In the Eye of the Beholder: Institutions, Political Risk, and China's Multinational Corporations

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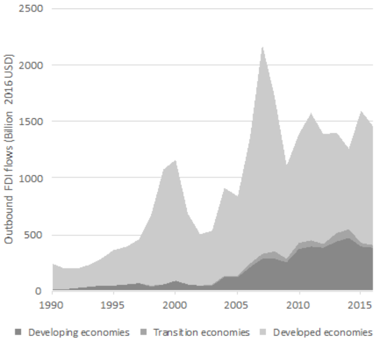
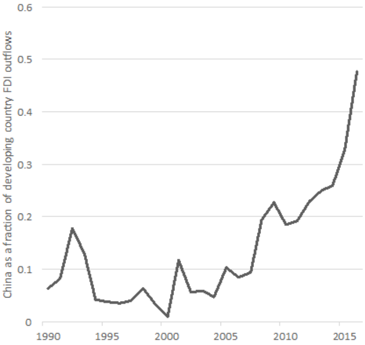
Motivation





Growing importance of FDI from emerging markets

China is the largest investor among emerging economies and second overall

Empirical Puzzle

- Political risks in host countries strongly associated with Chinese FDI (Buckley et al., 2007).
- China invests heavily in "pariah states" (Foreign Affairs, 2008).
- Chinese investors particularly attracted to countries rich in natural resources but with poor institutions (Kolstad & Wiig 2012).
- Yet, all existing studies rely on aggregate FDI flow data or anecdotal observation, and thus provide little insight into how Chinese MNCs perceive and respond to political risks.

How do Chinese MNCs perceive political risk and political institutions in host countries?

- Focus on policy uncertainty and regime type

Political Risk & EMMNCs

- Home-country embeddedness ⇒ political capabilities (ownership advantages) ⇒ less sensitive to political risk or even risk-prone.

- We argue that:
  - Risk mitigation strategies in weak institutions often extra-institutional (e.g., building political connections)
    - Firms lack institutionalized assess to policy-making.
    - Lack of credible commitment ⇒ high risk of reneging on agreed-upon policies.
  - Not transferrable because they are context-specific.

Hypothesis 1: Chinese MNCs are sensitive to political risks in host countries.

Regime Type & EMMNCs

- Democratic advantages
  - Checks and balances, credibility, political constraints, rule of law, etc. (e.g., Ahlquist 2006; Jensen 2003, 2006; Li & Resnick 2003)
- Autocratic advantages
  - Monopoly rents (e.g., Li & Resnick 2003; Wright & Zhu 2018).
  - Institutional familiarity (e.g., Athreye and Kapur 2009; Holburn & Zelner 2010).

H2a: Chinese MNCs favor authoritarian countries.

H2b: Chinese MNCs favor democratic countries.

An Experimental Vignette Approach

- A vignette experiment w/ 2×2 factorial design:
  - Regime type: democracy versus autocracy.
  - Policy instability—a primary concern for foreign investors (Henisz 2000; Holburn & Zelner 2010; Knack & Keefer 1995).
  - Confounding in observational studies.

		Policy Stability	
		Stable	**Adjusted frequently**
Democratically	**Yes**	Demo w/ Policy Stab.	Demo w/ Policy Instab.
Elected Govt.	**No**	Auto w/ Policy Stab.	Auto w/ Policy Instab.

Description of Vignettes

"Country X is a middle income developing country with a population of 30 million. For the past three years its economy has grown at 4.5% per year on average. The leader of this country **is/is not** democratically elected. In the past few years, the country's currency, fiscal, taxation, and tariff policies have been **stable/adjusted frequently**."

Experimental Design

- Firm executives randomly assigned one of the four vignettes.

- Firstly asked to rate the above business environment.

  1. Very bad 2. Bad 3. Fair 4. Good 5. Very good

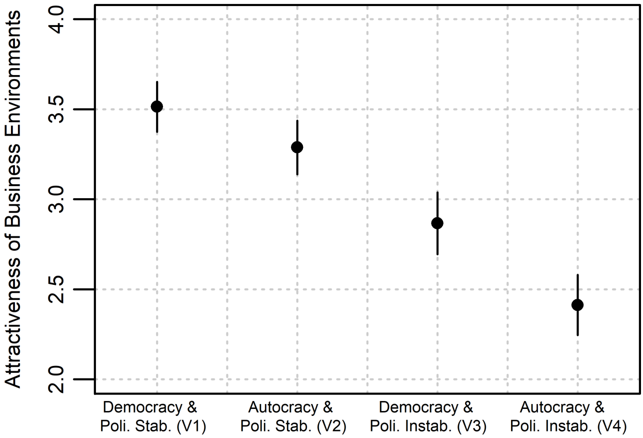
- Secondly asked about how they would like to invest.

  1. Wholly owned subsidiary; 2. Majority-owned joint venture;
  3. Minority-owned joint venture; 4. Equity investment;
  5. No investment; 9. Cannot answer

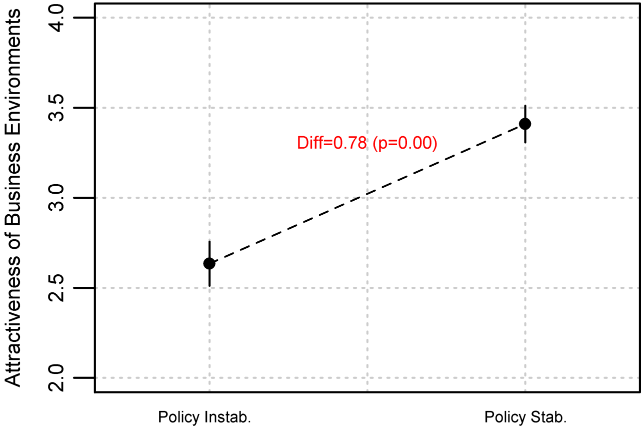
China Outward Direct Investment Survey (CODIS)

- A business survey of the risk perceptions and investment strategies of Chinese outward investors.
- 2014 module implemented between June and October 2014 in collaboration with CCPIT & Tsinghua University.
  - 601 responses in total.
  - A mix of random and convenience samples.
    - Results are consistent and robust with post-stratification weights.

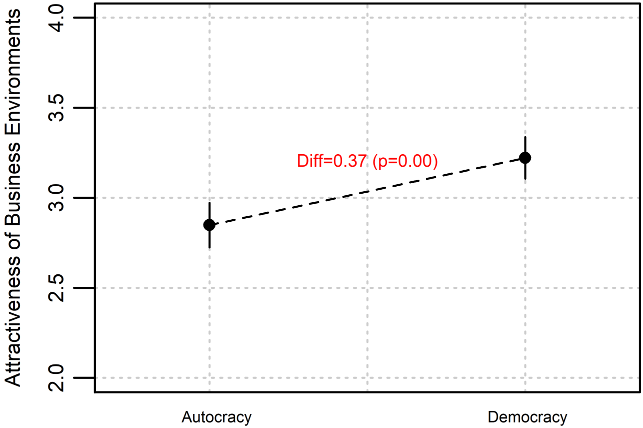
Perceived Attractiveness of Business Environments (Pooled Results)



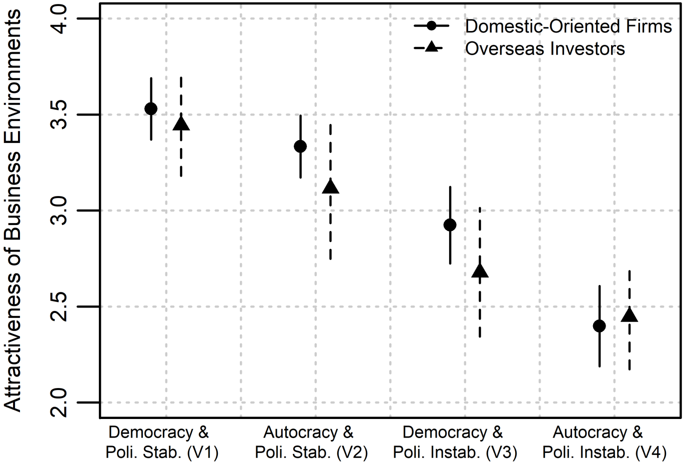
Policy Stability vs. Policy Instability



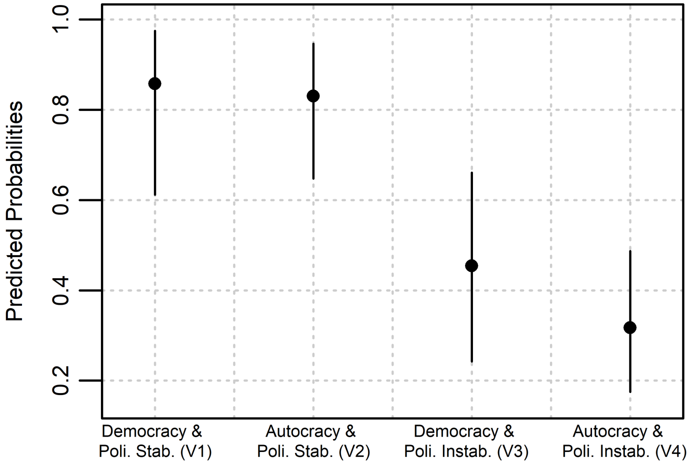
Democracy vs. Autocracy



Domestic vs. Overseas Investors



Market Entry Decisions (Overseas Investors Only)



Conjoint Analysis

- Embedded in the 2015 Module of CODIS
  - Two economic attributes
  - One regime attribute
  - Four political risk attributes

Macroeconomic conditions	Stable/Unstable
5-Year Average Growth Rate	Negative/Little/Moderate/High
Selection of Political Leaders	Democratically/Non-Democratically Elected
Expropriation Risk	Almost None/Some
Demand for Unofficial Payments	Seldom/Frequent
Policy Consistency	Low/Moderate/High
Risk of Armed Conflict	Low/Moderate/High

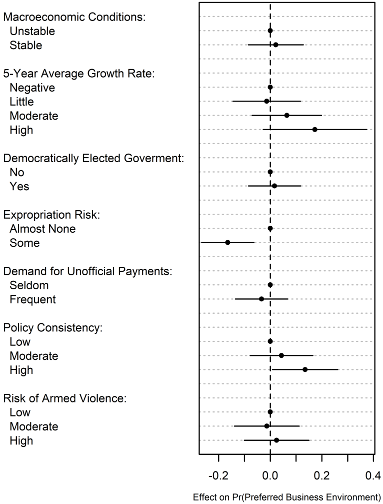
Illustration of the Conjoint Experiment

	Country [A] is a developing country and open to foreign investment	Country [B] is a developing country and open to foreign investment
Macroeconomic Conditions	Stable & Little Volatility in Growth Rates	Stable & Little Volatility in Growth Rates
5-Year Economic Growth Rate	Moderate	Negative
Selection of Government Leader	Democratically Elected	Non-Democratically Elected
Demand for Unofficial payments	Seldom	Frequent
Policy Consistency	Moderate	High
Risk of Armed Violence	Low	Low

"If your company were going to invest in these two countries, which one is more attractive?"

1. Country A
2. Country B

Conjoint Analysis Results



Conclusion

- **Findings:**
  - Policy instability matters more than regime type per se.
  - Chinese investors are sensitive to political risk in host countries, e.g., expropriation & policy instability.
  - Contrary to the popular perception that Chinese investors favor pariah states, they have no preference for authoritarian countries.
    - A slight preference for democracies.
- **Contributions**
  - First experimental study of Chinese MNCs and political risk.
    - Shed light on the behavior of Chinese investors.
  - Add to the debate on regime type and FDI in two ways:
    - Contribute direct evidence from firm executives.
    - Regime type weighted less than specific political risk.