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

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Empirical Motivation

- Persistence of trade and FDI flows despite interstate disputes, stated concerns of firm actors
  - 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
  - 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)
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)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm-Promoting CSR</td>
<td>168</td>
<td>149***</td>
</tr>
<tr>
<td>Country-Promoting CSR</td>
<td>39</td>
<td>74***</td>
</tr>
</tbody>
</table>
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:

\[
Pr(C = j) = \alpha + \beta_1 (\text{Risk Exposure}) + \sum_i \beta_i (\text{China Presence}) \\
+ \sum_i \beta_i (\text{Controls}) + \epsilon_i
\]

where \( j = [1 : 5] \) = contribution bracket
## Firm-Level Variation

<table>
<thead>
<tr>
<th>Variable</th>
<th>Full Model</th>
<th>Constrained Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Exposure</strong> (Instances Affected by Political Instability)</td>
<td>+ ***</td>
<td>+ ***</td>
</tr>
<tr>
<td><strong>Market Visibility</strong> (Market Directly to Consumers)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Firm Sensitivity to Politics</strong> (Office in Beijing)</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td><strong>Years in China</strong> (Capital Stock)</td>
<td>- *</td>
<td>- *</td>
</tr>
<tr>
<td><strong>Number of China Facilities</strong> (Capital Stock)</td>
<td>+ **</td>
<td>+ **</td>
</tr>
<tr>
<td><strong>Firm Size</strong> (Capital Stock)</td>
<td>+ **</td>
<td>+ **</td>
</tr>
<tr>
<td><strong>Return on Equity</strong></td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>Debt Equity Ratio</strong></td>
<td>+</td>
<td></td>
</tr>
</tbody>
</table>
Risk Ratio with Increasing Risk Exposure

Higher Contribution Categories

Odds that C=3,4,5

Lower Contribution Categories

Odds that C=1,2

First Differences, Level of Risk Exposure

Odds that C=3

Odds that C=4

Odds that C=5

First Differences, Level of Risk Exposure

C=1

C=2
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?
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