POLI 150: Effectiveness of Institutions & Foreign Direct Investment

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15 April 2020

Today's Class

- Institutions & the 2008 Financial Crisis
- Foreign Direct Investment (FDI)

Do International Economic Institutions Work?

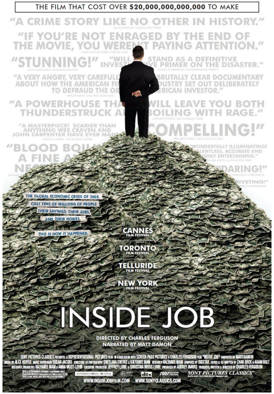
- The 2008 global financial crisis was a litmus test for the effectiveness of these institutions

- How well did the international economic institutions deal with the financial crisis?

Origins of the 2008 Crisis

- Tax cuts led the US to borrow from abroad to finance its spending
- Low interest rates led American citizens to borrow heavily
- 2001 → 2007: huge borrowing boom
- Lending practices were based on the assumption that housing prices would continue to rise
- Eventually, housing prices *fell*, leading homeowners to be unable to pay off their debt and heavily-invested banks to collapse

If You're Interested. . .



International Consequences

- The American financial decline spread to almost every other economy
- Borrowers were acutely harmed, and creditors were not being paid
- First truly global financial crisis since the 1930s

International Response to the Crisis

- United States: trillions of dollars were spent to bail out financial institutions
- Deficit funded stimulus → focus on American goods thought to be protectionist
- Similar dynamic in the EU, but with the added complication of some countries being lenders and some borrowers
- Developing countries complained that developed states' borrowing was crowding out smaller economies

Measuring the Effectiveness of Institutions

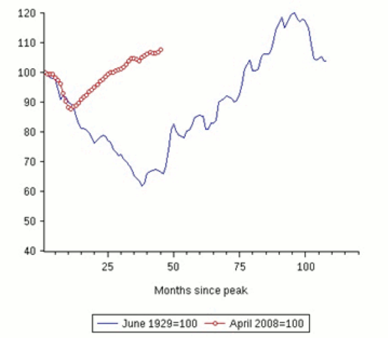
- Several critics of economic institutions have cited the collpase of the Doha round of WTO negotiations and Eurozone debt crisis as evidence for their failures
- Drezner argues that looking only at these two examples don't tell the whole story
- Suggests that we need to look at policy outcomes, policy outputs, and the resiliency and flexibility of the institutions

Policy Outcomes

- How has global production and trade changed since the Great Recession?
- We can compare the aftermath of the crisis to the aftermath of the Great Depression (Eichengreen & O'Rourke)
- Trade and output rebounded much, much faster following the 2008 crisis
- Conflict hasn't risen much; public opinion has move *toward* trade

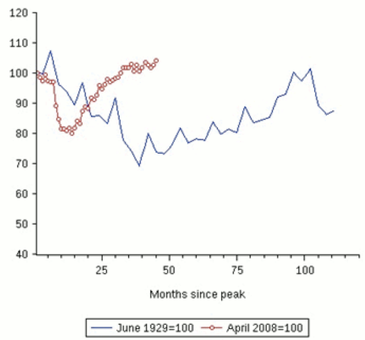
Output Comparison

Figure 1. World Industrial Production: Great Depression vs. Great Recession



Trade Comparison

Figure 2. World Trade Volumes: Great Depression vs. Great Recession

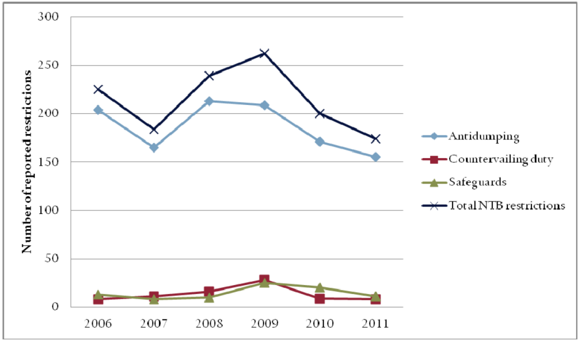


Policy Output

- Have economic institutions crafted policies that have been useful?
- One crucial piece of economic crisis recovery requires maintaining openness
- Governments have incentives to restrict trade to benefit their own producers, but effective institutions should assuage these
- Barriers to trade spiked around the crisis, but quickly receded
- Institutions have also set new standards for changing investment activity

Barriers to Trade

Figure 3. Trade Restrictions, 2006–2011



Source: WTO

Institutional Flexibility & Resiliency

- Have these structures maintained their relevance and authority, especially with respect to major powers?
- G20 replaced the G7 as the chief economic cooperation institution, and cooperation is improving
- IMF changed its voting rules to better reflect the distribution of economic power and has shifted all advice away from the "Washington Consensus"
- The WTO saw increased numbers of free trade agreements

Did the Institutions Work?

- In general, the institutions worked!
- Cooperation, facilitated by institutions, appears to have softened the blow of the crisis
- *Why* the institutions worked much better now is an open question

Foreign Direct Investment

- FDI is investment that is undertaken by multinational corporations (MNCs) in which the MNC retains its control over the investment
- MNC: a business that operates in multiple countries outside its country of origin
- Examples include Ford having facilities in Mexico, ExxonMobil in Angola, etc.
- Differs from portfolio investment in degree of control of the investment

Puzzles of FDI

- Why do companies pursue FDI?
- What are the controversies associated with this type of investment?
- Why do host states let foreign companies in?

Why Do MNC Use FDI?

- In general, companies choose to use FDI in pursuit of profits
- They are either looking for local market or resource access
- **Resources**: Oil companies setting up in oil-rich areas (ExxonMobil in Angola)
- **Market**: Lower transport costs, cheaper labor, avoiding trade barriers, etc. (Volkswagen in Brazil)

Why Do MNC Use FDI?

- MNCs generally select markets for specific types of work
- Labor intensive work in areas with cheap labor like Vietnam; more 'skilled' labor in more developed nations like Ireland
- MNCs generally have home government support to protect and promote interests

Controversies of FDI

- Actors in home states blame corporations for outsourcing and can punish them
- Labor unions criticize MNCs for threatening FDI to gain concessions
- Human rights activists blame companies for seeking areas with lowest standards for workers
- MNCs may also search for areas that are pollution-friendly

Why Do States Allow FDI?

- States that allow FDI to enter may face increased competition with domestic actors. Why do they do this?
- MNCs may have skills and capital that less-developed countries may lack
- Host governments can tax the production
- Creates jobs for citizens

Conflicting Interests

- Host states and MNCs sometimes have conflicting interests
- Disagreement over the division of benefits from FDI
- Local firms may complain about increased competition
- Developing countries often can't check powerful MNCs
- States statuses change over time; may like FDI when less-developed, but dislike it once they develop

Host Governments vs. MNCs

- Just like in debtor-creditor relations, hosts and MNCs bargain over gains of FDI
- Host can control taxation and regulation up to nationalizing or taking over the company
- MNCs can withhold capital and technology or ultimately pull out of economy

Conflictual Examples

- Changing norms over the appropriateness of agricultural and raw materials investment led to a huge number of takeovers
- MNCs can have preferences over local politics in host countries
- Example: International Telephone & Telegraph (ITT) Corporation in Chile $\rightarrow$ Pinochet's coup
- In spite of these controversies, FDI from MNCs is very common and usually desirable

Lack of Institutions

- For the other topics of IPE that we've focused on, institutions have governed the behavior of actors
- No such FDI institution exists. Why?
- The collapse of investment, governed by the IMF, has contagion effects that aren't relevant to FDI
- Individual countries negotiate with MNCs rather than one body
- Bilateral investment treaties (BITs) are smaller institutions