ORGANIZATIONAL & INSTITUTIONAL RESPONSES TO INTERNATIONAL RISK

DETERMINE INSTITUTIONAL RESPONSES TO RISK

It contains two problems:

1. **It isn't clear to which subject a risk could be regarded to: organizational/institutional or economics**
2. **Which types of international risk that would be addressed**

DIRECT INVESTMENT AS A RESPONSE TO RISK

Internalize certain transaction as a way of avoiding risk:

- Common in domestic and international settings
- Occurring most commonly when the number of firms in market is small
- When the surrounding environment is uncertain
- When the representation or commitments of the parties are difficult to verify or enforce

DIRECT INVESTMENT AS A RESPONSE TO RISK

Establishing the foreign subsidiary → internationalization

- **Caused by market imperfection in the market for the product or service**
- **Stimulate the firm to create its own internal market, to accept the narrowing of choice involved in the decision**
- **Commonly occurred in the exploitation and processing of oil and minerals, and the development and application of advanced technologies**

DIRECT INVESTMENT AS A RESPONSE TO RISK

Establishing the foreign subsidiary → entry barrier: oil companies

- **Large indivisible costs and high barriers to entry → keep the numbers small**
- **Type of entry barriers → difficulties of achieving agreements with host countries on the terms of entry and in part by the size of the capital commitment needed to finance the extensive developmental work and infrastructure that go with the launching of large raw material projects**
- **Dispersed location of overseas operations and the tenuous links among the participating parties create uncertainties and hamper fact finding to a degree that is especially acute**

DIRECT INVESTMENT AS A RESPONSE TO RISK

Establishing the foreign subsidiary → entry barrier: technology

- **Created by the fact that a considerable expenditure of money & time is commonly required while firms accumulate the necessary knowledge, skills, and reputation that may be necessary for the effective marketing of the product**
- **High-technology firms incur developmental costs in the launching of new businesses that are relatively high when compared with the actual costs of production**
- **After beginning production, individual firms experience a persistent decline in production costs (due to accumulated production) limiting for newcomers**

DIRECT INVESTMENT AS A RESPONSE TO RISK

Industries	Challenges	Response
Oil Companies	Fluctuation in net profits	▪ Stabilizing the demand for output ▪ Safeguarding against interruption in the supply of needed materials
	Reduced supplies of crude oil	Cut off all of the un-integrated processors that had supplied previously Continue to supply downstream processing facilities and distributors
	Secure a firm link to supplies and markets	Vertical integration – requires capital & cost (justify expected yield or reduction in risk), flexibility is reduced compared to un-integrated competitors

DIRECT INVESTMENT AS A RESPONSE TO RISK

Industries	Challenges	Response
High-technology industries	Secure a reliable return on its unique skills or knowledge ▪ Costs of setting up another production point can be high ▪ Relative unimportance of freight costs reduce the advantage of creating multiple production sites	Risk-reducing consideration → set up overseas subsidiaries for a portion of their foreign business

DIRECT INVESTMENT AS A RESPONSE TO RISK

Industries	Challenges	Response
High-technology industries	Technological edge of the firm is eaten away, foreign countries may begin to bar their products in favor of producers on their own soil	Countries with bargaining power obliged foreign firms to develop more substantive response: • Firms establish a world-scale plant in an important foreign market • Ship some of the output to other countries, not focus on the home country markets
	Avoidance of risk	Growth of foreign direct investment

DIRECT INVESTMENT AS A RESPONSE TO RISK

Follow the leader

- Quality of firm's information isn't clear: bad information burden the firm with a cost that will have to be absorbed in the rent cost. Good information leads to sources of ore whose low cost or strategic geographically → threat the stability of the oligopoly
- Risk avoiders → learn about the new location as soon as possible
- Acquisition & processing of information take time → slower response firms would be anticipated by the faster action of a rival firm
- Committed to new territories without all requisite information → take follow-the-leader pattern

DIRECT INVESTMENT AS A RESPONSE TO RISK

The exchange of threats

- **The US based industries that were generating the highest rates of FDI in Europe were much the same as the European industries that more or less simultaneously were investing in the US → exchange of threats hypothesis**
- **Threatened by the establishment of a foreign owned subsidiary in their home market, the response of the leading firms in that market is to set up subsidiaries in the invader's home market**
- **This two-way flows of FDI →reduce risk of lagging behind in the global technological race**

JOINT VENTURES AS A RESPONSE TO RISK

Consortia of foreigners

- **Firms in the raw material industries place a high premium on reducing the risks such as wars, strikes, and earthquakes → diversification can be costly → firms can multiply their resources by joining others in a number of consortia**
- **Firms engaged in the common exploitation of a raw material in a country that is foreign to all of them**
- **It is a respond to another risk → risk that a rival firm might be in a position to upset the stability of an oligopoly by securing its materials at an especially advantageous cost**

JOINT VENTURES AS A RESPONSE TO RISK

Consortia of foreigners

- In a consortia, political risk is existed in many different types
- It can arise because of a host country's hostility to some specific foreign country and its nationals
- Or because of a host country's hostility to foreigners in general, irrespective of nationality
- Or because of a host country's efforts, without hostility to any foreigners in particular
- Consortia is less common in manufacturing industry, especially those that require large scale and heavy investment
- Foreign automobile producers in Peru & Mexico have been compelled to merge to reduce the number of automobile types in the country and to achieve economies of scale

JOINT VENTURES AS A RESPONSE TO RISK

Joint ventures with local firms

Manufacturing firms take local partners to reduce political risk for some reasons:

- **Host government lay down and enforce a joint venture requirement**
- **To free the subsidiary from various discriminatory restrictions (disqualification from selling to government enterprises or borrowing from local bank)**
- **To represent effort to maximize profit: allow both partners to put slack resources to work in a single entity, allow each partner to earn returns on their investments that were higher than their respective opportunity costs, it may reduce the risks to the MNCs of securing local distribution channels, supplies**

JOINT VENTURES AS A RESPONSE TO RISK

Joint ventures with state owned enterprises

Partnership between foreign firms and enterprises owned by the state for some reasons:

- Freedom from special restriction
- Access to local resources
- Protection from political risk

Difference between partnership with private local firms → lies in the evolution of the local partner's interests over time → held by a large number of local stockholders (in terms of power, high concentration, few in number)

OTHER ARRANGEMENTS FOR AVOIDING RISK

Long-term contracts of various sorts:

- authorized and obligated foreign firms to exercise managerial functions over extended periods,
- planned cash flows for the foreign firm whose discounted value was not very different from the expected stream generated by an analogous FDI

Critical elements of the contract (prices and quantities) have been subject to repeated renegotiations

- Buyers of raw materials have made loans to raw material producers with provisions for immediate repayment whenever the producers failed to deliver specified quantities