Chapter 10

MANAGING POLITICAL RISK, GOVERNMENT RELATIONS, AND ALLIANCES

OBJECTIVES OF THE CHAPTER

Firms go international to become more competitive and profitable. Unfortunately, many risks accompany internationalization. One of the biggest risks emerges from the political situation of the countries in which the MNC does business. Terrorism is also a worldwide concern which can create a large barrier to MNC entry or survival in a country. MNCs must be able to assess political risk and conduct skillful negotiations. An overview of the political environment in selected areas of the world was been provided in Chapter 2. This chapter specifically examines the impact of political risk on MNCs and their subsequent decisions in managing it. One major way is through effective evaluation and risk reduction. This process extends from risk identification and quantification to the formulation of appropriate responses, such as integration and protective and defensive techniques.

This chapter also describes the process for developing productive relationships with governments and for managing alliances with foreign partners, many of which are influenced by home- and host-government relations. The specific objectives of this chapter are:

1. **EXAMINE** how MNCs evaluate political risk.
2. **PRESENT** some common methods used for managing and reducing political risk.
3. **DISCUSS** strategies to mitigate political risk and develop productive relations with governments.
4. **DESCRIBE** challenges to and strategies for effectively managing alliances.

The World of *International Management*

IKEA's Russian Roulette

In June 2009, the website for IKEA's mall in Samara, Russia, displayed an "OPENING SOON!" banner. The problem was that no one could say just how soon the public would be able to enjoy the new 1.4-million-square-foot mall. The owner, Swedish furniture giant IKEA, said the mall had been ready for more than a year. Local government officials, however, did not permit the mall's opening, citing numerous safety regulation violations.

The delay appeared to have been the last straw for IKEA in Russia. As Christer Thordson, an IKEA board member and global director of legal affairs, later told the press: "We have encountered something here that is outside the scope of what we normally encounter. I have never experienced anything like this." On June 23, the retailer said it was putting on hold all new investment in Russia. IKEA's Russia country manager, Per Kaufmann, said that the decision was "due to the unpredictability of the administrative processes" in Russia. While Kaufmann said IKEA hoped to complete a handful of projects under way, plans for an additional 30 or so stores have been postponed.

IKEA—among Russia's largest foreign investors—has plowed some $4 billion into the country since opening its first store in 2000. IKEA's stores in Russia are so popular that Russia's yuppies are called "the IKEA Generation." Russia now accounts for 5 percent of IKEA's business worldwide. Before the global economic crisis, IKEA's business in Russia was growing at 20 percent a year.

With such strong demand from Russian consumers, it comes as a surprise that IKEA would face unprecedented resistance from the local authorities. On closer examination of Russia's business environment, however, it becomes clear that IKEA's problems relate to Russia's number one business problem—corruption.

Corruption

Due to Russia's complex and ambiguous laws and regulations, weak judicial system, and corrupt bureaucracy, bribery is widespread in Russia. According to INDEM, the Moscow-based Information Science for Democracy foundation, more than $300 billion is paid in bribes each year in Russia, which was more than a quarter of the country's GDP in 2009.

In its Corruption Perception Index, Transparency International ranked Russia 146th out of 180 in 2009—a tie with Zimbabwe, Kenya, Sierra Leone, and few other countries—which puts Russia in the "very corrupted" zone. Alexandra Wrage, whose nonprofit organization TRACE International advises firms on how to avoid bribery, told Reuters that the "rampant endemic" corruption in Russia was much worse as compared with other large emerging economies.

As the world's ninth largest population, Russia is a potentially lucrative market of 140 million people with a rapidly rising middle class. Many MNCs contend that a presence in Russia is needed to remain competitive. For IKEA, the argument for a presence in Russia was even more compelling: When it comes to household durable goods, Russian households have a lingering deficit, a hangover from the Soviet command economy. IKEA understood the untapped potential of the Russian market when it entered in 2000. With ambitious plans to build malls across the country, IKEA vowed to never pay bribes.

Obstacles

In 2003, IKEA invested $40 million to build its first distribution center near the Moscow region town of Solnechnogorsk. Lennart Dahlgren of IKEA said he reached a verbal agreement on the center's construction with the Solnechnogorsk district head Vladimir Popov. However, according to Dahlgren, "[One day,] the police unexpectedly showed up at the building site. They halted work [and] shut everything down." Dahlgren contacted Popov, who promised to allow continued construction if IKEA paid 10 million rubles. IKEA agreed to pay, but on its own terms, by transferring the money to houses for the elderly. The company thought it had reached an agreement, but as Dahlgren said, "A few days later, Popov arrived and said the deal was off—10 million was too little, 30 million rubles was needed. Every day, we lost thousands of dollars because of the lost work. It was cheaper to pay the 30 million." Finally, IKEA transferred the money into a charity fund and "announced this to the entire city, to local journalists . . . and the police left and opened construction."

In addition to construction issues, IKEA faced other problems. Just weeks before the opening of its flagship store outside Moscow in 2000, IKEA was told by a local utility company that it must pay a bribe if it wanted to have electricity for the mall's grand opening. Instead of paying a bribe, IKEA rented diesel generators large enough to power a shopping mall. As IKEA opened stores across Russia, it rented generators to thwart extortion from power companies. The generators symbolized a resounding victory over corruption and bribery.

Yet, even the "power generators story" is tainted with Russian corruption. The board of IKEA's operating company discovered that the Russian executive hired to manage the generators was taking kickbacks from the rental company to substantially inflate the price of the service. Furthermore, when IKEA tried to cancel the fraudulent contract and sue the generator company, the Russian court took the side of the generator rental company and penalized IKEA for breach of contract.

Lessons from Russia

Although emerging markets like Russia hold vast potential, realizing this potential is incredibly challenging for MNCs. Foreign companies often find that the institutional (cultural, political, and economic) environments are such that the costs involved in navigating these markets exceed even their most conservative estimates. For this reason, companies from developed countries often struggle to achieve their desired returns when they enter emerging markets.

IKEA's fight with corruption in Russia came at a cost. Russian authorities tried to force IKEA to pay bribes in order to avoid business losses. Still, IKEA remains tied to its investments in ongoing construction projects, and thus must face the ambiguous labyrinths of the Russian legal system.

International managers interested in expanding into Russia or any emerging economy make a thorough assessment of its political risk beforehand. The World Bank is an excellent resource for assessing political risk. In the latest IFC/World Bank report "Doing Business 2010: Russian Federation," Russia is ranked 182nd out of 183 in the category of "Dealing with Construction Permits." The report states that it takes 54 different procedures and at least 704 days (almost 2 years) to gather all of these permits.

Russia is one of the most challenging countries in which to do business. Corruption, red tape, security concerns, and overall lack of faith in governmental policies result in an especially difficult political environment. IKEA faced all of these issues and more in its effort to expand and operate in Russia. At first, it seemed that these risks were manageable, but over time, the company concluded that the environment was just too much of a deterrent to their growth plans and put its expansion on hold. IKEA may revisit this decision; the announcement that it intended to defer its expansion, and the public reporting around its difficulties with corruption and red tape, could have the effect of easing some of these problems. In addition, IKEA may consider taking on additional local partners as a vehicle to address the government relations and political challenges.

MNCs must be able to evaluate and manage political risks on a global scale and contemplate the potential of alliances and other long-term cooperative relationships to help mitigate risks. In this chapter, we explore strategies for evaluating political risks, managing government relations, and developing and managing alliances with private and public partners.

The Nature and Analysis of Political Risk

Both domestic and international political developments have a major impact on MNCs' strategic plans. MNCs face hazards that originate directly from variation and unpredictability in political and governance systems around the world. The state, and its various institutions and agencies continue to pose a direct threat to MNCs through policy shifts in taxation or regulation, through outright or de facto expropriation, or by allowing the exploitation of assets by local firms. As government policies change, MNCs must be willing and able to adjust their strategies and practices to accommodate the new perspectives and actual requirements. Moreover, in a growing number of geographic regions and countries, governments appear to be less stable; therefore, these areas carry more risk than they did in the past. Applied to international management, **political risk** is the unanticipated likelihood that an MNC's foreign investment will be constrained by a host government's policies. Since the terrorist attacks of 9/11, political risk assessment has become especially vital to MNCs. Today, almost all countries are interested in sustaining investment from MNCs.[1] Yet political risks persist, especially in the emerging economies of the world, which continue to struggle with political and institutional instability. Examples of risk factors include freezing the movement of assets out of the host country, placing limits on the remittance of profits or capital, devaluing the currency, appropriating assets, and refusing to abide by the contractual terms of agreements previously signed with the MNC. As rapid globalization continues, MNCs must be aware of the political risk factors present in doing business abroad and develop strategies to respond to them. Policy and control mechanisms, along with awareness of the historical treatment of MNCs within certain nations, allow firms to evaluate the inherent risk of doing business there.

political risk
The unanticipated likelihood that a business's foreign investment will be constrained by a host government's policy.

The government of China, for example, was for years very anxious to see the country admitted to the World Trade Organization (WTO). Yet even after its entry into the WTO, China made decisions that were in its own best short-run interests but that created new political risks for MNCs doing business there. One analyst noted:

> A series of recent moves by Chinese authorities—price controls, currency restrictions, limits on sale of state-owned companies—seem to reflect a slowdown in the nation's effort to shift from a planned to a market economy. Whether such steps are justifiably cautious or

> simply timid, economists and business executives agree that they are likely to further deter trade and investment in the near future. Today, China's central bank announced new restrictions on foreign exchange transactions, an attempt to control the flow of convertible currency out of the country. Officially described as a crackdown on illegal transactions, the moves will effectively make it more difficult for both domestic and international companies to move money in and out of China.[2]

Some of the policies have since been relaxed; however, political risk still continues to be a major consideration for multinationals doing business there. As was brought out in Chapter 3, industrial piracy continues to be a big problem, and the Chinese government has yet to take effective action against it. For example, Procter & Gamble estimates that it loses $150 million in sales annually because of counterfeit brands. One reason for the reluctance of the Chinese government to take action may well be that state-owned factories are some of the biggest counterfeiters. Yamaha estimates that five of every six motorcycles and scooters bearing its name in China are fake; some state-owned factories turn out copies four months after Yamaha introduces a new model. Yamaha did win a trademark case in 2007, but the penalty was relatively modest and it was not clear if a broader crackdown would have the desired effect.[3] Sometimes, counterfeiters are so efficient that the fake goods reach the market even before the actual product. Nike, for example, experienced this with its Air Max 360 when someone at the China office stole blueprints and began manufacturing. This is not the first instance of fake Nikes being sold in China and abroad. The company often receives shipments of shoes or returns from customers which bear the very recognizable swoosh logo but which are in fact cheap knockoffs of the original.

Another common complaint is the way rules and regulations are interpreted in China. The case of Google in China, described in The World of International Management that opened Chapter 2, is an example. The cyber attacks on Google, apparently linked to government concerns about Google's content and a desire to limit that content, and ongoing negotiations with the government as to what services and links would be available in China, have resulted in a difficult and ambiguous situation for the company. Noting that the Chinese government can "arbitrarily decide" the level of service Google Inc. can provide in China, the company's chief executive, Eric Schmidt, said, "'We don't know' if what seems to have been a relatively minor disruption of Google's search availability in China Thursday was evidence of that government power."[4]

These types of actions by the Chinese government increase the political risk of doing business in China. On the other side of the coin, Chinese MNCs must also assess the political risk inherent in doing business in the United States. The U.S. government has begun to review its trade policy with China. In particular, American trade officials claim that China has taken for granted its relationship with the United States and warn that if markets there are not opened for American goods, there will be reciprocal action against Chinese firms that are selling in the United States.[5] Given the enormous trade deficit that the United States has with China, this situation could end up creating major political risks for Chinese MNCs doing business in the politically stable but very risky United States. In fact, tensions continue to rise as U.S. politicians have become frustrated by China's unwillingness to revalue the yuan, and concerns have grown over the safety of goods imported from China. Tainted pet food, unsafe toys, suspect dry-wall imported from China, and recalls by many U.S. companies that import products from China, such as the massive toy recall by Mattel, have caused many in the United States to question the safety and reliability of Chinese products.[6]

Macro and Micro Analysis of Political Risk

Firms evaluate political risk in a number of ways. One is through **macro political risk analysis,** which reviews major political decisions that are likely to affect all business conducted in the country. For example, China's decision regarding restrictions on foreign-exchange transactions represents a macro political risk because it affects all MNCs. Another

macro political risk analysis
Analysis that reviews major political decisions likely to affect all enterprises in the country.

micro political risk analysis
Analysis directed toward government policies and actions that influence selected sectors of the economy or specific foreign businesses in the country.

approach is **micro political risk analysis,** which is directed toward government policies and actions that influence selected sectors of the economy or specific foreign businesses. China's government policies regarding investment in the telecommunications industry fall into the micro political risk category. The following two sections examine both of these areas requiring analysis—macro political risk and micro political risk—in more depth.

Macro Risk Issues and Examples In recent years, macro risk analysis has become of increasing concern to MNCs because of the growing number of countries that are finding their economies in trouble, as in Southeast Asia, or, even worse, that are unable to make the transition to a market-driven economy. A good example of the latter is Russia, as we saw in The World of International Management. Russia has been tightening controls on the flow of foreign currencies. This decision represents a change in direction from the free-market principles that Russia had been following in order to ensure that it continued to receive assistance from the International Monetary Fund.

India provides plenty of examples of macro political risks for MNCs. India's legal system is stymied by a labyrinth of laws and bureaucratic red tape. In recent years, the Indian high courts have had a backlog of over 3 million cases. Moreover, approximately one-third of these cases have been winding their way through the legal system for more than five years. So while the government touts the fact that Indian law offers strong protection to foreign firms against counterfeiters, an MNC finding that it must rely on the Indian judicial system to enforce its proprietary rights is likely to be sadly disappointed. As a result, many MNCs accept this risk as a cost of doing business in India and formulate strategies for managing the problem. A good example is provided by the Timken Company of Canton, Ohio, which makes bearings and alloy steel. When Timken found that the Indian market was rampant with fake Timken products, the MNC's initial reaction was to sue the counterfeiters. However, after realizing how long this would take, the MNC opted for a different strategy. Management switched the packaging of its products from cardboard boxes to heat-sealed plastic with eight-color printing and a hologram that could not be forged. Result: Within months the counterfeit market began drying up. Timken is not alone; there are many counterfeit operations in India because the slow-moving judicial system encourages noncompliance. In fact, some counterfeiters have found that by filing countersuits, they can tie up a case in court for years.

Many other newly emerging economies, besides the big countries China, Russia, and India, also present macro political risks for MNCs. In Vietnam, the communist government earned a bad name among foreign investors because of all the pitfalls they have to face. Until recently the Vietnamese government required all foreign investors to establish joint ventures with local partners. But even with this arrangement, getting things done proved to be extremely slow and difficult because of the numerous levels of bureaucracy to be dealt with. One international manager described his MNC's experience this way: "The negotiations would follow a serpentine path, with breakthroughs in one session often being erased in the next."[7] To date, macro political risks in Vietnam remain high, although there is little risk of political instability. Investors continue to proceed with caution, which may be a wise approach in an economy that could prove to be challenging for an increasingly integrated global marketplace.[8]

An example of a macro consideration of political risk would be an analysis of what would happen to a company's investment if opposition government leaders were to take control. In the 1970s U.S. companies in Iran failed to forecast the fall of the shah and rise of Khomeini and as a result, they lost their investment. Because of this Iranian experience, the situation in Iraq under militant dictator Saddam Hussein and the subsequent instability after his removal, and the 9/11 terrorist attack on New York by ethnic Middle Easterners, many MNCs now are reluctant to invest very heavily in most Middle Eastern countries. Recently, the government of Iran appeared to be interested in attracting foreign investment, but there is still a great deal of concern that this region is too politically explosive.

Central, if not Eastern, Europe appears to be a better bet, as seen by the millions of dollars that MNCs have poured into transition postcommunist countries such as

Hungary and Poland. This geographic region is also regarded as politically risky, however, given the ongoing conflict in the Balkans, the breakup of Czechoslovakia into the independent Czech Republic and Slovak Republic, the continuing problems in the former Soviet republics, and the political instability in the entire region. As a result, many MNCs have been tempering their expansion plans in these still emerging economies. Recently, populist governments, somewhat hostile to capitalism and foreign investment, have emerged in a number of Latin American countries, including Bolivia, Ecuador, and Venezuela. In some cases, these governments have effectively forced divestment by MNCs, as was the case in Venezuela in the petrochemical sector.

Still another area of consideration for MNCs regarding macro political risks is government corruption, such as prevalence of bribery and government rules and regulations that require the inclusion of certain locals in lucrative business deals. One of the most commonly cited reasons for the severe economic problems in Indonesia in recent years is the corrupt practices of the government. Because the family of former president Suharto was involved in virtually every big business deal that took place under his regime, many loans and major projects were approved by banks and government agencies simply because these family members were part of the process. When these loans and projects ran into trouble, more money was poured in to shore up things—and no one dared to challenge these unsound decisions.

Which are the most and the least corrupt nations in the world? Table 10–1 provides the results for 2009 of the Corruption Perceptions Index, which measures the perceived level of public-sector corruption, in which 180 countries/territories were ranked. The United States ended up in 19th position, illustrating that even the U.S. has work to do in improving its business environment.

Table 10–1
Select Countries in the 2009 Transparency International Corruption Perceptions Index (Note: Some countries are "tied")

Rank	Country/Territory	Rank	Country/Territory
1	New Zealand	84	Thailand
2	Denmark	89	Mexico
3	Singapore	89	Rwanda
8	Canada	99	Jamaica
12	Hong Kong	111	Egypt
12	Luxembourg	111	Indonesia
14	Germany	120	Vietnam
17	Japan	139	Pakistan
17	United Kingdom	139	Philippines
19	United States	146	Russia
25	Chile	146	Ukraine
32	Israel	158	Cambodia
32	Spain	162	Angola
39	Oman	162	Kyrgyzstan
39	Korea (South)	162	Venezuela
49	Poland	168	Haiti
55	South Africa	168	Iran
63	Italy	174	Uzbekistan
63	Saudi Arabia	176	Iraq
79	China	179	Afghanistan
84	India	180	Somalia

Source: Transparency International, http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table.

Micro Risk Issues and Examples Micro risk issues often take such forms as industry regulation, taxes on specific types of business activity, and restrictive local laws. The essence of these micro risk issues is that some MNCs are treated differently from others, thus increasing the cost of doing business for some.

In 1992 American steel makers filed more than 80 complaints against 20 nations on a single day. They charged that foreign steel makers were dumping their products in the U.S. market at artificially low prices. In the first six months of 1998, the industry again demanded action against foreign producers in Brazil, Japan, and Russia who were dumping steel in the United States at unfairly low prices. What was even more troubling was that the American producers were in the process of negotiating with big auto and appliance makers for the steel that is sold under long-term contracts. Since steel prices had dropped sharply because of the alleged "dumping," the American firms were concerned that they would end up getting locked into contracts that offered very little, if any, profit. The American steel makers were insisting that their government force foreign producers to raise their prices.[9] The George W. Bush administration did ultimately impose tariffs on steel (these were, in part, subsequently rescinded). Such events underscore the uncertainty and volatility associated with micro political risks, even in the United States.

World Trade Organization (WTO) and European Union (EU) regulations on American MNCs have created new sorts of micro political risk. For example, the WTO ruled that the United States' 1916 Anti-Dumping Act violates global trade regulations and cannot be used by American firms to fend off imports.[10] Meanwhile on the European continent, the European Commission is investigating complaints by PepsiCo and other competitors that Coca-Cola has improperly attempted to shut down sales of its rivals.[11] The EU examines all major mergers and acquisitions and has the authority to block them. For example, the EU refused to allow the General Electric (GE) and Honeywell merger, a prime example of the forces of globalization (the EU was able to stop the actions of perhaps the most powerful U.S. firm) as well as of the need for political risk analysis (GE needed to better assess and manage the risk posed by the politicians and government bureaucrats in Brussels).

Other examples have included the EU's denying Volvo and Scania approval to merge and preventing Alcan Aluminum of Canada, Pechiney of France, and the Alusuisse Lonza Group of Switzerland, the world's three largest aluminum companies, from merging.[12] Microsoft has also faced challenges in the EU. In 2004, the European Commission issued its decision regarding allegations of anticompetitive practices by Microsoft, finding that Microsoft had engaged in such practices and issuing a sweeping set of penalties, including the biggest fine it has ever levied, $613 million. The EC also says it will require that the company offer computer makers in Europe two versions of its monopoly Windows operating system, one with Windows Media Player, which lets users watch videos and hear music, and one without. Microsoft must share technical information with rivals that will help their server software work better with Windows: "We are simply ensuring that anyone who develops new software has a fair opportunity to compete in the marketplace," said Mario Monti, competition commissioner for the EU. Although Microsoft had emerged generally unscathed from the extended litigation in the U.S. related to a variety of allegedly anticompetitive practices, this EU decision constituted a major setback for the firm, and reflected the uniquely European perspective on these practices. In 2007, Microsoft lost its appeal and the ruling stood.[13] These regulatory actions are good examples of the types of micro risk issues that MNCs face from industry regulation. Table 10–2 lists criteria that MNCs could use to evaluate the degree of political risk.

In some instances, it is not clear whether macro or micro political risk is at work. Research in Motion Ltd., the maker of the Blackberry line of smart phones, was threatened with expulsion from a number of markets, including Saudi Arabia, United Arab Emirates, and India, because of its proprietary encryption technology which makes it hard for countries to access calls and messages, which some claim is necessary to protect national security. The concerns center around corporate e-mail routed through the handsets and instant-messaging, which use high levels of encryption and proprietary technology. Consumer e-mails sent over the devices are lightly encrypted and can be decoded by local wireless

Table 10–2
A Guide to Evaluation of Political Risk

External factors affecting subject country:	*Other important groups:*
Prospects for foreign conflict	Unions and labor movements
Relations with border countries	Military, special groups within military
Regional instabilities	Families
Alliances with major and regional powers	Business and financial communities
Sources of key raw materials	Intelligentsia
Major foreign markets	Students
Policy toward United States	Religious groups
U.S. policy toward country	Media
Internal groupings (points of power)	Regional and local governments
Government in power:	Social and environmental activists
Key agencies and officials	Cultural, linguistic, and ethnic groups
Legislative entrenched bureaucracies	Separatist movements
Policies—economic, financial, social, labor, etc.	Foreign communities
Pending legislation	Potential competitors and customers
Attitude toward private sector	*Internal factors:*
Power networks	Power struggles among elites
Political parties (in and out of power):	Ethnic confrontations
Policies	Regional struggles
Leading and emerging personalities	Economic factors affecting stability (consumer inflation, price and wage controls, unemployment, supply shortages, taxation, etc.)
Internal power struggles	Anti-establishment movements
Sector and area strengths	Factors affecting a specific project (custom-designed for each project)
Future prospects for retaining or gaining power	

Note: Information in the table is an abridged version of Probe's Political Agenda Worksheet, which may serve as a guide for corporate executives initiating their own political evaluations. Probe International is located in Stamford, CT.

Source: From Benjamin Weinger, "What Executives Should Know About Political Risk," *Management Review,* January 1992, p. 20. Reproduced with permission of American Management Association via Copyright Clearance Center.

phone companies. The governments have focused on RIM because it operates its own network of servers, and is therefore outside their legal jurisdiction and monitoring reach. RIM also features corporate e-mail services that are heavily encrypted and which only each corporate customer can access. This security has made RIM popular among companies and governments, but the target for governments. In this example, a company has been targeted because of its unique product features and their implications for government security.[14]

Terrorism and Its Overseas Expansion

Terrorism has existed for centuries, but terrorism has become more of a concern everywhere over the last few years, and especially so in the United States in light of the September 11, 2001, attacks. **Terrorism** is the use of force or violence against others to promote political or social views. The ultimate goal of the violence is for government and citizens to change policies and ultimately yield to the beliefs of the terrorist group.[15] Three types of terrorism exist: classic, amateur, and religiously motivated.[16] *Classic terrorism* entails a specific, well-defined objective pursued by well-trained, professional, underground members. *Amateur terrorism* tends to occur once and often has poorly defined objectives, and therefore members are not as committed. *Religiously motivated terrorism* is carried out by individuals holding very strong core beliefs, regardless of how well defined their objectives are. The latter tends to be more chaotic and scattered, since the individuals involved are extremely passionate about the cause, despite the lack of unified goals.

terrorism
The use of force or violence against others to promote political or social views.

MNCs need to be wary of the combative political environment that may exist when they seek to engage in overseas expansion in certain geographic areas. For example, the Al Qaeda group has attacked in Yemen, Pakistan, Kuwait, Tunisia, and Kenya, to name a few. Palestinian suicide bombers have blown up buses in Israel. Australian tourists were killed in a massive attack in Bali, and a restaurant in the Philippines was the target of similar assaults. The United States' invasions of Afghanistan and Iraq have harmed political relations with countries that did not agree with those actions.[17] Violent conflicts in Africa are ongoing and endemic. There have been bombings in the U.K. In 2004, a terrorist group took over a school in Russia, resulting in the deaths of about 325 people when the Russian military recaptured the school.[18] As you well know, the list is long and likely to get longer.

It is clear that terrorism within a country can have a significant impact on the MNC in the macro sense. If a country has a high incidence of terrorist attacks against commercial businesses specifically, companies will need to be even more wary about setting up operations. Typically, terrorists target business areas or businesses that have high status or those that have great influence on initiating change. While terrorists now use an extensive array of attack methods, they tend to avoid institutions with high security; most attacks on private businesses are either driven by the amateur terrorist or those that are religiously motivated.[19] There is no way to guarantee that companies can fully avoid harm, but political risk analysis and preparation may forestall it. MNCs must thoroughly evaluate the political environment, install modern security systems, compile a crisis handbook, and prepare employees for situations that may arise.

Analyzing the Expropriation Risk

expropriation
The seizure of businesses by a host country with little, if any, compensation to the owners.

indigenization laws
Laws that require nationals to hold a majority interest in an operation.

Expropriation is the seizure of businesses with little, if any, compensation to the owners. Such seizures of foreign enterprises by developing countries were quite common in the old days. In addition, some takeovers were caused by **indigenization laws,** which required that nationals hold a majority interest in the operation. Generally, expropriation is more likely to occur in non-Western countries that are poor, relatively unstable, and suspicious of foreign multinationals.

Some firms are more vulnerable to expropriation than others. Often, those at greatest risk are in extractive, agricultural, or infrastructural industries such as utilities and transportation, because of their importance to the country. In addition, large firms often are more likely targets than small firms, because more is to be gained by expropriating large firms.

MNCs can take a wide variety of strategies to minimize their chances of expropriation. They can bring in local partners. They can limit the use of high technology so that if the firm is expropriated, the country cannot duplicate the technology. They also can acquire an affiliate that depends on the parent company for key areas of the operation, such as financing, research, and technology transfer, so that no practical value exists in seizing the affiliate.

Managing Political Risk and Government Relations

For well over two decades, businesses have been looking for ways to manage their political risk. Quite often, the process begins with a detailed analysis of the various risks with which the MNC will be confronted, including development of a comprehensive framework that identifies the various risks and then assigns a quantitative risk or rating factor to them.

Developing a Comprehensive Framework or Quantitative Analysis

A comprehensive framework for managing political risk should consider all political risks and identify those that are most important. Schmidt has offered a three-dimensional framework that combines political risks, general investments, and special investments.[20] Figure 10–1 illustrates this framework, and the following sections examine each dimension in detail.

transfer risks
Government policies that limit the transfer of capital, payments, production, people, and technology in and out of the country.

Political Risks Political risks can be broken down into three basic categories: *transfer risks, operational risks,* and *ownership-control risks.* **Transfer risks** stem from government policies that limit the transfer of capital, payments, production, people, and

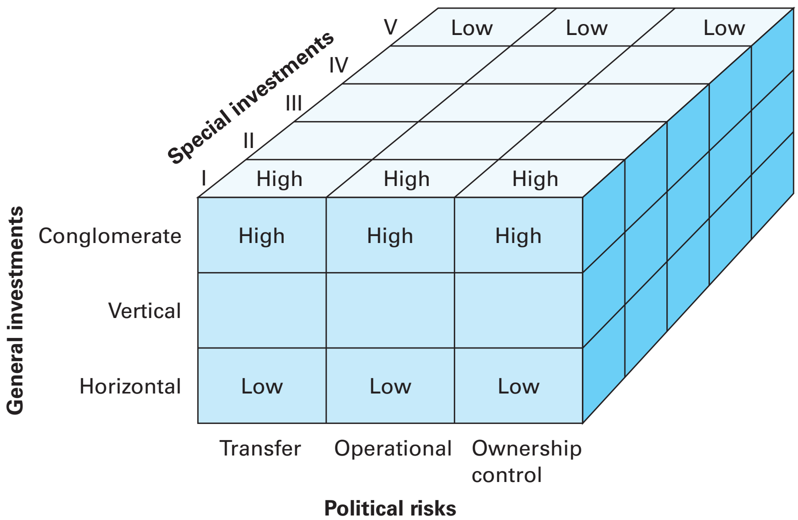


Figure 10–1
A Three-Dimensional Framework for Assessing Political Risk

Source: David A. Schmidt, "Analyzing Political Risk," *Business Horizons,* August 1986, p. 50. Copyright 1986 Elsevier. Reprinted with premission.

technology in or out of the country. Examples include tariffs on exports and imports as well as restrictions on exports, dividend remittance, and capital repatriation. **Operational risks** result from government policies and procedures that directly constrain the management and performance of local operations. Examples include price controls, financing restrictions, export commitments, taxes, and local sourcing requirements. **Ownership-control risks** are embodied in government policies or actions that inhibit ownership or control of local operations. Examples include foreign-ownership limitations, pressure for local participation, confiscation, expropriation, and abrogation of proprietary rights. For example, the Russian government canceled an agreement with the Exxon Corporation that would have allowed the firm to tap huge oil deposits in the country's far north. The Russian minister for natural resources cited "legal irregularities" as the reason for the decision. As a result, the $1.5 billion project came to a grinding halt. Commenting on the government's action, one Western investment banker in Russia said that "it raises the question of whether a deal is a deal in Russia, because Exxon is meticulous to a fault in following the letter of the law."[21] Abrogation of the agreement is an example of ownership-control risks.

For some other examples of political risks that must be managed, see the nearby International Management in Action box, "Sometimes It's All Politics."

operational risks
Government policies and procedures that directly constrain management and performance of local operations.

ownership-control risks
Government policies or actions that inhibit ownership or control of local operations.

conglomerate investment
A type of high-risk investment in which goods or services produced are not similar to those produced at home.

General Nature of Investment The general nature of investment examines whether the company is making a conglomerate, vertical, or horizontal investment (see Figure 10–1). In a **conglomerate investment,** the goods or services produced are not similar to those produced at home. These types of investments usually are rated as high risk, because foreign governments see them as providing fewer benefits to the country and greater benefits to the MNC than other investments. **Vertical investments** include the production of raw materials or intermediate goods that are to be processed into final products. These investments run the risk of being taken over by the government because they are export-oriented, and governments like a business that helps them generate foreign capital. **Horizontal investments** involve the production of goods or services that are the same as those produced at home. These investments typically are made with an eye toward satisfying the host country's market demands. As a result, they are not very likely to be takeover targets.

vertical investment
The production of raw materials or intermediate goods that are to be processed into final products.

horizontal investment
An MNC investment in foreign operations to produce the same goods or services as those produced at home.

Special Nature of Investment The special nature of foreign direct investment (FDI) relates to the sector of economic activity, technological sophistication, and pattern of ownership. There are three *sectors of economic activity:* (1) the primary sector, which consists of agriculture, forestry, and mineral exploration and extraction; (2) the industrial sector,

International Management in Action

Sometimes It's All Politics

www.india-times.com/index.shtml

One of the biggest problems in doing business internationally is that yesterday's agreement with a government may be canceled or delayed by today's politicians who disagree with that earlier decision. Enron, the now bankrupt Houston-based U.S. energy consortium, discovered this when its power project in Dabhol, India, became the focal point of political interest. India's economic nationalists began accelerating a campaign to scrap a high-profile, U.S.-backed power project despite warnings of potential damage to the confidence of foreign investors in the country. These politicians wanted to abandon the $2.8 billion deal as well as all other power projects in the country that had been approved under the government's "fast track" provisions. The contract for the two-stage, 2,000 megawatt plant was signed before the current politicians came to power in Maharashtra, the state where Dabhol is located.

What effect would this political move have on foreign investment in India? A number of foreign investors indicated that if the Enron project were canceled, they would review their investment plans for the country. A survey of international energy companies by the East-West Center in Hawaii found that of 13 Asian economies, India's investment climate ranked fifth from the bottom for power-sector investment. This seemed to have little effect on the politicians, who proceeded to cancel the project. Members of the political opposition, who supported the project, called it a mere political ploy designed to appeal to voters in the upcoming elections, and they urged foreign investors to sit tight and ride out the political storm. Many of these investors appeared to be apprehensive about taking such advice, and Enron announced plans for taking the case to international arbitration to reclaim the $300 million it had invested in the project—as well as $300 million in damages.

Eventually things were straightened out, but only for a while. Later the Maharashtra State Electric Board defaulted on $64 million in unpaid power bills. The board said that the company was charging too much for power, and Enron served notice that it would terminate the power supply contract and pull out. As of fall 2002, following Enron's own collapse, the power purchase agreement was to be reworked, and the foreign investors—Enron's creditors, GE, and Bechtel—were looking to divest their stakes in the venture, scrambling to recover whatever they could from the project.

The political climate in India is not unique. Russia also offers its share of jitters to investors. In particular, many joint ventures that were created during the Gorbachev era now are having problems. A good example is Moscow's Radisson-Slavjanskaya Hotel venture, in which American Business Centers of Irvine, California, owns a 40 percent stake. American Business Centers manages several floors of offices in the hotel, and now that the venture is making money, it appears that the Irvine firm's Russian partners and the Radisson hotel people are trying to oust them. The president of American Business Centers claims that his partners feel they do not need him any longer.

The dilemma faced by American Business Centers is becoming increasingly common in Russia. For example, the Seattle-based firm Radio Page entered into a joint venture with Moscow Public Telephone Network and another Russian company to offer paging services. Together, they built a system of telephone pagers in the Moscow region. Radio Page held a 51 percent stake. When annual revenues hit $5 million and the venture was on the verge of making $1 million, the agreement began to unravel. The Russian partners demanded control of the operation and even threatened to pull the critical radio frequencies if they did not get their way.

There is little that foreign joint-venture firms doing business in high-risk countries can do except try to negotiate with their partners. For instance, the political situation in Russia is so unstable that support from one government ministry may be offset by opposition from another, or, worse yet, the individuals supporting the foreign firm may be ousted from their jobs tomorrow. Economic considerations tend to be the main reason why firms seek international partners, but sometimes it seems that everything boils down to politics and the risks associated with dealing in this political environment.

consisting of manufacturing operations; and (3) the service sector, which includes transportation, finance, insurance, and related industries. Levels of *technological sophistication* characterize science-based industry and non-science-based industry. The difference between them is that science-based industry requires the continuous introduction of new products or processes. *Patterns of ownership* relate to whether businesses are wholly or partially owned.

The special nature of FDI can be categorized as one of five types (see Figure 10–1). Type I is the highest-risk venture; type V is the lowest-risk venture. This risk factor is assigned based on sector, technology, and ownership. Primary sector industries usually have the highest risk factor, service sector industries have the next highest, and industrial sector industries have the lowest. Firms with technology that is not available to the government should the firm be taken over have lower risk than those with technology that is easily acquired. Wholly owned subsidiaries have higher risk than partially owned subsidiaries.

Using a framework similar to that provided in Figure 10–1 helps MNCs to understand and manage their political risks. A way to complement this framework approach is to give specific risk ratings to various criteria and make a final compilation.

Quantifying the Variables in Managing Political Risk Some MNCs attempt to manage political risk through a quantification process in which a range of variables are simultaneously analyzed to derive an overall rating of the degree of political risk in a given jurisdiction. This would allow an MNC, for example, to compare how risky a particular venture would be in Russia and in Argentina.

Factors that are typically quantified reflect the political and economic environment, domestic economic conditions, and external economic conditions. Each factor is given a minimum or maximum score, and the scores are tallied to provide an overall evaluation of the risk. Table 10–3 provides an example of a quantitative list of political risk criteria.

Table 10–3
Criteria for Quantifying Political Risk

		Scores	
Major Area	**Criteria**	**Minimum**	**Maximum**
Political and economic environment	1. Stability of the political system	3	14
	2. Imminent internal conflicts	0	14
	3. Threats to stability emanating from the outside world	0	12
	4. Degree of control of the economic system	5	9
	5. Reliability of the country as a trading partner	4	12
	6. Constitutional guarantees	2	12
	7. Effectiveness of public administration	3	12
	8. Labor relations and social peace	3	15
Domestic economic conditions	9. Size of population	4	8
	10. Per capita income	2	10
	11. Economic growth during previous 5 years	2	7
	12. Prospective growth during next 3 years	3	10
	13. Inflation during previous 2 years	2	10
	14. Accessibility of domestic capital market to foreigners	3	7
	15. Availability of high-quality local labor	2	8
	16. Possibility of giving employment to foreign nationals	2	8
	17. Availability of energy resources	2	14
	18. Legal requirements concerning environmental protection	4	8
	19. Traffic system and communication	2	14
External economic relations	20. Restrictions imposed on imports	2	10
	21. Restrictions imposed on exports	2	10
	22. Restrictions imposed on foreign investments in the country	3	9
	23. Freedom to set up or engage in partnerships	3	9
	24. Legal protection for brands and products	3	9
	25. Restrictions imposed on monetary transfers	2	8
	26. Reevaluations against the home market currency during previous 5 years	2	7
	27. Development of the balance of payments	2	9
	28. Drain on foreign funds through oil and other energy imports	3	14
	29. International financial standing	3	8
	30. Restrictions imposed on the exchange of local money into foreign currencies	2	8

Source: From E. Diehtl and H. G. Koglmayr, "Country Risk Ratings," *Management International Review,* Vol. 26, No. 4, 1986, p. 6. Reprinted with permission.

Techniques for Responding to Political Risk

Once political risk has been analyzed by a framework, quantitative analysis, or both, the MNC then will attempt to manage the risk further through a carefully developed response. The MNC can also proactively improve its relationship with governments by means of pre-emptive political strategies to mitigate risk before it appears. Three related strategies should be considered: (1) relative bargaining power analysis; (2) integrative, protective, and defensive techniques; and (3) proactive political strategies.

Relative Bargaining Power Analysis The theory behind relative bargaining power is quite simple. The MNC works to maintain a bargaining power position stronger than that of the host country. A good example arises when the MNC has proprietary technology that will be unavailable to the host country if the operation is expropriated or the firm is forced to abide by government decisions that are unacceptable to it. Over time, of course, this technology may become common, and the firm will lose its bargaining power. To prevent this from happening, the firm will work to develop new technology that again establishes the balance of power in its favor. As long as the host country stands to lose more than it will gain by taking action against the company, the firm has successfully minimized its political risk by establishing an effective bargaining position. Figure 10–2 provides an example. As long as the MNC's bargaining power remains at or above the diagonal line, the government will not intervene. At point E in the figure, this power declines, and the host country will begin to intervene.[22]

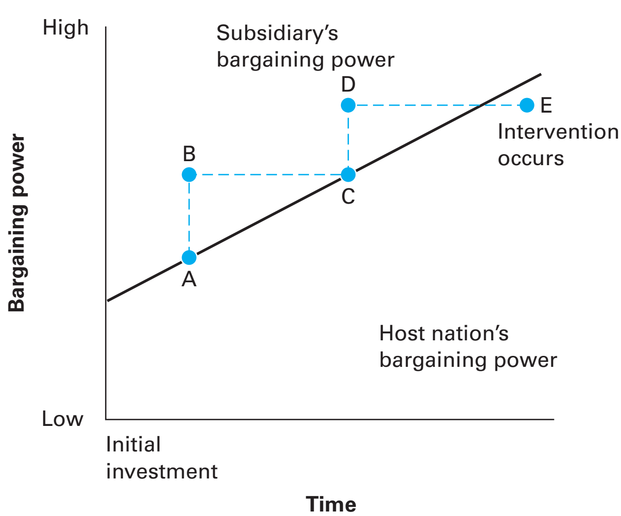
Gaining bargaining power depends on many factors, such as the host country's perception of the MNC's size, experience, and legitimacy. Furthermore, the ability to bargain and achieve security does not necessarily mean that the MNC must be aggressive or engage in a "power play." Enticing the host country with products or services which could benefit it in the short run could result in retaliatory actions if the MNC is not able to innovate or the host country grows weary of a lack of power.

Integrative, Protective, and Defensive Techniques Another way that MNCs attempt to protect themselves from expropriation or minimize government interference in their operations is to use integration and the implementation of protective and defensive techniques. **Integrative techniques** are designed to help the overseas operation become part of the host country's infrastructure. The objective is to be perceived as "less foreign" and thus unlikely to be the target of government action. Some of the most integrative techniques

integrative techniques
Techniques that help the overseas operation become a part of the host country's infrastructure.

Figure 10–2

Relative Bargaining Power over Time



Source: Adapted from Thomas A. Pointer, "Political Risk: Managing Government Intervention," in *International Management: Text and Cases,* ed. Paul W. Beamish, J. Peter Killing, Donald J. LeCraw, and Harold Crookell (Homewood, IL: Irwin, 1991), p. 125.

include (1) developing good relations with the host government and other local political groups; (2) producing as much of the product locally as possible with the use of in-country suppliers and subcontractors, thus making it a "domestic" product; (3) creating joint ventures and hiring local people to manage and run the operation; (4) doing as much local research and development as possible; and (5) developing effective labor-management relations.

At the same time, MNCs should be cognizant of how integrated they become in foreign markets. It is recommended that managers seek to maintain close ties between the subsidiary and the parent company, and not fully integrate into the host country. There is no guarantee that host countries will completely treat the MNC as a domestic company, making true competition difficult. Therefore, other, more distant techniques may be beneficial.

Protective and defensive techniques are designed to discourage the host government from interfering in operations, mainly by avoiding complex ties to the host country's economy. In contrast to the integrative techniques, these actually encourage nonintegration of the enterprise in the local environment. Examples include (1) doing as little local manufacturing as possible and conducting all research and development outside the country; (2) limiting the responsibility of local personnel and hiring only those who are vital to the operation; (3) raising capital from local banks and the host government as well as outside sources; and (4) diversifying production of the product among a number of countries.

protective and defensive techniques
Techniques that discourage the host government from interfering in operations.

Companies are more likely to use a protective-defensive strategy or a balance over completely integrating into another country, as illustrated in Figure 10–3. Organizations with an emphasis on innovative technology, such as Microsoft, prefer a protective technique as a way to safeguard against actions such as counterfeiting. MNCs that have products which are labor-intensive and have a high value to weight ratio also prefer protective methods, though there exists some integration. Here, strong global marketing systems are needed to sell the product, which is why integration occurs on some level despite the more cost-efficient method of either manufacturing in the home country or simply outsourcing construction to lower-wage regions.

Developing countries do not hold advanced management skills in as high regard as developed countries. For this reason, when selling products such as food, which requires advanced marketing and management skills, it is best to employ a mixed strategy (see Figure 10–3). That is, integration is necessary in order to effectively manufacture

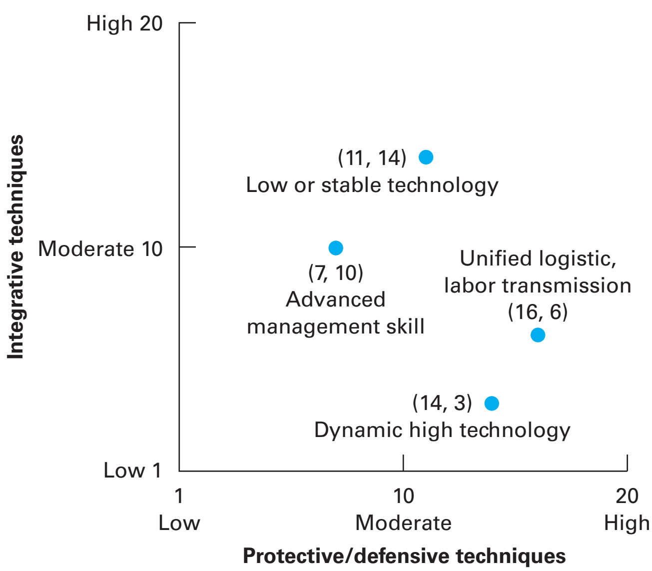


Figure 10–3

Use of Integrative and Protective-Defensive Techniques by Firms in Select Industries

Source: Adapted from Ann Gregory, "Firm Characteristic and Political Risk Reduction in Overseas Ventures," *National Academy of Management Proceedings* (New York, 1982), p. 77.

the product to local tastes and advertise, and there is little need for the company to distance operations from the host country in a manner tailored to local prefrences. Finally, industries that utilize little technology, such as steel manufacturing, exhibit the strongest integrative technique while still employing a defensive strategy. These companies require integration to ensure long-term production for projects, but may not desire to become completely enveloped in the host country's economy due to possibilities such as the host government suddenly requiring a greater share of profits generated by the MNC.

Proactive Political Strategies As mentioned at the beginning of the chapter, despite the general trend of developing countries seeking MNC investment, many developing-country governments continue to engage in practices that effectively overturn or renege on past deals.[23] In the last half of the 1990s, leaders of a number of countries in which autocratic or dictatorial governments controlled negotiations with foreign investors were toppled. The ousting of leaders in Peru, Indonesia, Malaysia, the Philippines, and Venezuela led to a backlash against incumbent foreign investors and forced many project leaders to withdraw or renegotiate the terms of their investments.[24]

In Indonesia, President Suharto's 30 years of dictatorial and nepotistic government were totally discredited, and investors whose reputations were closely associated with his legacy face a challenging environment for preserving the economic viability of their presence. For example, the government of Indonesia reneged on its commitment to buy power from two projects sponsored by MidAmerica Energy Holdings, arguing that the projects, both of which were awarded on a sole-source contract basis under the Suharto regime, were overpriced and the government simply could not afford to pay.[25] Recently, Indonesia's minister of mines and energy, Purnamo Yusgiantora, said his government would fight in U.S. courts to release \$130 million being held in a Bank of America escrow account after Karaha Bodas, a power developer, won an arbitration award in its dispute with the Indonesian government over cancelation of a geothermal plant that Karaha had agreed to build in collaboration with Indonesia's state electricity company.[26] The Bolivian government rescinded a 40-year contract with Aguas del Tunari—a consortium that included London-based International Water Ltd., Bechtel Enterprise Holdings, Italy's Montedison Energy Services, Spain's Abengoa Servicios Urbanos, and four of Bolivia's largest construction companies—to supply water to Cochabamba, Bolivia's third-largest city.

Often the challenges and complexity associated with government's tendency to seek to renegotiate investment rules and contracts are worsened by the participation of both national and subcentral governments in the project. In India, Brazil, and, increasingly, China, states and provinces wield significant power, and this has been a particular problem in the development and financing of power, water, and transport projects. The Linha Amarela project in Rio de Janeiro, an urban expressway that begins in the residential area of Rio and provides a direct link to the downtown area, was initially bid with an official traffic estimate of around 55,000 cars per day in 1993–1994. However, when construction was complete and the road opened for business in 1998, traffic exceeded that amount, reaching 80,000 vehicles per day in early 2001. When the new mayor of Rio, Cesar Maia, took office on January 1, 2001, he issued a number of decrees overturning policies of his predecessor. One of these decrees unilaterally dropped the toll by 20 percent, squeezing the foreign owner of the concession.

proactive political strategies
Lobbying, campaign financing, advocacy, and other political interventions designed to shape and influence the political decisions prior to their impact on the firm.

In addition to the approaches mentioned above, how else can MNCs respond to such unpredictable government decisions? Because government policies can have a significant impact on business activities and many governments face competing pressures from a range of stakeholders, corporations must adopt various **proactive political strategies** both to affect government policy and to respond to competitors' efforts to influence that policy. Comprehensive strategies are especially important in unstable and transitional policy environments.[27] These strategies are designed, in part, to develop and maintain ongoing favorable relationships with government policy makers as a tool to mitigate risk before it becomes unmanageable. Broadly, strategies may include leveraging bilateral, regional, and international trade and investment agreements, drawing on bilateral and multilateral financial support, and using project finance structures to separate project exposure from overall firm risk. They also can include entering markets early in the privatization-liberalization cycle (the first-mover strategy discussed in Chapter 8), establishing a local presence and partnering with local firms, and pursuing pre-emptive stakeholder management strategies to secure relationships with all relevant actors.[28]

More specific proactive political strategies include formal lobbying, campaign financing, seeking advocacy through the embassy and consulates of the home country, and more formal public relations and public affairs activities such as grassroots campaigning and advertising.[29] Strategies must vary based on the particular political system (parliamentary vs. non-parliamentary), distribution of power (highly centralized vs. decentralized), and other variations in political systems.[30] However, MNCs have the option of purchasing political risk insurance, which could be used across cultures and systems and protect the company from inherent uncertainty. This option has been available for decades, but many have not utilized it because risk assessment is so subjective and unpredictable, that most companies choose to forgo coverage.[31] MNCs that are concerned with currency convertibility issues, political unrest, or exporting matters may want to take a closer look. Insurance terms range anywhere from 3 to 15 years or more and can cover up to $80 million per risk.[32] As an MNC increases exporting or overseas operations, the benefits of coverage may outweigh the cost of the insurance.

Developing and maintaining ongoing relationships with political actors, including officials in power and in opposition parties, and with the range of stakeholders, including nongovernmental organizations (NGOs) and others, can help buffer host-government actions that may constrain or undermine MNC strategies and plans.[33] In the previous examples, had investors made low-level contacts with opposition groups, they might have aggravated existing strains in relationships with governments but secured some protections for the future. Knowing when—and how—to exercise such relationships is a difficult but necessary strategy.

How does an MNC know which strategy to pursue? There is no straightforward answer to this question, since strategic responses depend on a multitude of factors. The nature of the industry, the firm's technological capabilities, local conditions in a host country, management skills and philosophies, logistics, and labor transmission are just a few ways decisions are impacted. No one strategy is guaranteed to work, but building a relationship with all parties involved could assist in the betterment of any method an MNC employs.

Managing Alliances

Another dimension of management strategy related to political risk and government relations is managing relationships with alliance partners. Some partners may be current or former state-owned enterprises; others may be controlled or influenced by government agencies. For example, in China, most foreign investors have some sort of alliance or joint-venture relationships with Chinese state-owned enterprises. Motorola, one of the most active investors in China, has many alliances with state-owned enterprises, such as its joint venture with Nanjing Panda Electronics to produce a personal computer. The heart of the computer will be Motorola's Power PC chip, the major rival to Intel's Pentium.[34] In 2004, Siemens AG chief executive Heinrich von Pierer announced a sweeping expansion of the company's business in China using its more than 45 joint ventures as the primary vehicle for expansion.[35] As mentioned in Chapter 9, alliances and joint ventures can significantly improve the success of MNC entry and operation in many international markets, especially emerging economies. Managing the relationships inherent in alliances, especially when governments are involved, can be especially challenging.

The Alliance Challenge

A rich and increasingly diverse recent literature has examined the motivations for collective action through international strategic alliances (ISAs). Researchers have begun to focus on specific explanations of ISA formation, the conditions that appear to lead to better or worse ISA performance and endurance, and the primary factors motivating firms to enter into such relationships.[36] Motivating factors include faster entry and payback, economies of scale and rationalization, complementary technologies and patents, and co-opting or blocking competition.[37]

In the strategic alliance literature, several researchers have argued that learning can be a powerful force in the initial motivations for, and ultimate success of, ISAs.[38] Some kinds of local knowledge cannot be internalized simply as a result of an MNC entering and operating in a foreign market; acquisition of some kinds of local knowledge requires local firm participation. Collaboration facilitates rapid market entry by allowing firms to share costs and risks, combine product and market complementarities, and reduce the time-to-market.[39]

How an alliance relationship is developed is largely a function of interfirm negotiation. Alliances are an arena where both value-claiming activities (competitive, distributive negotiation) and value-creating activities (collaborative, integrative negotiation) take place. In order to lay claim to a larger share of the alliance pie, firms tend to seek an advantage over their partners. Firms do this by possessing superior resources or alternatives beyond the scope of the alliance. However, in order to create a "larger pie" through the combination of partner-firm resources and activities, firms must balance authority, allowing each firm to dictate certain activities within the alliance, and to commit to sharing and reciprocity where each partner firm plays some decision-making role. In these instances, alliance partners can create value through specialization gains or when the rationalization of redundant activities results in enhanced performance for the partners.[40]

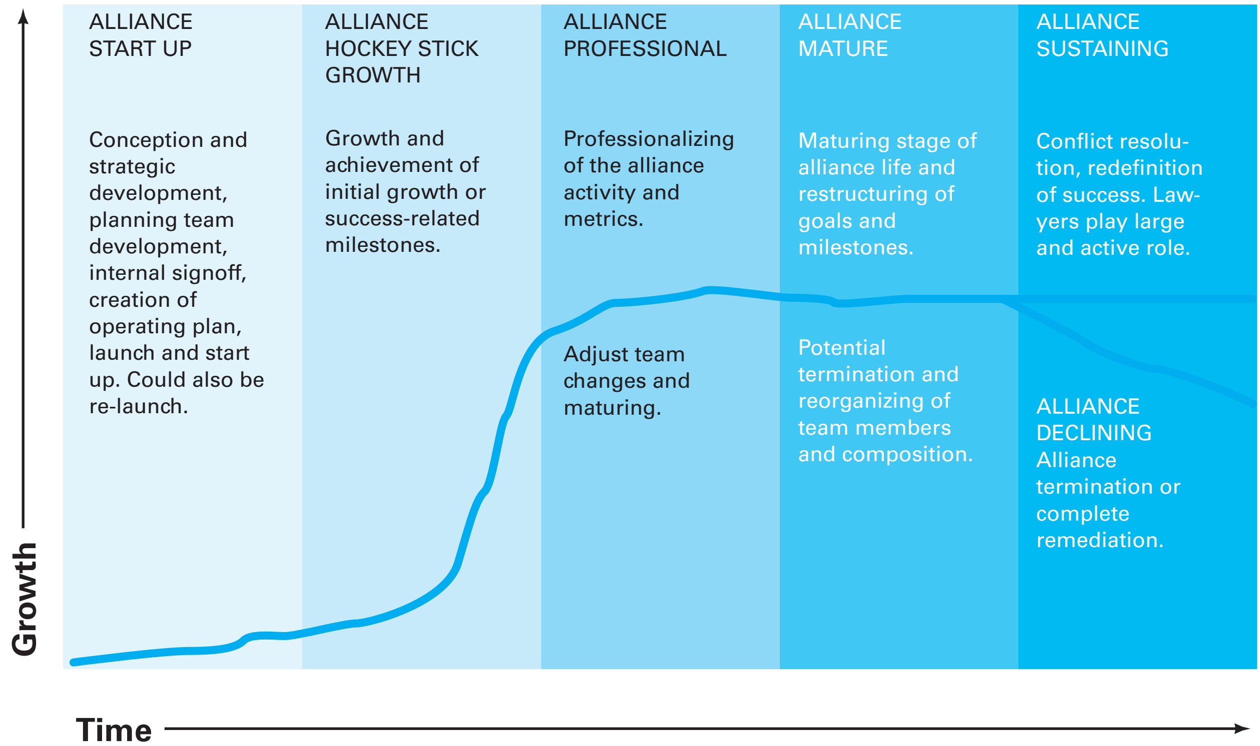
A fundamental challenge of alliances is managing operations with partners from different national cultures (as previously discussed in Chapter 5). Cultural differences may create uncertainties and misunderstandings in the relationship, which may lead to conflict and even dissolution of the venture. Indeed, an alliance may be viewed as a temporal structure designed to address a particular problem during a period in time; all alliances eventually outlast their purpose.

Differences in the cultural backgrounds of partners can potentially cause problems in alliances. One study tried to determine whether some differences are more disruptive than others. The researchers found that differences in uncertainty avoidance and in long-term orientation, in particular, cause problems (see Chapter 4 for cultural dimensions). These differences have a negative impact on survival and decrease the likelihood that firms will enter a foreign country through an alliance rather than a wholly owned subsidiary.[41] Apparently, these differences, which translate into differences in how partners perceive and adapt to opportunities and threats in their environment, are more difficult to resolve than differences in other cultural dimensions. Perhaps cultural differences in power distance, individualism, and masculinity are more easily resolved because they are mainly reflected in different attitudes toward the management of personnel—something firms can make explicit.

Successful management of alliances depends on situational conditions, management instruments, and performance criteria. Success factors may include partner selection, cooperation agreement, management structure, acculturation process, and knowledge management.[42] In particular, partner selection and task selection criteria have been identified as critical variables that influence alliance success or failure. Conducting due diligence, choosing the right partners, and defining the scope and limit of the alliance appear to be the most important elements in determining if an alliance will succeed or fail.

One difficult but important aspect of successful alliance management is preparation for the likely eventual termination of the alliance.[43] Many firms are caught off guard

Figure 10–4 **Alliance Life Cycle**



Source: From Larraine Segil, "Metrics to Successfully Manage Alliances," *Strategy & Leadership,* Vol. 22, No. 5 (2005), p. 47. Reprinted with permission of the author.

when their partners are better prepared to deal with issues related to termination of the alliance than they are. After studying two dozen successful alliance "divorces," a group of researchers identified a number of legal and business issues that were critical to successful divorces. Legal issues include the conditions of termination, the disposition of assets and liabilities, dispute resolution, distributorship arrangements, protection of proprietary information and property, and rights over sales territories and obligations to customers. Business issues include the basic decision to exit, people-related issues, and relations with the host government. Alliances, like individual businesses, experience a life cycle, as illustrated in Figure 10–4. Recognizing the point at which your alliance exists in the life cycle can help determine a proactive strategy to sustain the relationship and work toward a common goal.

The Role of Host Governments in Alliances

As previously mentioned, host governments are active in mandating that investors take on partners, and these mandates can pose managerial and operational challenges for MNCs. Many host governments require investors to share ownership of their subsidiaries with local partners—in some cases, state-owned or state-controlled partners. These mandates can include specific requirements that investors select local state-owned firms (China) or that investors form joint ventures to meet local regulatory requirements where restrictions or local-content rules apply (Central and Eastern Europe).[44]

Even when host governments do not require alliances or JV as a condition for entry, many MNCs find that having alliance or JV partners is advantageous to their entry and expansion. This is especially so in highly regulated industries such as banking, telecommunications, and health care. In a study conducted of alliances among global telecommunications firms, firms were found to establish alliances with local partners primarily to gain market access and to contend with local regulations.[45] In another study, also of telecommunications projects in emerging markets, firms were found to take on local partners as a way to cope with emerging-market environments characterized by arbitrary and unpredictable corruption.[46]

Even when alliances are dissolved, host governments can have a role. In particular, the host government of a partner may be unwilling to permit the alliance to terminate. It could object to the termination in an overt way, such as not permitting a foreign partner to sell its interest in the alliance.[47] There are also subtle ways to discourage a partner from leaving an alliance, such as blocking the repatriation of the foreign partner's investments in the alliance. It is also important to consider carefully the long-term effects of terminating an alliance on the ability of the company to do business in the same host country in the future.

In sum, host governments have a substantial role in the terms under which alliances are initially formed, the way in which they are managed, and even the terms of their dissolution. MNCs must be aware of these influences and use carefully crafted strategies to manage host-government involvement in their alliances.

Examples of Challenges and Opportunities in Alliance Management

Alliances and JVs are increasingly common modes of entry and operation in international business. A number of recent examples illustrate the challenges and opportunities associated with managing alliances.

A good example is provided by Ford Motor and Mazda. For a number of years the two have had a strategic alliance. Today, with guidance from its American partner, Mazda is trimming costs and introducing a host of popular new models in Asia. At the same time, the company is beginning to gain ground in both North America and Europe. Part of this success is accounted for by Ford executives who reined in Mazda's freewheeling engineers and forced them to share auto platforms and to source more components overseas. Mazda also began following Ford's advice to use customer clinics, thus helping the company to develop low-priced, compact sport vehicles that are proving very popular in the Japanese market. Over the next few years, Mazda intends to continue growing its market shares in North America and Europe. The two firms are also working closely together in Asia.

Starbucks Coffee International of Seattle, Washington, recently developed a joint venture with the Beijing Mei Da Coffee Company to open coffee houses in China. Getting local consumers to switch from tea to coffee is likely to be a major challenge. However, for the moment, the joint venture is focusing on the training of local managers who will run the coffee shops. Recruits are sent to Tacoma, Washington, to learn how to make the various types of Starbucks coffee and to get a firsthand look at the company's culture. As one of the general managers for the Mei Da Company put it, "People don't go to Starbucks for the coffee but for the experience. Focusing on the development of employees so that they can deliver that experience is our priority for now."[48] Part of Starbucks' strategy is also to show the new recruits that there are career and personal development opportunities in this new venture. This is an important area of emphasis for the firm because there is a major shortage of management personnel in China. As a result, many companies raid the management ranks of others, offering lucrative financial arrangements to those who are willing to change companies. One way that Starbucks is trying to deal with this is by encouraging the trainees to take responsibility, question the system, take risks, and make changes that will keep the customers coming back. Although the relationship began as a joint venture, Starbucks ultimately bought out its joint venture partner, a common progression as foreign and local partners begin to collaborate more closely and complete integration is desirable. The latest acquisition, which gives Starbucks a 90 percent controlling stake in Beijing Mei Da, will help the coffee company "achieve greater operational efficiencies and accelerate our expansion in China," said Wang Jinlong, president of Starbucks Greater China.[49]

As these examples show, MNCs are and will be making a host of decisions related to IJVs. In Russia, the current trend is to renegotiate many of the old agreements and seek smaller deals that entail less bureaucratic red tape and are easier to bring to fruition. At the same time, the U.S. administration is trying to create a plan for providing assistance to the former Soviet republics, and this likely will generate increased interest in the use of IJVs.

Besides the former Soviet Union, other areas of the world previously closed to foreign investment are beginning to open up. One of these is Vietnam, which had a very auspicious beginning in the early 1990s when investors began flocking there. During this time period, Japan's Idemitsu Oil Development Company signed a deal with the Vietnamese government that gave the company the right to explore an offshore oil and gas field in the Gulf of Tonkin. A number of U.S. companies also targeted Vietnam for investment, and Citibank and Bank of America both were approved for branch status by the government. The bulk of their business was to be in wholesale banking and, in the case of Bank of America, advising the government on financing the rebuilding of the nation's weak power sector. Other firms that began giving serious consideration to Vietnam included AT&T, Coca-Cola, General Electric, ExxonMobil, and Ralston Purina, to name but five. As a result, by 1996 the country was attracting over $8 billion annually in foreign direct investment (FDI). In the late 1990s and early 2000s, however, FDI dropped sharply. In recent years, it has risen sharply again.

The sometimes bureaucratic communist government often sends mixed signals to foreign investors. Ford Motor, for example, had spent over $100 million to build a factory near Hanoi, but because of pressure from its local rival, the Vietnam Motor Corporation, it took 16 months for Ford to get approval to sell its Laser sedan. By the end of 2000, the company had sold fewer than 1,000 vehicles, a far cry from the 14,000 that had been initially projected.[50] Many other firms reported similar experiences. Consequently, the Vietnamese government tried to turn things around by undertaking domestic economic reform, pursuing international trade agreements, and encouraging foreign investment, especially joint ventures.[51] Among other things, the country's coffee production was skyrocketing, and Vietnam exported over 20 percent of its coffee to the United States; so it is in the best interests of the country to open its markets. At the same time, a growing number of multinationals were re-examining Vietnam's potential and looking to create strategic alliances that will help them establish a foothold in one of the more promising emerging economies in Asia.[52] After several years, this approach seemed to be paying off. Vietnam had passed a domestic enterprise law and investment law easing and clarifying foreign investment and business rules, including those pertaining to joint ventures, signed a trade agreement with the United States, and, in 2005, joined the WTO. As a result, foreign investment was once again on the rise, reaching US$9.6 billion in 2008. In 2009, Ford had its best ever sales year in Vietnam, selling 8,286 units. To help support the growth of its business and increasing demand for Ford vehicles, Ford Vietnam continued with its expansion plans in 2009 by completing a new, state-of-the-art assembly line at its Hai Duong facility and increasing production capacity by 25 percent.[53]

The World of International Management—Revisited

A wide range of risks emanate from the political environment in which MNCs operate, and firms can employ an equally diverse set of strategies to mitigate those risks and improve their relations with governments. IKEA faced a series of challenges in Russia which it sought to overcome using a range of strategies. For the time being, IKEA chose to continue with its ongoing operations but defer further investment until the situation was clarified. After reading this chapter and considering the challenges associated with doing business in Russia, answer the following questions: (1) What are two main concerns that MNCs should evaluate when doing business in Russia? (2) How can MNCs protect themselves from government action? (3) What proactive political strategies might help protect MNCs from future changes in the political environment? (4) How might alliances and joint ventures reduce risk and help relationships with government actors and other stakeholders?

SUMMARY OF KEY POINTS

1. Political risk is the likelihood that the foreign investment of a business will be constrained by a host government's policies. In dealing with this risk, companies conduct both macro and micro political risk analyses. Specific consideration is given to changing host-government policies, expropriation, and operational profitability risk.
2. MNCs attempt to manage their political risk in two basic ways. One is by developing a comprehensive framework for identifying and describing these risks. This includes consideration of political, operational, and ownership-control risks. A second is by quantifying the variables that constitute the risk.
3. Common risk management strategies are the use of relative bargaining power, integrative, protective, and defensive techniques, and proactive political strategies.
4. Effective alliance management includes careful selection of partners, defining the tasks and scope of the alliance, addressing cross-cultural differences, and responding to host-government requirements.

KEY TERMS

REVIEW AND DISCUSSION QUESTIONS

1. What types of political risk would a company entering Russia face? Identify and describe three. What types of political risk would a company entering France face? Identify and describe three. How are these risks similar? How are they different?
2. Most firms attempt to quantify their political risk, although they do not assign specific weights to the respective criteria. Why is this approach so popular? Would the companies be better off assigning weights to each of the risks being assumed? Defend your answer.
3. How has terrorism impacted foreign interest in Iran and Saudi Arabia, considering the vast oil reserves that are there? How have terrorist attacks affected political relationships between countries such as the United States and Russia?
4. If a high-tech firm wanted to set up operations in Iran, what steps might it take to ensure that the subsidiary would not be expropriated? Identify and describe three strategies that would be particularly helpful. How might proactive political strategies help protect firms from future changes in the political environment?
5. What are some of the challenges associated with managing alliances? How do host governments affect these?

INTERNET EXERCISE: NOKIA IN CHINA

Asia still offers great opportunities for multinational firms. However, given the slowdown that has occurred in this region in recent years, there are also great risks associated with doing business there. The large Finnish-based MNC, Nokia, has determined that the opportunities are worth the risk and has staked a large claim in China and is determined to be a major player in the emerging Asian market. Visit its website at www.nokia.com and focus your attention on what this well-known MNC is now doing in Asia. Drawing from specific information obtained from the website, this chapter, and your reading of the current news, answer these questions: What political risks does Nokia face in Asia, particularly China? How can Nokia manage these risks? How can effective international negotiating skills be of value to the firm in reducing its political risk and increasing its competitive advantage in this area of the world?

In the International Spotlight

Brazil

After three centuries under the rule of Portugal, Brazil became an independent nation in 1822. By far the largest and most populous country in South America, Brazil has overcome more than a half century of military intervention in the governance of the country to pursue industrial and agricultural growth and the development of the interior.

After crafting a fiscal adjustment program and pledging progress on structural reform, Brazil received a $41.5 billion IMF-led international support program in November 1998. In January 1999, the Brazilian Central Bank announced that the *real* would no longer be pegged to the U.S. dollar. The consequent devaluation helped moderate the downturn in economic growth in 1999, and the country posted moderate GDP growth in 2000. Economic growth slowed considerably in 2001–2003—to less than 2 percent—because of a slowdown in major markets and the hiking of interest rates by the Central Bank to combat inflationary pressures. President Luiz Inácio Lula da Silva, who took office on January 1, 2003, gave high priority to reforming the complex tax code, trimming the overblown civil service pension system, and continuing the fight against inflation. By exploiting vast natural resources and a large labor pool, Brazil is today South America's leading economic power and a regional bellwether as it continues toward a free-market society.

After winning a landslide victory in 2002 on a campaign to revamp the economy and battle for the poor, President Lula da Silva reassured worried investors when he continued his predecessor's plan of strict financial austerity. Instead of catching the jitters as predicted, the country's bond and stock markets enjoyed stellar returns in 2003 and are still going strong. But within a year, pressure was mounting on Lula da Silva to keep true to his populist roots. After riding a wave of popular support through his first year, Lula da Silva faced some criticism from within his own Workers' Party and governing coalition as well as from ordinary voters. Lula has also gained a reputation for being thin-skinned when it comes to criticism; he expelled a foreign journalist critical of his policies. Although Lula's popularity dipped through this period, da Silva was reelected in 2006, and received more votes than any other Brazilian elected president. During his second term, Brazil continued its progress in modernization and da Silva's support gained steam again. In 2010, da Silva entered the final year of his second four-year term as one of the most popular Brazilian politicians of all time. But in Latin America, any change in leadership is always met with nervousness from financial markets because it creates uncertainty and reminds business of previous transitions that have been disruptive.

Brazil's economy rebounded sharply from the global economic recession in 2009, with GDP growth of 5.5 percent expected in 2010. According to *The Economist,* Brazil is likely to become the world's fifth largest economy, overtaking Britain and France before 2025. Brazil's progress in fighting poverty has been one of the most impressive of any developing country. Brazil boasts a number of world class companies, including Embraer, the global leader in short- and mid-range jet aircraft. In addition, Brazil will be host to the World Cup soccer match in 2014 and Rio will host the summer Olympic games in 2016. Substantial infrastructure investment is expected in advance of these two events. Brazil announced in early 2007 the discovery of the Tupi and Carioca oil fields off the coast of Rio de Janeiro. The oil reserves in these fields are conservatively estimated at between 30 billion and 80 billion barrels, which would put Brazil in the top ten countries in the world by reserves. In May of 2010, Brazil announced another large discovery in the Santos Basin. Output from the existing Campos Basin and the discovery of the new fields could make Brazil a significant oil exporter by 2015. Brazil's national oil company, Petrobras, is one of the largest in the world. The government has created a new state-owned company called Petrosal to manage licensing in the new fields. This new company will award some exploration and production rights straight to Petrobras without options for foreign firms. Also, by mandate, it will award over half of the shallow-water contracts to locally owned Oil Service Companies (LOSCs). In deeper and more challenging waters beyond the capacity of local companies, foreign companies will be invited to bid. Those pledging to incorporate Brazilian "content" would be more likely to succeed. Higher taxes and fees are expected as well. Nonetheless, this sector is likely to create substantial new opportunities for foreign firms in Brazil.

Questions

1. In your opinion, is there still political uncertainty in Brazil?
2. What strategy would be the most useful to companies interested in Brazilian investment?
3. Considering the economic and political environment, what types of companies would benefit the most by expanding operations to Brazil?
4. How should BellSouth, AES, and other companies address concerns about government policies in Brazil?

You Be the International Management Consultant

Rushing into Russia

As Russia continues to succeed with a decentralized economy and foreign investors flood in, a Chicago, Illinois–based computer chip manufacturer decides that it may be time to expand operations overseas. The company has a series of patents that provide legal protection and allow it to dominate a small but growing segment of the computer market. Its sales estimates reached $147 million within three years, but it believes that this could rise to $200 million if it was to expand internationally. Adam Smith, CEO of the company, had previously considered China and India for their cheap labor, but decided that their rapid growth and intense international interest would just lead to a higher bidding price. Furthermore, there are far fewer direct competitors expanding in Russia, whereas technological parts and services industries are already pervasive in other emerging countries. Adam recalls a time when Russia experienced high human trafficking, corruption, and general political instability, but he believes that with so much international interest in Russia, these issues must be curbed by this point in time.

Adam is confident that a deal will be accepted by Russia as it continues to welcome foreign investment to maintain economic growth. A state-of-the-art plant could help to reduce unemployment further and provide an inflow of needed capital. However, the banker is concerned that because of the political risks and uncertainty in Eastern Europe in general and Russia in particular, the company may either lose its investment through government expropriation or find itself unable to get profits out of the country. Given that the company will have to invest approximately $20 million, the venture could seriously endanger the company's financial status.

Adam understands these risks but believes that with the help of an international management consultant, he can identify and minimize the problems. "I'm determined to push ahead," he told the banker, "and if there is a good chance of making this project a success, I'm going to Russia."

Questions

1. What are some of the political risks that Adam's firm will face if he decides to go ahead with this venture? Identify and describe two or three.
2. Using Figure 10–3, what strategy would you recommend that the firm use? Why?
3. In his negotiations with the Russian government, what suggestions or guidelines would you offer to Adam? Identify and describe two or three.