a short note on political risk

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Political Risk

Political instability affects stocks returns (Diamonte, Liew and Stevens, 1996), international trade (Morrow, Siverson and Tavares, 1998), capital flight (Alesina and Tabellini, 1989), budget deficits (Roubini, 1991), tourism (Poirier, 1997; Naudè and Saayman, 2005), the level of foreign direct investments (Busse and Hefeker, 2007), the outcomes of foreign direct investments (Clark, 1977), and even investment strategies (Cosset and Suret, 1995).

This is why estimating the likelihood of political instability, what is known as political risk, can provide investors with the information they may need to minimize or avoid losses and make profits.

Political risk, over the years, has been estimated either at the macro or at the micro level. Macro-level assessments, qualitative or quantitative, have generally attempted to evaluate what is known as country risk that is how probable it is for a country to experience political instability however defined. Macro-level risk can be affected by economic, social and political factors both inside and outside the country and may significantly affect the functioning of firms operating in the country. Coups d'état, riots, kidnapping, nationalizations, expropriations can all have a dramatic impact on the firms operating in the host country.

This is why, in spite of the fact that critics have in recent years emphasized that the assessment of political risk is not always as objective as it should be (Slovic, 1999) or that even the notion of political risk is socially constructed (Dake, 1992), properly estimating political risk has remained an extremely valuable exercise for international investors (Stapenhurst, 1992).

The study of country risk or of the level of political risk to which a country is exposed has pursued three streams of inquiry. A stream of research has explored the political, social and economic consequences of political risk. These studies have documented that political risk matters as it affects investments, growth, capital flight, deficit, trade, tourism and even stock returns and have shown that international firms may need financial or fiscal incentives to be persuaded to invest in the host country (Emel and Huber, 2008). Another stream of research has attempted to identify the causes of instability. Studies generated in this stream of research have identified the causes of political risk in regional contagion (domino or snowballing effect), rapid modernization (Huntington, 1968), rapid urbanization, religious fundamentalism, ethno-linguistic fragmentation, cultural heterogeneity/polarization, corruption, poor governance, gap between political and economic development, and financial factors. One of the most comprehensive, methodologically-sophisticated and empirically rich analyses conducted in this line of research found that regime type, patterns of executive recruitment and political participation (Goldstone et al., 2010) provide the best explanation/prediction for various kinds of upheavals. Building on the insight generated by these studies, methodologists and analysts have used the variables of interest identified by the literature to generate increasingly more precise diagnostic tools and more accurate assessments.

While qualitative analysts have attempted to evaluate a country’s risk exposure on the basis of in-depth qualitative analyses, quantitative analysts have developed a wide variety of metrics to compute a country risk level. While nearly each political risk firms has its own method for estimating risk, some of the best known methodologies for assessing risk are BERI, PSSI, EIU, Brookings’s Index of state Weakness, the state fragility index (SFI), World Bank’s Governance indicators and IHS which is one of the most commonly used to estimate the risk to which extractive industries are exposed to.

Valuable as these macro-level models may be, they present three basic shortcomings. In most cases, even when they work well, they only offer ‘thin’ prediction because why such models and the
variables that they employ have a good predictive power. Most of these models are not grounded in theory and often give the impression of adopting a kitchen-sink approach whereby a large number of variable is included in the model for the sake of boosting the model’s predictive power but without providing any theoretical justification for the choice of variables.

The second problem, that characterize these models, is that they are neither parsimonious nor efficient. They require the collection of information of a fairly large number of variables and indicators. For example, in order to estimate the level of a country’s exposure to risk EIU has to collect, code, and process information about 77 variables; the PSSI methodology needs to collect information on about 15 variables to estimate risk; BERI requires information on more than 10 variables, SFI devised by the center for systemic peace is computed on the basis of 12 indicators, while IHS has to gather information on 11 level variables pertaining to a political, an economic and a commercial dimension. Given the considerable amount of information required to generate any risk estimate, these methodologies are not parsimonious and they are not efficient.

The third and most serious problem is that, in spite of the fact that in order to boost their predictive power employ a large number of variables and indicators, these models are not terribly effective in predicting a country risk level and, because of their design, they are even less effective in predicting the level of risk to which specific firms are exposed. In this regard the literature has shown that country risks or political instability do not automatically affect the value of a firm’s operation in a given country (de la Torre and Neckar, 1988). This is the reason why firms and analysts, however, have become increasingly aware of the fact firms with specific characteristics are more or less likely, because of such characteristics to be affected by macro-level risk. As Alon et al. (2009) noted “the energy sector is affected by variables such as environmental activism, energy vulnerability, and constraints on oil investment, the financial sector is affected by other variables such as debt service ratio, flow of funds rate, banking regulations, and so on.”

Other characteristics of the firm affect its exposure to risk. For instance Khattab, Anchor and Davies (2007) have underlined that the degree of a firm’s internationalization affects its vulnerability to political risk. This realization had an obvious consequences: firms and analysts understood the need to complement macro political risk assessments with micro political risk assessments.

The measures of micro political risk should be regarded, according to some analysts (Alon and Herbert, 2009), as deflators of macro political risks. In other words, the micro level risks should be used to discount or magnify the macro risk to which a specific firm. A firm that is regarded as very valuable for the local community where it operates, because it provides employment, education, technological diffusion and so on, it less likely to be affected by occurrences of political instability, whereas a firm that is regarded to be detrimental to the well-being of the community where it operates, is more likely to be negatively affected by instances of political instability.

Firms that are considered to be valuable for the local community can survive unscathed riots, coups, and other forms of political instability. By contrast firms that are viewed as exploitive or as detrimental, may be greatly harmed by occurrences of political instability. Such companies can be nationalized, their staff can be kidnapped, their assets can be expropriated, and contracts can be voided by the leaders of the new political regimes. As a result, it is very important for a firm to be viewed to be beneficial for the local community.

Alon and Herbert (2009) suggested that the extent to which a firm is able to be viewed as beneficial by and for the local community depends on three factors: the company’s contribution to the local economy, the bargaining power of the firm relative vis-à-vis the government and the governance structure of the company. According to Alon and Herbert (2009) the contribution to the local economy, the level of technology and technology transfer to the host country, the size of operations,
the level of exports, the dependence on the local market, the use of local natural resources, the level of firm diversification, the extent of local ownership, financial policies adverse to BOP and intra-corporate transfers affect a firm’s exposure to risk.

Using these and other variables, Alon and Herbert (2009) proposed a micro political risk assessment model, that focus on three dimensions: internal antecedents, external antecedents, and firm-related factors. Each of these dimensions is divided in a set of three sub-dimensions and each sub-dimension includes three factors or variables. By looking at the importance of each factor, at its impact on the firm and at the occurrence probability, the model estimates first the factor’s risk assessment and then the overall potential effect. Specifically by multiplying the occurrence probability by the factor’s impact on the firm, the model estimates the risk assessment. And then by multiplying the factor’s risk assessment by the factor’s importance, the model evaluates the overall potential effect.

Building on the work of Alon and Herbert (2009), we aim to develop a new model for assessing whether, how and to what extent the characteristics of a firm affect its risk exposure. And we will propose then how framework of analysis can be applied not only to assess a firm’s risk exposure but also to show what a firm can do to reduce and virtually eliminate the portion of the risk that is due to the firm’s characteristics.

First of all, it is important to clarify if, when and under what circumstances a firm is beneficial and it is even more important to develop a clear understanding of whom is a firm beneficial to. Previous assessments of micro risks have underlined the importance of being beneficial to the local economy. But, as Polanyi (2001) made clear, not all relationship are economic. In addition to economic relationships, individual, groups and communities may be embedded in and entertain social and political relationships. Furthermore what is economically valuable may not necessarily be politically or socially viable. For example, the presence and the activity of a mining company can be beneficial to the local economy, but socially detrimental because the negative side-effects of the pollution generated by the mining company may outperform its economic benefits. Hence, one should not worry about whether and to what extent a firm is valuable to the local economy, but rather whether and to what extent it is valuable to the local community. Economies don’t rebel, communities do.

The risk to which a company is exposed depends on whether and to what extent it is viewed as beneficial to the local community.

The second point that has to be emphasized is that local communities, as each and every form of social organizations, are characterized by the presence of two sets of actors: the members of the elite on the one hand and the masses on the other hand. It is important to acknowledge the existence of these two social groups, because their interests may at times converge, coincide, diverge and collide. The fact that members of the local elite are given shares in a foreign firm or are allowed to invest heavily in such a firm, makes the firm very appealing and beneficial to this group, but not necessarily to the masses. Likewise, the fact that a firm recruits its labor force from among the members of the community is beneficial at the mass level but may or may not be beneficial at the elite level. Obviously the risk exposure of a firm is highest when the firm is viewed as detrimental by elite and masses, is lowest when it is viewed as beneficial to both, and it is somewhere in between when it is beneficial to one social group but not the other.

The third point that should be considered is that the benefits that a firm may provide to a local community, to its leaders and to its members at large, may be symbolic or material, objective and perceived. And while citizen perceptions may, to some extent, reflect and be influenced by objective factors (a firm pollutes, creates employment, pays/does not pay bribes) they may also be affected and modified by a firm’ strategic positioning and communication on salient issues (Pelizzo,
This is why Alon, Gurumoorthy, Mitchell and Steen (2006) suggest that firms, in addition to developing their own risk-assessment tools, should also devise their own risk-minimizing strategies. For instance a firm could make an effective use of outreach programs to explain to the members of the local community why the firm is beneficial to them thus reducing the firms’ exposure to risk. For example a company believed to be polluting the environment in which it operates, could regain the trust of the local community by using outreach programs to explain what it does to protect the environment and minimize the impact of its operations on the well-being of the local community.

References


