

## 5.4: Political Risk

### Learning Objectives

After reading this section, students should be able to ...

1. define political risk
2. the effect of government policy changes on international marketing

### What is political risk?

Political risk is generally defined as the risk to business interests resulting from political instability or political change. Political risk exists in every country around the globe and varies in magnitude and type from country to country. Political risks may arise from policy changes by governments to change controls imposed on exchange rates and interest rates (Barlett et al, 2004). Moreover, political risk may be caused by actions of legitimate governments such as controls on prices, outputs, activities, and currency and remittance restrictions. Political risk may also result from events outside of government controls such as war, revolution, terrorism, labor strikes, and extortion.

Political risk can adversely affect all aspects of the international business from the right to export or import goods to the right to own or operate a business. AON ([www.aon.com](http://www.aon.com)), for example, categorizes risk based on economic; exchange transfer; strike, riot, or civil commotion; war; terrorism; sovereign non-payment; legal and regulatory; political interference; and supply chain vulnerability.

### Student Example

A business that operates abroad or that imports things from a certain country can be affected by the countries' political and economic environment. As most of us are aware, there have been constant riots in Venezuela in an effort to overthrow Nicolas Maduro. As one of the counties with the largest oil reserves, Venezuela is a great business source for U.S. based oil refineries. However, political instability has caused President Donald Trump to impose sanctions on Venezuelan oil. This has affected the U.S. refineries that purchase oil from that country. Additionally, Venezuela is currently facing hyperinflation rates that go above 2 million percent. This economic instability has led its citizens to live difficult lives. There has been news coverage on how individuals dig through garbage trucks to find scraps. Once more, President Donald Trump and other leaders have condemned Nicolas Maduro's regime on various occasions. One way this could affect an Oil Refinery business is that if they continue to conduct business with Venezuela, they might face challenges in importing the oil. They might also not be able to find other sources of business, which could lead to loss of jobs. These are just "what if" scenarios.

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### How to evaluate your level of political risk

#### Forms of investment and risk

For a firm considering a new foreign market, there are three broad categories of international business: trade, international licensing of technology and intellectual property, and foreign direct investment. A company developing a business plan may have different elements of all three categories depending on the type of product or service.

The choice of entry depends on the firm's experience, the nature of its product or services, capital resources, and the amount of risk it's willing to consider (Schaffer et al, 2005)

The risk between these three categories of market entry varies significantly with trade ranked the least risky if the company does not have offices overseas and does not keep inventories there. On the other side of the spectrum is direct foreign investment, which generally brings the greatest economic exposure and thus the greatest risk to the company.

#### Protection from political risk

Companies can reduce their exposure to political risk by careful planning and monitoring political developments. The company should have a deep understanding of domestic and international affairs for the country they are considering entering. The company

should know how politically stable the country is, the strength of its institutions, the existence of any political or religious conflicts, ethnic composition, and minority rights. The country's standing in the international arena should also be part of the consideration; this includes its relations with neighbors, border disputes, membership in international organizations, and recognition of international law. If the company does not have the resources to conduct such research and analysis, it may find such information at their foreign embassies, international chambers of commerce, political risk consulting firms, insurance companies, and international businessmen familiar with a particular region. In some countries, governments will establish agencies to help private businesses grow overseas. Governments may also offer political risk insurance to promote exports or economic development. Private businesses may also purchase political risk insurance from insurance companies specialized in international business. Insurance companies offering political risk insurance will generally provide coverage against inconvertibility, expropriation, and political violence, including civil strife (US Small Business Administration). Careful planning and vigilance should be part of any company's preparation for developing an international presence.

### Government policy changes and trade relations

A government makes changes in policies that have an impact on international business. Many reasons may cause governments to change their policies toward foreign enterprises. High unemployment, widespread poverty, nationalistic pressure, and political unrest are just a few of the reasons that can lead to changes in policy. Changes in policies can impose more restrictions on foreign companies to operate or limit their access to financing and trade. In some cases, changes in policy may be favorable to foreign businesses as well.

To solve domestic problems, governments often use trade relations. Trade as a political tool may cause an international business to be caught in a trade war or embargo (Schaffer et al, 2005). As a result, international businesses can experience frequent changes in regulations and policies, which can add additional costs of doing business overseas.

#### ✓ Student Example

This past year President Trump has imposed 25% tariffs on raw materials like steel and aluminum coming from China. In turn, China imposed a retaliatory tariff on American Agriculture. By doing this it American farmers have been hit the hardest by these tariffs. They are now seeing decreases in overseas purchasing of items like soybeans because other countries are reluctant to pay the tariffs. China was the number one market for American soybeans, and without their buying of soybeans, American farmers will have a hard time recovering from this financial loss. Farmers are also experiencing higher prices on farming equipment, because the material it is made of had tariffs placed on it. Large businesses like John Deere had to raise their prices on farm equipment since the metal that they used had tariffs imposed, thus making the prices higher. While for now, these tariffs seem to only be deeply affecting the American agricultural business, but there is fear that if metal tariffs increase, more industries like the car industry will be impacted.

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A trade war is a situation where countries try to damage each other's trade. The most common way they do this is by imposing tariffs or quota restrictions. With the recent trade war the United States and China are having, there are a lot of American companies that are seeing an impact on their businesses and profits. One company seeing a negative impact is Apple. China is the third-largest market for Apple and since the market is currently unstable in-between the countries, Apple is skeptical about long-term outlooks. Analysts have stated that if the China market collapses, then Apple's global market is going to fail. Apple has already seen a 10% drop in their stock and a 3% drop in the Dow Jones industrial average.

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