Smaller may be beautiful but is it more risky? Assessing and managing political and economic risk in Costa Rica

Jennifer Oetzel *

Kogod School of Business, American University, 4400 Massachusetts Ave., Washington, DC, NW 20016, USA

Received 22 September 2004; received in revised form 20 May 2005 and 15 August 2005; accepted 12 September 2005

Abstract

The purpose of this exploratory study is to examine how managers assess and manage political and economic risk once their company’s foreign direct investment (FDI) is on the ground. Using a qualitative research design involving personal interviews with CEOs/top managers of foreign firms operating in Costa Rica, findings indicate that managers at the subsidiary level generally do not engage in political and economic risk assessment on an ongoing basis, nor do they coordinate risk assessment with MNE headquarters. Propositions are developed that suggest subsidiary size may be more important for determining a firm’s political risk than the overall size of the corporation. Also, a firm’s political risk may vary over time as the host country’s policy priorities change, particularly the policies which favor some industries over others. Findings are expected to contribute to the literature on country risk and bargaining theories as well as to the research on the role of the subsidiary in FDI.

Keywords: Country risk; Foreign direct investment; Managing risk; Bargaining power; Qualitative research design; Developing country

Political and economic events in a host country can have a significant effect on the long-term profitability of foreign direct investment (FDI) projects. While attention is often focused on major risk events such as political coups or currency crises, smaller scale, day-to-day risks also pose a significant threat to a firm’s FDI. Major risks generally originate at the national level in the host country and are the result of the action (or inaction) of the central government. Also called sovereign risks, these major risk events include violent conflicts, expropriation of foreign assets, ‘grand’ corruption (i.e. demands for bribes from senior officials and politicians to win...
contracts), political violence and currency inconvertibility (Henisz & Zelner, 2004; Howell, 1998; Markwick, 1998; Simon, 1984; Wells, 1998a). Sub-sovereign—or micro—risks (Robock, 1971), on the other hand, are not the result of national level policies or actions. Rather, these risks occur at the sub-national level and affect individual firms, industries or geographic regions rather than all firms in a given country. In Costa Rica, companies primarily face firm—or industry-specific risks rather than geographically based ones. Localized, or so called ‘petty’ corruption (i.e. paying officials to facilitate bureaucratic processes), bureaucratic red tape affecting some firms or industries but not others, and local business regulations and restrictions are three types of sub-sovereign risks (Markwick, 1998). It is argued that petty corruption in particular poses a serious and potentially growing political risk to foreign direct investors.

Despite the fact that over the last two decades many developing countries have shed their closed door policies, established investment promotion agencies and begun to aggressively court FDI, the political risks—defined as risks that are principally the result of forces external to the firm and which involve government action or inaction (Wells, 1998a)—to foreign firms have not disappeared (Moran, 1998; Wells, 1998a). In fact, new political risks have grown in place of the old. For example, while expropriation of foreign assets was a significant political risk in the 1960s and 1970s, it is a relatively rare event today (Minor, 1994; Wells, 1998a). On the other hand, ‘creeping expropriation’¹ and the growing influence of powerful local businesses have become two of the more serious political risks of late. Evidence over the last several years indicates that private local firms are using, ‘their political connections to demand favorable treatment that places them at an advantage over existing or prospective foreign investors’ (Wells, 1998a: 19). Undoubtedly, there are a variety of economic and political factors that may create risk for the firm. Thus, we adopt the definition used by previous researchers and define country risk as a function of the economic and political events occurring at the sovereign or sub-sovereign level in a country that threaten firm profitability (and even survival) and are the result of forces external to the firm and its industry (Howell, 1998; Kobrin, 1978; Robock, 1971; Wells, 1998a).

While there have been a number of studies examining the economic and financial effects of political and economic risk events on firms’ foreign direct investments (Henisz, 2000; Henisz & Zelner, 2005; Ramamurti & Doh, 2004), a smaller number of studies have examined how managers assess and manage risks on an ongoing basis after the firm has made its initial investment. One of the earliest studies to do so found little support for the notion that US managers at the MNE headquarters level systematically assess political risk (Root, 1968). In a later study of US MNEs conducted in the 1970s, researchers found that assessments and evaluations of ‘nonmarket environments’ were emerging as new managerial functions in relatively large international firms however these assessments had several limitations (Kobrin, Basek, Blank, & Lapolombaro, 1980). In general, assessments were found to be reactive rather than proactive and the most important sources of information about the external environments were sources internal to the firm. In another study conducted in 1993, researchers interviewed managers at firms headquartered in the Netherlands regarding their risk identification, assessment and management practices for their foreign operations (Pahud de Mortanges & Allers, 1996). Results from interviews with 23 top executives in 23 different Dutch firms revealed that these firms had experienced political risk events in their foreign operations but that

¹ Creeping expropriation occurs when governments at either the national or provincial levels enact policy changes or new legislation that slowly erodes the property rights (or value of the property rights) of foreign investments.
most assessment being done was ad hoc in nature and largely based on personal judgment and expert opinion, although a few firms did use scenario planning or standardized checklists for assessing risk (Pahud de Mortanges & Allers, 1996).

While these studies have contributed to our understanding of the sovereign risk assessment practices of managers at the headquarters level, we know little about the extent to which risk assessment takes place at the subsidiary level, about firms’ experiences with sub-sovereign risks, and how subsidiary size may affect the relationship between host country conditions and firms’ political and economic risk. These issues are particularly understudied in emerging markets and developing countries. The purpose of the present study is thus to extend prior research by exploring the ongoing risk assessment practices of foreign subsidiaries and determining whether managers engage in risk assessment, either at the sovereign or sub-sovereign level, in a developing country context. Given the research question, a qualitative research design based on personal interviews with top managers/CEO’s of foreign subsidiaries in Costa Rica, a mid-level developing country with moderate risks, was employed to elicit information about firm practices. Researchers have noted the particular salience of this research design for studying the processes and mechanisms of international business practices (Welch, Marschan-Piekkari, Penttinen, & Tahvanainen, 2002; Yeung, 1995). Also, as Lee (1999) noted, qualitative research is particularly well suited when the research goal is to describe, interpret and explain, as is the case here. Although this study is exploratory in nature, past research on country risk analysis, bargaining theory, and FDI as it relates to these issues, provide important theoretical foundations and guidance for sample selection. Finally, this study may also extend prior research by examining the experiences of firms in the service and high technology sectors, not only manufacturing.

Findings from this study suggest that managers at the subsidiary level do not appear to engage in risk assessment or management on an ongoing basis. In addition, subsidiary size seems to be more important in determining a firm’s susceptibility to political risk than the overall size of the corporation. A firm’s vulnerability to political risk may also vary over time, particularly as the host country’s FDI policy priorities change. These findings may contribute to the literature on country risk and bargaining theory as well as to the research on the role of the subsidiary in FDI.

The remainder of the article is organized as follows. First, the literature on country risk and managing risk is reviewed, followed by a discussion of the research methodology, sample design and data analysis employed in this study. The findings are then discussed and several propositions are presented. The paper concludes with a discussion of the limitations and the theoretical and managerial implications of the study.

1. Country risk

As defined earlier, country risk refers to the economic and political events occurring at the sovereign or sub-sovereign level in a country that threaten firm profitability (and even survival) and are the result of forces external to the firm and its industry (Howell, 1998; Kobrin, 1978; Wells, 1998a). Sovereign economic risk events include currency crises, inflation, deflation, unemployment and fiscal deficits. Examples of sovereign political risk events are political coups, ‘grand’ corruption, expropriation or nationalization of property, war damage, and inconvertibility of financial assets imposed by the host country government. In contrast, sub-sovereign risk events may have no relation to the macro-policies or practices of the central government in the host country (Moran, 1998). Instead, these risks only affect certain firms, industries or regions in a country. Sub-sovereign risks may include the actions of corrupt local government
officials, frustration of contracts, and difficulties or holdups in obtaining permits or licenses at the local or regional level. The effect of such risks may be idiosyncratic affecting only certain firm or industries or it may be felt across a wide range of firms. Risks that fall outside the scope of this study include normal business or commercial risks, such as the risk of change in economic costs or demand, changes in the extent of competition in the marketplace, or risks associated with new product or service introduction (Moran, 1998).

Clearly there is considerable overlap between these economic, financial and political risks. It is often difficult, if not impossible, to determine whether a currency crisis led to a political coup or vice versa. Although the direction of causality between the different types of risks is often uncertain, for managers the impact of a currency crisis (economic risk) or request for a bribe (political risk) is quite clear. For this reason, the term country risk will be used throughout the paper to refer to the totality of risk events. Country risk will be categorized by level of analysis (sovereign and sub-sovereign) and type of risk (political and economic).

1.1. Techniques for assessing risk

A variety of approaches have been used to assess risk. Some of the techniques that are more qualitative in nature include the grand tours approach, which involves sending corporate executives, or teams of executives, to conduct preliminary research in the countries of interest. The old hands approach relies on advice from consultants and others deemed to be experts on certain country and/or risk related issues (see Pahud de Mortanges & Allers, 1996 for a more detailed discussion of these methods). Other tools such as scenario planning and real options strategies may help managers prepare for potential changes in the business environment and minimize firm risk (Miller & Waller, 2003).

Efforts are often made to quantify the possibility (or probability) that economic, financial or political events will affect the business climate in such a way that investors will lose money or not make as much money as they originally expected (Howell, 1998). Empirical studies have offered little support for the effectiveness of many of the widely used country risk ratings such as those produced by Institutional Investor magazine, Euromoney magazine, Political Risk Services and the International Country Risk Guide (Cosset & Roy, 1991; Oetzel, Bettis & Zenner, 2001). Despite their inability to predict future events, the country reports provided by these organizations may provide some insights into the past economic and political trends in a country.

1.2. Managing FDI risk after the initial investment

In both research and practice, political and economic risk assessment is generally emphasized in the site selection phase of an FDI decision, while less attention has been placed on assessing risk on an ongoing basis (Dunning, 1998; Vernon, 1966). Managers may understandably wish to avoid risky investment locations altogether, however it is difficult to predict or anticipate where or when political or economic events are likely to occur. Given the limitations of ex ante approaches, there is arguably a need for managers to develop risk assessment and management approaches that can be utilized on an ongoing basis. While researchers have found that corporate level strategies such as international diversification may reduce firm risk (Rugman, 1976), less is known about strategies undertaken at the subsidiary level. For example, researchers have argued that tools such as scenario planning and real options strategies may be effective at minimizing firm risk and planning for changes in the business environment (Miller & Waller, 2003), but it is less certain
whether managers use these or other tools for assessing and managing country risk. Some type of risk mitigation strategy would appear valuable given Wells’ (1998a) argument that contemporary managers may actually be less equipped to deal with political risks than their predecessors of two decades ago. Wells (1998a) argues that today’s manager is rewarded for closing deals, not worrying about changes that may not emerge for a number of years into the future.

Bargaining power theorists have offered important insights into the changing nature of firm risk and relative bargaining power both before and after a FDI has been made (Fagre & Wells, 1982; Kindleberger, 1969; Penrose, 1959; Vernon, 1971). Prior to the initial investment, the MNE is thought to wield more power if its investment is large relative to the size of the host country/host economy, if it is export intensive, if it involves the transfer of technology and if it creates a sizable number of jobs. Alternatively, the host country’s bargaining position is influenced by the size of the local market, its rate of growth, the number of alternative FDI destinations for the MNE, the degree of political and economic stability in the host country and the degree of sophistication of the host country government.

After the initial investment has been made, the bargaining power dynamics are expected to change. As the business risk (implying the risk of the business’ viability) and uncertainty decrease after successful implementation, the host country will find itself in a position to renegotiate the initial agreement resulting in the obsolescence of the original bargain. Clearly, these ideas have direct relevance for understanding country risk management. For example, researchers have argued that firms can reduce their risk by increasing their bargaining power through lobbying efforts or by leveraging their market power in the host country (Henisz & Zelner, 2004, 2005; Ramamurti & Doh, 2004).

Although the research on bargaining theory has been among the most influential for understanding country risk after an investment has been made, there are several opportunities for further investigation, particularly as the theory relates to country risk management. First, bargaining theory research has tended to emphasize the vertically integrated extractive industries; infrastructure and utility sectors and heavy manufacturing (Bergara, Heinsz, & Spiller, 1998; Bergsten, Horst, & Moran, 1978; Kobrin, 1987; Vernon, 1980). Less is known about the service and high technology sectors and how these industries differ from the manufacturing and extractive industries.

In addition, while earlier theoretical work described the bargaining process and the obsolescing bargain as dynamic in nature (Vernon, 1971), it is generally difficult to capture this dynamism in large scale empirical work since most of this research has relied on observed bargaining outcomes rather than processes. One important exception has been a study by Vachani (1995) in which he demonstrated the dynamic nature of bargaining power and how it can change significantly over time. Specifically, MNE’s with weak bargaining positions may find themselves increasingly vulnerable to political risk (Vachani, 1995). Another limitation of large-scale empirical studies is that they are often unable to account for uncertainty or politics, especially host country politics (Kobrin, 1987). More recent studies have also demonstrated that factors such as bribery, corruption and judicial unpredictability are important variables in influencing country risk and FDI (Habib & Zurawicki, 2001, 2002; Pfeffermann & Kisunko, 1999) but these factors are rarely included in empirical bargaining models.

2. Methodology and analysis

The methodology utilized in this study was a qualitative research design, based on semi-structured interviews with the top managers and CEO’s of foreign owned firms operating in
Costa Rica. Theoretical sampling, based on firm size, industry and nationality, was used to identify appropriate firms for the analysis (Lee, 1999; Glaser & Strauss, 1967). To complement this approach and strengthen the overall findings, background research on each sample firm was conducted using secondary sources and archival data. This additional step made it possible to validate managerial responses with archival information, where possible, and gain a greater understanding of the industry context and competitive pressures faced by each sample firm. The research design and methods are discussed in more detail in the following sections.

2.1. Research design

2.1.1. Country selection

The parameters used for determining site selection included a developing country with a substantial amount of FDI, a moderate degree of risk, multinational corporations of varying sizes, industries and nationalities, and a national FDI policy that has been articulated by the government. Variance across firms in terms of industry was also important for capturing sub-sovereign risk as defined in this study. Focusing on these parameters in the selection of the appropriate site helps control extraneous variation and defines the limits for generalizing the findings (Eisenhardt, 1989). These controls, according to Eisenhardt (1989), make the subject of interest transparently observable. Access to top level decision makers in foreign firms and at least minimal in-country support for the study was another important consideration. As Welch et al. (2002) have noted it can be particularly difficult to gain access to elites in international business research. Based on these considerations, the Central American country of Costa Rica—a country with a population of approximately 3.7 million people in 1999 (World Bank, 2004)—was chosen as an appropriate location for the study. Following is a discussion of how Costa Rica fits each of the criteria discussed above.

2.1.2. Costa Rica’s country risk profile

The first criterion used in determining an appropriate site was the level of country risk in the host country. For obvious reasons, in an extremely low risk country there is little need for frequent and ongoing economic and political risk assessments. Although even low risk countries are not immune to major risk events, the vast majority of risks facing firms in such countries are normal business risks rather than economic or political ones. In contrast, in an extremely high risk country businesses assume that a high level of economic and political risk permeates the operating environment. Country risk events are the norm rather than the exception. Such countries are generally characterized by very low levels of FDI. In both cases there is relatively little uncertainty regarding future expectations of the operating environment. In countries with moderate to high risk levels that have fluctuated over time there is generally less predictability regarding the operating environment and presumably a greater need for the assessment and management of economic and political risks. Costa Rica fits such a country risk profile. Although the country has been relatively stable in recent years, Costa Rica experienced significant economic difficulties during the 1970s and early 1980s. Fig. 1 shows how the historical country risk rating for Costa Rica has changed over the last 20 years and how the country compares to two reference countries, one low risk country, Canada, and an extremely high risk country, Nicaragua. As Fig. 1 illustrates, Costa Rica has not experienced significant upheavals over the last two decades or so however the country still experiences moderate investment risks.
2.1.3. Government’s policy on foreign direct investment

The Costa Rican government has articulated an explicit policy for attracting FDI. Since the early 1990s the country has supported the development of industry clusters, which consist of firms connected through vertical and horizontal relationships, as a way to promote economic development (Krugman, 1980, 1983; Porter, 1990). According to advocates of this approach, it is believed that countries (and/or regions) can gain a competitive advantage by focusing a nation’s limited resources on the development and support of a few select industry groups. Based on this logic, Costa Rica decided to focus its resources on developing clusters related to the electronics, medical devices/pharmaceutical and computing industries. The nature of Costa Rica’s industrial policy provided a basis on which to compare the experiences of different firms and industries; specifically, whether electronics, medical devices/pharmaceutical and computing firms’ experiences differed from those of firms in non-targeted industries. In addition to formally detailing its FDI objectives, Costa Rica has also allocated the resources necessary to achieve them by establishing the Costa Rican Investment and Trade Development Board (CINDE, its acronym in Spanish), which has since played an important role in attracting FDI. Fig. 2 shows the FDI inflows to Costa Rica from 1970 to 2003. It is apparent from the graph that Costa Rica experienced an upturn in FDI inflows in the mid-1990s. This upward trend continued until mid-2002 when FDI declined somewhat. The World Bank estimates that in 1999, Costa Rican exports of goods and services constituted 52% of GDP (World Bank, 2004), with a large percentage of these exports attributed to foreign firms operating in the country (as a comparison, exports constituted 19% of GDP in Guatemala, 31% in Mexico, 10% in Brazil and 11% in the United States during the same period (World Bank, 2004)).

2.1.4. Sample firms

Theoretical sampling was used to identify appropriate sample firms (Eisenhardt, 1989; Glaser & Strauss, 1967; Lee, 1999). As Eisenhardt (1989) has stated, a priori specification of constructs can also help to shape the initial design of qualitative research. She notes that although this type of specification is not common in qualitative studies to date, it is valuable because it permits researchers to measure constructs more accurately. Furthermore, she argues, if these constructs prove important as the study progresses, then researchers have a firmer empirical grounding for the emergent propositions. With this in mind, the objectives in sample selection were to choose
firms: (1) from different industries, ensuring that some were within the purview of Costa Rica’s industrial policy and some outside it, (2) with different sizes, and (3) with different nationalities (based on the distribution of firm nationalities in Costa Rica). Past research on bargaining theory and country risk analysis indicates the importance of these constructs for this study.

The sample frame included lists of foreign owned firms from embassies, CINDE, Chambers of Commerce and the Harvard-affiliated Central American Institute of Business Administration (INCAE), a private university offering MBA and executive education programs located in the city (and province) of Alajuela. The final sample included a total of fourteen top managers from fourteen MNE’s representing a broad range of sizes and industries. Of the fourteen firms in the sample, eight are subsidiaries of Global Fortune 500 firms (Table 1). Regarding firm size in the host country, 50% (7) of the firms had 50 employees or less, 28.57% (4) had between 101 and 500 employees, 7.1% (1) had between 501 and 1000 employees, and 14.28% (2) had between 1001 and 5000. With respect to industry representation, sample firms came from the following industries or business types: research and development facility (1), business-to-business retailer (1), manufacturing and sales of consumer products (1), petroleum industry (1), agrochemicals (2), pharmaceuticals (1), manufacturing (3), and the computer industry (including software sales, services, parts sales and manufacturing) (4).

Six firms had been in Costa Rica five years or less, four between five and fifteen years, and the remaining four firms had more than thirty years of experience in Costa Rica. In terms of export versus import focus, several firms focused primarily on producing products for export (4), others located in Costa Rica primarily to sell to the Costa Rican market (6), two were non-revenue centers serving the parent corporation (1 is an R & D facility and the other is a customer service center) and the remaining two focused on serving Costa Rica and the wider Central American region.

The nationality of these enterprises included one Asian, five European and eight firms from the US. This distribution of firm nationalities in the sample is proportional to the distribution of firms by nationality in the wider population. The majority of sample firms were run by local

---

2 One of these four firms, the European petroleum firm Firm L, had entered Costa Rica three times over the last three and a half decades. Most recently, the firm had been in Costa Rica between 5.1 and 10 years.
Costa Rican managers. Exceptions included Firm B, a Retailer/Distributor from the United States, Firm G, a manufacturing firm from the US and Firm M, a European consumer products firm, all of which were run by expatriate managers from each firms’ respective home country. Sample firms were located in the Central Valley region of Costa Rica and spread across three of the country’s seven provinces; Cartago, Heredia and San Jose. Approximately 40% of the population of Costa Rica resides in the Central Valley region. Costa Rica has several Free Trade Zones that offer tax exemptions and other investment incentives for foreign firms. Three of the sample firms (Firms A, E and N) were located in a Free Trade Zone. The provinces outside of the Central Valley are generally sparsely populated with the dominant industries being tourism and agriculture.

2.1.5. Data collection methodology

Interviews with top managers (Presidents, CEO’s) of MNE’s operating in Costa Rica were arranged with the assistance of staff at INCAE. Each respondent was asked, (1) whether his/her...
firm assessed and managed political and/or economic risks in Costa Rica, either national level risks affecting all firms in the country or sub-national risks felt by the respondent’s firm or industry but not necessarily by others, (2) whether the respondent’s firm used sovereign risk ratings or other methods at the subsidiary and/or headquarters level and if so, which ones, (3) whether the firm experienced economic and/or political risk in Costa Rica, and if so, what these risks were, and (4) whether the respondent’s subsidiary monitored political and economic risk on an ongoing basis. Respondents were also asked what strategies, if any, their firm had for managing risk on an ongoing basis. The terms ‘national level’ and ‘industry,’ ‘firm’ or ‘local’ level risks were used in place of ‘sovereign’ and ‘sub-sovereign.’ The definitions and descriptions of sovereign and sub-sovereign risks were used in place of the specific terms to ensure that all respondents understood the concepts. Each interview lasted between 1½ and 2 hours. Notes were taken during each interview and afterwards several hours were spent taking additional notes and reflecting on the interview. Subsequent interviews often brought new insights into previous interviews and these too were documented. All interviews were conducted over the summer of 1999. Respondents and their firms were guaranteed complete confidentiality in exchange for their participation. Although identifying the appropriate end point in any qualitative analysis is inherently subjective, Eisenhardt (1989), Lee (1999), and Glaser and Strauss (1967) suggest that further data collection should stop when ‘further hypothesizing, revising, and data collection are judged unlikely to lead to additional understanding’ (Lee, 1999; pp. 49–50). Given Lee’s (1999) criteria, as well as the financial and temporal limitations inherent in any field research, case collection ended after the sample was determined to be sufficiently diverse (in terms of industry, size, etc.) to facilitate cross-case comparison and after managerial responses started to become repetitive (Lee, 1999).

2.1.6. Additional data sources

To complement the semi-structured interviews, a variety of data sources were used to obtain multiple vantage points into the phenomenon of interest (Glaser & Strauss, 1967; Eisenhardt, 1989; Lee, 1999). Using multiple data sources allows for enhanced corroboration of facts and inferences. For these reasons, archival sources such as news articles, corporate web pages and expert insights from faculty at INCAE were used to corroborate interviewee responses and gain additional information on the sample firms.

2.2. Analysis

The first stage of analysis involved gaining sufficient background and understanding of the phenomenon in question. This involved extensive review of the history of FDI in Costa Rica, discussions with faculty at INCAE and interviews with top managers at CINDE. Officials at CINDE confirmed that the country’s industrial policy involved developing industry clusters in electronics, medical devices/pharmaceutical and computing. Archival research also offered important insights into the sample firms. Both before and after each interview, archival information on all sample firms, including news reports, corporate information and Securities and Exchange Commission (SEC) reports for US firms, was reviewed and analyzed. Due to the difficulties of conducting research in developing countries, particularly gaining access to managers and decision-makers, it was not possible to employ a second interviewer for the purpose of enhancing interrater reliability. Not only was it financially prohibitive to do so, but discussions with local experts suggested that managers may be reluctant to talk with more than
one researcher at a time, particularly because there is not a culture of openly providing data to researchers.

After the interviews were completed, an iterative process of reviewing the literature on FDI and bargaining theory, including a review of interview notes and archival information, was undertaken (Eisenhardt, 1989). Additionally, cross-case comparisons were conducted to identify both similarities and differences in terms of the concepts of interest across the sample firms. Through this cross-case analysis it was possible to identify common themes and constructs. For example, it became apparent that relative bargaining power was an integral factor in determining the level of political risk experienced by managers of foreign firms. Initially it was expected that managers would discuss political and economic risk identification and management as discrete activities. It soon became apparent that risk exposure and risk management could not be considered in isolation from the firm’s bargaining power. Finally, to check the validity of the insights from this study, findings were discussed with colleagues, industry and country experts. This last step provided valuable support for the findings discussed in the remainder of the paper.

3. Findings and discussion

Despite the perception that Costa Rica’s economy is relatively stable, sovereign level economic issues, specifically concerns about currency fluctuations, were a significant concern for foreign firms. Most respondents felt their firm was able to resolve currency concerns by dollarizing as many transactions as possible. Dollarizing was perceived as reasonably effective at minimizing risk exposure according to respondents. No respondent noted economic risks at the sub-sovereign level. As the analysis and review of the data progressed, it became evident that political risks, both sovereign and sub-sovereign, were more of a concern for managers than economic risks. Given this finding, the majority of the discussion and propositions that follow are related to foreign firms’ exposure to political rather than economic risks.

3.1. Assessing country risk

One of the main objectives of this study was to determine how firms assess country risk on an ongoing basis in the host country. Findings revealed that only one firm, Firm B, a small US retailer, engaged in either sovereign or sub-sovereign risk assessment on an ongoing basis at the host country level (Table 2). Although the President of Firm B used several of the sovereign-level country risk ratings and reports issued by The Economist Magazine, Institutional Investor, and Political Risk Services, it was not because of his confidence in their value. As he put it:

“Generally speaking I believe these [risk measures] are 6–8 months behind but they give me a good feel for the trends. Also, they beat throwing a dart against the wall. What else am I going to do?”

To better understand trends at the local or industry level (sub-sovereign risk) the respondent closely followed local news and related stories in the magazine Latin Finance. Three additional respondents (Firms H, I and L) reported that their corporation engaged in sovereign risk assessment at corporate headquarters (HQ) but they were generally unaware of exactly what this assessment entailed. For example, the respondent at Firm H, a small European agricultural R & D firm, stated that “I believe so [that we use those measures] but I don’t know too much about how the parent company makes their decisions.” It was their understanding that HQ engaged in risk assessment primarily for ex ante site selection decisions rather than as an ongoing
monitoring of the host country environment. The respondent from Firm I, a large US computer manufacturing firm, specifically stated that HQ consulted risk measures pre-investment to get a lay of the land but that consultants actually helped make the final location decision. The lack of formal risk assessment at the subsidiary level did not appear to be because of an absence of risk. Findings regarding the specific economic and political risks faced by sample firms are discussed below.

3.2. Economic and political risks faced by firms

3.2.1. Sovereign level economic risks

Respondents indicated that the economic risks in Costa Rica were macro in nature originating at the sovereign level. Fluctuations in currency values and increasing inflation rates were noted as particular concerns, ones which posed important business risks for respondents and their firms (Table 3). Changes in either currency values or inflation rates tended to affect nearly all firms operating in the country, not just a few select firms or industries. The President of a subsidiary of one MNE (Firm G, a large U.S. manufacturing firm), for example, stated that he was hired after the former President was caught with a huge inventory on the ground in another country during a massive currency devaluation. Given the historical fluctuation in the value of the Costa Rican colon, often around election cycles, respondents adopted a variety of commonly used strategies for managing economic risks such as currency hedges and other financial management tools. The most widely used strategy for managing economic risk was the dollarization of as many

Table 2
Assessing political and economic risks a

<table>
<thead>
<tr>
<th>Company</th>
<th>Risk rating agencies or services used by firms that assess country risk on an ongoing basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm B</td>
<td>Accesses all of the following via the Internet: - Business Environment Risk Intelligence (BERI) - Control Risks Group - Economist Magazine - Institutional Investor Magazine - Political Risk Services Other sources: Latin Finance magazine</td>
</tr>
<tr>
<td>Firm H</td>
<td>“I believe so [that HQ uses those measures] but I don’t know too much about how the parent company makes their decisions.”</td>
</tr>
<tr>
<td>Firm I</td>
<td>“I believe we have used Standard and Poor’s risk measures and I recognize the International Country Risk Guide but I can’t say anything more than I recognize it.” “Generally risk measures are consulted in the very beginning to get a lay of the land. If a country is really rated poorly we will take it off our list. For final decisions however, we rely much more heavily on outside consultants. Final decisions are based on in-house evaluations of country conditions and risk and the advice of consultants, with more weight often placed on the consultants.”</td>
</tr>
<tr>
<td>Firm L</td>
<td>“They use these [country risk] measures at headquarters.”</td>
</tr>
</tbody>
</table>

a Firms A, C, F: No, any assessment undertaken is done at corporate headquarters. Firms D, E, G, J, K, M, N: respondents answered, “No” or “Not that I am aware of”.
business transactions as possible. Even non-US MNE’s chose to dollarize rather than use their home country currency.

3.2.2. Sovereign political risks

With reference to sovereign political risks, risks with the potential to affect all firms operating in the country, respondents frequently cited the bureaucratic nature of the government (Firms A, D, I, K, L, M), upheaval that ensued after each election (Firms B and E), frequent changes in government policy (Firms E and G), and instability in neighboring countries (Firms B, D, F and H) as moderate to high risks for firms (Table 4). The President of the US retailer Firm B indicated that while it was not a serious risk for his company, party changes after elections created disruptions throughout all levels of government. For example, the respondent from Firm

---

Table 3
Economic risks faced by sample firms

<table>
<thead>
<tr>
<th>Company</th>
<th>Sovereign economic risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm A</td>
<td>Regarding the risk of currency fluctuations in Costa Rica the respondent stated that, “Currency appreciations can increase labor costs [and pose a moderated risk] but we are not a revenue center so for us any drop in the colon only reduces our labor costs.” “Inflation is a moderate risk.”</td>
</tr>
<tr>
<td>Firm B</td>
<td>“No, we do all our business in US dollars” to avoid problems associated with fluctuations in the Costa Rican colon. “Inflation is a moderate risk.”</td>
</tr>
<tr>
<td>Firm C</td>
<td>Not experiencing any moderate or high economic risks at this time [at the time of the interview the firm had been in Costa Rica just under a year]. Devaluations in the colon may affect sales in Costa Rica however this was not cited as a moderate or high risk by the respondent.</td>
</tr>
<tr>
<td>Firm D</td>
<td>“Inflation and fluctuations in exchange rates are moderate risks for us.” The company does business in both the Costa Rican colon and the US dollar</td>
</tr>
<tr>
<td>Firm E</td>
<td>“No, we do business in dollars and pay our employees in colones. Any drop in the colon only reduces our labor costs” [although currency appreciations can increase labor costs]. “Inflation is a moderate to high risk for us.”</td>
</tr>
<tr>
<td>Firm F</td>
<td>“Inflation is a big risk for us.”</td>
</tr>
<tr>
<td>Firm G</td>
<td>“Our [firm’s] major risk is the possibility of a currency devaluation when we have outstanding product exposed to this risk.” “Economic risks are definitely a concern. We do everything in dollars now. When I first came here we were doing business in all kinds of currency, you name it. Unanticipated devaluations can really hurt us.”</td>
</tr>
<tr>
<td>Firm H</td>
<td>“No, we are paid in US dollars even though we have a European parent. A devaluation in the Costa Rican colon only increases our salary” [but appreciation of the colon raises labor costs]. “Inflation is a moderate risk for our firm.”</td>
</tr>
<tr>
<td>Firm I</td>
<td>Respondent indicated nothing greater than a low risk for the firm.</td>
</tr>
<tr>
<td>Firm J</td>
<td>None indicated.</td>
</tr>
<tr>
<td>Firm K</td>
<td>“Inflation and currency risk are huge risks for us. All of our contracts are in dollars but people pay for our products in colones. If inflation goes up we can be in real trouble.”</td>
</tr>
<tr>
<td>Firm L</td>
<td>“Inflation and exchange rate fluctuations are very high risks. These are the two highest risks we face.”</td>
</tr>
<tr>
<td>Firm M</td>
<td>The respondent indicated that “The currency is poorly managed in Costa Rica” but did not indicate that this was a significant risk for the firm.</td>
</tr>
<tr>
<td>Firm N</td>
<td>None indicated.</td>
</tr>
</tbody>
</table>

---

a No sub-sovereign economic risks were noted by respondents.
Table 4
Sovereign political risks faced by sample firms

<table>
<thead>
<tr>
<th>Company</th>
<th>Sovereign political risks faced by firms operating in Costa Rica</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm A</td>
<td>“Labor law changes and government or legal policy changes as they relate to the Economic Free Zone (Zona Franca) are risks for us.” “Corruption in the Costa Rican government and judicial system, political turmoil and changes in government in Costa Rica are moderate risks for the firm.” “Doing business in Costa Rica is very bureaucratic” but the respondent believes this affects all firms operating in Costa Rica, not just Firm A.</td>
</tr>
<tr>
<td>Firm B</td>
<td>“When the party changes power in Costa Rica, turnover is complete throughout the entire government [this creates problems at both the national and local levels] (see Table 4 for more on related sub-sovereign risks). “In contrast to my experience in [another Latin American country] political changes in Costa Rica bring about some uncertainty but these changes are more like a hiccup than a complete disruption. However, local competition, political turmoil and elections in the neighboring countries, and corruption in the Costa Rican government and the judicial system” do pose moderate to high political risks” for the firm.</td>
</tr>
<tr>
<td>Firm C</td>
<td>According to the respondent, Firm C is not experiencing any moderate or high political risks at this time [at the time of the interview the firm had been in Costa Rica just under a year].</td>
</tr>
<tr>
<td>Firm D</td>
<td>“The country is not very flexible” [meaning highly bureaucratic]. “This poses a barrier to doing business in Costa Rica.” “The lack of transparency in dealing with RACSA [the government-run internet service] is risky because nobody knows exactly what is going on or what one needs to do to facilitate the process. The process is really highly uncertain.” “Instability in the neighboring countries is a high risk.”</td>
</tr>
<tr>
<td>Firm E</td>
<td>“Cambio del gobierno (change in government) is a big risk for us. When the government changes [referring to changes in political party] everything changes. We purchased land and made all of our plans [expansion plans] under the previous administration. Now that the government has changed, everything has changed - it put us back 8 months.” [This is because] “different administrations choose to enforce laws differently.” “Government promises and support to new foreign direct investments poses a risk for us.” The respondent also indicated that his firm faced tough competition for engineers/high skilled labor, which he attributed to increased FDI by high tech firms. While this would generally be considered a normal business risk, especially since it tended to affect high tech and non-high tech manufacturers alike, the respondent from Firm E, a US manufacturer, believed that his firm had less possibility for government assistance and support [such as the government sponsored university training programs targeted at careers in high-tech] with this problem than the new high tech entrants. In his opinion, this created a type of political risk for his firm.</td>
</tr>
<tr>
<td>Firm F</td>
<td>“Instability and changes in government in neighboring countries poses a moderate to high risk.”</td>
</tr>
<tr>
<td>Firm G</td>
<td>“Corruption in the government and the legal system in Costa Rica are sources of risk.” “Costa Rica does not have any consistency in government. Policies are made and changed at a whim (the respondent described the policy process as political rather than legislative policy making). There is no mechanism in place that will ensure that policies made under one administration will apply two years down the road.”</td>
</tr>
<tr>
<td>Firm H</td>
<td>“Changes in governments and political turmoil in neighboring countries in Central America, and corruption in the Costa Rican government, pose moderate risks for us.”</td>
</tr>
<tr>
<td>Firm I</td>
<td>[Doing business in Costa Rica] “…is very legalistic. That is a euphemism for bureaucratic. Having said that, it is not a ‘show-stopper for us’. The paper work can be overwhelming but it has been double.”</td>
</tr>
<tr>
<td>Firm J</td>
<td>The respondent only noted competitive risks, not political ones.</td>
</tr>
<tr>
<td>Firm K</td>
<td>“Government bureaucracy here is very difficult.”</td>
</tr>
<tr>
<td>Firm L</td>
<td>“Corruption in the judicial system and in the Costa Rican government are moderate to high risks for us.” “Of course the difficult part of doing business here [in Costa Rica] is the bureaucracy. It is absolutely horrible and it has not improved [over the years]. It is necessary to go through 10 institutions in order to get a permit to open a new [facility]. The permit process for a completely new [facility] can take up to 2 years.”</td>
</tr>
</tbody>
</table>
Firm M  
“The car accident claim’s process is ripe for corruption. The INS (The National Insurance Institute of Costa Rica) guy gets a kickback from the mechanic, the entire process lacks any form of competition so you are left with no other alternative.” [In Costa Rica, insurance is provided by the state. The 1924 Law of Monopolies of the Instituto Nacional de Seguros (National Insurance Institute) states that insurance is to be handled as a state monopoly].

“[Bureaucracy is a challenge]…we must go through four ministries to get the necessary permits to import key supplies for our business.” For those in land development [not the respondent’s industry] one ministry official will come to the land and tell you to do one thing and then another official will come tell you that you have to do the opposite. The only thing this means is that you have to buy one of the officials so they will go to bat for you and grease the wheels. “Corruption is a very significant problem. There is no way around paying bribes if you want to get anything done [in Costa Rica].”

Firm N  
“Costa Rica’s new industrial policy favors other firms and industries over our own. This is the single biggest risk for us.” The respondent noted that one of the political risks of doing business in Costa Rica is that, “Costa Rica is now looking for high tech foreign direct investment...[this has created] more uncertainty in our industry today.” The respondent then discussed how the agrochemical industry was one of the dominant industries in Costa Rica for many years and because of changes in FDI policy, it was now rather marginalized in comparison. According to the respondent, this created a political disadvantage relative to high-tech firms.
E, a large US manufacturer, stated that, ‘change in government is a big risk for us.’ The changes in government create policy uncertainty for firms and require managers to invest time and energy building relationships with the new government officials.

Several firms also noted that corruption in the judicial system (Firms A, B, G and L) or in other parts of the government (Firms A, B, G, H, L and M) posed a moderate to high sovereign political risk for firms. The respondent at Firm A, a computer services firm from Asia, indicated that ‘corruption in the Costa Rican judicial system is a moderate risk.’ A few of the respondents argued that Costa Rica’s targeted FDI policy posed a significant risk for their business. One respondent’s firm (Firm E) faced tough competition for engineers/high skilled labor which he attributed to increased FDI by high tech firms; firms that needed a significant number of engineers and highly skilled managers. While this would generally be considered a normal business risk, especially since it tended to affect high tech and non-high tech manufacturers alike, the respondent from Firm E, a US manufacturer, believed that his firm had less possibility for government assistance and support with this problem than the new high tech entrants. In his opinion, this created a type of political risk for his firm. The General Manager from Firm N, a European agrochemical firm, also stated that Costa Rica’s desire to attract high tech FDI had created uncertainty for his firm. The change in FDI focus by the government, in his view, created more competition for engineers and chemists in Costa Rica. He also felt that government support and policy assistance to high tech firms came at the expense of firms in more traditional industries. Not surprisingly, respondents holding this view were from firms in industries outside those targeted by the government (Firms E and N).

3.2.3. Sub-sovereign political risks

Over one-third of respondents indicated that they had experienced political risk at the sub-sovereign level (Table 5). The sub-sovereign risks noted by respondents were generally firm-specific and attributed to petty corruption or to local competitors using their political connections to create road blocks for their foreign competitors. The General Manager of the European consumer products firm (Firm M) indicated that political influence on the part of local competitors created a significant political threat for his firm. According to him, ‘When dealing with customs and other government agencies we find it to be a real struggle going up against the pride of Costa Rica.’ He went on to say that, ‘[our competitor] has an in with the multitudinous government agencies and there is a sense that it is okay to screw with the small foreign company.’ It is interesting to note that although Firm M is a subsidiary of a Global Fortune 500 firm, the General Manager considers his company a small player in Costa Rica relative to the local competition.

According to the General Manager of the US manufacturer Firm E, while his firm did not face obstacles from local competitors, bureaucratic delays and excessive (in his opinion) permitting requirements were delaying a planned plant expansion out many months and raising operating costs. The General Manager of Firm M stated that he and his associates at other firms experienced similar problems related to land development. Bureaucrats at a variety of levels across several departments were, according to the respondent, creating excessive red tape for the firm. The conflicting permitting and licensing requirements and delays in processing them, it was suspected, may be indirect requests for ‘grease’ payments.

3 The author would like to thank one of the reviewers for suggesting this change.
Managers also noted that changes in political party after an election may create sub-sovereign risks for the firm—in addition to the sovereign risks noted in the previous sub-section. Many local and regional government positions, including members of the police force, are based on political patronage. Thus, when the party changes there is significant employee turnover throughout the system. The President of Firm B, the US retailer, stated that, ‘in Costa Rica, when the party changes everyone in the police department changes. As a result, it takes 6–8 months after a change to rebuild confidence [at both levels of government].’

4. Propositions

After considering how managers assess risk and which risks they see as most important to their business, managers’ responses were compared with their firms’ basic characteristics. Results of this analysis revealed that several firm characteristics may be associated with an increased or decreased susceptibility to political risk. These firm characteristics and their potential relationship to firm risk are discussed in more detail below.
4.1. Subsidiary versus MNE size

Findings suggest several factors that may increase political risk for the MNE. First, smaller subsidiaries may face greater sovereign and sub-sovereign political risk than larger ones. This relationship between size and risk may be irrespective of the size of the subsidiary’s multinational parent relative to the host country since the size of the parent organization did not appear to mitigate subsidiary level exposure to sovereign or sub-sovereign political risks. Thus, while large firms, particularly in the infrastructure sector, may receive more sovereign level political attention (either positive or negative) because of their size and visibility in the host country (Henisz, 2000), smaller subsidiaries received little attention of any kind. This in turn exposed smaller subsidiaries to greater sovereign and sub-sovereign risks than larger subsidiaries. One explanation for this proposed relationship is that smaller subsidiaries (again, regardless of overall MNE size) have more difficulty getting the ear of higher level bureaucrats in the central government. The absence of bargaining power exposes the smaller subsidiaries to a greater number of bureaucratic delays and red tape. As a result, they could be held hostage to long permitting processes. Such delays, noted respondents, could only be expedited through so-called ‘grease’ payments. Although managers at larger subsidiaries faced similar problems, they indicated that they were able to use their political and economic power to avoid being held hostage in such a manner. In general, these managers felt that there were multiple channels available to them for resolving such problems. In contrast, managers of smaller firms indicated that it was hard for them to get things done without making grease payments. They felt there would be significant consequences to the business, in terms of increased time to obtain permits and other delays, if they did not make the necessary grease payments. Of course, it is important to recognize that response bias may affect these findings. Managers at larger firms may be either more aware or more afraid of the negative legal and publicity consequences of such a disclosure.

Unlike the managers of the smaller firms, respondents from the three largest subsidiaries indicated that they had access to top level government officials through formalized channels. In fact, two of the largest subsidiaries in the sample were able to use their economic influence and the bargaining power it conferred to expedite their product through customs, shape the national environmental standards for firms in their industry, and work with members of the Costa Rican government to improve their operating environment. This finding is supported by the political lobbying literature which asserts that lobbying efforts can be used to favorably influence host country policies (Boddewyn & Brewer, 1994; Hillman & Hitt, 1999; Hillman, Zardkoohi & Bierman, 1999; Schuler, Rehbein & Cramer, 2002). These findings suggest the first two propositions:

**Proposition 1.** After the firm’s initial foreign direct investment has been made, smaller subsidiaries, independent of the overall size of the MNE, are more likely to face greater sub-sovereign political risk than larger subsidiaries.

**Proposition 2.** Smaller subsidiaries, independent of the overall size of the MNE, are less likely than larger subsidiaries to gain access to key government decision makers through formalized channels.

4.2. Host country’s FDI policy

As detailed earlier, Costa Rica followed a well-articulated industrial policy which involved attracting and supporting firms in the electronics medical devices/pharmaceutical and
computing industries. Respondents in industries outside of the host country’s FDI focus, in this case outside of the electronics, computing and pharmaceutical industries, indicated that they faced greater political risk after their initial investment than companies within the country’s FDI focus. This finding was particularly interesting since firms that may have had strong bargaining power over the last twenty or thirty years faced diminished bargaining power and increased risk only recently. This reduction in bargaining power was attributed to the fact that their industry was not one of the industries actively targeted for support by the government. This finding is supported by Vachani’s (1995) research which suggests a firm’s relative bargaining power may take many years to obsolesce. Alternatively, it could be argued that firms favored under one administration may become outcasts in another. In such situations, favoritism can yield short-term benefits with uncertain long-term effects. At the time of this study it appeared that firms in nationally targeted industries had certain advantages vis-à-vis their counterparts in other industries. How long these benefits might last was uncertain.

The findings regarding the impact of host country FDI policy on firm bargaining power and political risks also have implications for the pattern of political risk faced by firms. Rather than experiencing a precipitous drop (or slow decline) in bargaining power after the initial investment, and a subsequent increase in political risk, it is possible that firms may experience the opposite effect. Certain firms may actually gain bargaining power over time if their industry becomes ‘favored’ by the host country government. New administrations may be just as likely to adopt favorable host country policies as they are to adopt unfavorable ones. These changes may be due to active lobbying efforts on the part of businesses or they may be due to changes in the political, economic or social environment in the host country. To the extent that managers can influence these periods of change, or their impact on the firm and its investment, ongoing risk management techniques such as lobbying would take on even greater importance. The preceding arguments suggest the following proposition:

**Proposition 3.** Foreign firms operating in industries outside of those targeted by the host country will face significantly greater political risk in the short-term than companies operating within industries targeted by the host country.

4.3. Local competition

Findings support the argument that foreign firms may suffer from a liability of foreignness vis-à-vis local firms (Zaheer, 1995; Zaheer & Mosakowski, 1997), which may in turn lead to increased risk. Respondents from sample firms that faced significant local competition reported greater political risk than companies with little competition in the host country. This finding is consistent with prior research that suggests stronger local business interests can threaten foreign ventures if they are able to use political connections to procure favorable treatment or preference over foreign firms (Dunning, 1992; Wells, 1998a; Kindleberger, 1969). In fact, Wells (1998b:108) has suggested that new risks facing multinational corporations in developing countries may be the result of clashes between foreign and domestic firms. It is also noteworthy that neither MNE nor subsidiary size appeared to mitigate this effect. MNE subsidiaries with strong local competition found their permitting processes and ability to get supplies through customs compromised relative to local competitors. This finding is supported by bargaining theory which suggests that foreign firms facing significant local competition will have less bargaining power than their local counterparts (Kindleberger, 1969; Vernon, 1980). Bargaining theory also suggests, however, that MNE size can minimize such effects. Yet, findings from this
study suggest that it is not overall MNE size that is important. Rather, subsidiary size may be the more important measure. For example, even a subsidiary of one of the largest Global Fortune 500 firms was unable to reduce the political risks associated with local competition. Although previous studies have recognized that local incumbents can create political risks for foreign firms (Gomes-Casseres, 1990; Wells, 1998a,b), this research has tended to focus on the dynamics between local firms and the MNE as a whole rather than on the MNE’s foreign subsidiary. Findings from this study extend prior research by suggesting that:

**Proposition 4.** Independent of the overall size of the MNE, foreign subsidiaries that face significant local competition will experience greater political risk than foreign subsidiaries with little competition in the host country.

**Proposition 5.** Subsidiary size, independent of the overall size of the MNE, moderates the relationship between changing host country conditions and political risk to the firm.

### 4.4. Strategies for managing political and economic risk

Several strategies were identified for managing political and economic risks (Tables 6 and 7). First, most MNE’s used US dollars over the local currency wherever possible. Despite the relative stability of the Costa Rican economy, dollarization of business transactions was widely employed. Respondents also indicated a significant degree of confidence in their ability to address these economic risks. They were reportedly much easier to manage than the political

<table>
<thead>
<tr>
<th>Company</th>
<th>What strategies, if any, do you have for managing any of the political risks you identified?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm A, C, F, K</td>
<td>Did not indicate any specific strategies in place at this site. All strategic planning and risk management occurs at corporate HQ in the US.</td>
</tr>
<tr>
<td>Firm B</td>
<td>The firm does refer to risk assessment services to get “a good feel of the trends.”</td>
</tr>
<tr>
<td>Firm D</td>
<td>No strategies employed at the local or HQ levels.</td>
</tr>
<tr>
<td>Firm E</td>
<td>Developed strategies for combating unionization of employees against the wishes of HQ.</td>
</tr>
<tr>
<td>Firm G</td>
<td>Works with the government to establish strong environmental standards for the industry. Beforehand, the government did not have any regulations in place. “We reduce risks by being good neighbors.” “We were [one of the first] company[ies] in Costa Rica to be ISO 14000 certified and we are very proud of that. We also follow OSHA and EPA standards here in the plant.” “Corporate HQs employs a geographic diversification strategy but no strategies are employed at this site.”</td>
</tr>
<tr>
<td>Firm H</td>
<td>HQ sometimes seeks the advice of the embassy here regarding costs and processes.</td>
</tr>
<tr>
<td>Firm I</td>
<td>Engaged in significant customs reform to increase efficiency and lengthen operating hours.</td>
</tr>
<tr>
<td>Firm J</td>
<td>No strategies mentioned.</td>
</tr>
<tr>
<td>Firm L</td>
<td>We have to fight the guerras de precios (price wars) and white pumpers. The white pumpers are the small guys who buy cheap, low quality fuel and sell it on the street corners. Guerras de precios are a much greater problem in the other countries (in the region) because there is far more competition. The (other) economies are more open.</td>
</tr>
<tr>
<td>Firm M</td>
<td>Respondent indicated that when risks could not be avoided grease payments would have to be made in order to expedite business transactions.</td>
</tr>
<tr>
<td>Firm N</td>
<td>All strategic plans come from the home country however some lower level strategic planning is also done locally.</td>
</tr>
</tbody>
</table>
ones. Second, these interviews suggest that FDI may be more mobile than previously thought. Several Presidents and CEO’s indicated that their firms had moved operations quite frequently throughout the region and were willing to do so again. If MNEs do indeed enjoy a reasonable degree of FDI mobility, this may provide an opportunity for the firm to increase its bargaining power vis-à-vis the host country government. Investment mobility enables the MNE to credibly argue that the firm will move its investment to an alternative location. Additionally, several top managers who had worked in other countries during extreme political or economic crises indicated the important role that experience played in their decision to locate in Costa Rica. This finding indicates that site selection decisions may be based on top managers’ experiences in other countries and thus path dependent to some degree.

Another finding from this study supports previous research suggesting that firms will manage political risk by lobbying host country governments to enact preemptive legislation (such as establishing or enhancing environmental laws) or reform inefficient government processes (such as customs, permit processing, etc.). The goal of such lobbying efforts is to minimize future legal or political risks. Factors important to lobbying success included subsidiary size relative to the host country economy, absence of local competition and the firm’s perceived importance to the Costa Rican economy (Murtha & Lenway, 1994; Schuler, Rehbein & Cramer, 2002).

Evidence also suggests that a company’s risk profile is extremely dynamic. In one era, a company may experience low political and economic risks. As the country’s FDI objectives change, and as new foreign firms enter the competitive landscape, a company’s risks can change dramatically. In this sense, foreign firms not only compete for political and economic resources with other local and foreign firms in their industry, they also compete with firms in other industries. As high technology firms become more attractive to the host country government, firms in other industries may experience a loss of power and an increase in political and economic risks.

In several cases, as top managers’/CEOs’ risk perceptions changed during operations in Costa Rica, so too did their strategies for future investment. The Costa Rican top manager of Firm E indicated that his firm’s increasing difficulty in hiring skilled engineers, pressure from the parent company to not fight against union organization and permitting delays for planned expansion of existing facilities led him to suggest that continued long-term complications might lead corporate headquarters to shift more of the organization’s operations to China. Likewise, the expatriate President of Firm B expressed his willingness to relocate operations in the event of

<table>
<thead>
<tr>
<th>Company</th>
<th>What strategies, if any, do you have for managing the economic risks you identified?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm B</td>
<td>Respondent indicated that Firm B did business (sales and purchases) in US dollars to avoid problems associated with fluctuations in the Costa Rican colon.</td>
</tr>
<tr>
<td>Firm E</td>
<td>Respondent stated that Firm E sells its products for US dollars and pays employees in Costa Rican colones. The firm has substantial inflows of US dollars and thus any drop in the colon only reduces our labor costs.</td>
</tr>
<tr>
<td>Firm G</td>
<td>The respondent stated that, “We do everything in dollars now. When I first came here we were doing business in all kinds of currency, you name it. To reduce our exposure to currency fluctuations we use a currency overlay system which is essentially a complicated system that involves hedging currencies. Depending upon the kind of money outstanding [our broker] will buy and sell currencies for us in order to mitigate currency risks.”</td>
</tr>
</tbody>
</table>

*No specific strategies were noted by respondents from Firms A, C, D, F, I, J, K, L, M or N.*
changing political or economic circumstances. In fact, at the time of the interview, he stated that in addition to his Costa Rican operations his firm also had an office in South America. Due to political and economic risks facing that venture, however, his firm was in the process of withdrawing its operations from that location.4 The expatriate manager of Firm M, one of the few to suggest that his firm had received direct requests for bribes, did not suggest that further expansion was part of the organization’s current strategic plan however all such decisions were made at corporate headquarters. On the other hand, the President of Firm G—one of the larger foreign subsidiaries in Costa Rica—who identified corruption in the government and the legal system as business risks for his firm, had been able to manage many of these risks through his firm’s financial resources and its long-term relationship with Costa Rican officials. The President stated that his corporation was confident enough of the firm’s ability to manage these risks that his facility had recently undergone a nearly $40 million plant expansion and had no plans to shift the firm’s investment to another location. Of course, it is important to note that this respondent’s firm did not face any local competition; a factor which may have contributed to the company’s ability to manage risks and influence host country policy. While the influence of subsidiary-level executives varied from firm to firm, all respondents indicated that strategic decisions, such as whether to divest or reinvest in the host country, took place at corporate headquarters.

Finally, an important distinction was found between the nature of economic and political risks faced by firms. Firms faced similar economic risks, regardless of industry. Economic risks such as inflation, currency fluctuations and economic crises originate at the sovereign level and are not opportunistically targeted toward one firm or industry. In contrast, the political risks identified by respondents were idiosyncratic across firms. This finding suggests that macro, or sovereign level, approaches to examining the nature and management of economic risk may be appropriate. When studying political risk however, researchers should also consider the idiosyncratic effects of sub-sovereign entities across different industries and firms.

4.5. Limitations

The findings and propositions presented in this study should be considered with several important limitations in mind. First, the findings should not be generalized beyond the scope of the study given the qualitative research design (Lee, 1999). Nevertheless, the conceptual findings may provide insights for future large sample studies examining these issues in other developing country contexts. A second limitation may relate to the appropriateness of the sample firms. It could be argued that the specific managers and firms in this study are unique and that a larger sample with different respondents would have yielded different results. Recognizing the importance of sample selection, theoretical sampling techniques and interviews with Costa Rican economic experts (CINDE representatives) were used to minimize this potential bias although future research is necessary to draw definitive conclusions regarding the appropriateness of the sample.

Another potential limitation of this study is the possibility of response bias. Although respondents were assured that their identity and the name of their firm would be kept strictly confidential, respondents still may have been reluctant to discuss grease payments or other quasi-legal actions aimed at reducing or combating risk. To the extent that such a bias exists, it

---

4 Firm A planned to close down its operations within the next year or so for business reasons not related to conditions in Costa Rica.
would imply that sample firms face even greater risk than was identified in the study. Ramamurti (2001) has also argued that host-home country negotiations have a major impact on the terms between foreign firms and host country governments. To the extent that influences such as World Trade Organization (WTO) agreements and home country political pressures outweigh firm-host country bargains, this too may have an impact on the overall findings.

5. Conclusions

Findings offered little evidence that managers used any of the widely available country risk measures on an ongoing basis (Table 2), or followed other strategies to assess and/or minimize sovereign or sub-sovereign economic and political risks. Of the fourteen managers interviewed, only one actively used one or more of the commercially available risk measures for assessing country risk on an ongoing basis. This finding is particularly interesting given that managers reported experiencing a variety of political and economic risks. Future research could make a valuable contribution by examining the relationship between ongoing risk assessment practices and firm performance. Such research would have important implications regarding the value of environmental scanning and various country risk assessment techniques and whether they are more effective when conducted at the subsidiary level, at corporate headquarters or some combination of the two (Birkenshaw & Morrison, 1995; Blumentritt & Nigh, 2002; Jarrillo & Martinez, 1990; Mahini & Wells, 1986; Rugman & Verbeke, 2001).

The study also suggests the importance of considering both sovereign and sub-sovereign political risks. Although attention is often focused on major risk events such as the expropriation of foreign assets or currency crises, smaller scale day-to-day risks also pose a threat to the profitability and viability of a firm’s FDI. In addition, the moderating effect that subsidiary size—indeed of the size of MNE as a whole—has on the relationship between political risk in the host country and political risk to the firm may also merit attention. Smaller subsidiaries may be particularly susceptible to sub-sovereign political risks since they may be less likely to gain access to key government decision makers through formalized channels or to mitigate the political power of local competitors. A firm’s vulnerability to political risk may also vary over time, particularly as the host country’s FDI policy priorities change. Firms operating in industries targeted by the host country government may experience reduced political risk in the short-term. Once the administration and/or the host country’s industrial policy changes, firms may suddenly find themselves facing increased political risks. This finding suggests that it may be beneficial for foreign firms to stay abreast of potential changes in the host country’s policy toward FDI and to consider lobbying the host government in an effort to shape the country’s policies.

5.1. Implications for research and practice

The results of this exploratory study suggest several issues that managers and researchers may wish to consider in future research and practice. First, evidence from this study, as well as from a much wider body of investment banking and financial service firm reports, suggests that sub-sovereign risk appears to be a concern for multinational enterprises, insurers and lending organizations. Managers may find that developing political relationships at the sub-sovereign level can be as important as building relationships with officials in the central government. Efforts made to lobby both sovereign and sub-sovereign levels of government may enhance firm performance and minimize the firm’s exposure to certain country risks. While it is possible that
increased competition for FDI in developing countries will lead host country governments to adopt the most favorable investment policies possible, political cycles tend to bring about changes in policy (Vaaler, Schrage & Block, forthcoming). Whether these changes are minimal or significant enough to create risks for foreign firms remains an open question for future research. Regardless of whether or not these changes ultimately affect foreign investors, however, managers should be prepared for a variety of possible scenarios.

Managers of multinational firms should not underestimate the strength of local competition abroad, even if they are working for a subsidiary of a Global Fortune 500 firm. Local competitors may have strong political connections in the host country; connections that can be leveraged to give the local firm an advantage over foreign investors. As competition intensifies between local and foreign firms, local managers may be increasingly motivated to leverage their political relationships. A better understanding of these issues may enable managers to develop firm-specific advantages in risk assessment that can lead to a competitive advantage and superior performance over the long-term.

Acknowledgements

The author is grateful to the Latin American Center for Competitiveness and Sustainable Development (CLACDS) at the Central American Institute of Business Administration (INCAE) in Costa Rica which very generously helped to fund and support this research. The author would also like to thank Lorraine Eden, Jean Boddewyn, Jorge Rivera and Erran Carmel for their comments on earlier versions of this article.

References


5 The author would like to thank one of the reviewers for suggesting this change.


Kobrin, S. J. (1978). When does political instability result in increased investment risk? *Columbia Journal of World Business, 13*(3), 113–122.


