US CONGRESS LIBRARY CARD NO : 90-640 754
ISSN 0970-4205

JOURNAL OF FINANCIAL MANAGEMENT AND ANALYSIS

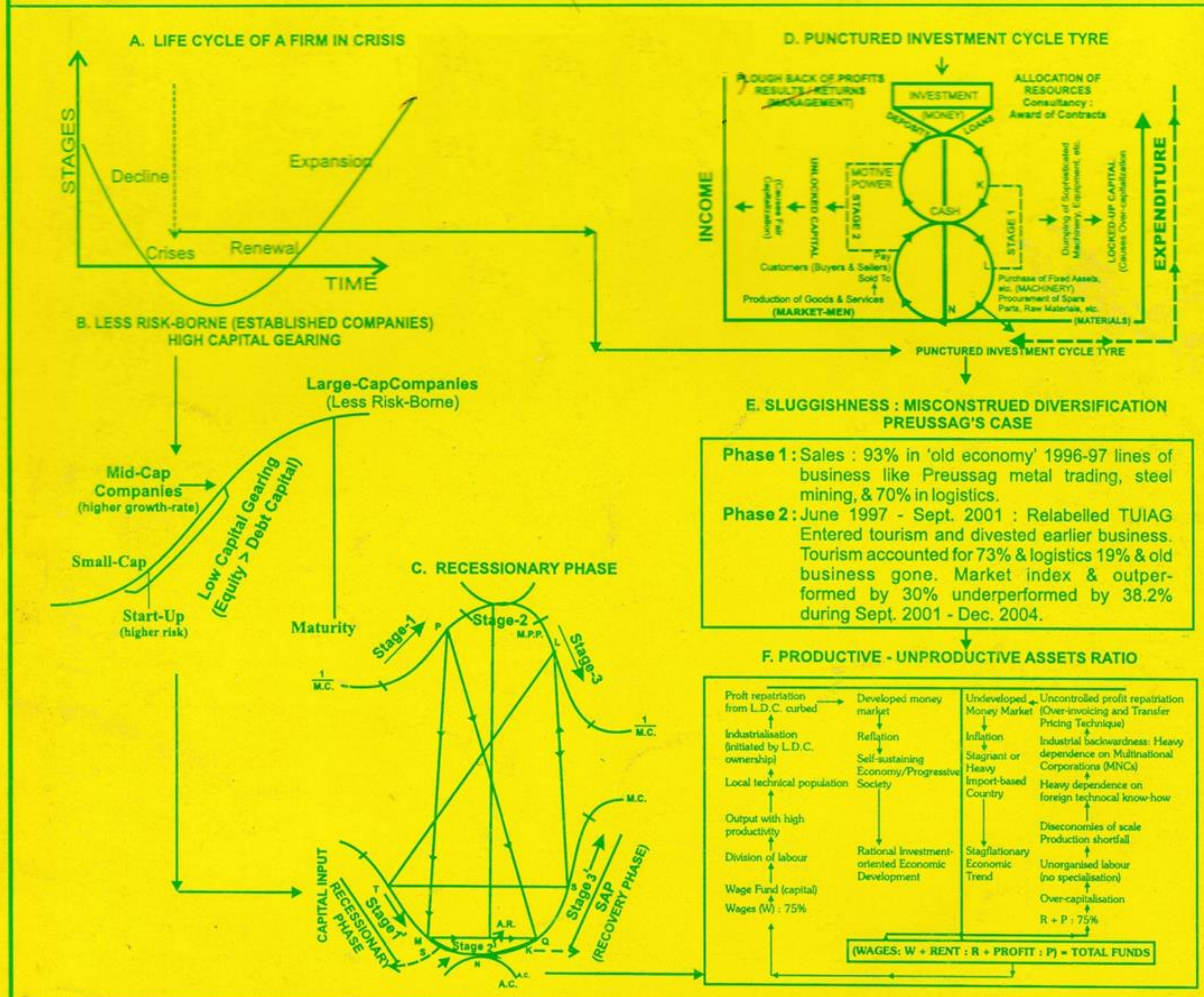
INTERNATIONAL REVIEW OF FINANCE

HALF YEARLY

VOL. 23 NO. 1

JANUARY-JUNE 2010

MISCONSTRUED BUSINESS DIVERSIFICATION LEADS TO PUNCTURED INVESTMENT CYCLE TYRE



Recent experiences have revealed that 'hard -earned money built' and 'well-run' enterprises by founding fathers, overtime, have got disintegrated by ill-conceived and misconstrued business diversification following diametrically contradictory rules of governance motivated by **quick money making** considerations combined with selfishness and gree resulting in investors losing confidence in the enteprises turning from low risk-borne (large cap) to high-risk (mid cap) companies and landing them into serious liquidity problems and resultant debt trap.

OM SAI RAM
CENTRE FOR FINANCIAL MANAGEMENT RESEARCH
MUMBAI, INDIA

Journal of Financial Management and Analysis, **23(1):2010**:27-32

POLITICAL RISK AND THE BUSINESS ENVIRONMENT: AN EXAMINATION OF CORE CHALLENGES

Professor DAVID B. EKPENYONG, Ph.D.
Faculty of Business Administration
and
NTIEDO J. UMOREN, Ph.D., C.P.A.
Associate Professor and Director
Centre for Entreprenurial Development
Department of Banking and Finance
Faculty of Business Administration
University of Uyo, NIGERIA

Abstract

This paper examined political risk as it affects businesses generally, and identified core challenges. We propose a modified integrative strategy for the management of political risk having argued that the present global economic crises increase political risk concerns for businesses. By recognizing the varying dimensions of political risk in business and the absence of a unified definition of political risk, we observed that even local businesses are not insulated from political risk. Given the shortcomings of implementing either the defensive or the integrative strategy strictly, we suggest that the integrative strategy be modified to allow for foreign businesses to retain control of corporate executives, and to be able to shift risk via government guarantees. This position is consistent with current research result in this subject area.

Key Words: Political risk; Foreign businesses; Modified integrative strategy
JEL Classification: F1 L14, O19

Introduction

During the 19980s and 1990s, there were spates of government interventions in business operations of foreign companies, particularly in the then Eastern-block countries. Ford Motor Company had a very devastating experience when the government of Hungary took-over their properties in that country. Similarly, British Petroleum had the same bitter experience when Nigeria nationalized the company in the early 1980s. Such events caused managers to become concerned with political risks especially when doing businesses overseas. Earlier studies in trying to understand political risk focused operationally on how companies can identify and mitigate risks associated with a country's political climate. Two characteristics consistently arose in definitions of political risk. These include political instability, and policy uncertainty. Recently however, scholars have focused on the determinants of political risk in democratic countries.

According to Williams[1] political instability is associated with the risk of major changes in political regimes that can result in war, revolution, death of political leaders, social unrest or other influential events. This explains why Holt[2] observes that wars, revolutions, paralyzing national strikes, disruptive social movements, and many other events may threaten a company's foreign operations. This aspect of political risk is widely captured in the theoretical and empirical literature. Policy uncertainty on the other hand is concerned with the risk associated with changes in laws and government policies that directly affect the way foreign companies conduct business.

Consequently political risk is primarily thought of during violent periods such as: coups, civil unrest and moments of major political changes, for example nationalization. The problem is that political risk in other areas such as intra-party power game, policy inconsistencies and intermittent realignments, society-

The authors own full responsibility for the contents of the paper.

induced shifts in priorities, and above all, political terrorism are often overlooked. These issues also influence the shape of organizations' bottom lines and their overall wellbeing. It is against this background that we attempt to examine political risk as they affect the business environment, detailing core challenges for both local and foreign firms. Efforts will also be geared towards the development of a mitigating political forecast model.

Definitions of Political Risk

There appears to be no universally accepted definition of political risk because different studies often provide different or conflicting opinions on the definition and scope of political risk. Also, different methods and strategies are often proposed to forecast and manage political risk. While Kobrin[3] for example defined political risk in terms of host government's interference with business operations, and Fitzpatrick[4], concentrated his definition on the adverse government actions, other scholars look at political risk in broader terms. For example, Truitt[5] defined political risk as all "non-business" risks which include expropriation. Frynas and Mellahi[6] argued that all social political risks are political risk with three major dimensions: political risk, government policy risk and social risk.

In the course of reviewing previous literature on political risk Fitzpatrick identified four categories of political risk to include: political risk in terms of government sovereign action; in terms of occurrences of a political nature, usually political events or constraints imposed at the specific industry at the specific firm level; in terms of an environment rather than in isolation and the fourth one though similar to the third one, has no detailed definition of a concept of political risk. Political risk is also defined more precisely but also differently in terms of environmental change and/or behaviours of the host government or other social actors. Robock[7] for example, in viewing political risk from an operational dimension, argued that political risk in business exists when discontinuities (which are difficult to anticipate) occur in the business environment as a result of political change. In his view these changes in the business environment constitute a risk if they have the potential to affect to a significant extent the profit or other goals of a particular enterprise.

Political risk according to Simon[8] constitutes governmental or societal actions and policies that originate either within or outside the host country and which negatively affect either a select group or the majority of foreign business operations and investments. This explains why Howell[9] asserts that political risk is the possibility of political decisions or political and social events in a country which affect the business climate in such a way that investors will lose money or not make as much money as they expected. Furthermore, political risk as defined from the behavioral angle, argues that it is the behavior of the Multinational Corporations (MNCs), and socio-political stakeholders that causes political risk.

Such behavioral definition helps to identify the underlying reasons behind political risk so as to take corresponding measures. This position is comprehensively covered in stakeholder theory where political risk is examined from the interaction between Multinational Corporations and the behavior of its stakeholders. From the foregoing therefore, it is indeed clear that there is no universal definition of political risk.

Working Definition of Political Risk

For purposes of clarity, this paper will trade the middle ground by drawing elements from most of the other definitions in the literature. From this standpoint therefore, we define political risk as any politically induced event that has destabilizing effects on the polity, and distorts the functionality of an enterprise. In our opinion, this definition incorporates the various theories and perspectives of political risk as they affect business organizations. In other words, it allows us to examine political risk from the perspective of

> "the business attitudes of government, ruling party, and opposition (legal and illegal), and the effectiveness of government bureaucracy" [10]

Nature, Sources, and Drivers of Political Risk

In an attempt to differentiate between political risk and country risk, Holt emphasizes that both terms imply neither identical nor mutually exclusive meanings, but that both business executives and diplomats look at the same variables when assessing risks. It is indeed true that political risk connotes the blowing up of oil pipelines, kidnappings, piracy, and other forms of riots that enjoy wide and sustained coverage from the press. **But businesses face a host of other political risks that are not usually given the attention they deserve by the mainstream media. Whereas community disturbances**

against an Indian garment firm in Lagos, Nigeria may not hit the headlines, the kidnapping of an American oil worker in the creeks of the Niger Delta region of Nigeria will be given sustained media attention across the globe.

By nature therefore, political risk derives its being from country risk. That is why local firms are not completely insulated from political risk because the fall-out of politically-induced social upheavals such as the social movements currently rocking some countries like Iran cut across all businesses in that country. Also, political risk transcends national boundaries; disturbances in one country sometimes spread to neighboring countries (the case of the refugee situation in Niger republic that spilled over to Nigeria).

Several reasons may be advanced as the causes and drivers of political risks. In the words of Daniel and Radebaugh[11], political risk may come from wars and insurrections, take-over of property, and /or changes in rules. Other researchers cite government intervention as a major source of political risk. The literature also describes the multidimensional facets of political risk. On the micro level, such events as war, political turmoil and social risks have been classified as political risk. On the micro level (where multinational corporations encounter the greatest risks) such events as intervention of host government and other non-governmental actors, have been identified as political risk. According to Simon political risk can be caused by internal, external, social and governmental sources. Building on Simon's analysis, Alon and Martin[12], argued that the sources of macro political risk are internal and external and are related to societal, governmental and economic factors.

This argument is further confirmed by Clark and Tunaru[13] when they noted explicitly that the nature of political risk is such that it is random and its sources are many and varied where each of the multiple sources are also dependent on one another. For example, the removal of oil subsidy leading to increases in the prices of petroleum products can lead to civil unrest that hurts the oil companies and the country's economy. This can in turn cause the government to issue directives that satisfy labour/populace demand which in the end can hurt the oil companies badly. In this article however, we shall limit our discussion to the two most compelling drivers in our time, namely, elections and contestations amongst key players in the polity, and radical changes in political ideological position by a new government.

Elections

Each time there is an election into public office in any country in the world, there is an attendant political tension. Put differently, elections or rather the outcome of elections drives the perception of political stability or the lack thereof. In new democracies in particular, the tension usual results in political turmoil which is a major cause of political risk. There are a number of cases around the world where the announcement of the results of a tensed political contest triggers orchestrated unrest in a magnitude inimical to business survival. For example, events in Nigeria 1993, 2007, and 2009, Sierra Leone, Zimbabwe, and more recently Iran 2009 attest to this claim. The contestation among political groups over power and resources through the political process is a common phenomenon in all democracies. However, politics in which contestation is high is indeed a double-edged sword.

As Phillips[14] puts it, such regimes may be more stable given the incorporation of diverse groups in the democratic process. However, policy stability may be adversely affected if groups that gain power have widely divergent preferences. Furthermore, the understanding of a country's political institutions and the interaction among players within different institutions is critical to determining the salience of political risk events. This position tends to corroborate Stoner & Freeman who opine that political risk is the possibility that political changes, either in the short or long run, will affect the activities of an organization doing business in foreign countries.

Changes in Political Ideology

Major Western democracies such as the U.S.A., France and the U.K. are divided along two core and predictable ideological lines, namely, conservatism and liberalism. In other parts of the world, especially the emerging democracies in Africa, Latin America, and parts of Asia, political parties are often not formed on the basis of common ideology; rather they are formed on the basis of marriages of convenience between the key political players. For example, the People's Democratic Party (PDP) in Nigeria was not founded on any political ideology or democratic agenda. Instead it was and it is a committee of likeminded Nigerians whose sole aim was and is to retain control of State apparatus and machinery of governance. It is for this reason that businesses became really concerned when the relationship between former

President Obasanjo and his deputy Abubakar hit the rocks prior to the 2007 elections.

Beyond the Nigerian experience however, there are such cases as that of the Democrats winning the U.S Presidential elections in 2008, and controlling congress as well. The political ideology of the Democrats is totally different from that of the Republicans. For some big businesses in the U.S.A., this development constitutes political risk especially for defense contractors, and oil majors. The same argument holds true for countries such as the U.K., Germany, France, Canada, etc. For example, when the conservative party took power under Margaret Thatcher, social institutions such as the labor unions felt the full weight of a political U-turn. The coal miners union under Author Scagil was dealt a debilitating blow when secondary picketing was used as a political tool to diminish the powers of the miners union. In other words, changes in political ideology mean changes in fundamental business environment since the policy thrust of the government in power will be a true reflection of that government's political ideology.

Why Political Risk Matters

Researchers have identified political risk as a major driver of international capital volatility and of risk premiums on borrowing rates. What this means is that perceptions of political risk condition investors' willingness to invest in developing countries particularly because politics plays a major role in the allocation of aid. Thus, quite often, the flow of aid is sensitive to the perception of political risk and stability. Furthermore, since the theoretical literature also emphasizes government intervention as a major source of political risk, businesses are keen to constantly analyze governmental utterances and actions.

In order to remain afloat therefore, business entities routinely assess situations that are likely to trigger political risk. Fundamentally, due to the volatile nature of political climate in most countries, businesses routinely adopt three broad approaches to predicting political risks. Whereas some businesses rely on the analysis of past patterns of political activities in a country or region, others apply the opinion analysis framework where various categories of political conditions are rated over different time frames. Yet another group of businesses may chose to employ the instability assessment technique where risk models are developed based on instability measurements. The action of attempting to predict political risk attests to its overbearing importance especially in an international business setting.

The obvious implication here is that any business that ignores political risk in its business plan does so at his/her peril. Nothing can be more damaging physically and psychologically than a government take over of a company's property or the kidnapping of a firm's employee. Each time there is a political turmoil, foreign businesses tend to cross their fingers and only but hope for the best. The situations in the Niger-Delta region of Nigeria where agitation for economic emancipation is growing louder by the minute, followed by gun battles and hostage takings demonstrate the treacherous consequences of political risk. Due to the political instability in that region, Shell Petroleum, the largest oil prospecting firm in the region is currently operating at less than twenty-five percent capacity. Whether it is in Namibia or Nicaragua, Lisbon or Lebanon, Taipei or Teheran, political risk is too significant and complex to be ignored.

Implications for Strategic Management Processes

As a rule of thumb, managers of international organizations must comply first and foremost with their home-government laws and regulations before attempting to deal dexterously with the laws and regulations of the host country government. Quite understandably, foreign businesses should not only seek to know but to also understand the political priorities of the host-country governments. Again, such businesses should also understand if there are any frosty relationships between their home government and their host-country government. But following the present economic meltdown, businesses should be prepared to deal adeptly with a number of other challenges that have characterized political risk in recent times. They include:

- Increases in political terrorism
- Social inequalities arising from world debt crises
- The North-South question
- Poverty and Disease

These challenges and the several variants of the four themes identified above caused researchers to develop a number of measures aimed at managing or ameliorating political risk. These measures are broadly categorized as :

- defensive strategies, and
- integrative strategies.

These measures provide the first line of defense and take the sting out of the pangs of political risk in a measure strong enough to allow the business to survive. Where these measures are lacking, businesses are more than likely to fail under the full weight of the catastrophic consequences of political risk.

Under the defensive strategy, businesses strive to maintain control by creating multiple vendors in host and third countries, distributing operations, maintaining high debt leverage, shifting risk to host country with government guarantees, and the repatriation of profits and insuring operations. Businesses also attempt to mitigate political risk via the integrative approach. This is where businesses localize their image and activities by investing in local logistics, engaging local executives, sourcing materials and services locally, and localizing debt and investment assets amongst others (see Holt[2]).

As with most other problems in business, there are several strategies that may be applied in attempting to minimize or contain political risk that is inherent in business. By the same token, the political environment is not amenable to a one cap fits all therapy. To the extent possible businesses rely on a combination approach in most cases, depending on the terrain and the nature of all anticipated political risk factors. However, current research findings (Keillor, Wilkinson, & Owens[15], Khattab, Anchor[16], & Davies, and Yongqiang)[17] reveal that international organizations are tilting more towards the integrative approach. They are reinvesting a good proportion of their profits and local revenues. They are also committed to discharging their corporate social responsibilities honestly and respectfully, and more importantly hiring more host country executives. From the foregoing therefore, we suggest a modified integrative strategy where foreign businesses retain home country control on corporate executives, and partially shift risk to home country via government guarantees. To the extent possible, foreign businesses should configure activities that leave them with many such options that do not compromise benefits derivable from foreign operations.

Summary and Conclusions

Accompanying the emergence of the global economic crisis, political risk is again attracting the attention of scholars. This paper finds ample theoretical and empirical evidence that political risk is an integral part of business. Our analysis of the varying perspectives of political risk allowed us sufficient latitude to incorporate the various associated elements of risk into our working definition of political risk. After defining political risk as any politically-induced event that has destabilizing effects on the polity, and distorts the functionality of an enterprise, we identified other challenges that characterize political risk to include; increases in political terrorism, social inequalities, the North-South question, as well as poverty and disease. Together, they provide opportunities for wars, insurrections, government takeover of assets, bombings, and hostage takings amongst others; all of which are inimical to business success. For these reasons, businesses tend to apply either defensive strategies or integrative strategies in order to ameliorate such political risks that may cripple their operations or out rightly destroy their businesses. Due to the limitations of either strategy, we recommend the adoption of the modified integrative strategy for managing political risk. This is consistent with recent research results in this area of study.

REFERENCES

1. Williams, C., **Effective Management: A Multimedia Approach** (Cincinnati, Ohio: 2002)
2. Holt, D., **International Management: Text & Cases** (New York: 1998)
3. Kobrin, S. J., Political risk: A review and recommendation, **Journal of International Business Studies** (44: 1979)
4. Fitzpatrick, M., The definition of political risk in international business: A review of the literature, **Academy of Management Review** (8: 1983)
5. Truitt, J. F., **Expropriation of Private Investment,** Indiana Division of Research. Graduate School of Business (Indiana University, 1974)
6. Frynas, J. G and Mellahi, K. (2003). Political risk as firm-specific (dis) advantages: Evidence on transnational oil firms in Nigeria, **Thunderbird International Business Review** (45: 2003)
7. Robock, S. H., Political risk: Identification and assessment, **Columbia Journal of World Business** (6: 1971)

8. Simon, J. D., Political risk assessment: Past trends and future prospects, **Columbia Journal of World Business** (8: 1982)
9. Howell, L. D., **The Handbook of Country and Political Risk Analysis (3rd. ed.)** (East Syracuse, NY; 2001)
10. Stoner, J. A. and Freeman, R. E., **Management: Annotated Instructor's Edition. (5th. Ed.)** (New Jersey: 1992)
11. Daniel and Radebaugh, **International Business Environment and Operations** (New York: 1995)
12. Alon, I. and Martin, M.A., A normal model of macro political risk assessment, **Multinational Business Review** (6:1998)
13. Clark, E. and Tunaru, R., Quantification of political risk with multiple dependent sources, **Journal of Economics and Finance** (27: 2003)
14. Phillips, L., Assessing Governance - How can Political Risk Analysis Help?, **Opinion Overseas Development Institute** (UK, 2006)
15. Keillor, B. D., Wilkinson, T. J. and Owens, D., Threats to international operations: Dealing with political risk at the firm level, **Journal of Business Research** (58: 2005)
16. Khattab, A. A, Anchor, J. R. and Davies, E. M., Managerial practices of political risk assessment in Jordanian International Business, **Risk Management** (10: 2008)
17. Yongqiang, G., Managing political risk in cross-national investment: A stakeholder view, **Singapore Management Review** (2009).

Statement about ownership and other particulars about
Journal of Financial Management and Analysis
International Review of Finance
Form IV, see Rule 8

1. Place of publication : Mumbai, India 2. Periodicity of Publication : Half Yearly 3, 4 & 5. Printers's, Publisher's and Editor's Name : Prof. Dr. M. R. Kumara Swamy Whether citizen of India : Yes. Address : 15, Prakash Co-op. Housing Society, Relief Road, Santacruz (West), Mumbai-400 054, India. Names and addresses of individuals who own the newspaper and partners of shareholders holding more than one per cent of the total capital : Prof. Dr. M. R. Kumara Swamy and address as in nos. 3, 4 & 5.

I, Prof. Dr. M. R. Kumara Swamy, hereby declare that the particulars given above are true to the best of my knowledge and belief.

Sd/-
Prof. Dr. M. R. Kumara Swamy
Publisher and Managing Editor