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The Volatile Effect of Conflict Risk on Foreign Investment

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Abstract

The opportunities of investment brought along by the global economic integrity might turn into a threat in an instant and undermine the underlying structures of national economies. It is necessary to analyze the conflict risk properly in terms of both portfolio investment and finance strategies. This is an important step to be included in the process of arriving to a rational decision. In that way, the existing investment risks could be priced more efficiently. It is proved on Collier and Starr models that there is a correlation between the conflict risk and unemployment, economic recession, inflation and fiscal discipline. In brief, the breakdown in the economic parameters increases the conflict risk and a progress occurring in the opposite way, decreases that risk. In this study, it is discussed the effects of the conflict risk for foreign investment availabilities.

Keywords: Foreign direct investment; volatile effect; conflict risk; investment climate

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1. Introduction

Creating uncertainty and trust issues, conflict risk affects the behavior of local and international investors. It is stated in the earlier chapter that the economic aspect of the conflict is of primary importance, rather than political, ethnic, and religious ones. In the first section, it is pointed out that especially in the globalization process the security concerns increases in the undeveloped countries and the emerging economies dependent on the financing provided by foreign investment are adversely affected by the capital movements.

In the econometric model of Starr, it is set forth that the states applying an efficient monetary policy appeal international investments after the conflict and they are integrated in the global economy much faster. As a result, the conflict risk decreases in parallel with the economic growth. Therefore, the increase of national income of a country with emerging economy after the conflict is associated with foreign capital investments.

It is an important recovery move for the economies after the conflict that countries undergo a process of foreign expansion financially.

According to Kula, "*There are two outright benefits of financial foreign expansion (World Bank, 1997): Thanks to the foreign capital inflows through the foreign expansion, domestic investments will increase. Moreover, foreign capital will remove the risk that might arise out of the fluctuations in the expenditures of the domestic investment and consumption"* (Kula, 2003; World Bank, 1997).

The most important impact that is expected as a result of foreign direct investment is the economic growth. According to Güven, "*Economic growth will bring along secondary advantages, in other words, externalities. In a*

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growing economy, unemployment will decrease, tax revenues will increase and most probably, exportation will also increase." (Guven, 2007: 64).

The capital provided directly by foreign capital investments, the knowledge, experience and the technology transfer increase the national income (see. Annex 1 and Annex 2). As Caliskan stated:

Foreign direct investments have a key role in the integration of a national economy in the globalizing economy. They provide capital inflow and also bring along management skills, "know-how", the transfer of new technology and they increase the resources of marketing, export and employment. Therefore they have an important role in the development of countries which have saving gap and difficulty in producing technology (Caliskan, 2003; Turkmen, 2006: 14).

Foreign capital inflows have a vital role for underdeveloped economies and the ones recovering from the conflict. *"One of the most important restraints that underdeveloped countries face during their recovery process is the fact that they lack capital. The cycle of low saving and low investment due to the low income canalizes the underdeveloped countries into the external savings"* (Kula, 2003: 141).

According to Karluk, *"The main reason of the economic problems in the developing countries like Turkey is the "lack of resources". Economic development requires investment. Without investment, development is not achieved, production does not increase. Therefore, investments assume a key role in economic development"* (Karluk, 1999: 98).

2. Foreign Direct Investment and Economic Growth

"Foreign direct investment" is examined in many dissertations and articles in the international literature. External cash inflow means the capital transferred from abroad into a country. On the other hand, "foreign capital" is the external supplementary contribution to the capital accumulation in a country.

In the definition of Rıdvan Karluk, the term "direct" explains that the capital brings along technology, know-how and the knowledge of business administration. Thereby, direct investments in the international economic theory differ from the "portfolio" investments made through the purchase of stocks and bonds from the international capital markets.

Production means gathering supply-side needs in order to provide for people's needs. It is the effort to meet the increasing demand. In a national economy, if the quantity and quality of the products and services increase, social needs could be supplied more efficiently. Therefore, economies that are able meet their demands stand out with their production capacity. For instance, colony empires were confronted with the problems of rising unemployment, inflation, lack of resources and famine as a result of leaving this system. The total of the products and services produced at a certain time in order to meet people's needs constitutes the national income (Orhan & Erdogan, 2008: 242). "*Economic development is the real increase of production in a country. The production of an economy is analyzed through the production function. Production function is a mathematical expression which shows the way the inputs such as physical capital, manpower, unskilled labor, natural resources are gathered in order to produce outputs"* (Kula, 2003: 141).

Within the operating mechanism of economy, national income brings along *income and expense stream*. In this cycle, the factors contributing to the production process earn an income, and this income returns to the economy through spending. Part of the income gained within this mechanism encourages production through expenses and the unexpended part constitutes savings and investments. Therefore, it is necessary to have market efficiency and the efficient functioning of intermediary firms in order to equilibrate between the investments and savings. This equilibration enables to have market interest rates at an optimum level and gives the opportunity to investors for optimum borrowing and meeting the increasing demand.

GDP is one of the concepts defining national income. In an economy, market value of all final products and services produced at a certain time is expressed through GDP concept. The calculation of GDP is based on the market value of the products and services produced within the country (Kula, 2003: 245). GDP defines national income, and it is analyzed according to the methods of production, income and expense. Expense management is based on the assumption that the income is spent on the final products and services. In a self-enclosed economy, the total of the expenses made by the base units of economy are equal to GDP (Seyidoglu, 2003-a). Household expenditure is expressed as the consumption expenditure(C), expenditures made by the companies are expressed as capital expenditure (I) state expenditures are called as government spending (G). Net export is stated as (X-M).

$$Y = C + I + G + X - M$$

The level of national income is specified through the analysis of the total supply and total demand. Keynes's national income theory sets forth that in an economy, the national income could be balanced only when the total

expenditures are equal to total national production (Seyidoglu, 2003-b). If the net export is negative, it shows that the country spends more than it earns. In an economy, the increase of national income enables the increase of export. It is named as propensity to import in economy. In order to balance the import and export gap, the total expenses, that is to say, the national income should be stabilized through fiscal policies.

In Starr's model, it is set forth that the efficient monetary policies influence the national income. The risk of conflict is reduced when inflation decreases and employment -during periods when efficient fiscal policies are in force- increase. In that way, the national economy is more integrated in the foreign market and affected positively by the international trade and capital flows. Growing economy reduces even more the risk of conflict. In Collier's analysis, the influence of the level of income on the conflict risk is measured as 40%. Considering the influence of the export on the employment and the level of income, it is possible to suggest that there is a relation between the increase of export and the decrease of the conflict risk. Therefore, World Trade Organization, World Bank and IMF play active role during the reconstruction phase the countries undergo after the conflict (Forman, Patrick & Salomons, 2000).

There are some restrictions of providing the balance of foreign trade through the fluctuations in the national income. The first one is the issue of discrepancy between the internal and external balance. In a country which has external deficits and faces the problem of unemployment because of the lack of demand, reducing the total expenses worsens the problem of unemployment (Seyidoglu, 2003-b).

Considering the influence of international capital and trade flows on the national income and employment, capital movements and the relations with the foreign market could be pursued through the balance of payments. The balance of payments is the systematic record of economic transactions that natural persons, businesses or corporations in a country conduct with the foreign. Along with the international economic activities and processes regarding the products and services, transactions regarding the factors of production are also counted among this group. Accordingly, cross border trade and production of products and services, short and long term transnational capital flows, direct investments, international labor force activities and technology transfers are included in the scope of this definition as well (Seyidoglu, 2003-b: 1-57).

Stabilization of the balance of payments has importance in determining the value of the national currency on the face of other currencies. For instance, in a foreign-dependent country in terms of export, import and financial flows, the instability of exchange rate fluctuations affects negatively the operation of the production mechanism and the economic discipline in general. Ultimately, it signals the increasing risk of conflict for an economy recovering from the conflict. Rising exchange rates raise the prices of export inputs used during the production causing the increase of general price level in the medium term (Orhan & Erdogan, 2007: 118-122). On the other hand, the foreign investments affect the amount of loanable funds. Expansion on the monetary base increases the sources of loan, capital expenditure and decreases the interest rate. Therefore, the sources of fund that is to be provided through foreign capital investments (FDI and Portfolio investments) will provide an investment saving balance (Seyidoglu, 2003-b; Mishkin, 2003).

Developments in the information technology in the globalizing world, disappearance of economic barriers, efforts of integration, active role of international intermediary firms in the domestic markets, the increase of direct investments, the development of new financing methods in order to meet the expectations of investors directly influence the international capital movements. The capital markets that are unable to adapt to this swift period of change are excluded from this system and miss the opportunities of investment (Allen, 1997; Bodie, Kane & Marcus, 2002).

In the global integration process, the countries are not able to develop their economies on their own any more. Especially the countries expending more than their production capacity, that is to say, the economies with current deficit constantly make an effort to finance this deficit through regular capital movements (Seyidoglu, 2003-b).

These investments are necessary in order to secure fiscal discipline, provide saving-investment balance and remove the negative effect of the current deficit on economy. Foreign capital investments needed for economic development appear two forms: Direct Capital Investments and Portfolio investments. The countries that finance regular current deficit through such investments have susceptibility in the face of capital movements and that creates a predicament and issue of trust for the economy.

Bringing along many uncertainties, the conflict risk might influence market risks and negatively affect the proper investment atmosphere for investors. Although these uncertainties are analyzed in Collier's risk analysis model, the total effect of the conflict risk on the market risks are not precisely set forth. Therefore, the existing market efficiency is limited and ultimately the capital investments are also affected. While the fluctuations on the market efficiency influence Direct Capital Investments and Portfolio investments, the requirement of the evaluation of all information on an efficient market disappears.

Considering the influence of market conditions on the price mechanism, pricing the risk of investment instruments gets difficult. Furthermore, "*whereas the politic risk and the conflict risk the country faces might influence the market efficiency, the direct capital investments rooted in the market reduces the conflict risk"* (Zehir & Hacioglu, 2009: 4-18). For instance, if McDonald's co-invest in Turkey and Greece, it means that it observes an opportunity of investment on these markets. While trying to keep this opportunity, a constraint will appear on the risk of conflict between these two countries.

Under these circumstances, the parties that need foreign investments economically will have to review their foreign policies and try to find ways of compromise. In a sense, the hypothesis that "if two countries have Mcdonald's, they never fight" is reinforced.

When the foreign capital investments in Turkey are analyzed, it is observed that in order to attract these investments governments made particular efforts. *"In Turkey, in terms of foreign capital investments, the policies changed after 1950, the year of accession of Democrat Party (DP) to power; the government made special efforts in order to attract foreign capital investments"* (Karluk, 1999: 104). As stated by Karluk:

Until 1980's, the foreign capital investments were limited; however during 1980's, extensive steps were taken in order to increase such investments. Liberalization policies that began in 1980 all over the world became effective in Turkey as well. The decisions taken on 24 Ocak 1980 signaled a radical change for Turkish economy. These decisions encouraged liberalizing the economy and import, abandoning the concept of import substitution and directing towards an export-oriented investment. Through the incentive of Turgut Özal and the influence of 1980 decisions, the foreign capital investments began to increase (Karluk, 1999: 104).

Table 1: Foreign Capital Investments by Year (million $)

1954-1980	228,1	1991	1,967.2
1981	337,5	1992	1,819.9
1982	167	1993	2,063.3
1983	102,7	1994	1,477.6
1984	271,3	1995	2,938.3
1985	234,4	**1996**	3,834.9
1986	364	1997	1.678.2
1987	655,2	1998	1,646.7
1988	820,5	1999	1,700.5
1989	1,511,9	2000	3,059.9
1990	1,861.1	2001	2,738.5

Source: www.hazine.gov.tr

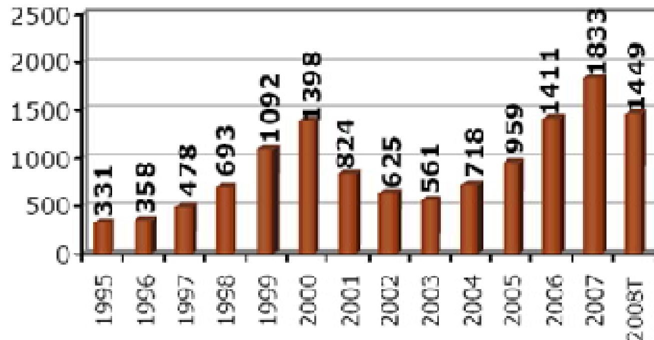
In Table 2.1, it is observed that after the reforms after 1980, foreign capital investment inflows increased in Turkey.

3. Foreign Direct Investments in the World and Turkey

Undersecretariat of Treasury's International Direct Investments Report-2006 analyzes the development of foreign direct investments and the share Turkey gets out of this development. It is stated that in 2000, the overall volume of the world international direct investment reached a historic record high amount of 1,4 trillion dollars (UN, 2007).

International direct investment flows which had downward trend until 2003, have had a growth trend since 2004. In 2004, international direct investment flows showed 27% increase, 29% increase in 2005 and 34,3% increase in 2006 reaching 1,2 trillion US dollars (UNCTAD, 2006). It is the second highest value reached after the international direct investment flow in 2000.

Economic growth in progress, increasing company profits and accordingly increasing cross-border unions and purchase transactions show that the growth trend in the international direct investment flows continued in 2007 as well.

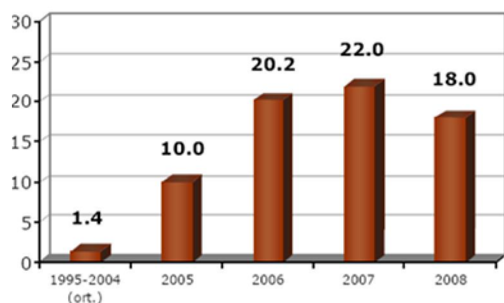


Graphic 1: Global International Direct Investments (billion TL)
Source: UNCTAD; YASED International Direct Investment Evaluation Report 2009

As seen in Graphic 1, Global International Direct Investments reached from 331 billion $ to 1.449 billion $ between 1995 and 2008. The increase of capital movements is the outcome of globalization and the development of information technologies.

Considering the distribution of Global International Direct Investments, it is obvious that developed countries profited most out of this share in 2007 and 2008. For instance, in 2007, total amount of the investments made into EU countries was 804 billion $ and the amount of the investments made into the countries recovering from the conflict was 86 billion $.

Graphic 2 shows that Turkey stands on a favorable spot in terms of foreign direct investment. Between 1995 and 2004, the period of crisis, the amount of average foreign direct investment inflows was 1.4 billion dollars. In 2007, this amount rose to 22 billion dollars. Especially with the influence of global financial crisis in 2008, a mild decline occurred in the last year. Table 2.3 shows the sectoral distribution of international direct investment inflows.



Graphic 2: International Direct Investments Inflows in Turkey
Source: YASED International Direct Investment Evaluation Report 2009

By the end of 2007, the stock of international direct investment in Turkey exceeding 150 billion dollars decreased to 75 billion dollars by the end of 2008 (YASED, 2009). According to the data of International Direct Investment Data Bulletin prepared by Undersecretariat of Treasury (2008), net international investment inflow in 2008, between January – September amounts to 12.311 million US dollars.

The international direct investment inflow (actual inflow/net) amounts to 441 million US dollars in June 2009 (Undersecretariat of Treasury, 2009). 5.159 million dollars of the total investments made in this period belongs to the activities of financial intermediary firms.

According to the statistics, 74,2% of the cash capital inflow between January- September 2008 had its source in EU countries; 206 million dollars of the cash capital inflow of 338 million dollars had its source on EU countries in 2009

as well (Undersecretariat of Treasury, 2009). Serving as monetary resource for the developing economies, Foreign Direct Investments increase the competitive power of a country and raises the national income.

4. The Influence of the Conflict on Foreign Direct Investments and the Investment Climate

As stated earlier, conflict risk influences the market risks and negatively affects the proper investment climate for the investors. In parallel with the growing uncertainties, capital outflows are observed. Although these uncertainties are analyzed in Collier's risk-analysis model, the total effect of the conflict risk on market risk cannot be precisely set forth. Therefore, the existing market efficiency is limited and ultimately the capital investments are also affected.

The fluctuations on the market efficiency affect Foreign Direct Investments and Portfolio Investments. Accordingly, the requirement to evaluate all the information on an efficient market disappears. According to the study applied by Rob Mills and Qimiao Fan and supported by World Bank, conflict risk has 8 basic effects on the investment climate (Mills & Fan, 2006: 5-17):

(i) Disappearance of physical security,
(ii) The decay of macroeconomic stability,
(iii) Disappearance of the binding force of the contract and security of property,
(iv) The problem of financing and deterioration of the infrastructure,
(v) Workforce loss and the disappearance of the labor market,
(vi) The lack of regulatory framework and inordinate taxation,
(vii) The lack of monetary policy,
(viii) Inactivation of the external environment,

i)Disappearance of Physical Security

Individuals face the problem of security in the conflict environment. The disappearance of spaces of sheltering, hospitals, and communication facilities bring along such problems as famine, AIDS, contagious diseases, the decrease of the literacy rate, the increase in the stillbirth rates, the decrease in young population.

ii)The Decay of Macroeconomic Stability

Government or emergency management which might maximize the defense and security expenses during the conflict period exercises its prerogative of coining money limitlessly. Increasing inflation rate diminish the purchase power of the national currency; the inability to afford the expenses of armament with the national currency leads to the under-valued exportation of domestic resources, recruiting the skilled labor into the army diminishes the productivity, the removal of the industrial and production facilities leads to the unemployment in the country. The shortage of resources bring along famine and uprisings which lead to the dissolution of the public authority.

iii) Disappearance of the Binding Force of the Contract and Security of Property

The dissolution of the state authority destroys the loan mechanism and the binding force of the contract which is the basis of commerce. Individuals tend to use force in order to claim their rights. Therefore, anarchy appears in society and the security of property will be dissolved. The war that might come up as a result of the lootings, uprisings and rebellions, might lead to the internal disorder (Justino, 2004; Andic, 2008).

iv) The Problem of Financing and Deterioration of the Infrastructure

The loan mechanism cones to a halt due to the weakening of the state authority and the decline of the banking sector in the financial system. And the problem of financing will eliminate the entrepreneurs' urge of production. In a country where the uprisings and the internal disorders are prevalent and the infrastructure is dissolved, the production, accordingly, halts (Bossane, 1998; Collier, 1999).

v) Workforce Loss and the Disappearance of the Labor Market

In a period when war escalates and even the reserve soldiers are at war, the employment of the skilled workforce for the constabulary creates a workforce loss for the existing producers.

vi) The Lack of Regulatory Framework and Inordinate Taxation

In order to finance the increasing defense expenses, there are two strategies to be followed by the state: tax boost and outsourcing through loan. Inordinate taxation leads to tax loss. An entrepreneur who cannot profit by the economy of scale and has a ruined infrastructure suspends its activities on the face of such taxation.

vii) The Lack of Monetary Policy

Martha Starr's econometric analysis shows that countries applying efficient monetary discipline are more successful compared the ones who do not apply. They are also capable of managing the conflict and reducing the risk after the conflict. However, considering the fact that the authority becomes more totalitarian during the war period while using the scarce sources for defense, it is very hard to secure an efficient monetary policy in the conflict environment (Collier, 1999: 168-183).

viii) Inactivation of the External Environment

As summarized by Mills and Fan, the external factors are as follows: Institutions, Government, Political Economy, Capacity, and Social Capacity. According to Mills and Fan, when this structure is in disorder, the investment climate is negatively affected (Mills & Fan, 2006: 5-17). As stated in Collier and Starr's models, when this structure gains strength in an efficient environment, the conflict risk reduces (Gilpin, 1987).

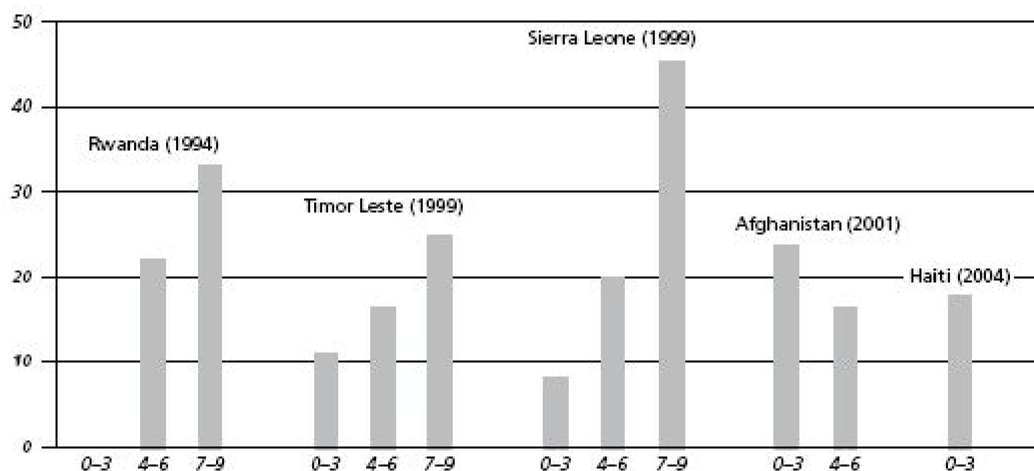
Table 2: Foundations of the Investment Climate

Foundations of the Invesment Climate			
Security and Stability	Finance and Infrastructure	Labor Markets	Regulatory Framework and Taxation
-Physical security -Macroeconomic stability -Contract enforcement -Land and property rights	-Access to credit market and services -Infrastructure such as telecoms and transport	-Skilled labor	-Licenses, registration -Customs, -Tax policy and administration
Enabling environment (Institutions, Governance, Political economy, Capacity, Social capital)			

Source: Rob Mills and Qimiao Fan, The Investment Climate in Post-Conflict Environment, The World Bank Institute, Washington, 2006.

In an environment with security problems, it is first necessary to provide physical security. In Collier's analysis, UN's allocation of more funds to defense and peace-keeping activities reduces the probability of conflict at the rate of 40%. However, taking merely military precautions is not enough to enliven the economy. Therefore, an efficient macroeconomic policy is needed which brings along stability.

The investment incentive and solving the problem of financing and infrastructure are vitally important. At this point, World Bank's financing activities held in post-conflict regions increase day by day.



Graphic 3: Financial Operations Held by World Bank Within the First 10 Years After the Conflict

Source: Rob Mills and Qimiao Fan, *The Investment Climate in Post-Conflict Environment*, The World Bank Institute, Washington, 2006

Starr's model emphasizes the role the foreign direct investments have on forestalling the conflict. As stated by Alesina and Barro, *"international investments make small countries more integrated in the big markets"* (Alesina & Barro, 2002; Starr, 2004: 23).

Considering the stabilizing influence of the investments made after the conflict, it is important to pay regard to the factors that might affect the foreign direct investments to be made in those regions.

As seen in the Graphic 3, the financial operations held by World Bank in the post-conflict regions took place mainly in the last 3 years. This graphic supports Collier's Risk-Analysis Model. Collier created the Risk-Analysis Model basing on the first 10 years after the war. Whereas the risk level of the conflict is 24% for the first 4 years; it is 17% in the ensuing years.

The assurance of the stability provides an increase in the financial operations of World Bank. However, it is seen in the graphic that the operations of World Bank have diminished in Afghanistan. However, it should not be forgotten that the conflicts still continue in Afghanistan.

5. The Macro Factors that Affect Foreign Direct Investments

Collier and Star Models set forth the relation between the post-conflict stability and economic growth. The most important factor in diminishing the conflict risk and providing the economic growth is the *Foreign Direct Investment* (DSY).

Foreign Direct Investments are analyzed in two basic groups: foreign direct investments that provide economic growth and private investments. Türkmen explains this category as follows:

International capital flows can be analyzed in two groups as investments for economic growth and private investments. In the investments for economic growth, foreign capital enters the country in order to form the technological infrastructure and provide such intangible rights and services as royalty and patent right. Foreign capital provides financial and technological fund for the economy in a short period. Financial and technological funds come into existence through loans, investment or contribution to the investment and production. The financial support the countries provide for one another through official bodies are also considered as capital flows for economic growth. The activities held on money and capital markets while requesting and offering funds are international private capital flows (Turkmen, 2006).

There are some macro factors affecting foreign direct investments that international investors pay attention to in their investment decisions (Turkmen, 2006; Ozyildiz, 1998):

- During the production process, the increase of the use of capital and technology-intensive techniques diminishes the use of employees; accordingly, the reforms regarding the workplace are envisioned more often.
- The swift development of regional trade blocks positively affects the international trade; it enables the domestic market to be more competitive, thereby, the local corporations that cannot compete in the international arena turn towards the foreign joint ventures in order not to face certain problems.
- The need for qualified labor force and flexible labor market increases the demand for the consumer-wise entrepreneurs and the work force with sales skills in the application of knowledge-based technology. Therefore, foreign direct investments turn towards the countries where they can find cheap workforce.
- As a result of the development of knowledge-based industries, the urge to invest in the regions which are knowledge centers increases.
- In order to gain high profit, it is important for the companies applying labor-intensive manufacturing to invest in the regions with cheap work force.

6. Conclusion

Foreign investments are important in the way that the foreign capital provide fund for the national economies. When considered with regards to the international political economy, in order for a country to gain an advantage over other countries, it has to increase its production capacity. In order to achieve this, the basic production parameters should be used effectively. In a globalizing world, industrialized countries lead the World trade and shape the international agreements that determine the rules of the economic activities. Thereby, they gain an advantage over the developing countries.

The required know-how and management skills the growing economies need are provided by the *Foreign Investments* made by the developed countries. The capital and management skills provided by foreign investments allows for a country with a foreign trade deficit to compete in the international markets and increase its profit in

foreign currency. Thereby, developing countries with foreign trade deficit like Turkey are provided with the fund to finance this deficit and the required know-how through foreign investments.

According to the Central Bank 2008 Economic Stability Report, international capital flows changed direction with the global crisis in 2008. Especially during this period of crisis, the slowdown of the global economy and its increasing influence on the developing countries discouraged the investors. In the report, it is stated that the developing countries including Turkey faced capital outflow and thereby capital loss and loss of value in their currencies because of the decrease in the risk appetite of the investors as of the second half of 2008.

UNCTAD 2009 Economic Conditions and Prospects Report states that the World economy underwent several crisis since the Great Depression; however, the crisis in 2008 led to the recession in world economy. It is also stated that in the beginning of 2006, 2007 and 2008, the signs of the crisis risk appeared. The report also includes the fact that after the sharp fall of the world production output in 2008, the output would decrease below 1% in 2009 and this would mostly affect the growing economies. In this regard, it is set forth that the economy of Turkey reached significant growth rates between 2002-2007 and attract foreign capital from many countries and in parallel with this, its growth trend will decelerate.

Considering the effects of the decrease in the foreign capital investments on the post-conflict regions, the problems regarding the employment might arise and it might increase the conflict risk.

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