

1 CHAPTER 11

3 POLITICAL VIOLENCE AND
5 FOREIGN DIRECT INVESTMENT
7

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11
13 **ABSTRACT**

15 *The international business literature presents an interesting intellectual*
17 *puzzle regarding the effect of political instability and political risk on*
19 *foreign direct investment (FDI). Survey evidence shows that multina-*
21 *tional executives take into account political instability in making invest-*
23 *ment decisions, while econometric studies produce conflicting findings. In*
25 *this paper, I offer a new theory that explains how political violence, an*
27 *extreme form of political instability, affects FDI. The new theory differs*
29 *from previous arguments on three points. First, the theory considers how*
31 *rational expectations and uncertainty on the part of foreign investors*
33 *affect the ways in which political violence influences investment behaviors.*
Second, the new theoretical argument argues for the need to investigate
separately the effects of different types of political violence (civil war,
interstate war, and transnational terrorism). Third, I consider FDI in-
flows as resulting from two distinct but related decisions, including the
investment location choice and the decision on investment amount, and
sort out statistically the separate effects of political violence on these two
processes. The empirical analysis of FDI inflows covers about 129 coun-
tries from 1976 to 1996. The statistical findings largely support my the-
oretical expectations. My theory helps reconcile the inconsistent
econometric findings on the effect of political instability on FDI flows.

35

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1 The international business literature presents an interesting intellectual puzzle regarding the effect of political instability and political risk on foreign
3 direct investment (FDI). In an early review of studies on political risk, Kobrin (1979) concludes that the empirical evidence is inconsistent and
5 mixed regarding the effect of political instability on FDI stocks or flows. Later econometric studies continue to produce mixed findings. For example,
7 Schneider and Frey (1985) find that political instability has a negative effect on FDI flows. Nigh (1985) finds in an analysis of 24 countries over 21 years
9 that both international and intra-national conflict and cooperation affect manufacturing FDI flows by U.S. firms. But Fatehi-Sedeh and Safizadeh (1989)
11 fails to find statistical association between political stability and FDI. In a cross-sectional analysis of FDI flows to 36 countries for 1977 and 1982, **QA:1**
13 Loree and Guisinger (1995) find that political stability significantly promotes FDI inflows in 1982, but not in 1977. Olibe and Crumbley (1997) do
15 not find consistent evidence that political risk index influences U.S. FDI flows to 10 out of 13 OPEC countries. Using data from all reported manufacturing
17 plant openings from 1984 to 1987, Woodward and Rolfe (1993) find that political stability increases the probability of a country being selected
19 as an investment location. More recently, in a pooled analysis of 52 developing countries from 1982 to 1995, Li and Resnick (2003) do not find
21 that political instability has any statistically significant effect on FDI inflows, but regime durability encourages FDI inflows. Sethi, Guisinger,
23 Phelan, and Berg (2003) find that political instability, measured by a composite variable on a 100-point scale, does not influence U.S. FDI flows to 28
25 countries from 1981 to 2000. Globerman and Shapiro (2003) conduct a two-stage analysis of U.S. FDI flows to 143 countries from 1994 to 1997, in
27 which the first stage investigates the causal factors of the probability that a country is an FDI recipient while the second stage examines the determinants
29 of the amount of FDI received. They find that an index of political instability and violence, including armed conflict, social unrest, terrorist
31 threats, etc., does not influence the probability whether a country receives any FDI inflow, but reduces the amount of FDI inflow a country receives.
33 That is, the average size of an FDI transaction may change independently of the probability of a country receiving the FDI. The econometric evidence is
35 obviously mixed and inconsistent across studies.

In contrast, evidence from studies of responses of executives to interviews
37 and questionnaires (e.g., Bass, McGregor, & Walters, 1977; Aharoni, 1966) typically demonstrates that political risk and stability are important considerations
39 when investors make investment decisions. More recently, Porcano (1993) finds in a survey of Canadian, British, and Japanese firms of 36

1 industries that political climate in the host country is consistently ranked
2 above 3 on a 5-point importance scale. The inconsistency of empirical evi-
3 dence among econometric studies of FDI flows and the inconsistency be-
4 tween econometric findings and survey evidence are widely noted in various
5 studies of the determinants of FDI (see, e.g., Pearce, Sauvart, & Islam,
6 1992).

7 Resolving this intellectual puzzle has important implications. First, the
8 issue is important for the operation and theoretical understanding of inter-
9 national production. Assume that the mixed econometric evidence reflects
10 the real nature of the relationship between political instability and FDI.
11 Firm executives are then misled in decision-making by their own beliefs of
12 the importance of political instability. Capital is not allocated to its most
13 productive use. On the other hand, if the individual executives are correct in
14 their perception of the importance of political instability, the conflicting
15 econometric findings suggest that our theoretical understanding of the re-
16 lationship between political instability and international production is
17 flawed.

18 Second, the issue is also important for understanding the effect of an FDI
19 on political violence. In the political science literature, national integration
20 into international production is found to reduce dyadic military dispute
21 (e.g., Gartzke, Li, & Boehmer, 2001; Gartzke & Li, 2003). FDI, particularly
22 in the manufacturing sector, also is found to decrease civil conflict in poor
23 countries by increasing resource availability and opportunities, while FDI in
24 the wealthier countries appear to intensify class conflicts (Rothgeb, 1990).
25 Furthermore, FDI inflows are found not to directly affect transnational
26 terrorist incidents, but to indirectly reduce such incidents by promoting
27 economic development in countries (Li & Schaub, 2004). A main underlying
28 premise of these studies is that political violence affects foreign investment
29 flows, which generates behavioral implications for a variety of political ac-
30 tors involved. To the extent that political violence does not have a logically
31 consistent effect on FDI, one may need to reexamine the effects of FDI on
32 political violence.

33 In this paper, I offer a new theoretical argument to explain how political
34 violence, an extreme form of political instability, affects FDI. The new
35 theory differs from previous arguments on three different issues. First, the
36 theory considers how rational expectations and uncertainty on the part of
37 foreign investors affect the ways in which political violence influences in-
38 vestment behaviors. Second, the new theoretical argument presents the need
39 to investigate separately the effects of different types of political violence.
40 Instead of applying an aggregate political instability or risk index, like it

1 typically has been done in the literature, I examine different forms of political violence, including civil war, interstate war, and transnational terrorism. Third, I consider FDI inflows as resulting from two distinct but related decisions, including the investment location choice and the decision on investment amount, and sort out statistically the separate effects of political violence on these two processes.

7 The empirical analysis of FDI inflows covers about 129 countries from 1976 to 1996. The statistical findings largely support my theoretical expectations. The new theoretical argument helps reconcile the inconsistent econometric findings on the effect of political instability on FDI flows.

11

13 **1. HOW DOES POLITICAL VIOLENCE INFLUENCE** 15 **FOREIGN DIRECT INVESTMENT?**

15

17 The theory builds on the following elements. First, investors believe political instability in the host country is important for choosing investment locations and deciding the investment amount. Second, forward-looking investors constantly anticipate the effect of political violence in the host country. Third, investors do not have perfect foresight and have to manage unanticipated political violence *ex post*. Fourth, political violence comes in different types, some of the most extreme of which include civil war, interstate war, and transnational terrorist attacks. Because different types of political violence have different characteristics, their effects on FDI inflows may differ.

25

27

1.1. Attributes of International Production

29

31 A multinational enterprise (MNE) organizes production of goods and services in more than one country, involving the transfer of assets or intermediate products within the investing enterprise and without any change in ownership. In this paper, the focus of analysis – FDI inflows – refers to the net inflows of investment to acquire a lasting management interest (10% or more of voting stock) in an enterprise operating in an economy other than that of the investor. Operationally, it is the sum of equity capital, reinvestment of earnings, other long- and short-term capital as shown in the IMF balance of payments statistics.¹

37

39

In the literature on FDI and MNE, several strands of theoretical explanations of why firms engage in international production exist. Some scholars

1 (e.g., Hymer, 1976) view FDI as the result of structural market imperfection
and the firm's desire to pursue monopoly status using its firm-specific assets.
3 Other scholars (e.g., Buckley & Casson, 1976; Rugman, 1981) look at FDI QA :2
as a way to resolve opportunistic behaviors in market transactions, that is,
5 exerting direct hierarchical control over foreign production, instead of serv-
icing the market with other alternative means (such as trade). Still others
7 (e.g., Vernon, 1971) consider FDI as the firm's response to the technological
maturity of its products and the growing demand in foreign market. The
9 eclectic paradigm by Dunning (1988, 1993) seeks to tie these explanations
into one OLI framework. That is, national firms become transnational to
11 exploit three types of advantages: (1) a firm's advantages due to ownership
(O) over tangible and intangible assets, (2) the firm's internalization (I)
13 advantages from its hierarchical control of cross-border production, and (3)
the location-specific (L) advantages perceived by firms based on the char-
15 acteristics of host countries, such as resource endowment or government
policies. In other words, a firm carries out FDI when the location and its
17 ownership advantages make production abroad profitable and its direct
hierarchical control of the production is preferred over other alternative
19 modes of satisfying the demand for its products (e.g., licensing or trade).

The logic of international production brings to bear two attributes of FDI
21 that are linchpins for my argument. FDI involves cross-border jurisdiction
and a long time horizon. I address the role of cross-border jurisdiction in my
23 argument in this subsection and turn to the implication of a long time
horizon in the next.

25 Because FDI is foreign in the host economy, subject to laws and regu-
lations by the host government, inter-jurisdictional issues arise. Cross-bor-
27 der jurisdiction implies that foreign investors operate in an unfamiliar
foreign environment. They often are not as well informed and connected as
29 domestic investors about the policy environment; they may be treated
differently than domestic investors by the host government. In the unfam-
31 iliar territory, foreign investors necessarily care about the expected return
to their investments and the ease to exit the host country when the security
33 of their property is threatened. Government policies toward FDI are im-
portant for foreign investors, because as part of the L-factors, they influence
35 the expected returns of the investment project and the barrier to exit the host
economy. Particularly critical are host policies on expropriation, exchange
37 control, breach of contract, repatriation of profits, voluntary divestment,
performance requirement, taxation, etc.²

39 To the extent that political violence influences these government policies,
foreign investors will take political violence into account when they make

1 decisions on the investment location and amount. Does political violence
 3 influence government policies toward foreign investors? Politicians, who are
 5 engaged in financially expensive and politically costly military warfare, often
 7 have an incentive to impose capital controls and prevent capital flight. The
 9 need to finance expensive wars often requires higher tax rates. Civil wars
 11 often result in regime changes that are typically associated with policy
 changes, such as expropriation of foreign assets and breaching contracts
 between MNEs and former regimes. The desire to crack down transnational
 terrorism invariably causes governments to monitor and scrutinize more
 closely private financial transactions because they may be used to finance
 terrorist activities.

13

15

1.2. Ex ante Effect of Political Violence on Investment

17

19 The logic of international production suggests that foreign direct investors
 21 typically have a long time horizon when operating in the host country. Their
 23 investments cannot be easily reversed without paying some cost. The in-
 25 vestment itself becomes a barrier to exit for the MNE (Rivoli & Salorio,
 27 1996). A long time horizon implies that foreign direct investors have to be
 forward-looking, constantly anticipating ex ante how political violence
 affects the expected returns of their investments and the political barrier to
 exit. Forward-looking firms operate based on the expected profit rate and
 hedge against risks. Ex ante, firms evaluate the probability of political vi-
 olence and the likelihood of such occurrences inducing unfavorable policy
 changes. Firms incorporate these evaluations into their choices of invest-
 ment location and amount.

29

31 The implication is that anticipated events of political violence can make
 33 an otherwise desirable investment location undesirable, deterring future in-
 35 vestment flows, and render an existing investment site less attractive, re-
 37 ducing reinvestment, limiting expansion, and potentially inducing pre-
 emptive divestment. These changes in investment decisions can occur before
 the events of political violence materialize. For such cases, the actual hap-
 pening of political violence ends up having little effect upon FDI inflows ex
 post.³

39

1 *1.3. Ex post Effect of Political Violence on Investment*

3 MNEs operate in an uncertain investment environment. While certain types
4 of uncertainty are endogenous and can be resolved by investment through
5 experiential learning, the type of uncertainty resulting from political vio-
6 lence-induced policy changes tends to be exogenous to investment (Rivoli &
7 Salorio, 1996). This is consistent with the notion in the international rela-
8 tions literature that the occurrence of military conflict should be treated as a
9 stochastic process, involving incomplete information and the signaling of
10 resolve at the crisis bargaining stage (e.g., Fearon, 1995). Civil wars and
11 terrorist attacks also are events that tend to be exogenous to investors.

12 Furthermore, investors do not have perfect foresight, cannot fully antic-
13 ipate occurrences of political violence, and have to adjust to the conse-
14 quences of unanticipated political violence ex post. Unanticipated
15 occurrences of political violence often lead to unanticipated unfavorable
16 government policy changes (e.g., expropriations), causing the expected re-
17 turns of an investment project to decline.

18 As long as firms have no perfect foresight of all political violence-induced
19 risks, their ex ante and ex post risk-adjusted returns will not be identical.
20 The unanticipated developments provide firms with new information re-
21 garding possible future government intervention or market disruption,
22 causing a downward revision of the expected stream of revenues. Hence,
23 unanticipated incidents of political violence force investors to moderate
24 their ex ante optimism, such that a country may no longer be chosen as an
25 investment site or the amount of future investment be reduced.

26 Consider the following thought experiment. An actual event of political
27 violence may be decomposed into a systematic component that investors
28 capture by forecasting based on all available information and a stochastic
29 component driven by the degree of uncertainty. The systematic component
30 measures the accuracy of ex ante expectations while the stochastic compo-
31 nent reflects the amount of new information ex post. Depending on the
32 relative size between the systematic and the stochastic components, firms
33 may be surprised more by some events of political violence and less so by
34 others. More unanticipated events cause greater unexpected disruptions and
35 higher expected future risks, generating larger ex post effects.

36 The theory suggests that the ex ante and ex post effects of political vi-
37 olence on investment flows are inversely related in size. A large anticipated
38 effect is likely to be internalized into investment decision ex ante, such that
39 the actual occurrence of violence brings no surprise, causing little ex post
change in investment decision, whereas a small anticipated effect implies a

1 large unanticipated surprise for investors, ending up being associated with a
2 large ex post adjustment in investor behavior. This is relevant to how the
3 effects of political violence on investment should be tested empirically. Us-
4 ing the actual violence occurrence in the statistical model, like it has been
5 done in the literature, one finds only an average of large and small ex post
6 effects. Such averaging, depending on the sample and model specification,
7 may produce inconsistent findings. Accurate empirical tests should distin-
8 guish between the unanticipated and anticipated effects. The anticipated
9 events should be uncorrelated with investment behaviors subsequent to ac-
10 tual event occurrence, while the unanticipated events should produce sta-
11 tistically significant negative effects ex post.

13

14 *1.4. Variations among Different Types of Political Violence*

15

16 The previous literature on the effect of political risk on FDI typically em-
17 ploys some composite index that lumps a variety of political activities to-
18 gether, ranging from demonstrations and strikes to armed conflicts and
19 terrorist attacks. This practice ignores the disparate attributes of different
20 types of political violence, a likely source of inconsistent findings.

21 Here I focus on three types of extreme political violence: civil war, in-
22 terstate war, and transnational terrorist incidents. They usually involve sa-
23 lient issues with high stakes. Politicians often commit tremendous
24 manpower and financial resources to deal with them. They are also less
25 likely to give in or compromise on these issues. As a result, these types of
26 political violence can cause economic recession in a host country, impose
27 financial constraints on the government, and damage the country's infra-
28 structure.

29 As for their differences, civil wars are fought between factions on the host
30 territory. They often result from various social cleavages (class, ethnic, re-
31 ligious, and/or ideological), and lead to massive migration, destruction of
32 infrastructure, repression, even massive killing, and genocide (e.g., Fearon &
33 Laitin, 2003; Ghobarah, Huth, & Russett, 2003; Li & Wen, 2005). Civil wars
34 are often associated with regime changes and policy swings. All these have
35 negative implications for foreign direct investors operating in the country.

36 Interstate wars, on the other hand, are fought between countries or their
37 alliances. Enduring large-scale wars obviously have detrimental effects on
38 the economic prospect of a host country. But such wars tend to be rare. In
39 addition, since many interstate wars involve territorial claims, they may be
40 limited to the border areas and sometimes, may not even be fought on one's

1 own territory. The current U.S. war against Iraq, for example, was fought
2 on the Iraqi territory, the effect of which may be large and negative on
3 investment flows to Iraq but not necessarily so for investment flows to the
4 U.S. Finally, while interstate wars are likely to disrupt investment flows
5 between belligerent countries, the disrupted flows may be substituted by
6 those from one's own allies. Therefore, while investors certainly want to
7 evade a country involved in an interstate war that is being fought on its own
8 territory, the overall effect of an interstate war on investment may be an
9 empirical issue and is likely to be smaller than that of the civil war.

10 Transnational terrorist incidents are different from both interstate and
11 intra-state wars. Terrorism is often defined as the premeditated or threat-
12 ened use of extra-normal violence or force to obtain a political, religious, or
13 ideological objective through the intimidation of a large audience (e.g.,
14 Enders & Sandler, 1999, 2002). These include a variety of activities, ranging
15 from assassination, and hijacking, to suicide bombing. To the extent that
16 these activities spread and threaten the host economic conditions and the
17 security of the investor's asset, they should have a dampening effect on
18 investment flows. But less significant and limited terrorist attacks may have
19 little effect on the expected returns of an investment project.

21

23

2. RESEARCH DESIGN

25

2.1. Modeling FDI Inflows

27

28 The typical dependent variable in the studies of the determinants of FDI
29 inflows at the national level is the level of FDI net inflows into a country.⁴
30 Conceptually the variable can be considered as consisting of two distinct but
31 related components (e.g., Woodward & Rolfe, 1993; Globerman & Shapiro,
32 2003). One is the presence or absence of any FDI inflow in a country, which
33 largely reflects the location choice by investors. The other is the amount of
34 positive FDI inflow into a country. One can only observe a positive amount
35 of FDI inflow when the country is chosen as an investment location by
36 enough investors to counteract the divestment flow out of the country. Since
37 events of political violence may affect the location choice and the investment
38 amount differently, one may model the effects on the two variables sepa-
39 rately by using the Heckman selection model (Heckman, 1979; Greene,
2003). The model can be specified as follows:

1 Equation of FDI inflow presence:

$$3 \quad z_{i(t+1)}^* = \gamma_0 + \gamma_k \text{Violence}_{it} + \gamma_l \text{Control}_{it} + u_{1i(t+1)}$$

5 where $z_{i(t+1)}^*$ is the probability of observing any positive FDI inflow into
 7 country i in year $(t+1)$, Violence_{it} and Control_{it} represent vectors of political
 9 violence-related variables and the control variables, γ_k and γ_l their corre-
 11 sponding vectors of coefficients.

Equation of FDI amount:

$$13 \quad \text{FDI inflow}_{i(t+1)} = \beta_k \text{Violence}_{it} + \beta_m x_{it} + u_{2i(t+1)}, \quad \text{observed only if } z_{i(t+1)}^* > 0$$

$$15 \quad u_{1i(t+1)} \sim N(0, 1), \quad u_{2i(t+1)} \sim N(0, \sigma), \quad \text{corr}(u_{1i(t+1)}, u_{2i(t+1)}) = \rho$$

17 where $\text{FDI inflow}_{i(t+1)}$ is the positive amount of FDI inflow into country i in
 19 year $t+1$, x_{it} the vector of economic control variables affecting the amount
 21 of FDI inflow. As in Gliberman and Shapiro (2003), the variable is log
 23 transformed to correct its skewed distribution. FDI inflow into country i in
 25 year $t+1$ is present only when the selection variable $z_{i(t+1)}^* > 0$ and the inflow
 27 is zero or negative otherwise. A zero or negative value for the variable
 29 indicates either that no investor chooses to invest in that country in the year,
 31 or that the new investment plus reinvestment equals to or is smaller than the
 33 divestment; either of the two scenarios demonstrates the lack of attractive-
 35 ness of the country as an investment location. Both the probability of ob-
 37 serving positive FDI inflow $z_{i(t+1)}^*$ and the amount of FDI inflow are a
 function of various forms of political violence associated with the country.
 The dependent variables in both equations are one year leading variables to
 control for possible reverse causality.

As denoted, the model assumes that the error terms from both equations
 are normally distributed, with zero means and correlation ρ . Where $\rho \neq 0$,
 the two equations are not independent from each other. The selection model
 as a whole takes into account the cross-equation correlation and allows us
 to estimate the effects of political violence on the presence of FDI inflow and
 the amount, separately.

The empirical analysis covers about 129 countries from 1976 to 1996. The
 pooled time-series cross-sectional (TSCS) design and wide temporal and
 spatial variations in the level of FDI inflows enable a discriminating statisti-
 cal assessment of the effect of political violence. I use the one-tailed t -test
 for hypothesis testing because my hypotheses are directional.

Statistical models for pooled TSCS data may exhibit heteroskedasticity
 and serial correlation. While these problems do not bias the estimated co-
 efficients, they often cause biased standard errors for the coefficients, pro-

1 ducing invalid statistical inferences. To deal with these potential problems, I
2 estimate the Huber–White robust standard errors clustered over countries.
3 These estimated standard errors are robust to both heteroskedasticity and to
4 a general type of serial correlation within the cross-sectional unit (Rogers,
5 1993; Williams, 2000).

7

2.2. Key Independent Variables

9

10 Several groups of political violence-related variables are designed to test the
11 above hypotheses. First, I construct three variables that measure a country's
12 involvement in the civil war, the interstate war, and the number of trans-
13 national terrorist incidents. They provide an initial test of the effect of
14 political violence without distinguishing the anticipated and unanticipated
15 effects of political violence. More specifically, civil war is a dummy variable
16 coded 1 if a country is involved in a civil war in year t and zero otherwise.
17 The definition and data on this variable is from Fearon and Laitin (2003).
18 Interstate war also is a dummy coded 1 if a country is involved in an
19 interstate conflict with more than 1,000 battle deaths in year t and zero
20 otherwise. The data come from the Armed Conflict Database from 1946 to
21 2000 by Gleditsch, Wallensteen, Eriksson, Sollenberg, and Strand (2002).⁵
22 Terrorist incidents are measured by the number of transnational terrorist
23 events that occur in a country in year t . Data are collected from the In-
24 ternational Terrorism: Attributes of Terrorist Events (ITERATE) data sets
25 (Mickolus, 1982; Mickolus, Sandler, Murdock, & Fleming, 1989, 1993,
26 2002). Since these variables do not distinguish the ex ante and ex post effects
27 of political violence, I do not have clear expectations of their effects on FDI
28 inflows. If anything, one should expect the results to be mixed.

29 Simulating how investors use available information to predict future oc-
30 currences of political violence, I construct forecasting models of civil war
31 involvement, interstate war involvement and transnational terrorist inci-
32 dents in year t , based on available information on the predictors from year
33 $(t-1)$. I use a civil war involvement model to identify anticipated and un-
34 anticipated civil wars. Fearon and Laitin (2003) estimate the effect on civil
35 war onset of a number of covariates, including gross domestic product
36 (GDP) per capita, population size, size of mountainous terrain, oil produc-
37 ing country, new state, non-contiguous state, political instability, political
38 regime type, ethnic fractionalization, and religious fractionalization. I use
39 their model to generate the predicted probability of civil war involvement of
a country in year t . Instead of civil war onset, I use civil war involvement of

1 a country as the dependent variable and estimate a logit model. I also
 3 include the number of years a country had been involved in any civil war till
 5 the previous year to increase the accuracy of the model forecast. Anticipated
 7 civil war is a dummy variable coded 1 if the predicted probability of civil war
 9 involvement is greater than 0.5 and the country is involved in a civil war in
 11 year t , and zero otherwise. I capture the unanticipated civil war using a
 truncated continuous measure, which equals [actual civil war involvement
 dummy in year t^* (1 – predicted probability of civil war involvement)]. The
 variable is superior to a dichotomous measure of unexpected civil war in-
 volvement because it contains information on the degree of surprise a civil
 war occurrence brings to investors.

I estimate a country level model of an interstate war involvement to
 13 identify anticipated and unanticipated interstate war involvement by a
 15 country. The logit model of an interstate war involvement includes the fol-
 17 lowing covariates: the major power status of a country, GDP per capita,
 19 country size, the number of years a country was involved in an interstate
 21 war, the change in urbanization (the annual growth rate of the urban pop-
 23 ulation), status of interstate war involvement in the previous year, political
 25 regime type, and peace duration variables (Beck, Katz, & Tucker, 1998).
 Predicted probability of an interstate war involvement is generated. Antic-
 27 ipated interstate war is coded 1 if a country is involved in an interstate war
 29 in year t and the predicted probability is greater than 0.3, and zero oth-
 31 erwise. Unanticipated interstate war is a continuous measure that equals
 33 [actual interstate war involvement dummy in year t^* (1 – predicted prob-
 35 ability of interstate war involvement)]. It is worth noting that interstate wars
 are fought between countries. A forecasting model of interstate war in-
 volvement based on country attributes is apparently insufficient. The model
 has poor predictive power, where the predicted probability for actual war
 involvement cases ranges between 0.004 and 0.55, with 0.3 around the 90th
 percentile. But the country level analysis of FDI inflows in this paper pre-
 vents the use of a dyadic model of interstate war involvement that is typical
 in the international relations literature. Despite the weakness, the country
 level model of interstate war involvement still produces useful information
 about the continuation of interstate war involvement by including several
 past conflict history variables in the model. Future research may usefully
 extend the analysis to bilateral investment flows.

37 To measure anticipated and unanticipated terrorist incidents in a country,
 I estimate a negative binomial model of transnational terrorist incidents
 39 based on the data and model in Li and Schaub (2004). Li and Schaub (2004)
 estimate how economic globalization affects terrorist incidents using a neg-

1 ative binomial model and the ITERATE data on terrorist incidents. The
2 dependent variable is an event count of the number of transnational terrorist
3 incidents in countries. Their model includes GDP per capita, major trading
4 partners' GDP per capita, trade openness, FDI inflows, portfolio invest-
5 ment, country size, government capability, number of incidents in the pre-
6 vious year, interstate conflict, regional dummies, Cold War dummy, and the
7 level of democracy. Because trade openness, FDI inflows, and portfolio
8 investment variables have a lot of missing values, I omit them from the
9 model, but add additional transnational terrorist hot spot variables (Li &
10 Braithwaite, 2005) that help to improve the accuracy of model forecast. The
11 anticipated terrorist incidents variable is a truncated continuous measure,
12 which equals the difference between the predicted event count and the actual
13 count in year t if their difference is equal to or less than three (the estimation
14 sample average number of incidents), and zero otherwise. The unanticipated
15 incidents variable equals the difference between the predicted event count
16 and the actual event count in year t if their difference is greater than three
17 incidents, and zero otherwise. The unanticipated variable should capture
18 those cases where events are most unanticipated.

19 What are the expected signs for these political violence-related variables?
20 Based on my theoretical argument, the actual act of violence (civil war,
21 interstate war, terrorism) that is anticipated to occur in year t , based on
22 information available at the end of year $(t-1)$, does not affect the invest-
23 ment flows that occur in year $(t+1)$. Investors have adjusted their invest-
24 ment decisions before the occurrence of the anticipated violence. As a result,
25 the realization of the anticipated event in year t has little effect on subse-
26 quent investment behaviors in year $t+1$. The coefficients for the anticipated
27 violence variables are expected to be statistically insignificant for both the
28 inflow presence equation and the inflow amount equation. Because the hy-
29 pothesized effects are not directional, two-tailed tests are applied in hy-
30 pothesis testing.

31 In contrast, where investors err on the side of optimism, they are taken by
32 surprise by the occurrences of political violence. Actual civil wars, interstate
33 wars, and terrorist attacks that are unanticipated to occur in year t may
34 affect investors' expected returns and their ease to exit in the next period.
35 Where the effect is strong enough to induce changes in investment behav-
36 iors, they are reflected in the decisions to invest elsewhere, to divest from
37 a country, or reduce the amount of planned investment. Therefore, the
38 coefficients for the unanticipated violence variables are expected to be sta-
39 tistically significant and negative for both the inflow presence equation and

1 the inflow amount equations. As these hypothesized effects are directional, I
 2 apply one-tailed test for hypothesis testing.

3

5

2.3. Control Variables

7 The set of control variables is different between the inflow presence equation
 8 and the inflow amount equation, which helps to identify the model based on
 9 different information sets, rather than relying on the functional form (as in
 10 the case of using identical model specification for both equations). The
 11 control variables for the investment presence equation include the invest-
 12 ment inflow in year t and the Cold War dummy. Since an investment inflow
 13 consists of new investment and reinvestment and firms tend to have a long
 14 time horizon, the investment inflow should exhibit inertia. In addition, the
 15 investment inflow in the current year should be the best predictor of invest-
 16 ment decisions for the next period, because the investment inflow in the
 17 current year results from best information available to the investor. The
 18 Cold War dummy is coded 1 for a country in years before 1990 and zero
 19 otherwise. The Cold War politics has seriously inhibited capital flows be-
 20 tween countries associated with the two superpowers, respectively. The end
 21 of the Cold War brought about many new attractive investment destinations
 22 in Eastern Europe and Asia for Western investors.

23 The control variables for the inflow amount equation include the usual
 24 suspects in the empirical literature on FDI inflows, including the market
 25 size, economic development, growth rate, exchange rate stability, as well as
 26 inflows in year t . Large markets are more likely to attract FDI due to an
 27 expected stream of future returns while small market size attracts less FDI.
 28 Studies of FDI inflows (e.g., Chan & Mason, 1992; Jun & Singh, 1996)
 29 typically control for market size. I use logged GDP in purchasing power
 30 parity (PPP) to measure market size. Data for all these control variables are
 31 from the World Bank's (1999) *World Development Indicators*.

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32 Economic development should affect FDI inflows positively. More de-
 33 veloped countries often attract more FDI than less developed ones, due to
 34 differences in consumer purchasing power, capital endowment, and infra-
 35 structure. The variable is measured as GDP per capita based on PPP, logged
 36 to deal with its skewed distribution.

37 Economic growth is often found to induce more FDI inflows to a country
 38 (e.g., Gastanaga, Nugent, & Pashamova, 1998; Jun & Singh, 1996; Schn-
 39 eider & Frey, 1985). Profit-maximizing foreign investors are attracted to
 40 fast-growing economies to take advantage of future market opportunities. It

1 is the annual percentage growth rate of GDP at market prices based on constant local currency.

3 Exchange rate risk may also affect FDI inflows. Large movements in the exchange rate inhibit long-term planning and disrupt local markets. To measure such risk, I use the absolute value of the percentage change of the official exchange rate of local currency units per U.S. dollar.

7

9 3. FINDINGS AND IMPLICATIONS

11 Table 1 presents the results of the effects of civil war, interstate war, and terrorist incidents, without separating the ex ante and ex post effects. The top panel of the table contains results for the inflow presence equation, while the bottom panel contains the results for the inflow amount equation. Each panel has four model specifications. Model 1 is the benchmark model, Model 2 includes only civil war among the violence-related variables, Model 3 only interstate war, and Model 4 only terrorist incidents. Model 5 evaluates whether the results in Model 1 are sensitive to alternative specification, by including identical sets of variables in the two equations.

19 Table 2 presents the results for anticipated and unanticipated political violence variables. Like Table 1, Table 2 also contains two panels, corresponding to the inflow presence equation and the inflow amount equation. Model 1 is the benchmark model, Model 2 contains only the unanticipated political violence-related variables and excludes the anticipated variables, Model 3 reverses Model 2 specification, and Model 4, like Model 5 in Table 1, evaluates whether allowing the same specification for the two equations affects the robustness of the results in Model 1.

27 Across all models in both tables, the hypothesis that the cross-equation correlation equals zero is rejected at the 1% level. The cross-equation correlation is about -0.9 , far different from zero correlation. The use of the Heckman selection model is appropriate. The negative correlation indicates the presence of unobservable characteristics that increase the probability of a country receiving FDI but reduce the amount of FDI it receives. Across all models in both tables, the Cold War dummy is consistently significant and negative for the inflow presence equation. On an average, a country is less likely to be chosen as an investment location during the Cold War years than after the end of it. The FDI inflow in year t is a statistically significant and positive predictor of the presence of FDI inflow across all models in both tables. In Model 5 of Table 1 and Model 4 of Table 2, where the inflow presence equation is specified the same as the inflow amount equation, the

Table 1. Effect of Political Violence on FDI Inflows, 1976–1996.

	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Inflow Presence Equation</i>					
Civil war	-0.1659 (0.1200)	-0.1499 (0.1178)			-0.1010 (0.1463)
Interstate war	-0.4154** (0.1611)		-0.4081* (0.1720)		-0.4683* (0.2325)
Terrorist incidents	0.0063 (0.0040)			0.0040 (0.0039)	0.0085 (0.0085)
Previous inflows	0.9147** (0.2461)	0.9379** (0.2510)	0.5819** (0.2102)	0.6129** (0.2168)	0.7183** (0.2124)
Cold war dummy	-0.3520** (0.0811)	-0.3388** (0.0776)	-0.3452** (0.0746)	-0.3869** (0.0723)	
Market size					0.0065 (0.0507)
Development					-0.0402 (0.0752)
Growth					0.0063 (0.0058)
Exchange rate instability					-0.00001** (0.000003)
Constant	0.6002** (0.0780)	0.5796** (0.0762)	0.5957** (0.0736)	0.5452** (0.0693)	0.8478 (0.9114)
q	-0.91	-0.91	-0.92	-0.92	-0.92
Wald (q = 0)	110.01	115.96	148.53	169.37	106
Total N	2682	2705	2918	3144	2289
<i>Inflow Amount Equation</i>					
Civil war	-0.1647 ⁺ (0.2206)	-0.1616 (0.2201)			-0.2100 (0.2214)
Interstate war	0.1317 (0.2081)		0.0738 (0.2343)		0.1355 (0.2129)
Terrorist incidents	0.0003 ⁺ (0.0061)			-0.0035 (0.0051)	-0.0007 (0.0066)
Previous inflows	0.0612* (0.0258)	0.0604* (0.0256)	0.0579* (0.0255)	0.0600* (0.0254)	0.0636* (0.0291)
Market size	0.5524** (0.0709)	0.5569** (0.0678)	0.6059** (0.0571)	0.5775** (0.0464)	0.5797** (0.0796)
Development	0.6291** (0.1189)	0.6249** (0.1169)	0.5653** (0.1045)	0.5807** (0.0996)	0.6899** (0.1247)
Growth	0.0317** (0.0085)	0.0315** (0.0084)	0.0323** (0.0084)	0.0314** (0.0081)	0.0222* (0.0096)
Exchange rate instability	-0.0001** (0.00002)	-0.0001** (0.00002)	-0.0001** (0.00002)	-0.0001** (0.00002)	-0.0001** (0.00002)
Constant	-20.0624** (1.2738)	-20.1179** (1.2144)	-20.8356** (1.1404)	-20.2065** (0.9734)	-21.3807** (1.4090)

Table 1. (Continued)

	Model 1	Model 2	Model 3	Model 4	Model 5
<i>N</i>	1912	1923	2051	2126	1912
Model Wald test	442.74	417.69	460.48	585.31	489

Note: Robust standard errors in parentheses.

*Significant at 5%.

**Significant at 1%.

+ Significant at 10%.

previous inflows' variable remains significant and positive, but the other control variables (market size, development, growth) that are typically found to be important determinants of FDI flows in the literature fail to achieve statistically significant, except for exchange rate instability. These two models do not appear to be superior to the benchmark model in both tables, which gives us more confidence in the benchmark model results.

The control variables for the FDI amount equation produce results that are quite consistent with the conventional wisdom in the literature. Even when we include the rather restrictive control variable, the previous inflows, the effects of the other control variables are highly significant and in the expected directions. Large market size, higher development, and faster economic growth all increase the amount of FDI inflows into a host country, while exchange rate instability reduces the amount of inflows. The results for these control variables are consistent across all models in both tables, giving us more confidence in the model results.

Next we turn to discuss the results for the political violence-related variables. We start with the results in Table 1. The statistical findings are quite mixed, which is not surprising given that each of these variables lumps the anticipated and unanticipated effects together. More specifically, civil war involvement does not influence the investment location choice across all five models, but it has a weakly significant negative effect on the investment amount in the host country in Model 1 only. In contrast, an interstate war involvement is highly significant and negative in the inflow presence equation. A country that is involved in an interstate war is less likely to be chosen as an investment destination. But an interstate war involvement does not reduce the amount of investment the country receives once it is chosen favorably. The number of transnational terrorist incidents in a country does not affect its chances of being chosen as an investment destination or the amount it receives once being chosen. The only exception is in Model 1, where the number of terrorist incidents appears to weakly increase the

1 **Table 2.** Anticipated and Unanticipated Effects of Political Violence on
 3 FDI Inflows, 1976–1996.

	Model 1	Model 2	Model 3	Model 4
<i>Inflow Presence Equation</i>				
5 Unanticipated civil war	-0.3765 ⁺ (0.2374)	-0.3794 ⁺ (0.2334)		-0.3604 ⁺ (0.2530)
7 Anticipated civil war	0.0855 (0.1961)		0.0567 (0.1894)	0.0196 (0.2062)
9 Unanticipated interstate war	-0.5589** (0.2395)	-0.6119** (0.2569)		-0.5391* (0.2452)
11 Anticipated interstate war	-0.2716 (0.2910)		-0.9129** (0.3013)	-0.4107 (0.2853)
13 Unanticipated terrorist incidents	0.0160 (0.0147)	0.0196 (0.0168)		0.0146 (0.0174)
15 Anticipated terrorist incidents	0.0134 (0.0332)		0.0193 (0.0313)	0.0268 (0.0333)
17 Previous inflows	0.7075** (0.2020)	0.7122** (0.2047)	0.7422** (0.2045)	0.6910** (0.2108)
19 Cold war dummy	-0.1814* (0.0919)	-0.1939* (0.0928)	-0.1547 ⁺ (0.0906)	
21 Market size				0.0234 (0.0488)
23 Development				-0.0525 (0.0778)
25 Growth				0.0057 (0.0064)
27 Exchange rate instability				-9.02e-06** (3.76e-06)
29 Constant	0.7971** (0.0901)	0.8057** (0.0928)	0.7489** (0.0852)	0.5776 (0.8829)
31 ρ	-0.91	-0.91	-0.91	-0.92
33 Wald ($\rho = 0$)	107.70	108.99	115.31	86.05
35 Total N	2183	2183	2183	2143
<i>Inflow Amount Equation</i>				
37 Unanticipated civil war	-0.7078* (0.3235)	-0.7131* (0.3249)		-0.7285* (0.3214)
39 Anticipated civil war	-0.0002 (0.2714)		-0.0125 (0.2754)	0.0705 (0.2713)
Unanticipated interstate war	0.0804 (0.2521)	0.0578 (0.2582)		0.1171 (0.2526)
Anticipated interstate war	-0.7628 (0.7510)		-0.8863 (0.5910)	-0.7914 (0.7176)
Unanticipated terrorist incidents	0.0005 (0.0064)	0.0011 (0.0062)		0.0004 (0.0062)

Table 2. (Continued)

	Model 1	Model 2	Model 3	Model 4
Anticipated terrorist incidents	0.0041 (0.0306)		-0.0004 (0.0309)	0.0003 (0.0290)
Previous inflows	0.0614* (0.0277)	0.0619* (0.0277)	0.0612* (0.0272)	0.0608* (0.0280)
Market size	0.5860** (0.0763)	0.5825** (0.0706)	0.5704** (0.0761)	0.5749** (0.0812)
Development	0.6742** (0.1315)	0.6718** (0.1237)	0.7141** (0.1293)	0.7192** (0.1321)
Growth	0.0283** (0.0093)	0.0285** (0.0093)	0.0318** (0.0093)	0.0211* (0.0104)
Exchange rate instability	-0.0001** (0.00002)	-0.0001** (0.00002)	-0.0001** (0.00002)	-0.0001** (0.00002)
Constant	-21.3973** (1.3499)	-21.2980** (1.3112)	-21.3866** (1.3244)	-21.4993** (1.4353)
N	1790	1790	1790	1790

Note: Robust standard errors in parentheses.

*Significant at 5%.

**Significant at 1%.

+Significant at 10%.

amount of FDI investment a country receives. The mixed nature of these results reflects the situation of the collective evidence in the literature to date.

Are the results for the political violence-related variables in Table 2 consistent with our theoretical expectations? Do they exhibit any coherent pattern that has been absent in the literature on the effect of political risk over FDI flows? Starting with the effects of civil war variables, we find that as expected, the effect of an unanticipated civil war involvement is statistically significant and negative across all relevant models in both equations; the effect of an anticipated civil war involvement is statistically insignificant across all relevant models in both equations, also as expected. A country that experiences a civil war that investors fail to anticipate will find itself being shunned by investors both in terms of its chances of being chosen as an investment location and the amount of FDI it receives. The coefficient estimate for the variable demonstrates that as the probability that a country experiences an unanticipated civil war rises from 0 to 1, the decline in its FDI inflow ranges from 70 (Model 1) to 74% (Model 4). This is an economically substantial change. However, the occurrence of a civil war that has been anticipated by investors will no longer influence subsequent in-

1 vestment behaviors, which is consistent with the notion that the repressive
effect has kicked in before the anticipated civil war occurs.

3 The results for the interstate war variables also are largely consistent with
our expectations. As expected, the anticipated interstate war does not affect
5 the chance that a country is selected as an investment destination across all
models, except in Model 3. This is not surprising, because Model 3 excludes
7 the unanticipated interstate war variable. The anticipated interstate war,
being constructed based on a model of poor predicted power and low
9 probability cut off, is likely to contain cases that are unanticipated. Finally,
as expected, the anticipated interstate war does not have any effect on the
11 amount of FDI inflows a country receives across all models for the inflow
amount equation.

13 Interestingly, the unanticipated interstate war reduces the chance that a
country is being chosen as an investment location, based on all models of the
15 inflow presence equation, but it has no statistically significant effect on the
amount of FDI a country receives across all models of the inflow amount
17 equation. The findings are not inconsistent with our understanding of the
nature of interstate wars. The results suggest that interstate war largely
19 deters new equity investment that flows into a country. The deterred new
investment may have originated from the belligerent country, or from those
21 investors that were contemplating to enter the market but are now put on
hold, given the increased uncertainty about the future direction of the host
23 country. However, pre-existing investment in the host country does not
necessarily shrink or withdraw and may even expand through an increased
25 reinvestment. This will occur so long as the war is limited to the border area
or fought on the soil of another country, without generating any real drastic
27 policy changes of wide impact. In addition, the war effort itself may generate
some perverse incentive for pre-existing MNEs to expand their operations,
29 due to the increased war-related demand for the products of the MNEs,
especially those in the agriculture, extractive, chemical, and manufacturing
31 industries. Finally, as noted, the market demand which the deterred new
investment was intended to serve may now be satisfied by existing MNEs in
33 the country through expanding their operations.

As expected, the anticipated transnational terrorist incidents do not pro-
35 duce any statistically significant effect on the chance that a country is chosen
as an investment location or the amount of FDI it receives. The statistical
37 finding with respect to the unanticipated terrorist incidents is not as ex-
pected. Contrary to our expectation, the unanticipated terrorist incidents,
39 despite their unexpectedness, do not generate any changes in investor be-
haviors, either in terms of the investment location choice or the decision

1 over investment amount. One interpretation that is consistent with the
3 findings is that investors do not care about or cannot deal with terrorist
5 incidents-related risks at all. This interpretation, however, is not plausible in
7 light of the catastrophic consequences of events like the 9/11. Another possi-
9 bility is that the measure of terrorist incidents that are used to generate
11 these anticipated and unanticipated measures is too crude by aggregating all
13 types of incidents together. It fails to separate terrorist attacks that have real
15 implications for business operations from those that are merely news of little
17 informational value (e.g., hoax). Future research may further explore the
19 issue by creating a measure of terrorist attacks similar in severity to those
21 measures of interstate and intra-state wars. A third possibility is due to the
23 particularistic attributes of FDI, relative to the flow of goods, for example.
25 In Chapter 10 of this volume, Fratianni and Kang show that terrorism
27 reduces real bilateral trade flows by raising trading costs and hardening
29 borders. While traders are sensitive to and constantly internalize the changes
31 in trading costs due to terrorist incidents, FDI tends to be much more rigid
and stationary in the host economy. As noted, foreign direct investors who
operate production facilities in the host economy tend to have long time
horizons and global business strategies. They are unlikely to respond to
every kind of terrorist threat, because not every type of terrorist incidents
has material influence over the firm operation and profit. A fourth possi-
bility that may account for the insignificant effect of unanticipated terrorist
attacks relates to the nature of the FDI data we use. In analyzing the effect
of terrorism on trade, for example, Fratianni and Kang examine bilateral
trade data and they find that countries sharing a common land border and
suffering from terrorism trade less than neighboring countries that do not
experience terrorism. But the impact of terrorism on bilateral trade declines
as distance between trading partners increases. The FDI flows are also di-
rectional. The effect identified by Fratianni and Kang in terms of trade may
also apply to FDI flows. Hence, the use of monadic FDI data makes it
difficult for us to identify accurately the effect of political violence, including
not just terrorism but also interstate and civil war.

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4. CONCLUSION

37 The international business literature presents an interesting intellectual puz-
39 zle regarding the effect of political instability and political risk on FDI.
Survey evidence shows that multinational executives take into account po-
litical instability in making investment decisions, while econometric studies

1 produce conflicting findings. In this paper, I offer a new theory that explains
2 how political violence, an extreme form of political instability, affects FDI.

3 The new theory contributes to the literature by bringing in rational ex-
4 pectations and uncertainty on the part of foreign investors to shed light on
5 the effect of political violence on investment behaviors. The amount of FDI
6 is analyzed separately from the probability of a country receiving FDI. The
7 empirical analysis of FDI inflows covers about 129 countries from 1976 to
8 1996. Unanticipated civil war has a negative ex post effect on investment
9 choices over location and magnitude, but anticipated civil war does not.
10 Unanticipated interstate war decreases the chance of a country chosen as an
11 investment location, but not the size of investment. Anticipated interstate
12 war does not influence ex post investor choices over either location or
13 magnitude. Likewise, anticipated terrorist attacks do not have such ex post
14 effects. But unanticipated terrorist attacks are not found to have any effect
15 on investment choices either, an issue worth further exploration. Overall, the
16 statistical findings largely support my theoretical expectations. The theory
17 helps reconcile the inconsistent econometric findings on the effect of polit-
18 ical instability on FDI flows.

19 However, future research should further investigate the unexpected find-
20 ing that unanticipated terrorist attacks do not influence investment be-
21 haviors. Disaggregating the types of terrorist attacks is a meaningful next
22 step. Where data are available, one should also look into bilateral invest-
23 ment flows, rather than relying on country level investment data. This may
24 also account for why interstate conflict does not influence country level FDI
25 inflows.

26 Despite these issues, this article suggests a new perspective that proves
27 useful in reconciling contradictory findings in the international business
28 literature. Analysts are urged to consider issues of rational expectation,
29 uncertainty, as well as attributes of political events, in order to understand
30 how politics influences investment behaviors. Political violence affects in-
31 vestment in a complex manner. More sophisticated understanding leads to
32 better appreciation of the negative consequences of political violence, pro-
33 viding a greater incentive to search for policy solutions that reduce violent
34 acts.

37 NOTES

39 1. Most countries fail to report data on reinvested earnings, hence resulting in a
40 downward bias in the reported size of the flows. I thank Alan Rugman for bringing

1 this data issue to my attention. To the extent that political violence is expected to
 2 reduce reinvestment, the lack of data on reinvestment makes it harder for us to find a
 3 statistically significant effect of violence on FDI.

4 2. One may argue that an MNE may not necessarily care too much about the risks
 5 of a particular investment asset, since the firm can diversify away some of the risks by
 6 holding a market portfolio (Butler & Joaquin, 1998, p. 600). For specific investment
 7 asset in a particular country, at least part of the political risks resulting from political
 8 violence-related policy changes are not diversifiable risks. This is because investors
 9 cannot fully anticipate all contingencies and because the market for the securitization
 10 of political risks is not yet well developed (Finnerty, 2001).

11 3. Li and Sacko (2002) offer a similar line of argument on the effect of interstate
 12 conflict on bilateral trade. But FDI has its own unique attributes and causal mech-
 13 anisms. Furthermore, this analysis considers civil war and terrorism in addition to
 14 interstate war.

15 4. Data on the variable are from the *World Development Indicators*. The ratio of
 16 FDI/GDP also is often used in empirical studies. The conceptual problem with the
 17 ratio measure is that both FDI and GDP are on the left-hand side, both affected by
 18 the same factors. Consequently, it is difficult to interpret whether the coefficient of a
 19 right-hand side variable reflects its effect on FDI or GDP. In addition, the level
 20 variable and the ratio variable have distinct conceptual implications.

21 5. In the database, an armed conflict is defined as “a contested incompatibility
 22 that concerns government and/or territory where the use of armed force between two
 23 parties, of which at least one is the government of a state, results in at least 25 battle-
 24 related deaths.”

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