and political risk). In Schroeder's (2008, p. 504) analysis of country risk determinants, she makes the connection between economic distress (which can be caused by lack of FDI since it is such a large portion of many countries' GDP) and elements of political risk by giving examples of political and economic consequences from a country experiencing economic distress. Since the literature on this relationship is very recent and sparse, the studies referenced here, like Schroeder's (2008), make the connection between FDI and its effects on determinants of political risk; consequently not explicitly referring to the broader term "political risk". The determinants of political risk that are mentioned here are all from the ICRG's political risk rating index. The assumption here is that if FDI affects determinants of political risk, then there is reason to explore the effect it has on political risk as a whole, which is the dependent variable being explored in this study.

Zaharia et al. (2011) conducted a study to see if transnational corporations influence global trade, the state of international law, the legal status of corporations in international law, and human rights in the host country. The study concludes with the finding that transnational corporations have a dominant role on the political risk variables that were tested (Zaharia et al., 2011). Dutta and Roy (2009) test FDI's impact on another political risk sub-determinant: free press. After empirically surveying 115 countries over a period of 20 years, the results reveal that FDI is an absolute necessity for a free and efficient media (Dutta and Roy, 2009).

Feng's (2014) study demonstrates another connection for FDI's effect on democratic accountability, the same political risk determinant as Dutta and Roy's (2009). Feng (2014) uses regression analysis to confirm that FDI does have an effect on democracy, but the effect can be different depending on the regime of the FDI home country or on the sector FDI is flowing to. FDI from developed democratic countries has a positive influence on democratization in the host country, while also having a pro-authoritarian effect on FDI in the primary sector (negative democratization effect) (Feng, 2014, p. 121). It is important to note that democratization in developing countries is a "long and tough evolution" since most of them must transition from authoritarian regimes (Feng, 2014, p. 117). This insight on the aspects of long term versus short-term effects of FDI on sub-determinants of political risk, like democratization, should be taken into consideration and not assumed that FDI's impact will be seen overnight. The current study acknowledges the time it takes for countries to transition and how that may affect political risk in the analysis.

The latter findings suggest that FDI is encouraged from developed democratic countries to developing countries, only if the FDI is going to non-primary sectors (Feng, 2014, p. 122). FDI in the primary sector which involves making use of natural resources (e.g. mining, fishing, forestry and agriculture) fuels authoritarianism in developing countries, like the Middle East. This is why the Feng (2014, p. 122) suggests a decrease of FDI in the primary sector in Asia, Africa and the Middle East and an increase of FDI in the manufacture, service and technological sectors. These differences in the way FDI affects democratization are acknowledged by Feng (2014), which creates new

skepticism in the literature and gives more significance to the current exploration of this study, especially addressing the potential long term and short term differences, the difference in region, and the difference in developmental stage.

The next piece of literature examines the effect of FDI on another political risk determinant: conflict (per ICRG, 2014). Addison and Murshed (2003) discuss the growing world interest, especially of economists, in international business and its effect on global conflict. Using other economic, political and corruption literature, their discussion raises some points for acknowledgement. First, the idea of the growing inequality gap is possibly an explanation for the growing number of civil wars around the world from the most recent decades (Addison and Murshed, 2003, p. 392). As stated before, FDI is a huge source of GDP for developed countries that have tended to only invest in one another, historically ignoring developing countries, which increases this income gap. It is also important, Addison and Murshed (2003) explain, that the idea of income inequality is not the exact cause of civil war, but it is the success (or lack thereof) of the institutions created to manage income inequality that lead toward violent or peaceful civil war. These institutions, especially for developing countries, need capital, technological know-how and expertise to create and maintain these institutions that can stabilize the country. Less FDI and help from the developed world may be a reason for lack of stability and success of these developing countries' institutions. FDI is a helpful, if not necessary component, for creating stability.

The next point is based on the assumption that in general the further developed a country is the lower the political risk there will be. This assumption provides the logic for the next study to demonstrate how increased FDI may positively impact political stability. Lautier and Moreaub (2011) argue that domestic investment in the host country brings about development. The overwhelming trend that FDI flows among developed countries demonstrates the fact that investors feel more comfortable in places where there is development. Once FDI flows into a developing host country, the capital from FDI can easily surpass the money raised from their own domestic development operations. With more capital accumulation in the country, development will likely increase further. From their study on the impacts of domestic investment on FDI in developing countries, Lautier and Moreaub (2011, p. 19) support this idea: "Our results show that the promotion of domestic firms' investment will lead to more FDI inflows." The current study explores this idea that as a country receives more FDI it usually becomes more and more developed. This development may be a good indicator that political stability is increasing since measures of development and political stability share many common determinants.

Along the same lines, Al Azzawi (2012, p. 632) examines the effect of FDI on innovation and productivity in the host and home countries and finds that both inward and outward FDI are found to have a strong positive effect on domestic innovation and productivity in countries that are technological followers. Moreover, Lautier and Moreaub (2011) found that even where productivity spillover effects are absent FDI can still improve host-country welfare. The improvement to host-country welfare, again, implies that political risk must be low or lowering because improving country welfare and increasing political risk seem unlikely to be present at the same time. AlAzzawi (2012) and Lautier and Moreaub (2011) help to explain where the idea for the current study came from. These studies give a general overview to the logic that if FDI in a country is fluctuating, it will influence other elements of the host-country's society and government.

The question of whether and how FDI affects political risk remains unanswered. However, the recent literature discussed in this section shows the attempts made at investigating the effects of FDI on political risk. The growing trends for FDI, the interest in the literature on effects of FDI, and the attempts at finding effects of FDI on elements of political risk demonstrate the need for further research on: *How FDI flows affect political risk as a whole.*

3. Data and Methodology

The primary variables of interest in the current study are FDI inflows and political risk. A log-linear regression model based on Ordinary Least Squares with corrections for serial correlation is used to analyze a sample of 30 country's time series over the 1984-2012 period. As mentioned earlier, this is a preliminary work of an ongoing study where future research will be using a panel data method in addition to the time series to test a sample of 140 countries over the same period.

The dependent variable in our model is a constructed index of political risk. The International Country Risk Guide (ICRG) provides political risk ratings for countries on a score of 0 to 100, with 0 denoting maximum political risk and 100 denoting the country is politically stable. Because the ICRG index is set up in a way that really measures political stability, we construct an index of political risk by subtracting each country's political stability score (given by the ICRG's index) from 100 to give a score that measures political risk. Hence, in our study a political risk index of 0 indicates maximum political stability and 100 indicates maximum political risk.

The ICRG's political risk source is used by this study because it is exhaustive, inclusive and well referenced in the literature. Frynas and Mellahi (2003) bring up social factors that are often forgotten, but the ICRG includes social components. The components are well defined and have sub-components within them for specification and clarification, and ambiguity has been a critique of political risk in the past. There are exact weights that have been assigned to each component and therefore make the method easily replicable and easy to manipulate and isolate components individually. The ICRG political risk rating index can be found in studies such as Howell (2014), Ritab et al. (2013), Lautier et al. (2012) Baek and Qian (2011), Iris and Schnitzer (2007), Claude et al. (1996), Sethi and Luther (1986).

Our main explanatory variable is FDI inflows, collected from UNCTAD (2014). Studies that use FDI flows include Lewandowski (1997), Solomon et al. (2012), Lautier et al. (2012), and Feng (2014). Solomon et al. (2012) and Lautier et al. (2012) use FDI flows as a percentage of GDP and Feng (2014) uses FDI flows because of the lack of available data on FDI stocks. Like Feng (2014), this study is confronted with the limited data availability on FDI stocks.

In this preliminary study, the 30 countries were selected based on the ones that had the highest levels of FDI (Australia, Belgium, Brazil, Canada, Chile, China, Colombia, France, Germany, Hong Kong, India, Indonesia, Ireland, Italy, Luxembourg, Mexico, Netherlands, Russia, Singapore, Spain, Sweden, Switzerland, United Kingdom, and United States) and the lowest levels of FDI (Bangladesh, Haiti, Iran, Madagascar, Saudi Arabia, and Togo).

After compiling the three groups of countries into one sample of 30, countries are then documented on their stage of development and their regime type. The source of each country's current stage of development was taken from the World Bank's Country Analytical History (2014) that is based on the World Development Indicators. This was crosschecked with the United Nations Department of Economic and Social Affairs (UN/DESA) report on countries' development stage for 2012. There are three stages of development according to the UN/DESA report: developing economies, economies in transition and developed economies. These three economic stages of development are used in the current study to categorize each of the 30 countries.

Each country's regime type was then documented for the most current year for the study (2012). The information was gathered from the Economist, which published the Democracy Index 2012 from the Intelligence Unit (Intelligence Unit, 2013). There are four regime types possible for a country, according to the Intelligence Unit, which are: full democracy, flawed democracy, hybrid regimes, and authoritarian regimes. Each country's regime in 2012 was determined by a set of five factors: electoral process, pluralism, civil liberties, the functioning of government, political participation and political culture. Each country is given a score from 1 to 10 based on these indicators (Intelligence Unit, 2013, p. 26-27). The entire sample was categorized by economic stage of

development and regime type to see if there were different effects of FDI on political risk in those countries.

4. Results and Discussions

Tables 1 and 2 provide a summary of the FDI coefficients of the sample countries as estimated by the regression models. The countries are rank ordered by their FDI coefficients, in descending order of political risk, that is, in ascending order of political stability. There were 25 countries with a negative FDI coefficient and 5 countries with a positive FDI coefficient. The range for the negative coefficient group was (-0.3306, -0.0027) with a median of -0.0412 and a mean of -0.07062. The positive coefficient group had a range of (0.0053, 0.1566) with a median of 0.0246 and a mean of 0.04676. The countries are also ranked within the groups that they are categorized in. These categories include their current regime and stage of economic development to see if there are differences among each category. A negative and statistically significant FDI coefficient indicates that FDI has a stabilizing effect on political risk: more FDI inflows are associated with lower levels of political risk. For example, in the case of China, a one percent increase in FDI inflows into China results in a 0.018 percent decrease in China's political risk. Such results confirms our claim that as FDI comes into China it brings foreign expertise, capital and technological know-how, which tend to stabilize the country politically.

| Country | Coefficient | Regime | Stage of Development |
|--------------|-------------|------------------|----------------------|
| Italy | -0.0027* | Flawed Democracy | Developed |
| Colombia | -0.0044* | Flawed Democracy | Developing |
| Brazil | -0.0073* | Flawed Democracy | Developing |
| Australia | -0.0156* | Full Democracy | Developed |
| China | -0.018* | Authoritarian | Developing |
| Madagascar | -0.0181* | Authoritarian | Developing |
| USA | -0.0212* | Full Democracy | Developed |
| Luxembourg | -0.0221* | Full Democracy | Developed |
| Sweden | -0.0252* | Full Democracy | Developed |
| Bangladesh | -0.0318* | Hybrid Regime | Developing |
| UK | -0.0322* | Full Democracy | Developed |
| Saudi Arabia | -0.035* | Authoritarian | Developing |
| Belgium | -0.0412* | Full Democracy | Developed |
| India | -0.0583* | Flawed Democracy | Developing |
| Mexico | -0.0633* | Flawed Democracy | Developing |
| Singapore | -0.0785* | Hybrid Regime | Developing |
| Canada | -0.0845* | Full Democracy | Developed |
| Ireland | -0.085* | Full Democracy | Developed |
| Netherlands | -0.0891* | Full Democracy | Developed |
| Hong Kong | -0.0964* | Flawed Democracy | Developing |
| Indonesia | -0.0979* | Flawed Democracy | Developing |
| Spain | -0.1055* | Full Democracy | Developed |
| Chile | -0.1974* | Flawed Democracy | Developing |
| Russia | -0.2042* | Authoritarian | Transition |
| Germany | -0.3306* | Full Democracy | Developed |

Table 1: Countries with Negative FDI Coefficients

| Country | Coefficient | Regime | Stage of Development |
|-------------|-------------|----------------|----------------------|
| France | 0.0053 | Full Democracy | Developed |
| Togo | 0.0101* | Authoritarian | Developing |
| Haiti | 0.0246* | Hybrid Regime | Developing |
| Iran | 0.0372* | Authoritarian | Developing |
| Switzerland | 0.1566 | Full Democracy | Developed |

Table 2: Countries with Positive FDI Coefficients

Results by Stage of Economic Development

There is debate within the FDI and political risk literature that there are differences in the amount of influence a country may experience from FDI because of their stage of economic development. Some countries are thought to be affected differently because the spillover benefits from FDI due to increased capital, technological know-how and expertise that FDI brings, are thought to be more influential in one type of economy over another. These differences are mainly discussed when it comes to FDI's influence on overall host-country development and not specifically political risk. Because of this debate and the lack of knowledge on FDI's direct effect of political risk,

the current study looks at each country's stage of development to see which how countries are affected differently with increased FDI. Countries are classified either as developing economies, economies in transition or developed economies using the World Bank's classification.

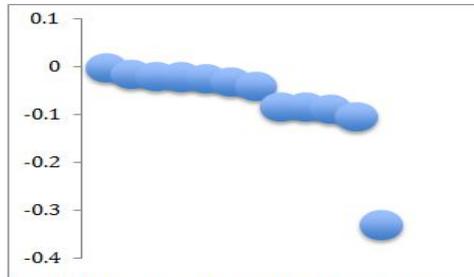


Figure 1: Coefficients for Developed Countries

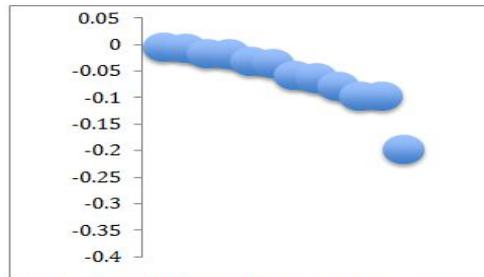


Figure 2: Coefficients for Developing Countries

Figures 1 and 2 show the FDI coefficients for each stage of economic development. Figure 3 shows country group coefficient averages by their stage of development. The results from these figures show that, in general, FDI seems to have a more stabilizing effect politically in developed countries compared to developing countries, and FDI in transition economies tends to have the biggest stabilizing effect. However, as noted, the transition economy group in the sample under study consists of only Russia. The outlier in the developed country category (Figure 1) is Germany, which is highly developed and FDI has been very stabilizing. The outlier in the developing category (Figure 2) is Chile that has been receiving plenty of FDI recently and creating a politically stabilizing situation. Regarding positive FDI coefficients, there are only 2 developed countries, 3 developing countries and 0 transition countries. So, that it was difficult to draw any general conclusions based on development stage.

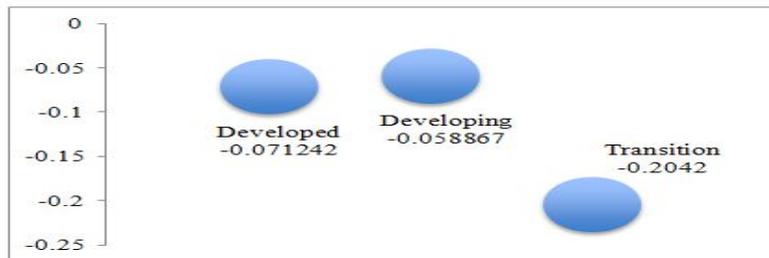


Figure 3: Country Group Coefficients by Stage of Development

Results by Political Regime Type

The concept of time is another important variable that is discussed within the literature and becomes pertinent when analyzing the effect of FDI on countries who have different types of regimes. Regime type may cause variations within the results because some regimes, like authoritarian, may not experience the same FDI spillover benefits if the government controls FDI and its resources. Another reason the regime type could vary the results is if the government keeps the FDI spillover benefits within the hands of the elites and uses them for their own personal gains. This in turn can lead to corruption and even civil unrest within the country, which means an increase in FDI would actually increase political risk. For these reasons, the results could show a positive relationship between FDI and political risk, but probably for only a limited amount of time until internal or external forces change the government in power or change the type of regime entirely.

There are four regime types that are used in this study based on the Intelligence Unit (2013) classification: authoritarian, hybrid, flawed democracy and full democracy. In our sample, this results in 6 authoritarian regimes, 3 hybrid regimes, 9 flawed democracies and 12 full democracies. Only the countries with a negative coefficient are used because this was the majority of the results. Of the five countries with a positive relationship, there were only 2 authoritarian, 1 hybrid and 2 full democracies. This is not enough data to make any valid claims or draw conclusions. The results are shown in Figures 4 to 7.

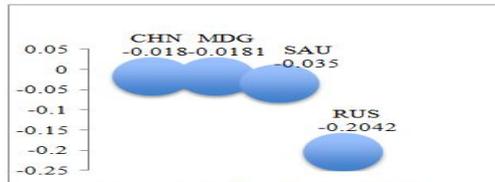


Figure 4: Authoritarian Regimes

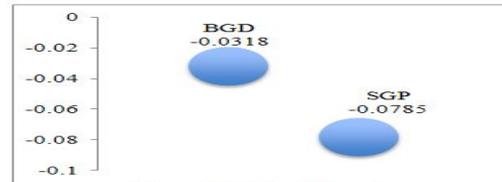


Figure 5: Hybrid Regimes

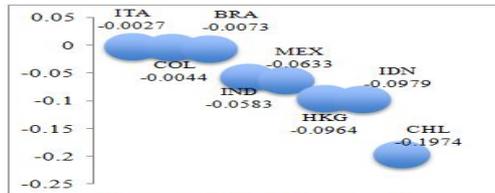


Figure 6: Flawed Democracies

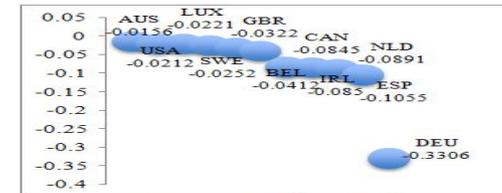


Figure 7: Full Democracies

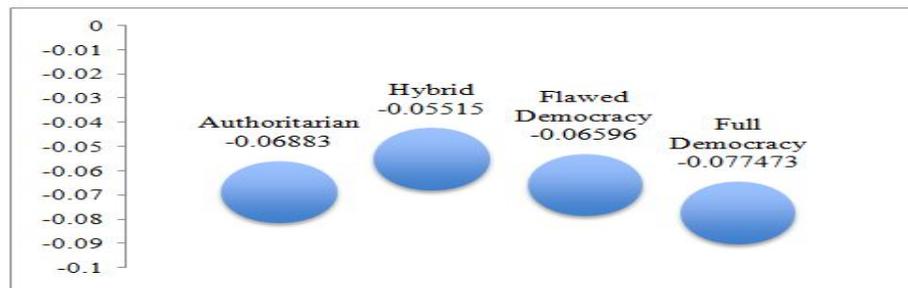


Figure 8: Country Group Coefficients by Political Regime Type

Figures 4, 5, 6 and 7 display the negative FDI coefficients of the countries taking into account their various government regimes. The mean coefficients of each group are summarized in Figure 8. The overall results match the extant literature which suggests that although there are variations across specific countries, country groups that are full democracies tend to exhibit the lowest levels of political risk when FDI flows in and those countries that have an authoritarian, hybrid and even flawed democracy (where corruption is more common within the government/elites), they tend to have higher political risk.

5. Conclusions and Future Research

The current study is a first contribution to the literature that explores the quantitative effect of FDI on political risk. Though FDI and political risk have long been said to have a relationship, it has been one where political risk is found to affect FDI and this perspective is mainly relevant to the investment community. However, in reversing the relationship (i.e. running from FDI to political risk), the first step must be to see if any such relationship even exists; this is the basis of this study. This study tested 30 countries over a 28-year period (1984-2012) and derived coefficients that represent the FDI-political risk relationship. In the sample under study, 25 countries exhibited that an increase in FDI leads to a reduction in political risk. In addition, it appears that FDI in developed countries tend to be more stabilizing politically than in developing countries, and countries that are full democracies tend to experience a more politically stabilizing effect of FDI compared to other types of regimes. Overall, this means that FDI inflows tend to reduce political risk, or promote political stability. This reinforces the notion that as countries try to fill their institutional voids and move towards democratic regimes, they will likely be more politically stable when they attract FDI. In this globalized era, it appears that an important component of political stability is the presence of foreign direct investors in host countries. Most studies show that low political risk tends to promote FDI. Our study shows that the presence of FDI itself could enhance the level of political risk. Our argument is that FDI can create important stakeholder effect in a host country and, because of that, host country governments may want to make sure political risk is contained in order to retain the

foreign direct investors who bring in know-how, capital stock and expertise. Thus it can be argued that FDI itself could lead to a reduction in political risk, as the current study demonstrates here.

It should be noted, however, that the current study is in no way making a case to include an FDI variable in political risk measures. Instead, the study shows that overall FDI does impact political risk and ignoring this fact would bias the interpretation of the political risk-FDI relationship. Hence, FDI should be taken along with any other components of political risk for a more accurate evaluation of a country's political risk situation.

In addition, this is a work in progress that only describes the first step in attempting to answer to the research question: How does FDI affect political risk? Ongoing research is currently trying to analyze all the 140 countries documented by the ICRG (2014) using both time series and panel data models. Following Ernst (2014), we will also be looking at how the FDI-political risk relationship may be different for country groupings at various income levels or stages of economic development.

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