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Managing Exposure of Direct Foreign Investment to Political Risk: The Case of Food Businesses in China

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ABSTRACT: Direct foreign investment (DFI) allows a multinational corporation (MNC) to generate and appropriate extra-normal profits from its unique assets in a foreign market. China has become increasingly attractive for foreign investment over the past 20 years. This entails political risk, but MNCs can reduce the risk by relying heavily on MNC-specific assets, often in the form of tacit knowledge. A joint venture with a local partner creates an incentive for a local stakeholder to shield the DFI from political risks and allows the partner to contribute location-specific assets to the venture, further reducing the MNC's risk.

From the 1960s and 1970s there had been much interest in assessing political risk of direct foreign investment (DFI). DFI arises from multinational corporations (MNCs) investing directly in operations in a foreign host country and so being exposed to foreign political forces. However, predicting adverse political events in a foreign country has always proven difficult due to the idiosyncratic nature of many of these risks. This paper instead focuses on how MNCs can manage the political risk exposure of their DFI for the long term. For perspective, we offer a broad overview of political risk, including factors such as social turmoil, but then focus on forces that an MNC can manage such as economic factors and government restrictions. The MNC cannot control political risk much, but can instead

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manage its exposure through the structure and type of investment. It can use specialized proprietary assets, often in the form of tacit knowledge that cannot be appropriated by other entities, to generate a stream of benefits to the host country. We describe these approaches to political risk management in the context of transaction cost theory, explaining how the host country has incentives to benefit from the MNC's continuing presence.

We apply the concepts to some investments that have been made by U.S. branded consumer food companies investing in China. We take the case of China because it is a major emerging market of 1.2 billion people to which many MNCs are looking for growth opportunities. For the past 20 years, China's economy, per capita income, and middle class have been growing at surprising speed. Pam Baldinger, editor of *The China Business Review*, believes that China's emerging consumer class—estimated by analysts at upwards of 60 million—has a special taste for the best-known, heavily advertised US brands (*Washington Post*, 1994). For example, Bestfoods (renamed from "CPC International" in January 1998) is one of the largest and most international U.S. food companies, and is looking to China as a growth market (*Business Wire*, 1993; *AFX News*, 1995). Bestfoods' global Knorr brand is already the number one name in bouillons and dehydrated soups in Asia through its well-established business in Hong Kong, Singapore, Malaysia, Taiwan, and Thailand. Bestfoods believes that Knorr brand will be popular in China which has a strong tradition of using broths and bouillons. Though Chinese historically have used homemade rather than commercially produced broths, Bestfoods is counting on China's large and growing consumer class to substitute prepared foods (*Business Wire*, 1993). To describe terms and issues, we turn next to overviews of DFI and its function, and political risk.

DIRECT FOREIGN INVESTMENT AND CHINA

The importance of DFI lies in the benefits to both MNCs and the foreign host countries. MNCs arise because they possess a special or unique advantage such as superior technology or lower costs that can best serve the host country market through DFI (Hymer, 1976). Dunning (1977) proposed three potential advantages of DFI over export. First, MNCs should have an advantage derived from ownership of intangible assets such as brand management, trade secrets, technology, or tacit management capability which confers a market or cost advantage. These assets or capabilities should be transferable within the firm, and have a joint character or public good attribute so that they can be applied to additional non-competiting enterprises at low cost (Markusen, 1995). If transferability is weak, then the MNC may not be able to efficiently exploit its ownership advantages through DFI (Madhok, 1997). Second, the DFI should confer an advantage to being located in the host country such as tariff avoidance, transport cost reduction, low factor prices, or proximity to customers. Learning

about customers or the market can be a key benefit of DFI and the resulting knowledge can become a unique or MNC-specific asset (Madhok, 1997). Third, the MNC should benefit from internalizing and more fully controlling its foreign business through DFI to more fully appropriate the profits or rents generated by its unique assets or capabilities. An exporter may suffer transaction costs related to large importer-distributors in the host country bargaining for a large share of the exporter's profits or knowledge, or mishandling and depreciating the exporter's brand name (externality principle of forward integration; Williamson, 1981). If appropriability and control issues are significant, then export markets can fail. DFI bypasses such market failure and opens the opportunity for the MNC. For the host country, DFI can improve welfare through new products, new technology, additional employment and training, and new management techniques that would otherwise not be available (Teece, 1981; Khan, 1991).

In China, DFI had been excluded by a national policy of self-reliance that extended from the Communist revolution in 1949 until its "open door policy" in 1978. For example, China was one of the Coca Cola Company's first overseas markets back in 1927 when it established two bottling plants in Shanghai and Tianjin. But the company was forced to leave in 1949 before re-entering China in 1979, and opening a series of plants in coastal cities (*Los Angeles Times*, 1993). China's "open-door policy" in 1978 sought to improve technology transfer and increase exports and marked a turning-point. Total DFI in China grew at an average rate of 34% per annum from 1983 to 1989 (Khan, 1991, p. 8). Joint ventures between MNCs and Chinese partners involving advanced technology and exports were particularly encouraged (Pomfret, p. 24, 1991). These joint ventures were given liberal tax breaks and local authorities offered additional incentive-concessions through land use and other local fees. Coastal cities were granted permission for special economic zones. Then the central government's austerity program in 1988, and the democracy movement and Tiananmen Square conflict of 1989 were followed by a significant decrease in the growth of DFI. This has been followed by another surge in DFI that began in 1992 (Prybyla, 1995). The periods of rapid increase and slowdown reflect the many changes in government policies and Chinese political discord. Coca-Cola, for example, suffered numerous setbacks in rebuilding their brand and did not make a profit in China until 1990.

We turn next to a discussion of political risk. For perspective within the overall context of political risk, we give an overview of political risk with various definitions, and briefly summarize empirical efforts at predicting political risk. We highlight the types of risk that the MNC can more actively manage in terms of reducing its exposure. In the succeeding section, we move on to how the MNC manages this exposure.

POLITICAL RISK

Attractive emerging markets can present large opportunities for foreign investors but are more highly uncertain in terms of political risk. In general, political risk is the exposure to unanticipated changes in political factors. Agmon and Findlay (1982) gave a loose definition of political risk that includes all government policy effects. Robock (1971) defined political risk in international finance as existing when political change can cause discontinuities in the business environment that are difficult to anticipate. Thunell (1977, pp. 4–10) defined two types of political risk. One is the risk within host countries which is also called sovereign risk. A company, either domestic or foreign, can be affected by government or social instability (e.g., political strikes, riots and revolutions). The other type of political risk is that between the MNC's home country and the host country. Examples are trade friction, cross-currency control risks, and wars. The extreme risk for an MNC is expropriation or nationalization of their investment, and forced withdrawal from the host country. Outright expropriation or nationalization are less common in the 1990s than in the 1960-70s. However, more subtle degrees of expropriation exist in the sense that a host country may appropriate MNC profits or rents by increasing taxes on the DFI or otherwise using its power to "partially expropriate." This is the type of risk to which the MNC can reduce its exposure, which we will address in the following section.

Coplin & O'Leary (1991) classified political risk into four types: (1) political system instability: turmoil, revolution, and corruption; (2) government restrictions: investment barriers, local equity restrictions, operations restrictions, taxation discrimination, cash flow or profit repatriation restrictions, borrowing restrictions, foreign exchange controls, trade barriers, and expropriation and naturalization; (3) economic forces: inflation, balance-of-payments deficits or surpluses, and growth rate of per capita GDP; and (4) ethnic and religious structures. Here, economic forces and government restrictions that impact DFI are often driven by host economic incentives. So, MNCs can manage their exposure to this risk through investments that generate benefits to the host, and generate profits that are difficult for host entities to appropriate. However, political, ethnic, or religious instability are often not driven (directly) by economic incentives and so it can be difficult for MNCs to manage exposure to these. These risks are highly idiosyncratic and difficult to predict.

To lend further perspective, we briefly characterize the three general types of models for predicting political risk (Kobrin, 1982, pp. 199–209; Kennedy, 1984; 1987, pp. 1–22): (1) *Observational data models* attempt to assess macro political risk using secondary data in formal statistical models of the structural causes of political risks; these minimize subjective analysis but have not been entirely successful and their use is decreasing. (e.g., see Knudson, 1974; Hibbs, 1973, pp. 3–17, 135–136, 181; Rummel and Heenan, 1978; Johnson, 1980).

(2) *Expert-generated data models* are based on expert-generated opinion with varying degrees of structure for the relationship between political events and managerial contingence; these can be tailored to a firm's specific needs through varying degrees of formalization, though their predictive power is low (e.g., see Haner, 1981; Kennedy, 1984; Coplin and O'Leary, 1985; Gladwin and Walter, 1980, pp. 66–89; Gebelein, Pearson and Silbergh, 1977). (3) *Components models* are based on expert- generated subjective models integrated with objective data models; this integrated approach has perhaps been the most successful (e.g., see Haendel, 1979, pp. 96–124). There was a surge of interest in political risk prediction following the Iranian revolution in 1979, but, in general, no predictive models have been consistently successful.

MANAGING EXPOSURE TO POLITICAL RISK

In pursuit of high investment returns, MNCs assume political risk that cannot be accurately measured but which can be managed. In this section we give an overview of political risk management in general, and highlight approaches for managing the exposure of DFI committed for the long term.

Shapiro (1981) offers four fundamental approaches for managing political risk of DFI at the outset: (1) Risk avoidance: if the probability of loss is too high and the expected profit does not justify the risk, the investment opportunity may be deferred or passed. (2) Insurance: most developed countries sell political risk insurance to cover the foreign assets of domestic companies. In 1979 the U.S. government established the Overseas Private Investment Corporation (OPIC) which provides insurance against expropriation, currency inconvertibility, political violence, and also loss of business income from interruptions to DFI operations. The Multinational Investment Guarantee Agency (MIGA) was established in 1988 to promote investment for economic development by insuring foreign investment against currency transfer restrictions, expropriation, war, civil disturbances, and breach of contract (Wallace, 1992). (3) Negotiating the environment: Some MNCs seek concession agreements with the host government before undertaking the investment, defining rights and responsibilities of both parties. Such agreements may include tax breaks or infrastructure construction, and more clearly define property rights. However, when the host government changes then concession agreements can become resented or unpopular, and may sometimes even increase political risk. These first three approaches offer less in terms of actively managing the exposure of DFI, while the fourth approach pertains to how the MNC makes its investment: (4) Structuring the investment: MNCs try to reduce their exposure to political risk by increasing the host country's cost of interfering with company operations. One such strategy is vertical integration that keeps the local affiliate dependent on external MNC subsidiaries for inputs or markets. Specifically, Bradley (1977) suggested (1) concentrating proprietary research, product development,

and process technology in the MNC's home country, (2) making each new DFI economically dependent on the MNC, (3) avoiding local brand-building in the host country (instead building on the MNC's established international brands), and (4) adopting a low profile, multiplant strategy, with a number of small investments spread throughout several countries.

Given an investment commitment, Shapiro (1981) gives five possible strategies for managing political risk: (1) Planned divestment: The MNC phases out their ownership of their DFI over a fixed time period by selling all or a majority of their equity interest to local investors. (2) Short-term investment with short payback period: The MNC can maximize cash generation for the short term. (3) Adaptation: Some firms have tried a more radical policy to adapt to expropriation as inevitable, and earn profits by entering into licensing and management agreements. These first three approaches relate less to managing the exposure of DFI for the long term, while the fourth and fifth approaches relate to how the MNC makes its investment and generates benefit streams for the host country: (4) Change the benefit/cost ratio: The MNC can try to make the host government's economic cost of expropriation or appropriation exceed the benefit. The cost could be negative sanctions for the host, or lost benefit streams that would have been generated for the host through MNC-specific assets (e.g., management training generated from the MNC's management capability). (5) Develop local stakeholders: The MNCs can establish joint ventures to develop host country stakeholders. Bradley (1977) found that joint ventures with local partners have historically suffered a lower rate of nationalization and suggested joint ventures with local private firms.

In this paper we focus on managing political risk for long-term DFI related to host policies, not the more idiosyncratic risks related to social or political turmoil. We do not further address risk avoidance, insurance, adaptation, nor short-term strategies such as short-term profit maximization or planned divestment. We instead examine two types of long-term strategies related to changing the benefit/cost ratio and developing local stakeholders: (1) Integration with MNC-specific assets and tacit knowledge, and (2) joint ventures.

INTEGRATION WITH MNC-SPECIFIC ASSETS AND TACIT KNOWLEDGE

DFI assets that rely on or are specific to MNC-controlled assets outside the host country are less exposed to the risk of expropriation or rent appropriation. In this context, asset specificity is the extent to which value-creating business transactions and supporting assets depend on the MNC. MNC-specific assets have a low value when separated from the MNC, or a low opportunity cost outside the MNC. If an MNC divests its DFI, MNC-specific investments would have a high opportunity cost to the MNC and could be largely redeployed. Conversely, host location-specific assets depend on the host location for their value. Host-specific assets, such as local distribution assets or brand-building investments, are largely a sunk cost of

the MNC with little opportunity outside the host market. Further, some portion of the host-specific investments may be appropriable by a host entity and so are most vulnerable to host policies. Finally, there will be a portion of any investment that would be specific to the DFI itself and be unrecoverable by any entity; that is it would be specific to the DFI's business transactions with little value to either the MNC or the host entity in a divestment scenario. (e.g., see Milgrom and Roberts, 1992, p. 307)

For managing political risk, DFI assets that are dependent upon vertically aligned MNC-controlled inputs or market distribution channels outside the host country have reduced risk exposure. This reduces the value of the investment when it is separated from the MNC and deters expropriation since it has low value to the host country without the MNC. For example, the MNC may control a unique input or knowledge or technology, or own a global trademark on which the DFI relies. All of these are specific to the MNC which makes its presence more valuable to the viability of the DFI and its resulting benefit to the host country.

Tacit Knowledge

MNC-specific assets often consist of tacit knowledge or technology that is difficult for host entities to copy or learn. Complex knowledge can reside in teams of employees and be implicit in their routines and responses to the environment. Value is drawn from all the individual member repertoires and their coordination through routines or learned responses. Routinization of activity constitutes the most important form of storage of the organization's specific operational knowledge (Nelson and Winter, 1982). This kind of knowledge has a significant tacit dimension that is very difficult to copy (Teece, 1982). Technology, research and development processes, marketing expertise (that builds trademarks), and management expertise generally represent tacit knowledge that the MNC may be able to transfer to a host country operation, but which cannot be transferred out of the MNC nor easily appropriated by host entities.

High technology, management expertise, and other forms of MNC-specific tacit knowledge generates a stream of benefits to the host country such as employment, training, and slow technology transfer. These local benefit streams reduce the incentive for the host to expropriate or appropriate rents because these would be lost without the MNC. For example, Anheuser-Busch Companies, the world's largest brewer, has made two joint venture investments in China. Anheuser-Busch brings advanced brewing and packaging technology and management techniques that improve product quality and consistency, and increases environmental protection. The joint venture will use the investment capital for equipment modifications to meet Budweiser's brewing and packaging specifications. Some of this investment is host-specific but it generates a continuing benefit stream to the host and demonstrates the MNC's long-term commitment in China (Melvin, 1996). MNC's often bring other benefit streams

to the host such as contributions to local charities and education (similar to "corporate citizenship" activities in their home countries).

Consider the ubiquitous cross-cultural example of cola and soft drinks for which China could be the world's second largest market by 2000 (*Atlanta Journal and Constitution*, 1994). PepsiCo has established a number of joint ventures in China and has transferred state-of-the-art technology and introduced modern management and marketing (*South China Morning Post*, 1994). PepsiCo also operates a research laboratory in Guangzhou which has a mandate to create new soft-drink flavors (South China Morning Post, Aug. 4, 1993). Similarly, Coca Cola has invested in bottling joint ventures with Chinese partners that need capital, technology and management. Coca-Cola has built plants, transferred technology and trained people, and in the process has built trust and goodwill (John Farell, head of Coca Cola's China operations; *Reuters Business Report*, 1997). This knowledge is not entirely tacit but the learning curve is high, the transfer is gradual, and the MNC continually introduces newer superseding knowledge and technology. DFI generates a continuing stream of benefits to the host country that helps shield the MNC from undue appropriation of profits.

Trademarks and Marketing

A global trademark or brand name is not tacit, but international trademark laws are generally supported by national governments. A local trademark, however, is specific to the host market and can be more exposed to the risks of local law (Shapiro, 1981). Although a global trademark can be copied, the building and maintenance of a trademark is derived from tacit marketing knowledge. For example, the Budweiser brand is one of the world's most popular and has widespread consumer appeal in China as an American icon brand. The global brand derives its value from Anheuser-Busch's distinct technical and marketing capability which can not be easily copied or expropriated. However, the investment in brand building is a sunk cost that is specific to the host market, and would be lost if the MNC divests its DFI. Even the most global brand names must be built in local host markets. Coca-Cola's main investment in its Chinese joint ventures is marketing, advertising and promotion; they tailor their product and marketing mix to different regions of China, generally selling a full range of products in big cities, but only Coke elsewhere. Coca Cola doubled these expenditures in 1996 and again in 1997 (*Financial Times*, 1996).

Although governments generally recognize ownership of global brands, piracy of intellectual property and weak law enforcement can be a substantial problem in some countries as it has been in China. For example, William Wrigley Jr. Company produces its three traditional chewing gum brands in China: Doublemint, Spearmint and Juicy Fruit. Wrigley's marketing challenge is substantial because Chinese do not have a gum chewing tradition as in the U.S.. They are working to educate wholesalers and retailers about chewing gum, and emphasizing their

American image and the benefits of fresh breath (*Crain's Chicago Business*, 1993). In the face of this challenge, one of Wrigley's biggest problems is pirating by Chinese manufacturers that make poor quality copies, both appropriating Wrigley's profits and damaging their trademarks. Most of the Wrigley's legal expenses are devoted to protecting its trademarks and patents and seeking help from the Chinese government through intellectual property rights agreements (*Chicago Tribune*, 1995).

Host countries are often careful about abusing an MNCs because it can deter future DFI and the attendant benefit streams. A high profile MNC with a prominent trademark can have less risk in this sense. McDonald's, one of the first U.S. fast-food companies in China, established a store in a prime location near Tiananmen Square in Beijing. In 1994, McDonald's was forced by local government agencies to move away for a commercial development, violating a 20-year lease McDonald's obtained in 1992 (Hammonds, 1994). After negotiation McDonald's was allowed to remain within the area's new development, perhaps because the government did not want to send a chill through foreign MNCs in China (*Hua Xia Digest*, 1996). A global trademark or brand name with a high profile may reduce exposure to some forms of appropriation.

JOINT VENTURES

If DFI assets are largely specific to the host country, this creates an exit barrier and may increase the MNC's exposure to host appropriation. This raises the prospect that the MNC can instead pursue a joint-venture with a host country partner that contributes host-specific assets while the MNC contributes MNC-specific assets. Moreover, the host partner shares a residual ownership claim and an incentive to protect it from political risks. For example, Anheuser-Busch's joint venture with Tsingtao allows it to access Tsingtao's established raw material sources, low-cost labor, transportation links, well-developed distribution channels, and excellent local production facilities. This allowed Anheuser-Busch to immediately begin production and marketing of Budweiser, and reduce their dependence on local specialized investments. Anheuser-Busch contributes technological and marketing expertise. A similar complementarity arises in the joint venture between Anheuser-Busch and the Zhongde Brewery: "The joint venture combines the market experience and distribution channels developed through (Zhongde's) Steinbrau brand with the sales strategies and marketing techniques of Budweiser, giving both brands a competitive edge in the Chinese beer market" (Raymond E. Goff, President of Anheuser-Busch Asia, and chairman of the joint venture; *Business Wire*, 1995). A joint venture partner can accelerate the MNC's learning about the local market and create more value through location effects; if this outweighs rent-sharing from ownership and internalization effects then a joint venture can be favored (Madhok, 1997).

Host Country Partners

An important problem in establishing a joint venture in China is selecting a local partner with appropriate complementary assets such as transportation and input sources that are negotiated with various government agencies (Melvin, 1995). One possibility is a government-owned partner that may receive preferential treatment such as lower taxes. For example, Tsingtao and Zhongde are big state-owned breweries, and investments with such leading companies are encouraged by the Chinese government. These can yield more protection and preferential treatment than could be gotten through small private companies. But many state-owned companies can be less efficient than private companies and may be more sensitive to changes in government policies.

Another problem of joint ventures is differing objectives of foreign partners. In principle, U.S. MNCs seek to maximize their firm value, consistent with economic efficiency. This objective depends on long-term profits generated from long-term investments that build product quality and reputation. However, local partners may seek to maximize short-term profit, sometimes at the expense of product quality or brand reputation, or may only wish to maximize their portion of cash flow which may be more closely tied to the level of business activity or short-term variables.

The joint venture of Anheuser-Busch with Tsingtao Brewery has suffered some from differing objectives. In one example, Anheuser-Busch wanted to build a modern brewery to expand beer production and marketing, but Tsingtao opted to not build and instead lend their capital to other state-owned companies to earn interest (Jenkins, 1995). Other goals that local partners may pursue are speedy transfer of technology and management expertise while maintaining a high degree of control (Khan, 1991, p.21–22). In this case, Anheuser-Busch brings advanced brewing and packaging technology and management techniques to the joint venture. These are expected to improve product quality and consistency, and lessen pollution (*Business Wire*, 1995).

PepsiCo has been investing in majority-owned partnerships, first focusing on China's large eastern cities such as Beijing and Shanghai, and booming southern cities such as Guangzhou and Shenzhen. These cities have benefited from the government's dramatic economic reforms, and PepsiCo's activity has been encouraged (*Atlanta Journal and Constitution*, 1994). Most of PepsiCo's partners are big state-owned companies, such as Beibingyang Foodstuff Co., Tianfu Cola Holding Co., Asia Beverage Co., and Changchun Number Two Food Factory. Many of these, such as Beijing Pepsi Beibingyang Beverage Co. and Pepsi Tianfu Beverage Co. Ltd., have their own popular local brand names. Established local partners provide established distribution networks, immediate access to raw materials, labor, utilities and transportation links. PepsiCo initially produces the local soft drink brands, then develops their own Pepsi products. By this means, PepsiCo can share the local partner's assets, and expand its capacity of production and sales.

Coca-Cola bottling plants in China are either state-owned or run as joint ventures with state-owned partners (*Reuters Business Report*, 1993). China's soft drink business is dominated by local brands with about 80% of the market. Like PepsiCo, Coca-Cola markets its products as well as locally developed drinks. Sales and distribution are handled by the Chinese partner while marketing and strategic planning are done by Coca-Cola. The Chinese government has pushed Coca-Cola to do more to help the Chinese soft drinks industry, yet the partnerships have actually eliminated many local brands or let them erode. Local partners have complained that the joint ventures have failed to fulfill a condition that at least 30% of the products bear local Chinese brand names (*Reuters Asia-Pacific Business Report*, 1995). The two sides of the joint venture have frequent differences and do not always cooperate enough. In 1995 and 1996, Coca-Cola established wholly owned subsidiaries in Harbin and Shenyang.

Generally, good long-term relations with host businesses and government officials, known as *guanxi*, have long been regarded as important for business in China. Further, a local joint venture partner has long been regarded as a key to developing key business and government relationships, and accessing inputs. However, MNCs are increasingly finding that *guanxi* is difficult to control and not strategically useful. Joint ventures may help the venture in the early stages, but may hinder it later (Vanhonacker, 1997). Further, *guanxi* can be developed without a local partner, though with much work. Motorola, one of first MNCs in China with a wholly foreign-owned enterprise (WFOE), has a "steering committee" that works to keep good relations with the Chinese government and lobby against harmful laws or codes. This reduces their exposure to political risk, even when Sino-American relations are tense and lead to adverse U.S. government decisions (Wang, 1996).

Option of Wholly Foreign-Owned Enterprises

Though most DFI in China is through joint ventures, differing partner objectives and other difficulties have excessively burdened many joint ventures. Historically, local partners have been viewed as almost essential, and often required by law. Over 70% of DFI in China by U.S. MNCs has been through joint ventures (Stoneman, 1993). But there recently appears to be some increase in sentiment towards DFI through wholly foreign-owned enterprises (WFOEs) (Vanhonacker, 1997; Smith, 1998). WFOEs are more flexible and controllable than joint ventures (Vanhonacker). Alternatively, a joint venture and WFOE can be evaluated as a strategic sequence rather than substitute approaches: A MNC can gain initial entry through a joint venture, and then eventually buy the Chinese partner's stake so that the operation becomes a WFOE.

Wrigley began in late 1989 to negotiate with the Chinese government to build a chewing gum plant, and in March 1993 opened a WFOE in the Guangzhou Economic and Technological Development Zone; the government allowed Wrigley to

expand distribution of its products in China and possibly export to other Asian countries (*Journal of Commerce*, 1989; *Reuters*, 1989; *Crain's Chicago Business*, 1993). This WFOE is almost unique among Western joint ventures in China in that Wrigley is not required to source a certain proportion of its raw materials from China, a requirement that discourages many MNCs. However, Wrigley is required to export its China-produced Doublemint (*Crain's Chicago Business*, 1993).

CONCLUSION

Direct foreign investment allows an MNC to exploit its unique assets and more fully appropriate the profits that they can generate in a foreign market. Investment in a foreign country entails political risk, but certain risks from host policies can be reduced through management practices. MNCs can rely on MNC-specific assets, often in the form of tacit knowledge, to render benefits to the host highly dependent on the MNC's continuing presence. These are often the same assets that create ownership and internalization advantages. Further, MNC-specific assets that are not also specialized to the host location do not present an exit barrier for the MNC.

A joint venture with a host partner can create a local stakeholder with an incentive to use its influence to shield the DFI from political risks. A joint venture partner can also reduce risks for the MNC by contributing host location-specific assets. A partner can also create value by contributing assets that are complementary to MNC assets, including the partner's knowledge of local markets and ability to help the MNC accelerate their learning.

The MNC can use its unique assets to generate profits and to provide a continuing benefit stream to the host country as well. Generally, host appropriation of the MNC's profits is economically inefficient. China recognizes that foreign investment has made a significant contribution to their economic development (Khan, 1991). DFI in China has increased technological transfer, improved enterprise management, improved efficiency and quality standards of MNCs' upstream suppliers and downstream buyers, increased exports and foreign exchange, increased foreign capital contributions, increased government tax revenue and employment from DFI operations, and improved income distribution for workers in China. China has been opening up to foreign investment for the last 20 years and the political risks for MNCs have varied but generally declined in this time. The future remains unpredictable but China offers attractive potential returns to investment in exchange for the risks. Given favorable risk-return prospects, MNC management practices can further reduce exposure to certain political risks.

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