Institutions, Volatility and Investment
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Discussion by
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Federal Reserve Board

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The views expressed here are those of the presenter and not necessarily of the Federal Reserve System.
Summary

Part 1: Empirical investigation
- FDI flows from Netherlands to 156 countries.
- Executive constraint
  - Strong executive constraints associated with more FDI flows.

Part 2: Build a theoretical model to explore a mechanism.
- Higher executive constraints
  - $\Rightarrow$ Lower variance of productivity growth
  - $\Rightarrow$ Higher investment
Positioning of the paper

**International or macro?**

- Elements of international economics:
  - Use FDI flow data

- Missing FDI Elements?
  - Foreign investment:
    - Additional layers of rules and regulations associated with national boundaries.
    - More sensitive to political environment than domestic investment (Dixit (2011)).
  - The model: “if we had good country level or sector specific data on firms, this too could be used”
The paper treats executive constraints as the “core measure of political institutions.”

- Shows executive constraints affect FDI flows more than other democracy components.
  - Other democracy measures: openness of executive recruitment, competitiveness of executive recruitment

- States the correlation doesn’t seem to stem from the fact that executive constraints proxy for other political institutions/economic factors.
  - Other democracy measures, GDP per capita, GDP per capita growth, schooling, fixed effects.
Executive Constraints and Political Institutions

- Political institution measures?
- ICRG political risk rating components:

<table>
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<th>Sequence</th>
<th>Component</th>
<th>Points (max.)</th>
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<tr>
<td>* A</td>
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<tr>
<td>* B</td>
<td>Socioeconomic Conditions</td>
<td>12</td>
</tr>
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<td>* C</td>
<td>Investment Profile</td>
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<tr>
<td>* D</td>
<td>Internal Conflict</td>
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<td>* E</td>
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<td>12</td>
</tr>
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<td>F</td>
<td>Corruption</td>
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<td>G</td>
<td>Military in Politics</td>
<td>6</td>
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<td>H</td>
<td>Religious Tensions</td>
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<tr>
<td>I</td>
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<tr>
<td>Total</td>
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Foreign investment literature has examined various components of quality of political institutions.

- Wei (2000): corruption
- Daude and Fratzscher (2008): expropriation risk, property rights
- Gelos and Wei (2005): government transparency
- Daude and Stein (2007): regulatory quality, control of corruption, rule of law, etc.
- Julio and Yook (2016): political uncertainty, government stability, checks and balances, etc.
Executive Constraints and Political Institutions—cont’d

- Adoption of strong executive constraints: exogenous?
- Is this a better political institution measure than others?
  - Correlated with other measures?

<table>
<thead>
<tr>
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<th>Correlation Coefficients</th>
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<td>Checks and Balances</td>
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- Checks: The number of veto players in a political system (World Bank Database of Political Institutions).
- Government stability: governments ability to carry out its declared programs, and its ability to stay in office (ICRG).
Time-series variation?

*Source: Financial Accounts of the United States, Federal Reserve Board*
Empirical Specification

Pseudo Poisson regression

- From the trade literature.
- Outcome variables cannot be negative.
  - Mostly use “gross” FDI flow data
  - Robustness check using net flows: they set negative flows to zero.

- FDI measure: flows to a country relative to those to all countries.
  - flows/population, flows/GDP, flows(t)/FDI stock(t-1)
Empirical Specification—cont’d

Statement that the correlation doesn’t seem to stem from the fact that executive constraints proxy for other political institutions/economic factors:

- The paper controls for log(GDP per capita), GDP per capita growth, and years of schooling.

- Other standard time-varying FDI controls:
  - Trade openness
  - Changes in exchange rate and volatility.
  - Stock market return, return volatility
To Wrap Up...

- I really enjoyed reading the paper.
- Interesting new approach.
- Intuitive model explaining the mechanism.
- Would benefit from better motivation and positioning.