Examining forms of political risk economics essay

Political risk is of two types, Macro and Micro. “ Macro-risk refers to unanticipated and politically motivated environmental changes directed to all foreign enterprises. Micro-risk, on the other hand, is concerned with environmental changes that only affect selected industries or firms in a country” (Robock, 1971).

Examples: Micro Political Risk: Anti-American protesters in Pakistan burned a McDonald’s restaurant, Shell gas station and a KFC restaurant due to US bombing in Afghanistan in October 2001.

Examples: Macro Political risk: Due to second world war communist governments expropriated private firms in Eastern Europe and China and the same did by fidel castro during 1958-1959 in Cuba. Due to this move the international businesses were hit hard.

International Businesses may face problems of both micro as well as macro political risk. Not only boycotts in political but also indigenisation laws, where international businesses must accept participation of certain percentage of local citizens as an employee in their organization as per the host country’s government agreement, results in macro political risk. Micro political include kidnapping, regulations of industry, threats from terrorists and taxes. International businesses due to it’s high visibility in host countries are often targets of micro-political risk.

Rather than initiating solely from local political actions, political risk has been found to have both external and internal sources (Haner, 1979). The origination of external factors, are outside the host country and may include cooperative effort between the other countries and the host country or attempts of conflicts/ influences. International factors are from inside the country and may include power struggles among social factions or local religious, government policies or actions, or economic/social conditions. " Economic conditions such as Balance of payments or income distribution can influence political risk because (1) they affect or are often the targets of government policy; (2) the economic environment can precipitate a change in government; and (3) the economic situation may influence such political actors as the general public and special interest groups, in turn influencing governmental policy" (I. Alon and M. Martin, A normative model of macro political risk assessment, Multinational Business Review (2) (1998), pp. 10-19. | Cited By in Scopus (10)Alon & Martin, 1998). Thus the sources of Micro political risk's can be in the Firm's home country, the host country, the international environment, or some combination thereof.

International business has grown rapidly in the past decade because of the changes in the environment and strategic imperative. This has resulted to take into consideration of factor like political risk for the operations of international business. For assessing Political risk international companies always looks at the host countries current or future political system. However, they always has to face some political risk. For instance: Full and on time payment by foreign customers may not be possible if you are operating a Canadian company due to instability of currency controls imposed by the government. Henisz(2000) showed that multinationals face an increasing threat of expropriation if political hazard in the host country increases. Therefore assessing the impact of political risk is very phenomenal for international businesses, especially when investing in a new location.

Political factors affecting business

Normally, “ Multinational Firms are more comfortable investing in markets with a good political environment and law transparency, in order to assure game rules will not change dramatically making them to pay more money for those changes or even loose their investments” (PriceWatershouseCoopers, 2006). The most changeable factors in which the international business deal with is the political factor. At the end of government period it becomes harder for international businesses to manage even if the formation of the government is from the same party.

Example: Some countries like Russia whose policies may change dramatically due to instability in governmence , If new government come into power. Political factors plays an important role for company’s entry into new market because it affects the company not only in its operations, short term and long term objectives but also in their main strategy.

Some of the Political factors which affect international businesses due to the policies set by the host government are:

Environmental Policies

Monetary and Fiscal policies

Immigration Policies

Agricultural support to locals

Schemes of regional development

Welfare state measures which includes security, education, pensions and health

Protection of employment and regulation of working conditions

Example: E. ON tried to enter the Spanish market in February 2006 by offering tender to Endesa(largest Spanish energy firm) but the GasNatural(local firm) also showed interest for Endesa. Spanish Government supported the bid for GasNatural because they wanted to create “ Spanish Energy Champion”. The prime minister of Spain, jose Luis Rodriguez Zapatero, was against to the E. ON offer. (The Economist , 2006). The Spanish government had the power to block E. ON offers by not only using administrative resources conditioning but also almost forbidding it because of the special right they had got through the ownership of 2. 95% of the company’s shares.(Lopez, 2006).

To minimize political risk, European Countries are voted as the common market and this makes it easier as well as safer for other European countries because of it’s supranational rules, to invest within the EU territory.

Types of Political Risk

The international businesses need to consider all of these issues while analysing level of political risk in a selected country to enter. They must take into consideration of the safety, of not only their products but also for their people in unstable political situations.

Ownership Risk

When operations of international businesses are at risk due to threatening of government expropriation or takeover, which may result for the company to lose their offshore property. This may be said as nationalization of business and protectionism.

Risk of General Political instability

It may not cause investors to withdraw from a particular country, as it is not considered to have very much impact on international businesses. However, it may raise uncertainty about foreign projects overseas.

Transfer Risk

Performance of the currency exchange rates depends on the government policy. Company's strength to transfer capital out of host country may be affected because of resultant of government policy in currency devaluation or economic downtime. If a company is creating a wealth in other country then it may be forced by host country government to return a considerable amount, which is known as repatriation of earnings.

Operations Risk

The government policies of the host country may act as an obstacles for the progress of international businesses in their operations such as marketing , finance or property. These policies are known as operational risk.

The critical issues faced by international businesses are the maintenance and establishment of legitimacy in their host countries. Many international businesses has faced this problem for instance Nike had faced this problem for its labour practices in Asia(Maitland, 1997; Marshall, 1997). The attack on

MNE operations, such as the destruction of Cargill's facilities in India(Dewan, 1994). In an even more extreme example, Shell was accused of conspiring with Nigerian government to execute Ken Saro-Wiwa, who had led a campaign against it environmental practices(Newburry & Gladwin, 1997).

Example of Political Risk

Cargill which is one of the world's largest private agricultural company entered in India in 1987 inorder not only to build salt extraction and processing facilities in western India but also to create and distribute high quality hybrid seeds in southern part of India, which is Bangalore.

At the beginning only its seeds project in Banglore experienced difficulties because the Indian government had already introduced new seed policy project in 1988, which endevour " to upgrade seeds and provide the Indian farmers with the best planting material in the world so as to optimize his input"(Pania, 1992: 82). The Cargill company faced many problems like resistance from local farmers, who were encouraged by local politicians. The farmers were angry on Cargill's seeds project because they thought by this move they would lose their traditional self-sufficiency in seed production, leave them to rely on multinational firms and may also result in economic exploitation and financial distress. The tension among the farmers increased to this extent that some of the warehouses and offices of Cargill's were destroyed and burned down by angry farmers.

Likely impacts on International Businesses due to Political Risk

Both insiders and outsiders are likely to engage in economic and political activities directed at altering Host Country perceptions of their legitimacy and at changing government policies in ways that benefit them and/ or harm rivals(Eden and Molot, 1996).

Taking of Assets

It will not only result in loss of sales and future profits but also assets.

Campaign against foreign goods

The campaign against the goods of international businesses will affect the company's sales. Therefore inorder to improve public image through public relation campaign a lot of spending of capital is expected.

Mandatory labour benefits legislation

This may result in increasing the operating cost of the international businesses.

Higher Taxation

International Business has to pay higher taxes which results in low profit margin.

Inflation

If the inflation rate of the country increases in which the international business are operating, the operating cost of the international businesses also increases.

Political Risk Assessment

It should consist of three interrelated parts. The first part should help in identifying those elements of political risk which are not only related to FDI but also to develop an intelligence system for monitoring and evaluating the changes in political system in the host country. The second part is the allowance of company in dealing with changing conditions by political risk assessment integration with its strategic planning. The third part is to keep the company safe from, especially from the risk of expropriation by devising strategies.

Monitoring Conditions

According to survey conducted by Pricewaterhouse-Coopers and Eurasia group in 2006 , at more than 100 global companies, 83% of the international businesses said that their company monitor the local political environment for their investment.

Domestic Climate:

The level of national violence which is measured by tendencies towards subversions, political turmoil or rebellion. The most important factor which international business should consider while investing is the level of political violence, crisis of government and power of political parties.

Economic climate:

A comprehensive assessment of the foreign investment climate. The factors include rate of inflation, government interference in the economy , external debt levels, BOP deficits and information on the rate of gross fixed.

Foreign Relations:

These factors include the evidence of an arms race, defence budget size and relationship with its neighbours.

Example:

American manufacturing company is proposing to build its plant in Chile, to manufacture subassemblies for Chile companies, which exports to Argentina. Therefore the company's political risk fell into three categories, which are: The political risk of operating in Chile , risk in the relationship between Chile and Argentina in terms of export trade and the risk specific to company's operation. In the first category, the firm identified Chiles domestic climate, economic climate and foreign relations on its investment. In the second category, company should be concerned about political risk of Chilean-Argentinean trade relations. In the third category, the American company evaluated project specific risks such as trends of local politics in the selected location, treatment of government in that sector and the incidence of labour militancy.

In-house expertise

There are several steps in which company can acquire In house expertise about the host country and these are by educating existing management, by going outside the company for retaining outside experts or by hiring local management for supervising a subsidiary.

The second aspect in developing a In-house expertise is by developing an intelligence system so that relevant information can be collected and distributed. While providing an alternative source of analysis this intelligence system helps in complementing the information provided by line management. Example: The countries which are bigger and more important this task can be simpler. China is attracted by a lot of foreign investment. There is an increasing amount of English language- translations, Chinese affairs analysis and information newsletter about business intelligence/politics. For international businesses gaining access to such literature is limited therefore spending on the development of its intelligence system is very essential.

Strategic integration

With the help of strategic planning two task plays an important role in integrating political risk assessment. The first is, inorder to invest in different conditions of political risk establishment of hurdle rates and the second one is designing of capital budgeting plans for reflecting changes in the level of political risk. In this scenario not only international bank but also multinational oil companies have had vast experiences for integrating political risk assessment into strategic planning. For instance: Exxon was one of the first companies in establishing hurdle rates for return on investment (ROI) due to conditions of political risk.

In some cases size of investment can be divisible. Capital budget plans can be altered inorder to reflect increased risk. These conditions are only applicable to natural resources companies and banks in their early phases of development. For example: Oil companies under conditions of not only low but also stable political risk can budget a certain amount of capital for development and exploration and thus can spend declining portion of capital from that budget due to increase in political risk; in effect, to drill only 4 exploratory wells instead of 6. Likewise, due to increase in the level of political risk banks can impose higher premiums on new loans and can also increase premiums on existing loans. i. e imposing higher hurdle rates.

Risk reduction Strategies

It would be very difficult for international businesses to deal with political instability or with internal violence but international businesses can use a number of techniques to discourage expropriation. This can be achieved by not only increasing the company's political leverage but also by making its assets difficult for the host country government to nationalize.

Individual risk for international businesses can be reduced through diversification. In this situation, However it may depends on the company to choose, inorder to increase the political cost of nationalization to the host government by diversifying the risk of their operations among other foreign stakeholders or multinationals. While increasing their political leverage it is very important for international businesses to diversify their risk.

In the financing decision, country should not rely on single country sources instead they should keep an eye on broad international financing.

Example: Companies such as Kennicott copper in Chile and Marcona Mining in Peru, to increase their political clout both companies diversified their sources of debt capital. After nationalizing they could gain tremendous support from international banking community and also from those banks in their negotiations with respective to host governments.

Joint venture investment projects with foreign nationals or with foreign companies is another method of diversifying political risk. Allowance of host countries stockholders to participate in finance or a joint venture with local company is other method of diversification but it can be said that only diversification is not guaranteed against political risk

Example: In winter 2005, when the flow of gas from Russia into Europe was reduced businesses and homes across the region suffered due to reduction in energy.

The best way of preventing nationalization is by making companies investment difficult to nationalize and one of the most effective means of increasing companies leverage against the host government is by retaining control of marketing network as well as distribution of the company's product.

How to analyse Political Risk

International Businesses should consider the following factors of country risk analysis , when deciding FDI in host countries.

Industrial regulation

Foreign capital controls

Civil unrest

System of Government

Diplomatic problems

Country risk analysis has been defined as “ the study of conditions, situations and events that might impact favourably or unfavourably on conducting business or investing in a country”.(Yavas, 1989 & Merrill, 1982).

Evaluating Political Risks

International businesses which are planning to do business in other countries needs to do depth research about the host country and also should find answers to the following questions:

Commitment of the current government towards the rules of ownership rights

When is the chances of the next election or duration left for the current government

Over the next five years chances of economic and political instability in the host country

Risks of safety and profitability of international projects due to formation of new government

Chances of new government to propose changes in policies that would affect international businesses

What agreements are in place between the host government and the investors government for investment

How would its platform and ideology change in the current state of business affairs, if a new government were to be formed

Corruption perception index of the host country, because there is negative impact of corruption on FDI flows(Wei, 2000)

Consequences of Terrorism

If a terrorist attack takes place it may affect countries economy and its businesses along with transportation, security and travel.

Evaluating legal concerns

Laws and regulation of each country are different. If international businesses are doing businesses in other countries they must obey the law and make work safe for workers, which may increase the cost of the business.

In Practice

Managers can visit host country and take the help of government agencies, international bank and insurers, Country risk assessment companies and can also use internet industry association's inorder to assess the political risk of the host country.

Conclusion

On Balance, If international businesses planning to invest in a host country for its operation they may encounter various political risk but these may not result in insurmountable difficulties. Although it is not possible to eliminate such political risk entirely but their impact on international businesses can be reduced with the help of systematic assessment and management. The above methods discussed in this essay describes how to assess and manage political risk for international businesses, inorder to operate it's operation in a country which are more stable with the involvement of less political risk factors.