

# Domestic Effects from International Risk Management Strategies: Foreign Direct Investment and Political Risk

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October 26, 2013

# Empirical Motivation

- Persistence of trade and FDI flows despite interstate disputes, stated concerns of firm actors
- Cold Politics, Hot Economics: Sino-Japanese Relations, 1992-2012
  - Japanese firms and business associations vocally concerned about political risks in Chinese business environment
  - Increasing economic flows amidst bilateral political instability and nationalist tensions

# Theoretical Motivation

- Effects of international political conflict on trade and FDI
  - Rational expectations (Morrow 1999, Li and Sacko 2002, Li 2006, Long 2008, Li and Vashchilko 2010)
  - Discrepancy between firms' statements of concern and behaviors
- Existing literature overly narrow in:
  - Firms understanding of political-conflict risk (Jensen 2008, Woll 2008)
  - Potential strategic response of firms to political-conflict risk (Miller 1992, Godfrey 2005)

# Research Question

How do firms sustain economic relationships in the face of persistent international political conflict?

What do firms do in the face of a business environment made unstable by international political conflict?

# Firms as Strategic Social Actors

- Firms try to mitigate risk using social engagement activities aimed at reducing the uncertainty in the business environment arising from nationalist tensions and anti-Japanese sentiments
  - Private sector “hearts and minds” campaign
  - Foreign firms try to transform host country conditions
- Firm-level, temporal, and spatial variation
  - Firm-level: Firm’s historical experience in the aftermath of political conflict
  - Temporal: Level of political conflict
  - Spatial: Location of firm and exposure to political-conflict risk

# Testing the Argument

- Statistical analysis of the social engagement activities of firms:
  - Japan Foundation and Japan Chamber of Commerce's *Survey Report of Japanese Corporate Social Contribution Activities in China*
  - Firm contributions to Japan Chamber of Commerce and Industry in Beijing exchange program
- 125 interviews conducted in Tokyo, Beijing, Shanghai, Guangzhou, Shenyang, and Dalian in 2010-2011
  - Firms
  - Japanese and Chinese state officials
  - Business consultants and business organizations

# Social Contribution Activities of Firms

**Firm-Promoting CSR:** promotes a firm's image, usually in the same locality as the firm's production facilities

- Donations to welfare programs
- Disaster relief
- Educational philanthropy
- Community outreach

**Country-Promoting CSR:** promotes a firm's home country or culture

- Cultural exchange programs
- Educational exchange programs

# Temporal Variation

## Change over time in social contributions (difference in means test)

	2005	2009
Firm-Promoting CSR	168	149***
Country-Promoting CSR	39	74***



# Spatial and Temporal Variation

- Temporal: as political environment worsened, shift from firm-promoting to country-promoting CSR
- Regional differences: country-promoting CSR not practiced in regions of China more friendly to Japanese business
- National differences:
  - “Hearts and minds” activities conducted by private sector in China, Japanese state elsewhere
  - American firms in China use state resources

## Firm-Level Variation

- Estimate firm-level contributions to educational/cultural exchange program run by the Japanese Chamber of Commerce in Beijing using ordered logit model:

$$\begin{aligned} Pr(C = j) = & \alpha + \beta_1(\text{Risk Exposure}) + \sum_i \beta_i(\text{China Presence}) \\ & + \sum_i \beta_i(\text{Controls}) + \epsilon_i \end{aligned}$$

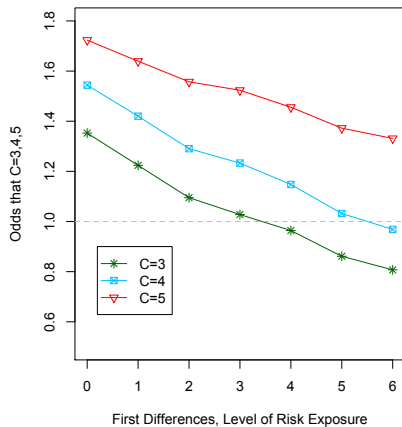
where  $j = [1 : 5]$  =contribution bracket

## Firm-Level Variation

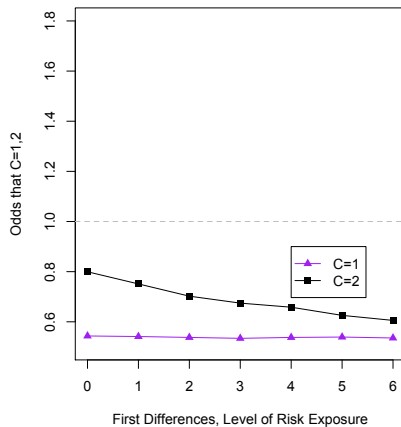
Variable	Full Model	Constrained Model
<b>Risk Exposure (+)</b> <i>(Instances Affected by Political Instability)</i>	+ ***	+ ***
<b>Market Visibility (+)</b> <i>(Market Directly to Consumers)</i>	-	-
<b>Firm Sensitivity to Politics (+)</b> <i>(Office in Beijing)</i>	+	+
<b>Years in China (-)</b>	- *	- *
<b>Number of China Facilities (+)</b>	+ **	+ **
<b>Firm Size (+)</b> <i>(Capital Stock)</i>	+ **	+ **
<b>Return on Equity (+)</b>	+	
<b>Debt Equity Ratio (+)</b>	+	

# Risk Ratio with Increasing Risk Exposure

### Higher Contribution Categories



### Lower Contribution Categories



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# Conclusions

- 1 Firms actively respond to political instability, trying to ameliorate business uncertainty
  - Firms reduce uncertainty using social engagement activities
  - Public diplomacy practiced by *private sector*
- 2 Firms seek to transform domestic political context to reduce international political-conflict risk
- 3 Political-conflict risk countered with political or social strategies: firms respond to political risk using non-economic strategies