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Political Risk, Trade, and Capital Allocation*

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Abstract

Export exposure is a significant conduit of foreign political uncertainty into US markets. Specifically, industries that export considerable shares of their output to countries with high political risk or countries that hold national elections experience suboptimal investment efficiency. Lower transparency, difficulty in predicting cash flows generated by exports and estimating cost of capital could be contributing to this result. Our findings remain robust when we account for potential endogeneity of export flows.

Keywords: Investment efficiency, Political Risk, Trade

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1. Introduction

Efficient allocation of capital is a cornerstone of a well-functioning economy. Resources are supposed to flow out of declining industries and into growing ones. Therefore, capital allocation is an essential requirement for economic growth. The literature on the importance of efficient capital allocation goes back as far as Schumpeter (1912). Other papers on the critical importance efficient capital allocation are Diamond (1984), Boyd and Prescott (1986), Goldsmith (1969), McKinnon (1973), Shaw (1973), Greenwood and Jovanovic (1990), Wurgler (2000), to name a few.

Numerous factors have been shown to affect investment efficiency. Durnev, Morck, and Yeung (2004) observe a positive association between corporate investment efficiency and magnitude of firm-specific return variation. Biddle et al. (2009) document a positive relationship between financial reporting and capital allocation efficiency.[1] Morck, Yavuz, and Yeung (2010) document less efficient capital allocation in countries whose banking systems are thoroughly controlled by tycoons and families. Durnev, Errunza, and Molchanov (2009) relate investment efficiency to firms' deviation from the optimal levels of corporate transparency. Specifically, industries with sub-optimal transparency levels exhibit worse capital allocation and slower growth.

While the influence of political variables on economic outcomes[2] and financial markets[3] has been studied extensively, the list of literatures analyzing the impact of politics on capital allocation efficiency is, to the best of our knowledge, relatively scarce. In assessing economic policies of transitional economies, Shleifer (1998) notes that "… elimination of politically motivated resource allocation has unquestionably been the benefit of privatization around the

[1] A similar result has been established by Bushman and Smith (2001). Healy and Palepu (2001) provide a comprehensive literature review on the issue.
[2] See, for example, Alesina and Rodrick (1994), and Bloomberg and Hess (2001).
[3] See, for example, Santa-Clara and Valkanov (2003), Leblang and Mukherjee (2005), Snowberg et al. (2007), Pastor and Veronesi (2010), Belo, Gala and Li (2010).

world…"[4] In a more recent strand of literature, Durnev (2010) shows that election uncertainty translates into less efficient capital allocation due to less informative stock prices during election years. Julio and Yook (2009) document corporate investment cycles generated by political uncertainty during election years, particularly in countries with weak system of checks and balances.

Foreign political risks[5] have been shown to have a substantial effect on corporate choices of domestic companies. Greene, Hornstein, and White (2009) document greater capital allocation efficiency in multinational corporations. Desai, Foley, and Hines (2008) analyze exposures of multinational firms to political risk. They document more volatile returns on investment in riskier countries. Firms reduce their leverage in response to these risks. Desai, Foley, and Hines (2004) document that subsidiaries located in politically risky countries are more highly leveraged than their counterparts in safer countries. Henisz (2000) suggests that multinational firms serving politically risky markets are likely to share ownership with local partners.

Unlike the above papers, that analyze multinational firms, this paper adopts an alternative view of exposure to foreign political risks. We posit that export activity is a channel of foreign risk transmission into domestic financial markets.[6] While it has been often assumed that foreign political risk is of lesser importance to exporters than to multinationals, as less capital is at stake (Stapenhurst, 1992), loss of future revenues from exporting may significantly outweigh the value of expropriated assets (Gillespie, 1989).

[4] Investigating a somewhat related topic, Isham and Kaufmann (1999) establish a strong association between a country's policy environment and investment project performance. More specifically, projects are adversely affected by by distortions in the macroeconomic, trade and pricing policies.

[5] Such risks may include outright asset expropriations, regulatory changes or risks associated with profit repatriations. In the context of international trade, political risk may refer to either political events within the trading partner country or changing relationships between trading partners.

[6] Boutchkova et al. (2010) document higher volatility of export-oriented industries.

This paper's contribution to the existing literature is twofold. First, we explicitly relate political risk to the quality of capital allocation. Second, we posit that *foreign* political risk has a significant effect on *domestic* investment efficiency. More specifically, we assume that export activity is an important conduit of foreign political risk transmission into quality of investment efficiency. We expect industries more exposed to foreign political factors to experience less efficient capital allocation for a number of reasons.

First, cash flows from export operations are more difficult to predict than cash flows generated by domestic sales for both political and economic reasons. Political risks associated with export activity, ranging from outward expropriation to imposition of capital and exchange controls to contract repudiation. Economic factors are primarily associated with adverse exchange rate movements.[7] As investment efficiency fundamentally hinges on economy's ability to channel capital to channel funds to the projects with positive NPV, poor cash flow predictability may lead to misidentification of such projects. Therefore, capital may not flow freely to growing industries, thus resulting in less efficient investment.

Second, cost of capital of companies that engage in international operations is notoriously difficult to estimate. Harvey (2001) notes that calculation of cost of capital in international capital markets is a long-standing problem in finance and notes a wide variety of approaches to the calculation. Butler and Joaquin (1998) note that the political risk affects the value of a multinational corporation through its cost of capital, although the degree of its impact depends on the extent of investors' international diversification. Stulz (1999) points out that the reduction of cost of capital through international diversification is not as large as expected partly due to political risk. Therefore, we hypothesize that as an additional variable – foreign political risk – enters the cost of capital equation of a firm operating internationally, the value of such a firm becomes more difficult to estimate, resulting is less efficient capital allocation.

[7] In our analysis, extra care is exercised to distinguish political and economic export risk factors.

Using a large sample of industry-year observations of the US manufacturing sector, we provide robust evidence of a detrimental effect of foreign political risk on domestic investment efficiency. More specifically, those industries that export to countries with high political risk (or the ones that hold national elections) experience significantly worse capital allocation, as measured by deviation of Tobin's marginal q, which is the ratio of the change in market value of the firm to unexpected change in assets, from its optimal level.[8] This paper is not the first one to document adverse effects of foreign trade: Newbery and Stiglitz (1984) find that trade increases uncertainty and income volatility. Di Giovanni and Levchenko (2009) document higher output volatility in more open industries.

To better gauge economic significance of our results, note that the export share of sales is very large for the US manufacturing industries, with an average of over 18%. A one standard deviation increase in trade sensitivity (our main variable) of 6.1 (it is indicative of the move from Stone&Clay industry to Furniture industry from Table 1) lowers deviation of marginal q from one by 6.1 * 0.00873 = 0.0532 (the coefficient from specification 1 of table 3). This drop in deviation corresponds to 0.0532 / 0.335 = 16% reduction relative to the average deviation of marginal q from 1 equal to 0.335 from Table 1.

We must be careful about what little we have to say: trade in itself is beneficial to industries, and diversification effects of foreign trade for cash flows have long been established in the literature.[9] However, as Desai, Foley, and Hines (2008) point out, foreign political risk, although potentially diversifiable, has tangible effects on firms that engage in international operations.

[8] Initially, the optimal level is set equal to 1. In the latter part of the analysis, we consider factors that may affect the optimal benchmark.
[9] See, for example, Hirsch and Lev (1971).

Certainly, political environment itself has a substantial effect on export flows. Countries and industries consider a variety of political factors when developing trade policy.[10] Export structure is, in this sense, endogenous to political environment. Such endogeneity could potentially create a bias in our estimates of political risk transmission through exports. However, we believe that such a bias will work against our potential findings. Countries and industries adjust their export flows in order to, among other things, mitigate political uncertainty. Therefore, any statistical significance of foreign political risk we document will be, if anything, reduced by endogeneity of export flows.

It is, however, possible for a different type of omitted variable bias to arise: industries with better capital allocation could be selectively exporting to countries with stable political environment and vice versa. Thus, any association between political risk and capital allocation may be driven by such self-selection. We address the issue by employing the two-stage Heckman self-selection correction. Our results remain robust.

When considering potentially adverse impacts of foreign trade, political, economic, and financial risks of trading partner countries go hand-in-hand (Erb, Harvey and Viskanta, 1996). Therefore, we include economic and financial risk measures as control variables and in order to empirically assess relative importance of the three types of risks in their impact on capital allocation. While all three have a significantly negative impact on capital allocation, political risk has the largest economic impact. In addition, we include a variety of other control variables in our regressions. The results remain qualitatively unchanged.

The rest of the paper is organized as follows. Section 2 describes the sample and the empirical specification. We present the results in section 3. Section 4 concludes.

2.

[10] See, for example, Mitra, Thomakos, and Ulubasoglu (2002), Magee (2003), Egger, Egger, and Greenway (2008), and Baier and Bergstand (2007).

3. Data, Variables, and Empirical Specification

Our sample includes US manufacturing industries aggregated at a 3-digit SIC level (SIC codes 2000 through 3900), a total of 137 industries.[11] The unit of observation is industry-year, and the scope of the sample is 2000-2005, giving us 628 industry-year observations.[12]

Capital Allocation Efficiency

We measure the quality of capital allocation by the proximity of Tobin's marginal q ratio to its optimal level. We follow Durnev, Morck, and Yueng (2004) and define marginal q as a coefficient of regression of change in the market value of a firm on an unexpected unit increase in its stock of capital goods (both scaled by a lagged value of its stock of capital goods).

$$\dot{q} = \frac{\Delta V}{\Delta K} \tag{1}$$

is operationalized by

$$\dot{q}_{j,t} = \frac{V_{j,t} - V_{j,t-1}(1 + \hat{r}_{j,t} - \hat{d}_{j,t})}{A_{j,t} - A_{j,t-1}(1 + \hat{g}_{j,t} - \hat{\delta}_{j,t})} \tag{2}$$

where $V_{j,t}$ and $A_{j,t}$ are the market value and stock of capital goods of firm *j* in year *t*, $\hat{r}_{j,t}$ is the expected return from owning firm *j*. $\hat{d}_{j,t}$ and $\hat{\delta}_{j,t}$ represent disbursements to investors and expected depreciation of capital goods, respectively. Rewriting (2) and normalizing by $A_{j,t-1}$, we obtain

$$\frac{V_{j,t} - V_{j,t-1}}{A_{j,t-1}} = -\dot{q}_j(g_j - \delta_j) + \dot{q}_j \frac{A_{j,t} - A_{j,t-1}}{A_{j,t-1}} - \xi_j \frac{D_{j,t-1}}{A_{j,t-1}} + r_j \frac{V_{j,t-1}}{A_{j,t-1}} \tag{3}$$

where *j* indicates average across time. In terms of actual estimation, each industry's average q is represented by a coefficient β_0 in the following regression:

[11] The sample is restricted to manufacturing industries primarily to more comprehensive trade and accounting data coverage.

[12] We choose this particular timeframe in part due to better trade statistics coverage for those years. Also, the period does not include the crises periods of 1998 and 2007.

$$\frac{\Delta V_{j,t}}{A_{j,t}} = \alpha + \beta_0 \frac{\Delta A_{j,t}}{A_{j,t-1}} + \beta_1 \frac{V_{j,t-1}}{A_{j,t-1}} + \beta_2 \frac{D_{j,t}}{A_{j,t-1}} + u_{j,t} \quad (4)$$

We estimate $V_{j,t}$ and $A_{j,t}$ for firm *j* in year *t* as:

$$V_{j,t} = P_t(CS_{j,t} + PS_{j,t} + LTD_{j,t} + SD_{j,t} - STA_{j,t}) \quad (5)$$

$$A_{j,t} = K_{j,t} + INV_{j,t} \quad (6)$$

Where CS = market value of shares outstanding,

PS = estimated market value of preferred shares,

LTD = estimated market value of long-term debt,

SD = book value of short-term debt,

STA = book value of short-term assets,

P = inflation adjustment using the GDP deflator,

K = estimated market value of plant, property, and equipment,

INV = estimated market value of inventories.

We refer to Durnev, Morck, and Yeung (2004) for detail of estimating long-term debt, plant, property and equipment, and inventories. Quality of capital allocation is measured by the deviation of marginal q from its optimal level, *h*, which is initially set equal to one. We employ two metrics, $|\dot{q} - h|$ and $(\dot{q} - 1)^2$.

Optimal value of *h* can deviate from 1 for a number of reasons, such as taxes, endogeneity of capital structure and disbursement policies, low frequency of capital spending disclosure. Also, change in value of the firm can arise from past investments or future investment options. Therefore, in the latter part of the analysis, we relax the assumption of *h* being equal to 1 and estimate

$$(\dot{q}_i - h)^2 \, or \, |\dot{q} - h| = b'Z_i + u_i \quad (7)$$

where Z_i represents the list of independent variables. We estimate (7) using nonlinear least squares and determine *h* and regression coefficients simultaneously. In case of squared deviation from *h*, (7) is equivalent to

$$\dot{q}_i^2 = -h^2 + 2h\dot{q}_i + b'Z_i + u_i \quad (8)$$

In a nonlinear least squares estimation, the following function is minimized with respect to *b*:

$$Q_i(b) = \frac{1}{I}\sum_{i=1}^{I}[y_i - f(x_i;b)]^2 \qquad (9)$$

where $y_i = \dot{q}_i^2$ and $f(x_i;b) = -h^2 + 2h\dot{q}_i + b'Z_i$. In case of an absolute deviation from *h*, $f(x_i;b) = -h^2 + 2h\dot{q}_i + (b'Z_i)^2$

Using data from CRSP/COMPUSTAT merged database, we estimate $\dot{q}$ and *h* for every year for every 3-digit SIC industry using firm observations. We drop industries with fewer than 10 companies.

Political Risk Variables

We use two sets of variables to measure riskiness of political environment – overall political risk score and whether national elections take place in a given year. Political risk scores are obtained from the International Country Risk Guide (ICRG), compiled by the Political Risk Service Group. The political risk score is the sum of the following sub-indices: socioeconomic conditions, investment profile, external conflict, military in politics, religious tensions, and democratic accountability.[13] Note that we exclude corruption, law and order, and bureaucracy quality from the calculation.

National election in a dummy variable equal to one for national election years and zero otherwise. We use the 2006 edition of the World Bank's Database on Political Institutions described in Beck et al. (2001) to obtain election dates. We then cross-reference the dates with a number of sources, such as *Journal of Democracy, Elections around the World, Election Guide,* and *CIA Factbook.*

Foreign Trade Exposure

Our analysis rests on the premise that foreign political risk is transmitted into domestic industries through their export activities. We define trade exposure of industry *j* to trading partner *c* in year *t* as

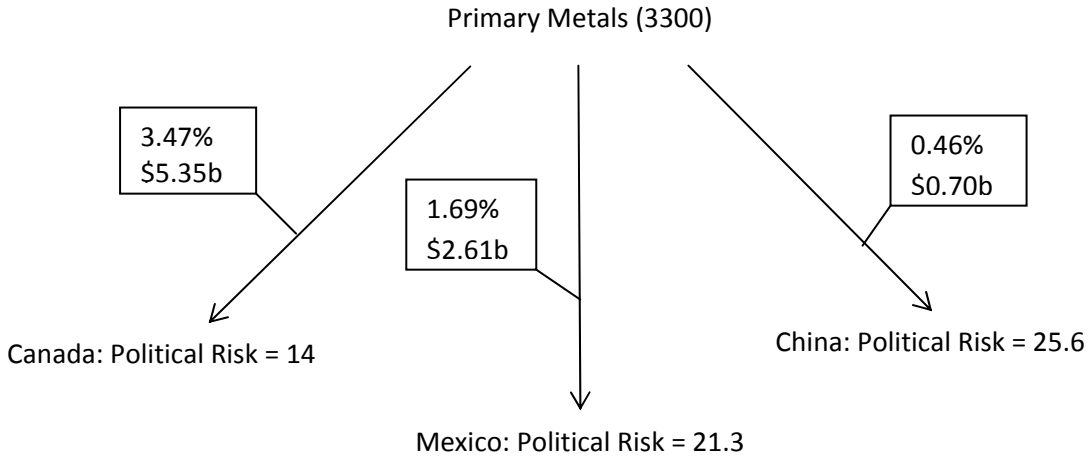
$$TRADE_{j,c,t} = \frac{EXPORTS_{j,c,t}}{SALES_{j,c,t}} \qquad (10)$$

[13] Full definitions are available at http://www.prsgroup.com/ICRG_Methodology.aspx

Data on exports is obtained from UNCTAD/WTO PC-TAS database combined by COMTRADE[14]. Data in industry sales is obtained from the Bureau of Economic Analysis. Interaction of trade exposure with political environment – the main independent variable in our analysis – is defined as

$$\sum_c TRADE_{j,c,t} \cdot POLITICAL_{c,t} \quad (11)$$

To illustrate, consider an example presented in the diagram below:



In this example, Primary metal industry's top three trading partners in 2000 were Canada, Mexico, and China.[15] The interaction of trade exposure with overall political risk would thus be equal to

$3.47 \cdot 14 + 1.69 \cdot 21.3 + 0.46 \cdot 25.6 = 96.35$

In 2000, Canada and Mexico held national elections. Therefore, interaction of trade exposure with elections would be equal to $3.47 \cdot 1 + 1.69 \cdot 1 + 0.46 \cdot 0 = 5.16$

Some of the descriptive statistics of trade shares and interactions are presented in Table 1.

Control Variables

We include a number of variables, as quality of capital allocation may be influenced by exogenous factors. For example, liquidity may affect investment efficiency, as cash-strapped firms may be prone to underinvestment. Therefore, not controlling for liquidity may obscure the relationship between foreign political risk and capital allocation. In addition, our analysis

[14] Need to insert a footnote similar to the one in PolVol regarding imports

[15] The actual number of trading partners is much greater, with an average industry exporting to 39 countries. Three trading partners should be sufficient for illustrative purposes.

may suffer from omitted variable bias, as some factors may have a simultaneous effect on trade exposure and capital allocation quality. For example, more diversified firms may be more inclined to engage in foreign trade. Also, such firms may exhibit worse investment efficiency, as they are less focused. We include the following variables.

Economic and Financial Risk. Erb, Harvey, and Viskanta (1996) analyse relative importance of country political, economic, and financial risk for portfolio investment. We include economic and financial risk (both in levels and in interactions with export exposure) to ensure that the main independent variable (political risk – export interaction) is not picking up economic and political factors. The variables are obtained from the ICRG. Economic risk is based on such variables as GDP per capita, real GDP growth, inflation, budget balance, and current account. Financial risk is based on state foreign debt, debt service, international liquidity, and exchange rate stability.

US political risk and US elections. Domestic political environment may influence both foreign trade exposure (through a variety of politically-motivated trade barriers and/or agreements) and investment efficiency (through politically-motivated resource allocation).

Firm-specific return variation. Durnev, Morck, and Yueng (2004) document that the magnitude of firm-specific return variation is indicative of more informative stock pricing, which, in turn, results in more value-enhancing capital budgeting.

Average Q. This variable serves as a proxy for the presence of intangibles and measures the importance of growth options. We expect high growth (low q) industries to exhibit worse capital allocation quality. Average q is defined as the average market value over replacement cost, measured over 2000-2005.

Size. Industry size may have a significant impact on capital allocation efficiency. Firms in large industries may have more cash and fewer growth opportunities, thus making them prone to overinvestment. On the other hand, firms in smaller industries may be more likely to ration capital and underinvest. We measure industry size as the natural logarithm of property, plant, and equipment, measured over 2000-2005.

Liquidity. We conjecture that cash-strapped firms may be prone to underinvestment and vice versa. Liquidity is measured by net current assets over plant, property and equipment.

Leverage. Both Jensen (1986) and Myers (1977) argue that existing capital structure impacts capital allocation decisions. We define leverage as the 2000-2005 industry average ratio of long-term debt to tangible assets.

Diversification. Extensive literature relates corporate diversification to investment efficiency. While Lewellen (1971), Matsusaka and Nanda (1994) and Stein (1997) demonstrate positive effects of diversification, Amihud and Lev (1981), Morck, Shleifer, and Vishny (1990), Rajan, Servaes, and Zingales (2000), among others, document adverse effects of diversification. We measure diversification as an asset-weighted average diversification level of firms with primary business in a given industry. Firm diversification is, in turn, defined as the number of three-digit segments reported in COMPUSTAT Industry Segment file.

R&D Expenditures. We include this variable as capital budgeting may be less efficient in industries with higher intangible asset intensity. R&D expenditures are measured per dollar of tangible assets.

In addition, we include industry and year fixed effects in order to control for industry and time specific factors.

Empirical Specification

We regress the quality of capital allocation, measured by the distance of marginal q from its optimal level on the interaction of export exposure with the political variable (either political risk or elections dummy). We also include interactions of export exposure with economic and financial risks, in order to assess their relative importance. In order to account for unobserved heterogeneity, we include industry and year fixed effects. The regression equation is, therefore, as follows:

$$|\dot{q}-1|_{j,t} \; or (\dot{q}-1)^2_{j,t} = \eta_j + \gamma_t + \beta \cdot TRADE \times POLITICAL_{j,t} + \delta \cdot TRADE \times PECONOMIC_{j,t} + \varphi \cdot TRADE \times FINANCIAL_{j,t} + CONTROLS_{j,t} + \varepsilon_{j,t} \quad (12)$$

where *j* indexes industries and *t* indexes years. The standard errors are clustered by industries and years to adjust them for heteroskedasticity, cross-sectional, and time-series correlation. The main coefficient of interest (β) measures the transmission of trading partner country political risk into quality of investment efficiency. In the latter part of the analysis, $\dot{q}$ is benchmarked against endogenously determined optimal level, *h*.

4. Results

Descriptives

Table I presents some descriptive statistics for industries in our sample, aggregated at a 2-digit SIC level. Marginal q is, on average, slightly less than one (0.968). Industrial and computer equipment (SIC 3500) exhibits the lowest marginal q (0.074), while Transportation equipment (SIC 3700) has the highest (1.784). Electronic and electrical equipment (SIC 3600) has the highest trade share, exporting over 32% of its output. Apparel industry (SIC 2300) has the highest trade-political risk interaction (320.014), and the highest trade-election interaction (6.36).

Table II presents statistics on political, economic, and financial risk of trading partner countries. Luxembourg has the lowest political risk, while Somalia has the highest. Norway and Zimbabwe have the lowest and highest economic risk scores, respectively. Brunei is the country with the lowest financial risk, and Liberia has the highest.

Regression results

Table III presents the results of the main regression analysis. The dependent variable is the distance between marginal q from its optimal level, which is initially set at 1. Specifications 1 and 2 consider the trade-political risk interaction, while specifications 3 and 4 report the results for trade-elections interaction. The coefficients for political-trade interactions are positive and highly significant in all specifications. Consistent with our hypotheses, industries that export more to countries with high political risk or countries that hold national elections exhibit greater deviation from optimal investment level. We interpret this finding as being indicative of less transparent cash flows generated by exports to less politically stable countries, as well as difficulty in estimating cost of capital of firms that engage in export operations.

Interactions of economic and financial risks with export exposure are also positive and significant in all specifications, implying that capital allocation is less optimal in industries that export more to countries with higher economic and financial risks. While all three risks interactions are statistically significant, political risk interaction displays the highest economic significance. Consider Primary Metals industry (SIC 3300), which exports 17% of its output (which is close to the average in our sample). One standard deviation increase in political risk of its trading partners (which is equivalent to switching exports entirely from

Canada to China) increases deviation of marginal *q* from one by 14%. A similar one-deviation increase in economic risk raises the deviation of marginal *q* by 5%, and a one-deviation increase in financial risk – by only 1%.

It is also important to note that the US political environment (political risk and elections) appears to have an insignificant effect on capital allocation efficiency. Interactions of export exposure with the US political risk and US elections are insignificant in almost all specifications.[16] To account for the possibility that more export-dependent industries exhibit less optimal capital allocation regardless of political environment in trading partner countries, we include the trade exposure level variable. Data does not support this conjecture, as the variable is insignificant in all specifications.

As for the control variables, firm-specific return variation is negative and significant in most specifications, which is consistent with the results documented in Durnev, Morck, and Yeung (2004) – industries with less synchronous stock prices exhibit more efficient capital allocation. Average q us also negative and significant, implying that high growth (low q) industries, on average, experience worse capital allocation. Similarly, industry size is negative and significant across the board, implying better capital allocation in larger industries. Industries with higher leverage also exhibit better investment allocation. R&D expenditures are positively related to marginal *q* deviation from one, implying that higher importance of intangible assets has a negative impact on capital allocation quality.

As mentioned in the previous section, optimal level of marginal *q* can deviate from one for a number of reasons. Therefore, in Table IV, we use the deviation of marginal *q* from its optimal endogenously estimated level, *h* (see (7) – (9) for details). For the most part, the results remain qualitatively unchanged. The interaction of trade exposure with the political environment variables is positive and highly significant. The remaining results remain largely robust. Perhaps somewhat surprisingly, average *q* becomes positively significant.

Addressing Endogeneity

Our results may suffer from a selection bias. It is conceivable that industries with more efficient capital allocation choose to trade with countries with more stable political environments (and vice versa). Thus, any relationship between political-trade interactions and

[16] In specification (2), when squared deviation of marginal *q* is used as the dependent variable, interaction of export exposure with US political risk is significant at a 10% level when coupled with political risk of trading partners.

capital allocation may be spuriously driven by such self-selection. In order to address this, we perform Heckman's (1979) two-step estimation procedure that corrects for such self-selection. In the first step, we estimate a binary probit model of trade:

$$S = X\beta + \varepsilon \tag{10}$$

where S is a dummy variable which is equal to one if an industry is trading with a given trading partner and zero otherwise. *X* is a vector of variables that presumably determine the likelihood of trade taking place. In our application, *X* includes industry size (defined as the proportion of industry's sales to total sales within a country), and distance between the country and the US. We assume that larger industries are more likely to export. Also, US industries are more likely to trade with countries closer to the US. The inverse Mills ratio obtained from the above estimation is then used as an additional regressor in the estimation. Our results remain robust.

5. Conclusion

Economic growth hinges on efficient allocation of capital. Investments are supposed to flow into growing industries and withdraw from declining ones. Capital misallocation can have adverse consequences, ultimately resulting in slower economic growth. Numerous theoretical and empirical enquiries have addressed the issue.

In this paper we show that capital allocation efficiency is adversely affected by industries' exposure to foreign political risk. Specifically, volume of exports to a particular country acts as a conduit of transmission of that country's political risk into quality of domestic capital allocation. We show that even modest changes in trading partner country political environment can have detrimental consequences for investment efficiency.

For our empirical analysis, we construct a measure of foreign political risk sensitivity, which is essentially an index of relative export volumes of particular industries. That index, coupled with trading partner countries political risk scores, gives us a measure of foreign political risk

exposure. Industries with greater political risk scores experience significantly worse capital allocation.

Our findings are consistent with the notion that cash flows from export operations are more difficult to predict that the ones generated by domestic sales, particularly in the presence of foreign political risk, which may range from expropriation to capital controls and regulatory changes. Also, cost of capital of firms that engage in international operations is difficult to estimate. Due to the above reasons, it is difficult for investors to gauge investment NPV, which results in less efficient investment.

We control for a number of factors to ensure that our results are not driven by omitted variables. In addition, we explicitly acknowledge the possibility of endogeneity of export flows. Our results remain robust.

By applying a novel methodological approach to political risk transmission analysis, we believe this paper makes an important contribution to our understanding of capital allocation by showing that export exposure could be detrimental to a firm in the long run. Along with gains from export activity, such as diversification, managers and policymakers should also consider potential slower industry growth in the long run.

Clearly, this paper is not a last word on the subject. Our measure of political risk transmission captures only one dimension of risk, and future research may build upon our results to capture alternative transmission mechanisms. Also, one may develop a theoretical model that endogenizes political risk, trade policy, and capital allocation.

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Table I
Panel A: Descriptive Statistics by Industry.

This table reports average values of main variables: absolute value of deviation of marginal q from one, investment elasticity, trade shares, trade-political risk index, and trade-elections index. The average values are calculated across two-digit manufacturing SIC industries and years. The sample is based on 628 three-digit SIC industries spanning years from 2000 through 2005. Marginal q is calculated as elasticity investment with respect to change in firm value of as in Durnev et al. (2005). The absolute value of deviation of marginal q from one is the measure of capital allocation quality with larger values indicating worse capital allocation. Trade shares are calculated as the ratio of the value of exports to the value of production in an industry. Trade-political risk index is the weighted average of country political risk with weights equal to trade shares. Trade-election index is the weighted average of country national elections with weights equal to trade shares. Political risk is political risk rating from ICRG with corruption, law and order, and bureaucracy quality excluded from calculation. That is the index is the sum of the following sub-indexes: socioeconomic conditions, investment profile, external conflict, military in politics, religious tensions, ethnic tensions, and democratic accountability. Larger values for this variable indicate more political uncertainty. National elections are based on years of the elections of the chief executive from the World Bank's Database of Political Institutions (Beck et. al (2001)).

industry name	sic code	marginal q	|marginal q – 1|	trade shares , %	trade-political risk index	trade-election index
Food Products	2000	0.435	0.565	17.475	159.420	5.84
Tobacco Products	2100	1.077	0.077	6.976	41.576	3.12
Textile Mill Products	2200	1.3	0.3	22.140	183.469	4.06
Apparel	2300	1.122	0.122	24.273	320.014	6.36
Lumber And Wood Products	2400	0.671	0.329	22.833	194.023	4
Furniture And Fixtures	2500	1.16	0.16	12.804	74.169	4.32
Paper And Allied Products	2600	0.752	0.248	19.085	225.400	5.7
Printing And Publishing	2700	1.096	0.096	23.508	221.198	5.14
Chemicals And Allied Products	2800	1.163	0.163	20.243	195.942	4.18
Petroleum Refining	2900	1.269	0.269	3.574	65.488	4.42
Rubber And Plastics Products	3000	1.155	0.155	23.236	210.110	4.7
Leather And Leather Products	3100	1.014	0.014	10.927	100.263	3.89
Stone, Clay, And Glass	3200	0.685	0.315	6.018	24.324	4.16
Primary Metal Industries	3300	1.314	0.314	17.284	138.174	5.89
Fabricated Metal Products	3400	1.579	0.579	11.693	86.404	4.28
Industrial And Computer Equipment	3500	0.074	0.926	32.263	286.788	4.49
Electronic And Electrical Equipment	3600	0.43	0.57	32.315	214.733	5.16
Transportation Equipment	3700	1.784	0.784	27.420	253.708	5.64
Measuring Instruments	3800	0.794	0.206	14.301	135.929	4.72
Miscellaneous Industries	3900	0.491	0.509	20.581	182.294	5.1
average		0.968	0.335	18.44	165.671	4.759

Table II
Panel B: Descriptive Statistics of Trading Partners.

This table reports average values of political risk, economic risk, and financial risk variables for trading partners. Average values are calculated for years from 2000 through 2005. Economic risk is based in such variables as GDP per capita, real GDP growth, annual inflation rate, state budget balance, and current account. Financial risk is based on such variables as state foreign debt, foreign debt service, international liquidity, and exchange rate stability.Political risk is political risk rating from ICRG with corruption, law and order, and bureaucracy quality excluded from calculation. That is the index is the sum of the following sub-indexes: socioeconomic conditions, investment profile, external conflict, military in politics, religious tensions, ethnic tensions, and democratic accountability. Larger values for these variables indicate greater risks.

Country	Political Risk	Economic Risk	Financial Risk	Country	Political Risk	Economic Risk	Financial Risk	Country	Political Risk	Economic Risk	Financial Risk
Albania	26.922	67.222	66.514	Guyana	26.018	72.201	69.889	Paraguay	27.841	67.729	61.833
Algeria	39.818	59.194	59.118	Haiti	43.781	71.563	65.431	Peru	31.052	63.458	62.313
Angola	39.885	72.861	72.625	Honduras	30.576	68.771	65.201	Philippines	27.070	63.194	63.500
Argentina	22.620	64.306	73.236	Hong Kong	19.667	55.201	56.014	Poland	17.320	64.292	61.590
Armenia	30.916	68.500	66.924	Hungary	16.904	64.861	64.035	Portugal	12.398	63.660	65.347
Australia	12.813	59.160	64.708	Iceland	11.875	61.597	67.771	Qatar	21.076	57.188	66.222
Austria	12.518	59.688	57.625	India	33.034	65.451	58.049	Romania	22.773	69.090	64.194
Azerbaijan	28.975	65.951	62.319	Indonesia	36.339	64.299	65.632	Russia	30.430	61.347	59.764
Bahamas	14.445	63.528	66.271	Iran	31.594	63.243	59.910	Saudi Arabia	25.721	58.528	54.958
Bahrain	23.471	61.382	56.361	Iraq	52.419	75.451	73.875	Senegal	32.940	64.701	65.125
Bangladesh	36.102	65.431	62.167	Ireland	10.372	56.903	59.333	Serbia-Montenegro	40.778	76.257	75.361
Belarus	30.633	69.472	64.076	Israel	32.867	61.868	61.493	Sierra Leone	43.375	74.938	79.896
Belgium	15.383	57.042	60.396	Italy	17.018	60.368	59.486	Singapore	13.073	52.861	54.604
Bolivia	28.518	66.750	63.826	Jamaica	18.768	69.750	64.007	Slovakia	18.156	65.910	62.632
Botswana	18.047	60.444	55.139	Japan	14.906	61.889	52.625	Slovenia	14.822	62.340	60.472
Brazil	25.789	65.597	69.167	Jordan	22.646	63.618	62.917	Somalia	61.026	74.271	69.639
Brunei	15.297	53.979	50.910	Kazakhstan	20.112	63.931	62.667	South Africa	23.276	63.646	62.354
Bulgaria	21.396	64.882	64.410	Kenya	32.074	67.375	63.229	Spain	18.359	60.319	61.688
Burkina Faso	31.380	69.757	73.229	Korea, DPR	36.846	75.326	76.076	Sri Lanka	36.521	69.139	64.208
Cote D'Ivoire	36.633	62.944	67.201	Korea, South	18.602	57.243	59.118	Sudan	50.945	65.750	69.743
Cameroon	34.513	57.146	59.472	Kuwait	20.490	54.438	52.694	Suriname	28.138	69.625	65.944

Canada	14.070	60.688	62.493	Latvia	19.719	62.938	60.743	Sweden	12.445	56.264	62.215
Chile	18.656	61.174	54.889	Lebanon	32.492	74.229	71.521	Switzerland	10.523	55.465	54.104
China	25.615	66.542	63.660	Liberia	46.618	70.215	83.014	Syria	28.500	61.681	62.542
Colombia	35.208	64.160	71.424	Libya	29.826	58.951	56.722	Taiwan	16.596	57.278	54.146
Congo	37.885	71.188	71.993	Lithuania	19.405	62.361	61.965	Tanzania	28.760	66.264	76.597
Congo, DR	51.445	65.583	62.722	Luxembourg	7.008	55.014	57.549	Thailand	25.178	60.931	60.194
Costa Rica	18.651	65.979	69.806	Madagascar	30.849	68.646	69.375	Togo	38.227	67.118	66.417
Croatia	21.773	63.840	63.417	Malawi	30.833	72.785	72.514	Trinidad & Tobago	23.664	60.069	57.882
Cuba	31.807	65.722	67.868	Malaysia	20.388	59.056	58.410	Tunisia	21.674	62.965	63.965
Cyprus	19.232	59.313	57.347	Mali	29.586	71.458	68.306	Turkey	33.365	72.340	70.083
Czech Republic	16.849	63.889	60.993	Malta	11.484	65.007	62.653	UAE	18.945	54.868	56.167
Denmark	12.487	57.021	58.618	Mexico	21.307	63.049	62.569	Uganda	36.529	66.063	64.708
Dominican Republic	25.331	65.014	64.785	Moldova	27.707	71.271	69.160	Ukraine	27.295	64.403	61.340
Ecuador	33.930	67.465	68.819	Mongolia	24.411	72.181	67.299	United Kingdom	14.307	59.639	61.465
Egypt	28.904	65.028	62.007	Morocco	24.367	63.208	61.243	United States	15.328	60.285	66.049
El Salvador	24.031	64.660	59.785	Mozambique	30.333	73.007	68.408	Uruguay	20.581	66.410	68.285
Estonia	18.652	61.833	63.153	Myanmar	40.802	65.924	61.826	Venezuela	33.182	65.910	60.465
Ethiopia	37.044	67.854	69.521	Namibia	17.745	63.535	58.306	Vietnam	25.385	64.285	63.243
Finland	9.622	54.604	62.729	Netherlands	11.154	58.083	61.389	Yemen	28.435	63.708	65.694
France	17.440	58.618	61.132	New Zealand	12.500	59.389	70.063	Zambia	27.831	73.104	75.236
Gabon	29.508	60.639	64.778	Nicaragua	29.938	74.903	75.236	Zimbabwe	39.143	86.514	74.833
Gambia	26.883	65.521	68.076	Niger	35.534	67.431	72.632				
Germany	14.578	59.500	60.028	Nigeria	42.435	67.299	62.333				
Ghana	26.443	70.090	69.201	Norway	12.328	52.833	53.160				
Greece	18.497	61.792	65.972	Oman	19.659	57.958	57.861				
Guatemala	26.964	65.979	60.125	Pakistan	41.115	65.743	64.444				
Guinea	41.346	67.090	66.722	Panama	21.586	63.354	65.306				
Guinea-Bissau	38.849	74.764	79.493	Papua New Guinea	30.586	66.653	63.625				

Table III
Capital Allocation Quality and Trade-Political Risk, Trade-Elections Indexes.

This table reports the results of OLS panel regressions of the measures of capital allocation quality (absolute deviation of marginal q from 1 and squared deviation of marginal q from 1) on interaction of trade with political risk, interaction of trade with elections, interaction of trade with economic risk, interaction of trade with financial risk, interaction of trade with U.S. political risk, interaction of trade with U.S. elections, average q, diversification, size, liquidity, leverage, R&D expenditures. The regressions are run using the panel of three-digit SIC U.S. manufacturing industry industries spanning years from 2000 through 2005. Every regression includes industry and year fixed effects. Numbers in parentheses are probability levels at which the hypothesis of zero coefficient can be rejected. The coefficients significant at the 10% level (based on a two-tailed test) or higher are in bold face. *, **, *** indicate significance at the 10%, 5%, and 1%, respectively. Standard errors are clustered at the industry level to adjust them for heteroskedasticity and time-series correlation.

DEPENDENT VARIABLE	**|MQ-1|**	**$(MQ-1)^2$**	**|MQ-1|**	**$(MQ-1)^2$**
SPECIFICATION	**1**	***2***	**3**	**4**
Interaction of trade with political risk	**0.873**	**0.212**	-	-
	(0.00)	(0.00)		
Interaction of trade with elections	-	-	**0.361**	**0.380**
			(0.00)	(0.00)
Interaction of trade with economic risk	**0.318**	**0.311**	**0.381**	**0.241**
	(0.01)	(0.05)	(0.02)	(0.08)
Interaction of trade with financial risk	**0.082**	**0.140**	**0.137**	**0.063**
	(0.01)	(0.09)	(0.01)	(0.00)
Interaction of trade with U.S. political risk	0.314	0.312	0.228	0.308
	(0.16)	(0.10)	(0.13)	(0.23)
Interaction of trade with U.S. elections	0.022	-0.044	-0.056	-0.065
	(0.28)	(0.25)	(0.18)	(0.30)
Trade exposure	-0.039	-0.068	-0.031	-0.084
	(0.16)	(0.22)	(0.12)	(0.11)
Political risk	0.018	-0.009	0.086	0.068
	(0.12)	(0.18)	(0.19)	(0.12)
Economic Risk	**0.622**	**0.707**	**0.707**	**0.701**
	(0.02)	(0.00)	(0.01)	(0.01)
Financial Risk	**0.514**	**0.526**	**0.584**	**0.592**
	(0.05)	(0.07)	(0.06)	(0.04)
U.S. political risk	-0.082	-0.093	-0.038	-0.057
	(0.34)	(0.27)	(0.34)	(0.35)
U.S. elections dummy	-	-	0.180	0.091
			(0.14)	(0.21)
Scaled firm-specific variation	**-0.032**	**-0.042**	**-0.054**	-0.037
	(0.04)	(0.03)	(0.10)	(0.12)
Average Q	**-0.118**	**-0.192**	**-0.062**	**-0.278**
	(0.05)	(0.02)	(0.06)	(0.01)
	(0.20)	(0.38)	(0.31)	(0.26)
Size	**-0.412**	**-0.491**	**-0.084**	**-0.587**
	(0.00)	(0.00)	(0.00)	(0.00)
Liquidity	-0.818	-0.887	-0.059	-0.963
	(0.24)	(0.29)	(0.31)	(0.38)
Leverage	**-1.182**	**-1.244**	**-0.053**	**-1.333**
	(0.00)	(0.00)	(0.00)	(0.00)
R&D expenditures	**1.766**	**1.699**	**-0.081**	**1.632**
	(0.00)	(0.00)	(0.00)	(0.00)
Regression R^2 –adj.	0.446	0.448	0.421	0.427
Number of observations	628	628	628	628

Table IV

Capital Allocation Quality and Trade-Political Risk, Trade-Elections Indexes. Estimation using endogenously determined threshold level.

This table reports the results of OLS panel regressions of the measures of capital allocation quality (absolute deviation of marginal q from h and squared deviation of marginal q from h) on interaction of trade with political risk, interaction of trade with elections, interaction of trade with economic risk, interaction of trade with financial risk, interaction of trade with U.S. political risk, interaction of trade with U.S. elections, average q, diversification, size, liquidity, leverage, R&D expenditures. Every regression includes industry and year fixed effects. Numbers in parentheses are probability levels at which the hypothesis of zero coefficient can be rejected. The coefficients significant at the 10% level (based on a two-tailed test) or higher are in bold face. *, **, *** indicate significance at the 10%, 5%, and 1%, respectively. Standard errors are clustered at the industry level to adjust them for heteroskedasticity and time-series correlation.

DEPENDENT VARIABLE	**|MQ-h|**	**$(MQ-h)^2$**	**|MQ-h|**	**$(MQ-h)^2$**
SPECIFICATION	**1**	***2***	**3**	**4**
Endogenously estimated threshold level h	**0.867**	**0.714**	**0.821**	**0.777**
	(0.00)	(0.00)	(0.00)	(0.00)
Interaction of trade with political risk	**1.058**	**0.374**	-	-
	(0.00)	(0.00)		
Interaction of trade with elections	-	-	**0.548**	**0.391**
			(0.00)	(0.01)
Interaction of trade with economic risk	**0.471**	0.218	**0.624**	-0.010
	(0.05)	(0.15)	(0.02)	(0.12)
Interaction of trade with financial risk	**0.318**	0.031	**0.113**	**0.114**
	(0.01)	(0.14)	(0.00)	(0.01)
Interaction of trade with U.S. political risk	0.565	0.418	0.303	0.485
	(0.23)	(0.17)	(0.31)	(0.20)
Interaction of trade with U.S. elections	-0.134	-0.033	-0.031	-0.299
	(0.13)	(0.34)	(0.21)	(0.14)
Trade exposure	0.238	0.199	-0.095	-0.008
	(0.18)	(0.24)	(0.21)	(0.17)
Political risk	**0.157**	**0.147**	**0.354**	**0.067**
	(0.10)	(0.01)	(0.07)	(0.05)
Economic Risk	**1.002**	**0.824**	**0.425**	**1.049**
	(0.00)	(0.00)	(0.00)	(0.00)
Financial Risk	**0.809**	**0.354**	**0.921**	**0.547**
	(0.10)	(0.09)	(0.05)	(0.03)
U.S. political risk	0.040	0.020	-0.159	-0.167
	(0.13)	(0.21)	(0.29)	(0.24)
U.S. elections dummy			**-0.470**	**-0.304**
			(0.10)	(0.11)
Scaled firm-specific variation	**-0.059**	**-0.299**	-0.225	-0.107
	(0.00)	(0.01)	(0.10)	(0.12)
Average Q	**0.050**	**0.262**	**0.311**	**0.625**
	(0.01)	(0.01)	(0.02)	(0.01)
Diversification	-0.467	-0.628	-0.393	-0.182
	(0.22)	(0.14)	(0.21)	(0.28)
Size	**-0.576**	**-0.151**	**-0.010**	**-0.531**
	(0.00)	(0.00)	(0.00)	(0.00)
Liquidity	**-1.113**	**-1.208**	**-0.269**	**-0.923**
	(0.10)	(0.10)	(0.04)	(0.03)
Leverage	**-1.574**	**-1.377**	**-0.248**	**-1.688**
	(0.00)	(0.00)	(0.00)	(0.00)
R&D expenditures	**2.075**	**1.372**	**0.869**	**1.256**
	(0.00)	(0.00)	(0.00)	(0.00)
Regression R^2 –adj.	0.480	0.431	0.514	0.577
Number of observations	628	628	628	628