Political Risk Assessment in International Firms: the "Visegrad Four" Countries

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ABSTRACT

This paper seeks to develop a research proposal in the field of political risk assessment (PRA) in the context of the "Visegrad Four" countries. A literature review – both theoretical and empirical – is presented; based on which the research framework is developed. Previous studies are concerned mostly with PRA in the context of developed countries, and those in the context of transition and emerging economies have been concerned mainly with inward investment; this study will fill the gap in literature by investigating the practices of PRA and its institutionalisation within and between the "Visegrad Four" countries.

INTRODUCTION

Political risk assessment (PRA) is the process of analysing and evaluating political risk while undertaking international business activities. Although political risk per se is often seen as one of the major threats to firms' international business activities, a low standard of PRA undertaken by international firms has been identified in the literature. Such an approach to PRA indicates either resistance by firms to the notion that political risk is amenable to analysis, a lack of awareness of political risk among business participants or that their perception is that PRA is an unnecessary and time-consuming activity given its constantly changing nature and the actual costs of the analysis (Al Khattab et al., 2008).

Nevertheless, the political risk literature suggests that the assessment of political risk is not only possible but it also helps the decision-maker to lower the chance of both property and income losses by the use of appropriate management tools or to avoid them completely. The existing literature also indicates that there is an awareness of international firms' exposure to political risk and that it is considered to be one of the most important risks for their international business activities (Rice and Mahmoud, 1990; Stapenhurst, 1992; Wyper, 1995; Pahud De Mortanges and Allers, 1996; Burmester, 2000; Hood and Nawaz, 2004; Al Khattab et al., 2008).

THE VISEGRAD FOUR

This study is set in the context of the "Visegrad Group" – a group of four Central and Eastern European countries; namely Poland, Hungary, the Czech Republic and Slovakia. The "Visegrad Group" is a "low-profile", relatively closed, political, social, economic and cultural formation for cooperation between its members, which became a role-model for many other formations of its kind e.g. the "Vilnius Ten". Given that these countries together fill a relatively strategic and large part of Europe, and all of them are members of the European Union, Visegrad is sometimes perceived similarly as the Benelux group, i.e. having the power to influence decision making within the EU. In 1992 when these countries achieved to integrate their markets under the CEFTA (Central European Free Trade Agreement) agreement, which was in 2004 surpassed by joining the European Union (Cottey, 1999; Rhodes, 2003; Fawn, 2008; CEFTA, 2009; EU, 2012).

Although it would appear that the "Visegrad Group" countries – given their similar historical background and the direction of their strategies – would be at about the same level of development this is not necessarily the case. There are two major factors which – to a great extent – vary among these countries. Firstly, it is the historic development of countries' economies that differs; for example the transition from centrally planned, communist economies towards open economies where the process in the Czech Republic and Slovakia was different and much faster and more turbulent than in Poland and Hungary. This has had consequences for both the economies and business procedures of the "Visegrad Group" countries (Aybar et al., 2000; Fawn, 2008). The second factor influencing the development and the current status of these countries in the international business arena is the level of FDI into these countries. Given that the most obvious external determinants of FDI within the host-country are predominantly sound macroeconomic bases – which go hand in hand with political, social and cultural stability and the level of democracy, and a sound economy – Poland and the Czech Republic managed to attract the highest levels of FDI (Wieners, 1996; Blonigen, 2005; Birsan and Buiga, 2009; Haksoon, 2010). This sets them ahead of the remaining countries in economic terms. Of the "Visegrad Four" the Czech Republic seems to be the most developed country, and Hungary the least developed one, mainly in terms of social and political stability. The situation in Slovakia is very similar to the one in the Czech Republic; Slovakia however, is the only member of the "Visegrad Group" which is a member of the Eurozone (Kaderabkova, 2006; Alguacil et al., 2008).

The actual research analysis will be based on the differences between these countries. In addition to the "between countries" differences, "within country" differences will also be analysed, given the regional diversity in these countries. The focus on Central Europe will also enable an exploration of how international firms from transition countries perceive and assess political risk and ascertain the reasons for any divergent approaches to political risk assessment (PRA) which may be identified. In the same vein, the researcher will be able to make a comparison between the findings in the "Visegrad Four" countries and previous studies aimed at investment from developed economies.

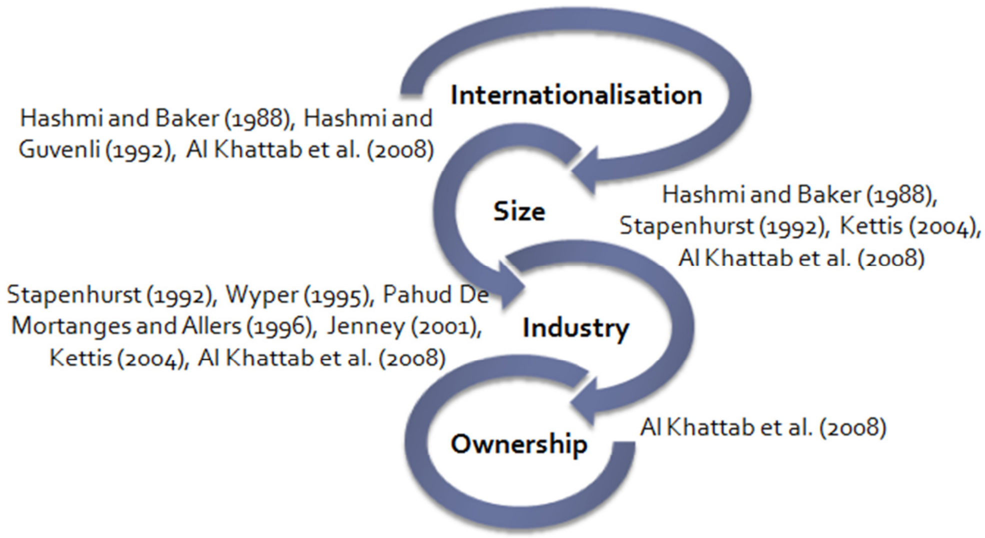
LITERATURE REVIEW

As a result of previous studies – both theoretical and empirical – PRA has been described typically as 'informal', 'unsystematic', 'reactive', 'inadequate' or 'subjective'. In view of this, the term institutionalisation is used to describe the process by which PRA becomes "more explicit and systematic" within a firm. In a 'traditional' firm there is no formal assignment of responsibility for PRA nor is any effort made to assess political risk associated with international business activities. PRA begins to be institutionalised when formal responsibility for its performance is *assigned to a specific individual or group*; is institutionalised further when the *process is 'routinized'*; and in a more institutionalised setting, there is a greater *emphasis on objective assessment*, in addition to subjective assessment (Blank et al., 1980; Kobrin et al., 1980; Kobrin, 1981; Kobrin, 1982; Hashmi and Baker, 1988; Wyper, 1995; Pahud De Mortanges and Allers, 1996; Al Khattab, 2008).

DETERMINANTS OF INSTITUTIONALISATION

The diversity and the nature of potential political risks and the differences in a firm's exposure to political risk may of course lead to different approaches to political risk assessment (PRA). A firm's exposure to political risk is related to its characteristics. The literature on political risk suggests that the extent to which international firms are involved in PRA is correlated with a number of organisational characteristics. These characteristics include: a) a firm's size (Hashmi and Baker, 1988; Stapenhurst, 1992; Kettis, 2004; Al Khattab et al, 2008); b) a firm's degree of internationalisation (Hashmi and Baker, 1988; Hashmi and Guvenli, 1992; Al Khattab et al, 2008); c) a firm's type of industry (Stapenhurst, 1992; Wyper, 1995; Pahud De Mortanges and Allers, 1996; Jenney, 2001; Kettis, 2004; Al Khattab et al, 2008). These three characteristics will be investigated, along with a firm's ownership; a variable which was not taken into account in any of the aforementioned political risk research, other than that of Al Khattab et al. (2008). Figure 1 below provides an overview of these determinants and of previous studies in which these determinants were identified.

Figure 1: Determinants of PRA Institutionalisation



Source: *Developed from the literature referenced*

The following sections will explain in more detail the ways in which the above identified determinants influence the PRA institutionalisation process in firms. However, before specifying the variables employed in this study, it is important to note that these might not be independent from each other, i.e. some of them, e.g. size and ownership, might be correlated. It also needs to be pointed out that not all of the variables will necessarily be of the same importance.

Internationalisation

Internationalisation is probably one of the most important factors among the above mentioned variables. It has been suggested in the previous literature on PRA that the more activities a firm has abroad the more it is exposed to host-country risks. The relationship between the institutionalisation of PRA and the level of firms' internationalisation has been investigated by all Blank et al. (1980), Kobrin (1982), Hashmi and Baker (1988), Rice and Mahmoud (1990), Wyper (1995), Pahud de Mortanges and Allers (1996), Keillor et al. (1997), Keillor et al. (2005), Oetzel (2005) and Al Khattab et al. (2008).

In line with the above mentioned studies the indicators of a firm's level of internationalisation are a) number of years in international business; b) number of countries of functioning; c) percentage of revenue from international business activities. Although these methods are all used to determine and indicate firms' level of internationalisation their relationship with PRA institutionalisation is not explicit. For example, in the case of "years in international business" higher values would suggest a higher level of internationalisation; however it has been pointed out by Kobrin (1982) and Oetzel (2005) that the experience will result in a reduction in risk perceptions over time. The results are quite consistent for the "number of operating countries" and the "foreign revenues" where a significant positive relationship with PRA institutionalisation has been found for both of these variables (Al Khattab et al, 2008). However, as Iankova and Katz (2003) suggested, the diversification of firms' activities across multiple markets can lead to the offsetting of losses and gains by portfolio diversification in which case the effect of the "number of operating countries" can be disputable. Nevertheless, in line with previous studies, Al Khattab et al. (2008) conclude that indeed both the "international revenues" and the "number of countries of operating" are in a significant positive relationship with PRA institutionalisation.

Size

A company's size is certainly one of the traditional independent variables in the majority of organisational studies. There are many ways in which the size of a firm can be measured e.g. total assets, market value of equity, and number of employees or net sales. Although there are various measures of a firm's size the "total assets" and "number of employees" were identified as the most appropriate ones for the purpose of our study. As Kobrin (1982) suggested, the bigger a company is the more likely it is to identify any potential risks, and also the more resources it has to mitigate its risks.

In contrast to Kobrin's (1982) theory, Albright (2004) and Brink (2004) suggested that there are too many extra responsibilities for already overwhelmed senior managers, and therefore large companies might not be in favour of PRA institutionalisation. And although Henisz (2000) points out that large companies are more likely to be 'spotted' by and by extension becoming potential victims of sovereign authorities, Stosberg (2005) argues that large companies have more power in host-countries and are more likely to negotiate a deal with local governments than the smaller ones. This would suggest that the bigger a company is the less likely it is to institutionalise the PRA. However, the relationship is not this definite. As Fitzpatrick (1983) and Al Khattab et al. (2008) highlighted, small companies are more flexible and adaptable to environmental changes which would imply that the smaller companies would not analyse the risk stemming from political environments, as they can – in the case of unexpected events – move their activities to another country more easily than larger companies.

In relation to the "number of employees" an important point, which we have not come across in any of the previous studies, needs to be made. It is not only important how many employees a company has but what also matters is the structure of firms' staff. We propose that companies with more both line and senior managers are more likely to institutionalise the PRA as their capabilities will allow them to do so, given that this is a responsibility which cannot and/or should not be assigned to ordinary staff. By extension, this should vary across sectors given that firms operating in the industrial sector would have a lower share of managers/total staff than firms in a service industry. It needs to be stressed that this is a hypothesis yet to be tested.

Industry

Since the relationship of the industry in which a firm operates to its activities is probably one of the most frequently discussed ones (e.g. Stapenhurst, 1992; Wyper, 1995; Pahud De Mortanges and Allers, 1996; Jenney, 2001; Kettis, 2004; Al Khattab et al, 2008), we also attempt to explain the PRA practices in the "Visegrad Four" countries with regards to the industry influence. Many approaches to the treatment of this variable have been developed in previous studies; these would mostly distinguish between a) the primary, secondary and tertiary sectors; b) industrial and manufacturing, service and financial companies; c) many specific industrial branches. Given that it is desirable to shed some light on the relationship between PR and the industry in which firms operate before the approach to the treatment of this variable in our study, we would specify the “industry” variable at the end of this section.

Since the existing literature on the PRA function suggests that there would be significant differences between companies which are linked tightly to the host-country governments in which they operate; such as construction, military or extracting companies, whose activities are those of a contractual nature; whereas sectors over which the home country governments have only a little control would probably not worry about the potential risks stemming from the host-country political environment as much as the previous group. By no means do we suggest that companies from the “low-profile” sectors are not exposed to political risks at all; the nature of the PR to which these sectors would be exposed would be rather of the macro environmental nature rather than industry-specific as it is in the case of the more sensitive industries. Therefore the nature of PR varies between industries and by extension so does that of the PRA. There is not a single industrial sector completely free from PR; however, given that the nature of PR varies between sectors, it is expected that the attitude towards and the approach to PRA would vary between industries.

In order to measure the relationship, we use the standard distinction between sectors; more precisely the manufacturing, services, military, extraction, construction and financial ones. Moreover, having considered the above mentioned characteristics of the PR(A) – industry relationship, we propose – although using a fundamental and older models of Porter’s competitive analysis and PESTEL – a relatively innovative approach to explaining the “industry” variable in the context of PRA research. We believe that the model will allow us to split our sample into groups according to the nature of all the industrial factors.

For example, an important factor will certainly be the bargaining power of customers and suppliers (especially if a government increases tariffs on imports from foreign suppliers), conditions of entering new markets and eventually leaving these markets. We believe these factors are certainly industry-specific and have a great explanatory power. For example, it is desirable to explore whether companies operating in sectors with low barriers to entry will assess PR and move across countries accordingly or whether they would abandon PRA completely – due to its costs and relatively time-consuming nature – and in case a problem appears they will simply switch to another country. Industries where the entry and/or exit barriers are higher will, on the other hand, need to be more careful as, once they enter a market, it would certainly be desirable for them to remain in it; given that their limited “operational mobility” will not allow these companies to respond to many potential risks quickly enough they would probably need to carry out the PRA in order to prepare for or to avoid any of the risks these companies face. These are just a few examples of how the PRA and Porter’s model of competitive forces are interlinked. However we believe this approach can contribute significantly to the current literature (Grundy, 2006; McKellar, 2010).

Ownership

The “ownership” variable, given the historical development of corporate ownership in the “Visegrad Four” countries, is one of the central variables of our research. Due to the different characteristics of the privatisation process among these countries, the corporate structure is, to some extent, diversified. Since the privatisations in the Czech Republic or Slovakia were much faster and unorganised, there are not too many companies with direct ties to governments anymore; the situation is very similar in Poland and Hungary. Given the different levels of development of financial markets and institutions in these countries, especially their stock exchanges, which certainly affect the structure of firms’ shareholders by using public sources of financing, we also expect the legal structure to vary between these countries (Aybar, 2000; Fawn, 2008; Morgese Borys and Zemcik, 2011).

With regards to the above described we intend to test for the “ownership” variable twice: a) according to firms’ ownership, i.e. state-owned versus private firms; and b) according to firms’ legal structure, i.e. publicly listed versus private firms. These variables are in line with the studies of Al Khattab et al. (2008; 2010; 2011).

The literature suggests that ownership significantly affects the tolerance and attitude towards risk. As, for example, Yazid (2001) emphasizes, firms owned by government are usually more risk-averse than private ones. This is caused mainly by the different objectives of managers since the primary goal of private organisations is to generate profit whereas the public ones need to ensure they serve public interests in the first place. Also the ownership structure of publicly listed versus private firms appears to influence how companies perceive and tackle risks (Yazid, 2001; Yazid et al., 2012). Aretz and Bartram (2010) note that publicly traded companies need to ensure they will not only generate profit but that they will also meet their shareholders' expectations which – in most cases – are profits. Therefore these companies are much more likely to monitor and assess potential risks stemming from the environments in which they operate – including the political one.

THE NEED FOR THE STUDY

The political risk assessment (PRA) literature consists of conceptual research, e.g. Desta (1986), Torre and Neckar (1988), Miller (1992), Zou (1993), Clark (1997), Kearns (1997), Stevens (1997), Alon and Martin (1998), Howell (2001) and Brink (2004) and empirical research which is concerned, inter alia, with identifying the managerial concerns of political risk in different contexts, e.g. Rice and Mahmoud (1990) within Canadian firms; Hashmi and Guvenli (1992) within US firms; Wyper (1995) within UK firms; Pahud De Mortanges and Allers (1996) within Dutch firms; Demirbag and Gunes (2000) within Turkish firms; Zarkada-Fraser and Fraser (2002) within UK firms orientated toward Russian markets; Hood and Nawaz (2004) within UK international firms; Kettis (2004) within Swedish firms; Keillor et al. (2005) within US firms; Nawaz and Hood (2005) in Mozambique, France and Myanmar and Al Khattab et al. (2008) within Jordanian international firms. Most of these empirical studies, however, were carried out in the context of developed countries and offer little by way of analysis of the concept in transition or emerging markets. Furthermore, an in-depth review of such literature suggests that few studies have related the managerial concerns of risk to firm-specific characteristics.

RESEARCH CONTEXT AND PROPOSED METHODOLOGY

The research will be conducted in the context of international firms based in four Central European countries (Poland, Hungary, Czech Republic and Slovakia). No previous PRA research has been conducted in relation to Central European firms. This is a significant omission given the specific post-socialist transition market context. In addition to the specific market characteristics, it has also been pointed out that the differences between well-developed western markets and the Central and Eastern European ones are diminishing; hence the time left for studying the PRA function in this particular context is running out (Wieners, 1996; Djankov and Murrell, 2002; Makhija, 2004).

The focus on Central Europe will also enable an exploration of how international firms from transition countries perceive and assess political risk and an assessment of the reasons for any divergent approaches to political risk assessment (PRA) which may be identified. In the same vein, it will be possible to undertake a comparison between the findings in the context of Central European firms and those findings in different geographical contexts. Since earlier studies also targeted firms from one nationality operating in different countries, a comparison is feasible.

Only international firms will be targeted, to the exclusion of domestic (i.e. non-international) firms. This delimitation does not mean that domestic firms are not vulnerable to political risk in the home country. The focus on international firms, however, aims to achieve consistency with the majority of the literature in which exposure to political risk in its many forms is a consequence of undertaking international business activities. This focus was also justified by Eiteman et al. (2000), Kettis (2004), Hood and Nawaz (2004) and Stosberg (2005) who argued that political risk is a special dimension of risk that an international firm has to deal with, in addition to the traditional risks associated with business activity in the home country.

RESEARCH OBJECTIVES AND METHODOLOGY

From the general aim of the study – to analyze political risk assessment in 'Visegrad Four' firms with special reference to the assessment and management of political risk in international business and institutionalisation of the PRA function – the following objectives were developed: a) to analyze political risks identified by managers of CEE international firms; b) to compare managerial concerns in CEE with different geographical contexts; c) to measure the exposure to and mediation of political risk in CEE firms; d) to analyze the PRA function in CEE firms by home-host country relationship and firm-specific factors (institutionalisation); e) to compare PRA between and within "Visegrad Four" countries and previous studies.

With regards to our research aim and objectives, and following previous studies aimed at research into PRA, a three-stage, mixed-method methodology has been developed. In the first stage, interviews with companies' senior managers will be carried out in order to identify the types of political risks concerning firms in CEE countries the most; the practices of PRA among these companies will also be identified. Following these interviews a self-administered questionnaire will be designed. The data obtained via questionnaires will allow us to describe the managerial perceptions in terms of descriptive statistics, which contain frequency, percentage, central tendency, standard deviation, range, minimum, maximum and sum. The findings will be explained in terms of exploring potential correlations or differences between managerial concerns and firm-specific characteristics. In the final stage semi-structured interviews will be used to explore and explain themes that have emerged from using self-administered questionnaires. The findings will then be compared with the findings reported in other countries.

CONTRIBUTION OF THE RESEARCH

The expected contribution of this research can be divided into two main streams: a) an academic contribution; and b) a real-world contribution. Firstly in terms of the academic contribution, the research is expected to enhance the understanding of PRA by adding the unique context of transition economies. The literature contribution as such is threefold: the literature of risk; the literature of emerging economies; the literature of international business. Given the distinct nature of these transition economies, we believe that there are potential ideas and practices in this market which would contribute to and enhance the literature on political risk assessment.

With regards to real world practice, the research is expected to provide valuable information to all firms, independent agencies carrying out studies into various business risks, and governments. The evidence from the "Visegrad Group" will contribute to the understanding of the aforementioned organisations to the needs of this specific group of firms in transition economies. We also believe that this study will improve the understanding of the importance of political risk in business activities to firms' management.

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