Foreign Direct Investment in High-risk Environments:

An Historical Perspective

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Abstract

Since the Banking Crisis of 2008 the global economy is perceived as riskier than before. Flows of foreign direct investment (FDI) have contracted. Firms that cannot manage risks have withdrawn from countries in which they previously invested. These problems are not new. For centuries firms have invested in risky foreign environments, and many of them have succeeded. This paper reviews the risk management strategies of foreign investors. Using archival evidence and secondary sources it distinguishes the different types of risks that investors face and the different strategies by which risks can be managed. It investigates which strategies are used to manage which types of risk. It shows that strategies to prevent and mitigate risk are key to survival, and examines the specific measures that can be used. While drawing on the theory of international business it shows that, in the light of historical evidence, the theory is too narrow in the range of risks it discusses and in the range of strategies it recommends.

Keywords: FOREIGN INVESTMENT RISK MANAGEMENT PREVENTION MITIGATION
1. Introduction

A foreign investor entering an unfamiliar environment always faces risks, but there are some countries in which these risks appear formidable. Nevertheless, entry occurs. Historical examples of risky investments include Dutch investment in the East Indies, French investment in Africa, British investment in Latin America and recent US investment in Eastern Europe.

A major motive for entering any country is the pursuit of profit. But when the environment is volatile and uncertain, losses cannot be ruled out. This paper considers why, notwithstanding these considerations, some firms enter high-risk environments when others stay out. One possibility is that entrants under-estimate the risks involved, but if this were always the case then their foreign ventures would fail. While failures are not unknown, they are not so frequent as such over-optimism would imply.

A more plausible explanation is that some firms are better at managing risks than others. If one firm has better risk management skills than others then it may recognise that the foreign country is not so risky as others believe. Other firms may avoid entering the country because
of their lack of risk management skills. When rivals stay out, and domestic competition is weak, an entrant may achieve local monopoly power. The monopoly profit more than compensates for the high level of risk involved.

Consider, for example, a country with a corrupt government. Some potential entrants may recognise the corruption and others may not. If no firm has effective risk-management strategies, then only firms that under-estimate corruption will enter, and they will withdraw (if they can) once the problem becomes apparent. The other firms will avoid the country altogether. But if some firms have superior risk management strategies they may be able to survive. If they are aware of their own superiority then they will enter even though they know that others are staying out.

Many risks can be insured. These include not only familiar risks such as fire, fraud, accidental damage and employee sickness, but also, to some extent, strikes, wars and natural disasters. Insurance, though available, may not be affordable, however. The insurance principle works best when the risks incurred by different policy-holders are independent, exposure to risk can be measured (so that actuarial calculations can be made) and moral hazard can be controlled (e.g. policy-holders have an incentive to be prudent). This paper is concerned with risks that are costly to insure, notably commercial risks arising from changes in market conditions, government regulations, and discrimination against foreign firms.

While the insurance market normally works by pooling risks, the capital market facilitates the sharing of risks. It allows the specialization of risk between different types of financial asset holder. In a large firm the equity shareholders share profit risk (reflected in volatile dividends and unexpected share price depreciations) while bondholders share the risks of insolvency.
and default. A comprehensive analysis of risk management would encompass the optimization of the firm’s capital structure to maximize its resilience to unexpected losses, the optimization of insurance policy portfolios to lay-off risks to the insurance market and its underwriters, and the use of independent arbitrators to resolve contractual disputes, but the focus of this paper lies elsewhere.

The paper draws on both archival research and secondary sources. It examines foreign investments from Europe and the United States since 1870. It includes two separate eras of globalisation (1870-1914, 1970-date) and an intervening period of protectionism. It encompasses eras of high imperialism (1870-1914), colonialism (1914-c.1960) and post-colonialism (c.1960-date), and that included the emergence of the League of Nations, the United Nations and the World Bank.

The paper focuses exclusively on host-country risks that originate in the host country itself. It does not consider, for example, host-country risk that originates in the home country, e.g. where financial problems at headquarters force a firm to divest foreign assets.

Classic historical works addressing the role of risk in foreign investment include Wilkins’s studies of inward and outward US investment; Jones’s work on the developing countries and the oil industry; Kobrak and Hansen (2004) and Nicosia and Huener (2004) on European investment; and Godley and Shechter (2008) on investment in the Middle East. This paper provides a conceptual framework within which the findings of these and other studies can be synthesized.

2. A classification of risks
Foreign countries afford many different types of risk. Table 1 presents a classification of business risks based on the international business (IB) literature, including classic papers such as Boddewyn (1986), Boddewyn and Brewer (1994), Sanyal and Guvenli (2000), Pedersen, Pedersen, and Benito (2002), and more recent contributions such as Gleason, Malgwi, Mathur and Owhoso (2005), Verbeke and Greidanus (2009) and Glambosky, Gleason and Wiggenhorn (2010). The first column distinguishes between subjective risks that will diminish once the firm has entered the foreign environment, and objective risks that prevail however much experience the firm acquires. Subjective risks can be resolved through learning, but objective risks cannot. For example, subjective risk stemming from uncertainty about the size of the local market may reflect an initial lack of information that will be resolved once the firm commences operations. By contrast, objective risks, such as rivalry from local firms, result from known factors that are impossible to fully control. Although the nature of the problems can often be predicted, their size and timing cannot. Experience can be gained in managing objective risks but no amount of experience will make them disappear.

Objective risks are of two main types, as the second column indicates: institutional and natural. Institutional risks stem from the actions of individual people, or the organizations to which they belong. By contrast, natural hazards stem from physical factors such as floods and earthquakes. The IB literature tends to focus on institutional risks, but in practice natural hazards are a prominent feature of many high-risk environments.

These two categories are further disaggregated in column three according to the agents that instigate the problems. Each type of risk shown in column three is caused by the type of agent shown in column four. Governments, social groups, businesses and banks are mainly
responsible for institutional risk, whilst climate and geology are the principal factors relevant to natural hazards. Examples of specific instigators are given in column five. Seven main types of risk are identified altogether: unfamiliarity with the environment, political risk, social risk, business risk, financial risk, climatic risk and geological risk.

With respect to financial risk, it should be noted that all the risks discussed in this paper have financial implications for the firm. The financial risks identified below stem from volatility in the firm’s environment rather than from the firm itself: they are caused by speculation in international markets (e.g. exchange rate volatility), mismanagement of the domestic money supply (e.g. hyperinflation) or defective financial institutions (e.g. the collapse of banks).7

Risks can be classified not only by the instigator, but also by the nature of the problem. Table 2 identifies six main types of problem that are faced by foreign investors (see column one). The first two are general problems affecting all firms: disruption, arising mainly from natural causes, and economic losses inflicted by other people’s hostility (e.g. nationalistic governments, local protest groups). The next two arise directly from the nature of the firm’s operations – deficient demand and shortage of inputs – while the remaining two arise from the business environment – the emergence of rival firms, and the presence of powerful players within the supply chain. The examples cover all the main issues addressed in the literature, such as expropriation, infringement of intellectual property rights (IPR), and strikes.8 They also include some important risks that have received less attention, such as shortcomings in local infrastructure and utility services.

The table shows that any particular problem can be instigated in different ways: thus a shortage of inputs can be caused by trade union disruption or a disease affecting the health of
workers. Conversely, a given instigator can cause a variety of problems: protestors, for example, can lead to loss of demand through boycotts, or damage to property through insurgency.

3. The management of risk

The IB literature focuses on political risks, and the main strategy recommended is avoidance of the country concerned, or a rapid withdrawal when problems arise.\(^9\) It is impossible for such an approach to explain how some firms are able to survive successfully in high-risk environments, since it suggests that they either will not enter or will not stay. The literature tends to discuss one risk at a time, which is inappropriate in high-risk environments, which often involve the cumulative impact of multiple risks.\(^{10}\) While it might be easy to deal with one risk in isolation, it can be difficult to manage several risks at once.\(^{11}\) The interplay of institutional risks and natural hazards is a prominent feature of many high-risk environments: high risk arises because natural disasters are common and local institutions are often inadequate to deal with them.

The focus on political risk within the IB literature means that risk is normally associated with certain countries, but in practice the industry in which an investment is made is a significant determinant of risk as well. Sectors such as mining involve large sunk costs, and tend to be riskier than footloose manufacturing operations because they are vulnerable to expropriation. High-technology sectors are vulnerable to the theft of IPR, while high-status fashion industries are vulnerable to counterfeiting.
Four main types of risk-management strategy may be distinguished (see Table 3). Two have already been alluded to: risk avoidance, which involves staying away from a hostile environment, and withdrawal, which involves quitting the environment when problems arise. The other two strategies apply to firms that enter high-risk environments with the intention of remaining there. Prevention involves taking steps to counter a potential problem before it occurs, whilst mitigation involves reducing the impact of a problem once it has occurred. In the case of government corruption, for example, prevention may involve lobbying the host country government, whilst mitigation may involve partnering with other firms (perhaps local firms) in order to spread the risk of capital loss.

Risk management can be implemented individually – by a single firm acting alone – or collectively – in conjunction with others. Collective action may be effected through a partnership of firms initiated to address a specific risk, or membership of a trade association or national tariff association that provides a range of services and manages a variety of risks. Price-fixing cartels can provide a convenient (and sometimes covert) mechanism for the collective management of their members’ risks.

Risk management is normally most effective when strategy is put in place at the time the firm enters a country. Although the firm can improvise later, it is often costly to do so (e.g. its bargaining position may be weaker once it has committed to entry). Thus lobbying is best performed at the time the firm enters, and partnering arrangements are best finalized at this time too. In Table 3, column two sets out the measures that need to be taken before the firm has entered the country, and column three sets out the measures that need to be taken should a problem arise after entry. In practice, firms often show limited foresight at the time of entry, but nevertheless some firms appear to be more alert than others when problems later emerge.
Successful risk managers will invest in early-warning systems and remain alert to potential problems that can be tackled promptly before they become severe.

Prevention and mitigation, theory suggests, are distinct but related strategies. They are distinct because a firm can invest in prevention without investing in mitigation, and vice versa. They are related because investment in prevention reduces the incentive to invest in mitigation, since preventative measures make a problem less likely to occur. Likewise investment in mitigation reduces the cost incurred by a problem and thereby reduces the incentive to prevent it. Suppose, for example, that a corrupt government plans to raise taxes once the firm has invested. If a firm cannot lobby successfully against an increase (prevention is impossible) then it may share ownership with others (mitigation), whereas if lobbying is viable (prevention is possible) then it is more likely to own the investment outright (no mitigation).

The focus of this paper is on the prevention and mitigation of institutional risks and natural hazards. The business history literature has particular strengths in analyzing such risks, since the types of problem to which they relate tend to be well-documented in relevant sources – company archives, press reports, trade journals and official documents. The evidence is organized according to the classification of risks and not according to time. Although different eras generate different types of risk, the focus in this paper is on the type of risk rather than the specific era in which it emerged.

4. Managing institutional risk: the evidence

4.1. Political risks
4.1.1. Overview

Host government policy changes are a major source of political risk, the evidence shows.\textsuperscript{12} In a democracy adverse policy changes may occur when a new government is elected, or when an existing government facing re-election adopts a populist stance. Exposure of government fraud or wrong-doing may also stimulate a policy change. In totalitarian governments a shift in the balance of power between rival factions within the governing party can have radical implications for business.

Discrimination against foreign investors was common amongst developing countries in the period 1960-80, although in the 1990s the policy stance reversed as governments sought to attract foreign technologies. Discrimination has often been stimulated by deteriorating political relations between governments, e.g. a colony gains independence and then pursues a policy of indigenising local business. Foreign investments may be nationalised, with or without compensation, and possibly presented to supporters of the government as a reward for their political or military services. Indigenisation may involve replacing expatriate managers with local managers, thereby complicating headquarters-subsidiary relations within the firm.

Relations with host governments can sometimes be improved by lobbying, but this is often ineffective, and sometimes aggravating, when the host government is hostile from the outset. In such cases the foreign investor may turn to third parties – such as the source-country government - for support. In 1970 the US multinational International Telephone and Telegraph (ITT) enlisted the cooperation of the US government, and in particular the CIA, to prevent the election of Salvador Allende as President of Chile. After this failed, they collaborated with other US multinationals involved in Chile in encouraging his downfall.\textsuperscript{13}
Domestic trade associations can be used as intermediaries too in interceding with governments. Over the period 1875-1914, many Japanese silk manufacturing and trading firms operating in the United States were members of the Silk Association of America (SAA). Although these firms mainly targeted their products to Japanese immigrants, many of their problems were common to domestic firms as well, and so the SAA was able to present a united front to the government.\textsuperscript{14}

Foreign investors can also develop relationships with indigenous elites in order to manage popular opposition to foreign ownership and control of politically sensitive industries. Puig and Castro (2009) show that the first wave of French and German investment in Spain in the nineteenth century pursued a specific policy of forging strong links with the host-country’s business, financial and political elite.\textsuperscript{15}

4.1.2. Decolonisation

Decker (2008) examines the relations between British multinationals (MNEs) and governments in West Africa after independence in the 1950s and 1960s. She argues that in Ghana and Nigeria MNEs often tried to mitigate the effects of decolonization by building relationships with African politicians. In order to out-stay the Empire the firms overhauled their entire operations, including their commercial and political strategies, staffing policies, and corporate image. The United Africa Company (UAC), a subsidiary of Unilever, shifted from using imperial symbolism in the 1950s to displaying images indicative of modernisation and youth. This ‘Africanisation’ message was addressed essentially at African business and political elites.\textsuperscript{16}
Colonial powers could also be used to exert pressure on strident nationalist politicians. In Kenya British MNEs sought an alliance with the colonial government and moderate local politicians in order to block radical African nationalist politicians seeking to eliminate all vestiges of European power, and to outmaneuver recalcitrant white settlers who opposed any power-sharing arrangements with African leaders.\textsuperscript{17}

Sluyterman (2005) shows that despite the chaotic political situation after Indonesian independence in 1949, most Dutch MNEs tried to get back to business as soon as possible. They adapted to the new political circumstances by complying fully with the demands of the government for ‘Indonesianisation’. However, armed attacks and political unrest continued. The trading company Borsumij responded by creating joint ventures with local partners and establishing advisory management companies. However, these strategies failed and the company quit Indonesia in 1959. Royal Dutch Shell used a different approach: it replaced its Dutch personnel with staff of other nationalities and changed its legal structure in 1960 by founding PT Shell Indonesia. Six years later all Shell interests in Indonesia were nationalised.\textsuperscript{18}

Decolonization impinged heavily on trading companies, but many were resilient, and ‘reinvented’ themselves successfully in the post-war and post-decolonization periods.\textsuperscript{19} They changed from partnerships to incorporated companies and focused on more specialized products, often integrating backwards into manufacturing to gain greater control over their supply chains. They also used their traditional skills in marketing and distribution to diversify into the provision of business and trade-related services. Some far-sighted firms commenced ‘reinvention’ very early; e.g. John Swire & Sons began reforming its internal organization and external business networks to deal with changing conditions in China, such as the demise
of the *comprador* system, long before 1945. However, the informal culture of these firms meant that reform was gradual and piecemeal, unlike the modern managerial firms founded in the early twentieth century.

Overall, business had little influence over governments during the period of decolonization and independence. Maintaining an empire had become prohibitively costly for colonial powers, particularly in respect of policing militant nationalist groups, and so politicians in both home and host countries shared a common interest in political change. Prevention strategies therefore had limited scope. Colonial investors were, however, able to mitigate their problems by re-branding themselves as youthful companies that were part of the new nations. They publicly rejected the racially prejudiced and elitist policies that had characterized the final years of European colonialism, whatever their private views may have been. They diversified out of high profile areas that were likely to be indigenised, and moved into a range of specialised services that emerging nations could not easily supply for themselves.

4.1.3. Radicalism

Moreno (2003) argues that popular nationalism and radical social upheaval made investment in Mexico too risky for US companies from the 1920s to 1950. During this period political leaders and workers who sought to defend the ideals of the revolution as outlined in the 1917 constitution used nationalism to stop FDI and trade. President Plutarco Elias Calles ordered government institutions to boycott US companies in 1927, and the mayor of Juarez launched a national ‘buy at home’ campaign in 1931, which involved a boycott of US merchandise. Store owners in Mexico City in the early 1930s threatened to stop purchasing US products if federal authorities did not block plans by foreign distributors to invoice in dollars. The US
MNE Sears responded by using nationalist and revolutionary rhetoric in its advertising strategies to placate local opposition.22

Some MNEs pursued mitigation strategies in an attempt to neutralize discrimination against foreign investors. Andina Insurance company was created in Bogota, Colombia, which between 1940 and 1946 was operated by five British companies: Liverpool and London and Globe, Central, Prudential, Maritime, and Sea. The capital was a modest £25,000, as it was not intended to transact a large volume of business. It was available as a local company in case legislation prevented British firms from competing with Colombian, US or other foreign firms in the domestic market.23 This is an example of the ‘cloaking strategy’ that is discussed more fully below.

4.1.4. Totalitarian states

The legacy of popular nationalism is often a totalitarian regime. Bucheli (2008, 2010) has examined relations between MNEs and Central American governments during the first seven decades of the twentieth century. The US-based United Fruit Company, which produced and distributed bananas from Central America and the Caribbean, benefited from alliances with totalitarian Central American governments, and the elites that controlled them, in combating threats of disruption from labour movements. These alliances prospered so long as United Fruit’s operations provided a constant flow of income to the host countries. They collapsed as soon as the governments and the elites needed extra rents which the MNE was unable to supply. During the oil crisis of the 1970s, host governments imposed higher taxes and demanded fuller participation for independent local planters in the banana export business. The crisis generated a new type of international alliance between right-wing dictators, democratically elected presidents, local landowners, labour unions and left-wing politicians
against United Fruit. The MNE attempted to fight back but failed to get support from the US government. In the end, it was forced to accept the new terms, but it never lost control over the worldwide marketing and distribution of bananas from Central America.\textsuperscript{24}

A similar situation confronted Royal Dutch Shell in Chile throughout the twentieth century.\textsuperscript{25} Despite nationalistic policies, Shell was able to survive and flourish throughout a great part of that period by accepting conditions imposed by the government. Until 1937 Shell was part of a cartel with Standard Oil, which controlled 100 percent of the market. In 1937 the Chilean government forced a domestic private company COPEC (Compania de Petróleos de Chile) into the cartel. COPEC’s involvement with Chilean business groups protected the two foreign MNEs from hostile actions by the government and gave legitimacy to the cartel until 1978 when, following new private investments permitted by the government, the cartel was undermined.

Totalitarian regimes can become theocracies. The political and religious revolution in Iran in 1979 led to major changes in the strategies of foreign MNEs operating in that market. Since 1970 Iran had become an important trading partner with the United States, and it hosted a large number of US investments. In 1974 DuPont set up a 40/60 percent joint venture with a local partner to build a high-technology fibre facility - Polyacryl Iran Corporation (PIC) - that was intended to modernize Iran’s textile industry. DuPont’s goal was to exploit its proprietary knowledge in engineering and marketing, and Iran was an attractive target because it afforded a large domestic market for fibres and was a reliable source of petrochemical feed stocks. A joint venture was chosen deliberately to reduce political risk by protecting the firm from hostile intervention. Iranian engineers were also trained to manage the plant in order to reduce DuPont’s “liability of foreignness.” The growing power of the
radical factions in 1979 was too much for the firm, however, which failed to retain control despite a range of mitigation strategies, and its plant was ultimately nationalized. DuPont subsequently filed suit in the United States against PIC and the Iranian government and in 1984 received $42 million in compensation.\textsuperscript{26}

While DuPont had recognized that a revolution was fomenting as early as 1973-74, its unfamiliarity with Iran’s culture and social structure, and its incomprehension that religion could unite dissatisfied groups into a powerful coalition, led it to remain in the country rather than withdraw. It was also misled by incomplete intelligence reports from the CIA and the US Embassy in Tehran. It had not calculated that its local partner in the joint venture, far from being its protector, would be an ‘outsider’ in the new regime. With the benefit of hindsight, its investment had been excessive from the outset. The firm’s management believed, however, that an early withdrawal would be bad for its international reputation. Management confidence was boosted by the fact that the joint venture strategy had succeeded in other countries previously, where it had allowed the firm to survive in hostile circumstances.

Iran was the scene of an earlier conflict involving a foreign MNE. This was the nationalization dispute of 1951-54, which culminated in the Anglo Iranian Oil Company quitting the country. After the nationalization of its Iranian operation the company adopted the name of its marketing affiliate: British Petroleum (BP). It subsequently diversified into petrochemicals and other related products, and became truly multinational.\textsuperscript{27} Anglo Iranian’s risk management strategies included political interventions by the British government and local concessions on matters that did not threaten control by British management, such as housing and health care.\textsuperscript{28} While unsuccessful in averting nationalization, these strategies
ultimately improved the company’s reputation, both locally and internationally, for corporate social responsibility.

4.1.5. Wars

Wars affect both the inward and outward foreign investment of the belligerent countries, and often impinge significantly on other countries too. Military conflict spills over into economic warfare, and political risks spiral dramatically. Expropriation of enemy property and the freezing of enemy financial assets are both key elements in economic warfare. Other possible consequences include the internment of expatriate managers, inflation caused by budget deficits, and a breakdown in international payments.

The high costs of war mean that businesses often lobby their home governments to maintain good relations with countries that are major export customers, although the lobby is not always unanimous; domestic import-competing industries, and armaments manufacturers, both stand to gain from war. Foreign subsidiaries usually have little influence with host governments at a time of war, and therefore tend to keep a low profile or to withdraw from the country. Indeed, keeping a low profile can be taken to extremes. It is often convenient for foreign subsidiaries to ‘cloak’ themselves in a false identity, as companies owned by allies rather than by enemies of the host country. This does not prevent the disruption caused by war, but it mitigates the consequences, as it allows the firm to maintain a presence in the country.

Cloaking was a common strategy amongst German MNEs just before and during the two World Wars. 29 Parent firms camouflaged their foreign investments by creating complex organizational structures in which a subsidiary in a neutral country (e.g. the Netherlands,
Sweden and Switzerland) managed subsidiaries in other countries. Cloaking also made it possible to repatriate managers of foreign subsidiaries who might be at risk due to their race or religion. Through ‘cloaking’ the headquarters of MNEs often became less important, both strategically and operationally, whilst neutral subsidiaries gained importance. The predecessor firms of Schering AG, Germany’s second largest chemical company in 1939, camouflaged their US affiliate and their associated businesses in several European countries during the 1920s. As late as 1941, Schering AG cloaked its Italian subsidiary in order to avoid Mussolini’s plans to make the Italian economy self-sufficient through protectionist measures.

There were, however, some cases where cloaking structures were not as successful, eg. the German MNE Beiersdorf, a pharmaceutical and skin care company, producer of Nivea cream, which lost control of its investments and trademarks in major markets after World War II. This firm adopted a ‘ring’ organisational structure in 1934, with Amsterdam as the hub, thereby separating the foreign businesses from the headquarters in Hamburg. The ring encouraged cooperation between affiliates, facilitated the flow of goods and capital between countries by evading policy restrictions, and acted as an organizational framework to regain assets that were lost during World War I. During World War II it was used to conceal assets from hostile governments and to provide a safe haven for individuals working in hostile countries. Even though the firm managed to survive in the long term, this strategy which had been based on ‘gentlemen’s agreements’ and trust with foreign partners (e.g. previous employees, distributors), led to the loss of Beiersdorf’s trademarks in many key markets. It took many years to get them back.
In Germany, the Nazi regime confiscated Polish, Soviet and Jewish property, but left the assets of MNEs from other countries more or less alone. It did however, block the transfer of foreign exchange, ration raw materials and restrict economic activity in many other ways. Foreign MNEs used various strategies to circumvent such restrictions. IBM, for instance, remitted some profits from Germany to the United States as royalties, and through a form of countertrade - shipping finished goods to be paid for by credit against the subsidiary’s debt to IBM in New York.\(^{33}\) Spare capital not transferred to the United States was re-invested in additional plant capacity and real estate in Germany, where it could be used to produce exports to other divisions of the company.

There is some controversy on whether foreign MNEs were able to remain in Germany during the War because they collaborated with the Third Reich. While Black (2001) argues that IBM was complicit in the Nazi genocide, historians such as Allen (2002) and Heide (2004) disagree. Heide claims that IBM was able to keep its investments because of the German subsidiary’s ability to develop key technical innovations in the collation of statistics and other fields.\(^{34}\)

Unilever, a leading manufacturer of margarine and soap in Germany, used trapped funds to diversify into ice cream and cosmetics, and later financed the building of ships, which it then sailed out of Germany as a means of repatriating funds. Unilever Germany, which was under foreign control, removed Jews from senior management by the end of 1933, transferring several of them to the Netherlands, in order to prevent further conflict with the Nazi regime. This was despite a strong disdain for the Nazi regime by the Dutch and British directors of Unilever.\(^{35}\)
4.1.6. *International sanctions*

Although global discontent about Apartheid began in 1948, it was only from the 1980s that racial segregation sparked strong international opposition and United Nations sanctions. The risk of doing business in South Africa suddenly increased, even for firms that had been operating there for many years. The country had been a very attractive destination for foreign investors as it had vast mineral deposits, the white minority was able to earn high incomes, there was a high level of tariff protection, an absence of antitrust laws, and tight restrictions on union activity by black workers.

IBM had entered South Africa in 1952, and was vocal in its opposition to the Apartheid regime. When sanctions were imposed it sold its local operations to Information Services Management, an offshore trust created for the benefit of its employees. However, it maintained ties with the new firm, and continued to invest in social programmes. It returned to South Africa in 1994 and bought back its shares.36 A similar approach was followed by the Japanese motor manufacturer Toyota, which maintained its business links to South Africa during the boycott year, trading extensively with a nominally independent firm – Toyota South African Manufacturing. This was a local firm wholly owned by South Africans but wholly dependent on Toyota for its inputs. In just the first half of 1988, this firm imported 47,927 cars and knockdown vehicles for assembly. It was South Africa's largest automaker, with a local market share of about 55 percent, and its imports accounted for almost half of all Japanese trade with that country.37

Overall, however, few foreign firms remained in South Africa throughout the Apartheid period. MNEs such as Ford, General Motors, Citibank, Mobil and Kodak pulled out entirely. Some faced boycotts organized by Anti-Apartheid activists in their domestic markets and
other developed markets. The threat to the value of their global brands from continued association with the Apartheid regime meant that no prevention or mitigation strategy that involved remaining in the country was deemed viable. When they returned to South Africa in the mid and late 1990s, after the end of Apartheid, rival MNEs from other countries were already operating in the market, making it harder for these subsidiaries to re-establish their original competitive positions.\textsuperscript{38}

4.2. \textit{Social risks}

4.2.1 \textit{Overview}

Social protests often arise in response to perceived injustices.\textsuperscript{39} The most serious protests can escalate into civil wars, which then disrupt economic activity, including the activities of foreign investors. Foreign investors are particularly vulnerable to disruptions of transport systems that distribute their products to the domestic market or carry exports to ports or airports. Because of the high profile of their branded goods, they are also vulnerable to consumer boycotts.

4.2.2. \textit{ Strikes, riots and boycotts}

Trade union activity can impact significantly on the performance of MNEs in foreign countries. The difficult relations between oil MNEs and trade unions in Mexico at the beginning of the twentieth century led to the replacement of several managers from local subsidiaries. For example, in 1905 the Labour union requested the expulsion of a British manager from the US Mexican subsidiary of Gulf Oil because he was alleged to be a troublemaker who had denied rights to trade union members.\textsuperscript{40}
British firms operating Ghana and Nigeria in the 1930s and 1940s were widely criticized for monopolizing lucrative trades, discriminating against Africans and colluding with colonial governments. In 1948, just before independence, they were subject to public protests, boycotts, strikes and riots. Many trading companies had their shops looted. As noted earlier, after independence they addressed this negative legacy by changing their image through a policy of African advancement.⁴¹

4.2.3. Bandits and terrorists

Abadie and Gardeazabal (2003) have studied the consequences of terrorism by ETA (Euskadi ta Askatasuna) in the Basque country.⁴² They agree with The Economist (2000) that Basque terrorism imposed a negative reputational externality on other Spanish regions, and that in response foreign investors chose alternative destinations.⁴³ Terrorist activity started in the 1970s, when the Basque region was one of the richest in Spain. Between then and the end of the 1990s ETA terrorist activity resulted in almost 800 deaths. The Basque country was traditionally an industrialized European region which attracted foreign direct investment.⁴⁴ During this period Basque entrepreneurs and corporations abandoned the Basque country, and foreign investors avoided the region.

Terrorism is not a recent phenomena. In 1929 Russian terrorism and banditism affected the Chinese Eastern Railway in Manchuria. Many acts of sabotage took place and the telegraph and telephone lines were cut on several occasions. Foreign businessmen affected by this disruption requested the German council to appeal to Moscow through the home government in Berlin in order to prevent further terrorism.⁴⁵
Terrorism in Malaysia and Singapore in 1948 also affected FDI. European planters were under almost constant attack from Communists and other insurgents. Estates and buildings were burned down. The attacks involved major thefts of goods such as rubber from large European estates, which were sold to fund the Communist party. Mines were also targets, as was property owned by the minority Chinese population. The police and military were not available in sufficient numbers to provide protection, and the European planters were determined to remain on their estates, and so a private defense force was recruited. The Colonial Office appointed a committee in London to represent the interests of British corporations in Malaysia if insurance companies should be forced to give notice of withdrawal. By 1955 terrorism had dissipated due to effective co-operation between the security forces and the majority of the Malaysian people.

4.3. Business risks

4.3.1. Infringements of IPR

While some MNEs invest in high-risk environments in order to gain access to valuable minerals, ranches or plantations, others invest in order to gain access to the local market. This applies particularly to the manufacturers of consumer goods; some global brands, such as Pepsi and Coke, have a large potential market even in quite poor countries. In other cases, manufacturers may invest in off-shore processing in high-risk countries in order to gain access to cheap labour. Such firms often place their proprietary knowledge at risk. In any environment where local people can learn from a foreign investor there is a risk of building up local competitors as a result of knowledge spill-overs. Where the knowledge transferred is protected by patents, there is a risk that the host government may not recognize, or may not enforce, the patent rights. Even if the government is willing to enforce the rights, the foreign investor may have difficulty detecting an infringement or identifying those responsible.
There are many cases of patent infringement. This is particularly true in periods when revolutionary inventions appear in the market. Edison, known for his path breaking inventions such as the phonograph, the microphone, telephone, electric lighting and electricity generation, both sued and was sued for patent infringement in the United States and abroad on numerous occasions. In the United Kingdom, rather than fight a patent suit against Joseph Swan, who had invented his own incandescent lamp, he merged his company with Swan’s in 1882.48

Even where advanced technology is not involved, the foreign investor may find that they have placed their reputation at risk. ‘Me too’ products may be produced, and sold at low prices that undercut the investor. Trademark or copyright protection may not be available locally if the host government does not recognize the rights involved. As a result, an investor may find that their trademark is attached to counterfeit goods of inferior quality, which bring its name into disrepute.

Coca-Cola was unwilling to enter countries such as Argentina, Uruguay and Brazil until the 1940s because trademark law in those countries based ownership rights on priority of registration rather than priority of use. This meant that local companies were able to register the trademark even if they did not produce the beverage. Coca Cola therefore adopted a conservative internationalization strategy during this period, confining its investments in Latin America to a number of carefully selected countries.49

Coca-Cola failed to register its trademark in Uruguay despite the persistence of its legal counsel. Government responded to Coca-Cola’s initial request in August 1912 with a split
decision. The Trademark Office opposed registration on the grounds that both parts of the name were words in common use in pharmacy, but the Chamber of Commerce approved. The split decision sent the case to the Attorney General, who agreed with the opposition. Two months later, the Executive Brach accepted the Attorney General’s judgement, officially denying registration. In April 1913 legal counsel applied for reconsideration, which once again produced a split decision that in December 1913 finally went against the firm, and the case was then dropped.

Other firms, however, entered risky markets using prevention and mitigation strategies. British investors used a wide range of strategies to defend their trademarks overseas, many of which involved collective action, including lobbying host governments, sharing the costs of hiring local investigators, and bringing joint actions against counterfeiters.50

When British businessmen in China in 1907 discovered Japanese imitations of their trademarks, they lobbied the Japanese government to enter into an agreement with the United Kingdom for the mutual protection of trademarks. Apart from producing imitations of manufactured trademarks, the Japanese were photo-typing standard British works and selling them in China as if they were of British origin. Russia, Germany, France, and other powers had already signed reciprocal trademark agreements with the United Kingdom, but before making an agreement with Britain the Japanese wanted China to organize local registration of trademarks.

Even when trademark protection was available, enforcement could be a costly business. It was up to trademark owners to take the initiative. In 1907 two British firms and a US firm joined forces to prosecute a counterfeit beer producer in Canada. The British brewers
Guinness and Bass, together with their US bottler and labeler E. & J. Burke, jointly prosecuted Bowie & Co Brewery in Canada for fraudulent labeling of their beer brands ‘Black Bass’ and ‘Guinea Stout’. Through their attorneys the allied companies arranged for the withdrawal of the imitation labels, and for a new label to be issued bearing the name of the local brewery.

Threats of legal proceedings were usually more cost effective than going to trial. To maintain the credibility of the threat, however, counterfeiters were often pursued through the courts even when the chance of obtaining a favourable verdict was relatively small. Threat power often secured an informal agreement with the offender, to the mutual benefit of the parties involved. An informal agreement was reached between Bass and Wielmans-Ceuppens, a Belgian brewery, in 1921, after Bass had begun Tribunal of Commerce proceedings. The agreement provided for the abandonment of the court case in exchange of the destruction of the defendant’s stock of contentious labels and the renunciation of the diamond design thereafter.

4.3.2. Supply chain coordination problems

Both Wilkins (1970) and Chandler (1977) emphasise the importance of vertical integration as a risk-management tool. The problems created by unreliable partners in the supply chain is a constant theme in The Visible Hand. The solution may involve either forward integration into distribution, or backward integration into upstream production, or a combination of the two. In the first half of the twentieth century vertical integration was not just a strategy but almost a management philosophy for many large US firms, and was applied not only domestically but overseas. Reliance on foreign suppliers was reduced by maintaining links with home-country plants that provided crucial components. In extreme cases this meant that foreign
assembly was reduced to a mere ‘screwdriver operation’. Even where local suppliers were used, they would only account for a proportion of total supplies. By maintaining a diversified supply base, MNEs were able to switch away from troublesome suppliers at short notice. This was an important consideration for foreign subsidiaries in the automotive industry – particularly in the strike-prone Britain of the 1970s.51

Meanwhile integration into distribution was an important way of controlling the message delivered by the salesman to the customer. Building a direct relation with the customer was crucial to firms like Singer, who leased rather than sold their products, or who sold through instalment plans and needed to continually update their knowledge of the credit-worthiness of their customers in order to control the risk of default.52

Other risks relate to unexpected hold-up problems associated with dealing with powerful distributors or local suppliers. Japan was for many years a difficult country to enter for ‘market-seeking’ foreign investors. The powerful sogo-sosha trading companies controlled much of the domestic wholesale trade and maintained close long-term relationships with retailers.53 This barrier to entry was reinforced by cultural differences which made many Japanese consumers suspicious of imported goods sold through smaller retail channels. Some foreign investors, such as Unilever, attempted to mitigate these problems through alliances with domestic firms, but with only limited success.54 If they allied with a powerful firm that also handled products produced by Japanese firms then discrimination could occur within the partner firm, while if the partner did not handle Japanese products then it might have little reputation with consumers. Lobbying the Japanese government to liberalize domestic wholesale trades took a long time to produce results. As a result, early attempts at prevention and mitigation were failures, and many early entrants decided to withdraw from the market.
4.3.3. Controlling competition by preventing entry

In the second half of the nineteenth century and the first quarter of the twentieth century, concessions were an important aspect of foreign investment. Under a concession a firm purchased a monopoly right over some activity for a fixed period of time. From the foreign investors’ perspective the purchase of a concession reduced the risk of subsequent competitive entry into the local market. Most concessions related to stand-alone activities, such as railways, tramways, electricity supply and general urban infrastructure. While early British financing of concessions was effected mainly through free-standing firms, later US and Canadian investments were often effected through modern corporations that that operated in several countries. Significant lobbying (sometimes linked to allegations of bribery) was involved in securing contracts, and was often followed by significant litigation in order to enforce the contracts.

4.4. Financial risks

During the globalization wave from the 1870s until 1914, investors in foreign markets often had to deal with problems associated with underdeveloped banking systems abroad. Such foreign markets included the least developed parts of Europe (e.g. Spain, Italy), regions of recent settlement (e.g. Australia, Canada), and developing countries under colonial rule (e.g. India, Malaysia) or outside (e.g. Persia, Latin America). In order to overcome these problems, many investors financed their businesses through major financial centers, in particular the United Kingdom. Wilkins (1988) shows that a substantial part of British investment before 1914 involved investments made through ‘free-standing’ firms. By investing in firms headquartered in Britain rather than in countries overseas, shareholders not only had access to
the British legal system, and to the political power of the Empire in ensuring the security of
their overseas assets, but also to the gold standard, the sterling area and the financial expertise
of the City of London.\textsuperscript{57}

Financial risks have remained a problem for foreign investors throughout the twentieth
countries, which had severe consequences in the overall performance of the MNE. From the
1960s onwards the conversion of profits from soft local currency into hard reserve currencies
incurred losses for the firm. Populist nationalist governments ran sustained budget deficits
which could not be funded fully out of foreign investment and foreign aid, and so they
resorted to printing more money; this drove up domestic inflation and led to exchange rate
depreciation. In Brazil Unilever paid hard currency for raw materials imported from Europe
for use in the production of detergents, but received local revenues from the finished product
in a soft currency. Inflationary risk in Brazil stimulated speculation against the currency, and
the consequent volatility in the exchange rate made the timing of remittances between parent
firm and subsidiary of crucial importance to the overall performance of the firm.\textsuperscript{58}

Unilever’s receivables policy meant that it did not receive income when it dispatched its
products, but only when they were received by distributors and consumers, which could
involve a three-week lag in some parts of the country. Because of inflation, this delay in
receipts eroded their value. In addition, Unilever’s capital depreciation policy meant that its
subsidiaries did not have sufficient cash reserves to replace worn out equipment because the
new equipment was far more expensive than the old. In response to these problems,
Unilever’s traditional accounting system was replaced by a modern management reporting
system more appropriate to dealing with high inflation environments. This system managed
trade credit so that the company borrowed more and lent less to other firms in the supply chain. It also involved revaluing assets on the balance sheet at replacement cost rather than historic cost. At times of hyperinflation, Unilever organized frequent – often daily – management meetings to review its cash position; wages and salaries were paid on a weekly, or even daily, basis, and suppliers and distributors were carefully monitored.

In the 1970s McKinsey were hired to evaluate Unilever’s worldwide strategy. They recommended, amongst other things, that the organization be restructured geographically rather than by product, in order to deal with the special problems created by high-risk local environments.

Most foreign investors from time to time face changes in accounting, deposit and reporting requirements. Costs of compliance can be high to begin with, especially when the regulatory regime is idiosyncratic and unfamiliar to the investor, and these costs are further increased when regulations are frequently changed. Such risks increased significantly in the second half of the twentieth century in many host countries as part of an international trend towards greater regulation of business operations that included, not only financial transactions, but also customer protection, product quality, and health and safety at work.

5. Natural hazards

5.1. Climate

5.1.1. Storms and Hurricanes

Climatic conditions vary significantly across the globe and certain types of problem are particularly severe in certain locations – e.g. countries located on geological fault lines, or in
the path of major air streams. Foreign investors that have developed a technology under one climatic regime may encounter problems in adapting it to another.

Tropical areas are particularly vulnerable to extremes of weather, although their warm and wet climate provides fertile conditions for specialized agriculture. Storms and hurricanes made planting in the British Greater Caribbean, a region stretching from Barbados through to South Carolina, an especially volatile and uncertain business during the seventeenth and eighteenth centuries. Although the wind and rain fertilized the earth and purged the atmosphere from malignant vapours, storms repeatedly devastated the sugar and rice plantations and ruined the grain crops. They also destroyed buildings and infrastructure, sank ships, and took the lives of African slaves. The combined effects of such destruction resulted in serious short-term physical and economic losses, and complete financial ruin for some planters and merchants, who were driven out from the region and forced to return home to Britain. Many planters stayed and rebuilt the plantations, however, often using credit extended by British merchants. The demand for plantation staples and the protected market for sugar and rice in Great Britain meant that the potential profits from these crops was sufficiently large to compensate for the high risks involved. Planters could choose between strong structures that resisted storms and flimsier structures which were easy to rebuild. Those who made the right decisions could become extremely wealthy – successful sugar and rice planters were amongst the wealthiest colonists in the British Empire.

5.2. Floods

Railway companies were particularly affected by floods at the end of the nineteenth century. Railways were often built along river valleys where the gradients were relatively low, but to keep a straight alignment the lines usually crossed and re-crossed the river. In 1889 the
British-owned Pennsylvania Railway in the United States was seriously affected by the Johnstown flood in the Alleghanies. Lives were lost, the track was swept away, telegraphs were cut, and many bridges destroyed. The railway company responded rapidly, forwarding materials for temporary repairs and arranging alternative routes for people to get to their destinations.  

The Manila Railway Company in the Philippines, also British-owned, was similarly flooded in 1910. Lines were damaged and the substantial expenditure on repairs meant that further expansion of the line was placed on hold.

The railway engineer had to trade off the cost of preventing a disaster against the costs arising when it occurred. Wide bridges, for example, could accommodate greater floods than narrow bridges, but they were more expensive to build. Government regulators tended to assume that private infrastructure owners were inclined to economize on construction costs and compromise on safety, and so they usually stipulated minimum requirements that must be satisfied before the infrastructure came into public use. In practice, therefore, it was the health and safety standards of the host government that normally regulated the risks. In countries where government standards were low, public infrastructure could be so unreliable that foreign investors preferred to invest in private infrastructure as an insurance policy. Thus some mining enterprises constructed their own lines from mine to port in order to avoid dependency on unreliable public infrastructure. For example, soon after acquiring Rio Tinto mines in Spain in 1873, the British entrepreneur Hugh Matheson built a rail link and a shipping pier between the Rio Tinto mines and the Seaport of Huelva.

5.3. Earthquakes and Fires
Earthquakes cannot be prevented, but their effects can certainly be mitigated. In many parts of the world it is normal practice to design buildings – especially high-rise office buildings – with earthquakes in mind. Despite this, this occurrence of earthquakes always identifies certain investors in a city or region who have no credible mitigation plan.

The San Francisco earthquake of 1906 had a major impact on the British insurance industry and was unique in that both earthquake damage and fire damage affected the city. San Francisco had a long history of trade relations with Britain, and was a thriving city. British insurance companies, such as Alliance Assurance and Royal Exchange Assurance, which had many branches in the city, and large portfolios of policy-holders, incurred huge losses. Neither had taken sufficient steps to diversify their risks. They found it easy to sell insurance in San Francisco because many residents were aware that the risks were high, and local insurers, who were also aware of these risks, asked for correspondingly high premia. Foreign investors who underestimated risks therefore found it easy to sell loss-making insurance policies. After the earthquake, both the British companies, realizing the mistakes they had made, pulled out of San Francisco. Royal Exchange Assurance withdrew from California in 1908 and expanded in other parts of the United States instead, while Alliance Assurance, which had entered the United States mainly through acquisition, withdrew from the United States altogether. It has even been claimed that financial liabilities connected with the earthquake contributed to the severity of the Financial Panic of 1907.

5.4. Disease

Phyloxera devastated the vineyards in France, Spain and Portugal between the 1860s and 1880s. In France, at that time the world’s largest exporter of wines, the disease quickly spread to the whole country. French producers (many of British origin) responded to the
crisis by importing wines, particularly from Portugal, and re-exporting them under their own names. Portuguese wine producers, who were initially less affected, were able to expand as a result. They drew upon stocks of aging wines, and also started producing fortified wines with grapes from regions surrounding the legally demarcated region of the Douro. The need to secure future supplies from Portugal encouraged many British wine merchants, including such leading brands as Taylor’s, Fladgate and Yeatman, Warre’s and Graham’s, to integrate backwards into vineyards in the Douro valley. Thus vertical integration was used by foreign merchant houses to manage the risks associated with the disruption of their usual source of supply through disease.

Foot and mouth is another disease that has had an impact on FDI. In 1903 it was discovered in sheep exported to the United States and the United Kingdom from Argentina. It affected the trade of live cattle, and especially the shipping firms that specialized in it. Infections in cattle could spread whilst in transit, and considerable losses were sustained when an entire cargo had to slaughtered at their destination. Slaughtering cattle before shipment was more economic, but preservation of the meat was a problem. Ships with refrigerated holds had been used to export sheep from New Zealand since 1882, and so the leading ship-owners in the Argentinian meat trade therefore mitigated the problem by fitting refrigerators. Firms that failed to adapt went out of business, and eventually purpose-built ‘reefer’ ships replaced ordinary ships in the world-wide meat export trade.

‘Panama Disease’, which cuts off the supply of nutrients to a plant’s roots, attacked United Fruit’s banana plantations in Panama in 1903. At that time United Fruit possessed a near-monopoly of banana production world-wide, and much of this production was concentrated, for climatic and geological reasons, in Central America and the West Indies. By the late
1920s the disease had affected its business in Panama, Costa Rica, Honduras, Guatemala, and the West Indies. United Fruit responded by abandoning thousands of banana plantations, and redoubling its efforts to control its work force and plantation system. This reshaped the Central American landscape, as former rain forests were drained and irrigated, flooding of thousands of hectares of infected soils.\textsuperscript{71} By 1960 United Fruit’s main competitor, Standard Fruit, had developed a disease-resistant bananas species, which eliminated the need to abandon plantations. United Fruit followed suit and adopted this innovation.\textsuperscript{72}

5.5. \textit{Disasters}

Industrial disasters such as oil and gas explosions, mining disasters and tanker shipwrecks affect both local populations and the physical environment. The Bhopal explosion in India in 1984 killed more than 2000 people and permanently disabled several thousand more.\textsuperscript{73} The plant was 50.9 percent owned by US multinational Union Carbide, and 49.1 percent indirectly by the Indian government. The plant was shut down because the Indian government refused to reissue the operating license. To mitigate the short-run effects of the disaster, Union Carbide organized a team of international medical experts, provided relief supplies and worked with the local Bhopal medical community, but lack of preparation reduced effectiveness. In the long-run it established a fund for the victims of the tragedy and financed a hospital. The cost of investing in future prevention and mitigation strategies, and the risks to the firm’s reputation of any repetition, may have been factors in Union Carbide’s decision to sell out in 1994.\textsuperscript{74} This disaster raised serious issues about the responsibility of MNEs in transferring hazardous technologies to developing countries – especially the need to educate workers and to enforce stringent safety measures.\textsuperscript{75}

6. Risk management strategies: an assessment
The evidence illustrates the wide range of risk-management strategies employed by foreign investors. It also highlights the serious consequences of failing to develop a risk-management strategy. The evidence shows that firms can operate successfully in a high-risk environment if they possess the skills required to implement appropriate strategies, but it also shows that firms that lack the requisite skills may be forced to quit at short notice – not to avoid losses, but in response to losses that have already been sustained.

The various risks identified by the historical studies fit readily into the conceptual framework. Table 4 re-examines the six main types of objective risk set out in Table 1. It reviews the risk management strategies used by the case-study firms to manage each type of risk, and classifies each strategy as either prevention or mitigation, using the typology of strategies set out in Table 3.

The table highlights the importance of prevention strategies. Many of these involve alliances with other parties, whether governments, trade associations or local partners (in particular indigenous firms). Sometimes these alliances are intermediated by third parties, e.g. when relations with a host government are poor, political support from the headquarters country government may be solicited. Such intermediation is common where the headquarters government is an economic or colonial power (e.g. United States or United Kingdom). Third parties can also be brought in to undermine opposition.

The balance between prevention and mitigation varies according to the type of risk that is being managed. Very little mitigation is available in the case of business risks: once competitors have entered a market they are hard to remove, and once the reputation of a
brand has been damaged or diluted through counterfeiting it is difficult to restore. This irreversibility encourages firms to invest heavily in prevention. Thus patent and trademark infringement is often punished as heavily as possible, even when compensation is difficult to obtain, purely for purposes of deterrence.

Mitigation is more common in the case of political risks. When confronted with decolonization there is usually little an investor can do to influence government policy, as the host government is implacably opposed to foreign influence and the HQ government wishes to distance itself from its colonial past. Similarly when countries are about to go to war there is little the firm can do to resolve the tensions. In response to nationalism, however, a firm can create a new identity for itself as an indigenous entity – foreign owned but locally controlled, and fully aligned with host-country ambitions in a post-colonial era. Similarly, in the case of war the firm can create a false identity for its operations, using a subsidiary in a neutral country, a local partner, or a locally registered company it has previously created for this purpose. Sometimes these strategies have worked, but occasionally they have failed.

Investors often face a trade-off between different risk-management strategies. It was noted at the outset that pursuing a prevention strategy tends to reduce the value of a mitigation strategy, and vice versa. Nevertheless, evidence suggests that firms often pursue both types of strategy when they are available. This suggests that risks are often so severe that any strategy to reduce them is welcome.

Some strategies involve stark trade-offs, however. Making an alliance with one organization, for example, makes it difficult to ally with a rival organization as well. For example, a foreign firm that makes a special deal with a host government is unlikely to be welcomed by
a trade association that represents the industry as a whole. Many investors seek partnerships with the host government first and only pursue partnerships with other parties when this fails.

Some strategies involve aggressive behaviour, and others acquiescent behaviour – often to the same party – and it is difficult to pursue both at once. It is problematic, for example, to acquiesce conspicuously in a post-colonial government’s demands for indigenization whilst at the same time seeking to undermine the government’s legitimacy. In general, investors normally pursue acquiescent policies first, and only resort to aggressive ones when these fail. Thus a firm will seek to destabilize a government only when its initial attempts at lobbying have been rebuffed. Similarly, firms developing local supply chains will often seek out local partners first and only develop their own independent chains when they decide that their partners cannot be trusted.

Table 4 confirms the intuitive notion that political and social risks tend to be country specific, whilst business risks tend to be industry-specific. Within an industry, the risks tend to be greater for knowledge-intensive firms. On the other hands, the rewards to be gained from managing risks successfully are usually far greater for knowledge-intensive firms. Financial risks are present, to some degree, in all countries and all industries; they cannot usually be prevented, but can be mitigated through sophisticated cash management procedures. Natural hazards tend to be both industry-specific and country-specific – an obvious example is post-colonial mining in a geologically unstable country.

7. Conclusion
Whilst IB theory addresses the risks faced by MNEs in foreign markets, it tends to emphasize political risks. It argues that firms should avoid high-risk environments altogether, and should make a quick exit from countries when risks increase. This paper challenges this view by drawing on historical case studies which show that many firms have survived in high-risk environments through the use of sophisticated risk management strategies. When risks increase they have tended to be ‘stickers’ rather than ‘quitters’ and in the long run have been rewarded, on average, with high profits.

Most markets are perceived as high-risk not because any one source of risk is particularly high, but because there are many separate sources of risk. This paper has identified six main types of objective risk and four main types of strategy for managing them: avoidance, prevention, mitigation and withdrawal. A major feature of this paper is that it examines prevention thoroughly.

Whilst political risks are amongst the most dramatic risks that firms can face, business risks have always been important too. The IB literature tends to regard IPR risks as a modern phenomenon generated by globalisation, but business history literature provides a useful antidote to this view. Just as modern MNEs face threats to intellectual property from countries such as India and China pursuing ‘catch up’ industrialization policies, so one hundred years ago early MNEs faced problems from the ‘catch up ‘ economies of the time. At that time Britain and France were the leading countries in the development of patents and brands, and the United States, Germany and Japan – some of today’s leading countries – were then in the ‘catch up ‘ phase. The fact that they caught up so easily demonstrates, amongst other things, the serious consequences for leaders of failing to uphold IPR. History also
shows that political risks do not emanate only from weak governments: in practice they also stem from strong sophisticated governments pursuing catch-up policies.

The analysis of high-risk environments goes to the heart of what strategy really means in IB, and this creates important opportunities for future research. Risk management may be seen as a fundamental firm-specific competency. Differences in such firm-specific competency can have profound effects on where firms invest, the strategies they use and the success that they achieve. Competent risk managers will enter high-risk environments where they will earn high profits because of the absence of effective competition. Such high profits may be interpreted as a reward to a scarce competency in risk management.

Finally, the study of high-risk environments has increasing significance for the modern IB studies. Prior to the Banking Crisis of 2008 it was widely believed that the global economy was moving steadily towards an equilibrium based on integrated international markets for labour, capital, products and knowledge. Despite a rise in international terrorism, continuing civil wars in some developing countries, and cooling relations between the United States, Russia and China, political risks were considered to be relatively low. The potential impact of global warming, major earthquakes, overpopulation and new strains of disease were mainly concerns for left-wing activists rather than for the business community as a whole. Since 2008, however, opinion has shifted, and managers are now more aware of the risks involved. Risk is perceived as widespread: the Oil Price Crisis of 1973-76 and the Asian Crisis of 1997 have now been followed by the European Crisis of 2011, and no major industrial economy is immune. Countries that already host major levels of foreign investment now face the multiple sources of risk that history shows are characteristic of high-risk environments. For many international investors, the choice between prevention, mitigation and withdrawal has
become crucial as they consider how best to manage their operations in environments that are suddenly much riskier than before.
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References


Table 1: Typology of risks facing a firm entering a foreign country

<table>
<thead>
<tr>
<th>Epistemics</th>
<th>General classification</th>
<th>Specific classification</th>
<th>Type of instigator</th>
<th>Examples of instigators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subjective</td>
<td>Unfamiliarity</td>
<td>Unfamiliarity</td>
<td>Investor</td>
<td></td>
</tr>
<tr>
<td>Objective</td>
<td>Institutional</td>
<td>Political</td>
<td>Government</td>
<td>Host government, headquarters, government, international organizations, market regulators</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Social</td>
<td>Social groups in the host country</td>
<td>Trades unions, pressure groups, bandits and terrorists</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Business</td>
<td>Other firms operating in the host economy</td>
<td>Customers, Suppliers, Rivals, Imitators</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial</td>
<td>Banks and money markets</td>
<td>Banks, Governments, Speculators</td>
</tr>
<tr>
<td>Natural</td>
<td>Climatic</td>
<td>Extreme weather</td>
<td>Floods, fires, famines, diseases</td>
<td></td>
</tr>
<tr>
<td>Geological</td>
<td>Geology</td>
<td>Earthquakes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 2: Specific problems associated with different types of risk

<table>
<thead>
<tr>
<th>Type of problem</th>
<th>Unfamiliarity</th>
<th>Political</th>
<th>Social</th>
<th>Business</th>
<th>Financial</th>
<th>Climatic and geological</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disruption and destruction</td>
<td>Accidents caused by misjudgement of natural factors (e.g. mining disaster)</td>
<td>War damage</td>
<td>War damage</td>
<td>Breakdown of law and order: Sabotage, violence by protest groups</td>
<td></td>
<td>Plant and equipment destroyed by storms, floods, earthquakes</td>
</tr>
<tr>
<td>Outright economic loss</td>
<td>Unexpected restrictions and regulations (e.g. maximum prices, minimum wages)</td>
<td>Expropriation, punitive taxation, freezing of assets and other discrimination High taxes and tariffs by populist nationalist government</td>
<td></td>
<td>Expropriation, punitive taxation, freezing of assets and other discrimination High taxes and tariffs by populist nationalist government</td>
<td></td>
<td>Capital losses due to bankruptcies, fraud, financial market volatility, hyper-inflation</td>
</tr>
<tr>
<td>Deficient demand</td>
<td>Over-estimation of market size</td>
<td>Boycotts of product</td>
<td>Boycotts of product</td>
<td>Boycotts of product</td>
<td></td>
<td>Damage to transport and communication infrastructure impede distribution</td>
</tr>
<tr>
<td>Input shortage</td>
<td>Under-estimation of labour costs, etc.</td>
<td>Strikes</td>
<td>Incompetent local suppliers</td>
<td></td>
<td></td>
<td>Famine and disease damage worker health</td>
</tr>
<tr>
<td>Rivalry</td>
<td>Government does not recognize intellectual property rights</td>
<td></td>
<td></td>
<td>Local learning, imitation, patent and trademark infringement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hostage to monopoly</td>
<td></td>
<td></td>
<td></td>
<td>Monopolies of distribution channels, raw materials, utilities, etc.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 3: Four risk-management strategies and their implementation

<table>
<thead>
<tr>
<th>Risk management strategy</th>
<th>Action taken before entry</th>
<th>Action taken after entry in response to a problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoidance</td>
<td>Evaluate the consequences of entering in order to determine that a failure is likely</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Prevention</td>
<td>Insulate against hostile forces. Solicit protection Negotiate with trustworthy parties to negotiate deals Build reputation</td>
<td>Call up support previously pledged</td>
</tr>
<tr>
<td>Mitigation</td>
<td>Invest in rapid-response measures. Take out insurance by sharing risks with partners or shifting it onto other parties (e.g. customers, suppliers)</td>
<td>Activate the pre-planned responsive measures, improvising where necessary</td>
</tr>
<tr>
<td>Withdrawal (also known as divestment)</td>
<td>Invest in assets that are ‘liquid’ (easy to sell off), mobile (easy to move to a safer environment) or flexible (easy to transfer to an alternative use in another industry)</td>
<td>Sell, move or transfer the vulnerable assets</td>
</tr>
</tbody>
</table>
Table 4: Specific prevention and mitigation strategies exemplified by historical case study evidence

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Prevention</th>
<th>Mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Political</strong></td>
<td>Lobby HQ government to intercede with host government, influence elections, destabilise persistently hostile government (Cuba, Kenya)</td>
<td>Assimilation: improve local image (Ghana, Nigeria, Mexico)</td>
</tr>
<tr>
<td>Build alliances with local elites (Ghana, Nigeria, Spain)</td>
<td>Diversify out of politically sensitive activities (Indonesia, China)</td>
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<tr>
<td>Enter partnerships with local firms (Indonesia, Iran)</td>
<td>Cloaking Disguise nationality using domestically registered firms or firms registered in neutral countries (Europe during two World Wars, Colombia). Sell assets to local firms with an option to buy back later (South Africa)</td>
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<td></td>
<td>Use funds trapped in host country to purchase produce or purchase high-value goods that can be exported (by smuggling if necessary) (Germany)</td>
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<tr>
<td><strong>Social</strong></td>
<td>Make alliances with corrupt host governments to restrict trade union activities, suppress local protest, etc. (Central America)</td>
<td>Mitigate the effects of strikes using imports as alternative source of supply (UK)</td>
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<tr>
<td>Organise a local defence force in collaboration local partners (e.g. an ex-patriate community) (Malaysia)</td>
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<tr>
<td><strong>Business</strong></td>
<td>Lobby HQ government to reciprocal IPR agreements with countries liable to make infringements (Russia, Germany, France, UK)</td>
<td>Use alliances, partnerships and other contractual arrangements to share risks with other parties (many countries)</td>
</tr>
<tr>
<td>Prosecute IPR infringements (even at great cost) and advertise successful prosecutions - as a deterrent (Canada, Belgium)</td>
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<tr>
<td>Negotiate a concession that gives a statutory monopoly of an activity for a fixed period (Latin America, Southern Europe)</td>
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<tr>
<td>Negotiate long-term agreements with dominant local firms that can hold-up the supply chain (Japan)</td>
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</tbody>
</table>
Financial

Develop high-frequency cash management procedures that reduce outstanding credit and repatriate funds as quickly as possible (Africa and Latin America)

Climatic and geological

- Avoid concentrating too much activity on vulnerable sites in the host country (US). Construct flood defences, weather-proof buildings, etc. (Caribbean, US)
- Invest in rapid-response procedures and the training and equipment required to implement them (India)
- Avoid prolonged mono-culture; develop disease-resistant crops
- Slaughter animals prior to transit to avoid spread of disease during transit (Argentina)
- Build improved infrastructure that is less vulnerable to disruption (Spain)

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