

Coercive Assets? Foreign Direct Investments and the Use of Economic Sanctions

Dong-Hun Kim
Korea University

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The East Asia Institute
909 Sampoong B/D, 310-68 Euljiro 4-ga
Jung-gu, Seoul 100-786
Republic of Korea
Tel 82 2 2277 1683
Fax 82 2 2277 1684



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I. Introduction

Since the 1980s China has steadily increased its foreign direct investments (FDIs) in African nations for various reasons. Not only has China overtaken the World Bank in lending to Africa, but also Chinese firms have heavily invested in various sectors and nearly 800 Chinese companies now operate in that continent (Foerstel 2009). For instance, in 1998, China began a 957-mile-long oil pipeline project in Sudan, the largest foreign project in China's history. It sent 7,000 workers to Sudan, along with multi-billion investments in infrastructure projects for other natural resources such as gold mines (Lee 2007). Africa's business opportunities and natural resources, however, prompted other countries to work to catch up. As EU spokesperson Amadeu Altafaj Tardui once said, "Most African countries are smart enough to diversify portfolios. We don't fear a Chinese monopoly." The competition indeed heated up as foreign investments from European Union countries and the United States started to increase (Foerstel 2009). In the meantime, the Western countries were concerned with human rights abuses in Africa, especially in Sudan, where more than 200,000 people have died in Darfur since 2003, and attempted to impose economic sanctions to demand that the Sudanese government halt the genocide. China, however, has been reluctant to leverage its investments to correct the Sudanese government and has repeatedly blocked the United Nation's efforts to impose sanctions against Sudan. The reason why China would not join sanction efforts seems obvious: its foreign investment in oil. Yet the puzzle remains. Do foreign investments deter the use of sanctions in general? Do all types of foreign investment have similar consequences? This paper examines the relationship between foreign direct investment and the use of economic sanctions.



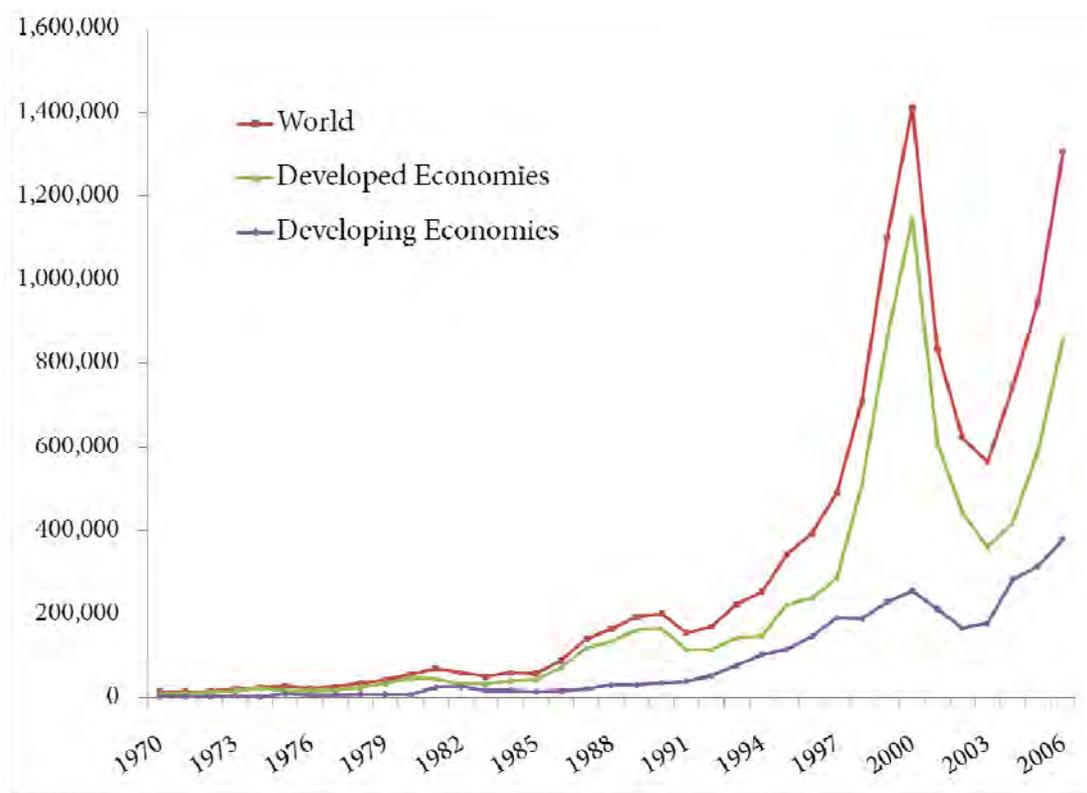
The use of economic policy instruments to coerce other states has been a prominent tool of statecraft for thousands of years. It is well known that this method goes as far back as 432 B.C., when Athens used it against the state of Megara (Tsebelis 1990). Since the 1990s, however, the popularity of economic statecraft, defined as the use of economic policy instruments to achieve the goals of nation-states (Baldwin 1985), has been increasing. The threat of economic sanctions as well as the actual use of them has increased more than 20 percent over previous decades (Drezner 2003). It is no coincidence that the heightened attractiveness of economic coercion as a policy tool has grown along with increased economic ties in the era of globalization. It is the economic relationship that creates the direct economic leverage and makes economic coercion possible. Furthermore, it is possible that increased economic ties will create more means and greater opportunities for sanctions (Cox and Drury 2006; Hafner-Burton and Montgomery 2008). At the same time, increased economic ties limit a state's willingness to engage in military conflict and force foreign policymakers to resort to less costly actions such as economic statecraft if friction occurs (Drury 2001). Consequently, sanctions have never been as popular among foreign policymakers as they are today (Kirshner 2002).

The popularity of sanction, not surprisingly, has brought increased scholarly attention to it, and the sanction debate, the question of whether or not sanction works, has become one of the heated controversies in the literature (For example, Pape 1997; Elliott 1998; Drezner 1999; Hovi, Huseby, and Sprinz 2005; Hufbauer et al. 2007). Following recent attempts to increase our understanding of various aspects of economic sanctions (for example, Dorussen and Mo 2001; Lektzian and Souva 2003; Lektzian and Sprecher 2007; Hafner-Burton and Montgomery 2008; Bapat and Morgan 2009; Peksen and Drury 2010; McLean and Whang 2010), this paper pays attention to an aspect of economic statecraft that was neglected in previous literatures. In particular, there are few, if any, studies on the impact of the new forms of economic interdependence such as various types of foreign direct investments on economic statecraft. This is critical, since we are experiencing rapid changes in the global economy. States are increasingly tied to each other through different forms of exchange relations as evident by the explosive growth in foreign direct investments and international capital markets. As Figure 1 displays, the size of FDI grew exponentially over the last three decades, and the volume of international production by FDI exceeded that by trade in the mid-1980s. In addition, the forms of foreign investment have been rapidly changing. Cross-border mergers and acquisitions (M&As) and cross-border corporate alliances have become prominent components of foreign investment during the past few decades (Conybeare and Kim 2010). It is not an exaggeration to say that the main characteristics of the global economy have been fundamentally changed



(Strange 1996; UNCTAD 2000). Unfortunately, however, there exists little research examining the impacts and implications of these changes for foreign policy (Schneider, Barbieri, and Gleditsch 2003). What are the implications of various foreign investments on economic statecraft? Do these changes make sanctions more likely? This paper addresses this important gap in the literature by examining the impact of specific types of foreign investment, in particular, cross-border M&As and cross-border corporate alliances on the use of economic sanctions.

Figure: Inward FDI flows, 1970-2006 (millions of US dollars)



Source: UNCTAD (2009)



II. Varieties of Foreign Direct Investments

During the past two decades, the globalization of production through foreign direct investment (FDI) has grown to characterize international economic ties. Global FDI inflows reached a historic high of \$1,979 billion in 2007 after achieving more than a 30 percent growth rate annually from 1986 (UNCTAD 2009). A notable feature is the fact that not only developed countries but also other major groups of economies such as developing countries, transition economies, and least developing countries saw continued growth in FDI. Additionally, in terms of geography, almost no region, including Africa, has been left out of this trend (UNCTAD 2009). Without a doubt, these trends have changed how countries are linked in economic terms. The importance of FDI can be better recognized if one examines the indicators of international production. In 2007, the number of multinational corporations (MNCs) reached 79,000, and these control some 790,000 foreign affiliates around the world, whose activities account for about 11 percent of the global GDP, employing more than 80 million people (UNCTAD 2009).

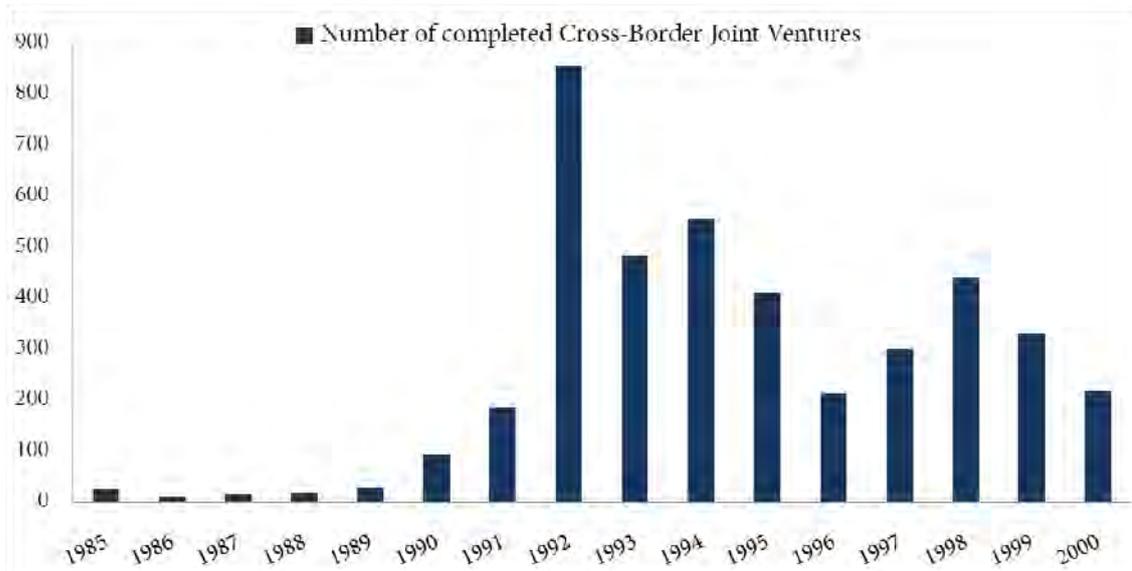
In addition, foreign affiliates of MNCs account for about a third of the total world export of goods and services (UNCTAD 2009). While the earlier theoretical works such as Mundell (1957) suggested that trade (product movement) and foreign direct investment (factor movement) are substitutes rather than complements, recent empirical and theoretical investigations indeed support the opposite—a complementary relationship between FDI and trade (Helpman 1984; Blonigen 2001). For example, according to Bernard, Jensen, and Schott (2007), 90 percent of U.S. trade flows via U.S. multinational corporations, with about 50 percent between affiliates of the same multinational corporations. Not only does FDI establish a larger distribution base and stimulate sales in a foreign market, but also the FDI creates local production that requires inputs to be imported and also exports intermediate goods to the home and other regions. Note that this complementarity between FDI and trade is mainly the result of the growing fragmentation of production, that is, the division of the production process into two or more steps that can be undertaken in different locations, and the trade-boosting effects of FDI do not just occur in the bilateral relationship.¹ Indeed, as Brooks (2005) has argued, it no longer makes sense to focus on the security implications of trade. The activities of multinational corporations, FDI and the globalization of production, are now the key integrating forces in the international economic transaction.² It is an international production via FDI that characterizes the economic interdependence among states rather than mere exports and imports.

FDI, however, does not entail a singular form. Firms do not invest abroad only by a few means. They have to make strategic decisions when they start foreign operations. Firms can



acquire an existing company or set up a new venture and also must decide the level of control of their foreign affiliates. An FDI could entail a form of joint venture /corporate alliance by forming partnerships with local firms or be greenfield investments or cross-border M&As with full ownership.³ Corporate alliances or joint ventures (JVs) occur when two or more firms pool a portion of their assets in a common and separate legal organization (Conybeare and Kim 2010). There are two general reasons why JVs are often preferred as the entry mode. First, JVs offer benefits especially such as allowing FDI to limit the initial risk and gain the flexibility that later enables them to terminate the investment depending on the performance with lower costs than other entry modes (for example, M&As).⁴ Second, JVs create mutual hostage positions between FDI and the host. Through the joint commitment of financial or physical assets, JVs can provide the incentive for the host to care more (Reuer 2004). Not surprisingly, the number of JVs has dramatically increased in the past two decades. Since 1990, on average, more than 6,400 JVs were announced annually worldwide and more than 4,500 deals were completed annually (Conybeare and Kim 2010). The share of cross-border JVs also increased altogether. About 58 percent of all completed JVs are cross-border JVs that include more than one firm from another country (Conybeare and Kim 2010). For example, as Figure 2 displays, the number of completed cross-border JVs by U.S. firms increased dramatically after the 1990s.

Figure 2: Number of completed Cross-Border Joint Ventures, the United States, 1985-2000.

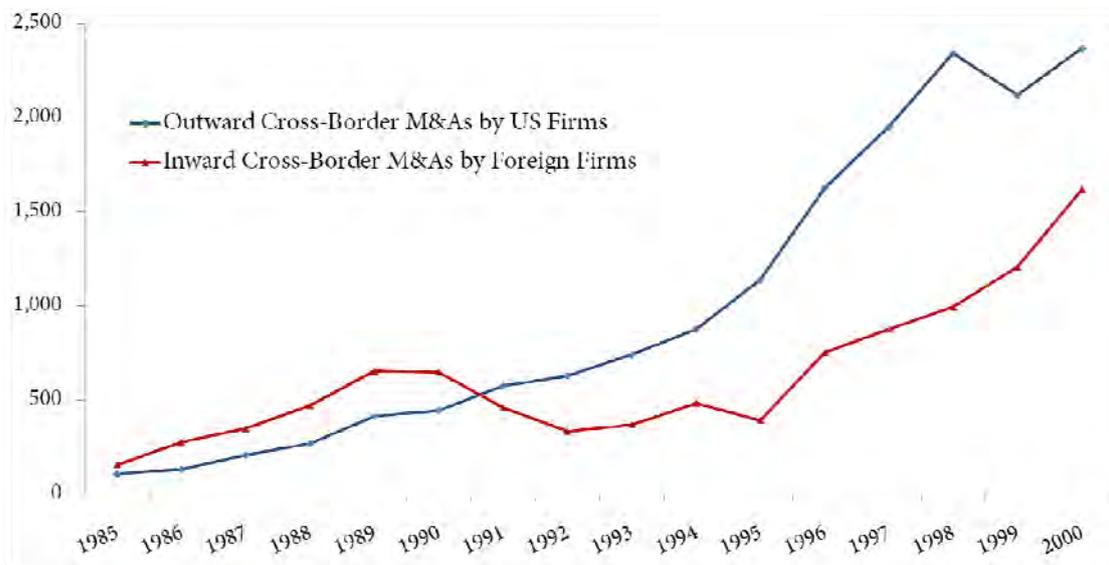


Source: Thomson One Financial (2010)



With the rise of JVs, cross-border M&As as a way to enter the foreign market also significantly increased. In fact, cross-border M&As have become a dominant feature of FDI worldwide. The ratio of the value of cross-border M&As to world FDI flows reached 80 percent in 2007, and even in developing countries the ratio reached 40 percent of total FDI (UNCTAD 2009). In terms of number of deals, in 2007, more than 45,000 deals have been announced throughout the world, compared with fewer than 10,000 deals in 1980, after attaining 40 percent growth annually on average (Kim 2010). Several advantages of M&As have been offered in explaining the rise of cross-border M&As. FDI through M&As is obviously a much faster way to enter foreign markets. It gives the acquiring company ready access to market share by taking over an existing local firm, for example, with an established local network. Also the assets of a local firm such as locally recognized brand names, possession of local permits and licenses, and technological know-how can be extremely valuable (UNCTAD 2000). Moreover, having full control of the operation could avoid a possible conflict over shared assets that could result from a joint venture.

Figure 3: Number of Completed Cross-Border M&A, the United States, 1985-2000



Source: Thomson One Financial (2010)



III. Foreign Direct Investments and Economic Coercion

As already noted, FDI enters the foreign markets in various ways. In particular, MNCs need to decide whether to enter a foreign market by full investment (for example, M&As) or shared investment (JVs). These modes vary significantly in terms of resource commitment, level of control, and risk for both MNCs and the host country. Do all types of FDI have a similar effect on economic sanction? To address the question, I begin by focusing on the fundamental nature of the relationship between FDI and the host country.

While many aspects of FDI have been discussed, the most important nature of FDI is what Vernon (1971) called the "obsolescing bargaining" situation where FDI is mobile *ex ante*, but relatively immobile *ex post*. Once FDI enters the foreign market, it is exposed to various risks, including expropriation by the host government. In FDI, because it obtains physical assets or significant ownership of a company abroad, it is inevitable that investments become subject to the host's policy discretion and coercive power to enforce the policy (Li 2009). Even if the host made the promise *ex ante*, the relationship or contract between the host and FDI is always incomplete due to a non-simultaneous exchange situation and the lack of tools to correct the opportunistic *ex post* behaviors of the host. This inherent risk, obviously, affects MNCs' entry mode decisions when investing abroad. It is well argued that FDI takes the form of a JV when political, legal, economic, and social risks are high (Deng 2001). As noted by Marjit (1990), MNCs may opt for JVs rather than wholly-owned subsidiaries as insurance against the host government's behavior, including nationalization. Compared with M&As, which entail full ownership of the subsidiaries, JVs form partnerships with local firms that possess local knowledge that helps to reduce various risks (Brouthers and Brouthers 2003), and more importantly, local partners and foreign investors share resources and risks, thus making MNCs less committed while making the domestic actors of the host more committed. In addition, even if the joint ventures fail due to market or governmental policy including expropriation, the disinvestment cost is relatively low compared with other entry modes of FDI such as M&As.

Despite these advantages, FDI through a local partner is exposed to the opportunistic behaviors of the local partner that help mitigate the risks, especially those involving the host government. This is one of the reasons why FDI through cross-border M&As where the parent firm enjoys full ownership is often preferred (Dunning 1981). In particular, when a MNC owns special technological and management knowledge (that is, when asset specificity is high), investing firms are highly exposed to the negative consequences of the partner's behaving opportunistically, including the cost of safeguarding those assets (for example, Puck et al. 2009). In fact, many have argued that MNCs establish wholly foreign-



owned operations in order to deal with the possible danger of their local partner's opportunistic behaviors.⁵ For example, Chen and Hu (2000) report that firms prefer to enter the Chinese market through wholly-owned operations due to the lack of intellectual property rights and their enforcement. Hennart et al. (1999) noted that once Japanese firms learned local knowledge from a partner, they frequently terminated joint ventures, using FDI via JVs as Trojan horses to enter the market. Indeed, the worry of potential loss of specific assets and creating future competitors increases the propensity to enter the foreign market by having wholly-owned operations such as M&As (Contractor and Lorange 1988).⁶ In sum, JVs and M&As as entry modes of FDI offer trade-offs. The former is better at dealing with the behavior of local uncertainty including the host government, and the latter is better at protecting firm-specific assets since it retains full ownership.⁷

Although firms may behave differently depending on the degree of asset specificity and market uncertainty, the preference of the host government can vary. FDI influences the host economy in various ways, including research & development, technological transfers, knowledge spillovers, employment quality and quantity, trade, and market competition. Both physical and knowledge-based assets are extremely valuable, especially for developing and less developed countries, and trigger the competition for FDI (Moran 1998). The entry modes of FDI, however, significantly affect the ways in which MNCs interact with the local economy and determines the degree of benefits that FDI generates (UNCTAD 2000). In terms of physical assets that contribute to economic growth, both JVs and M&As contribute to local capital formation since, in general, both require immediate transfers of funds to acquire the existing local firm or to start a new venture. However, M&As often have to go through a restructuring process to remove unwanted business units or duplicated offices and plants, which entails a loss of employment, while JVs create jobs and have a positive impact on the level of employment (Beckmann and Forbes 2004; Kim 2010).⁸ In terms of productivity spillover, MNCs have a greater incentive to transfer firm-specific assets such as technology, management, and marketing skills to the acquired firms. Technology transfers and interchanges of managers and technicians between MNCs and the acquired local firm are much higher than the partnership between MNCs and the local firm via JVs (Ramachandran 1993). It has been found that the technology transferred into joint ventures was three to four years older than the technology introduced into the local firms that were acquired through M&As (Lee and Mansfield 1996).⁹ The overall impact on the local economy, however, is possibly reversed. It is JVs that contribute more since firm-specific assets obtained through partnerships will be localized and dispersed much more easily through the local partner. MNCs' intangible assets have the nature of a public good and, once available, the host country enjoys the benefits without



having to make its own investments (Horstmann and Markusen 1989). This is one of the reasons why many developing countries, including China, often impose the requirements that foreign investors operate with local partners while MNCs prefer wholly-owned subsidiaries due to piracy problems (Moran et al. 2005). Caves (2007) nicely summarizes the situation by saying, "JVs are shunned by the MNCs that cherish a secret intangible asset while JVs are forced on unwilling multinational corporations." Lastly, the host government and the public often display economic nationalism that creates xenophobic fears when foreign takeovers occur (Graham and Krugman 1995). It is also often the case that countries block or regulate foreign acquisitions of domestic assets based on national security concerns, as exemplified by the recent controversy over Dubai Ports World's attempt to acquire several port terminals in the United States as well as the bid by the Chinese firm the China National Offshore Oil Corporation (CNOOC) to buy the U.S. oil firm UNOCAL. Joint ventures, on the other hand, do not raise the same national security concerns as cross-border M&As. It is often believed by politicians that JVs are synergistic. For instance, the Exon-Florio amendment of the United States excluded joint ventures from government reviews of foreign investment (Graham and Marchik 2006).

How do the entry modes of foreign direct investments matter in the case of economic sanctions? While many theoretical models of sanctions exist, almost all assume strategic interdependence as the fundamental characteristic of the relationship between the sender and the target (for example, Drezner 1999; Hovi, Huseby, and Sprinz 2005; Whang 2010). At the initial stage, the sender threatens to impose economic sanctions unless the target concedes to the demands by the sender. If the target resists, the sender decides either to back down or implement its threat. If the target complies, sanctions are not imposed. The insight is that the target will yield only if the threat of sanction is credible and sufficiently severe. Otherwise, the target will resist because it knows that the sender's threat is a bluff and the sender will back down rather than imposing the sanction. There are primarily two factors that matter in this interaction. First, as Baldwin (1985) and Fearon (1997) noted, the essence of this interaction is the problem of credibility. In order for the sender to compel the target to do what it wants, the threat must be credible enough so the target will comply. Second, for the target, the severity of the sanction must be greater than carrying out the demand, and for the sender, the cost of the sanction must be less than the cost of inaction; otherwise the threat will not be credible to the target.¹⁰ Sanctions, by definition, exploit the economic relationship, and foreign direct investment should affect the credibility and severity of the sanctions.¹¹

The effects of FDI, however, differ depending on how FDI enters the host (or the target). First, if the sender is tied to the target through M&As, the cost for the sender will be



much greater when a sanction is imposed. As noted above, MNCs with wholly-owned subsidiaries are more committed than JVs not only in terms of various resources but also due to the low degree of exit mobility. Consequently, the disinvestment cost of the wholly-owned subsidiary is much greater than a JV's if a sanction occurs. In addition, the possible disruption of exchange between the wholly-owned subsidiary and the parent MNCs indirectly affects the parent firm via the stock market more than JVs. For instance, Oxley and Shnietz (1997) reported that firms with high foreign assets experience a significant drop in their stock returns, as much as a 2.5 percent loss, when barriers to foreign activities occur. Also, due to the complementarity between FDI and trade, the loss of the wholly-owned subsidiary will force the parent firm to change the trade structure (for example, pattern of exports and imports) and the international production chain, which may entail temporary unemployment and lower output (CBO 1999).¹² More important, the high asset specificity of wholly-owned operations matters. Kaempfer and Lowenberg (1988) claimed that sanctions are imposed in order to respond to internal political pressures by the interest group. Also, as Morgan and Bapat (2003) pointed out, it is the sender's firm that pays the highest cost since essentially the sender government accomplishes the goal through prohibiting economic exchange between its firms and the target. Thus, without forcing or persuading its MNCs, the sanction will not be successful, and often, the sender's firms violate sanction laws outright or circumvent the policy to keep the ties with the target. It is well known that firms whose assets are more specific and less mobile are more likely to lobby the government (Alt et al. 1999; Iversen and Soskice 2001), and following this line of logic, the parent firm with the wholly-owned operations that entails relatively high asset specificity will be more likely to resist the sanction attempts by the government. The Myanmar case illustrates the argument. When the United States imposed sanctions for the human rights violations by the Myanmar government, Pepsi pulled out while Unocal continued its business (Morgan and Bapat 2003). Not surprisingly, Pepsi's operation in Myanmar was a bottling plant that was a joint venture between Pepsi and a local company while Unocal, with other foreign firms, had the wholly-owned operation that was in charge of developing oil pipelines (La Mure 1998). Taken together, the economic ties created by M&As that create foreign wholly-owned operations will constrain the use of sanctions by making sanctions more costly for the sender as well as making the sender's firm more likely to resist, thus making the threat of sanctions less credible.

FDI through local partners (that is, JVs), on the other hand, may influence the use of sanctions in an opposite way. First, the main motivation behind JVs is to reduce various risks by sharing partnership with a local firm. Consequently, a MNC's commitment is relatively low in a JV since the MNC provides fewer resources, including firm-specific assets.



Thus, when sanctions are imposed, disinvestment cost is also low. In addition, due to sanctions' flexibility, it is easier to cope with the sudden disruptions of economic exchange that economic sanctions cause. Second, FDI through JVs makes local partners and possibly the host government shareholders of FDI. The local firm and the target government have the incentive to maintain ties with the sender's firms in order to have access to international markets via the foreign partner as well as intangible assets such as technological and managerial skills.¹³ Thus, unlike wholly-owned foreign operations, sanctions will directly affect the local firms that will create local firms' incentive to pressure the target government to yield. In addition, sanctions will result in job losses that were additionally created by JVs and also stop benefits of productivity spillovers to the local economy, which adversely influence the target. In sum, the economic ties that were created by FDI through partnership enhance the stakes of the local firms and the host government, thus, when sanctions are imposed, the costs to the target (the host) will be much greater than other types of economic ties not created by FDI. It disrupts not only the inflow of physical and intangible benefits but also the trade relationship that the target enjoyed through foreign partners. Most of all, it is less costly for the sender due to the nature of JVs. Taken together, FDI through JVs creates a situation of asymmetrical interdependence where the target becomes more dependent on the sender, making the target more likely to yield to the demands of the sender (Hirshman 1945). This is a situation that Hufbauer et al. (2007) identified as the conditions for an effective sanction, where sanctions result in significant costs for the target while the costs for the sender are modest, making the sanction credible and severe.

To summarize, the economic ties created by FDI are important for economic statecraft, but the substantial impact should depend on the entry modes of FDI as the following hypotheses suggest.

Hypothesis: As the share of FDI through cross-border M&As (wholly-owned operations) increases, sanctions are less likely to occur.

IV. Empirical Analysis

Several considerations confined the selection of observations in the data set to test the hypotheses. Since hypotheses concern the impact of FDI between countries, the sanctions targeted or initiated by international organizations need to be excluded. Second, the send-



er must be active in foreign investments. Third, to avoid the selection bias in the estimations, the non-sanction cases including those cases involving only threats but no imposed sanctions need to be considered. Under these constraints, I make use of observations that the Threat and Imposition of Economic Sanctions (TIES) data set identified.¹⁴ Compared with other available sanction data such as Hufbauer et al. (2007), the TIES data set offers two advantages in testing the hypotheses. First, the TIES data set includes sanction cases related to "low" politics such as conflicts over trade and environmental policy (Bapat and Morgan 2009). Second, TIES data set includes cases in which states threatened and/or imposed economic sanctions on a single target (Morgan et al. 2009). More important, compared with Hufbauer et al. (2007), the TIES data set identified more threat-only cases, which are critical in testing hypotheses related to sanction initiation.

Among the 888 observations identified by TIES, however, two constraints required that several observations be dropped. The data on FDI, in particular data on M&As and JVs, are not available or are incomplete for years before 1985. In addition, the sender needs to be relatively active in foreign investments, otherwise it would be impossible to test the hypotheses. Against these constraints, I chose to examine observations involving the United States, a country that dominates sanctions cases, representing more than 60 percent and, at the same time, being the most active country in FDI in the world (UNCTAD 2009). As a result, the data set consists of U.S. sanction episodes including threat-only cases ranging from 1985 to 2000

The dependent variable *Sanction* is coded one if economic sanctions were used, and zero otherwise. As main explanatory variables, *Cross-Border M&As* is employed to examine the impact of the entry modes of FDI on sanction onset. *Cross-Border M&As* indicates the *ratio* of cross-border M&As, that is $CBMA/(CBMA+JV)$, where *CBMA* represents the number of cross-border M&As by U.S. firms in the target country and *Joint-Venture* presents the annual number of joint ventures between U.S. firms and the target's firms. Note that this measure only captures the number of JVs in the target by the United States and does not include the target's FDI in the United States by joint ventures. The data for both of these are from the SDC Platinum financial transaction database compiled by Thompson One Financial (2010).¹⁵



Table 1: Summary Statistics

Variables	Mean	Std. Dev.	Min	Max
Sanction	.523	.500	0	1
Cross-Border M&As (U.S. in Target, ratio)	.472	.386	0	328
Trade	.112	.133	0	.734
Capacity (log)	2.613	1.620	-.016	10.184
Alliance	.620	.485	0	1
Democracy	4.877	6.613	-10	10
GDP (log)	25.967	2.103	18.765	28.849
CBMA-T (Target in U.S., count)	20.718	46.985	0	280

Following the previous studies, several control variables are also included in the empirical models. First, to capture the effect of trade dependency, the variable *Trade* measures the sum of target exports to and imports from the United States, divided by the target's GDP (gross domestic product). Second, the relative capability between the sender and the target is also considered. *Capability* measures the ratio of the senders' capability index to that of the target. The capability index is from the Correlates of War project's National Material Capabilities data (Singer and Small 1995).¹⁶ Third, the ties by military alliance may affect the use of sanctions, and the *Alliance* variable, which indicates the formal alliance between the United States and the target, is included (Lekzian and Souva 2003). The data are from the Correlates of War project (Gibler 2004), and the variable equals one if tied with a defense pact, entente, or nonaggression agreement, and equals zero otherwise. Fourth, it is possible that the political characteristics of the target may influence the onset of the sanction (Cox and Drury 2006; Hafner-Burton and Montgomery 2008). To control for this concern, the *Democracy* variable, indicating the level of democracy of the target, is included. The variable ranges from -10 to 10, 10 indicating full democracy.¹⁷ Fifth, the *GDP* variable is included to control for the level of wealth and the market size. It is the log of a country's real GDP in 1990 dollars, and the data is from the United Nations' Comtrade Database (UN 2008). Finally, in order to control for the effect



of the target's FDI in the sender, *CBMA-T* is included. This variable is measured as the number of cross-border M&As by the target's firm in the United States.¹⁸ Summary statistics for the variables can be found in Table 1.

Table 2: Cross-Border M&As, Joint Ventures, and Economic Sanction Onset, 1985-2000

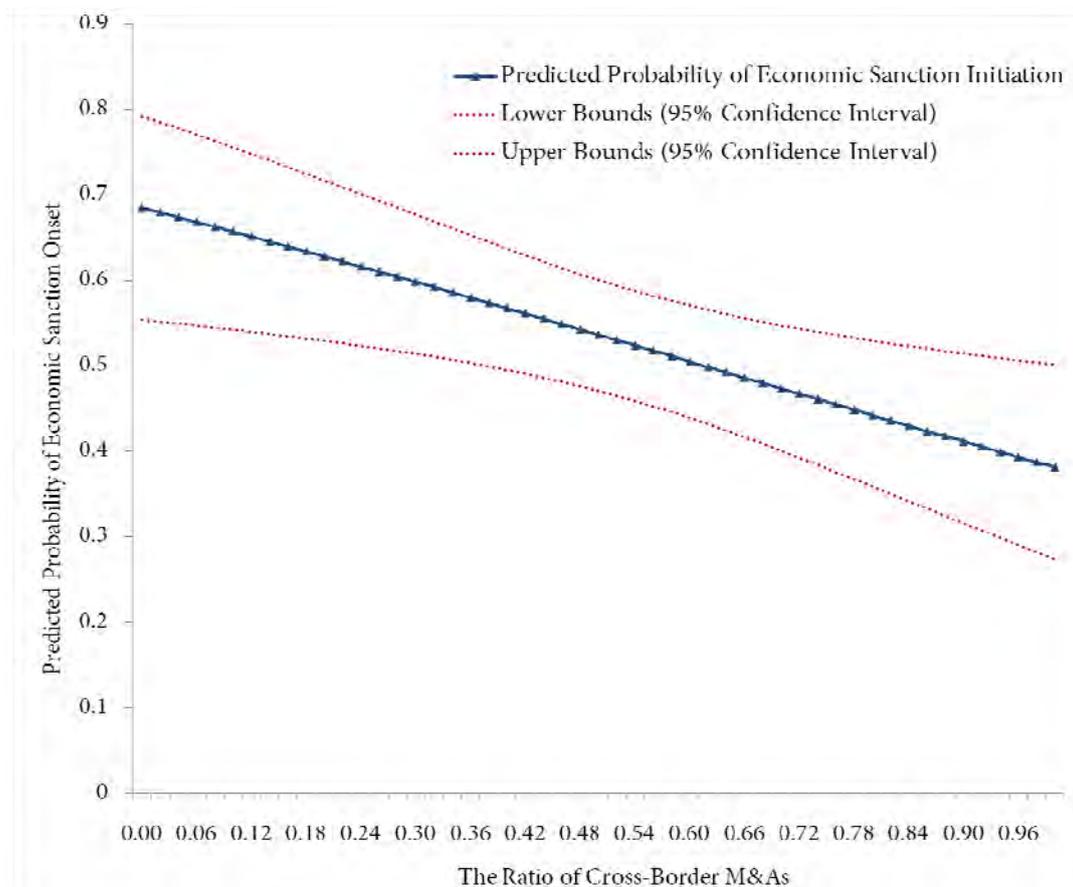
Variables	Economic Sanction Imposed				
	Model 1	Model 2	Model 3	Model 4	Model 5
Cross-Border M&As (U.S. in Target, ratio)	-.600** (.300)	-.792** (.316)	-.753** (.326)	-.962** (.362)	-1.025** (.384)
Trade		.783 (.910)	.352 (.980)	.390 (1.017)	.642 (1.103)
Capability			.125* (.083)	.445** (.231)	.485** (.237)
Alliance			.025 (.263)	-.268 (.363)	-.282 (.364)
Democracy				.001 (.029)	.001 (.029)
GDP				.231 (.192)	.304 (.221)
CBMA-T (Target in U.S., count)					-.068 (.119)
Constant	.375** (.184)	.454** (.211)	.146 (.321)	-6.343 (5.33)	-8.236 (6.048)
N	286	286	286	286	286
R ²	.01	.02	.02	.04	.04

Notes: Logit with robust standard errors in parentheses. All independent variables are lagged one year. ** p<0.05 *p<0.10 (two-tailed).



The results of logistic regression analyses of economic sanction onset are summarized in Table 2. First, the results strongly support the hypothesis as the *Cross-Border M&As* variable has a negative impact on the probability of sanction onset. As expected, the economic ties by cross-border M&As significantly deter the use of sanctions. As the sender invests more in the target country through M&As that entail the wholly-owned subsidiary, the propensity to use sanctions against it decreases. On the other hand, the results imply that the likelihood of sanctions increases as economic ties through joint ventures between the sender and the target increases. FDI through joint ventures seems to be less costly for the sender while more costly for the target, thus making the use of sanctions more likely. Substantively, as Figure 4 displays, if the number of cross-border M&As changes from 0 to 1, the propensity to use economic sanctions decreases about 30 percent. Given that the cross-border M&A became the most popular way for U.S. firms to invest abroad (see Figure 2), its deterring effect is not trivial at all.

Figure 4: Effect of Cross-Border M&As on Economic Sanction Initiation





The effects of several control variables are worth noting. Besides the hypothesized relationships, the *Capability* variable is positive and significant. This is consistent with the findings of previous studies indicating that the stronger the sender relative to the target, the use of sanctions is more likely (Cox and Drury 2006; Lektzian and Sprecher 2007; McLean and Whang 2010). The *Trade* variable, indicating trade dependency of that target, has a positive coefficient across the models but failed to reach statistical significance. As Whang (2010) explains, the insignificance of trade dependency may be due to the possibility that the target can rely on third parties for aid and trade. The positive coefficient again is consistent with previous findings that often trade ties offer little to deter the sender from using sanctions (Cox and Drury 2006). In particular, this would especially be the case if the sender is the United States, because its trade with a target will not add much to the level of overall trade. Note that an FDI relationship has different characteristics than a trade relationship. Trade can be substituted by finding alternative sources for imports and exports, but foreign direct investments are relatively illiquid. In other words, FDI incurs significant sunk costs once appropriated by the target due to an economic sanction. As Frieden (1994) noted, foreign direct investments in raw materials and agriculture are location-specific and even provide the incentive to use military force to protect them.

Overall, these results offer important implications for the literature. First of all, almost all studies on economic sanctions emphasize the fact that economic coercion imposes costs for both the sender and the target due to the disruption of the trade relationship (for example, Hufbauer et al. 2007). The results of Table 2 imply that FDI also contributes to the cost of sanctions independently from the trade relationship. In addition, despite the theoretical plausibility, studies often find inconsistent or insignificant empirical results for the impact of economic interdependence on economic coercion (for example, Cox and Drury 2006; Haftner-Burton and Montgomery 2008; Lektzian and Souva 2007; Whang 2010). It may well be due to the fact that previous studies focus too much on trade without specifying the impact of economic ties created by FDI. Furthermore, the results suggest that, even if FDI is considered, we need to consider the various forms of FDI. During last two decades several scholars did emphasize the importance of FDI in economic statecraft. For instance, Gilpin (1975) and Rodman (1995) convincingly argued that the activities of MNCs and FDI decreased the leverage of the United States in employing economic coercion. Those arguments, however, need to be qualified. It may depend on the form of FDI and, in particular, the entry modes of FDI.



V. Conclusion

During recent debates over trade imbalances between the United States and China, several members of the U.S. Congress argued for the use of economic sanctions to correct China's foreign exchange rate policy (Krugman 2010). However, the use of sanctions against China faced stiff opposition, because it was impossible to make China concede without harming the United States. Since a great share of Chinese goods enter the U.S. market as intermediate inputs, directly affecting the production of U.S. firms, it is estimated that a 10 percent increase in tariffs on Chinese imports would cause a million job losses in the United States (Francois 2010). This is all due to production fragmentation between China and the United States, making the use of sanctions self-defeating and less credible. The sanctions against North Korea also illustrate the point. Since 2004, South Korea economically engaged with North Korea through the Kaesong Industrial Complex (KIC) in North Korea. About 100 South Korean firms invested and operate, for example, textile plants employing North Korean workers. The goods made are basically exported back to South Korea and elsewhere, and it is estimated that the value of exports is about \$1 billion with about 6,000 related firms. Although this trade is not a big part of South Korea's overall trade picture, not surprisingly, the South Korean government exempted economic exchanges associated with KIC when the United Nations imposed sanctions against North Korea for the nuclear test (Noland 2008). As Kang (2010) mentioned, it seems that investments by South Korean firms made the South Korean government reluctant to employ economic sanctions while the initial intention of the investments was to make North Korea vulnerable. These examples clearly illustrate that globalization of production affects the use of economic statecraft. We have examined here the impact of FDI, which is the main vehicle of globalization of production, on the use of economic sanctions.

How do foreign direct investments affect the use of economic coercion? Extant research on economic sanctions suggests that the relative costs of the sender and the target matter greatly. Not surprisingly, many observers have noted that foreign direct investments need to be considered when examining the effects of sanctions (CBO 1999; Hufbauer et al. 2007). This article argues that while FDI matters, the effect depends on the form of, and especially the entry mode of, FDI. As almost every business trade association opposes the use of economic sanctions (Rodman 1995), corporations are often not persuaded regarding the use of economic relationships in achieving foreign policy goals (Morgan and Bapat 2003). Without a doubt, as corporate activities abroad increase, the use of economic coercion will face a greater opposition from those corporations. However, the economic interdependence created by FDI does not have a monotonic effect on economic statecraft. The relative costs



incurred by economic disruption differ depending on the form of foreign investment. In particular, FDI that creates wholly-owned subsidiaries (for example, cross-border M&As) imposes greater costs to the sender's firms than cross-border joint ventures with a local partner, while FDI through JVs incurs greater costs for the host than for the firms and the home country. Consequently, cross-border M&As have a negative impact while cross-border JVs have a positive impact on the use of economic sanctions.

Just as the impact of globalization of production created by FDI has varying effects on security relations (Brooks 2005), the same is true for economic statecraft.¹⁹ Economic ties created by various factors such as technological progress and free trade agreements may provide a stronger link between countries. Yet the impact of those links depends on how firms behave and interact with others. Currently, as firms gain more experience investing abroad, firms are increasingly establishing wholly-owned subsidiaries rather than forming a partnership with a local company when they enter the foreign market (UNCTAD 2009). Under this trend, it is possible to cautiously predict that the use of economic sanctions will become more difficult in the future.

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Endnotes

¹ For instance, US foreign direct investment in China serves both China and other nearby regional markets and also plays an important role in trade with others by supplying necessary parts and components (Buckley 2010). Tadesse and Ryan (2004) also report that 74% of total Japanese FDI not only serves the host but also the regional and the Japanese market. This rise of positive relationship between FDI and trade is certainly making the traditional view of FDI, either as market-seeking, resource-seeking or efficiency-seeking less useful, and this is the main reason why this article focuses on the entry mode of FDI as a way to disaggregate FDI.

² For instance, due to this globalization of production (or product fragmentation), firms from developing and least developed economies, who do not possess an ability to have a competitive advantage, are able to join the production chain by specializing in the labor-intensive fragment of the production process which enables to them access to foreign markets (directly and indirectly) with additional benefits such as knowledge spillovers.

³ See, for example, Buckley and Casson (1998) and Muller (2007) for the determinants of entry mode. Several important factors identified by the studies of international business are investments costs, difference in technologies, market size, market structure, and the level of competition.

⁴ In addition, JVs may provide economies of scale, easy access to foreign markets and distribution system, and reduction of various risks in investing abroad (Brewer and Young 1998).

⁵ This line of argument is known as the asset specificity hypothesis in international business literature. See, for example, Holmstrom and Roberts (1998), and Brouthers (2002).

⁶ In addition, parties involved in JV obviously have to pay a high transaction cost due to the conflict of goals, means, profits, and thus more negotiating compared with the wholly-owned operation, which is clearly a disadvantage for MNCs that need rapid technological innovation and marketing (Brouthers 2002).

⁷ The other side of the coin is that JV creates coordination challenges with local partners but M&As face challenges in managing the purchased business and the relationship with the host government (Buckley and Casson 1998; Meyer et al. 2009).



⁸See, for example, Conyon et al (2001) and McGuckin and Nguyen (2001), for the negative effects of M&As on the labor demand. It is no coincidence that labor unions across the world oppose M&As (for example, AFL-CIO 1987)

⁹ Also see Moran (2005) who reports that the wholly owned foreign subsidiaries in China are much more likely to employ the most advanced technology available from the parent firm than JVs.

¹⁰ As Drezner (2003) mentioned, under the assumption of complete information, the threat of sanction should have a 100 % success rate, and obviously sanctions should never be imposed. However, sanctions do occur, and many offer theoretical models with incomplete information (for example, Dorussen and Mo 2001; Lacy and Niu 2004; Whang 2010). Nevertheless, the problem of credibility and severity still remain as the main characteristics of strategic interaction whether or not the level of uncertainty is incorporated into theoretical considerations (Hovi, Huseby, and Sprinz 2005).

¹¹ Previous studies identified several factors affecting the credibility and the severity of sanctions such as, for example, the limited goals of the sender, modest cost for the sender and significant costs for the target, issue salience, domestic institutions, and international cooperation (for example, Hufbauer et al. 2007; Lektizan and Souva 2007; Krustev 2010; McLean and Whang 2010).

¹² This adjustment costs will be lower in JVs since the parent firm is less committed.

¹³ This is especially the case when the JV is between the developed countries and less developed countries.

¹⁴ See Morgan et al. (2009) for details on the data set.

¹⁵ The SDC database collects information on publicly announced M&As and joint ventures globally. For more information, see <http://thomsonreuters.com>.

¹⁶ For this variable, the COW Project National Material Capabilities Data (Version 4.0) is used.

¹⁷ For this variable, Polity IV data is employed (Marshall and Jaggers 2009).



¹⁸ The data is from the SDC Platinum database by Thompson Reuters (2010).

¹⁹ For the relationship between FDI and the use of force, see, for example, Russett and Oneal (2001), Rosecrane and Thompson (2003), Souva and Prince (2006), and Lee and Mitchell (2010).



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Author's Biography

Dong-Hun Kim
Korea University

Dong-Hun Kim is an Assistant Professor of Political Science at Korea University. His current research interests include politics of non-tariff barriers, anti-trust and competition policies, and foreign investments. He received his BA and MA from Korea University, and PhD from the University of Iowa. Professor Kim has previously taught at Oakland University (2006-2009). His recent publications include articles in journals such as *Comparative Political Studies*, *State Politics & Policy Quarterly*, *Public Procurement Law Review*, *Public Choice*, *Kyklos*, *the World Economy*, *Journal of Peace Research*, and *Journal of Conflict Resolution*.



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