CHAPTER 4

RISK IN BUSINESS ENVIRONMENT

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INTRODUCTION: TYPES OF BUSINESS ENVIRONMENT RISK

Broadly defines, risk is a state in which the number of possible future events or outcomes is larger than the number of events or outcomes which will actually take place. Risk is manifested in the probability of loss or damage to a business firm. The dynamic business environment which is the resultant of a number of national and international macroeconomic and microeconomic and economic and non-economic factors conceals within its folds a variety of risks affecting individual firms. It is not possible to identify and assess the risks until one has a proper understanding of the current state of the environment and its leading determinants. There are basically seven types of major risks that can be identified:

- ***Legal risk,*** arising from legal challenges or changes in law;
- ***Regulatory risk,*** arising from regulatory design and its changes;
- ***Political risk,*** resulting from political changes;
- ***Social risk,*** emanating from social attitudes, perceptions and mores;
- ***Direct environment risk,*** resulting from those environmental risks that have a direct impact on business firms;
- ***Indirect environment risk,*** resulting from environmental risks that have indirect impact on business firms; and
- ***Natural risks,*** associated with natural catastrophes likes earthquakes, floods and fires.

Though these risks are identifiable, it is difficult to assess the level of each type of risk in a business environment. These risks keep on changing and a firm's reaction or response depends mainly on its own perception of assessment of risk. All business rganizations are not equally exposed to these risks. The environmental risk is different for different firms depending on their technology, product mix, and area of operation, internal working, financial structure and relative position in a market.

METHODS OF ASSESSING ENVIRONMENT RISK

Risk assessment is both an important and a specialized task. Medium and small enterprises don't have risk assessment system as it involves substantial resources, information and expertise, which increases costs. Such firms are generally not able to afford such costs. Large domestic firms and multinational enterprises are more aware about the risk factors and make efforts to reduce them. Many banks and financial institutions are already developing risk-based management system. In India, all the scheduled commercial banks have been required by the banks to develop full-fledged risk based management systems by the year 2005 and they will also be required to maintain data on assets in the risk-weighted form. While calculation of business risk is internal to a firm, a risk-conscious firm must be able to assess the business environment, from inside or outside sources, as it substantially affects its overall risk profile.

Some of the main environment risk assessment methods of concern, both to domestic and foreign firms, are as follows:

CHECKLISTS

These consist of a number of economic, social and political variables which affect the business environment and point to some risk element in it. The lists also contain points relating to the various issues that the country is facing. Such lists may contain items like the variability in national income, fluctuations in rate of interest, inflation rate and the exchange rate, variations in stock exchange indicators, fluctuations in foreign investment inflow, movements in foreign exchange reserves and a number of other macro and micro-variables which are relevant for risk assessment. This method gives a rough approximation about the business environment risk and the future outlook. Using the same checklist, risk level can be compared for the same country for two different points of time or for two or more different countries at the same point of time.

EXPERT-BASED SCORING SYSTEM

In this method, questionnaires designed to assess environment risk are sent to acknowledged experts and their opinions, observations and comments are obtained. The different parameters are rated on the basis of score assigned to each question or item in the questionnaire. These scores are averaged or aggregated to obtain a risk index which can be used for inter-temporal or cross-national comparisons. Sometimes, in addition to experts, questionnaires are sent to business executives, prominent citizens or social leaders, banks and even government officials. A variant to this method is the Delphi Technique in which a panel of experts is constituted and they are asked to give an assessment or prediction of risk, individually and separately. Confidentiality and independence is ensured so that one expert's opinion is not, in any way, influenced by the others. Consensus or average opinion is conveyed to all the panelists and dissenters are invited to justify their opinion and modify their response, if they want to. The process may be repeated and the final response is recorded as risk assessment.

ECONOMIC METHODS

Such methods are complex and sophisticated and are used to quantify economic risk and related aspects. These methods are used both for estimation and forecasting. In such methods, we first identify the factors (called independent variables) which affect environment risk (called dependent variables) and establish a model of their cause-effect relationship. The relationship is specified in a functional form usually stated as a mathematical equation (which may be in linear or non-linear form), which involves certain parameters whose values are estimated. In this approach, it is possible to state, quantitatively, the strength of each variable (or causative factor) that affects or determines business environment risk. Econometric methods have high forecasting value. However, the reliability of the estimated and forecast values of an econometric model greatly depends on the reality and the validity of the assumptions on which it is based.

RATING AND RANKING SYSTEMS

This system is very close to the scoring system. Country rating is done on the basis of a number of economic, financial, political and social parameters. Each of these parameters is weighted

according to its importance in the total environment risk. The weighted parameters are assigned scores according to some pre-set guidelines and different countries or different sectors within a country are rated and ranked on a scale. Many banks provide these services to their clients who are prospective investors in domestic or foreign markets. Bank of America, for example, maintains World Information Services (WIS) through which it provides national and international economic analyses and forecasts to its customers. These analyses are provided through various reports like Country Outlooks, Country Data Forecasts and Country Risk Monitor.

Assessment of Country's Creditworthiness

Creditworthiness of a country figures among the leading indicators of its business environment risk. Countries with unsustainably large internal and external public debts are poor destinations for investment. The probability of economic restructuring, overhaul of major macroeconomic policies and application of adhoc emergency measures is high in such countries. Countries like Mexico, Argentina, and Brazil are examples of such countries. In countries with large internal debt, firms usually fear higher taxation, public sector disinvestments, reduced expenditure on infrastructure and excessive bureaucratic control. High external debt attracts policies for import control, exchange controls and restriction on outward remittances. Some of the major indicators of a country's creditworthiness are taxes as proportion of GDP, fiscal deficit, debt services as percentage of GDP and exports, import restrictions, balance of payments deficit and exchange controls. These data are compiled by almost all the countries of the world and are easily available.

Risk Benchmarking

In this method, the risk level of a normally functioning healthy economy with major environment factors in the acceptable range is ascertained and selected as a benchmark. Then, using the same criteria, business environment risk of a particular country is calculated and compared with the benchmarked risk level. The difference between the actual risk level and the benchmarked risk as per cent of the benchmark risk is taken as an indicator of the relative riskiness of the environment of the country. Thus,

$$r_r^1 = \frac{r_a^1 - r_b^0}{r_b^0}$$

r_r^1 = relative riskiness of country 1; r_a^1 = actual (absolute) level of business environment risk of country 1; r_b^0 = absolute business environment risk of the reference country; 0 taken as benchmark. The reference or the benchmark country may lose its status as such if the level of business environment risk rises substantially in the subsequent year.

Risk Premium on Interest

The prevailing interest rate in the economy can be taken as an indicator of environment risk. In developed international markets, London Inter-Bank Offer Rate (LIBOR) can be taken as a risk free rate on inter-bank loans. As lending risk increases, higher rate of interest is charged. So the difference (called spread) between the average rate of interest at which a country receives foreign

loans and the LIBOR shows the risk premium and it provides an indicator of the overall business environment risk in that country. Within the country, the average rate of interest prevailing in the market is generally higher than the bank rate (set by the central bank of the country) or the prime-lending rate set at narrow margins by different scheduled commercial banks. So the difference between the actual average rate of interest and the bank rate (or alternatively, the average of the prime lending rates of commercial banks) can serve as an indicator of general risk in business environment. Recognizing that the market rate of interest is also affected by loan maturity and loan volume, the effect of these factors has to be removed to calculate spread and risk premium. Euromoney magazine has developed the following formula to make this adjustment:

$$SI = \frac{v.s}{EI(v.m)}$$

Where SI = spread index; v = loan volume ; s = loan maturity; EI = Euromoney Index; m = loan maturity.

The formula is usable by foreign investors to find out the spread risk as an indicator of general environment risk in a country and to compare it with other countries index. For domestic investors, spread can be benchmarked to the bank rate, average prime lending rate or yield rate on government securities, which are regarded as riskless assets.

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COUNTRY RISK ANALYSIS

Country risk analysis is basically concerned with the performance of an economy and the behaviour of the government and the institutions which determine the business environment. It takes a holistic view of the economy and its working. The analysis requires application of economic theory and concepts to the practical macroeconomic situations and its determinants and agents of change. Foreign companies intending to make investment in specific industries conduct economic and social analysis up to the sectoral level to gauge the risk to the extent possible. Every investor makes his own analysis and assessment and the element of subjectivity is large. Nevertheless, the analysis is largely in quantitative terms and much less rigorous as compared to econometric and advanced statistical studies.

For an individual firm, this form of environment risk is the risk that is associated with having transactions and acquiring assets in a particular country. The risk is manifested basically in the economic fluctuations that could be the result of the vulnerability of the economy to changing economic circumstances, poor economic policies and their implementation or adverse movements in social and political circumstances.

SOURCES OF COUNTRY RISK

Major sources of country risk are contained in sharp or frequent swings in content, objectives or implementation design of macro policies including monetary policy, fiscal policy, anti-inflationary policy, exchange rate policy, foreign trade policy, policy towards foreign investment and multinational corporations, industrial policy, agricultural policy, income policy and policy towards major social

sectors. Within this broad area, the specific sources of country risk are identified in **Table 4.1**:

Domestic Economic Sources	Domestic Social and Cultural Sources	External Sources
• Changes in industrial licensing policy • Variations in price controls • Taxation and subsidy changes • Governance standards • Changes in environment regulation • Fiscal deficit and internal debt growth • Changes in competitive environment • Variations in interest rate structure and credit control • Changes in government expenditure and investment • Variations in national income and sectoral contribution • Inflationary pressure • Demographic changes • Changes in income and wealth distribution • Infrastructure growth and maintenance • Changes in industrial ownership patterns • Changing pattern of industrialization • Growth of unemployment and poverty • Technological developments • Changes in the growth and pattern of distribution channels • Changes in the coverage and attitude of media towards business.	• Changes in family patterns (nuclear, joint and extended families) • Family dynamics (parental roles, male/female roles, marriage, kinship and courtship) • Changes in quality and level of education • Changing nature of social organisations • Changing religious, ethical and aesthetical values • Changes in lifestyles and living conditions (including food, nutrition, sanitation, hygiene, housing, clothing, recreation and health care, use of mode, gadgets and devices) • Language factors (covering official language, use of international languages, particularly English, trends in spoken versus written language and dialects) • Economic nationalism	• Changes in balance of payments and its constituents • Variations in foreign exchange resources in relation to imports • Conditions on repatriation of profits and other remittances • Growth rate and variability of exports and imports • Changes in composition and direction of exports and imports • Changing volume, pattern and direction of foreign investment inflow • The extent and pattern of presence and dominance by multinational corporations • Policy changes towards MNCs and foreign direct investment • Trade dispute between countries • Bilateral and multilateral economic corporation • Changes in the size of external debt and its servicing • Fluctuations in exchange rates • Exchange controls.

Impact of Country Risk Factors

The various country risk factors impact individual corporate organisations in a number of ways. The effect varies from organisation to organisation depending upon its vulnerability to such factors. Many of these factors are interrelated and exert their joint impact. A fiscal deficit, for example may be followed by increase in taxes and money supply, both further leading to a rise in the rate of inflation. A firm would thus be impacted by these four variables in quick succession. The impact of some of the major factors of country risk are briefly discussed below.

Monetary Policy Swings

Monetary policy affects the supply of money and the cost and availability of credit. Larger supply of money and credit improves liquidity, stimulates demand and lowers the rate of interest. This is often termed as easy money policy and creates favourable business conditions particularly at the time of recession. A low rate of interest encourages both consumer and investment demand, which has favourable impact on various firms producing consumer and industrial goods. Easy money policy is adopted by the central banks generally in the time of slump or recession so that the economy could be revived. In times of inflation, restrictive monetary policy is adopted under which credit and monetary expansion are restricted and the rate of interest is raised to control the surging demand. This policy raises production costs on the one hand and deflates market demand for a wide range of industries on the other.

Economic stabilisation is generally the leading objective of monetary policy though it has important growth effects as well. Nevertheless, a particular design of monetary policy affects different firms differently depending upon their capital structure, production cost structure and the sensitivity of demand to rate of interest on consumer credit and prices. Products like automobiles, entertainment, electronic goods, air conditioners, computers, microwave ovens and refrigerators, the demand for which is heavily based on consumer credit, are substantially impacted by the availability and cost of finance. To reduce the adverse impact of monetary policy changes on selected industries of high national priority (like fertilizers, cement, pharmaceuticals, basic chemicals and sugar), the central bank has a separate tool kit of selective credit controls though which, among other measures, there are separate margin requirements for selected industries for commercial bank credit. Monetary policy is announced once or twice a year though minor variations continue to take place intermittently keeping in view the economic circumstances. Commercial banks, non-bank financial institutions and firms with high debt-equity ratio and working capital requirements are particularly affected by monetary policy changes.

Fiscal Policy Variations

Fiscal policy changes by the government affect tax and non-tax revenues, subsidies, public sector and infrastructure investments, social expenditures and eventually the government borrowing programmes. Fiscal policy is determined by expenditure requirements as dictated by the macroeconomic objectives (like economic growth, price stability, employment growth, balanced economic development, balance of payments stability and welfare) and revenue mobilization. A fiscal deficit (difference between revenue receipts and total expenditure) forces the government to adopt a mix of expenditure reduction, additional taxation, increased non-tax charges and additional borrowings from the market.

Business organisations are impacted by each of the elements of the fiscal mix. As government itself is a big buyer and investor, reduced expenditure means slowdown in government demand and slower growth of public sector infrastructure. The firms whose products are principally demanded by the government or the public sector are generally those which are most severely impacted by austerity measures of the government. Such firms must diversify their markets in times of tight fiscal controls. A rise in commodity taxes like excise duty, import duty or sales tax has a direct positive effect on prices. Taxes increase not only the prices of products on which taxes are imposed but also the prices of all other products that are the taxed products as inputs or intermediates. Thus, additional taxes on a limited range of products have a multiplier effect particularly if they are industrial products. The price of the taxed product for the final user or consumer would rise by less than the amount of the tax if producers or sellers decide to absorb a part of the additional tax in their profits. This generally happens in case of products the overall price elasticity of demand of which is more than unity in the market. At the time of presentation of Union Budget in India, a number of firms producing consumer durables like music systems, computers, electric appliances, air-conditioners book orders for delivery in the post budget period at pre-budget prices or simply sell the products after budget at pre-budget rates. This squeezes the firm's profit margins and those already operating on this margin are pushed into losses.

The borrowing programmes of the government affects firms in a number of ways. Government borrowings siphon off funds from the market, which makes funds scarce to private borrowers and raises the cost of funds. Government borrowings weaken the force of demand as individuals and organisations save in government bonds and other securities. These factors together can reduce the growth of private investment affecting total output and income in the economy. If the resources raised through government borrowings are not invested in productive activities, the growth rate of the economy, other things being equal, may fall creating slump conditions for the business sector as a whole. According to the Budget Estimates for 2001-2002, central government borrowings (including other liabilities) were of the order of Rs 1,16,000 crores which were about 5.1 per cent of gross domestic product and 12 per cent of the total outstanding deposits of all scheduled commercial banks.

Exchange Controls

These controls greatly affect domestic firms with international business transactions and foreign operations of multinational companies as they controls basically emanate from foreign exchange scarcity. Countries with dwindling foreign exchange reserves, persistent balance of payments deficits, mounting burden of external debt or difficulties of external debt servicing are most likely to apply exchange control. The controls may also be applied for reasons of national security, protection of some infant or newly developed industries against import competition, retaliation against unfair trade practices or for conserving foreign exchange.

There is a variety of exchange controls and a government can choose any combination or change the mix depending upon its own wisdom or compulsion of circumstances. There can be multiple exchange rates varying according to the type of transaction or the product or industry on which it is applied. For example, import of luxury goods may be applied high exchange rate to make it costly to domestic consumers and a critical industry input or a consumer good of basic necessity may be applied a low exchange rate to make it cheap or affordable. Similarly a high exchange rate may be used to attract foreign investment and a low rate imposed on outward profit

and other income remittances. Many countries impose controls on currency convertibility. In a large number of developing countries, including India, full capital account convertibility is yet to come about. This restricts international flow of capital. These factors substantially affect profitability, trade competitiveness and foreign collaboration between firms.

Import Controls

These controls are applied when the trade and balance of payments positions are adverse and foreign exchange reserves decline. Import restrictions take place through higher import duties and non-tariff measures such as import quotas, state trading, import licensing, voluntary export restraints (VERs) and orderly marketing arrangements (OMAs). There exist a host of other practices, which a number of countries apply in an indirect or veiled fashion, but very effectively, to restrict imports. These can be highly restrictive health and safety norms, complicated import procedures and documentation complex product testing, specification and standards and import-restricting financial controls.

Firms, both with and without international business operations, are affected by import controls. These controls are often applied to redirect domestic producers and consumers to indigenous sources of supplies but, in the process, these also raise costs. Import controls restrict competition, withdraw motives for technological up-gradation and innovation and eventually breed inefficiency through domestic industry protection. Exporting firms also fear retaliatory import controls abroad. The intensity, direction and duration of the retaliatory measures are hard to predict which induct elements of uncertainty in business. Import control measures are kept regularly fine-tuned in most countries and, in the process, import prices remain volatile. This vitiates business planning of firms using imported inputs. Other domestic firms producing close substitutes of imported materials have great temptation to follow parity pricing which makes domestic input prices to fluctuate in tandem.

Trade-Related Investment Measures (TRIMs)

These measures basically affect multinational companies and their affiliates. There are two principal government measures that affect investments and operations of such companies. One is the local content requirements (LCRs) under which firms are required to use a minimum specified percentage of the local amount or value of raw materials, components or intermediates used to manufacture specific products. The measure is designed to save foreign exchange and provide market to the domestic producers of inputs. This measure is most commonly applied to firms, which are predominantly engaged in assembly operations using imported components. This restriction is applied by developing and developed countries alike. The main problem posed to the concerned firms is that the domestic producers may not be able to provide the desired quality at competitive prices or maintain regular supplies. It may even breed monopolistic tendencies among domestic suppliers.

The other measure is what is called dividend-balancing requirements (DBRs). DBRs provide that the dividend outflow of an MNC must be matched by at least an equal amount of inflow of foreign exchange through exports, foreign investment or other receipts generated by it, within a specified time frame. The basic objective of DBRs is to ensure that the operations of MNCs don't cause a drain on the host country's foreign exchange reserves. The firms, whose foreign

investments are not export-oriented but are meant basically to cater to the domestic demand of the host country, find it difficult to cope with such requirements. To riggle out of the restrictions these firms seek exemptions on various grounds, resort to transfer pricing or simply appear as defaulters.

Price Controls

Business firms resent price controls as these often prescribe maximum price limits or the basis for price determination. Price controls are generally applied by the governments on products of mass consumption and substantial public interest such as cement, sugar, petroleum products, pharmaceuticals and food. The basic objective of price control is to make the products available to masses at reasonable or affordable prices. For this purpose, price controls are often complimented by subsidies and distribution controls. Price controls are also applied on agricultural produce which is price sensitive and seasonal in nature. In India, price support is provided to wheat, rice, coarse grains and sugarcane. Prices of selected pharmaceuticals are regulated through Drug Price Control Order (DPCO). Agricultural Prices Commission and Bureau of Industrial Costs and Prices lay cost and price criteria and standards for a number of products. Similarly there are a number of products in the public sector the prices of which are administered by the government.

For an individual firm, an externally controlled or regulated price takes away 'price' as a vital 'P' from its marketing mix and it is left to compete in the market in non-price areas like customer service, product quality, delivery standards, after sale services and advertising. Price controls discourage domestic and foreign investment in affected areas. Existing firms face constant challenge of market and profit management with this handicap.

Labour Policy and Legislation

Labour policy and legislative support to labour are major factors impacting the working environment of business firms. Labour policy affects wages, working conditions, productivity and industrial peace. In countries where labour unions are strong and heavily protected by government and legislation, firms are reluctant to make new investment particularly in labour-intensive industries. In India there are more than 150 pieces of major and minor legislation covering various aspects of labour. Companies frequently need to adjust the size of the labour force in tune with changes in their market position. In countries where retrenchments and layoffs are impossible or difficult, the existing employee costs become unsustainable in times of recession. The burden can make these organisations uncompetitive. Many firms, particularly MNCs, are not able to take the risk of investing in such countries. Where labour unions are strong, firms often face problems of labour militancy and strikes. Even in routine working, managements find themselves straight-jacketed in taking decisions on labour matters.

POLITICAL RISK ANALYSIS

Political environment is a critical concern area for a business firm as it is capable of impacting its very existence. The political and economic environments are so inextricably interwoven that it is difficult to isolate the two. For this reason, a number of business environment experts use country

risk and political risk interchangeably or regard the former to be covered under the latter. In this Chapter the two are discussed separately for the sake of analytical convenience and better comprehension. There are a large number of economic policy changes which are triggered by political compulsions or considerations and vice-versa.

Political environment is set by the political system, the constitutional framework, external political relations, functioning of the government and the role and behaviour of various political pressure groups. The philosophy of the ruling government plays a dominant role in determining the current political environment. In the present world, international influences exert an important impact on the political environment of a country. The environment is highly dynamic and changes in it can be assessed or predicted only with thorough and rational analysis. With changes in the political environment, a number of firms can suddenly be in business crises.

TYPES OF POLITICAL RISK : ROOT'S CLASSIFICATION

Political risk comes in various forms and manifestations, all of which are nightmares for business firms. A firm could be exposed to more than one type of risk at a time. Root (1982) has given the following classification of political risk.

- ***General Instability Risk.*** This risk emanates from the uncertainty about the future viability of a host country's political system. The political system may change with a change in government either in the normal election process or through such violent means as army revolt, a social revolution, leadership struggles, coups, riots or guerrilla war. Poor countries characterised by poor governance, poverty and exploitation and weak and inefficient governments are more prone to political instability. The instability problem is further exacerbated in countries which are heavily dependent on economic, military and political support from outside.

- ***Ownership Risk.*** It results from the probability that the government might take actions that may lead to erosion in ownership or control in the business firm. There could be the risk of confiscation (government taking ownership of property without compensation), expropriation (government taking ownership with some compensation), naturalization, or domestication (surrendering part or full control in an MNC to nationals of the host country or of a domestic firm to government agency or public sector unit). In India, under the earlier Foreign Exchange Regulation Act (1973), foreign firms were required to dilute foreign shareholding to 40 per cent. A number of firms, unable to comply with the legislation, wound up or sold their units to domestic companies.

- ***Operation Risk.*** The risk arises from the possibility that the government may take some action that might restrict the operations of the firm in production, marketing, finance, human resource management or international business. This could be the result of a new legislation, an exigency of political or economic circumstances or specific disciplinary action against a particular firm. Such a construction might affect a firm's competitiveness or viability.

- ***Transfer Risk.*** This risk applies to MNCs having affiliates in foreign countries or to the domestic firms having international business operations or subsidiaries in the same or foreign countries. The risk arises from the possible actions of a government which might

affect transactions, remittances or transfer of profits, funds or assets between the parent company and its affiliates whether in the same country or abroad. A large number of companies with a network of affiliates are known to practise transfer pricing to save taxes or to artificially give cosmetic effect to the group's performance.

SOURCES AND INDICATORS OF POLITICAL RISK

The major sources or triggers of political risk may now be listed as follows:

- Radical regime change through coups, revolutions, army takeover or regular elections
- Negative media reports
- Pressures from business community for concessions
- Unfair, unethical or exploitative business practices
- Economic crises and bankruptcies
- International economic and political sanctions
- Widespread strikes, lockouts and boycotts
- Civil strife, law and order problems and terrorism
- Border tension, conflicts and international wars
- Rising business disputes
- Flood of counterfeit and unsafe products
- Fiscal crisis and administrative failure
- Consumer movements.

These factors, in their extreme form and at an unsustainable level, are capable of causing political instability making the political environment volatile and risky. What government action these situations will produce is often major or drastic but difficult to ascertain beforehand. The decisions of the governments which are formed by coalitions or which face a strong opposition in parliament can frequently swing. This puts obstacle in the process of business planning of individual firms and makes it particularly difficult for them to invest further. For MNCs, attitude of the host country government and nationals towards foreign enterprise is a major factor in political risk. Social campaigns to shun foreign companies and buy local products can create formidable marketing problems.

CORPORATE STRATEGIES FOR MANAGING ENVIRONMENT RISK

A business firm, for its survival and growth, has to cope with and manage the business environment risk. To a business firm, risk refers to the probability of a large price or rate movement in its assets or liabilities. A business environment, when transmitted to an individual firm, can take any one or more of the following forms:

- ***Credit Risk.*** The possibility that a borrower fails to pay interest, principal or both.
- ***Counter-party Risk.*** The credit risk of creating contractual obligations with third parties.
- *Settlement Risk.* The risk that a transaction will not be settled when it becomes due.
- ***Industry Risk.*** The risk of being in a particular industry classification.
- ***Default Risk.*** The risk that a debtor will not honor his obligation or commitment as per contract.
- ***Market Risk.*** The probability of an adverse change in market prices.
- ***Interest Rate Risk.*** The risk arising from changes in the market interest rate.
- ***Exchange Rate Risk.*** The risk emanating from fluctuations in the rate of exchange.
- ***Transaction Risk.*** Risk resulting from dealing in different currencies.
- ***Translation Risk.*** Risk arising from converting assets and liabilities from one currency into other.
- ***Price Risk.*** Risk associated with movements in the prices of various commodities.
- ***Liquidity Risk.*** The risk that the convertibility of assets into cash will be reduced.
- ***Availability Risk.*** Risk that the new funds will not be available adequately at the time of need.
- ***Performance Risk.*** Risk that assets and liabilities will not perform as per normal expectations.
- ***Spread Risk.*** Risks associated with hedging through cross-market or cross-asset positions.
- ***Underwriting Risk.*** The risk assumed in the process of underwriting. It is the sum of market risk and the risk associated with market response.
- ***Fiduciary Risk.*** Risk associated with actions taken on behalf of the clients.

Most of the risks are in the usual course of business but are substantially increased by country and political risk factors. Different firms have different levels of vulnerability to these risks depending upon the quality of management, nature of operations, market and financial position and the quality of business planning. There are basically three approaches to manage risk - risk avoiding, risk shifting and risk reducing.

RISK AVOIDING STRATEGIES

These strategies involve taking managerial decisions that avoid environment risk. Firms may not be able to avoid environment risk fully but can avoid it to a considerable extent by avoiding the risk-prone areas. Some major approaches towards risk avoidance are briefly described below:

- ***Avoiding Politically-Sensitive Products:*** Firms can avoid the product lines which affect exchange rates, national security and public health or are contrary to the general beliefs and moral values of people. Alcoholic drinks for ladies, adult magazines, firearms and explosives, hormone-treated non-vegetarian foods, late-night clubs are most likely to attract public

criticism and government attention particularly in developing economies. Firms can engage themselves in product lines which are not controversial.

- *Avoiding Sensitive Regions:* Firms can avoid politically sensitive regions and choose safer or more peaceful locations. Multi-plant and multi-product firms are able to avoid risk to a considerable extent.
- *Contractual Agreements:* Another way to avoid risk is to conduct and transact business, as far as possible, on contractual terms. Contractual arrangements are not possible to negotiate in every sphere of business activity but there exist a number of ways like purchase and sale contracts, contract appointments and standby credit arrangements through which environment risk can be avoided.
- *Tie-up with Other Firms:* Firms can avoid risk by not standing alone. Firms in a high environment risk situation may have the strategy of not fully manufacturing a product but only a part of it or process it at a particular stage through horizontal integration with other firms which are less valuable to environment risks. This strategy is particularly suitable to MNCs operating in an environment charged with paranoid economic nationalism or hostile attitude towards foreign enterprise. Similarly, co-production arrangements and marketing tie-ups can be negotiated with the same objective.

Risk Shifting Strategies

Risk can be shifted to other parties through insurance. Depending upon the degree of development of the insurance market, a number of general insurance covers are available to business firms. Some covers like motor vehicle insurance and marine insurance are obligatory. Firms can avail business property insurance, liability insurance, workers' compensation insurance, credit insurance, surety-ships and insurance against such hazards as fire, earthquakes, floods and theft. Against nominal premium costs, such risks can be shifted to insurers. In the era of competition, the range of business insurance covers is gradually expanding. A firm must be able to identify the magnitude of various insurable risks and seek suitable covers.

Risk Reduction Strategies

A number of other strategies are available to a firm that can be deployed to reduce its vulnerability to environment risk.

- *Establishing a Risk Assessment System.* As a pre-condition for any risk reduction strategy, a firm must develop its risk assessment system designed to identify and evaluate environment risks relevant to it. It requires the establishment of market intelligence and early warning system. There has to be a thorough analysis of economic and political developments in the country. Corporate managements must be able to specify the risk which they can take so that that the rest of it could be dealt with through an appropriate strategy.
- *Developing the Local Economy.* In order to develop good public relations around the area of location and to avoid any possible local confrontation and criticism, it is a prudent policy for a firm to contribute to the development of the local economy. The firm may make local purchases, employ local people in unskilled or semi-skilled activities and provide sub-

contracting opportunities to local industrial units. Facilities like local roads, primary school, dispensary and parks may also be developed for the welfare of the local people. This strategy works to enhance acceptance of the firm by the people. MNCs need to do more in this direction so that the alien effect could be reduced.

- ***Local Equity Participation.*** This strategy enhances the acceptability of an MNC in the host country. In this way local residents share the prosperity of a growing company and may provide public support at the time of need. A number of countries make legal provisions regarding the maximum limit of foreign equity holding so that the home investors are able to share the ownership and profits. In case of domestic firms, widely dispersed pattern of shareholding helps them in acquiring national status and reputation. Such firms are generally large and get support from public and investing masses through broad based equity.
- ***Good Corporate Citizenship.*** This is amongst the best strategies to deal with political risk. Firms, particularly those with sufficient resources, must combine civic projects with investment projects. Building hospitals, link roads, minor bridges, water supply and sewerage systems not only help their own commercial projects but also alleviates the financial burden on civil authorities. The proposition might appear expensive in the short run, but in the long run it projects a favourable image of social responsibility and creates a soft corner in government circles. With such an image, a firm may find it easy to obtain licenses, permits, power connections, government land and other facilities from the government easily.
- ***Maintaining Good Political Relations.*** Many business firms find wisdom in maintaining politically-neutral postures but it is commonly believed that business firms must have normal or cordial relations with the political parties in power for having a say in the government. A large number of firms are found to provide silent and financial support to parties having better chances to win in elections. It is a wise policy for the firms to keep special interest groups, social organisations, lobbyists, consumer activists, intelligentsia organisations and the media regularly informed about their contribution to the industry and the society so that their political support could be enlisted in time of need. In the same way, firms can protect themselves by obtaining membership of business associations so that their problems and concerns could be voiced to the government from a common platform.

CONCLUSION

Risk in the business environment is extremely difficult to quantify. However, the firms must observe and monitor global macroeconomic, social and political developments closely and take strategic and tactical decisions accordingly. Rating agencies, media reports, business clubs, conferences and seminars are some of the important sources from where critical insights into the risk component of the environment can be gained. Risk monitoring requires a good understanding of the social, economic and political system of the country. What is important is the realistic and appropriate assessment of risk. An over-assessment may result in no decision on fresh investment and an under-assessment can be hazardous for an existing business. In risk assessment, some element of subjectivity or biasedness will always remain. A growing number of organisations particularly in the area of finance are already developing risk management systems.

Key Terms

Balance of payments
Bank rate
Capital account convertibility
Currency convertibility
Debt-equity ratio
Dividend balancing requirements
Easy money policy
Fiscal deficit
Fiscal policy
Horizontal integration
Inflation
Liability insurance
Local context requirements
London-inter-bank offer rate
Margin requirements
Monetary policy
Multinational corporations
Multiple exchange rates
National income
Orderly marketing arrangements (OMAs)
Price elasticity of demand
Prime lending rate
Public debt
Recession
Risk assessment
Selective credit controls
Spread
Stock exchange
Transfer pricing
Voluntary Export Restraints (VERs)

Supplementary Readings

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Long Questions

1. What are the various types of risk implicit in business environment? Discuss the view that risk emanates basically from the dynamism or instability of business environment.

2. What are the different methods of assessing business risk? Which of the method do you consider the best and why?

3. What are the sources of political risk? Discuss the various factors that determine and affect political risk.

4. What is the purpose of political risk analysis? Explain the alternative sources and indicators of political risk. Comment upon the reliability of political risk indicators.

5. Discuss the alternative strategies available to a business firm to deal with business environment risk.

Short Questions

1. What are the various identifiable risks in business environment?
2. What is the Delphi technique of assessing business risk?
3. How does an investor assess the credit worthiness of a foreign country?
4. How can risk premium of interest be taken as a measure of business environment risk?
5. What is country risk analysis?
6. List five leading domestic sources of country risk.
7. What is political risk analysis?
8. Why should a business manager be interested in understanding country risk and political risk in the country of operation?
9. Give five leading indicators of political risk in a developing country like India.

Practical Assignments

1. Select one business organisation each in the categories of small, medium and large industries. Conduct survey to find out how these firms assess business environment. Discuss the comparative results in the class.
2. Conduct a group discussion on the factors that can he considered appropriate to conduct country risk analysis for India.
3. You represent a multinational company producing non-vegetarian fast food items and intending to establish a chain of food joint in India. Assess the political risk factors and present your decision on investment in the class for discussion.
4. You are a company producing industrial chemicals. Now you intend to enter pharmaceutical business. How will you proceed to assess business environment risk for the proposed new venture?