

MSc INTERNATIONAL BUSINESS, ESCI-UPF & BSM
INTERNATIONAL RISK ANALYSIS
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NOTE 2 - POLITICAL RISK AND COUNTRY RISK

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1 Three categories of risk – And Why Risk is Hard to talk about?

1.1 Three categories of risk

The first step in creating an effective risk management system is to understand the qualitative distinctions among the types of risks that organizations face. According to Kaplan and Mikes (2012), risks fall into one of the three categories. Risk events from any category can be fatal to a company's strategy and even to its survival.

Category I: Preventable risks

These are internal risks, arising from within the organization, that are controllable and ought to be eliminated or avoided. Examples are the risks from employees' and managers' unauthorized, illegal, unethical, incorrect or inappropriate actions and the risks from breakdowns in routine operational processes. To be sure, companies should have a zone of tolerance for defects or errors that would not cause severe damage to the enterprise and for which achieving complete avoidance would be too costly. But in general, companies should seek to eliminate those risks since they get no strategic benefits from taking them on. A rogue trader or an employee bribing a local official may produce some short-term profits for the firms, but over time such actions will diminish the company's value.

This risk category is best managed through active prevention: monitoring operational processes and guiding people's behaviours and decisions toward desired norms. See Simon (1995) and Simon (1999) for more information about this type of risks

Category II: Strategy Risks

A company voluntarily accepts some risks in order to generate superior returns from its strategy. A bank assumes credit risk, for example, when it lends money; many companies take on risks through their research and development activities. Strategy risks are quite different from preventable risks because they are not inherently undesirable. A strategy with high expected returns generally requires the company to take on significant risks and managing those risks is a key driver in capturing the potential gains. BP accepted the high risks of drilling several miles below the surface of the Gulf of Mexico because of the high value of the oil and gas it hoped to extract.

Strategy risks cannot be managed through a rules-based control model. Instead, you need a risk-management system designed to reduce the probability that the assumed risks actually materialize and to improve the company's ability to manage or contain the risk events should they occur. Such a system would not stop companies from undertaking risky ventures; to the contrary, it would enable companies to take on higher-risk, higher-reward ventures than could competitors with less effective risk management.

Category III. External risks

Some risks arise from events outside the company and are beyond its influence or control. Sources of these risks include natural and political disasters and major macroeconomic shifts. External risks require yet another approach. Because companies cannot prevent such events from occurring, their management must focus on identification (they tend to be obvious in the hindsight) and mitigation of their impact.

Companies should tailor their risk-management processes to these different categories. While a compliance-based approach is effective for managing preventable risks, it is wholly inadequate for strategy risks or external risks, which require a fundamentally different approach based on open and explicit risk discussions.

Table 1. Three categories of risk

| | Category I Preventable Risks | Category II Strategy Risks | Category III External Risks |
|--------------------------------------|---|--|---|
| Definition | Risks arising from within the company that generate no strategic benefits | Risks taken for superior strategic returns | External, uncontrollable risks |
| Risk mitigation objective | Avoid or eliminate occurrence cost-effectively | Reduce likelihood and impact cost-effectively | Reduce impact cost-effectively should risk event occur |
| Control model | Integrated culture-and-compliance models | Interactive discussions about risks drawing on tools such as: maps of likelihood and impact of identified risks; key risk indicator scorecards. | “Envisioning” risks through: tail-risk assessment and stress testing; scenario planning and “war-gaming” |
| Role of the risk-management function | Coordinates, oversees and revises specific risk controls with internal audit function | Runs risk workshops and risk review meetings Helps develop portfolio of risk initiatives and their funding Acts as devil’s advocates | Runs stress-testing, scenario-planning and war-gaming exercises with management team Acts as devil’s advocates |

Source. Kaplan and Mikes (2012).

1.2 Why Risk is Hard to Talk About

That, however, is easier said than done; extensive behavioural and organizational research has shown that individuals have strong cognitive biases that discourage them from thinking about and discussing risk until it’s too late.

Multiple studies have found that people overestimate their ability to influence events that, in fact, are heavily determined by chance. We tend to be *overconfident* about the accuracy of our forecasts and risk assessments and far too narrow in our assessment of the range of outcomes that may occur.

We also *anchor* our estimates to readily available evidence despite the known danger of making linear extrapolations from recent history to a highly uncertain and variable future. We often compound this problem with a confirmation bias, which drives us to favour information that supports our positions (typically successes) and suppress information that contradicts them (typically failures). When events depart from our expectations, we tend to *escalate commitment*, irrationally directing even more resources to our failed course of action – throwing good money after bad.

Organizational biases also inhibit our ability to discuss risk and failure. In particular, teams facing uncertain conditions often engage in *groupthink*: Once a course of action has gathered support within a group, those not yet on board tend to suppress their objections – however valid – and fall in line.

Collectively, these individual and organizational biases explain why so many companies overlook or misread ambiguous threats. Rather than mitigating risk, firms actually incubate risk through the *normalization of deviance*, as they learn to tolerate apparently minor failures and defects and treat early warning signals as false alarms rather than alerts to imminent danger.

Effective risk-management processes must counteract those biases. “Risk mitigation is painful, not a natural act for humans to perform” (Gentry Lee, chief systems engineer at Jet Propulsion Laboratories, a division of the U.S. National Aeronautics and Space Administration, quoted by Kaplan and Mikes (2012)).

2 International business risks

2.1 Dimensions of international business risk

In general, international business risk entails:

- a) Political risk
- b) Financial risk
- c) Transactional risk

Financial risk concerns the variance of the domestic currency value of asset, liability or operating income that is attributable to unanticipated changes in foreign or international financial market systems. The most common financial risk is foreign exchange risk, which is a positive function of foreign exchange exposure and the variance of unanticipated changes in exchange rates.

To alleviate foreign exchange risk, MNE can use external financial instruments, such as forward, future, options and swap, as well as internal initiatives, such as lead and lags, netting and matching, etc.

Transactional risk concerns the likelihood of disruption to an MNE’s individual investment or project from transactional forces that are not directly associated with political or financial factors. Transactional risk arises when an MNE faces disruptions to daily operations of an individual project due to the conflicts with its local partners, the leakage of its critical knowledge due to employee

turnover, the lack of expertise and experience of local workforce, the difficulty in exiting from the host country business, or the underdeveloped distribution channels that hamper local marketing or logistics.

Unlike financial risk, transactional risk is intractable to mitigate through the use of external instruments. Instead, MNE must accumulate organizational expertise, control the pace and scale of operations and resource deployment (thus including economic exposure), employ right entry modes and partners, and select appropriate timing and project locations.

Still, *political risk* is arguably more critical in importance, comprehensive in scope, and enduring in impact than financial or transactional risk in international business. Political risk is the probability of disruption to an MNE's operations from political forces or events and their correlates. It involves governmental or societal actions, originating either within or outside the country, and negatively affecting foreign companies' operations and investments. Political risk reflects the degree of uncertainty associated with the pattern of decisions made by the political institutions such as governmental and legislative agencies.

2.2 Political risk

2.2.1 Levels of political risk

This definition views political risk as entailing both macro and micro elements, caused by forces from both host country and non-host country environments. In a host country environment, political risk is largely determined by the behaviour of political institutions, not necessarily by the political ideology of the government or the form of the political system. A government with a capitalist ideology may pose more risk to business if it abruptly changes its policies than a socialist government that has a record of maintaining consistent policies over extended periods of time.

Political risks can be:

- Country-specific
- Industry-specific
- Firm-specific
- Project-specific

Hostile diplomatic and political relationships between two countries may fortify the country-level political risk borne by international companies investing in each other's territory. For example, poor political relationships between Venezuela and the US have imposed enormous political risks for American companies operating in Venezuela.

Industry-specific risk derives mainly from regulatory variations for foreign firms operating in different industries in a host country. In China, for instance, foreign companies in restricted industries (e.g. wristwatch chips, aluminium materials, photocopiers) must export at least 70% of their total production.

Firm-specific risk involves either a favourable or unfavourable response aimed at a particular company. When investing in foreign emerging markets, MNE that undertake investments fundamental to economic development in host countries (e.g. infrastructure investment, high-tech development, large pool of employment) have strong bargaining power in negotiating with local government authorities for better regulatory treatment. By maintaining a superior cooperative relationship with local authorities and stronger bargaining power arising from resource commitment, they are likely to have longer taxation breaks or lower rates.

Project-specific risk involves special treatment bestowed on a certain type of project. For example, countries such as Iran and Libya that are very unfriendly to foreign investments by the United States are nonetheless eager to collaborate with American oil companies in oil drilling and exploitation.

In general, country-level risk belongs to *macropolitical* risk that normally affects all firms in a country, whereas industry-, firm- and project-risk is *micropolitical risk* that affects only a specific industry, organization or project in a host country.

2.2.2 Types of political risk

The three types of political risk include ownership, operational and transfer.

Ownership risk represents a threat to the current ownership structure or to the ability of the MNE to select or shift to a given governance structure. Its most extreme form is outright expropriation, namely the forced divestment of assets as a result of a host government decisions to nationalize or otherwise transfer ownership. Milder forms of ownership risk include pressure towards or a formal change in investment rules that force firms to reduce their stake. (e.g. sharing ownership with a local firm). In the early 1970s, the Indian government established such rules that resulted in a strategic shift towards unrelated diversification and eventually to the exodus of many foreign MNE. Ownership risk has been lowered in recent years because of the competition for investment dollars and because of the development of institutions such as the WTO that make such unilateral steps prohibitively difficult. Some countries often bow to domestic pressures to keep MNEs at bay. For instance, in some EU countries there are laws that require local ownership of all pharmacies.

Operational risk includes any changes to the 'rules of the game' under which the foreign firm operates (e.g. new and arbitrary taxation), especially when foreign firms are singled out. Operational risk is less tangible than ownership risk but may be equally damaging should it limit strategic freedom or autonomy. For example, Amway has recently faced an effort on the part of the Japanese authorities to curb the direct selling practices which are at the core of its business model.

Finally, *transfer risk* involves impediments to the transfer of production factors, e.g. newly imposed capital control.

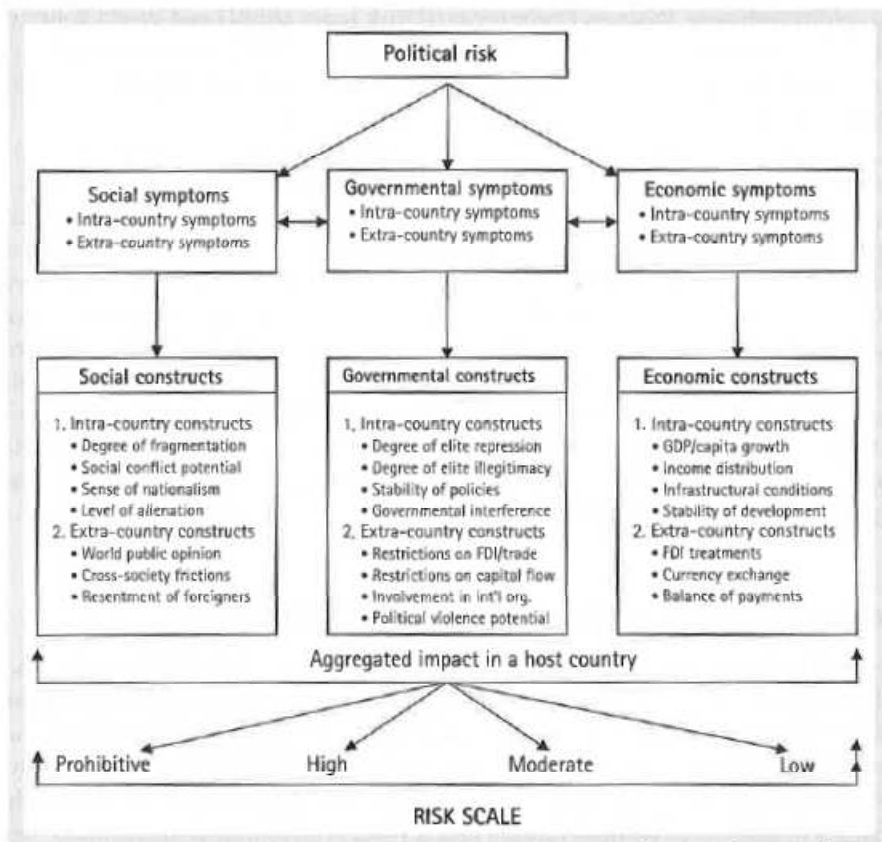
The three risk types are interrelated. For instance, if a government prohibits the placement of expatriated in key positions, this may present an operational risk compromising efficient operation and technology protection.

2.2.3 Political risk assessment

The importance of political risk creates demand for its assessment. The various ways to measure risk can be roughly classified into two categories: qualitative approaches and quantitative approaches. Many MNE combine both types of approaches in political risk assessment. Others use their own customized instruments to gauge political risk or rely on independent assessments by the Economist Intelligence Unit (EIU), Business International (BI), Euromoney, and the like.

As global firms have become more aware of their risk exposure, the demand for quantitative political risk assessment has increased. Under the quantitative approach, political risk measures are usually tabulated by intra-country items to capture the host country-caused risks as well as extra-country items to capture the risks caused by home country or international events. Within intra- or extra- country group there are: governmental items, social items and economic items. Below are some example items included in each category.

Figure 1. Political risk in International Business



Source. Luo in Rugman and Collinson (2009 eds.)

3. Country Risk

3.1 Country risk and political risk

All business transactions involve some degree of risk. When business transactions occur across international borders, they carry additional risks not present in domestic transactions. These additional risks, called *country risks*, typically include risks arising from a variety of national differences in economic structures, policies, social-political institutions, geography and currencies. Country risks analysis attempts to identify the potential for these risks to decrease the expected return of a cross-border investment. Country risks exist whatever the level of economic development of the country in question. Even the most economically advanced nations may generate a substantial degree of country risk.

While they are highly inter-related, country risk differs from political risk in several ways. First, country risk is primarily a summation of macro issues occurring at the country level affecting a broad spectrum of foreign investors, whereas political risk encompasses not only macro but also micro issues that are aimed at specific foreign investments. Second, country risk entails not merely the political aspect of uncertainty but extends to economic, social, financial, infrastructural, and demographic aspects of uncertainty. Thus country risk concerns the country's all-combined investment-climate, and political risk is part of that climate.

In general, the country risk of a given country is composed of

- a) Economic risk
- b) Financial risk
- c) Political risk

3.2 country risk assessment

Several country risk rating agencies have specific indicators to measure these dimensions. The most well-known rating agencies include Moody's, S&P, Economic Intelligence Unit (EIU), S. J. Rundt & Associates (R&A), Business Environment Risk Intelligence (BREI), Institutional Investor (II), Political Risk Services (PRS), Fitch IBCA and International Country Risk Guide (ICRG).

The following table shows the frequency of ratings, grading range, the number of countries covered, and most importantly, the number of variables and items included to measure political risk, economic risk and financial risk.

When country risk specifically involves with lending to a sovereign government, it is known as *sovereign risk*. Sovereign risk emerges when a sovereign government repudiates its overseas obligations and when a sovereign government prevents corporations and individuals residing in the country from fulfilling such obligations. Sovereign risk also emerges where countries are experiencing genuine difficulties in meeting their obligations.

Table 2. Country risk rating agencies and methodologies

| Agency name ^a | Debut year | No. of countries covered | Frequency of ratings | Grading range | Number/weight (%) of variables ^b | | |
|--------------------------|------------|--------------------------|----------------------|---------------|---|----------|-----------|
| | | | | | Political | Economic | Financial |
| Moody's | 1914 | 109 | Annual | Aaa to C | 6 | 7 | 0 |
| S&P's | 1941 | 93 | Annual | AAA to D | 6 | 3 | 1 |
| EIU | 1946 | 100 | Quarterly | A to E | 11/22 | 55/55 | 10/23 |
| R&A | 1952 | 100 | Tri-annual | 1 to 10 | 12/33.3 | 16/33.3 | 16/33.3 |
| BERI | 1966 | 50 | Tri-annual | 0 to 100 | 20/33.3 | 8/33.3 | 11/33.3 |
| II | 1979 | 135 | Semi-annual | 0 to 100 | 1 | 5 | 3 |
| PRS | 1979 | 100 | Quarterly | A+ to D- | 5 | 13 | 2 |
| Euromoney | 1983 | 185 | Semi-annual | 1 to 100 | 11/25 | 2/25 | 10/40 |
| ICRG | 1984 | 140 | Monthly | 0 to 100 | 12/50 | 5/25 | 5/25 |
| Fitch IBCA | 2000 | 81 | na | AAA to D | 29 | 53 | 46 |

^a EIU (Economist Intelligence Unit); R&A (S.J. Rundi Et Associates); BERI (Business Environment Risk Intelligence S.A.); II (Institutional Investor); PRS (Political Risk Services); ICRG (International Country Risk Guide);
^b This column reports the number of risk component variables in political, economic, and financial risk assessments as well as the weights (%) assigned to each risk component. The agencies without using the weights determine the composite risk ratings on a subjective basis. Moody's weighs the risk component variables according to their assessment of the likelihood of default by a country and its borrowers. S&P weighs risk components based on their assessments of credit fundamental affecting each government. Fitch IBCA rating system draws on instances of default and near default to establish key indicators of distress. PRS weighs risk components according to the assessed potential risks to business investments and trade.

Source. Luo in Rugman and Collinson (2009 eds.)

With globalization, international companies need to protect themselves from the risk of default and other complications. To this end, they need to take quick decisions about who they wish to work with, whether to grant or request supplier credit, how to win over a new partner, or check whether or not a company is financially secure. Banks and electronic marketplaces in international business have similar needs.

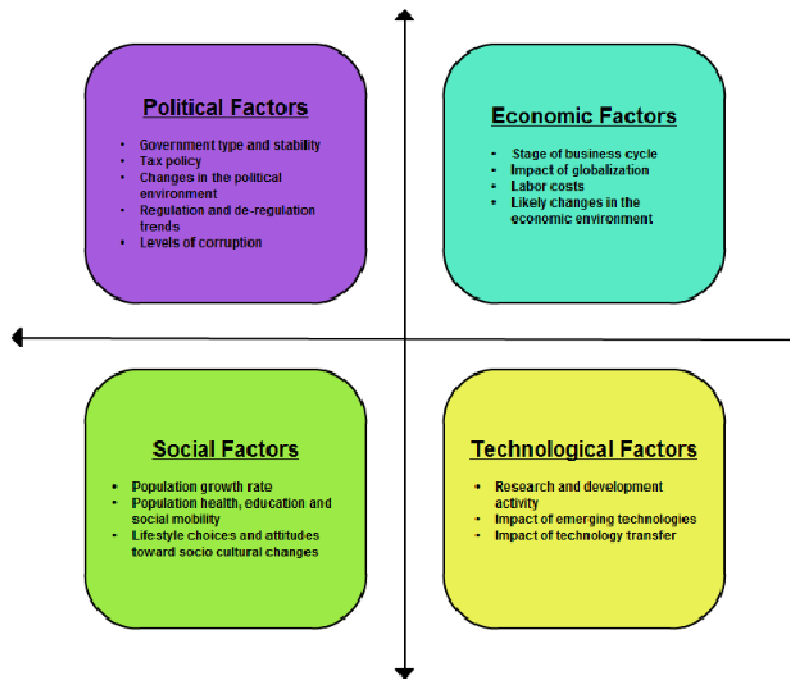
Annex. Country Risk Assessment by S&P and Moody's.

3.3 PEST Analysis

The PEST analysis examines the chances of nonmarket events (P-olitical, E-conomic, S-ocial, and T-echhnological) causing financial, strategic or personnel losses to a firm following FDI in a specific country market. Often, firms use the generic PEST framework to map out particular competitive environments or investment contexts for firms at the regional or national levels, to compare country conditions and build future scenarios to understand short-term and long-term threats and opportunities.

The PEST analysis can be extended to include legal and environmental factors. It is then called the Political Economic Social (or socio-cultural) and Technology legal and environmental (PESTLE). The PEST and PESTLE frameworks provide a good starting point but must also be complemented by further economic, political and social analysis to add depth and "foresight". The information gathered through PEST, PESTLE and other analysis must then be used to forecast potential scenarios to determine risk.

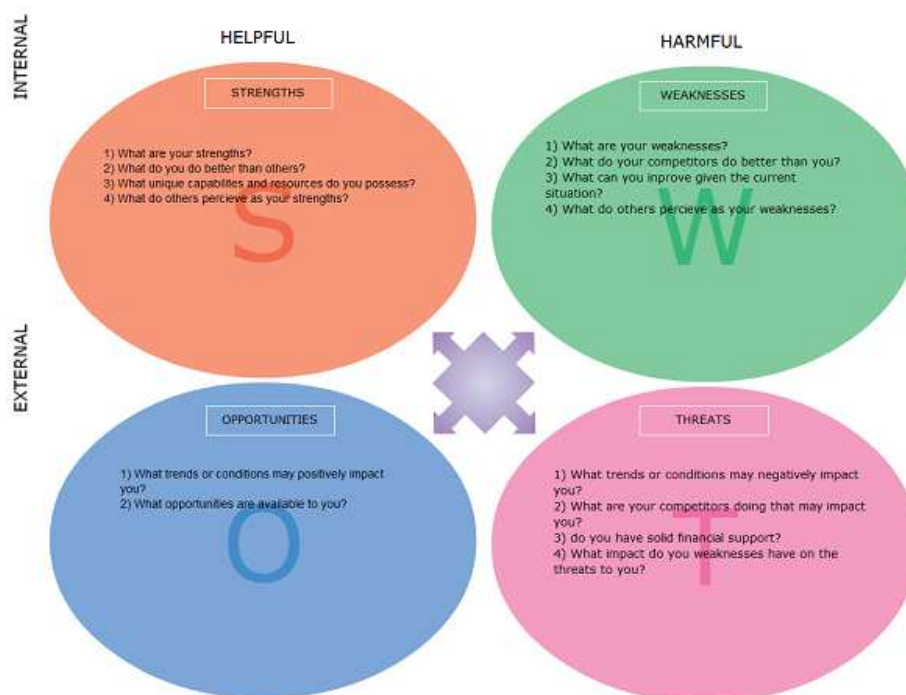
Figure 2. A PEST analysis



Source. <http://creately.com/blog/diagrams/swot-analysis-vs-pest-analysis/>

Sometimes, the PEST analysis is used in conjunction, or combined with, the SWOT analysis as a strategy tool.

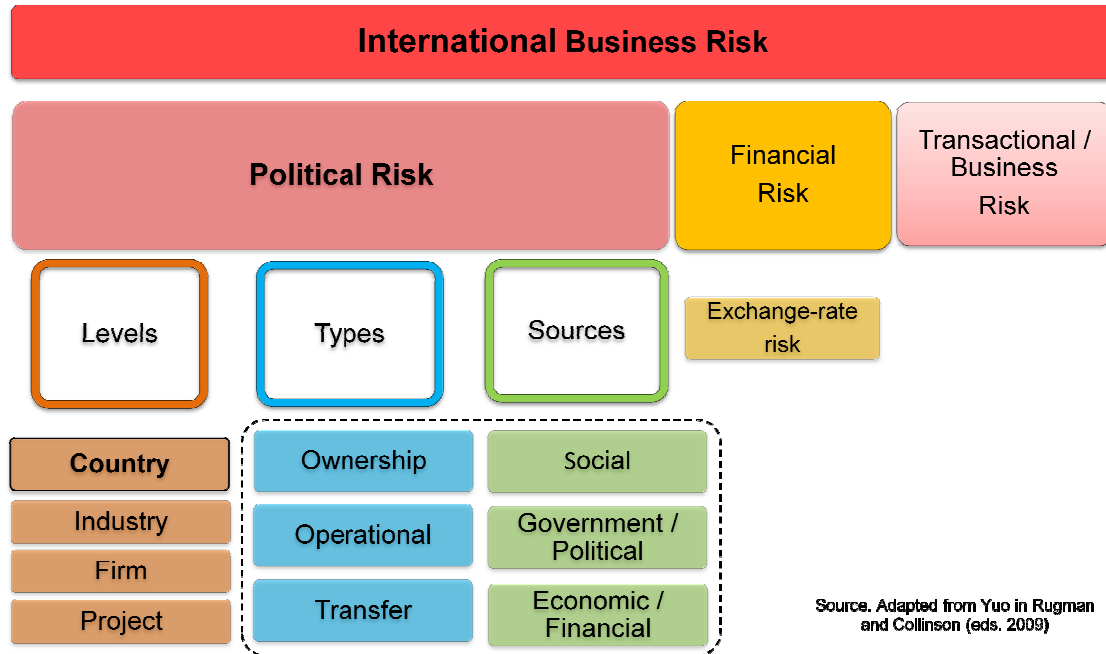
Figure 3. A SWOT analysis



Source. <http://creately.com/blog/diagrams/swot-analysis-vs-pest-analysis/>

The following table summarizes the classifications of risk presented so far.

Table 3. The main elements of International Business Risk



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