

INFORMATION, POLITICAL RISK AND THE COMPETITIVE ADVANTAGE OF BANKS

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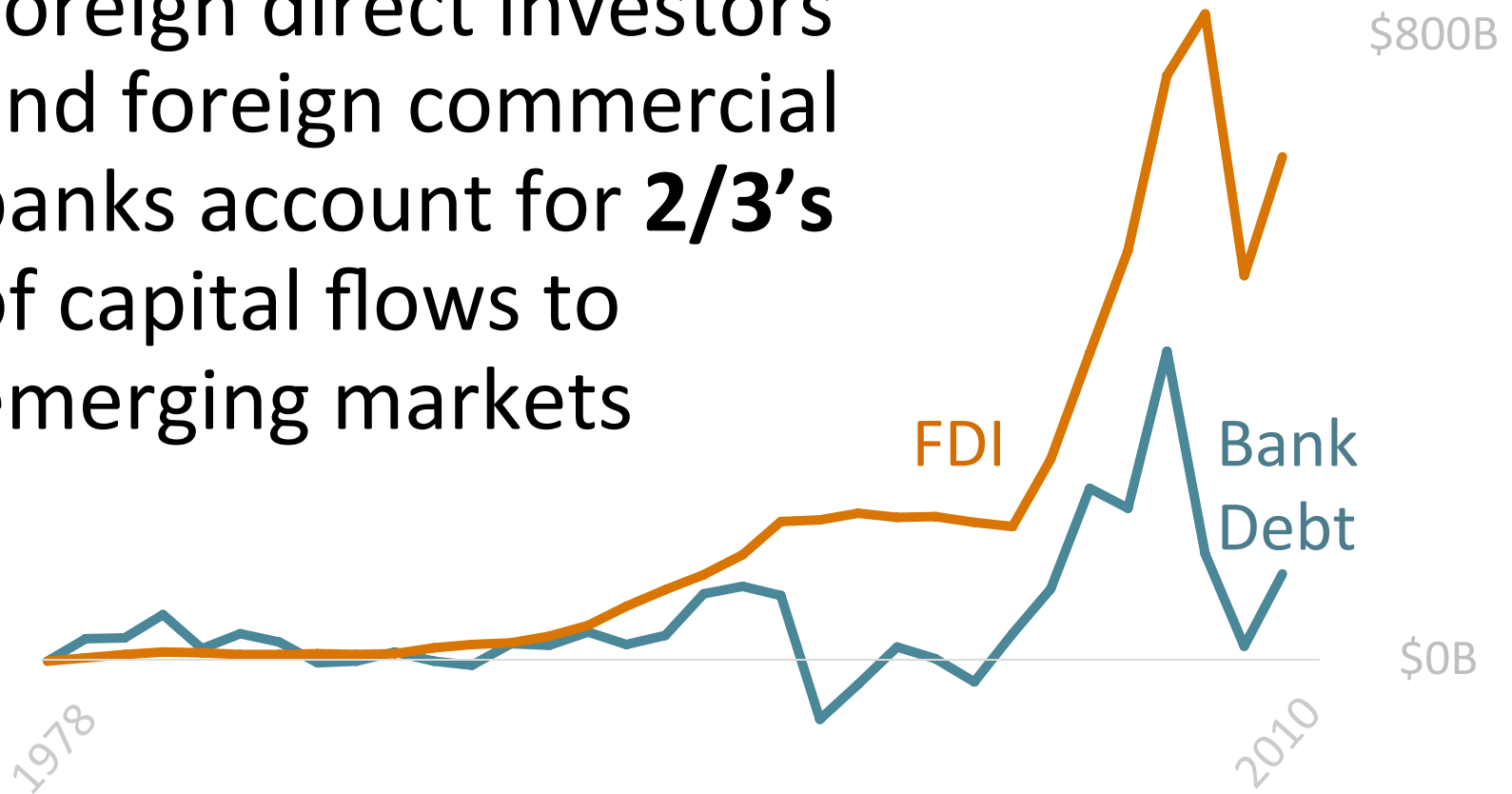
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GLOBAL CAPITAL FLOWS

- Foreign direct investors and foreign commercial banks account for **2/3's** of capital flows to emerging markets



- Banks matter

TRANSFER RISK

Transfer risk is **frequently encountered ...**

- ~55% of political risk insurance claims 3x annual rate of expropriation claims since 1970
- ~45 countries with restrictions, per year
- Even in politically constrained countries

Source: Berne Union, OPIC, IMF, Graham, Johnston, & Kingsley (2013).

... and matters to foreign investors

- 44% rate as highest or second highest impact on corporate risk assessment
- 18% suffered transfer losses in last three years
- 40% consider most concerning political risk

Source: World Bank, 2012.

HOW ARGENTINA STEALS

Expropriation:

REPSOL
YPF



\$10.5 Billion

Transfer Restrictions:



\$225 Million PER DAY

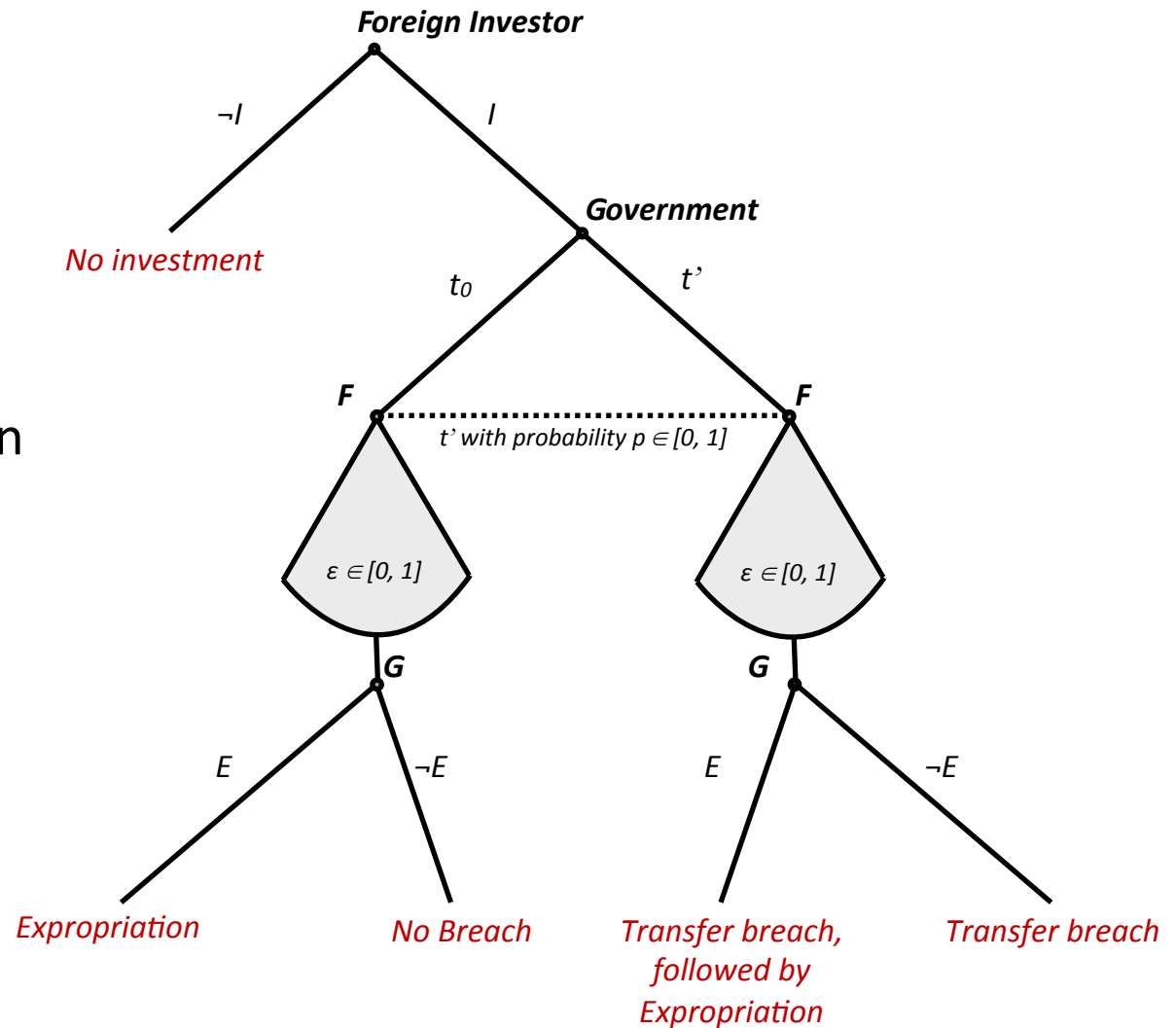
**Do investors
differ in their
vulnerability to
transfer risk?**

Why?

(So what?)

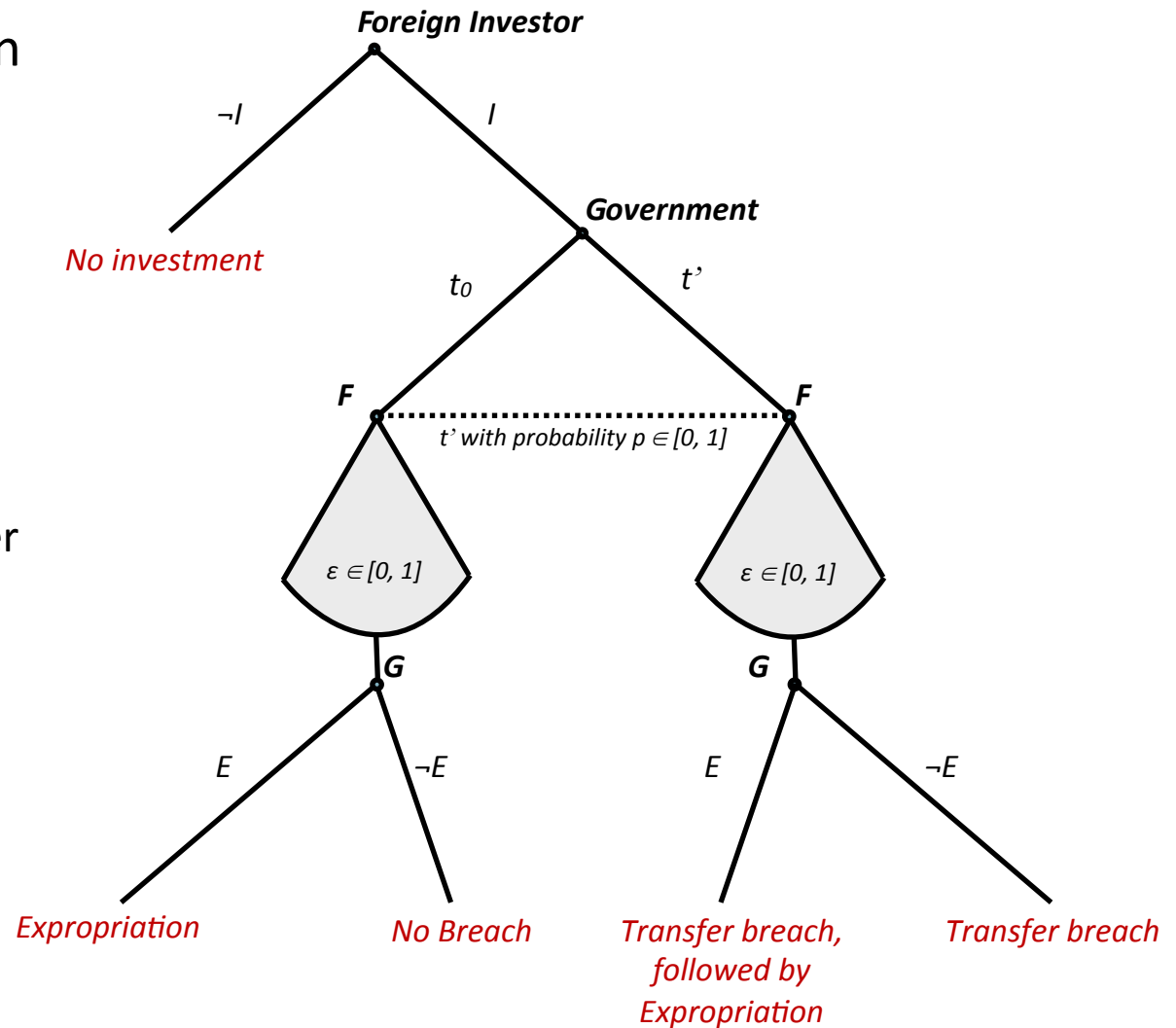
THEORY

- Investor and Government maximize revenues
- Expropriation and transfer rents are substitutes
- Government tension between seeking rents and avoiding political costs



THEORY

- Two types of foreign investor:
 - Bank
 - Direct investor
- Two critical dimensions:
 - Information about probability of government transfer breach (p)
 - Differences in costs of expediting repatriation (λ)



THEORY: FOREIGN INVESTORS

	COMMERCIAL BANK (Bank Debt)	DIRECT INVESTOR (FDI)
<p>INFORMATION on Probability of Transfer Breach</p> <p><i>H1: Public information about the local investment climate in the host country has a larger positive effect on inflows of FDI than on inflows of bank debt.</i></p>	<p>High: experience across host economy and access to relevant elites</p>	<p>Low: idiosyncratic experience limited in scope</p>
<p>COST of Expediting Repatriation</p> <p><i>H2: Flows of bank debt will respond more quickly to changes in transfer risk than flows of FDI.</i></p>	<p>Low: flexible investment with rapid exit option</p>	<p>High: illiquid investment with limited exit options</p>

DATA & SAMPLE

- **30 Emerging Markets**
 - **1994 to 2012**

 - FDI (net inflows, US\$M) (WDI)
 - Bank Debt (net inflows, US\$M) (IIF)
 - Transfer Risk (ONDD)
 - Investment Press Coverage (GJK)
 - Economic Transparency (HRV)
- Foreign Investment*
- Information*
- *Controls*: Trade (% of GDP), GDP per capita, GDP growth, Inflation, Natural Resource Exports, BITs

TESTING H1: INFORMATION

	Linear Regression with country & year fixed effects FDI	Linear Regression with country & year fixed effects BANK DEBT
Investment Press	+ **	+
Economic Transparency	+ **	+
GDP Per Capita (logged)	+ *	+ ***
Trade (% of GDP)	+ *	+
BITs (logged)	+ *	+
Transfer Risk	- *	-
GDP Growth	+	+ ***
Inflation	- **	+
Natural Resource Exports	- *	-
Observations	348	348

Public information has larger positive effect on FDI than on bank debt

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

TESTING H2: COST OF REPATRIATING

	Linear Regression Δ FDI	Linear Regression Δ BANK DEBT
Δ Transfer Risk	- ***	- **
Δ Transfer Risk (1-year lag)	-	+
Δ Transfer Risk (2-year lag)	- ***	+
Δ GDP Per Capita (logged)	+ ***	+***
Δ Trade (% of GDP)	+ **	+
Δ BITs (logged)	-	-
Δ GDP Growth	+	+ **
Δ Inflation	+	- ***
Δ Natural Resource Exports	-	+ *
Observations	497	497

FDI's adjustment to changes in transfer risk lags behind bank flows'

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

FINDINGS

- Information has *larger positive* effect on FDI

**Public information
matters most to FDI**

- Changes in transfer risk have immediate effect on bank debt but *lagged effect* on FDI

**Banks exit fast but
FDI moves slowly**

SO WHAT?

- Transparency is effective strategy for governments who want FDI
- Governments who don't want to be transparent can still recruit foreign capital
 - Banks have competitive advantage in opaque and risky countries
- FDI is not good proxy for “foreign investors”
 - Foreign investors heterogeneous
 - Wildly different capabilities

NEXT STEPS

- **Paper 1:** Effect of **domestic constraints** on different political risks (transfer and expropriation). *Under review.*
- **Paper 2:** Effect of transfer risk on **different foreign investors** (banks and direct investors).
- **Paper 3:** Effect of **foreign constraints** on different political risks (transfer and expropriation). *Draft in progress*
- **Book:** **Comprehensive model of political risk** (war, expropriation, and transfer risks). *Theoretical model in progress.*

THANK YOU

FORMAL MODEL

Assumptions: $V, R, \gamma, a, v, \pi, C_E, C_T \geq 0$
 $t, \mu, \beta, \varepsilon, \tau \in [0, 1]$

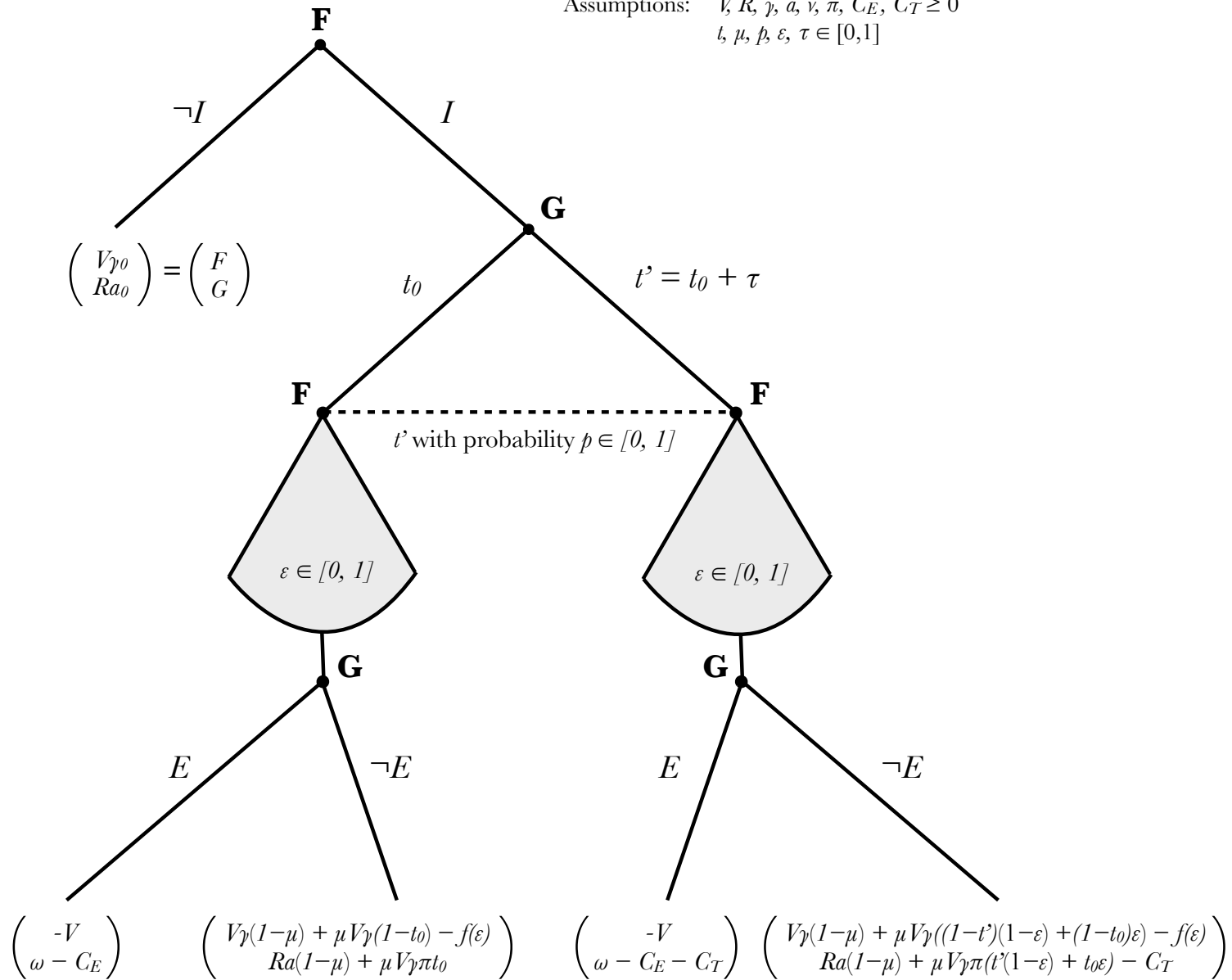


Table 1: Information and Capital Flows

	DV=FDI (logged, SD = 1)			DV=Bank Debt (logged, SD=1)		
	(1)	(2)	(3)	(4)	(5)	(6)
Investment Press Coverage	0.114*** (0.033)	0.088** (0.033)	0.096** (0.039)	0.103 (0.085)	0.081 (0.085)	0.032 (0.076)
Economic Transparency	0.561** (0.256)	0.751** (0.283)	0.762** (0.350)	0.185 (0.733)	0.530 (0.710)	0.254 (0.347)
GDP Per Capita (logged)		0.345* (0.205)	0.435* (0.217)		0.261 (0.461)	0.688*** (0.214)
Trade (% of GDP)		0.001 (0.001)	0.003* (0.001)		0.007 (0.006)	0.000 (0.004)
BITs (logged)		0.166** (0.071)	0.136* (0.069)		0.177 (0.140)	0.001 (0.075)
Transfer Risk			-0.050* (0.026)			-0.043 (0.030)
GDP Growth			0.001 (0.005)			0.019*** (0.005)
Inflation			-0.000** (0.000)			0.000 (0.000)
Natural Resource Exports			-0.009* (0.005)			-0.007 (0.009)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Constant	5.432*** (0.243)	2.386 (1.859)	2.061 (1.825)	3.533*** (0.677)	0.673 (3.184)	-0.727 (1.840)
Observations	461	445	348	461	445	348
R ²	0.560	0.572	0.574	0.163	0.169	0.254

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < .01$

Sample = developing countries only.

All independent variables are lagged one year.

Table 2: Change in Risk and Change in Investment Inflows (Logged)

	Dependent Variable = Change in Bank Debt Flows					Dependent Variable = Change in FDI Flows				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Δ Transfer Risk	-6.317*** (1.274)			-6.205*** (1.400)	-4.257** (1.654)	-4.801*** (1.340)			-4.768*** (1.485)	-4.366*** (1.544)
Δ Transfer Risk (1-year lag)		0.486 (1.551)		1.187 (1.559)	1.481 (1.661)		-3.483** (1.516)		-3.051* (1.618)	-1.051 (1.804)
Δ Transfer Risk (2-year lag)			2.746* (1.464)	2.235 (1.444)	1.369 (1.527)			-2.973** (1.501)	-3.299** (1.468)	-5.100*** (1.532)
Δ GDP per capita (logged)					103.118*** (27.857)					108.022*** (30.032)
Δ Trade (%of GDP)					0.030 (0.103)					0.249** (0.106)
Δ BITs (logged)					-8.546 (9.745)					-10.183 (9.718)
Δ GDP Growth					0.541** (0.225)					0.030 (0.252)
Δ Inflation					-0.014*** (0.003)					0.004 (0.010)
Δ Natural Resource Exports					0.331* (0.198)					-0.090 (0.230)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	1.377* (0.769)	1.516* (0.804)	1.630** (0.827)	1.341 (0.828)	-1.543 (1.181)	3.585*** (0.783)	3.656*** (0.816)	3.289*** (0.845)	2.803*** (0.860)	0.049 (1.290)
Observations	664	627	588	588	497	664	627	588	588	497
R ²										

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < .01$

Sample = developing countries only. DV is the annual change in investment flows (logged).

Table 3: Change in Risk and Change in Investment Inflows (Unlogged)

	Dependent Variable = Change in Bank Debt Flows					Dependent Variable = Change in FDI Flows				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Δ Transfer Risk	-1851.988*** (489.833)			-2132.868*** (563.448)	-1056.742 (738.345)	-594.251** (239.462)			-730.819*** (269.652)	487.001 (620.026)
Δ Transfer Risk (1-year lag)		165.387 (390.640)		334.955 (412.161)	360.090 (653.168)		-640.439** (301.903)		-653.051** (319.273)	323.650 (594.460)
Δ Transfer Risk (2-year lag)			-314.425 (467.880)	-488.767 (455.732)	-708.468 (550.777)			-779.273* (440.873)	-834.508* (447.915)	-899.935 (572.664)
Δ GDP per capita (logged)					44211.387* (24547.566)					69357.930** (23486.201)
Δ Trade (%of GDP)					-47.913 (36.871)					120.084** (46.863)
Δ BITs (logged)					993.907 (2438.517)					1005.841 (2436.676)
Δ GDP Growth					327.366** (163.420)					-151.156 (116.897)
Δ Inflation					0.275 (1.975)					2.484** (1.235)
Δ Natural Resource Exports					-20.066 (61.235)					42.776 (41.142)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-46.769 (312.454)	26.572 (329.301)	-23.812 (343.445)	-127.473 (352.641)	-1296.478* (727.959)	683.673** (312.664)	698.472** (331.752)	691.131** (341.585)	603.417* (356.022)	-1182.780* (622.968)
Observations	667	630	591	591	500	667	630	591	591	500
R ²										

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < .01$

Sample = developing countries only. DV is the annual change in investment flows (unlogged).