

Chapter ten

Managing Political Risk, Government Relations, and Alliances

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Chapter Objectives

The four 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 Nature and Analysis of Political Risk

■ Political risk

- ❑ The likelihood that a business foreign investment will be constrained by a host government's policy.

■ 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 politics and actions that influence selected sectors of the economy or specific foreign businesses in the country

- http://www.duke.edu/~charvey/Country_risk/couinde x.htm

Macro Risk Factors

- Freezing the movement of assets out of the host country
- Placing limits on the remittance of profits or capital
- Devaluing the currency
- Refusing to abide by the contractual terms of agreements previously signed with MNC
- Industrial piracy (counterfeiters)
- Political turmoil
- Government corruption

2006 Transparency International Corruption Perceptions Index

**Table 10-1
The 2006 Transparency International Corruption Perceptions Index**

Country Rank	Country	Country Rank	Country
1	Finland	40	Jordan
	Iceland	41	Hungary
3	New Zealand	42	Mauritius
4	Denmark		South Korea
5	Singapore	44	Malaysia
6	Sweden	45	Italy
7	Switzerland	46	Czech Republic
8	Norway		Kuwait
9	Australia		Lithuania
	Netherlands	49	Latvia
11	Austria		Slovakia
	Luxembourg	51	South Africa
	United Kingdom		Tunisia
14	Canada	53	Dominica
15	Hong Kong	54	Greece
16	Germany	55	Costa Rica
17	Japan		Namibia
18	France	57	Bulgaria
	Ireland		El Salvador
20	Belgium	59	Colombia
	Chile	60	Turkey
	United States	61	Jamaica
23	Spain		Poland
24	Barbados	63	Lebanon
	Estonia		Seychelles
26	Macao		Thailand
	Portugal	66	Belize
28	Malta		Cuba
	Slovenia		Grenada
	Uruguay	69	Croatia
31	United Arab Emirates	70	Brazil
32	Bhutan		China
	Qatar		Egypt
34	Israel		Ghana
	Taiwan		India
36	Bahrain		Mexico
37	Botswana		Peru
	Cyprus		Saudi Arabia
39	Oman		Senegal

Source: Transparency International, http://www.transparency.org/news_rooms/in_focus/2006/cpi_2006__1/cpi_table.

Corruption Perceptions Index

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11	Austria		Slovakia
	Luxembourg	51	South Africa
	United Kingdom		Tunisia
14	Canada	53	Dominica
15	Hong Kong	54	Greece
16	Germany	55	Costa Rica
17	Japan		Namibia
18	France	57	Bulgaria
	Ireland		El Salvador
20	Belgium	59	Colombia
	Chile	60	Turkey
	United States	61	Jamaica
23	Spain		Poland
24	Barbados	63	Lebanon
	Estonia		Seychelles
26	Macao		Thailand
	Portugal	66	Belize
28	Malta		Cuba
	Slovenia		Grenada
	Uruguay	69	Croatia
31	United Arab Emirates	70	Brazil
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Source: Transparency International, http://www.transparency.org/news_rooms/in_focus/2006/cpi_2006__1/cpi_table.

Micro Risk Factors

- Some MNCs are treated differently than others
- Industry regulation
- Taxes on specific types of business activity
- Restrictive local laws
- Impact of WTO and EU regulations on American MNCs
- Government policies that promote exports and discourage imports

Evaluation of Political Risk

Table 10-2
A Guide to Evaluation of Political Risk

External factors affecting subject country:

- Prospects for foreign conflict
- Relations with border countries
- Regional instabilities
- Alliances with major and regional powers
- Sources of key raw materials
- Major foreign markets
- Policy toward United States
- U.S. policy toward country
- Internal groupings (points of power)

Government in power:

- Key agencies and officials
- Legislative entrenched bureaucracies
- Policies—economic, financial, social, labor, etc.
- Pending legislation
- Attitude toward private sector
- Power networks

Political parties (in and out of power):

- Policies
- Leading and emerging personalities
- Internal power struggles
- Sector and area strengths
- Future prospects for retaining or gaining power

Other important groups:

- Unions and labor movements
- Military, special groups within military
- Families
- Business and financial communities
- Intelligentsia
- Students
- Religious groups
- Media
- Regional and local governments
- Social and environmental activists
- Cultural, linguistic, and ethnic groups
- Separatist movements
- Foreign communities
- Potential competitors and customers

Internal factors:

- Power struggles among elites
- Ethnic confrontations
- Regional struggles
- Economic factors affecting stability (consumer inflation, price and wage controls, unemployment, supply shortages, taxation, etc.)
- Anti-establishment movements
- Factors affecting a specific project (custom-designed for each project)

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.

Terrorism and Its Overseas Expansion

- Terrorism: the use of force or violence against others to promote political or social views
- Three types of terrorism: amateur, religiously motivated, and classic
- MNCs disinclined to set up operations in countries with high terrorism risk
- MNCs must assess political risk, install modern security, compile crisis plans, and prepare employees for possible situations

Expropriation Risk

- Expropriation: the seizure of businesses by a host country with little, if any, compensation to owners
- Indigenization laws
 - Require nations to hold a majority interest in an operation

Operational Profitability in Risk Analysis

- Most MNCs are more concerned with operational profitability than expropriation
- They are concerned with ability to make desired return on investment
 - Require MNCs to use domestic suppliers vs. those from other company-owned facilities or purchase in world market
 - Restrict the amount of profit taken out of country
 - Wages and salary that must be paid to employees
 - <http://lcweb2.loc.gov/frd/cs/cshome.html>

Managing Political Risk and Government Relations

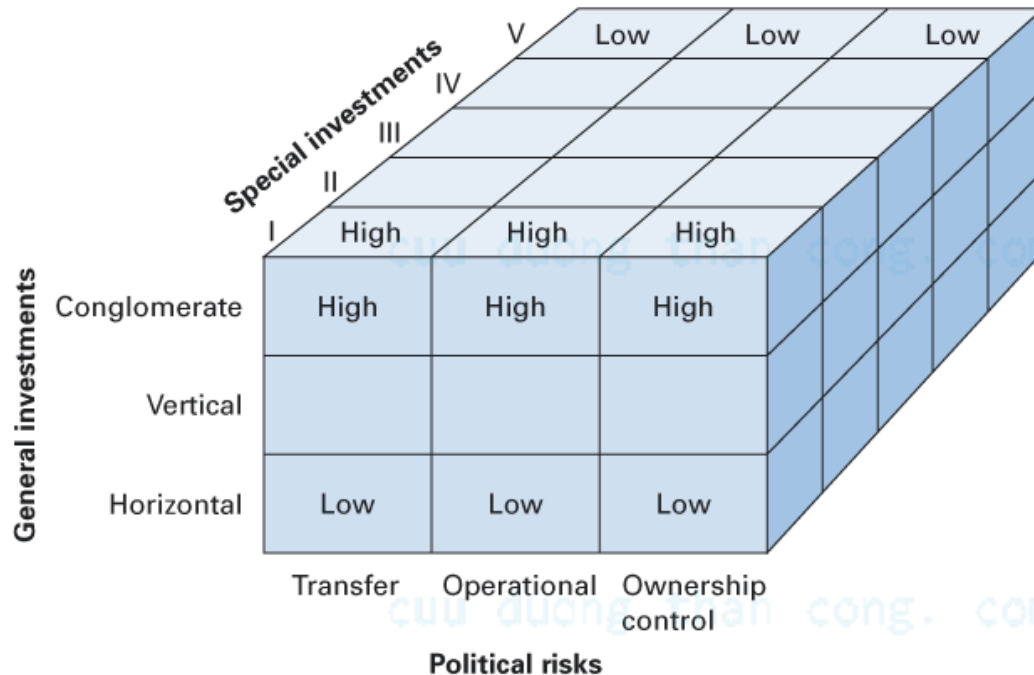


Figure 10-1
A Three-Dimensional Framework for Assessing Political Risk

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

Managing Political Risk and Government Relations

1. Transfer risks
2. Operational risks
3. Ownership control risks

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Political Risks: Transfer Risks

- Government policies that limit transfer of capital, payments, production, people, and technology in and out of country
 - Tariffs on exports and imports
 - Restrictions on exports
 - Dividend remittance
 - Capital repatriation

Political Risks: **Operational Risks**

- Government policies and procedures that directly constrain management and performance of local operations
 - Price controls
 - Financing restrictions
 - Export commitments
 - Taxes
 - Local sourcing requirements

Political Risks:

Ownership Control Risks

- Government policies or actions that inhibit ownership or control of local operations
 - Foreign-ownership limitations
 - Pressure for local participation
 - Confiscation
 - Expropriation
 - Abrogation of proprietary rights

General Nature of Investment

- **Conglomerate** investment
 - Type of high-risk investment in which goods or services produced are not similar to those produced at home
- **Vertical** investment
 - Production of raw materials or intermediate goods that are to be processed into final products
- **Horizontal** investment
 - MNC investment in foreign operations to produce the same goods or services as those produced at home

Special Nature of Investment

- Three sectors of economic activity
 - Primary sector: agriculture, forestry, mineral exploration and extraction
 - Industrial sector: manufacturing
 - Service sector: transportation, finance, insurance, and related industries

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Special Nature of Investment

Special nature of foreign direct investment can be categorized as one of five types (see Slide 12):

- Type I: highest-risk venture (type V is lowest)
- Risk factor is assigned based on sector, technology, and ownership
 - Primary sector industries usually have highest risk factor, service sector industries have next highest; industrial sector industries have lowest
 - Firms with technology not available to government should 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

Quantifying Variables in Managing Political Risk

- Each factor is given minimum or maximum score; scores tallied for overall evaluation of risk
- Slide 21 gives an example of a quantitative list of political risk criteria
- Factors typically quantified
 - Political and economic environment
 - Domestic economic conditions
 - External economic conditions

Quantifying Political Risk

Table 10-3
Criteria for Quantifying Political Risk

Major Area	Criteria	Scores	
		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

- Three related corporate political strategies
 - Relative bargaining power analysis (1)
 - The MNC works to maintain a bargaining power position stronger than that of host country
 - Integrative, protective, and defensive techniques (2)
(Integrative techniques help overseas operation become part of host country's infrastructure)
 - Developing good relations with host government and other local political groups
 - Producing as much of product locally as possible with use of in-country suppliers and subcontractors
 - Creating joint ventures and hiring local people to manage and run operation (cont'd)

Techniques for Responding to Political Risk (cont'd)

- Doing as much local R&D as possible
- Developing effective labor-management relations

(Protective and defensive techniques discourage the host government from interfering in operations)

- Doing as little local manufacturing as possible and conducting all research and development outside country
- Limiting responsibility of local personnel and hiring only those who are vital to operation
- Raising capital from local banks and host government as well as outside sources
- Diversifying production of product among number of countries

<http://www.intracen.org>

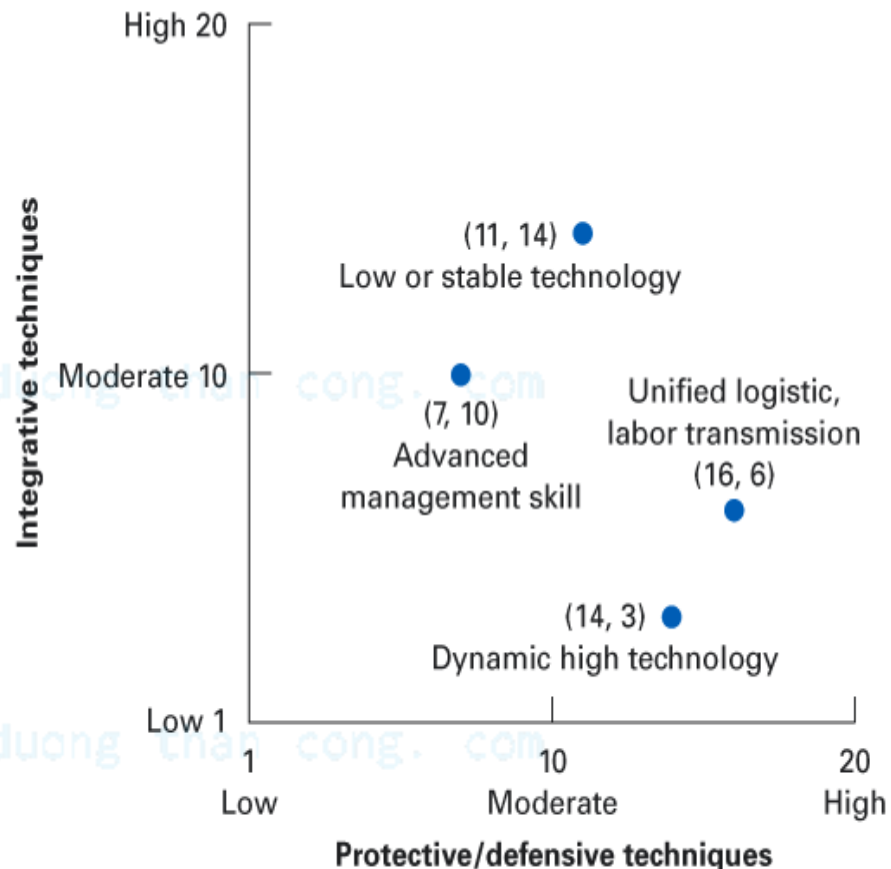
Techniques for Responding to Political Risk (cont'd)

- Proactive political strategies (3)
 - Lobbying, campaign financing, advocacy and other political interventions designed to shape and influence political decisions prior to impact on firm
 - Formal lobbying
 - Campaign financing
 - Seeking advocacy through embassy and consulates of home country
 - Formal public relations and public affairs activities such as grassroots campaigning and advertising

Use of Integrative, Protective, and Defensive Techniques

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.

Managing Alliances

- Alliance and joint ventures can significantly improve the success of MNC entry and operation, especially in emerging economies
 - Motivating factors
 - Faster entry and payback, economies of scale and rationalization, complementary technologies and patents, and co-opting or blocking competition
 - Preparation for likely eventual termination of alliance
 - Business issues (basic decision to exit, people-related issues, relations with the host government)

Role of Host Government in Alliances

- Alliance or joint-venture partners may be advantageous to MNC entry and expansion
 - Highly regulated industries such as banking, telecommunications, and health care
 - Cope with emerging markets environments characterized by arbitrary and unpredictable corruption
 - May be required by host government
 - Host government may be unwilling to permit alliance to terminate

Review and Discuss

1. What types of political risk would a company entering Russia face?
2. Most firms attempt to quantify their political risk although without specific weights. Why is this approach so popular? Would assignment of weights be useful?
3. How have terrorist attacks affected political relationships between countries such as U.S. and Russia?
4. What are some of the challenges associated with managing alliances? How do host governments affect these?