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FDI and sanctions: An empirical analysis of short- and long-run effects

Irina Mirkina

School of Economics and Management, Lund University, Box 7080, 220 07 Lund, Sweden

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ABSTRACT

Although the relationship between trade and the success of international sanctions has been a topic of many debates in political economy over the past 30 years, the effect of sanctions on foreign direct investment (FDI) is still largely unexplored. Using the data for 184 countries from 1970 to 2010 and bias-corrected estimators, this study tests the effect of sanction imposition on foreign investment. I find that the effect of sanctions on foreign investment indeed changes over time, depending on sanction costs, primary sanction imposer, and decade. High-cost sanctions lead to a significant decrease in FDI in the short run, although they do not have a long-run effect. In many sanctions episodes in the 1990s, FDI has been negatively affected in the short run, although this effect has partially dissipated in the long run. Sanctions episodes from other decades, on average, did not have a significant effect on foreign investment.

1. Introduction

Economic and political effects of international sanctions have been a focal point of many debates in both political economy and international relations over the years. Governments have placed embargoes and travel bans on other governments and their officials—all in the hope that falling volumes of foreign trade and investment will force the target states to succumb to harsh economic consequences and to change their policies. Early findings from the studies on economic coercion showed that its use had significant negative effects on target states, particularly in combination with military intervention (for a review of early studies, see Gray and Licklider, 1985; Morgan and Schwebach, 1997; Blanchard and Ripsman, 1999). A change of tune in the late 1990s was based on the overwhelming evidence that only a moderate share of the coercion cases could be called 'successful,' i.e., taking such a great toll on the targeted country that it would force a change in its policies or a government replacement (Drury, 1998; Drezner, 1999; Pape, 1997; Allen and Lektzian, 2013; Allen, 2005; Bapat et al., 2013; Jones, 2015).

The puzzle of such a mediocre success of coercion episodes comes primarily from the fact that the restrictions and barriers established by one state could be seen as business opportunities by others. Various types of sanctions are generally aimed at restricting trade flows in the most sensitive sectors, imposing travel bans on government officials or limiting access of national banks to the global financial market. But FDI could in many instances help to substitute for a large share of import flows and loaned financial resources (Lektzian and Biglaiser, 2014; Early, 2009; Peksen and Peterson, 2016; Hatipoglu and Peksen, 2018). Moreover, the rise of FDI in the past 50 years led to a greater mobility of both production and capital across countries. In a globalized world, sanctions intended to harm the host economy could lead, in fact, to a salient growth in the auxiliary flows from other sources. Such growth could not only secure the target's independence from the relations with the imposer of sanctions, but also have a consolidating effect on its economy, change the

E-mail address: i.mirkina@gmail.com.<https://doi.org/10.1016/j.ejpoleco.2018.05.008>

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structure of its trade networks, and diminish the sanctions success—as, for example, Dizaji and van Bergeijk (2013) demonstrate in case of Iran. On the other hand, if many multinational companies at once decide to move their investment elsewhere due to increased risks in the sanctioned country, such a move could have a devastating economic impact on the target even when trade sanctions are not as harmful per se. Therefore, ignoring the FDI-sanctions nexus could misguide the interpretation of coercion research findings and mislead policy decisions. This paper fills this gap in the literature by examining a large panel dataset of coercion cases and employing bias-corrected estimation techniques to address various methodological issues.

2. Literature review

To analyze the effect that coercion may have on multinationals' decision to invest in or disinvest from an economy, the paper relates to two largely opposing theories. *Political risk theory*, following the works of Haendel (1979) and Simon (1984), explains how instability in foreign systems influences investment opportunities. Investors in this theory are generally portrayed as moral, risk-averse, and cautious. They seek to minimize political, financial, and operational risks, as well as the costs of combating those risks. Hence, they choose the host countries with better protection of property rights and investment support, withdraw from the regions where conflict and violence arise, and avoid links to ill-reputed places with illegal practices, such as money laundering or support of terrorism (for a review of the literature, see Busse and Hefeker, 2007; Hayakawa et al., 2013). International sanctions, according to this theory, send a strong signal of an increasing level of risk. Banned imports or limited banking operations mean that the host market's capacity will shrink, reducing the rate of return to investment. Any prospects of future development and market expansion become dubious, as the host economy struggles to survive. Sanctions imposed on non-democratic governments could also indicate higher risks of political instability, impending armed conflicts or civil unrests, as well as potential reputation losses to the investors. Biglaier and Lektzian (2011), for instance, argue that US firms often anticipate sanctions and disinvest prior to their imposition. Many studies support this view by providing evidence of the foreign investors' withdrawal from the sanctioned countries and the shattering consequences of such a withdrawal for their economies (e.g., Posnikoff, 1997; Kaempfer and Lowenberg, 2007; Lektzian and Sprecher, 2007).

Another theory—discussed in the literature under the umbrella term of *economic opportunism*—portrays multinationals as rational and opportunist (Rugman, 1986; Williamson, 1981). Studies that support this theory are motivated by the examples of investors cooperating with authoritarian regimes and turning a blind eye to the violation of human rights as long as their profits are steady and growing (Peksen and Drury, 2010; Oechslin, 2014). According to this theory, investors would see the imposition of sanctions as a way to exploit the targeted country's market with little to no competition from imports. They would offer financial resources to the domestic companies that could no longer borrow money abroad or survive with their own resources. They would further try to oust the competition even in those sectors that are not directly affected by sanctions. Finally, if a multinational company decides to disinvest from the targeted country, some others might be ready to replace the fleeing capital. This line of argument is supported by the research findings in Early (2009); Barry and Kleinberg (2015), Shin et al. (2016); Lektzian and Biglaier (2013); McLean and Whang (2010), among many others.

The mixed findings endorsing both of these theories contribute to one of the largest pieces of the sanctions puzzle. To resolve it, one must take into account two issues: asymmetrical impact of coercion across countries and the changes of such impact over time. First, different countries may respond differently to sanctions—based on their pre-sanctions development, involvement in the global economy or their military and non-military cooperation. While most of the early empirical studies have implicitly assumed the homogeneity of the parameters, recent studies rely on the advanced bias-correcting techniques that relax such assumptions and allow the effect of sanctions to be heterogeneous among the target countries. The second important aspect that has not been yet addressed in coercion studies is the variation in the effect of sanctions on investment over time.¹ Kaempfer and Lowenberg (2007) present a theoretical model that shows that the short-run effects of sanctions on both foreign and domestic investment would be different from those in the long run, leading to a possible increase in the rate of return to investment immediately after sanctions imposition, but ultimately causing higher production costs and lower profits when the capital resources have drained away. Once the structure of the target economy adjusts to a new equilibrium, the effect of coercion on FDI may well be different in direction and magnitude. This paper provides novel insights for both of these important issues, as it focuses on the heterogeneous effect of international sanctions on foreign investment across countries, while also disentangling short- and long-run effects.

3. Empirical specification

3.1. Dynamic common correlated effects mean group estimator

The vast majority of the early studies on sanction consequences relied on conventional estimation methods, such as pooled ordinary least squares (OLS) regressions with country or time fixed effects. Only more recent studies came to question the validity of the OLS assumptions in application to sanctions research and to employ various bias-correcting techniques.² The use of more advanced models to

¹ A few studies have demonstrated that the dynamics of sanction effects matters for other economic indicators, e.g., Neuenkirch and Neumeier (2015) analyze the dynamic effect of sanctions on economic growth, Avetisyan and Lektzian (2018)—on domestic production and trade, Shin et al. (2016)—on trade, direct and portfolio investment, Gutmann et al. (2017)—on life expectancy.

² E.g., Shin et al. (2016) advocate the use of panel corrected standard errors (PCSE) with AR(1) and robust error correction, and Dizaji and van Bergeijk (2013) use vector autoregressive models (VAR).

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