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An analysis of the effects of soft power on the risk of foreign direct investment projects

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An Analysis of the Effects of Soft Power on the Risk of Foreign Direct Investment

Projects

by

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Honors Thesis

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Approved by:

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Abstract

As the world has become more interconnected due to the rapid expansion of trade and communication technologies, countries have been able to create a reputation based on their image instead of their military power. This attraction or soft power, has become a topic of discussion as many scholars have tried to define soft power and the effects it has on the world. This research study focuses on how a country's soft power affects the foreign direct investment projects it participates in based on the level of soft power its home country has over the host country. This study examines criteria for determining what constitutes soft power, such as the migration of people to a country, and then uses a database of foreign direct investment projects to examine how the soft power of a company's home country compares to the host country's affects project risk. Furthermore, the paper provides background on some characteristics of soft power in the countries of China and South Korea to provide background on the complexity of defining soft power. The examples of soft power described through the analysis of China and South Korea will also serve as a method of explaining the different ways in which soft power has been measured before and how the new measure differs. The purpose of this research is to investigate whether and how soft power affects foreign investment project risk. Furthermore, this paper also may provide companies with a new form of risk assessment that can be used when determining whether a country will be a good candidate for investment.

Keywords: Soft power, Investment risk, Migration, Foreign direct investment

Introduction

The goal of the thesis is to contribute knowledge of research on whether and how soft power affects investment risk. This type of research will allow both companies and countries to have a new perspective on how soft power perception can boost their economic growth. This research study analyzes the trends of soft power as it influences investment projects around the world. Through this analysis, a database of immigration and emigration will be constructed as a measure of soft power. Then the data collected from the migration patterns will be matched with information gathered on fully foreign investment projects to determine the effect soft power has on the risk level of the projects. The key proposition is that project risk will decrease as the soft power increases between the home country of the company sponsoring the project and the host country where the project is located. In essence, greater soft power reduces project risk.

As globalization and the internet have interconnected the world there has been an increase in interest in other countries and what could be achieved through going abroad. Soft power as Joseph Nye stated, was not only limited to citizens but also to companies who sought to broaden their markets (Lee, 2009; Nye, 1990). Soft power became a topic of discussion in the business and political world as scholars created different measures of soft power to describe how countries came to affect trade and investment through more reputation-based e.g. soft power means rather than through primarily coercive means e.g. military power.

Many sources delve into soft power and how it could be categorized or how it affects the perceptions of other people. The plethora of discussions ranges from what constitutes soft power with some consensus to the way that soft power is used by governments. Although the business and political worlds have studies on soft power, mainstream media are behind on how effective soft power can be. Although not commonly discussed, there have been instances where a country will openly come forward about its plans to create its soft power.

Many articles focused on policies and regulations as the measure of soft power for investment risks. Amidst these articles, Zhang and Wang (2023) use migration as a form of soft power. Although the focus of the paper is on a company's willingness to conform to the culture of the foreign country, using this information creates a window into the influence soft power can have on a company's behavior. Similarly, the paper highlights the ability that companies have to maintain their norms from their native country in light of the increase in the soft power of said native country.

Furthermore, the soft power theory will be analyzed through different industries to gauge the efficacy of the theory across multiple types of projects. This will be done to determine whether the model could be used universally across industries. It will also provide companies with a baseline for which industries aren't affected by soft power as it's defined in this paper.

Soft Power

Soft power was coined in 1990 by Joseph Nye through his observation of trade post-Cold War (Nye, 1990). In its infancy, soft power was not clearly defined and was only used as a way to describe the new method of trade no longer based on military influence which was called hard power. As time went on and business became more interconnected through globalization, more scholars aimed to define soft power that has taken the reign as the new form of influence used by countries. According to scholar Valieva, soft power can be used to describe the usage of culture to influence foreigners to explore other countries (Valieva, 2018, p. 210). Soft power can also be defined as an influential factor that doesn't rely on military force. The usage of this influence can take many forms be it cultural, economic, or political (Lee, 2009; Mary J. Ainslie, 2016, p. 17; Gupta, 2013, p. 41).

Although soft power deals with cultural aspects, there is a difference between soft power and cultural affinity. Cultural affinity deals with the "closeness" and the "likeness" of one culture to another in a way that connects the two. If the home country's culture is similar to the host culture then there is a sense of closeness and the host country will view the company better. Through this example, it is easy to see why cultural affinity may be considered soft power but the difference lies in the scope of soft power. Soft power encompasses cultural, economic, and political attributes that can describe the coercion a country has over another country. While cultural affinity falls under the cultural element of soft power, soft power is not in its entirety cultural affinity.

The economic aspect of soft power deals with monetary forms of influencing another country such as providing aid. According to Gill and Huang, China has also provided aid to countries trying to rebuild after some kind of misfortune including providing monetary aid to the United States after Hurricane Katrina hit Louisiana in 2005 (Gill & Huang, 2006, p. 23). Correctly utilizing the catastrophes, China was able to receive a positive reception as a country that lends a helping hand to those in need. Furthermore, the political element of soft power can be described as using diplomacy as a method to increase the influence it has over the other country. This can be seen in China's aid in peacekeeping missions (Gill & Huang, 2006, p. 22).

Projects

A project “involves the creation of a legally independent project company financed with non-recourse debt (and equity from one or more corporations known as sponsoring firms) for the purpose of financing investment in a single purpose capital asset, usually with a limited life” (Etsy, 2014). As stated these projects are usually created through a company already in the country the company is trying to enter whether through joint ventures or partnerships. The purpose of these projects is to enter a new market while having an established company there to aid the transition into a new country. Most projects are financially supported by the host country or company through established contracts so that both companies can benefit from the transaction. These financially dependent projects are sometimes preferred especially since there is an inherent sunk cost in investing that can be mitigated through financial support

(Dudley, 2012). In the context of this paper, projects refer to the investment of single-owned companies into another country through different sectors aided by the host country. According to Dvir and Lechler, “projects are complex, time-restricted, unique endeavors and special tasks that have not been done before” (Dvir & Lechler, 2014). There are different methods of investment projects such as expansive investment projects, investment projects to preserve or replace, fine-tuning investment projects, and innovative investment projects (CEOpedia, n.d).

Theory & Hypothesis

Soft Power Theory

While conducting the research for the hypothesis many articles explained the importance of soft power but there was no connection to how it could affect investment risk. Though this thesis covers the soft power of a multitude of countries, to further understand the effectiveness of soft power background research was done on what soft power achieves in the countries of China and South Korea.

One of the most common countries thought of when discussing soft power is South Korea, due to the “Korean wave” or “hallyu” (Lee, 2009). As we have discussed before, a country or corporation can utilize different types of soft power for its benefit. For Korea “soft power” was used to boost its image in the 1990s (Lee, 2009). The Korean wave began in East Asia during the 90s during a time of economic hardship for Korea (Hahm et al., 2023, p. 12). Korean media began amassing new followers from East Asian countries like Taiwan in the 90s (Hahm et al., 2023, p. 12).

Nowadays K-pop has become an international sensation with groups like BTS being invited to the United States White House as a diplomatic way to decrease the rise of anti-Asian hate in the United States (Hahm et al., 2023, p. 11). The Biden administration using the famous musical group as a way to address the violence in its country shows how effective Korea's soft power has gotten. But before K-pop became popular there was one instance that introduced Korean pop music to the United States and that was the popular song Gangnam Style by the artist PSY. Gangnam Style became an internet sensation in the United States and is attributed as the first step into Korean culture for many Americans. Another form of cultural soft power can be seen in the Netflix show Squid Games which amassed a huge following in the United States and was the gateway for many Americans into Korean films. After Squid Games streamed on Netflix, there was an increase in Americans consuming Korean media such as Korean dramas or Kdramas.

Similarly, Korea has been at the forefront of esports to promote both its technological advancement and its culture (Valieva, 2018, p. 210). Not only was esports a form of cultural soft power but it was also a diplomatic move as the Korean government sought to create a school that would teach esports in its curriculum (Valieva, 2018, p. 210). It is important to note that there has been a shift in the type of people who influence the common masses. Where celebrities used to dominate the influential sphere we now see that the common people have started to focus on influencers from social media platforms. This is a powerful shift as now almost anyone

can create an influential sphere and there is a big space for online gaming content and gaming influencers. Furthermore, the Korean government promoted the gaming industry as a way to increase its stance in the gaming community which is the newest influential power.

Professor Wong claims that Korean comics called manhwas, which have Japanese roots, are used to promote Korean culture (2006, p. 34). Most manhwas translated into English have footnotes where Korean culture is present. Korean words such as *hyung* are left in and the translator will leave a note that explains the importance of the word to the story. Since manhwas were created with Japanese manga in mind, the Korean government banned the production of Japanese media to ensure that the comics remained as true to the Korean image as possible.

At the same time that the popularity of manhwas began, Korean media began to circulate in Laos as a cheaper alternative to other media from more prominent countries (Mary J. Ainslie, 2016, p. 17). Although Korean media was being shared in Laos, Korea's influence on the country had not yet been established and it wasn't until the Korean Broadcasting Commission donated a large sum of money that Korea began to establish itself as a cultural force in Laos (Mary J. Ainslie, 2016, p. 17). Once the media was widely accepted fanbases began to form and the demand for Korean culture boomed leading to culture festivals that showcased Korean culture as a form of persuasion to deepen the interest in Korean culture in Laos.

Unlike Korea, the People's Republic of China (PRC) stands as a notable force at the international power level especially considering its trade industry. China has an image internationally that it is actively trying to change. In 2014, President Xi Jinping stated "We should increase China's soft power, give a good Chinese narrative, and better communicate China's message to the world" (Xi, 2014).

China has begun to reshape its image through diplomatic measures in the Southeast Asian region. One of the main ways that China engaged in soft power is through its participation in Southeast Asian organizations such as the Association of Southeast Asian Nations or ASEAN Plus Three (Congressional Research Service, 2008). China is a special case as its participation in these organizations stems from the countries involved wanting to have a superpower that is not as restrictive as the United States (Congressional Research Service, 2008). Unlike the United States, China has employed a hands-off approach to the governments of the countries it partners with. China has also focused on providing peacekeeping troops to the UN to diminish the aggressive image it garnered in the past (Gill & Huang, 2006, p. 22). In providing aid to peacekeeping missions and more readily accepting treaties with its neighboring countries, Chinese politicians have influenced the countries that have previously resented it to accept trade and begin the process of gaining their goodwill.

Concurrently, China has economically supported the Southeast Asian countries that prefer China's lax aid. Although China doesn't provide high economic aid, it doesn't have many requirements for its loans keeping with its hands-off approach.

These types of loans are mostly infrastructure-based with Chinese companies overseeing the construction of the buildings (Congressional Research Service, 2008). One of the limited conditions that China imposes on the countries it assists is access to its raw materials. While China takes the materials from the country, it also teaches the countries' politicians about diplomacy (Gupta, 2013, p. 41).

Like most prominent Asian countries, China has exported its culture through comics called manhuas in Chinese. What began as copied work shifted to a homegrown production of Chinese comics that has spread internationally (Wong, 2006, pp. 30–31). Although Chinese manhuas arose from Japanese mangas, the Chinese government demanded that manhuas remove Japanese influence (Wong, 2006, pp. 35). In parallel to the method that the Korean translators have taken, those who translate manhuas leave in Chinese anecdotes and explain them in the footnotes. Furthermore, translators also explain the cultural dynamics whether they be how office workers refer to each other or how Chinese honor their dead.

An important method of soft power that is harder to distinguish from the rest is spoken soft power in which a country changes the way that foreign countries discuss it. To ensure that other countries speak positively about China, the Xinhua News Agency has broadcasted in developing countries while also promoting Chinese propaganda (Shambaugh, 2015, pp. 102–103). In broadcasting in developing countries, Xinhua can push its ideology without having to compete with well-known news agencies that would highlight the news station as a form of propaganda. In an

attempt to decrease the negative publicity against China, the Chinese government will monitor and reprimand both domestic and foreign journalists (Shambaugh, 2015, p. 104).

Hypothesis

Soft power theory is based on previous research that details the positive effect soft power has in the business world, specifically the ability of companies with higher soft power to maintain their company norms from their home country (Zhang & Wang, 2023). As detailed by Letian Zhang and Shinan Wang (2023), soft power is measured through the attraction of a country based on the inflows of immigrants compared to the total migration out of the host country. Based on these findings, the soft power theory indicates that if soft power increases in a host country then the risk factor of an investment project will decrease accordingly. As soft power can't easily be defined there is major speculation on what causes soft power to be effective in other countries.

There are many reasons why soft power could influence investment risk. The home country may be globally positioned in a better way than the host country which could in turn the company entering the host country may offer a method to increase the host's global standing on a political basis. Similarly, if the home country has a damaging economic or political standing, the host country may not offer loans for the company's investment project as it is deemed riskier since the home country may prefer to change its policies regarding the host country. If the home country has a higher soft power rating, then the host country may be able to gauge the efficiency of

the company based on the cultural impact the home country had on the company. If the host country and the company find themselves in arbitrage the country may rule in favor of the multinational through biases formed from the soft power. In a political sense, public opinion may be lenient towards the company based on the perceived positive impact the company may have compared to the politicians.

Hypothesis: Investment risk is lower when the home country of the sponsoring firm of the project has a higher level of soft power when compared to the foreign host country.

Method

Data Collection & Sampling

The immigration data utilized in this paper came from the Organization for Economic Co-operation and Development (OECD) database which contains the immigration inflows and outflows of countries from 2000 through 2019. The data was formatted to show how many people immigrated from country A to country B. The data provides the relevant information for the measure of soft power which will be used as one of the independent variables. After gaining access to the database, the data was downloaded into Excel to begin the analysis of the country's immigration patterns.

Similarly, the data for the investment projects was gathered from the Securities Data Company (SDC) database, provided by Refinitiv (Refinitiv, 2021). From the SDC database the data for multiple industries included metals and wood manufacturing, mining, oil and gas, petrochemicals, power generation and distribution, telecommunications, transportation, waste and recycling, water and sewerage.

Empirical model and variables

The model used to create the measure of soft power was created by Letian Zhang and Shinan Wang. “Our method is to take the proportion of a country’s outmigrants to a particular country relative to its total number of outmigrants. More specifically, to measure the soft power between country A and country B, we first take the number of migrants from country B to country A and divide it by the total number of outmigrants from country B. We then take the number of migrants from country A to country B and divide it by the total number of outmigrants from country A. We finally take the difference between these two values to determine the two countries’ relative soft power on each other. (Zhang & Wang, 2023)” The method establishes the quantitative measurement of soft power used in further equations.

Table 1

Variable Name	Variable Description and Data Sources	Descriptive Statistics	Expected Impact on Investment Risk
<i>Investment Risk</i>	Percentage of equity-based (not debt-based) capital funding an investment project. Source: Refinitiv (2021)	Average= 8.91 S.D.= 14.7 Min= 0 Max= 55.0	<i>Dependent Variable</i>
<i>Right or Center Chief Exec of Government</i>	0-1 Dummy that equals one (and zero otherwise) if the host country’s chief executive of government (e.g., president or prime minister) is a member of a political party oriented on the “right” or “center” of the	Average= 0.56 S.D.= 0.5 Min=0 Max= 1	Negative

	political spectrum. Source: Database of Political Institutions (2020)		
<i>Sponsor Experience</i>	The count of previous projects of the foreign equity investor in the host country. Source: Refinitiv (2021)	Average=0.56 S.D.=1.63 Min= 0 Max= 10	Positive
<i>Soft Power</i>	The measure created from the immigration from country A to country B	Average=-0.01 S.D.=0.22 Min= -0.75 Max= 0.87	Negative
Project Cost	Cost of the project in the host country. Source: Refinitiv (2021)	Average= 5.25 S.D.= 1.35 Min= 0.31 Max= 0.78	Positive
<i>Sovereign Rating</i>	Annual average sovereign rating by Fitch, Moody's, and Standard and Poor's Investment Bank Credit Analysis of long-term foreign currency-denominated debt converted to a 0-16 scale (AAA = 16, AA+ = 15, B- = 1, Below B- (Default) or No Rating = 0). Source: Bloomberg (2021).	Average= 13.47 S.D.= 3.35 Min= 5.33 Max= 16	Negative
<i>Policy Stability</i>	Natural log of 1-18 "checks and balances" score (1= no/minimal checks to 18 = substantial checks on political authority) assessing the number of relevant policy veto holders in national polity. Source: Database of Political Institutions (2020)	Average= 1.42 S.D.= 0.28 Min= 0.69 Max= 2.30	Negative

Results

Preliminary Analysis Results

When analyzing the sample collected from the databases, a correlation table was created to gauge the relationships between the variables. The pairwise correlation of the relationship of all the variables is stated in Table 2. The first column of Table 2 illustrates the relationship between investment risk and the independent variables. In this column, it is seen that as soft power increased investment risk decreased supporting the soft power theory hypothesis. As soft power increases, investment risk decreases with a correlation of -3%. It is important to note that the only variable with a positive correlation is the log of project cost so as cost increases so does risk at 1%. This is to be expected as there usually is more risk involved with more expensive projects.

Table 2

	1.	2.	3.	4.	5.	6.	7.
1. Investment risk	1.00						
2. Project cost	0.01	1.00					
3. Sponsor Experience	-0.06	-0.08	1.00				
4. Sovereign Rating	-0.07	0.02	0.10	1.00			
5. Right or Center Chief Executive of Government	-0.13	0.09	-0.15	-0.15	1.00		
6. Policy Stability	-0.17	0.11	-0.22	0.12	0.36	1.00	
7. Soft Power	-0.03	0.01	-0.21	-0.27	0.12	-0.15	1.00

The analysis of the regression results in Table 3 showcased that three of the variables were statistically important with a p-value of $p < 0.10$. These variables were

sovereign rating, soft power, and right or center chief executive of the government. The first column of Table 3 shows the regression results with the control without soft power as a variable. Column 2 of Table 3 introduces the variable of soft power in the regression. In this column, it can be seen that the coefficient for soft power is both negative and statistically significant with a coefficient of -23.266. This result indicates that soft power does affect investment risk.

Table 3

VARIABLES	(1) risk	(2) risk
Project Cost	0.092 (2.554)	0.218 (2.483)
Sponsor Experience	-0.706 (0.839)	-1.431 (0.987)
Sovereign Rating	-1.090 (0.697)	-1.374* (0.724)
Right or Center Chief Executive of the Government	-12.929** (5.259)	-11.560* (5.248)
Policy Stability	-1.145 (8.866)	-5.256 (8.173)
Soft Power		-23.266* (12.261)
Constant	-235.039*** (34.641)	-226.770*** (28.317)
Year and Industry Dummies	Yes	Yes
Observations	169	169
Robust standard errors in parentheses		
*** p<0.01, ** p<0.05, * p<0.1		

Discussion

Key Findings and Implications

The soft power theory developed and tested highlights the notion that soft power can change the way that business is conducted in a global market. The importance of creating and maintaining soft power can be detrimental for a country that has low hard power if it wishes to level the playing field. Furthermore, based on the findings from both this paper and Letian Zhang and Shinan Wang (2023) it can be inferred that soft power can create positive effects on companies whose country of origin has high soft power when expanding abroad. Through this research, it can be concluded that although hard power is important for a country, its soft power is just as important for the company's ability to globalize. In terms of why soft power affects investment risk, this can be explored through how a country achieves soft power and why countries with soft power don't have to adapt to another country as they have less pushback on how the owners of the companies organize their companies. If a company from a country that has high soft power goes abroad it can be expected that the company holds the same values as the home country which is viewed positively already.

Limitations and Future Research

During the data analysis, it was found that the oil and gas industry was not affected by soft power which calls for future research on the reasoning behind the lack of effect. It is important to note that the oil and gas industry is affected strongly by political factors which could mean that soft power might not be as effective. Future research could also be done to figure out how other measures of soft power could

affect investment risk. This would allow insight into whether some measures of soft power do not affect investment risk or find soft power measures that do affect the oil and gas industry.

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