Chapter 3
The Effects of Political and Economic Risk on FDI:
A Theoretical Survey

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ABSTRACT

Foreign direct investments (FDI) are becoming the key element in achieving development in developing countries. On the global scale, FDIs reached the level of $1,75 trillion back in 2016. FDI also brings lots of economic benefits to host countries. However, beyond these economic indicators, political structure and social characteristics of a host country also have special importance for investors' decisions. Political risk indicators cover mainly democratization level, political/government instability, war, immigration problems, problems with neighboring countries, internal and external conflicts, corruption level, military and religious influence on politics, law and order, ethnics tensions, property rights protection, national security and geographic situation - all of these factors also deeply affect decisions on FDI. Also, some basic social characteristics for host countries can play the catalyzer role for FDI, such as literacy rate, education opportunities, etc. The aim of this study is to examine theoretically the relationship between political and economic risks on the one hand with FDI on the other. It is aimed to show the theoretical background for the political and economic risk factors. Statistical figures on the FDI trends worldwide will be also presented.

INTRODUCTION

Risk is a concept of daily life that affects economic and social decisions of individuals. Individuals direct their activities assessing the risk factors in the course of decision-making. Likewise, investors make their decisions on to invest or not by paying attention to the risk factors of their activities. Political risk, a type of risk that an investor is exposed to, is also one of the important factors affecting investment decisions. It is among the factors that investors primarily consider when deciding on foreign investments. Political risks that are not under their control and make it difficult to recover sunk costs are decisive for foreign direct investors.

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Since the 1990s there have been significant increases in foreign direct investment volumes all over the world. Today, too quick changes in political risk elements require foreign investors to be more careful. This is especially concerns the influence of globalization, since both trade and investment can easily go beyond the borders. Both investors and host countries of FDI mutually benefit from this situation. Key advantages from cross-border investments can briefly be summarized as lower production costs, large market volume and high profit expectations.

Countries that are unable to save enough and have saving deficit, aim to increase their production volumes by hosting foreign direct investments, thus providing high earnings, employment potential and technology transfers. To this end, foreign direct investment is being encouraged for host countries. Foreign direct investment is a bigger priority for developing countries. In these countries, the inadequacy of capital accumulation and low level of savings can lead to inadequate investments. This situation causes the production level of the countries and the national income decrease accordingly. Inadequate production causes the level of employment fall below potential and income per capita stabilize at rather low levels. Thus, developing countries are constantly seeking to break this vicious circle of poverty, and one of the potential ways to do that is through foreign direct investments' inflow. In other words, developing economies often hope to find solutions to their chronic economic problems via FDI inflows.

The influence of globalization and neoliberal policies has increased the interdependence of all countries. This necessitates greater cooperation with foreign traders and investors, but also requires the presence of foreign trade in these countries. For this reason, they should not be independent of financial, political and socioeconomic developments in the world beyond their national boundaries. Any socioeconomic development experienced by trade partners in the course of their cross-border cooperation affects these countries rather spontaneously. Similarly, political risks posed by trading partners can affect trade and investment volumes on both sides of cooperation.

The tendency of developing countries' shares' increase in the global FDI volumes which is mostly due to political and economic vulnerability of the early 2000s is also reflected the investors' most worried factors. The World Investment and Political Risk (WIPR) Report of the Multilateral Investment Guarantee Agency (MIGA) as of 2013 shows that political risks are second only to macroeconomic stability with little difference (World Bank, 2014).

According to the UNCTAD database, by the end of 2016 the total FDI inflows in the world reached the level of approximately 1,8 trln USD, with 1 trln falling on developed countries and the rest of 600 bln - on developing countries. FDIs which demonstrated several falls before and after the global crisis, increased in 2015 and then in 2016. During the Arab Spring of 2010 which spread all over the Middle East and North Africa (MENA) countries and was triggered by socioeconomic reasons as well as political corruption, the effects of political risks on FDI volumes were felt quite strongly. Events related to political and global concerns such as the 9/11 attacks in the USA, the London subway attack, the Spanish attack, tensions in the Middle East, the Arab Spring, the Syrian crisis and the immigrant problems show how political risks can affect FDI volume and how difficult it can be to foresee those risks due to the impossibility to predict such events. In addition, security threats and terrorist attacks in developed countries confirm the assumption that political risks are not be limited only to developing countries with their governmental instability. This situation makes FDI investors' decision-making an even more difficult task.

This study attempts to theoretically examine the effects from political risks on foreign direct investment decisions. First, the concept of risk will be defined, then the concept and types of political risk will be explained. Statistical data on both variables will be presented, specifying the foreign direct investments

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