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Proactive management of political risk and corporate performance: The case of Spanish multinational enterprises

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ABSTRACT

The present study analyzes the relationship between the political risk assumed by Spanish multinational enterprises in their internationalization strategies and their performance over a five-year period, from 2000 to 2005. Significant evidence is obtained of a positive and simultaneous relationship between political risk and performance through the use of simultaneous equations applied to a sample of 164 firms. These results are consistent with the premises of the Prospect Theory and with the traditional financial and economic theory grounded in risk aversion. They also explain the proactive use of political risk, to the extent that greater risk results in greater performance, which in turn contributes the amount of resources that are needed to undertake investments in countries with greater risk.

1. Introduction

The literature on the relationship between the degree of multinationality, measuring the company's foreign direct investment strategy, and its performance is relatively abundant (see Verbeke & Brugman, 2009 for a sample of more representative studies over the last 50 years in this field). Several authors have identified a relationship in the form of an inverted S (*e.g.*, Bobillo, López-Iturriaga, & Tejerina-Gaite, 2010; Contractor, Kundu, & Hsu, 2003; Lu & Beamish, 2004; Riahi-Belkaoui, 1998), which implies that firms go through three stages in their internationalization processes. At first, an increase in the degree of multinationality impacts negatively on performance, given that the firm faces problems which are, to a great extent, unknown. In the second stage, once the firm has started to acquire the necessary knowledge to manage foreign operations, the increase in the degree of multinationality is accompanied by an increase in performance, until the third stage is finally reached, in which management of the foreign operations is at an excessively complicated level which implies worse performance.

However, this stream of literature has lately left risk analysis to one side, despite it had been a mainstream component in earlier studies (Verbeke & Brugman, 2009). This lack of analysis might be due to traditional arguments which assumed that internationalization reduced the firm's exposure to risk through diversification (Agmon & Lessard, 1977; Brewer, 1981; Hughes & Sweeney, 1975; Kim, Hwang, & Burgers, 1993). Nevertheless, it may be argued that the firm has no need to carry out international operations to gain the advantages that ensue from international diversification, as these may be achieved through contractual arrangements such as licenses or supply contracts, among others (Verbeke & Brugman, 2009). Moreover, various authors point out that a firm's international diversification may increase firm risk due to fluctuations in exchange rates, agency problems and mainly institutional risks (Bartov, Bodnar, & Kaul, 1996; Reeb, Kwok, & Baek, 1998; Siegel, Omer, Rigsby, & Theerathorn, 1995).

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Drawing on the New Institutional Economics framework, which analyzes public sector institutions and their interaction with the economic activity of the private sector (Davis & North, 1971; Henisz, 1998; Holburn, 2001; North, 1989), it can be argued that institutional issues such as economic freedom, political constraints or corruption levels of the countries where a multinational enterprise (MNE) invests, condition the level of political risk that it assumes in its foreign investments. This level of political risk that MNEs want to assume in their foreign investments may be related to their levels of performance. On the one hand, investment decisions in countries with certain levels of risk may influence MNEs performance. On the other hand, the choice of countries may be conditioned by MNEs performance. Thus, an analysis that differentiates the influence of MNEs' performance on the risk they assume in their foreign investments, and *vice versa*, is an interesting research issue.

It is precisely the scant attention that previous research has paid to institutional risks in overseas operations and their relevance for the management of MNEs, which justifies the objective of our study. Specifically, our paper seeks to analyze the simultaneous relation between the level of political risk assumed by MNEs in their foreign direct investment location portfolio and their performance. We take the empirical case of the Spanish MNEs investments. We have chosen this particular set of MNEs because recent literature has pointed out a proactive use of political risk in the internationalization strategy of Spanish MNEs by taking advantage of their political capabilities in certain locations (García-Canal & Guillén, 2008; Jiménez, 2010, 2011; Jiménez, Durán, & De la Fuente, 2011).

From a strategic point of view, it has been recently claimed that MNEs may take advantage of their experience in less institutionally developed environments to obtain competitive advantages in other markets with similar characteristics, whereas other MNEs lacking this experience may have a disadvantage (Cuervo-Cazurra & Genc, 2008). However, it is still unexplored if this particular strategy is positively reflected in the MNE's performance. Our study can be considered a first step to investigate such an issue in a "late-investor" country, at least compared to other developed economies, where literature has found that this proactive use of political risk has been implemented. The results can be extrapolated, with caution, to MNEs from other countries that might also take advantage of political capabilities in their internationalization strategy to be able to compete with dominant global competitors in selected locations.

The remainder of the paper is structured in the following way. In the second section, we review prior research on the relation between political risk and the degree of internationalization of the firm. In this section we also develop the hypotheses relating the influence of the political risk assumed by Spanish MNEs with their performance, as well as the effect of Spanish MNE performance on the level of political risk. The subject of sections three and four are the sample, variables and the results. Finally, the fifth section extracts and discusses the main conclusions of the paper and points out some limitations and future lines of research.

2. Literature review and hypotheses

Academic literature has traditionally interpreted political risk as a threat for MNEs. Thus, most studies establish a negative effect of corruption (Cuervo-Cazurra, 2006, 2008; Habib & Zurawicki, 2002; Lambsdorff, 2003; Wei, 2000a, 2000b), political discretionality (Henisz & Zelner, 2001, 2002a, 2002b) and lesser economic freedoms and the protection of property rights (Bengoa & Sánchez-Robles, 2003; Kapuria-Foreman, 2007) on foreign direct investments.

However, these results do not imply generalized behavior by all firms nor for all investor countries. In fact, Spanish MNEs are characterized, on occasions, by their proactive use of political risk in their overseas expansion strategies,[1] which is based on taking advantage of their political capabilities to obtain competitive advantages (Henisz, 2003; Hillman & Hitt, 1999; Holburn, 2001; McWilliams, Fleet, & Cory, 2002; Wan, 2005) either through negotiating skills, opportunities to exert pressure or even to commit bribery.

Although political capabilities are extremely hard to measure, and therefore it is also difficult to determine to which extent MNEs possess them, there is some empirical evidence of their impact on the internationalization strategy of Spanish MNEs. García-Canal and Guillén (2008) find that Spanish MNEs in regulated industries show a bias to countries with low governmental constraints, even in spite of their aversion to macroeconomic uncertainty. This is due to the possibility of their using negotiating skills, originally honed in their home country, to obtain advantageous entry conditions.

Following this line of research, Jiménez et al. (2011) found that greater levels of political constraint positively influence the probability of investments in Europe and North America, in concordance with the results of Galán, Gonzalez-Benito, and Zúñiga-Vicente (2007). The same happens in Asia and Europe when testing lower levels of corruption. However, in the case of Latin America, higher levels of corruption favor Spanish investment. In turn, Jiménez (2010) shows that the greater the level of political risk faced by Spanish MNEs, measured by the relative degree of corruption, the greater the scope of internationalization. In another paper (2011), this author demonstrated that in the countries of North Africa and those of Central and Eastern Europe that have recently joined the European Union, greater levels of political risk measured through levels of political discretionality, corruption and economic freedoms, attract greater direct investment inflows from Spain, France and Italy.

These results are consistent with the Bribe Payers Index 2008[2] prepared by Transparency International, in which both Spain and France, together with the United States, and Singapore, which are found in Cluster 2, have a greater likelihood of

[1] Evidence for this behavior has also been found among North-American firms in the electricity sector (Holburn, 2001).

[2] Bribe Payers Index 2008 catalogs countries into four clusters according to their bribe levels, including countries with lower bribery levels in Cluster 1 and countries with higher levels in Cluster 4.