

ECONOMIC AND FINANCIAL RISK AND ITS CLASSIFICATION

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ABSTRACT

The commonly used terms of economic and financial risk are usually vaguely defined. Narrowing down economic risk to only lending transactions or equity investments, which is often done, is considerably narrowing down the term.

The following definition can be offered for economic risk: the risk of a project or enterprise that the result can vary due to different external and internal circumstances. For financial risk the following definition could be given: the risk of a project or enterprise that the result can vary due to external conditions on the financial markets or internal reasons of financial risk management.

As an example of internal financial risk could be mentioned the decision on the leverage level to be used. An example of ether internal economic risks could be the decision on the technology and human resource management techniques chosen, which will affect the profitability and thus the economic stability of the company in the future. External financial risk is, for example, currency and interest rate movements on the world markets. As an example of external economic risk of an enterprise can be mentioned the development of world and country economy.

The division between economic and financial risk, as well as between internal an external risks at times can be hard to determine. However, in the offered definition as well as in the illustration, which will be inserted in the full text of the article, these types of risks are strictly divided, which simplifies understanding.

Key words: Economic risk, financial risk, definition.

Introduction

Understanding and management of economic and financial risk is important for all enterprises. The economic results of enterprise operations are subject to fluctuations, and sudden decrease of the profit can lead to bankruptcy. Commonly are used terms of economic and financial risk, which, however, are at times vaguely defined.

Common classifications of economic and financial risk

In literature many definitions of economic risk in respectable internet sources can be met. Some of them are:

In financing a project, the risk that the project's output will not generate sufficient revenues to cover operating costs and to repay debt obligations.

A means of the possible eventualities which may affect the operation result of an enterprise which mean that this result cannot be guaranteed over time.

The risk that company economic value may decline as a result of currency movements causing a loss in competitive strength.

In some sources the term of economic risk is not used at all, and it has given way to the term business risk, which means approximately the same as economic risk. For example, Brealey and Myers (1994) define business risk as the risk of a common stock.

The following definitions can be met in the same internet sources for financial risk:

Risk associated with the chosen debt level of a company (Brealey and Myers, 1994).

An assessment of the possibility that a given

investment or loan will fail to bring a return and may result in a loss of the original investment or loan.

Uncertainty in financial transactions.

The uncertainty of the future financial abilities of the issuer to pay stockholders and creditor's principal and interest.

The risk that a firm may not be able to meet its financial obligations.

The uncertainty associated with how a firm finances its business (that is, debt vs. equity).

The risk that is associated with a firm's financial policies.

This is the risk arising from the method the firm uses to finance its investments and it is reflected in the firm's capital structure. It is the risk that less income will be available to the common shareholders due to the use of fixed cost financing (debt and preferred stock). As financial leverage increases, the risk inherent in operations (business risk) is spread over a smaller equity base, thus increasing risk for each share.

An increase in stockholders' risk, over and above the firm's basic business risk, resulting from the use of financial leverage.

Damodaran (1999), when investigating risk, follows a completely different approach, and avoids the common categories of economic and financial risk. The author classifies risk in the following categories:

Project risk – the risk that affects only the project under consideration, and may arise from factors specific to the project or an estimation error;

Competitive risk – the unanticipated effect on the cash flows in a project of competitor actions (posi-

tive or negative);

Industry specific risk – the unanticipated effects on project cash flows of industrywide shifts in technology, changes in laws or in the price of a commodity;

International risk – the additional uncertainty created in cash flows of project by unanticipated changes in exchange rates and by political risk in foreign markets;

Market risk – unanticipated changes in project cash flows, created by changes in interest rates, inflation rates, and the economy, that affect all projects and all forms, though to differing degrees.

Most of these risks under the classification developed by the authors of this article would fall under the category of economic risk.

Rurane (1997) in her work defines credit risk as:

- Honesty of credit taker
- Competitive situation
- Overall economic situation
- Management incompetence
- Mistakes in market assessment.

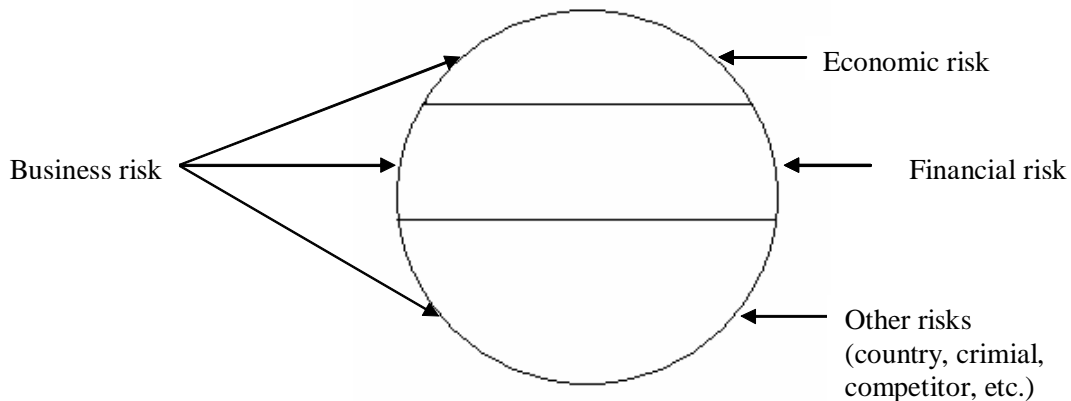
Default risk in its essence is the same business, economic, and financial risk, therefore, the classification can be compared to the classifications developed in this article.

The classification according to Holliwell (1997)

Holliwell (1997) divides financial risk into four categories: counterparty risk, funding risk, interest rate risk, and currency risk, and explains this in much detail. He also divides business risk into the following categories:

- Competitors
- Country
- Criminal/fraud
- Economic
- Environmental
- Financial:
- Counterparty
- Funding
- Currency
- Interest rate
- Information
- Legal
- Market
- Operational
- Personal
- Political
- Product/industry
- Public relations
- Resources
- Technological
- War/terrorism

In fact, the division of Holliwell (1997) can graphically be described as follows:



Risk division according to Holliwell (1997) (Illustration 1)

Proposed definition

It can be seen that there is no unanimity on the definitions of economic and financial risk, and clear definition of these terms would be of benefit to understanding and managing this risk. This necessitates new and clear definition of economic and financial risk.

Taking into account the available information, the most appropriate definition should be made. Narrowing down economic risk to only lending transactions or equity investments would considerably nar-

row down the term. The authors of this work propose a definition, which is a little bit different from the definition of Holliwell (1997), notably in the fact that financial risk is considered to be a subset of economic risk. Of course, this definition can be discussed. The question of whether financial risk is a subset of economic risk, or is it purely independent, is complex from a linguistic as well as scientific point of view. Do we consider the word “economics” as only “microeconomics” and “macroeconomics” as a scientific discipline, or do we consider it to include

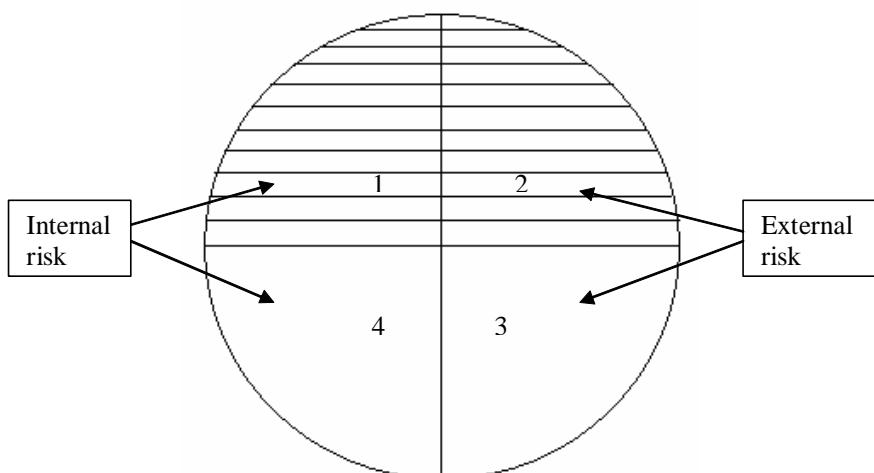
also all financial and business aspects – all that happens in an economy.

The following definition can be offered for economic risk: the risk of a project or enterprise that the result can vary due to different external and internal circumstances.

For financial risk the following definition could

be given: the risk of a project or enterprise that the result can vary due to external conditions on the financial markets or internal reasons of financial risk management.

These definitions can be illustrated also graphically:



Proposed risk classification (Illustration 2)

where:

- 1 – Internal financial risk
- 1 and 4 – Internal economic risk
- 4 – other internal economic risks
- 2 – external financial risk
- 2 and 3 – external economic risk
- 3 – external economic risks
- 1, 2, 3 and 4 – economic risk

As an example of internal financial risk could be mentioned the decision on the leverage level to be used. The higher the chosen leverage level, the higher the risk. An example of other internal economic risks could be the decision on the technology and human resource management techniques chosen, which will affect the profitability and thus the economic stability of the company in the future. External financial risk is, for example, currency and interest rate movements on the world markets, which affect the profit of the company.

Conclusion

The division between economic and financial risk and economic risk, as well as between internal and external risks at times can be hard to determine. However, in the offered definition as well as in the illustration these types of risks are strictly divided, which simplifies understanding.

The authors acknowledge also the strong rationale in the classification proposed by Holliwell (1997)

and recognize that it is a very complex decision whether to include financial risk as a subset of economic risk, or to treat it as a separate type of risk, therefore leaving some room for discussion on this difficult decision. While it makes sense to say that financial market fluctuations and default risk is something determined by the movements in the economy, there is also a sense to define the terms based on the root “economic” as something related to the micro and macro economics – the aggregated markets for goods and services.

As the decision which way of classification of economic and financial risk to choose involves not only aspects of economic theory, but also many linguistic aspects, which determines that the decision of favorable classification can be different in different languages depending on the semantics of the respective words.

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