FORECASTING COUNTRY POLITICAL RISK

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FORECASTING COUNTRY POLITICAL RISK

Consider the following highly arbitrary list:

- war between Iran and Iraq;
- turmoil in the Gulf States and in the Horn of Africa;
- racial unrest in South Africa, the U.K. and the Netherlands;
- revolution in Portugal and Nicaragua;
- labor strife in Poland and Italy;
- religious animosity in Ireland and India;
- military coups in Turkey and Bolivia;
- guerrilla activity in Angola and Malaysia;
- the strain caused by refugees streaming into Thailand and Miami;
- political repression in Chile and the Philippines;
- civil war in El Salvador and Afghanistan;
- acerbic regionalism in Spain and Belgium;
- inner city clashes in the United States;
- disidents in the Soviet Union and Argentina; and
- terrorism almost everywhere.

There is no region, no country, no corner of the globe that is not touched by one form or another of social and political conflict. Conflict can lead to political change and this, in turn, may have significant adverse consequences on the economic environment in these and neighbouring areas. For firms transacting business internationally, the implications are rather sobering.

In 1979, the world's stock of foreign direct investments (defined as those firms where 25% or more of the stock was under foreign control) approached a value of $500 billion. If other assets owned abroad by corporations, such as bank deposits, securities, inventories and minority (less than 25%) interests, were added to this figure the total may very well reach $1000 billion. In addition, world trade amounted to more than $1,400 billion in 1979. Given that a significant proportion of these figures would be exposed to loss at any point in time, the total capital value exposed to political risk is phenomenal.

Surely there is nothing new in this. Trade has been exposed to risks of this nature ever since the first caravans ventured across the Middle East. More recently, the history of expropriation of foreign investments is replete with examples such as Mexico's takeover of petroleum companies in 1938, Cuba after Castro, Indonesia under Sukarno, Libya, Chile, Uganda, etc. Large international companies have been coping with the consequences of political changes and social upheavals for years.

Ever since the collapse of the Shah's regime in Iran, however, where international companies found themselves with exposure to potential losses that may have exceeded $2 billion, the issue of political risk has gained both in importance and popularity. It is no longer acceptable simply to consider political uncertainty as just one more factor complicating the life of the international manager. The frequency of change and the size of the exposure have made it essential for most multinational enterprises to begin in earnest to assess and manage their political risks.

The term "country political risk" is an amalgam: "country" risk has tended to become a more defined term regularly employed by bankers, whereas "political" risk is widely and indiscriminately used. For example, country risk has been defined as: "The possibility that economic, political and social factors within a country might create a situation in which borrowers within a country would be unable to service and repay their debts to foreign lenders in a timely manner." (U.S. Comptroller of the Currency). Political risk, on the other hand, is generally applied in the context of events which are non-commercial and which lie outside the specific product/market or technological risks with which a given business is concerned. One could add that such political risks normally arise from the actions (or inactions) of governments. (1)

The first section below includes a general review of the main approaches to the question of assessing political risks. This will be followed by a detailed examination of the problems involved in forecasting political risks as applied to the specific instance of expropriation of foreign assets. By doing this we hope to clarify the nature of the challenge which the topic poses, and provide some indication of the way in which forecasting techniques may be applied to meet that challenge.

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1. To be more exact, political risk could be defined either in terms of government <u>actions</u> (e.g., direct interference with the conditions under which business operates or with the operations themselves) or in terms or political <u>events</u> which may or may not give rise to any governmental action. Second, it is important to distinguish changes that are gradual (and, presumably, predictable) and those which are sudden or discontinuous. Third, whatever the cause of change or its rate, further differentiation must be made between political events that directly impact business and those which, although highly unstable or disruptive, may not substantially change the business environment. Finally a distinction must be drawn between political risk and uncertainty. Here we approach the crux of the issue: only through information and its assessment can uncertainty about a political environment and its potential impact on business be transformed into measurable and manageable risk. For a discussion of these definitions in more detail see Kobrin (1978).

I

THREE MAJOR APPROACHES

The problems associated with measuring the incidence of political risks in foreign countries have only become the subject of serious examination in comparatively recent times. The earliest approaches tended to focus upon the impact of political risk on the foreign investment decision. In the last decade, and particularly following the 1973 oil crises, a number of studies have concentrated on the risks involved in international bank lending. None of these attempts, however, have been explicitly addressed to the problem of forecasting political change, although all are at least implicitly concerned with projecting some future outcome or with the possibility of change from an unstable present. Instead, the approach frequently adopted was to rank the perceived current level of political stability or instability, and thus infer a greater or lesser probability for change.

It may be useful to review these different approaches under three headings: empirical studies, political assessments, and quantative models. (2)

Empirical studies

There are no comprehensive catalogues documenting the political events around the world that have had specific or discriminatory effects on international business, or of governmental interference on business activities. Since the range of events which are of potential interest is so broad and the impact of the changes in regulation or interference so variable, such an absence is not surprising. We do have available, however, a number of studies that have traced and attempted to analyse the history of expropriation, particularly with reference to the last thirty years. Three of the most notable studies are those by Truitt (1970 and 1974), Hawkins, Mintz and Provissiero (1976) and Bradley (1977). They provide a useful starting point to illustrate the difficulty of gathering suitable data from which to draw prescriptive or normative conclusions.

Truitt considered the expropriation experience of British and U.S. investors since the conclusion of World War II, and established that the extractive and service sectors were the most vulnerable to foreign government takeover, as illustrated in Table I. He derived from this a tentative framework for explaining expropriations and identifying the crucial variables affecting the propensity of the host government to expropriate, and the vulnerability of the foreign investment to such action.

A similar survey was that of Hawkins et. al. which examined instances of foreign takeovers of 170 U.S. affiliates during approximately the same period (1946-1975) as Truitt had studied. They confirmed the vulnerability of firms in the extractive sector, and also provided a breakdown of expropriations in terms of other criteria such as region and the nature of the takeover (see Table 2). Among their findings were that most expropriations involved some form of compensation (however inadequate), and that the rationale behind most takeovers, although couched in the traditional left-wing rhetoric, was basically economic in nature. Most expropriations were directed at controlling an economic activity vital to the nation's economy, its external sector, or both.

A recent study by Bradley, examined the characteristics which were common to a sample of 114 affiliates of U.S. multinationals which had been expropriated by foreign governments during the period 1960-1976. Four areas emerged as being significant. First, he cast doubt on the widely held notion that joint ventures, particularly with public institutions, reduce political risk. Technological sophistication was the second significant variable. Very high or very low levels of technological complexity seem to provide good insurance against expropriation. In the first case the local government is aware of its inability to duplicate the technology without the aid of the foreign firm; in the other, it appears simply not interested in getting involved. Third, Bradley's data show that affiliates which are highly integrated into a multinational system are less likely to be expropriated if cutting them off from the parent company would render them valueless. Finally, it appears that large, visible firms have a higher incidence of expropriation than small firms.

Table 1

Expropriation and Nationalization Experience by Sector, 1945-1970

Sector	Expropriation and/or Nationalization Programs		Number of U.S. and U.K. Firms taken	
Extractive				
Petroleum		12		29
- integrated operations[1]	5		7	
- refining/distribution	7		22	
Plantation agriculture		3		3
Mining		1		1
Total extractive		16		33
Manufacturing		7		8
Public Utilities		5		3
Service				
Trade[2]		5		12
Commercial Banking		7		22
Insurance		6		131
Misc.and unknown[3]		-		160
Total service		18		325
TOTAL		46		369

[1]Any petroleum investment except refining or distribution.
[2]Retail and export-import.
[3]Indicates that author is not sure how companies affected should be allocated between categories.

Source: Truitt (1970) p.30.

Table 2

Distribution of Foreign Takeovers of U.S. Firms, by Type of Characteristic and by Period

	Total Period		Percent			
	Number	Percent	1946-60	1961-66	1967-71	1972-73
By Industry :						
Extractive	69	41	50	50	39	37
Financial	32	19	—	5	28	18
Manufacturing	51	30	—	27	27	40
Utilities	18	10	50	18	6	5
	170	100%	100%	100%	100%	100%
By Region :						
Latin America	93	55	83	59	44	61
Africa	51	30	17	—	51	16
Middle East	14	8	—	32	4	7
Asia	12	7	—	9	1	16
	170	100%	100%	100%	100%	100%
By Form of Takeover :						
Expropriation	103	60	67	95	63	42
Intervention/Requisition	25	15	—	—	14	25
Renegotiation Contract	20	12	—	—	8	25
Forced Sale	22	13	33	5	15	8
	170	100%	100%	100%	100%	100%
By Selectivity of Takeover :						
Entire Industry: Mixed	21	12	33	—	8	19
Entire Industry: Foreign	68	40	42	68	38	28
Selected Firms: No Industry Specification	25	15	8	—	21	16
Selected Firms within a Specific Industry	56	33	17	32	33	37
	170	100%	100%	100%	100%	100%
By Political-Economic Circumstances :						
Leftist Change in Government	81	48	17	41	65	33
Right or Center Nationalist	7	4	17	—	6	2
Natural Resource Sovereignty	35	20	33	41	4	32
Mature and Standardized Product	47	28	33	18	25	33
	170	100%	100%	100%	100%	100%
Total Number :	170	100	12	22	79	57

Source : Hawkins et. al. (1976) p.9.

Political assessments

General political assessments based on subjective data comprise the most widely practised approach in dealing with country political risks. They range from general surveys carried out by one- or two-man teams sent for specific on-the-spot assessment of local conditions, to the more complex ranking systems used by many banks. All of them, rely almost exclusively on subjective assessments of a wide range of variables.

Until very recently, most international firms limited their analysis of the political climate in a specific country to such occasions when a particular new investment was being considered. The assessment was geared to reach a go/no go decision based on present conditions concerning the relative attractiveness of the investment climate. If management perceived political risks to be high, the investment would be cancelled or postponed, or, at best, a "risk premium" would be added to the financial calculations to account for the higher probability of loss. At no time was this exercise conceived as an on-going proposition; unless a major catastrophe occurred, the country's political rating was unlikely to be reassessed.

In one of the earliest surveys of corporate practice in this area, Stobaugh (1969) reported a prevalence for the "go/no go" or "premium for risk" methods involving little quantification or sophistication. Similarly, Root (1968) showed the lack of sytstematic approaches to the appraisal of political risks by most U.S. multinationals, as did Marois (1979) for French firms. What is perhaps more astonishing is that a survey of 193 U.S. corporations conducted by the Conference board and reported in Fortune (Kraar, 1980) showed that after the experience of a decade of political turmoil, less than half of them had any formal means for making political assessments. And even when such a formalized approach exists, as Kobrin (1980) has shown, there is no guarantee that the output of the company's environmental assessment unit can be successfully integrated into the firm's strategic planning.

Some progress has been made, nonetheless, in handling subjective data about political trends in a systematic and prescriptive sense. One of the oldest methods is Professor Haner's BERI (for Business Environment Risk Index) system

Table 3

Factors Assessed by BERI Panelists in Their Determination of the Level of Political Risk

1. Political stability
2. Attitude toward foreign investors and profits
3. Nationalization
4. Monetary inflation
5. Balance of payments
6. Bureaucratic delays
7. Economic growth
8. Currency convertibility
9. Enforceability of contracts
10. Labor costs/productivity
11. Professional services and contractors
12. Communications and transportation
13. Local management and partners
14. Short-term credit
15. Long-term loans and venture capital

Source: BERI Reports.

which collects judgments on fifteen critical areas from a panel of experts located throughout the world. Using a standard Delphi technique, the panel's responses are collated, weighted, and incorporated into a composite index. The fifteen criteria listed in Table 3 can also be rearranged to highlight either political, operational, financial or nationalistic factors in four sub-indices.

These and other similar techniques have the advantage of permitting rank ordering of different environments on a fairly comparative basis. They also allow for a significant degree of flexibility since the weights associated with the various criteria can be modified to suit different circumstances. However, the rankings can only be as good as the judgments which go into their components. Furthermore, they are basically static in nature, reporting conditions as they are now, with little reference to future risks. Implicitly, however, the monitoring of the results of past ratings invite graphically the identification and projection of trends.

More complex and ambitious techniques have been developed by some of the major international banks which attempt to combine judgmental data with harder empirical information. Van Agtmael (1976) reports on one of the earlier efforts in this direction. He suggested a two scale process: an assessment of the priority the bank should assign to the country in question (a market measure), followed by an independent analysis of its credit worthiness (the risk factor). Within the latter, in addition to the standard measures on debt servicing potential, foreign reserves and the quality of the country's financial management, van Agtmael suggested a complex "political checklist" (see Table 4) aimed at introducing a systematic approach to an area where "qualitative judgment is unavoidable".

An ambitious approach was proposed by Nagy (1979). He defines country risk as the size of the potential loss multiplied by the probability of its materialization. The net present value (NPV) of the expected cash flow from a

Table 4

Major Political Variables

I. Internal aspects

A. **History**

1. Time and mode of independence?
2. Record of stability.

B. **Homogeneity**

1. Sense of national duty?
2. History of conflicts between ethnic or religious groups?
3. Is there a dominant ethnic group or are groups of equal strength?

C. **Form of government**

if democracy

1. a. Strong opposition parties with radically different ideology?
   b. Effective government or chaotic situation?
   c. Corruption?
   d. Voting along ethnic lines?
   e. Is government sensitive to needs of population?

If military government

2. a. Widespread popular support or national liberation front?
   b. How strong is the army?
   c. Rivalries among army commanders?
   d. Underground opposition strong?
   e. Did military government follow ineffective, unpopular democracy?
   f. Does the regime have to rely heavily on repression or can it afford a certain degree of freedom?
   g. Do civil servants play a major role or are they alienated?
   h. What alternative power bases are there?
   i. Return to civil rule planned?

If one-man, one-party state

3. a. What if present leader dies?
   b. Are various ethnic groups represented in government?
   c. Is military large enough to be a major contender for power?
   d. Is civil service strong and independent?
   e. Is opposition effectively organized; does it have moral stature?
   f. Are there specific interest groups opposing the regime?

D. **Sources of potential unrest**

1. Is there a suppressed minority group?
2. Are the students, intellectuals, civil servants, military, businessmen, or public opinion alienated from government?
3. Are there conflicts between the central government and traditional, regional centres of power?
4. Is strong foreign influence resented?
5. Is unemployment high?
6. Has the cost of living risen sharply without offsetting wage increases?
7. Is corruption widespread? Who are the victims?
8. Is there a sense that the government is unusually ineffective or that there is no economic progress?
9. Is economic progress confined to the centre or purposely spread over the country as a whole?
10. Do the farmers own the land they till or are they mostly tenants with absentee landlords?
11. Is the economic gap between elite and the populace widening or narrowing?

E. **Drastic political changes**

1. Will a change in government or a coup lead to a drastic change in political orientation or economic chaos?
2. Is there any chance of a civil war?
3. Would a coup lead to political paralysis and a counterswing?
4. Would the next political regime be more/less likely to renounce or reschedule debt for political/ideological reasons?

II. External aspects

A. **Danger of war**

1. Is the area as a whole explosive or calm?
2. Are there major sources of conflict with neighbours?
3. Will a war seriously impair the economy?

B. **Economic relations**

1. Is there a threat of an effective economic boycott?
2. Are relations with major aid donors stable?
3. Are relations with World Bank and IMF healthy?
4. Are there plans for political agreements with major trade-blocs for ensured access to major markets?
5. Does the country want to increase US investment and trade?
6. Does the US government have any leverage?

Source: Van Agtmael (1976), p. 27.

typical loan serves as the basis for estimating the amount of the potential loss depending on whether the loss is by default, renegotiation, rescheduling or blockage of funds transfer. Nagy's system is organized around five quesions:

- What is the likelihood that an adverse event will occur?
- When is this event most likely to occur?
- What is the probability that risk materializes from the event?
- Specifically, how does this probability break down in terms of default, renegotiation, etc.?
- When is the loss, irrespective of its form, most likely to occur?

By multiplying these various probabilities by the NPV's of the different outcomes and adding across years and outcomes, a "country risk factor" is obtained. Nagy put forward a checklist of relevant factors which bear upon these assessments and provides a framework for monitoring critical assumptions upon which the judgments have been based in order to identify any sudden deterioration in the risk profile.

Quantative models

The last decade has witnessed a considerable increase in the application of quantitive techniques to the analysis of political conditions. Whether concerned with rank ordering of countries by different measures of stability or with econometric projections, the development of these models is the most significant step towards a true forecasting approach to political risk analysis.

Among the statically based models, perhaps the best known is the "Political System Stability Index" (PSSI) developed by Haendel, West and Meadow (1975). Its major advantage is that by measuring directly a series of discrete components of political risk, the resulting index is claimed to be free of any judgmental inferences or distortions (Figure 1). (2)

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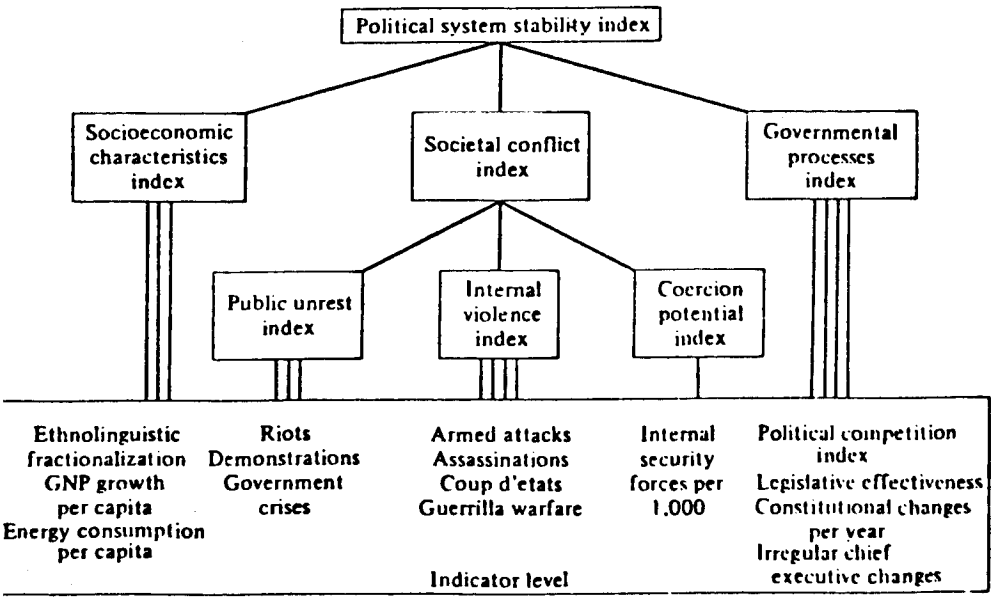
2. However, one cannot ignore the fact that the model is itself founded upon a number of judgments and assumptions, e.g., that "societal conflict" is adequately described by the components of "public unrest", "internal violence", and "coercion potential", or that, in turn, these components are adequately measured by the raw data on riots, size of internal security forces, etc.

Figure 1

Variables Included in the Political System Stability Index (PSSI)



Source: Reproduced from Overseas Investment and Political Risk, by Dan Haendel and Gerald T. West, with Robert G. Meadow, FPRI Monograph Series Number 21, 1975, p. 64.

The fifteen underlying variables can all be measured directly (e.g., number of armed attacks in a year, defined as "an act of violent political conflict carried out by an organized group to destroy the power exercised by another organized group") from independent sources.

The Knudsen (1974) "ecological approach" is based on the proposition that the presence of both a high level of national frustration and a visible foreign-owned sector will result in a high propensity to expropriate. The linking hypothesis is that whenever discontent is high, foreign investors serve as useful scapegoats to vent national frustrations. The key, obviously, is the measure of the level of frustration which Knudsen calculates as the gap which exists between the aspirations of the people and their welfare. Knudsen tested his model on data for 1968-1971 and developed a classification of Latin American countries according to their propensity to expropriate which corresponded closely to later developments in the area.

Other more traditional techniques have been employed more recently to the same general problem. Rummel and Heenan (1978) have employed multivariate analysis in order to "predict future political trends on the basis of current and historical information... and describe more fully underlying relationships affecting a nation state". Standard econometric techniques have also been attempted such as those developed by Feder and Just (1977) and the Export-Import Bank of the United States.

Summary

These various methods share one unavoidable drawback: they are based on historical data that may be totally or partially irrelevant for future conditions. Recent high levels of political turmoil, for example, leading to a radical change in government may appear under the various quantitative indices as evidence of a high degree of political instability. While this may be undeniable for the immediate past, does it signify that instability will continue into the future? Or is the new government more likely to address the root causes of past instability and lead the nation to a new era of prosperity and tranquility? Obviously, no time series analysis can adequately answer these questions. Furthermore, to the extent that the data fed into the

analysis is not entirely current, there will be a potentially significant gap between the last period for which data is available and current conditions. Given the rate of change of political and social phenomena in the less developed countries, and the difficulties (and commesurate delays) in generating reliable data in many of them, this is not an insignificant problem.

Haendel, West and Meadow, for example, recognize these problems in the rankings generated by their model, and provide a judgmental "confidence" factor for each ranking which reflects their qualitative appraisal of the data sources and their reliability. Rummel and Heenan also state that "success is more likely when ... subjective and objective approaches are brought together in an integrated fashion"; and Kobrin (1978) found that risk assessments based on the notion of instability tended to overstate actual risks to foreign investment and led to overly cautious policies. In the next section, we attempt to confront these problems by providing a comprehensive approach to measuring firm-specific political risks. It incorporates the lessons derived from various model-building efforts with years of experience in assessing the potential for loss in hundreds of projects from many firms and throughout many countries.

II

A COMPREHENSIVE MODEL FOR ASSESSING POLITICAL RISKS

The political risks upon which we shall focus in this paper are those related to the expropriation of foreign investments or assets, that is, the compulsory take-over of foreign assets by a host government with the implication of little or no compensation. In general, the "prompt adequate and effective" compensation called for by international law seems rarely to be paid by expropriating governments. But a firm operating in a given country needs to go beyond the question of what is the likelihood that its assets will be expropriated, and be prepared to deal with whatever change in political conditions is forthcoming. The ability to predict an emerging situation

before it is fully manifested is essential to any preparations required to survive it. It is this predictive ability that we believe can be enhanced through careful systematic analysis.

Figure 2 summarizes our approach; it consists of a total of thirty variables or composite factors that must be monitored on an on-going basis. Those variables which are particular to the country in which the investment is located (or to be located) are examined first, followed by those pertaining to the investment or project itself, and each of the two elements have risks which are specific to themselves. The intention in the Country Risk Analysis is threefold: establish some basic measures of reference, identify current trends and any potential break in the trends, and delimit the areas of concern that may harbour the seeds of potential threats to the investment. Such an analysis provides the backdrop against which the Project Risk Analysis can bring into sharper relief the different features proper to the investment which either increase or diminish the risk.

Part I: The Country

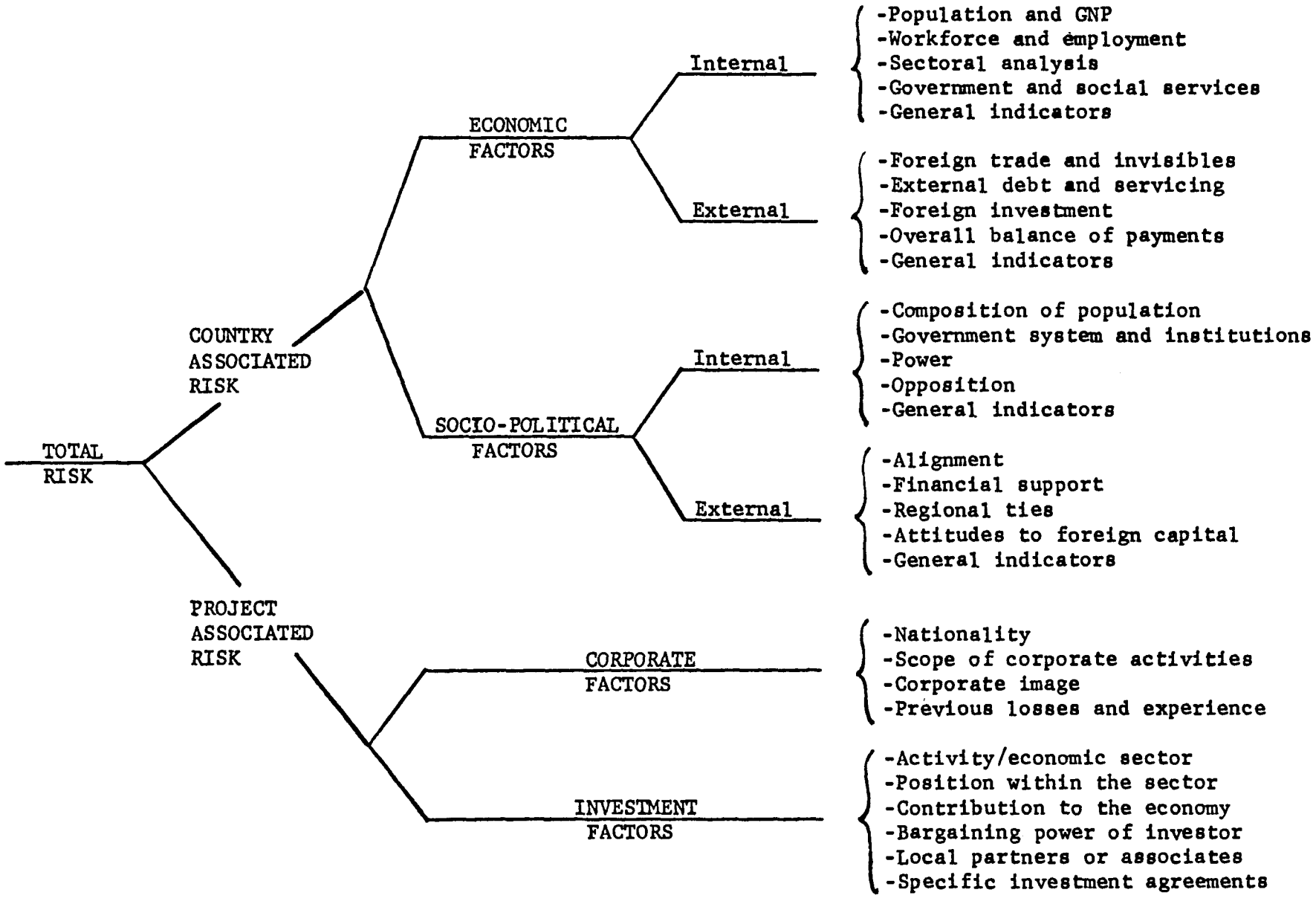
It would be very difficult to provide an exhaustive set of questions for all the factors that should be considered under this heading; time and cost limitations make such an exercise futile. We divide the analysis into those factors which are predominantly economic and political, and then into those which are mostly internal to the country or related to its external relations. Such a division is obviously arbitrary as developments in one area of the economy or political life may have considerable consequences for the other variables under scrutiny. Therefore, the analyst must constantly be on the lookout for these ramifications and interdependencies and not be fooled by the apparent simplicity of the proposed structure.

(A) Economic Factors - Internal

A reasonable starting point is an understanding of the basic components of the country's domestic economy. This means not only an analysis of what is produced, who consumes it, what levels of government involvement, etc., but also what changes in these various features are taking place, at what rate, and for what reasons. Typical points to watch are the state of the country's

Figure 2

Major Variables for Assessing Country Political Risk



agricultural sector (e.g., percent of population working in agriculture vs. its contribution to total GNP) analyzed against the rate of urbanization and the level of unemployment. We may want to carry out this analysis under five separate headings.

Population and GNP. Historical trends in the size of the country's population, the development of its economy and its GNP per capita provide a first approximation of national welfare. When considered against the recent past, public pronouncements about expected growth rates indicate the potential disparity between the country's aspirations and its capacity to provide for its future development needs. Things to look for are, for example, relative growth rates of different GNP components, efforts at controlling population growth, etc. Income distribution within the country and changes over time are useful clues to potential trouble. Countries which may appear stable and otherwise prosperous on the surface, such as Mexico or Venezuela, may look quite different in terms of risk if one observes that, for example in the case of Mexico, the percent of national income going to the poorest 70% of the population has declined steadily since the late 1940's, when it oscillated around 34%, to about 28% in recent years. The implications for social discontent, even in a high growth economy, are evident.

Active workforce and employment profile. The size of the workforce, its distribution according to major economic sectors, as well as its geographic location will show what the country's productive human resources are and how and where they are deployed. It may also indicate disturbing trends, such as migration to the cities and growing masses or urban unemployed. Of significance here is the rate of economic growth required to create new jobs in particularly depressed areas and the levels of government spending for social services. The Brazilian experience provides a case in point for this type of analysis. Over the years 1960 to 1977 the percentage of the population living in urban areas has increased from 40% to 60%, that is, an increase of 40 million people in urban areas versus 3 million in the rural populaton.

Sectoral analysis. This is probably one of the most straight-forward elements in the analysis and must address such questions as:

- What is the strength and diversity of the agricultural sector and is the country self-sufficient in food?

- What are the country's major raw material resources; is it self-sufficient in energy?

- How significant is the industrial sector; is it capable of responding to the need to generate employment and foreign exchange?

- What are the strategic sectors; are they controlled by the government or by foreign investors?

- How large is the public sector; how efficient; is there a discernable trend to greater government involvement in the economy with a corresponding increase in its public accountability?

Government and social services. The absolute level of government expenditures should be examined against that of the private sector. The sectoral and geographic distribution of such expenditures need to be considered carefully to determine, for example, whether there are areas of obvious and urgent need (e.g., urban housing, health services, defense, etc.) and how are these needs being met. Furthermore, one should determine how public expenditures are being financed (e.g., external debt which may lay claims on future resources and their distribution) and the trends in terms of both revenue sources and major expenditure programs. The rigidities exhibited by either of these to changes in economic conditions is also a fundamental question. If revenues are highly volatile while expenditures consist mainly of inflexible social programs, any major disturbance to the system could result in severe political consequences. For example, the need to maintain substantial defense expenditures in Morocco and South Korea (in the former, for example, this item accounts for at least 40% of the government budget) places great strains on government finances - particularly if accompanied by problems in other key areas such as fluctuations in the price of phosphate or loss of export markets at a time of recession.

General indicators. It is also important to trace certain economic indicators such as the rate of inflation (both official and unofficial), the interest rate levels, the extent and growth of the government deficit, etc., any major discontinuity in these series should be cause for concern and investigation.

At this stage of the process the analyst should have a reasonably clear picture of which economic variables are critical for continuity in the country's present development path, of the potential gaps between reality and aspirations, of the sensitivity of the economic system to a breakdown or failure in any of its critical links, of the chances that any such break might occur (or has already occurred), and of the inconsistencies that may exist between sectors or areas of the economy. The first set of questions should also involve the development of key measures of economic variables and performance, the observance of historical trends and, most importantly, the discovery of any breaks in the various series. Assuming the 'how' is possible, one might ask why these measures. Our objective is not economic analysis per se, but a search for what one might call the potential for trouble. If "what is likely to go wrong" follows Murphy's perfidious dictum, it is the political consequences that interest us, as these are ultimately the ones that may affect the safety of the investment.

(B) Economic Factors - External

The overall side of understanding a country's domestic economy must be an appreciation of its external payments position: what are its international obligations; their extent and burden on the economy; what is the level of diversification of its export earnings and the exposure to changes in the prices of its key export commodities; to what extent it is dependent on imported oil, etc. Again, five headings would be helpful in organizing the analysis of these issues.

Foreign trade and invisibles. The essential items which the country needs to import and the products or services upon which it relies in order to pay for these are the main objective of this section. One must consider to what extent do imports consist of essential goods such as food, energy, or raw materials which are relatively price and income inelastic, and assess the possibility of adverse price movements and their potential impact on the economy. In like manner, possible fluctuations in expected export earnings must be examined -- whether caused by internal (e.g., crop damage) or external events (e.g., import restrictions in major markets). In addition, one should review the pattern of evolution of the country's overall foreign trade and its

principal trading partners. What are the levels of dependency by commodity and by markets? How flexible is the external sector to respond to changing conditions? One critical area is the cost of oil: for a country such as Tanzania it represents over 50% of the country's foreign exchange earnings (earnings which are in themselves highly volatile). The same problem arises over Brazil's foreign trade account which is highly sensitive to the changes in prices of a few key agricultural products (coffee, soya beans, cocoa) on the income side, while being equally exposed to oil price increases on the payments side, since oil accounts for at least 50% of imports value.

External debt. Three essential elements should be treated here:

- the level of the outstanding foreign debt (public and private), in both absolute terms and relative to GNP and exports;
- its maturity profile; and
- the level of debt service (including dividend payments on foreign investments) relative to national income and exports.

The figures must be weighed carefully against the level of foreign exchange earnings and the size and potential of the economy. If difficulties in servicing the debt are being experienced or are expected, the impact on domestic economic and political pressures must be evaluated, as well as the possibility and likely effects of transfer restrictions and import controls. Many recent examples of this type of problem come to mind: In Jamaica, the weight of external debt and the chronic balance of payment's difficulties became a major issue in the 1980 election which led to the defeat of Manley by Seaga.

In the case of Brazil, the awesome overhang of foreign debt has already led to growing import controls and restrictions on foreign remittances - and there are signs of pressure building up to oblige foreign investors to convert their subsidiaries' foreign debt into equity.

Foreign investment. Countries which often shun external indebtedness as a solution to their exchange difficulties, turn instead to foreign investment on the twin assumptions that more real income is thereby generated to pay future claims and that dividend payments are cyclical and not likely to fall due in

hard times. This, history has taught us, is not always the case. The size and importance of the foreign sector, its distribution by branches of economic activity, its diversification in terms of countries of origin, etc. are all critical elements to the analysis. They affect the probability that when all else fails a "nationalistic" government will point to the spectre of foreign ownership as the root of all evil. Over 70% of Nigeria's manufacturing sector was foreign-owned in the late 1960's, which probably was a major force behind the indigenization programme known as the Nigerian Enterprises Decree launched in 1974. Similarly, the fact that over 55% of Canadian industry was in foreign (predominantly U.S.) hands was the principal motivation for the creation of the Foreign Investment Review Agency in April 1974.

Overall balance of payments. To complete the examination of the country's external position the overall balance of payments should be reviewed with particular emphasis on trends in the remaining items in the capital account and on the level and changes in the country's reserves. In this context, the "Errors and Ommissions" entry may provide revealing information of irregular capital flows and sudden surges in flight capital.

General indicators. Lastly, the country's official and unofficial exchange rates and the spread and terms which its borrowers can obtain on the international capital markets should be monitored for clues of sudden changes in confidence levels, both external and domestic.

This set of questions serve an evident purpose: determine to what extent external constraints will dictate domestic economic policy. If there is a high degree of dependence and instability together with high debt-service payments, risks of inconvertibility and expropriation will rise commensurately. In Mozambique, shortly after the revolution, the government, faced with severe external payment difficulties, nationalized those enterprises which consumed significant amounts of foreign exchange. Likewise in Nicaragua, the grave shortage of foreign currency after Somoza's ouster has prompted the new revolutionary government to take control of the main sources of foreign exchange. A diversified export base, on the other hand, may reduce the potential for downstream economic impacts of disastrous proportions even when the economy may be highly export dependent as is the case with most island states in Asia.

(C) Socio-Political Factors - Internal

Composition of population. The division of the country's population into its various ethnic, religious, tribal or class components provides a useful starting point. The size of each component part, its geographic distribution, its political and social status, its share in the country's wealth and its participation in key governing institutions should be examined in order to determine how well they fit together and how coherent is the whole social structure. A typical problem area for this kind of analysis is the Arab world where in some countries minority sects (Wahabites in Saudi arabia, Alawites in Syria) hold the reins of power against a background of fundamentalist religious turbulence caused by the Shi'ite Moslem revolution in Iran, ethnic separatism and traditional complications such as the problem of substantial numbers of expatriat workers. With regard to the latter, in countries such as the Gulf emirates, Iran and Kuwait, these non-citizen immigrants easily outnumber the local (and privileged) nationals. Similarly, there is the implicit tension in the Far East over the expatriate Chinese minorities: in Malaysia for example the Chinese are notably more prosperous and successful than the Malays which has led to the government imposing restrictive Malasianisation measures applicable to foreign investments.

System of government and institutions. The formal status and composition of the country's government and its institutions are important to the analysis since they provide the external "appearance" which needs to be grasped in order to understand how the system works or is meant to work. (The different "reality" of power is considered separately below.) a suitable framework should accurately describe the constitution, the deliberative, legislative and executive functions and the structure and nature of the political parties (should there be any). For example, unless one understands that a country such as Brazil is divided into states which elect deputies for the Bicameral National Congress, but which each has individually a governor appointed by the President, it is difficult to understand the significance of constitutional issues raised by the opposition. One has, as it were, to learn the political language of the country concerned within which the reality of power is played out.

Power. The external forms of the country's institutions will rarely reveal the effective structure of power therein. They should, however, provide an essential framework for its analysis and draw attention to areas of potential or actual conflict, or of unexplained obscurity. The type of questions which one should ask here include: who actually makes the key decisions and what the principal sources of support are for the current government; how far it is either dependent upon or closely associated with foreign capital; what role the armed forces and internal security apparatus play; who are the major beneficiaries of the status quo, who are the major losers; etc. This is a particularly critical and difficult area of analysis since almost by definition the data are obscured or concealed. Perhaps more than anywhere else, what is required is a great deal of skill in inferring from external observations and considerable judgment in the use of internal or local sources of information.

Opposition. Although earlier sections may have partially illuminated the question of the actual or potential alternative government, one should give specific attention to the issue of opposition to the status quo within the country. The basic questions which must be answered are what are the significant opposition groupings, whence did they draw their support and how effective are they. Unfortunately, it is often extremely hard to obtain balanced information on these questions and one must treat one's data extremely carefully in order to compensate for the inevitable biases that are inherent therein. One example of this problem was the now well publicized and analyzed incident at the Great Mosque in Saudi Arabia which was originally presented as an isolated minor incident involving a few religious fanatics. In order to obtain a proper appreciation of this event, one needed to be aware of the deep significance of the location and the shock which was felt by the other Gulf nations and the basic tribal tensions undermining the political system. The difficulty which the army and the national guard had in subduing this rebellion meant that it had more significance than the Saudies were prepared to admit as confirmed by evidence of other linked disturbances elsewhere within the Kingdom which went largely unreported.

General indicators. Data to be monitored include the level and frequency of strikes, riots or terrorist acts, the number of political prisoners and the extent of official corruption. Incidents such as the Great Mosque affair should encourage one to check back through the analysis, question all assumptions and review areas which show signs of breaking under the tension.

(D) Socio-Political Factors-External

Alignments. The best starting point is to establish how the country is aligned, what its position is on certain key global issues (e.g., apartheid, the Middle East, etc.), who its principal political allies are and how dependent it is upon them. For example, if we take a "non aligned" nation do we mean one that is non aligned such as Yugoslavia or such as Cuba? Has the country signed a treaty of friendship with the Soviet Union as in the case of Syria or Afghanistan?

Financial support. Besides political allies one must also identify economic supporters of significance: both those who deliberately provide items such as aid, food, soft loans and military supplies as well as those which are de facto important supporters by virtue of vital economic links. The support which America provides to Saudi Arabia is obvious but the support which Syria receives from Saudi Arabia, Iraq and Kuwait is less so - although the effect was quite clearly shown in 1980 when the Saudies induced the Syrians to step back from their confrontation with Jordan. The position of France in Africa is also interesting: by virtue of the CFA franc system the French government and Treasury exercise considerable de facto influence over the French West African states - as well as some more obvious support such as military aid for example in the Central African Empire.

Regional ties. The global alignment of the country must not make one overlook the country's relations with its immediate neighbours, including the existence of border disputes or external military threats. The question of whether nearby states are involved in supporting, harbouring or financing groups opposed to the government should also be addressed here. A particular problem country is Qaddafi's Lybia: engaged in regular border tension with Egypt to the East, it supports internal subversion in Tunisia to the West (incident in 1980) and direct military intervention to the South (Uganda and Chad). To the

North, it has a point of influence and sporadic discord in Malta. In addition, Lybia has been involved in encouraging the Polisario in the Western Sahara dispute as well as in destabilising attempts in Gambia, possibly Senegal and the Central African Empire, not to speak of its general support of terrorist activities worldwide. A different case in point is Pakistan where we can find as complex and external position as may be found anywhere: once aligned with the U.S. and the West, but recently estranged from them; drawn unwillingly into the Afghanistan conflict and thus into confronting Russia, the principal support of its distrusted neighbour India; with the Chinese poking their heads round the door.

Attitude to foreign capital and investment. The role which foreign capital plays should have become clear in the economic sections, and the government's (and the opposition's) attitudes towards it in the subsequent political section. The existence of an investment code is not an absolute guarantee of protection of investors' rights (Zaire, for example, nationalized a number of enterprises in 1974, some of which were "protected" by its investment code; Egypt's law 43 is worded in such a way that expropriation and nationalization can be justified). It does serve, however, as evidence that the government (at least the current one) has recognized certain rights of the investor. In this context China poses an interesting problem: It does not have an established system of commercial law as we know it in the West and, therefore, there is a risk, not so much of deliberate expropriation, but of difficulties arising out of misunderstandings caused by different interpretations of the general rights of investors and those of the government.

General Indicators. Finally some useful indicators of the country's external position are its voting pattern at the U.N., the existence of formal and active opposition groups in exile and terrorist acts committed in third countries.

The progression from a system where foreign companies freely operate sales branches and wholly-owned subsidiaries, to one where they must divest part or most of their shareholdings and export a significant portion of their output is now history in many developing and industrializing countries. The likelihood and speed with which these events may take place depend not only on the extent of foreign capital domination in key sectors of the economy, but also on whether or not the current government finds itself in a position where the sacrifice of foreign goodwill is the cheapest price for survival.

Part II: The Specific Project

The intention in this section is to identify the key features of the project itself and of the investor responsible for it, and to consider these as systematically as possible in the light of any particular problem areas which have been identified in the earlier analysis. One is not simply concerned with whether the investment or project is likely to be expropriated by a current government but also whether there are features proper to the project or the investor which may make it particularly vulnerable in the event of any change in the status quo.

(A) Corporate Factors

Nationality. The actual (or perceived) nationality of the investing corporation will have a significant impact on the safety of the investments, depending on the relations which the host country has or has had with the investor's home country. Difficulties can arise from the vestiges of a colonial relationship or from previous support for an earlier government. The memories of its bitter struggle for independence still complicates Algeria's dealings with France and the queston of compensation for nationalized French interests has never been properly settled. An example of where this problem can arise suddenly and unexpectedly was the recent occasion when British companies in Saudi Arabia were put at risk as the result of the screening on U.K. television of a film entitled "Death of a Princess," a film which was judged by the Saudies to be particularly offensive. Yet, certain countries are able to maintain surprisingly good relations with difficult countries - witness the recent experience of Italian companies in Lybia, although at the time of Qaddafi's accession they did suffer some losses. United States corporations in Latin America tend to be exposed to relatively higher risks than their European counterparts since they have inherited an historical role as symbols of support for repressive military regimes.

Scope of corporate activities. The type and geographic location of the corporations' activities worldwide may have a material influence on the level of risk: for example, trading with or investing in a nation that is hostile to or boycotted by the host government. Apart from the well known boycott of

Israel by Arab and Moslem countries, other complications can arise such as those which result from a company's dealing with South Africa. Nigeria is one of many Black African nations which has taken an exceptionally strong line against corporations which trade with South Africa.

Corporate image. The investors reputation or image is another possible source of risk. Corrupt payment scandals or a history of involvement in the financing of political subversion have left lasting scars on certain U.S. corporations which are still viewed by local governments (and opposition groups) with mistrust. Apart from the notorious example of ITT and the Allende regime in Chile, one may cite the United Fruit Company and its successors which are still trying to live down the reputation acquired in Central America in the 1950s, in spite of major changes in corporate policy and extensive public relations efforts.

Previous losses. Careful scrutiny of the circumstances in the past which have led to expropriation or other political-type losses is essential. Apart from being indicative of what may be expected, it can show certain strengths - e.g., if the investor managed to obtain proper compensation or retains a good working relationship in the country concerned. For example, the nationalizations of oil companies in the Middle East and elsewhere appear to have taken place quite smoothly with reasonable compensation being paid and with the companies continuing to operate on the basis of management contracts. Gulf Oil managed to live through the revolution in Angola and emerged from it in a strengthened position. Certain banks, in an industry which is particularly exposed to nationalization, have fared better than others in obtaining reasonable terms from governments which are obliged to maintain good working relationships with international financial organizations.

(B) Investment Factors

Activity/economic sector. The first feature to establish is the significance of the sector in which the foreign enterprise is active, both in respect of the internal and the external economy of the country. In general, certain sectors such as those involving primary sources (mining, plantations, oil) are more likely to be nationalized. However, one must consider the relative level of foreign capital within the sector as well as the importance or political sensitivity of the sector to both government and opposition.

Position within sector. The size of the enterprise relative to others (including those which are locally owned) within the sector affects the degree of monopoly or oligopoly power that a firm may exercise thus making it a more or less suitable target for expropriation. Monopolies in sectors such as public utilities, railroads, electricity, etc., have historically been particularly vulnerable to nationalization. There may of course be occasions where a foreign investor is the only corporation capable of deploying the technology or resources for given investment. However, it is usually only a matter of time before the government or a succeeding government requires the investor to give up or share part of its monopoly.

Contributions to the country's economy. It is essential to attempt to quantify the net benefits which the enterprise brings to the local economy. Positive contributions include capital invested or loans, technology, the hiring of local labour and the corresponding generation of income and tax revenues plus reinvested earnings if any, savings or foreign exchange through import substitution effects and the support of local businesses. This is partially offset by dividends and capital repatriation, loan repayments, license fees and royalties, management fees, intercompany payables, transfer pricing and additional imports required. The view which the host country will have of these costs and benefits may not correspond to that of the firm. It should be obvious that in terms of risks the former view is the important factor. A typical case of this dichotomy can be found in those industries which have been set up in low wage countries in Southeast Asia, North Africa and the Caribbean to process goods for export markets. Whilst foreign investors may consider that they are creating jobs that would not otherwise have existed and generating foreign exchange, local governments increasingly question whether reasonable wages are being paid and what the long-term benefits are for the local economy. This may lead to increasing demands that foreign companies make more substantial investments in production and transfer higher levels of technology.

Bargaining power of the investor. One must identify the real strength of the investors' inputs to the project in order to identify those which may be exclusive and difficult to replace such as spare parts, control of technology

or down stream processes and markets. A widely cited example of an investor which has enormous power in this respect is that of IBM, a corporation which has consistently refused to dilute its shareholdings in its foreign subsidiaries. In India, when put under pressure to cede part of its local affiliate to domestic interests, IBM chose to close down operations rather than comply. The large multinational oil companies have also exercised considerable strength from their control of refining and distribution networks, although there are indications that their relative power is declining in this respect with the rise of national and independent oil companies.

Local partners or associates. The nature and identity of any local partners should be checked to determine whether they might in fact increase the risk: for example, eminent local figures closely associated with the government will only be an asset as long as the government lasts. In Nicaragua, in the aftermath of the Sandinista revolution, one of the first decrees issued concerned the nationalization of assets owned by the Somoza family and those closely associated with it in either the army or the administration.

Specific investment agreements with host governments. Lastly, one needs to examine any special agreements which have been entered into by the investor with the host government to consider whether or not they improve the risk. A typical problem area is that of oil or mining exploration and production agreements which frequently offer attractive tax concessions in order to attract investors, but which are very frequently renegotiated once the investor has become committed and is successful. The very favourable agreement negotiated between Rio Tinto Zinc's Australian subsidiary and the Papua-New Guinea government turned into a major contentious issue once production had started and copper prices climbed unexpectedly. A renegotiation of the agreement under difficult conditions made it possible for both parties to save face and continue operations. By assuring that social benefits accrue to the host nation over the duration of the project, and that these benefits are evident to all major political forces, the firm can have a major impact on how it is perceived and, therefore, on the likelihood that changes in economic or political factors would result in a higher probability of intervention.

III

CONCLUSION

No purely mechanical system could be expected to deal with the subtleties required in forecasting country political risk. Rough rankings of countries in terms of their relative political stability can and have been performed using various quantitative techniques. But how good these are as predictors of future stability remains questionable. The facts that causality is not easily determined in political phenomena, that up-to-date information is difficult to obtain and that stability itself is not necessarily a good measure of risk all contribute to the many doubts often expressed about such methods. Furthermore, the nature of the industry and of the investor and the timing of the project are critical variables that alter in a significant way the risk profile within the same set of economic and political conditions.

Yet, no human being could possibly master this complexity for more than just a handful of countries. Unaided by quantitative tools the political risk analyst would be drowned in a sea of information. Judgment can best be applied when the range of variables to consider has been reduced to a manageable set. Here lies the challenge for truly forecasting political risks. It requires first of all good measures of quantifiable variables that can be processed in a mechanic and efficient fashion. Second, it calls for many qualitative assessments of elusive trends such as levels of aspiration and frustration among diverse interest groups. Finally, it demands good judgment above all, to mix these many inputs in a coherent manner and to spot, as Holmes, the dog that did not bark in the night.

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