

C H A P T E R 1 7

*Political Risk
Assessment and
Management*



LEARNING OBJECTIVES

Define and classify foreign political risks

Analyze firm-specific risks

Examine country-specific risks

Identify global-specific risks

This chapter starts by defining political risks by classifying them on three levels: firm-specific, country-specific, or global-specific. The next section examines how an MNE can assess political risk by predicting each of these levels of risk. This is followed by a detailed discussion of firm-specific risks related to corporate governance and goal conflict. Then comes an analysis of one of the two main categories of country-specific risk called transfer risk. The following section describes the other main category of country-specific risk, namely, culture and institutional risks. This chapter ends with an analysis of global-specific risks, such as terrorism and other actions that are worldwide in origin rather than specific to a particular country.

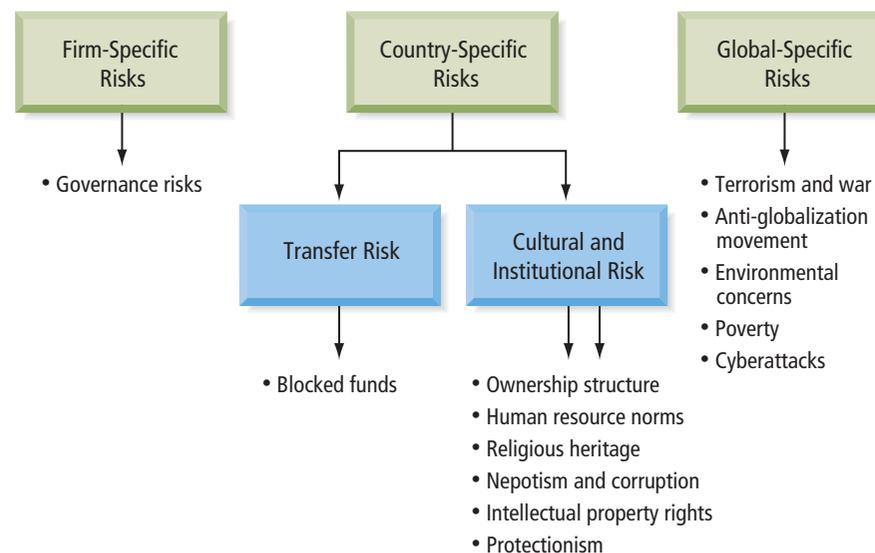
Defining Political Risk

In order for an MNE to identify, measure, and manage its political risks, it needs to define and classify these risks. Exhibit 17.1 classifies the political risks facing MNEs as being firm-specific, country-specific, or global-specific.

- *Firm-specific risks*, also known as *micro risks*, are those political risks that affect the MNE at the project or corporate level. *Governance risk*, due to goal conflict between an MNE and its host government, is the main political firm-specific risk. (An MNE also faces business risks and foreign exchange risks, which are covered extensively in other sections of this book).
- *Country-specific risks*, also known as *macro risks*, are those political risks that also affect the MNE at the project or corporate level but originate at the country level. The two main political risk categories at the country level are *transfer risk* and *cultural and institutional risks*. Transfer risk concerns mainly the problem of blocked funds, but also peripherally sovereign credit risk (covered elsewhere in this book). Cultural and institutional risks spring from ownership structure, human

EXHIBIT 17.1

Classification of Political Risks



resource norms, religious heritage, nepotism and corruption, intellectual property rights, and protectionism.

- *Global-specific risks* are those political risks that affect the MNE at the project or corporate level but originate at the global level. Examples are terrorism, the anti-globalization movement, environmental concerns, poverty, and cyberattacks.

This method of classification differs sharply from the traditional method that classifies risks according to the disciplines of economics, finance, political science, sociology, and law. We prefer our classification system because it is easier to relate the identified political risks to existing and recommended strategies to manage these risks.

Assessing Political Risk

How can multinational firms anticipate government regulations that, from the firm's perspective, are discriminatory or wealth depriving? Normally a twofold approach is utilized.

At the macro level, firms attempt to assess a host country's political stability and attitude toward foreign investors. At the micro level, firms analyze whether their firm-specific activities are likely to conflict with host-country goals as evidenced by existing regulations. The most difficult task, however, is to anticipate changes in host-country goal priorities, new regulations to implement reordered priorities, and the likely impact of such changes on the firm's operations.

PREDICTING FIRM-SPECIFIC RISK (MICRO RISK)

From the viewpoint of a multinational firm, assessing the political stability of a host country is only the first step, since the real objective is to anticipate the effect of political changes on activities of a specific firm. Indeed, different foreign firms operating within the same country may have very different degrees of vulnerability to changes in host-country policy or regulations. One does not expect a Kentucky Fried Chicken franchise to experience the same risk as a Ford manufacturing plant.

The need for firm-specific analyses of political risk has led to a demand for tailor-made studies undertaken in-house by professional political risk analysts. This demand is heightened by the observation that outside professional risk analysts rarely even agree on the degree of macro-political risk that exists in any set of countries.

In-house political risk analysts relate the macro risk attributes of specific countries to the particular characteristics and vulnerabilities of their client firms. Mineral extractive firms, manufacturing firms, multinational banks, private insurance carriers, and worldwide hotel chains are all exposed in fundamentally different ways to politically inspired restrictions. Even with the best possible firm-specific analysis, MNEs cannot be sure that the political or economic situation will not change. Thus it is necessary to plan protective steps in advance to minimize the risk of damage from unanticipated changes.

PREDICTING COUNTRY-SPECIFIC RISK (MACRO RISK)

Macro political risk analysis is still an emerging field of study. Political scientists in academia, industry, and government study country risk for the benefit of multinational firms, government foreign policy decision makers, and defense planners.

Political risk studies usually include an analysis of the historical stability of the country in question, evidence of present turmoil or dissatisfaction, indications of economic stability, and trends in cultural and religious activities. Data are usually assembled by reading local newspapers, monitoring radio and television broadcasts, reading

publications from diplomatic sources, tapping the knowledge of outstanding expert consultants, contacting other business persons who have had recent experience in the host country, and finally conducting on-site visits.

Despite this impressive list of activities, the prediction track record of business firms, the diplomatic service, and the military has been spotty at best. When one analyzes trends, whether in politics or economics, the tendency is to predict an extension of the same trends into the future. It is a rare forecaster who is able to predict a cataclysmic change in direction. Who predicted the overthrow of Ferdinand Marcos in the Philippines? Indeed, who predicted the collapse of communism in the Soviet Union and the Eastern European satellites? Who predicted the fall of President Suharto in Indonesia in 1998, or Saddam Hussein in 2004?

Despite the difficulty of predicting country risk, the MNE must still attempt to do so in order to prepare itself for the unknown. A number of institutional services provide updated country risk ratings on a regular basis. A sample of these rating for selected countries is shown in Exhibit 17.2.

EXHIBIT 17.2

Country Risk Ratings for Selected Countries

Risk Ratings	Indonesia	Finland	Brazil	Russia	Mexico
Currency unit	rupiah	euro	real	ruble	peso
Arrangement	floating	EMU	floating	managed float	floating
S&P Rating	CCC+	AA	B+	SD	BB
Moody's Rating	B3	Aaa	B2	B3	B2
Fitch ICA	B-	AAA	B	CCC	BB
<i>Economist Intelligence Unit:</i>					
Rating	D	B	D	D	C
Score	67	35	62	79	53
<i>Euromoney:</i>					
Rank	88	12	76	161	47
Score	36.4	90.9	41.7	20.9	55.2
<i>Institutional Investor:</i>					
Rank	86	14	65	104	49
Score	27.9	82.2	37.4	20.0	46.0
Trend	Negative	Positive	Negative	Negative	Positive
<i>International Country Risk Guide:</i>					
Political	42.0	90.0	66.0	54.0	69.0
Financial	22.0	39.0	31.5	25.5	31.0
Economic	18.0	45.5	33.0	18.5	35.0
<i>Milken Institute Capital Access Index:</i>					
Score	37.8		61.65	57.81	61.65
Quantitative	56.6		52.38	71.15	52.38
Risk measures	26.3		29.41	43.59	31.25
Qualitative	0.0		36.36	31.03	34.76
<i>Overseas Private Invest Corp.</i>	Yes	No	Yes	Yes	No

Adapted by authors from the sources listed above. All values for March 1999. Each of these institutional services has its own regularly updated publications that were used to prepare this table.

PREDICTING GLOBAL-SPECIFIC RISK

Predicting global-specific risk is even more difficult than predicting the other two types of political risk. Nobody predicted the surprise attacks on the World Trade Center and the Pentagon in the United States on September 11, 2001. On the other hand, the aftermath of this attack — the war on global terrorism, increased U.S. homeland security, and the destruction of part of the terrorist network in Afghanistan — was predictable. Nevertheless, we have come to expect future surprise terrorist attacks. U.S.-based MNEs are particularly exposed to not only al Qaeda but also to other unpredictable groups willing to use terror or mob action to promote such diverse causes as anti-globalization, environmental protection, and even anarchy.

Since there is a great need to predict terrorism, we can expect to see a number of new indices, similar to country-specific indices, but devoted to ranking different types of terrorist threats, their locations, and potential targets.

Firm-Specific Risks

The firm-specific risks which confront MNEs include foreign exchange risks and governance risks. The various business and foreign exchange risks were detailed in Chapters 8, 9, and 10. We focus our discussion here on governance risks.

GOVERNANCE RISKS

As introduced in Chapter 1, *governance risk* is the ability to exercise effective control over an MNE's operations within a country's legal and political environment. For an MNE, however, governance is a subject similar in structure to consolidated profitability — it must be addressed for the individual business unit and subsidiary, as well as for the MNE as a whole.

The most important type of governance risk for the MNE on the subsidiary level arises from a goal conflict between bona fide objectives of host governments and the private firms operating within their spheres of influence. Governments are normally responsive to a constituency of their citizens. Firms are responsive to a constituency of their owners and other stakeholders. The valid needs of these sets of constituents need not be the same, but governments set the rules. Consequently, governments impose constraints on the activities of private firms as part of their normal administrative and legislative functioning.

Historically, conflicts between objectives of MNEs and host governments have arisen over such issues as the firm's impact on economic development, perceived infringement on national sovereignty, foreign control of key industries, sharing or non-sharing of ownership and control with local interests, impact on a host country's balance of payments, influence on the foreign exchange value of its currency, control over export markets, use of domestic versus foreign executives and workers, and exploitation of national resources. Attitudes about conflicts are often colored by views about free enterprise versus state socialism, the degree of nationalism or internationalism present, or the place of religious views in determining appropriate economic and financial behavior.

The best approach to goal conflict management is to anticipate problems and negotiate understandings ahead of time. Different cultures apply different ethics to the question of honoring prior contracts, especially when they were negotiated with a previous administration. Nevertheless, prenegotiation of all conceivable areas of conflict provides a better basis for a successful future for both parties than does overlooking

the possibility that divergent objectives will evolve over time. Prenegotiation often includes negotiating investment agreements, buying investment insurance and guarantees, and designing risk-reducing operating strategies to be used after the foreign investment decision has been made.

NEGOTIATING INVESTMENT AGREEMENTS

An *investment agreement* spells out specific rights and responsibilities of both the foreign firm and the host government. The presence of MNEs is as often sought by development-seeking host governments as a particular foreign location sought by an MNE. All parties have alternatives and so bargaining is appropriate.

An investment agreement should spell out policies on financial and managerial issues, including the following:

- The basis on which fund flows, such as dividends, management fees, royalties, patent fees, and loan repayments, may be remitted
- The basis for setting transfer prices
- The right to export to third-country markets
- Obligations to build, or fund, social and economic overhead projects, such as schools, hospitals, and retirement systems
- Methods of taxation, including the rate, the type, and the means by which the rate base is determined
- Access to host-country capital markets, particularly for long-term borrowing
- Permission for 100% foreign ownership versus required local ownership (joint venture) participation
- Price controls, if any, applicable to sales in the host-country markets
- Requirements for local sourcing versus import of raw materials and components
- Permission to use expatriate managerial and technical personnel, and to bring them and their personal possessions into the country free of exorbitant charges or import duties
- Provision for arbitration of disputes
- Provisions for planned divestment, should such be required, indicating how the going concern will be valued and to whom it will be sold

INVESTMENT INSURANCE AND GUARANTEES: OPIC

MNEs can sometimes transfer political risk to a home-country public agency through an investment insurance and guarantee program. Many developed countries have such programs to protect investments by their nationals in developing countries.

The U.S. investment insurance and guarantee program is managed by the government-owned Overseas Private Investment Corporation (OPIC). OPIC's stated purpose is to mobilize and facilitate the participation of U.S. private capital and skills in the economic and social progress of less developed friendly countries and areas, thereby complementing the developmental assistance of the United States. OPIC offers insurance coverage for four separate types of political risk, which have their own specific definitions for insurance purposes:

- *Inconvertibility* is the risk that the investor will not be able to convert profits, royalties, fees, or other income, as well as the original capital invested, into dollars.

- *Expropriation* is the risk that the host government takes a specific step that for one year prevents the investor or the foreign subsidiary from exercising effective control over use of the property.
- *War, revolution, insurrection, and civil strife* coverage applies primarily to the damage of physical property of the insured, although in some cases inability of a foreign subsidiary to repay a loan because of a war may be covered.
- *Business income* coverage provides compensation for loss of business income resulting from events of political violence that directly cause damage to the assets of a foreign enterprise.

OPERATING STRATEGIES AFTER THE FDI DECISION

Although an investment agreement creates obligations on the part of both foreign investor and host government, conditions change and agreements are often revised in the light of such changes. The changed conditions may be economic, or they may be the result of political changes within the host government. The firm that sticks rigidly to the legal interpretation of its original agreement may well find that the host government first applies pressure in areas not covered by the agreement and then possibly reinterprets the agreement to conform to the political reality of that country. Most MNEs, in their own self-interest, follow a policy of adapting to changing host-country priorities whenever possible.

The essence of such adaptation is anticipating host-country priorities and making the activities of the firm of continued value to the host country. Such an approach assumes the host government acts rationally in seeking its country's self-interest and is based on the idea that the firm should initiate reductions in goal conflict. Future bargaining position can be enhanced by careful consideration of policies in production, logistics, marketing, finance, organization, and personnel.

LOCAL SOURCING. Host governments may require foreign firms to purchase raw material and components locally as a way to maximize value-added benefits and to increase local employment. From the viewpoint of the foreign firm trying to adapt to host-country goals, local sourcing reduces political risk, albeit at a tradeoff with other factors. Local strikes or other turmoil may shut down the operation and such issues as quality control, high local prices because of lack of economies of scale, and unreliable delivery schedules become important. Often the MNE lowers political risk only by increasing its financial and commercial risk.

FACILITY LOCATION. Production facilities may be located so as to minimize risk. The natural location of different stages of production may be resource-oriented, footloose, or market-oriented. Oil, for instance, is drilled in and around the Persian Gulf, Russia, Venezuela, and Indonesia. No choice exists for where this activity takes place. Refining, on the other hand, is footloose: A refining facility can be moved easily to another location or country. Whenever possible, oil companies have built refineries in politically safe countries, such as Western Europe, or small islands (such as Singapore or Curaçao), even though costs might be reduced by refining nearer the oil fields. They have traded reduced political risk and financial exposure for possibly higher transportation and refining costs.

CONTROL OF TRANSPORTATION. Control of transportation has been an important means to reduce political risk. Oil pipelines that cross national frontiers, oil tankers, ore

carriers, refrigerated ships, and railroads have all been controlled at times to influence the bargaining power of nations and companies.

CONTROL OF TECHNOLOGY. Control of key patents and processes is a viable way to reduce political risk. If a host country cannot operate a plant because it does not have technicians capable of running the process, or of keeping up with changed technology, abrogation of an investment agreement with a foreign firm is unlikely. Control of technology works best when the foreign firm is steadily improving its technology.

CONTROL OF MARKETS. Control of markets is a common strategy to enhance a firm's bargaining position. As effective as the OPEC cartel was in raising the price received for crude oil by its member countries in the 1970s, marketing was still controlled by the international oil companies. OPEC's need for the oil companies limited the degree to which its members could dictate terms. In more recent years OPEC members have established some marketing outlets of their own, such as Kuwait's extensive chain of Q8 gas stations in Europe.

Control of export markets for manufactured goods is also a source of leverage in dealings between MNEs and host governments. The MNE would prefer to serve world markets from sources of its own choosing, basing the decision on considerations of production cost, transportation, tariff barriers, political risk exposure, and competition. The selling pattern that maximizes long-run profits from the viewpoint of the worldwide firm rarely maximizes exports, or value added, from the perspective of the host countries. Some will argue that if the same plants were owned by local nationals and were not part of a worldwide integrated system, more goods would be exported by the host country. The contrary argument is that self-contained local firms might never obtain foreign market share because they lack economies of scale on the production side and are unable to market in foreign countries.

BRAND NAME AND TRADEMARK CONTROL. Control of a brand name or trademark can have an effect almost identical to that of controlling technology. It gives the MNE a monopoly on something that may or may not have substantive value but quite likely represents value in the eyes of consumers. Ability to market under a world brand name is valuable for local firms and thus represents an important bargaining attribute for maintaining an investment position.

THIN EQUITY BASE. Foreign subsidiaries can be financed with a thin equity base and a large proportion of local debt. If the debt is borrowed from locally owned banks, host-government actions that weaken the financial viability of the firm also endanger local creditors.

MULTIPLE-SOURCE BORROWING. If the firm must finance with foreign source debt, it may borrow from banks in a number of countries rather than just from home country banks. If, for example, debt is owed to banks in Tokyo, Frankfurt, London, and New York, nationals in a number of foreign countries have a vested interest in keeping the borrowing subsidiary financially strong. If the multinational is U.S.-owned, a fallout between the United States and the host government is less likely to cause the local government to move against the firm if it also owes funds to these other countries.

Country-Specific Risks: Transfer Risk

Country-specific risks affect all firms, domestic and foreign, that are resident in a host country. Exhibit 17.3 presents a taxonomy of most of the contemporary political risks and firm strategies that emanate from a specific country location. The main country-specific political risks are *transfer risk* and *cultural and institutional risks*.

BLOCKED FUNDS

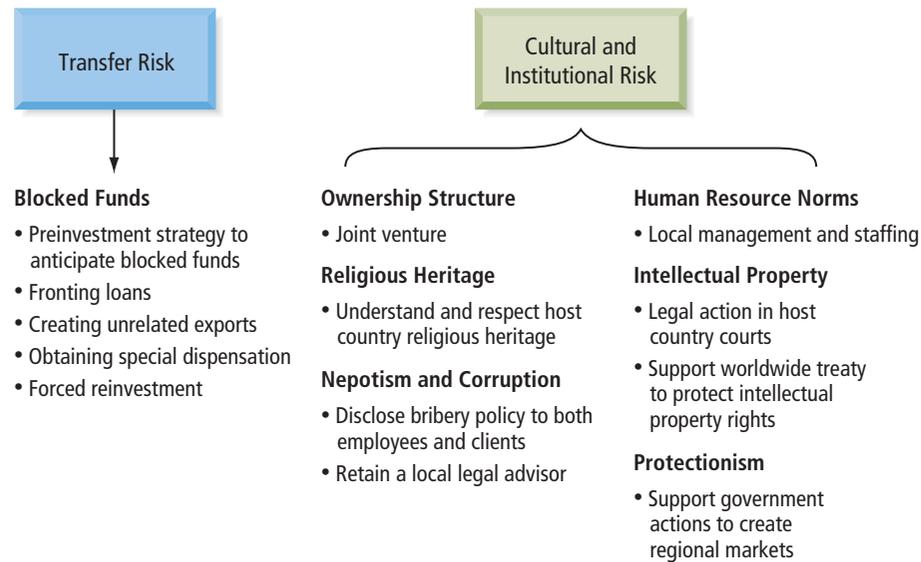
Transfer risk is defined as limitations on the MNE’s ability to transfer funds into and out of a host country without restrictions. When a government runs short of foreign exchange and cannot obtain additional funds through borrowing or attracting new foreign investment, it usually limits transfers of foreign exchange out of the country, a restriction known as *blocked funds*. In theory, this does not discriminate against foreign-owned firms because it applies to everyone; in practice, foreign firms have more at stake because of their foreign ownership. Depending on the size of a foreign exchange shortage, the host government might simply require approval of all transfers of funds abroad, thus reserving the right to set a priority on the use of scarce foreign exchange in favor of necessities rather than luxuries. In very severe cases the government might make its currency nonconvertible into other currencies, thereby fully blocking transfers of funds abroad. In between these positions are policies that restrict the size and timing of dividends, debt amortization, royalties, and service fees.

MNEs can react to the potential for blocked funds at three stages.

1. Prior to making an investment, a firm can analyze the effect of blocked funds on expected return on investment, the desired local financial structure, and optimal links with subsidiaries.

EXHIBIT 17.3

Management Strategies for Country-Specific Risks



2. During operations a firm can attempt to move funds through a variety of repositioning techniques.
3. Funds that cannot be moved must be reinvested in the local country in a manner that avoids deterioration in their real value because of inflation or exchange depreciation.

PREINVESTMENT STRATEGY TO ANTICIPATE BLOCKED FUNDS

Management can consider blocked funds in their capital budgeting analysis. Temporary blockage of funds normally reduces the expected net present value and internal rate of return on a proposed investment. Whether the investment should nevertheless be undertaken depends on whether the expected rate of return, even with blocked funds, exceeds the required rate of return on investments of the same risk class. Preinvestment analysis also includes the potential to minimize the effect of blocked funds by financing with local borrowing instead of parent equity, swap agreements, and other techniques to reduce local currency exposure and thus the need to repatriate funds. Sourcing and sales links with subsidiaries can be predetermined so as to maximize the potential for moving blocked funds.

MOVING BLOCKED FUNDS

What can a multinational firm do to transfer funds out of countries having exchange or remittance restrictions? At least six popular strategies are used:

1. Providing alternative conduits for repatriating funds (analyzed in Chapter 21)
2. Transfer pricing goods and services between related units of the MNE (analyzed in Chapter 20)
3. Leading and lagging payments (described in Chapter 8)
4. Using fronting loans
5. Creating unrelated exports
6. Obtaining special dispensation

FRONTING LOANS. A *fronting loan* is a parent-to-subsidary loan channeled through a financial intermediary, usually a large international bank. Fronting loans differ from parallel or back-to-back loans, discussed in Chapter 9. The latter are offsetting loans between commercial businesses arranged outside the banking system. Fronting loans are sometimes referred to as *link financing*.

In a direct intracompany loan a parent or sister subsidiary loans directly to the borrowing subsidiary, and at a later date the borrowing subsidiary repays the principal and interest. In a fronting loan, by contrast, the “lending” parent or subsidiary deposits funds in, say, a London bank, and that bank loans the same amount to the borrowing subsidiary in the host country. From the London bank’s point of view the loan is risk-free, because the bank has 100% collateral in the form of the parent’s deposit. In effect the bank fronts for the parent — hence the name *fronting loan*. Interest paid by the borrowing subsidiary to the bank is usually slightly higher than the rate paid by the bank to the parent, allowing the bank a margin for expenses and profit.

The bank chosen for the fronting loan is usually in a neutral country, away from both the lender’s and the borrower’s legal jurisdiction. Use of fronting loans increases chances for repayment should political turmoil occur between the home and host

countries. Government authorities are more likely to allow a local subsidiary to repay a loan to a large international bank in a neutral country than to allow the same subsidiary to repay a loan directly to its parent. To stop payment to the international bank would hurt the international credit image of the country, whereas to stop payment to the parent corporation would have minimal impact on that image and might even provide some domestic political advantage.

CREATING UNRELATED EXPORTS. Another approach to blocked funds that benefits both the subsidiary and host country is the creation of unrelated exports. Because the main reason for stringent exchange controls is usually a host country's persistent inability to earn hard currencies, anything an MNE can do to create new exports from the host country helps the situation and provides a potential means to transfer funds out.

Some new exports can often be created from present productive capacity with little or no additional investment, especially if they are in product lines related to existing operations. Other new exports may require reinvestment or new funds, although if the funds reinvested consist of those already blocked, little is lost in the way of opportunity costs.

SPECIAL DISPENSATION. If all else fails and the multinational firm is investing in an industry that is important to the economic development of the host country, the firm may bargain for special dispensation to repatriate some portion of the funds that otherwise would be blocked. Firms in "desirable" industries such as telecommunications, semiconductor manufacturing, instrumentation, pharmaceuticals, or other research and high-technology industries may receive preference over firms in mature industries. The amount of preference received depends on bargaining among the informed parties, the government and the business firm, either of which is free to back away from the proposed investment if unsatisfied with the terms.

SELF-FULFILLING PROPHECIES. In seeking escape routes for blocked funds — or for that matter in trying to position funds through any of the techniques discussed in this chapter — the MNE may increase political risk and cause a change from partial blockage to full blockage. The possibility of such a self-fulfilling cycle exists any time a firm takes action that, no matter how legal, thwarts the underlying intent of politically motivated controls. In the statehouses of the world, as in the editorial offices of the local press and TV, MNEs and their subsidiaries are always a potential scapegoat.

FORCED REINVESTMENT. If funds are indeed blocked from transfer into foreign exchange, they are by definition reinvested. Under such a situation the firm must find local opportunities that will maximize rate of return for a given acceptable level of risk.

If blockage is expected to be temporary, the most obvious alternative is to invest in local money market instruments. Unfortunately, in many countries such instruments are not available in sufficient quantity or with adequate liquidity. In some cases government treasury bills, bank deposits, and other short-term instruments have yields that are kept artificially low relative to local rates of inflation or probable changes in exchange rates. Thus the firm often loses real value during the period of blockage.

If short- or intermediate-term portfolio investments, such as bonds, bank time deposits, or direct loans to other companies, are not possible, investment in additional production facilities may be the only alternative. Often this investment is what the host country is seeking by its exchange controls, even if the existence of exchange controls

is by itself counterproductive to the idea of additional foreign investment. Examples of forced direct reinvestment can be cited for Peru, where an airline invested in hotels and in maintenance facilities for other airlines; for Turkey, where a fish canning company constructed a plant to manufacture cans needed for packing the catch; and for Argentina, where an automobile company integrated vertically by acquiring a transmission manufacturing plant previously owned by a supplier.

If investment opportunities in additional production facilities are not available, funds may simply be used to acquire other assets expected to increase in value with local inflation. Typical purchases might be land, office buildings, or commodities that are exported to global markets. Even inventory stockpiling might be a reasonable investment, given the low opportunity cost of the blocked funds.

Country-Specific Risks: Cultural and Institutional Risks

When investing in some of the emerging markets, MNEs that are resident in the most industrialized countries face serious risks because of cultural and institutional differences. Among many such differences are

- Differences in allowable ownership structures
- Differences in human resource norms
- Differences in religious heritage
- Nepotism and corruption in the host country
- Protection of intellectual property rights
- Protectionism

OWNERSHIP STRUCTURE

Historically, many countries have required that MNEs share ownership of their foreign subsidiaries with local firms or citizens. Thus, joint ventures were the only way an MNE could operate in some host countries. Prominent countries that used to require majority local ownership were Japan, Mexico, China, India, and Korea. This requirement has been eliminated or modified in more recent years by these countries and most others. However, firms in certain industries are still either excluded from ownership completely or must accept being a minority owner. These industries are typically related to national defense, agriculture, banking, or other sectors that are deemed critical for the host nation. Even the United States would not welcome foreign ownership of large key defense-related firms such as Boeing Aircraft.

The risks involved in controlling foreign joint ventures were described in Chapter 16. Potential limitations on an MNE's operating decisions make foreign joint ventures less desirable than wholly-owned foreign subsidiaries, exporting, licensing, contract production, strategic alliances, and other alternative forms of serving foreign markets.

HUMAN RESOURCE NORMS

MNEs are often required by host countries to employ a certain proportion of host country citizens rather than staffing mainly with foreign expatriates. It is often very difficult to fire local employees due to host country labor laws and union contracts. This lack of flexibility to downsize in response to business cycles affects both MNEs and their local competitors. It also qualifies as a country-specific risk.

Cultural differences can also inhibit an MNE's staffing policies. For example, it is somewhat difficult for a woman manager to be accepted by local employees and

managers in many Middle Eastern countries. The most extreme example of discrimination against women has been highlighted in Afghanistan while the Taliban were in power. Since the Taliban's downfall in late 2001, several women have been suggested for important government roles. It is expected that the private sector in Afghanistan will also reintegrate women into the workforce.

RELIGIOUS HERITAGE

The current hostile environment for MNEs in some Middle Eastern countries such as Iran, Iraq, and Syria is being fed by some extremist Muslim clerics who are enraged about the continuing violence in Israel and the occupied Arab territories. However, the root cause of these conflicts is a mixture of religious fervor for some and politics for others. Although it is popular to blame the Muslim religion for its part in fomenting the conflict, a number of Middle Eastern countries, such as Egypt, Saudi Arabia, and Jordan, are relatively passive when it comes to *jihads*. Jihads are calls for Muslims to attack the infidels (Jews and Christians). Osama bin Laden's call for jihad against the United States has not generated any great interest on the part of moderate Muslims. Indeed one Muslim country, Turkey, has had a secular government for many decades. It strongly supported efforts to rid the world of bin Laden.

Despite religious differences, MNEs have operated successfully in emerging markets, especially in extractive and natural resource industries, such as oil, natural gas, minerals, and forest products. The main MNE strategy is to understand and respect the host country's religious traditions.

NEPOTISM AND CORRUPTION

MNEs must deal with endemic nepotism and corruption in a number of important foreign investment locations. Indonesia was famous for nepotism and corruption under the now-deposed Suharto government. Nigeria, Kenya, Uganda, and a number of other African countries had a history of nepotism and corruption after they threw out their colonial governments after World War II. China and Russia have recently launched well-publicized crackdowns on those practices.

Bribery is not limited to emerging markets. It is also a problem in even the most industrialized countries, including the United States and Japan. In fact, the United States has an antibribery law that would imprison any U.S. business executive found guilty of bribing a foreign government official. This law was passed in reaction to an attempt by Lockheed Aircraft to bribe a Japanese Prime Minister.

TI'S CORRUPTION PERCEPTION INDEX. Transparency International (TI) publishes a monthly newsletter on corruption in international business. TI's Corruption Perception Index for 2002 is shown in Exhibit 17.4. This index is based on the level of corruption as perceived by persons working for MNEs and financial institutions. Thus it is an index not of actual corruption, but rather of perceptions. The score is based on an integrity ranking, where 10 equals an entirely clean country and 0 a country in which business transactions are entirely dominated by kickbacks, extortion, bribery, and similar practices. The standard deviation measures the dispersions of opinion.

MANAGING BRIBERY. MNEs are caught in a dilemma. Should they employ bribery if their local competitors use this strategy? Alternative strategies are

- Refuse bribery outright, or else demands will quickly multiply.

EXHIBIT 17.4

Transparency International's Corruption Perception Index, 2002

Country Rank	Country	CPI 2002 score	Standard deviation	Country Rank	Country	CPI 2002 score	Standard deviation
1	Finland	9.7	0.4	52	Czech Republic	3.7	0.8
2	Denmark	9.5	0.3		Latvia	3.7	0.2
	New Zealand	9.5	0.2		Morocco	3.7	1.8
4	Iceland	9.4	0.4		Slovak Republic	3.7	0.6
5	Singapore	9.3	0.2		Sri Lanka	3.7	0.4
	Sweden	9.3	0.2	57	Colombia	3.6	0.7
7	Canada	9.0	0.2		Mexico	3.6	0.6
	Luxembourg	9.0	0.5	59	China	3.5	1.0
	Netherlands	9.0	0.3		Dominican Rep.	3.5	0.4
10	United Kingdom	8.7	0.5		Ethiopia	3.5	0.5
11	Australia	8.6	1.0	62	Egypt	3.4	1.3
12	Norway	8.5	0.9		El Salvador	3.4	0.8
	Switzerland	8.5	0.9	64	Thailand	3.2	0.7
14	Hong Kong	8.2	0.8		Turkey	3.2	0.9
15	Austria	7.8	0.5	66	Senegal	3.1	1.7
16	USA	7.7	0.8	67	Panama	3.0	0.8
17	Chile	7.5	0.9	68	Malawi	2.9	0.9
18	Germany	7.3	1.0		Uzbekistan	2.9	1.0
	Israel	7.3	0.9	70	Argentina	2.8	0.6
20	Belgium	7.1	0.9	71	Cote d'Ivoire	2.7	0.8
	Japan	7.1	0.9		Honduras	2.7	0.6
	Spain	7.1	1.0		India	2.7	0.4
23	Ireland	6.9	0.9		Russia	2.7	1.0
24	Botswana	6.4	1.5		Tanzania	2.7	0.7
25	France	6.3	0.9		Zimbabwe	2.7	0.5
	Portugal	6.3	1.0	77	Pakistan	2.6	1.2
27	Slovenia	6.0	1.4		Philippines	2.6	0.6
28	Namibia	5.7	2.2		Romania	2.6	0.8
29	Estonia	5.6	0.6		Zambia	2.6	0.5
	Taiwan	5.6	0.8	81	Albania	2.5	0.8
31	Italy	5.2	1.1		Guatemala	2.5	0.6
32	Uruguay	5.1	0.7		Nicaragua	2.5	0.7
33	Hungary	4.9	0.5		Venezuela	2.5	0.5
	Malaysia	4.9	0.6	85	Georgia	2.4	0.7
	Trinidad & Tobago	4.9	1.5		Ukraine	2.4	0.7
36	Belarus	4.8	1.3		Vietnam	2.4	0.8
	Lithuania	4.8	1.9	88	Kazakhstan	2.3	1.1
	South Africa	4.8	0.5	89	Bolivia	2.2	0.4
	Tunisia	4.8	0.8		Cameroon	2.2	0.7
40	Costa Rica	4.5	0.9		Ecuador	2.2	0.3
	Jordan	4.5	0.7		Haiti	2.2	1.7
	Mauritius	4.5	0.8	93	Moldova	2.1	0.6
	South Korea	4.5	1.3		Uganda	2.1	0.3
44	Greece	4.2	0.7	95	Azerbaijan	2.0	0.3
45	Brazil	4.0	0.4	96	Indonesia	1.9	0.6
	Bulgaria	4.0	0.9		Kenya	1.9	0.3
	Jamaica	4.0	0.4	98	Angola	1.7	0.2
	Peru	4.0	0.6		Madagascar	1.7	0.7
	Poland	4.0	1.1		Paraguay	1.7	0.2
50	Ghana	3.9	1.4	101	Nigeria	1.6	0.6
51	Croatia	3.8	0.2	102	Bangladesh	1.2	0.7

Source: Transparency International, <http://www.transparency.org/cpi/2002/cpi2002.en.html> © 2002 Transparency International. Reprinted with permission.

- Retain a local advisor to diffuse demands by local officials, customs agents, and other business partners.
- Do not count on the justice system in many emerging markets, because Western-oriented contract law may not agree with local norms.
- Educate both management and local employees about whatever bribery policy the firm intends to follow.

INTELLECTUAL PROPERTY RIGHTS

Rogue businesses in some host countries have historically infringed on the *intellectual property rights* of both MNEs and individuals. *Intellectual property rights* grant the exclusive use of patented technology and copyrighted creative materials. Examples of patented technology are unique manufactured products, processing techniques, and prescription pharmaceutical drugs. Examples of copyrighted creative materials are software programs, educational materials (textbooks), and entertainment products (music, film, art).

MNEs and individuals need to protect their intellectual property rights through the legal process. However, courts in some countries have historically not done a fair job of protecting intellectual property rights of anyone, much less of foreign MNEs. In those countries the legal process is costly and subject to bribery.

The agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) to protect intellectual property rights has recently been ratified by most major countries. China signed the treaty as one of the conditions it needed to meet to join the World Trade Organization (WTO) in 2001. It remains to be seen whether host governments are strong enough to enforce their official efforts to stamp out intellectual piracy. Complicating this task is the thin line that exists between the real item being protected and look-alikes or generic versions of the same item.

PROTECTIONISM

Protectionism is defined as the attempt by a national government to protect certain of its designated industries from foreign competition. Industries that are protected are usually related to defense, agriculture, and “infant” industries.

DEFENSE. Even though the United States is a vocal proponent of open markets, a foreign firm proposing to buy Lockheed Missile Division or other critical defense suppliers would not be welcome. The same attitude exists in many other countries, such as France, which has always wanted to maintain an independent defense capability.

AGRICULTURE. Agriculture is another sensitive industry. No MNE would be foolish enough as to attempt to buy agricultural properties, such as rice operations, in Japan. Japan has desperately tried to maintain an independent ability to feed its population. Agriculture is the “Mother Earth” industry that most countries want to protect for their own citizens.

INFANT INDUSTRIES. The traditional protectionist argument is that newly emerging industries need protection from foreign competition until they can get firmly established. The infant industry argument is usually directed at limiting imports but not necessarily MNEs. In fact most host countries encourage MNEs to establish operations in industries that do not presently exist in the host country. Sometimes the host country offers foreign MNEs infant-industry status for a limited number of years. This status could lead to tax subsidies, construction of infrastructure, employee training, and

other aids to help the MNE get started. Host countries are especially interested in attracting MNEs that promise to export, either to their own foreign subsidiaries elsewhere or to unrelated parties.

TARIFF BARRIERS. The traditional methods for countries to implement protectionist barriers were through tariff and nontariff regulations. Negotiations under the General Agreements on Tariffs and Trade (GATT) have greatly reduced the general level of tariffs over the past decades. This process continues today under the auspices of the WTO. However, many nontariff barriers remain.

NON-TARIFF BARRIERS. Nontariff barriers, which restrict imports by something other than a financial cost, are often difficult to identify because they are promulgated as health, safety, or sanitation requirements. A list of the major types of nontariff barriers would include those shown in Exhibit 17.5.

STRATEGIES TO MANAGE PROTECTIONISM. MNEs have only a very limited ability to overcome host country protectionism. However, MNEs do enthusiastically support efforts to reduce protectionism by joining together in regional markets. The best examples of regional markets are the European Union (EU), the North American Free Trade Association (NAFTA), and the Latin American Free Trade Association (MERCOSUR). Among the objectives of regional markets are elimination of internal trade barriers, such as tariffs and nontariff barriers, as well as the free movement of citizens for employment purposes. External trade barriers still exist.

The EU is trying to become a “United States of Europe,” with a single internal market without barriers. It is not quite there, although the European Monetary Union and the euro have almost eliminated monetary policy differences. The EU still tolerates differences in fiscal policies, legal systems, and cultural identities. In any case, the movement toward regional markets is very favorable for MNEs serving those markets with foreign subsidiaries.

ENRON INTERNATIONAL

Enron was introduced in Chapter 1 as the poster boy of failed corporate governance. However, country-specific risks also played a role in Enron’s eventual demise. A particular problem was its overly aggressive direct investment activities in emerging markets. *Real World Example 17.1* illustrates some of Enron International’s problems.

EXHIBIT 17.5

Types of Non-Tariff Barriers

1. Specific limitations on trade, which either limit the amount of imports directly or establish import procedures that make importing more difficult
2. Customs and administrative entry procedures, which include inconsistent procedures for valuation, classification, of documents, or assessing fees
3. Unduly stringent or discriminating standards imposed in the name of protecting health, safety, and quality
4. Governmental participation in trade
5. Charges on imports
6. Other nontariff barriers

Source: Adapted from material in A. D. Cao, “Non-Tariff Barriers to U.S. Manufactured Exports,” *Columbia Journal of World Business*, Summer 1980, pp. 93–102.



Real World Example 17.1

ENRON INTERNATIONAL IN INDIA

Enron International, first under John Wing and later under Rebecca Mark, signed and sealed new power and pipeline projects at a breakneck pace. The difference was that by the time Enron International grew to size and influence in the mid-1990s under Rebecca Mark, projects recognized earnings up front using the same mark-to-market accounting as employed in the trading businesses. These projects committed Enron's capital resources for years to come, and in many cases, locked in cash flow shortfalls for as many years as well. In the rush to sign and deliver deals, inadequate due diligence became common, overly aggressive bidding promised unprofitable margins, and a growing disdain for the costs and complexity of project execution characterized deals. Deals were done at the expense of delivery.

Enron Development would often sign and book deals which later proved to be dead in the water. Accounting rules required that projects which were no longer in progress be written down in current earnings. Enron Development fought these write-offs at every turn. Rich Kinder had instructed the unit that these unrecognized losses, called "snowballs" within Enron, be kept below \$90 million in total. In early 1996, however, they soared to over \$200 million.

The Dabhol, India project was a microcosm of Enron's business model. In December 1993, after roughly 18 months of negotiations, Enron Development signed a long-term power sales contract with the electricity board of Maharashtra, India (MSEB). Enron would build a 2,000-megawatt natural gas-fueled power plant at an estimated cost of \$2.8 billion. The Maharashtra energy board

agreed to buy 90% of the power produced by the plant at a U.S. dollar-denominated price for a minimum of 20 years. From the very beginning, problems mounted. It took Rebecca Mark more than two years and millions of dollars in negotiations, court cases, and contract restructurings to get the financing in place. Within months a change in the Maharashtra government resulted in an outpouring of project opposition. Once again, Mark went into overdrive for months of negotiations and renegotiations. Finally, on February 23, 1996, a new contract was signed between Enron and the MSEB. By December financing was in place and the project's construction resumed. But opposition continued, and it became clear that the MSEB would never be willing or able to pay for the power (estimated at over \$30 billion for the project life).

The project was dead. In the words of one Wall Street analyst on Enron's India activities, "I've never been to another country where every single person hates one company." Phase I of the project was operational for only a short period of time, and Phase II (as of December 2003) is still only 80% complete. The Dabhol power plant today is considered a failure for everyone involved but Rebecca Mark. Mark earned bonuses for both the original deal and the successful renegotiation. In 1996 Enron International generated 15% of Enron's total earnings, and was expected to grow at double-digit rates for years to come. Rebecca Mark was named CEO of Enron International. Many people believed that Rebecca Mark would be Enron's next CEO, but she left in 2000, selling here 1.4 million shares for \$79.5 million.

Global-Specific Risks

Global-specific risks faced by MNEs have come to the forefront in recent years. Exhibit 17.6 summarizes some of these risks and the strategies that can be used to manage them. The most visible recent risk was, of course, the attack by terrorists on the twin towers of the World Trade Center in New York on September 11, 2001. Many MNEs had major operations in the World Trade Center and suffered heavy casualties among their employees. In addition to terrorism, other global-specific risks include the anti-globalization movement, environmental concerns, poverty in emerging markets, and cyberattacks on computer information systems.

TERRORISM AND WAR

Although the World Trade Center attack and its aftermath, the war in Afghanistan and Iraq, have affected nearly everyone in the world, many other acts of terrorism have been committed in recent years. More terrorist acts are expected to occur in the future.

EXHIBIT 17.6Management
Strategies for
Global-Specific
Risks**Terrorism and War**

- Support government efforts to fight terrorism and war
- Crisis planning
- Cross-border supply chain integration

Poverty

- Provide stable, relatively well-paying jobs
- Establish the strictest of occupational safety standards

Anti-Globalization

- Support government efforts to reduce trade barriers
- Recognize that MNEs are the targets

Cyberattacks

- No effective strategy except Internet security efforts
- Support government anti-cyberattack efforts

Environmental Concerns

- Show sensitivity to environmental concerns
- Support government efforts to maintain a level playing field for pollution controls

*MNE movement toward multiple primary objectives:
Profitability, Sustainable Development, Corporate Social Responsibility*

Particularly exposed are the foreign subsidiaries of MNEs and their employees. As mentioned earlier, foreign subsidiaries are especially exposed to war, ethnic strife, and terrorism because they are symbols of their respective parent countries.

No MNE has the tools to avert terrorism. Hedging, diversification, insurance, and the likes are not suited to the task. Therefore, MNEs must depend on governments to fight terrorism and protect their foreign subsidiaries (and now even the parent firm). In return, governments expect financial, material, and verbal support from MNEs to support antiterrorist legislation and proactive initiatives to destroy terrorist cells wherever they exist.

CRISIS PLANNING

MNEs can be subject to damage by being in harm's way. Nearly every year one or more host countries experience some form of ethnic strife, outright war with other countries, or terrorism. It seems that foreign MNEs are often singled out as symbols of oppression because they represent their parent country, especially if it is the United States.

Resolving war and ethnic strife is beyond the ability of MNEs. Instead, they need to take defensive steps to limit the damage. *Crisis planning* has become a major activity for MNEs at both the foreign subsidiary and parent firm levels. Crisis planning means educating management and other employees about how to react to various scenarios of violence. For example, MNE units must know how to stay in communication with each other; how to protect the MNE's property; how to escape the country; and how to protect themselves by maintaining a low profile.

CROSS-BORDER SUPPLY CHAIN INTEGRATION

The drive to increase efficiency in manufacturing has driven many MNEs to adopt just-in-time (JIT) near-zero inventory systems. Focusing on *inventory velocity*, the speed at which inventory moves through a manufacturing process, arriving only as needed and

not before, has allowed these MNEs to generate increasing profits and cash flows with less capital being bottled-up in the production cycle. This finely tuned supply chain system, however, is subject to significant political risk if the supply chain extends across borders.

SUPPLY CHAIN INTERRUPTIONS. Consider the cases of Dell Computer, Ford Motor Company, Dairy Queen, Apple Computer, Herman Miller, and The Limited in the days following the terrorist attacks of September 11, 2001. An immediate result was the grounding of all aircraft into or out of the United States. Similarly, the land (Mexico and Canada) and sea borders of the United States were also shut down and not reopened for several days in some specific sites. Ford Motor Company shut down five of its manufacturing plants in the days following September 11 because of inadequate inventories of critical automotive inputs supplied from Canada. Dairy Queen experienced such significant delays in key confectionary ingredients many of its stores were also temporarily closed.

Dell Computer, with one of the most highly acclaimed and admired virtually integrated supply chains, depends on computer parts and subassembly suppliers and manufacturers in Mexico and Canada to fulfill its everyday assembly and sales needs. In recent years Dell has carried less than three full days sales of total inventory — by cost-of-goods value. Suppliers are integrated electronically with Dell's order fulfillment system, and they deliver required components and subassemblies as sales demands require. But with the closure of borders and grounding of air freight, the company was brought to a near standstill because of its supply chain's reliance on the ability to treat business units and suppliers in different countries as if they were all part of a single seamless political unit.

As a result of these newly learned lessons, many MNEs are now evaluating the degree of exposure their supply chains possess in regard to cross-border stoppages or other cross-border political events. These companies are not, however, about to abandon JIT. It is estimated that U.S. companies alone have saved more than \$1 billion a year in inventory carrying costs by using JIT methods over the past decade. This substantial benefit is now being weighed against the costs and risks associated with the post-September 11 supply chain interruptions.

To avoid suffering a similar fate in the future, manufacturers, retailers, and suppliers are now employing a range of tactics:

- **Inventory management.** Manufacturers and assemblers are considering carrying more buffer inventory in order to hedge against supply and production-line disruptions. Retailers, meanwhile, should think about the timing and frequency of their replenishment. Rather than stocking up across the board, companies are focusing on the most critical parts to the product or service, and on those components that are uniquely available only from international sources.
- **Sourcing.** Manufacturers are now being more selective about where the critical inputs to their products come from. Although sourcing strategies will have to vary by location, firms are attempting to work more closely with existing suppliers to minimize cross-border exposures and reduce the potential costs with future stoppages.
- **Transportation.** Retailers and manufacturers alike are reassessing their cross-border shipping arrangements. For example, many inputs that currently are carried by passenger flights may be precluded from cohabitation on these flights in the

future. Although the mode of transportation employed is a function of value, volume, and weight, many firms are now reassessing whether higher costs for faster shipment balance out the more tenuous their delivery under airline stoppages from either labor, terrorist, or even bankruptcy disruptions in the future.

Real World Example 17.2 illustrates how many of the security policies adopted by the U.S. government also have an impact on the efficiency of supply chain management.

ANTI-GLOBALIZATION MOVEMENT

During the past decade there has been a growing negative reaction by some groups to reduced trade barriers and efforts to create regional markets, particularly to NAFTA and the European Union. NAFTA has been vigorously opposed by those sectors of the labor movement that could lose jobs to Mexico. Opposition within the European Union centers on loss of cultural identity, dilution of individual national control as new members are admitted, overcentralization of power in a large bureaucracy in Brussels, and most recently the disappearance of individual national currencies in mid-2002, when the euro became the only currency in 12 of the 15 member nations.

The anti-globalization movement has become more visible following riots in Seattle during the 2001 annual meeting of the World Trade Organization. Anti-globalization forces were not solely responsible for these riots, or for subsequent riots in Quebec and Prague in 2001. Other disaffected groups, such as environmentalists and even anarchists, joined in to make their causes more visible.

MNEs do not have the tools to combat anti-globalism. Indeed, they are blamed for fostering the problem in the first place. Once again, MNEs must rely on governments and crisis planning to manage these risks.



Real World Example 17.2

INTERNATIONAL SUPPLY CHAIN SECURITY: TIME IS MONEY

Many new and evolving border security laws and guidelines will have a hand in slowing import processing times at the U.S. border. To protect businesses from these events, U.S. importers must navigate through a variety of new security initiatives, including the following:

- C-TPAT** **The Custom-Trade Partnership Against Terrorism.** A U.S. Customs program designed to encourage companies across the supply chain to voluntarily self-assess and strengthen security practices to protect the United States against the risk of terrorist activity via product and conveyance tampering on import shipments.
- CSI** **Container Security Initiative.** A U.S. Customs program focusing on securing ocean-going containers by engaging the authorities of certain foreign ports shipping the highest volumes of container traffic into the United States in a way that will facilitate early detection of potential security problems.
- FAST** **Free and Secure Trade.** A joint U.S.-Canada program designed to expedite customs clearance of goods moving across the northern border through specially designated FAST lanes for qualified goods by qualified shippers.
- CIP** **Carrier Initiative Program.** A voluntary U.S. Customs and carrier program designed to prevent smuggling of narcotics on air, sea, and land commercial conveyances.
- BASC** **Business Anti-Smuggling Coalition.** A business-led initiative designed to complement the CIP program by combating contraband smuggling via commercial trade and eliminate the contamination of legitimate business shipments by criminal hands.

Source: Adapted from "The New Era of International Supply Chain Security," *World Trade*, November 2002, pp. 56–57. Used with permission.

ENVIRONMENTAL CONCERNS

MNEs have been accused of exporting their environmental problems to other countries. The accusation is that MNEs frustrated by pollution controls in their home country have relocated these activities to countries with weaker pollution controls. Another accusation is that MNEs contribute to the problem of global warming. However, that accusation applies to all firms in all countries. It is based on the manufacturing methods employed by specific industries and on consumers' desire for certain products such as large automobiles and sport vehicles that are not fuel efficient.

Once again, solving environmental problems is dependent on governments passing legislation and implementing pollution control standards. In 2001, the Kyoto Treaty, which attempted to reduce global warming, was ratified by most nations, with the notable exception of the United States. However, the United States has promised to combat global warming using its own strategies. The United States objected to provisions in the worldwide treaty that allowed emerging nations to follow less restrictive standards, while the economic burden would fall on the most industrialized countries, particularly the United States.

POVERTY

MNEs have located foreign subsidiaries in countries plagued by extremely uneven income distribution. At one end is an elite class of well-educated, well-connected, and productive persons. At the other end of the spectrum is a very large class of persons living at or below the poverty level. They lack education, social and economic infrastructure, and political power.

MNEs might be contributing to this disparity by employing the elite class to manage their operations. On the other hand, MNEs are creating relatively stable and well-paying jobs for those who were otherwise unemployed and living below the poverty level. Despite being accused of supporting sweatshop conditions, MNEs usually compare favorably to their local competitors. For example, Nike, one of the targeted MNEs, usually pays better, provides more fringe benefits, maintains higher safety standards, and educates their workforce to allow personnel to advance up the career ladder. Of course, Nike cannot manage a country's poverty problems overall, but it can improve conditions for some persons.

CYBERATTACKS

The rapid growth of the Internet has fostered a whole new generation of scam artists and cranks that disrupt the usefulness of the World Wide Web. This is both a domestic and an international problem. MNEs can face costly cyberattacks because of their visibility and the complexity of their internal information systems.

At this point in time, we know of no uniquely international strategies that MNEs can use to combat cyberattacks. MNEs are using the same strategies to manage foreign cyberattacks as they use for domestic attacks. Once again, they must rely on governments to control cyberattacks.

GOVERNANCE, RIGHTS, AND THE FUTURE

The first years of the twenty-first century have seen a rebirth in society's reflections on business. One of the most audible debates has been that regarding sustainable development, the principle that economic development today should not compromise the ability of future generations to achieve and enjoy similar standards of living. Although sustainable development initially focused on environmental concerns, it has evolved to

include equal concerns which “incorporate the ambition for a just and caring society.”¹ Although these debates have typically remained within areas of economic development, the debate in business circles has centered on corporate social responsibility. *Real World Example 17.3* illustrates corporate social responsibility in practice. The mini-case below describes how Starbucks Coffee manages its social responsibility in practice.



Real World Example 17.3

CORPORATE SUSTAINABILITY

Recent reports from the Danish pharmaceuticals group Novo Nordisk and Carrefour, the French food retailer, demonstrate the potentially wide practical impact of a company’s commitment to sustainability.

Novo Nordisk (*Reporting on the Triple Bottom Line 2001*) identifies a wide range of indicators that measure its impact on the environment, people, and societies. Examples of areas covered include animal welfare, water and energy use efficiency, and compliance with regulatory limits. The report stresses the need to involve and educate employees; work internationally; define targets and report annually; balance financial, environmental, social, and health policies in the

business decision processes; and conduct dialogue and partnerships with stakeholders.

The operational impact at Carrefour (*Sustainability Report 2001*) involves everything from fostering fair trade — the report cites 54 tons of Carrefour organic coffee sold in France last year that was bought in Mexico for 30 percent more than the market price — to reducing atmospheric emissions from cold storage units and a commitment to eliminate genetically modified organisms from animal feed in the company’s product lines.

Source: Excerpted from “Measuring the Impact of a New Approach,” *Financial Times*, Monday August 19, 2002, p. 5.
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MINI-CASE

Globalization and Starbucks Coffee²

Starbucks defines corporate social responsibility as conducting our business in ways that produce social, environmental and economic benefits to the communities in which we operate. In the end, it means being responsible to our stakeholders.

There is growing recognition of the need for corporate accountability. Consumers are demanding more than “product” from their favorite brands. Employees are choosing to work for companies with strong values. Shareholders are more inclined to invest in businesses with outstanding corporate reputations. Quite simply, being socially responsible is not only the right thing to do; it can distinguish a company from its industry peers.

Corporate Social Responsibility Annual Report
Starbucks Coffee, Fiscal 2001, p. 3.

Starbucks found itself, somewhat to its surprise, an early target of the anti-globalism movement. Like McDonald’s

before it, it appeared to be yet another American cultural imperialist, bringing a chain-store sameness to all countries everywhere. Like McDonald’s, Starbucks found that its uniquely defined brand and experience did not have to conform to local cultural norms, but could exist alongside traditional practices, creating its own market and successfully altering some consumer behaviors.

Unlike McDonald’s, however, Starbucks was the purveyor of a commodity, coffee, that was priced and sold on global markets. Coffee was sourced from hundreds of thousands of small growers in Central and South America, many of whom were severely impoverished by all global income and purchasing power standards. As coffee prices plummeted in the late 1990s, companies like Starbucks were criticized for benefitting from lower cost sourcing and for their unwillingness to help improve the economic conditions of the coffee growers.

¹Dickson, Tim, “The Financial Case for Behaving Responsibly,” *Financial Times*, August 19, 2002, p. 5.

²This illustrative case is adapted from “Planet Starbucks (A)” by Professors Michael H. Moffett and Kannan Ramaswamy, Thunderbird Case Series, A06-02-0000, 2003. Copyright © 2003 Thunderbird — The Garvin School of International Management. All Rights Reserved.

Procurement

Coffee was traditionally bought and sold using *market pricing*, which means buying from wholesalers at a global market price — the so-called New York C. Since Starbucks purchased only arabica bean premium grade coffee, *green coffee*, it always paid a premium above New York C. Both New York C prices and the premium, however, moved up and down with global market conditions. Traditional robusta bean purchases by mass-market labels were made on the wholesale markets through brokers and buyers.

Starbucks, however, preferred to purchase using *outright pricing*, in which the price was negotiated directly with owners of small and medium-sized farms, cutting out the segment of the supply chain which the wholesalers (called *coyotes* in Central and South America) usually occupied. In principle, a greater proportion of the price went directly to the producers, assuring a higher return to the small farmer. In addition to the pricing structure, Starbucks was also attempting to break from traditional market practices of always buying in the cash market. The company was moving aggressively to purchase more and more of its coffee under long-term contract guaranteeing prices to growers over multiple crop years.

Coffee Prices

The single biggest problem was the price of coffee itself. As illustrated by Exhibit 1, the global price of arabica coffee had been extremely volatile over the previous 20 years. In fact, arabica beans had been as high as \$1.50/lb (annual average, they had been significantly higher on a daily and weekly basis) as recently as 1994. The price in recent years had plummeted, as more and more coffee production came on to the market, creating a substantial excess supply. This

was an obvious benefit to coffee consumers, including Starbucks. The growers, however, most of whom had small farms of 7 hectares or less, were now receiving prices nearly 40 cents/lb, when average production costs were 77 cents/lb. Although this was not the fault or responsibility of Starbucks (it was estimated to use less than 1% of the world’s annual coffee crop), the company was criticized for paying less than a living wage to its growers.

By 2001 Starbucks had implemented a multitude of programs to pursue its program for corporate social responsibility (CSR) and pursue sustainable economic development for the people in its supply chain. Not wishing to own the supply chain, Starbucks arrived at a strategy that was a complex combination of altered business practices in procurement, direct support to the coffee growers, and the formation of brands that would provide conduits for consumers wishing to support CSR initiatives. Exhibit 2 provides a brief overview of some of these programs.

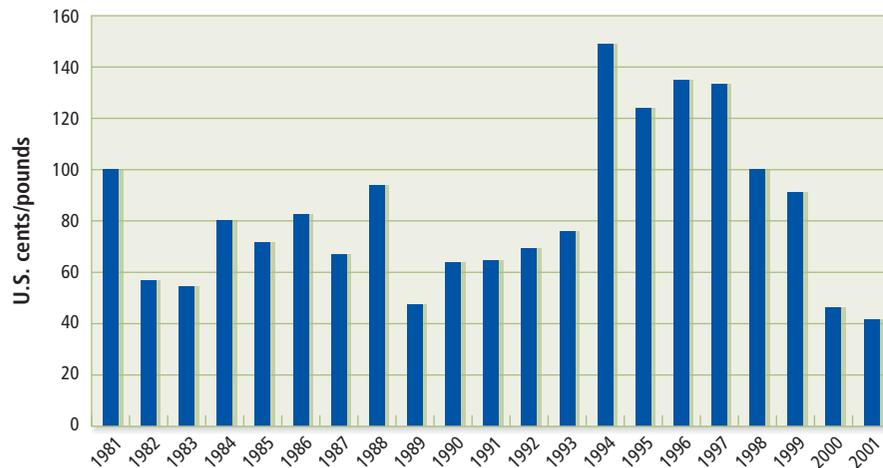
Conduit Brand Development

Much of the growing pressure on all multinational companies for sustainable development and social responsibility arose directly from consumer segments. In an effort to provide a direct conduit for these consumer demands, Starbucks had initiated a company program called *Commitment to Origins* “dedicated to creating a sustainable growing environment in coffee originating countries.” Under the program Starbucks had introduced Shade Grown Mexico coffee and Fair Trade Certified coffee.

Shade Grown Mexico coffee was introduced in 1998 in partnership with Conservation International (CI), a non-profit environmental organization. Coffee purchased by Starbucks from CI’s Conservation Coffee Program was

EXHIBIT 1

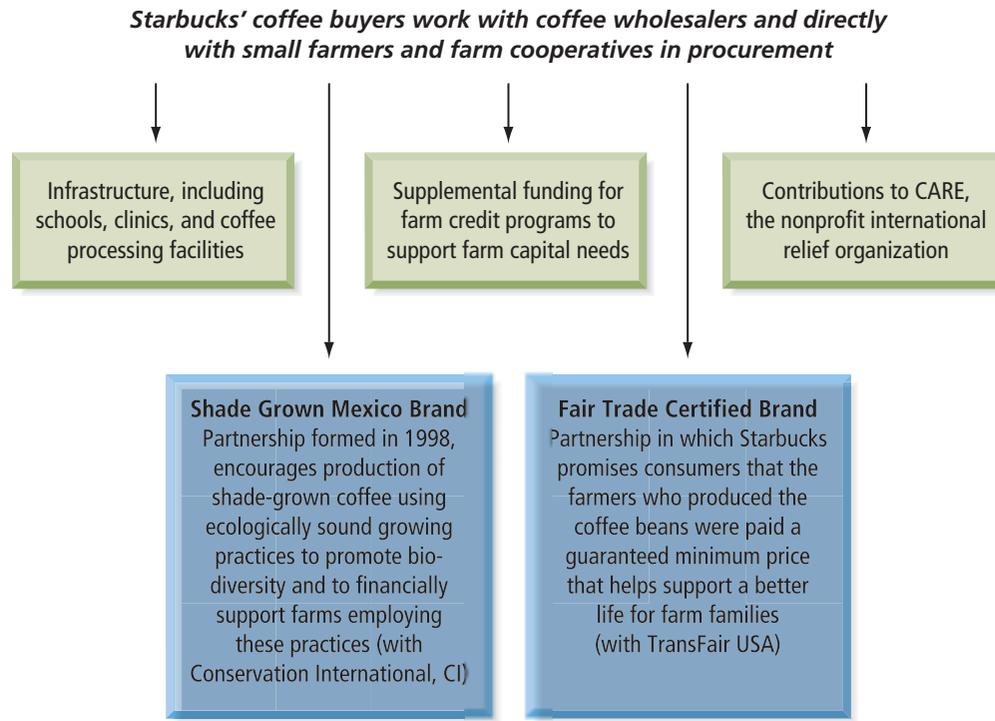
Arabica Bean Coffee Prices, 1981–2001



Source: International Coffee Organization (ICO), www.ico.org.

EXHIBIT 2

Starbucks' CSR Programs
Focusing on
Coffee Growers



cultivated under the canopy of shade trees in origin countries. This practice was considered ecologically sound and helped support bio-diversity. Shade Grown Mexico coffee purchases had grown from 304,000 pounds in 2000 to an estimated 1.5 million pounds in 2002.³ Shade Grown Mexico coffee had been selectively introduced in Starbucks stores in North America and through online sales at starbucks.com.

Beginning in 2000, Starbucks began working with TransFair USA, a nonprofit organization which provided independent certification for all Fair Trade coffee in the United States.⁴

The concept of Fair Trade addressed the question of the just distribution of the burdens and benefits of trade. The Fair Trade movement argues that when most of the customers' purchasing dollar goes to the retailer, the marketer, the wholesaler, and the speculator and very little goes to the laborer or the farmer, something is wrong with the mutual benefits of the exchanges, particularly when those who provide the product have earnings that do not even cover subsistence costs.⁵

Although Starbucks had introduced *Fair Trade* coffee in North American stores, and promoted it through various

³Starbucks' commitment to CI was established on an annual basis. Starbucks had renewed its partnership in 2000 for a three-year period, agreeing to purchase at least 200,000 pounds of shade grown coffee annually. Starbucks has also noted that growers of Shade Grown Mexico coffee received price premiums of 60% over local coffee prices in fiscal 2001.

⁴TransFair USA is associated with Equal Exchange, a Fair Trade organization promoting socially responsible business practices with coffee growers in Central and Latin America.

⁵John Kohls and Sandra L. Christensen, "The Business Responsibility for Wealth Distribution in a Globalized Political-Economy: Merging Moral Economics and Catholic Social Teaching," *Journal of Business Ethics*, February 2002, p. 12.

brochures and promotions (“Coffee of the Day” monthly), it continued to be heavily criticized for not expanding the program faster. In October 2001 the company expanded its commitments, agreeing to purchase at least one million pounds of Fair Trade certified coffee, meeting its quality requirements in the following 12 to 18 months.

Both of these product brand programs allowed consumers wishing to support these sustainable development initiatives to express their interest through purchasing. But Fair Trade certified coffee was higher cost, by definition, and that cost premium was reflected in the retail price.⁶ Both Fair Trade and Shade Grown Mexico coffees were 20% to 25% more expensive compared to Starbucks’ traditional blends (whole bean coffee sales).

Starbucks was a regular and growing giver, supporting relief organizations such as CARE, the nonprofit international relief organization, as well as providing direct support to farmers and farm communities around the world.⁷ For

example, Starbucks had contributed \$43,000 in 2001 to the construction of a health clinic and school in Guatemala and a health clinic in East Timor. The company was also providing aid in a variety of ways to the improvement of coffee processing facilities in a number of the countries of origin.

The anti-globalization movement continued to focus much of its efforts on Starbucks. Plummeting coffee prices on world markets in 2001 and 2002 had led to more and more pressure on Starbucks to increase the prices it paid to growers. Starbucks chairman Howard Shultz became the increasing target of mail, fax, and e-mail campaigns to pressure Starbucks into more proactive policies for grower income support (see Exhibit 3). Although Starbucks had actively pursued a number of corporate social responsibility initiatives, it was accused of polishing its image more than truly working to improve the lives of those its existence depended on, the coffee growers.

EXHIBIT 3

Cyberattack: The Starbucks Campaign

Participate in the Organic Consumers Association “Global Week of Action Against Starbucks,” September 21–28.

In October 2001, Starbucks made a commitment to buy 1 million more pounds of Fair Trade coffee and brew Fair Trade coffee once a month. Don’t let Starbucks stop there — Send a Free Fax to demand that Starbucks brew Fair Trade Coffee of the Day EVERY WEEK!

The coffee industry is in crisis. Coffee prices are at an all-time low, remaining below \$.50 since August with no increase in sight. This means that farmers are becoming even more impoverished, going further into debt and losing their land. Meanwhile coffee companies such as Starbucks have not lowered consumer prices but are pocketing the difference, even taking into account the quality premiums in the specialty industry.

The Fair Trade Labeling Organizations International recently released figures that show a total production by groups on the Fair Trade Coffee Register of 165,000,000 pounds in year 2000, whereas total sales were only 30,000,000 pounds. This leaves an additional 135,000,000 pounds of Fair Trade coffee produced by cooperatives that are not receiving a Fair Trade price.

Source: © 2004 Global Exchange. Used with permission. www.globalexchange.org/economy/coffee/starbucks, accessed 10/6/02.

⁶Starbucks reported that buyers paid \$1.26/lb for non-organic green and \$1.41/lb for organic green in 2001, when New York C prices were hovering at roughly \$.50/pound. Although production costs varied significantly across countries and regions, coffee growers associations estimated average production costs to be \$.80/pound.

⁷Starbucks gave \$120,000 to CARE in fiscal 2001, bringing its cumulative contributions over time to more than \$1.8 million. Starbucks’ work with CARE began in 1991.

Summary of Learning Objectives

Define and classify foreign political risks

- Political risks can be defined by classifying them on three levels: *firm-specific*, *country-specific*, and *global-specific*.
- *Firm-specific risks*, also known as *micro risks*, are those that affect the MNE at the project or corporate level.
- *Country-specific risks*, also known as *macro risks*, are those that affect the MNE at the project or corporate level but that originate at the country level.
- *Global-specific risks* are those that affect the MNE at the project or corporate level but that originate at the global level.

Analyze firm-specific risks

- The main firm-specific risk is *governance risk*, which is the ability to exercise control over the MNE as a whole, globally, and within a specific country's legal and political environment on the individual subsidiary level.
- The most important type of governance risk arises from a goal conflict between bona fide objectives of governments and private firms.
- The main tools used to manage goal conflict are to negotiate an investment agreement; to purchase investment insurance and guarantees; and to modify operating strategies in production, logistics, marketing, finance, organization, and personnel.

Examine country-specific risks

- The main *country-specific risks* are *transfer risk*, known as *blocked funds*, and certain cultural and institutional risks.
- Blocked funds can be managed by any of five strategies: (1) management should consider including blocked funds in their original capital budgeting analysis; (2) fronting loans; (3) creating unrelated exports; (4) obtaining special dispensation; and (5) planning for forced reinvestment.
- Cultural and institutional risks emanate from host country policies with respect to ownership structure, human resource norms, religious heritage, nepotism and corruption, intellectual property rights, and protectionism.
- Managing cultural and institutional risks requires the MNE to understand the differences, take legal

actions in host country courts, support worldwide treaties to protect intellectual property rights, and support government efforts to create regional markets.

Identify global-specific risks

- The main global-specific risks are currently caused by terrorism and war, the anti-globalization movement, environmental concerns, poverty, and cyberattacks.
- In order to manage global-specific risks, an MNE should adopt a crisis plan to protect its employees and property and to secure its supply chain integrity. However, the MNE largely relies on government to protect its citizens and firms from global-specific threats.

QUESTIONS

1. **Political risk definition.** In order for an MNE to identify, measure, and manage its political risks, it needs to define and classify these risks. Define the following political risks:
 - a. Firm-specific risks
 - b. Country-specific risks
 - c. Transfer risk
 - d. Cultural and institutional risk
 - e. Global-specific risk
2. **Country risk ratings.** Exhibit 17.2 shows country risk ratings for selected countries. Using Moody's, S&P, and Euromoney rating services, prepare a country risk rating for Argentina.
3. **Governance risk.**
 - a. Define what is meant by the term *governance risk*.
 - b. What is the most important type of governance risk?
4. **Investment agreement.** An investment agreement spells out the specific rights and responsibilities of a foreign firm and its host government. What are the main financial policies that should be included in an investment agreement?
5. **Investment insurance and guarantees (OPIC).**
 - a. What is OPIC?
 - b. What types of political risks can OPIC insure against?

- 6. Operating strategies after the FDI decision.** The following operating strategies, among others, are expected to reduce damage from political risk. Explain each one and how it reduces damage.
- Local sourcing
 - Facility location
 - Control of technology
 - Thin equity base
 - Multiple-source borrowing
- 7. Country-specific risk.** Define the following terms
- Transfer risk
 - Blocked funds
 - Sovereign credit risk
- 8. Blocked funds.** Explain the strategies that an MNE can use to counter blocked funds.
- 9. Cultural and institutional risks.** Identify and explain the main types of cultural and institutional risks, except protectionism.
- 10. Strategies to manage cultural and institutional risks.** Explain the strategies that an MNE can use to manage each of the cultural and institutional risks that you identified in Question 9, except protectionism.
- 11. Protectionism defined.**
- Define protectionism and identify the industries that are typically protected.
 - Explain the “infant industry” argument for protectionism.
- 12. Managing protectionism.**
- What are the traditional methods for countries to implement protectionism?
 - What are some typical nontariff barriers to trade?
 - How can MNEs overcome host-country protectionism?
- 13. Global-specific risks.** What are the main types of political risks that are global in origin?
- 14. Managing global-specific risks.** What are the main strategies MNEs can use to manage the global-specific risks you identified in Question 13?
- 15. U.S. anti-bribery law.** The United States has a law prohibiting U.S. firms from bribing foreign officials and business persons, even in countries where bribery is a normal practice. Some U.S. firms claim this places them at a disadvantage compared to host-country firms and other foreign firms that are not hampered by such a law. Discuss the ethics and practicality of the U.S. anti-bribery law.
- 16. Fair Trade movement.** How does the Fair Trade movement differ from the traditional income redistribution plans used by many countries?
- 17. Starbucks’ coffee procurement.** Do you think Starbucks should pay a higher-than-market price to its growers, even if there is no significant difference in the quality of the coffee or reliability of production?
- 18. Corporate social responsibility.** What is Starbucks’ strategy for corporate social responsibility? Is it consistent with shareholder wealth maximization?
- 19. Cool Cola Company.** Cool Cola Company, one of the world’s major manufacturers of cola soft drinks, is considering the establishment of a very large cola bottling plant in India. Cool Cola expects to sell half its product within India and to export the other half to southeast Asian countries. If the Kashmir conflict could be resolved, Pakistan and even Afghanistan might become important markets.
- Prepare an analysis of all the potential areas of goal conflict between Cool Cola and India.
 - Considering your answers to part a, prepare a political risk forecast for Cool Cola’s bottling plant in India. Consider the potential for political unrest in India or for war with Pakistan, as well as whether a foreign-owned soft drink plant would be affected by such unrest. Use current periodicals and newspapers to gather your data.
 - Assume Cool Cola Company decides to build a large bottling plant in India. Recommend operating strategies for Cool Cola Company that would reduce its political risk. Include strategies for marketing, production, finance, and organization.
 - Prepare a crisis plan for Cool Cola in India in case political conditions deteriorate.
- 20. Divestment: China.** Assume that Cool Cola Company also has a network of soft drink bottling plants throughout China, but political stresses between the United States and China increase to the degree that Cool Cola would like to divest. What should Cool Cola consider in developing a plan that will enable it to divest its investment in bottling plants and distributions systems in China with minimum loss?



Internet Exercises

1. **The World Bank.** The World Bank provides a growing set of informational and analytical resources to aid in the assessment and management of cross-border risk. The Risk Management Support Group has a variety of political risk assessment tools, which are under constant development. Visit the following site and compose an executive briefing (one page or less) of what the political risk insurance provided by the World Bank will and will not cover.

World Bank Risk Management
http://www.worldbank.org/business/01risk_manage.html

2. **Global corruption report.** Transparency International (TI) is considered by many to be the leading nongovernmental anti-corruption organization in the world today. It has recently introduced its own annual survey analyzing recent developments, identifying ongoing challenges, and offering potential solutions to individuals or organizations. One dimension of this analysis is the Bribe Payers Index. Visit TI's Web site to view the latest edition of the Bribe Payers Index.

Transparency International
<http://www.transparency.org/surveys/index.html#bpi>

3. **Sovereign credit ratings criteria.** The evaluation of credit risk and all other relevant risks associated with the multitude of borrowers on world debt markets requires a structured approach to international risk assessment. Use Standard & Poor's criteria, described in depth on their

Web site, to differentiate the various risks (local currency risk, default risk, currency risk, transfer risk, etc.) contained in major sovereign ratings worldwide. Use any of the major Internet search engines to find recent evaluations on sovereign ratings and individual country rating changes.

4. **Milken Capital Access Index.** The Milken Institute's Capital Access Index (CAI) is one of the newest informational indices that evaluates how accessible world capital markets are to MNEs and governments of many emerging market countries. According to the CAI, which countries have seen the largest deterioration in their access to capital in the last two years?

Milken Institute
<http://www.milkeninstitute.org/>

5. **Overseas Private Investment Corporation.** The Overseas Private Investment Corporation (OPIC) provides long-term political risk insurance and limited recourse project financing aid to U.S.-based firms investing abroad. Using the organization's Web site, answer the following questions.

- a. Exactly what types of risk will OPIC insure against?
- b. What financial limits and restrictions are there on this insurance protection?
- c. How should a project be structured to aid in its approval for OPIC coverage?

Overseas Private Investment Corp
<http://www.opic.gov/>