INTERNATIONAL BUSINESS IN THE FRAGMENTATION AND TRANSFORMATION OF THE GLOBAL ECONOMY

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Abstract

Multinational companies, which plan to continue their work in confronting countries, should adapt their activities in order to meet the requirements of the various markets in which they operate. The process of fragmentation and transformation of the global international relations sharply increases the political risk, which is substantial part of the overall risk structure of the multinational companies. The purpose of this research is to derive an up-to-date definition and manifestation of political risks as a major risk affecting the activities of the multinational companies in contemporary conditions. The methodology of the research is a desk research and analysis of the existing papers, related on political risks for the recent years. The conclusions include summary of the main reasons increasing the political risks for the multinational companies, as well as the main forms of influence and appearance.

Key words: International Business, Multinational companies, Business risk, Political risk

JEL: F5

Introduction

Over the last 30 years, the processes of integration and globalization have created preconditions for the unification of all aspects of social life, such as information and cultural space, technology and economy sector, even preferences for world-famous brands of goods and services. The main objective and value for the international business was cost minimization and profit maximization, which was perceived as a basic prerequisite for increasing the welfare of particular countries and nations.

The world now faces an unprecedented situation with post-Covid, major military conflict on the territory of Europe, a serious military escalation in the Middle East, tensions in the Southeast Asia and Africa, and an increasing number of measures and actions leading to the de-globalization of all fields of social life - economics, international trade, international law, technology, etc. Profit maximization is no

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longer a core value for the multinational companies, and the focus is shifting towards values such as reputation and national security of their home countries.

The process of increasing safeguards on the security of individual countries leads to the introduction and enforcement of various restrictive economic and political measures aimed at limiting the development and expansion of the influence of individual countries such as Russia, China, Iran, Belarus, etc. This is leading to a deeper process of disruption of economic relations and supply chains for a wide range of tangible and intangible assets and processes. The main affected are multinational companies that have operations in various confronting countries. At the same time, however, complex industries require a wide range of materials that are sourced and produced in different countries. For example, the production of a civil aircraft requires more than 40 types of raw materials and minerals that are not mined simultaneously in any individual country in the world. This means that, despite the process of deglobalization, large corporations in different countries somehow have to interact and cooperate with companies in other countries considered as “unfriendly” or even as “enemy”. This is what makes it necessary for multinational companies to review and update their policies for managing the overall system of risks. At the forefront is the management of political risks, which in recent years have been assumed by many experts to be insignificant or negligible by default.

This research focuses on the extent to which the ongoing processes and events in international economy and finance are consistent with the traditional understanding of political risks for the international business.

Working hypothesis of this research is that the established definitions of political risks remain relevant in the contemporary context of fragmentation and transformation of the international economy and no conceptually new drivers of political risks have been identified.

The presented study focuses on political risks as the most significant risks arising in the current conditions of fragmentation of international relations and the formation of technological-economic and political blocs of countries. This research is mainly limited to review over the large multinational companies with presence in different countries that may have explicit or implicit political, economic, ideological and technological confrontation between each other.

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1. Political risk as part of the overall set of risks

Risk is measured in terms of the likelihood of its occurrence and the extent of the damage or impact that would be caused if the risk were to occur (McKellar, 2010). The intersection of these two independent variables indicates the overall risk severity assessment. Risk can be interpreted as the result of the probability and the consequences (Bracken, J. P, Bremmer, 2008) or the probability and the impact (McKellar, 2010) of a destructive event.

There are different definitions of the political risk.

- Political risk is usually seen as a concept referring to the asymmetric relationship between corporate interests and the foreign state interests (Jarvis, S D, 2004).
- Political risk is also defined as government interference in the economy that affects, for better or worse, the value of an enterprise (Shapiro, C. A,1992).
- Any political event that can (directly or indirectly) change the value of an economic asset can be considered a political risk, such as acts of terrorism, declarations of war, and expropriation of private assets, while geopolitical risks are those that arise for economic actors and governments from the relative rise and fall of great powers and the impact of conventional wars on states and corporations (Bremmer, and I, P, 2010). At the country level, it is useful to distinguish between risks caused by government action, risks caused by the lack of government action or capacity, and risks caused by the challenges to government. Both government action and the absence of government represent political risk.
- In political risk, activities having both political and societal influence, as a result of conscious or unconscious actions, may jeopardize the company's economic objectives (Howell, L, 2001).
- Political risk refers to those political and social events that may affect the value or repatriation of foreign investments or the repayment of cross-border loans or obligations (Ronald, L. S, 1992). These events can occur in the host country, on the international stage or in the home country. In addition, companies should understand the potential reputational damage and associated costs caused by political risks (Bekefi, T., M. J. Epstein, 2006).

Another important aspect of political risk is the political behaviour. Politics refers to activities aimed at determining how society should be organized - who gets what and how, who sets the rules, what prevailing ideas should be the moral basis of social organization. Most often this political activity is associated with individual states, but it can also be global, regional or local. Political activity is a consequence of political power, which is the ability to influence social organization. Governments often have formal power, i.e. the legal authority to make and enforce laws that regulate society, but power can also derive from social mobilization, from economic bargaining power, or from brute coercion. Such behaviour is exercised by governments, but also by social activists and interest groups, rebel and terrorist groups, international organizations such as the UN[2] or the OECD[3], and even by the media when they support a particular political point of view. This calls for the development of stakeholder maps of the main political actors, public organizations, media and other stakeholders who have the influence and/or the power and can potentially generate negative consequences for the operations in a particular country or region. A consistent and comprehensive analysis of the activities of all these players can enable multinational companies to take timely actions in order to minimize the possible adverse consequences resulting from the activities of such players.

There is also geopolitical risk, which is the risk associated with wars, terrorist acts, and conflicts within and across nations—heightens awareness of potential reallocation of economic resources. Geopolitical risk profoundly impacts a country's economic environment, financial market, and micro firms' decision-making (Khoo, J., 2021).

2. Impact of political risk on the multinational companies

Multinational companies operating in politically volatile environments take risks to their employees, reputation and to achieving intended business results (McKellar, R, 2010).

2.1. Reputational risk

A company's reputation may be at risk in its particular business environment, both domestically and internationally. Reputation can be damaged by inappropriate behaviour, such as inappropriate choice of local partners or inappropriate public relations. Local politicians who cause scandals or conflicts to smear a company can have a similar effect on a company's reputation. For most companies, reputation is an important aspect, and intangible assets, such as a trademark, can represent a significant portion of a company's market value. Reputational damage from issues such as negative public opinion and costly litigation can lead to loss of revenue, fewer customers or key employees leaving (Argenti, P, 2005). Reputational risk is seen as a cost arising from social and political risk and is therefore a secondary effect. Analyzing the recent events, the fear of reputational risk was the main driver for many western companies to leave the Russian market after 24.02.2022, although there were no legally-bonded reasons for such actions.

2.2. Risk to the employees

Every business is a combination of capital, technology and resources, including human resources. The key element of any business project are the people who work in the company, regardless of their place in the hierarchy. Staff, which includes

[2] United Nations

[3] Organization for Economic Co-operation and Development

all employees as well as their families, are subject to various risks. Personnel is essential not only because employees play a key role in the continuity of business operations, but also because the way a company cares for its employees is central for its corporate culture. All employees face a multitude of risks that can reduce companies' profitability or even lead to a complete shutdown of business processes. The events from the last week in Israel and Palestine once again show that in case of a critical situation, the majority of foreign employees of the multinational companies are evacuated within 4-5 days from the conflict states. On the other hand, local employees of multinational companies in a particular country may become subject to military mobilisation. In both cases, the multinational companies' operations may be severely affected and even threatened, which requires the preliminary development of contingency plans for such adverse scenarios.

2.3. Performance risk

Performance risk is related with the achievement of business objectives, be it production, sales or R&D. Typically, in business practice, performance risk includes financial risk (credit risk, liquidity risk and operational risk). In the long term, performance (or the financial well-being of the company) depends heavily on people and reputation, but in the short term it can be viewed as a separate asset at risk (Argenti, P, 2005).

3. Manifestation of political risks in the multinational companies

The following manifestations of risk in multinational companies can be highlighted:

- Increase in administrative costs - this group includes all additional costs related to increase in personnel costs, legal and consultant costs, maintenance of buildings, equipment, utilities, consultancy and other costs, etc. incurred due to political risks.
- Impairment losses on investments - this group includes losses resulting from the partial or total inability to recover investments in subsidiaries, associates and non-controlling interests due to political risks.
- Costs related to regulatory requirements - violations of regulatory requirements by multinational companies may result in higher costs for fines. Costs related to regulatory risk have a direct impact on the multinational companies' financial position. In the study "US Sanctions and Enforcement on Financial Sector Companies" (Timofeeva, Y, 2021) Julia Timofeeva analyzes the effect of US sanctions on banks and concludes that "banks have the highest number of cases sanctioned for violating US sanctions regimes, as well as the highest number of cases in which they have been sanctioned." The author of the article supports the view that in contemporary international relations, sanctions are one of the main drivers of political risk and international banks are the most vulnerable to this risk.

- Increase in the cost of financing - as the severity of political risk varies with aggregate policy uncertainty, there exists an implicit contract between a borrower and its relationship bank, whereby a borrower accepts less favorable terms during normal times in exchange for the bank's support during difficult times (Huang G., Shen C.H., Wu Z., 2023).

In general, the Political risk impacts firm-level risk, influencing funding costs, cash holdings, and capital structure choices (Chuli H., Est´evez M., Uribe J.M, 2023).

4. Classification of political risks - Micro- and macro-political risks

Multinational companies should determine the most appropriate approach or combination of approaches for managing political risks. A key aspect of assessing and managing political risks is to analyse what types of events may adversely affect foreign investment and operations. The second key step is to pre-design a response actions tailored to minimize the consequences in case the risk occurs. There are two main categories of political risk factors - macro and micro political risk factors. Macro political risk factors include those actions and policies that target all foreign enterprises in the host country, while events that affect only individual enterprises or specific sectors are defined as micro political risk factors. The importance of this distinction is to highlight the significance of changes in the conditions of individual economic sectors compared to larger political and social shocks.

Within macro and micro political risk, there are two sub-categories that are crucial when analysing socio-political processes in a particular country. One sub-category relates to societal processes and the second to government actions. Political risk can be driven by events and conditions that evolve in society, or it can result from decisions and actions emanating from governments. Macro-political risk includes events that can adversely affect and disrupt virtually all economic activity in a country. Micro-political risk related to society includes terrorist acts against individual businesses, strikes, trade boycotts and protests against individual businesses, sabotage, etc. This sub-category also includes riots in particular regions or cities that affect only those firms that operate in the unrest areas. Macro-political risk associated with the government includes events that are typically associated with catastrophic losses to foreign enterprises, i.e. nationalizations, expropriations and restrictions on capital repatriation. Government-related micropolitical risk includes treaty violations, nationalizations or expropriations of individual companies, seizures of certain assets, environmental laws, sanctions[4] and discriminatory taxes against certain firms. Multinational companies' investments in host countries typically evolve around "physical" assets such as plants, factories,

[4] Sanctions refer to targeted actions by a state ('initiating state'), a coalition of such states or international organisations to reduce, restrict or withdraw from customs, trade or financial relations with a 'target state' or 'recipient state'. This type of action has political objectives: changing political regimes, fundamental principles or particular aspects of domestic and foreign policy, and fulfilling or renouncing certain political obligations (Timofeev I., 2018)

buildings and other facilities. These can be subject to sabotage, terrorist attacks and strikes by various interest groups. Civil unrest and instability in the host country can have a direct impact on the multinational companies' investments through disruption of normal business activities (e.g. interruption or disruption of supply chains, transportation, etc.), restrictions on remittances, and other events.

The table below outlines the source, scope and manifestation of the political risks on the activities of the multinational companies.

Table 1: Macro and micropolitical risks in the multinational companies

Scope and source of political risk	Manifestation of political risks
Macro-political risks associated with government actions	Refusal to repay public debts, including interest
	Requests for rescheduling of all public debts and for modifications of their terms
	Expropriation/nationalization of all foreign enterprises or assets
	Restrictions on international funds transfers for all foreign enterprises
	Introduction of foreign exchange control measures
Micropolitical risks associated with government actions	Waiver of repayment of public debts to particular multinational company
	Requests for rescheduling of all public debts and for modifications of their terms
	Selective expropriation of assets belonging to particular multinational company
	Introduction of discriminatory taxes/laws against individual multinational company
	Violation of the terms of contracts with individual multinational company
Macro-political risks associated with societal processes	Demands by various stakeholders or public organizations to waive public debts
	General instability due to revolution, civil war, etc.
	Terrorism/violence targeting all foreign companies in a country or region
Micro-political risks associated with societal processes	Civil protests against a particular multinational company
	Terrorist attacks or sabotage against a particular multinational company
	Strikes and boycotts against a particular multinational company

Source: Solberg, R. L. Country Risk Analysis: A Handbook, p. 126

Conclusion

In this paper, the author conducts a review of the main established and contemporary scholarly work in the field of political risks for multinational companies. Based on the analysis, the author's working hypothesis is confirmed - the established definitions of political risks remain relevant, and no new ones have been conceptually identified.

As a result of the review of the scientific works in the field of political risk analysis, the following definition of political risks is derived - adverse consequences for the multinational companies that may occur with a certain degree of probability and lead to financial or reputational losses. Negative consequences result from political decisions or societal actions and the main characteristic of such political decisions is that they are aimed to achieve political objectives and may have no economic justification. Political risks arise as a result of conscious and unconscious acts or omissions of government or public organizations (or public actors). Therefore, political and social actors can be global, state, regional and local governments, as well as social activists and stakeholder groups, transnational organizations and the media, when they support a particular political viewpoint. Political risks that can change the value of an economic asset in the short or long term include terrorism, declaration of war, expropriation of private assets, consumer boycotts, protests, radical changes in the tax code, sanctions leading to trade restrictions or asset freezes, etc.

Some of the best opportunities for growth are in emerging markets and new economic sectors, and globalization is enabling and even forcing multinational companies to seek these opportunities to sustain their growth and competitive advantage. There are extremely favourable risk-return ratios in emerging markets or in certain sectors. Companies know how to identify and manage risk are benefiting. Managing political risk is therefore a key success factor in risky markets and a key enabler of international development. Companies that master these competencies early are able to gain a strategic advantage, while for others political risk is a barrier to entry. Such companies can only watch as their more experienced competitors benefit from their presence in emerging markets, while traditional markets become increasingly competitive and saturated.

This paper would be useful for experts and senior managers in multinational companies who could use the findings to challenge and improve the existing system of total risk management of the company operating in foreign markets.

ACKNOWLEDGEMENT:

The present paper is financed within the implementation of project NI-11-2023 of the UNWE, titled "Payments in international trade - trends and perspectives."

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