Country Risk Management Practices – Evidence from Croatian Companies

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ABSTRACT

In today's globalized world characterized by economic, social and technological changes, international trade represents one of the most important levers of economic development of any country. Positive impacts of international trade directly reflect on GDP, employment and technology transfers and indirectly on competitiveness, country credit rating etc. History shows that companies that are successful in domestic market often fail in foreign. This is due to the fact doing business in foreign market is much more complex in terms of market riskiness. Market risks are greater due to the insufficient information pertaining to political, economic and cultural factors or inadequate quality of such. This provides a strong reason for understanding in what ways companies analyze, manage and control different components of market risk when expanding abroad. To analyze this authors conduct both primary and secondary research. Majority of companies analyzes risks simply by rules of thumb or doesn't analyze it at all because they believe that cost would exceed the benefits. At the end authors propose implications and ideas for further research.

Keywords: international trade, risk management, market risk.

Introduction

There are numerous definitions of risk. Most authors define risk as a combination of the probability of an event to occur and its consequences (Ashley, Vaughan, Andrijašević, Kereta, Thomas, Heretz,). Most of the time, however, it will be impossible to precisely calculate any of the two elements. According to ISO 31000:2009 – standards on risk management, risk is defined as „deviation from expected objectives caused by uncertainty, where uncertainty represents the state of deficiency of information related to, understanding or knowledge of an event, its consequence, or likelihood". For the purposes of this paper we will adhere to the definition which explains the risk as „volatlity of expected outcomes" (Jorion). Risk may result in losses or gains and may affect all firms in a class or particular firms. If there is a possibility that risky events may result in gains we refer to them as speculative risks. Otherwise, we refer to them as pure risks.

Risk is permanently present throughout business activities of any company. In order to create economic value, companies deliberately expose themselves to different market risks as a part of an everyday business conduct. For companies from relatively small economies, such as Croatia, entering foreign market will be the only way in which they can ensure further growth and competitiveness. Inevitably, companies that engage in any form of international business expose themselves to even greater perils due to the fact they have to cope with many different elements of risk for which they have poor or inadequate information regarding foreign market(s). Besides competition, the most important elements include political, economic and cultural environment in those markets. Although there is no universally accepted typology for categorizing risks in international business (Al Khattab) three aforementioned factors are often stressed as the most relevant components of international business risks i.e. country risk. Country risk is defined as "the unique risk faced by foreign investors when investing in specific country as compared to the alternative of investing in other countries" (Al Khattab).

Figure 1. General risks in international business

Political risk is often stressed as the most important risk in emerging and developing markets.
It represents the possibility that political decisions or political or societal events in a country will affect the business environment in such a way that investors will lose money or not make as much money as they expected when the investment was made. Political risks can be very subtle and difficult to notice, but still as dangerous as the obvious ones. Companies that understand how to interpret political risks greatly improve their chances of operating profitably in emerging markets (Pacek, Thorniely).

Political and economic risks are often closely related and intertwined. Political concerns influence economic policies and vice versa. Economic risk (sometimes also referred to as financial risk) represents the threat of unfavorable changes of foreign exchange, interest rates and commodity prices, which in turn can disrupt the business in a foreign market and often lead to foreign market abandonment.

Cultural risk is probably the most difficult to define out of all risks that constitute country risk. This is due to the fact that there is no straightforward, agreed definition of culture. Culture is constituted out of many elements, some of which are easier and some of which are more difficult to discover; it is dynamic category and evolves over time in interaction with people; it can be transnational but single culture can also encompass many sub-cultural groups. Since countries are different with regard to elements comprising specific culture, international business is also different from that of national business. Having all this in mind we will define cultural risk as potential losses caused by inability to adapt to foreign culture because of the lack of understanding of elements that comprise foreign culture.

Unfamiliarity with external market conditions inevitably leads to greater exposure of company to different business risks. Company success is therefore greatly dependent on its ability to manage these risks. In order to adapt to foreign market conditions, companies must use reliable sources of information. If large enough, they can establish their own risk management departments; otherwise they can use services of specialized agencies.

Hereby, we could conclude that risk management function would be essential for subsistence and development of any company, especially international ones. However, numerous market failures indicate that in most of the companies managers either do not understand risks they take up or do not know how to handle them effectively. Having that in mind, authors of this paper have conducted a research to get information on usage of risk protection instruments, understand management attitudes toward risk and risk management practices. Authors also believe that the research poses a good starting point in trying to understand the context of relatively low competitiveness of Croatian international companies.

Doing business internationally

Since international competitiveness of Croatian companies is constantly decreasing and only a small fraction of companies successfully captures new market shares, authors of this paper wanted to find out whether companies' risk managements policies and practices had anything to do with it. While majority of developed economies successfully use export component of international trade as a lever of economic growth, according to the majority of indicators (e.g. structure of exports, share of exports in GDP, exports/imports ration etc.) Croatia does not exploit enough international trade opportunities. With numerous benefits to the economy as a whole, going to foreign markets can bring numerous benefits to companies that decide to take such a move. There are three main reasons for the internationalization of business enterprises: economic, technological and / or strategic reasons (Prasad).

In light of the problems faced by Croatian economy where imports/exports ratio is constantly growing, net value of exports and international competitiveness is decreasing while foreign debt increasing, risk management practices of Croatian international companies seemed to authors as a very interesting topic for which no empirical research had been made before.

Aim of the research was to find out whether managers of he biggest international Croatian companies are familiar with risks faced in foreign markets, in what ways they measure risks when entering foreign markets and if they don't to find out why. We also wanted to find out whether they have prescribed risk management policies when entering foreign markets or any department or person in charge of risk management. Lastly, this empirical research was supposed to answer how they perceive quality of their own risk management practices and to find out what determines their appetite for risk.

Methodology

Empirical research had been conducted from September 2009 – February 2010. Companies had to fulfill several conditions in order to be included in the survey sample:

- Only large companies according to the Croatian Law were included. That means they had to satisfy at least two of the following conditions:
  – value of assets greater than HRK 130.000.000,00;
  – yearly revenues greater than HRK 260.000.000,00;
  – yearly average of employees above 250.
- At least 25% of revenues generated in a foreign market(s)
- Only non-financial companies were included, since government regulators and legislative acts require risk management procedures and processes in place for financial companies
- Specific industries and companies that engage in international business but do not need to enter foreign markets (such as telecoms, hotels, seaports, airports etc.) were excluded from the sample.

Top managers of the companies included in the sample were asked to fulfill questionnaire that had been sent to them by mail. Because of the specificity of empirical research, analyzed set comprised of only 80 companies, out of which 24 companies took part in the survey.

Variable	Respondents, N=24
1. Gender (%)	100.0
1.1. Male (%)	50.0
1.2. Female (%)	50.0

2. Age (%)	100.0
2.1 ≤ 30 years old (%)	37.5
2.2. 31-40 years old (%)	41.7
2.3. ≥ 40 years old (%)	20.8
3. Qualifications (%)	100.0
3.1. B. Sc. (%)	75.0
3.2. M. Sc./MBA (%)	20.8
3.3. PhD. (%)	4.3
4. Years with the company	100.0
4.1. ≤ 5 years (%)	41.7
4.2. 6-10 years (%)	37.5
4.3. ≥ 11 years (%)	20.8
5. Nationality of top management	100.0
5.1. Mostly Croats (%)	75.0
5.2. Mostly foreigners (%)	16.7
5.3. Equal share of Croats and foreigners	8.3

Table 1. Sample structure of conducted research

Table 1 shows summary statistics on sampled managers. There was an equal split between male and female managers in the sample. Most of the examinees were bachelor's of science - 75%, 20.8% were masters of science or had an MBA title, while only 4.3% of examinees had a PhD.

Analysis and research results

One of the most important questions referred to the key method used for analyzing market risks when entering foreign market(s). Results show that risk analysis is merely a subjective *ad hoc* assessment of manager in charge. 16.7% of companies organize a project teams to assess different aspects of market risks, which is good, but still not the best possible solution to examine and quantify risks. The biggest problem with the two methods is a great deal of subjectivity involved in addition to the very limited knowledge pool. More than 8% of companies did not analyze risks at all when going international, which is a stunning result. Only one company out of 24 examined has formal procedures for risk assessment and evaluation when going international. Having in mind that sample was set out of biggest Croatian international companies, we could say that results are poor and to a great extent surprising.

Method	Frequency	Percent	Valid Percent	Cumulative Percent
Subjective assessment of management	17	70,8	70,8	70,8
Organization of project teams	4	16,7	16,7	87,5
Specialised (external) agencies	0	0	0	0

Formal systematic procedures in place	1	4,2	4,2	91,7
Company did not analyze risks	2	8,3	8,3	100,0
Total	24	100,0	100,0	

Table 2. Key method for analyzing and assessing market risks when entering foreign market

Since management's attitude is that subjective *ad hoc* risk assessment and evaluation is sufficient, it doesn't come as a surprise that 87.5% companies doesn't have any sort of department in charge of risk management (Table 3), while 79.2% of examined companies doesn't even have a single person in charge of risk management (Table 4). Not even one company will certainly increase the budget for the purposes of risk management in the next 12 months, while more than 70% of companies are certain that they will not (Table5).

	Frequency	Percent	Valid Percent
Can not answer	1	4,2	4,2
Yes	2	8,3	8,3
No	21	87,5	87,5
Total	24	100,0	100,0

Table 3. Company has department in charge of risk management.

	Frequency	Percent	Valid Percent
Can not answer	2	8,3	8,3
Yes	3	12,5	12,5
No	19	79,2	79,2
Total	24	100,0	100,0

Table 4. There is a risk management function within the company.

	Frequency	Percent	Valid Percent
Can not answer	7	29,2	29,2
Yes	0	0	0
No	17	70,8	70,8
Total	24	100,0	100,0

Table 5. Company plans to increase the budget for the purposes of risk management in the next 12 months.

On the scale from 1-5 (where 1indicated strong disagreement, while 5 indicated strong agreement) managers had to indicate to what extent they agreed with stated attitudes. Variables (i.e. attitudes) v30, v37, v38 and v 41 proved statistically significant.[1]

	Test Value = 3			
			95% Confidence Interval of the Difference	
Variable	Sig. (2-tailed)	Mean Difference	Lower	Upper
v28	,739	-,083	-,60	,43
v29	,461	,167	-,29	,63
v30	,000	,833	,45	1,22
v31	,396	-,208	-,71	,29
v32	,529	-,182	-,77	,41
v33	1,000	,000	-,52	,52
v34	,308	-,217	-,65	,21
v35	,234	,238	-,17	,64
v36	,188	,348	-,18	,88
v37	,000	1,087	,70	1,48
v38	,047	,435	,01	,86
v39	,071	,391	-,04	,82
v40	,461	,167	-,29	,63
v41	,002	,682	,29	1,08
v42	,062	,571	-,03	1,17
v43	,724	-,087	-,59	,42

Table 6. One sample test.

Results of the empirical research are very interesting. We can see that majority of examinees agrees that quality risk management mechanisms in place positively affect business results of companies. However, we could see previously that majority of those managers doesn't have or plan to have any kind of risk management systems or mechanisms. Key method of assessing foreign market risks relates to subjective notions. Managers are also confident they are familiar with the main sources of risk and levels of risk exposure. This may be quite astonishing since sources of risk are numerous and interrelated and majority of examined companies does not have a single person in charge of risk management. Knowing what the business results of Croatian international companies are, we might conclude that there is substantial level of overconfidence in management's own abilities.

[1] v30 stated "Executive board and top management of the company know from which sources is company threatened with the greatest risk.
v37 stated "When entering foreign markets, top management of the company subjectively assesses foreign market risks."
v38 stated "Executive board and top management of the company know what is the company's risk exposure in the foreign market(s)."
v41 stated "Quality risk management mechanisms in place positively affect business results of companies."

Conclusion

Risk management is a process of active decision making throughout which chances of a risky event to occur are reduced or completely diminished. Since all companies regardless the size, industry or any other business aspect are exposed to risks, risk management represents a prerequisite for business success. Different studies have shown that companies that create above the average market value for their shareholders have integrated risk management as a part of corporate processes, while companies that do not have these mechanisms have to often confront unexpected and sometimes substantial financial losses. Risk management is even more important when entering foreign market because of the lack of reliable information and greater uncertainty related to external market conditions.

Croatia represents in any and all aspects a rather small market, so the only way for growth of domestic companies and indirectly domestic economy is through conquering of foreign markets. That is why it would be logical to assume responsible top management would pay much attention to different aspects of market risks. Firstly we would expect them to understand from which sources is company being threatened mostly, i.e. to be able to identify sources of risk. Secondly, we would assume top management should facilitate processes within the company which will ensure adequate risk assessment. And thirdly, we would expect top management to develop a risk response strategy to ensure minimization of possible damages.

Empirical evidence revealed a different picture. Majority of Croatian international companies do not pay much attention to market risks. This is to a large extent puzzling, since top management of examined companies is completely unison in regard that quality risk management mechanisms in place positively affect business results of companies. Moreover, majority of top management that took part in the survey stressed that risk assessment as integral part of risk management process is extremely important when entering foreign markets. That is why one might find confusing to see that almost all examined companies do not have either risk management department or even risk management function in place. Surprisingly, they don’t even seek for an advice from specialized agencies that assess different aspects of country risk.

As results show, most of the managers assess risk only subjectively, relying on the rules of thumb. Having all the complexity international business bears, we find this approach completely wrong. Lack of understanding of external market factors in foreign markets and all the uncertainty that comes out of it might be one of the crucial factors why Croatian companies in general achieve poor results in foreign markets. Changes in the attitude toward risk, as well as usage of risk management systems would definitely contribute to the efficiency of Croatian companies and their greater market understanding and (indirectly) competitiveness.

Affinity towards risk represents foundation for creation of economic value within the company. That is why it is of absolute necessity that management understands how much they expose themselves to different market risks and how much risk can company bear. Hence the healthiest solution is choosing the option in which balance between risk exposure and company resilience (i.e. adaptability to changing market conditions) is assured, i.e. situation in which company can create new values and grow whilst at the same time protect themselves from significant financial losses. Since risk exposure is completely unique for any company, development of mechanisms for risk management will require complete adaptation to company’s needs. Precondition for development of corporate resilience is creation of corporate culture in which objective analysis and consideration of risk is related to every corporate decision making process. Logically, corporate culture in this form will not come into being unless company management does not understand risks and dependence of company success on market risks.

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