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**Approaches to the Problems  
of Political Risk in  
Foreign Direct Investment**

by

Christopher O. Howard

Supervised by

Robert Schrire

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in fulfillment of the requirements for  
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*Dedicated to Marie*

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## **Abstract**

This thesis examines the challenges multinational enterprises face from political risk when making and operating foreign direct investments. The thesis considers political risk and a wide variety of approaches to its analysis and provides insight into the process of foreign direct investment, the nature of the political threat facing it, foreign investment decision making by multinationals, and the tools developed in the commercial, academic, and governmental arenas to avoid and combat the effects of political risk. In essence, the thesis addresses a business application of theories and methodologies used in political studies.

The first hypothesis is: **if political risk is properly understood as a phenomenon of the political environment, then it a) defies direct quantification and b) can be explained as a series of discrete elements which can be analyzed separately.** The second hypothesis is: **if political risk is properly understood as a series of non-quantifiable elements, analysis of political risk cannot be depended upon alone to protect multinational enterprises from political risk in foreign direct investment.**

The first hypothesis is addressed through a critical review and consideration of business and political risk literature. Two analytical tools are developed in this process: a ladder of cognition consisting of a series of conditions of knowledge which can be held regarding a specific risk, and indicating the type and approximate accuracy of analysis which can be undertaken of such risk; and a representation of the political risk equation as a two stage process consisting of an abstract (environmental) risk event and a discrete effect which the event may or may not have on a specific investment.

The second hypothesis is addressed through a critical review of methods of political risk analysis including "qualitative" approaches with roots in traditional studies and "quantitative" approaches derived from statistical analysis and behavioralist-based determinism. Critiques of each approach include operational strengths and weaknesses, performance histories (when applicable), conceptual and practical capabilities from the perspective of the analytical tools described above, and theoretical strengths and weaknesses from the perspective of the political studies discipline.

Both hypotheses are supported and the thesis concludes by reviewing tools which can be used by multinationals to manage and mitigate the effects of political risk and considering additional academic work in this arena which would be useful in developing this application of political studies.

## Part I

### Introduction

An investment is made when the expected return on invested capital exceeds the cost of capital used in the investment by a percentage which is greater than that which could be generated by any alternate investment.<sup>1</sup>

One of the fundamental principles of free enterprise is that the employment of capital is a rational action oriented toward maximizing return on investment. In fact, innumerable other issues can enter into the investment decision. One of the most common of such factors is the perception of an investment's potential vulnerability to risk.

Risks in business include such basic possibilities as fire in the factory, unexpected changes in interest rates or taxation, equipment failures, or a labor dispute. Such risks are generally described in terms of the likelihood or probability of their occurrence and by the kinds of costs they can exact on a business. The more likely and/or expensive, the "higher" the risk.

Most business enterprises operate in a familiar environment and enjoy a good understanding of their local polity. In such settings, business risks are essentially financial or economic in nature and are therefore predictable. Businesses careful about their investments use economists, actuaries, and econometric models to identify risks, determine the probability of their occurrence and costs of their effects, and develop a business plan which will provide profits despite them.

Investment in foreign countries is not essentially different from domestic investment, but foreign direct investment (FDI) attracts additional risks of a political nature that are not usually encountered in domestic business activity.<sup>2</sup> FDI requires multinational enterprises (MNEs) to work within two or more distinct polities with different norms, sets of laws, and goals and expectations. This creates the potential for conflict -- the possible need to 'serve two masters.' It also obliges the MNE to operate within an unfamiliar environment where indicators of

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<sup>1</sup>Raymond Vernon, "Conflict and Resolution Between Foreign Direct Investors and Less Developed Countries," *Public Policy*, Vol. XVIII (Fall, 1968), p. 334.

<sup>2</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), p. 9.

potential risks may not be recognized and what should be easily predictable or avoidable hazards can have major and costly consequences due to this lack of awareness.<sup>3</sup> Such **ignorance** is the fundamental factor of vulnerability to politically-based risk in FDI: the greater the differences between the home and host environments, the more likely the investor is to be ignorant of the host environment and the more vulnerable the investment is likely to be to such risk.

This is why major political risk is such a recent phenomenon relative to the centuries long history of FDI. Before decolonization, the polities of colonies and protectorates were largely controlled by imperial governments and presented a stable investment environment of few surprises. MNEs could expect a high rate of return on investment, low local taxes, few regulations, and little threat to their assets. Even after decolonization, weak and inexperienced host governments often made it appear as if multinationals were powerful enough to keep their hosts's 'sovereignty at bay.'<sup>4</sup>

As time passed however, governments in many developing countries began to seek control over MNEs. In some cases, this resulted in a large scale seizure of foreign owned assets. But outright nationalization discourages the new foreign investment needed to support continued development, so this approach is no longer common. Host governments have now developed more subtle, more effective, and in some ways even more expensive forms of economic nationalism to maximize the benefits they receive from FDI.<sup>5</sup>

Foreign direct investment has become a high stakes 'wager,' where an MNE bets it will be able to earn a return on its investment greater than its aggregate cost and a host government bets the investment will provide

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<sup>3</sup>R.J. Rummel and David A. Heenan, "How Multinationals Analyze Political Risk," in Douglas N. Dickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), p. 382.

<sup>4</sup>The phrase was coined to represent the phenomenon of the sovereignty of developing countries being subsumed by powerful, self-interested MNEs which considered themselves to be beyond the control of any single country. See Raymond Vernon, *Sovereignty at Bay*, (New York: Basic Books, 1971) and "Economic Sovereignty at Bay," in Raymond Vernon, *The Economic and Political Consequences of Multinational Enterprise: An Anthology* (Boston: Division of Research, Graduate School of Business, Harvard University, 1972 [Article originally published in 1968]), pp. 3-19.

<sup>5</sup>C. Richard Peterson, "Can Multinationals Survive in Today's World?" *Risk Management*, Vol. 28 (February, 1981), p. 35 and John D. Sassi and Shaheen F. Dil, "The Art of Corporate Crystal Ball Gazing: Political Risk Analysis Experiences at Gulf Oil Corporation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 2.

benefits (in terms of capital, employment, training, technology, taxes, or anything else the government values) greater than the costs it exacts on the country's economy.<sup>6</sup> The political risk involved in such a wager "cannot be captured by minor addenda to the principles of finance, such as calculating the appropriate risk adjustment for a target rate of return or computing the appropriate price to be paid for a hedge."<sup>7</sup> It is not "realistic to use only commercial and technological assessments as planning inputs, for [if] the life of any venture may be cut short by political disruption," the nature and causes of such must be investigated and accounted for in the planning process.<sup>8</sup>

Political risk is now a major concern for any enterprise considering a foreign direct investment. Dealing with this problem is a significant activity in both the private and public sectors. Large MNEs with high foreign risk exposures devote substantial time, money, and effort to a variety of in-house attempts to lower their political risk. Smaller enterprises which do not have the same depth of resources turn to outside vendors for similar service. International banks and commercial political risk services offer foreign investors everything from thumbnail sketches of countries through sophisticated country risk assessments and rating indices to multi-faceted analyses using econometrics and other highly technical modelling techniques. Even governments provide political risk analysis through trade ministries and quasi-public corporations established to encourage investment in developing countries.<sup>9</sup>

This thesis examines the challenges MNEs face from political risk when making and operating foreign direct investments. Critical consideration of political risk and a wide variety of approaches to its analysis will provide insight into the process of foreign direct investment, the nature of the political threat facing it, FDI

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<sup>6</sup>John T. Reid, "Perspective: Managing Country Risk for a Manufacturing Corporation," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 187.

<sup>7</sup>Raymond Vernon, "Organizational and Institutional Responses to International Risk," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 211.

<sup>8</sup>F.T. Haner, "Rating Investment Risks Abroad," *Business Horizons*, Vol. 22, No. 2 (April, 1979), p. 18.

<sup>9</sup>David Bruce, "Integrating Political Risk Methodologies at a California International Bank," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 132.

decision making in multinationals, and the tools developed in the commercial, academic, and governmental arenas to avoid and combat the effects of political risk. These critiques will be theoretically grounded but will focus on the practical issues of political risk for those making direct investments in developing countries.

The first two chapters provide a foundation for the analytical work which follows. They are designed to act as an introduction to the field of political risk and to facilitate an understanding of the relevant ideas and terminology.

Chapter 1 defines and discusses the terms and concepts needed to develop a practical understanding of political risk. Throughout the chapter, the goal will be to establish definitions of relevant concepts which are as broad and inclusive as possible while still being useful, and to identify supportive terminology which is etymologically consistent with the definitions. The chapter opens with a consideration of the nature of foreign direct investment and introduces the two primary actors in the FDI equation. A variety of other terms are also defined and several additional issues addressed.

Chapter 2 provides a somewhat broader introduction to and background on the topic of foreign direct investment and political risk. It then outlines the hypotheses, goals, and organization of the thesis.

## Chapter 1

### Definitions and Terminology

"Direct investment implies a transfer of resources -- technology, management skills, marketing knowledge, capital, etc. -- from the home to the host environment. It also entails control in the managerial sense. The direct investor transfers resources, usually scarce in the host economy, and maintains control over the use of the resources in their new environment."<sup>1</sup>

Three things differentiate direct investment from other investment:<sup>\*</sup> the nature of what is invested, the element of control after the investment is made, and the implication the investment is made for operational purposes. Foreign direct investment (FDI) can be defined as the investment of capital and non-capital assets (e.g. personnel, expertise, technology, or trademarks) in a foreign country for use by, or under the control of, the investor for purposes other than solely the marketing of imported goods.

When a multinational enterprise (MNE) chooses to enter a market through a direct investment (as opposed to a sales agreement with a local agent), the goal is generally diversification or flexibility in meeting local market demand.<sup>2</sup> A second potential motivation for foreign direct investment is a desire to minimize the risk which comes from doing business with others. To accomplish this, MNEs build vertically integrated chains of ownership or control over raw material or component supplies, transport, and sales and marketing.<sup>3</sup> When a government refuses to permit market entry without a direct investment, or actively solicits a direct investment and

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<sup>1</sup>Stephen J. Kobrin, "The Political Environment," in Vern Terpstra, *et. al.*, *The Cultural Environment of International Business* (Cincinnati: South-Western Publishing Co., 1978.), p. 235.

<sup>\*</sup>Business investment is generally divided between direct investment and portfolio investment. The latter is the investment of liquid capital (cash or its equivalents) in shares of stock in a business, or in other so-called 'securities,' and does not entail any managerial control. Michael Z. Brooke and H. Lee Remmers, *The International Firm: A Study of Management Across Frontiers -- Trade and Investment* (London: Pitman Publishing Limited, 1977), pp. 248-249.

<sup>2</sup>Philip R. Cateora, "The Multinational Enterprise and Nationalism," *MSU Business Topics*, Vol. 19, No. 2 (Spring, 1971), p. 49.

<sup>3</sup>Raymond Vernon, "Organizational and Institutional Responses to International Risk," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 191.

offers an agreement which makes the investment appear profitable, the government initiation constitutes a third stimulus for FDI.<sup>4</sup>

Schmidt labels these three types of foreign direct investment **conglomerate** -- made for expansion; **vertical** -- made for integration; and **horizontal** -- made to parallel existing operations. He also identifies three individual factors which characterize every investment: the sector of economic activity (e.g. agriculture, light manufacturing, banking) in which the investment is made; the technological sophistication of the operation; and whether the investment is wholly or only partly owned by the investor.<sup>5</sup> An additional specific characteristic is common to virtually all foreign direct investment: it "must be considered as reasonably permanent and involves substantial commitments of parent company human and capital resources."<sup>6</sup>

### The Actors

"Risk analysis [including political risk analysis] is part of the theory of rational choice, and in order to appear within that theory at all [participants] must be represented as rational actors."<sup>7</sup>

The operative question in considering the activities of any "rational actor" is "what they have good reason to do."<sup>8</sup> To this question must be added two caveats:

1. The operative question is properly considered as a matter of perception. The theory implies the actions of rational actors can only be based on information or experience available to *them*. This set of knowledge may be different from that held by an analyst, so actions may *appear* irrational without actually being irrational.

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<sup>4</sup>Harold Crookell, "Investing in Development -- A Corporate View, *Columbia Journal of World Business*, Vol. X, No. 1 (Spring, 1975), pp. 80-82. This activity also can stimulate investment indirectly. One of the concessions commonly offered to attract an investor is market protection. If an MNE sees a strong market position in a country put at risk by protection being offered to a competitor, it too may choose to invest in domestic production facilities to defend its own market share. This motivation is also known as the 'bandwagon' effect.

<sup>5</sup>David A. Schmidt, "Analyzing Political Risk," *Business Horizons*, Vol. 29, No. 4 (July/August, 1986), pp. 46-47.

<sup>6</sup>Dolph Warren Zink, *The Political Risks for Multinational Enterprise in Developing Countries: With a Case Study of Peru* (New York: Praeger Publishers, 1973), p. 26.

<sup>7</sup>John Dunn, "Country Risk: Social and Cultural Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 144.

<sup>8</sup>*Ibid.*

2. Nations, and in some cases even governments, are not necessarily actors *per se*. They may behave as unitary entities, but they tend to be aggregates of individual actors with individual interests. In the case of political risk, this trait may also apply to opposition political groups, entities which could be thought of as 'would be' governments.

### Multinational Enterprise

"While there is no universally accepted definition of [multinational enterprise], it is generally considered to be a company having production and marketing facilities in many countries, enjoying worldwide access to capital, depending on foreign income, and being managed with a worldwide point of view."<sup>9</sup>

This broad generalization is no more than a guide to the tangled group of terms and definitions which describe the independent actor in foreign direct investment. Brooke and Remmers identify over fifteen discrete definitions and conclude that despite similarities between them, the definitions have significant differences, the differences tend to be arbitrary, and there is no compelling evidence to favor any single definition over any other.<sup>10</sup> Arbitrary definitions are invariably deterministic -- including some business entities under the aegis of the label, excluding others, the final tally often dictating the conclusions a writer will make. Things can be little different in this case, although the nature of the study is such that the choices will not impose specific conclusions.

Most definitions of multinational enterprise are based on thresholds which an enterprise must surpass to be considered an MNE. Among the determinants used are the percentage of assets owned or controlled by a firm in countries other than that in which its headquarters is located, the number of countries in which production or similar operations are held, and/or the amount of turnover or gross or net income from such 'foreign' operations as a percentage of the firm's total. Other factors used in various definitions include the nature of foreign investments being held, the length of time an enterprise has been involved internationally, and the internal structure of the enterprise (which is supposed to suggest whether the enterprise views itself as a truly 'multinational' entity or as a domestic business with an outside investment).<sup>11</sup>

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<sup>9</sup>David W. Ewing, "MNCs on Trial," in *Managing the Multinationals: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1974 [Article originally published in 1972]), p. 157.

<sup>10</sup>Brooke and Remmers, *op. cit.*, pp. 2-3.

<sup>11</sup>Zink, *op. cit.*, p. 5.

The terms available to describe multinational enterprises are equally varied.<sup>12</sup> Corporation is used often instead of enterprise, as are firm and business among others. For multinational, various writers have substituted international, supernational, and transnational.

**Multinational** is chosen here not just because it is now the closest thing to a consensus term, but because it has the appropriate connotations. Where 'international' merely suggests involvement beyond one set of borders, 'multinational' seems to go a step further, to involvement *within* more than one set of borders. 'Transnational' on the other hand, when not being used interchangeably with multinational,\* generally refers to a small subset of multinational firms with leadership and roots in more than one country (e.g. the Anglo-Dutch corporations Unilever and Royal Dutch/Shell), while 'supernational' describes enterprises which act as if they exist beyond the borders of any country (a description or accusation often used twenty years ago to describe ITT). While the present use of multinational is not intended to exclude firms which might fit or aspire to fit either or both of the latter descriptions, neither is it intended to require such characteristics.

'Enterprise,' 'corporation,' 'firm,' 'business,' and so forth, are virtually interchangeable in most situations, but **enterprise**, significantly, does not require or presume any particular type of business organization. Enterprise can therefore stretch over the entire array of different types of corporations around the world and also include non-corporate groups such as partnerships which might be involved in multinational business.

**Multinational enterprise** as used in this thesis therefore refers to any business entity which has made a foreign direct investment regardless of the size, purpose, structure, profitability, or other characteristics of the FDI and regardless of the structure, orientation, or goals of the enterprise. This means the specific nature, structure, and/or outlook of different MNEs may vary greatly from one to another despite a few shared characteristics. If an enterprise has made in the past, but no longer holds, a foreign direct investment, it would be considered an MNE in the context of any consideration of that investment. Also, in the context of the study of business processes which

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<sup>12</sup>The following information is taken from a wide variety of sources but is essentially a condensation of similar discussions in John D. Daniels and Lee H. Radebaugh, *International Business: Environments and Operations, Fourth Edition* (Reading, Massachusetts: Addison-Wesley Publishing Company, 1986), pp. 16-17 and Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 1-2.

\*Transnational corporation (TNC) was long the term favored for use by the United Nations and other international organizations, as well as many writers.

necessarily precede a foreign direct investment, any enterprise contemplating such an investment would be considered an MNE even in the absence of other characteristics.

Each MNE has a headquarters element which is generally known as the **parent** and is located in the **home country**. Both of these are widely used terms.<sup>13</sup> The foreign investment itself will be known as an **affiliate**. This will avoid any confusion which might be created by using limited or deterministic terminology such as 'branch office,' 'subsidiary,' 'joint venture,' or 'associated company;' all are affiliates.<sup>14</sup> Should one of the precise terms be more appropriate for a specific usage, it will be used.

### MNE Interests, Goals, and Needs

In order to analyze political risk in foreign direct investment, one first needs to understand the motivations MNEs have for making such investments. Zink sees MNEs as rational actors with 'primary goals' of "profit maximization, growth, asset protection, and survival."<sup>15</sup> Gladwin and Walter identify a total of six MNE objectives:

1. To find large and growing markets;
2. To achieve and benefit from market domination in both sales and resource acquisition;
3. To minimize all costs;
4. To minimize exposure to all forms of risk;
5. To avoid or minimize all artificial barriers to trade and finance;\*
6. To maximize net profits.<sup>16</sup>

All of these goals overlap and are empirical in nature. Shubik argues they are merely components of one overriding desire: to maximize profits at minimal risk.

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<sup>13</sup>Brooke and Remmers, *op. cit.*, p. 3.

<sup>14</sup>Norman A. Baglini, *Global Risk Management: How U.S. Corporations Manage Foreign Risks* (Risk Management Society Publishing, Inc., 1983), p. 2.

<sup>15</sup>Zink, *op. cit.*, p. viii.

\*This refers to trade and finance barriers which would interfere with the operations of the business in question. Barriers which would assist in the achievement of other goals by blocking the activities of competitors are not necessarily included.

<sup>16</sup>Thomas N. Gladwin and Ingo Walter, *Multinationals Under Fire: Lessons in the Management of Conflict* (New York: John Wiley & Sons, Inc., 1980), pp. 503-504.

Shubik adds a normative component to the goal structure: the desire to be seen as 'a good corporate citizen.' Because MNEs are more than merely economic entities, they must be sensitive to their social and political roles in countries in which they operate.<sup>17</sup> In order for an enterprise to be capable of doing anything else effectively, its workers, customers, and neighbors must be satisfied with its behavior. In this case, neighbors refers to not just those people who literally neighbor a plant or other business site, but to all groups in society at large, including government organizations, which perceive an interest in the activities of the enterprise and have some means and capability of making their expectations felt. If the enterprise is a publicly held corporation, stockholders are among those who must be kept happy. Conflicting needs and expectations among different groups can make the 'satisfaction factor' particularly problematic.<sup>18</sup>

#### EXHIBIT 1.1: THE BUSINESS INTERESTS OF A TYPICAL ENTERPRISE\*

##### Business Interests

| Assets                     | Organization             | Operations              | Markets                   |
|----------------------------|--------------------------|-------------------------|---------------------------|
| Secure equity position     | Autonomous               | Access to equipment     | Growing domestic          |
| Physical safety of assets  | management decision      | Access to raw materials | markets                   |
| Secure land rights         | making                   | Right to export         | Access to foreign markets |
| Secure mineral rights      | Ability to hire and fire | Right to import/export  | Fair competition          |
| Secure patents, copyrights | Smooth labor relations   | funds                   |                           |
|                            | Employee safety,         |                         |                           |
|                            | financial security,      |                         |                           |
|                            | general comfort          |                         |                           |

To meet these goals, a business enterprise has certain needs. First and foremost among them is stability, not in the sense of peace and prosperity, but in the sense of lack of change.<sup>19</sup> Stability is the basis of long-term

<sup>17</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), pp. 112 and 134.

<sup>18</sup>Daniels and Radebaugh, *op. cit.*, pp. 374-375 and 409.

\*Taken from William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), p. 32.

<sup>19</sup>*Ibid.*, pp. 374-375.

planning and development and is therefore crucial to ongoing operational profitability.<sup>20</sup> Several writers have suggested that stability is so important, MNEs often will be willing to accept harsh operating and financial restrictions and low rates of return on investment in exchange for consistency and predictability.<sup>21</sup>

Other interests have been grouped by Overholt into four categories as shown in exhibit 1.1. These 'interests' can be summarized as **safety** (of assets), **autonomy** (in both organizational management and operations), **flexibility** (across the board), and **access** (to markets).

### Host Countries

**Host country** refers to a nation in which an MNE has made or is considering making an investment. Like its counterpart home country, the term is generally accepted throughout the political risk literature.<sup>22</sup> As the dependent primary actor in foreign direct investment, host countries are of particular interest in the study of political risk in FDI. A representative host country is a rational actor "motivated toward maximization of net national benefits...[e.g.] contributions to development, expanded foreign exchange earnings, monetary stability, economic independence, and national prestige."<sup>23</sup> Additional motivations include full employment of trained workers, training and lower unemployment or underemployment for untrained workers, assistance for and support of local business, increased tax revenue, politically tolerable distribution of income, and control over economic development, among other things.<sup>24</sup>

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<sup>20</sup>Overholt, *op. cit.*, p. 25.

<sup>21</sup>Stephen J. Kobrin, *Managing Political Risk Assessment: Strategic Response to Environmental Change* (Berkeley: University of California Press, 1982), pp. 120-121, R. Hal Mason, "Conflicts Between Host Countries and the Multinational Enterprise," *California Management Review*, Vol. XVII, No. 1 (Fall, 1974), p. 12, and Zink, *op. cit.*, p. 42.

<sup>22</sup>Brooke and Remmers, *op. cit.*, p. 3.

<sup>23</sup>Robock and Simmonds, *op. cit.*, pp. 384-385.

<sup>24</sup>Mason, *op. cit.*, p. 7 and P. Streeten, "New Approaches to Private Investment in Less Developed Countries," in John H. Dunning (ed.), *International Investment: Selected Readings* (Middlesex, England: Penguin Books, 1972 [Article originally published in 1969]), pp. 444-445.

## EXHIBIT 1.2: CONTRIBUTIONS OF MULTINATIONAL ENTERPRISE IN DEVELOPING COUNTRIES\*

| Contributions   | Nature of Response  |                           |                    |
|---|---------------------|---------------------------|--------------------|
|   | Very Important<br>% | Moderately Important<br>% | Not Important<br>% |
| <u>Capital Usage</u>  |                     |                           |                    |
| Bring in foreign capital  | 71.0                | 26.3                      | 2.7                |
| Help in capital intensive investment by local investors                               | 36.9                | 47.3                      | 15.8               |
| Make more capital intensive investment than local investors                           | 68.4                | 31.6                      | 0                  |
| Show more efficient use of capital than do local investors                            | 47.5                | 47.5                      | 5.0                |
| Create a favorable climate for the inflow of other foreign capital                    | 57.5                | 40.0                      | 2.5                |
| Create a favorable climate for the approval of loans from international organizations | 57.5                | 37.5                      | 5.0                |
| Create a favorable climate to receive loans from developed countries (foreign aid)    | 42.5                | 50.0                      | 7.5                |
| <u>Technology Usage</u>   |                     |                           |                    |
| Introduce new products soon after innovations in home country                         | 23.1                | 51.2                      | 25.7               |
| Introduce new production methods and processes soon after innovation                  | 28.2                | 48.7                      | 23.1               |
| Conduct research and development locally  | 7.7                 | 43.6                      | 48.7               |
| <u>Training</u>   |                     |                           |                    |
| Train local people in new industrial processes  | 45.0                | 47.5                      | 7.5                |
| Introduce new managerial techniques to national managers                              | 50.0                | 45.0                      | 5.0                |
| Increase labor productivity over that found in domestic companies                     | 45.0                | 55.0                      | 0                  |
| <u>Economic Development</u>   |                     |                           |                    |
| Materially add to the industrial infrastructure                                       | 55.0                | 40.0                      | 5.0                |
| Develop local supply industries   | 30.0                | 65.0                      | 5.0                |
| Set an example for national corporations to become more efficient and productive      | 47.5                | 52.5                      | 0                  |
| Help in increasing exports  | 47.5                | 50.0                      | 2.5                |
| Create new markets for products other than the local market                           | 30.0                | 52.5                      | 17.5               |
| Help in import substitution   | 32.5                | 50.0                      | 17.5               |
| Promote a more equitable income distribution by providing new jobs                    | 15.0                | 65.0                      | 20.0               |
| Help in developing natural resources  | 47.5                | 37.5                      | 15.0               |
| <u>General</u>  |                     |                           |                    |
| Promote political stability   | 15.0                | 52.5                      | 37.5               |
| Tend to preserve the existing socio-cultural setting                                  | 12.5                | 57.5                      | 30.0               |
| Support and promote technical education   | 27.5                | 70.0                      | 2.5                |
| Support and promote managerial education  | 32.5                | 62.5                      | 5.0                |
| Introduce new products which enrich consumers's lifestyles                            | 25.0                | 70.0                      | 5.0                |

\*Taken from Subhash Jain and Yash Puri, "Role of Multinational Corporations in Developing Countries: Policy Makers' Views," *Management International Review*, Vol. 21, No. 2 (1981), p. 63.

FDI can provide for these, so it follows that they comprise a country's rationale for pursuing MNE investments. In addition, FDI can provide 'human' and other non-traditional forms of capital: advanced technology and processes, expertise in all fields of business, access to global resources and markets, and related skills and knowledge generally unavailable to developing countries through other channels.<sup>25</sup> From a survey of 84 policy makers in 35 developing countries with 'market' economies, Jain and Puri compiled exhibit 1.2, a list of specific contributions for which would-be host countries look and which they expect MNEs to provide when considering FDI.

### Additional Definitions

Political risk itself is the subject of part II, but in the context of 'political risk analysis,' the term analysis will represent the entire appraisal process comprising: **identification**, or the recognition and classification of risk;<sup>26</sup> **assessment**, or the determination of the probability and manner of manifestation of risk; and **forecasting**, or the extension of identification and assessment into the future.

For the purposes of clarity and differentiation, 'nationalization' will be used to describe the mass seizure of assets by the state and 'expropriation' will refer to discriminatory or selective seizures of assets. To constitute nationalization, seizures must effect an entire class of business (industrial sector, country of ownership, and size of operation are possible classifications).<sup>26</sup> Both terms imply, but do not require, that seizures be made with no compensation, or without adequate compensation, for the property and assets taken.<sup>27</sup>

In both theoretical and practical discussions of risk, there will be differentiation between the terms **event** and **effect**. A **risk event** is a discrete occurrence -- anything from thermonuclear war to a home-country employee

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<sup>25</sup>Peter P. Gabriel, "MNCs in the Third World: Is Conflict Unavoidable?" in *Managing the Multinationals: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1974 [Article originally published in 1972]), pp. 136-137 and Raymond Vernon, "Foreign Trade and Foreign Investment: Hard Choices for Developing Countries," in Raymond Vernon, *The Economic and Political Consequences of Multinational Enterprise: An Anthology* (Boston: Division of Research, Graduate School of Business, Harvard University, 1972 [Article originally published in 1971]a), p. 25.

<sup>26</sup>Robock and Simmonds, *op. cit.*, p. 366.

<sup>27</sup>Don R. Beeman and Sherman A. Timmins, "Who Are the Villains in International Business," *Business Horizons*, Vol. 25, No. 5 (September-October, 1982), p. 8.

getting arrested in the host country for saying the wrong thing in public -- transpiring in the **environment**. A **risk effect** is the manner in which the event manifests itself upon the MNE in question (the **organization** in theoretical parlance). A given event may effect an organization directly, through the 'filter' of government or public reaction to it, or not at all.<sup>28</sup>

### Other Terminology

Due to the nature of the subject, it will be necessary throughout the thesis to refer to that group of countries known variously as the 'Third World,' less developed countries (LDCs), underdeveloped countries, and so forth. This thesis will use the term **developing countries** because, in the modern era, no country hosts FDI unless it chooses to; therefore, it is reasonable to assume that a host country is seeking to develop further. In context then, the term is not prejudicial or otherwise judgmental. For the sake of simplicity, all host countries not classified by the World Bank as 'high income industrialized states' will be considered 'developing.'<sup>29</sup>

Another terminological issue of great concern in some circles is the matter of gender. Whenever possible, this thesis will employ gender neutral language; however, as the English language has no natural neuter, this thesis will follow the tradition of the language and utilize the masculine as the neuter when necessary.

Finally, to describe a professional with academic training in the discipline of political studies, this thesis will use **political analyst**. The term is far from ideal because it is often used to describe those who analyze political situations for commercial use regardless of whether they have academic training in political studies. But without joining the age old argument as to whether politics is a 'science,' a strong contention is made in part III that 'scientific' politics is not effectively applicable to political risk analysis in FDI. Therefore, use of the traditional term 'political scientist' could be somewhat confusing. The natural alternative choice might be 'student of politics,' but this is both awkward and may appear, given the definitional connotations of 'student,' somewhat limiting. Likewise, 'political theorist' and 'political historian' may be read to limit the scope of the work undertaken. In the

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<sup>28</sup>Stephen J. Kobrin, "When Does Political Instability Result in Increased Investment Risk?" *Columbia Journal of World Business*, Vol. XIII, No. 3 (Fall, 1978), p. 115.

<sup>29</sup>World Bank, *World Bank Development Report 1990* (Oxford: Oxford University Press, 1990), p. xi.

context of the thesis, therefore, political analyst seems the best option and will accordingly refer *only* to those with an academic background in politics.

### Political Risk Insurance

Insurance is the acquisition of protection against the costs of harm or loss. Insurance is usually purchased in the commercial insurance market, where an insurer guarantees a payment should harm occur in exchange for a fee paid in advance; however, an MNE can also insure itself internally. The most common **self insurance** is just a variation on the commercial approach -- the retention of funds for use should a harm occur. An alternative is to study the situation and take proactive measures to protect against potential harm.<sup>30</sup> This method will be referred to as **non-financial self insurance (NFSI)**. This is not to imply NFSI is without cost, merely that 'finance' is not the direct method of insurance.

While insurance is an important issue in the field of political risk, its nature makes it somewhat separate from the main line of inquiry in the thesis. When insurance is directly involved in a matter at hand, it will be addressed, but when the relationship is tangential, insurance will be discussed in short sections toward the end of chapters.

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<sup>30</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 59.

## Chapter 2

### Background and Hypotheses

Political risk is viewed by businesses and business professors alike as something to be avoided. In the academic field of business studies, there has developed a subdiscipline over the last thirty to thirty-five years which can be called **political risk analysis**.

Political risk analysis differs from traditional, 'pure' academic disciplines in that business professors educated in economics, finance, management, actuarial science and the like apply theories and methods developed in other fields to business purposes.<sup>1</sup> Political risk analysis was originally oriented toward international economics, but for the last twenty years or so has drawn heavily upon political studies and related fields.<sup>2</sup> This application of methodologies from 'foreign' fields can create problems for educators and practitioners alike.

Robock argues 'political scientists' provide no help in applying their theoretical 'tools' for situational analysis to the problems faced in foreign direct investment (FDI). He asserts that their focus on "'political instability' in the form of revolutions [and other major discontinuities]...is not likely to produce the answers needed for international business. For one thing, the discontinuities that might affect international business do not necessarily require a revolution. Another consideration is that political instability, depending on how it is defined, is a separate, though related phenomenon from that of political risk."<sup>3</sup>

Robock does not offer an explanation for this state of affairs --perhaps political analysts do not believe their analytical approaches are applicable to business issues -- but this situation has not stopped such applications. The work is simply being done by economists and business experts with little or no grounding in politics. Because

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<sup>1</sup>William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), p. 124.

<sup>2</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), p. vi.

<sup>3</sup>*Ibid.*, p. 357.

of the lack of trained political expertise in the fields of international business and political risk in FDI, there developed "a gap in the literature bridging the two disciplines [of 'political science' and international business]."<sup>4</sup>

The 'gap' was widened by two contemporaneous series of events in the late 1960s and early 1970s. The increase in expropriation, particularly in South America, triggered a surge in demand for formal political risk analysis in the hope of protecting multinational enterprises (MNEs) from the effects of such events. At the same time, new analytical methodologies became available to supplement the traditional approaches of historiography and basic economic analysis. The development of econometrics and the popularization of theories of political determinism based on the 'behavioralist revolution' provided 'political risk analysts' entering a burgeoning commercial market with the basis of competitive product differentiation.<sup>5</sup> Unlike academics and serious students, commercially oriented political risk analysts have little interest in the pursuit of theoretical explanations through the "formulation and testing of abstract hypotheses;" they tend to be interested more in substantive results with direct applications.<sup>6</sup> As models and methodologies have become trade secrets instead of academic pursuits, the field of political risk analysis has become more confused.

It can be argued then, that "the state of the art of political risk policy, strategy, and tactics has gotten stuck."<sup>7</sup> While 'political risk analysis' is commonplace throughout the multinational business community, its form, intensity, and effectiveness vary greatly and the use of trained political analysts is still exceptional. Even within international banking -- a business sector with a long history of political risk exposure, a particularly high degree

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<sup>4</sup>Dolph Warren Zink, *The Political Risks for Multinational Enterprise in Developing Countries: With a Case Study of Peru* (New York: Praeger Publishers, 1973), p. vii-viii.

<sup>5</sup>David Bruce, "Integrating Political Risk Methodologies at a California International Bank," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 132-133.

<sup>6</sup>Stephen J. Andriole and Gerald W. Hopple, "An Overview of Political Instability Research Methodologies: Basic & Applied Recommendations for the Corporate Analyst," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 89.

<sup>7</sup>Warnock Davies, "Unsticking the State of the Art of Political Risk Management," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), p. 144.

of assets exposed to international political risk, and a major role as supplier of political risk analysis to customers<sup>8</sup> -- "comparatively few [banks employ] political analysts: most country risk work *including the political element* is still done by economists."<sup>9</sup>

Since the early 1980s, academic work has stressed the need to turn back from behavioralist approaches in political risk analysis, to be more careful in the application and integration of practices from 'foreign' academic fields, and to incorporate analysis into corporate planning and decision-making in an effective fashion.<sup>10</sup> For the most part though, these goals have been reached only by the biggest multinationals with the means, need, and patience to spend years of trial and error effort developing effective in-house approaches to dealing with the threat of political risk. For most smaller MNEs, the challenges have been too great and the costs prohibitively high.

### The Thesis

The goal of this thesis is to examine the nature of political risk in foreign direct investment and the tools available in political studies to help investors protect themselves from the costs of its effects.

The first hypothesis is: **if political risk is properly understood as a phenomenon of the political environment, then it a) defies direct quantification and b) can be explained as a series of discrete elements which can be analyzed separately.**

The second hypothesis is: **if political risk is properly understood as a series of non-quantifiable elements, analysis of political risk cannot be depended upon alone to protect multinational enterprises from political risk in foreign direct investment.**

In the course of the thesis, three additional specific goals will be pursued:

1. To develop consistent definitions of relevant terminology specific enough for effective application and flexible enough for wide usage both in business and in future academic studies.

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<sup>8</sup>James C. Baker and M. Anaam Hashmi, "Political Risk Management: Steering Clear of Risky Business," *Risk Management*, Vol. 35 (October, 1988), p. 46.

<sup>9</sup>John Calverley, *Country Risk Analysis* (London: Butterworth & Co. (Publishers) Ltd., 1985), p. 114, emphasis added. The specific nature of 'country risk' will be discussed in chapter 3.

<sup>10</sup>William Ascher and William H. Overholt, *Strategic Planning and Forecasting: Political Risk and Economic Opportunity* (New York: John Wiley & Sons, 1983) and Stephen J. Kobrin, *Managing Political Risk Assessment: Strategic Response to Environmental Change* (Berkeley: University of California Press, 1982).

2. To provide a literature review of the field in a format which imposes some measure of order on disparate and discontinuous development tracks.
3. To establish useful boundaries and parameters for the field which facilitate the application of academic tools to business problems and provide a viable base for future applied academic research.

### The Format

The current state of the study of political risk makes it unrealistic to conduct a standard brief review of the significant literature in the field. To do so would require arbitrary and/or deterministic choices and result in an incomplete and prejudicial product. The disorder of the field makes it effectively impossible to examine critically the problems of political risk analysis without reviewing a large cross-section of political risk literature, so the review will be incorporated within the body of the thesis.

Part II of the thesis is a comprehensive consideration of the phenomenon of political risk in both theoretical and practical terms. Chapter 3 takes a theoretical approach to the problem, examining the evolution of 'risk' as an economic and business concept and placing it in the political context. Chapter 4 reviews and critiques 'operational' definitions of political risk developed over the past thirty years. Chapter 5 applies this work to the real world manifestations of political risk by assessing classification schemes for different kinds of political risk, investigating the ideological and practical roots of political risk, looking at MNE vulnerabilities to various manifestations of risk, and identifying various forms of political risk.

Part III provides practically and theoretically based critiques of a wide variety of approaches to political risk analysis. Chapters 6 and 7 address qualitative and quantitative approaches to political risk analysis respectively. Each chapter contains a survey of the evolution of the analytical approaches and specific examples, practical and theoretical critiques, and a catalogue of strengths and weaknesses for each approach. Chapter 8 considers efforts in both academia and the commercial sector to move beyond fixed analytical approaches to address some of the problems identified in the preceding chapters.

Part IV concludes the thesis and ties it together. Chapter 9 applies the preceding work to the FDI decision making process within MNEs. Chapter 10 then moves beyond the question of analysis to the issue of political risk management, including approaches which could be considered under the aegis of non-financial self insurance. A number of management techniques for use both before and after the actual time of entry into the host country are

considered. Finally, chapter 11 reviews the major tenets and conclusions of the thesis and considers the need for additional academic work in the future.

### Purpose and Parameters

At one level, this thesis is a case study in the potential utility of abstract academic work -- the valuable, 'real world' role of the theoretical side of political studies *and* the need for the political analysts themselves to be involved in the application of their work. At another level, it is an effort to provide such involvement; to supply some of the insight needed for the effective application of political studies methodologies to a *bona fide* business problem. It is not an attempt to propound or defend the practice of foreign direct investment. While the selection of the topic does indicate general support for the concept on the part of the writer, the paper itself is merely an academic investigation, not a political treatise. FDI will continue to occur as long both parties see value in the arrangement; it needs neither defense nor encouragement.

Another assumption of the thesis is that the field of political risk is an application of the political studies discipline.\* There will be no attempt to prove this statement *per se*, but a great deal of evidence suggesting it is a reasonable assumption will be presented throughout the thesis.

Because it deals with a field oriented toward facilitating the application of academic work to business, the thesis will aim to cover topics as broadly as possible without sacrificing utility. The primary focus however, will always be political risk in foreign direct investment. Should it be necessary to narrow the focus further, attention will be given to small and medium sized manufacturing firms with actual operations in place in developing countries.

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\*This is not to suggest that the field of political risk cannot be viewed also as an applied field of international economics or any other discipline, merely that to look at the subject from this point of view is reasonable and will be enlightening. In fact, the writer has no argument with those who would assert that political risk analysis is the application of tools and lessons from many other disciplines; it is believed however, that this consideration of political risk will suggest that the field owes more to political studies than to any other single discipline.

## Part II

### Political Risk

"Most writers tend to use 'political risk' as a catchall term for the risk dimensions of political events which have an impact on business decisions. As such, [the term] is replete with definitional incongruities."<sup>1</sup>

Political risk is a problematic term. Both words are value laden and suggest images and notions which may be prejudicial. At best, the words, separately and in combination, are unclear. The two goals of part II are to develop a definition of political risk specific enough to be analytically useful and a practical description of it clear and broad enough to be applicable to the real world of foreign direct investment. In meeting these goals, part II will also provide support for the first hypothesis and lay a foundation for the analysis in part III.

Chapter 3 addresses, in both theoretical and practical terms, the concept of risk. It starts with early notions of risk in business and traces the evolution of critical writing on the subject. Through this review it identifies and examines a series of ideas which permit the development of a clear and concise definition.

Chapter 4 applies the definition of risk to the political arena. It examines the unique nature of political risk, the literature on the subject, and the various definitions previously offered. The goal of chapter 4 is to develop a practical definition for political risk consistent with the definition of risk developed in chapter 3.

Chapter 5 examines the operational role of political risk in the foreign direct investment equation by examining the host - investor relationship. It focusses particularly on the attitudes of host countries toward outside investors, the characteristics of investment from an operational, or 'on the ground' standpoint, and the scope and nature of the conflicts of ideas and interests which often, perhaps inevitably, arise between investors and their host country.

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<sup>1</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 58.

## Chapter 3

### What Is Risk?

Risk can be seen as a chance, a probability, an unknown, an uncertainty, a gamble; it usually relates to a loss. But is risk the chance of the loss, the event which might cause the loss, the loss itself?

More than seventy years ago, a young economics professor named Frank Knight wrote *Risk, Uncertainty, and Profit*, a groundbreaking work which attempted to explain, in terms somewhat more sophisticated and complete than those of Adam Smith (or Karl Marx, for that matter), why and how individuals make money in a vaguely free-market economic system. While much of the theory has been superseded (in some cases by Knight's own later work), the ideas Knight introduced remain landmarks in economics. Among those concepts, his treatment of risk, uncertainty, and their relationship has direct application to this subject.

According to Knight, traditional economic definitions of risk always center around the possibility of loss: **A condition of risk exists when a loss may, but is not certain to, occur.** Given this, Knight identifies three conditions of existence in economics: that of the known, where there is no risk (risk requires doubt, so a certain loss is not a risk); that of 'known risk,' where the precise probability of a loss is known or can be determined; and that of "a unique kind of risk, which is not susceptible to measurement."<sup>1</sup> For the moment, these three conditions will be called **certainty**, **risk<sub>k</sub>** (for known risk), and **risk<sub>u</sub>** (for 'unknown' risk). Generic risk -- simply the possibility of loss -- will be known as **risk<sub>g</sub>**.

Certainty is a unique and absolute situation, but as a concept, because it only refers to absolute fact, it has very little explanatory value in any business consideration. The differentiation between risk<sub>k</sub> and risk<sub>u</sub>, on the other hand, is crucial in business applications. "If the actuarial chance [the probability] of gain or loss in any transaction is ascertainable,...the burden of bearing the risk can be avoided by" using insurance -- grouping cases

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<sup>1</sup>Frank H. Knight, *Risk, Uncertainty, and Profit, Reprint Edition* (London: London School of Economics and Political Science, 1940 [Original publication: Boston and New York: Houghton Mifflin Company, 1921]), pp. 45-48. Please note that Knight acknowledges the "unique kind of risk" can be represented by a mathematically precise probability *theoretically*; the problem is *practically* such a risk is not measurable. One could conclude that all risks (even all possibilities) are, in *theory*, specific probabilities at any discrete time, regardless of whether or not they are by nature measurable. R.J. Rummel and David A. Heenan, "How Multinational Analyze Political Risk," in Douglas N. Dickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), p. 382.

and determining sums to be set aside for each case such that their total will equal the value of any losses which will occur in the aggregate. Through insurance, "a single situation involving a known risk [which] may be regarded as 'uncertain'...is easily converted into effective certainty."<sup>2</sup> Once certainty has been approximated, risk has been eliminated from the given situation.

Knight identifies two ways of calculating probabilities for risk<sub>k</sub>: *a priori* calculations (risk<sub>ap</sub>) of known factors and statistical calculations (risk<sub>s</sub>) based on empirical observations of actual experience. The former method is applicable only when exact probabilities can be known, but any specific outcome cannot; a situation "practically never met with in business." Statistical probabilities are definitionally less precise and most useful within a large aggregate. A simple example is fire insurance: Given all the relevant characteristics for a specific building, an actuary, through the application of figures gathered from actual experience with similar buildings, can calculate a probability of the likelihood it will burn sufficiently accurate to support the commercial sale of insurance.<sup>3</sup>

Even risk<sub>s</sub> is a relatively rare condition in business. Most business decisions are completely unique and therefore exist under the condition of risk<sub>u</sub>. This is due to ignorance or to the perception of instability (where whatever knowledge is held would be believed to have little applicable value). Ignorance results from either a lack of knowledge (the decision maker does not know) or a lack of information (the decision maker cannot know).<sup>4</sup> Decisions made under such conditions can be only intuitive estimates and judgments. Knight recognizes such judgments tend to be expressed as ratios or proper fractions and therefore appear similar to the two types of risk<sub>k</sub>; however, they are different. Risk<sub>ap</sub> is a mathematical calculation of fact based on an "absolutely homogeneous classification of instances completely identical" and risk<sub>s</sub> is a statistical evaluation of 'associational frequency' based "on an empirical classification of instances," but risk<sub>u</sub> is an intuitive judgment in which "there is *no valid basis of any kind* for classifying instances." It is simply an "estimate of an estimate." Knight suggests that should

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<sup>2</sup>Knight, *op. cit.*, p. 46.

<sup>3</sup>*Ibid.*, pp. 214-216.

<sup>4</sup>Yair Aharoni, *The Foreign Investment Decision Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966), p. 37.

such an 'opinion' be confused for calculated fact, the results would be "meaningless" and could be "fatally misleading."<sup>5</sup>

### Preliminary Conclusions

As shown in exhibit 3.1, Knight's three conditions of knowledge can be conceived of as a ladder of cognition which can be 'climbed' through conversion to, or approximation of, a higher 'rung.' Conversion can be accomplished through insurance while approximation requires the ability to calculate a probability with the same accuracy required at the higher level.

#### EXHIBIT 3.1: THE LADDER OF COGNITION

|                                      |   |  |
|--------------------------------------|---|--|
|                                      | <u>°Knight</u>  |  |
|                                      | <u>Certainty</u>                                      |  |
|                                      | Known   |  |
|                                      |   | <u>Risk<sub>ap</sub></u><br>Calculated <i>a priori</i> |
| Generic<br>Risk [risk <sub>g</sub> ] | <u>Risk [risk<sub>k</sub>]</u><br>Calculated          |  |
|                                      |   | <u>Risk<sub>s</sub></u><br>Calculated statistically    |
|                                      | <u>Unmeasurable Risk [risk<sub>u</sub>]</u><br>Judged |  |

In a business decision making process, possible results of a decision could be laid out in a probability distribution -- a listing with a discrete probability of occurrence assigned to each possible result. The probability of risk (risk<sub>g</sub>, some generic harm to the organization) would be represented by the sum of the probabilities of occurrence of 'risky' results. Confidence in the accuracy of the probability distribution would vary depending upon the condition on the ladder of cognition under which the calculation of the probabilities was made.<sup>6</sup> Confidence

<sup>5</sup>Knight, *op. cit.*, pp. 223-227 and 231.

<sup>6</sup>While the scenario is original and the terminology has been chosen to minimize the possibility of confusion, the basic idea is adapted from Aharoni, *op. cit.*, pp. 36-37.

should be high in a decision made under conditions approximating certainty and low in a decision made solely on an intuitive basis. The word 'should' is used because confidence is a purely normative concept, representing only a decision maker's perception of a situation and not any objective evaluation.

Additional conclusions which can be drawn at this point include:

- There are conditions of knowledge in the making of business decisions.
- As these conditions are hierarchical and not overlapping, they constitute a ladder of cognition up which a case can be moved if it sufficiently approximates a higher condition.
- Risk is the condition where the possibility (but *not* certainty) of harm or loss to a business exists and can be eliminated either by making harm or loss certain (as opposed to merely possible) or impossible.
- In those cases where there is neither certainty nor the ability to approximate certainty, decisions cannot be the result solely of objective reasoning. They must be subjective and intuitive judgments based on knowledge which, by definition, is incomplete.

### Applications

As useful as Knight's ideas are, they are not sufficient for direct application to the problem of political risk in foreign direct investment. Because FDI decisions tend to be truly unique in a myriad of ways, and therefore to provide little reliable opportunity to apply experience gained from prior observation, it is rarely possible to derive a meaningful probability for risk<sub>g</sub> in either specific cases or the aggregate.<sup>7</sup> This makes it virtually impossible to determine statistically a rate of return on investment with accuracy sufficient to guarantee the coverage of all costs, including those accruing from risk, and leave sufficient profit to make the investment worthwhile.<sup>8</sup>

Aharoni attempts to deal with this application problem by focussing on the behavior of decision makers. He identifies four conditions of knowledge which approximate those established by Knight: **certainty**; **assumed certainty**, when "the decision maker behaves *as if* he has the full information;" **risk**, when "the decision maker knows the problem and its alternatives, and can state the probabilities of each one of the consequences;" and **uncertainty** (risk<sub>u</sub>).<sup>9</sup> He identifies the intuitive or subjective estimate of a 'probability' of a risk<sub>u</sub> as "a measure of a

<sup>7</sup>Aharoni, *op. cit.*, p. 17.

<sup>8</sup>*Ibid.*, pp. 250-251.

<sup>9</sup>*Ibid.*, pp. 16-17. *N.B.*: Although assumed certainty and risk are not the same as risk<sub>ap</sub> and risk<sub>s</sub> respectively, both sets are divisions of risk<sub>k</sub> and fill similar positions in the ladder of cognition.

degree of belief about the relative occurrence of events" rather than actual likelihood.<sup>10</sup> Aharoni's ideas, along with those outlined in the following paragraphs, are shown in exhibit 3.2.

**EXHIBIT 3.2: THE LADDER OF COGNITION**

|                                      | <u>Knight</u>  | <u>Aharoni</u>                                     | <u>Kobrin</u>  | <u>Shubik</u>   |
|--------------------------------------|--|--|--|---|
|                                      | <u>Certainty</u><br>Known                                | <u>Certainty</u><br>Known                          | <u>Certainty</u><br>Known                                | not mentioned   |
|                                      |  | Assumed<br><u>Certainty</u><br>Behavioral          |  | Objective<br>Probability<br><u>[risk<sub>ap</sub>]</u><br>Calculated<br><i>a priori</i> |
|                                      | <u>Risk [risk<sub>k</sub>]</u><br>Calculated             |  | Objective<br><u>Uncertainty</u><br>Calculated            | Subjective<br><u>Probability</u><br>Calculated  |
| Generic<br>Risk [risk <sub>g</sub> ] |  | <u>Risk</u><br>Calculated<br>statistically         |  |   |
|                                      | Unmeasurable<br><u>Risk [risk<sub>u</sub>]</u><br>Judged | Uncertainty<br><u>[risk<sub>u</sub>]</u><br>Judged | Subjective<br><u>Uncertainty</u><br>Judged               | <u>Uncertainty</u><br>Judged  |
|                                      |  |  | Complete<br><u>Uncertainty</u><br>Cannot be<br>evaluated | not mentioned   |

In his literature review of political risk, Kobrin also goes back to Knight for the basics of risk and uncertainty. He refers to risk<sub>k</sub> as objective uncertainty, where 'objective' refers to the manner in which the probabilities of such an uncertainty can be calculated. He also divides risk<sub>u</sub> into two parts: subjective uncertainty, about which there is some knowledge but not enough to make it risk<sub>k</sub>;<sup>\*</sup> and complete uncertainty, about which there is no information whatsoever. The last grouping needs to be recognized so it can be dismissed as an area of inquiry; it is not possible to work in a knowledge vacuum.<sup>11</sup>

<sup>10</sup>*Ibid.*, pp. 275-276.

<sup>\*</sup>"Uncertainty is subjective in the sense that opinions about the relative likelihood of events are based upon perceptions that are a function of the available information, previous experience and individual cognitive processes which synthesize both into an imagined future." Kobrin (1985[1979]), *op. cit.*, pp. 132-133.

<sup>11</sup>*Ibid.*

Writing in the early 1980s, Shubik reasserts the importance of differentiating between methods of calculating probabilities. Those calculated *a priori* are labelled **objective**; those calculated in other ways, **subjective**. Subjective probability is not the same as risk, but would embrace it. Shubik says anything not absolute requires some measure of judgment and therefore cannot be properly considered objective. Since "the assignment of subjective probabilities can come about casually or after much thought, research, and calculation," actuarial-style statistical calculations would be included.<sup>12</sup>

### "Climbing the Ladder"

Kobrin suggests two additional ways for certainty to be approximated on the ladder of cognition:

1. When the known probability for one specific outcome is *overwhelmingly* dominant, certainty has been 'approximated,' even in the absence of other information.
2. Where environmental change is so gradual and progressive\* as to be predictable, any outcome dependent on the environment may become 'certain' long enough before its arrival to be an effective approximation.<sup>13</sup>

Kobrin also asserts that under specific circumstances, cases in a condition of uncertainty can also approximate one of the risk<sub>k</sub> conditions (and therefore certainty, if they meet the criteria of the methods already reviewed). If all possible outcomes are known, or if there is at least sufficient knowledge to identify meaningful probabilities such that the probability of a known outcome is *overwhelmingly* dominant, *and* there is sufficient knowledge about the nature and consequences of known possible outcomes to know how they will effect the business, it *may* be possible to minimize the role of subjective judgment in decision making to such an extent that

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<sup>12</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), pp. 132-133.

\*This term is not to be read as value laden. It does not refer to the name, ideals, nor platform of any political party, nor is it normative in its suggestion of any goals or results toward which 'progress' is being made. In this context, the word strictly refers to a pattern of change which occurs with regularity in a logical fashion, building upon itself step by step, and which is therefore vaguely predictable. Unless specifically noted, this and similar terms shall always be used in accordance with general, non-political, etymologically based definitions.

<sup>13</sup>Stephen J. Kobrin, "Political Risk: A Review and Reconsideration," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1979]), p. 133.

objectivity has been approximated. Kobrin implies success in this effort would result in meaningful quantification where it was previously impossible and therefore facilitate standard statistical business planning.<sup>14</sup>

The primary inadequacy of the Kobrin approach is that the set of characteristics required for uncertainty to sufficiently approximate risk<sub>k</sub> is so narrow a large number of cases remain the realm of pure intuition. For this reason, a proposition is offered that the condition of uncertainty can be subdivided in three:

Uncertainty<sub>1</sub> can approximate one of the conditions of risk<sub>k</sub> through the Kobrin method and is therefore **quantifiable uncertainty**;

Uncertainty<sub>2</sub> consists of those cases about which sufficient information exists to permit the systematic development of knowledge about possible occurrences and consequences as is true with quantifiable uncertainty, but for which specific probabilities cannot be calculated; such cases would exist under a condition of **non-quantifiable uncertainty**;

Uncertainty<sub>3</sub> is that remainder of Kobrin's original condition of **subjective uncertainty** and would retain the title.

The utility of this proposition, as shown in exhibit 3.3, is that while subjective uncertainty (as redefined) can only be evaluated through the application of intuition, cases of non-quantifiable uncertainty could conceptually (if in fact, such cases can be shown to exist) be evaluated in a systematic (and therefore more objective) fashion and could approximate certainty through the use of non-financial self insurance as defined in chapter 2.

### Conclusions

This chapter has established a number of specific conclusions which lead to a functional definition of risk:

- There are many cognitive conditions in which specific cases of potential risk<sub>g</sub> can exist.
- In order to achieve, convert to, or approximate certainty, a case must be susceptible to accurate quantification.
- There are methods through which quantification can be simulated and cases existing in one condition of knowledge can be treated as if they existed in another condition "higher" on the ladder of cognition.

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<sup>14</sup>*Ibid.*, pp. 133-134.

\*It seems reasonable to assume that if Shubik were evaluating this proposition, he would place the categories of quantifiable and non-quantifiable uncertainty under the heading of subjective probability.

**EXHIBIT 3.3: THE LADDER OF COGNITION**

|                                      | <u>Knight</u>  | <u>Aharoni</u>                                     | <u>Kobrin</u>  | <u>Shubik</u>   | <u>Proposition</u>   |
|--------------------------------------|--|--|--|---|--|
|                                      | <u>Certainty</u><br>Known                                | <u>Certainty</u><br>Known                          | <u>Certainty</u><br>Known                                | not mentioned   | <u>Certainty</u><br>Known  |
|                                      |  | Assumed<br><u>Certainty</u><br>Behavioral          |  | Objective<br>Probability<br><u>[risk<sub>ap</sub>]</u><br>Calculated<br><i>a priori</i> | Objective<br><u>Probability</u><br>Calculated<br><i>a priori</i>                       |
|                                      | Risk<br><u>[risk<sub>k</sub>]</u><br>Calculated          |  | Objective<br><u>Uncertainty</u><br>Calculated            |   | Statistical<br>Probability<br><u>[risk<sub>s</sub>]</u><br>Calculated<br>statistically |
|                                      |  | <u>Risk</u><br>Calculated<br>statistically         |  | Subjective<br><u>Probability</u><br>Calculated  | Quantifiable<br><u>Uncertainty</u><br>Effectively<br>calculatable                      |
| Generic<br>Risk [risk <sub>g</sub> ] |  |  | Subjective<br><u>Uncertainty</u><br>Judged               | <u>Uncertainty</u><br>Judged  | Non-<br>quantifiable<br><u>Uncertainty</u><br>Systematical<br>judged                   |
|                                      | Unmeasurable<br><u>Risk [risk<sub>u</sub>]</u><br>Judged | Uncertainty<br><u>[risk<sub>u</sub>]</u><br>Judged |  |   | Subjective<br><u>Uncertainty</u><br>Intuitively<br>judged                              |
|                                      |  |  | Complete<br><u>Uncertainty</u><br>Cannot be<br>evaluated | not<br>mentioned  | Complete<br><u>Uncertainty</u><br>Cannot be<br>evaluated                               |

- Where certainty cannot be approximated, perfectly objective evaluation is not possible and any judgment must be based, at least in part, on subjective or intuitive evaluation.
- Risk requires uncertainty, the possibility of loss, and ignorance or perceived ignorance, of relevant information.

Therefore,

**Risk is the possibility of unexpected harm or loss accruing to a business due to real or perceived ignorance. It can be mitigated through some form of quantification or it cannot be objectively evaluated.**

Since quantification permits at least the approximation of certainty and risk requires uncertainty, risk "defies direct quantification" as the first part of the first hypothesis asserted would be the case for political risk.

## Chapter 4

### Risk In the Political Context

"When businessmen talk about risk, they use this word to include both the subjective probability of loss, either in absolute terms or in relation to some expectations, and the amount the company may lose. The loss referred to may be a monetary one, or the waste of management time, or the inability to achieve a specific objective of the company other than profits (*e.g.* risk of losing control). Thus, when a businessman says 'the political risks abroad are high,' he may be referring to the possibility of losing his freedom of decision making because of a high degree of government regulation. Political risks may mean to him a high subjective probability of total or partial loss of the investment itself because of expropriation, nationalization, or war; they may mean that the unsettled conditions put the very basis of planning in question and make the work of management more difficult; or they may be any combination of all these factors."<sup>1</sup>

As considered in chapter 3, the concept of risk, if not simple, is reasonably straightforward. Risk in the political context, however, is far more complex. This complexity has many sources and examining them is complicated by connotative problems surrounding the understanding of the political context itself.

Kobrin sees the biggest connotative problem to be the common assumption that political risk *must* stem from major political discontinuities. This false assumption often leads multinational enterprises (MNEs) to focus on the possibility of a political 'earthquake' -- a relatively rare occurrence -- and overlook more likely possibilities which "tend to be both less dramatic [in nature] and more extensive [in potential effect]."<sup>2</sup> Another difficulty is the misconception that risk is an entirely negative thing. "Risks and opportunities are two sides of the same coin."<sup>3</sup> A missed opportunity --the loss of a chance to increase profits, assets, turnover, or market share -- can be as harmful to an organization in the long term as a decrease in real performance. Too narrow a focus on the potential

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<sup>1</sup>Yair Aharoni, *The Foreign Investment Decision Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966), p. 37.

<sup>2</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), pp. 252-253.

<sup>3</sup>Jean Boddewyn and Etienne F. Cracco, "The Political Game in World Business," *Columbia Journal of World Business*, Vol. VII, No. 1 (January-February, 1972), p. 45. This idea is also discussed in William Ascher and William H. Overholt, *Strategic Planning and Forecasting: Political Risk and Economic Opportunity* (New York: John Wiley & Sons, 1983), p. 10.

'downside' of a risk event can blind an organization to opportunities and thereby increase its likelihood of loss from such 'risk.'

The first generation definitions of political risk were merely descriptive and therefore not very useful for understanding the nature of political risk and the ways in which it can effect MNEs. The landmark second generation definition of political risk was laid down by Stefan Robock.\*\* It acknowledges the complexities of the subject and reflects an effort to develop a framework of understanding which meets both the theoretical requirements of academia and the practical requirements of international business. For these reasons, Robock's approach has provided the base from which others have worked in refining definitions, and therefore provides a useful foundation for this work.

"Political Risk in international business exists when

- "1. discontinuities occur in the business environment,
- "2. they are difficult to anticipate, and
- "3. they result from political change.

"To constitute a 'risk' these changes in the business environment must have a potential for significantly affecting the profit or other goals of a particular enterprise."<sup>4</sup>

Robock adds four caveats:

1. Not all political change affects the business environment; therefore, not all political change can constitute political risk;
2. What may be a political risk for one business may not affect others [political risk tends to be specific or selective in nature];
3. Where political change is gradual and predictable ['progressive' as outlined earlier], such change approximates a *status quo* and therefore does not represent a political risk.
4. Political risk is not found only in the developing world, it is "pervasive" and can also affect business in the industrialized world and in MNEs's home countries.<sup>5</sup>

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\*Several MNEs operating in Chile, for example, chose to leave the country after the 1970 election of President Salvador Allende (even though they were permitted to remain) because they felt his left-wing government might lead to economic and political disaster. In fact, the business environment did deteriorate drastically, but this helped trigger a military coup which resulted in vastly improved business conditions for MNEs which chose to remain.

\*\*Sometimes collaborating with Kenneth Simmonds, Robock wrote a series of articles published in the *Columbia Journal of World Business* in 1970 and 1971 and later incorporated into their international business textbook.

<sup>4</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), p. 356.

Robock's definition also has four noteworthy and valuable characteristics:

- It requires that political risk "be thought of as a peril (cause of loss) rather than a unique loss exposure," permitting each effect to be measurable on a universal scale -- that of finance.<sup>6</sup>
- It differentiates between environment and organization by identifying and distinguishing between **risk events** -- environmental phenomena which have the potentially harmful consequences -- and **risk effects** -- organizational phenomena which are the harmful consequences themselves.<sup>7</sup>
- It analytically links conceptual sources of political risk -- independent variables such as political philosophies, armed conflicts, or social unrest -- to dependent variables -- the risk events (government regulation, a strike) and their effects on MNEs.<sup>8</sup>
- It identifies the role of sudden or discontinuous change in political risk. While there tends to be a simple, negative correlation between political risk and the predictability of environmental change,<sup>9</sup> the nature of risk is not inextricably tied to this condition. Once instability exists in the environment, the nature of risk is most closely linked to the predictability of the *final* outcome of a series of events. Therefore, the existence of a gradual and predictable series of *intermediate* events will not necessarily lower risk.<sup>10</sup>

As useful as Robock's approach is to understanding the operational components of political risk, it also has some significant shortcomings. Its tendency to tie risk effects to specific sources and groups is deterministic and limiting. While there are trends in the manifestation of risk, there are few limits; many potential risk effects

<sup>5</sup>*Ibid.*, pp. 355-357. Overholt points out that "the rules of the economic game are established everywhere by political decision." The developing world arguably may have the most dramatic developments, but political risk can be just as dangerous elsewhere. William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), p. 16.

<sup>6</sup>Norman A. Baglini, *Global Risk Management: How U.S. Corporations Manage Foreign Risks* (Risk Management Society Publishing, Inc., 1983), p. 62.

<sup>7</sup>David A. Schmidt, "Analyzing Political Risk," *Business Horizons*, Vol. 29, No. 4 (July/August, 1986), p. 44.

<sup>8</sup>Robock and Simmonds, *op. cit.*, p. 358 and pp. 362-368. A late 1970s study of FDI by Kobrin and others found evidence that the event/effect differentiation and the variable linkage, both theoretical concepts developed to help depict the political risk equation, are genuine phenomena found in the FDI environment. Stephen J. Kobrin, "When Does Political Instability Result in Increased Investment Risk?" *Columbia Journal of World Business*, Vol. XIII, No. 3 (Fall, 1978), p. 120.

<sup>9</sup>*Ibid.*, p.114 and Attila Yaprak and Keith T. Sheldon, "Political Risk Management in Multinational Firms: An Integrative Approach," *Management Decision*, Vol. 22, Pt. 6 (1984), p. 54.

<sup>10</sup>Stephen J. Kobrin, "Political Risk: A Review and Reconsideration," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1979]), p. 131.

"can arise from a variety of sources and be generated by a number of different groups."<sup>11</sup> A related complaint raised by Sethi and Luther is that the Robock construction appears to draw the line for understanding risk at the description of the source. This may be sufficient if financial insurance is to be used for protection, but for non-financial self insurance, it is "not very useful. A business entity needs to have an understanding of the sources of risk to take a proactive stand against such risks or initiate measures to contain them."<sup>12</sup>

### The Third Generation of Definitions

In his extensive literature review of the field of political risk, Kobrin identifies a third type of definition for the term. More sophisticated, more useful, and rarer, these definitions differentiate between uncertainty and risk in terms similar to those discussed in chapter 3. They explicitly recognize a specific set of information about which there must be knowledge in order to identify, assess, and manage the risk.<sup>13</sup>

Friedman and Kim offer one such approach by defining political risk as "business risk brought about by political sources or environment."<sup>14</sup> In this approach, traditional business risk ( $\beta$  or beta risk) is a systematically derived, quantified aggregate of financial and related factors and political risk is  $\alpha$  (alpha) risk -- all unsystematic or 'non-business' risk.<sup>15</sup>

An alternative is offered by Grosse and Stack who adapt the concept of country risk as used in international banking.<sup>16</sup> Country risk is the possibility that a bank will make a loss on a loan made to a foreign

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<sup>11</sup>Jeffrey D. Simon, "Political Risk Assessment: Past Trends and Future Prospects," *Columbia Journal of World Business*, Vol. XVII, No. 3 (Fall, 1982), pp. 62-64.

<sup>12</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 59.

<sup>13</sup>Kobrin (1985[1979]), *op. cit.*, pp. 130-131.

<sup>14</sup>Roberto Friedman and Jonghoon Kim, "Political Risk and International Marketing," *Columbia Journal of World Business*, Vol. XXIII, No. 4 (Winter, 1984), p. 64.

<sup>15</sup>Joseph Micallef, "Political Risk Assessment," *Columbia Journal of World Business*, Vol. XVI, No. 2 (Summer, 1981), p. 47.

<sup>16</sup>Robert Grosse and John Stack, "Non-Economic Risk Evaluation in Multinational Banks," *Management International Review*, Vol. 24, No. 1 (1984), pp. 41-42.

country. It is divided into economic and non-economic types by differentiating between the questions of *ability* and *willingness* to service a debt.<sup>17</sup> Although willingness to service a debt is not as broad a concern as those faced by MNEs with full-scale operations in a foreign country, it still requires recognition of "the character of social and political relations in the country in question."<sup>18\*</sup>

### The Stages of Political Risk

The difference between uncertainty and risk can, as noted in chapter 3, be observed by an analyst through the application of the ladder of cognition. In order to observe the differentiation between risk events and risk effects, an analyst must conceive of political risk as a two stage process. First, an analyst must ask, "what *events* will occur in a given environment in the future?" Second, "how will a given event *affect* the organization, either internally or in its relationship with its operating environment?"<sup>19</sup> In an operational situation, both of these sample questions would actually be requests for probabilities -- the probability of a given event occurring and, given the occurrence, the probability of it affecting the firm generally and/or having specific consequences.<sup>20</sup>

The first stage, a determination of *environmental risk*, can be handled in the abstract -- it is essentially a matter of political forecasting. The second stage, a determination of *organizational risk*, requires "a value assessment of the importance of [an effect] to the concerned corporation...in the context of a specific goal structure.

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<sup>17</sup>Patrick Foley, "Country Risk Assessment," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), p. 4.

<sup>18</sup>John Dunn, "Country Risk: Social and Cultural Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 139-141.

\*It may be interesting to note, however, that political risk -- the willingness question -- did not seem to be very important to international bankers...at least not several years ago. At a 1987 conference on country risk analysis, the subject of non-economic country risk was raised several times by speakers, but despite numerous panel discussions and question and answer sessions, political issues were *never* raised by anyone in an audience filled with international bankers. The entire focus of the audience was on the question of economic stability. *Euromoney, Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987).

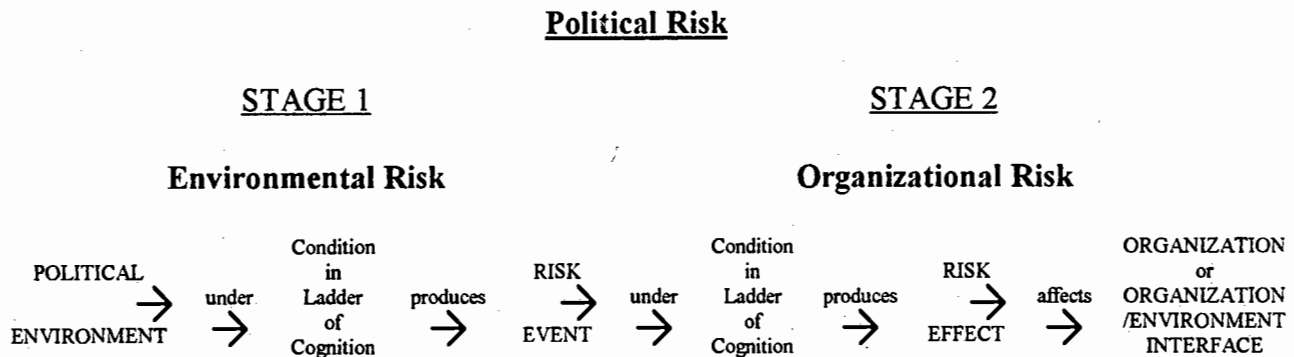
<sup>19</sup>The concept of the "organization-environment interface" comes from Friedman and Kim, *op. cit.*, p. 64.

<sup>20</sup>Kobrin (Fall, 1978), *op. cit.*, p. 114.

It cannot be assessed independently."<sup>21</sup> The ladder of cognition can be used for both stages since each requires the assignment of probabilities for accurate evaluation should such probabilities be determinable. But in order to approximate certainty in the whole process, and thereby effectively eliminate all risk, certainty must exist or be approximated for each stage (a chain is only as strong as its weakest link). If this cannot be accomplished, there still exists a need for subjective judgment about uncertainty.

An analytic tool for examining the two stages of political risk is offered in exhibit 4.1. It is a schematic representation of the series of relationships between abstract events in the political environment and their discrete effects on organizations. This equation has both a causal flow and an explicit structure.<sup>22</sup> The structure represents the manner in which 'risky' environmental situations or events become operational by creating effects which manifest themselves upon an organization as specific, concrete final results.<sup>23</sup>

**EXHIBIT 4.1 A SCHEMATIC REPRESENTATION OF THE POLITICAL RISK EQUATION**



**Defining the Political Environment**

Can the political environment be considered distinct from the economic, financial, social, legal, cultural, and whatever other environments one might be able to identify? Surely, at a practical level, it cannot. Reality

<sup>21</sup>Shubik, *op. cit.*, p. 134.

<sup>22</sup>Although the general concept of the exhibit is original, it is influenced by numerous writings, particularly Kobrin (1981), *op. cit.* In addition, the specific concept of a causal flow of occurrences embodied within the exhibit is adapted from Grosse and Stack, *op. cit.*, p. 52.

<sup>23</sup>Kobrin (1981), *op. cit.*, p. 267.

lacks the clear indicators which in theoretical constructions demarcate boundaries between 'environments.' But for the purposes of analysis, some type of boundaries will be useful. Considering the practical, applicative nature of this inquiry, the most useful boundaries will be those which approximate divisions already recognized in business and are as general as possible while still retaining utility.

The existing differentiation between  $\alpha$  and  $\beta$  risk is a useful place to start.  $\beta$  risk is a risk<sub>k</sub> in the ladder of cognition because it is made up of variables which can be accurately measured at a fixed point at a given time. If all such factors were grouped into what could be called the static environment, it would leave a dynamic environment, filled with factors which are not fixed and cannot be measured and therefore would exist under a condition of risk<sub>u</sub>.

The 'political environment' in the case of FDI does not equate perfectly with this dynamic environment as defined. For the purpose of forecasting -- a major part of risk analysis -- there are areas in the static environment where political knowledge could be extremely helpful; but at the less holistic and more basic level of current situation assessment, the differentiation holds. Likewise, there will be dynamic situations where political factors will be no more than tangential. But in any dynamic situation, societal knowledge of the host country, which by its very nature must be at least somewhat political, will be valuable.

### Conclusions

- Political risk must be considered as a cause of loss rather than a loss itself because with the possibility of negative effects from political risk comes concomitant positive opportunity.
- Political risk requires sudden discontinuous change, but the change need not be major or cataclysmic, merely unexpected.
- There are two stages in the political risk equation -- the independent risk event and the dependent risk effect -- which link at the interface between the political environment and the organization at risk. Each stage can be analyzed separately through application of the ladder of cognition.
- The political environment is a fluid, poorly bounded concept, but can be viewed as roughly analogous to the 'dynamic' environment when the latter is differentiated from the 'static' environment incorporating quantifiable business ( $\beta$ ) risk.

Therefore,

**Political risk is an independent variable in business existing under a condition of non-quantifiable, subjective, or complete uncertainty.**

All other things being equal -- assuming all  $\beta$  risk has been effectively dealt with -- political risk is the primary factor determining the operational profitability of a foreign direct investment.

As asserted in the second part of the first hypothesis, political risk "can be explained as a series of discrete elements which can be analyzed separately." Furthermore, through the use of the ladder of cognition, analysis can show that political risk as a whole "defies quantification." Therefore, chapters 3 and 4 have supported the first hypothesis:

"If political risk is properly understood as a phenomenon of the political environment, then it a) defies direct quantification and b) can be explained as a series of discrete elements which can be analyzed separately."

### Political Risk Insurance

"Broadly defined by the private insurance market, political risk is an arbitrary and capricious act of a foreign government that would adversely affect the contracts or investments of companies or firms carrying on business either within those countries or with public entities, corporations or firms in those countries. However, it can also be an act, usually reactive, of one's own [home] government in relation to the same kinds of businesses."<sup>24</sup>

The ability to convert risk<sub>k</sub> to effective certainty through grouping cases has already been discussed. This is one aspect of commercial political risk insurance. But in fact, virtually any conceivable political risk can be insured against, even if accurate probabilities of occurrence cannot be determined and cannot therefore be grouped by actuarial calculation.<sup>25</sup>

In the insurance industry, risk is either pure or speculative. Two things make the differentiation: pure risk is that with a potential for loss only -- a fire or disaster, for instance -- and for which probabilities of occurrence are known or can be actuarially calculated; speculative risks have the potential for both gain and/or loss and are too unique by nature for their probabilities to be calculable. Typically, businesses are interested in insuring

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<sup>24</sup>Ray Antes, "Political Risk: Private Insurance Market," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), p. 127.

<sup>25</sup>Philip J. Stein, "Should Your Firm Invest in Political Risk Insurance," *Financial Executive*, Vol. LI, No. 3 (March, 1983), p. 18.

against pure risk and insurers sell only pure risk coverage, but in the political risk market, there is both demand for and supply of speculative insurance.<sup>26</sup>

Speculative insurance is not a calculated risk in the traditional sense, but an unmitigated gamble with no clear odds. Therefore, "there is no objective way to assess the fairness of the insurance premium." Given this, the conversion of subjective uncertainty to insurance is the trade of one risk for another -- the risk that too much is being paid for protection -- and cannot automatically constitute an approximation of certainty.<sup>27</sup>

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<sup>26</sup>David B. Hertz and Howard Thomas, *Risk Analysis and its Applications* (Chichester: John Wiley & Sons, 1983), p. 9.

<sup>27</sup>Aharoni, *op. cit.*, p. 277.

## Chapter 5

### Sources and Manifestations of Political Risk

"The crux of the problem lies in the very nature of the multinational enterprise, namely its ability to think in terms that extend beyond a single country and to use resources located in more than one jurisdiction. These characteristics are seen as a threat by government leaders bent on full control, by local businessmen aspiring to compete, and by intellectuals hoping to overturn the status quo."<sup>1</sup>

"Public officials are charged with the responsibility of meeting social and economic goals, the desirability of which can be measured in political terms. Through the exercise of public policy, host governments attempt to influence the behavior of foreign firms in order to shape the domestic environment and meet national objectives."<sup>2</sup>

This chapter applies the abstract work of chapters 3 and 4 to the real world. It provides an introduction to the major actors in the political environment of foreign direct investment (FDI), a brief review of their ideological, political, and practical motivations for action, and provides some examples of ways in which their actions can affect the affiliates of multinational enterprises (MNEs).

Among the most important tools in the academic study of political risk are classification schemes for such risk. Friedman and Kim have identified three categories of schema -- classification by:

- the nature of selectivity of the risk;
- types of actors creating the risk; and
- elements of organizations affected or targeted by the risk.<sup>3</sup>

The most useful of such schemes for this chapter is Robock's differentiation between macro and micro risks. In the simplest sense, **macro-political risk** affects all foreign owned enterprise within a country while **micro-political risk** affects some subset of the whole.<sup>4</sup> Macro risk tends to be the result of major events and to

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<sup>1</sup>Raymond Vernon, "The Multinational Enterprise: Power Versus Sovereignty," in Raymond Vernon, *The Economic and Political Consequences of Multinational Enterprise: An Anthology* (Boston: Division of Research, Graduate School of Business, Harvard University, 1972 [Article originally published in 1971]c), p. 153.

<sup>2</sup>David A. Schmidt, "Analyzing Political Risk," *Business Horizons*, Vol. 29, No. 4 (July/August, 1986), p. 43.

<sup>3</sup>Roberto Friedman and Jonghoon Kim, "Political Risk and International Marketing," *Columbia Journal of World Business*, Vol. XXIII, No. 4 (Winter, 1984), pp. 66-67.

<sup>4</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 359-362.

affect the safety of physical assets and the ability to recover investment costs. Micro risk tends to be caused by smaller and more easily overlooked events and to affect freedom of operation and the ability to generate cash flow and profit.<sup>5</sup>

The writer suggests another way of classifying political risk which might be helpful for this chapter. Risks are either intentional or unintentional in nature. The determining factor is whether they stem from events triggered with the intention of putting one or more MNE affiliates at risk. Unintentional risk may be the result of unpremeditated environmental events, premeditated environmental events not related to issues of FDI, or unintended secondary effects of such events.

### Actors

The two major classes of actor in the first stage of political risk in FDI are the host government and other host country groups and individuals in dependent of the host government.<sup>6</sup> The government generally operates through legislation and regulation, while independent internal actors use disruptive action and public opinion to provoke risk events.

Another internal actor, frequently overlooked, is the host country bureaucracy.<sup>7</sup> Administrative or bureaucratic risk generally manifests itself in an MNE's inability to understand the structure and functioning of the public sector (**transparency risk**), difficulty in predicting administrative decisions because of the lack of a "standard practice" (**regularity risk**), and bureaucratic operations which fall out of the realm of "standard

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<sup>5</sup>William P. Kelly, "Political Risk Assessment: Half the Equation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 157 and Charles W. Hofer and Terry P. Haller, "GLOBESCAN: A Way to Better International Risk Assessment," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1980]), pp. 150-151.

<sup>6</sup>Robock and Simmonds, *op. cit.*, p. 358.

<sup>7</sup>Michael Z. Brooke and H. Lee Remmers, *The International Firm: A Study of Management Across Frontiers -- Trade and Investment* (London: Pitman Publishing Limited, 1977), p. 6.

administrative procedure" as experienced by MNEs in other places (functional risk).<sup>8</sup> It is a matter of bureaucratic willingness to accept and accommodate an investment.

Other actors are external. Through their regulatory and legislative powers, home governments can play a significant role in political risk, often based on their relationship with host governments.<sup>9</sup> Home country nongovernment organizations can also have influence through actions they take which affect parent MNEs. Events in third countries, especially those neighboring the host country, can also influence FDI operations.<sup>10</sup> Finally, direct or indirect intervention by 'supranational' groups also can generate political risk. The policies of organizations from the General Agreement on Tariffs and Trade (GATT) or the United Nations and its myriad of agencies, through the development oriented International Monetary Fund, World Bank, and Organization for Economic Cooperation and Development, down to regional associations like the European Community or the Organization of African Unity can all have significant, unexpected effects on the ability of affiliates to conduct business within host countries.<sup>11</sup>

Although each of these different sets of actors are independent of each other in the political environment, they are also interdependent, as actions by one to create a political risk event often prompts activity among others.<sup>12</sup>

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<sup>8</sup>Udo Pretschker, "The Administrative Environment as Risk Factor for Direct Investments in Developing Countries," *Management International Review*, Vol. 20, No. 1 (1980), pp. 94-96.

<sup>9</sup>Derek F. Channon with Michael Jalland, *Multinational Strategic Planning* (London: MacMillan Press Ltd., 1979), pp. 239-240, Patrick Crow, "Political Risks," *Oil & Gas Journal*, Vol. 84, No. 19 (May 12, 1986), p. 35, Stephen J. Kobrin, "The Political Environment," in Vern Terpstra, et. al., *The Cultural Environment of International Business* (Cincinnati: South-Western Publishing Co., 1978.), pp. 231-233 and Hans Schöllhammer and Douglas Nigh, "The Effect of Political Events on Foreign Direct Investments by German Multinational Corporations," *Management International Review*, Vol. 24, No. 1 (1984), pp. 26-33.

<sup>10</sup>John Calverley, *Country Risk Analysis* (London: Butterworth & Co. (Publishers) Ltd., 1985), p. 128 and Suleiman K. Kassiech and Jamal R. Nassar, "Political Risk in the Gulf: The Impact of the Iran-Iraq War on Governments and Multinational Corporations," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), pp. 73-78.

<sup>11</sup>Channon and Jalland, *op. cit.*, p. 240.

<sup>12</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 59.

### Motivations

As established in chapter 1, there is significant potential for conflicts of interest between host countries and MNEs. Many of the conflicts are rooted in the gap between the needs of MNEs and the available resources of host countries. Particularly in developing countries, poor conditions can make investment less attractive to MNEs searching for lower costs but unwilling to sacrifice quality, flexibility, or other goals in exchange.<sup>13</sup> Exhibit 5.1 is a list of many such incentives along with the views of policy makers in developing countries on their value in attracting MNE investment.

Incentives are usually included in a concession or investment agreement between the government of the host country and the investing MNE. While these agreements are designed to minimize conflict and maximize understanding between the parties, the host country - MNE relationship is dynamic. Environmental conditions or the goals of the parties may change, the bargain may become obsolete, and at least one of the parties may feel cheated by the other in the investment relationship.<sup>14</sup>

Additional potential sources of conflict and tension are host country fears of losing control of the FDI relationship or becoming dependent economically on MNEs.<sup>15</sup> Since investment is only attractive to the host country if more is gained from the investment than is lost to the investor and the losses are the lowest possible in order to achieve the gains, hosts need to protect their political and economic independence and retain a modicum of control over MNE business operations.<sup>16</sup>

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<sup>13</sup>Harold Crookell, "Investing in Development -- A Corporate View," *Columbia Journal of World Business*, Vol. X, No. 1 (Spring, 1975), pp. 82-82, Yves L. Doz and C.K. Prahalad, "How MNCs Cope with Host Government Intervention," in Douglas N. Dickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), p. 46 and Robock and Simmonds, *op. cit.*, p. 207.

<sup>14</sup>R. Hal Mason, "Conflicts Between Host Countries and the Multinational Enterprise," *California Management Review*, Vol. XVII, No. 1 (Fall, 1974), p. 7.

<sup>15</sup>Mason, *op. cit.*, p. 4.

<sup>16</sup>Robock and Simmonds, *op. cit.*, p. 208 and Raymond Vernon, "Conflict and Resolution Between Foreign Direct Investors and Less Developed Countries," *Public Policy*, Vol. XVIII (Fall, 1968), pp. 334.

### EXHIBIT 5.1: STEPS WHICH DEVELOPING COUNTRIES MAY FOLLOW TO INTEREST MNEs\*

| Steps  | Nature of Response  |                           |                    |
|--|---------------------|---------------------------|--------------------|
|  | Very Important<br>% | Moderately Important<br>% | Not Important<br>% |
| Project an image of stability and reliability in the eyes of MNEs  | 87.0                | 12.5                      | 0                  |
| Guarantee <i>no</i> changes in the rate of taxation for a certain period of time   | 45.0                | 42.5                      | 12.5               |
| Create confidence among MNEs about host government as one which lives up to its promises   | 77.5                | 22.5                      | 0                  |
| Invite discussions with MNEs <i>prior</i> to fixing rules which will affect business   | 52.5                | 37.5                      | 10.0               |
| Circulate proposed regulations to all businesses in country before setting laws  | 47.5                | 35.0                      | 17.5               |
| Spell out economic policies (at least those aspects which are relevant to MNEs) clearly and in objective terms   | 85.0                | 15.0                      | 0                  |
| Apply uniform rules to both domestic corporations and MNEs   | 42.5                | 37.5                      | 20.0               |
| Clearly spell out any exceptions to the law or concessions which must be guaranteed to selected businesses to avoid a feeling of discrimination among MNEs | 75.0                | 22.5                      | 2.5                |
| Discover projects suitable to local conditions and make such projects known to MNEs  | 80.0                | 20.0                      | 0                  |
| Provide MNEs information on local market opportunities   | 70.0                | 25.0                      | 5.0                |
| Determine MNE requirements for components and supplies which could be provided by existing business and inform MNEs  | 62.5                | 32.5                      | 5.0                |
| Analyze comparative economic advantages for MNEs   | 70.0                | 27.5                      | 2.5                |
| Bear (or share with MNE) the cost of investigating investment opportunities  | 22.5                | 55.0                      | 22.5               |
| Assist MNEs in other ways during their on-the-spot investigation of an opportunity   | 60.0                | 40.0                      | 0                  |
| Help MNEs reduce risks by providing local currency loans   | 12.5                | 47.5                      | 40.0               |
| Provide accelerated depreciation allowances on MNE investments   | 12.8                | 53.8                      | 33.4               |
| Give 'loss rebates' to the extent of depreciation if profits do not cover the depreciation   | 0                   | 42.5                      | 57.5               |
| Provide incentives to MNEs which may increase their rate of return on investment   | 15.0                | 60.0                      | 24.0               |
| Provide concessions to MNEs which may reduce capital costs   | 7.5                 | 70.0                      | 22.5               |
| Provide concessions to MNEs which reduce their production costs  | 17.5                | 57.5                      | 25.0               |
| Provide perpetual incentives for MNEs rather than one-shot assistance  | 10.0                | 50.0                      | 40.0               |
| Cut red tape involved in obtaining essential government licenses and permits   | 74.3                | 23.1                      | 2.6                |

\*Taken from Subhash Jain and Yash Puri, "Role of Multinational Corporations in Developing Countries: Policy Makers' Views," *Management International Review*, Vol. 21, No. 2 (1981), p. 66.

There may also be concern about local firms being driven out of business by foreign-owned competition, the net loss of capital or foreign exchange through the repatriation of funds to parents, and the destruction of irreplaceable natural resources.<sup>17</sup> Yet another potential fear is that foreign-owned enterprises represent their home governments and will act on their behalf, or at least in their interests, instead of in the interests of the government and people of the host country.<sup>18</sup> Exhibit 5.2 is Jain and Puri's list of some of these possible concerns and the feelings about them of policy makers in developing countries.

Conflicts of interest are the prime reason there is latent hostility toward foreign ownership present in all countries. Robock argues the strength of this feeling is *the* determining factor for the amount and type of political risk an investor will face.<sup>19</sup> Though free marketeers would argue MNEs are crucial to development and progress and rationally should not be met with hostility, the *dependencia* school of thought tends to view MNEs as a major part of the problems facing developing countries. Shaped by the personal ideologies of western educated, charismatic leaders of the 'Third World,' *dependencia* is rooted in the concepts of Fabian socialism and Lenin's economic imperatives of imperialism and depicts MNEs as the last gasp of 'the metropole.'<sup>20</sup> This is especially true in the case of former colonies where the colonial powers stifled development by forcing specialization in low-margin primary commodities and limiting industrialization in order to protect their own economies from competition.<sup>21</sup>

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<sup>17</sup>John D. Daniels and Lee H. Radebaugh, *International Business: Environments and Operations, Fourth Edition* (Reading, Massachusetts: Addison-Wesley Publishing Company, 1986), pp. 383-384.

<sup>18</sup>Raymond Vernon, "Multinational Enterprise and National Security," in Raymond Vernon, *The Economic and Political Consequences of Multinational Enterprise: An Anthology* (Boston: Division of Research, Graduate School of Business, Harvard University, 1972 [Article originally published in 1971]b), pp. 113-116.

<sup>19</sup>Robock and Simmonds, *op. cit.*, pp. 362-363.

<sup>20</sup>Eugene B. Mihaly, "The Multinational Corporation and Its Political Environment: Change and Survival," in S. Prakash Sethi and Richard H. Holton (eds.), *The Management of Multinationals: Policies, Operations, and Research* (Detroit, Michigan: The Free Press, A Division of Macmillan Publishing Co., Inc., 1974), p. 28 and Arvind V. Phatak, *Managing Multinational Corporations* (New York: Praeger Publishers, Inc., 1974), pp. 131-132.

<sup>21</sup>Mason, *op. cit.*, p. 9.

### EXHIBIT 5.2: PROBLEMS ASSOCIATED WITH MNE OPERATIONS IN DEVELOPING COUNTRIES\*

| Problems   | Nature of Response |                   |                 |
|--|--------------------|-------------------|-----------------|
|  | Major Problem %    | Average Problem % | Not a Problem % |
| <u>Capital Usage</u>   |                    |                   |                 |
| Use capital from local sources depriving domestic companies of needed funds              | 25.0               | 45.0              | 30.0            |
| Use of local capital frustrates some government development objectives                   | 15.0               | 42.5              | 52.5            |
| Emphasis on short-term profitability does not serve host's best interests                | 42.5               | 37.5              | 20.0            |
| More interested in repatriating profits than investing them in growth                    | 55.0               | 27.5              | 17.5            |
| <u>Technology Usage</u>  |                    |                   |                 |
| Tend to use outdated technology  | 10.2               | 59.0              | 30.8            |
| <u>Training</u>  |                    |                   |                 |
| Tend not to give local employees training needed to make production process work         | 15.0               | 42.5              | 42.5            |
| Do not provide fair chance for national managers to move up in organization              | 50.0               | 45.0              | 5.0             |
| <u>Economic Development</u>  |                    |                   |                 |
| Do not help host countries become economically self-sufficient                           | 32.5               | 50.0              | 17.5            |
| Force host countries and local-owned industries to become economically dependent on them | 22.5               | 50.0              | 27.5            |
| Help in planning economic development  | 45.0               | 50.0              | 5.0             |
| Help in solving unemployment problem   | 5.0                | 75.0              | 20.0            |
| Operations controlled by parent organizations with little concern for interests of host  | 50.0               | 42.5              | 7.5             |
| MNEs benefit more than host from investments   | 47.5               | 37.5              | 15.0            |
| <u>Alignment</u>   |                    |                   |                 |
| Do not align themselves with new government policy statements which affect them          | 10.0               | 70.0              | 20.0            |
| Do not want to work with host in establishing new laws                                   | 10.0               | 75.0              | 15.0            |
| Comply only with letter of law, not spirit   | 30.5               | 47.5              | 20.0            |
| Are more difficult to control than domestic companies                                    | 57.5               | 37.5              | 5.0             |
| Frustrate government policies  | 35.0               | 40.0              | 25.0            |
| Parent's control of affiliate conflicts with host's economic development program         | 55.0               | 35.0              | 10.0            |
| Enforces parental policies of little relevance in host environment                       | 40.0               | 45.0              | 15.0            |
| <u>General Policies</u>  |                    |                   |                 |
| Conduct business with corrupt practices  | 7.5                | 55.0              | 37.5            |
| Have poor impact on local culture  | 25.0               | 57.5              | 17.5            |
| Do very little to promote labor welfare  | 7.5                | 62.5              | 30.0            |

\*Taken from Jain and Puri, *op. cit.*, p. 64.

The most severe political risk manifestation of *dependencia* is expropriation, particularly when not accompanied by compensation. Studies show expropriation is not simply the operationalization of an ideology but has been "used selectively as an instrument of economic policy"<sup>22</sup> "in a rational and discriminating manner [f]ollowing the logic of the 'obsolescing bargain.'"<sup>23</sup>

While extreme *dependencia* continues to shape the views of some groups, it has given way in most of the developing world to what has been called the "Vernonian reality" of FDI: the need to bargain.<sup>24</sup> The goal of the bargain "is to dissociate the boon of the resources that accompany direct investment from the bane of foreign ownership inherent in such investment" without discouraging MNEs from investing.<sup>25</sup> This has led to what Moran calls "business-as-usual economic nationalism in the Third World [*sic*]... a more rational attempt by host authorities, to paraphrase Samuel Gompers, 'to get more.'"<sup>26</sup>

### Political Risk Effects

The most notorious effect of political risk on FDI is expropriation without compensation, but this has become increasingly rare in recent decades. It has been replaced largely by strategies of domestication or

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<sup>22</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), p. 253.

<sup>23</sup>John Dunn, "Country Risk: Social and Cultural Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 143. 'Obsolescing bargain' refers to a contractual agreement between the host country and an investor which is no longer seen as suitable by one or both of the parties. The concept is discussed further in the next section of this chapter.

<sup>24</sup>Adhip Chandhuri, "Multinational Corporations in Less-developed Countries: What Is In Store?" *Columbia Journal of World Business*, Vol. XXIII, No. 1 (Spring, 1988), p. 58. "Vernonian reality" refers to Raymond Vernon, one of the first and most influential business school professors to study political risk in FDI, who has written extensively on the nature of the MNE-host country "bargain."

<sup>25</sup>Peter P. Gabriel, "MNCs in the Third World: Is Conflict Unavoidable?" in *Managing the Multinationals: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1974 [Article originally published in 1972]), pp. 139-140.

<sup>26</sup>Theodore H. Moran, "International Political Risk Assessment, Corporate Planning, and Strategies to Offset Political Risk," in Theodore H Moran (ed.), *Multinational Corporations: The Political Economy of Foreign Direct Investment* (Lexington, Massachusetts: Lexington Books -- D.C. Heath and Company, 1985), p. 108.

'creeping expropriation;' "the gradual encroachment on the freedom to operate within the country."<sup>27</sup> From the host country's point of view, this approach can, by decree or through the offer of incentives, result in a larger role for and more control by nationals without sacrificing foreign expertise, capital, and technology.<sup>28</sup> But from the MNE's point of view, the long-term effects can be just as devastating as outright expropriation -- the complete loss of both assets and the ability to generate income for the parent without any form of compensation -- even though the slower process provides some measure of adjustment time.<sup>29</sup> As shown in exhibit 5.3, there are a wide variety of domestication strategies available for use by host governments.

The ultimate effects of political risk events on an MNE, whether they be the result of a domestication strategy or not, can be classified in numerous ways. Some writers look at effects in terms of assets --both tangible and intangible.<sup>30</sup> Others view effects through the window of operation freedom.<sup>31</sup> Root developed a highly descriptive framework which has been adapted by many followers:

"Transfer risks are the result of uncertainty\* with respect to host government actions that restrict the transfer of capital, payments, products, technology, and persons into or out of the host country. Exchange controls and import restrictions (tariffs and non-tariff trade barriers) are the most notable types of transfer restrictions.

"Operational risks are the result of uncertainty with respect to the policies, regulations, and administrative procedures of host governments that directly constrain the management and performance of local operations in production, marketing, finance, and other business functions. Monetary and fiscal policies, price controls, taxation, labor codes and regulations, local content requirements, and general administrative behavior fall into this category of political risk.

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<sup>27</sup>Philip R. Cateora, "The Multinational Enterprise and Nationalism," *MSU Business Topics*, Vol. 19, No. 2 (Spring, 1971), p. 52.

<sup>28</sup>*Ibid.*, pp. 52-53.

<sup>29</sup>C. Richard Peterson, "Can Multinationals Survive in Today's World?" *Risk Management*, Vol. 28 (February, 1981), p. 35.

<sup>30</sup>Norman A. Baglini, *Global Risk Management: How U.S. Corporations Manage Foreign Risks* (Risk Management Society Publishing, Inc., 1983), p. 62 and Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 113.

<sup>31</sup>Frans G.J. Derkinderen, "Transnational Business Latitude in Developing Countries," *Management International Review*, Vol. 22, No. 4 (1982), p. 56 and Doz and Prahalad, *op. cit.*, pp. 413-415.

\*In this usage, 'uncertainty' refers to any condition on the ladder of cognition which does not approximate certainty.

"Ownership-control risks are the result of uncertainty about government policies and actions with respect to ownership and/or effective managerial control of the local operations of an international company. This type of risk includes possible shifts in discriminatory treatment of foreign-owned enterprises, the reservation of certain industries to local nationals, the role of state enterprise, official requirements or pressures for joint ventures with nationals (including the host government), and expropriation policies."<sup>32</sup>

### EXHIBIT 5.3: EXAMPLES OF HOST COUNTRY INTERVENTION OPTIONS\*

Affirmative action for local firms in public sector bidding  
 Bureaucratic processes designed to control investors  
 'Creeping' expropriation or 'domestication'  
 Devaluation or revaluation of currency  
 Embargoes and boycotts  
 Export requirements  
 Expropriation or nationalization  
 Flow of funds restrictions (e.g.: dividends, royalties, interest payments, profit, repatriation)  
 Foreign capital importation requirements  
 Foreign exchange control (e.g.: convertibility)  
 Government to government sales policies  
 Hiring and firing constraints  
 Ideological changes  
 Labor relations regulations  
 Local content regulations  
 Local education requirements (e.g.: technical, managerial)  
 Locally shared ownership requirements  
 Minimum local employment in managerial and technical positions  
 Minimum local representation on board  
 Non-tariff trade barriers (e.g.: regulations, subsidies)  
 Price controls  
 Production quotas  
 Recognition of international trade barriers and constraints  
 Refining and shipping requirements  
 Reinvestment requirements  
 Restrictive trade practices  
 Sectors of economic activity reserved for host country nationals  
 Social spending and involvement requirements (e.g.: housing, medical care)  
 Tariff trade barriers  
 Taxes  
 Unilateral changes to investment agreements

The shortcoming of Root's scheme is its failure to consider the marketing and operating environments.

Overholt provides what is arguably the most comprehensive and useful target classification scheme by organizing

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<sup>32</sup>Franklin R. Root, "Analyzing Political Risks in International Business," in A. Kapoor and Phillip D. Grub (eds.), *The Multinational Enterprise in Transition* (Princeton, New Jersey: The Darwin Press, 1973), p. 357.

\*Compiled from numerous sources already cited.

things into the four groups discussed in chapter 1 to describe the business interests of a typical enterprise: assets, organization, operations, and markets. This approach, illustrated in exhibit 5.4, clearly links risk events with the types of effects they can have on organizations.

#### EXHIBIT 5.4: THE BUSINESS RISKS OF A TYPICAL ENTERPRISE\*

| Business Risks                             |  |                                |                                      |
|--|--|--------------------------------|--------------------------------------|
| Assets                                     | Organization   | Operations                     | Markets                              |
| Nationalization                            | Over regulation/red tape                               | Labor shortage                 | Erratic economic environment         |
| Indirect nationalization                   | Denial of approvals for:                               | Import restrictions            | Lack of growth                       |
| Wage price squeezes                        | --expansion  | Local content rules            | Restricted exports                   |
| Inflation/indexing risk                    | --technological change                                 | Export restrictions/embargoes  | Subsidized competition               |
| Disorder/ambiguous ownership rules         | --site shifts  | Production quotas              | Export subsidy changes               |
| Erosion of patent and copyright privileges | --entering new markets                                 | Widespread labor conflict      | Nationalized marketing               |
| Seizure of data                            | Regulatory indecision                                  | --tradition                    | Politically caused economic problems |
|  | War, crime, riots                                      | --politics                     |                                      |
|  | Management indigenization                              | Uneducated or unreliable labor |                                      |
|  | Hiring and firing constraints                          | Restricted repatriation        |                                      |
|  | Excessive, unfair, or inefficiently managed regulation | --profits                      |                                      |
|  | Personnel comfort and safety risks                     | --royalties                    |                                      |
|  |  | --loans                        |                                      |
|  |  | Corruption                     |                                      |

#### Conclusions

Regardless of how political risk is described, whether it is political or practical in origin, and how it can affect a direct investment, the overwhelming conclusion is that the ultimate source of political risk is a conflict of interest between the host country and the investor. These problems have led some to label conflict between MNEs and hosts as inherent and intractable.<sup>33</sup> But although the near term interests of MNEs and host countries in FDI may be different, the reasons both are interested in FDI are mutually dependent and they undeniably have many

\*Taken from William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), p. 33 and modified with information from pp. 33-36.

<sup>33</sup>Gabriel (1974[1972]), *op. cit.*, p. 137.

shared interests.<sup>34</sup> Both want to see economic growth and increases in production and profits,\* both have an interest in a skilled labor force and capable local managers (less expensive than home country personnel), and, as rational actors, both are interested in mutual understanding and cooperation wherever possible so as to maximize the opportunity for both parties to profit from the relationship at minimum cost to the other.<sup>35</sup> The juxtaposition of extreme conflict of interest with an unavoidable mutuality of concerns, is reflected in exhibit 5.5, the expectations of developing countries's policy makers regarding the taking and using of profits from FDIs.

This apparent paradox may be explained by a new theory which suggests hosts and investors may not have conflicting interests after all. Stevens argues the real conflict is between "technoglobalism" -- global markets, competition, and enterprises -- and "technonationalism" -- the protection of assets like jobs, markets, technology, and resources for the sole use of each individual country. Within this framework, conventional wisdom would tie MNEs to technoglobalism and countries to technonationalism, but Stevens says technoglobalism is in the long-term interest of all actors *and* all actors in the short-term can benefit from some application of technonationalism. She concludes, therefore, that the tensions which produce political risk for investors come from actors being at conflicting points along the 'technonationalism - technoglobalism continuum' at a given time.<sup>36</sup>

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<sup>34</sup>Subhash C. Jain and Vinod Bavishi, "Strategies for Doing Business with LDCs," *Management International Review*, Vol. 19, No. 3 (1979), pp. 70-71.

\*What happens to the profits, however, is often a matter of some contention. Generally the host government favors taxes and/or reinvestment and the MNE favors repatriation, but in the case of joint ventures, local shareholders tend to prefer high dividends and it is the MNE which favors reinvestment. Mason *op. cit.*, p. 12.

<sup>35</sup>P. Streeten, "New Approaches to Private Investment in Less Developed Countries," in John H. Dunning (ed.), *International Investment: Selected Readings* (Middlesex, England: Penguin Books, 1972 [Article originally published in 1969]), pp. 446-447.

<sup>36</sup>Candice Stevens, "Technoglobalism vs. Technonationalism: The Corporate Dilemma," *Columbia Journal of World Business*, Vol. XXV, No. 3 (Fall, 1990), pp. 43-47.

**EXHIBIT 5.5: HOST GOVERNMENT EXPECTATIONS FROM MNEs\***

|  |                       |      |
|--|-----------------------|------|
| Reasonable rate of profit as a percentage of investment:   | 20% or more           | 12.8 |
|  | Between 15% and 20%   | 48.7 |
|  | Between 10% and 15%   | 33.3 |
|  | Less than 10%         | 5.1  |
| Percentage of profits which should be reinvested:  | 75% or more           | 10.3 |
|  | Between 60% and 75%   | 15.4 |
|  | Between 50% and 60%   | 28.2 |
|  | Between 40% and 50%   | 38.5 |
|  | Less than 40%         | 7.7  |
| Percentage of profits which should be paid in host country taxes:  | 60% or more           | 0    |
|  | Between 50% and 60%   | 10.0 |
|  | Between 40% and 50%   | 45.5 |
|  | Between 30% and 40%   | 27.5 |
|  | Less than 30%         | 17.5 |
| Percentage of gross income (before tax profits) which should be spent on research and development in the host country: | 5% or more            | 31.6 |
|  | Between 4% and 5%     | 23.7 |
|  | Between 3% and 4%     | 28.9 |
|  | Between 2% and 3%     | 13.2 |
|  | Less than 2%          | 2.6  |
| Maximum percentage of managerial positions which should be filled with home country nationals:                         | 75% or more           | 5.0  |
|  | Between 50% and 75%   | 12.5 |
|  | Between 25% and 50%   | 15.0 |
|  | Less than 25%         | 67.5 |
| Maximum percentage of technical positions which should be filled with home country nationals:                          | 75% or more           | 10.0 |
|  | Between 50% and 75%   | 22.5 |
|  | Between 25% and 50%   | 40.0 |
|  | Less than 25%         | 27.5 |
| Percentage of total net income which should be spent on voluntary public service activities in host country:           | 10% or more           | 12.5 |
|  | Between 8% and 10%    | 17.5 |
|  | Between 6% and 8%     | 20.0 |
|  | Between 4% and 6%     | 42.5 |
|  | Less than 4%          | 7.5  |
| Voluntary public service activities on which MNEs should spend money:**  | Education (technical) | 85.0 |
|  | Housing               | 60.0 |
|  | Medical care          | 42.5 |
|  | Education (general)   | 37.5 |
|  | Sports and recreation | 22.5 |
|  | Agriculture           | 5.0  |
|  | Communications        | 5.0  |
|  | Research              | 5.0  |
|  | Roads                 | 5.0  |
|  | Transportation        | 5.0  |
| Arts   | 2.5                   |      |

\*Taken from Jain and Puri, *op. cit.*, p. 65.

\*\*Total responses are over 100% due to multiple responses.

While Stevens may be right in theory, the evidence is overwhelming that throughout the FDI process, actors do not *perceive* a commonality of interest sufficient to eliminate risk. Nevertheless, the major actors in the FDI relationship are rational and will work to minimize the costs of their conflicts within the political environment. Therefore, "the political [environment] can be seen as a market in which groups of individuals both inside and outside government compete" for power, wealth, and the support necessary to create and use both.<sup>37</sup> In the simplest sense, political risk is the result of this competition for resources, this pursuit of interests, and it will continue to be a problem as long as there are actors in the environment who perceive interests to be in conflict.

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<sup>37</sup>Phillips-Patrick, *op. cit.*, p. 653.

### **Part III**

#### **Political Risk Analysis**

"At one extreme, a seasoned pro might simply pick up the phone to chat with former associates at, say, the Central Intelligence Agency. At the other, elaborate computer models massage the surveyed opinions of foreign observers around the globe.<sup>1</sup>

Kobrin divides the approaches or methodologies used in political risk analysis into two simple groups: "those aggregating subjective assessments and those relying on quantified indicators of economic, social, and political factors;" basically a 'soft/hard' differentiation.<sup>2</sup> These two kinds of techniques can be used separately or in combination, for general analysis or in highly specific applications, solely to analyze the occurrence probability of political risk events or to consider the entire political risk equation.

Chapter 6 considers and critiques the 'soft' methods, while chapter 7 examines those grounded in 'hard' data. Each chapter includes assessments of strengths and weaknesses, general utility, and effectiveness -- all from a practical standpoint. Chapter 8 looks at the challenges for successful political risk analysis and at attempts to improve and build upon the techniques reviewed in chapters 6 and 7.

Since the subject at hand is the analysis of the probabilities of occurrences in unique, two-stage situations, success is something hard to define. Among the criteria are simplicity, ease of use, cost, flexibility, and specificity; perhaps most important is the amount and confidence level of information yielded. This is the key to whether or not political risk analysis alone can be sufficient to protect multinational enterprises from political risk in foreign direct investment, and therefore to whether or not the second hypothesis is supported.

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<sup>1</sup>Bob Donath, "Handicapping and Hedging the Foreign Investment," *Industrial Marketing*, Vol. 66, No. 2 (February, 1981), p. 57.

<sup>2</sup>Stephen J. Kobrin, "Political Risk: A Review and Reconsideration," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1979]), p. 139.

## Chapter 6

### Qualitative Approaches to Political Risk Analysis

"Conceptual models and analytical methodologies that are intuitive and implicit rather than explicit represent the most common approach [to political risk analysis] among US-based international firms."<sup>1</sup>

There are two basic ways to consciously analyze the political risk factor in foreign direct investment (FDI) in an informal or 'soft' manner. One can study the past patterns of action of the actors in the environment in which an investment is being contemplated or one can gather and evaluate the opinion of experts on the question.<sup>2</sup> Either way, qualitative analysis "rel[ies] principally upon the wisdom, experience, and judgment of the analyst" and therefore occurs at a low level on the ladder of cognition.<sup>3</sup>

#### The Personal Approach

Political risk analysis is frequently "based implicitly...on a series of hypotheses that resembles nothing more than an *extrapolation of existing tendencies*, in which the politico-economic future is supposed to unfold as the natural prolongation of the past and the present."<sup>4</sup>

One looks to history as a guide to what will occur because the study of history so clearly reveals that things routinely recur. This shibboleth of historians is in many ways almost an article of faith for traditional political analysts and others in the social studies. History can indicate the patterns of behavior of actors, the timing and frequency of action by groups both in and out of government, the signs which tend to precurse changes and other potential risk events, the administrative capability of potential host governments, and the general nature and

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<sup>1</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), p. 259.

<sup>2</sup>John D. Daniels and Lee H. Radebaugh, *International Business: Environments and Operations, Fourth Edition* (Reading, Massachusetts: Addison-Wesley Publishing Company, 1986), p. 552.

<sup>3</sup>Stephen J. Andriole and Gerald W. Hopple, "An Overview of Political Instability Research Methodologies: Basic & Applied Recommendations for the Corporate Analyst," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 76-77.

<sup>4</sup>Michael P. Sloan, "Strategic Planning by Multiple Futures Techniques," *Management International Review*, Vol. 24, No. 1 (1984), p. 4.

caliber of governmental decisions over time.<sup>5</sup> At the very least, the history of a potential host country, if considered over time, will usually offer a general indication "of the broad climate for operations" in that country over time.<sup>6</sup>

The historical approach, writes Sloan, "presents the advantage of the law of least effort, but it is also not without its dangers."<sup>7</sup> Put simply: things can change. Historians will argue that over the long term, patterns of occurrences will tend to develop in most countries; in many, such patterns may be clear even in the relatively short term. But short term for history -- 10 to 30 years perhaps -- is a long time to a potential investor. Not only is it possible for the past not to repeat itself, it is possible the changes expected will happen at unexpected times or in unexpected ways. "A simple-minded extrapolation from the past to the future" can lead to a business disaster if a government or a system of government changes (or fails to change) against the historical pattern.<sup>8</sup> These are, of course, strong arguments to extend any historical investigation into the present. To properly analyze an environment one must learn about the current political system, government, and opposition, what their vulnerabilities are, and who is dependent upon whom; one must evaluate "the country's ability to withstand adverse circumstances."<sup>9</sup>

In conducting a historically-based current assessment, it is easy to overlook something, or more likely several things, of potential importance. This can be overcome by creating a checklist of information necessary to conduct a proper analysis of the political risk equation. As shown in exhibit 6.1, a list can make the gathering and analysis of information a more systematic process and thereby improve the efficiency and efficacy of the analysis.

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<sup>5</sup>J.N. Robinson, "Is it Possible to Assess Country Risk?" *The Banker*, Vol. 131, No. 659 (January, 1981), p. 73.

<sup>6</sup>John D. Daniels, Ernest W. Ogram, Jr., and Lee H. Radebaugh, *International Business: Environments and Operations, Second Edition* (Reading Massachusetts: Addison-Wesley Publishing Company, 1979), p. 335.

<sup>7</sup>Sloan, *op. cit.*, p. 4.

<sup>8</sup>Thomas L. Brewer, "Political Risk Assessment for Foreign Direct Investment Decisions: Better Methods for Better Results," *Columbia Journal of World Business*, Vol. XVI, No. 1 (Spring, 1981), p. 8.

<sup>9</sup>Robinson, *op. cit.*, p. 73.

**EXHIBIT 6.1: CHECKLIST FOR POLITICAL RISK ANALYSIS\*****Internal Aspects of the Country****History**

Time and mode of independence?

Record of Stability?

**Homogeneity**

Sense of national unity?

History of conflicts between ethnic or religious groups?

Is there a dominant ethnic group or are groups of equal strength?

**Form of Government****Democracy**

Strong opposition parties with radically different ideology?

Effective government or chaotic situation?

Corruption?

Voting along ethnic lines?

Is government sensitive to needs of population?

**Military government**

Widespread popular support or national liberation front?

How strong is the army?

Rivalries among army commanders?

Underground opposition strong?

Did military government follow ineffective, unpopular democracy?

Are civil servants utilized or alienated?

Are there alternative power bases?

Return to civil rule planned?

**One-man, one-party state**

What if present leader dies?

Are various ethnic groups represented in government?

Is military major contender for power?

Is civil service strong and independent?

Is opposition effectively organized; does it have moral stature?

Is there a specific interest group opposing regime?

**Sources of potential unrest**

Are the young, intellectuals, civil servants, military, businessmen, or public opinion alienated from government?

Is there a suppressed minority group?

Are there conflicts between the central government and traditional regional centers of power?

Is strong foreign government influence resented?

Is unemployment high?

Is corruption widespread? Who are the victims?

Is there a sense that the government is unusually ineffective or that there is no economic progress?

Is economic progress confined to the center or purposely spread over the country as a whole?

Is the economic gap between elite and the populace widening or narrowing?

**Drastic political changes**

Will a change in government or a coup lead to a drastic change in political orientation or chaos?

Is there any chance of a civil war?

Would a coup lead to political paralysis and a counterswing?

Would the next political regime be more/less likely to renounce of reschedule debt for political/ideological reasons?

**External Aspects of the Country****Danger of war**

Is the area as a whole explosive or calm?

Are there major sources of conflict with neighbors?

Will a war seriously impair the economy?

**Economic relations**

Is there a threat of an effective economic boycott?

Are relations with major aid donors stable?

Are relations with World Bank and IMF healthy?

Are there plans for political agreements with major trade-blocs for ensured access to major markets?

Does the country want to increase U.S. investment and trade?

Does the U.S. government have any leverage?

\*Taken from Antoine W. van Agtmael, "How Business Has Dealt With Political Risk," *Financial Executive*, Vol. XLIV, No. 1 (January, 1976), pp. 27-28.

But the existence of a list also can create the *prima facie* appearance that everything of importance is on the list and thereby can lead to a major oversight should something have been left off.<sup>10</sup>

A second problem is more difficult to overcome. The information available about a potential host country, particularly a developing country, can be extremely limited. The easily accessible history often consists of little more than a few survey volumes, rife with the interpretations of their authors, while readily obtainable current information is often as narrow -- failing to cover areas which could be very important to the investor but are otherwise obscure -- and/or the product of the government information office and therefore of dubious utility. One management textbook advocates dealing with this by

"reading statements made by political leaders both in and out of office in order to determine their political philosophies on business in general [and their attitudes toward foreign investors and various home countries and analyzing] the context of statements to determine whether they express true intentions or were made merely to appease particular interest groups or social strata."<sup>11</sup>

Good advice, but much easier to do when one is considering investing in Belgium, for instance, than in Zaire.

Another approach to overcoming this problem is to go to the source and take what has become known as a "Grand Tour" of the country under consideration. Such tours are ideal in a number of ways, providing opportunities to meet, look, and listen; to experience the investment environment and its reaction to investors.<sup>12</sup> A well organized tour can fill in a lot of the blanks left from earlier investigations through meetings with local business leaders, journalists, dissidents, academics, labor leaders, members of the *intelligentsia*, and political leaders of all stripes.<sup>13</sup> In systematizing the tour, it is possible however, to commit the same oversight errors as with other types of checklists. Additional difficulties endemic to the 'grand tour' are likely to cause even more serious problems.

Grand tours tend to be just that -- grand. Top executives of MNEs are important people and, even if they do not want to be treated as such, the host government is likely 'roll out the red carpet' for them. Tour schedules

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<sup>10</sup>Robert Grosse and John Stack, "Non-Economic Risk Evaluation in Multinational Banks," *Management International Review*, Vol. 24, No. 1 (1984), p. 47.

<sup>11</sup>Daniels, Ogram, and Radebaugh, *op. cit.*, pp. 336-337.

<sup>12</sup>Daniels and Radebaugh, *op. cit.*, pp. 553-554.

<sup>13</sup>Daniels, Ogram, and Radebaugh, *op. cit.*, p. 337.

can become clogged with 'top level' briefings in which negative information may be glossed over or ignored altogether, guided tours which never include people or places the host fears would discourage the investor, and other special events designed to make the trip more a recruiting visit than an on-the-scene investigation into potential risk factors. Even in the best cases, when executives have the desire and sufficient foreknowledge to seek the information they need, their high profiles limit their freedom to visit who and what they wish. More often, MNE executives are quite happy to be celebrities and such unimportant details as "difficulty in clearing customs, a bad meal, or other displeasing firsthand experiences can, unfortunately, have a profound effect on their evaluation of a particular country."<sup>14</sup>

### Expert Generated Data

When businesses believe specific expertise, and or the ability to look at things more objectively, can help them resolve or avoid problems, they hire consultants. In the United States, and to a growing extent in Europe, there are entire business communities of management and marketing consultants, to name only the best known, filling this role. Political risk consultants are generally either political analysts with specific country expertise or analytical methodologies to offer, or **old hands** with a background in intelligence work (Richard Helms, for example, the former U.S. Director of Central Intelligence and Ambassador to Iran who has a small consulting firm called *Safeer*<sup>\*</sup>) or diplomacy (the best known example of this sort of firm is Kissinger & Associates, run by the former US Secretary of State). MNEs which use informal analytical methods generally use old hands.<sup>15</sup>

In order to be useful, old hands must offer more than just experience and intelligence. They must be able to analyze what may happen in the future, not only relate what happened in the past, and must compile and communicate the information in such a way as to make it applicable to the proposed project.<sup>16</sup> Even consultants

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<sup>14</sup>R.J. Rummel and David A. Heenan, "How Multinationals Analyze Political Risk," in Douglas N. Dickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), pp. 382-384.

<sup>\*</sup>'Ambassador' in Persian.

<sup>15</sup>Louis Kraar, "The Multinationals Get Smarter About Political Risks," *Fortune*, Vol. 101, No. 6 (March 24, 1980), p. 87.

<sup>16</sup>Rummel and Heenan, *op. cit.*, pp. 384-385.

skilled at these tasks make mistakes and have an inherent bias which cannot but show in their work. The responsible executive must take these potential problems into account.<sup>17</sup>

The Delphi method is a systemization of the use of experts designed to minimize the impact of any single expert's bias or errors.<sup>18</sup> The system was developed in the late 1960s by the RAND Corporation, a non-profit California think tank which borrowed the name from the famous Greek oracle. Delphi surveys ask the same questions of a number of experts, give them a chance to review and consider the answers of others (and to discuss them among themselves if the survey is being conducted in person), and then compile final thoughts for use by the investor.<sup>19</sup> The panel of experts is usually composed of a wide variety of people with various professional backgrounds and opposing political viewpoints. Ideally, this approach results in a sufficiently broad array of advice to overcome the bias inherent in the ideas of each individual.<sup>20</sup>

If Delphi appears to solve many of the difficulties associated with the use of single consultants, it also creates a number of new problems of its own. The 'ideal' Delphi scenario is to have the experts sitting around a table working with one another to reach consensus on those issues where it is possible and to clarify the alternative options in those areas where it is not. At best, this is an expensive process, difficult for small firms to use. Ironically though, if the investing MNE can afford the personal approach, it might end up getting a product not worth the extra expense. While face to face contact may seem an efficient way to 'smooth' discontinuities and produce a more useful final product, the role of personalities is enhanced in face to face situations and the risk of bias in the final product due to the excessive influence of dominant personalities therefore increases.

In order to avoid both of these difficulties, Delphi surveys are usually done on paper through the mail. This creates a potential control and motivation problem because the experts are essentially 'on their honor' to do

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<sup>17</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), pp. 120-122.

<sup>18</sup>Charles W. Hofer and Terry P. Haller, "GLOBESCAN: A Way to Better International Risk Assessment," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1980]), pp. 152-153.

<sup>19</sup>Shubik, *op. cit.*, pp. 127-129 and Andriole and Hopple, *op. cit.*, p. 80.

<sup>20</sup>William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), pp. 8-9.

their best. In addition, by effectively duplicating the form of a checklist, Delphi surveys may suffer from their problems as well.<sup>21</sup> Finally, the indirect approach creates an enormous amount of paperwork because surveys with open-ended answers can be so lengthy. To make the survey more user friendly at both ends, the majority of remote Delphi surveys utilize a scoring system where the expert answers questions by choosing a 'value' from a nominal scale. Although this eases the workload tremendously, it raises yet more potential problems.

A nominal scale is really nothing more than a representation of a qualitative judgment, an arbitrary "coding device for identifying items[,] and has nothing to do with quantification." But the assignment of a number falsely implies a numerical value which can be mathematically manipulated. If '5' represents certainty that a given risk event will affect an investment and '1' represents certainty that it will not, '2,' '3,' and '4' have no real value. It may be said they represent 'points along the continuum' or 'degrees' of difference, but the 'difference' is not a thermometer demarcated in finite, representable intervals and the 'continuum' has no measurable length, therefore 2, 3, and 4 are just labels.<sup>22</sup>

The only conceptual problem of nominal scales, provided their limitations are recognized, stems from the fact the arbitrary 'labels' may well represent different concepts to each expert who participates in the survey. Practically however, this issue only exacerbates the more serious problem: the need to aggregate the survey responses for some form of final report or recommendation. In a face to face Delphi, this can be done by the experts themselves; in an extended answer mail survey, it can be done by staff (although not without the attendant risks of distortion). With numbers alone and no words to help those who would interpret them, aggregation can only be done mathematically, and this, for the reasons just outlined, will inevitably produce an effectively meaningless 'score.'

Regardless of how the Delphi survey is run, there are two other basic difficulties which limit their potential for reliability and effective utility. There is no truly effective way to reach consensus between diametrically opposed viewpoints. 'Yes' and 'no' cannot be averaged. In any Delphi which includes widely divergent opinions, there will have to be a choice of an 'expert among experts,' a choice which seems inherently

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<sup>21</sup>Shubik, *op. cit.*, pp. 127-129.

<sup>22</sup>Giovanni Sartori, "Concept Misformation in Comparative Politics," *The American Political Science Review*, Vol. LXIV, No. 4 (December, 1970), p. 1036.

opposed to the purpose of the original exercise.<sup>23</sup> In addition, the very nature of the method is theoretically inadequate. No matter how many different experts are involved in an attempt to neutralize the effect of individual biases, the sample can never be large or random enough to reach this goal. In effect, Delphi only serves to alter, and sometimes to hide, the bias in the recommendations, not to eliminate it.<sup>24</sup> It could even be argued that the nature of the Delphi approach undermines the real value of multiple experts -- their distinctly different points of view and ideas.

### Conclusions

Political risk analysis methods informed by traditional social studies methodologies have much to recommend them. They are highly flexible and can address the entire risk equation from a firm specific point of view, but have a severe shortcoming. They rely ultimately on purely intuitive judgments which can only be made at the bottom of the ladder of cognition. This situation can lead to missed opportunities (in cases of excessive conservatism based on a lack of faith in political risk analysis) or disastrous investments (in cases of misplaced confidence in the conclusions of such analysis). Either way, the results can be expensive.

The use of systems like checklists can help overcome some of the problems of traditional informal methods, particularly when the system is to be used only as a procedural guide, not an inflexible regimen. But a systematic process can suggest an implicit level of understanding of the political risk problem which it does not necessarily contain. Procedural systems do not inherently recognize the two-stage nature of the political risk equation. Unless a system is specifically designed to address the unique characteristics of a given instance of foreign direct investment, it will not be able to support useful analysis of the second stage of the equation.

The academic world -- both business schools and the social studies -- told MNEs interested in political risk analysis to gather knowledge; to learn -- about the past, about the present, about alternatives. But traditional academicians talk of knowledge alone, not of where to get it, how to get it, or what to do with it once they have it.

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<sup>23</sup>Sloan, *op. cit.*, pp. 4-5.

<sup>24</sup>Overholt, *op. cit.*, pp. 8-9.

A good system can help resolve the first two problems, but the last can only be dealt with through an understanding of the structure of political risk -- how political events can affect organizations.

## Chapter 7

### Quantitative Approaches to Political Risk Analysis

"From the mid to late 1970s, the emphasis in political risk analysis shifted from conceptually-oriented studies to more quantitative ones....[This was because] the link between political events and economic ones was becoming more apparent to corporate decision makers...[and] quantitative studies of political behavior [were becoming] accepted as an integral part of the discipline."<sup>1</sup>

The perils of subjectivity in political risk analysis were only one of the reasons many major multinational enterprises (MNEs) began to try to keep their political risk analysis process as 'objective' as possible.<sup>2</sup> The other was a growing frustration with the inability to integrate political analysis with the statistically based analysis of other business (β) risk.<sup>3</sup> This would permit MNEs to "quantify risk in terms of potential costs" in order to integrate such costs into foreign direct investment (FDI) plans by altering the capital budget, shortening the payback time, or figuring an appropriate compensatory premium on the return on investment (ROI).<sup>4</sup> In the terms of this thesis, statistical quantification of political risk should move confidence in the analysis of such risk several rungs up the ladder of cognition.

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<sup>1</sup>Jeffrey D. Simon, "Political Risk Assessment: Past Trends and Future Prospects," *Columbia Journal of World Business*, Vol. XVII, No. 3 (Fall, 1982), p. 65.

<sup>2</sup>David Kern, "Forecasting Country Risk," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), p. 16.

<sup>3</sup>In addition to examples raised throughout the chapter, support for this statement and examples of specific approaches may be found in numerous sources including John Calverley, *Country Risk Analysis* (London: Butterworth & Co. (Publishers) Ltd., 1985), pp. 134-153, Robert Grosse and John Stack, "Non-Economic Risk Evaluation in Multinational Banks," *Management International Review*, Vol. 24, No. 1 (1984), p. 46, Gilbert D. Harrell and Richard O. Kiefer, "Multinational Strategic Market Portfolios," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), pp. 288-289, Kern (1987), *op. cit.*, pp. 15-16, Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 372-374, and Simon (1982), *op. cit.*, p. 66.

<sup>4</sup>Joseph Micallef, "Political Risk Assessment," *Columbia Journal of World Business*, Vol. XVI, No. 2 (Summer, 1981), p. 50 and Alan C. Shapiro, "Managing Political Risk: A Policy Approach," *Columbia Journal of World Business*, Vol. XVI, No. 3 (Fall, 1981), p. 64.

This chapter will look first at the quantification of previously discussed analytical methodologies, then at deterministic models with roots in behavioralism, and finally at sophisticated econometric approaches. This organization is a roughly chronological representation of the development and implementation of the methods. Since the methods build on one another, descriptions and critiques which apply to each section will only be considered in detail when first introduced. Likewise, several issues already discussed, particularly the matter of nominal scales examined in Chapter 6, apply here and will not be reviewed in detail.\*

### Quantification of Pre-Existing Methods

The checklist and the Delphi survey are two methods to systematize political risk analysis which can be quantified easily. Like the traditional versions of these techniques, the quantified versions can be used in specific instances to analyze the entire political risk equation or in general applications to evaluate the political environment and the first stage of the equation. Quantified Delphi surveys are often used by commercial political risk rating services to evaluate political risk in multiple nations and create rating indices which compare and contrast "levels" of political risk between nations.

Exhibit 7.1 offers a good example of why quantified political risk analysis is appealing to MNEs. This quantified checklist system has been used by a company which compensates for political risk by requiring a higher ROI -- a "premium on risk." Quantification permits the insertion of a numerical value representing the 'level' of political risk in the equation for the generation of an ROI which 'accurately' reflects the risk involved in the investment. The checklist covers a variety of factors, some more purely political than others, but the assignment of rating weight and value to the factors is purely judgmental. There is no clear reason why capital repatriation is considered somewhat more important than the availability of local capital or less important than inflation, nor is there any indication of how something like political stability is to be 'measured.'<sup>5</sup>

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\*One caveat, however: all the problems with nominal scales become more acute when numbers representing merely a qualitative description or label are treated mathematically as if they have real numerical value.

<sup>5</sup>Robert B. Stobaugh, Jr., "How to Analyze Foreign Investment Climates: Four Techniques for Dealing with Trick Questions of Economic and Political Stability," in *International Business: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1970 [Article originally published in 1969]), pp. 91-92.

### EXHIBIT 7.1: CORPORATE RATING SCALE FOR DETERMINING A COUNTRY'S INVESTMENT CLIMATE\*

| <u>Item</u>   | <u>Number of Points</u> | <u>Item</u>   | <u>Number of Points</u> |
|---|-------------------------|---|-------------------------|
| <u>Capital repatriation:</u>  | 0-12                    | <u>Political stability:</u>   | 0-12                    |
| No restrictions   | 12                      | Stable long term  | 12                      |
| Restrictions based only on time   | 8                       | Stable, but dependent on key person                                 | 10                      |
| Restrictions on capital   | 6                       | Internal factions, but government in control                        | 8                       |
| Restrictions on capital and income                                      | 4                       | Strong external and/or internal pressures that affect policies      | 4                       |
| Heavy restrictions  | 2                       | Possibility of coup (external and internal) or other radical change | 2                       |
| No repatriation possible  | 0                       | Instability, real possibility of coup or change                     | 0                       |
| <u>Foreign ownership allowed:</u>                                       | 0-12                    | <u>Willingness to grant tariff protection:</u>                      | 2-8                     |
| 100% allowed and welcomed   | 12                      | Extensive protection granted  | 8                       |
| 100% allowed, not welcomed  | 10                      | Considerable protection granted, especially to new major industries | 6                       |
| Majority allowed  | 8                       | Some protection granted, mainly to new industries                   | 4                       |
| 50% maximum   | 6                       | Little or no protection granted                                     | 2                       |
| Minority only   | 4                       |   |                         |
| Less than 30%   | 2                       |   |                         |
| No foreign ownership allowed  | 0                       |   |                         |
| <u>Discrimination and controls, foreign versus domestic businesses:</u> | 0-12                    | <u>Availability of local capital:</u>                               | 0-10                    |
| Foreign treated same as local   | 12                      | Developed capital market; open stock exchange                       | 10                      |
| Minor restrictions on foreigners, no controls                           | 10                      | Some local capital available; speculative stock market              | 8                       |
| No restrictions on foreigners, some controls                            | 8                       | Limited capital market; some outside funds (IBRD, AID) available    | 6                       |
| Restrictions and controls on foreigners                                 | 6                       | Capital scarce, short term  | 4                       |
| Some restrictions and heavy controls on foreigners                      | 4                       | Rigid controls over capital   | 2                       |
| Severe restrictions and controls on foreigners                          | 2                       | Active capital flight unchecked                                     | 0                       |
| Foreigners not allowed to invest  | 0                       | <u>Annual inflation for last 5 years:</u>                           | 2-14                    |
|   |                         | Less than 1%  | 14                      |
| <u>Currency stability:</u>  | 4-20                    | 1% - 3%   | 12                      |
| Freely convertible  | 20                      | 3% - 7%   | 10                      |
| Less than 10% open/black market differential                            | 18                      | 7% - 10%  | 8                       |
| 10% to 40% open/black market differential                               | 14                      | 10% - 15%   | 6                       |
| 40% to 100% open/black market differential                              | 8                       | 15% - 35%   | 4                       |
| Over 100% open/black market differential                                | 4                       | Over 35%  | 2                       |
|   |                         | Total   | 8-100                   |

Quantified Delphi surveys of the political environment have an additional practical problem. Since

"scores do not take industry and firm specific factors into account..., the scores of factors, such as attitude towards

\*Taken from Robert B. Stobaugh, Jr., "How to Analyze Foreign Investment Climates: Four Techniques for Dealing with Trick Questions of Economic and Political Stability," in *International Business: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1970 [Article originally published in 1969]), p. 92.

private investment and quality of local management, that often vary by industry [are reduced] to a common denominator that may not have any intrinsic meaning."<sup>6</sup>

Quantified checklists and Delphi surveys also suffer from some severe theoretical problems. Quantification implies the use of numbers "in relation to their arithmetical properties."<sup>7</sup> But as has been established, the simple assignment of a number to a judgment -- the implementation of a nominal scale -- carries with it no real value. In order to have value, a number (such as a risk 'rating' in a Delphi survey) must actually represent something which can be conceived as finite and constant. As Sartori says, "we cannot measure unless we know first what it is that we are measuring."<sup>8</sup> Since the act of assigning a numerical label does not provide automatically a measurable value, the 'quantification' of opinion cannot be considered quantification in any technical sense of the word and cannot (except by fluke) result in figures of any meaningful worth as measurements. It follows also that the impression of measurement along an interval scale which is given by a ratings system is, in these cases, equally illusory. Therefore, this sort of quantification cannot be considered sufficient to create or approximate a condition of accurately calculable probabilities on the ladder of cognition.

An additional problem faced by any ratings service is the nature of the ordinal rankings implicit or explicit in its risk index. To say that country *x* is less risky than country *y*, the two countries must be comparable.<sup>9</sup> While it is reasonable to assert that two sovereign nation states can be compared, it may not be reasonable to carry that assumption down a level of abstraction to the internal factors in each state.<sup>10</sup> The question is one of functional equivalence: do indicators mean the same things in different environments? The Soviet Union had a list of rights guaranteed by its constitution which was among the most extensive in the world, but they were all but meaningless in practice. The United Kingdom, on the other hand, does not even have a written constitution, yet the rights

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<sup>6</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), p. 261.

<sup>7</sup>Giovanni Sartori, "Concept Misformation in Comparative Politics," *The American Political Science Review*, Vol. LXIV, No. 4 (December, 1970), p. 1037.

<sup>8</sup>*Ibid.*, p. 1038.

<sup>9</sup>*Ibid.*, pp. 1035-1036.

<sup>10</sup>*Ibid.*, pp. 1047-1048.

enjoyed by Britons are among the most complete in the world. To have assigned comparative risk ratings based on examinations of the constitutional guarantees in these two countries would have been extremely misleading.

The value of some risk rating indices was examined, more by accident than design, in a recent study by Chase, Kuhle, and Walther. They looked at ROI rates for FDI in 46 countries between 1972 and 1984 and compared them to the political risk ratings found in two commercial risk rating indices. The goal was to find out if political risk is a major determinant in the FDI decision making process, but since the ratings were used as a surrogate for the actual incidence of risk events (measuring risk effects on such a scale would be effectively impossible because of their specificity, so some form of surrogate must be used), the effect was an evaluation of the ratings themselves. Underlying the study were two major assumptions: investors demand a premium on risk, and they actually get it (meaning their demands are met sufficiently so that the premium should be identifiable in an examination of ROI). The results for both indices were almost identically inconclusive --sometimes the relationship between risk ratings and return was strongly positive (supporting the hypothesis), sometimes strongly negative, and usually not very clear. The conclusions drawn were that either the ratings indices are not very helpful and/or that conventional accounting methods are not capable of measuring the real return on foreign direct investment as valued by the investor.<sup>11</sup> The second conclusion has fascinating possibilities but is well out of the scope of this thesis; the first one however, seems reasonable given the theoretical and practical problems of the indices.

### Statistical Approaches

In order to generate theoretically sound statistical analyses of political risk, political risk analysts turned to explanatory quantitative methodologies based on causal links between statistical data and specific environmental changes (risk events). The approach permits the leverage of real, measurable, numerical data in the derivation of likely outcomes and the calculation of statistical probabilities. Use of this method should result in high confidence levels on the ladder of cognition. The approach is an application of behaviorist theories developed in the social studies in the early 1960s which argue that certain factors automatically lead to certain outcomes (if independent

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<sup>11</sup>Carmen D. Chase, James L. Kuhle, and Carl H. Walther, "The Relevance of Political Risk in Foreign Direct Investment," *Management International Review*, Vol. 28, No. 3 (1988), pp. 34-37.

variable  $x$  has value  $n$ , then dependent variable  $y$  will have value  $a$  (and ' $a$ ' only, not ' $b$ ' or ' $c$ ').<sup>12</sup> Examples of causal relationships include: 'poverty leads to revolution,' 'worsening poverty leads to revolution,' 'a wide gap between rich and poor leads to political tension,' 'development leads to instability or to repression (which eventually leads to instability),' and 'relative deprivation of wealth [or] frustration of expectations leads to instability.'<sup>13</sup>

Because political risk is a complex, two stage concept in which events impact different organizations in different ways, it is not practical to postulate direct causal links between event and effect for other than specific circumstances. For more general analysis, analysts and academics alike often adopt political instability as a surrogate for the first stage of the risk equation.<sup>14</sup> Political instability is not political risk, does not automatically create political risk, and certainly is not the only source of political risk, but it does produce events which are of the type which history shows have effect on business in general and foreign direct investments in particular.\* It is therefore reasonable to assume a study of instability could produce information useful in political risk analysis.

Instability in this conception occurs when existing governments or structures fail to meet the needs and demands of actors within a given system and the failure leads actors to demand and/or actually create changes in

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<sup>12</sup>Stephen J. Andriole and Gerald W. Hopple, "An Overview of Political Instability Research Methodologies: Basic & Applied Recommendations for the Corporate Analyst," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 85-87.

<sup>13</sup>These generalizations are found in many places and are all grounded in extensive theoretical work. Their immediate sources for this application include Andriole and Hopple, *op. cit.*, pp. 85-87, John D. Daniels and Lee H. Radebaugh, *International Business: Environments and Operations, Fourth Edition* (Reading, Massachusetts: Addison-Wesley Publishing Company, 1986), pp. 554-555, Roberto Friedman and Jonghoon Kim, "Political Risk and International Marketing," *Columbia Journal of World Business*, Vol. XXIII, No. 4 (Winter, 1984), pp. 66-67, William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), p. 8, and R.J. Rummel and David A. Heenan, "How Multinationals Analyze Political Risk," in Douglas N. Dickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), pp. 387-388.

<sup>14</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 58.

\*It is now widely recognized that political instability is a related but fundamentally different matter than political risk in FDI. This has not always been agreed upon, particularly not in the early 1970s, as has been explained by Robock and Simmonds and Sethi and Luther.

the government and/or the system itself.<sup>15</sup> Serious instability can lead to "radical political change" which "connotes the ascendancy to power of a person or group holding a different political philosophy than the person or group that it replaced."<sup>16</sup> Changes of this sort can be gradual or revolutionary, with the latter often implying a violent change of structure as well as personnel, and often entailing a substantially different set of relationships between actors in the environment.<sup>17</sup>

### Problems with Determinism

"The government is very keen on amassing statistics. They will collect them, add them, raise them to the  $n^{\text{th}}$  power, take the cube root, and prepare wonderful diagrams. But you must never forget that every one of these figures comes in the first instance from the village watchman, who just puts down what he pleases.

--Sir Josiah Stamp, Inland Revenue Department, England  
(1896-1919)<sup>18</sup>

In political risk analysis, the quality and utility of raw data is paramount. Achieving a condition of subjective probability, or even quantifiable uncertainty, on the ladder of cognition requires data which is both accurate and representative of the complete political risk environment.

Independent data collection is prohibitively expensive, but unless they collect their own, political risk analysts have to adapt data not collected with consideration for business applications. Even under ideal conditions, this can be a handicap.<sup>19</sup> For data to be considered 'ideal,' they must be accurate, appropriate for the intended use, up to date, and, when merely a percentage sample of the whole, truly representative. If the data are to be used in comparative studies, there needs to be consistency in definitions, formats, data gathering methods and the

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<sup>15</sup>Patrick Doyle, "Political Risk Assessment: The View from an Export Credit Agency," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 37-38.

<sup>16</sup>Robert T. Green, "Political Structures as a Predictor of Radical Political Change," *Columbia Journal of World Business*, Vol. IX, No. 1 (Spring, 1974), p. 29.

<sup>17</sup>James E. Austin and John C. Ickis, "Managing After the Revolutionaries Have Won," *Harvard Business Review*, Vol. 64, No. 3 (May-June, 1986), pp. 103-104.

<sup>18</sup>William Ascher and William H. Overholt, *Strategic Planning and Forecasting: Political Risk and Economic Opportunity* (New York: John Wiley & Sons, 1983), p. viii.

<sup>19</sup>Sethi and Luther, *op. cit.*, pp. 63-64.

applicability of gathering methods across samples.<sup>20</sup> For example, the U.S. Census is conducted through questionnaires. This method may not be as accurate as, and therefore not directly comparable to, a census conducted by hand count; on the other hand, it is also not comparable to a census conducted in precisely the same manner, with equivalent questionnaires, in a country with a 10% literacy rate.

As the example suggests, poorer countries tend to provide additional data problems. Obstacles tend to be greater in developing countries which appear to have potential for the most serious political risk. Data gatherers are often inadequately paid and monitored, publication of data can lag well behind collection, and supporting resources and information are rarely sufficient.<sup>21</sup> Often, desired data is either censored by the government or simply not extant; when it does exist, it is often heavily slanted in favor of the sitting government.<sup>22</sup> One result of these data problems could be "an over reliance on a few readily available quantitative indicators" of environmental conditions by an MNE tied to the idea of statistically objective political risk analysis.<sup>23</sup> Another result is the effective impossibility of defining the variables in deterministic relationships with sufficient rigor and specificity to make the relationships directly applicable in operational situations. In operation, what are considered discrete events not only appear to have multiple causes, they also appear to have multiple effects (meaning either simultaneous multiple effects and/or a multiplicity of discrete effects). This is why tests of deterministic theory have demonstrated its inapplicability to practical political risk analysis, if not necessarily a theoretical lack of validity.<sup>24</sup>

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<sup>20</sup>John D. Daniels, Ernest W. Ogram, Jr., and Lee H. Radebaugh, *International Business: Environments and Operations, Second Edition* (Reading Massachusetts: Addison-Wesley Publishing Company, 1979), pp. 326-329.

<sup>21</sup>J.N. Robinson, "Is it Possible to Assess Country Risk?" *The Banker*, Vol. 131, No. 659 (January, 1981), p. 77.

<sup>22</sup>Briance Mascarenhas and Clifford Atherton, "Problems in Political Risk Assessment," *Management International Review*, Vol. 23, No. 2 (1983), p. 25.

<sup>23</sup>Thomas L. Brewer, "Political Risk Assessment for Foreign Direct Investment Decisions: Better Methods for Better Results," *Columbia Journal of World Business*, Vol. XVI, No. 1 (Spring, 1981), p. 8.

<sup>24</sup>While Sartori does not deal with this problem directly, the reasoning employed here was derived from his discussion of structure and function in Sartori, *op. cit.*, pp. 1046-1052.

There are also practical problems with the use of causal link models in political risk analysis. Even if one of these models could be used successfully to determine the probability and broad nature of political instability, it could not address the 'post instability' environment, the aspect of the first stage crucial to any follow on second stage analysis of the effects of instability on an MNE or its affiliate.<sup>25</sup> History shows that changes vary in nature, intensity, and result. Change the leader of Iran in 1979 and everything changes with him; change the entire political system of the Philippines in 1971 and virtually nothing is altered in the operating environment. Because political changes are so fungible, instability alone, without any signal of what will follow, has little value as an indicator of political risk.<sup>26</sup>

Furthermore, a measure of political instability may not recognize the potential for political risk in a country with a popular, stable, long serving government but no system for succession.<sup>27</sup> Likewise, a measure of government stability would be less than useless as an indicator of political risk in France's Fourth Republic or modern day Italy. Besides, change is necessary for economic growth and societal progress. Complete stability can only mean stagnation – a situation which, apart from any question of political risk, generally is not conducive to profit.<sup>28</sup> The conclusion therefore, must be that stability *per se* is not an issue; the issue is whether an MNE can identify a profitable opportunity from which it can continue to profit regardless of the changes.<sup>29</sup>

This conclusion is supported by an even more practical reason simple causal link models have fallen out of favor: they do not work. The simple truths of determinism have been found false: there are many poor countries not in revolt and when revolutions do occur, they tend to begin as things are improving, not as they are worsening.<sup>30</sup> Since World War II this has been the case in Hungary (twice), Cuba, Czechoslovakia (twice),

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<sup>25</sup>Bob Donath, "Handicapping and Hedging the Foreign Investment," *Industrial Marketing*, Vol. 66, No. 2 (February, 1981), p. 57.

<sup>26</sup>Calverley, *op. cit.*, p. 115.

<sup>27</sup>*Ibid.*

<sup>28</sup>Overholt, *op. cit.*, p. 25.

<sup>29</sup>Louis Kraar, "The Multinationals Get Smarter About Political Risks," *Fortune*, Vol. 101, No. 6 (March 24, 1980), p. 98 and Micallef, *op. cit.*, pp. 47-48.

<sup>30</sup>Overholt, *op. cit.*, p. 8.

Nicaragua, Cuba, China, and the former Soviet Union. At the same time, countries as diverse as Costa Rica (poor despite its name) and those of the oil rich Middle East stand as counter examples to the assumptions that a wide gap between rich and poor leads automatically to instability.<sup>31</sup> Even the theories of frustration and deprivation have shown a lack of predictive success.<sup>32</sup>

Since the deterministic relationships which were believed to produce political instability do not reliably do so, statistical models which presume to predict the probability of political instability through those relationships can be of no real use in predicting potential political risk. This has been confirmed by a recent study of U.S. direct investment in Central and South America from 1950-1982. Over the years, a number of studies have shown a limited, or more frequently, "absence of a[,] negative association between political instability and FDI."<sup>33</sup> Fatehi-Sedeh and Safizadeh believe the failure of the studies to find any significant link between political instability and some indicator of real or perceived political risk is more indicative of bad study methodologies than a lack of link. In their study they do find significant negative association in some countries and evidence of mitigating factors to explain its lack in others.<sup>34</sup>

Three factors differentiate this study from what has gone before:

1. The use of major real risk events (exhibit 7.2) as independent variables instead of risk indices;
2. Separate analyses of each home - host country investment flow relationship instead of an aggregate analysis of all the flow into one country, all the flow from one country, or all the flow into one region (to eliminate any possible distortions from aggregation); and

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<sup>31</sup>Rummel and Heenan, *op. cit.*, pp. 387-388.

<sup>32</sup>Simon (1982), *op. cit.*, p. 58.

<sup>33</sup>K. Fatehi-Sedeh and M. Hossein Safizadeh, "Sociopolitical Events and Foreign Direct Investment: American Investment in South and Central American Countries, 1950-1982," *Journal of Management*, Vol. 14, No. 1 (1988), pp. 94-95 provides a comprehensive listing of these studies. A similar list can also be found in Stephen J. Kobrin, "Political Risk: A Review and Reconsideration," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1979]), pp. 136-137.

<sup>34</sup>*Ibid.*, pp. 104-105. These factors include industry specific factors which require investment virtually regardless of risk, factors which appear to lower vulnerability to potential risk events, the availability of political risk insurance, and particularly attractive market conditions or highly advantageous entry concession agreements which appear to offer a sufficient premium on ROI to compensate for the fear of potential risk.

**EXHIBIT 7.2: LIST OF INDEPENDENT VARIABLES OF POLITICAL INSTABILITY\*****Variable Description**

Protest demonstrations  
 Regime support demonstrations  
 Riots  
 Armed attacks  
 Successful assassinations  
 Political strikes  
 Executive renewals  
 Executive adjustments  
 Unsuccessful regular executive transfers  
 Regular executive transfers  
 Unsuccessful irregular executive transfers  
 Irregular executive transfers  
 Elections  
 Imposition of [internal] political sanctions  
 Political executions  
 Relaxation of sanctions  
 Deaths from domestic violence

3. Measurement of FDI flows one, two, and three years after events (time lags so MNEs have an opportunity to react to events) instead of contemporaneous measurement (which can only show a failure to perceive and/or avoid a risk).<sup>35</sup>

The study suggests MNEs are very sensitive to political instability (and/or political instability does have a significant tendency to produce real political risk) but, as they often react only after the fact, they are not good at predicting and avoiding it. This failure at the FDI decision making level suggests bad political risk analysis and reflects poorly on the various analytical methodologies available during the period.\*\* Fatehi-Sedeh and Safizadeh are also specifically disparaging of the variety of risk indices which have been used as surrogates for real political instability in the numerous studies which have failed to find a link, often perhaps, because of the inaccuracy of the indices.<sup>36</sup>

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\*Taken from Fatehi-Sedeh and Safizadeh, *op. cit.*, p. 98.

<sup>35</sup>*Ibid.*, p. 104.

\*\*No 'failure rate' for political risk analysis in FDI can be calculated because it is not possible to measure the success of FDI decision making in avoiding political risk; it is also impossible to gauge the cost of opportunities missed due to overly conservative judgment.

<sup>36</sup>*Ibid.*, pp. 95-96.

### Powerful Statistical Tools...

"With much the same precision that econometricians apply to the forecast of economic events, decision makers can gauge a nation's political future."<sup>37</sup>

Many economists involved in political risk analysis, particularly those working for international banks, see as a solution to the lack of accuracy in simple causal link models the adaptation of more sophisticated econometric models. Econometrics is a broad term for arithmetical manipulation of statistical economic data to increase the accuracy and utility of the final figures. In risk analysis, econometric techniques are used to estimate the probability of future events from statistical data representing past and current situations. According to Foley, normal statistical models are merely data representations of existing situations and can only be used in prediction through the assignment of "a set of somewhat arbitrary weights to the various statistical factors used, rather than estimating weights from the use of econometrics."<sup>38</sup> Econometrics also could be a useful tool for linking the two stages of political risk because it "estimates the likelihood of *discrete* events...for given levels of [independent variables]."<sup>39</sup>

The nature of econometric methods, however, requires the values of most variables in the equation be constant -- an impossibility in many political environments. Dougherty and Specter argue this problem can be overcome through the use of an econometric technique known as intervention analysis which theoretically permits the estimation of each variable through the development of a statistical trend line from the recent past and then examines the interaction of all variables in the future. A test of this theory using the GNP growth rates and political history of Chile, Greece, India, Indonesia, and the Philippines from 1951-1977 led to these conclusions:

- High growth tends to lead to internal strife and socialism;
- Flat growth tends to lead to the decline of strong leaders; and

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<sup>37</sup>Rummel and Heenan, *op. cit.*, p. 386.

<sup>38</sup>Patrick Foley, "Country Risk Assessment," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), pp. 5-6.

<sup>39</sup>*Ibid.*, pp. 9-10.

- Declining growth tends to lead to 'elitist' power struggles, military takeovers, and/or the rise of strong civilian leaders.<sup>40</sup>

Although these relationships have been true in some cases, the last fifteen years have produced numerous counter examples, including in some of the countries studied.

### ...And Why They Are Not Enough

"Powerful statistical techniques [can be useful] for protecting ourselves against sampling and measurement errors [and] also for establishing significant relationships among variables. However, statistical processing enters the scene only when sufficient numbers have been pinned to sufficient items."<sup>41</sup>

Ultimately, no statistical analysis can be any better than the quality of its statistics. Econometric analysis cannot correct for, or even identify, data which is inaccurate or incomplete in a consistent fashion. For reliable political risk analysis, "there are simply not enough data [of sufficient quality and quantifiability] to permit formal specification of relationships between a wide band of possible contingencies...and environmental characteristics."<sup>42</sup> In a circular fashion, the overdependence on the limited types and amounts of data available which appear sufficient for analysis requires and appears to justify definitions of political risk narrow enough to support reliance on such data.<sup>43</sup> Such reasoning is employed to justify the use of behavioralist-type causal link models which form the basis of econometric analysis of political risk just as they do simpler forms of statistical analysis.

This means most of the problems of deterministic quantitative analysis carry through to econometrics despite the additional sophistication. For example, there is no guarantee that "apparent regularities derived from past data using econometric models will continue in the future" or represent the situation they appear to describe. An econometric analysis of a country with a high debt-service to exports ratio would, for instance, all things being equal, indicate a continuance or perhaps worsening of this ratio; a situation generally viewed as having high risk potential. But "a high ratio may merely reflect other factors [which would likely not show up in an econometric

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<sup>40</sup>David M. Dougherty and Christine Specter, "Intervention Analysis: A Tool for Improved Risk Analysis in International Business," *Management International Review*, Vol. 22, No. 3 (1982), pp. 9-19.

<sup>41</sup>Sartori, *op. cit.*, p. 1037.

<sup>42</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), p. 258.

<sup>43</sup>Sethi and Luther, *op. cit.*, p. 66.

model of just the ratio] *perceived* by lenders as lowering [sovereign] risk and justifying high debt service." If the bankers are correct, the high ratio does not represent a high risk potential and would not be likely to continue into the future nor to cause political risk events.<sup>44</sup>

### Conclusions

"The real danger is that a sophisticated approach for political risk assessment would be used by corporate managements as a 'black box,' giving interpretations that are questionable and based on data that are very dubious to begin with."<sup>45</sup>

Business people, particularly bankers and staff analysts with backgrounds in fields like economics, accounting, and statistical management techniques, are used to working with numbers and quantifiable concepts. In much of their work, they expect and depend on the existence of one best approach or right answer and the ability to realize it through statistical calculation. Their prejudice toward this 'reality' inevitably carries over to any analysis of political risk. But political risk is a fundamentally different field. Concept definitions are complex and inexact, the values of variables constantly change and are difficult to measure accurately, the statistical data which does exist or appears easily gatherable is often of questionable accuracy and rarely sufficient for the analytical task at hand.

This is not an abstract theoretical critique of analytical methods based on behaviorist theory, but a conclusion drawn regarding their application to the task of political risk analysis in foreign direct investment.

Three things make deterministic methods unsuitable for this task:

1. It is difficult to identify the basic underlying causal links in advance in unique, two stage situations.
2. It is difficult to gather sufficient data of sufficient quality to facilitate effective analysis of the first stage of the political risk equation, especially if the goal of the analysis is a comparison between political environments.
3. It is difficult to apply even the best abstract analysis of the first stage of the political risk equation to the second stage without the use of judgment or intuition.

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<sup>44</sup>Jonathan Eaton and Mark Gersovitz, "Country Risk: Economic Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 75.

<sup>45</sup>Sethi and Luther, *op. cit.*, p. 65.

If the subjective approach with its roots in traditional social studies methodologies has proven insufficient for the analysis of political risk in foreign direct investment, so has the 'objective' approach with its roots in economics and behavioralist political 'science.'

## Chapter 8

### Toward a Better Approach to Political Risk Analysis

"In assessing political risk, we are not concerned with the likelihood of change *per se*, or even of discontinuous change, but rather with the criteria that the 'rules of the game' under which the firm made its calculations of risk and return will not change in such a way as to obviate the original calculations."<sup>1</sup>

The challenge for an analytical methodology for political risk in foreign direct investment (FDI) is to address the entire political risk equation. Failure to consider the background and source of environmental events is just as problematic as failure to consider the way in which such events affect investments. Avoidance of these pitfalls requires an analytical approach which, at minimum, implicitly accounts for the two stage nature of the political risk equation (as illustrated in exhibit 3.2).<sup>2</sup> Since political risk is relative to the characteristics of the investing firm, both the home and host countries, the nature of the investment, and other factors specific to the investment, any structure used for political risk analysis should reflect these relationships as well.<sup>3</sup> This suggests the use of an analytical structure which is firm specific in its approach to assessing risk. Such a structure can assist in overcoming the "assum[ption] that the sociopolitical environment of a host country is the key variable in determining the continuation of profitable operations of an investment."<sup>4</sup> The structure also should integrate the

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<sup>1</sup>Joseph Micallef, "Political Risk Assessment," *Columbia Journal of World Business*, Vol. XVI, No. 2 (Summer, 1981), pp. 47-48.

<sup>2</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), pp. 268-269.

<sup>3</sup>David F. Gould, "Political Risk Assessment in the Corporate Planning Environment," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 16-17.

<sup>4</sup>Warnock Davies, "Unsticking the State of the Art of Political Risk Management," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), pp. 144-145.

firm and its impact as an active participant in the operating environment into the analysis.<sup>5</sup> Finally, the analytical structure used should be flexible enough to deal with all environmental actors in any specific environment.

An analytical methodology for political risk analysis should endeavor to operate at high levels on the ladder of cognition to maximize the level of confidence in its results. Since political risk, by definition, is effectively limited to the realm of uncertainty, analytical techniques should be systematized in such a manner as to facilitate the broadest possible collection and most efficient possible organization of data for evaluation. A strong analytical system not only guides an investigation, saves time, and limits the chances of overlooking potentially important factors, it can also provide the framework for direct data comparison, facilitate cross checks of data for accuracy and objectivity, and enhance the analytical abilities of non-experts.

A third 'requirement' for an effective analytical methodology is flexibility. Both because inflexible systems can result in major analytical oversights and because the output of any analysis of political risk must be of value in the FDI decision making process.<sup>6</sup> This means a) the process must be affordable and b) the results must be in a form both appealing and useful to decision makers.

"Third World [*sic*] leaders sometimes speak of 'appropriate levels of technology.' Political risk analysts in a corporation must provide, on a timely basis consistent with executive needs, *appropriate levels of analysis.*"<sup>7</sup>

An analysis not tailored to the needs of decision makers who ordered it is irrelevant and a waste of resources.

Brewer identifies three basic kinds of problems with the wide variety of traditional techniques for political risk analysis discussed in the preceding two chapters:

1. They focus too much on specific factors like expropriation rates, financial statistics, or political instability, assumed to determine a 'level' of political risk;
2. They utilize methods of information collection and analysis which tend to be too impressionistic and intuitive *or* too mechanistic and formalized; and

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<sup>5</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 135.

<sup>6</sup>John Calverley, *Country Risk Analysis* (London: Butterworth & Co. (Publishers) Ltd., 1985), pp. 132-133.

<sup>7</sup>William P. Kelly, "Political Risk Assessment: Half the Equation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 155.

3. They neither incorporate nor support appropriately structured models of political risk directly applicable to the FDI decision making process.<sup>8</sup>

To level such criticism is not to say the techniques thus far reviewed are without merit or utility, nor that there is some magic alternative which will permit investors to avoid all political risk. On the contrary, the problem at hand is much too complex for such a panacea to be effective.

### The Academic Contribution

Sethi and Luther argue the structure provided by formal models of political risk analysis is invaluable despite the danger that it might "be treated as a substitute for reality," because such models "demand a formal accounting of dimensions which otherwise might have been ignored with qualitative assessments." But such models are "no substitute" for the skills and knowledge required for traditional political analysis: "solid experience, deep familiarity with the economic, social, and political environment (as well as the political leadership) of the countries involved, a willingness to look at the long-term prospects of direct foreign investments, and an appreciation of the legitimate needs and aspirations of the host country governments and people."<sup>9</sup>

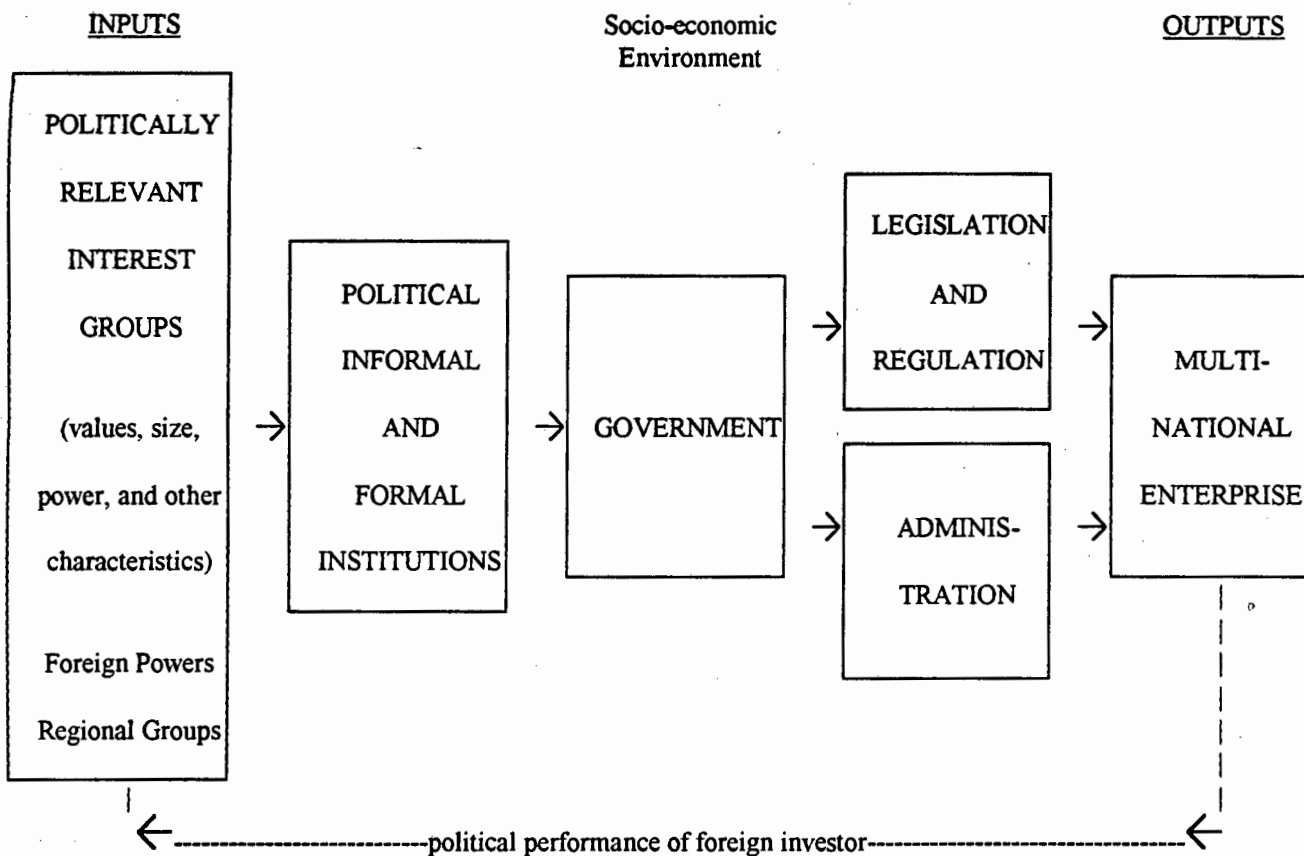
Some of the earliest work along these lines was done by Dolph Zink, a Harvard MBA holder writing a doctoral thesis (International Relations, University of Pennsylvania, 1971) after a 25 year career in the upper management echelon of a U.S. based MNE. Zink's "conceptual guide" (exhibit 8.1) is basically an input/output structure which specifies paths linking various societal actors to the MNE through their influence on the performance of government. While it depicts certain elements of the structure as boxes, it does not presume any 'black box' activity (that is to say none of the boxes represent deterministic equations which, given input  $x$  will produce output  $y$ ); instead they represent loci of actors which tend to operate within some sort of specific structures. Though Zink does not do it, it would not conflict with the model to portray the innards of each box as a diagram similar to this one. The structure describes a 'dynamic' system in which the inputs are "pressures exerted by politically relevant interest groups," including foreign and regional groups "in some cases," and the outputs are government legislation

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<sup>8</sup>Thomas L. Brewer, "Political Risk Assessment for Foreign Direct Investment Decisions: Better Methods for Better Results," *Columbia Journal of World Business*, Vol. XVI, No. 1 (Spring, 1981), p. 5.

<sup>9</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 65.

### EXHIBIT 8.1: ZINK MODEL FOR ANALYSIS OF POLITICAL RISK IN FOREIGN DIRECT INVESTMENT\*



and regulation and/or the activities of the bureaucracy (depicted in parallel because in many countries

"administration does not necessarily correlate with the language of decreed or legislated acts").<sup>10</sup>

"The pressure potentials of each domestic group of the system are conceived as a function of its value system (conception of desirable or undesirable ends, means and styles of action) multiplied by its political power which is determined by such factors as group size, leadership and organization, share of societal benefits received and interest span....Interaction among and between the several interests groups will also affect the manner in which government policy is influenced."<sup>11</sup>

"The influence of the [MNE] on the system is shown as a feedback representing the foreign investor's role as a political performer within the host society. This impact might be exerted at the level of administration (the bureaucracy), government (legislative and executive), political institutions (political parties, etc.) or within the interest groups themselves."<sup>12</sup>

\*Taken from Zink, *op. cit.*, p. 153.

<sup>10</sup>*Ibid.*, pp. 46-47.

<sup>11</sup>*Ibid.*

<sup>12</sup>*Ibid.*, pp. 47-48.

The Zink model has some obvious weaknesses -- its narrow definition of political risk, its lack of systematic data gathering and analytical procedures, its lack of clarity about the role of statistical data in what is clearly an essentially intuitive analytical methodology, its failure to define the nature of political actors in such a way as to facilitate direct comparative analysis, its opaque depiction of government. But the new ground broken by this tool is substantial. Not only does Zink suggest and provide an illustration of ways in which risk events are caused and affect investments, he also ties the MNE and its affiliate into the picture and provides a construction which expresses the ability of an investor to affect the investment environment.\*

Writing a decade later, Overholt fills many of the holes left by Zink. Although he does not directly subscribe to the sort of structural guide created by Zink, Overholt does provide a number of tools which make using such a model much easier.

First, he defines the inputs in the Zink model in such a way as to permit direct comparisons between them:\*\*

All political groups and polities, whether formal or not, are organizations with some form of executive leadership, institutional structure, and mass social base. This "systematizes the collection and organization of information[,] identifies the issues one wants to collect information about[, and] enables one to make use of the partial insights of all academic theories."<sup>13</sup>

Second, Overholt provides a checklist (exhibit 8.2) of questions to ask and areas to investigate in order to effectively analyze the risk environment.

Third, he offers a conceptual structure through which to analyze the interaction or 'competition' of actors in the political environment:

politics is the struggle of opposing organizations (or coalitions of organizations) and their strategies, goals, and values.<sup>14</sup>

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\*This raises the possibility of the ability to manage political risk. The management issue will be taken up in section IV along with a brief consideration of other strategies available to MNEs faced with the effects of political risk on a foreign direct investment.

\*\*If the reader is not familiar with the basic rules of comparison in comparative politics, a good review can be found in Giovanni Sartori, "Concept Misformation in Comparative Politics," *The American Political Science Review*, Vol. LXIV, No. 4 (December, 1970), pp. 1033-1036.

<sup>13</sup>William H. Overholt, *Political Risk* (London: Euromoney Publications, 1982), pp. 9-11.

<sup>14</sup>*Ibid.*, p. 61.

**EXHIBIT 8.2: STANDARD COUNTRY RISK PARAMETERS\***

Domestic political

Consensus on values, and principles of organization:

- Do they exist?
- With what content?

Executive leadership.

Institutional quality:

- personnel;
- performance;
- crisis adaptability;
- coherence.

Centralization vs. decentralization.

Social base of support.

Order vs. disorder:

- terrorism, demonstrations.

Policy Stability.

International political

Relationship to or with:

- North-South conflict;
- East-West conflict [*sic*];
- OECD countries;
- Sino-Soviet conflict [*sic*];
- key neighbors;
- home country of MNE.

Military relationships.

Domestic economic

Growth.

Distribution of income.

Employment.

Ownership; MNE -- government -- domestic private.

Spatial distribution of economic activity.

Infrastructure: communications, transportation.

Energy.

Financial system.

Inflation/indexing.

State role:

- management;
- planning;
- finance;
- regulation;
- ownership.

Labor:

- size and quality;
- political role.

Sectoral structure of economy:

- balance among sectors;
- leading sectors;
- government priorities.

International economic

Balance of payments.

Structure of exports and imports.

Trade partners and diversification.

Trade restrictions.

Debt/borrowing capacity.

Relationship to World Bank and IMF.

Monetary exchange rate.

Foreign investment/exchange controls.

World environment:

- growth;
- inflation;
- protectionism;
- terms of trade;
- financial markets;
- interest rates.

Social

Basic social goals (growth, equity, democracy, order, national security and independence).

Priorities among basic social goals.

Population.

Population distribution -- age cohorts and ethnic cohorts.

Population distribution -- spatial.

Key social groups:

- labor, middle class, military, government technostructure, political leaderships, small-medium businesses, agriculture;
- issues: size, influence, goals, organization, relations to other groups, generational differences.

Ethnic conflicts.

Regional conflicts.

\*Taken from Overholt, *op. cit.*, p. 76.

Finally, he furnishes a procedural system for analysis:

- "1. Analyze regime organization:
  - executive leadership;
  - institutions;
  - social base.
- "2. Characterize the political/economic/social context of the regime and the regime's strategy for dealing with its problems; or, if the contest is between factions within the regime, analyze them in a similar fashion.
- "3. Analyze opposition organizations and their strategies.
- "4. Develop scenarios for possible political/economic outcomes.
- "5. (Derive the business implications of the scenarios.)"<sup>15</sup>

Overholt's process is what is known among military planners as a net assessment or military audit. Sun Tzu, the strategic genius of ancient China, used this technique roughly 2500 years ago; it has been in development ever since. Shubik argues it is ideal for political risk analysis because like military analyses, "political analysis is also explicitly strategic; policy, to be successful, cannot be merely reactive. Intentions and capabilities must be taken into account. Moves must be planned and countermoves must be assessed and evaluated." In order to do this effectively, the effort must be integrated into the organization, its investment process, and its ongoing operations, not imposed upon them.<sup>16</sup>

Integration with the planning process can be achieved through another military technique: the simulation exercise. It involves decision makers or analysts in the playing of a 'game' which simulates an entire business activity -- the making of a foreign direct investment, for instance -- and permits experimental usage of alternative strategies in the face of a variety of environmental contingencies.<sup>17</sup> A simulation exercise can be used to assess the receptiveness of an environment to a given investment and to identify and test different management strategies to be used should contingencies arise in the future.

The key to an effective simulation exercise is a good set of scenarios "clearly rooted in history" expressing the trends which have led to current relationships, involving all major actors and their interrelationships, and covering a variety of potential future occurrences. By nature, a good group of scenarios represents sufficient research and intellectual activity in its construction to identify potential future surprises, avoid a simple reliance on

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<sup>15</sup>*Ibid.*, p. 63.

<sup>16</sup>Shubik, *op. cit.*, pp. 125-127.

<sup>17</sup>*Ibid.*, pp. 129-132.

the labels, public pronouncements and reputations of actors, abstain from dogmatic or inflexible responses to situations, and compensate for the tendency toward wishful thinking. Ideally, it will not only cover basic strategic options but inspire analysts and decision makers to develop new and better ones. As with any group being used for a comparative study, a range of scenarios must have a standard set of parameters such that "within each scenario, what is happening to the various parameters must be consistent."<sup>18</sup>

### Conclusions

There are integrated, multi-technique systems for the analysis of political risk in foreign direct investment which do succeed somewhat in applying the strengths of many of the techniques reviewed in chapters 6 and 7 while mitigating or compensating for their weaknesses. The work of Zink, Overholt, Shubik, and others suggests it is possible to examine the entire political risk equation in a structured and disciplined fashion through which it appears possible to minimize, if not eliminate, the subjectivity inherent in the analysis of anything which cannot be directly quantified. Nevertheless, no model has been offered which is free of subjective or intuitive judgment; no structure has been developed which can facilitate the truly objective analysis of a political environment, let alone the effects on a given organization of events predicted in such an analysis. The political environment and its interfaces with individual organizations operating within it are "too complex for total understanding....No matter how powerful a predictive tool one has, any estimate of a societal outcome will have some minimum irreducible uncertainty."<sup>19</sup>

The most that can be achieved are informal estimates of likelihood, approximations of probabilities of events and their effects. This alone is not sufficient for MNEs to evaluate accurately their likelihood of economic success over the life of a foreign direct investment. Therefore, as asserted in the second hypothesis,

"If political risk is properly understood as a series non-quantifiable elements, analysis of political risk cannot be depended upon alone to protect multinational enterprises from political risk in foreign direct investment."

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<sup>18</sup>*Ibid.*, pp. 72-77.

<sup>19</sup>*Ibid.*, p. 71.

## Part IV

### Application and Conclusions

"Focussing on the wrong issues, rather than inaccurate intelligence, is the cause of most poor political risk management."<sup>1</sup>

Part I of the thesis provided a foundation and a framework for the consideration of political risk in foreign direct investment. Part II showed political risk to be a two stage, non-quantifiable equation existing under a condition of non-quantifiable, subjective, or complete uncertainty on the ladder of cognition, which can result in loss and is the result of sudden, discontinuous change in the dynamic environment. Part III established that there are many ways to analyze political risk, that due to the complexity of the subject and the unavoidable role of judgment, even in the most quantitative analytical methodologies, there is an irreducible uncertainty, and that therefore, political risk analysis cannot produce the accurate probabilities of risk needed to protect investors. Part IV brings the thesis full circle by applying these findings to the problems faced by multinational enterprises contemplating foreign direct investment.

Chapter 9 addresses the first question of application by examining the ways in which MNEs make decisions about FDI and conduct political risk analysis. Chapter 10 looks at the application of political risk analysis to the investment process itself by examining different options for the management of political risk which have heretofore been referred to collectively as non-financial self insurance. Chapter 11 provides closure by recapping significant conclusions, reviewing support for the hypotheses, and revisiting the goals introduced in chapter 2. Chapter 11 then draws some final conclusions and looks ahead by examining gaps in this work and opportunities for future research.

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<sup>1</sup>Warnock Davies, "Unsticking the State of the Art of Political Risk Management," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), p. 146.

## Chapter 9

### Political Risk Analysis and the Investment Decision

"Businessmen often look at the world around them as they would like to see it, not as it really is. The higher the managerial position, the greater the resistance to reality. There must be a conscious, deliberate effort to achieve pragmatic objectivity, to shed preferences from the past and to minimize the importance of experience, which does not help under new circumstances and conditions."<sup>1</sup>

In one of the first studies made of how multinational enterprises (MNEs) deal with political risk, Aharoni found decisions regarding foreign direct investment (FDI) are generally made by high ranking executives after little investigation. These 'gut decisions' reflect an intuitive evaluation about risk the executive presumes is either above or below a threshold of "acceptable business risk."

In terms of the ladder of cognition, Aharoni's findings suggest decisions dealing with political risk in FDI tend to be made under conditions of subjective uncertainty. The presumptions often are based on preconceptions about specific countries, continents, regions, types of economies, or other arbitrary categorizations, and stem from "ignorance, generalizations, [and] projection of U.S. culture and standards to other countries." Aharoni ties the perception of risk to five factors:

1. Differences in habits, culture, and business conduct --greater differences, greater risk;
2. Physical distance between the home and host countries --greater distance, greater risk;
3. A history of inflation or currency devaluation is perceived to be risky even though such changes are often profitable for investors;
4. Government interference in the economy -- practices differing from those of the home government cause concern; and
5. Level of development -- among other things, most surveyed businessmen do not believe developing countries can be counted on to honor contracts.

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<sup>1</sup>Michael J. Kami, "Planning In Times of Unpredictability," *Columbia Journal of World Business*, Vol. XI, No. 2 (Summer, 1976), p. 27.

The prejudice Aharoni found is summed up in this typical survey response: "I shall think twice before I shall go to Asia or Africa. They are too risky."<sup>2</sup>

Aharoni's conclusions that political risk is seen as an obstacle but is rarely a subject of investigation have been confirmed by several studies conducted since his. One study found "the perception of the political situation is the most important non-economic determinant of foreign direct investment decisions,"<sup>3</sup> while another found "the most frequently cited political obstacle [to FDI] was political uncertainty or political instability."<sup>4</sup> Zink's survey revealed MNEs would sometimes "bypass opportunities altogether [when faced with] anticipated risks that are difficult to quantify."<sup>5</sup> Even a 1973 *Wall Street Journal* study verified entire regions are routinely rejected for investment by major MNEs on the basis of perceived, non-specific "riskiness."<sup>6</sup> But studies also show "few companies undertake a systematic evaluation of political risks." A review of preinvestment surveys done under the aegis of the U.S. Agency for International Development by MNEs interested in investing in Latin America in the 1960s shows "with very few exceptions, political and social consideration received only slight attention."<sup>7</sup> Most political risk analysis done by MNEs considering FDI is conducted informally by non-experts and is "superficial and subjective" in nature.<sup>8</sup>

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<sup>2</sup>Yair Aharoni, *The Foreign Investment Decision Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966), pp. 92-96.

<sup>3</sup>Hans Schöllhammer and Douglas Nigh, "The Effect of Political Events on Foreign Direct Investments by German Multinational Corporations," *Management International Review*, Vol. 24, No. 1 (1984), p. 21.

<sup>4</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises*, (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 355 and 369.

<sup>5</sup>Dolph Warren Zink, *The Political Risks for Multinational Enterprise in Developing Countries: With a Case Study of Peru* (New York: Praeger Publishers, 1973), p. 44.

<sup>6</sup>John D. Daniels, Ernest W. Ogram, Jr., and Lee H. Radebaugh, *International Business: Environments and Operations, Second Edition* (Reading Massachusetts: Addison-Wesley Publishing Company, 1979), p. 370.

<sup>7</sup>James R. Piper, "How U.S. Firms Evaluate Foreign Investment Opportunities," *MSU Business Topics*, Vol. 19, No. 3 (Summer, 1971), p. 16.

<sup>8</sup>Stephen J. Kobrin, "Political Risk: A Review and Reconsideration," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1979]), pp. 137-139.

A study of the FDI decision making process of 40 U.S. MNEs conducted by Stobaugh may help explain the paradox. Stobaugh divides the methods of decision making into four groups:

1. **Go/no go** choices are the most common type of decision and usually are made on one or two often superficial criteria. These decisions sometimes result in bad investments but more often seem to result in missed opportunities.
2. The **premium on risk** approach requires a higher return on investment (ROI) than would normally be sought to compensate for high perceived "levels" [*sic*] of risk in an investment. Procedures for measuring all the variables involved in determining the appropriate premium to be charged vary from MNE to MNE, but the general approach (used by 80% of Stobaugh's subjects) is conceptually similar to actuarial and accountancy methods of dealing with various kinds of known risk.<sup>9</sup>
3. A **range of estimates** technique requires 'educated guesses' of the value of the independent variables which can affect ROI. A range of 'guestimates' for each variable are run through a variety of scenarios for each of which an estimate of ROI is made. As with the premium on risk approach, the ways of executing this concept are many and varied. Since the range approach is borrowed from economic modelling, and since economic figures are easier to work with than imaginary political variables, exhibit 9.1 is an monetary example of a how a simple range of estimates works.<sup>10</sup>

#### EXHIBIT 9.1: RANGE OF ESTIMATES -- ONE YEAR FOREIGN INVESTMENT AT FIXED INTEREST RATE MADE AT 1:1 EXCHANGE RATE

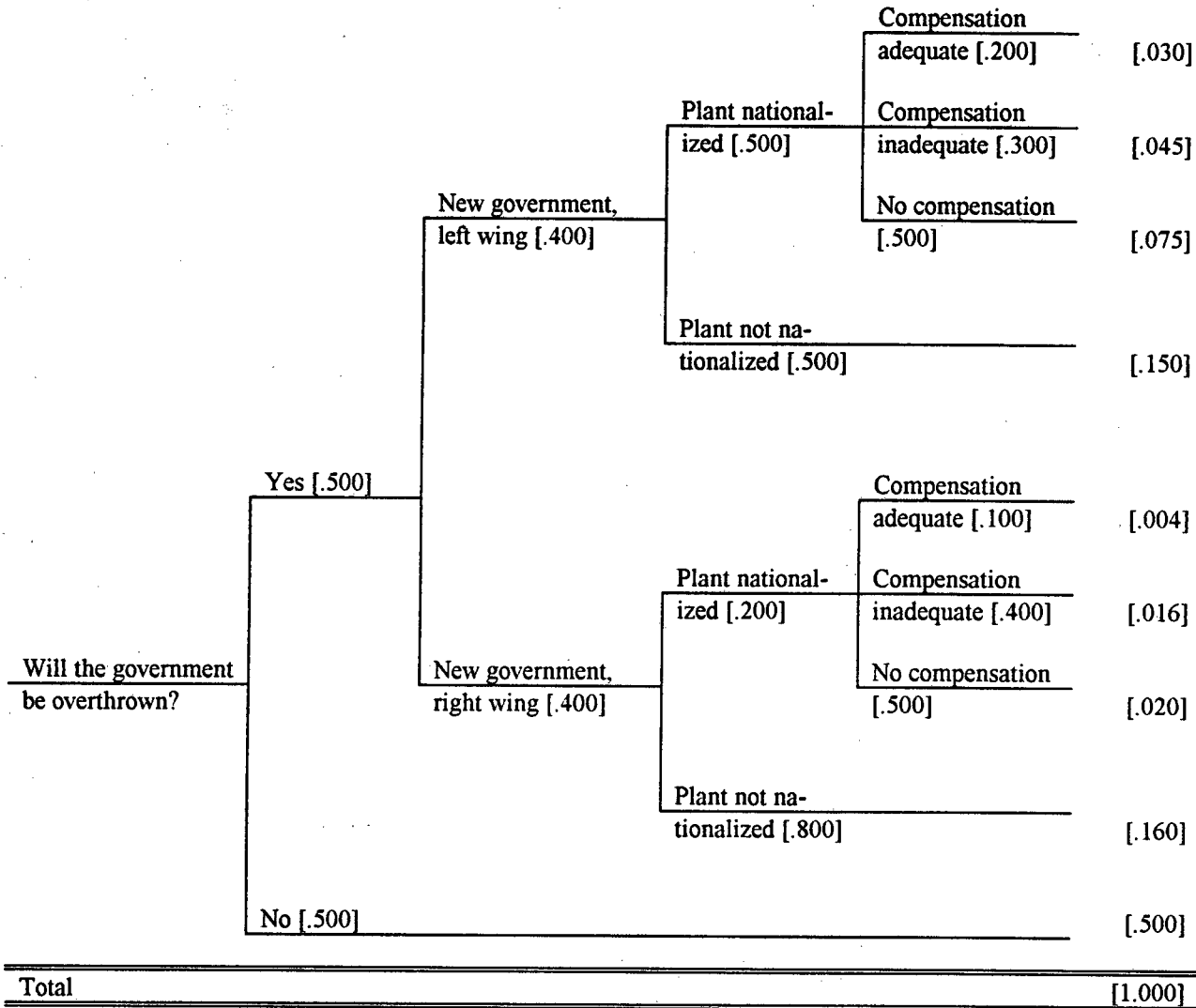
|            | Exchange Rate<br>(ratio) | Inflation Rate (%) | Nominal Yield (%) | Effective Real<br>Yield (%) |
|------------|--------------------------|--------------------|-------------------|-----------------------------|
| Scenario 1 | .9:1                     | 2                  | 10                | 20.00                       |
| Scenario 2 | 1:1*                     | 2                  | 10                | 8.00                        |
| Scenario 3 | 1.1:1                    | 2                  | 10                | -1.82                       |
| Scenario 4 | .9:1                     | 5*                 | 10                | 16.67                       |
| Scenario 5 | 1:1*                     | 5*                 | 10                | 5.00*                       |
| Scenario 6 | 1.1:1                    | 5*                 | 10                | -4.55                       |
| Scenario 7 | .9:1                     | 10                 | 10                | 11.11                       |
| Scenario 8 | 1:1*                     | 10                 | 10                | 0.00                        |
| Scenario 9 | 1.1:1                    | 10                 | 10                | -9.09                       |

\*'Best' guess

<sup>9</sup>Robert B. Stobaugh, Jr., "How to Analyze Foreign Investment Climates: Four Techniques for Dealing with Trick Questions of Economic and Political Stability," in *International Business: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1970 [Article originally published in 1969]), pp. 91-93.

<sup>10</sup>*Ibid.*, pp. 93-96. The range of estimates illustrated in exhibit 9.1 is original.

**EXHIBIT 9.2: PROBABILITY TREE FOR RISK ANALYSIS -- GOVERNMENT OVERTHROW: YEAR ONE\***



|                      |                                |                |
|----------------------|--------------------------------|----------------|
| Regrouping outcomes: | Plant not nationalized         | [.810]         |
|                      | Plant nationalized             |                |
|                      | --with adequate compensation   | [.034]         |
|                      | --with inadequate compensation | [.061]         |
|                      | --with no compensation         | [.095]         |
|                      | <b>Total</b>                   | <b>[1.000]</b> |

4. Risk analysis is another group heading under which there are many different specific methods to achieve results. In essence, risk analysis is "a sophisticated application of probability theory [in which] an estimate is made of the probable outcomes of various events." Again, methods for making the estimates vary, but the utility of such an estimate depends on the condition on the ladder of cognition under which

\*Taken from Stobaugh, *op. cit.*, p. 98.

the estimate is made.\* The most common tool Stobaugh found for depicting risk analysis results is the probability tree, a sample version of which is reproduced as exhibit 9.2.<sup>11</sup>

Zink's survey of nearly 100 U.S. MNEs confirms many of Stobaugh's conclusions, particularly those regarding the rare usage of systematic approaches to political risk analysis. Zink found less than half have policies or processes which make use of political information, gathered formally or informally, in the FDI decision making process; only about one third attempt to conduct political analyses of any sort on an ongoing basis; and less than 20% employ full time political analysts or utilize outside political consultants.<sup>12</sup>

### Banks and Insurance Companies

Following the overthrow of the Shah of Iran and the other unexpected environmental changes of the late 1970s, resources available for political risk analysis soared and many major MNEs, including most large international banks, established staffs to handle the task.<sup>13</sup>

At Britain's National Westminster Bank, political risk has become a significant factor in the process of sovereign risk analysis as methods of gathering and evaluating information about the political environment in debtor countries have become more comprehensive and systematic.<sup>14</sup> At other major international lenders as well, "an in-depth knowledge of the country concerned" is considered alongside the more traditional statistical factors of country risk analysis.<sup>15</sup> Chase Manhattan Bank has gone even further, no longer using "a formal statistical process by which all...factors are summed to produce a single number" in the "final assessment" of risk because

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\*This is true also in the range of estimates, premium on risk, and any other approach which requires estimates. Statistically calculated estimates derived under a condition of statistical probability are going to be more accurate and therefore of more use than intuitively judged estimates made under a condition of subjective uncertainty.

<sup>11</sup>*Ibid.*, pp. 96-98.

<sup>12</sup>Zink, *op. cit.*, p. 39.

<sup>13</sup>William Ascher and William H. Overholt, *Strategic Planning and Forecasting: Political Risk and Economic Opportunity* (New York: John Wiley & Sons, 1983), pp. 1-2.

<sup>14</sup>David Kern, "Forecasting Country Risk," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), pp. 15-16 and David Kern, "The Evaluation of Country Risk and Economic Potential," *Long Range Planning*, Vol. 18, No. 3 (1985), pp. 24-25.

<sup>15</sup>Patrick Foley, "Country Risk Assessment," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), p. 5.

many "political and legal factors" are not easily quantifiable and "even if the process was confined to only the economic variables there would still be room for doubt about [the single number's] validity."<sup>16</sup>

The American Express Export Bank's John Calverley advocates a flexible analytical approach by suggesting four basic questions as a guide to investigating a country's suitability for investment or loans:

1. How secure is the government and, even more important, how firm is its commitment to its current policies?
  - a) Which groups or classes support the government *and* its policies?
  - b) How does the government retain control; through repression or popular support?
  - c) What are the roles and views of institutions such as the military, the government bureaucracy, the courts, banks, unions, and the clergy, among others?
  - d) How strong and of what nature is any opposition?
2. Who and what are the most likely alternatives should the government and/or current policies change?
3. Are there actors advocating revolution, civil war, or other societal strife, and if so, what is the strength and nature of their support?
4. What are the critical issues in the country -- succession to leadership; ethnic, religious, or other fractionalization; the role of the military; the state and/or structure of the economy; political tensions; military pressures; other things?<sup>17</sup>

Related, if very different steps have been taken by the political risk insurance industry. Insurance companies "do not have staffs of economists or country desk officers analyzing country risk or coming up with models to be used by underwriters." Rather, underwriters themselves try "to get a handle on" some fundamental economic statistics and to gain an elementary intuitive understanding of political and social factors which define the host country environment.<sup>18</sup> Since political risk insurance is a purely speculative venture, underwriters must also take some pains to protect their firm from the risk that the insured, being insured, will act in a manner which may increase the likelihood of a claim being filed. Sometimes this 'moral hazard' is created through the use of a deductible, as with standard insurance; more often, however, insurers employ either a co-insurance scheme,

<sup>16</sup>J.N. Robinson, "Is it Possible to Assess Country Risk?" *The Banker*, Vol. 131, No. 659 (January, 1981), p. 77.

<sup>17</sup>John Calverley, *Country Risk Analysis* (London: Butterworth & Co. (Publishers) Ltd., 1985), pp. 117-118 and 125-127.

<sup>18</sup>Ray Antes, "Political Risk: Private Insurance Market," *Country Risk Analysis, A Euromoney Conference* (London: Euromoney Seminar Transcripts, June 10-11, 1987), pp. 130-131.

whereby the insured will be responsible for a certain percentage of the loss, and/or a cap on the total potential liability from a claim.<sup>19</sup>

### Major Multinationals

Royal Dutch/Shell uses a unique, inductive system of political risk analysis known as ASPRO/SPAIR. It is a combination of Delphi technique and scenario development and focusses solely on industry specific issues.<sup>20</sup> It defines political risk "as the probability of not maintaining a contract for the exploration, development, and production of oil that is perceived as equitable by both company and host country over a ten year period in the face of changing political and economic conditions." Potential risk effects are assumed to be rooted in nine basic potential risk events which are 'fleshed out' for the analysis of each proposed investment to reflect the nature of the host country environment and the specific characteristics of the investment.<sup>21</sup>

Gulf Oil and Ford Motor Company have developed simpler, less structured analytical procedures. Gulf has developed a formal strategic intelligence unit staffed by several former U.S. Foreign Service officers.<sup>22</sup> The group uses "a normative, evaluative approach where each case is examined individually" and interacts with senior management to apply its opportunity and risk assessments.<sup>23</sup> The unit can look back at particular successes in Zaire, in Angola after decolonization and the MPLA takeover, and in Iran, where Gulf was prepared four months

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<sup>19</sup>Philip J. Stein, "Should Your Firm Invest in Political Risk Insurance," *Financial Executive*, Vol. LI, No. 3 (March, 1983), p. 22.

<sup>20</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 130 and Jeffrey D. Simon, "Political Risk Assessment: Past Trends and Future Prospects," *Columbia Journal of World Business*, Vol. XVII, No. 3 (Fall, 1982), p. 66.

<sup>21</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), pp. 264-265.

<sup>22</sup>Louis Kraar, "The Multinationals Get Smarter About Political Risks," *Fortune*, Vol. 101, No. 6 (March 24, 1980), p. 87.

<sup>23</sup>John D. Sassi and Shaheen F. Dil, "The Art of Corporate Crystal Ball Gazing: Political Risk Analysis Experiences at Gulf Oil Corporation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), pp. 4-7.

before the fall of the Shah.<sup>24</sup> Ford's group also uses a flexible, normative approach to analyze each host country and each investment as unique cases with different key factors and variables.<sup>25</sup> In addition, the Ford group actively manages political risk for established foreign operations and provides a "focal point for contacts with foreign governments and political leaders" for virtually any conceivable purpose during any stage of the FDI process.<sup>26</sup>

Another method for political risk analysis being utilized in the private sector is the "multiple futures" technique developed by Concorde Group International. Concorde works with MNEs to develop a series of potential investment strategies, uses a computer to evaluate the strategies in the context of 3,000 different scenarios, and then determines both profit/loss potential and a minimax regret.\* Exhibit 9.3 is a matrix showing an extremely simplified version of the Concorde approach, effectively a giant range of estimates program.<sup>27</sup>

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<sup>24</sup>Kraar, *op. cit.*, p. 88.

<sup>25</sup>Gilbert D. Harrell and Richard O. Kiefer, "Multinational Strategic Market Portfolios," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), pp. 286-294.

<sup>26</sup>William P. Kelly, "Political Risk Assessment: Half the Equation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 153.

\*Minimax regret is a concept from games theory which recognizes the 'opportunity cost' of choices by calculating the difference (the 'regret') between the return from a chosen investment strategy and the return from the best possible investment strategy for a given situation. It is valuable because the economic effects of various different 'futures' on an investment cannot be analyzed in the aggregate. If an investment has an 80% chance of making 100 and a 20% chance of losing 50, the outcome of the investment is not 70, it is *either* 100 *or* -50. Even precisely known probabilities (a case only possible in theory) will not permit the calculation of a guaranteed return higher than the minimum return possible.

The use of minimax regret (which essentially means the minimizing of maximum potential regret) protects against the kind of wishful thinking which can cloud decision making and guarantees the selection of the option which has the minimum possible loss (though not the maximum possible profit for) to the investor *provided the statistical data is accurate*. Michael P. Sloan, "Strategic Planning by Multiple Futures Techniques," *Management International Review*, Vol. 24, No. 1 (1984), pp. 13-14.

<sup>27</sup>*Ibid.*, pp. 7-14.

**EXHIBIT 9.3: THE CONCORDE MULTIPLE FUTURES TECHNIQUE\***Investment condition: 17% ROI *per annum* for ten years; no capital recovery

| <u>Strategies</u>                                      | <u>Future 1</u><br>Continuation of<br>present regime (value<br>of investment/ regret) | <u>Future 2</u><br>Nationalization in<br>year x+3<br>(value/regret) | Maximum regret  |
|--|---|---|-----------------|
| Investment of 100 in year<br>x for 10 years            | 170/0   | 51/49   | 49              |
| No investment  | 100/70  | 100/0   | 70              |
| Investment of 50 in year x<br>for 10 years (retain 50) | 135/35  | 75.5/24.5   | 35<br>(minimax) |

**Recent Practices and Pitfalls**

Despite the variety of methodologies available and being used for political risk analysis, surveys show approximately two thirds of U.S. MNEs still depend solely on top management for most political analysis and continue to utilize outside sources of information for political risk analysis.<sup>28</sup>

Perhaps because of the wide availability and convenience of using outside information on risk potential, many MNEs considering FDI seem to assume such information comes with "secret formulas or cookbook solutions" to risk problems. But outside information is rarely directly applicable to any specific project (and therefore of limited utility in analyzing the second or effect stage of the risk equation). Furthermore, many outside data and analysis suppliers have a conflict of interest which makes the quality of their information dubious. Host countries, after all, are seeking investment, while a home country may be trying to encourage or discourage investment depending on the state of relations between it and the prospective host country. Banks interested in financing an operation may be over optimistic about its chances for success (especially if their own risk is mitigated by home country collateral), while insurers trying to peddle protection tend to be too gloomy.<sup>29</sup>

\*Adapted from Sloan, *op. cit.*, p. 14.

<sup>28</sup>Norman A. Baglini, *Global Risk Management: How U.S. Corporations Manage Foreign Risks* (Risk Management Society Publishing, Inc., 1983), pp. 67-68.

<sup>29</sup>Baglini, *op. cit.*, p. 66, Pravin Banker, "You're the Best Judge of Foreign Risks," *Harvard Business Review*, Vol. 61, No. 2 (March-April, 1983), p. 157, and Alexandre de S.C. Barros and Amoury de Souza,

### An Interesting Footnote

Despite all the changes in the world political environment, all the developments in the political risk field, and all the new theories, methodologies, and information sources available to MNEs, two small but very specific studies of firms making high risk investments in the last decade strongly indicate little has changed since Aharoni started surveying FDI decision making practices more than 30 years ago.

When the People's Republic of China opened itself to FDI in 1983, many firms rushed in to seize their share of the largest potential market in the world. A study of 10 of the first 15 MNEs on the scene indicates that they all perceived political risk to be a significant factor in the investment. However, they "did not employ individuals whose primary responsibility was to analyze political conditions in foreign countries." What little analysis was done tended to be informal and unsystematic and "the firms which perceived greater political risk in China tended to have the least developed capability to assess political risk."<sup>30</sup>

These tendencies were confirmed by a study of 9 of the first firms to form new joint ventures with the Soviet government when the Soviet Union was opened to limited FDI as one of Mikhail Gorbachev's first reforms.

"The approach used by these pioneering American firms [was] informal and unstructured, with heavy involvement by the highest level executives. In no case...do we find evidence of the application of an institutionalized assessment function utilizing structured, systematic analytical methods. Rather the approach used in most companies involves intuitive judgments of the political risk made by the CEO [Chief Executive Officer] or another executive with country responsibility or, less frequently, by the headquarters staff."<sup>31</sup>

Despite reporting fears of serious risk effects from unexpected changes in the political environment, particularly the possibility that Gorbachev could be replaced in a "palace coup," "most of the companies reported they [were] not monitoring political risk" on an ongoing basis. None of the firms had a political analyst on staff, although two

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"Political Risk and the Risk of Political Blunder," in Jerry Rogers (ed.), *Global Risk Assessments: Book 1* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 68.

<sup>30</sup>John D. Daniels, Jeffrey Krug, and Douglas Nigh, "U.S. Joint Ventures in China: Motivation and Management of Political Risk," *California Management Review*, Vol. XXVII, No. 4 (Summer, 1985), pp. 54-56.

<sup>31</sup>Douglas S. Nigh and Karen S. Smith, "The New U.S. Joint Ventures in the USSR: Assessment and Management of Political Risk," *Columbia Journal of World Business*, Vol. XXIV, No. 2 (Summer, 1989), p. 42.

firms did have a staff member whose responsibilities included part time monitoring of ongoing political risk. Two other firms said they monitored political risk "informally."<sup>32</sup>

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<sup>32</sup>*Ibid.*, pp. 40-43.

## Chapter 10

### Political Risk Management

"Specifying relationships between organization and environment, even if done on the most rudimentary basis, may suggest options that allow the firm to reduce either its vulnerability to [risk effects] or the cost of [them] should they arise, and it may even suggest opportunities arising from the political environment."<sup>1</sup>

"In theory, the divine right of sovereignty can always prevail over the 'divine right of capital.' In practice, as we shall see, the international enterprise does have defenses and does not have to be a helpless victim of sovereignty and nationalism."<sup>2</sup>

"Very broadly, investors...can expect to face the risks they *collectively* deserve."<sup>3</sup> Studies have shown that across industries, actions of economic nationalism, from greater regulation to outright confiscation, have been rational reactions to the perception of danger to the host country from the investor. This phenomenon suggests the host country "objective is to avoid being the whipping boy and the means is by modifying individual corporate behavior."<sup>4</sup>

The most commonly cited management options in the face of political risk are: 1) avoidance, 2) insurance, 3) negotiation, and 4) defensive structuring.<sup>5</sup> The first option has now received all the consideration it deserves in the context of this chapter; the second, traditional financial insurance, will be examined in a section at the end of this chapter; the third option is essentially non-financial self insurance (NFSI) on the part of the multinational enterprise (MNE).

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<sup>1</sup>Stephen J. Kobrin, "Political Assessment by International Firms: Models or Methodologies?" *Journal of Policy Modeling*, Vol. 3, Part 2 (1981), p. 267.

<sup>2</sup>Stefan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Homewood, Illinois: Richard D. Irwin, Inc., 1973), p. 144.

<sup>3</sup>John Dunn, "Country Risk: Social and Cultural Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 163.

<sup>4</sup>Warnock Davies, "Beyond the Earthquake Allegory: Managing Political Risk," *Management International Review*, Vol. 21, No. 3 (1981), pp. 6-7.

<sup>5</sup>Adrian Buckley, "Taking Account of Political Risk," *Accountancy*, Vol. 100, No. 1127 (July, 1987), pp. 80-81 and Alan C. Shapiro, "Managing Political Risk: A Policy Approach," *Columbia Journal of World Business*, Vol. XVI, No. 3 (Fall, 1981), pp. 64-65.

NFSI is proactive, rather than reactive, in nature and "entail[s] anticipating the political risk problem well in advance and taking measures to lessen...conflict."<sup>6</sup> It can take the form of defensive action -- through concession agreements, ownership structure, and debt and exposure structure; participative action -- the thrust and parry of 'good citizenship,' public involvement, and judicious political activity; and aggressive action -- the use of all available operational and asset tools to make any form of economic nationalism as damaging to the host as to the MNE.

In practical terms, NFSI permits an MNE to quantify accurately costs of avoiding or mitigating political risk in lieu of the real costs of potential political risk. Each identifiable risk possibility can be 'insured' against (in some fashion, at some cost) and NFSI techniques have costs which should be estimable in the same terms as other business expenses. Thus, if the rest of the political risk analysis is accurate, a cost for the mitigation of political risk should be calculable. Because there is an irreducible uncertainty in political risk analysis, certainty can never be approximated directly, but if the analysis is sufficiently rigorous, it should be possible to achieve an approximation sufficient to provide the basis for a realistic cost-benefit analysis of the sort generally applied to business decision making.\*

One alternative option sometimes suggested is to attempt to mitigate political risk through the involvement of the home government. In the modern era, MNEs are loathe to do this because it "could have a price in terms of ill will and retaliation" throughout the world.<sup>7</sup> Besides, as U.S. President George Bush's 1992 trade mission to the Far East clearly showed, such intervention may have little positive effect. In addition, recent history has shown home governments will avoid involvement in commercial affairs unless they can reap political benefit

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<sup>6</sup>S. Prakash Sethi and K.A.N. Luther, "Political Risk Analysis and Direct Foreign Investment: Some Problems of Definition and Measurement," *California Management Review*, Vol. XXVIII, No. 2 (Winter, 1986), p. 63.

\*This would be possible under a condition of non-quantifiable uncertainty through the Kobrin method outlined in chapter 3. Despite the generation of meaningful numbers, however, this would not constitute quantification in the context of the ladder of cognition because the direct derivation of probabilities would still be impossible.

<sup>7</sup>Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 3 and Raymond Vernon, "The Multinational Enterprise: Power Versus Sovereignty," in Raymond Vernon, *The Economic and Political Consequences of Multinational Enterprise: An Anthology* (Boston: Division of Research, Graduate School of Business, Harvard University, 1972 [Article originally published in 1971]c), pp. 150-151.

and, in those cases, the involvement tends to be on behalf of entire industries, not individual MNEs. For these reasons, this option will not be considered as a major one in this chapter. Another alternative widely used in the past is bribery. Its use however, often brings nothing but a different form of political risk as it is generally illegal and always difficult to justify publicly.<sup>8</sup>

To avoid the problem of simply exchanging one form of political risk for another, NFSI has some guiding rules. "The action must:

1. "reduce or eliminate the political problems associated with the overseas investment;
2. "be consistent with the enterprise's corporate culture and must be fully supported by senior management; [and]
3. "be both legal and morally defensible in the country where the investment decision applies *and* in the country where the enterprise's management is based."<sup>9</sup>

In addition, when making NFSI decisions, MNEs must avoid "the tendency to...[emphasize] the relationship of the subsidiary to the parent rather than the subsidiary to the host society."<sup>10</sup> It is also important affiliates be given sufficient autonomy to permit creativity and flexibility in developing political risk management strategies at the local level.<sup>11</sup> In Kami's words, managers must be "fast, fluid, and flexible" (the three 'Fs') in their responses to potential risk.<sup>12</sup> Finally, decision makers must differentiate between "potentially serious, probably not urgent..., and ultimately not actionable areas of concern."<sup>13</sup> This process might be called 'information triage' and is crucial if limited resources are to be employed to maximize the protection against political risk.

<sup>8</sup>Raymond Vernon, "Organizational and Institutional Responses to International Risk," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), pp. 209-210.

<sup>9</sup>William P. Kelly, "Political Risk Assessment: Half the Equation," in Jerry Rogers (ed.), *Global Risk Assessments: Book I* (Riverside, California: Global Risk Assessments, Inc., 1983), p. 152.

<sup>10</sup>Dolph Warren Zink, *The Political Risks for Multinational Enterprise in Developing Countries: With a Case Study of Peru* (New York: Praeger Publishers, 1973), p. 49.

<sup>11</sup>James E. Austin and John C. Ickis, "Managing After the Revolutionaries Have Won," *Harvard Business Review*, Vol. 64, No. 3 (May-June, 1986), p. 109.

<sup>12</sup>Michael J. Kami, "Planning In Times of Unpredictability," *Columbia Journal of World Business*, Vol. XI, No. 2 (Summer, 1976), pp. 32-33.

<sup>13</sup>John T. Reid, "Perspective: Managing Country Risk for a Manufacturing Corporation," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), pp. 186-187 and Warnock

Because NFSI has real costs, MNEs may find political risk is essentially traded for greater standard business risk in the form of smaller margins.<sup>14</sup> In order to properly accommodate this situation in economic business planning, it is necessary to differentiate between pre-investment or one time NFSI costs -- such as those involved in negotiating a concession agreement -- which are capital costs, and operational or ongoing NFSI expenses which should be placed in the operating budget.<sup>15</sup> To reassure executives concerned about high operating costs which appear to produce nothing, Phillips-Patrick suggests viewing NFSI costs as part of the total of implicit and explicit taxes because, like other taxes, they are wealth transferred from the firm to the host environment in exchange for primarily intangible benefits.<sup>16</sup>

### Defensive Action

Concession agreements may make an investment economically more attractive to an MNE, but except in cases of host country initiation, their primary purpose is to guarantee a tolerable degree of operating latitude and freedom from unexpected changes over a period of time sufficient for profitable business operations.<sup>17</sup> In this vein, most concessions involve fixing things which might otherwise vary: foreign exchange rates, transfer prices, taxation, capital costs, export quotas, local sales prices, and raw material supplies.<sup>18</sup> In his research, Aharoni found the most popular concessions among MNEs to be protection against changes in market size and currency

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Davies, "Unsticking the State of the Art of Political Risk Management," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), p. 147

<sup>14</sup>Frederick D.S. Choi, "Political Risk -- An Accounting Challenge," *Management Accounting*, Vol. LX, No. 12, (June, 1979) p. 19.

<sup>15</sup>John D. Daniels and Lee H. Radebaugh, *International Business: Environments and Operations, Fourth Edition* (Reading, Massachusetts: Addison-Wesley Publishing Company, 1986), p. 412.

<sup>16</sup>Frederick J. Phillips-Patrick, "The Effect of Asset and Ownership Structure on Political Risk -- Some Evidence From Mitterand's Election in France," *Journal of Banking and Finance*, Vol. 13, Nos. 4/5 (September, 1989), p. 653.

<sup>17</sup>Frans G.J. Derkinderen, "Transnational Business Latitude in Developing Countries," *Management International Review*, Vol. 22, No. 4 (1982), p. 57.

<sup>18</sup>Derek F. Channon with Michael Jalland, *Multinational Strategic Planning* (London: MacMillan Press Ltd., 1979), pp. 248-250.

exchange rates and against long term asset exposure. The former is usually provided in the form of import quotas and guaranteed rates, while the latter is provided through capital cost assistance such as free or low rent land, import duty exemptions on machinery, and low cost government loans. The least popular concessions for MNEs are those involving temporary tax abatements and direct government interference in the business environment.<sup>19</sup>

Another issue sometimes covered by concession agreements is ownership structure. By placing at least a percentage of ownership in local hands, MNEs give their affiliates a vested interest in the long term well being of the host country and create local contacts to enhance local business opportunities and provide a countervailing force to local calls for economic nationalism.<sup>20</sup> Two traditional alternatives to this strategy of local shareholding are international consortia of investors, which may protect against risk emanating from antipathy toward one particular home government,<sup>21</sup> and joint ventures with the host government which offer access to local resources and theoretically protect against political risk.<sup>22</sup> Both of these 'risk protection' techniques may actually increase an affiliate's vulnerability to political risk,<sup>23</sup> but local joint ventures do appear to be successful at limiting interference in affiliate operations and tend to provide stronger and more active partners than the local shareholding technique (though this may not be a desirable result).<sup>24</sup>

Another option in setting up an ownership structure to reduce political risk is **predetermined domestication**. Regardless of the percentage ownership the investor starts with, the management plan is a gradual

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<sup>19</sup>Nevertheless, Aharoni found foreign government officials believe this last group of concessions to be the most effective at attracting investment. Yair Aharoni, *The Foreign Investment Decision Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966), pp. 164-167 and 169-170.

<sup>20</sup>Peter P. Gabriel, "Adaptation: The Name of the MNC Game," *Columbia Journal of World Business*, Vol. VII, No. 6 (November-December, 1972), pp. 10-12.

<sup>21</sup>Vernon (1983), *op. cit.*, p. 203.

<sup>22</sup>*Ibid.*, pp. 206-207.

<sup>23</sup>David G. Bradley, "Managing Against Expropriation," *Harvard Business Review*, Vol. 55, No. 4 (July-August, 1977), pp. 80-82.

<sup>24</sup>Theodore H. Moran, "International Political Risk Assessment, Corporate Planning, and Strategies to Offset Political Risk," in Theodore H Moran (ed.), *Multinational Corporations: The Political Economy of Foreign Direct Investment* (Lexington, Massachusetts: Lexington Books -- D.C. Heath and Company, 1985), p. 115 and Vernon (1985), *op. cit.*, pp. 204-205.

phaseout until all equity is in local hands and the affiliate is tied to the parent only through contractual agreements covering such things as raw material supply, sales, trademarks, patented processes, and product development.<sup>25</sup> An adjunct or alternative to this strategy is the management contract under which an MNE agrees to manage and provide other services and or assets to a locally owned firm for a fee and/or a percentage of profits, but without investing any capital or holding any equity. Perhaps the best known 'service supplier' is FIAT, the Italian automobile firm which built, equipped, and managed for a limited time several plants in Yugoslavia, Poland, and the former Soviet Union.<sup>26</sup>

If the parent MNE has no intention of voluntarily surrendering ownership, its defensive strategy may involve the use of local capital. Loan capital can be raised locally from host country banks, through bond issues, or from the government treasury and its use eliminates the exchange costs involved in repatriating foreign loans.<sup>27</sup> Other ways to avoid equity exposure include raising finance through a series of small commercial loans from a multiple banks in a variety of countries (increasing the number of governments which may perceive an interest in the investment because of exposure held by firms based in their countries); borrowing from international development organizations including the International Monetary Fund, the World Bank, and regional development banks; and channeling parent company capital to the affiliate in the form of loans rather than equity investment which has the secondary advantage of reducing vulnerability to limits on *profit* repatriation).<sup>28</sup> Whatever specific strategy is adopted to realize the goal, debt to equity ratios in FDI can be as high as 90%. As one of Aharoni's

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<sup>25</sup>Pravin Banker, "You're the Best Judge of Foreign Risks," *Harvard Business Review*, Vol. 61, No. 2 (March-April, 1983), pp. 158-160 and Philip R. Cateora, "The Multinational Enterprise and Nationalism," *MSU Business Topics*, Vol. 19, No. 2 (Spring, 1971), pp. 54-55.

<sup>26</sup>Peter P. Gabriel, "MNCs in the Third World: Is Conflict Unavoidable?" in *Managing the Multinationals: A Harvard Business Review Reprint Series* (Boston: Harvard College, 1974 [Article originally published in 1972]), pp. 140-141.

<sup>27</sup>Jean Boddewyn and Etienne F. Cracco, "The Political Game in World Business," *Columbia Journal of World Business*, Vol. VII, No. 1 (January-February, 1972), p. 54.

<sup>28</sup>Joseph Micallef, "Political Risk Assessment," *Columbia Journal of World Business*, Vol. XVI, No. 2 (Summer, 1981), p. 502.

respondents said, "you can always bail yourself out of the risk [of high debt] by putting up more equity, so why do it in advance?"<sup>29</sup>

An alternative or an adjunct to the high leverage strategy for defending against potential political risk involves the use of expected sales. Either one can use such 'assets' as collateral for loans (instead of using secure assets of the MNE),<sup>30</sup> or one can sell the rights to the profits from such sales as Kenecott Copper did when financing a vast new investment in Chile in the 1960s.<sup>31</sup> The other major exposure reduction option is short term profit maximization to minimize the time period needed to pay back capital investment costs. This strategy however, may attract other forms of political risk through the appearance of taking unfair advantage of the host country.<sup>32</sup>

### Good Citizenship

"Many firms strongly believe that by acting as a good corporate citizen abroad they will remove local animosities and concern that might affect their short- or long-term competitive ability."<sup>33</sup>

Good corporate citizenship starts with simple things like developing allies among local suppliers and customers, learning how the government thinks and operates and adjusting to it, making gifts to respected charitable organizations, and avoiding flashy expenditures on offices and other things in the public eye.<sup>34</sup> An MNE is a public actor, whether it wishes to be or not. To be successful, it must learn how to adjust to and interact with its surroundings regardless of the situation.<sup>35</sup> Perhaps the most difficult part of this process is the need to

<sup>29</sup>Aharoni, *op. cit.*, p. 152.

<sup>30</sup>Moran, *op. cit.*, pp. 114-115.

<sup>31</sup>Dunn, *op. cit.*, pp. 145-146. In fact, Kenecott pioneered a variety of new proactive defensive techniques in making that investment. The entire strategy is fully examined in Theodore H. Moran. *Multinational Corporations and the Politics of Dependence: Copper in Chile* (Princeton, New Jersey: Princeton University Press), 1974.

<sup>32</sup>Buckley, *op. cit.*, pp. 80 and Shapiro, *op. cit.*, pp. 66-67.

<sup>33</sup>Daniels and Radebaugh, *op. cit.*, p. 423.

<sup>34</sup>Boddewyn and Cracco, *op. cit.*, pp. 55-56.

<sup>35</sup>Austin and Ickis, *op. cit.*, pp. 108-109.

show care and interest in the relevant issues in the host country through active involvement with the government and in the community. "Many firms seek to maintain a 'low profile' in the mistaken belief that this will insulate them from problems, but in the long run, a firm must actively sell its advantages to the host society if it is to prosper." MNEs must, however, avoid becoming involved in the specific *politics* of a sitting government.<sup>36</sup>

An MNE can seek influence and involvement at three levels of the governing process, as indicated in Zink's conceptualization of political risk (exhibit 8.2): the legislative and executive powers making policy, the bureaucratic structure implementing policy, and the general environment of actors influencing policy.<sup>37</sup> The last level, what Overholt calls the mass social base (chapter 8), incorporates several 'communities' made up of organizations and individual actors. In many environments, involvement in the business community is "not really optional, but either mandatory or highly desirable" for the MNE.<sup>38</sup> In fact, "sound business policy clearly dictates that the MNC [*sic*] be sensitive to [all] the environments [communities] in which it operates." But this does not mean it should or can act as a foreign aid institution, merely that it should support projects, like education, training, and medical care, which are both considered valuable by the entire community and are consistent with the long term goals of growth and prosperity shared by all conscientious businesses.<sup>39</sup> In addition, affiliate managers should take care to carry out normal business with a sensitivity toward the objectives of individual pressure groups which have the potential to effect the MNE's ongoing operations.<sup>40</sup>

Finally, the most important ingredient in 'good corporate citizenship' is publicity. Good behavior and sensitivity alone is not sufficient (some might argue not even necessary); actors in the environment must be aware

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<sup>36</sup>Zink, *op. cit.*, p. 4.

<sup>37</sup>*Ibid.*, p. 41.

<sup>38</sup>Jean Boddewyn, "The Development of External Relations by American Multinational Enterprises," in S. Akash Sethi and Richard H. Holton (eds.), *The Management of Multinationals: Policies, Operations, and Research* (Detroit, Michigan: The Free Press, A Division of Macmillan Publishing Co., Inc., 1974), p. 142.

<sup>39</sup>Gabriel (1974[1972]), *op. cit.*, p. 136.

<sup>40</sup>Zink, *op. cit.*, pp. 64-65.

of an MNE's supportive behavior in areas of particular interest to them.<sup>41</sup> Some form of aggressive public relations effort to sell the good public image is crucial to any participative effort to minimize political risk.<sup>42</sup>

"No matter how responsibly a corporation behaves, it will be viewed with skepticism unless it effectively communicates its activities, its plans, and its goals to its many publics."

--J. Peter Grace<sup>43</sup>

### Combatting Risk

There are three tools for aggressively combatting political risk which are available to most MNEs simply by virtue of their size and multinational nature. All work on the principal that host countries want something from FDI and will not interfere with the operations of an MNE if doing so would put their interests at risk.

1. Technology is a primary attraction of FDI to host countries and an MNE which can offer a continuing flow of new technology is likely to be quite secure from political risk.<sup>44</sup> Likewise, a firm which can retain control of technologically advanced operating processes without which their affiliate's assets are worthless, will be reasonably safe, at least from cataclysmic political risk.<sup>45</sup> One way of facilitating these goals is to concentrate research and development efforts and proprietary technology in the home country or in places where there is very low political risk.<sup>46</sup>
2. Widely recognized brand names and trademarks are protected by law in much (though not all) of the world and can be an invaluable marketing tool which helps differentiate a product from its competitors. Without the name and the advertising funds which often accompany it, products may become prohibitively difficult to sell.<sup>47</sup>
3. MNE affiliates often play a specific role in a global business plan. If an affiliate specializes in the production of one particular product for which there is a limited domestic market, or of a component for which the MNE is the only potential customer, there will be little temptation for a host government to

<sup>41</sup>Davies (1981), *op. cit.*, p. 7.

<sup>42</sup>Boddewyn, *op. cit.*, pp. 149.

<sup>43</sup>As cited in Daniels and Radebaugh, *op. cit.*, pp. 423-424.

<sup>44</sup>Yves L. Doz and C.K. Prahalad, "How MNCs Cope with Host Government Intervention," in Douglas N. Mickson (ed.), *Managing Effectively In the World Marketplace* (New York: Harvard Business Review and John Wiley & Sons, Inc., 1983), pp. 416-418.

<sup>45</sup>Jonathan Eaton and Mark Gersovitz, "Country Risk: Economic Aspects," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 90.

<sup>46</sup>Shapiro, *op. cit.*, p. 65.

<sup>47</sup>Channon and Jalland, *op. cit.*, p. 254, Daniels and Radebaugh, *op. cit.*, p. 408, and Shapiro, *op. cit.*, p.

expropriate.<sup>48</sup> However, this strategy may entail substantial costs if a plant is seized anyway and is the only one producing the specific component: the MNE's entire production chain can stall.<sup>49</sup>

### Political Risk Insurance

Traditional insurance against political risk is also a management option despite the impossibility of determining appropriate rates through standard actuarial methods, but the resulting high cost of commercial insurance makes it an unusual purchase. According to research done by Baglini, commercial purchase of political risk insurance is common only for protection against terrorism, extortion, kidnap, and ransom (risks against which just over 50% of respondents to his survey commercially insure themselves). For most other political risk, the "vast" majority of respondents self insure.<sup>50</sup>

More affordable sources for financial political risk insurance are government backed organizations. The U.S. Overseas Private Investment Corporation (OPIC) offers low cost political risk insurance for investments with which it has some involvement, as does the U.S. Export-Import Bank. Most other governments in the Organization for Economic Cooperation and Development (OECD) have established similar organizations.<sup>51</sup> In addition, in 1988, the World Bank established the Multilateral Investment Guarantee Agency (MIGA) to assist MNEs based in one of its 10 industrialized member states in making direct investments in one of its 25 developing member states. MIGA works through the World Bank's International Finance Corporation (IFC) to provide political risk insurance for those investments the IFC helps organize or finance.<sup>52</sup>

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<sup>48</sup>Channon and Jalland, *op. cit.*, pp. 250-251.

<sup>49</sup>Moran (1985), *op. cit.*, pp. 112-113.

<sup>50</sup>Norman A. Baglini, *Global Risk Management: How U.S. Corporations Manage Foreign Risks* (Risk Management Society Publishing, Inc., 1983), p. 73.

<sup>51</sup>Adhip Chandhuri, "Multinational Corporations in Less-developed Countries: What Is In Store?" *Columbia Journal of World Business*, Vol. XXIII, No. 1 (Spring, 1988), p. 62.

<sup>52</sup>Ibrahim F.I. Shihata, "Encouraging International Corporate Investment: The Role of the Multilateral Investment Guarantee Agency," *Columbia Journal of World Business*, Vol. XXIII, No. 1 (Spring, 1988), pp. 11-12.

## Chapter 11

### Summary and Additional Thoughts

This thesis promised to consider the challenge multinational enterprises (MNEs) face from political risk in foreign direct investment (FDI). Through theoretically-grounded and practically-oriented examinations of the phenomenon of political risk and methodologies used to analyze it, the thesis has addressed the subject from many different angles and affirmed its hypotheses.

Chapter 1 provides consistent, etymologically sound definitions for relevant terms. The definitions are broad enough for wide application within the field of political risk, yet sufficiently specific to be suitable for these and other specific applications. The development of such a set of definitions was one of the specific goals enumerated in chapter 2.

Part II is entirely devoted to developing an understanding of political risk itself. Chapter 3 reviews the evolution of 'risk' as an economic and business concept and provides a structure to facilitate the classification of different kinds of abstract risk (the ladder of cognition, exhibits 3.1-3.3). Chapter 4 employs this work to place risk in the political context and develops a diagram which illustrates political risk as a two stage phenomenon (exhibit 4.1). Insights gained through the creation and application of these two analytical tools are then used in a review of 'operational' definitions of political risk developed over the past thirty years. Chapter 5 applies this work to the real world sources and manifestations of political risk; reviewing classification schemes for different kinds of political risk effects, the ideological and practical roots of political risk, and ways in which MNEs are vulnerable to various manifestations of risk.

Part II served three concurrent purposes within the thesis. It completed the development of a set of definitions begun in chapter 1 and called for as the first supplementary goal of the thesis. It provided the basis from which to consider the analytical methodologies addressed in part III -- without the definition and analytical tools developed in part II, the critical and analytical aspects of part III would not have been possible. Finally, part III affirms the first hypothesis:

"if political risk is properly understood as a phenomenon of the political environment, then it a) defies direct quantification and b) can be explained as a series of discrete elements which can be analyzed separately."

The very nature of political risk defies any meaningful measurement. Because it is dynamic, one can never develop an ordinal scale with fixed intervals and finite values on which to measure it. Without such a tool, any number assigned to a condition cannot have numerical value and therefore cannot represent measurement in any understood sense. Furthermore, analysis of the way in which political risk manifests itself on MNE affiliates clearly shows a two stage process -- the occurrence of some problematic *event* and the distinct (though related) *effect(s)* on the affiliate.

Part III addresses qualitative approaches to political risk analysis based on traditional political and social studies methodologies (chapter 6), quantitative approaches based on behaviorist theory and statistical manipulation (chapter 7), and integrated approaches developed to maximize the benefits and minimize the problems of earlier techniques (chapter 8). Each chapter contains a survey of the evolution of the given analytical approach and specific examples, practical and theoretical critiques, and a catalogue of strengths and weaknesses for the approach.

Along with part I and II, part III accomplishes the second supplementary goal of the thesis by completing a structured, if extenuated, literature review of the political risk field. Given the relative youth and fractionalization of this field, a concise literature review would have been extremely difficult. Given the practical orientation of the thesis and the applicative nature of both the academic (business school) and commercial literature in the field, the structured examination of the various facets of political risk and its analysis embodied, at an almost unconscious level, a reasonably comprehensive and ordered review of the relevant literature.

Part III also affirms the second hypothesis:

"if political risk is properly understood as a series of non-quantifiable elements, analysis of political risk cannot be depended upon alone to protect multinational enterprise from political risk in foreign direct investment."

Even the most sophisticated, the most comprehensive, the most structured, and the most successful analytical methodologies reviewed in part III cannot overcome what Shubik calls the "minimum irreducible uncertainty."<sup>1</sup> The reasons for this are sound: anything fundamentally unmeasurable requires significant intuitive judgment in

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<sup>1</sup>Martin Shubik, "Political Risk: Analysis, Process, and Purpose," in Richard J. Herring (ed.), *Managing International Risk: Essays Commissioned in Honor of the Centenary of the Wharton School, University of Pennsylvania* (Cambridge: Cambridge University Press, 1983), p. 71

analysis, and intuition is fallible. This being the case, MNEs require something more than good political risk analysis to protect their investments from the risks associated with political occurrences.

Chapters 9 and 10 take the conclusions of the preceding parts of the thesis and apply them directly to the original problem: the challenges MNEs face from political risk in foreign direct investment. Chapter 9 considers the FDI decision making process within MNEs and chapter 10 examines the options available for defense against and mitigation of the potential effects of political risk events.

Taken as a whole, the thesis meets the third supplementary goal put forth in chapter 2. The attention paid to the practical needs of multinational enterprise in the realm of foreign direct investment has illuminated areas where academic assistance will be helpful in applying existing analytical tools to real world problems. Specifically, assistance is required to improve the utility of analysis and political risk management techniques by tailoring them for use within the business world. This means providing or enhancing attributes like low cost, flexibility in a variety of specific applications, and sufficient systemization to require limited expertise on the part of the user.

### Specific Conclusions

Specific, significant conclusions realized in the thesis include:

Risk is the possibility of unexpected harm or loss accruing to a business through a subjective judgment based on ignorance of either present or future environmental circumstances. Different kinds of risk can be identified by the amount and accuracy of knowledge held. These risk 'types,' when ordered from complete uncertainty to complete certainty, form a ladder of cognition (illustrated in exhibits 3.1-3.3). Through the accumulation and application of additional knowledge, it is possible to 'climb' the ladder of cognition or to approximate higher conditions on it. When certainty is achieved or approximated, risk no longer exists.

Political risk is a two stage phenomenon consisting of environmental risk -- the possibility a risk event will occur --and organizational risk -- the possibility a given risk event will effect a given investment. Because political risk is a dynamic, two stage phenomenon, it provides opportunity for gain as well as the possibility of loss. Failure to take advantage of such opportunity can be considered a cost. Because political risk is dynamic and not measurable, no precise numerical probability of its occurrence can be derived and it is reasonable to assume such risk can only exist under conditions of complete, subjective, or non-quantifiable uncertainty on the ladder of cognition.

Foreign direct investment only occurs through the mutual consent of two rational actors -- the multinational enterprise and the host country -- both of which have interests they wish to maximize. Political risk can be generated in the home country of the investing MNE, through regional or international tensions and groups, and through additional means other than just the host country. The

primary root cause of political risk events intended to have specific effects on investments is conflict arising from the desire of both the investor and the host country to maximize benefits from the investment. Such conflict can manifest itself in both ideological and operational forms. The likelihood of any given risk event affecting any given investment is related to the specific characteristics of the investment -- vulnerabilities vary and the second stage of the political risk equation cannot be evaluated in the abstract.

- Qualitative or 'soft' approaches to political risk analysis using traditional analytical methods provide insufficient guidance to analysts and executives without a background in politics and effectively require decision makers to work at the bottom of the ladder of cognition.
- Quantitative or 'hard' approaches to political risk analysis have limited utility for reasons of practicality and applicability. The most obvious of the many former problems is the difficulty of reliably being able to gather sufficient data of suitable accuracy. The most serious application problem is the repeated failure of deterministic explanations of political instability to survive empirical testing.
- The most useful approaches to political risk analysis are oriented toward a specific investment proposal, recognize the two stage link between environmental risk events and their organizational effects, and are accessible to senior management not expert in political studies.
- Political risk can either be avoided (no investment) or insured against. Insurance options include the purchase of financial insurance (a speculative investment since political risk, being unmeasurable, cannot be analyzed through traditional actuarial means) from either commercial insurers or quasi-governmental agencies, self insurance through retention, or non-financial self insurance (NFSI). The utility and value of political risk analysis is enhanced if the analytical process is integrated into the MNE's general FDI decision making process and the product is tailored to support political risk management activities including NFSI.
- Because each NFSI activity incurs an expense just like any other business expense, this approach to political risk permits its quantification indirectly through the cost of protection against it. This means that, conceptually, political risk analysis can be carried out under a condition of quantifiable uncertainty and that therefore, even though meaningful probabilities cannot be derived, an approximation of near certainty may be possible under the right conditions.

### Future Work in the Field

As was suggested in chapter 2, the state of the art in the analysis and management of political risk is stuck.<sup>2</sup> There is an enormous gap between the highly specific techniques which have been successful for major MNEs like Shell and Ford, and which address both stages of the political risk equation, and the "universal" approaches to environmental assessment even the most successful and useful of which can only address the first stage. Closing this gap is the primary task awaiting any political analyst interested in applying the academic tools of political studies to the problems of international business. One must wonder if the growing popularity of mid-

<sup>2</sup>Warnock Davies, "Unsticking the State of the Art of Political Risk Management," in Heidi Vernon Wortzel and Lawrence H. Wortzel (eds.), *Strategic Management of Multinational Corporations: The Essentials* (New York: John Wiley & Sons, Inc., 1985 [Article originally published in 1981]), p. 144.

range theories in political studies will perhaps act as a catalyst in this task much as behavioralism did a generation ago. Certainly, the idea of some theoretical approach which could provide assistance to an array of firms without running into the problems of universality has enormous appeal.\*

Before meaningful work on mid-range applications can be undertaken, however, there needs to be developed a better base of primary research from which to work. It would be informative to survey decision makers in a wide variety of large and small MNEs about their attitudes toward political risk, its analysis, and its management, how they make their foreign investment decisions, what analytical information they seek, what defines success for them, and what resources they are willing to commit to the political risk mitigation effort. Also enlightening would be a series of case studies of MNEs with a history of success in political risk analysis. Comprehensive examinations of their decision making, analytical, and risk management processes from first consideration of an investment into the first several years of operation, would be extraordinarily valuable. Unfortunately, such work may be difficult to complete as major MNEs are understandably loathe to put at risk any potential competitive advantage.

A different tack to take toward the development of mid-range theory would be to examine the potential utility of leveraging one stage of the political risk equation as a scale against which variations of the other could be measured. If, for example, the characteristics of a proposed investment can be fixed in a model, the "risk performance" of various potential investment environments could be compared against this model. By using a fixed and meaningful reference point, such comparison would be much more useful than the abstract comparisons now derived by risk ratings services.

Another area which bears some investigation is the utility of current generally accepted accounting principles and the possibility of developing some form of accounting system to measure the complete return on FDI in terms of things like growth potential, public recognition and image, and greater operating efficiency, as well as direct financial gain. Chase, Kuhle, and Walther seem to suggest that a few firms may already use some form of

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\*If the reader is not familiar with the basic problems of universal application in comparative politics, a good review can be found in Giovanni Sartori, "Concept Misformation in Comparative Politics," *The American Political Science Review*, Vol. LXIV, No. 4 (December, 1970), pp. 1040-1045.

"broad accounting," at least informally.<sup>3</sup> Certainly, the development of such a system could greatly assist both students and businesses in analyzing investment options and results.

### Final Thoughts

With the evolution of a new, and many analysts argue less stable, political world, the importance of political risk analysis is likely to grow. It is not so much that new paradigms will produce new types of political risk -- they may, they may not. But in either case, the loss of dominating international actors focussed on an apparently eternal conflict removes a large and limiting influence on the behavior of host countries. As the international political climate becomes more fluid and dynamic, it follows that the international business climate, and therefore the investment and political risk environment, will as well.

The collapse of the Soviet Union and other recent events are stimulating governmental changes around the world which may have far reaching effects on international business conditions. Many popular new governments are aggressively seeking foreign direct investment while at the same time speaking the contentious language of economic nationalism: 'local control,' a 'middle road' between communism and capitalism, the importance of FDI for national development purposes. The west may have won the cold war, but there is no such clear victory for unfettered international capitalism. Every investment is a joint venture between host and MNE, each trying to maximize its own interests without scaring off the its partner.

The paradigm of the past is changing rapidly and ambiguously and the new world requires dynamic techniques for dealing with political risk. MNEs unable to understand the unique and problematic nature of political risk will be unable to analyze risk potential in possible investment environments and will be poorly prepared to protect their affiliates and themselves against harm. Their only alternatives will be either to gamble or to seek to avoid all risk altogether. Firms able to invest with confidence and in safety will enjoy a substantial competitive advantage. Such is the argument for further work in applying the tools of political studies to the analysis and management of political risk in foreign direct investment.

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<sup>3</sup>Carmen D. Chase, James L. Kuhle, and Carl H. Walther, "The Relevance of Political Risk in Foreign Direct Investment," *Management International Review*, Vol. 28, No. 3 (1988), pp. 34-37.

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