International Finance: Portfolio Investment, Concessional Finance, and FDI

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POLI 150

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Announcements

- NO CLASS on Thursday 3/28
- PSSP module 2 open from 3/27 - 4/10

Class Overview

- Types of international financial relations
- International borrowing and foreign loans
- International financial institutions
- Debtor-creditor strategic interactions
- Concessional finance
- FDI: Reasons, Types, and Conflicts

Key Terms

- Portfolio investment
- Interest rate
- Financial crisis
- Default
- Austerity
- IMF
- Conditionality

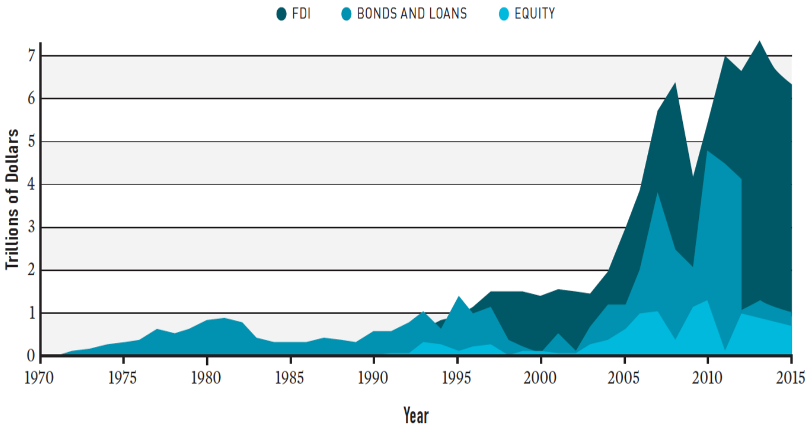
Key Terms Continued

- Concessional Finance
- FDI
- MNC
- Obsolescing Bargain
- Bilateral investment treaty
- Investor-state dispute settlement

Central Questions

Why and how is money invested internationally?
What tensions are caused by such investing?

International Investment Flows



Types of International Financial Flows

There are 3 types of international financial flows.

1. Portfolio Investment (slides 9-36)
2. Concessional Finance (slides 38-40)
3. Foreign Direct Investment (slides 41-65)

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  - Derivatives and complex financial products
  - Bonds (including **sovereign lending** to governments)

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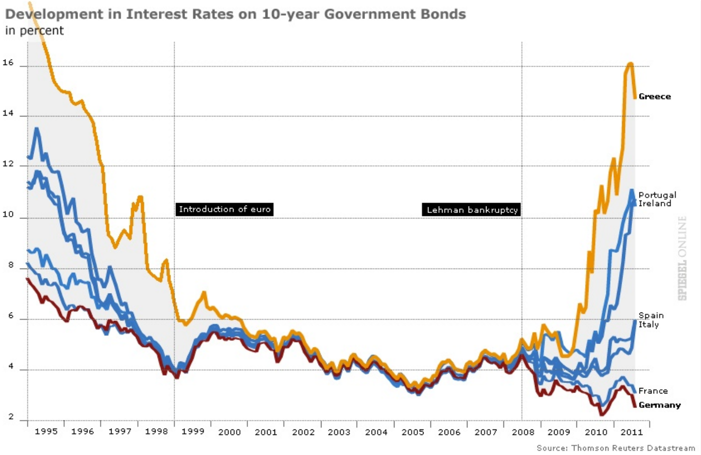
- **Derivatives** and complex financial products: see here for optional details.
- **Sovereign Lending**: private-sector financial institutions in one state loan to the sovereign government of another state.

Government Bonds

Eurozone Bond Rates



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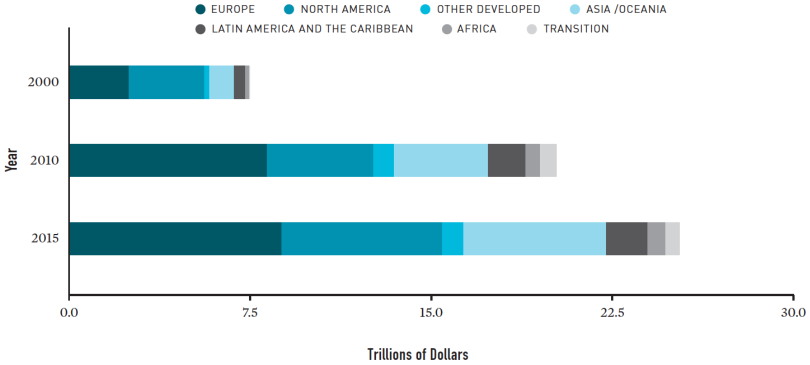
- As developing states are by definition capital-scarce, we should see firms from capital-rich developed states investing their capital in developing states.
- **But, a majority of capital flows occur between rich countries with lower interest rates. Why?**

FDI by Area


EUROPE
NORTH AMERICA
OTHER DEVELOPED
ASIA /OCEANIA
LATIN AMERICA AND THE CARIBBEAN
AFRICA
TRANSITION
Year
2000
2010
2015
0.0
7.5
15.0
22.5
30.0
Trillions of Dollars

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- The **incentive** for investing abroad is greater economic returns, in the form of higher interest rates and strong growth (for stocks, loans, bonds) and/or cheaper costs of production (for FDI).
- **The risk is that the foreign state make policy choices that devalue the investment.**

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All of this explains why a majority of capital investments are between already-developed rich countries, even though returns are lower.

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- Fund private and public sector activities
- Promote economic growth
- Transfer technologies and expertise (esp. FDI)
- Higher returns than in "safer" markets.

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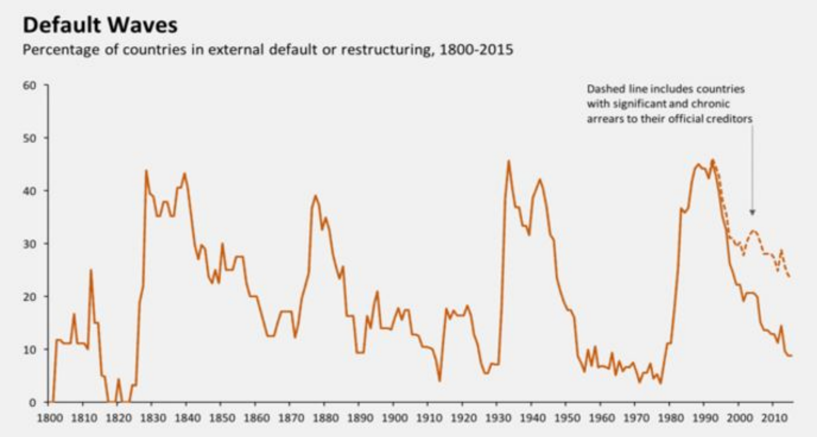
- The most common type of crisis associated with international finance is a **default**: failure by an actor to make payments on their debt.
- When a corporation defaults, it generally goes bankrupt, with its remaining assets purchased by other firms. But this is not an option for a state.
- Financial/debt crises are common across time and space.

Waves of Default



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  - Currency crisis (covered later).
- Creditors begin to worry that they will not recoup their investment.

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- The debtor state, facing a sudden loss of financing and lacking a meaningful financial backstop, reduces or stops payment on its debts to avoid insolvency.
- Current creditors entirely cease any remaining lending, while other potential sources of capital avoid this market due to the perceived risk of non-repayment.

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- At some point, debt restructuring negotiations begin.

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  - Fiscal policy: bailouts from a Lender of Last Resort
  - Monetary policy: reduce interest rates
  - Regulation: prevent future vulnerabilities
- But all of these have domestic and international costs, and are often influenced by creditor states during debt restructuring negotiations.

Crisis and Strategic Interactions

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- These measures have far-reaching negative consequences for citizens who had nothing to do with the financial crisis, creating a **bargaining interaction** over the scale of austerity measures between those citizens who will be hurt by them versus the state and affected economic sectors.

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- Debtors can threaten full default, while creditors can threaten to cut off future lending and freeze funds.
- Additionally, there is a risk that investor panic may cause a crisis to spread from one state's markets to other similar states.

Crisis and Strategic Interactions

- Such an economic conflict is destructive, so both sides also have an incentive to negotiate. This resembles a bargaining problem with incomplete information about resolve.
- When such crises are resolved successfully, the debt is **restructured** so that (mostly) normal financial life can resume, but this may involve unpopular cutbacks and lingering austerity measures...

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  - National governments do not serve as Lender of Last Resort (LLR) internationally
  - Incentives to defect by under-regulating domestically and by self-interested macroeconomic policies

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  - G-20: group of mostly rich developed states that coordinate macroeconomic policies, especially after the 2008 Financial Crisis.

The International Monetary Fund

- The IMF was originally founded to manage the gold standard under the Bretton Woods monetary system.
- After the end of the gold standard in the 1970s, it adapted to stay relevant.
- 1980s and after: its primary role is preventing the spread of economic and financial crises, and helping to contain them if they do spread.
- Primary way it does this is by serving as the global **Lender of Last Resort**: a source of emergency loans to states in crisis that conventional capital sources deem too risky to invest in.

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  - These reforms are controversial domestically.

Protesting IMF Programs

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- Bias due to domination by rich developed Western states.

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  - AIIB may not focus on traditional conditionality, but includes other conditions that benefit China.

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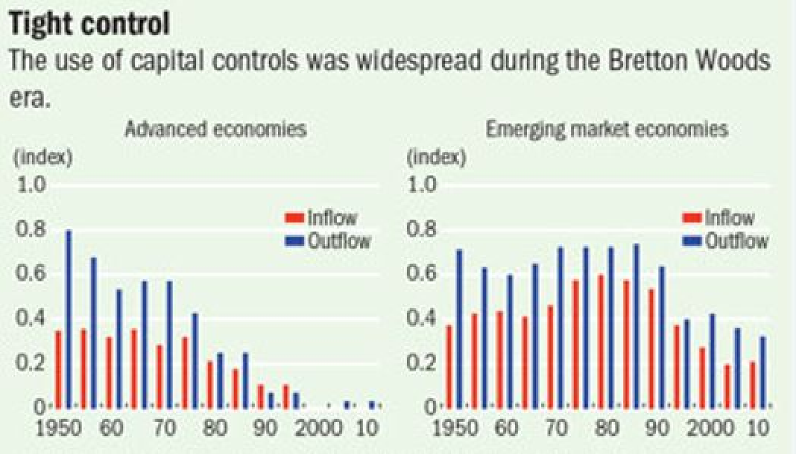
Financial Liberalization Over Time



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  - Potential for economic growth and interdependence
  - Can be more beneficial to major powers, but still be Pareto-improving

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  - Potential for economic growth and interdependence
  - Can be more beneficial to major powers, but still be Pareto-improving
- Ideational: neoliberalism and the Washington Consensus

Why are International Flows Increasing?

In spite of financial crises, international capital flows have continued to increase in recent years. Why?

- Political reasons: response to crises.
  - Pressure from IMF and US
  - Some domestic groups benefit from liberalization and deregulation
  - Potential for economic growth and interdependence
  - Can be more beneficial to major powers, but still be Pareto-improving
- Ideational: neoliberalism and the Washington Consensus
- Technological: more difficult to impose controls

Types of International Financial Flows

There are 3 types of international financial flows.

1. Portfolio Investment
2. Concessional Finance
3. Foreign Direct Investment

Up to this point, we have discussed portfolio investment. The rest of these slides focus on **concessional finance** and then on **foreign direct investment**.

Concessional Finance

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- The main international institution here is the **World Bank**.

Concessional Finance: The World Bank

The **World Bank** is...

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- The third Bretton Woods institution, after the GATT/WTO and IMF, originally intended to promote economic development via loans following WWII.
- After the end of the Bretton Woods monetary system in the 1970s, it shifted to generally providing affordable loans to developing states, usually for basic development projects.

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- The Bank is less prominent than IMF due to less conditionality around these loans, lack of private investor involvement, and smaller total amounts.
- It tends to deal in lower amounts than amounts of FDI, today's next topic...

FDI Central Questions

Why do companies want to produce in other states? Why do those states let them in?

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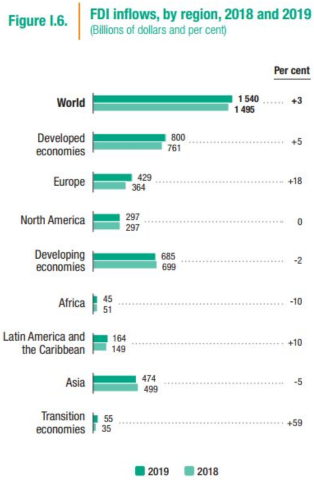
- Any company doing FDI is by definition an MNC.
- MNCs can also sell and produce through sub-contracting, outsourcing, and globalized supply chains.

FDI Inflows Regionally



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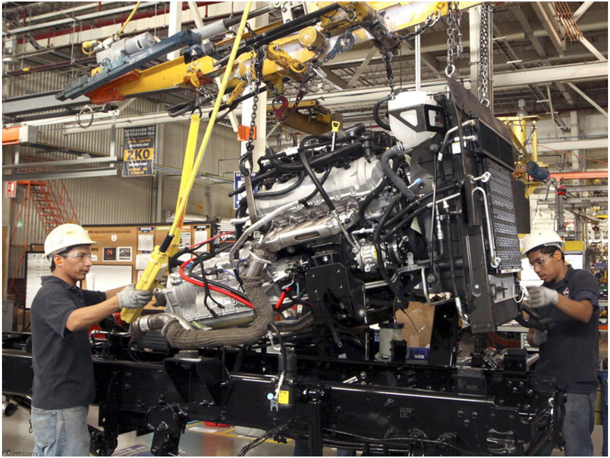
- **Horizontal**: expanding a firm so that it is carrying out the same operations in *home* and *host* countries.
- **Vertical**: a firm adding new business activities or breaking apart current ones into a chain spread across multiple states.

Horizontal FDI: Coca-Cola

Vertical FDI: Ford



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  - Selling to new markets and avoiding trade barriers (via horizontal FDI).
  - Cheaper production costs, such as low-skilled labor (e.g. clothing produced in Bangladesh).

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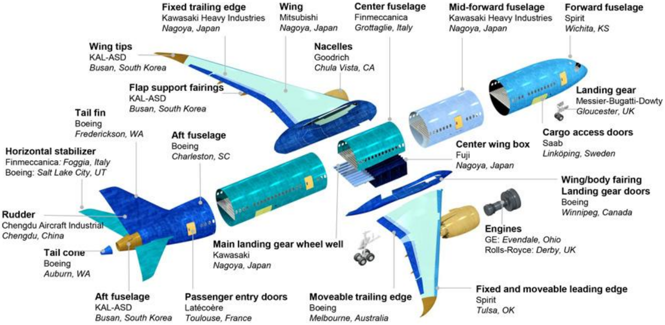
  - Pre-investment bargaining advantages.
  - Cheaper supply chain input production.

Global Supply Chains



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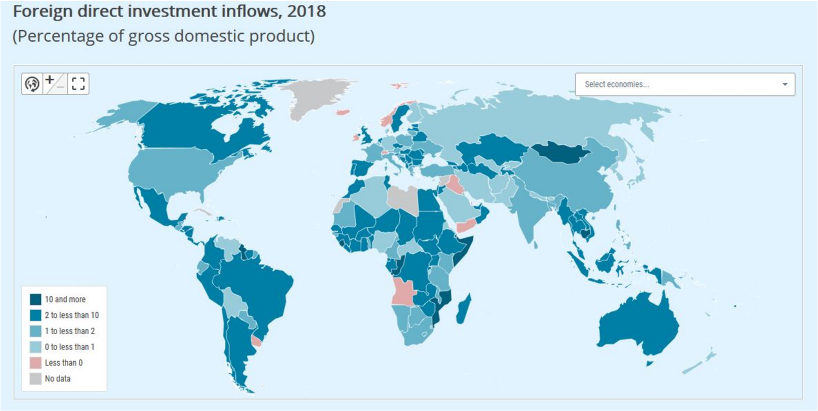
- Host governments can count on long-term, relatively stable tax revenues.
- Creates relatively high-paying jobs for citizens in developing states.

FDI by Country



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- The MNC's home state may be upset that capital and production are moving elsewhere.

The Obsolescing Bargain

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  - This may encourage a **race to the bottom** by developing countries to attract investments by cutting tax rates and labor safety laws, with negative impacts on worker safety (e.g. Rana Plaza Accident)

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  - The government may **expropriate** income from the investment, either through nationalizing the investment or via stringent regulations and taxes.
  - Given the global shift toward FDI and free trade, MNCs are less concerned about nationalizations and more worried about **creeping expropriation** in which the state slowly increases its taxation, regulation, and ultimately control over the investment without nationalization.

Conflict Between Hosts and MNCs

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  - Cuba famously nationalized US property (including casinos) after the 1959 revolution.
  - Venezuela nationalized oil production in 1976.
  - More recently, Bolivia seized all oil and gas production facilities in 2006.
- Opposing interests between host state and MNC, as well as the shadow of the Obsolescing Bargain, can motivate economic conflict.

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  - Lobbying the host governments (e.g. in Honduras prior to the Soccer War; concerns about dependency).
  - Advocating for foreign, home government interference (e.g. United Fruit in Guatemala in 1954, ITT (and Pepsi) implicated in the 1973 Allende coup in Chile)

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- These states have also tried to re-negotiate trade agreements to include more domestic jobs (e.g. provisions in the USMCA, a trade pact that replaced NAFTA).
- However, most reshoring jobs are linked with automated production, and thus aren't likely to address the needs from when jobs left.

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- First reason: no global public good is threatened if individual FDI ventures fail (unlike financial contagion).
- Second reason: Conflicts are only between individual countries and MNCs, decreasing the number of actors, making bargaining somewhat less complicated.

What about Institutions?

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  - Governments can commit to avoid expropriation by tying their hands through tax cuts or regulatory commitments.
  - Some states have bargaining advantage because of market size (China) or resource endowments (oil, gas, minerals, etc.).

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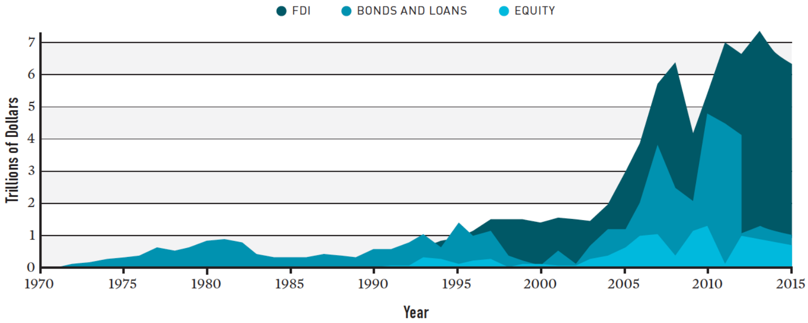
    - Which results in almost 2,600 active BITs as of this month.
- These contain **investor state dispute settlement** mechanisms: provisions for how to solve any dispute that occurs, often biased in favor of the MNC and its home state.

FDI Surge


FDI
BONDS AND LOANS
EQUITY
Trillions of Dollars
0
1
2
3
4
5
6
7
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Year

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  - Could generate more political instability?

Brooks, Cunha, Mosley (2015) Review

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- What implications does this have for a rationalist framework? Threatens its external validity.

Summary

- International finance can be divided into 3 categories:
  - Portfolio Investment
  - Concessional Finance
  - Foreign Direct Investment

Summary: Portfolio Investment

- Investors (lenders) seek out markets where their capital will return good interest rates, but balance this desire for returns with evaluations of market risk and political risk in their target countries.
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- This creates a strategic interaction between creditor and debtor, as debtors want all of their debt forgiven while creditors want to recover as much as they can.
- This also leads to bargaining within the debtor state as creditors demand domestically unpopular austerity measures in return for restructuring the debt and providing new loans.

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- In spite of the risks, international capital flows have continued to increase in recent decades.

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- Both rich states and international institutions do this, with the World Bank as the primary international institution providing concessional finance.
- Generally deals in smaller amounts of capital than either portfolio investment or FDI.

Summary: FDI

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- Both hosts and MNCs must overcome commitment problems in the form of the obsolescing bargain.
- MNCs and hosts can clash over the distribution of benefits from the investment.
- FDI is still generally attractive to LDCs because of its relative stability, though it may create political conflict.

To Ponder...

Given the risks of international finance and the increasing openness of the world to it, what are the distributional consequences at the state level? At the firm level? In domestic politics?