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Journal of Conflict Resolution published online 1 May 2012

DOI: 10.1177/0022002712438348

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Journal of Conflict Resolution

00(0) 1-29

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Hoon Lee¹ and Sara McLaughlin Mitchell²

Abstract

This study evaluates the relationship between foreign direct investment (FDI) and interstate conflict, focusing on four prominent causal mechanisms: the declining benefits of territorial conquest, increasing preference similarity, increasing opportunity costs of violence, and improved information signaling. Empirical analyses show that new territorial issues are less likely to arise as global levels of FDI increase, although monadic and bilateral FDI flows have no effect on states' decisions to start new issue claims. Higher bilateral FDI flows between two disputants significantly reduce the chances for escalation to high levels of violence over issues and improve the chances for peaceful management. Increasing global levels of FDI also reduce the chances for severe militarized conflicts. Opportunity costs are an important mechanism linking FDI and states' conflict management practices, as the pacifying effect of bilateral and monadic FDI on militarized conflict becomes stronger in dyads with a history of militarization over the issues at stake.

Keywords

FDI, territory, conflict, issues, investment

Liberal peace scholars have pointed to many advantages of economic exchange, 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 We

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evaluate the FDI–conflict relationship in the context of territorial disputes where states’ interests are often highly salient. If FDI has the capacity to discourage militarized conflict and promote the peaceful resolution of disputes, finding pacific effects for FDI in the most contentious set of territorial issues may strengthen the liberal peace proposition. This is 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). We examine the influence of FDI on territorial disputes 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. This comparison will help us determine whether FDI is linked to conflict in an informational or opportunity cost sense or whether FDI alters states’ interactions by removing the most conflict-prone issues from the menu. Our theory and empirical models probe the monadic-, dyadic-, and systemic-level effects of FDI on territorial conflict to help understand the causal mechanisms linking FDI to interstate conflict and peaceful conflict management.

We test theoretical propositions using data on issue claims over territory, maritime areas, and cross-border rivers from the Issue Correlates of War (ICOW) project (Hensel et al. 2008) and Huth and Allee’s (2002) territorial disputes project. We find that increases in global FDI reduce states’ willingness to start new border disputes, consistent with arguments in the international relations literature about the declining benefits of territorial conquest. Bilateral FDI flows between two claimants significantly reduce the chances for escalation to the use of militarized force over contested issues and improve the chances for peaceful conflict management. We also find that monadic and bilateral FDI reduce the chances for militarized conflicts even in pairs of states that have experienced prior militarization of contested issues. This fits with the long-standing Kantian view that economic exchange helps to promote peaceful interaction, even in situations of heightened security dilemmas. Our analysis and discussion of specific cases shed further light on the causal mechanisms relating FDI and interstate conflict.

The Relationship between FDI and Interstate Conflict

Increased FDI can reduce the chances for dyadic militarized conflicts and improve 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). These findings are important in light of the massive increase in FDI globally. Worldwide annual inflows of FDI rose from around \$13 billion in 1970 to \$1.4 trillion in 2001, with developed and developing countries witnessing significant increases in their FDI inflows (UNCTAD 2003). Given that FDI growth since 1970 has outpaced growth in trade or gross domestic product (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 and mitigates asymmetries of privately held information in dyadic bargaining (Gartzke, Li, and Boehmer 2001; Gartzke and Li 2003). A second theoretical position asserts that FDI increases the *opportunity costs* of conflict and encourages more peaceful foreign policy practices (Souva 2002; Souva and Prins 2006). 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; Rosecrance 1999).

Although FDI is believed to make states less likely to engage in conquest of other states' territories, few studies directly test the relationship between FDI and territorial disputes. Gartzke (2006) 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 border conflicts. However, this 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).

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. Some studies find that military conflict has no significant effect on FDI flows (Li 2006b; Lee 2008; Li and Vashchilko 2010), although US investors appear sensitive to the presence of conflict (Biglaiser and DeRouen 2007). By examining the effect of FDI on the onset of new border disputes, the management of preexisting disputes, and the interaction between FDI and prior conflict, 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. The steps-to-war model (Vasquez 1993) is based on the assumption that war stems from a long-term process of conflict escalation. Few empirical studies examining the FDI–conflict relationship focus on the dynamics of conflict processes. By studying contested issues from their diplomatic beginnings to their violent endings, we can test the varied roles of FDI at different stages of issue conflict more fully.

Theory

We embed our theory in the work on territorial issues (Vasquez 1993; Huth and Allee 2002; Senese and Vasquez 2008; Hensel et al. 2008). Territorial claims have been shown to be one of the most important causes of militarized dispute onset and

escalation to interstate war (Vasquez 1993, 1995; Huth 1996; Hensel 1996, 2001; Huth 1996; Huth and Allee 2002; Hensel and Mitchell 2005; Senese 2005; Senese and Vasquez 2003, 2008). While conflict scholars show that contiguity is an important predictor of militarized conflict (Bremer 1992), research on territorial issues demonstrates 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. Realpolitik strategies of arms buildups, repeated crises, alliance formation, and hawkish foreign policies significantly increase the chances that a territorial dispute will result in interstate war (Vasquez 1993, 1995; Senese and Vasquez 2003, 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. Prior militarization and power parity increase the risks of militarized dispute onset for all three 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 1. 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 simultaneously. Next, we show how monadic, dyadic, and systemic FDI influence states' actions in the dynamic process of interstate competition over issues.

Stage 1: Onset of Issue Claims

Our first step is to determine how decisions by businesses to increase foreign investments in another country might influence the home states' and recipient states' foreign policies toward each other. If businesses operate according to rational expectations models, they should consider ongoing or potential interstate conflicts when deciding where to invest. Yet, 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 (Li 2006b; 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 home and recipient states. 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

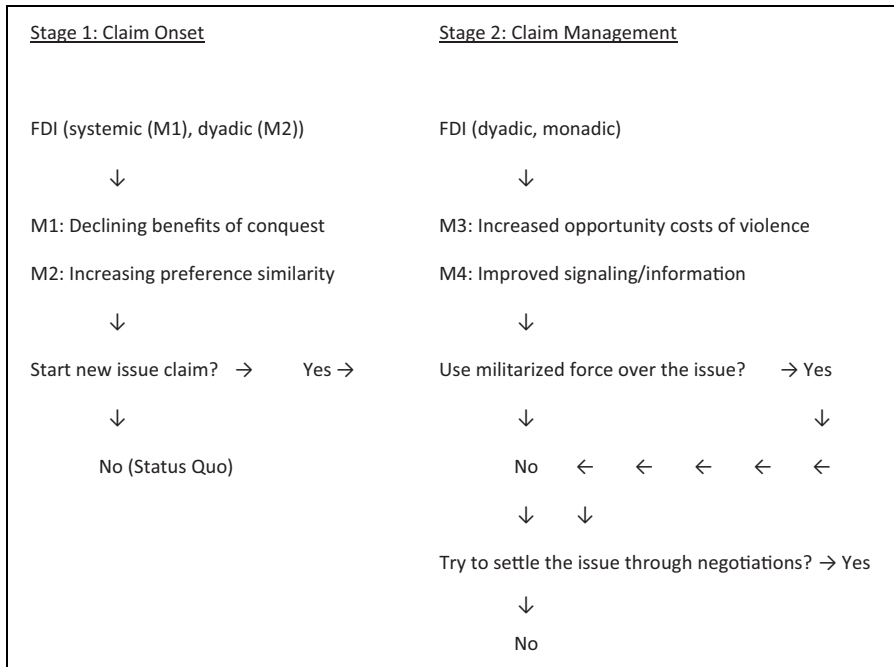


Figure 1. Theoretical framework

globalization and the increasing foreign policy preference similarity of states that are economically interdependent. We argue that the declining benefits of conquest is captured best with a systemic FDI indicator, whereas increasing preference similarity manifests itself through dyadic FDI flows between states.

Causal mechanism #1: Declining benefits of conquest. One explanation for the pacific effect of FDI on interstate 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). Increases in global FDI flows reduce the chances for new border disputes because states can gain more from a peaceful, economic exchange of goods and services. Conquering states with highly advanced economies is seen as a costly strategy due to the high costs for appeasing nationalist and rebellious factions in the newly conquered state, which could reduce the economic gains that would accrue to the conqueror. The geographic dispersion of multinational corporations also reduces the payoff of conquest because the conquering state could capture only a percentage of economic assets linked to economic production inside a state. The increased presence of interfirm alliances also disperses technological knowledge and development geographically, making it harder to capture via conquest. The emergence of knowledge-based economies also reduces the

benefits of conquest because citizens, the most important economic assets, are more difficult to “capture” and because centralized oversight reduces economic innovation (Brooks 1999, 2005).

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 1998). Some have suggested that major power conflict itself is becoming obsolete, much like slavery and dueling (Mueller 1989). The internationalization of the production of military weapons has also made potential conquering states more susceptible to attempts to cut off their supplies in wartime, which reduces the incentives for offensive conquest strategies (Brooks 2005). Increased democratization around the world works against territorial conquest as well, given that democratic publics are often averse to fighting wars (Kant [1775] 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).

Rapidly expanding FDI globally provides another explanation for why the benefits of territorial conquest have declined in the past few centuries. Transformation in the global economy has increased the power of global capital. 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. Global capital has become 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 1993). This decreases the value of conquest because businesses can simply remove their investments after a war is underway. Thus, globalization creates an economic world without borders (Ruggie 1993; Ohmae 1995).

Multinational corporations may be unwilling 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, August 1, 2001). Similarly, 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, April 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, March 3, 1995). Each of these examples illustrates how global FDI influences dyadic interactions over territorial issues. As multinational corporations seek to protect their interests abroad, and as the total amount of global FDI increases, this results in greater external pressures being brought to bear on governments involved in potentially dangerous territorial disputes.

States pay economic costs for aggressively expanding claims to land or water borders. Because the decline in conquest is a long-term historical shift in states' practices, we think it is best measured using total levels of FDI in the world. Furthermore, if a norm of territorial integrity has emerged, it should manifest itself most clearly at the claim onset stage, as states should make fewer challenges to pre-existing land or water borders.

Hypothesis 1: Increases in global levels of FDI reduce the likelihood that a pair of states becomes involved in a geopolitical issue claim.

Causal mechanism #2: Increasing preference similarity. Another way to think about how FDI 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 (EU) 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 integrate citizens across countries and bring states' security and economic interests in closer alignment. We think this operates most clearly at the dyadic level, as states are more likely to be influenced by other states with whom they have direct and frequent interactions.

Given the sometimes tumultuous relationship between multinational corporations and host governments and North–South conflict more generally, it may be somewhat controversial to assume that increased levels of bilateral FDI will improve interstate cooperation. Yet, developing countries' desire for attracting FDI has grown in the past few decades, as FDI now constitutes the largest foreign capital source in the developing world and an increasing share of developing states' total GDP (Büthe and Milner 2008), bringing “jobs, technology transfer, productivity improvements, and economic growth” (Garland and Biglaiser 2009, 227; Markusen and Venables 1999; Jensen 2006). Developing countries are engaging less frequently in threats of expropriation because the vertical nature of FDI renders expropriation ineffective. Countries are turning to “more subtle measures” to extract greater benefits from FDI, including “changes in regulation, taxation, tariffs, and fees, or selective law enforcement” (Büthe and Milner 2008, 743–44). Developing countries with a weak rule of law often create reduced tax rates for foreign companies to attract investment (Li 2006a). As the global supply of FDI has increased, developing states have engaged in more intense competition to earn their share of that overall investment pie (Oman 1999). Developing states' desires to attract and protect FDI may produce

a secondary effect as well, as higher levels of interdependence and economic integration may create shared interests between donor and recipient FDI states.

In the liberal peace literature, the influence of Kantian processes on states' preferences has been examined by focusing on how shared membership in international organizations and interstate trade influences affinity between cooperating states. Bearce and Bondanella (2007) find that shared Intergovernmental Organization (IGO) memberships significantly increase the likelihood that states will vote together in the UN General Assembly. Risse-Kappen (1996) makes a similar argument about democratic foreign policy preference alignment in the North Atlantic Treaty Organization military alliance. Kleinberg and Fordham (2010) argue that societal actors who benefit directly from trade, such as business owners, workers, and consumers, may improve their views of their trading partners as a result of increased interaction and economic payoffs. Using survey data on forty-seven countries in 2007, they find that export dependence translates into more positive views of trading partners. Individuals who express a strong preference for foreign trade and investment also view their trading partners in a less-threatening manner. We believe these latter findings suggest FDI will have similar effects on states mutually invested in each other's territories.

Foreign aid also serves to promote similarity of states' UN voting patterns, moving nondemocratic leaders in the direction of voting with democratic donors (Lai and Morey 2006). FDI 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. 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 pairs of states with very high levels of mutual FDI avoided new diplomatic conflicts over their borders. We might also expect that foreign investment underway for longer periods would have stronger, pacifying effects, as this would create time for states' and citizens' interests to be altered. This relationship should be strongest at the dyadic level, given the increased interactions and ties created between two mutually invested states.

Hypothesis 2: Increases in dyadic levels of FDI reduce the likelihood that a pair of states becomes involved in a geopolitical issue claim.

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, 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. Disputing states could also use

FDI as a form of leverage in the bargaining process to resolve a contentious issue. We examine two possible causal mechanisms of FDI at this stage of the conflict process: increasing opportunity costs of violence and improved information in interstate bargaining.

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 FDI ties are even more costly to break than trading ties.² 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 . . . 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). 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 to 1992, finding that reciprocal (or bilateral) FDI flows have a very strong pacifying effect on hostility escalation. However, their 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. In 2009, the Croatia EU Business Council 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, March 3, 2009). The University of the Thai Chamber of Commerce has repeatedly warned the Thai government about the economic costs of failing to resolve its border dispute with Cambodia (The Nation Thailand, November 13, 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, August 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.

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, September 4, 2009)

Governments can also threaten to withdraw or withhold FDI as a bargaining tool in the context of a territorial dispute. In the early 1990s, President Mikhail Gorbachev asked Japanese leaders to increase economic investment in the Soviet Union. However, the Japanese refused to sign investment treaties until four islands in their northern territories that had been seized by the Soviet Union in World War II were returned to Japan (Washington Post, April 18, 1991). In 2010, Argentina targeted British companies with links to new oil drilling operations off the coast of the Falkland Islands. The Argentine government sought to limit the operations of British banks inside Argentina who were funding the oil operations, including Barclays, HSBC, and BHP Billiton (Daily Telegraph, February 20, 2010). In 1995, in light of their ongoing territorial disputes with Yemen, the Saudi Arabian government sought to discourage multinational companies from investing in oil discovery in Yemen, threatening these firms’ investments in Saudi Arabia (Irish Times, January 16, 1995). In each of these cases, the presence of a territorial dispute creates economic opportunity costs for firms with investments in the disputing states.

We see opportunity costs as arising from both dyadic FDI flows and monadic FDI levels, as loss of investment could come from investors in rival states or more generally from risk-averse multinational corporations’ behavior abroad. 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 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 expost behavior. If multinational corporations were perfectly forward looking, we would not observe any FDI between pairs of states with highly contentious, militarized issues. In situations where the potential for more several militarized conflicts is high, such as the case of repeated crises (Colaresi and Thompson 2002), higher levels of investment should bring more pressure to bear on the disputing governments to resolve the issues at stake and avoid future militarization.

Hypothesis 3: Increases in monadic or bilateral FDI in an issue claim dyad will decrease the likelihood of a militarized dispute over the contested issue and

increase the chances for peaceful settlement attempts to resolve the contested issue.

Hypothesis 4: As the number of previous militarized disputes over a contested issue increases, dyads with higher levels of monadic or bilateral FDI will be less likely to experience additional militarized conflicts over the issue.

Causal mechanism #4: Improved signaling/information. FDI may not simply raise the opportunity costs of violence; it may also constrain governments' foreign policy strategies by creating more transparency in interstate relations. Gartzke (2006) 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 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 difficult for leaders of FDI endowed states to bluff in world politics, increasing the success of peaceful settlement attempts. However, Gartzke argues that the process of globalization has differential effects on territorial and nonterritorial disputes. Increased FDI reduces the chances for militarized border disputes between neighbors, as it is more difficult to generate profit from captured territory. 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 noncontiguous states. Gartzke's (2006, 174) analysis of directed dyads from 1950 to 2001 supports these claims, showing that "development decreases the propensity to initiate disputes over territory."

Morrow (1999) also explains why economic interdependence influences the onset and escalation of crises. Focusing on trade relations, Morrow argues that while trade flows are observed *ex ante*, they can reduce a state's resolve for fighting over an issue due to the fear of losing that trade should war occur. Once a crisis is underway, states more heavily invested in their opponent's economy can impose higher costs upon themselves and signal their intentions in crises more credibly. We can extend this argument to FDI as well. Consider Vietnam's actions in 2009 toward China with respect to their historical territorial disputes involving the Gulf of Tonkin, the Paracel and Spratley Islands, and the demarcation of their 840-mile land border. Early in 2009, the Vietnamese government was facing a 40 percent decline in the overall level of FDI in the country and sought to remedy this problem by luring capital investment for the mining of bauxite and aluminum refinement. The Vietnamese signed an agreement with a Chinese multinational corporation, Chinalco, while at the same time seeking investment from Alcoa, an American company. Several individuals and groups in Vietnam protested the government's cooperation with China. To protect its new investment, the

government went so far as to ban a Vietnamese newspaper, *Du lich*, from publicizing information about the historical Chinese–Vietnamese territorial disputes, arguing that FDI was too crucial to lose (Economist, April 25, 2009). The presence of new FDI between the two sides helped Vietnam signal its peaceful intentions over the disputed border with China more clearly.

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 and as levels of investment change over time. 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, the pacifying effect of FDI may diminish as states have learned 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 create an interaction term multiplying bilateral or monadic FDI flows with the number of years an issue claim has been ongoing. If this variable is positive and significant, it would wash out the 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. Thus, while support for Hypothesis 3 could arise from either opportunity costs or information mechanisms, Hypotheses 4 and 5 are designed to tease out the particular effects of these two different causal relationships. We also control for global FDI in our analyses of issue claim management because capital market integration may reduce the chances for militarized conflict (Gartzke 2003).

Hypothesis 5: Increases in monadic or bilateral FDI in an issue claim dyad will have diminishing effects on the likelihood of a militarized dispute over a contested issue as the number of years the issue has been contested increases.

Research Design

To determine how FDI flows influence the onset and management of territorial disputes, we analyze data on geopolitical conflicts over territory, maritime areas, and cross-border rivers from the ICOW project (Hensel et al. 2008). Our data set covers 1970–2001, the years in which FDI and ICOW data are available. The ICOW data include information on issue claims in the Western Hemisphere, Europe, and the Middle East. We also conduct separate analyses using territorial conflict data coded by Huth and Allee (2002) that covers all regions.

Stage 1 of our causal sequence involves an examination of the onset of new geopolitical issues. We focus on politically relevant directed dyads as the unit of analysis, or 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 (COW) project. The

directed dyad approach creates one case for country A to country B and a second case for country B to country A per year. This approach 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.

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 (Bennett and Stam 2000). Of the 39,311 total politically relevant directed dyadic observations from 1970 to 2001 in the three regions we analyze, 2,639 dyads (6.7 percent) experience territorial, maritime, or river-issue claims as coded by the ICOW project. While this might seem rare, the existence of bilateral FDI is also rare, with positive values occurring in just over 3,818 dyad-year observations (9.7 percent).

Our empirical tests are run in two stages. To test Hypothesis 1, we run a logistic regression model testing whether an increase in world FDI reduces the likelihood of an issue claim. We also include bilateral FDI flows to evaluate the increasing preference similarity causal mechanism (Hypothesis 2) and monadic FDI levels as a control variable. We take as our baseline model the standard conflict onset model used among scholars in dyadic studies of international conflict (Bremer 1992; Russett and Oneal 2001).

To test Hypothesis 3, 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. We limit our sample only to the cases where there was an ongoing issue claim over a territorial, maritime, or river border. Control variables are selected based on previous work on issue claim management (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 and monadic FDI flows to evaluate the opportunity cost (Hypothesis 4) and informational (Hypothesis 5) mechanisms.

Dependent Variables

To evaluate the effect of FDI flows on conflict management processes, we analyze several dependent variables. The online appendix provides descriptive statistics.³

Issue claim involvement. This variable is coded one if there is a territorial, maritime, or river issue claim between two countries in a given year and zero otherwise. 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). We create a similar measure for the Huth and Allee data set, which takes on a value of one in any year that a politically relevant dyad experiences a territorial dispute. Of the 64,100 politically relevant dyads in the Huth and Allee sample, 1,629 experience territorial disputes (2.54 percent).

Militarized disputes and fatal militarized interstate dispute (MID). We also include variables measuring whether 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 COW Project's MID data set (Ghosn, Palmer, and Bremer 2004). We estimate models for all militarized disputes and only those that experience fatalities.

Independent Variables

World FDI inflows. To test Hypothesis 1 (decline in conquest mechanism), we include a variable of world FDI inflows measured in logged millions of current US dollars each year (World Bank 2009). The mean ranges from 10.9 to 11.6 in the data sets.

Bilateral FDI/GDP. We use a data set of bilateral FDI flows compiled by Li and Vashchilko (2010) for our second FDI independent variable. The data set measures FDI flows either from one Organisation for Economic Co-operation and Development (OECD) country (origin) to any of the other fifty-seven OECD countries (destination), or from one of the twenty-nine 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; thus, we replace those missing values as zero.⁴ However, we only recode missing FDI values as zero when there is a positive flow in monadic FDI. We assume in these cases that the opportunity for bilateral FDI flows is reasonably high. Bilateral FDI flows are measured in millions of US dollars and divided by the average GDP of the two countries to capture interdependence and lagged one year. The average value for bilateral FDI flows in our samples ranges from 0.012 percent of GDP to 0.14 percent of GDP.

Monadic FDI/GDP_{LOW}. We also include a monadic level measure of FDI, which captures net FDI inflows as a percentage of GDP per country in a given year (World Bank 2009). This variable provides valuable information about the effect of FDI on territorial disputes, especially due to its longer temporal coverage (from 1970 to 2001) and broader spatial coverage including non-OECD countries. *FDI/GDP* uses the lower of the two monadic values, using the "weakest link" assumption. The average value for the lower monadic FDI in our samples ranges from 0.46 percent of GDP to 0.87 percent of GDP. We estimate models with the monadic measure excluding the bilateral FDI variable to allow for a broader sample of states.

Bilateral FDI × Prior MIDs. In addition to the effect of bilateral FDI flows on militarized dispute onset, we test the interactive relationship between bilateral FDI flows and militarized conflict history (Hypothesis 4). Using the ICOW data, we interact *Bilateral FDI/GDP* with a variable *Prior MIDs* measuring whether

there were any militarized disputes between two countries over the contested issue in the past fifteen years. We also estimated models interacting monadic FDI with prior MIDs.

Bilateral FDI \times *Claim Years*. To test information as a primary mechanism linking FDI to conflict management (Hypothesis 5), we generated an interaction variable between *Bilateral FDI/GDP* and the variable *Claim Years* measuring the number of years since the issue claim began using the ICOW data set. The start date goes back to the initial diplomatic point of contention over the issue, even if that precedes the start of our bilateral FDI data set (prior to 1970). We also estimate an interaction effect for monadic FDI and claim years.⁵

Control Variables

ICOW/Huth and Allee (2002) control variables. We build our empirical models based on variables that Hensel et al (2008) and Huth and Allee (2002) use in their studies of territorial disputes. All variables are lagged one year. These variables include *Capability Ratio*, *Joint Democracy*, *Alliance*, *Issue Saliency*, *Peace Years*, and *Other MIDs*. Relative state capabilities in the dyad (*Capability Ratio*) are measured using the composite index of national capabilities scores derived from the COW project's data set on national material capabilities (Singer, Bremer, and Stuckey 1972). For *Joint Democracy*, we generate the *Polity 2* variable from the Polity IV database (Marshall and Jaggers 2010) using the EUGene program, 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; 0 otherwise. *Alliance* is coded 1 if two countries currently have a defense pact, entente, or neutrality pact and 0 otherwise. The COW data set on interstate alliances is used to code this variable (Gibler and Sarkees 2004). We also include an *Issue Saliency* variable distinguishing between claims of higher and lower saliency for a given issue. For the Huth and Allee data, we employ the strategic value variable (0/1); for the ICOW data, we use the saliency index of the claimed territory, river, or maritime zone to the two countries (Hensel et al. 2008), ranging from 0 to 12. We also include a variable, *Peace Years*, to count the number of years since the two countries last engaged in a militarized dispute. This serves to eliminate some concerns about serial correlation for the data (Beck, Katz, and Tucker 1998). For *Other MIDs*, we collect the data on militarized disputes in which either country is involved, which includes militarized disputes over nongeopolitical 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 MID data set.

Economic openness. Economic openness has been regarded as a constraint to foreign policy options, especially when a country attempts to resort to violence. We measure

economic openness as a country's total exports plus its total imports divided by its GDP (Gleditsch 2002).

Economic development. We also consider the possible effect of economic development on geopolitical conflicts. Gartzke (2006) finds in his study that economic development reduces the chances for neighboring countries to engage in conflict over territorial borders. The variable is measured using GDP per capita in logged US dollars (World Bank 2009).

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 in logged millions of US current dollars (Gleditsch 2002).

Distance. Long distances between a challenger and a target may not only provide fewer opportunities 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).

Empirical Results

Table 1 presents the results of a logistic regression analysis of the first stage of conflict: the involvement of a pair of states in a territorial, maritime, or river issue claim. All results are reported using two-tailed significance tests and robust standard errors. The first column in Table 1 depicts the effect of all three levels of FDI flows (monadic, bilateral, and world FDI) on the likelihood of claim involvement (model 1). Consistent with Hypothesis 1, we find that world FDI inflows are negative and statistically significant ($p < .05$), indicating that an increase in the supply of FDI at the global level discourages potential challengers from making new issue claims against potential targets. In models 2 and 3, which cover a longer period (1970 to 2001), we find similar results; an increase in world FDI reduces the incentives for territorial conquest. The results in model 4 using Huth and Allee's data also confirm that such an effect is not limited to the Western Hemisphere, Europe, and the Middle East. Increases in world FDI also significantly reduce the chances for territorial disputes in a sample of data that includes all regions of the world. Increasing global FDI from its minimum to its maximum value, the probability of a dyadic issue claim decreases from .0612 to .0386, a 59 percent reduction in the likelihood of new border claims. These results are consistent with the first causal mechanism we identified; increasing global FDI reduces states' incentives to obtain resources by capturing neighboring territories.⁶

On the other hand, we find that bilateral FDI flows are not significant for reducing the probability of issue claim involvement ($p < .215$, model 1). Thus, we fail to find supportive evidence for the second posited causal mechanism, whereby an increase in

Table 1. FDI Flows and Issue Claim Involvement in Politically Relevant Dyads

	Model 1 ICOW Data	Model 2 ICOW Data	Model 3 ICOW Data	Model 4 Huth and Allee Data, 1980–95
Bilateral FDI/GDP _{CH, t-1}	0.626 (0.504)			-0.225 (0.231)
FDI/GDP _{CH, t-1}	-0.027 (0.034)	-0.008 (0.029)		0.018 (0.024)
World FDI _{t-1}	-0.142** (0.072)	-0.164** (0.075)	-0.160** (0.064)	-0.302*** (0.082)
Capability ratio _{CH, t-1}	-0.420 (0.498)	-0.714 (0.472)	-0.615 (0.457)	-0.370 (0.456)
Joint democracy _{t-1}	0.365 (0.249)	0.227 (0.239)	0.274 (0.238)	-0.152 (0.350)
Development _{CH, t-1}	0.338 (0.219)	0.396** (0.182)	0.329* (0.170)	-0.445*** (0.138)
Alliance _{t-1}	1.333*** (0.339)	1.235*** (0.320)	1.183*** (0.318)	0.603 (0.368)
Openness _{CH, t-1}	-3.831*** (1.339)	-4.316*** (1.140)	-4.342*** (1.099)	-0.305 (0.631)
Bilateral trade _{t-1}	0.024 (0.094)	0.061 (0.099)	0.082 (0.098)	0.352*** (0.083)
Distance _{t-1}	-0.365** (0.180)	-0.400** (0.167)	-0.379** (0.165)	-0.401** (0.139)
Peace years	-0.019** (0.009)	-0.014* (0.008)	-0.013* (0.008)	-0.068*** (0.024)
Constant	-0.213 (1.449)	-0.111 (1.265)	0.045 (1.302)	5.746*** (1.551)
N	15,303	23,007	23,737	18,411
Pseudo R ²	.15	.14	.14	.23
Wald χ^2	50.06	40.58	41.74	86.09

Note. FDI = foreign direct investment; GDP = gross domestic product; ICOW = Issue Correlates of War. Numbers in parentheses are clustered-robust standard errors.

p values: ***p < .01. **p < .05. *p < .1.

bilateral FDI flows generates more similar foreign policy preferences (Hypothesis 2). When we look at the results based on Huth and Allee's data (model 4), we see similar results whereby bilateral FDI flows are not significant for predicting the onset of territorial disputes. Bilateral FDI flows do not seem to exert a strong effect through the posited causal mechanism of increased foreign policy preference similarity.

The second stage of the conflict process involves pairs of countries who have an ongoing diplomatic dispute over a territory, river, or maritime area. The analyses in Table 2 restrict our samples to only those pairs of states that have experienced one or more border disputes. Hypothesis 3 predicts that increasing monadic and

Table 2. FDI Flows and Militarization of Issue Claims, and Interaction Effects for Prior Conflict, ICOW Data

	Model 1 escalation to MID	Model 2 escalation to MID	Model 3 escalation to fatal MID	Model 4 escalation to fatal MID	Model 5 escalation to MID	Model 6 escalation to MID
Bilateral FDI/GDP _{t-1}	-3.323 (2.759)		-5.072*** (1.686)		-0.843 (1.844)	-4.472 (3.038)
FDI/GDP _{LOW,t-1}	-0.037 (0.109)	0.027 (0.107)	-0.215 (0.210)	-0.286* (0.153)	-0.031 (0.117)	-0.019 (0.126)
World FDI _{t-1}	0.172 (0.283)	-0.075 (0.157)	-1.069** (0.529)	-0.736** (0.288)	0.224 (0.246)	0.181 (0.351)
Capability ratio Low	3.606*** (0.905)	1.564* (0.873)	2.897 (2.584)	4.395*** (1.410)	3.451*** (0.971)	4.540*** (1.182)
Joint democracy	0.302 (0.406)	0.077 (0.393)	0.094 (1.132)	0.710 (0.807)	0.040 (0.321)	-0.025 (0.428)
Development _{LOW}	-0.144 (0.157)	-0.286* (0.154)	-0.031 (0.444)	-0.352 (0.299)	-0.117 (0.137)	-0.091 (0.163)
Peace years	-0.014** (0.006)	-0.021*** (0.006)	-0.073*** (0.020)	-0.069** (0.032)	-0.006 (0.005)	-0.015** (0.007)
Alliance	0.467 (0.506)	0.204 (0.347)	-0.788 (1.102)	-1.008 (0.843)	0.191 (0.330)	-0.001 (0.575)
Issue salience	0.340*** (0.100)	0.298*** (0.078)	0.498*** (0.128)	0.334*** (0.112)	0.230*** (0.082)	0.145 (0.098)
Other MID _{CH}	-0.206 (0.431)	-0.282 (0.310)	1.093 (0.769)	1.436*** (0.540)	-0.316 (0.460)	-0.207 (0.552)
Other MID _{TG}	-0.091 (0.399)	0.189 (0.281)	0.635 (0.922)	0.898* (0.535)	-0.302 (0.381)	-0.326 (0.422)
Prior MIDs					0.351*** (0.090)	
Bilateral FDI × Prior MIDs _{t-1}					-3.831*** (1.335)	
Claim years						0.003 (0.003)
Bilateral FDI × Claim Years _{t-1}						0.029 (0.034)
Constant	-7.508** (3.828)	-2.359 (2.240)	2.687 (4.519)	1.494 (3.547)	-7.458** (3.110)	-6.250 (4.763)
N	1,267	1,929	1,267	1,929	1,267	1,069
Pseudo R ²	.14	.11	.27	.22	.18	.14
Wald χ ²	52.55	67.17	280.62	53.51	260.46	66.66

Note. FDI = foreign direct investment; GDP = gross domestic product; ICOW = Issue Correlates of War; MID = militarized interstate dispute. Numbers in parentheses are clustered-robust standard errors. ***p < .01. **p < .05. *p < .1.

bilateral FDI flows will reduce the probability of militarized disputes over the issues at stake. 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 (information argument).

With respect to the occurrence of militarized disputes, the results of our analyses (Table 2, models 1 and 2) suggest that bilateral and monadic FDI flows do not significantly influence the probability of a militarized dispute over the contested issue. Although the estimated parameter is negative, the coefficient for bilateral FDI is not statistically significant ($p < .228$, model 1). The results in models 1 and 2 also show that monadic FDI is not significant for reducing MID onset ($p < .733$ and $p < .800$, respectively). However, when we look at the effects of monadic and bilateral FDI on fatal MID onset, our analyses reveal that both levels of FDI flows have significant effects (model 3 and 4). As seen in model 3, bilateral FDI flows are negative and highly significant ($p < .003$) in reducing the chances for militarized disputes with fatalities. Although it is not significant when included in the same model as bilateral FDI flows (model 3), we also find in model 4 that monadic FDI flows have a negative and weakly significant effect on fatal MID onset ($p < .061$).⁷ Although not reported herein, we find similar results with the Huth and Allee data set. Bilateral FDI and monadic FDI significantly reduce the chances for MID initiation relative to status quo maintenance, even when including less severe forms of issue militarization. Our results show that states are reluctant to employ severe levels of violence to pursue territorial claims when they face potentially high levels of lost FDI.

Interestingly, we also find that an increase in world FDI flows discourages two disputants to escalate militarized disputes to severe levels to resolve claimed issues. This could reflect in part the diplomatic pressure of states with investments in those countries, as the case of Japanese investments in Russia during the Chechnya conflict illustrates. Issue claims that are more salient for tangible or intangible reasons are much more likely to result in militarized conflict, a finding consistent with previous ICOW studies (Hensel 2001; Hensel et al. 2008). We also find that peace years are significantly and negatively related to MID onset (whether fatal or not).

In Table 3, we evaluate the influence of FDI flows on the probability of states seeking peaceful settlement, through such tactics as bilateral negotiations and third-party peaceful settlements (Hypothesis 3). The results suggest that both bilateral and monadic FDI flows have positive and statistically significant effects on two claimants' willingness to employ peaceful strategies to resolve an ongoing border dispute. The first and third columns in Table 3 (models 1 and 3) show that an increase in bilateral FDI flows has positive and significant effects on bilateral negotiations ($p < .011$) and all types of peaceful settlement ($p < .032$). Likewise, the

Table 3. FDI Flows and Peaceful Settlement of Issue Claims, ICOW Data

	Model 1 bilateral negotiation	Model 2 bilateral negotiation	Model 3 peaceful settlement	Model 4 peaceful settlement
Bilateral FDI/GDP _{t-1}	0.373** (0.147)		0.335** (0.157)	
FDI/GDP _{LOW, t-1}	0.145 (0.098)	0.182** (0.086)	0.143 (0.087)	0.204** (0.083)
World FDI _{t-1}	-0.033 (0.131)	-0.049 (0.085)	-0.121 (0.129)	-0.144 (0.091)
Capability ratio _{LOW}	2.284** (0.995)	1.640** (0.936)	2.106** (0.981)	1.705* (0.880)
Joint democracy	0.489 (0.319)	0.364 (0.263)	0.400 (0.294)	0.253 (0.238)
Development _{t,LOW}	0.135 (0.136)	0.095 (0.130)	0.156 (0.139)	0.095 (0.125)
Peace years	-0.011** (0.005)	-0.007* (0.004)	-0.014*** (0.005)	-0.011** (0.004)
Alliance	-1.295*** (0.299)	-1.033*** (0.212)	-1.414*** (0.300)	-1.135*** (0.254)
Issue salience	0.036 (0.050)	0.065 (0.045)	0.078 (0.049)	0.102** (0.044)
Other MID _{CH}	-0.755*** (0.231)	-0.694*** (0.196)	-0.793*** (0.220)	-0.696*** (0.209)
Other MID _{TG}	0.214 (0.261)	0.195 (0.187)	0.028 (0.223)	0.122 (0.164)
Constant	-2.230 (1.791)	-1.963* (1.173)	-1.005 (1.708)	-0.622 (1.172)
N	1,267	1,929	1,267	1,929
Pseudo R ²	0.12	0.08	0.13	0.10
Wald χ^2	84.42	73.50	78.74	65.09

Note. FDI = foreign direct investment; GDP = gross domestic product; ICOW = Issue Correlates of War; MID = militarized interstate dispute. Numbers in parentheses are clustered-robust standard errors.

*** $p < .01$. ** $p < .05$. * $p < .1$.

second and fourth columns (models 2 and 4) show that increasing monadic FDI flows have positive and statistically significant effects on bilateral negotiations ($p < .036$) and peaceful settlement attempts ($p < .014$). In the analyses using the Huth and Allee data set (not shown), increasing bilateral FDI and global FDI flows significantly raise the chances for peaceful talks to resolve border disputes relative to status quo maintenance, while the effect for monadic FDI flows is not different from zero. These statistical results are consistent with the cases discussed earlier where businesses with investments in countries with territorial disputes encourage those

Table 4. Changes in Predicted Probabilities: FDI Flows and Claim Management

	Escalation to fatal MID (%)	Bilateral negotiation attempt (%)
Bilateral FDI/GDP		
5 percent increase	-1.6	+36
10 percent increase	-3.2	+72
FDI/GDP		
5 percent increase	-0.5	+17
10 percent Increase	-1.0	+34

Note. FDI = foreign direct investment; GDP = gross domestic product; MID = militarized interstate dispute. The probabilities are calculated by holding each variable of the model at its mean; joint democracy, alliance, and involvements in other militarized disputes for both challenger and target are held at zero.

governments to resolve the contested issues peacefully (e.g., Croatia–Slovenia, Cambodia–Thailand, and China–India).

In Table 4, we examine the substantive effects of FDI flows by looking at the changes in the predicted probabilities for fatal militarized disputes and bilateral negotiation attempts based on varying FDI values. We take values of 5 percent and 10 percent increase in bilateral and monadic FDI flows as a percentage of GDP, respectively, and examine how they change the predicted probability of each dependent variable. One noticeable finding is that the effect of bilateral FDI flows is stronger substantively than the influence of monadic FDI flows on states' conflict management practices. If we look at the size of the probability changes in fatal MID, for example, we find that a 10 percent increase in bilateral FDI flows has a bigger effect on the predicted probability (-3.2 percent) of a dispute than that of monadic FDI flows (-1.0 percent). This is also supported by the results of our analysis using Huth and Allee's data set; bilateral FDI flows have a greater substantive effect on the change in the probability of MID initiation by a challenger than monadic FDI flows (1 percent vs. 0.3 percent). This pattern of a greater influence of bilateral FDI flows is also found with respect to bilateral negotiation attempts (72 percent vs. 34 percent). The other interesting finding is that bilateral and monadic FDI flows have a greater impact on the claimants' peaceful settlement attempts in comparison to the occurrence of militarized disputes with fatalities. As we can see, a 5 percent increase in bilateral FDI and monadic FDI results in a 36 percent and 17 percent increase in the probability of bilateral negotiations, respectively, whereas the same amounts of FDI changes reduce the probability of fatal MID by 1.6 percent and 0.5 percent, respectively. 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 preventing the governments from engaging in militarized disputes.

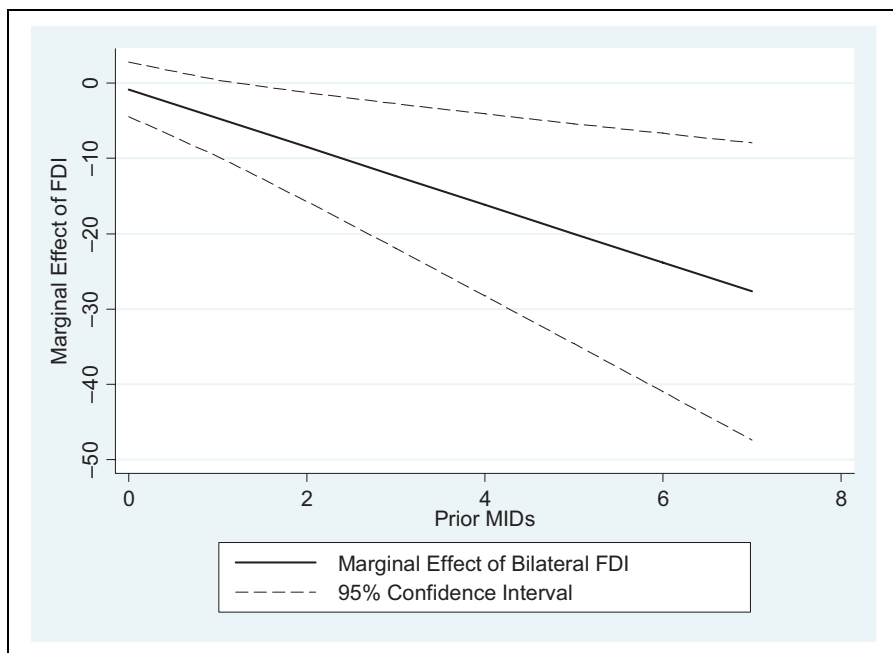


Figure 2. Marginal effect of foreign direct investment (FDI) on geopolitical conflict over number of prior militarized interstate dispute (MIDs)

Models 5 and 6 in Table 2 present the results of two different models including interaction variables with bilateral FDI flows, one with prior MIDs and the other with issue claim years. These interaction variables capture the opportunity costs and information mechanisms, respectively. Model 5 shows that the coefficient for *Bilateral FDI* \times *Prior MIDs*_{*t*-1} is negative and highly significant ($p < .004$), indicating that increasing bilateral FDI reduces the chances for militarized disputes in dyads that have experienced prior militarized disputes of the contested issue.⁸ This supports the opportunity costs argument in which economic exchanges promote peace even in situations of geopolitical conflicts. In Figure 2, we also 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 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 because the inferences for a high number of prior disputes are based on a relatively small number of dyads.

The results in Table 2, model 6 show that the coefficient for *Bilateral FDI* \times *Claim Years*_{*t*-1} is not statistically significant ($p < .39$), suggesting that bilateral FDI has a relatively constant temporal effect on militarized conflict. 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. The pacifying effect of FDI works most strongly through the opportunity costs mechanism.

Conclusion

In this article, we evaluate the relationship between monadic, bilateral, and global FDI flows and the management of geopolitical disputes, including contention over territory, cross-border rivers, and maritime areas. We identify four causal mechanisms linking FDI and interstate conflict prevalent in the international relations literature, focusing on the effect of FDI at 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 (issue claim onset): (1) declining benefits of territorial conquest due to increased globalization and economic exchange and (2) increased foreign policy preference similarity between states with higher bilateral levels of investment flows. In the second stage of the conflict process (issue claim management), we discuss two potential mechanisms by which monadic and bilateral FDI flows might reduce the chances for militarized conflict and promote peaceful negotiations: (1) increased opportunity costs for violence in dyads characterized by high levels of monadic and bilateral FDI and (2) improved information and signaling in pairs of states with FDI, which should improve the chances for peaceful interstate agreements to be struck. We evaluate these different causal mechanisms using data from the ICOW project on territorial, maritime, and river conflicts in the Western Hemisphere, Europe, and Middle East from 1970 to 2001 and data from Huth and Allee's (2002) territorial dispute data set from 1970 to 1995.

Our empirical analyses provide strong support for the idea that there are declining benefits of territorial conquest in an economically globalized world. As world FDI levels have increased, states have become significantly less likely to make new diplomatic claims to other states' land or water territories. This reflects the sheer size of FDI globally today, which was not felt in earlier periods, as well as the increasing importance of FDI for states' GDP relative to trade, especially in the developing world. However, world FDI levels dropped sharply in 2008 and 2009. In the same period, China pressed its claims to islands and contiguous land areas in Southeast Asia more strongly. This strategy makes sense given that China's FDI is more urgently needed by states in its region, as the 2009 incident involving Vietnam illustrates. Given this systemic change in FDI flows, it will be important to analyze more recent issue claim data as it becomes available.

Second, we find evidence that monadic and bilateral FDI flows create opportunity costs for governments seeking to grab contested territory with violent strategies. Higher levels of bilateral and monadic FDI flows reduce the chances for severe militarized disputes over border issues. While conflict scholars find repeated disputes to be dangerous in terms of raising the probability of future disputes, pairs of countries who are mutually invested in each other's territories are less likely to employ militarized strategies for resolving territorial disputes. We find a similar effect for monadic FDI, which implies that governments who depend on outside financing for economic growth and development are more restricted in the coercive foreign policy strategies that they can employ. This is an important finding for the steps-to-war model, as it identifies FDI as a potential path to peace for countries embroiled in long-standing border disputes.

Third, we find that the pacifying effect of FDI works primarily as an opportunity costs causal mechanism, which makes sense when we consider that issue claim data sets 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 FDI 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 FDI and trade between the disputing states.

Acknowledgement

We are grateful to Glen Biglaiser, Joe Clare, Chris Jensen, Dave Lektzian, and Cameron Thies for comments. We also thank Quan Li and Tatiana Vashchilko for sharing their data with us.

Declaration of Conflicting Interests

The author(s) declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

This research was supported by National Science Foundation grants SES-0079421, SES-0214447, SES-0960320, and SES-0960567.

Notes

1. 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.”
2. Simmons (2006) also shows the high opportunity costs for trade that are generated by ongoing border disputes, finding that border disputes significantly reduce contiguous countries’ bilateral trade.
3. This is available at www.saramitchell.org/research.html.
4. We also ran the models with the original data without any replacement and found similar results.
5. While not reported herein, we obtain similar findings for the interaction variables using the Huth and Allee data set.
6. To ensure that the effects for systemic FDI are unique, we also estimated similar models controlling for the number of democratic countries, the number of countries as system members, power concentration among great powers, and world export levels. Even with these other systemic factors, we obtain similar results, which are available in the online appendix.
7. Our analysis shows that the correlation between monadic FDI and bilateral FDI is 0.12. We believe that the changes in significance for monadic FDI come from differences in the sample sizes where model 4 has a bigger sample covering the years from 1970 to 2001.
8. We estimated the interactions models with respect to fatal MID as a dependent variable in which bilateral and monadic FDI flows are significant, but the interactions variables, *Bilateral FDI* × *Prior MID* and *Bilateral FDI* × *Claim Years*, drop from the results due to their perfect correlation with the dependent variable.

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