

## Chapter 14 Country Risk Management

- 14.1 Country Risk Assessment
- 14.2 Strategies for Managing Country Risk
- 14.3 Country Risks and the Cost of Capital
- 14.4 Summary

## The risks of international business

- **Political risk**
  - is the risk that a sovereign host government will unexpectedly change the rules of the game under which businesses operate
- **Financial risk**
  - refers more generally to unexpected events in a country's financial, economic, or business life

## Political risk

- **Examples of political risks**
  - Expropriation risk
  - Disruptions in operations
  - Protectionism
  - Blocked funds
  - Loss of intellectual property rights

## Financial risk

- **Examples of financial risks**
  - Currency risk
  - Interest rate risk
  - Inflation risk
  - Unexpected changes in the current account balance
  - Unexpected changes in the balance of trade

## Sources of country risk

- **Macro risks**
  - affect all firms in a host country
- **Micro risks**
  - specific to an industry, firm or project in a country

Whether a particular country risk is macro or micro affects the **diversifiability** of the risk

## Assessments of country risks

- Bank of America
- Business Environment Risk Intelligence
- Control Risks Information Services
- Dun and Bradstreet
- Economist Intelligence Unit
- Euromoney
- Institutional Investor
- Moody's Investor Services
- Org for Econ Co-operation and Development
- Political Risk Services
- Standard and Poor's

### Country risks

	Africa	Asia	Europe	Mid East	Americas
A1		Australia	Switzerland UK		Canada
A2	Botswana	HK S. Korea	Japan Germany Italy	Kuwait UAE	USA
A3	Mauritius Namibia	China Thailand	Cyprus Czech Rep	Israel	Chile Trinidad
A4	Egypt S. Africa	India Philippines	Latvia Poland	Saudi Arabia	Mexico Panama
B	Algeria Uganda	Bangladesh Sri Lanka	Slovakia Russia	Egypt Jordan	Brazil Peru Venezuela
C	Congo Kenya	Indonesia Vietnam	Azerbaijan Romania	Iran Syria Turkey	Haiti Jamaica
D	Nigeria Sudan Zimbabwe	Afghanistan N. Korea Pakistan	Albania Ukraine Yugoslavia	Iraq	Argentina Cuba Ecuador

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### Strategies for managing country risk

1. **Negotiate** the environment with the host country prior to investment
  - The **investment** environment
  - The **financial** environment
2. **Structure foreign operations** to minimize country risk while maximizing return
3. Obtain **political risk insurance**

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### Strategies for managing country risk

- > **Negotiate** the environment with the host country prior to investment
  - The **investment** environment
    - Taxes
    - Labor issues
    - Concessions
    - Obligations and restrictions
    - Provisions for planned investment divestiture
    - Performance assurances and remedies
    - International arbitration of disputes

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### Strategies for managing country risk

- > **Negotiate** the environment with the host country prior to investment
  - The **investment** environment
  - The **financial** environment
    - Cash flow remittance
    - Access to capital markets
    - Subsidized financing
    - Corporate governance environment
    - Performance assurances and remedies
    - International arbitration of disputes

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### Strategies for managing country risk

- > **Structure foreign operations** to **minimize risk** while **maximizing return**
  - **Limit the scope** of technology transfer to foreign affiliates to include only non-essential parts of the production process
  - **Limit dependence** on any single partner
  - **Enlist local partners**
  - Use more **stringent investment criteria**
  - Plan for **disaster recovery**

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### Insurable risks...

- Loss is **identifiable** in time, place, cause, and amount
- A **large number** of individuals or businesses are **exposed** to the risk, ideally in an i.i.d. (independently and identically distributed) manner
- The **expected loss** over the life of the contract is **estimable**, so that reasonable premiums can be set by the insurer
- Loss is outside the **influence** of the insured

### Political risk insurance

- Insurable political risks include
  - **Expropriation** due to
    - war
    - revolution
    - insurrection
    - civil disturbance
    - terrorism
  - **Repatriation restrictions**
  - **Currency inconvertibility**

### Political risk insurers

- **Government export credit agencies**
  - **U.S.** Overseas Private Investment Corporation
  - **U.K.** Export Credits Guarantee Department
- **International**
  - **World Bank**
    - Multilateral Investment Guarantee Agency
- **Private**
  - **Lloyd's of London**
  - **American International Group (AIG)**

### Political risk insurance

- **MNCs are self-insured** if their risk exposures are diversified across a large number of countries

### Country risks & the cost of capital

- From shareholders' perspective, only nondiversifiable country risks should affect the MNC's cost of capital
  - Whether a particular country risk is **diversifiable** depends on whether investors are **locally or globally diversified**
- From managers' perspective, country risks are usually not diversifiable
  - This creates an **agency conflict** as managers serve as shareholders' agents

### The evidence on country risks and investors' required returns

- An **increase** (decrease) in country risk tends to be followed by a **stock market fall** (rise)
- Countries with high country risk have
  - **more volatile returns**
  - **lower betas** (systematic risks)

Claude Erb, Campbell Harvey and Tadas Viskanta, "Political Risk, Financial Risk and Economic Risk," *Financial Analysts Journal*, 1996.