

## RISK ASSESSMENT FOR INTERNATIONAL INVESTMENT

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### ABSTRACT

This paper introduces a new approach to risk assessment for international investment. The process allows a risk analyst to include both qualitative and quantitative factors in his analyses. Furthermore, this approach provides an excellent framework for discussion and exchange of ideas among the decision makers involved in risk assessment.

### INTRODUCTION

Dramatic increase in international trade during the past two decades and increasing political instability of the third world countries have forced the multinational firms to devote more time and resources to risk assessment. In the past decade we have witnessed that international business can be affected by wars, revolutions, coup d'etats, social unrest, third world debt crisis, and terrorism. Some firms have been forced out of the third world countries without a reasonable compensation.

Risk assessment is not a new subject to multinational firms, but increasing complexity in global environment make risk assessment virtually impossible without a proper systematic technique. Numerous factors of political, legal, socio-cultural, economic, financial, and technological nature must be considered before a firm makes a commitment to enter a country. The risks involved varies from country to country and is dependent upon the product or services offered by the firm. Thus, the challenge facing the management of a multinational firm is to develop their own systematic method by which they can assess the risks involved in a particular operation.

The primary objective of this paper is to provide a framework within which a firm can analyze all the crucial factors affecting its business abroad and make a logical decision in a short time. The uniqueness of this approach is that the management of a multinational firm can incorporate their own judgments and the judgments of other experts in the model.

## FACTORS AFFECTING INTERNATIONAL BUSINESS DECISIONS

### Sociocultural Factors

Culture has been defined as "that complex whole which includes knowledge, belief, art, law, morals, custom, and any other capabilities and habits acquired by man as a member of society." (Taylor, 1889). It is a comprehensive concept, encompassing the variables that influence the way individuals think and behave. Cultural patterns are learned by members of a society through socialization and these learned patterns influence consumers' beliefs and values.

Values and beliefs that are widely accepted by members of a society serve as a guide for the establishment of cultural norms which specify appropriate behavior for the society's members.

Culture is dynamic in nature and cultural differences must be one of the main factors considered in international business decisions. Wheeler and Hunger in their book Strategic Management and Business Policy stated that "differences in languages and social norms will affect heavily the marketing mix for a particular country. Product presentation, packaging, distribution channels, pricing, and advertising must be attuned to each culture."

A multinational firm must be well aware of the impacts of their products on the host country's religious values, morality, values about work, family, leisure time, etc.

Van Mesdag lists three international marketing strategies: SWYG - "sell what you have got," SWAB - "sell what people actually buy," and GLOB - "a global response to emerging needs." This author also stated that since language, level of education, and attitudes toward marketing in general often serve as cultural barriers to conducting original product research in less developed countries (LDC), the SWYG strategy has been popular in LDCs. However, it has also been the most common source of international marketing failure (Van Mesdag, 1985).

The way business is conducted is also determined by the cultural environment. Lee suggests that "the unconscious reference to one's own cultural values is the root cause of most international business problems overseas." This unconscious reference to the cultural values of one's home-country is termed self-reference criterion, or SRC.

The international manager must also be able to differentiate between cultural imperatives or business customs that must be complied with; customs that are inappropriate for a foreigner to emulate; and behavioral areas where adaptation is not required but is acceptable (Cateoria, 1983).

### Economic/Financial Factors

The economic system of a country would be a major determinant of the market potential of a host country.

"Licensing, acquisition, and joint ventures may be restricted severely by such a host country. In addition, in most countries inflation and currency exchange rate create further difficulties for a MNC." (Wheeler and Hunger, 1986). Lack of reliable and adequate information in most developing countries has always been a problem for MNCs.

Other economic factors affecting international business decisions include the economic infrastructure of the host country: road conditions, adequate modes of transportation, storage facilities, and efficient communication systems. Also economical access to physical and human resources, product standardization, and existence or lack of appropriate technology are major determinants of production costs.

Financial risks encountered in doing business internationally include commercial risks, political risks, and foreign exchange risks.

### Political Factors

A country's political environment encompasses diverse elements including political structures and institutions, cultural temper, power centers, bureaucracy, internal civil strife, relations with neighbors, religious cohesiveness, framework within which decision-making is established, structural growth, acceptance of the status quo by the popular, and government attitudes towards foreign investment. Although political environments characterized by uncertainty and instability may be considered too risky for initial entry, change in the political environment does not necessarily connote instability. More important to the marketing manager is the frequency and character of change.

Robock (1971) defines political risk as follows:

Political risk in international business exists (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate, and (3) when they result from political change. To constitute a risk these changes in the business environment must have the potential for significantly affecting the profit or other goals of a particular enterprise.

political risk is dependent on the role of the host government in fiscal policy, monetary policy, exchange rate, trading policy, and interest rates. Forms of political intervention by the host country include expropriation, confiscation, domestication, exchange controls, price controls, tax controls, market control, import restrictions, and labor restrictions. These actions may be taken either arbitrarily or discriminatorily (Densmore, 1982). Corporate citizenship may pose an additional risk.

Risk may be further categorized as country specific, caused by instability within a country and by uncertain and/or unchanging attitude towards foreign investment; industry specific, caused by changes in host government policy towards foreign investment in a business of strategic national importance; or project specific, where changes in policy affect the marketability and profitability of a particular project (Bhalla, 1983).

Current methods of determining political instability within a country include Delphi techniques, "grand tours," "old hands," and quantitative analysis. Ways of minimizing risk include joint ventures, licensing technology, and predetermined domestication. In addition, political risk insurance is available to provide protection against risks of war, revolution, civil strife, and currency inconvertibility.

#### Legal Factors

International firms must be concerned not only with legal system of the home country but also of the host country. Although legal trends include movement toward international cooperation, there is no common body of international law at this time. In some countries laws function only as guidelines; in other countries they are very specific.

Elements of the marketing environment subject to legal problems include anti-dumping laws, laws affecting advertising, hiring, firing, promotional activities, product quality, packaging, amount of competition, price setting, patents, trademarks, taxes, tariffs, licensing, and repatriation of profits.

Legal systems of countries are based on either common law or code law. Common law is based on precedents while code law is based on a system of detailed rules, or codes. Interpretation of industrial property rights and "acts of God" differs between the two systems. For example, under common law, ownership is based on prior use and "acts of God" are usually considered to be acts of nature such as floods and earthquakes. Under code law, ownership is established by registration and "acts of 'god'" are not limited to acts of nature but include such things as riots and labor strikes.

Jurisdictional Clauses in agreements between the international firm and the host country settle the question of which laws apply if there is a conflict of interest (Cateora, 1983). Absence of such a clause may necessitate litigation or arbitration, with most disputes being settled

by arbitration. Organizations available for arbitration hearings include the International Chamber of Commerce, the American Arbitration Association, the Canadian-American Commercial Arbitration Commission, the London Court of Arbitration, the Inter-American Commercial Arbitration Commission, and the International Center for Settlement of Investment Disputes.

#### Technological Factors

Technology is part of the material culture of a country and as such there is the potential for conflict between traditional values and emerging values brought as a result of the new technology. In addition, the effects of an ethnocentric orientation should be considered. The main question here is the determination of appropriate technology to be used in a host country.

In the past, most MNCs were equity-based where managerial control was based on ownership. In recent years, however, many LDCs have been aggressively seeking new technology, which is perceived to be the key to country development. This has resulted in the emergence of technology-based MNCs where managerial control is based on expertise and technology. Included are management contracts, transfer of technology, production sharing arrangements, and industrial lease agreements (Kolde, 1985).

#### Physical Factors

A country's physical environment includes such factors as climate, natural resources, topography, territorial size, and lakes and rivers. Also included is capital formation through investments in infrastructure (Kolde, 1985). Climate features must be taken into consideration in product development and product modifications may be required due to extremes in topographic and climatic variations. Natural barriers increase costs of distribution both financially and in terms of opportunity costs. Natural barriers within a country may create barriers to effective and efficient communication.

#### Availability of Resources

Availability of, and economical access to physical and human resources is important to the international firm. Firms with extractive operations abroad especially need systematic political risk analysis to provide timely warnings of adverse changes in foreign government or of political instability (Coplin; O'Leary, 1983). In addition, there are often barriers to entry.

The international manager must make decisions regarding the range of responsibility management has towards employees, policy toward international labor unions, training of foreign nationals, and whether pay scale and benefits should be at, above, or below the market level of the surrounding business community.

Changes in the labor force may trigger the potential for instability in a nation. Causal factors include a decline in per-capita income of the lowest economic group; urbanization of labor force, leading to a "jobless proletariat" vulnerable to "populist ideas"; a surplus of workers unable to leave the country; changing demographics of the work force (Densmore, 1982). Turmoil within the labor force may affect the firm directly as a result of labor violence, demonstrations, strikes, riots, or mob violence. Turmoil may also indirectly affect the firm through disruptions in the labor supply which in turn will cause disruptions in commercial activities.

#### Market Factors

Markets, whether domestic or international, need people with desires, buying power, and willingness and eligibility to buy. Data about a foreign market, if available and reliable, needs to be interpreted with specific country in mind. For example, some countries with incomes on a per capita basis equivalent to US may be too small in the aggregate to be profitable; countries with high population may not have the buying power.

Competitive conditions may be more risky than political conditions any opportunities available will be dependent on both the size and competitive conditions of a particular segment. Another opportunity for the international marketer is the identification of latent demand and establishment of a marketing strategy to satisfy it.

Channels of distribution, if they exist at all, must be evaluated for availability, efficiency, and effectiveness. It must fit the character of the company and the markets served. Attitudes and preferences of channel agents must be considered.

Other considerations include: barriers to entry to other market restrictions; a sense of pride where loyalty is to host country products and brands; distribution of demand; availability of international market segments. Supply, demand, and uncertainty factors often contribute to a preference for market similar to the home country. However, as an international firm's experience in other countries increases, reliance on similar market declines (Davidson, 1983).

**Example**

Suppose that company A is considering an important investment in country X. A group of managers responsible for such a decision would get together to construct the decision hierarchy and to make the necessary judgments. The hierarchy considered by this group is shown in Figure 1. To simplify the model, we have considered only a few factors. Obviously, for each decision problem one must include all the important factors affecting that decision.

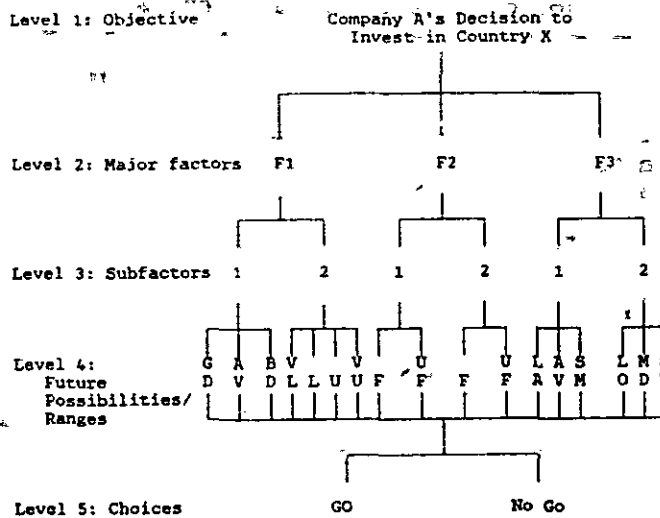


Figure 1. Risk Assessment Model

**Legend:**

**F1: Political Factors**

- 1: Diplomatic relations between the host and home country  
 GD: Good; AV: Average; BD: Bad
- 2: Possibility of nationalization/expropriation  
 VL: Very likely; L: Likely; U: Unlikely;  
 VU: Very unlikely

**F2: Legal Factors**

- 1. Trade regulations  
 F: Favorable; UF: Unfavorable
- 2. Tax laws  
 F: Favorable; UF: Unfavorable

**F3: Market Factors**

- 1. Size of market  
 LA: Large; AV: Average; SM: Small
- 2. Market life  
 LO: Long; MD: Medium; ST: Short

The Decision Process

Step 1 First, the group must prioritize the major factors F1, F2, and F3. The question asked is: which factor is more important for such a decision? (see Table 1).

Step 2 Since the factors are too broad, they are broken down into more specific subfactors. Now we determine priorities of subfactors under each factor (see Table 1).

TABLE 1  
Priorities of Factors and Subfactors

Factors:	F1	F2	F3	Composite Weights
Priorities of factors	0.455	0.091	0.455	
Priorities of subfactors				
F1,1	0.25	0	0	0.114
F1,2	0.75	0	0	0.341
F2,1	0	0.83	0	0.076
F2,2	0	0.17	0	0.015
F3,1	0	0	0.25	0.114
F3,2	0	0	0.75	0.341

Step 3 Figure 1 shows possible outcomes for each subfactor. We must determine the likelihood of each outcome considering the time horizon under consideration. For example, what would be the likelihood of nationalization (F1,2): very likely, likely, unlikely, or very unlikely? (see Table 2)

Step 4 Finally, we must decide that based on our vision of the future, which of the two options is a better choice? "Go" or "No Go?" For example, we ask if the diplomatic relations between our country and the host country is good (GD), which is a better decision? "Go" or "No Go?" Table 3 lists priorities of the "Go" and "No Go" choices and their overall priorities. The final decision is a "Go" (.570) but with the small margin over "No Go" (.430).



TABLE 2  
Priorities of Subfactors and Ranges

Subfactors:	F1,1	F1,2	F2,1	F2,2	F3,1	F3,2	
Priorities of subfactors							
	0.114	0.341	0.076	0.015	0.114	0.341	
Priorities of ranges							Composite Weights
GD	0.09	0	0	0	0	0	.010
AV	0.17	0	0	0	0	0	.019
BD	0.74	0	0	0	0	0	.084
VL	0	0.04	0	0	0	0	.014
L	0	0.07	0	0	0	0	.022
U	0	0.57	0	0	0	0	.196
VU	0	0.32	0	0	0	0	.109
F	0	0	0.75	0	0	0	.057
U	0	0	0.25	0	0	0	.019
F	0	0	0	0.17	0	0	.003
U	0	0	0	0.83	0	0	.013
LA	0	0	0	0	0.64	0	.072
AV	0	0	0	0	0.26	0	.029
SM	0	0	0	0	0.10	0	.012
LO	0	0	0	0	0	0.08	.028
MD	0	0	0	0	0	0.19	.064
ST	0	0	0	0	0	0.73	.249

TABLE 3  
Priorities of Ranges and Choices

Ranges:	GD	AV	BD	VL	L	U	VU	F	UF	F	UF	LA	AV	SM	LO	MD	ST	
Priorities of ranges																		
	.01	.02	.08	.01	.02	.20	.11	.06	.02	.003	.01	.07	.03	.01	.03	.06	.25	
Priorities of Choices																	Composite Weights	
Go	.90	.83	.20	.10	.13	.88	.90	.90	.13	.90	.25	.90	.83	.17	.90	.83	.10	.57
No Go	.10	.17	.80	.90	.88	.13	.10	.10	.88	.10	.75	.10	.17	.83	.10	.17	.90	.43

It should be emphasized that in this method, the process of prioritization is much more important than the numbers resulting from the method. The prioritization process, especially if it is done by a group of experts, would provide a means for discussion and the exchange of ideas and information on the problem among the participants.

The same process could be used to choose a country among a group of alternative countries for investment. In this case, the countries under consideration would form the last level of the hierarchy.

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