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

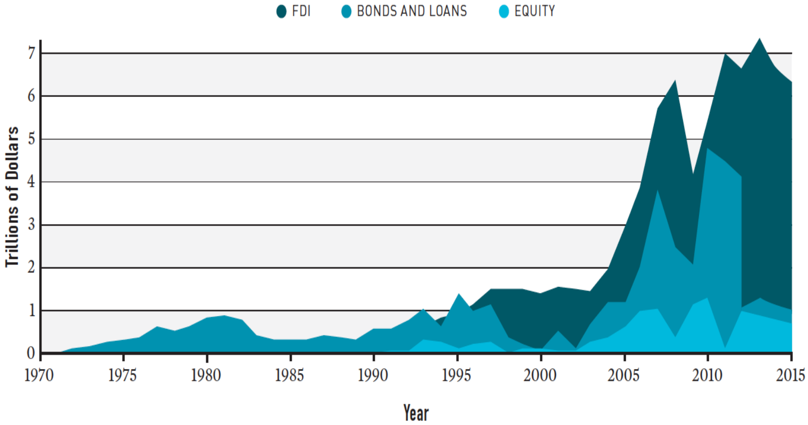
Key Terms Continued

- 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)

Types of International Financial Flows

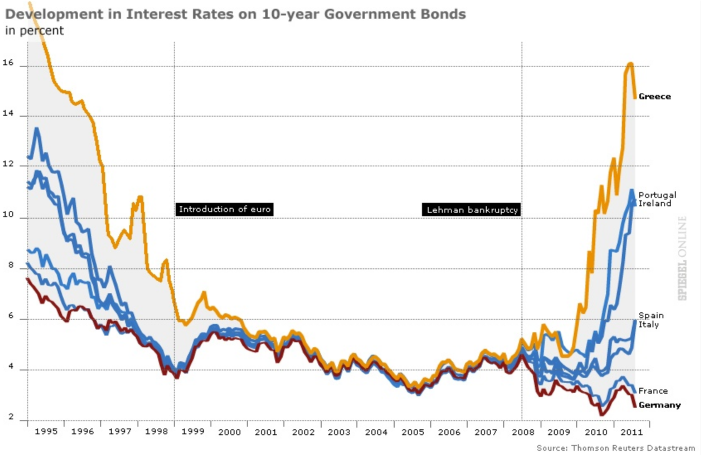
- **Portfolio investment**: purchase of financial products in a foreign country where investors do not have any managerial control over the businesses in which they are investing. This includes:
  - Bank loans
  - Stocks (equities)
  - Derivatives and complex financial products
  - Bonds (including **sovereign lending** to governments)

Portfolio Investment Type Definitions

- **Bank loans**: agreement by a lender to loan a sum of money with a date of repayment and interest rate.
- **Stocks (equities)**: fractional shares of ownership of a company.
- **Bonds**: like a loan, except tradeable on secondary markets. Issued by both corporations and states. The owner is a **creditor** of the entity that issued the bond (the **debtor**).
- **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.


COUPON BOND
10,000
10,000
THE UNITED STATES OF AMERICA
1072
10⅛%
TREASURY BOND OF 1994
Dated October 18, 1979
Due November 15, 1994
CUSIP 912810 CJ 5
INTEREST PAYABLE MAY 15 AND NOVEMBER 15
CIRCULAR No. 23-79
FOR VALUE RECEIVED PROMISES TO PAY TO THE BEARER THE SUM OF
TEN THOUSAND DOLLARS
ON THE DUE DATE, AND TO PAY INTEREST ON THE PRINCIPAL SUM FROM THE DATE HEREOF, AT THE RATE SPECIFIED HEREON. THIS BOND AND INTEREST COUPONS ARE PAYABLE AT THE DEPARTMENT OF THE TREASURY, WASHINGTON, D.C., OR AT ANY FEDERAL RESERVE BANK OR BRANCH. THIS BOND IS ONE OF A SERIES OF BONDS, AUTHORIZED BY THE SECOND LIBERTY BOND ACT, AS AMENDED, ISSUED PURSUANT TO THE DEPARTMENT OF THE TREASURY CIRCULAR REFERRED TO HEREON, AND IS NOT SUBJECT TO CALL FOR REDEMPTION PRIOR TO MATURITY. THE INCOME DERIVED FROM THIS BOND IS SUBJECT TO ALL TAXES IMPOSED UNDER THE INTERNAL REVENUE CODE OF 1954. THIS BOND IS SUBJECT TO ESTATE, INHERITANCE, GIFT OR OTHER EXCISE TAXES, WHETHER FEDERAL OR STATE, BUT IS EXEMPT FROM ALL TAXATION NOW OR HEREAFTER IMPOSED ON THE PRINCIPAL OR INTEREST HEREOF BY ANY STATE, OR ANY OF THE POSSESSIONS OF THE UNITED STATES, OR BY ANY LOCAL TAXING AUTHORITY. THIS BOND IS ACCEPTABLE TO SECURE DEPOSITS OF PUBLIC MONEYS. IT IS NOT ACCEPTABLE IN PAYMENT OF TAXES.
WASHINGTON, D.C., OCTOBER 18, 1979.
SECRETARY OF THE TREASURY
10,000
10,000
TEN THOUSAND DOLLARS

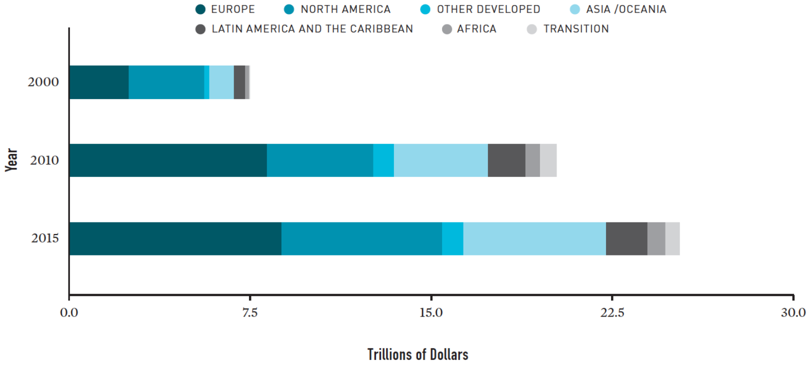
Eurozone Bond Rates



Why Does Money Move Internationally?

- **Money itself (capital) travels between states based on the interest rate of loans and bonds**, and the financial performance of stocks.
- The return on loaning capital is driven by its interest rate.
- In markets where capital is (relatively) scarce, that scarcity of supply increases the value of capital and thus increases the interest rates lenders can charge.
- 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

Why Does Money Move Internationally?

- The answer is found in the risk-return trade-off (political *and* economic risk) of foreign investments.
- 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.**

Political Risks of Foreign Investment

What kinds of political risks?

- Foreign governments can make policy choices that make investments less profitable, such as changing tax rates.
- In cases of FDI, the state may nationalize corporate property, creating losses for the corporation.
- Political instability or war can also devalue investments and destroy property.
- Portfolio investment is volatile and prone to reversals.
- Crises and contagion are common, followed by austerity.

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

Benefits of International Finance

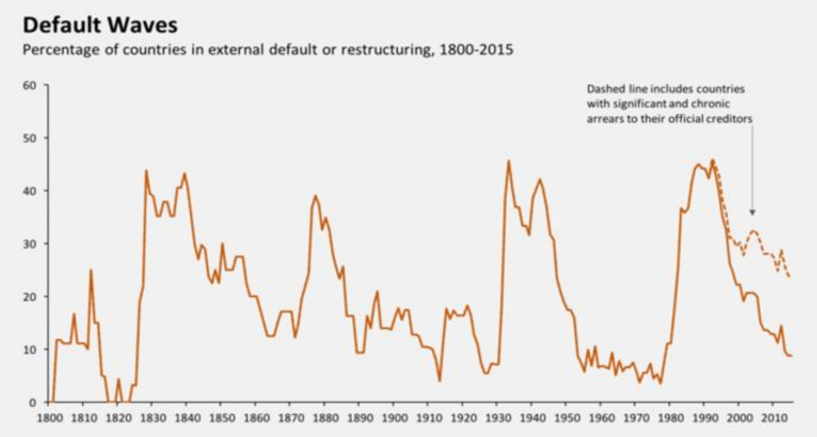
However, international investment between developed and developing states does still occur. Why? There are still substantial benefits:

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

Domestic Governance of Finance

- **Financial crises** are what happens when something goes wrong with this process of international investment.
- 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



Anatomy of a Financial Crisis

- A state, or a significant sector of that state's economy, takes out loans from foreign actors.
- Something threatens the ability of the debtor state/corporations to repay those loans.
  - Economic downturn that decreases demand for goods and services that provided revenues to make payments on those debts.
  - State instability or drastic shift in monetary policy (ex: election of a candidate promising to nationalize sectors of the economy).
  - Currency crisis (covered later).
- Creditors begin to worry that they will not recoup their investment.

Anatomy of a Financial Crisis

- Creditors cease to approve new loans, and may (depending on the terms of the debt) call for immediate repayment in an attempt to secure their capital.
- If one creditor does this, it is manageable. But if every creditor does this...
- 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.

Anatomy of a Financial Crisis

- The debtor state eventually runs out of reserves, cannot get new ones via lending as it normally would, and defaults.
- If there are other debtor countries with similar economies, investor fear can spread, leading to a repeat of this cycle in other states. This is **financial contagion**.
  - This can spread the crisis even to states that were otherwise economically healthy - a self-fulfilling prophecy.
- At some point, debt restructuring negotiations begin.

Domestic Governance of Finance

- How do governments respond to a financial crisis? Ideally, they have a bundle of options...
  - 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

- A common response to repayment issues is **austerity**: application of policies to reduce state spending, usually involving cutting government programs, raising taxes, and cutting wages.
- 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.

Crisis and Strategic Interactions

- Additionally, interactions between debtor and creditor states are also strategic.
- A state in default (a debtor state) would prefer to have its debt entirely forgiven, while creditor states (those that loaned to it, either directly or via corporations headquartered in those states) want full repayment of their loans.
- 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...

Governing International Finance

- Given the costs of financial crises and defaults, it is clear that financial stability is a public good.
  - Like all public goods in IR, it is undersupplied
  - Governments, banks, firms need access to loans
  - 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

Governing International Finance

- International institutions step in to fill some of those roles:
    - **International Monetary Fund (IMF)**: focuses on financial stability, serves as primary Lender of Last Resort.
    - Bank for International Settlements: provides regulations for international, large banks.
    - 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.

The International Monetary Fund

- The IMF's financial resources come from contributions from its member governments.
    - Larger contributions lead to greater voting power
    - U.S. has largest share (18%) followed by the EU (32%)
    - IMF rules require 85% supermajority to take action.
- IMF lending comes with conditions, often called **structural adjustment programs/conditionality**:
    - These are conditions partially for economic growth, partially for IMF to manage its own lending risk.
    - Requires a country to make economic reforms, usually cutting domestic spending via austerity measures.
    - These reforms are controversial domestically.

Protesting IMF Programs

Critiques of the IMF

- Effects of liberalization on economic growth (especially structural adjustments)
- Effects of IMF lending on growth (do countries actually recover?)
- Conditions are not always enforced
- Moral hazard, as with any Lender of Last Resort
- Potentially a tool for international investors
- Bias due to domination by rich developed Western states.

Alternative Institutions? The AIIB

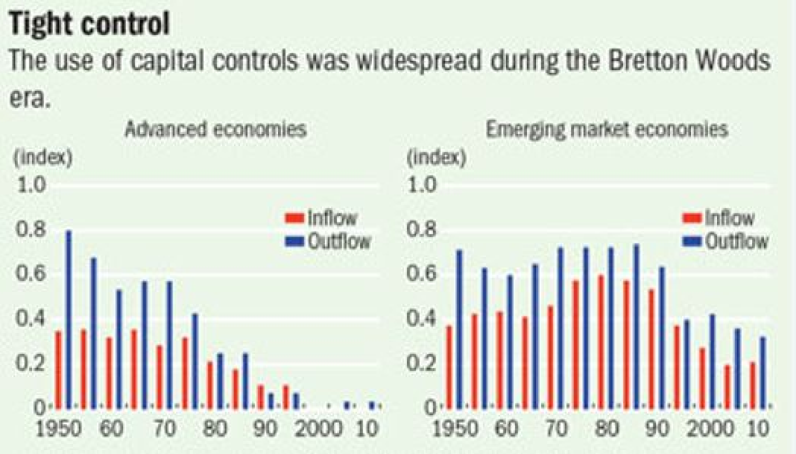
- Asian Infrastructure Investment Bank (AIIB) is a very new (2015) international financial institution.
  - China's power in it is similar to the US' in the IMF.
  - China uses its trade income to generate investment returns, some of which help fund this.
- As its name suggests, the AIIB loans to Asian countries (and some African states) to develop infrastructure.
  - Has also made several loans related to coronavirus response.
- The way the AIIB manages risk is quite different than the IMF.
  - Does not include the same structural adjustment reforms.
  - However, can include conditions of infrastructure ownership.
  - AIIB may not focus on traditional conditionality, but includes other conditions that benefit China.

Alternative Institutions? The AIIB

Implications of the AIIB:

- The AIIB means that the IMF is no longer the only entity that can act as a Lender of Last Resort.
- Previously, states in financial crises that disliked IMF conditionality had no real other options.
- AIIB provides an alternative to Western-dominated institutions, and may be less willing to cooperate with those institutions in traditional debt restructuring.

Financial Liberalization Over Time



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

- **Concessional finance**: giving or loaning money to the poorest developing states by both rich countries and intergovernmental organizations.
- These states are generally considered too risky to invest in, necessitating a form of finance that is closer to aid than traditional investment.
- The main international institution here is the **World Bank**.

Concessional Finance: The World Bank

The **World Bank** is...

- Officially named the International Bank for Reconstruction and Development.
- 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.

Concessional Finance: The World Bank

- The World Bank gets its funding by borrowing on member state financial markets, but usually at low rates due to its backing by member states.
- 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?

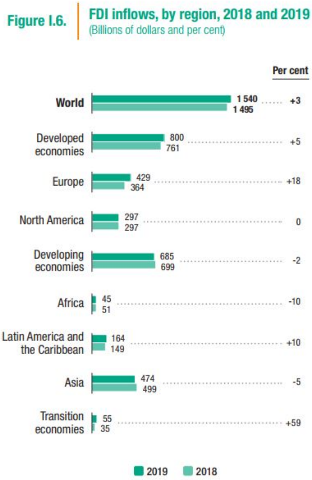
Foreign Direct Investment

- **Foreign direct investment**: a multinational company investing in a foreign state by acquiring local facilities over which it has direct managerial control.
- Another way to describe this is as the purchase of real assets that afford an MNC control over production.
- Multiple possible types of FDI:
  - Controlling stake in foreign entity
  - Setting up new commercial operation
  - Purchasing an existing commercial operation

Who Invests via FDI?

- **Multinational Corporations (MNCs):** firms operating in at least 2 states, with production/service facilities outside their state of origin.
- 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



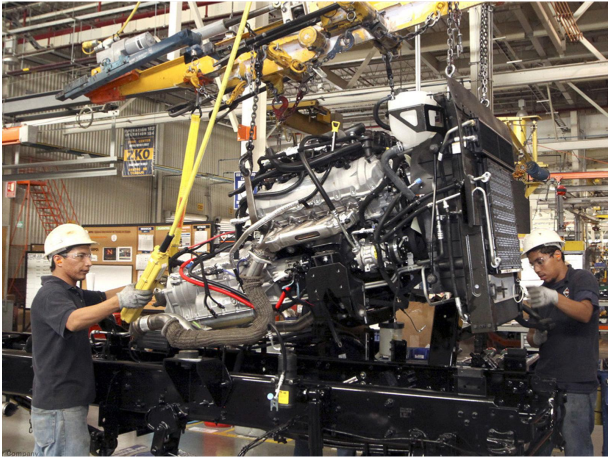
Types of FDI

Two kinds of FDI: horizontal and vertical.

- **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



Foreign Direct Investment

Relevance of FDI to international politics:

- Enormous portion of world financial flows
- Unique regarding control of production
- Most directly related to actual economic activity
- Pertinent for economic growth
- Generates conflicts of interest

Why Invest in Production Overseas?

From the perspective of an MNC, why engage in FDI?

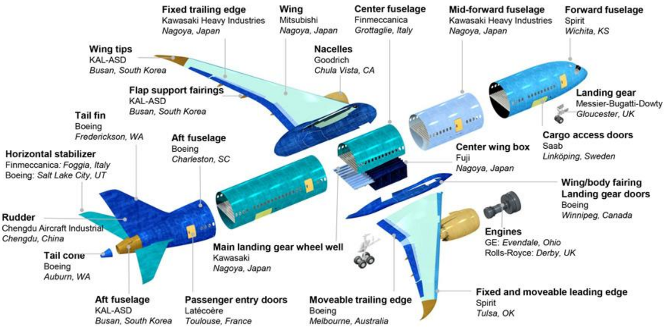
- Direct advantages of new locations:
  - Access to natural resources (e.g. ExxonMobil investing in Angola for oil).
  - Selling to new markets and avoiding trade barriers (via horizontal FDI).
  - Cheaper production costs, such as low-skilled labor (e.g. clothing produced in Bangladesh).

Why Invest in Production Overseas?

From the perspective of an MNC, why engage in FDI?

- General advantages to operating internationally (regardless of specific locational advantages):
  - Shifting profits between countries allows for tax avoidance. Ex: Google avoiding taxes on $22 billion via a series of transfers so common they have a name: Double Irish with a Dutch Sandwich.
  - Pre-investment bargaining advantages.
  - Cheaper supply chain input production.

Global Supply Chains

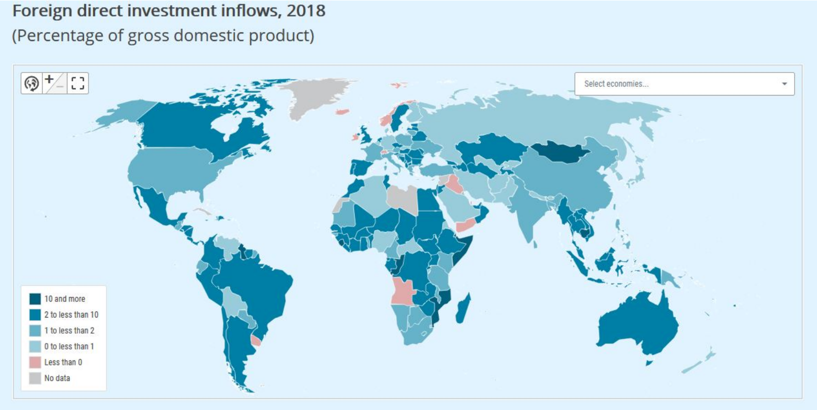


Why Allow FDI?

From the perspective of the state, what are the advantages?

- MNCs may have skills and technology that less-developed countries lack, especially in the case of natural resource extraction.
  - On-the-job training
  - Technology transfer
- Creates linkages in the host economy.
  - E.g. a Coca-Cola production facility might spur the development of local bottle-making and bottling facilities, creating jobs.
- Host governments can count on long-term, relatively stable tax revenues.
- Creates relatively high-paying jobs for citizens in developing states.

FDI by Country



Why Prevent FDI?

From the perspective of the state, what are the disadvantages?

- FDI may drive local firms out of business.
- MNCs may work in enclaves, rather than integrating into local economies.
- Higher-paying positions may not materialize, or may be given to immigrating foreign workers.
- MNCs use **investor-state dispute settlement** provisions of bilateral investment treaties to undermine government labor or environmental regulations.
- Developing countries may lack capacity to monitor MNCs.
- The MNC's home state may be upset that capital and production are moving elsewhere.

The Obsolescing Bargain

In their interactions, an MNC and a host government face a particular kind of commitment problem called the **Obsolescing Bargain**:

- **Before they make their investment, MNCs have almost all the bargaining leverage.**
  - They choose if and where to invest with no consequences for not investing in a given location.
  - 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)

The Obsolescing Bargain

In their interactions, an MNC and a host government face a particular kind of commitment problem called the **Obsolescing Bargain**:

- After the investment, an MNC has spent substantial time, money, and resources to establish their presence. **Now, due to the difficulty of easily exiting, host governments have all the leverage.**
    - 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

- Hosts control taxation and regulation, up to the point of nationalizing or taking over the company, and host states have done so:
  - 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.

Conflict Between Hosts and MNCs

- MNCs have a number of possible options in such a conflict:
  - Withholding capital and technology.
  - Transferring profits out of the country.
  - Withdrawing entirely, despite the costs of leaving.
  - 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)

Home Countries and MNCs

- The relationship between MNCs and their home/origin states has received far less attention from academics, until recently.
- Most post-industrial advanced economies have some kind of "reshoring" initiative to bring back jobs lost to vertical FDI.
- 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.

What about Institutions?

- Thus far, global institutions have not been mentioned. Why?
- **There are no global international institutions that oversee FDI** in the same way that the IMF oversees flows of capital. But why not?
- 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.

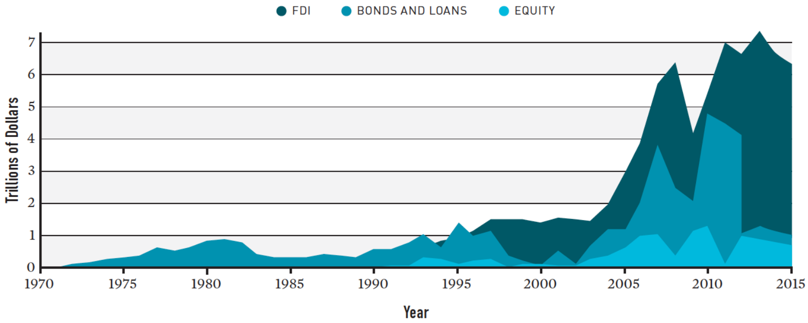
What about Institutions?

- Third reason: states have some bargaining tactics that can force a compromise.
  - 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.).

Bilateral Investment Treaties

- Instead of international institutions, countries use **bilateral investment treaties (BITs)** as smaller institutions to govern expectations regarding FDI between the two states.
    - 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

Why the FDI Surge in LDCs?

- Developing countries/less developed countries (LDCs), by definition, lack capital.
- Portfolio investments (bonds, stocks, loans) allow for local control of production, rather than MNC control.
  - Crisis contagion means *entire economy* may go out of control in a financial crisis.
  - LDCs might struggle to control investment.
- FDI, by contrast, cedes local control to MNCs.
  - No connection to contagion, so creates more financial stability.
  - Could generate more political instability?

Brooks, Cunha, Mosley (2015) Review

- What is this article about? Investors evaluate a given state's sovereign debt through the use of heuristic groups of perceived peer states.
- What mechanism drives their argument? Heuristic grouping, in which investors sort states by perceived similarity rather than true risk.
- What evidence do they provide? Quantitative.
- How might this connect to other forms of investment (namely, FDI)? FDI decisions may be made in a similar way.
- 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.
- In the event of a financial crisis, a sector of the economy (and/or the government of a state) defaults on its debts.
- 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.

Summary: Portfolio Investment

- The IMF tries to promote international financial stability, while also serving as a lender of last resort in financial crises.
- The price of an IMF emergency loan is frequently harsh, unpopular austerity measures.
- The IMF's decision-making process is dominated by the US and EU, leading to accusations that it is a tool of rich creditors despite its claims to impartiality.
- This has fueled the rise of a potential alternative in the form of the AIIB.
- In spite of the risks, international capital flows have continued to increase in recent decades.

Summary: Concessional Finance

- Concessional finance describes giving or loaning money to the poorest developing states, which are considered too risky for traditional investors.
- 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

- MNCs are drivers of FDI, because of profit advantages to producing outside of their home state.
- Host governments may welcome FDI because of its contributions to the economy.
- 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?