Foreign Investment Risk Strategy

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Introduction

Exposure to investment risk is generally much greater for long-term foreign involvement than for a short-term business transaction. The decisions involving long-term direct foreign investment must be made with particular care. Investment risk covers a wide range of events in foreign countries, ranging from a boycott of particular foreign products to physical confiscation of financial assets and physical properties. As shown in Figure 1, risk assessment is a necessary step in formulating risk reduction strategies. It must focus on the existing environment and likelihood of various future events.

Figure 1  Investment Risk Assessment

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The most critical element in the host country environment is the stability of the existing
political system. The type of political system does not necessarily indicate the degree of political stability. A country ruled by a powerful dictator may offer a stable political environment for foreign investment. Brunei and Kuwait are two such examples. Firms from France, Spain and Canada have long conducted a considerable amount of commerce and investment activities with centrally planned countries such as Cuba. A newly organized market economy, on the other hand, may present highly unstable investment climate. Russia and East European countries can be in this category. The existing government system must be carefully studied as to its competence, policies and efficiency. The opposition groups also must be investigated in order to assess the likelihood of a change in the power structure of the government. External forces which could destabilize the existing government should also be investigated.

Types of Risk

Investment risk can be grouped into two categories: political risk and non-political risk. Political risk is due to a sudden or gradual change in local political systems or policies which is disadvantageous or counterproductive to foreign firms or investors. Non-political risk can be due to unexpected change in economic conditions, climate, consumer taste, and so on. Risk due to these elements cannot be easily reduced or avoided by management strategy. Sudden rise in the price of coffee beans due to draught and the resulting high cost of raw material for a coffee company is an example.

Political risk is risk due to sudden or gradual change in local political and economic environment which is disadvantageous or counterproductive to foreign firms or investors. Political risk can be reduced or avoided by appropriate management strategy since the risk is mostly due to policy changes by the host government.

Political risk can be grouped into three major categories: operational restrictions, discriminatory restrictions and physical expropriation or disruptions. Operational restrictions may be placed on daily operations of all firms, while discriminatory restrictions are placed on selected foreign firms only. Expropriation is the seizure of assets of foreign firms and subsidiaries by the host government. The political risk deals with the government-imposed regulations affecting the business activities of foreigners. The host government may unilaterally void all contractual agreements or interfere with the private sector business activities by imposing regulations such as capital control, production limit and labor requirements.

Unlike negotiable securities, a direct investment in a foreign country cannot be easily transferred out of the country, quickly liquidated or traded in an open market. A direct foreign investment generally is made on a much longer-term basis than a portfolio investment, involving investment in plant, equipment, land, buildings, transportation, port facilities and other fixed assets. There are many sources of political risk. Table 2 shows major sources of political risk and the effects on international business.

i) Other types of risk, which have some relation to political conditions of the host country, include riot, revolution, and other violent acts. These events can also be classified as operational restrictions, discriminatory restrictions or expropriations.
Table 1 Causes and Effects of Political Risk

Sources of Risk

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<th>Political Ideology</th>
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<td>Religious Conflicts</td>
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<td>Social Unrest</td>
<td>Coup d’Etat</td>
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<td>Nationalism</td>
<td>Hostility to Foreigners</td>
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Effects on Management

Expropriation, Confiscation Discriminatory Restrictions:
Operational Restrictions: exchange special taxes, tariffs, employment controls, employment policies, regulations, ownership, product specifications, local ownership of business
Noncompliance and breach of contracts
Physical damages and threats to foreigners and property

Operational and Discriminatory Restrictions

The host government may place operational restrictions on foreign and domestic firms so that normal operations of business can become difficult. Even though both domestic and foreign firms are subjected to such restrictions, they can be serious operational obstacles especially to foreign firms and subsidiaries since domestic firms need not pay attention to many of the international operations such as international transfer of funds or employment of foreign personnel. One of the most frequently used forms of operational restrictions is the blockage of funds by currency inconvertibility and exchange controls on a temporary or a long-term basis. Such actions by the host government will make it extremely difficult for foreign investors to transfer funds out of the country or to convert funds into other currencies. Countries experiencing a severe foreign exchange shortage may block all transfers. Exchange controls are relatively rare, but some developing countries have occasionally established such controls. Other operational restrictions include regulations involving employment of foreigners and local workers, local ownership, product requirements, wages and organized labor.

Discriminatory restrictions are placed only on selected foreign firms, subsidiaries and affiliates. Discriminatory requirements include special taxes, tariffs on imports of certain products, and higher rates of utilities charged to foreign firms. Taxation can be utilized to increase control by the host government over foreign business. Foreign firms may also be required to give up ownership of a business or control of management so that local investors can gain a majority position. Many developing countries including India, Mexico and China have established such requirements. Foreign firms may also face mandatory wage requirements for
local workers. In China, most foreign firms establishing local subsidiaries before 1990s were allowed to have only a minority ownership in joint ventures with state owned enterprises. Currently, all foreign subsidiary firms are required to pay host employees the minimum wages established by the government in many countries including China, India, Indonesia, Brazil, Mexico and Hungary.

In some cases, the host government or firms may default on their business contract or credit obligation. The host government may also refuse to renew export-import licenses, or other forms of licenses necessary to operate in the country. The unilateral noncompliance to fulfill contracts by some newly established regimes was based on the contention that the contracts made with the previous governments were not binding with the new governments after the revolution.

Expropriation

Another category of political risk is the possibility of the seizure or control of foreign assets by the host government. In case of an expropriation, the host government is required by international law to make adequate and prompt compensation in convertible currencies. Confiscation is a form of seizure without a fair compensation. Some notable examples of expropriations are Libya’s expropriation of Occidental Petroleum’s oil fields in 1969, Peru’s takeover of Exxon refineries in 1968, and the gradual takeover of Aramco by Saudi Arabia between 1972 and 1980. Nationalization refers to the transfer of a whole industry from private to state ownership. Examples are the nationalization of some French industries and private banks by the French government in 1981, the Iranian government’s nationalization of private businesses after the ouster of the Shah in 1979, and the nationalization of the U.S. owned refineries by the Venezuelan government in the 1990s. Natural resource extractive industries, financial institutions and public utilities were the frequent targets of expropriations in the past, but manufacturing firms have become vulnerable in recent years.

Risk Forecasting

In assessing a particular country’s political risk, the investigator should determine the country’s present discriminatory measures toward foreign businesses, and the likelihood of the country’s imposition of restrictive measures in the future. The key factors should include:

- the country’s policies toward foreign investment,
- the country’s present economic conditions and its future potential.

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ii) There are many examples of expropriations, including the expropriation of U.S. oil properties by Mexico in 1917, Bolivia’s expropriation of U.S. properties in the 1960s and 70s, and Venezuela’s expropriation of U.S. oil industries in the 1960s and 90s.

iii) According to the study investigating the patterns of takeovers of foreign properties between 1960 and 2010 indicated that practically all expropriations occurred in developing countries, with Latin American countries accounting for about half, and the rest in Africa and the Middle East.
the country’s political stability and the system of government, and, the relation of the foreign business in question to the country’s economic goals and potential conflicts.

The forecasting of risk is complex and often subjective. The prospective investors should spend some time in the host country. With “Grand Tours”, people from the investing firm visit the host country. The visitors then make a comprehensive report based on their impression of the host country’s investment climate. In the Delphi Technique, experts who have extensive experience in or knowledge of the country in question are surveyed. By analyzing the opinions of these experts, some characteristics of the political and economic conditions of the country should emerge. Some statistical method may be utilized to forecast likelihood of events such as currency devaluation, long-term price stability, unemployment and change in the government policies.

**Delphi Technique**

This method of forecasting involves a systematic survey of expert opinions in a particular area of international business activities. Since experts’ opinions can be highly subjective, the crucial aspect of this method is the total number and the level of expertise of respondents.\(^{iv}\) The experts can be drawn from multinational corporations with extensive experience in a particular area of business, academic institutions, governmental agencies, and others with knowledge and experience related to international business.

Typically, a list of variables which are likely to influence political risk is compiled. This list is given to each member of a group of experts, who rank these variables and form a composite index of political risk based on the weighted variables. The respondents can, for example, choose a number from one to five to answer each question, or rank answers according to some other criteria. The completed returns are tabulated and countries are ranked with respect to political risk on the basis of the composite index. Some of the critical factors in this method are the selection of variables, and the proper weighing of the variables. It is fundamentally a qualitative method of forecasting, since it depends largely upon the opinions of people, not on quantitative numbers. Moreover, the definition of political risk can be subjective. It is therefore crucial that experts present their opinions based on objective facts and data.

A number of research organizations, international banks and trading firms specialize in conducting these surveys, including the Business Environment Risk Index published by BERI, Country Risk Assessment Service by Business International, and major international banks.\(^{v}\)

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\(^{v}\) “The Country Risk Ranking” is issued frequently by *Euromoney*. 
Probability Analysis

In another risk analysis approach, the probability of various events occurring can be estimated. Suppose a British firm is considering a direct investment project in a meat processing business in Nigeria. The existing government and its policies regarding foreign investment in the country are regarded as favorable. However, the government may abruptly alter the policies or a new government may be established. After careful investigation of investment conditions, a decision tree such as shown below may be constructed.

Figure 2 Decision Tree

Quantitative Approaches

Some quantitative methods can be utilized in forecasting of political risk. In constructing statistical models, however, factors in the social and cultural environment must be quantified. It is often difficult or questionable to quantify factors such as attitudes, traditional values, feelings and satisfaction in different cultural and social environments. While an executive from England may find certain management practices in Thailand strange, the native Thai workers may feel perfectly comfortable. Another potential problem in utilizing quantitative methods is that such methods are generally based on macro data. In collecting data from foreign countries, macro
data are often readily available. If a statistical model is based on macro analytical data, even if such data are accurate, the model may not be necessarily useful to a particular firm. The prospective foreign investor may need micro data regarding costs, competition, future market potential, labor practices and other elements in day-to-day operations of business activities. Even if a forecasting method based on a statistical model indicates that a particular country in Latin America is not desirable for direct investment, the conditions for some other businesses may be highly favorable.

One method of political risk forecasting is the political system stability index, vi) in which the elements of the political system stability are grouped into three major categories, namely,

1. Socioeconomic characteristics index-GNP growth per capita, energy consumption per capita, etc.
2. Social conflict index-public unrest, internal violence, coercion potential such as security police per unit population.
3. Governmental processes index-legislative effectiveness, legal changes, etc.

These three sub-indexes are obtained from 15 elements, which can be measured on a quantitative basis without depending on subjective bias. In this approach, the elements of political stability are objectively measured with minimum influence of individual opinions.

Another quantitative method is the ecological approach. It is rather an old theory, but it is an interesting approach to the analysis of political instability. In this method, a level of national frustration is measured. It is obtained by aspirations minus welfare-expectations. The elements (variables) of national aspirations are degree of urbanization, literacy rate, number of newspapers and radios, degree of labor unionization, and natural resource endowment. Welfare variables are infant survival rate, calorie intake per capita, number of physicians and hospital beds per population size, percent of housing with running water, and GNP per capita. National expectation variables are per capita GNP growth rate and the rate of investment as a percent of GNP. According to this model, if aspirations are great, but welfare and expectations are low, the level of national frustration will be high. If welfare and expectations are low but aspirations are also relatively low, the resulting level of frustration will be low.

Other Approaches

Some multinational firms perform political risk analysis by monitoring foreign activities through their own foreign operations. Exxon analyzes the political environment of countries in which it has operations in terms of influence groups, labor unions, the military, and any significant political activities such as elections, changes in political leaderships and legislative actions. Many European and Japanese multinational firms have comprehensive analytical network around the world. Some firms utilize computer models for forecasting political risk. In one such model called

primary risk investment screening matrix (PRISM)\textsuperscript{vii}, responses are collected from overseas business executives and U.S. government officials to determine indexes of economic and political stability. Euromoney publishes annual list of countries according to political risk based on bond market assessment. In this approach, the rating of political risk is based on the comparative performance of the bond and money market of countries studied.\textsuperscript{viii}

According to the study between 2005-2010, the top ten countries with the least political risk, in alphabetical order, are Australia, Canada, Denmark, Finland, Germany, Japan, Netherlands, Norway, Sweden, and Switzerland.\textsuperscript{ix}

Investment Risk Strategy

There are some fundamental strategies to reduce vulnerability to conflicts in production, labor relations, finance, management styles and other aspects of foreign business operations. Some multinational companies keep a low profile and pro-host-country policies. It is often advisable that the company participate actively in programs designed to improve local living conditions, health and education, infrastructures and overall economic environment. A foreign firm should understand the host country’s requirements and priorities, and maintain flexible management policies to adjust to the changing needs of the local community as much as possible.

In order to reduce conflicts with the host governments and the public, foreign firms can continuously monitor the changing host environment. In some countries, majority ownership of equity by local nationals or governments is the initial requirement for entry, while in others a gradual transfer (phased transfer) of equity and managerial control to the local nationals is required.\textsuperscript{x} A carefully negotiated agreement with the local government can address the needs of the host society. The local priorities include transfer of capital to the local economy, and the development of local infrastructure, management skills, technology, employment and export industries.

Investment Risk Insurance

Most industrialized countries have some type of political risk insurance organizations, usually government agencies. The government insurance agencies work closely with export-import banks and other official trade organizations. In many industrialized countries, export-import banks offer government backed insurance for international business activities involving developing countries. Such insurance covers losses due to war, revolution, cancellation of import or export licenses and currency losses. Many governments have insurance programs to protect

\textsuperscript{vii) Originally developed by the American Can Company.}
\textsuperscript{viii) Yields and conditions in these markets are weighted 50% for access to the market, 25% for the spread and maturity terms obtained, and 25% for the sales success of the offering. Euromoney, 1997.}
\textsuperscript{ix) The highest risk countries were such countries as Afganistain, Ethiopia, Nigeria, Pakistan, Tanzania, Sudan, Zambia.}
\textsuperscript{x) The phased transfer period was 15 years for Andean nations in 1995.}
private foreign investments. For example, investors of France, Japan, Germany and Canada are protected by government insurance agencies against expropriation, war, and currency inconvertibility with coverage of up to 90 to 95 percent of their investment.\(^{10}\)

In most of these political insurance programs, the home government extends insurance for new projects including modernization or expansion of an existing investment projects. Only citizens of the country offering the insurance programs are eligible to receive the protection. Generally, foreign direct investors can buy partial coverage of insurance, such as currency inconvertibility, war risk and strikes. The cost of insurance depends on the risks covered, form of investment and type of activity. Rates are higher for risky projects and projects in politically risky areas.

**Forms of Association**

Carefully planned transfer of ownership and control of the foreign investment to local investors and government can be an effective method to reduce political risk. Such transfers can be negotiated at the beginning with the host government, or offered as a defensive measure to reduce local hostility against the foreign investment. In most countries, key industries such as telecommunications, heavy industries, transportation and energy are government owned or controlled. Entry into these industries on a wholly owned basis are impossible or extremely difficult because of strong government regulations in many countries.

A joint venture is often the most feasible method of entry permitted in many countries. This method can reduce political risk, increase the market and the contact with the local community, expand the capital and financial base, open access to public and private sectors and improve the investor’s public image. Joint ventures can also increase opportunities to enter Eastern European centrally planned economies, which would otherwise be impossible to enter. Obviously this form of association with foreign partners would create a number of problems as well, including reduced profits, more governmental interference, lack of control, loss of technology and lack of local management and skilled personnel.

Licensing is another method of reducing risk, both politically and financially, while allowing the host country to participate in essential technical and managerial activities. It can also protect technology and intangible properties from foreign competitors. Licensing can give the investing firm opportunities to expand revenue and profit from foreign markets without committing a large amount of capital to foreign operations. Licensing, however, can bring significantly less profit than direct investment, and create future competitors. For example, many textile and light industries in the Far East and Southeast Asian countries were originally joint venture and foreign direct investment projects of Japanese firms. In the 1980s, developing countries such as South Korea and Taiwan became strong competitors against the Japanese in shipbuilding, steel, and consumer electronics.

Franchising is another form of licensing by which a firm can expand abroad with minimum expenditure and risk. In this form of licensing, the licensor sells the licensees the right to use...
Some foreign companies have avoided overly aggressive policies in sales, promotion, advertising, and trademarks, brand names, management styles, recipes and other industrial properties for a fee. Soft drinks, fast food chains and hotel chains are all examples of franchising. In management contract agreements, local firms generally control the entire production and physical assets, while the foreign investors maintain the control of the management know-how. It is another form of licensing generally involving intangible assets such as technology and designs. For example, a civil engineering firm in Brazil can have a management contract agreement with a U.S. engineering firm. In this case, the U.S. firm has a minimum investment, but has some control over the technological and managerial aspect of the Brazilian firm. Management contract agreements can be established in accounting, technological designs, methods of manufacturing, etc. It involves little financial investment, but the profit base may also be much smaller than the direct investment option. Contract manufacturing is a method by which local firms produce some parts or components of the final product according to the manufacturer’s specifications. For example, a German machinery firm can make a contract manufacturing agreement with a number of local firms in Mexico to produce various components, while the German firm brings in the critical components. Using this method, the Mexican firms can participate in the production of the product, while the German firm can protect the critical technology.

Operational Strategy

In any foreign direct investment project, political risk can be substantially reduced by being flexible and adaptive to the host country’s requirements and priorities. An important step toward an adaptive strategy is the flexibility in the affiliate’s management policy. Centralized control by the parent organization in all aspects of management decision making may not offer sufficient local incentives, flexibility of local management styles, prompt reaction to unique local characteristics, or efficient handling of local problems. A rigid and centralized decision making system (ethnocentric management) may encounter resistance by locals in many countries. Total control by the head office may create an impression of exploitation, since decision making control is generally accompanied by financial control. On the other hand, a total decentralization of decision making (polycentric management) in all aspects of management by local subsidiaries may not be an efficient system of international management, unless the headquarters and local subsidiaries have had extensive experience and maintain harmonious management relationships. Complete decentralization can lead to sub-optimization due to the lack of consensus among the subsidiary managers and control by the corporate headquarters. It can also lead to the isolation of subsidiaries from each other, unnecessary competition, and lack of flow of information among subsidiaries.

An adaptive strategy that allows local managers to maintain close relationships with the host government and population, while keeping harmonious relationships with the head corporate management, may be the most effective and risk reducing approach. Risk strategy in forms of association, production, finance, labor and personnel should be developed with the same flexibility.\footnote{xiii}{Some foreign companies have avoided overly aggressive policies in sales, promotion, advertising, and...}
Production

Increasing the share of locally produced parts and local raw materials, generally known as local content, is an effective method to reduce political risk. Local content laws are in effect in most countries, particularly in developing countries, and the degree of local integration required by law varies. In a forced manufacturing agreement, the host government requires the foreign manufacturer to produce a certain minimum content of the final product locally. In a phased manufacturing agreement, the percentage of locally produced components must be increased by steps within a specified time period. Some host governments require that foreign firms submit essential technical know-how or patents to the host partners or the government. For example, the Indian government tried but failed to force the Coca Cola Company to transfer the patented manufacturing processes of the soft drinks to the host government in order to operate in India. For high technology industries or firms with rapidly changing product specifications such as electronics, computers, scientific and medical instruments, the required transfer of technology to local governments and firms may not be necessarily risky since the transferred know-how may be quickly outdated. However, many successful foreign companies have protected key technologies while transferring non-essential technologies and know-how to local governments and partners.

Financial Arrangement

Financing foreign operations with heavy local debt and capital is an effective method for reducing financial risk even though it may be difficult due to the shortage of local capital. A large financial commitment by a host government and individuals is often desirable, especially when the business involves heavy investment in physical assets. Alternatively, multinational firms can phase out their foreign investments by selling off their assets to local investors or the host government in stages over a period of time in a system of “planned divestment”. A majority participation by host country nationals has become a standard requirement in many developing countries in recent years, including Brazil, Mexico, India and China. Other methods to reduce financial risk include swaps, hedging, intra- and inter-company capital transfer, which are discussed in Chapter 17, International Financial Management. Overdependence on local financing sources may be risky, since such local financing can be strongly influenced or controlled by the host government policies. Local finance is considered a vital element of the host governments’ political leverage in many countries, and financing arrangements can easily be interfered with.

corporate exposure so that they do not give the impression that the foreign company “dominates” the local market or community. Many Japanese, U.S., and European firms have changed their company and product names in foreign countries.
Labor and Personnel

Use of local nationals in foreign subsidiaries may not only be an effective measure to reduce political risk, but may also be necessary to improve efficiency. The local nationals are well acquainted with the culture, habits, markets, regulations and many other important elements of business activities. They can communicate much more effectively with the local government and institutions than foreign nationals can. They may contribute to the long term stability of the firm, public image and strengthening of company loyalty. On the other hand, the use of local managerial personnel can reduce control by corporate headquarters, and increase the possibility of technology leaks. If the subsidiary’s executives are all foreign personnel and the lower ranking personnel and workers are locals, the situation can create some degree of anti-foreign sentiment. By placing locals in the executive positions, such antiforeign resentment can be reduced and loyalty by the lower ranking workers may be increased. When local personnel with needed skills are not found, third country nationals can be sent to the foreign subsidiaries to reduce conflicts. Using a third country national may be particularly useful in some politically and culturally sensitive areas. For example, a U.S. subsidiary in Lebanon may be headed by a Swedish or Japanese national rather than a person of Jewish, or Arabic origin.

Conclusion

When a conflict between a foreign investor and its partner in a host country becomes apparent, the two sides must make every effort to come to a mutually agreeable solution. In case of a conflict between investors in a joint venture, two sides should solve the conflict before it becomes a full-scale court battle. All parties involved in a dispute may decide to concede to each other’s demands. If rational negotiations fail to produce positive steps toward a solution, the next alternative courses of action should be considered. These are:

a. third party involvement: mediation, arbitration, and litigation,

b. Soliciting support for joint action from other countries.

Mediation is a system of solving conflicts by which a third party, preferably people with no vested interest in the outcome of the solution, is asked to render their opinion after listening to arguments from both sides of the issue. Without binding power or enforceability, the mediator’s findings may have little power unless both sides agree to accept their opinion and suggestions.

A solution of international commercial dispute can be sought through arbitration when there is an arbitration clause included in the contract. Without such contractual agreement, the parties can still seek commercial arbitration if they so wish. Arbitration has more enforceability than simple mediation because of its binding contractual nature. In arbitration, an impartial third party acts as an arbitrator to evaluate the nature of disputes, and make recommendation

to solve the disputes. The arbitrator’s decision is legally binding on both parties and backed by the courts having jurisdiction over where the disputes took place. Generally, an arbitration clause is entered in most foreign investment agreements. Mediation and arbitration have been utilized on numerous occasions by many multinational firms.

Commercial arbitration is less time-consuming and less costly than litigation. By utilizing international organizations, commercial arbitration can be carried out in an atmosphere of multinational cooperation. The use of commercial arbitration is facilitated by most international commercial and trade organizations including the World Bank, IMF, WTO, the International Chamber of Commerce, and many trade organizations.\textsuperscript{xiv} In spite of some legally binding power, successful solution through arbitration is not likely if one of the parties decides not to concede at all costs.\textsuperscript{xv} A solution to the investment conflict may be sought through the courts of the host country.\textsuperscript{xvi} If the foreign investor decides to accept the verdict of the host country’s court, such legal proceedings will be relatively fast and efficient in terms of time and cost. If the litigation must be sought in the court of the foreign investor’s parent country, the conflict takes on a different meaning.

If the conflict worsens, a government may take more serious steps including economic sanctions or embargoes. At this point, a particular country may cease to have all economic and political relationships with another. This level of hostility is highly unlikely, unless the conflict is of an extremely grave nature. Most embargos and sanctions have not been too effective because of lack of international cooperation. If every trading and investing nation stops all economic activities with a particular country, the impact can be substantial. However, due to complex interdependence and needs, unanimous actions by all trading countries against one country is practically impossible.

\textbf{References}


\textsuperscript{xiv} The International Centre for Settlement of Investment Disputes, established in 1966 as an affiliate organization of the World Bank, is the most comprehensive international arbitration organization. With approximately 80 members, the Centre has adopted the Convention of Settlement of Investment Disputes.


\textsuperscript{xvi} Many multinational firms have utilized litigation in patent violations, investment disputes, and contractual disagreements. For example, Japanese VCR makers, including SONY and Matsushita, successfully appealed to the French court to remove time-consuming inspection requirements on Japanese VCRs in the early-1980s.


