Foreign Direct Investment and Territorial Disputes

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<Abstract>

In this paper, we evaluate the relationship between bilateral foreign direct investment flows and geopolitical disputes, including contention over territory, cross-border rivers, and maritime areas. We consider the causal mechanisms linking FDI and interstate conflict by focusing on different stages of the conflict process, such as the declining benefits of territorial conquest, increasing preference similarity, increasing opportunity costs of violence, and improved information signaling. Our empirical analyses on the Issue Correlates of War project data from 1980-2001 suggest that bilateral FDI flows have no effect on states' decisions to start new issue claims. However, bilateral FDI flows between two disputants significantly reduce the chances for escalation to high levels of violence over contested issues and improve the chances for peaceful conflict management. Our additional analysis also finds strong support for the opportunity costs as a primary mechanism linking FDI and conflict management.

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Liberal peace scholars have pointed to many advantages of economic exchange (Russett and Oneal 2001), finding that foreign direct investment (FDI) tends to reduce the likelihood of interstate conflict (Gartzke and Li 2003) and civil war (Barbieri and Reuveny 2005).[1] In this paper, we evaluate the FDI-conflict relationship in the context of geopolitical disputes, where states' interests are often highly salient (Gartzke 2006). If foreign direct investment has the capacity to discourage militarized conflict and promote the peaceful resolution of disputes, then finding pacific effects for FDI in the most contentious set of issues related to geopolitical disputes will further strengthen the liberal peace proposition. This is especially important given recent claims that the democratic peace is threatened by the onset and escalation of territorial disputes between democratic states (James, Park, and Choi 2006; Lektzian, Prins, and Souva 2010).

We situate our theoretical argument in the literature on territory, which treats border disputes as an important step to war (Vasquez 1993, 1995). This literature demonstrates that once states make competing claims to territory, they are much more likely to use violent force to resolve those claims if the contested land is very salient to both sides (Hensel et al. 2008) and if the disputants engage in hawkish behavior, such as arming, forming alliances, and escalating crises (Senese and Vasquez 2008). We examine the influence of FDI in this causal chain by considering whether economically interdependent states avoid new border disputes altogether or whether FDI simply raises the costs of escalation to militarized conflict in the context of contentious issue claims. If the latter were true, we would observe geopolitical disputes between states that are mutually invested in each other's territories, although these issues would be less likely to escalate to high levels of interstate violence in comparison to geopolitical disputes between less economically interdependent states. This comparison will help us determine

[1] Foreign Direct Investment (FDI) refers to funds that are transferred to overseas affiliates, subsidiaries, or joint ventures by multinational corporations (Spero and Hart 2003). The OECD defines FDI as "a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (*direct investor*) in an enterprise (*direct investment enterprise*) that is resident in an economy other than that of the direct investor...The direct or indirect ownership of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship."

whether FDI is linked to conflict in an informational sense or whether FDI alters states' interactions by removing the most conflict-prone issues from the menu.[2]

We test these propositions using data on geopolitical conflicts over territory, maritime areas, and cross-border rivers from the Issue Correlates of War (ICOW) project (Hensel et al. 2008). We find that FDI has no effect on states' decisions to start new issue claims.[3] However, bilateral FDI flows between two disputants significantly reduce the chances for escalation to high levels of violence over contested issues and improve the chances for peaceful conflict management. Interestingly, we also find that FDI reduces the chances for militarized conflicts even in pairs of states that have experienced prior militarization of contested issues. This fits with the longstanding Kantian view that economic exchange helps to promote peaceful interaction, even in situations of heightened security dilemmas. We discuss many real world examples where companies put pressure on their governments to resolve outstanding border disputes, moves which help to raise the home governments' opportunity costs for violence. Our analysis and discussion shed further light on the causal mechanisms relating FDI and conflict management.

Our paper is organized as follows. We begin by summarizing previous work on economic interdependence and conflict, focusing on the relationship between FDI and interstate conflict. We then describe some of the limitations of previous research. Next, we develop a theoretical argument linking FDI more clearly to the dynamic process of interstate conflict through four causal mechanisms: the declining benefits of territorial conquest, increasing preference similarity, increasing opportunity costs of violence, and improved information signaling. We describe the data used to test our hypotheses

[2] One sees a similar linkage between democracy and militarized conflict. Mitchell and Prins (1999) find that fully democratic regimes do not fight over territory when threatening, displaying, or using military force against other democratic states. Newer, democratizing states, on the other hand, do experience MIDs over territorial issues. Gibler (2007) argues that the relationship is endogenous, with democratic regimes being more likely to flourish in peaceful regions where border issues have been resolved.

[3] Issue claims are defined by the ICOW project (Hensel et al. 2008: 128) as involving "evidence that official representatives of at least one state make explicit statements claiming sovereignty over a specific piece of territory that is claimed or administered by another state, or contesting the use or abuse of a specific international river or maritime zone."

empirically and then present our results. We conclude by discussing the academic and policy implications of our research.

The Relationship Between FDI and Interstate Conflict

Liberal peace theorists have made significant advances in explaining and evaluating the effects of foreign direct investment (FDI) on militarized interstate conflict. Most studies find that increased foreign direct investment reduces the chances for new dyadic militarized conflicts and improves interstate cooperation levels (Gartzke, Li, and Boehmer 2001; Souva 2002; Gartzke and Li 2003; Rosecrance and Thompson 2003; Lee 2006; Polachek, Seiglie, and Xiang 2007). This research builds upon earlier analyses that examined the relationship between interstate trade and conflict, with many studies in this literature also finding a negative relationship between dyadic trade and militarized dispute onset (Polachek 1980; Gasiorowski 1986; Domke 1988; Mansfield 1994; Oneal et al. 1996; Oneal and Russett 1997, 1999a, 1999b; Bliss and Russett 1998; Polachek, Robst, and Chang 1999; for a review of the literature, see Mansfield and Pollins 2001). These findings are important in light of the massive increase in global foreign direct investment globally. As seen in Figure 1, worldwide annual inflows of FDI rose from around $13 billion in 1970 to $1.4 trillion in 2001. Developed and developing countries have witnessed significant increases in their inflows of FDI over time. Given that FDI growth since 1970 has outpaced growth in trade or GDP (Rosecrance and Thompson 2003), it is important to understand the effect of increasing global FDI on interstate conflict patterns.

Theoretical arguments relating FDI to interstate conflict can be categorized into three broad perspectives. The first perspective asserts that FDI provides more *information* to states about their opponents' capabilities and resolve, which creates situations where states can prevent militarized conflicts by mitigating asymmetries of privately held information in dyadic bargaining. For example, Gartzke, Li, and Boehmer (2001) and Gartzke and Li (2003) argue that economic interdependence promotes peace by allowing states to engage in costly signaling and reducing the need to resort to military contests. In their argument, trade and foreign investment function as a medium for information exchange, dissipating

private information, one of the key elements producing conflict according to the bargaining model of war (Fearon 1995). In this view, FDI facilitates states' bargaining to reach an acceptable agreement through peaceful means, reducing their need to resort to militarized strategies of conflict management.

A second theoretical position asserts that foreign direct investment (FDI) increases the *opportunity costs* of conflict and thus encourages more peaceful foreign policies. Similar arguments were posited in much of the earlier work on trade and conflict. For example, Russett and Oneal (2001: 141) suggest that "foreign investment and the globalization of production, like trade, should increase the incentive for peace. Investment creates similar networks of shared interest and communication. Military conflict raises the risk that foreign investment will be expropriated or destroyed." Focusing on the increasing amount of foreign direct investment for the last thirty years, Souva (2002) and Souva and Prins (2006) argue that since FDI enhances a nation's wealth through the inflows of financial and human capital, state leaders do not want to disrupt this investment through conflict. This is consistent with the *welfare effects* argument that FDI improves capital stock and technology (Johnson 1970). Rosecrance and Thompson (2003) also argue that FDI produces vulnerability interdependence that is costly to break, and thus FDI constrains a state from resorting to militarized conflict due to the expected heavy opportunity costs of violence. Simmons (2006) makes a similar argument about the high opportunity costs for trade that are generated by ongoing border disputes. She finds that border disputes reduce contiguous countries' bilateral trade.

A third theoretical perspective treats FDI as a mechanism for states to peacefully extract wealth from other countries, as opposed to extraction of resources through military *conquest*. Brooks (1999) argues that foreign direct investment modifies the willingness of states to engage in conflict with other states. He suggests, "In general, as a state is increasingly able to rely on multinational corporations to secure needed external resources and supplies, the overall willingness of that state to engage in conquest should decrease" (Brooks 1999: 666). Rosecrance (1999) asserts that nations choose one of two paths for promoting domestic wealth: territorial aggrandizement or commercial transactions. States focused on

political-military interests emphasize territorial aggrandizement and pursue aggressive foreign policies. In contrast, states focused on commercial interests emphasize exchange and pursue more peaceful foreign policies. As states focus on exchange, they become more economically dependent on international commerce in terms of both trade and foreign investment. Souva (2002) and Souva and Prins (2006) also argue that FDI typically takes the form of fixed assets in other countries and thus is regarded a form of "extracting" wealth from other states. Considering that conquest is a way of extracting resources from a territory, FDI provides an alternative peaceful tool for the extraction of resources and enables the local population to benefit as well (Souva 2002: 12).[4]

Limitations of Current Research on FDI and Conflict

Although FDI is believed to make states less likely to engage in territorial conquest of other states' territories, previous research on this topic has not directly tested the relationship between FDI and territorial disputes. Gartzke (2006) looks at this relationship in a broader context, treating FDI as one aspect of a more general measure of globalization. He finds that economic development increases states' abilities to fight conflicts at greater distances, while at the same time decreasing the propensity for neighbors to engage in conflict over territorial borders. However, his study does not track the dynamic process of territorial conflict, which is problematic considering that over half of all territorial claims never experience any militarized disputes (Hensel et al. 2008). By omitting border disputes that are settled with peaceful means, previous results may have been biased against the liberal peace proposition.

Another inconsistency in the FDI-conflict literature is the assumption that conflict creates opportunity costs for future investments or trade. However, there is little evidence that military conflict is harmful to states' ability to attract FDI from outside investors. On the contrary, some studies find that military conflict has no significant effect on the flow of FDI (Li 2006; Lee 2008; Li and Vashchilko 2010). This naturally raises a question about whether FDI reduces the likelihood of military conflict between

[4] "Indeed, it is interesting to note that although there were large portfolio investments between the major opposing European powers prior to World War I, the amount of direct investments was small" (Souva 2002: 26).

states because of the opportunity costs that states have to pay, and demands a more rigorous test that explores more carefully the causal mechanisms relating FDI to interstate conflict. By examining the effect of FDI on the onset of new geopolitical disputes, as well as the management of pre-existing disputes, we can more clearly evaluate the opportunity costs assumption.

Scholars in international relations have focused on the process or steps to war, from lower levels of disagreement to higher levels of military conflict, attempting to explain how those steps are linked. As Vasquez (1993) describes, the steps to war model is based on the assumption that war stems from a long term process of conflict escalation. Yet few empirical studies examining the FDI-conflict relationship focus on the process of conflict development. For example, we know little about how FDI works in the early stages of an issue disagreement between states, how FDI affects the escalation to the use of militarized force when states attempt to resolve a given issue, or how FDI might improve chances for de-escalation through companies putting pressure on their respective governments to initiate peaceful talks. By focusing on contested issues from their diplomatic beginnings to their sometimes violent endings, we can test the varied roles of FDI at different stages of issue conflict.

In addition, most previous studies looking at the FDI-conflict relationship have employed a monadic measure of FDI, such as the total amount of investment flowing into a country in a given year from all other states, even though the underlying theoretical arguments linking FDI and conflict are typically dyadic (Gartzke, Li, and Boehmer 2001; Gartzke and Li 2003; Souva and Prince 2006). This approach is understandable given the lack of systematic data sets on bilateral FDI flows (Rosecrance and Thompson 2003). Li and Vashchilko (2010) have assembled a new dataset of bilateral FDI flows based on OECD data, which will help us obtain more direct evidence about how FDI influences the onset and escalation of issue claims. In this preferred research design, we can examine how FDI flows between state A and state B influence the onset and management of geopolitical issues between state A and state B. This will also help us to deal more carefully with the endogenous relationship between FDI and conflict,

which can move this literature in the direction of the more advanced empirical work on trade and conflict.[5]

Theory

Our theory seeks to overcome many of these limitations by considering more carefully how foreign direct investment influences states' foreign policy strategies. In particular, we hope to obtain a better understanding of the causal mechanisms linking FDI and interstate conflict. As noted earlier, we embed our theory in the work on territorial conflict, including the issue-based approach to world politics (Hensel et al. 2008) and the steps to war model (Vasquez 1993; Senese and Vasquez 2008). This is an ideal testing ground for evaluating the FDI-conflict relationship because "territorial disputes are a central issue over which militarized disputes, crises, and wars have erupted" (Huth and Allee 2002: 31). Huth and Allee (2002) argue that the importance and frequent militarization of territorial disputes creates a very demanding and critical test of the democratic peace theory. Given that we view FDI as part of the broader liberal peace phenomenon, we think this approach will also prove useful for evaluating the potentially pacific effects of foreign direct investment. Furthermore, datasets in the issue-based tradition also contain richer information about the overall conflict process, from the diplomatic onset of contentious issues to their diplomatic or violent endings, which will make it possible for us to evaluate the effect of FDI on different stages of interstate competition.

Territorial claims that involve disagreements over the ownership of territory have been shown to be one of the most important causes of militarized dispute onset and escalation to interstate war (Brecher 1993; Vasquez 1993, 1995, 1996; Holsti 1991; Kocs 1995; Huth 1996; Brecher and Wilkenfeld 1997; Hensel 1996a, 1996b, 2001; Vasquez and Henehan 2001; Huth and Allee 2002; Hensel and Mitchell 2005; Senese 1996, 2005; Senese and Vasquez 2003, 2008). While conflict scholars have believed for a long time that contiguity is an important predictor of militarized conflict (Bremer 1992), research on

[5] For studies that discuss and empirically test the endogenous trade-conflict relationship, see Reuveny and Kang (1996, 1998), Morrow (1999), Morrow, Siverson, and Tabaras (1999), Reuveny (2001), Li and Sacko (2002), Kesch, Pollins, and Reuveny (2004), and Long (2008).

territorial issues has shed light on why contested borders are dangerous. Border issues that remain unresolved are more likely to lead states down the steps to war, while contiguous states with mutually accepted borders are less likely to fight each other (Vasquez 1993, 1995; Senese and Vasquez 2003, 2008). Furthermore, the manner in which states attempt to settle territorial disputes is also important. Realpolitik strategies of arms build-ups, repeated crises, alliance formation, and hawkish foreign policy tools significantly increase the chances that a territorial dispute will result in interstate war (Vasquez 1993; Senese and Vasquez 2008).

These patterns have also been observed in a broader set of geopolitical issues, including contestation over maritime areas and cross-border rivers. Hensel et al. (2008) find that territorial, maritime, and river issues are more likely to result in militarized disputes if the contested stakes are more salient to the opposing sides. Furthermore, they find that prior militarization and power parity increase the risks of militarized dispute onset for all types of geopolitical disputes. By expanding our focus beyond land borders to water borders, we have access to a richer set of data for evaluating the effect of FDI on interstate conflict and cooperation.

We present our theoretical framework relating FDI to the onset and management of geopolitical issue claims in Figure 2. A new issue claim begins when one state challenges another state's rights over a land or water area. Once an issue claim is underway, states can employ either militarized or peaceful tools to pursue their issue related goals or do nothing and maintain the status quo. These strategies are not mutually exclusive, as states often pursue both diplomatic and militarized solutions to interstate issues. In the next section, we discuss how bilateral FDI flows influence states' strategies at each stage of the issue conflict process.

Stage 1: Onset of Geopolitical Issue Claims

Our first step is to determine how decisions by businesses to increase foreign investments in another country might influence the host states' and recipient states' foreign policies towards each other. If businesses operate according to rational expectations models, they should consider ongoing or potential

interstate conflicts when deciding where to invest. Yet, as noted above, studies that have evaluated the effect of conflict on FDI show mostly null results, although firms do seem to respond to unexpected conflict by reducing trade (Li and Sacko 2002) and FDI (Lee 2008), especially if they are dealing with specific assets whose prices are relatively high (Lee 2008). Once firms have invested in other countries, this could alter the likelihood for future interstate conflicts between the host and recipient states. The general hypothesis is as follows:

> Hypothesis 1: An increase in bilateral foreign direct investment will reduce the likelihood that a challenger initiates a geopolitical issue claim toward a target country.

This empirical relationship could be driven by a variety of causal mechanisms, but we focus on two specific mechanisms: the declining benefits of conquest brought about by increased globalization and exchange and the increasing foreign policy preference similarity of states who are more economically interdependent.

Causal Mechanism #1: Declining Benefits of Conquest

As noted earlier, one explanation for the pacific effect of FDI on conflict stems from the belief that the benefits of territorial conquest decline as states engage in increased economic exchange, trade, and investment (Brooks 1999; Rosecrance 1999). In this situation, increases in bilateral FDI flows between two countries would reduce the chances for new border disputes because both sides could gain more from a peaceful, economic exchange of goods and services.

Declining conquest can be explained by many factors that have altered the way states maintain their security in world affairs. Weapons have become more powerful and destructive, especially nuclear weapons, raising the costs of large scale territorial conquest. The development of nuclear weapons also coincides with a broader shift in favor of defensive weapons over offensive ones (Jervis 1978; Van Evera 1990/91). Some have suggested that major power conflict itself is becoming obsolete, much like slavery and dueling (Mueller 1990). Increased democratization around the world works against territorial conquest as well, given that democratic publics are often averse to fighting wars (Kant 1795/1991; Russett 1993), and that democratic states are less likely to challenge (Lemke and Reed 1996) and

militarize (Mitchell and Prins 1999; Huth and Allee 2002) each other's borders. Democratic states were also key players in pushing for territorial integrity norms in the post-war settlements after World War I and World War II, norms which have effectively removed successful territorial aggrandizement from the international scene (Zacher 2001; Hensel, Allison, and Khanani 2009).

Transformation in the global economy has increased the power of global capital. Since Angell (1933) argued that seizing the wealth of another nation by conquest is no longer an efficient or sustainable instrument for a state to increase its own wealth, many scholars have focused on the transformation of the global economy in their explanation of the globalization-conflict relationship. Over time, global capital has become more and more essential for economic productivity, surpassing international trade in total volume in recent years (Brooks 1999). While capital has become more sensitive to political environments, it has also experienced increased freedom of movement across borders (Olson 2000). This decreases the value of conquest because businesses can simply remove their investments after a war is underway. In this sense, globalization creates an economic world without borders (Ruggie 1993; Ohmae 1995; Cohen 1998). The increased frequency and movement of global capital is a broader part of global economic interdependence, which increases states' opportunity costs for violent foreign policy strategies (Russett and Oneal 2001).

One form of such increased opportunity costs stems from firms' unwillingness to make new investments or to uphold contractual obligations in the face of new or unresolved territorial disputes. For example, in July 2001, British Petroleum (BP) ceased its contractual obligations for oil drilling in the Alov-Sharg-Araz area of the Caspian Sea. Azerbaijan's maritime dispute with Iran in the Caspian Sea had affected company operations, as an Iranian warship threatened a BP survey vessel (AFX European Focus 8/1/2001). Daewoo International imposed an extension on its contract for oil drilling off the west coast of Myanmar in April 2009 due to the unresolved maritime boundary dispute between Myanmar and Bangladesh in the Bay of Bengal (Yonhap 4/3/2009). Russia also faced costs in its aggressive territorial dealings with Chechnya, as Japanese investors threatened to withhold foreign investment until the issue was resolved (Associated Press Worldstream 3/3/1995).

More comprehensive historical evidence about the declining trends in territorial conquest has been examined in detail elsewhere (Holsti 1991; Zacher 2001). What we consider in this paper is the relative frequency of geopolitical disputes over time relative to the potential number of land and water borders that could have been contested. As we show later on, there has been a significant drop in the frequency of new territorial disputes (in the Western Hemisphere), consistent with the broader literature's findings on the declining benefits of territorial conquest. On the other hand, maritime and river conflicts have become more frequent, although on average, these issues have become militarized less frequently than traditional disputes over land borders (Hensel et al. 2008). The general pattern of geopolitical disputes over the past two centuries, however, fits with the expectation that increased global FDI will reduce states' incentives to obtain resources by capturing neighboring territories. By looking at how bilateral FDI influences the onset of new dyadic diplomatic claims to land or water borders, we can determine whether economic interdependence is an important causal factor for explaining the territorial integrity norm that has emerged in the past century.

Causal Mechanism #2: Increasing Preference Similarity

Another way to think about how foreign direct investment might be related to states' decisions to initiate new geopolitical disputes is to consider whether FDI moves states' foreign policy preferences closer together. The economic integration of Europe presents a clear example along these lines, as states in the European Union have essentially removed violence as a tool for settling interstate disputes in the region and respected each other's territorial boundaries for over half a century. FDI may help to integrate citizens across countries and bring states' security and economic interests in closer alignment.

In the liberal peace literature, this question has been examined by focusing on how shared membership in international organizations influences states' foreign policy preferences. Bearce and Bondanella (2007), for example, find that shared IGO memberships significantly increase the likelihood that states will vote together in the United Nations General Assembly. Risse-Kappen (1996) makes a similar argument about democratic foreign policy preference alignment in the North Atlantic Treaty Organization (NATO) military alliance. Foreign aid also serves to promote similarity of states' UN

voting patterns, moving non-democratic leaders in the direction of voting with democratic donors (Lai and Morey 2006). Foreign direct investment could have a similar effect on the alignment of states' foreign policy views. Increased investment and trading ties between citizens and businesses may alter perceptions about citizens, businesses, and governments in other states. In this regard, FDI may enhance states' satisfaction with the regional or global status quo and reduce the chances for new conflicts over land or water boundaries (Lemke and Reed 1996). Empirically, this relationship would be observed if states with very high levels of FDI avoided new diplomatic conflicts over borders. We might also expect that foreign investment underway for longer periods of time would have stronger, pacifying effects, as this would create time for states' and citizens' interests to be altered.

Stage 2: Claim Management

Once a geopolitical issue claim is underway, states can maintain the status quo, engage in peaceful conflict management strategies to help settle the issue (including bilateral talks and seeking out third party assistance), or employ militarized strategies to reach a favorable settlement. Firms with significant amounts of investment in countries with dangerous border disputes may bring pressure to bear on their governments to settle the issue peacefully. The general form of this hypothesis is as follows:

> Hypothesis 2: An increase in bilateral foreign direct investment in a dyad will decrease the likelihood of a militarized dispute over a contested issue.

We examine two possible causal mechanisms at this stage of the conflict process. FDI may increase states' opportunity costs of violence, which encourages them to seek out diplomatic resolutions to border disputes. FDI may also improve states' information about their opponents' capabilities and resolve, which should make it easier to strike an acceptable bilateral agreement over a contested issue.

Causal Mechanism #3: Increasing Opportunity Costs of Violence

The basic idea of the opportunity costs argument is that firms and states pay a price for the potential disruption of trade and investment brought about by war. Rosecrance and Thompson (2003) argue that foreign direct investment ties are even more costly to break than trading ties. The significant

growth in FDI has been the result of companies seeking to reduce labor costs by shifting some production abroad. "With full capital mobility (which did not exist in the 1930s), policy makers are forced to choose between setting interest rates or currency values (these are the well-known Mundell-Fleming conditions). If they depreciate their currencies, capital may leave, causing interest rates to rise. If they wish to hold interest rates constant or to lower them, they cannot depreciate their currency. The armory of national policy instruments has been reduced" (Rosecrance and Thompson 2003: 386). Furthermore, FDI locks businesses into a longer term investment relationship in comparison to more mobile foreign portfolio investments, especially if they are dealing with specific assets, like oil wells or diamond mines. Rosecrance and Thompson examine the effect of reciprocal and one-sided FDI in all conflict dyads involving the United States from 1950-1992, finding that reciprocal (or bilateral) FDI flows have a very strong pacifying effect on hostility escalation. However, this research design does not consider the effect of FDI flows on peaceful dyads that have the potential for militarized conflict, but do not experience interstate violence.

If firms pay opportunity costs for escalating violence in locations where they have already invested, we should observe companies taking an active role pressuring the governments involved to settle disputes quickly and peacefully. This should be especially true in the case of FDI given that it is less mobile than foreign portfolio investment. There are many examples of companies intervening in precisely this manner. Last year, the Croatia EU Business Council (CEUBC) put strong pressure on Croatia and Slovenia to settle their border dispute through mediation or with the assistance of the International Court of Justice (BBC News 3/3/2009). The Chinese government has been vocal about settling its dispute with the Philippines over the Spratly Islands with peaceful means only, especially in light of $2.6 billion in investments by Philippines' companies in China (BBC News 8/15/2009). China is also cognizant of the significant financial risks of escalating the situation with India over their disputed land border, as the two countries engage in over $50 billion in trade annually (International Herald

Tribune 9/4/2009).[6] The University of the Thai Chamber of Commerce (UTCC) has repeatedly warned the Thai government about the economic costs of failing to resolve its border dispute with Cambodia (The Nation Thailand 11/13/2009).

The opportunity costs argument predicts a negative relationship between FDI and the onset of militarized disputes. However, firms are sometimes invested in countries long before new interstate conflicts arise. If FDI is less mobile relative to foreign portfolio investment, we should observe ramped up efforts by businesses to pressure governments to resolve conflicts peacefully, especially in highly salient border disputes that have become militarized previously (e.g. the China-India border dispute). On the other hand, if investors are forward looking enough to avoid conflict zones, then only unexpected conflict should alter their investment decisions. In addition to the monotonic effect of FDI on militarized dispute onset, we also analyze the interactive effect of prior militarized conflicts and FDI levels, to see if businesses respond to protect their investments or whether such events have little effect on their ex post behavior. If multinational corporations were perfectly forward looking, we would not observe any FDI between pairs of states with highly contentious geopolitical disputes.

Causal Mechanism #4: Improved Signaling/Information

FDI may not simply raise the opportunity costs of violence; it may also constrain governments' foreign policy strategies, especially by creating more transparency in interstate relations. Gartzke (2006; Gartzke, Li, and Boehmer 2001) focuses on the informational properties of globalization in his study of territorial conflict. His work utilizes the bargaining model of war (Fearon 1995) as a baseline model for interstate conflict, which views war as the result of incomplete information about capabilities/resolve, commitment problems, or issue indivisibilities. In this perspective, "states exposed to mobile capital are...more transparent in their political dealing. It is difficult for these states to bluff given the contrasting

[6] "Business people say the stepped-up tensions over the disputed territory increase the risk of government officials striking down proposed business deals, in turn dampening the willingness of Chinese and Indian companies to work in each other's countries. 'Officials start taking more time, scrutinizing things more carefully, and all that means more delays and ultimately more denials', said Ravi Bhoothalingam, a former president of the Oberoi Group, a luxury hotel chain, and a member of the Institute of Chinese Studies in New Delhi. 'That's not good for business.'" (International Herald Tribune 9/4/2009)

incentives of sovereigns to both calm markets and compel foreign opponents" (Gartzke 2006: 157). The competing forces of market stability and interstate demands make it more difficult for leaders of FDI endowed states to bluff in world politics, which makes peaceful settlement attempts more likely to succeed. However, Gartzke argues that the process of globalization has differential effects on territorial and non-territorial disputes. Increased FDI should reduce the chances for militarized border disputes between neighbors, as it is more difficult to generate profit from captured territory in these instances. On the other hand, globalization brings about greater wealth, which can help a state project force over greater distances. This might lead to an increase in other types of interstate disputes between non-contiguous states. Gartzke's (2006: 174) analysis of directed dyads from 1950-2001 confirms these claims, showing that "development decreases the propensity to initiate disputes over territory". However, his analysis includes all possible pairings of states, which makes it difficult to tease out the specific effects of globalization on the management of border disputes, either peacefully or with militarized means.

If the primary mechanism linking FDI to conflict management is informational, we should observe different effects of FDI across the life cycle of an issue claim. When a new border dispute arises, states may not have much information about each other's capabilities and resolve over the contested issue, thus the presence of FDI should serve as an important channel for the flow of information. Over time, however, the pacifying effect of FDI should diminish as states have already learned a great deal about each other's resolve. This is similar to claims in the formal theory literature that wars should be more likely to end in light of decisive victories on the battlefield, as combatants have better information about their chances for future victory (Slantchev 2003). To examine this causal mechanism, we interact bilateral FDI flows with the number of years an issue claim has been ongoing. If this interaction term is positive and significant, it would wash out the monotonic pacifying effects of FDI on militarized conflict. On the other hand, if the interaction is insignificant, this might suggest that the pacifying effect of FDI works more through opportunity costs than through information.

Research Design

To determine how bilateral FDI flows between state A and state B influence the onset and management of geopolitical issues, we analyze data on geopolitical conflicts over territory, maritime areas, and cross-border rivers from the Issue Correlates of War (ICOW) project (Hensel et al. 2008). Our dataset covers the 1980-2001 time span due largely to temporal limitations in the FDI data. The ICOW data includes information on geopolitical conflicts in the Western Hemisphere, Europe, and the Middle East. Our construction of dyad-year data is limited to these three regions.[7]

Stage one of our causal sequence involves an examination of the onset of new geopolitical conflicts, such as a border dispute. We focus on politically relevant directed dyads as the unit of analysis, which are pairs of states that share a direct land or water border (up to 400 miles) or contain a major power as defined by the Correlates of War project. The directed dyad approach creates one case for country A to country B and a second case for country B to country A. This is utilized because the ICOW project records specific information about which state is the challenger of the territorial, maritime, or river status quo and which state is the defender. This unit of analysis is also selected to avoid a potential problem that might arise if we analyzed all pairs of states. When we compare countries with geopolitical issues to those without geopolitical issues, this helps us identify two distinct types of dyads – dyads with some level of geopolitical issue relevance (e.g. Mexico and United States) and those that have no geopolitical issues (e.g. Mexico vs. Zambia). Including non-politically relevant dyads might artificially generate a negative relationship between FDI flows and geopolitical conflicts due to increased transaction and transportation costs as distance between countries increases (Liu et al. 1997; Braunerhjelm and Ekholm 1998; Markusen and Maskus 1999; Carr et al. 2001). Thus, pairs of countries that do not have much general opportunity for interaction would also be predisposed to have few bilateral FDI flows. To

[7] The ICOW data expand much further back in time to 1816 for territorial claims and to 1900 for maritime and river claims. We also conducted separate analyses using territorial conflict data coded by Huth and Allee (2002) for all regions, finding very similar results to analyses employing the ICOW data. These are available from the authors.

prevent this potential bias in our analyses, we focus on politically relevant dyads in which some pairs of countries have greater opportunity for geopolitical conflicts than others (Most and Starr 1989).

We use the EUGene program (version 3.204) to generate a sample of politically relevant dyads defined by 400 miles of water separation between countries or major power status. Out of 113,410 total politically relevant directed dyadic observations from 1980-2001, 1,342 dyads (1.2%) experience geopolitical issue claims as coded by the ICOW project. While this might seem rare, the existence of bilateral FDI is rare as well, with positive values occurring in just over 5,600 dyad-year observations (4.9%).

Our empirical tests are run in two stages in accordance with the hypotheses identified for issue claim onset and the peaceful or militarized management of ongoing issue claims. In the first part, we run a logistic regression model testing whether an increase in bilateral FDI reduces the likelihood that a challenger initiates a geopolitical issue claim towards a target country (Hypothesis 1). One of the challenges we face in running the model, ironically, is that there have been few studies examining what factors affect the onset of new issue claims, despite numerous studies about the onset and escalation of territorial disputes. In the absence of a widely-accepted model, we take as our base model the standard conflict onset model used among scholars in dyadic studies of international conflict (Bremer 1993; Russett and Oneal 2001). In the second part, we estimate several logistic regression models testing how increased bilateral FDI affects the management of geopolitical issues, such as encouraging bilateral negotiations or escalating to militarized disputes (Hypothesis 2). However, we limit our sample only to the cases where there was an ongoing issue claim over a territorial, maritime, or river border or area. Our control variables are selected based on previous work on territorial claims (Huth 1996; Hensel 2001; Huth and Allee 2002; Hensel et al. 2008). We also interact the effects of prior militarization and issue claim years with bilateral FDI flows to help evaluate the opportunity cost and informational mechanisms more fully.

Dependent Variables:

To evaluate the effect of bilateral FDI flows on conflict management processes, we analyze several dependent variables: issue claim onset, bilateral negotiations, and militarized dispute onset. As stated earlier, these variables are taken from the ICOW project (Hensel et al. 2008). The appendix provides descriptive statistics for all variables.

Onset of Geopolitical Issue Claim: This variable measures whether or not there is a territorial, maritime, or river issue claim between two countries in a given year. As noted earlier, an issue claim occurs when official representatives from one country claim a specific piece of territory owned or administered by another country. Water-based issue claims arise when states contest the ownership or usage of a specific international river or maritime zone (Hensel et al. 2008: 128). This coding does not require militarization for issue claims to exist; in fact, as Hensel et al (2008) note, less than half of all issue claims have ever resulted in a single militarized dispute. For each politically relevant dyad year, we code this dependent variable as one if there is an ongoing geopolitical issue claim and zero otherwise. As we noted earlier, 1,342 of the total 113,410 politically relevant directed dyads experienced an issue claim 1980-2001.

Bilateral Negotiation: This variable measures whether or not there is at least one round of bilateral negotiations between two countries over the claimed issue in a given year. It is coded 1 if there are one or more bilateral negotiations in a given year and 0 otherwise.[8] There are 178 instances of bilateral negotiations (13.2% of issue claim dyad years).

Militarized Disputes: To test the escalation of a claimed issue to higher levels of violence, we also include a variable measuring whether or not two countries engaged in militarized disputes in a given year. The ICOW project includes only militarized disputes that occurred specifically over the issue in question (Hensel et al. 2008). The source for the dispute data is version 3 of the Correlates of War Project's Militarized Interstate Dispute (MID) data set (Ghosn, Palmer, and Bremer 2004). There are 44

[8] We get similar results using a measure for all peaceful settlement attempts, which includes third party conflict management as well. In this sample, bilateral negotiations constitute 82% of the total attempts to resolve issue claims (Hensel et al 2008).

militarized disputes over geopolitical issues in our data set in the Western Hemisphere, Europe, and the Middle East from 1980-2001.

Independent Variables:

Bilateral FDI Flows: We pointed out earlier that one of the empirical problems in previous studies of the FDI-conflict relationship is the employment of a monadic measure of FDI for evaluating theoretical arguments that are dyadic. To overcome such an inconsistency between theory and empirical tests, we use a new dataset of bilateral FDI flows compiled by Li and Vashchilko (2010) for our primary independent variable. Their dataset is based on OECD data and has by far the most comprehensive coverage of bilateral FDI flows. The dataset measures FDI flows either from one OECD country (origin) to any of the other 57 OECD countries (destination), or from one of the 29 non-OECD countries (origin) to an OECD member (destination). Unfortunately, the data do not cover the flows between non-OECD countries, generating many missing values (see Li and Vashchilko (2010) for more detail). For this reason, we replace those missing values as zero.[9] However, we only recode missing FDI values as zero when there is a positive trade relationship. We assume in these cases that the opportunity for bilateral FDI flows is reasonably high. Bilateral FDI flows are measured in billions of US dollars and lagged one year to ensure (weak) exogeneity. The average value for bilateral FDI flows in our sample is approximately $47 million.

*Bilateral FDI Flows*Prior MIDs*: In addition to the effect of bilateral FDI flows on militarized dispute onset, we also test whether an increase in bilateral FDI flows has any impact on militarized disputes even in dyads that have experienced prior militarized conflicts over a contested issue. To do so, we interact *Bilateral FDI Flows* with a variable *Prior MIDs* measuring whether there were any militarized disputes between two countries over the contested issue in the past fifteen years before the observation. We again use the ICOW data for this variable.

[9] We also ran the models with the original data without any replacement. Although it reports smaller observation numbers, we find that the empirical results are the same as the ones with the data having replaced missing values.

*Bilateral FDI Flows*Claim Years*: To test information (or signaling) as a primary mechanism linking FDI to conflict management, we also generate an interaction variable between Bilateral FDI Flows and a variable called *Time Since Claim Onset* measuring the number of years since the claim over a geopolitical issue was first made. The start date goes back to the initial diplomatic point of contention over the issue, even if that precedes the start of our FDI dataset (prior to 1980). Information from this variable is taken from the ICOW dataset.

Control Variables:

At both stages of testing the onset and management of geopolitical issue claims, we include several control variables. All variables are lagged one year to ensure weak exogeneity.

World FDI Inflows: World FDI inflows have increased exponentially since 1970 (see Figure 1). Given that fact, one thing we need to consider in our model specification is that the chances that a challenger initiates a new issue claim against a target country or that two countries engage in high levels of violence over a claimed issue could also be influenced by increasing levels of globalization via world FDI inflows. If countries increase their size of foreign investment around the world or if they are the recipients of such investment, the benefits of conquest should decline so that countries are discouraged to engage in geopolitical disputes. In Figure 3, we examine the proportion of potential issue claims that occurred in the Western Hemisphere. This is generated using politically relevant dyads in the region based on land/water contiguity or major power status and then determining the percentage of dyads that have experienced geopolitical issue claims. The evidence is consistent with declining benefits of conquest, as contestation over land borders declined significantly over time in the region. However, maritime and river conflicts have increased in frequency over time, thus some form of geopolitical contestation have increased. We should point out, though, that these issues are less likely to result in militarized disputes with fatalities (Hensel et al. 2008), thus the more dangerous contests over land borders have declined a pattern consistent with the literature on the declining benefits of territorial conquest. We include a control variable of world FDI inflows measured in logged millions of current U.S.

dollars each year to capture this changing opportunity aspect of geopolitical conflicts. The data come from the World Bank's (2009) *World Development Indicators*.

Capability Ratio: Relative state capabilities in the dyad are measured using the composite index of national capabilities (CINC) scores derived from the Correlates of War (COW) project's dataset on national material capabilities (Singer, Bremer, and Stuckey 1972). Previous studies of issue claims have shown that militarized conflict and peaceful negotiations are less likely in dyads characterized by power asymmetries. We utilize a measure of country A's CINC score divided by the sum of the capabilities of country A and country B. This variable ranges from (near) zero to 0.999, with an average around 0.5.

Joint Democracy: This variable measures whether or not two countries in a dyad are both democratic. Previous studies in the democratic peace tradition (Russett and Oneal 2001) suggest that joint democracy will reduce the chances for militarized conflict and increase the likelihood of peaceful conflict management. Using the EUGene program, we generate the *Polity 2* variable from the Polity IV database (Marshall and Jaggers 2003), which ranges from -10 (strongly autocratic) to +10 (strongly democratic). We code *Joint Democracy* as 1 if both countries have polity scores greater than or equal to 6 and 0 otherwise. In our sample, just over 54% of the dyads are jointly democratic.

Alliance: Common security ties are considered to influence both the onset and management of geopolitical issues (Huth and Allee 2002). To test this, we include a variable measuring whether two countries share alliance ties. This variable is coded 1 if two countries currently have a defense pact, entente, or neutrality pact and 0 otherwise. The Correlates of War (COW) dataset on inter-state alliances is used to code this variable (Gibler and Sarkees 2004). 25% of the pairs of states in our sample share membership in a military alliance.

Foreign Policy Preferences: If two countries' foreign policy preferences are similar to each other, we expect that they select their policies over geopolitical issues in a way to improve their diplomatic relationships rather than create potential conflicts. To test this, we include a variable *Tau-glob* measuring alliance portfolio similarity between two countries (Bueno de Mesquita 1975, 1981). Its value ranges

from -1 to +1, with -1 representing a dyad that shares no alliance ties in common and +1 representing a dyad that shares membership in the same set of military alliances. The data were created in EUGene (Bennett and Stam 2000). The average score is 0.204.

Economic Openness: Economic openness has been regarded as a constraint to foreign policy options, especially when a country attempts to resort to violence. Thus, we consider the effect of total trade on the likelihood of states raising a new geopolitical issue. We measure economic openness as a country's total exports plus its total imports divided by its GDP. Gleditsch's (2002) data set is used for creating this variable. The average value is 0.368.

Bilateral Trade: Similar to economic openness, liberal peace studies find that bilateral trade flows put pressure on foreign policy choices due to the stakes trade generates. We measure bilateral trade as the sum of imports of country A from country B and imports of country B from country A. We use Gleditsch's (2002) trade data, which is measured in logged millions of US current dollars. The average value in our sample is 2.469.

Distance: Long distances between a challenger and a target may not only provide less opportunity for the challenger to start a new issue claim, but also discourage the pair of states from engaging in militarized disputes due to high costs or difficulty to project power. We capture the effect of distance by including a variable measuring the distance between national capitals in miles (Bennett and Stam 2000). This variable is used in a logged form, with an average of 7.8.

Issue Salience: Issue salience has been regarded as an important factor determining decision makers' willingness to pursue costlier or riskier options when settling geopolitical disputes (Huth and Allee 2002; Hensel et al. 2008). We include a variable *Issue Salience* distinguishing between claims of higher and lower salience for a given issue. For this, we use the ICOW index of the salience of the claimed territory, river, or maritime zone to the two countries (Hensel et al. 2008), ranging from 0 (lowest salience) to 12 (highest salience). The average issue claim has a salience score of 6.7.

Peace Years: To control for the impact of time and past history on decisions to challenge the status quo (at both stages), we also include a variable to count the number of years since the two countries

last engaged in militarized disputes. This serves to eliminate some concerns about serial correlation for the data (Beck, Katz, and Tucker 1998). The mean value is 33 years.

Involvements in Other Military Dispute: Considering the value of relative military strength and uncertainty in estimating the military strength and resolve of adversaries, Huth and Allee (2002) emphasize that we should control for whether countries are already involved in military conflicts elsewhere. We collect the data on militarized disputes in which either country is involved, which includes militarized disputes over non-geopolitical issues in a given year. We then construct two dummy variables – one for country A and one for country B – with a value of one indicating that the country is simultaneously involved in militarized disputes elsewhere. This measure is constructed using the Militarized Interstate Dispute data set. Close to 28% of the dyads are characterized by pairs of states engaged in outside military conflict.

Empirical Results

Our theory suggests that countries are less likely to start a new claim over a geopolitical issue or to escalate contentious issues to high levels of violence when there is an increase in bilateral FDI flows between the two countries. We also predict that pairs of states are more likely to attempt peaceful settlement of contentious geopolitical issues when they have more bilateral FDI flows. Theoretically, we focused on the declining benefits of conquest and increasing preference similarity for the onset stage and the opportunity costs of violence and information for the escalation stage. We now test these hypotheses with the ICOW data from 1980 to 2001 using logistic regression analysis.

Table 1 presents the results of a logistic regression analysis of two stages of geopolitical conflict: the onset and management (militarized disputes and peaceful settlement) of territorial, maritime, and river issues. All results are reported using two-tailed significance tests and robust standard errors. The changes in the predicted probabilities for militarized disputes and bilateral negotiation attempts based on changing FDI values are presented in Table 2.

The first column in Table 1 depicts the effect of bilateral FDI flows on the likelihood of a challenger raising a geopolitical issue claim against a target country (Model 1). As opposed to our hypothesis (Hypothesis 1), we find that bilateral FDI flows are not significant for reducing the probability of the onset of issue claims ($p < .433$). This indicates that an increase in bilateral FDI flows, although suggested to generate the disincentives of conquest or similar foreign policy preferences, does not affect states' decisions to make new claims on geopolitical issues. The chances of initiating a new issue claim seems independent of the level of FDI flows that the challenger transmits to the potential target country. Bilateral FDI flows do not seem to exert a strong effect through the other causal mechanism, via increased foreign policy preference similarity. The bivariate correlation between FDI and the *Tau-glob* alliance portfolio similarity measure is close to zero (0.04).

One of the interesting findings in this onset model, on the other hand, is that world FDI inflows, in contrast with bilateral FDI flows, are negative and highly statistically significant ($p < .01$), indicating that an increase in the supply of FDI at the global level discourages potential challengers from making new territorial, maritime, or river claims against potential targets. As described earlier, the result seems consistent with our explanation that increasing global FDI reduces states' incentives to obtain resources by capturing neighboring territories.

As expected, an increase in peace years in a dyad significantly reduces the chances for new issue claims. Trade openness also reduces the chances for border disputes, although it is surprising that bilateral trade has a positive effect on claim onset. The variable for military alliances is positive and significant in both the claim onset and escalation to MID models (Model 2), which supports the argument from the steps to war tradition that power politics can increase states' chances for violent interstate interactions (Senese and Vasquez 2003, 2008).

The next two columns in Table 1 report the results of our analysis about how bilateral FDI flows affect the management of geopolitical conflicts in the set of dyads that experience contention over territorial, maritime, or river issues. Our hypotheses predict that increasing bilateral FDI flows will reduce

the probability of militarized disputes over the issues at stake and will increase the probability of states seeking peaceful settlement, through such tactics as bilateral negotiations. These relationships could occur if businesses put pressure on their respective governments to resolve these conflicts peacefully (increased opportunity costs) or if increased investment ties provide states with better information in interstate bargaining situations about their opponent's capabilities and resolve (informational/signaling argument).

With respect to the occurrence of militarized disputes, the results of our analysis (Model 2) suggest that bilateral FDI flows have a negative and highly significant effect on MID onset ($p < .001$). This indicates that two claimants are less likely to resort to militarized foreign policy strategies to resolve their geopolitical issues when they have high levels of bilateral FDI flows between them. Overall, these results strongly support our hypothesis (Hypothesis 2) that an increase in bilateral FDI between two issue claimants will decrease the likelihood of a militarized dispute over a contested issue claim. Issue claims that are more salient for tangible or intangible reasons are much more likely to result in militarized conflict, a finding consistent with the Hensel et al. (2008) results. We also find that peace years have a significant and negative effect on MID onset.

Turning to peaceful settlements, the last column in Table 1 (Model 3) shows that bilateral FDI flows have a positive and significant ($p < .05$) effect on bilateral negotiations. Claimant countries are more likely to engage in an attempt to settle their issues through bilateral negotiations when there is an increase in bilateral FDI flows between them. Bilateral negotiations are significantly less likely to occur in dyads characterized by stark power asymmetries.

Table 2 reports the changes in the predicted probability of having militarized disputes and bilateral negotiation, respectively, when the flows of bilateral FDI increase between two states. For a simple comparison, we took extreme values of bilateral FDI flows and examined how they change the predicted probability of each dependent variable. One noticeable finding is that bilateral FDI flows generate different consequences on the two different management processes, If we look at the size of the

probability change in each variable, in other words, we find that there is a huge difference, about 0.61, between them. As we can see, moving from the minimum FDI value (FDI = loss of 4.7 billion) to the maximum FDI value (inflow of 119 billion) results in a 0.18 decline in the probability that the claimants become involved in militarized disputes. The same amount of change in bilateral FDI flows increases the probability of bilateral negotiations by 0.79, representing an 878% increase in the probability over the baseline. This finding fits with our theory and examples, showing that multinational corporations are taking an active role pressuring the governments involved to settle disputes quickly and peacefully, rather than simply prevent the governments from engaging in militarized disputes.

Although we find that increasing bilateral FDI flows decrease the likelihood of a militarized dispute and increase the likelihood of peaceful settlement over the contested issues, we are still left with a question of which causal mechanism between opportunity costs and information (or both) actually works in this management stage of geopolitical conflicts. As we pointed out earlier, this is important in the sense that the opportunity costs argument is still empirically weak (Li 2006; Lee 2008) and the debates between two approaches are still unsettled (Gartzke et al. 2001; Russett and Oneal 2001; Gartzke and Li 2003; Rosecrance and Thompson 2003; Souva and Prince 2006). In an effort to answer the question, we conduct additional empirical analyses that may help tease out the causal mechanisms between FDI and conflict.

Table 3 presents the results of two different models including interaction variables with bilateral FDI flows, one with prior MIDs and the other with claim years. These interaction variables capture the opportunity costs and information mechanisms, respectively. The first column (Model 1) in Table 3 shows that the coefficient for *Bilateral FDI*Prior MIDs* is negative and significant ($p < .01$), indicating that increasing bilateral FDI reduces the chances for militarized disputes even in dyads that have experienced prior militarized disputes of the contested issue. This supports the opportunity costs argument in which economic exchanges promote peace even in situations of geopolitical conflicts.

In Table 3, Model 1, we use a dichotomous measure of prior militarized disputes. We also estimated a model with a continuous measure of prior MIDs. The interaction term is also negative and

statistically significant using this alternative operational measure. In the full sample, the number of prior MIDs ranges from 0-7, and not surprisingly, it is truncated to a smaller range of 0-4 for the set of dyads that have positive bilateral FDI flows. In Figure 4, we show how the marginal effect of FDI changes as the number of prior MIDs increases. The marginal, pacifying effect gets stronger for pairs of states with a greater history of militarized disputes, which again supports the idea of increased opportunity costs for dyads with significant FDI flows. However, the standard error bands increase as the number of prior MIDs increases, which indicates that inferences for a high number of prior disputes are based on a relatively small number of dyads.

The second column (Model 2) shows that the coefficient for *Bilateral FDI*Claim Years* is not statistically significant ($p < .22$), suggesting that bilateral FDI has a relatively constant temporal effect on militarized conflict. Thus, our finding does not support the information mechanism in which the pacifying effect of FDI may decline over time as states learn more about each other's capabilities and resolve. Thus, our analysis shows that the pacifying effect of FDI is more likely to work through the opportunity costs mechanism than through the informational mechanism.

Discussion

In this section, we discuss several issues that could be raised with our empirical analyses. The first concern is that valid inferences cannot be made about the probability of a geopolitical conflict by simply looking at the amount of FDI flows for possible sampling bias. In other words, our empirical finding might suffer from a potential selection bias where we draw an inaccurate inference that an increase in FDI flows reduces the likelihood of militarized conflict, although the real cause comes from the fact that FDI flows help prevent countries from initiating a new geopolitical issue in the first place, rather than the fact that FDI flows work against the militarization process itself. Although we do test the first onset stage, a criticism might still arise that we do not take into account the factors that affect the onset of a geopolitical issue claim when modeling the factors that affect the escalation of such an issue claim to higher levels of violence (Achen 1986; Huth 1996; Reed 2000). We checked for a potential selection process by running

a Heckman selection model (1979), setting issue claim onset as the first stage and escalation to a militarized dispute over the contested issue as the second stage.[10] The correlation of the error terms across the two stages of the model (rho) is not statistically significant. Furthermore, the results reported above hold in the selection model also; bilateral FDI flows significantly reduce the chances for militarized dispute onset and have no significant effect on issue claim onset.

A second concern might be raised with respect to the robustness of our empirical findings given the limited spatial domain of the ICOW issue claims dataset. The main reason we selected the ICOW data for our empirical tests relies on the fact that the ICOW dataset provides a bigger sample size than the Huth and Allee dataset because even though it is more limited regionally, it covers a longer time period (through 2001 versus 1995 for Huth and Allee). We also estimated our models using Huth and Allee's (2002) territorial dispute dataset, finding very similar results to those estimated with the ICOW dataset. Bilateral FDI has a negative and significant effect on militarized dispute onset and a positive and significant effect on bilateral negotiations.[11]

Lastly, one might address a problem with our empirical tests, since we do not control for regime type in the second stage of our model. Two states may be less likely to escalate geopolitical issues to high levels of violence not because of high flows of bilateral FDI between the countries, but because of some unobserved mechanisms driven by similar political institutions, such as joint democracy. First, we want to clarify that studies have been mixed in finding evidence regarding a clear relationship between democracy and FDI inflows (O'Donnell 1988; Olson 1993; Oneal 1994; Barro 1996; Li and Resnick 2003; Jensen 2006). Second, even after controlling for joint democracy in our empirical models for militarized dispute onset and bilateral negotiations, we find identical results to the models estimated without this variable.[12] Bilateral FDI flows reduce the chances for militarized conflict and improve the

[10] This is very similar to the research design employed by Senese and Vasquez (2003).

[11] All of these additional results are available from the authors upon request.

[12] Again, the results of our analysis with including joint democracy are excluded due to space limitations. They are available upon request.

likelihood of peaceful negotiation, while the effect of joint democracy is only weakly (if ever) significant. This reflects to some degree the non-random selection of states into some types of geopolitical disputes, such as territorial disputes, whereby fully democratic states are less likely to challenge each other's land borders (Mitchell and Prins 1999).

Conclusion

In this paper, we evaluate the relationship between bilateral foreign direct investment flows and the management of geopolitical disputes, including contention over territory, cross-border rivers, and maritime areas. We consider the causal mechanisms linking FDI and interstate conflict by focusing on different stages of the conflict process. In the first stage, a potential challenger decides whether to challenge the status quo over some interstate border. In the second stage, once a challenge to a land or water border has been issued, the disputing states can choose peaceful or militarized strategies to pursue their issue related goals. We identify two potential mechanisms at the first stage of the process: 1) declining benefits of territorial conquest due to increased globalization and economic exchange, and 2) increased foreign policy preference similarity between states with higher economic interdependence. In the second stage of the conflict process, we discuss two potential mechanisms by which bilateral FDI flows might reduce the chances for militarized conflict and promote bilateral negotiations: 1) increased opportunity costs for violence in dyads characterized by high levels of economic exchange and 2) improved information and signaling in pairs of states with bilateral FDI, which should improve the chances for peaceful interstate agreements to be struck. We evaluate these different causal mechanisms using data from the Issue Correlates of War project on territorial, maritime, and river conflicts in the Western Hemisphere, Europe, and Middle East from 1980-2001.

Our empirical analyses suggest that bilateral FDI flows have different effects on interstate conflict depending on what stage of the conflict process we are examining. Economically interdependent state with positive bilateral FDI flows are no better suited to avoid new diplomatic claims over land or water borders than states without foreign direct investment ties. FDI flows do not seem to translate into

more similar foreign policy practices either. Yet increases in world levels of FDI flows are significantly and negatively related to the onset of new geopolitical issue claims, which is consistent with the declining benefits of conquest theory. Once new land or water border disputes arise, our analysis reveals that bilateral FDI flows significantly raise the costs of escalation to militarized conflicts over contentious issues and put pressure on governments to settle those issues with peaceful conflict management tools. These effects are fairly sizable as well; when comparing pairs of states with the minimum and maximum values for bilateral FDI flows, we find that bilateral negotiations are over 800% more likely to occur in the most economically interdependent dyads.

The stronger findings for opportunity costs mechanisms make sense when we consider that issue claim datasets allow for a broader range of diplomatic interaction over contentious issues. Less than half of all issue claims coded by the ICOW project have resulted in even a single militarized dispute. Many studies of economic interdependence and conflict treat all politically relevant dyads as the set of cases for which the effect of economic exchange on conflict is evaluated. Our research design more fully captures the mechanisms linking economic interdependence and conflict. We are able to show how foreign direct investment influences foreign policy decision making at different stages of diplomatic contention. Multinational corporations might not be able to completely avoid making investments in countries that have diplomatic territorial disputes with their home government. However, as the cases of China-India, Croatia-Slovenia, and Cambodia-Thailand illustrate, multinational companies can lobby their respective governments for a peaceful resolution of the disputed issues, moves that will encourage further foreign direct investment and trade between the disputing states.

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Table 1: Bilateral FDI Flows and Geopolitical Disputes, 1980-2001

	Model 1 Claim Onset	Model 2 Escalation to MID	Model 3 Bilateral Negotiation
Bilateral FDI$_{t-1}$	0.010	-0.791***	0.049**
	(0.013)	(0.177)	(0.020)
Capability Ratio$_{t-1}$	0.244	-0.028	-0.773*
	(0.429)	(0.612)	(0.452)
Alliance$_{t-1}$	2.041**	1.006*	-0.460
	(0.846)	(0.589)	(0.354)
Peace Years	-0.017**	-0.019*	-0.013**
	(0.007)	(0.010)	(0.006)
World FDI Inflows	-0.140***	0.306	0.112
	(0.048)	(0.212)	(0.115)
Joint Democracy$_{t-1}$	0.052		
	(0.214)		
Distance$_{t-1}$	-0.252		
	(0.177)		
Foreign Policy	-0.378		
Preference$_{t-1}$	(0.818)		
Bilateral Trade$_{t-1}$	0.266***		
	(0.064)		
Openness$_{t-1}$	-2.235***		
	(0.657)		
Issue Salience		0.258***	0.166**
		(0.081)	(0.068)
Challenger Involvement		-0.994	-0.264
in other Military Dispute		(0.635)	(0.262)
Target Involvement in		-0.093	-0.133
other Military Dispute		(0.373)	(0.201)
Constant	-1.316	-8.950***	-3.208**
	(1.530)	(2.913)	(1.397)
N	56064	1170	1170
Pseudo R^2	0.22	0.11	0.08
Wald χ^2	161.69	30.15	35.95

Note: Numbers in parentheses are clustered-robust standard errors. *p*-values: *** <.01, **<.05, *<.10. The hypothesis tests are two-tailed tests.

Table 2: Changes in Predicted Probabilities: Bilateral FDI Flows and Claim Management

	Escalation to Militarized Disputes Probability (Change)	Bilateral Negotiation Attempt Probability (Change)
Bilateral FDI Flows		
Min(= -4.7)	0.18	0.09
Max (= 119)	0.00 (-0.18)	0.88 (+0.79)

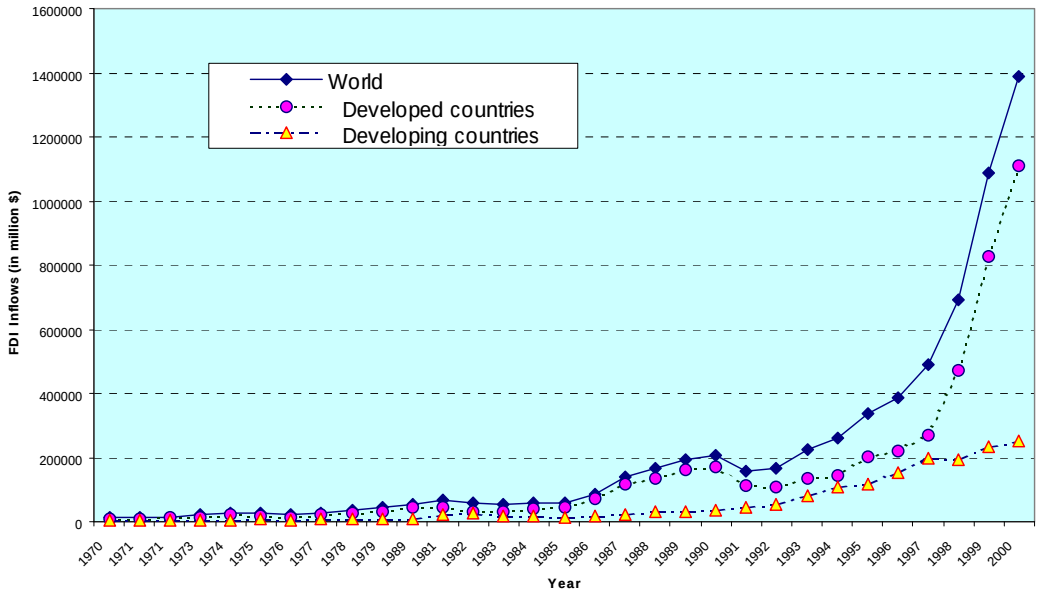
Note: The probability is calculated by holding each variable of the model at its mean or mode while changing the values of bilateral FDI flows.

Table 3: Interactive Effects for Prior Conflict and Issue Claim Years, 1980-2001

	Model 1 Escalation to MID (Prior MIDs)	Model 2 Escalation to MID (Claim Years)
Bilateral FDI$_{t-1}$	-0.660***	-0.536*
	(0.206)	(0.285)
Prior MIDs	1.345***	
	(0.339)	
*Bilateral FDI*Prior MIDs*$_{t-1}$	-22.73***	
	(7.626)	
Claim Years		0.0006
		(0.004)
*Bilateral FDI*Claim Years*$_{t-1}$		-0.010
		(0.008)
Capability Ratio$_{t-1}$	-0.003	-0.052
	(0.563)	(0.609)
Alliance$_{t-1}$	0.731	1.255**
	(0.491)	(0.582)
Peace Years	-0.007	-0.023**
	(0.007)	(0.011)
World FDI Inflows	0.341*	0.272
	(0.200)	(0.223)
Issue Salience	0.244***	0.272***
	(0.090)	(0.088)
Challenger Involvement in other Military Dispute	-0.949	-1.162*
	(0.604)	(0.672)
Target Involvement in other Military Dispute	-0.044	0.059
	(0.347)	(0.363)
Constant	-9.839***	-8.789***
	(2.604)	(3.128)
N	1170	1073
Pseudo R^2	0.15	0.14
Wald χ^2	44.85	37.09

Note: Numbers in parentheses are clustered-robust standard errors. *p*-values: *** <.01, **<.05, *<.10. The hypothesis tests are two-tailed tests.

Figure 1: World FDI Inflows (1970-2001)



Source: United Nations Centre for Transnational Corporations (UNCTC). *Transnational Corporations in World Development*, 2003.

Figure 2: Theoretical Framework

<u>Stage 1: Claim Onset</u>

FDI
↓
M1: Declining benefits of conquest
M2: Increasing preference similarity
↓
Start new issue claim?→ Yes →
↓
No (Status Quo)

<u>Stage 2: Claim Management</u>

FDI
↓
M3: Increased opportunity costs of violence
M4: Improved signaling/information
↓
Use militarized force over the issue? → Yes
↓ ↓
No ← ← ← ← ←
↓ ↓
Try to settle the issue through negotiations? → Yes
↓
No

Figure 3: Trends in 20th Century Claims in the Americas

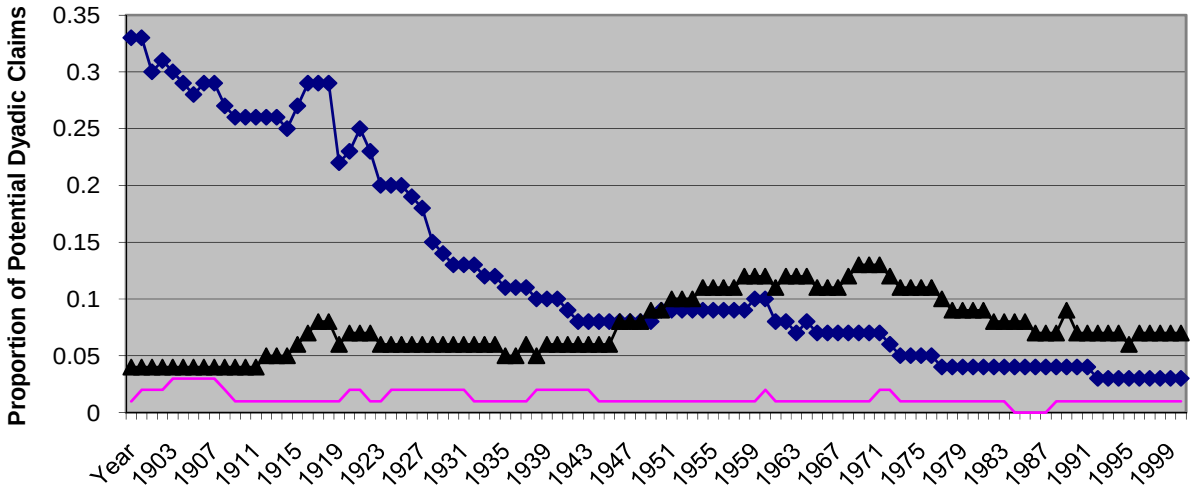
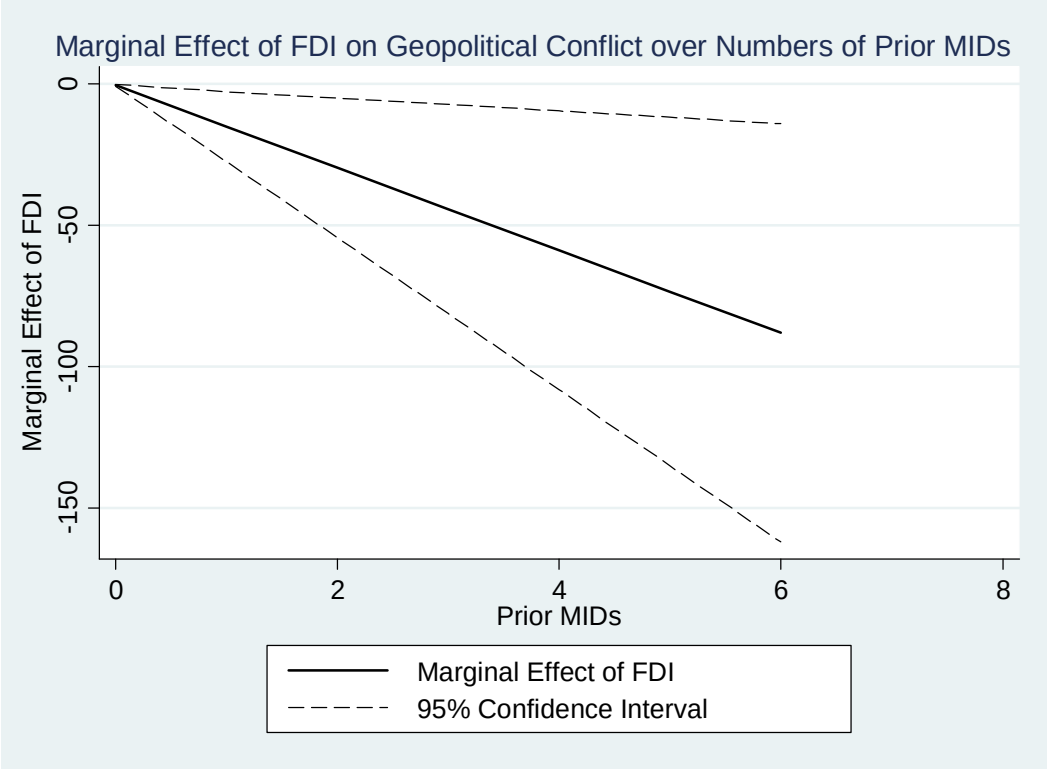


Figure 4: Marginal Effect of FDI on Geopolitical Conflict over Number of Prior MIDs



Appendix: Descriptive Statistics

	N	*Mean*	*Std. Dev.*	*Min*	*Max*
Claim Onset	113,410	.011	.108	0	1
Escalation to MID	1,342	.032	.178	0	1
Bilateral Negotiation	1,342	.132	.339	0	1
Bilateral FDI	79,865	.047	1.08	-4.743	119.134
Capability Ratio	106,494	.500	.386	6.39e-06	.999
Alliance	106,494	.253	.435	0	1
Peace Years	113,410	33.461	35.084	0	185
World FDI Inflows	113,410	12.364	1.011	10.803	14.233
Joint Democracy	66,280	.545	.497	0	1
Distance	106,494	7.805	1.000	3.583	9.125
Foreign Policy Preference	106,494	.204	.443	-.243	1
Bilateral Trade	82,505	2.469	3.284	-6.907	12.908
Openness	104,794	.368	.347	.00005	4.944
Issue Salience	1,342	6.744	2.038	2	12
Challenger Involvement in other Military Dispute	113,410	.277	.447	0	1
Target Involvement in other Military Dispute	113,410	.277	.447	0	1
Prior MIDs	113,410	.990	.095	0	1
Claim Years	1,234	35.500	34.727	0	185