FDI Political Risks: The New International Context

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***Abstract* - The understanding of country risk for investors is extremely important. Considering the current international context on geostrategic countries' environment this subject gains additional relevance. The growing global nature of investments makes the country's risk measurement essential in terms of economic consequences. The international country's political risk show that companies investments abroad need an involving and multifaceted organization. This paper intends to analyze the conditions of attractiveness and the risks in a political context of a country in which a company intends to invest. The politics' stability of a country's government is often determinant to have investments, particularly the ones from an international company. The complexity of this analysis requires the understanding of the way the interrelationships are made. The case of Latin America countries is presented and the new context of China is also analyzed.**

Keywords - *China, Latin America, Political Risks, Competitive Advantages, Foreign Direct Investment (FDI).*

1. Introduction

The existence of countries risks impacts on global investment strategies. Different measures for countries' risk exist, some of which coming for instance from the Political Risk Services' International Country Risk Guide (ICRG). These measures include, for example, political risk, economic risk and financial risk. The ICRG also states about a measure of composite risk which is a simple function of the three base indices. In fact the graduation of risk determines how attractive a country is for the international investments, given the fact that the existence of international investments is explained because investors want to maximize the return on their investments. As a consequence they analyze the risks in order to reduce eventual future negative impact on returns.

FDI involves a complex system of analysis for the conditions of countries' attraction. Political conditions are a very central point of analysis when a company studies a country. The different frameworks that allow to analyze the attraction of investments show that the international political environment always works as an important factor for companies to go to international business. The stability of politics of a country's government is often determinant to get investments, particularly investments from an international company.

The great level of political consciousness was going working side by side with the internationalization of business and socio/economic relationships.

The economic and social development of developing countries depends often on commercial advantageous investments and on the reinvestment of capitals on these economies. The economies need to grow up and for that, at a large extent, they require foreign capital and foreign investments. The risk involved in the operation is determinant to an economy to be interestingly attractive for investors.

If companies consider the investments to be risky, considering for example the existence of any reversal conditions on the political system of a country, and also if the economic environment of an economy or just if the perception of investors change about it, the feeling of investors to retract the investments is effective and a financial and economic crisis comes potential.

Currently the international investments have reached maximum values and there is now a question. Will FDI keep growth trends? Or is it now reaching a tipping point? If reality shows that countries consider essential to promote development and economic and social growth, the truth is that

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sometimes political agendas, individual interest or the lack of long-term vision by politicians make the context in many countries little conducive to receive foreign investments.

While China has been the country that most has attracted FDI in the last decade, in Latin America, for example, some countries kept structural political problems, what reduces the attractiveness for foreign investments. In the other hand, the good combination of factors in China has given China the potential to become extremely competitive in this area.

Productivity gains play a vital responsibility for countries competitiveness and for global international economy ranking in countries businesses.

In section 2, a review of some important aspects of competitive advantages of countries, political risks and the conditions to get international investments is made. In section 3 the political risk in international arena is studied. In section 4 some reasons for investments attraction in several world regions are pointed out. In section 5 some notes about the new international scenario are presented previously to the final remarks.

2. Competitive Advantages, Political Risks and Attractiveness Conditions for International Investments

A company or a country can obtain a better situation if it bases its choices on a competitive advantage at several levels (national, local, corporate, individual). And a country must aim to get long term competitiveness by getting competitive advantages in the global market.

The constant changes in the global market may have a strong and direct influence in the competitive advantages of companies and countries. Any significant investment require that the company is aware of risks and be aware of the general environment of the destination country, managing the inherent risks. An important factor that influences and that is determinant in the companies' decision about international investments is, in fact, the political risk.

The "political risk" concept has appeared often in the international business literature since long time ago. Its usage usually means that there is a strong chance of unwanted consequences arising from political activity. However, the precise meaning is far from just that. The political risk is customarily seen as the (usually host) government interference in business operations.

According Robock, cited in Kobrin (1978), political risk in international business exists when:

- discontinuities occur in the business environment;
- they are difficult to anticipate; and
- when they result from political change.

To constitute a "risk", accordingly, these changes in the business environment roust have the potential for significantly affecting the profit or other goals of a particular enterprise.

Many authors define political risks as the government interference with the business operations (see, for example, Carlson (1969), Greene (1974), Aliber (1975), Baglini (1976) or Lloyd (1976). Others define political risks in terms of specific events (political acts, constraints imposed on firms, a combination of both).

In this context of the analysis of the political risks, let see also several other authors' points of view about political risks. For example, Weston and Sorge's definition shows that political risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially foreign owned business property.

Root (1976), cited in Kobrin (1978), defines political risk in terms of the "...possible occurrence of a political event of any kind (such as war, revolution, *coup d'etat*, expropriation, taxation, devaluation, exchange controls and import restrictions), at home or abroad, that can cause a loss of profit potential and/or assets in an international business operation".

As shown in Kobrin (1978), Root also emphasizes that the distinction between uncertainty and risk (a distinction with normative and positive implications) attempts to distinguish between political and other environmental risks.

Considering that it is interesting to know the essential conditions to invest in a country and to analyze the mode of a country's inclusion in a market economy, several factors are presented for the analysis of the attraction of investments. These factors can be grouped in three big economic groups:

- national security,
- development of new industries and
- protection of areas in decline.

Accordingly, the stability and instability of government policies are first-order political factors in making decisions on the deployment of large-scale investments, which may change the economic reality of a region. They may represent a significant change for two important economic variables: income and consumption.

It is not possible to avoid political risk completely. Even if the company keeps all its investments in a country, the company will be always exposed to governments' decisions, even if the company may consider the risks very low.

Busse and Hefeker (2005) have also studied the linkages between political risk, institutions and foreign direct investment inflows. The authors used different econometric techniques for a data sample of 83 developing countries for the period 1984-2003, identifying the indicators that matter most for the activities of multinational corporations. Their results showed that government stability, the absence of internal conflict and ethnic tensions, basic democratic rights and ensuring law and order are highly significant determinants of foreign investment inflows.

It must be also noted that the legal system where international business is inserted is very important to FDI. There is a great dilemma for international law, leading many analysts to doubt about normative character of law. When and where to complain when a business group is the victim of a sanction imposed by a host country?

3. International Environment and the Management of Political Risk

A relative equilibrium in relationships in international business environment, which is often unpredictable is very hard to get and organisations must find many adjustments. Companies need to minimize the risks as much as they can. Managing the international environments depends on the circumstances of the system. Companies have to know exactly the contexts to define strategies, particularly the political contexts, having in very particular account the long-term for investments.

Political risk shall take into account the sovereignty of nations, the legal systems, government policies, philosophies, interest groups, political parties among other factors. The analysis of political risk is a kind of barometer of what large companies forming the environment of international business measure the risk of the political environment.

The study PricewaterhouseCoopers and Eurasia Group (2009) shows that these organizations believe that a more effective management of political risk can help companies to protect their investments and take advantage of new opportunities, thereby improving global business performance. For that, it is necessary to go over any fear and uncertainty and they must integrate political risk management into a systematic process embedded in the company's business processes in general.

By doing business internationally, companies are, by nature, willing to take big risks. It is believed that big risks' takers shall be well informed about risks. Political risk management is an essential element of risk-taking knowledge.

When doing business across national borders, the size of companies often faces international political and legal barriers. This is due to the fact that government policies and laws in each nation are different. Thus, in most cases a foreign company must accept the policies and laws of a host country, since there are variables that are beyond its control.

Government policies and laws are strictly linked to the political system of each country and the risk of international investments depends, above all, on the political environment involved. The international political system is formed by sovereign states, theoretically free of external control, with legal equality to the other states, governing their own territories and applying social systems specific to their reality. Sovereignty itself guarantees requirements for citizenship, geographical boundaries and rules of such trade and surveillance of people and goods, and borders. A major cause of conflict in international business is the idea of the extension of the internal laws of a nation. Besides, sovereign states still have power and authority to enter into agreements among themselves.

Therefore, taking into account the fundamental principle of sovereignty, the evaluation of the foreign market is of vital importance to the international business. The analysis of a country's political environment is also essential to the operation of a foreign company business. This political environment that causes risks may be minimized, aiming that foreign organizations will not be subject to penalties such as confiscation, expropriation or nationalization.

A country has to invest in the creation of a global environment that attract FDI. Moreover, it is necessary that the governments know about the importance to have a stable political framework. An international company will work the political expectations about the country to decide about investments.

Often, it is recommended the installation of investments in democratic countries, where there are no major policy changes. However, sometimes major competitive advantages are not achieved in these nations, when taking into consideration the factors of production. Thus, the issue is not to point out a model to manage the political risk, but showing more options and tools to manage the risk that is provided by political environment.

4. Regions Attractiveness

A general view of regions attractiveness is given in this chapter, considering the particular cases of Latin America and China. Some additional notes about USA, Europe and Africa are presented.

4.1. Investments in Latin America

Nowadays, Latin America is a region with 21 countries, 11 territories included since North America, from Mexico, until Argentina in South America. The Latin America territory was scene of major disputes by its field since its discovery in the ends of XIV century.

Let us focus in the period of the increased instability in Latin America after 1930. It is not to mention just the crisis of capitalism and the second World War II, between 1930-1947, when Latin America saw the birth of "desenvolvimentista" thinking. The apex of the "desenvolvimentista" paradigm occurred between 1947-1979 with authoritarian governments. Latin America holds in the people’s mind a phase of modernization in this period, responsible for economic advances that brought at the time some prominent countries to the world. Latin America "desenvolvimentismo" brought a process of industrialization, income growth and *per capita* growth rate.

It was identified that policies were giving attention to issues respecting to investment rates, external financing and the mobilization of domestic savings. But the paradigm of Latin America subtraction issues was in the area of income concentration, regional concentration, social, political and cultural influence on development process. Added to authoritarian governments and dictatorial force, in the Latin America countries there was a chaos of instability in which people felt a temporary “satisfaction” on the system.

It seems evident from the way that there was an assertive degree of instability of the region in 18 countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panamá, Paraguay, Peru, Dominican Republic, Uruguay and Venezuela) for long time and only 3 countries of them (Costa Rica, Colombia and Venezuela) did not use to have large instabilities along the time. Venezuela, however, undid this quality, with the steady rise of Hugo Chavez to the power in the early 2000's.

Accordingly, the Latin America political instability inhibits economic development through its effect on the political system with consequences larger than the physical and human capital. Events such as the ones in Honduras and the political ascents of Evo Morales in Bolivia, bring no help at all to the Latin America stability.

So, historically, Latin America has always been a storehouse of examples of how to remove large investments, often disregarding the right to private property, along with changes in the policies promoted by blows of states and / or changes to populist political leaders. The Brazil’s neighbors, such as Venezuela, Bolivia or Ecuador live in this situation. Some important Brazilian companies (Petrobras and Odebreth) for the first time are faced with political instability, causing incalculable damage and consequently, it is important to learn how to minimize the effects of the political environment.

However, many Latin American countries have been very attractive last decade for international investments because in some countries - as it is the case of Brazil - many conditions of attractiveness were got in order to promote investments in their territories.

Anyway, the political context “ghost” was not forgot and the recent case of the nationalization of YPF, a filial of the Spanish Repsol in Argentina, shows well how things are volatile in Latin America. This has motivated a strong reaction by the Spanish government. Besides, strong consequences in terms of investment in Latin America are expected.

This recent event and the background on the political climate of Latin America show this new facet within international geostrategic relationship, in which Latin America incurs serious risks. The international framework is getting a much more complex stage in terms of international relations, as much as the new dimensions of international economy, show the evidence of complex vulnerabilities for which the solutions seem very difficult. This framework will not be under review here, although it is important to note that the map of international relationships is being redesigned and a new reality is being built.

4.2. China Attractiveness

China got important measures in order to promote a stable economic framework for international companies to install their factories in Chinese territory. Its advantages have worked promoting China to the most competitive country in the world.

In fact, China got a strong combination of factors to get important competitive advantages. There are many factors - like cheap costs for labor, competent technicians, low cost infrastructures, important incentives, for example – that made China very attractive.

However, the increase of labor costs and other factors are changing a little this reality. Anyway, China has an important support line, what guarantees to China a strong basis for competiveness.

While many companies are moving some investments outside China, coming back to their countries, for example (it is the case of some USA companies coming back to USA) or are investing in other countries, the fact is that there are investments in China and other Asian countries remaining interesting because, among other reasons, the demand in these countries is growing considerably.

4.3. Developed Countries Investments

For several decades USA has found, internally and externally, ways to overcome the successive problems in industry, sometimes very hardly. FDI has been for many USA companies the solution for the wealth creation. After the East Asian Tigers, China has emerged as the solution for many USA companies.

What European countries respects, the EU countries have searched as well for interesting destination countries to invest. Particularly, the Lisbon Treaty amends the Treaty Establishing the European Communities, and renames it the Treaty on the Functioning of the European Union (TFEU). Article 207(1) of the TFEU explicitly mentions foreign direct investment as forming part of the common commercial policy. As such, the Treaty establishes the EU's exclusive competence on foreign direct investment. As a result, the EU investment platform vis-à-vis third countries could be gradually enriched with investment protection standards for all EU investors establishing its presence in these countries.

4.4. Other Regions

Africa countries have also their own problems, very well known, since corruption, lack of infrastructures, illiteracy, to strong political risks, for example. Anyway, sometimes there are specific conditions to invest in some African countries.

There are several countries in other regions that may attract also investments.

Anyway, the big question resides on the attractiveness of these countries and the implications of the actual international context, very problematic and very complex.

5. The New International Environment

China has a very significant domestic market. China has been converting all the potential to adjust the productive structures and it is enlarging the basis of the production structure what concerns to many capital-intensive industries. China is guaranteeing many skilled workers and is developing many conditions for the Chinese development. Many Chinese cities are now very well positioned for new challenges. China is also penetrating around the world guaranteeing a support for future activities.

The substantial changes in China reveal that in more options will exist for international investments and international trade flows, considering the existence of more choices for companies' production in the future. Anyway, many products to be supplied to the world and more specifically to Asian countries may remain being produced in China.

International companies have new options about the global supply networks. The usual criteria to decide about investments remain valid: the total cost of production, the proximity of markets and raw materials, and so on. However, companies must analyze now the new circumstances of fast change on the global combination of factors. The flexibility and dynamism of the supply chains and their capability to be balanced is now central in the companies' decisions. Movements from one to another center of production are also analyzed considering that as important as becoming closer to the final customer, according the needs and new demands. A new stage for international trade is in the front door and is determined by the new relative position of countries considering the speedy effects of international investment movements and the new requirements for production and supply that respond to the new trends of demands.

6. Final Remarks

Internal market of China seems to be guaranteed in the future. China power remains and is able to supply many sophisticated products.

USA has overcome the challenges of last decades. Its flexibility made USA resistant enough to maintain its economic and political hegemony in the world. One of the big defies of USA for the coming years is the emergence and consolidation of China as one of the most powerful countries.

By its side, EU protects the advantages of international trade and keeps trade policy as being essential to generate development and jobs through the increasing of international trade. The various EU countries look for improving the conditions of competitiveness of domestic companies and to get a better graduation in the international ranking of competitiveness. EU countries are currently adjusting production structures and creating more competitive administrative conditions for internal investments and production.

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