CHAPTER 3
Legal, Technological, and Political Forces

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:
• Describe the major types of legal systems confronting international businesses.
• Explain how domestic laws affect the ability of firms to conduct international business.
• List the ways firms can resolve international business disputes.
• Describe the impact of the host country’s technological environment on international business.
• Explain how firms can protect themselves from political risk.
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Harry Potter Goes to China

One of the best-known celebrities of the new millennium is Harry Potter, a young wizard and the hero of a series of books written by the British author J. K. Rowling. It’s fair to say that Potter has woven a spell over the publishing industry. An estimated 270 million copies of Harry’s first six magical adventures have been sold. Bloomsbury Publishing, Potter’s publisher, believes the young wizard’s appeal is universal, and has been busily expanding into non-English-speaking markets. Rowling’s stories now appear in 62 different languages. China offers a particularly appealing target because children’s literature in China often focuses on imparting moral lessons or promoting the latest government policies, rather than entertaining young readers. For example, in “Today I Will Raise the Flag,” a teacher tames a mischievous student by promising to let him be in charge of hoisting China’s national flag on the school flagpole if he behaves. Another children’s story tells of Little Wen, who wants to reforest a local mountain. After accomplishing this task, the story triumphantly concludes, “Little Wen did truly serve the people!”

Given the unappealing nature of such literary fare to most young readers, competition for the Chinese rights to the Potter series was fierce. Notes Wang Ruiqin, an editor at the People’s Literature Publishing House in Beijing, “Chinese books exhort children to be courageous, whereas Harry’s courage is evident through a story that everyone likes to read.” The People’s Literature Publishing House beat out 10 domestic rivals by promising to pay a 10 percent licensing fee to the British publisher. The company planned to sell the first three books as a boxed set priced at $10, which is expensive by Chinese standards.

As is the case in any Harry Potter novel, the publisher’s path to success was full of obstacles. Translators struggled to maintain the magic of Rowling’s writing while converting her words and whimsy into Chinese. Harry Potter, for example, was translated phonetically into “Ha-li Bo-te.” More troubles arose when, as Harry was preparing to make his debut in China, the Chinese government initiated a propaganda campaign against “feudal superstition.” Ms. Wang became concerned that this government initiative could reduce parents’ interest in a book about a young wizard. Despite these obstacles, Harry and his Chinese licensee, the People’s Literature Publishing House, quickly tasted success. The company rapidly sold out its initial printing of 600,000 sets of Potter novels. And, not surprisingly, when the first Potter movie, Harry Potter and the Philosopher’s Stone, was shown in Chinese movie theaters in January 2002, it was an instant hit.

Is there such a thing as being too popular? Within six months of his Chinese debut the fifth Harry Potter novel—Harry Potter and the Leopard-Walk-Up-To-Dragon—was being snapped up by eager
young readers throughout China. Its success, however, was not happy news for Rowling; she hadn’t yet finished writing her fifth installment of Harry’s adventures. Apparently, an unknown local author/thief had decided to cash in on Harry’s popularity by writing his own Harry Potter novel. Although Chinese police threatened to fine bookstores selling the counterfeit novel, its sales remained brisk. Fortunately, when the real fifth novel—Harry Potter and the Order of the Phoenix—was released in June 2003, Chinese children joined their peers around the world in purchasing copies as soon as they hit their local bookstores. And when July 16, 2005, arrived, Shanghai and Beijing parents and grandparents, like their counterparts in London, Chicago, and New York, dutifully waited in long queues to purchase Harry Potter and the Half-Blood Prince, the sixth novel of the series, which was released simultaneously in every country on that date. Within two weeks, however, unauthorized Chinese translations of it were available for sale on the streets of Beijing. Despite such widespread piracy, to date an estimated 8 million legal copies of Rowling’s works have been sold in China.1

Virtually all decisions facing international managers—whom to hire, how to market their company’s goods in the host market, which technologies to adopt, and so forth—are affected by the national environment of the country in which the transaction occurs. Harry Potter’s publisher had to confront cultural, legal, and political issues unique to China in developing its strategy for entering the Chinese market. The goal of this and the next chapter is to understand the impact of the various dimensions of a country’s environment on the management of a firm’s international business. This chapter discusses the legal, technological, and political dimensions, while Chapter 4 focuses on the cultural.

The Legal Environment

A domestic firm must follow the laws and customs of its home country. An international business faces a more complex task: It must obey the laws not only of its home country but also the laws of all the host countries in which it operates. Both home and host country laws can critically affect the way international firms conduct their business. These laws determine the markets firms may serve, the prices they can charge for their goods, and the cost of necessary inputs such as labor, raw materials, and technology. The laws may also affect the location of economic activity. For example, some Internet companies have chosen to base their operations outside the People’s Republic of China because of the seemingly arbitrary rules imposed by its government. “E-World” discusses some additional effects the rapid growth of the Internet has had on the legal systems of various countries.

Differences in Legal Systems

National legal systems vary dramatically for historical, cultural, political, and religious reasons. The rule of law, the role of lawyers, the burden of proof, the right to judicial review, and, of course, the laws themselves differ from country to country. In the United States, for example, in times of economic distress firms can lay off workers with minimal notice and severance pay. In Belgium, however, firms wishing to trim their white-collar workforces must provide each worker with three months’ notice, three months’ severance pay, or some combination of the two for every five years (or fraction of five years) the employee has worked for the firm. Access to the legal system also may vary from country to country. In the United States, for example, easy availability of lawyers and nondiscriminatory access to its legal system are helpful to international businesses wishing to settle disputes with suppliers and customers. South Korea, in contrast, suffers from a shortage of lawyers because of its tough bar exam—only 3 percent of the candidates taking it pass. Thus many international businesses are forced to resolve disputes privately rather than utilize South Korea’s courts. Because the Indian court system has a backlog of over 3 million
aisle or a window seat, and the billing addresses of their credit cards. However, European laws provide consumers with stronger privacy protection than do U.S. laws. Under European law any information collected from a consumer for one purpose cannot be used for another purpose without the express permission of that person. U.S.-based Web companies must thus alter their marketing and information-gathering practices to accommodate European privacy laws.

Another issue is what to do with “cybersquatters”—people or firms who try to register domain names of established organizations or famous people and then sell back the names to their owners at inflated prices. The World Intellectual Property Organization operates an arbitration program to reduce this problem. Although successful, it has not totally eliminated cybersquatting.


Law and the Internet

Most existing laws predate the World Wide Web. Adjusting these laws to the needs of the Internet age is a massive undertaking, to say the least. One basic issue is deciding which country’s laws should oversee e-commerce transactions. Activities sponsored by a Web site may be legal in its home country yet violate the laws of other countries. For example, in 2000, Yahoo! Inc. was found guilty of allowing neo-Nazi paraphernalia to be sold on its Web sites in violation of a French law that prohibits the sale of anything that incites racism. Although Yahoo! had carefully excluded such goods from its French portal, it had not done so for its U.S. sites. Because French citizens had access to the U.S. Web sites over the Internet, Yahoo! was fined $2,800 and given two months to make the site inaccessible to French Internet users.

National policies toward consumer privacy also need to be adjusted. Many U.S. companies routinely collect information from their customers that the companies then use internally to cross-sell other products, or the companies sell the information to third parties. Similarly, many Web sites produce “cookies” that help facilitate repeat online transactions. For instance, cookies allow an online travel vendor to remember customers’ frequent flyer numbers, whether the customers prefer an aisle or a window seat, and the billing addresses of their credit cards. However, European laws provide consumers with stronger privacy protection than do U.S. laws. Under European law any information collected from a consumer for one purpose cannot be used for another purpose without the express permission of that person. U.S.-based Web companies must thus alter their marketing and information-gathering practices to accommodate European privacy laws.

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Common Law. Common law is the foundation of the legal systems in the United Kingdom and its former colonies, including the United States, Canada, Australia, India, New Zealand, Hong Kong, Barbados, Saint Kitts and Nevis, and Malaysia. Common law is based on the cumulative wisdom of judges’ decisions on individual cases through history. These cases create legal precedents, which other judges use to decide similar cases.

Common law has evolved differently in each common law country. Thus laws affecting business practices vary somewhat among these countries, creating potential problems for the uninformed international businessperson. For example, manufacturers of defective products are more vulnerable to lawsuits in the United States than in the United Kingdom as a result of evolutionary differences in the two countries’ case law.

In addition to evolutionary differences in case law, statutory laws—those enacted by legislative action—also vary among the common law countries. For example, many business transactions between firms and the British government are shielded from public scrutiny—and the prying eyes of competitors—by Britain’s Official Secrets Act. In contrast, more information about transactions between firms and the U.S. federal government
Although Hong Kong is now a Special Administrative Region of China, its legal system is based on British common law. Hong Kong follows many of the traditions of the British legal system, as these bewigged jurists suggest.

is publicly available because of the U.S. Freedom of Information Act. Even the administration of law may vary. For instance, in the United States the plaintiff and the defendant in a lawsuit generally pay their own legal fees. Often, defendants agree to quick settlements regardless of the strength of their cases to avoid expensive litigation. In the United Kingdom, the losers in trials pay the legal expenses of both parties. Thus the British have less incentive to file frivolous lawsuits.

Civil Law. Another common form of legal system, civil law, is based on a codification, or detailed listing, of what is and is not permissible. The civil law system originated in biblical times with the Romans, who spread it throughout the Western world. Its dominance was reinforced by the imposition of the civil-law-based Napoleonic Code on territories conquered by French emperor Napoleon Bonaparte during the early nineteenth century.

One important difference between common law and civil law systems is apparent in the roles of judges and lawyers. In a common law system the judge serves as a neutral referee, ruling on various motions by the opposing parties’ lawyers. These lawyers are responsible for developing their clients’ cases and choosing which evidence to submit on their clients’ behalf. In a civil law system, the judge takes on many of the tasks of the lawyers, determining, for example, the scope of evidence to be collected and presented to the court.

Religious Law. Religious law is based on the officially established rules governing the faith and practice of a particular religion. A country that applies religious law to civil and criminal conduct is called a theocracy. In Iran, for example, a group of mullahs, or holy men, determine legality or illegality through their interpretation of the Koran, the holy book of Islam.

Religious laws can create interesting problems for firms. Consider the teaching of the Koran, which denounces charging interest on loans as an unfair exploitation of the poor. Muslim firms and financial institutions have had to develop alternative financing arrangements to acquire and finance capital. Muslim businesses often rely on leasing arrangements, rather than borrowing money, to obtain long-term assets. In Iran banks often charge up-front fees that act as a substitute for loan interest payments, and owners of bank deposits receive shares of the bank’s profits rather than interest payments. Pakistani banks are adopting similar policies—often referred to as Islamic banking—because Pakistan’s Supreme Court
issued a ruling in 1999 declaring all interest-bearing transactions to be contrary to Islamic law. Family-owned firms are often influential in countries where legal systems are based on the Koran because members of an owner’s extended family may be the best available source of capital, given the costs of circumventing the prohibition on interest.

Countries relying on religious law often have other features, such as an absence of due process and appeals procedures, which should make outsiders cautious. In Saudi Arabia, for example, all foreign firms must have a local representative or sponsor, typically a government agency or a person well connected to the royal family. Should a commercial dispute arise between a foreign businessperson and the local representative, the local representative can have the foreigner detained by the local police. Because no independent judiciary exists in the country to protect the foreigner’s rights, the foreigner is in a weak bargaining position.

**Bureaucratic Law.** The legal system in communist countries and in dictatorships is often described as bureaucratic law. Bureaucratic law is whatever the country’s bureaucrats say it is, regardless of the formal law of the land. Contracts can be made or broken at the whim of those in power. The collapse of Zairean dictator Mobutu Sese Seko’s government in 1997, for example, threatened the viability of all existing contracts signed by foreign companies and triggered a mad scramble to revalidate old contracts and negotiate new ones with the government of his successor. Protections that may appear in the country’s constitution—such as the right to an attorney and the right to hear witnesses against one—may be ignored if government officials find them inconvenient. For instance, the formalities of Ugandan law afforded Ugandans and foreigners little protection under dictator Idi Amin’s regime of terror during the 1970s. Similarly, the elaborate protections detailed in the constitution of the former Soviet Union offered little solace to the victims of Joseph Stalin’s political purges during the 1930s.

In countries relying on bureaucratic law, the ability of an international business to manage its operations is often compromised by bureaucrats. International managers are often confronted with arbitrary rules or decisions that have the force of law. This is often the case in China, for example. One study notes

Chinese bureaucracies have sometimes been accused of selectively applying regulations. China has many strict rules that are usually ignored in practice until a person or entity falls out of official favor. Governmental authorities can wield their discretionary power to “crack down” on foreign or disfavored investors or make special demands on such investors simply by threatening to wield such power.

Many international managers have learned the hard way that an unfortunate by-product of bureaucratic law is the lack of consistency, predictability, and appeal procedures.

International businesspeople must be aware of these general differences in legal systems to avoid costly misunderstandings. They should also rely on the expertise of local lawyers in each country in which they operate to help them comply with the specific requirements of local laws and to counsel them on substantive differences in due process, legal liabilities, and procedural safeguards.

**Domestically Oriented Laws**

The laws of the countries in which an international business operates play a major role in shaping the opportunities available to that firm. Some of these laws are primarily designed to regulate the domestic economic environment. Such laws affect all facets of a firm’s domestic operations: managing its workforce (recruitment, compensation, and labor relations laws); financing its operations (securities, banking, and credit laws); marketing its products (advertising, distribution, and consumer protection laws); and developing and utilizing technology (patent, copyright, and trademark laws). Although such laws are primarily focused on the domestic marketplace, they may indirectly affect the ability of domestic firms to compete internationally by increasing their costs, thus reducing their price competitiveness relative to foreign firms. For example, labor
Russia—particularly Siberia—is now the world's largest market for Japanese used cars, despite the steering wheels being on the “wrong” side. Geography plays a role: Used cars can be easily and inexpensively transported across the Sea of Japan to Siberia. But so does quality. Notes Anatoly Kiselev, the director of the largest car market in the Siberian city of Khabarovsk, “A Russian car practically falls apart after 50,000 kilometers,” which is mere adolescence for a Toyota or Honda built in a quality-conscious Japanese factory. As a result, Russian consumers spend more on used foreign cars than they do on new Russian cars.

and Liberia to cut the flow of arms to their war-torn area, while the United States levied sanctions against Sudan and Myanmar (Burma) for human rights violations.

An embargo—a comprehensive sanction against all commerce with a given country—may be imposed by countries acting in unison or alone. For example, the United Nations embargoed all trade with Iraq after Iraq’s 1990 invasion of Kuwait. Most countries embargoed goods to or from South Africa during the 1980s to protest its apartheid policies. The United States has unilaterally embargoed trade with Cuba since 1961, when the attempted U.S.-supported overthrow of Fidel Castro died on the beaches of the Bay of Pigs. Similarly, India acted alone during the early 1990s when it embargoed trade with Nepal because it believed Nepal’s prime minister was favoring China’s interests over India’s (see Map 3.1).

A particularly important form of sanction is export controls on high-technology goods. Many technologically advanced countries control the export of so-called dual-use products that may be used for both civilian and military purposes. McDonnell Douglas ran afoul of U.S. dual-use controls when it sold sophisticated machine tools to the China National Aero-Technology Import and Export Company, which claimed that the equipment would be used to build civilian aircraft. However, the tools were instead shipped to a military factory that builds ballistic and cruise missiles. Similarly, Boeing agreed to pay a $15 million fine in 2006 because it sold China 94 commercial airliners whose avionics systems contained a tiny gyrochip that could be used to guide air-to-surface missiles, without receiving an export license, in violation of the Arms Control Export Act.

Countries may also attempt to regulate business activities that are conducted outside their borders, a practice known as extraterritoriality. For example, firms are vulnerable to U.S. antitrust lawsuits if they engage in activities outside the United States that diminish competition in the U.S. market. In one such case the United States successfully sued Pilkington PLC, the British owner of the most important patents for producing flat glass, for limiting the ability of its U.S. licensees to use the technology in international markets. U.S. authorities claimed that Pilkington’s policies hurt U.S. exports and reduced the incentive of U.S. flat glass producers to invest in research and development, thereby lessening competition.
Antiboycott provisions in U.S. trade law also have extraterritorial reach. U.S. antiboycott law prohibits U.S. firms from complying with any boycott ordered by a foreign country that prohibits trade with a country friendly to the United States. This law is primarily directed against a 1954 resolution adopted by the League of Arab States that calls for a boycott of any firm that does business with Israel. Baxter International found itself in deep trouble after a U.S. grand jury investigated it for selling discounted hospital supplies to Syria, allegedly as a bribe for the Arab states terminating their boycott of the company. Baxter pleaded guilty to violating the antiboycott law and paid a fine of $6.6 million.10

The Helms-Burton Act is probably the most controversial application of extraterritoriality affecting international business today. This act is directed against international firms that “traffic” in the assets of U.S. companies that were confiscated by the Cuban government when Fidel Castro assumed control in 1959. Over time the Cuban government has leased or sold many of these confiscated assets to foreign companies. The Helms-Burton Act authorizes the U.S. government and the former U.S. owners of the confiscated assets to take action against their new foreign owners. The U.S. government can deny entrance to the United States of officers of companies that benefit from the use of these confiscated assets; such a fate has befallen executives of Canada’s Sherritt Corporation, which is producing nickel and cobalt from a mine formerly owned by Freeport McMoRan, a New Orleans–based natural resources company.

In the eyes of the U.S. government the Helms-Burton Act is simply designed to ensure that foreign companies do not profit from Cuban property that was stolen from U.S. owners. In the view of many other countries, such as Canada and the European Union, the Helms-Burton Act is an ill-conceived policy of trying to bludgeon them into joining the U.S. anti-Castro crusade. By some estimates 85 percent of all foreign-owned private property in pre-Castro Cuba was owned by U.S. interests, so it is easy to see why the disposition of confiscated property in Cuba is more important to the United States than to other countries.11

Laws Directed Against Foreign Firms

On other occasions countries may pass laws that are explicitly directed against foreign-owned firms. Ownership issues are a particular area of concern. In most countries there is ongoing debate between the political left and right regarding the appropriate balance between governmental control of the economy and reliance on market forces to allocate resources. Often when leftist governments obtain power, they choose to transfer ownership of resources from the private to the public sector, a process known as nationalization. Most vulnerable to such actions are industries that lack mobility: natural resource industries such as crude oil production and mining, and capital-intensive industries such as steel, chemicals, and oil refining. When the host government compensates the private owners for their losses, the transfer is called expropriation. When the host government offers no compensation, the transfer is called confiscation. Most governments, including that of the United States, recognize the right of other national governments to mandate the transfer of private property within their borders to the public sector, although nonhost governments do expect that foreign owners will receive suitable compensation for their lost property. For example, many Arab oil-producing countries nationalized the properties of Western oil firms after 1973. These countries, however, offered the Western firms a combination of compensation, continuing operating agreements, and future drilling rights that the firms found acceptable. Conversely, a key element in the U.S. conflict with Cuba is Cuba’s lack of compensation for assets seized from U.S. firms.

Privatization. The conversion of state-owned property to privately owned property is called privatization. Although not strictly an issue of host country control, privatization is the opposite of nationalization and creates opportunities for international businesses. Most state-owned enterprises sold to the private sector are unprofitable, undercapitalized, and overstaffed. Nevertheless, they are often attractive to international businesses seeking to expand their operations into new markets located in key sectors of a national economy, such as telecommunications, transportation, and manufacturing.
Privatization, which gained momentum in the 1980s, stems from two primary forces: political ideology and economic pressure. Political ideology prompted Margaret Thatcher, the prime minister of the United Kingdom from 1979 to 1990, to call for diminishing the role of the state in the economy. During the 1980s the British government sold its interests in British Airways, British Telecom, the British Airport Authority, and British Petroleum. Brian Mulroney, head of Canada’s Progressive Conservative Party, followed a similar agenda during his tenure as Canada’s prime minister from 1984 to 1993, as did the leaders of Argentina, Brazil, Chile, Mexico, and many other countries during the 1990s.

Privatization has also resulted from competitive pressures that firms face in global markets. The telecommunications industry provides a perfect example of this phenomenon. That industry has benefited from rapid technological change, yet many national governments, facing enormous budgetary pressures and deficits, have found it difficult to raise the capital required to upgrade and expand state-owned telecommunications systems. As a result, countries such as Argentina, Mexico, Chile, Venezuela, and the United Kingdom have privatized telecommunications services.

Constraints on Foreign Ownership. Many governments limit foreign ownership of domestic firms to avoid having their economies or key industries controlled by foreigners. For example, Mexico restricts foreign ownership in its energy industry, believing that the benefits of its oil reserves, which it views as part of its “national patrimony,” should accrue only to its citizens. Canada effectively limits foreign ownership of newspapers to 25 percent as part of its program to protect the country’s culture from being inundated by its neighbor to the south. Foreign firms are often excluded from the radio and television broadcasting industries. For example, the United States limits foreigners to 25 percent ownership of U.S. television and radio stations. Similar rules exist in Europe.

Countries can also constrain foreign MNCs by imposing restrictions on their ability to repatriate (return to their home countries) the profits earned in the host country. Such restrictions were common in the 1980s, but many countries, such as Botswana and Ethiopia, abolished their repatriation controls during the 1990s as they adopted more free-market-oriented policies.

The Impacts of MNCs on Host Countries

Firms establishing operations beyond the borders of their home country affect and are affected by the political, economic, social, and cultural environments of the host countries in which the firms operate. To compete effectively in these markets and maintain productive relationships with the governments of the host countries, managers of MNCs must recognize how they and their firms should interact with the national and local environments.

Economic and Political Impacts. MNCs affect every local economy in which they compete and operate. Many of the effects are positive. For instance, as Western supermarket chains like France’s Carrefour enter the Chinese market, they offer Chinese consumers greater selection, national brands, and high standards of hygiene. MNCs may make direct investments in new plants and factories, thereby creating local jobs. Such investments provide work for local contractors, builders, and suppliers. MNCs also pay taxes, which benefit the local economy and help to improve educational, transportation, and other municipal services. Technology transfer can also have positive local effects. An important benefit to the Shanghai Automotive Industry Corporation of its joint venture with Volkswagen was access to the latest German automotive technology. Similarly, General Electric raised the productivity of Hungary’s largest lightbulb manufacturer by transferring technological knowledge to the Hungarian firm.

MNCs may also have negative effects on the local economy. To the extent that MNCs compete directly with local firms, the MNCs may cause these firms to lose both jobs and profits. For instance, Carrefour’s entry into the Chinese market makes it more difficult for mom-and-pop operators in China’s open-air food markets to eke out a living. Also, as a local economy becomes more dependent on the economic health of an MNC, the financial fortunes of the firm take on increasing significance. When retrenchment by an MNC is
accompanied by layoffs, cutbacks, or a total shutdown of local operations, the effects can be devastating to a local economy. For example, in 2000, BMW announced that it would liquidate its ownership of Rover by selling part of its interests to Ford Motor Company and the rest to a small British buy-out specialist. Many U.K. politicians immediately raised concerns that BMW’s decision would devastate the local Oxford economy, a region long dependent on Rover’s factories and jobs.

MNCs also may have a significant political impact, either intentionally or unintentionally. Their sheer size often gives them tremendous power in each country in which they operate. Furthermore, there is always the possibility that this power may be misused. Even when it is not, MNCs are often able to counter efforts by host governments to restrict their activities. The MNCs simply threaten to shift production and jobs to other locations. For example, when Spain passed new laws that raised labor costs, MNCs such as Colgate-Palmolive, S. C. Johnson & Son, Kubota, and Volkswagen closed some of their Spanish factories and/or slashed payrolls. The result was soaring unemployment that reached 24.5 percent in the mid-1990s.13

Cultural Impacts. MNCs also can exert a major influence on the cultures in which they operate. As they raise local standards of living and introduce new products and services previously unavailable, people in the host cultures develop new norms, standards, and behaviors. Some of these changes are positive, such as the introduction of safer equipment and machinery, better health care and pharmaceuticals, and purer and more sanitary food products. Other changes are not positive. Nestlé, for example, has received much criticism for its promotion of infant formula in the world’s developing countries. Mothers in these countries were allegedly enticed into buying the formula but were not trained in its proper use. The mothers diluted the formula to make it go further and often were unable to follow adequate sanitation procedures. As a result, critics argue, infant mortality in these countries increased significantly.

Dispute Resolution in International Business
Disputes in international commerce can be very complicated. Typically, four questions must be answered for an international dispute to be resolved:

1. Which country’s law applies?
2. In which country should the issue be resolved?
3. Which technique should be used to resolve the conflict: litigation, arbitration, mediation, or negotiation?
4. How will the settlement be enforced?

Many international business contracts specify answers to these questions to reduce uncertainty and expense in resolving disputes. The courts of most major trading countries will honor and enforce the provisions of these contracts, as long as they are not contrary to other aspects of the country’s public policy.

If a contract does not contain answers to the first two questions, each party to the transaction may seek to have the case heard in the court system most favorable to its own interests, a process known as forum shopping. Forum shopping allegedly places U.S. manufacturers at a disadvantage in international markets. Monetary awards are higher in U.S. courts, so many plaintiffs’ lawyers attempt to use these courts to adjudicate foreign lawsuits for product defects in U.S.-made goods sold internationally. In contrast, a foreign manufacturer of a good sold outside the United States would not face the threat of having to defend its product in a U.S. court because the manufacturer lacked a tie to that forum.

Whether a foreign court order is enforced is determined by the principle of comity. The principle of comity provides that a country will honor and enforce within its own territory the judgments and decisions of foreign courts, with certain limitations. For the principle to apply, countries commonly require three conditions to be met:

1. Reciprocity is extended between the countries; that is, country A and country B mutually agree to honor each other’s court decisions.
2. The defendant is given proper notice.
3. The foreign court judgment does not violate domestic statutes or treaty obligations.\textsuperscript{14}

Because of the costs and uncertainties of litigation, many international businesses seek less expensive means of settling disputes over international transactions. Often business conflicts will be resolved through alternative dispute resolution techniques, such as arbitration. Arbitration is the process by which both parties to a conflict agree to submit their cases to a private individual or body whose decision they will honor. Because of the speed, privacy, and informality of such proceedings, disputes can often be resolved more cheaply than through the court system. For example, a five-year-old conflict between IBM and Fujitsu over the latter’s unauthorized use of proprietary IBM software that was moving slowly through the U.S. judicial system was settled quickly with the help of two neutral arbitrators from the American Arbitration Association.\textsuperscript{15} Similarly, 16 francophone African nations have established a regional commercial arbitration court in Abidjan, Côte d’Ivoire. By providing a site for resolving commercial disputes independent of behind-the-scenes politicking or pressures from a host government, this court should encourage more international trade and investment in the 16 countries.\textsuperscript{16}

Another set of issues arises when an international business is in a dispute with a national government. The legal recourse available to international businesses in such disputes is often limited. For example, the U.S. \textit{Foreign Sovereign Immunities Act of 1976} provides that the actions of foreign governments against U.S. firms are generally beyond the jurisdiction of U.S. courts. Thus, if France chose to nationalize IBM’s French operations or to impose arbitrary taxes on IBM computers, IBM could not use U.S. courts to seek redress against the sovereign nation of France. However, the Foreign Sovereign Immunities Act does not grant immunity for the commercial activities of a sovereign state. If the French government contracted to purchase 2,000 servers from IBM and then repudiated the contract, IBM could sue France in U.S. courts.

Countries, including the United States, often negotiate bilateral treaties to protect their firms from arbitrary actions by host country governments. These treaties commonly require the host country to agree to arbitrate investment disputes involving the host country and citizens of the other country. The United States and Jamaica have such a treaty. When the Jamaican government announced a tax increase on Alcoa’s aluminum refining plant despite a contract between the two parties that prohibited such an increase, Alcoa was able to force the Jamaican government to submit its decision to arbitration.\textsuperscript{17}

\textbf{The Technological Environment}

Another important dimension of a country is its technological environment. The foundation of a country’s technological environment is its resource base. Some countries, such as Australia, Argentina, and Thailand, are blessed with much fertile agricultural land. Other countries, such as Saudi Arabia, South Africa, and Russia, are endowed with rich natural resources like oil, gold, and diamonds. Countries such as China and Indonesia have abundant labor supplies, while other countries, such as Iceland and New Zealand, do not. The availability or unavailability of resources affects what products are made in a given country. Because of their abundance of fertile land, Australia, Argentina, and Thailand are major exporters of agricultural goods. Similarly, the easy availability of low-cost labor allows firms in China and Indonesia to produce labor-intensive products for the world market. Conversely, firms in Iceland and New Zealand are net importers of such products because these firms lack low-cost labor, which hinders their ability to manufacture labor-intensive goods profitably.

Countries may change or shape their technological environments through investments. Many countries, such as Canada, Germany, and Japan, have invested heavily in their infrastructures—highways, communications systems, waterworks, and so forth—to make producing and distributing products easier. Similarly, many countries have invested heavily in human capital. By improving the knowledge and skills of their citizens, countries improve the productivity and efficiency of their workforces. Investments in infrastructure and
human capital have allowed developed countries to continue prospering in world markets despite the high wages paid to workers in those countries.

Another means for altering a country’s technological environment is technology transfer, the transmittal of technology from one country to another. Some countries have promoted technology transfer by encouraging foreign direct investment (FDI). For instance, Hungary and Poland jump-started their transition from communism to capitalism by using tax and other incentives to entice firms like General Electric and General Motors to build new factories there. Other countries have improved their technological base by requiring companies eager to access a country’s resources or consumers to transfer technology as a condition for operating in that country. Saudi Arabia, for example, mandated that oil companies wishing to extract its crude oil hire and train Saudi petroleum engineers, who then learned state-of-the-art exploration and extraction methods on the job. Similarly, the Chinese government approved General Motors’ request to build Buicks in Shanghai only after GM agreed to establish five research institutes in China that would train Chinese engineers and advance China’s technological know-how in such areas as fuel injection systems and power trains.

An important determinant of a country’s technological environment—and the willingness of foreign firms to transfer technology to the country—is the degree of protection that its laws offer intellectual property rights. Intellectual property—patents, copyrights, trademarks, brand names, and so forth—is an important asset of most MNCs. It often forms the basis of a firm’s competitive advantage/core competency in the global marketplace. The value of intellectual property can quickly be damaged unless countries enforce ownership rights of firms. Countries that provide weak protection for intellectual property are less likely to attract technology-intensive foreign investments. Weak intellectual property protection also discourages local firms from developing intellectual property of their own.

Most countries have passed laws protecting intellectual property rights. Protection of such rights has also been promoted by numerous international treaties. Among these are the International Convention for the Protection of Industrial Property Rights (more commonly known as the Paris Convention), the Berne Convention for the Protection of Literary and Artistic Works, the Universal Copyright Convention, and the Trade-Related Intellectual Property Rights agreement (part of the Uruguay Round). On paper these laws and treaties would appear to provide adequate protection to owners of intellectual property. However, not all countries have signed the treaties. Further, their enforcement by many signatories is lax.

Weak protection for intellectual property rights can have high costs for international businesses—as Harry Potter’s publisher discovered in the chapter’s opening case. According to the Business Software Alliance, piracy of computer software cost its members $34 billion in revenues in 2005. As Table 3.1 indicates, piracy rates are highest in Vietnam, Zimbabwe, and Indonesia, while they are lowest in the United States and New Zealand. Similarly, music and movie companies estimate that their losses due to illegal duplication of cassettes, CDs, and videos exceed $8 billion annually. Unfortunately for these companies, technology is allowing pirates to move faster than ever. For example, bootleg copies of Hollywood movies routinely appear on the streets of China, Hong Kong, and Indonesia within days of their debuts in theaters.18

International conflicts often develop because intellectual property laws are not consistent. Alone among the major trading countries, the United States follows a “first to invent” patent policy.19 This system focuses on protecting the rights of the “true” inventor. Unfortunately, it also encourages much litigation as competing patent applicants attempt to prove they were the first to invent the product. The “first to file” system adopted by other countries avoids this litigation by unambiguously assigning rights to the first patent applicant. However, it also puts a premium on speed in applying and favors larger firms with deeper pockets.

Differences in patent practices can also lead to conflicts. For example, Japanese firms tend to file numerous patents, each of which may reflect only a minor modification of an existing patent. Conversely, U.S. patent law requires that patentable inventions be new, useful, and nonobvious. Accordingly, U.S. firms tend to file far fewer patents than Japanese companies. This has led to trade disputes between the United States and Japan over the use of so-called patent flooding by Japanese firms. With patent flooding, a company files a series of patent applications protecting narrow, minor technical improvements to a competitor’s
### TABLE 3.1 Software Piracy Rankings

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>90%</td>
<td>92%</td>
<td>92%</td>
<td>United States</td>
<td>21%</td>
<td>21%</td>
<td>22%</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>90%</td>
<td>90%</td>
<td>87%</td>
<td>New Zealand</td>
<td>23%</td>
<td>23%</td>
<td>23%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>87%</td>
<td>87%</td>
<td>88%</td>
<td>Austria</td>
<td>26%</td>
<td>25%</td>
<td>27%</td>
</tr>
<tr>
<td>China</td>
<td>86%</td>
<td>90%</td>
<td>92%</td>
<td>Finland</td>
<td>26%</td>
<td>29%</td>
<td>31%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>86%</td>
<td>82%</td>
<td>83%</td>
<td>Denmark</td>
<td>27%</td>
<td>27%</td>
<td>26%</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>85%</td>
<td>85%</td>
<td>85%</td>
<td>Germany</td>
<td>27%</td>
<td>29%</td>
<td>30%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>85%</td>
<td>91%</td>
<td>91%</td>
<td>Sweden</td>
<td>27%</td>
<td>26%</td>
<td>27%</td>
</tr>
<tr>
<td>Cameroon</td>
<td>84%</td>
<td>84%</td>
<td>81%</td>
<td>Switzerland</td>
<td>27%</td>
<td>28%</td>
<td>31%</td>
</tr>
<tr>
<td>Russia</td>
<td>83%</td>
<td>87%</td>
<td>87%</td>
<td>United Kingdom</td>
<td>27%</td>
<td>27%</td>
<td>29%</td>
</tr>
<tr>
<td>Bolivia</td>
<td>83%</td>
<td>80%</td>
<td>78%</td>
<td>Japan</td>
<td>28%</td>
<td>28%</td>
<td>29%</td>
</tr>
<tr>
<td>Paraguay</td>
<td>83%</td>
<td>83%</td>
<td>83%</td>
<td>Belgium</td>
<td>28%</td>
<td>29%</td>
<td>29%</td>
</tr>
<tr>
<td>Algeria</td>
<td>83%</td>
<td>83%</td>
<td>84%</td>
<td>Netherlands</td>
<td>30%</td>
<td>30%</td>
<td>33%</td>
</tr>
<tr>
<td>Zambia</td>
<td>83%</td>
<td>84%</td>
<td>81%</td>
<td>Norway</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>82%</td>
<td>79%</td>
<td>72%</td>
<td>Australia</td>
<td>31%</td>
<td>32%</td>
<td>31%</td>
</tr>
<tr>
<td>Botswana</td>
<td>82%</td>
<td>84%</td>
<td>81%</td>
<td>Israel</td>
<td>32%</td>
<td>33%</td>
<td>35%</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>82%</td>
<td>84%</td>
<td>81%</td>
<td>Canada</td>
<td>33%</td>
<td>36%</td>
<td>35%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>82%</td>
<td>84%</td>
<td>84%</td>
<td>UAE</td>
<td>34%</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>Senegal</td>
<td>82%</td>
<td>84%</td>
<td>81%</td>
<td>South Africa</td>
<td>36%</td>
<td>37%</td>
<td>36%</td>
</tr>
<tr>
<td>Serbia/Montenegro</td>
<td>81%</td>
<td>81%</td>
<td>81%</td>
<td>Ireland</td>
<td>37%</td>
<td>38%</td>
<td>41%</td>
</tr>
<tr>
<td>El Salvador</td>
<td>81%</td>
<td>80%</td>
<td>79%</td>
<td>Singapore</td>
<td>40%</td>
<td>42%</td>
<td>43%</td>
</tr>
</tbody>
</table>


Existing patents. Patent flooding makes it difficult for the competitor to improve its own technology without infringing on the intellectual property of the patent flooder. CyberOptics, the small Minneapolis developer of LaserAlign (a software and laser-based technology that helps robots position miniature components on circuit boards), provides an example of a firm that believes it has been harmed by patent flooding by a much larger company. CyberOptics had worked closely with Yamaha for five years to incorporate CyberOptics technology on the pick-and-place robots Yamaha used to produce its motorcycles and other products. Both companies agreed that, without each other’s consent, neither would file for patent protection for technology they had developed jointly. However, CyberOptics discovered that Yamaha had filed 26 patent applications in Japan, Europe, and the United States for technology that CyberOptics believed was developed collaboratively based on the LaserAlign system. CyberOptics further discovered that Yamaha was allegedly warning potential CyberOptics customers that they might be in violation of Yamaha’s patents if they purchased CyberOptics’ services. Consequently, the Minneapolis firm sued Yamaha for breach of contract and infringement of its patents.

Registration of trademarks and brand names can also cause problems for international businesses. Generally, most countries follow a “first to file” approach, which often lends itself to abuses against foreigners. A firm may popularize a brand name or trademark in its home market, only to find, when it attempts to export its product to a second country, that an opportunistic entrepreneur has already applied for the intellectual property rights in that country. For example, J. C. Penney, which had registered its trademark in most markets to avoid such problems, lost the rights to its name in Singapore to a small entrepreneur who adopted the name “J C Penney Collections” for her two clothing stores. The High Court of Singapore, while acknowledging that J. C. Penney had validly registered its trademark in that country, determined that the U.S. firm had lost the right to its company name for failure to exercise its use in Singapore.
Piracy of computer software, DVDs, CDs, and other intellectual property costs international businesses billions of dollars of revenues annually. Often illegal DVDs of Hollywood movies are sold on the streets of Beijing and Shanghai within days of their theatrical release. The inability and/or unwillingness of Chinese authorities to control intellectual property theft is a major source of conflict between China, the European Union, and the United States.

Administrative delays may also hurt the rights of intellectual property owners. In Japan approval of a trademark application often takes four times as long for a foreign firm as for a Japanese firm. Approval of foreign patent applications may also take a long time. For example, three decades elapsed before Japanese courts recognized Texas Instruments’ (TI) original patents on integrated circuits in 1989, substantially reducing TI’s royalty payments from Japanese licensees. Some firms, such as Fujitsu, were able to avoid paying TI any royalties, arguing that Fujitsu’s circuit designs rely on newer, more improved technology rather than on TI’s original patents. In essence the slowness of Japan’s judicial process allowed companies like Fujitsu to benefit from TI’s technology during the early days of the semiconductor industry without having to compensate TI for its intellectual property.22

The Political Environment

An important part of any business decision is assessing the political environment in which a firm operates. Laws and regulations passed by any level of government can affect the viability of a firm’s operations in the host country. Minimum-wage laws affect the price a firm must pay for labor; zoning regulations affect the way it can use its property; and environmental protection laws affect the production technology it can use as well as the costs of disposing of waste materials. Adverse changes in tax laws can slowly destroy a firm’s profitability. Civil wars, assassinations, or kidnappings of foreign businesspeople and expropriation of a firm’s property are equally dangerous to the viability of a firm’s foreign operations.

Political Risk

Most firms are comfortable assessing the political climates in their home countries. However, assessing the political climates in other countries is far more problematic. Experienced international businesses engage in political risk assessment, a systematic analysis of the political risks they face in foreign countries. Political risks are any changes in the political environment that may adversely affect the value of a firm’s business activities. Most political risks can be divided into three categories:

- Ownership risk, in which the property of a firm is threatened through confiscation or expropriation
Operating risk, in which the ongoing operations of a firm and/or the safety of its employees are threatened through changes in laws, environmental standards, tax codes, terrorism, armed insurrection, and so forth.

Transfer risk, in which the government interferes with a firm’s ability to shift funds into and out of the country.

As Table 3.2 shows, political risks may result from governmental actions, such as passage of laws that expropriate private property, raise operating costs, devalue the currency, or constrain the repatriation of profits. Political risks may also arise from nongovernmental actions, such as kidnappings, extortion, and acts of terrorism, as “Emerging Opportunities” indicates.

Political risks may affect all firms equally or focus on only a handful. A **macropolitical risk** affects all firms in a country; examples are the civil wars that tore apart Sierra Leone, Zaire, Bosnia, and Rwanda in the 1990s or the recent conflicts in Afghanistan, Iraq, and Liberia. A **micropolitical risk** affects only a specific firm or firms within a specific industry. Saudi Arabia’s nationalization of its oil industry in the 1970s is an example of a governmentally imposed micropolitical risk, as is the Venezuelan government’s recently announced requirements that foreign oil companies renegotiate their contracts with the government. Nongovernmental micropolitical risks are also important. Disneyland Paris and McDonald’s have been the target of numerous symbolic protests by French farmers, who view them as a convenient target for venting their unhappiness with U.S. international agricultural policies. In other instances, protests may turn violent, forcing firms to shut down their operations. For instance, Total SA, Royal Dutch/Shell, and Chevron have been forced to temporarily suspend their operations in the Niger Delta several times this decade because of fighting between the Nigerian government and local ethnic communities who believe that they have not received a fair share of the wealth generated by the oil.

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**TABLE 3.2 Examples of Political Risks**

<table>
<thead>
<tr>
<th>Type</th>
<th>Impact on Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expropriation</td>
<td>Loss of future profits</td>
</tr>
<tr>
<td>Confiscation</td>
<td>Loss of assets</td>
</tr>
<tr>
<td></td>
<td>Loss of future profits</td>
</tr>
<tr>
<td>Campaigns against foreign goods</td>
<td>Loss of sales</td>
</tr>
<tr>
<td></td>
<td>Increased costs of public relations efforts to improve public image</td>
</tr>
<tr>
<td>Mandatory labor benefits legislation</td>
<td>Increased operating costs</td>
</tr>
<tr>
<td>Kidnappings, terrorist threats, and other forms of violence</td>
<td>Disrupted production</td>
</tr>
<tr>
<td></td>
<td>Increased security costs</td>
</tr>
<tr>
<td></td>
<td>Increased managerial costs</td>
</tr>
<tr>
<td></td>
<td>Lower productivity</td>
</tr>
<tr>
<td>Civil wars</td>
<td>Destruction of property</td>
</tr>
<tr>
<td></td>
<td>Lost sales</td>
</tr>
<tr>
<td></td>
<td>Disruption of production</td>
</tr>
<tr>
<td></td>
<td>Increased security costs</td>
</tr>
<tr>
<td></td>
<td>Lower productivity</td>
</tr>
<tr>
<td>Inflation</td>
<td>Higher operating costs</td>
</tr>
<tr>
<td>Repatriation</td>
<td>Inability to transfer funds freely</td>
</tr>
<tr>
<td>Currency devaluations</td>
<td>Reduced value of repatriated earnings</td>
</tr>
<tr>
<td>Increased taxation</td>
<td>Lower after-tax profits</td>
</tr>
</tbody>
</table>
PART 1 • THE WORLD’S MARKETPLACES

Piracy on the High Seas

Earlier in the chapter we discussed the growth of piracy of intellectual property. Unfortunately, the traditional kind of piracy—attacks at sea—still plagues international business practitioners, endangering sailors and passengers as well as raising the risks and costs of shipping goods by sea. The International Maritime Organization reported that 266 acts of piracy or attempted piracy occurred in 2005. The motives for the piracy vary: Some pirates seek cargoes, such as vegetable oils that are easily sold in the black market. Other pirates focus on kidnapping passengers or crew for ransom, while some seek the ships themselves.

Two areas are of primary concern to the international maritime industry. The first is the region surrounding the Strait of Malacca, the narrow channel between Malaysia and the Indonesian island of Sumatra (see Map 3.2). The area has been a haven for pirates for centuries. It is the primary passageway between the Indian and Pacific Oceans, annually traversed by 60,000 ships carrying a quarter of the world’s seaborne trade and almost all the oil imported by Korea, Japan, and China. Although the navies of Singapore, Malaysia, and Indonesia routinely patrol the Strait, they have been unable to suppress pirate gangs armed with rocket-propelled grenades and machine guns from preying on shipping.

MAP 3.2
A Map of the Region Surrounding the Malacca Strait

continued
The second is the Somali coast, which is fast overtaking the Malacca Strait as the world’s most dangerous waters. One highly publicized attack occurred in November 2005, when pirates in several speedboats fired upon the Seabourn Spirit, a 10,000-ton cruise liner carrying 300 passengers on its way to Mombasa, Kenya, as it traveled 70 miles off the coast of Somalia. The captain successfully evaded the pirates, but other captains in the area have not been so lucky. Two ships carrying food for the UN World Food Program were hijacked earlier in the year, and many ship owners refuse to travel these waters without armed escorts. Kenya has taken the lead in rallying international support to curb piracy in the area, because the government of Somalia is nonexistent. The country descended into anarchy following the 1991 ouster of Mohamed Siad Barre as the country’s ruler, creating a perfect environment for piracy to flourish.


Any firm contemplating entering a new market should acquire basic knowledge of that country, learning, for example, about its political and economic structures in order to control the firm’s political risks. The firm needs answers to such questions as:

- Is the country a democracy or a dictatorship? Is power concentrated in the hands of one person or one political party?
- Does the country normally rely on the free market or on government controls to allocate resources? How much of a contribution is the private sector expected to make in helping the government achieve its overall economic objectives? Does the government view foreign firms as a means of promoting or hindering its economic goals?
- Are the firm’s customers in the public or private sector? If public, does the government favor domestic suppliers? Are the firm’s competitors in the public or private sector? If public, will the government allow foreigners to compete with the public firms on even terms?

Community activists in Nigeria have argued that local residents receive little of the wealth generated by oil companies operating in the Niger Delta, while oilfield operations have polluted local streams and lakes. But the companies face more substantial political risks than those generated by peaceful protesters: Armed gangs and local rebel groups have kidnapped workers off of drilling rigs and sabotaged vulnerable pipelines in their quest for cash and political power.
When making changes in its policies, does the government act arbitrarily or does it rely on the rule of law?

How stable is the existing government? If it leaves office, will there be drastic changes in the economic policies of the new government?

Most MNCs continually monitor the countries in which they do business for changes in political risk. Often the best sources of information are employees. Whether they are citizens of the home country or of the host country, employees possess firsthand knowledge of the local political environment and are a valuable source of political risk information. The views of local staff should be supplemented by the views of outsiders. Embassy officials and international chambers of commerce are often rich sources of information. Governments themselves can supply vital information. Most governments signal their economic and political agendas during the political campaigns that lead to their elections or during the military campaigns that lead to the overthrow of their opponents; once in office, the governments continue to provide useful information about their current and future plans. Moreover, numerous consulting firms specialize in political risk assessment to help firms evaluate the risks of doing business in a particular country. Several international business publications print annual surveys of political risk around the world. Map 3.3 depicts the results of one such survey published in *Euromoney* magazine.

What and how much information a firm needs to assess political risk will depend on the type of business it is and how long it is likely to be in the host country. The greater and longer-lived a firm’s investment, the broader its risk assessment should be. A Singapore toy manufacturer that subcontracts with a Chinese firm to assemble toy trucks needs to know about politically influenced factors such as trends in exchange rates, reliability of customs procedures, and the legal recourse available to it should the Chinese subcontractor fail to deliver products that meet contract specifications and deadlines. If the Singapore toy manufacturer wants to build and operate its own toy factory in China, its political risk assessment must be broadened. It needs to scrutinize its vulnerability to changes in laws dealing with labor relations, environmental protection, currency controls, and profit repatriation. It also needs to weigh the likelihood of the Chinese government nationalizing foreigners’ property or splitting into warring factions and triggering a civil war.

Some degree of political risk exists in every country, although the nature and importance of these risks vary. The French farmers’ protests merely inconvenienced the managers of Disneyland Paris and McDonald’s, whereas the ethnic cleansing conducted by Serbian nationalists in Kosovo destroyed the economic viability of firms operating there. In political risk assessment, as in most business decisions, it is a matter of balancing risks and rewards. If a firm is considering an investment in a politically risky environment, it should be sure that it can obtain rates of return that are high enough to offset the risks of entering that market. Firms already operating in a high-risk country may choose to take steps to reduce their vulnerability. A firm can reduce its financial exposure by reducing its net investment in the local subsidiary, perhaps by repatriating the subsidiary’s profits to the parent company through dividend payments, by selling shares in the subsidiary to host country citizens, or by utilizing short-term leases to acquire new capital equipment rather than purchasing it outright. Alternatively, a firm might build domestic political support in the host country by being a good corporate citizen; for example, the firm might purchase inputs from local suppliers where possible, employ host country citizens in key management and administrative positions, and support local charities.

To reduce the risk of foreign operations, most developed countries have created government-owned or government-sponsored organizations to insure firms against political risks. For instance, the Overseas Private Investment Corporation (OPIC) insures U.S. overseas investments against nationalization, insurrections or revolutions, and foreign-exchange inconvertibility. In a typical transaction, in 2005, OPIC sold ACD Research, a small Staten Island health care consulting firm, $46.7 million of political risk insurance, allowing it to provide advanced equipment and training to a major oncology center in Russia. However, OPIC insurance is limited to firms operating in countries with which the United States has signed bilateral investment treaties. The Multilateral Investment Guarantee Agency (MIGA), a subsidiary of the World Bank, provides similar insurance against political risks. Private insurance firms, such as Lloyd’s of London, also underwrite political risk insurance.
MAP 3.3
Countries’ Relative Political Riskiness, 2006

Chapter Review

Summary

The legal systems used by the world’s countries vary dramatically. The former British colonies follow the common law tradition of the United Kingdom, while most other Western countries use the civil law system that originated with the Romans. A few countries, such as Iran and Saudi Arabia, use religious law, while centrally planned economies use bureaucratic law.

Laws adopted by national governments can influence the global marketplace in many ways. A country can impose restrictions on the ability of firms to conduct business internationally and can indirectly affect their competitiveness by raising their costs of doing business. A country’s laws may also have extraterritorial reach, affecting transactions conducted beyond the country’s borders.

MNCs operating in a host country can influence the country’s economic, political, and cultural environments. Often these changes are positive. For example, FDI generates new employment opportunities and raises the productivity of local workers. MNCs can also impact the host country negatively by increasing competition for workers or by introducing products or practices incompatible with the local culture.

Resolution of international disputes is an important dimension of the legal environment. Because of the costliness of international litigation, firms often attempt to resolve disputes through dispute resolution techniques such as arbitration. When U.S. MNCs are dealing with sovereign countries, however, their ability to resolve conflicts is often hindered by the terms of the Foreign Sovereign Immunities Act.

The technological environment is an important facet of the national environment. A country’s natural resources, as well as its investments in physical and human capital, affect the country’s attractiveness as a location for international business activities. A country’s willingness (or unwillingness) to enforce intellectual property rights of foreign firms often plays a major role in their location decisions.

International businesses operating in foreign environments are subject to political risks. To protect themselves from changes in the political environment, firms should continually monitor the political situations in the countries in which they operate by consulting with local staff, embassy officials, and, where appropriate, firms specializing in political risk assessment.

Review Questions

1. Describe the four different types of legal systems with which international businesses must deal.
2. What is extraterritoriality?
3. How can an MNC affect its host country?
4. How do expropriation and confiscation differ?
5. Why do countries impose restrictions on foreign ownership of domestic firms?
6. What is the difference between “first to invent” and “first to file” patent systems?
7. How do restrictions on repatriation of profits affect MNCs?
8. What is political risk? What forms can it take?
9. What is OPIC’s role in promoting international business activity?

Questions for Discussion

1. What options do firms have when caught in conflicts between home country and host country laws?
2. What is the impact of vigorous enforcement of intellectual property rights on the world economy? Who gains and who loses from strict enforcement of these laws?
3. Do you agree with the U.S. government’s policies restricting the export of dual-use goods? Why or why not? (You may wish to check out the Bureau of Industry and Security’s Web site, which details how the bureau operates.)
4. Map 3.3 presents the relative political riskiness of countries in 2006. For which countries has political riskiness changed significantly since then?

Building Global Skills

This exercise will help you better understand the influence of legal and political forces on a firm that is entering a foreign market. Your instructor will divide the class into groups of four or five members each and then assign a different type of firm to each group. Types of firms include food retailers, general merchandisers, auto parts makers, steel producers, paper recyclers, computer manufacturers, beer producers, cigarette makers, filmmakers, and petroleum refineries.

Assume your group is a top management team of a foreign firm. The firm has decided to expand into the United States (or, if your instructor prefers, another country) and has selected the local community as its first point of entry. Your
task is to find out what legal and political barriers the firm may encounter and to develop a general strategy for dealing with them. Use whatever resources are available. For example, you could interview a member of the city council or a representative from the area’s economic development committee. You could also identify potential competitors and discuss what strategies they might adopt to block your entry. As you identify potential barriers, try to determine if they are industry-specific or applicable only to foreign firms.

Finally, carefully assess each potential political or legal barrier and determine how difficult or easy it might be to address it.

1. How easy or difficult was it to identify political or legal forces affecting your firm’s proposed entry?
2. What political or legal barriers might exist that you were unable to identify?
3. Are the potential barriers so great as to keep your firm out altogether? Why or why not?
4. Do different levels of government (city, state, and federal) pose different political and legal barriers to your firm? If so, describe these differences.

Closing Case

A Job for 007

Millions of people around the world have watched Pierce Brosnan in movie theaters or on DVD play James Bond, 007, in The World Is Not Enough. The movie’s plot centered on the destruction of an existing pipeline bringing oil from the Caspian Sea to Western markets. The pipeline’s destruction would make the value of a new pipeline owned by the movie’s villainess skyrocket. Although Hollywood producers are often accused of playing fast and loose with the truth, The World Is Not Enough focuses on a real-world problem: There’s a lot of oil in the Caspian region, but it has to be brought to market. Moreover, if you are looking for a perfect example of the importance of political risk analysis, you cannot find a better one than the conundrum facing oil companies trying to exploit the rich oil and gas reserves of the Caspian Sea and the Central Asian Republics.

Baku, the capital of Azerbaijan, is the center of the oil industry operating in the Caspian Sea region. Home to over a quarter of Azerbaijan’s 8 million citizens, Baku is also the Caspian’s main port (see Map 3.4). The Caspian Sea sits on a sea of oil, which virtually every oil company in the world is eager to exploit. The companies know where the oil is; they know how to get it out of the ground. There’s just one catch: They need to get the oil to market, and all the possible transportation routes traverse territory marked by political instability.

The problem is most acutely felt by the Azerbaijan International Operating Company (AIOC), which is owned by a consortium of oil companies, including BP, Exxon Mobil, Unocal (now part of Chevron), Shell, and Russia’s Lukoil. AIOC expects to spend $8 to $10 billion over the next three decades to develop and produce 4 billion barrels of Caspian Sea oil. AIOC initially could ship the oil to Western markets through two pipelines from Baku to the Black Sea. The first route, which is 850 miles long, goes from Baku to Russia and thence to the Black Sea port of Novorossiysk. The second route goes from Baku through Georgia to the Black Sea port of Supsa, a mere 550-mile journey. Unfortunately, the first route goes through Grozny, the capital of the breakaway Russian province of Chechnya. Chechen rebels fought the Russian army to a standstill during a bloody revolt from 1994 to 1996 and proclaimed their independence from Moscow’s control. Russian troops recaptured most of the province in early 2000 in a bitter struggle that horrified foreign human rights observers. Armed conflict could break out again at any time. The area is also vulnerable to terrorist activity, as the seizure of an elementary school in Beslan by Chechen separatists in September 2004 (which led to the deaths of at least 344 people, the majority of whom were schoolchildren) or attacks on area gas pipelines in January 2006 indicate. The second route, which bypasses Russia, goes through rough mountainous terrain where security is difficult. Local residents routinely tap into an existing pipeline in the area, siphoning off oil to heat their homes. Moreover, some Russian politicians have indicated their displeasure with the second route, claiming that it threatens the “energy security” of Russia. (A less charitable interpretation is that Russia does not wish to lose its monopoly over the transportation of Caspian Sea oil and the lucrative transit fees that it generates.) The Yeltsin and Putin administrations have not disrupted the pipeline, but if Russian nationalists capture control of the government in the next election, they might adopt a more bellicose policy.

Two new pipelines have been built in the past decade. In March 2001, oil started flowing through a $2.4-billion, 990-mile pipeline connecting Kazakhstan’s Tengiz field with the Russian port of Novorossiysk on the Black Sea. Although avoiding Chechnya, the Kazakhs are now at the mercy of a Russian government that in the past had a reputation for imposing new tax burdens on foreign companies whenever it faces a revenue shortfall or wishes to make a political point. For example, in early 2006, the Russians disrupted the flow of gas to Georgia, Moldova, and Ukraine until they agreed to pay higher prices for it.

The newest pipeline in the area, the so-called BTC (Baku-Tbilisi-Ceyhan) route, became operational in June 2005. The 1,038-mile pipeline cost $4 billion to construct and can carry a million barrels of oil a day. This expensive project had the strong support of Turkish officials, who have grown increasingly
concerned about the potential for collisions of oil tankers going through the narrow, crowded Straits of Bosporus (which separate the continents of Europe and Asia at Istanbul) on their way to Western markets. A collision between loaded tankers there would make the *Exxon Valdez* disaster seem like a minor environmental nuisance. The BTC route bypasses the Bosporus bottleneck, because Ceyhan is located on the eastern Mediterranean Sea.

However, the BTC route is not risk-free. Eastern Turkey, through which the pipeline passes, is home to the country’s Kurdish population. The Kurds—some 27 to 30 million strong—are the largest ethnic group in the world without their own country. Groups like the Kurdistan Workers Party have been fighting for an independent Kurdistan for decades. Turkish officials fear that should post–Saddam Hussein Iraq fragment politically, the Kurds of the northern regions of Iraq, Iran, and Syria will join with their brethren in eastern Turkey to try to create an independent Kurdistan. Such an attempt would lead to a multicountry civil war. Georgia adds to the pipeline’s political risks. Georgia’s political stability has been threatened by two secessionist movements in its Abkhazia and South Ossetia provinces. Georgia’s central government has no effective presence in these areas, which are ruled by unauthorized, unelected, and internationally unrecognized governments that enjoy the tacit support of Russia. Adding to Georgia’s political uncertainty is its unresolved boundary with Russia; while the two neighbors have agreed on where 80 percent of their border lies, years of negotiations have failed to define the rest of their common boundary.

Azerbaijan has problems of its own. Although business is thriving at bars like the Ragin’ Cajun and Margaritaville that cater to slaking the thirst of free-spending American oilfield workers, the oil boom has not yet benefited the average citizen: Annual per capita income is only $950. After declaring its independence from the Soviet Union, the country was run, Soviet style, by a former KGB general, Geidar Aliyev, who was not a poster boy for democracy. After taking office in a 1993 coup, Aliyev suppressed political dissent, stifled freedom of the press, and imposed a blockade on neighboring Armenia. His health failing, in 2003 he engineered the election of his son, Ilham Aliyev, to be his successor as president in an election plagued by voting irregularities. Moreover, after Azerbaijan declared its independence from the Soviet Union, the ethnic Armenians of the Nagorno-Karabakh province declared their independence from Azerbaijan. A bloody, still unresolved civil war ensued, sending hundreds of thousands of refugees to Baku and other cities.

Meanwhile, oil companies operating on the other side of the Caspian Sea in Turkmenistan and Kazakhstan face similar problems. California-based Unocal, which merged with Chevron in 2005, owns production rights in Turkmenistan. The company is proposing to build an oil pipeline and a gas pipeline from Turkmenistan to Pakistan. The only problem is that the proposed route goes through Afghanistan, which has been ripped apart by insurrections and civil wars since the mid-1970s. Afghanistan was the scene of intense fighting in 2001–2002 as U.S., British, and Northern Alliance forces defeated Taliban troops and al Qaeda terrorists. The democratically elected Afghan government
has limited presence and control over much of its countryside. Another possible pipeline route for Turkmen oil is through Iran to the Persian Gulf or through Iran and Turkey to the Black Sea. However, the United States has exerted diplomatic pressure to discourage companies from doing business with Iran. The volatility in diplomatic relations between the United States and Iran should make company executives think twice about this project. Moreover, Russian companies like Gazprom are unhappy that such a route would limit their access to Turkmen reserves.

A route through China is another possibility. In 1997 the Chinese National Petroleum Company purchased a 60 percent stake in Aktobemunaigaz, a leading Kazakh oil company, which controls reserves containing 1 billion barrels of high-quality crude oil and 220 billion cubic meters of natural gas. In conjunction with Korean and Japanese firms China also agreed to finance and construct a new 1,800-mile pipeline to Karamay in the western Chinese province of Xinjiang, which would then tap into China’s existing pipeline grid, allow Kazakh oil access to the Chinese, Japanese, and Korean markets, and generate huge transit fees for China’s government. Unfortunately, Xinjiang, a vast desert province, is the subject of a small but tense rebellion by native Uighur separatists. The Uighurs, who are ethnic cousins to the Turkic populations of the Central Asian republics, resent the growing influx of the Han Chinese to the province. Today the Han Chinese comprise 38 percent of Xinjiang’s population, whereas in 1949 they comprised only 5 percent. The Uighurs claim that the Han (the main ethnic group in China) have flooded the province and reserved the best jobs for themselves. So far the attacks of the poorly trained and poorly armed separatists have had little impact on Chinese control of the province, although local residents fear the situation could worsen. During 1997 riots in the border city of Gulja, the army had to escort 1,200 Han settlers out of town to safety.

Needless to say, each of these routes poses problems for the oil companies operating in the region. Nonetheless, the rewards are large. Proven oil reserves in the region are estimated to reach 15 to 20 billion barrels; based on the area’s geology, some experts believe as much as 160 billion barrels lie underground waiting to be discovered.

Case Questions

1. Characterize the types of investments that are most vulnerable to political risk. Characterize those that are least vulnerable. Oil and natural gas pipelines are immobile and long lived. They are also very expensive. On a scale of 1 to 10, with 10 being highest, how vulnerable are they to political risks?

2. Suppose you are employed by a pension fund that has been asked to lend $100 million to upgrade and refurbish one of the pipelines discussed above. The project sponsors are willing to pay an interest rate 8 percent above the rate currently being paid by U.S. Treasury bills, so your boss is definitely interested in examining the proposal. Your boss assigns you the task of conducting a political risk assessment of the project. Begin by listing all the types of political risks that could possibly affect the ability of your pension fund to receive interest payments and the return of its principal in a timely fashion. Having developed this list, for each pipeline assess the likelihood that the risks will arise. Which of the pipeline routes offers the least political risk? Which offers the greatest political risk?

3. Turn the clock back to 2000. Would your answers to question 2 change?

4. In his novel Kim, Rudyard Kipling introduced the phrase “The Great Game” to describe the struggle between the Russian czars and the British Empire to control the wealth of Central Asia and the Caspian Sea. Clearly, the great game is being replayed as countries fight to control access to the area’s oil and natural gas reserves. What can international businesses do to protect themselves from the geopolitical struggles of Russia, China, Iran, the United States, and other nations that are taking place in this region?