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THE IDENTIFICATION AND MEASUREMENT OF POLITICAL RISK:

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THE IDENTIFICATION AND MEASUREMENT OF  
POLITICAL RISK : TOWARD A FIRM-CENTRIC  
APPROACH .

by

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SEPTEMBER 1995

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D.D.D.  
to the Roman Stoics

## Abstract

Political risk analysis is the study of economic and social discontinuities and changes which result in speculative constraints and opportunities for transnational business. This paper explores the problem of establishing definitional congruity at conceptual and operational levels of analysis and recommends the adoption of firm-centric approaches to assessing risk originating in the political environment. Conclusions are arrived at by means of partial induction, based on a rigorous comparative examination of a comprehensive body of literature.

The first section delineates various fiduciary frameworks, historical and definitional issues, covering the foundational concepts of certainty, uncertainty, chance and risk. Current definitions of political risk are compended, and a new definition is suggested, compatible with the day-to-day operations of globalised firms. Models and methods for the measurement and identification of political risk are reviewed in the second part of the paper. Conceptual and operational incongruencies are investigated from a perspective which aims at establishing the need for a firm-specific conceptual schematicisation of political risk. Approaches based on aggregation by macro or micro distinction are rejected in favour of the proposed conceptual model. Finally, the remaining part of the paper considers current and past models which place the firm at the centre of the analytical procedure. An abstract model of the firm is described for the purpose of including constraints on business interests, norms, rules, practices and procedures, profitability and other goals. Some empirical data is discussed with a view to confirming the necessity for adopting firm-centric approaches. The conclusion recommends further research in the form of empirical case studies which consider risk in relation to the individual firm.

**Key Words :** Political Risk - analysis; & firm; identification; measurement.

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Naturally, the author accepts full responsibility for all opinions and conclusions expressed in the dissertation.

1. Chapter One - Introductory :

1.1. The Dissertation :

Paradigmatic development<sup>1</sup> within the field of political risk analysis has been impaired by lack of real consensus regarding the definition, identification and measurement of the phenomenon of political risk. From promising beginnings in the early seventies (represented in the work of Robock 1971, and Root 1972, for example), reaching its zenith during environmental discontinuities such as the fall of the Shah in Iran, the Russian invasion of Afghanistan, and the Falkland crisis; the paradigm appears to have dissipated as a distinct area of academic research - prompting one writer to suggest that the concept be dropped from usage. (Kobrin, 1979.) Other writers have attributed the evident theoretical and methodological disunity and lack of consensus about the precise meaning of the concept, to the **infancy** of the field of political risk analysis. (See Fitzpatrick, 1983 in this regard.)<sup>2</sup> Epistemologically, the field is multidisciplinary - a fact which results in analyses permeated by fiduciary frameworks of a metatheoretical nature<sup>3</sup>. Some of these inherited frameworks have been determined, and are discussed in more detail below, in relation to the identification and measurement of political risk.

Political risk analysis is practised by two distinct, but commensurable communities; namely business and academia. However, a social dichotomy of this nature raises questions about the nature of reasoning as applied to the concept of uncertainty. For example, if risk is identified with objective uncertainty, and analysis is performed by an independent service organisation in the absence of an explicit model of 'the firm'; then two standards of

reasoning would apply to uncertainty in the analysis. Namely, that of the firm (or its management), and that of the analyst. Indicative of the need for a firm-centric paradigm based on a common conceptual and definitional vocabulary. An additional problem noted by Kobrin (1979), is what he describes as the 'relative' nature of the concept of uncertainty at the empirical/operational level of analysis; Kobrin ascribes objective and subjective dimensions to uncertainty, with obvious implications for the definition of and determination of political risk. For the purpose of this paper,<sup>4</sup> uncertainty is political risk and is considered to be a function of theory as well as empirical elements derived from the firm and the environment in which it operates.

In this dissertation, the twin problems of identifying and measuring political risk are discussed at a fairly high level of abstract generalisation, with a view to the development of a firm-centric approach to political risk analysis. Naturally, the firm-centric conceptual schematicisation described in chapter five, and discussed in chapter six, should be tested and corroborated empirically, in order to fulfil the requirement of falsifiability demanded by the scientific method of analysis. An impenitent application of the scientific method, the logical structure for this investigation is 'research then theory'.<sup>5</sup> Conclusions supportive of the main hypothesis, are arrived at by means of partial induction based on empirical research in the form of a critical comparative review of relevant literature.<sup>6</sup>

However, it should be noted that being a creative work, the dissertation embodies both inductive and hypothetico-deductive research strategies. The resultant model of political risk analysis is susceptible to refutation or at least modification, by means of further empirical research on a 'theory then research' basis - the latter unfortunately exceeding the scope of this project in terms of original intent, budget and available time.

1.1.1. On The Main Hypotheses :

Central to the discussion presented in this paper, is the hypothesis that political risk can only be identified and measured in relation to the firm. Accordingly, much of the argument in this paper is devoted (a) to demonstrating how writers in the field, by ignoring the characteristics of the firm in their analyses, have failed to establish congruency between conceptual and operational definitions of the term political risk; and therefore (b) to building a case for the presentation of a conceptual schema which places the firm at the centre of the analytical process involved in identifying and measuring political risk. A secondary hypothesis is that political risk can be measured and in some cases quantified,<sup>7</sup> according to the perceived strength and direction of changes in the socio-political environment, and the probable impact of political events on the firm during the forecasting period. Secondary aims are (c) to provide a useful critical review of works on political risk analysis for researchers and (d) to compile a reference work containing details of models which have been used to identify and measure political risk.

1.2. Uncertainty, Chance, Probability and Risk :

1.2.1. Introduction :

The concept of risk can be expressed in both verbal and nominal forms; activities, occurrences or events can be regarded as risk. At the same time in terms of prospects for the potential management of risk via insurance or adaptive strategies, it is possible to 'take a risk', to 'transfer risk' and to 'avoid risk'. Although first recorded during the mid-seventeenth century according to the Oxford English Dictionary, the word was used commonly during the Industrial Revolution in England for the first time during the 1830's in insurance vocabulary, and has been used most often in conjunction with the

## Uncertainty, Chance, Probability and Risk

more familiar anglicised spelling 'risk'. In addition the word carries connotations of mystique - in the (introductory) words of one well known writer on business risk and decision-making under conditions of uncertainty: '...risk has about it an aura of achievement and progress, communities commonly rewarding those who handle difficult risk situations successfully.' (Moore, 1983:1) In the commercial environment, investors are exposed to risk in the form of possible losses, should a company in which they hold equity go into liquidation. Entrepreneurs take risks in anticipation of reward when establishing new business enterprises, and insurance companies attempt to calculate premiums according to assessed risk based on statistical evidence of past events.

The concepts of uncertainty and chance are associated inextricably with risk taking behaviour; as are outcomes such as opportunity for profit or other less tangible benefits, and the possibility of loss. Risk is about uncertainty, and in particular, uncertainty related to the future, or future events. It has been defined by Valsamakis et al., as '... the uncertainty surrounding an event and outcome in a specific situation'. (1992:31) Hertz and Thomas (1984:1), have defined risk analysis as '...methods which aim to develop a comprehensive understanding and awareness of the risk associated with a particular variable of interest (be it a payoff measure, a cash flow profile, or a macroeconomic forecast) in strategic decisions.' In the business environment, the word is associated interchangeably with hazard, and also causes of and exposure to the chance of injury or loss, particularly financial loss. Valsamakis et al., (1992), when considering cause and outcome, differentiate between hazard or potential cause of loss; and peril, which they define as the source of potential loss. Risk analysis is used in corporate forecasting and planning, the strategic positioning of firms in relation to competition, scanning of the business environment for information on uncertainties, scenario development and risk management, and strategic management and response to identified uncertainties in the business environment.

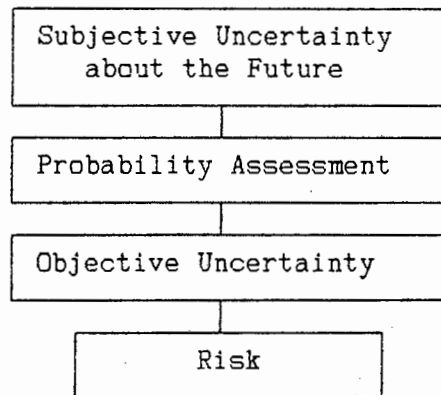


Figure 1. Exhibit 1A. Defining Risk

### 1.2.2. Certainty, Uncertainty and Risk :

The concepts of risk, uncertainty and chance should be distinguished from the concepts of political risk, subjective uncertainty, and objective uncertainty for the purpose of this study, which concerns only political risk and objective uncertainty. However, being important frameworks which influence the political risk analyst's 'way of knowing' they are discussed in more detail in this section of the paper. Risk is usually associated in the literature with uncertainty about the magnitude of potential loss and the chance of loss, (see Hertz & Thomas, 1984; Moore, 1983; Valsamakis et al., 1992 in this regard.) and this normative approach pervades many definitions of political risk. The result being normative fiduciary frameworks from the literature on business risk, which permeate the business of political risk analysis at the theoretical/conceptual level of analysis. At the practical analytical level, it should be noted that cognitive processes and perception are important factors in risk identification and rating, despite the maintenance of a fiction

## Uncertainty, Chance, Probability and Risk

of objectivity. (Refer to discussion on defining political risk in chapter two of this document.) Haendel et al., (1975) have noted that a situation of certainty is one in which there is a single known outcome. It could be argued though, that irreducible risk exists even in situations characterised by certainty and continuity. Valsamakis et al., would include this type of risk in their conceptual category of fundamental risk. Seismic and meteorological disturbances are an example of risk associated with irreducible uncertainty. Certainly, within the logic of minimum probability assignments, this is the case. By contrast, in situations of uncertainty, outcome/s<sup>a</sup> are unknown and in the first instance judgements regarding them are intuitive or subjective in nature, raising questions about whether risk should be considered to be the anticipated event, or the subjective probability assignment regarding its probable or anticipated occurrence and possible effect.<sup>9</sup>

Accordingly, whether explanations and predictions are expressed qualitatively or quantitatively, the analyst requires information and a reliable methodology for analysis regarding situations characterised by stochastics, in order to ascertain associated risks. In this regard, subjective uncertainty or informed conjecture has been distinguished from objective uncertainty by various authors on political risk (Refer to Kobrin, 1979 for a typical example; and Exhibit 1A above.) Within the political risk and risk management paradigms, objective uncertainty or risk, exists where a definite probability distribution whether explicit or implicit, exists for a future outcome or set of outcomes.<sup>10</sup> Admittedly, probability assignments related to the future have a subjective character, whether statistically or qualitatively based.<sup>11</sup> As the business of political risk analysis is orientated to ascertaining risks related to the future, the concept of objective uncertainty has been equated with political risk in this paper. A definition of objective uncertainty which ascribed risk to uncertainty about the event exclusively would ignore important factors such as the goals, norms, values, rules, procedures, strategic predispositions, structure and business risks of the typical firm.

Forecasts based on scenario development are included in this latter definition by most writers and practitioners of political risk, in that they represent implied probabilistic assessments of the occurrence of future events. The distinction between subjective and objective uncertainty mentioned above,<sup>12</sup> is based on the mathematically derived logic of probability assessments as it has been incorporated into business science, and may be somewhat contrived under certain circumstances. For example, in terms of data selection, relationships may be taken on faith where descriptive/qualitative type scenario forecasting is the chosen method of analysis. Problem definition is also subjective, in terms of the personnel involved, conceptions of real interests which motivate the risk analysis and techniques used to define it; as is the assessment of available strategic responses to probable occurrences. This type of subjectivity can only be accounted for consistently where the process of identifying and measuring risk (and political risk) is firm-centric. Nevertheless, the somewhat artificial distinction is retained for the purposes of this study in the sense that subjective uncertainty is **not** considered to be the result of a process of identification and measurement.

### 1.2.3. Two Facets of Risk :

In this paper, the concept of risk has two conceptual sub-components or dimensions, affecting the process of identification and measurement and enabling risk to be classified according to subjective ratings. (see Exhibit 1B, below.) The first of these two basic elements is associated with the process of identification and is the probability of an event occurring, and the second involves measuring the degree of impact that an identified event/s or occurrence will have on the firm, its activities and interests. As risk can imply potential for loss or no loss, as well as increased or diminished profit or other less tangible benefits and contingencies,<sup>13</sup> this study presents a

## Uncertainty, Chance, Probability and Risk

broader definition of risk which includes potential for loss as well possible effects on the other goals and interests of the firm. (See chapter five for a detailed discussion.)

For the purposes of this paper : Political risk is objective uncertainty about future socio-political developments and outcomes as related to the profitability, business interests, norms, values, procedures, structures and other goals of the firm.

The first dimension of objective uncertainty or risk as defined above is usually referred to in this dissertation in connection with the problem of identifying political risk, while the second dimension involves gauging possible effects on the firm. It should be noted that it is at this level that notions of subjectivity and objectivity are difficult to distinguish, because ultimately all analyses are subjective, though statistical techniques may help in ascertaining measures of central tendency, and rational choice models could define risk related managerial contingencies. Formal probability assessments merely add a false sense of comfort and 'the scientific' to proceedings and should be recognised as simple quantitative representations of expert opinion regarding possible occurrences. Convention underlying risk analysis equates these subjective probability assignments with objective uncertainty and it is on this intersubjective epistemological foundation that much of the ontology of risk identification and measurement presented in this dissertation is based.

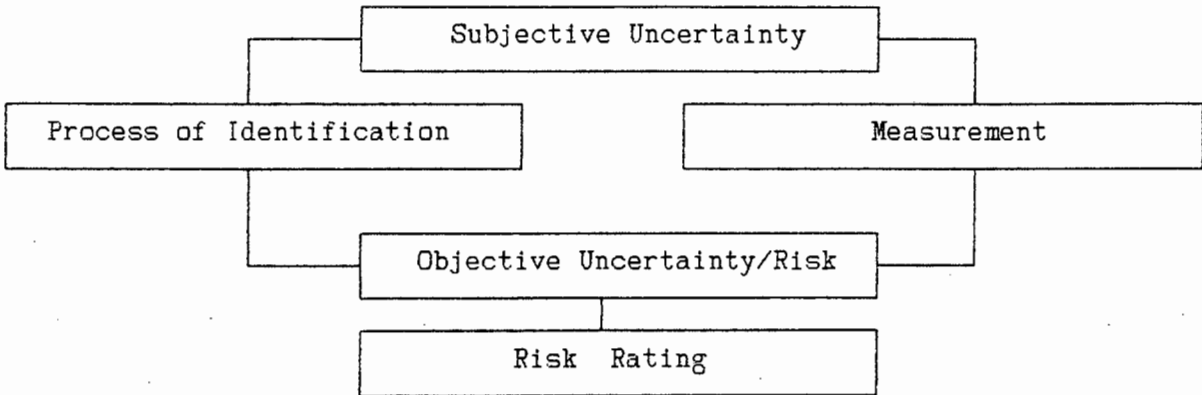


Figure 2. Exhibit 1B. Two Dimensions of Risk Analysis

#### 1.2.4. Risk and Probability :

Chance<sup>14</sup> and risk refer to relative predictability, in the form of probability assignments (explicit and implicit) about the possible occurrence of future events affecting the firm. Risk has been defined to mean uncertainty and the expected results of uncertainty (e.g. Hertz and Thomas, 1984; and Moore, 1983). In the context of this paper, the analyst is concerned only with objective uncertainty as expressed in subjective probability assignments and probabilistic explanations and predictions regarding the occurrence of future events and their possible effects on the firm. Chance and risk are synonymous, following Bayes' (1763) definition. A subjective probability<sup>15</sup> value of zero denotes an expert judgement that an event will not occur during the forecasting period. (Usually up to five years in the case of foreign direct investment planning) A value of one would mean absolute certainty about a future occurrence. As has been noted in chapter three, (and by Bayes, [1958 reprint]:298) probability ratings of zero are impossible to revive in later iterations of the probability theorem and should therefore be avoided. Subjec-

## Uncertainty, Chance, Probability and Risk

tive probability assignments usually fall somewhere in the range between these two extremes. After identifying risks and assessing probabilities, it is possible to assign a risk rating of low, medium or high according to the expert assigned probabilities regarding the occurrence of the event, and the magnitude of expected loss or effect on the other goals of a firm. Analytical rationality regarding risk causing events on the part of management can be assumed, in that an investor is likely to base his current assessments and strategic response on past assessments and decisions made under circumstances perceived as being similar.

Within the risk management paradigm, calculating levels of risk for the firm, depends on specific characteristics of the investment or business activity being assessed, and the importance of the investment in relation to the total operations of a transnational enterprise temporally and spatially. Establishing ratings for political risk is more complicated than assessing risks associated with the chances of striking oil during exploratory oil drilling operations, or the occurrence of traffic accidents at a busy intersection, for example. In the first case, risks will depend on the probability of oil being found at a specific drill site and calculations can be based on geological and seismic records. In the latter case, risk can be calculated statistically. Drilling risk is a combination of reward or liability and chance, which can be calculated consistently and coherently in ratio form, assuming that probabilities for striking oil and creaming potential are known. In the second case, insurers would base calculations of risk and chance on deviations about the mean in a hypothetico-deductive manner.

However, when uncertainty regarding drilling success is combined together with political risk in the form of subjective uncertainty about the likelihood of increased fiscal demands on revenues earned from the sale of oil supplies once drawn to the surface, or changes in host government exchange rate policy, analysis becomes more complicated and subjective. In assessing the likelihood of a host country introducing fiscal measures, and possible adaptive strategies, the political risk analyst introduces a host of variables and interdependencies both empirical and conceptual/dialectical, to the analysis. Reward and risk become more difficult to analyse, though the probability metaphor is retained, being consistent with managerial self-interest or rational utility. It should be added that defining political risk as fiscal change or changes in foreign remittance and exchange regulations is simplistic. For example, if a wider range of possible policy changes regarding management indigenisation or equity sharing were to be included in the definition, predicting probable events becomes more difficult as does predicting and measuring effects on other corporate goals.

#### 1.2.5. Rating Risk :

In the context of political risk analysis, consistency and coherence are difficult to attain when assessing risk across cases. Transnational firms and the states in which they operate have differing goals and often use conflicting strategies for their attainment. It cannot be assumed for example, that a political risk producing trend in one host country will amount to the equivalent in another, or that combining probability assignments based on qualitative methods of risk identification can produce reliable results. In addition, what is classified as high risk for one firm may be rated as an opportunity for another. An example of the application of the two dimensions of probabilistic risk rating can be expressed diagrammatically as follows :

Uncertainty, Chance, Probability and Risk

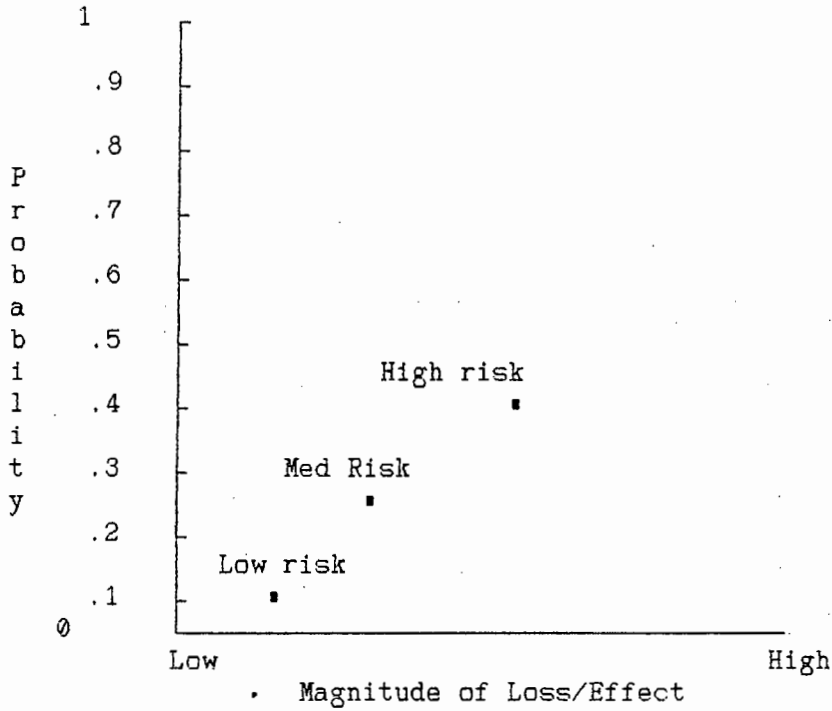


Figure 3. Exhibit 1C. Rating Levels of Risk (Adapted from Moore, 1983)

Coherence and consistency across investments have been maintained by some analysts ( for example in the ASPRO-SPAIR system) by means of weighting expert assessments according to the strength of an expert's feeling that a particular event will occur during the forecasting period. Scenario forecasters overcome the problems associated with establishing consistency of analysis by describing and using well defined methods for their analyses. Because of the subject matter, (i.e. the interactions of the firm with the socio-political environment) these assessments can never be as reliable as those made according to statistical principles regarding accident rates or the risk of HIV infection, for example. (See Moore, 1983 for a discussion of this point and the rule governing probability assignments.) Nevertheless, within the rationality of political risk analysis, and accepting these recognised limitations, probabil-

ity assignments and probabilistic explanations form the basis for analysing<sup>16</sup> and rating risks inherent in future events in the socio-political environment within which transnational firms conduct business.

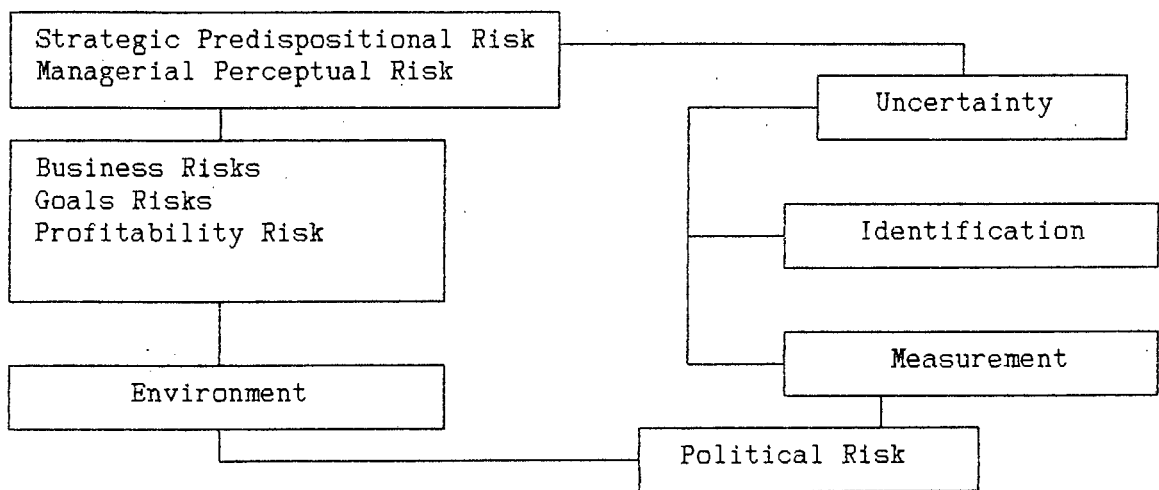


Figure 4. Exhibit 1D. Defining Political Risk Analysis.

Political risk analysis has been defined logically by most writers on the subject, in relation to the two dimensions of risk described above. (See chapter two for a critical overview of the definitions.) However, a central critique of past assessments and methodologies discussed in this dissertation, is that the second dimension of risk has been excluded by most political risk analysts at the operational level of analysis. In this thesis, it is proposed that in the interest of conceptual/operational congruity, political risk can only be identified and measured in relation to the individual firm. Including the firm at both conceptual and operational levels of analysis means accounting for the interests of business<sup>17</sup> as well as goals, strategic predispositions, norms, rules and practices peculiar to the firm, when identifying and measuring political risk.

## Uncertainty, Chance, Probability and Risk

The distinction between the concepts of subjective and objective uncertainty described above, has been retained in this dissertation, although writers such as Howard (1993) have rejected it. In addition, based on the discussion in chapter two, this thesis argues in favour of wider definitions of political risk, for use in determining objective uncertainties with regard to the business interests and day-to-day operations of transnational firms. Identification and measurement involves a range of techniques and models - there being no 'correct' or 'best' method save the one that suits the individual firm best. (Refer to chapter five of this dissertation, for a detailed analysis of the implications of this approach.)

### 1.3. Overview of the Dissertation :

#### 1.3.1 Chapter by Chapter :

Concerned mainly with a critique of existing approaches to the measurement and identification of political risk; this thesis commences in chapter two, with a discussion of the background to political risk analysis, and historical trends in the development and stagnation of the paradigm. Definitional and conceptual issues are covered in detail in chapter two, including a presentation of the differences and similarities between country risk and political risk. In addition, the chapter offers a critical review of some of the literature on the subject of political risk analysis and introduces various typologies of political risk. Chapter two commences the argument in support of definitional consistency and a firm-centric model for political risk analysis, by highlighting some of the fiduciary frameworks discussed in chapter one, at the conceptual level of analysis, and conceptual incongruities at the operational/empirical level of analysis.

In chapter three, the political risk analysis paradigm is evaluated broadly in relation to measurement and forecasting methods. One of the purposes of this dissertation is to provide a useful reference guide to methods for the analysis of political risk, and so in chapter three the following methods and models for measurement are discussed and reviewed critically : ASPRO-SPAIR, BERI, BI, PSSI, WPRF. Scenario forecasting is covered, as are the strengths of quantitative and qualitative approaches for measurement. Probability theory as applied to political risk analysis, is introduced and critiqued in this chapter, which continues the argument in favour of the main hypothesis that political risk analysis can only be undertaken in relation to the individual firm.

Chapter four discusses issues of identification. A number of inconsistencies and incongruities of identification are presented. The limitations of defining political risk in terms of expropriation and economic nationalism are reviewed together with the work of analysts who have proposed general taxonomies of political risk, and models of the firm and its interests. Chapter five presents a firm-centric conceptual model of political risk after over-viewing the firm-centric literature and discussing the problems encountered by the political risk analyst when attempting to link politics with the firm. A conceptual schematicisation of the firm and the environment in which it operates is discussed and an integrative conceptual/analytical framework recommended. Level of analysis issues are discussed in more detail in chapter five of the dissertation, and a model of the international environment is presented and discussed. Chapter six concludes the dissertation, and Chapter seven contains recommendations for future research agendas.

1.3.2. Terminological Consistency :

1.3.2.1. Transnational, Multinational, Firm :

In this dissertation, the terms firm, multinational enterprise, multinational corporation, transnational corporation, (Eden, 1991) and transnational firm (Strange, 1992) are used interchangeably when referring to those enterprises which are headquartered in one country and do business across national borders. They vary in size and structure and may have established operations in one or more countries other than their country of origin. As Eden has noted, these terms originate in differing paradigmatic interests, and the interdisciplinary nature of political risk analysis would warrant their interchangeable use for the purposes of this thesis. Accordingly, the terms multinational enterprise, firm and transnational corporation are used more or less interchangeably in connection with the conceptual schema presented in this dissertation - their respective organisational and legal structures being the most common. Kaplinsky, (1991) in noting their global nature, has coined a new term for them - 'world firms'.

1.3.2.2. Politics :

It is important to distinguish between the 'political' element of the concept of political risk and the concept of 'political risk'. The latter concept can only be understood in relation to the transnational or world firm, while the first concerns the uncertain socio-political environment within which transnational firms operate. Identifying and measuring political risk involves the analysis of 'things political'. In the interest of a broader definition of political risk capable of including policy and regulation change as well as radical discontinuities such as social revolutions, the concept of the

'political' upon which this dissertation is based, is derived from public policy analysis. Dye (1992:4), defines public policy as '...everything governments choose to do, or not to do.'

In the context of this paper, the 'political' refers to all aspects of the public policy formulation and implementation process at the national, sub-national and international levels of analysis, in which the firm can be regarded as a 'stakeholder'. The consequences of action and inaction are important aspects of the political for society and the firm, as are the processes which lead to outcomes. If Dunn's definition of stakeholder<sup>18</sup> is accepted, the political risk analyst, in identifying and measuring political risk, will need to identify individuals and groups<sup>19</sup> ( and their respective power and authority differentials as well as capacity and strategies for action ), with regard to specific firm related problems or issue areas characterised by uncertainty about probable outcomes and occurrences, during the forecasting period. The associated analytical process of identification and measurement involves the heuristic selection and application of theoretical and methodological approaches.

1.4. Key Terms for Review :

Chance	Political Risk
Probability	Politics
Risk	Risk Rating
Uncertainty	Hazard
Subjective Uncertainty	Peril
Objective Uncertainty	Transnational Firm
Fundamental Risk	Certainty

1.5. Chapter One - End Notes :

- 
1. In the sense of knowledge construction by a social community based on the development over time and space, of shared language, norms, traditions and rules of interpretation. (On this point, refer to George & Campbell, 1990:275)
  2. Although in agreement with findings contained in this dissertation, Mark Fitzpatrick has not suggested an explicit alternative framework for analysis.
  3. From the disciplines of Business Studies, Economics, Psychology, Comparative Politics and Mathematics, and the Insurance Industry.
  4. Which is merely a preliminary exploration of the subject.
  5. Refer to Nachmias & Nachmias, (1992) for a succinct discussion of the inductive/deductive dilemma imposed by the scientific method, on the researcher selecting strategies for research.

## Chapter One - End Notes

6. In this regard, a comprehensive bibliography of standard works from the political risk analysis paradigm accompanying Howard's (1993) thesis, has provided much inspiration.
7. Albeit in a highly subjective manner.
8. i.e. possible occurrences and possible effects.
9. In the sense that in this context, the concept of uncertainty refers to uncertainty based on uninformed opinion.
10. Typically assessed by means of Bayesian logic. (See chapter three.) However, epistemologically, Bayesian probability assignments may be based on inductive logic in the form of observation, and experiment (as is the case currently in political risk analysis), or hypothetico-deductive logic as in actuarial type assessments for the insurance industry derived from aggregated statistical data.
11. '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 synthesise both into an imagined future.' (Kobrin, 1979:70)
12. And which has commonly been adopted by political risk analysts.
13. See Valsamakis et al., (1992:28)
14. Bayes equated chance with probability, which he defines as '... the ratio between the value at which an expectation depending on the happening of the event ought to be computed, and the value of the thing expected on its happening.' (Bayes, 1763, [1958 reprint]:298)

## Chapter One

15. The use of Bayesian probability analysis in political risk analysis is critiqued in detail, in chapter three of this dissertation.
16. For the purposes of this dissertation, analysis refers to the process of identification and measurement.
17. See Overholt, 1982
18. Individuals and groups (or organisations), which affect and are affected by the process of policy implementation and formulation. ( See Dunn,1981:360)
19. In government and outside of government.

2. Chapter Two : Political Risk Analysis :

2.1. Background to Political Risk Analysis :

2.1.1. Introductory :

Political risk analysis<sup>1</sup> involves the identification, measurement and incorporation into managerial procedures of potentially risky socio-political aspects of the business environment in which international firms engage in commerce and investment. In Chapter one, it was shown that the concepts of risk and political risk have two dimensions for the firm contemplating uncertainties about future developments - namely, hazard or cause and peril or outcome (Peril in this case is the source of the effects of political risk on the firm.) The process of analysis involves three phases which can be described as identification, measurement and management. This dissertation concentrates on the first two dimensions of the analytical process, and relates them to a model of political risk analysis which places the firm at the centre of things, as opposed to the state (as in country risk), or acts of government and political events (as in many of the event-aggregative taxonomic approaches discussed below). It was also asserted in Chapter one, somewhat controversially that political risk analysis is a 'paradigm lost'. Reasons cited being disparate definitions of political risk, fiduciary frameworks<sup>2</sup> of a theoretical/conceptual and empirico/historical nature, and the lack of a firm-centric approach.

In this chapter, political risk is differentiated from the related, but equally important concept of country risk, and set in historical context as a concept and as an industry. Many of the definitions reviewed below, could be described as tautological - in the sense that what is possible can never be false. Yet definitionally, the politically possible can only be constituted

## Historical Trends in the Industry

consistently in relation to the individual firm; broader aggregate analyses of political risk at the conceptual level of analysis lack congruity at the operational level of analysis. What is needed therefore, is a dynamic conceptual/operational schema capable of relating the socio-political environment directly to the firm during the forecasting period. When based on historical trends, instability and expropriation; definitions tend to be unidimensional, and insufficiently broad to be of practical use to the political risk analyst. In addition, the many exceptions to these definitions indicate that political risk analysts should base their definitions of political risk on the firm and its activities as they relate to future political developments. This analysis concludes that political risk is not an essentially contested concept. At the least, it has been defined and operationalised in an idiosyncratic fashion by various analysts who have used the concept. It is hoped that this chapter will contribute (if only in a minor fashion) toward establishing conceptual clarity for the scientific community dedicated to the analysis of political risk.

Chapter three, surveys current methodologies for the measurement of political risk, and discusses the difficulties associated with evaluation<sup>3</sup> and establishing congruity between conceptual and operational definitions, in a field characterised by stochastic dominance, numerous variables, and relational dynamics which are often non-linear or difficult to identify and operationalise. In chapter four, issues of identification are covered more rigorously than is possible in this introductory section of the paper, which deals with historical and essential definitional/conceptual background.

### 2.1.2. Historical Trends :

From ancient times, the analysis of politics has been recognised as an important part of the commercial environment, especially where business has been conducted across frontiers and different political systems.<sup>4</sup> For example,

## Background to Political Risk Analysis

regarding the potentially catastrophic effects of political developments, some of the calamitous Florentine bankruptcies of the thirteenth and fourteenth centuries can be attributed directly to inaccurate forecasting of the international political environment by merchant-lenders.<sup>5</sup> As William Overholt (1982) puts it; reflecting on the need for information on the socio-political environment, as an industry, political risk analysis has become more important in modern times than it was during the reign of Cyrus the Great. (When Hebrew bankers employed sophisticated spy networks to gather information on the political environment.) Bankers and traders have always needed information on the non-economic environment when incorporating business risks into their planning; and notwithstanding the critique below, techniques for gathering information, analysing trends and interrelationships and forecasting future scenarios have become more sophisticated, efficient and widespread as commercial activities have globalised.<sup>6</sup> Increasing global activity has resulted in higher international profiles for transnational corporations and firms. Transnationals and multinationals are pursued by host countries for their ability to create wealth (Strange, 1992) - yet, a recent publication on the international political economy, described transnationals as '...the most visible and attacked agents in the global economic system.' (Walters and Blake, 1992:104) Recent research reflects trends of increasing interdependence between states and firms - and the globalisation of multinational enterprises; necessitating a broader conceptualisation of political risk to account for muted power differentials.<sup>7</sup>

Since the second world war, analysis of the risks associated with the interaction of politics and international business has become an especially American activity; carried out by academics, managers, foreign policy and intelligence officials.<sup>8</sup> In the literature, theoretical and methodological approaches to the measurement and identification of political risk tend to reflect the interests of and problems faced by American business as it expanded abroad and eventually became global.<sup>9</sup> Howell (1983:51), has identified

## Historical Trends in the Industry

three main approaches to political risk analysis in modern times (since 1945). The first is an in-house assessment similar to that carried out by Shell International, the second is the incorporation of outside consultants into the planning structure, and the third is to employ a political risk service to do all of the analysis. Many of the writers on political risk have listed examples of the types of event which give rise to the need for professional political risk analysis. (Choi, 1979; Shubik, 1983; Davies, 1981; Rummel & Heenan, 1978.) Davies in particular, has described changes in host country policies which have made political risk more corporate, than industry or home country specific (1981:5). Buckley (1987) has listed changes in tax regulations and exchange controls, stipulations about local production, expropriation and restrictions on access to local borrowings as examples of the types of situation which constitute political risk. However, as this chapter shows, there are many definitions, typologies and models of political risk. Each offers partial insight into the complex field of political risk analysis. To date, no organised integrated approach to political risk analysis capable of identifying, measuring and managing political risk reliably across cases, business cultures and countries has been developed.<sup>10</sup>

### 2.1.3. Influence of Historical Events :

Historically, the paradigmatic development of political risk analysis shows two main trends - firstly there have been attempts to design abstract conceptual models of government-business relations; and secondly, at the operational level of analysis, the development of measurement and forecasting methods, both quantitative and qualitative. To be effective, political risk analysis should enable managers to identify and measure political risk, assess the potential for future changes in the political environment and incorporate their findings into investment planning and managerial processes. However,

## Background to Political Risk Analysis

later discussion will show that there has been little cumulative growth in the field - political risk has been variously and ambiguously defined, identified and measured in a plethora of studies.

Writing in 1982, J.D. Simon drew attention to the impact of these trends on international business. He found that haphazard theoretical development hindered corporate decision makers' attempts to understand political risk. Many decision makers simply continued to "... muddle through by having overseas staff or independent consultants produce sporadic analyses." (Simon, 1982:62) Economic nationalism, which took the form of expropriations of foreign owned firms, particularly in South America between 1967 and 1972,<sup>11</sup> and political instability such as the revolutionary events in Iran during 1978/9, were the twin stimuli<sup>12</sup> for many studies on political risk. One of the more thorough reviews of the historical direction of research into political risk analysis, Simon's (1982) study classifies political risk analysis into three chronological eras (a) the Pre-OPEC era, (b) the Post-OPEC, Pre-Iran era, and (c) the Post-Iran era. More recently, the literature search for this paper found a dearth of material on political risk post-1990, perhaps denoting a decrease in interest among American academic research programmes and corporations, or alternatively, lack of progress toward the development of integrated methods for analysing political risk.

### 2.1.4. Agenda for Future Research :

However, it should be added that in South Africa: Pretoria, Stellenbosch and Witwatersrand universities have commenced political risk analysis research programmes at the Master's level for students of international studies and business practices. In terms of possible direction for the future, recent

## Country Risk And Political Risk Compared

developments and trends in the international political economy have altered the balance of power between states and firms, decreasing the relative power of third world states while at the same time the relative power of 'foreign owned firms' has increased. (Strange: 1989) These facts should be reflected in research agendas, and in conceptions of political risk, which ought to be broadened to allow for the more general analysis and forecasting of political risk exposure during all phases of day-to-day operations.<sup>13</sup> In the next section of this chapter, after a preliminary discussion of the differences between the concepts of 'country risk' and 'political risk', the impact of these developments on political risk analysis is discussed in more detail.

### 2.2. Conceptual and Definitional Inconsistency :

#### 2.2.1. Country Risk and Political Risk Compared :

##### 2.2.1.1. Defining Country Risk :

Country risk is a state-centric concept which is used by international bank lenders and has been defined as '...the probability that a country will fail to generate enough foreign exchange to service its foreign currency loans according to the terms laid down in the original loan agreements.' (Robinson, 1981:71) Robinson distinguishes country risk from sovereign and transfer risk, and notes that some definitions of country risk include all foreign loans outstanding. For example, (Heffernan, 1986:1) who defines sovereign risk as '...all cross-border loans granted by a private bank in one country directly to a foreign government or publicly guaranteed loans made to a foreign firm.' An important analytical distinction to make, because the latter would include loans to private non-banks as well as to government borrowers. On the differences between political and country risk; Siegwart, Caytas and Mahari (1989:2) contend that political risk and country risk are '...congruent, except for economic nationalism, and discrimination against foreign investors

## Background to Political Risk Analysis

and market operations. Grosse & Stack (1984:41) would agree with this assessment, but prefer to use the term non-economic risk synonymously with country risk; and have adapted Robock's definition of political risk, to include discontinuities in the political environment which are difficult to anticipate and which result from political change. Whether all discontinuities in the political environment could be classified as country risk, or even political risk, is debatable. An alternative definition which subsumes political risk under country risk is that of Lars Oxelheim : country risk is '...the likelihood and magnitude of unanticipated changes in the 'rules of the game', including laws, regulations and policy regimes selected by monetary and fiscal authorities.' (Oxelheim, 1987:9) (Political risk according to Oxelheim's limited definition, is, 'The possibility of changes in legislation and regulation that may influence the return on investment...'. Essentially, country risk analysis concerns the evaluation of risks, including political risks, which could affect the creditworthiness of a country from the perspective of international lenders (generally banks). The probability of potential losses is more important in the analysis of country risk, while political risk analysts consider a wider range of business related risks, relevant to the activities of foreign direct investors and traders (usually multinational or transnational firms).

### 2.2.1.2. Similarities :

However, while the typology of risks<sup>14</sup> for banks and lenders differs from that for foreign owned firms involved in foreign direct investment; the assessment of the political content of country risk is similar to the process of assessing political risks in foreign direct investment.<sup>15</sup> Both require a formal conceptual model of the business investment or loan, which could be used to identify relevant risks by means of a method based on hypothetico-deductive logic. In addition, both require a model of the interaction of the political system and the business concerned. Root's analysis of the politico/economic

## Country Risk And Political Risk Compared

aspects of risk (discussed below), is one example of a structured schematicisation incorporating methods from economics and politics, which would apply equally to bank lenders and foreign direct investors assessing political risks. Although his model of business risks is not as rigorous as that offered by Overholt (1982), Root's conceptual model goes beyond mere information in that he attempts to describe a model which relates economics, politics and government actions to the firm. Both political risk and country risk analysis require the use of a method of measurement and forecasting, whether formal and quantitative, informal and qualitative or other combination. Finally, both require a system of integrating findings into financial planning in the form of political risk accounting. Nagy (1978) writing about a system developed at the Bank of Montréal, has quantified the potential effects of country risk in terms of '... the difference between the discounted present values of the expected and the actual net income flows during a given period, expressed as a percentage of the discounted present value of expected cash flow during the same period.' (1978:136) His definition of risk is based on potential loss 'Risk is defined as the multiplication of the size of a potential loss by the probability that the loss will occur.' (Nagy, 1978:135)

### 2.2.1.3. Role for Political Risk Analysts :

Much of the inductive analysis to be found in the research literature on country risk, including Nagy's paper, is based on general checklists of possible events and probability assessments, rather than a delimitation of the salient characteristics of the client as they relate to loan risk. For example, Nagy's typology of risk for private bank and non-bank borrowers (without government guarantee), makes inadequate allowance for weighting and therefore the assessment of the relative importance of individual events. The Bank of Montréal's system weights only according to the probability of when a particular event is likely to occur during the loan period. In addition, as he has admitted, many of the types of risk listed are interdependent and

## Background to Political Risk Analysis

provision is made neither for analysing the impact of intervening variables nor the nature of their interdependence, thereby negating the weighting process. Assessing measurements across countries by means of his system, would also be difficult. (Nagy, 1978:140). On probability assessments of future host government activity, Root has written that they are '...the key to any viable approach to the problem of political uncertainty in international business.' (Root, 1973:355) Probability assessments are based on the opinions of experts, and as such, are really only as good as the information available to the experts who estimate them. However, as Nagy has stated - their usefulness lies in their orientation towards future projections rather than the known. Methods of integrating political risk analysis into the accounting systems of banks would make the subject of an interesting research programme. (for examples, refer to Grosse & Stack, 1984:43 and van Agtmael, 1976:27)

The most important difference between political risk and country risk with respect to bank-government loans, is that country risk is essentially a macro-risk;<sup>15</sup> it would apply to all bank lenders equally with regard to a particular country; contrastingly, because of the varied activities of foreign investors, political risk analysis for foreign direct investors and traders has macro as well as micro implications.<sup>17</sup> van Agtmael (1976) has noted that bank loans have generally been less vulnerable than direct investments to changes in policy. After crises such as coups or economic recessions, governments have been '...less inclined to renege on commercial debt repayments...' (1976:16), than they have been to indulge in expropriation or other forms of discrimination against foreign direct investors. His political checklist for identifying country risk does not differ greatly from those of political risk analysts concerned with foreign direct investment (1976:27), and his conclusion about the necessity for formalised assessment of country risk is not that different from the conclusions of many writers on political risk analysis.

Political risk analysts, more accustomed to analysing the risks for foreign direct investors and traders, clearly have a role to play in the assessment of the social and politico-economic aspects of country risk for bank lenders.

## 2.2.2. Political Risk Defined :

### 2.2.2.1. Classifying Definitions :

In view of the many definitions of political risk to be found in the literature, it seems appropriate to continue the discussion of the differences between political risk and country risk, by reviewing the concept of political risk. While the concept of political risk should not be regarded as essentially contested,<sup>18</sup> analysis of a compendium of definitions shows ambiguity, and a dearth of consensus about the meaning of the concept among the main writers in the field. Political risk has been defined in terms of conceptual components including: the actions of governments (Baglini, 1983; Gillespie, 1989; Buckley, 1987; Gebelein et al, 1978; Smith, Ring et al, 1990; Root, 1973;<sup>19</sup> Schmidt, 1986; Shapiro, 1981; Simon, 1982; van Agtmael, 1976; Yaprak & Sheldon, 1984); instability and change and their effects on business - usually considered to be negative ( e.g. Bunn & Mustafaoglu, 1978; Choi, 1979; Prakash Sethi & Luther, 1986; Rice & Mahmoud, 1986; Schöllhammer, 1978; Shreeve, 1984; Siegwart, Caytas & Mahari, 1989; Stein, 1983; Wu, 1982);<sup>20</sup> in terms of managerial perceptions (examples are Fatehi-Sadeh & Safizadeh, 1989; Brewer, 1985; Kobrin, 1981; Rummel & Heenan, 1978); as events such as expropriation (refer to Bradley, 1977; Bunn & Mustafaoglu, 1978; Haendel, Meadow & West, 1975; Howard, 1993; Raddock, 1986; Radetzki, 1982) or changes in the rules of the game (exemplified by Overholt, 1982).<sup>21</sup> More general conceptualisations, encountered mostly in the weekly business journals and newspapers, recognise the existence of political risk intuitively, but do not offer explicit conceptualisations (for example, refer to Badenhorst, 1993; Bruce, 1993; Johnson, 1994; and Much, 1980 ).<sup>22</sup>

2.2.2.2. Fiduciary Frameworks :

The broad classificatory categories above, are not intended to be mutually exclusive, some definitions contain a mix of conceptual elements. Implicit normative assumptions and fiduciary frameworks of a conceptual and historical nature permeate most of the definitions; exacerbating conceptual and methodological disparity within the field of political risk analysis to the point of sheer idiosyncrasy. Epistemologically however, the related concepts of risk, objective uncertainty, subjective uncertainty and probability discussed and defined in chapter one, underly many of the definitions and methodologies categorised above. (In particular, refer to Gebelein et al., 1978:726; Brewer, 1985; for examples.) Five researchers who have based their approaches to the definition of political risk on the conceptual vocabulary of insurance, are Root (1973); Haendel, Meadow & West (1975); and Kobrin (1982). Because their respective conceptual approaches influence the forecasting and assessment methodologies used, their papers are examined in more detail below.

2.2.3. Overview of Five Perspectives :

2.2.3.1. Franklin Root :

One of the earlier analyses of political risk, Root's (1973) paper commences with a discussion of the differences between international business, and 'uninational' or domestic business. Root contends correctly, that international business is conducted 'within and among a plurality of states' (1973:354) each of which has exclusive sovereignty or jurisdiction over the territory which it controls. The problem, as Root identifies it, is to predict behaviour over the long term where uncertainty predominates. Political uncertainty is converted into political risk when a manager makes a probability judgement regarding a future political development or event. Root's paper concerns the source of probability judgements (he identifies four sources - in-

## Political Risk Defined

tuition, experience, information, and analysis). Only the last can be assessed reliably both logically and methodologically, and may therefore be called truly scientific, according to Root. (1973:356) Political risk may thus be equated with objective uncertainty<sup>23</sup> about conditions in the political environment. Root outlines a conceptual model of reality on which probability assessments can be based. It should be noted that probability assignments remain subjective. However, as the scientific method adopted for this study allows for them to be assessed according to principles of falsifiability and intersubjectivity the term objective uncertainty has been retained. His functional/descriptive taxonomy identifies three main groupings of political risk - namely transfer, operational and ownership-control. His scheme for the analysis of these risks is divided into two dichotomous diads, namely politico-economic and politico-social, within a general analytical schema that attempts to model the dynamics of these firm-polity interrelationships.

### 2.2.3.2. Haendel, Meadow and West :

Haendel, West & Meadow (1975), discuss the conceptual and definitional problem in more detail. Their attempt to clarify the 'risk' component of the term 'political risk', centres on a debate which originated in the insurance industry. They distinguish between the 'subjective' and 'objective' aspects of risk and uncertainty, (1975:45) and contend that 'risk' is the same as 'objective doubt', but uncertainty is 'subjective doubt'. Risk is measured in terms of probability, and uncertainty by belief. Uncertainty is unwelcome to business enterprises in that it is not 'measurable' while the causes and effects of 'risk', as they have defined it - are at least potentially measurable in the form of probability assessments.

The realm of risk, thus concerns objective information, or 'analysis', as Root would express it. The authors admit that the selection of criteria upon which a measure of risk could be based, remains a subjective or particularis-

## Background to Political Risk Analysis

tic matter. (Haendel et al., 1975:50) In the realm of certainty, a single action is associated with a single outcome. In the realm of risk, action can be associated probabilistically with outcomes, while in the realm of uncertainty, actions are associated with many possible outcomes - probabilities being unknown. Accordingly, they arrive at a definition of political risk as "...the risk or probability of occurrence of some political event that will change the prospects for the profitability of a given investment. (1975:56) They propose that the assessment of probabilities related to risk can be accomplished in two ways, the particularistic (discussed above); and the generalised - the latter involves the use of broad brush strokes resulting in a general assessment of risks. The main weakness of their argument is that they have not attempted to formulate an abstract model of the firm in the same way that Root has. In addition, the distinction between subjectivity and objectivity is valid only within the terms in which they have defined it. In other words - even probability assessments are subjective by nature. Gebelein has noted that when people attempt to solve complex problems, they do so serially, attempting to solve one portion at a time - the final result being a biased overall judgement which has not weighed all factors. (Gebelein et al. 1978:726)

### 2.2.3.3. S.J. Kobrin :

A typical definition of political risk, based on the logic of probability is Kobrin's. He defines risk as "...the distribution of probable returns which is, ceteris paribus, a function of the probable impacts of political events on operations." (1982:71) He contends that both certainty and uncertainty are ideal constructs. Certainty can be proximated where one outcome dominates all others, or in situations where gradual change points to trends. He also notes that risk which is associated with losses should be distinguished from speculative risk which could be associated with either. (1982:71) Political events are thus of interest because of the possible constraints they place on the firm. Quoting Hannah Arendt's remarks about the 'seem to be' world in

which we live, for support; he states that opinions formed about future events are inherently subjective. Of course, he is right in noting that argument - although the distinction between subjective and objective uncertainty is of pragmatic value to the political risk analyst.

The remainder of his paper, which concerns the integration of political risk assessments into decision making is discussed in the following chapter of this paper. The distinction between subjective and objective uncertainty is one which has preoccupied many writers on political risk - prompting Howard (1993) in his thesis, to propose a 'ladder of cognition', (as old as the thought of Aristotle on the classification of knowledge), on which he positions the different approaches to subjectivity/objectivity within cognitive perceptual boundaries. While Howard correctly points out the unavoidable element of irreducible uncertainty attached to political risk assessments, the author of this paper doubts the utility of such an approach to the classification of conceptual and discursive practices, because of the difficulties in establishing truly objective classifications of cognition. A microscope can influence perspectives on the objects of a natural scientist's investigations into the 'real' world, as quantum physicists have shown.<sup>24</sup>

### 2.3. Causes of Political Risk :

#### 2.3.1. Historical Trends Related to Conceptual Development :

##### 2.3.1.1. Normative Assumptions :

Definitional approaches to the concept of political risk, such as those detailed above, reflect the influence of historical trends in the type of events which have affected international companies; and consequently the way in which politics has been understood by political risk analysts. This section discusses in more detail, historical trends as they relate to conceptual

## Background to Political Risk Analysis

developments within the field of political risk analysis. It is almost tautological to state that political risk occurs simply because the business environment exists within the socio-political environment. In fact, the formalised assessment of political risk, and the incorporation of these assessments into the strategic planning function has become more widespread since the 1979 revolution in Iran. Kobrin, in his review of methodologies and models (1981:252), has noted the following statistics: after the debacle in Iran, at least 55% of United States based international firms had taken minimal steps to integrate political risk analysis into the business process, and 35% had attempted to institutionalise the function.

The assessment of the causality of political risk can also be reactive; in itself a cause of political risk. In the social sciences, subject often influences the object of study and vice-versa. Often, notions of causality exist only in theory - in verbal and conceptual form; few of the writers have attempted to identify or quantify and operationalise dependent/independent relationships. (Root, 1975:355) Formal method, and the conscious explication thereof can help reduce these problems. 'Analysis implies a methodology and the political risk forecaster must be conscious of the method being applied, since it can, by itself, determine outcomes.' (Howell, 1983:51) The author of this paper would add that method (or possible bias) should also be revealed consciously to the client. The points outlined above indicate the need for further empirical case studies in this regard.<sup>25</sup>

Normative assumptions regarding probability assessments which underly many of the definitional approaches are derived from the insurance industry, and affect the notion of causality as well as analytical methods, for many researchers. A preoccupation of the insurance industry with the aggregation of cases into classes of risk, is reflected in the macro-micro distinction

adopted by many analysts following Robock's analytical approach. Knight (1967) has noted in this regard that 'We hardly find in practice really homogeneous classifications (in the sense in which mathematical probability implies, as in the case of successive throws of a perfect die) and at the other extreme it is hard to find cases which do not admit of some possibility of assimilation into groups and hence of measurement.' (Knight, 1967:246) Those who ascribe to Bayesian type probabilistic explanations are inclined to require quantitative approaches as opposed to qualitative analysis. Whether qualitative or quantitative, establishing causal relationships involves proving plausible covariation of dependent and independent variables, or at least showing the degree and direction of covariation, non-spuriousness, and time order. (Nachmias & Nachmias, 1992:102) For the purposes of this dissertation, another fiduciary element, namely the fiction of objective uncertainty based on formalised methodological assessment is retained. However, the aggregation of types of risk into laundry lists has been avoided in favour of a firm-centric conceptual schema and the heuristic selection of methods for identification and measurement.

In view of the fact that political risk is by nature firm-specific though not necessarily unique to a particular firm, many of the aggregate studies at macro and meso levels of analysis are inadequate for incorporation into the management of political risk. Static indices such as that of Haendel, et al., (1975) are more useful to firms contemplating a particular country for the first time, than to firms incorporating political risk analysis into management on a day-to-day basis. The author of this paper hypothesises that the distinction between micro and macro risk (Robock, 1971) has little utility for the identification and measurement of political risk and its management, other than in the most generalised terms for the purpose of flagging potential areas of risk. Macro risk applies at the micro level of analysis, meaning that the problem of identifying and measuring political risk should be approached from the perspective of the firm's day-to-day operations. This would require a

## Background to Political Risk Analysis

model of business risks and a broader definition of political risk - one such model is discussed below in more detail in the section on typology. Analysis of generalised risks is essentially of use for initial go-no-go decisions, or assessing the 'business climate' of a country or countries. Given a conceptual model of the firm's activities, macro risk could be subsumed profitably, under micro risk for the purpose of identifying and measuring political risk for individual firms. (Refer to chapter five in this regard.)

### 2.3.1.2. Economic Nationalism and Acts of Government :

Some typical definitional approaches based on historical trends toward economic nationalism, of the mid to late 'sixties and early 'seventies, are those which view political risk as being caused exclusively by the actions of governments. Exemplary of this approach are Gillespie (1989); Buckley, (1987); Gebelein et al. (1978). Gebelein et al., writing for the oil industry define the causes of political risk rather narrowly. Their paper and method of measurement concerns the probability of the amendment, abrogation and renegotiation of oil production contracts. Reflecting developments rising from the oil crises of the early seventies, they attribute their concern for political risk assessment to the increasing assertion of sovereignty over national resources, by the governments of oil producing countries.

Buckley's paper deals with the consequences of government intervention in national economies. He defines the causes of political risk as '...the exposure to change in value of an investment or cash position because of government actions.' (1987:79) Following the trend noted above, he delineates two main routes to analysing the causes of political risk. The macro, applying to all companies, and the micro. As an example of a macro-measure, he reviews Haner's BERI,<sup>25</sup> in detail. Buckley conceives government action as expropria-

tion - and in his paper, makes recommendations for post-expropriation policies. His analysis has limited use, and would be of value only to companies involved in the extractive industries.

Gillespie (1984) whose paper falls into the post-Iran chronological era; notes the post-1979 surge in interest in political risk analysis. Somewhat unusual for the genre, her article deals with the political risks for exporters, contractors and licensors in Iran after the fall of the Shah. Her definition is an implied one, and includes government activities in the form of import restrictions, cancellation of contracts, and changes in intellectual property rights such as trademarks and royalty payments. The paper contains an in depth study of losses and court actions by exporters after the Iranian revolution - what she describes as a "...rare case of macro loss..." (1989:44).

These approaches to the definition of political risk are not broad enough to be applied widely. Defining political risk exclusively in terms of the actions of host governments limits the scope for analysis and applicability of findings. Extra-governmental activities of stakeholders, such as strikes by organised labour, can constitute important political risks for companies. In addition, the domestic actions of home country governments, as well as inter-governmental relations can also constitute political risk for firms. Clearly, the dynamics of socio-political interaction at the local and international levels of analysis, should be a factor in any analysis of the causes of political risks for foreign firms, wherever they operate. Similar problems occur when the causes of political risk are identified synonymously with instability and change. Adaptive strategies which could be adopted by firms under conditions of instability could actually result in change being advantageous to the firm. For example, the strategy followed by Gulf Oil in Angola - to deal with the new Marxist government actually reduced risk for the

## Background to Political Risk Analysis

company. (Kraar, 1980) Other firms may not be affected by change at all - for example most of IT&T's operations in Chile were affected by expropriation, while their hotel interests were not affected.

### 2.3.1.3. Instability and Change :

Typical of the definitions of political risk as change and its (negative) effects on business are those of Bunn & Mustafaoglu, (1978); Choi (1979); and Schöllhammer (1978). Bunn & Mustafaoglu have defined political risk events as '...any outcome in the host country, which if it occurs, would have a negative impact on the success of the venture.' (1978:155) Their analysis of causality is based on a panel of experts probability assessment, used in the oil industry. Causality is treated by means of multi-expert, multi-regression decomposition analysis which uses Bayesian probability and partial probability assessments. Political risk events are attributed to a number of key causal or influencing factors. For example, expropriation is linked to a list of political risk causal factors including ideological change, visibility of foreigners in the economy, colonial identification of the firm, and demonstration effect. Analysis is performed by means of Bayesian probability assessments by experts in their fields, and much of the paper consists of a hypothetical analysis using the method. Their method is orientated to the oil industry, but does not include a formal model of the business, its risks or the political system.

Frederick Choi (1979), has defined causality simplistically in terms of '...the risk of loss occasioned by actions of governments that interfere with the profitable conduct of international business.' (1979:17) Risks are classified as operational and asset risk - for accounting purposes. He notes a trend towards increasing nationalism on the part of host governments, and proposes the use of an ecological explanatory model of political behaviour in

## Causes of Political Risk

host countries. No explicit model of the business is proposed, although he does discuss briefly, methods of integrating assessments of political risk into the accounting system of firms involved in foreign direct investment.

Schöllhammer's analysis (post-Iran), of the risks for German foreign direct investment is based on a model of the political environment which includes what he describes as intra-nation and inter-nation events in host country, home country and third country. Broad events are rated on a scale varying from conflictive to co-operative, and his method is based on quantitative analysis of data from the COPDAB (Conflict and Peace Data Bank). He concludes that 'The relative impact of political events on foreign direct investments is conditioned not only by risk preferences of individual decision makers, but also by corporate resource capabilities and the complex international political relationships between countries.' (1984:35). His conclusion seems to support the need for further work on models of the firm and political system, and the way in which they interact as a way of identifying the causes of political risk.

To sum up, reflecting historical trends in terms of demand and socio-political events, the causes of political risk have been associated in the literature on the subject with managerial perceptions, instability and its effects on business, expropriation, changes in the 'rules of the game', and the actions of governments. Early papers, some of which have been critically reviewed above have concentrated on expropriation, while those from the mid-seventies concentrate on radical political change, later efforts have noted the need for broader definitions. Establishing causality has been hampered by the diverse approaches exemplified above, and an inability of researchers to link cause and effect across cases. The distinction which is made between macro and micro risks underpins many of the difficulties associated with the process of establishing causality. This paper supports the notion that analysis should start with a model of the firm, or investment,<sup>27</sup> and that

## Typologies of Political Risk

political risk should be identified and measured according to the way in which the firm interacts with the political system at the national and international level.

Writers who base their methodological analyses on probability assessments imply that identifying and measuring the causality of political risk is a management/perceptual problem. Later papers have introduced the elements of internationalisation and globalisation. However, defining and assessing the causes of political risk remains a difficult task due to the lack of cumulative conceptual and methodological development. It should be noted that political risk involves threat as well as opportunity, definitions of the phenomena associated with political risk should account for this fact.

### 2.4. Typologies of Political Risk :

#### 2.4.1. Common Typologies :

##### 2.4.1.1. Macro-Micro Aggregation :

Descriptive taxonomies of political risks are fairly common in the literature, and tend to take the form of lists of events emanating from the political environment, which could affect the firm. Comprehensive, abstract conceptualisations or models, which link these taxonomies to the dynamics of the socio-political system are rare. The most common distinction (Robock's) made with regard to types of political risk, is that between macro and micro risk. They have been termed generalised and particularistic risks by Haendel et al.. As has been seen above, this distinction may have been useful during the early to mid seventies, but is of limited utility - not being accompanied by an explicit abstract explanatory model. In any case, micro-risk always includes

macro-risk. Except in the case of country risk analyses for banks, macro-risk analysis can do little more than provide a survey of the general political environment of a country or countries for foreign direct investors and traders.

#### 2.4.1.2. Ownership, Control, Operation and Transfer :

Taxonomies have been developed by various writers attempting to describe causal linkages. A common descriptive taxonomy which has been used to make analysis more manageable, is that which was developed by Root (summarised above), who distinguishes between ownership-control, operational and transfer risks. For example, Schmidt (1986) uses Root's (1972) typology which classifies risks as transfer, ownership-control and operational. These types are operationalised by Schmidt as follows : transfer risk includes tariffs on exports, export restrictions, tariffs on imports, import quotas, dividend remittance restrictions, capital repatriation restrictions, nationality restrictions. Operational risks include : price controls, increased taxation, export commitments, local content requirements, local sourcing requirements, local manufacturing requirements, financing restrictions; and Ownership-control risks include : geographic limitations on investment, economic sector limitations on investment, abrogation of property rights, foreign ownership limitations, pressure for local participation, expropriation, confiscation. (Schmidt, 1986: 46)

His approach favours policy analysis and monitoring by investment type and industry sector. In fact, he is correct in asserting that managers must go beyond the macro-historico event centred analysis of war, revolutions and inconvertibility in order to assess and manage political risks. On a firm-centric note, he goes further in classifying investments according to whether

## Ownership, Control, Operation and Transfer

they are horizontal, conglomerate or vertical; and discusses the effect this perspective has on the identification of political risk for foreign investors. Proper description and classification of political risk is clearly bound to the type of firm involved in the investment. Prakash Sethi & Luther (1986) have developed a taxonomy of risks which is presented in the form of a matrix of risk and containment. (1986:61) The matrix is based on economic, political and socio-cultural risks in home and host countries - and strategies for containment. Their concern was to break away from the focus on instability which had suffused so many of the works on political risk, and present a wider gamut of risk for the manager interested in containment or risk management. The remainder of their paper comprises a critique of prevailing methods of measuring political risk. (Dealt with in chapter three of this dissertation).

In his (1982) paper, Simon proposes a framework for political risk assessment which classifies macro and micro risk as societal and government related, as well as internal and external. Macro/Internal/societal includes such events as revolutions, civil war and coups d'état. (1982:67) Micro/internal/societal includes selective terrorism, and selective strikes. Government related risks at the micro/internal level include selective indigenisation/expropriation; joint venture pressure and discriminatory taxes. External factors at both levels tend to be broad international events such as war, international activist groups, and MNE competition. Kobrin (1984), has described a similar taxonomy but in terms of a flow-chart, depending on whether the direction of causality is host-country to multinational, or vice versa for example. (Kobrin, 1984:128-9) He has also developed a taxonomy which distinguishes between industrialised and developing nations.

In an attempt to include the firm, Overholt (1982) presents a descriptive taxonomy which includes a more detailed development of Root's (1972) typology from the perspective of business. His 'components of business', are assets, organisation, operations, and markets (1982:7). Business risk comprises a taxonomy of factors classified under each of the components of business. For example, the political component of assets risk includes nationalisation, wage prices squeezes, inflation/indexing risk, disorder/ambiguous ownership rules, erosion of patent and copyright privileges, and seizure of data. Unfortunately, he does not propose a formal conceptual model against which political risk can be analysed, it is left for the reader to hypothesise. His approach is to perform 'old hand' type scenario forecasting, based on his assessment that extant methodologies have failed to predict reliably. Whether scenario forecasting is any better in that regard is a matter for debate, and is discussed in paper three of this series. The academic credibility of Overholt's paper suffers greatly as a result of his decision not to credit source material other than his own publications.

### 2.5. Conclusion, and Recommendations for Future Research :

#### 2.5.1. Concluding Remarks :

This chapter has shown that conceptually, political risk analysis is under-developed. Although a relatively old field, with historical roots in ancient commerce. The reasons for the relative lack of coherent development are : the personnel involved - business science professors and managers with relatively little training in the analysis of politics; the historico-contextual dependence of the development of theoretical and methodological approaches and fiduciary frameworks from economics and insurance which lead to incongruencies

between conceptual and operational definitions. Events have been the main fixation among analysts attempting to define political risk and attribute causal inferences. As Simon discusses in his article, it is possible to classify the political research according to some clearly demarcated chronological periods. The discussion and literature reviewed above conclude in agreement that political risk theory has tended to follow the chronological events fairly closely, from concern about expropriation and nationalisation to instability, to possible applicability in day-to-day operations.

The logical conclusion flowing from the discussion in this chapter, is that political risk researchers need to concentrate on formulating a model of the firm, or investment procedure against which interactions with the socio-political environment can be assessed more reliably. In addition, more research needs to be undertaken in conjunction with firms in order to ascertain how the findings of political risk analysts can be integrated into accounting, as well as day-to-day management. The state of the art of political risk analysis has become disorganised, and may be characterised by disparate approaches and definitions which have hindered paradigmatic development in the field.

2.6. Key Terms for Review :

Country Risk	Political Risk
Sovereign Risk	Macro Risk
Transfer Risk	Micro Risk
Non-Economic Risk	Ownership Risk
Control Risk	

2.7. Chapter Two: End Notes :

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1. Differentiated from country risk analysis.
  2. i.e. Systems of concepts and theoretical/methodological precepts inherited from other disciplines. Perhaps it is natural that a community would be reluctant to discard constitutive conventions in haste, though in the case of political risk analysis, progress has been severely constrained by the confidence placed in these frameworks.
  3. Evaluation in the sense of the dialectics of identification and measurement.
  4. Overholt (1982), has noted the importance of access by business to political information, citing as illustrative examples, modern technical innovations and ancient spy networks which enabled bankers such as the Rothschilds in modern times, and the Hebrew bankers during the reign of Cyrus the Great, to act on political information often before it became available to governments.
  5. The most well known being the Mannini, who were heavily exposed to political risk with regard to loans to Richard II of England (1395), made via their Paris office. (Origo, 1963:87) Similar disasters overtook the Bardi and Peruzzi during the previous century, as well as the Fuggers of Augsburg in later centuries. (Walters and Blake, 1992)
  6. Predicting accurately, has proven to be difficult though - more of an art than a science, as a later chapter will show. It is not only the interpretation of the relationship between politics and business which affects the risks involved - individuals and businesses are affected by political events

simply because they exist in a political environment. The rise and fall of dictators can be just as risk laden for individuals and corporations as inaccurate predictions about the ability of a corporation to deal with a change of government. (Shubik, in Herring, 1983: 109)

7. Strange (1992:4) contends that changes in the power structure of the international political economy have resulted in new modes of diplomacy and accommodation between states, and firms as well as between firms and firms. Third world countries are now competing against one another to attract firms. These changes could form the basis of an interesting research agenda for political risk analysts

8. It should be noted that the global personnel arrangements of transnationals tend to reflect various nationality patterns; country divisions being managed primarily by local personnel. (Keohane & Nye, 1974:41) This does not apply to U.S. diplomats, AID, or the CIA. Most information gathering beyond transnational organisational boundaries is accomplished by personnel of the transnational - nationality composition is thus bound to affect organisational perceptions on political risk.

9. For example, refer to Kraar (1980) and Much (1980).

10. Comprehensive literature reviews include the following works: Fitzpatrick, (1983); Simon, (1982); and Kobrin, (1979).

11. In June 1971, Overseas Private Investment Corporation (OPIC) records reflected expropriation exposure totalling more than US \$3,7 billion (US \$3 732 812 162), more than half of it incurred since 1967 - an indication of concern about expropriation as a political risk to foreign investors. (Wheelock, 1973:60)

12. Losses to American business in Iran during 1978/9, were estimated to total

in excess of US \$1 billion.

13. Yaprak and Sheldon (1984) found that respondents to a survey on when political risk assessment is utilised, cited initial investments 80%; strategic planning 71%; reinvestment 67%; disinvestment 48%; day-to-day monitoring 26%. (Yaprak & Sheldon, 1984:57). This seems to be a clear case in support of the integration of political risk analysis into all phases of the business cycle.

14. A typology of political risk for country risk analysts would include items such as deterioration in the balance of payments, devaluation/depreciation of currency, overextension in external borrowing, fall in export earnings, mismanagement of the economy, unilateral change in debt service means. (Nagy, 1978:138)

15. Grosse & Stack have identified a 'laundry list' of factors which includes : expropriation, nationalisation, kidnapping of executives, strikes and riots for foreign direct investors; and payment arrears, rescheduling of payments, renegotiation of the debts, total default, and interrupted payments due to exchange controls for bank lenders. (1984;43)

16. i.e. following Robock's (1971) distinction.

17. The writer of this study would argue that the distinction between macro and micro risk is a fallacious one. Based on Overholt's model of business risks, what is needed is a rigorous conceptual model of the business and its activities. This model could then be integrated into a structured schematicisation of the political environment relevant to the investment.

18. Gallie, (1956: 179) in his paper on essentially contested concepts, defines an essentially contested concept as one which never succumbs to a definite judicial knockout. The main contention of this investigation into

political risk, is that a multiplicity of conceptual definitions has resulted in confusion and operational incongruency.

19. In his definition, which includes an 'act of government', or 'political event of any kind', Root (1973:355) includes war, revolution, coups d'état, expropriation, taxation, devaluation, exchange control and import restrictions.

20. Choi, for example defines the concept as follows, 'Political risk generally refers to the risk of loss occasioned by actions of governments that interfere with the profitable conduct of international business.' (1979:17)

21. Fitzpatrick's, (1983) literature review contains a comprehensive overview of a different range of literature, and was intended as a basis for future research into the conceptualisation of political risk, in much the same way as this work is. He concludes that many of the conceptual problems associated with the evaluation of the political environment which have been identified in his paper, may be a reflection of the infancy of the field.

22. With the exception of Much, (1980) who mentions the effects of the Islamic revolution in Iran, these articles deal cursorily, with political risk in contemporary South Africa.

23. As opposed to subjective uncertainty, which results from probabilistic assessments based on intuition, personal experience or information.

24. For an interesting, though superficial discussion of interference patterns in quantum physics, and the apparent influence of knowledge on end-results and photon behaviour, see Sharon Begley's article in *Newsweek* (June 19, 1995:44)

25. In this regard, Kobrin, (1979) has suggested further study of the effects of nationalist policies on multinational corporations in South America.

## Chapter Two : End Notes

26. Business Environment Risk Index - reviewed critically below.

27. An observation which has been made by Marks (1983:188) though not developed further by him, is that 'Managers usually seek accurate, relevant answers to concrete issues related to a company's lending, exporting, investing or producing activities in a country.' In his 1979 reconsideration, Kobrin mentions the need for firm-centric approaches.

3. Chapter Three : Methods and Models for Measurement :

3.1. Critical Review and Evaluation :

3.1.1. Introductory :

At the heart of political risk analysis, lie three problems : (a) identifying socio-political environments or issues as they relate to business, (b) of forecasting the probable occurrence of political events likely to constitute political risk, and (c) of measuring the potential effect of political risk on the profitability and other goals of the firm. Identification and measurement processes are interrelated; identification occurring at both the conceptual-theoretical level of analysis prior to measurement, and at the conceptual-operational level of analysis. In many cases, while exact relationships remain putative simply because risk assessments are future orientated; measurement may help to identify and predict 'generalised' political risk related managerial contingencies for companies by means of 'post-hoc' inductive logic. (Examples of quantitative methods are : Rummel & Heenan, 1978; Coplin & O'Leary, 1983; Heenan & Addleman, 1976).<sup>1</sup> By contrast, Overholt and Root have proposed conceptual systems which allow for risk identification (on the basis of hypothetico-deduction), prior to measurement - Overholt's (1982) model being qualitative, while Root's (1973) model through reference to econometric analysis is partially quantitatively grounded. In both of these cases, measurement consists of ascertaining the likelihood of and occurrence of political risk, and the potential outcome with respect to the firm.

Additional practical and methodological problems arise when the findings of the process of identification and measurement have to be presented in a format suitable for integration into managerial decisionmaking processes. The politi-

Critical Review and Evaluation - Introductory

cal risk analyst often performs a translatory role when presenting information to personnel; while organisational constraints such as those discussed below, influence the effectiveness of attempts to incorporate political risk assessments into managerial processes. Identification, measurement and reliable prediction across cases<sup>2</sup> and countries, have thus been central, practical concerns for political risk analysts.<sup>3</sup> This chapter comprises a thorough, broader in-depth critique and review of past and current approaches to the measurement of political risks, focusing on some of the problems of political risk analysis, and overviewing the most important forecasting methods. Some further conclusions are also presented with regard to the reasons for paradigmatic dissipation, and lack of 'grand theory' within the field of political risk analysis. Chapter four of this paper examines issues of political risk identification, in more detail.

3.1.2. On Qualitative/Quantitative Methods :

		Dimensionality <sup>4</sup>	
		Event	Outcome
Formal	Aggregate Comparative	PSSI BERI, BI WPRF, PRINCE	
	Specific	ASPRO-SPAIR Overholt	Root

Figure 5. Exhibit 3A. Two Facets of Risk : A Taxonomy

The problems and relatively limited utility of political risk analyses are derived to a great extent from quantitative and qualitative methods and models, formal and informal in structure, generalised and particularistic in

scope, which have been developed and used, with varying degrees of success, to identify and measure the complex sets of phenomena known as political risks. Unfortunately, many of the models and methods covered in this paper are proprietary; available information for this study, is limited for obvious reasons, to what could be gleaned from academic and trade journals. The following formal methods and models are reviewed below : ASPRO, BERI, BI, DELPHI, PRINCE, PSSI, SPAIR, WPRF,<sup>5</sup> and political risk forecasting by means of the Scenario Method. In addition and by way of contrast, a number of less formal methods, both qualitative and quantitative, are also reviewed. For the purposes of analysis, measurement models and methodologies have been classified taxonomically, according to degree of formalism,<sup>6</sup> scope; and a distinction has been made between qualitative and quantitative approaches. As is discussed in later chapters,<sup>7</sup> many of the measures omit the dimension of domain - once identified, political risks should be linked directly to the activities of the transnational investor or firm. It is in this respect i.e. with regard to

	Formal Structure	Informal Structure
Quantitative	PSSI BERI, BI WPRF, PRINCE ASPRO-SPAIR	Rummel & Heenan
Qualitative	Root	DELPHI Overholt

Figure 6. Exhibit 3B. Methods Reviewed : A Comparative Taxonomy

## Political Risk Assessment and Evaluation - The Human Factor

specifying exact causal connections, that many of the systems have been found to be most inadequate - in common with Kobrin (1979a), the author of this paper recommends further empirical case study. Possible effects on business, of events constitutive of political risk, can only be gauged after causal linkages have been clarified in detail.

The principles and techniques of political risk analysis are similar to those used by surveyors of military/strategic intelligence.<sup>9</sup> Political risk analysis is about (a) the gathering of relevant intelligence related to the political environment in which the transnational firm operates, (b) analysis of that information through the risk analyst's, or manager's particular conceptual, theoretical and methodological 'lens', and (c) the incorporation of resultant probabilistic judgements into management processes. Intelligence on the socio-political environment in which transnational corporations conduct business, is gathered in a number of different ways. Problematizing the processes and effectiveness of attempts to identify, measure and forecast political risk. First, by way of introducing some of the fiduciary frameworks which problematise judgements made under conditions of stochastic uncertainty: a few words on who does the measuring and some of the uses for political risk forecasts.

### 3.2. Assessment and Evaluation : Human Factors :

#### 3.2.1. Internal Logistics of Measurement :

In a survey of fifty executives, Keegan (1974), found that for individual executives in the domestic environment, external information is sourced mostly from individuals outside the organisation. However, when headquarters executives in international operations acquire external information, it is usually from the organisation's own staff abroad.<sup>9</sup> Findings which have been confirmed by Kobrin et al., (1979b), in their survey discussed below. In the international sphere, service organisations outside the company were almost as impor-

tant as the corporation's own executives as information sources. However, individual sources of information in foreign operations are likely to offer different biases compared to service-organisations assessing the same countries or regions. As interpersonal contact is the most important source of information on organisations' external environments, it seems that additional research would be needed to assess the full import of these findings (Kobrin et al., 1979b:33). As a percentage of all sources within the company, corporate executives abroad accounted for 15 percent, and service-organisations outside the corporation for 14 percent of information, (Keegan, 1978:416). Documentary sources and physical phenomena are cited by Keegan as being of secondary and tertiary importance as sources of information. These factors affect perceptions about political risk, and need to be accounted for when assessments are made internally. In terms of calculating or ascertaining the effects of political events on different aspects of the organisation they are crucial to the delineation of uncertainty. Divisional boundaries, functional specialisation and the executive's level within the corporate hierarchy influence information flows within corporations, and therefore should be taken into account when developing methodologies and strategies for measuring and managing political risk.

Rice and Mahmoud, (1986:19) would agree with this assessment, their recommendation is that political risk forecasting should be completely integrated into the organisation, for optimal results. Where political risk identification and measurement is informal; internal, or company specific analysis exacts a high price tag (Baker & Hashmi, 1988:47), in terms of duplication of personnel and data sources, consulted by different individuals. Keegan found no artificial division of labour in terms of the assimilation of documentary sources of information.<sup>10</sup> The end result being that a narrow range of non-human, information sources is consulted. Storage and retrieval were also found to be manual rather than automated, in most cases. All of these factors influence political risk for the individual firm, and can be accounted for by the analyst using an appropriate model.

3.2.2. Assessing the Environment :

Kobrin et al. (1979b),<sup>11</sup> in one of the best known surveys on political risk personnel, found that specialised assessment and evaluation of the socio-political environment had become a recognised managerial function by the late seventies. Mainly in response to events in Iran during 1978; but also due to what they describe as "...secular changes in political-economic structures." (Kobrin et al. , 1979b:32),<sup>12</sup> which appeared to have broadened the meaning of national security policy in many host countries during the late seventies, to include factors such as individual economic welfare and socio-political inclusivity.<sup>13</sup> Primary goals of the survey, were to find out (a) how multinationals assess non-economic environments; (b) how these assessments are integrated into decision-making; (c) and the impact of the assessments and evaluations on managerial strategy. Based on the analysis of responses to a mailed questionnaire.<sup>14</sup> Their findings were fairly consistent with other research and studies such as that by Keegan detailed above. However, Keegan's study found that on aggregate, external information comes mostly from external sources, while international divisions source most information from within the firm.

In common with these studies, Kobrin et al., found that assessment of non-economic environments tends to be relatively unsophisticated and unstructured. Information is usually supplied by general rather than specialised sources. In addition, evaluation frequently tends to be reactive rather than active, as well as subjective and ethno-centric. As a result of these factors, the authors of the report conclude that assessments and evaluations of the political environment, are difficult to integrate into decision-making processes such as the capital budgeting process, for example. (Although there are noted examples which have succeeded in integrating formalised measurement of political risks into financial planning and management phases - for example Shell

Oil, General Motors and Gulf Oil.)<sup>15</sup> See also Thomas Brewer's (1981:9-11) article on the assessment of political risk and its impact on capital budgeting analysis.

### 3.2.2.1. Company Specificity :

Their survey highlights company specificity as an important aspect of risk identification and measurement, and organisational responses to the measurement function. Demographically, 33% of respondents had sales of under US\$ 750 million; 37% reported sales of US\$750-2 500 million, and 31% sales of over US\$ 2 501 million. Median firms generated 11-25% of sales abroad (i.e. outside of America), had operations in 11-20 countries; and started to expand globally between 1945 and 1965. Two thirds of the firms with international divisions reported organisation by area; 50% of global (that is, respondents who did not report the existence of a dedicated international division) firms reported organisation by product division; while 17% of global, and 10% of firms with international divisions reported a matrix type organisational structure. The significance of these figures with regard to conceptualising a model or abstract schematicisation of business risks, is discussed in more detail in Chapter five of this paper.

Those companies which were found to have institutionalised the assessment function, were also likely to be larger, and more international than those with no institutionalised function. The significance of correlations between sales and routine assessment was at the 0,5 level. Assessment is also more likely to be institutionalised for industrial and mining sectors in particular. 71% of natural resource based companies, against 55% overall. (Kobrin et al., 1979b:35) In terms of organisation, the assessment function was found to lie along a 'continuum', from a single analyst in a corporation's Treasury Department responsible for country assessments for new ventures; to a mid-point of two or three individuals assessing new investments as well as current

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operations; and at the most evolved point of the continuum, they place those corporations with groups of political scientists and panels of country experts responsible for assessing risk.<sup>15</sup> In her paper on the increased importance of political risk analysis since the fall of the Shah; Mariolyn Much has noted, that General Motors regards the function of political risk identification and measurement as important in day-to-day operations, and their approach to political risk analysis reflects this concern, by monitoring and evaluating policy changes and regulatory process concerning local content, as political risk factors. (Much, 1980:69) Stephen Kobrin, John Basek et al., (1979b), hypothesise the existence of a significant correlation between financial or capital intensiveness, and a high degree of institutionalisation of political risk assessment functions. (Refer to Shelagh Heffernan (1986:67), for confirmation of this point in the context of sovereign lending risk.) Further evidence of a need for company specific analyses of political risk. (Refer to Howell, 1983:51; and Robock, 1971 for similar observations.)

Assessment functions were found to be located in planning, legal and international divisions as well as in the treasury department/function (in 60% of cases). Bearing in mind that many of the respondents reporting the existence of a 'group' to assess political risk may only have had one person responsible for the function. Functions thus overlap in some cases. 26% were to be found in corporate economics and 22% in public affairs divisions. Where political or environmental assessment was not institutionalised, top management was most likely to bear responsibility for evaluation. (In 77% of reported cases.) Environmental assessment was found to be utilised systematically for purposes of planning initial investment in 80% of cases, and for strategic planning in 71,1% of cases. 66,8% of respondents reported using systematic environmental analysis as part of reinvestment activities, next in importance were divestment (47,9%), and exchange operations such as repatriation (42,6%), while day-to-day operations accounted for 25,9% of reported utilisa

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tion. (Please refer to Table three, in Kobrin et al., 1979b:37) Attempts to formulate more rigorous approaches to measuring and identifying political risk should take account of these factors. Unfortunately, Kobrin et al., did not attempt to research reactive biases in measurement and identification which may occur due to factors such as the location of non-business environment evaluation functions within the organisation and varying personnel expertise.

### 3.2.2.2. Usage Patterns :

In order to gauge the relative importance of various assessment methodologies discussed in this chapter, it may be useful to review reported usage patterns. Fifty-five percent of respondents to Kobrin et al., reported using a methodological approach; with 19,2% reporting the use of quantitative models; and 46,1% preferred structured-qualitative methods. The most popular of the latter methods were checklists, scenario development, structured qualitative and DELPHI. Checklists were used routinely by 30,1% of respondents. Of the quantitative methods, statistical analysis was marginally more popular ( being used in 13,5% of cases) than investment models (which were used in 10,9% of reported cases). It is significant, given the size of the firms in the sample, that only 55% of respondents reported using a method of any kind. As Kobrin et al., (1979b:44) have concluded, current practice, as reported in the results of their survey, leads to assessments that are subjective, impressionistic and difficult to aggregate across cases in terms of project, country or region. The problem of aggregation across cases is discussed in more depth, in Chapter five of this dissertation.

### 3.3. Measuring Political Risks : a Critical Review :

#### 3.3.1. Introductory Remarks :

In this section of the paper, two questions are discussed : (a) Is there an adequate or 'best'<sup>17</sup> method for measuring political risk ? (b) How do the qualitative approaches differ from the quantitative approaches ? The various methods covered in the debate can be classified conveniently according to degree of structural formalism; whether they are quantitative or qualitative; and scope (generalised or particularistic), for purposes of taxonomic comparative analysis.<sup>18</sup> The section following, below, covers Political Risk Forecasting; aspects of set theory and a critique of the theory of Bayesian Probability Assessments; and Statistical Analysis methods, in more detail. Analysis commences with a brief comparative review and critique of some of the most important methodologies.

Measurement methodologies are likely to be used in the context of four main types of decision : (a) whether to invest, i.e. as the basis for go-no-go decisions; (b) when planning for performance expectations and investment tolerances; and how much to invest, and (c) on deciding the type of investment to be made - given the potential for successful adaptation, or (d) the ability to deploy suitable strategies for the management of political constraints. (Refer to Howell, (1983:47); also the findings of Keegan, (1974); and Kobrin et al., (1979b), above.)

#### 3.3.2. The Delphi Method :

The alternatives to informal in-house assessments based on old-hands, grand tours by senior management, or information from personnel in the field, are those by groups of experts. A method for eliciting and refining group opinion-making developed by Dalkey and Helmer of the Rand Corporation, in 1953; Delphi,<sup>19</sup> is the foundation-stone for most evaluative political risk

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forecasting methods based on the considered opinions of external panels of experts. For example, among others, it has been used as the basis for predictions regarding the occurrence of political events in general (Coplin & O'Leary, 1983); and for predicting events related to specific investments in the oil industry (Gebelein et al., 1978). The basic principle behind Delphi is that under conditions of uncertainty, where exact knowledge is not available, and answers are not 'known' before the application of a questionnaire - 'two heads are better than one'.<sup>20</sup> Conditions of uncertainty which apply to political risk measurement and management.

|| The Delphi procedure is designed (i) to minimise possible biasing effects in decision-making due to dominant individuals, (ii) to eliminate irrelevant communications among members of the group or panel of experts, and (iii) to reduce group pressure towards conformity of opinion. (Dalkey, 1969:15) The procedure has three main elements: anonymous response, iteration and controlled feedback, and statistical group response. || Dalkey has noted that the system is open to abuse or misuse despite the fact that it offers improvements on individual assessments. Dalkey claims that statistical definition of the group response is an effective way of reducing group pressure for conformity, and also ensures representation of all opinions. Anonymity, and the suppression of dominant individuals is assured by means of the application of structured questionnaires, or the use of on-line computer communication. 'Noise' or extraneous communication between members of the group, a common problem where group opinions are expressed, is reduced by means of controlled feedback. These two qualities of the Delphi method reduce bias due to known problems such as individual dominance and noise, without necessarily introducing group consensus. Significant correlations were found between Delphi estimates and degree of reliability of predictions in Dalkey's experiments, carried out at the University of California, between 1968 and 1969. (Dalkey, 1969)

### 3.3.2.1. Reliability and Accuracy :

Reliability in terms of accuracy of predictions and reproducibility<sup>21</sup> are central concerns of decision-makers under conditions of uncertainty. The Delphi method produces group median results which are closer to 'true' - even when misinformation in group responses is accounted for. Dalkey discusses this problem in the context of a continuum with speculation at one end, misinformation at the mid-point and knowledge at the other extreme. Knowledge is equated with group opinion which has been found to be reliable through iteration. However, as is shown below, in this dissertation, while it does assure anonymity, the contents of a questionnaire can be manipulated, (consciously or unconsciously) resulting in apparent observer bias and reactive experimental conditions, even where statistical analysis is used to assess opinions on factual issues such as maximum and minimum temperatures.<sup>22</sup> // Shubik (in Herring, 1983:128), has noted four difficulties with the Delphi system. (a) Questionnaire design, and the specification of the dimensions of the measures, (b) problems of selection and availability of a pool of experts,<sup>23</sup> (c) control and motivation of the experts and (d) interpretation and utilisation of the results. Political risk assessment involves a mix of factual observations and value-judgements. Provided that assessors recognise and accept this fact, and the fact that questionnaire construction can result in biased assessments;<sup>24</sup> the method could be used with a fair degree of confidence when assessing business-government relations. // The main advantages of the Delphi method over conference papers or detailed individual written reports, are the rapidity with which expert group opinions can be obtained and evaluated for incorporation into managerial processes; and a reduction in individual bias. There is also a significant decrease in the amount of individual effort required, when using variations of the Delphi technique to produce forecasts and assessments.

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### 3.3.3. BERI and BI :

#### 3.3.3.1. Comparative Analysis :

Two quantitative methods for the macro-assessment of political risk, based on expert opinion, are Haner's Business Environment Risk Index, (BERI); and Business International's Country Assessment Service, (BI). BERI, assesses and updates reviews on forty-five countries quarterly; while BI surveys seventy-one countries twice per annum. Both risk assessment firms make use of experts located in the United States or the countries surveyed. (Much, 1980) BERI rankings are supplied by a panel of approximately one hundred and five volunteers. BERI Ltd., attempts to encourage a degree of convergence of assessment by maintaining a permanent panel. BERI includes short (approximately 30 page) reports on each country reviewed, but both systems are numbers orientated. BERI panelists rate fifteen factors that affect the general business climate negatively, on a scale of zero to four. Four being superior, and at the other extreme, zero signifying unacceptable conditions. (Baker & Hashmi, 1988:41) These factors include bureaucratic delays, nationalisation, professional services and contractors, quality of local management and partners, long-term credit availability and terms, currency convertibility, labour cost productivity and political stability. (Hill, 1974:15; Kobrin, 1981: 260-261; Simon, 1982:63) The factors are weighted from one (eg. bureaucratic delays), to three (eg. stability) in such a way that the sum of the weighting equals twenty-five; a perfect environment would total one hundred. Factors included in the BI assessments are internal factions, size and influence of the middle-class, and government attitudes toward the private sector.

3.3.3.2. BERI & BI : A Critique :

Both methods have been criticised in the studies referred to above. BERI, although offering a formalised assessment, is not based on an explicit model of the political system as it relates to business - as such - BERI scores are probably only of use in go-no-go decisions, and as warning indicators upon which to base deeper analysis. Kobrin notes that assessments are subjective, and that weighting does not give a true indication of the importance of a factor. For example, attitudes to private investment and local content might be of varying importance depending on industry and sector. Normative bias could result from the private sector backgrounds of panelists. In addition, ratings vary greatly between services; as Mariolyn Much has noted in her report, together with criticism by users.<sup>25</sup> In Much's report, ratings on the top ten countries diverged; Frost and Sullivan rating the U.S., Singapore and Finland as top three; and in the same period, BI rated Singapore, Netherlands and Norway as top three. Users such as Conoco, (Much, 1980; 69) are reported to have a clear preference for the more qualitative company specific assessments. Opinions which are supported by Overholt (1982:47), in his critical review of quantitative methods. (Specifically, his critique of Frost & Sullivan's WPRF.) Incidentally, Haner would agree that BERI should be used in conjunction with other sources. (Hill, 1974:14)

3.3.4. ASPRO-SPAIR :

3.3.4.1. Description :

A particularistic, formalised quantitative assessment system, based on the opinions of a panel of experts (expressed in terms of probability assessments), is ASPRO-SPAIR; used by Shell Oil to assess political risks for oil lease ventures.<sup>26</sup> In terms of potential for establishing congruity between conceptual/theoretical and operational definitions, ASPRO-SPAIR is investment

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specific and assesses two categories of risk which include a range of nine factors known to constitute political risk for the firm. These include civil disorder losses, general war losses, sudden expropriation, creeping expropriation, taxation changes, domestic price controls, production restrictions, oil export restrictions and restrictions on remittances. The two main categories comprise (a) return on investment within the host country, and (b) flow of funds out of the host country. (Emphasis theirs.) Political risk is defined specifically as '...the probability of not maintaining the described contract during a 10-year time span in the face of changing economic and political circumstances.' (Gebelein et al., 1978:726)

The developers of ASPRO-SPAIR attempted to circumvent a number of well known research problems in their method, and claim to have succeeded. The problems include the propensity of individual assessors to set up and solve complex problems in a serial fashion - failing to weigh all factors in the end assessment. By specifying research hypotheses in detail, Gebelein et al., claim to have countered the problem of simplifying rules and heuristics which are often adopted by individuals when making assessments, and which result in opinion adjustments varying little from the expert's starting point. Their method also attempts to strike a balance between observer conservatism on the one hand, and radicalism on the other. Radicalism occurring when a forecasting method places too much faith in a small number of samples. All experts evaluate and assign probabilities to the same complete 'suite' of politico-economic factors. The assessments are weighed and combined by the technique itself, which also standardises reporting procedures. For each scenario presented, the experts are required to respond on the null hypothesis along two dimensions. Confidence is assessed along a range comprising a 90% confidence interval, including weak, moderate and firm. Support for or against a proposition is assessed along a continuum, from strong support to neutral, to strongly refuting. Bayesian probability rules are used to establish revised predictions

based on previous hypotheses and prior probability estimates, over time. The method can be used across countries for a global risk assessment, or simply for a single country assessment.

#### 3.3.4.2. A Favourable Critique :

Although it is possible to level the criticism that ASPRO-SPAIR is little more than a modified Delphi technique, the main advantage of the system compared to BERI and BI, is its versatility, and the high degree of congruity between issues and questions covered, and the activities of the firm. Quality control, and a degree of intersubjectivity are assured in terms of selection procedures by which experts are chosen, and unlike many of the Delphic methodologies, the procedure does not require forced consensus. (Gebelein et al., 1978:727) Of course as in the case of Delphi, hypotheses remain falsifiable in terms of discrete events which may not have been included in the range of probability estimates on which an environmental forecast was based. However, the developers claim to have succeeded in formulating a method capable of aggregating opinions on component events constituent of an overall uncertain event. Widely divergent probability assessments are communicated to panelists prior to reassessment. It seems as if reliability assurance is attainable within a range acceptable to the firm concerned. In terms of wider applications for the average business, the extremely large number of independent variables which influence the existence of political risk for a foreign owned firm, would make the ASPRO-SPAIR system unwieldy and expensive to apply. In terms of domain specificity, the system is one of the more useful models.

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### 3.3.5. WPRF : World Political Risk Forecasts :

#### 3.3.5.1. Description :

Another formal, but generalised measuring and forecasting method based on Delphic principles, is Coplin and O'Leary's WPRF.<sup>27</sup> The output of the WPRF system consists of numbers orientated, sixty page monthly reports on eighty-five countries; containing information on projected regime scenarios for eighteen month, and five year forecasts.<sup>28</sup> Overholt's (1982), critique of WPRF is somewhat biased in that he has not reviewed the qualitative report accompanying the quantitative, probabilistic assessment of Philippine politics. However, some salient remarks include his observation that the PRINCE summary statistic form gives no indication of the type of election procedure which would be followed to arrive at the projected results. From the perspective of a foreign investor, this information could be crucial to understanding and evaluating political risk. The failure to specify how forecasts of projected regime changes are arrived at, is an important fiduciary framework which would have to be accounted for.

More detailed examination of the WPRF method reveals the following about how it operates : An application of the PRINCE approach - Frost and Sullivan's method makes use of a sixty page questionnaire, used by a minimum of three panelists as a guideline to write and review a particular country study. Prior to presenting a synthesis of conclusions on risk ratings to the client, the degree of agreement and disagreement between experts is noted in the report. Coplin and O'Leary make no mention of whether the direction and degree of differences are discussed with the panelists, as is done by Shell Oil when using ASPRO-SPAIR; and also recommended by Dalkey and Helmer in their discussion of the DELPHI method. Human fallibility, and the large number of variables

characteristic of this type of study would indicate a need for communication of this nature. It may be useful at this stage to present and critique an example of the procedures followed by Frost and Sullivan's risk service, when preparing the eighteen month forecast.

An oft quoted example; prospects for regime change in the Philippines would be analysed as follows, using the WPRF method. (Refer to Coplin & O'Leary, and Overholt, above for details.) Guidelines for drawing up the country analysis include sections on background, political turmoil, restrictions on international business, trade policies, and economic policies. Typically, each of these sections includes questions on the degree to which factors under that heading influence regime support, and the likelihood that the regime under study would be in power in eighteen months time from the date of analysis. Three scenarios are then outlined for regime change, the second most likely regime to be in power in eighteen months, and the third most likely alternative. The expert would also be required to write estimates and forecasts of the types and magnitudes of changes expected under that particular heading. Other conditions which could affect change are also covered in the report under each of the analytical headings. For example, forecasts of restrictions on international business includes questions on the likelihood of restrictions on foreign ownership, and possible changes of policy under each of the three scenarios.

Coplin and O'Leary claim that the system has been used successfully by the United States Army Corps of Engineers in forecasting the probability of North and South Korea reaching agreement on outstanding issues, and by the CIA to estimate positions of 52 countries on various issues at a World Administrative Radio Conference. In addition to the valuable narrative type analysis required of experts, the system also requires panelists to complete numbers orientated PRINCE charts (referred to in Overholt's (1982) critique), recording the positions of important individuals, groups and institutions on a particular issue, such as changes in currency repatriation rules under the Marcos regime for ex-

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ample. Actors' positions are estimated according to four categories - orientation, certainty, power, and salience. Where experts differ, consensus is obtained regarding estimates by means of obtaining additional information from panelists who differ. These estimates are used to draw up a decision structure map, which illustrates graphically the position of each actor. Probability calculations for the occurrence of an action are then sought from each panelist.

### 3.3.5.2. An Unfavourable Critique :

The probability of an action's occurrence is defined as :  $\frac{\sum W_{+}}{\sum W_{\pm}}$ , or the sum of positive PRINCE scores (total weight in support of an action), divided by the sum of absolute values (total weight) of each PRINCE score. The resulting probability score, based on relative weights, indicates the probability of an action occurring within eighteen months. Special procedures are followed in the case of neutral scores. Decision structure charts and probability assessments are included for each section of the narrative. For use as indicators, or flags, the analysis also includes a summary score for purposes of cross country comparison. The latter is of dubious value without narratives showing how the scores were arrived at, and are to be taken with a good pinch of salt. Whether weights, as calculated by the system, could be considered reliable bases for probability assessments is also open to debate. Logically, and in terms of fiduciary frameworks, the measurement takes dynamics of change for granted - as Overholt has noted, PRINCE charts on regime change make no provision for indicators of how a particular change will come about - there is a big difference between elections involving violence and those which could be termed democratic. Also missing is a model of the company or investment - the other independent variable which must be accounted for, in any political risk equation. Discrete elements which may not have been accounted for in the narrative due to observer bias are also not provided for in the statistical analysis - sudden discontinuities caused by factors such as

unexpected assassinations could change the entire outlook for a country during the forecast period. (As happened in the Philippines when Benigno Aquino was assassinated.)

### 3.3.6. PSSI : Political Systems Stability Index :

#### 3.3.6.1. A Description :

PSSI, the generalised, quantitative but less formal system<sup>29</sup> proposed by Haendel, West and Meadow (1975), is a political stability measure based on fifteen indirect indicators of system stability and adaptability in sixty-five countries. Based on an extensive analysis and critique of BERI and BI, Haendel et al., concluded that political stability is one of the important variables considered by multinational corporations when assessing levels of risk. A distinction is made between 'soft', panel of expert derived assessments; and 'hard' quantitative data. PSSI is based on what Haendel et al., describe as 'hard' data. Indicators were selected on the basis of possibilities for integration, suitability for time series analysis, and stability of value over cases. Sixty-five countries were selected from the OPIC<sup>30</sup> listing for 1974, and data collected for the period from 1961 to 1966.

The index of political system stability comprises three equally weighted sub-indices. (a) a socio-economic index, (b) governmental index and (c) the societal conflict index. The latter of the three is composed of three minor indices - public unrest index, an internal violence index and an index of coercion potential. Main indices (a) and (b) were weighted equally, while minor indices for coercion potential and internal violence were equally weighted at .4; and the index of public unrest was weighted at .2. In order for indicator scores to be additive, data was standardised by means of Z-scores. Scores were standardised with a mean of zero, and standard deviation of one - component scores representing deviations from the mean of all

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countries for each index. Higher scores indicate greater degrees of stability as it was defined for the project, lower scores indicating greater degrees of relative instability. Comparison is only possible between countries forming part of the sample for the study. One important caveat, and weakness of the system is that it is possible for two different countries and political systems to have the same score. An element of faith is present in that missing data was drawn from the compilers' personal experience, knowledge of the countries and considered evaluation of the scores.

### 3.3.6.2. An Unflattering Critique :

While the authors of the PSSI study claim to have demonstrated the potential for a quantitative measure of political instability, their study has some important lacunae. It covers a limited number of developing countries with a wide diversity of political systems. The index is valid only as an extremely broad assessment, and the authors certainly cannot claim to have succeeded in measuring political risk as it has been defined for most studies within the paradigm. No hypotheses are presented regarding relations between political stability and individual investments, industries or companies. One of the important themes returned to throughout this thesis is the need for company specific data, and hence the need for political risk assessments to proceed from the perspective of a model of the individual company within the political system. Statistical indicators such as those presented by Haendel, Meadow and West are useful only as flags - before they could be incorporated into decision making in a meaningful way it would be necessary to conduct further in-depth study. The possibilities for establishing indices of general import are minimal, due to the large number of variables, and also the wide range of potential responses to assessments of stability. Political instability 'per se', does not constitute political risk.

### 3.4. Forecasting Political Risk :

#### 3.4.1. A Quantitative, Multivariate Technique :

Additional techniques for measuring, identifying, rating and forecasting political risk include scenario forecasting, multivariate statistical methods and probability assessments. Quantitative, multivariate techniques have been used to assess past trends and predict future developments. Rummel and Heenan, (1978) noted the need for an integrative approach to the measurement and forecasting of political risk, and demonstrated a multivariate statistical technique for assessing probable instability. Their study comprised a quantitative evaluation of a number of factors related to political instability over a twenty-five year period from 1950-1975. A projection of renewed instability from 1976 to 1980, and a qualitative analysis based on personal interviews with experts on Indonesia. Once again, while useful as a general indicator of political stability, their study lacks the breadth to be reliable as a base for political risk measurements, but could be the basis for broad decisions on the degree of caution with which to proceed. Oversimplification, superficiality and the normative biases of their system, could result in investment opportunities being neglected by users.

#### 3.4.2. Probability Assessments and Scenario Forecasts :

Probability assessments and scenario based forecasts are the foundation of most methods for the measurement of political risk. Scenario forecasting (regularly incorporating probability assignments), forms the basis for most qualitative approaches to identification and measurement; while probability assignments often express quantified forecasts once qualitative assessments

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have been written. The main advantage of numeric Bayesian probability assessments is the possibility for their graphic representation - enabling assessments to be taken in easily. (Schweitzer, in Heuer, 1978:18) Bayes' rule, upon which most probability assignments are based, is derived from the laws of the intersection of sets, mutually exclusive events, and definitions of conditional probability.<sup>31</sup> Expressed linguistically; updated probabilities for hypotheses are calculated in a recursive fashion starting from the panelists intuitive feeling in favour of the likelihood of a set of mutually exclusive hypotheses  $P(H_1)$ , his assessments  $P(E|H_1)$  being givens.  $H_1$  usually corresponds to outcomes at some intermediate stage of the forecasting procedure, and  $E$  to some final outcome which can be readily observed.

### 3.4.2.1. A Brief Critique :

Simplistically, at the cognitive level of analysis, it is possible to suggest that Bayesian logic links cause with effect, although of course, as McCord & Moroney have noted - 'reality' would scorn that proposition. In many cases the only link is purely intuitive. Another caveat, regarding the logic of problem statements for which Bayesian logic is used in an attempt to find solutions, has been noted by McCord and Moroney, (1965:55). Namely, higher levels of aggregation, and greater degrees of certainty regarding specifications are sometimes required in order to avoid absurdities which result from not being able to calculate intermediate probabilities,  $H_1$  based on original problem statements. Panelists thus face the problem of ascertaining the availability of necessary and sufficient information, when assigning equal probabilities to intermediate events. (McCord and Moroney, 1965) Laplace (quoted in Valsamakis et al., (1992:31) has noted that probability assessments are really little more than common-sense reduced to calculation - a representation of what the reasonable mind feels regarding future events.<sup>32</sup>

## Probability Assessments and Scenario Forecasts

The method has been demonstrated by Schweitzer in his article on Bayesian analysis of the Middle East conflict, as well as in discussions above. (Refer to Heuer, 1978) Qualitatively based judgements often require weighting in terms of confidence levels - for an example of how this has been applied, see the discussion of ASPRO-SPAIR, above. Other approaches to resolving uncertainty of set composition, and hedging against propagation of events, have been explored by possibility theorists, but space limitations preclude any coverage of fuzzy set theory in this paper. It should also be noted, that panelists are required to make intuitive judgements, thereby introducing the element of faith into quantitative analyses. Companies resolve this problem by choosing experts carefully, nevertheless, this is an important fiduciary framework which influences projections. Another problem with the method, concerns zero probabilities, which are both analytically and mathematically unacceptable - once a probability has been assessed at zero, no other evidence can revive it during future iterations. Probabilities may thus have to be forced in certain circumstances, if calculations are to be consistent with mathematical rules. Regarding the human factor, it is also possible for individual analysts to assess probabilities according to demand characteristics, or hidden personal agendas. If consistent, these trends can usually be identified and dealt with when trend lines for individual panelists are assessed. To sum up, although useful as handy representations of intuitive feelings regarding outcomes, and for their manipulative qualities; one should perhaps term probability assessments of political risk, pseudo-quantitative analyses.

### 3.5. Scenario Forecasting :

#### 3.5.1. Introductory :

Nowhere near sibylline nor even prophetic; scenario forecasting is a complex method for formulating and expressing qualitative judgements about future events, and is the cornerstone for many of the Delphic methodologies described in previous discussion, above. According to William Overholt (1982), there are

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four criteria for good scenarios : '...they must be clearly rooted in history and in the evolution of present relationships; ...be sufficiently detailed and integrated to analyse the major forces and their interactions, while remaining sufficiently clear and abstract to provide an unobstructed focus on major issues;...be sufficiently numerous to cover all the basic options, but sufficiently few to be intellectually manageable;...they must be informed by sufficiently detailed knowledge and sufficiently pragmatic intelligence to avoid standard ideological reactions to situations.' (Overholt, in Brewer, 1985:155)

The first phase of scenario analysis involves historical analysis of trends, and present configurations. The second phase includes an expansion of options for the future; which are then reduced in the third phase to a selection of central possibilities. The final phase involves identifying possible surprises which may have been missed in the previous phases due to conservatism, or radicalism of approach on the part of the analyst.

### 3.5.1.1. Advantages :

Scenarios are abidingly arbitrary, the selection of directions for viewing the future is as reliable as the imagination and intuition of panelists. It follows from this that scenarios should be linked closely to the activities, goals and strategies of the firm. Therefore, they also tend to have strong normative biases. Nevertheless, the inherently untidy process of scenario building can help to reduce uncertainty about future developments to the irreducible level required by definitions of political risk. Scenarios are about possible outcomes, and identifying these outcomes is therefore the central theme of any attempt at scenario building. Details of hypotheses on the type of conditions which could result in each outcome are filled in by means of research, and methodologies appropriate to the particular interest being considered. The main advantage of scenario forecasting is that it enables decision makers and analysts to move away from a 'seat of the pants approach' to a more disciplined analysis. Scenarios involve a good deal of creative thought - but then normal business activities involve creativity.<sup>33</sup>

3.6. Concluding Remarks :

Measuring political risk involves issues of identification as well as definition. A central debate about measurement concerns the merits of qualitative versus quantitative measures. This chapter contains a survey of methods and models for measurement, some based on a mix of qualitative and quantitative; and others based on the purely descriptive analysis of statistics. One multivariate statistical model which claims to predict is that of Rummel and Heenan (discussed above), although their study is too narrow to constitute a measurement of political risk. Both quantitative and qualitative techniques are constructed on fiduciary frameworks, which should be accounted for in analyses which attempt to measure risk. Apart from Shell Oil's ASPRO-SPAIR method, none of the methods has a formal structured model of the firm, or investment as dependent variable. Methods for measurement differ in scope and domain. Measurements based on indices discussed above, can be regarded as too broad in scope, others, such as ASPRO-SPAIR are too narrow in regard to domain, to be of use in wider applications.

Attempts to measure political risk have concentrated on the first dimension of risk, viz. the probability of occurrence. In addition, adoption of the macro-micro risk categories of aggregation derived from Robock's (1971) analysis has led to various attempts to establish comparative cross-country measures. (for example PSSI, BERI, BI, all discussed in detail above.) The result has been a shift of emphasis away from the individual firm. Forecasting has been the major preoccupation of analysts, to the detriment of the second

## Methodologies for Assessing Political Risks; A Critical Review

dimension of risk - namely establishing and measuring managerial contingencies related to the forecast events. The second dimension of risk has been neglected in most of the articles and works researched for this dissertation.

Brewer, (1981:9) and Micallef, (1981:50) have attempted to develop methods for measuring the impact of political risk events on the firm, from a financial accounting perspective. Brewer's model measures the effect of political risk on the firm in terms of the capital budgeting process. He asserts that political risk can be accounted for in terms of net present value (NPV), by calculating differences between net present value and terminal value via discounted expectations, or by a certainty equivalent method. (Based on standard formulae for the calculation of NPV and TV.) Similarly, Micallef has suggested the imposition of hurdle rates on the expected rate of return on the investment (ROI). He quotes EXXON's measurement strategy as an example of the application of this method. "...if EXXON detects the possibility of a radical change in government or tax planning, the company may add 1 to 5 percent to its required return on investment."

However, in terms of broader definitions of political risk, where effects may be less tangible and more difficult to express in terms of the financial planning process - their efforts have limited application. Obviously, different strategies are required for measuring the effects of political risks such as affirmative action or management indigenisation for example. It may be, that integrating measurement of both the first and second dimensions of risk would involve a combination of methods from the social and economic sciences. Not enough is known about these aspects of political risk, and clearly further research is required.

The following chapter covers issues of identification in more detail - continuing to offer support for the assertion that analyses of risk should start with models of the company as it relates to the socio-political environment.

3.7. Key Terms for Review :

DELPHI	Scenario Forecasting
BERI	BI
ASPRO-SPAIR	WPRF
WPRF	PSSI
PRINCE	Bayes' Theorem

3.8. Chapter Three : End Notes :

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1. In the absence of a model of the investment, Rummel & Heenan's analysis of political stability in Indonesia, measures prior to identification. Similarly, Coplin & O'Leary's discussion of Frost & Sullivan's 'Prince' reveals that this method does not express explicit links to a particular business. In addition, as Rummel and Addleman's article shows, the identification of political risk phenomena also depends on whether statistical methods used are internally descriptive or predictive. (Rummel & Addleman, 1976:34)

2. At the industry, sector and project levels of analysis.

3. It is unlikely that the equivalent of a 'crystal ball' will ever be invented by political risk analysts.

4. Refer to Chapter one for a detailed discussion of the two dimensions of political risk.

5. Glossary of acronyms :.....

- ASPRO = Assigned Probabilities
- BERI = Business Environment Risk Index
- BI = Business International's Country Assessment Service
- DELPHI = Panel of experts forecasting & assessment, Rand Corporation
- PRINCE = Frost & Sullivan
- PSSI = Political Systems Stability Index
- SPAIR = Subjective Probabilities Assigned to Investment Risk
- WPRF = World Political Risk Forecasts, Frost & Sullivan

6. Formalism is used here to mean degree of formal structure.

7. Please refer to the detailed discussions in chapters four and five.

8. For an overview of the CIA experience with regard to quantitative analytical techniques of intelligence gathering and assessment, see Heuer (jr.), 1978.

9. As a percentage of all information sources, those human sources inside the organisation were cited as being responsible for 24 percent of information acquired by executives. As a percentage of human sources, internal sources accounted for 35 percent of information. Outside the organisation, human sources accounted for 43 percent of acquired information, and human sources for 65 percent of information acquired. (Keegan, 1974: 415)

10. Most frequently consulted publications were the **Wall Street Journal**, and **New York Times**, as well as information services to a lesser extent. Scientific and academic journals were consulted mostly by financial executives.

Chapter Three : End Notes

11. Refer to : Kobrin, Basek, Blank & La Palombara, (1979b).
12. Their sample consisted of 455 companies, each with 1976 sales of at least \$100 million, and operations in two or more countries. Interviewing from a stratified sample of 113 respondents in 37 firms followed up the mailed survey.
13. The survey authors base this statement on research carried out by Nye, on multinational corporations and world politics.
14. Sample N = 455  
Responses = 42.2% usable  
Interviews = 133
15. See Gebelein et al., (1978); Much, (1980); and Kraar, (1980) for details.
16. Examples of the latter include : TEXACO, and Bankers Trust Corporation. (Grosse & Kujawa, 1992:434)
17. In this case 'best' would be a method capable of measuring possible occurrences about which subjective uncertainties exist, and probable effects on the organisation or firm.
18. Please refer to Exhibit 3B, above.
19. Refer to fn. 4 above, for glossary.
20. The procedure is used extensively by the United States Air Force, and Transnational Corporations when formulating strategic forecasts. Dalkey noted at least one hundred different applications for the system in 1969.
21. i.e. consistency and coherence as discussed in Chapter one.

22. For example, a question may elicit negative figures which were not planned for in the experimental design. Such as questions about the lowest temperature recorded in a tropical climate.

23. Problems of selection and anonymity are also discussed by Coplin & O'Leary, (1983).

24. In terms of omission, underlying theoretical constructs, and the accuracy of individual observations, as well as statistical end-results.

25. For example, predictions of revolution do not indicate the importance of the event for a particular firm. In 1975, Gulf Oil was able to maintain oil exploration operations in Angola when the Marxist MPLA siezed power - Cuban soldiers even provided protection for Gulf's drilling rigs. (Much, 1980)

26. (For a detailed discussion, see Gebelein et al., 1978)

27. Refer to fn. 4.

28. (see Coplin & O'Leary, in Raddock & Albinski eds., 1983; Much, 1980, and Overholt, 1982; for additional details and critique.)

29. Degree of formality is determined for this study by the criterion of a model which specifies relationships between the political system and the business.

30. Overseas Private Investment Corporation.

31. Bayes' Rule :

$$P(H_1|E) = \frac{P(H_1) \times P(E|H_1)}{\sum_{i=1}^n [P(H_i) \times P(E|H_i)]}$$

Where : E is an event or item of intelligence  
H is an hypothesis, or hypothesised cause of events  
 $H_i$  is one of a set of mutually exclusive hypotheses  
 $P(H_i)$  is the prior probability of a hypothesis  
 $P(E|H_i)$  is the probability of an event occurring  
given the prior probability of  $H_i$   
 $P(H_i|E)$  is the revised probability of  $H_i$  given  
that event E has already occurred

(See Bayes, 1958; and Heuer, 1978:26-27 for additional details.)

32. In the context of this paper, Laplace would have been referring to what has been defined as objective uncertainty in Chapter one.

33. Refer to Shubik, in Herring, 1983; for a discussion of game theoretic scenario building. Game theoretic approaches are too abstract to be of anything other than metaphorical value, or as highly stylised representations of reality.

#### 4. Chapter Four : Identification of Political Risk :

##### 4.1. Identification - Introductory :

Identification is a central concern when political risk analysts attempt to answer the question : 'What does that country's politics mean for this company's operations ?' (Kobrin, 1981-2:25)<sup>1</sup> In chapters two and three of this dissertation, it was pointed out that issues of measurement and definition are inseparable from the problem of identification. In Chapter one, political risk was defined for the purposes of this dissertation as '...objective uncertainty about future socio-political developments and outcomes as related to the profitability, business interests, norms, values, procedures, structures and other goals of the firm.'; and in Chapter two, for analytical and comparative purposes some of the more common definitions were discussed and classified into a taxonomy<sup>2</sup> (using categories which are not necessarily mutually exclusive). In Chapter three, a critical survey of methods for measurement concluded that few, if any of the methods for measurement have succeeded in terms of explanatory and predictive power with respect to the two facets of risk.<sup>3</sup> Similarly, a main theme of this chapter on identificatory issues, is that for political risk to be identified, the analyst must establish plausible connections between the type and probability of occurrence and expected effects on the firm. A task which offers considerable challenges, even to the most capable of 'old hands'.

Fiduciary frameworks alluded to in the previous chapter pervade models and methods, influencing the taxonomical composition of political risk. For example, during the late 'sixties and early 'seventies, environmental trends toward economic nationalism spurred a host of studies in which political risk is defined and identified in terms of one aspect of political risk, namely ex-

## Incongruities and Inconsistency of Definition

propriation. Empirical research on the phenomenon is often temporally and methodologically restricted.<sup>4</sup> Dramatic socio-political events such as the revolution in Iran also stimulated a host of studies which explained political risk in terms of sudden discontinuities in the socio-political environment. Methodological restrictions are evident in the work of Rummel and Heenan (1978), which claims to identify trends toward political instability - yet fails to include the firm as an intervening variable. Analysis of the extensive literature on the subject,<sup>5</sup> highlights incongruities and idiosyncrasies of definition, measurement and identification. Paradigmatic dissipation and a relatively unsuccessful search of the wasteland for a golden grail of grand-theory, have been the result.

As Kobrin contends, the problem is conceptual rather than operational. 'We need better definitions of the phenomena, a conceptual structure relating politics to the firm, and a great deal of information about the political environment.' (Kobrin, 1979:77) However, establishing congruity between conceptual/theoretical and operational definitions of political risk, requires precise identification of the various conceptual components of the phenomenon. This chapter reviews critically, relevant literature on the subject and discusses issues of identification, in more detail.

### 4.1.1. Incongruities and Inconsistencies :

It is possible to identify twin trends in the way political risk has been identified :

- (a) 'Predictively' and focusing on socio-political process, by means of analysis based on theories derived from the works of writers on comparative politics.

These approaches concentrate on events and their probable occurrence, and generally represent only half of the equation. They are mostly descriptive attempts at prediction in that they offer no explicit explanations of causal linkages between firm and polity.

(b) With regard to possible effects on the profitability, goals and strategies of multinational corporations.

The 'predictive' approaches differ widely in the degree of sophistication and formalism of structure in their analyses of political processes. The latter tend to show 'lacunae' due to the widely acknowledged dearth of empirical research on the effects of political risk and perceptions of political risk on decision making, profitability, goals and strategies of firms. Both groups of approaches are of limited practical applicability; often being little more than the broadest of indicators of the need for an integrative schematic conception of the transnational firm as it relates to the political environment. In addition, hypothesised relationships between dependent and independent variables are often based on fiduciary frameworks received from comparative politicians.

#### 4.2. Radical Change and Instability : Introduction :

One thread in the fabric of political risk analysis, identifies risk rather narrowly with the probability of radical change and instability occurring in the host country.<sup>6</sup> The focus of these studies is on political trends and their prediction, rather than on political risk 'per se'.

##### 4.2.1. Change and Instability :

Writers whose research equates political risk with the phenomena of change and instability are : Brewer, (1983); Fatehi-Sadeh and Safizadeh, (1989); Green (1974); Haendel, et al., (1983); Kobrin, (1982); Rummel & Heenan,

## Change and Instability

(1978); Shreeve, (1984). Measuring instability is a complex task, in some cases involving analysis of data on hundreds of variables. (Rummel & Heenan, 1978:72) Possibilities for comparative cross country analysis are complicated by difficulties in ascertaining the type of instability likely to affect business during the forecasting period. Rummel & Heenan, in their predictive analysis of instability in Indonesia, (1978:73) identified political instability with internal turmoil and rebellious conflict. The first component (political turmoil), is composed of measures of observations of protest demonstrations, riots, politically related deaths, and attempts at regime change. The latter comprises data on rebellions, government sanctions against insurgents and rival political groups, violent armed attacks attributed to social and political groups, and insurgent attacks on government troops. The difficulties of identifying these factors with political risk are fairly obvious - riots may be general or targeted and may not affect all business equally. Particular firms will be affected differently by events - for example, during Japanese Prime Minister Tanaka's visit to Jakarta, anti-Japanese rioters targeted Chinese owned businesses, causing extensive damage to property.<sup>7</sup>

### 4.2.1.1. Connotations of Change :

In addition to problems related to company specificity; political risk arising from political instability in one country may not be political risk in another. In other words "...political instability has different connotations in different socio-cultural frameworks." (Prakash-Sethi & Luther, 1986: 58) Identifying, defining and measuring political risk in terms of instability thus involves overcoming locational specificity in terms of country (nationally and sub-nationally), (Overholt, 1982) as well as problems of establishing company or investment specificity. Schöllhammer and Nigh (1978a) have discussed the importance of location specificity in identifying political risk, and have identified relations between home, host and third countries as being significant determinants of German foreign direct investment.<sup>8</sup> Sector of

activity and investment structure have been identified by Schmidt (1986) as additional factors to be taken into account. It is important to note that causality may also be external, implying the necessity for analysis of external environments in order to ascertain causal relationships at the national level and make predictions regarding change and instability. At the conceptual level, political instability has been defined differently by various writers on the subject.

Using the pluralist theoretical models developed by Dahl and Harrison, in conjunction with models of exchange control limitations from the discipline of political economy, Brewer (1983) found a 'Positive but weak relationship between investment policy instability and other indicators of political instability.' (Brewer, 1983:147) The study of 115 developed and developing countries focused on personnel change, factional change and systemic change, but excluded riots and external war. However, the weak correlations described in the study appear to indicate the need for a redefinition of instability if it is to be identified with political risk. Change and instability may result in a range of policy adaptations from increased controls to increased liberalisation. None of which necessarily constitute political risk unless considered empirically at the operational level of analysis, in relation to the firm. A UNCTC study on policy liberalisation as a factor in foreign direct investment found that GNP, or GNP change explained the largest amount of variance in investment flows - no significant evidence was found that any of seven policy change variables were significant (UNCTC, 1991). The study concludes that '... government policies seem to have only a weak and scattered effect.' (UNCTC, 1991:55) There is a clear need for additional empirical study to ascertain whether exchange controls, or the relaxation of policies can indeed be correlated with investment flows, and therefore be identified with political risk. Schneider & Frey (1985), tested the hypothesis that political instability has negative effects on investment flows, controlling for economic conditions, and concluded that political and economic factors influence investment flows. They have noted that '... an amalgamation of economic and

## Change and Instability

political influences into a single credit risk indicator is not advisable because it is not able to do justice to the complexity of politico-economic interdependence. (Schneider & Frey, 1985:173) As Brewer concludes "... we might do well to think less in terms of political risk and more in terms of the political economy of risk." (Brewer, 1983:154)<sup>2</sup>

In their study to assess associations between political instability and flows of foreign direct investment in 15 countries, Fatehi-Sedeh and Safizadeh (1989a), utilised lagged multiple regression analysis. United States manufacturing foreign direct investment was the dependent variable and frequencies of sociopolitical stability served as independent variables. They defined political risk as "...negative perceptions emanating from internal instability, intergovernmental relationships, anticipated or unanticipated government actions, or government discontinuities all brought about by social, economic, or political imperatives existing in a country's internal or relevant external environment." (Fatehi-Sadeh & Safizadeh, 1989a: 10) Their study highlights problems arising from identifying political risk with instability. Delays due to lags in the investment planning process mean that instability has to be viewed over time - historically and predictively. A temporal constraint which would have to be taken into account in establishing the relationship between instability and political risk. In addition, they found that studies of political stability should be industry and company specific due to difficulties associated with making associations across cases and countries. Similar findings were reported by Schöllhammer and Nigh, who found that "...German multinationals seem to react with great sensitivity and with speed to changes in the economic sphere while it takes them longer to react to changes in the political situation within the host countries as well as to political changes between Germany and the host countries." (Schöllhammer & Nigh, 1984:28) Identifying political risk in terms of political instability depends on establishing interdependencies between investment flows and economic developments, as well as the relationships between economic conditions and political developments in host countries.<sup>13</sup>

Haendel et al., identify political risk with political system instability. Their proposal<sup>11</sup> is for the formation of a political system stability index composed of three main sub-indices : a socio-economic characteristics index, a societal conflict index and governmental processes index. Intended to be a broad measure of system stability; stability defined as '... its ability to cope with new demands made on it to move to a new functioning equilibrium.' (Haendel et al., 1975:62), the developers have suggested that PSSI be used in conjunction with a xenophobia measure, a socialist trend measure,<sup>12</sup> a nationalism measure, and other measures (unspecified) at the individual country level of analysis. They recognise the importance of the regional and global levels of analysis, and have proposed what they consider to be appropriate measures. One problem in using their definition and the associated method, is that measurement is purely descriptive, while the use of indices tells the analyst little about direct relationships between polity and firm.<sup>13</sup>

Assessing and measuring instability and the locus of risk attached to it has proved to be difficult. Agarwal (1980) has presented a comprehensive review of attempts to link flows of foreign direct investment to political instability, and concluded that the association is tenuous. For example, a thorough study of investment flows to the ASEAN group of nations showed no correlation. (Agarwal, 1980:761) The analyst should also be careful to take account of the implicit normative associations of political instability with negative impacts on the firm or investment. As has been noted above, change can be seen to offer threats as well as opportunities for transnational corporations : '... the relative impact of political events on foreign direct investments is conditioned not only by risk preference of individual decision makers, but also by corporate resource capabilities and the complex international political relationships between countries.' (Schmidt, 1986: 35)

4.2.2. Change and Instability : Concluding Remarks :

The phenomena associated with political risk appear to require more complex definitions, and more specific identification : '... to compile a comprehensive estimate of political risk for a particular investment, the political risk analyst should incorporate estimates of risk from wherever they originate in the environment.' (Haendel, Meadow & West, 1975:75)<sup>14</sup> Change and instability do not necessarily constitute political risk, although they should be considered to be an important aspect of political risk when modelling the individual investment for the purposes of political risk analysis. The real link between political instability and foreign direct investment flows may be at the preliminary go-no-go stage, which tends to be impressionistic and un-systematic. (Refer to surveys by Keegan and Kobrin et al., quoted in chapter three, above.) Clearly, a distinction must be made between instability in the form of comparatively rare cases of revolutionary social change, and those which define it as changes in policy which affect foreign firms. However, establishing correlations between foreign direct investment flows and political instability, and by association with political risk, remains a matter for further investigation. Bennett and Green (1972), in a study to assess political instability as a determinant of foreign investment found that '...political instability did not affect the overall allocation of U.S. foreign direct investment throughout the world. International managers appear to have allocated their investments according to other overriding factors.' (Bennett & Green, 1972:185) Seemingly indicating the primacy of other factors. Citing the United States as example, Brewer has noted that '...there can be many forms of stability/instability for a given government policy of interest. Analyses of instability should therefore be specific about the element of the political environment that is unstable, the specific form of instability, and of course the implications of the instability for a firm's interests.' (Brewer, 1985:339)

### 4.2.3. Expropriation and Economic Nationalism :

Another narrow phenomenological definition identifies political risk with expropriation and the dynamics of economic nationalism. Analysts who have followed this research direction, include : Boddewyn and Cracco, (1972); Bradley, (1977); Radetzki (1982); and Buckley, (1987).

#### 4.2.3.1. Aspects of Expropriation and Nationalism :

Writing in favour of the development of approaches capable of detecting the more subtle nuances of risk, Boddewyn and Cracco have stated that the problem is : 'To perceive beyond the extreme and exceptional case of revolutionary change in government ideology, whether the government will move towards more or less nationalist policies.' (Boddewyn & Cracco, 1972:45). Identifying political risk with nationalism, creeping nationalism and expropriation implies negative normative, and perhaps even ethno-centric orientations on the part of the analyst. Frameworks for identifying political risk would have to take account of these factors which are not necessarily inconsistent with political risk as defined in this thesis. Cases of outright expropriation expected, adaptive strategies can alter actual risk for companies which are 'locked in'. The use of confrontational or co-operative strategies often determines risk for transnational corporations facing economic nationalism. (van Agtmael, 1976:29) If political risk is to be defined as nationalism, the risks to companies from nationalism should be viewed from the perspective of the individual firm or investment, or at a more general level of analysis, using a model of the firm and its risks. The focus should be on identifying and measuring uncertainties about the probability of policy changes in the direction of economic nationalism.

In line with the argument presented in this chapter, and on a firm-centric note, Bradley has recommended the inclusion of what he calls non-political factors in the analysis of expropriations. He has suggested that expropriations can be influenced by regional politics on a 'copy cat' basis; by individual industry; by a firm's individual characteristics, including composition of ownership, technology barriers and vertical integration; and size of assets. (Bradley, 1977) van Agtmael's findings corroborate Bradley with regard to technology and industry - oil and mining industries are the most sensitive, followed by retail and agriculture, special finance and high-technology. (van Agtmael, 1976: 29)<sup>15</sup> These findings would appear to have been confirmed by Susan Strange (1992) and Candice Stevens (1990). Strange has noted the structural changes which have altered balances of power and bargaining options in the relations between states and firms. Stevens has noted that multinationals may actually be aiding countries in strategies of technonationalism, while pursuing technoglobal strategies. Concessions which may be offered to governments in the adaptive process include : hiring national managers; raising transfer prices from the locally based firm to other parts of the multinational or group; accepting local partners; changing expatriate management; investing more capital; contributing to political campaigns; releasing the host government from concessionary agreements; supporting government programmes; suspending payment of dividends; surrendering majority control; removing all home country personnel; and reorganising to give greater benefit to the local community. (Buckley, 1987: 81)<sup>16</sup>

#### 4.2.3.2. Concluding Remarks : Economic Nationalism and Expropriation :

Nationalisation and expropriation are one aspect of political risk. Recent studies have identified trends which appear to indicate a decrease in the likelihood of nationalisation and expropriation compared to the high levels

pertaining during the late sixties and early seventies ( Chaudhuri, 1988). Most of the studies discussed above agree that nationalisation can be mitigated by the adoption of what could be termed co-operative strategies towards host countries. Expropriation and nationalism are another factor to be reckoned with in analyses of political risk. However, as with instability - individual characteristics of companies should be considered as central to any estimate regarding political risk; as should international factors at regional and global levels of analysis.

#### 4.2.4. Taxonomies of Events :

##### 4.2.4.1. Introductory :

Yet a third group of political risk analysts has identified political risk with taxonomies of politically related events. Writing in 1976, prior to the Iranian débacle, van Agtmael has identified risk in terms of types of risk to which types of business operations are exposed to in varying degrees. His typology of political risk includes (a) political instability, (b) nationalisation and creeping nationalisation, and (c) external political change (van Agtmael, 1976:28) On the operational side of the equation, van Agtmael considers selling, lending and investing as broad categories of business activity affected by political risk. In common with approaches discussed below, van Agtmael's definition recognises the importance of analysing risk from the perspective of the individual firm and its activities. '...before starting to analyse political risk itself, it is useful to first define what the risk exposure of one's particular business operation is.' (van Agtmael, 1976:29) While his approach represents a major improvement on index based approaches such as BERI, BI or PSSI, it remains too narrow for wider applications.

Rejecting models of political instability, Prakash-Sethi and Luther have argued for a '...more encompassing identification of the types of risk that are generated by events that have political dimensions.' (1986:60) However, to accomplish this would imply deeper analysis of the underlying socio-political and politico-economic trends to which events can be attributed. Increasing the level of analytical sophistication required for political risk identification and measurement. Bunn & Mustafaoglu's (1978) methodologically orientated quantitative analysis of political risk includes a number of factors which they have identified as being major influences on particular events. However, they do not attempt to describe underlying causality. Their probability assessments are based on expert opinion using a cascaded inference technique which decomposes the task of assessing probabilities into components of conditional probabilities, the latter of which focus on factors upon which events have been found to have been conditional.<sup>17</sup>

The generalised nature of Bunn & Mustafaoglu's suggested approach reduces its utility to identify risk for a particular company. For example, civil disorder (the event to be explained and predicted) includes : acts of internal strife, and is based on contributory factors including strength of the economy, aspiration levels, continuity in leadership, socio-economic repression, political suppression, national coherence, regime legitimacy, government corruption, external support of resistance or liberation movements, hostility towards the home country, and visibility of foreigners.<sup>18</sup> Yet their system makes no provision for the inclusion of relevant data on the company or investment for which the assessment is being conducted. Mathematically, it would be relatively simple to provide subjectively for company characteristics in the beta function. However, problems would arise in gathering empirical data upon which to base expert probability assignments or weights regarding the contributory effect on the company in combination with an event, as a factor in the identification of political risk. The wide range of events and contributory factors covered in their analysis means that the identification of

political risk based on their method would be founded on the opinions of a group of experts - and in fact one of the motivating factors for their study was to overcome a weakness of the DELPHI approach, by accounting statistically for contributory factors leading to probability forecasts of events. While Bunn and Mustafaoglu are correct in their use of statistical analysis - the extremely large number of variables and correlations involved in comprehensive analyses of political risk would make qualitative analyses cumbersome and unmanageable - data identification and collection will remain a major problem in political risk identification. (Rice & Mahmoud, 1986:15)

David Raddock (1986), has argued a convincing case for the qualitative analysis of domestic politics in host countries. His model for the identification of political risk includes analyses of leadership succession, crises of legitimacy, frustrated social mobility, disaffection of the middle classes and professionals, historical propensities towards expropriatory or nationalistic policies, corruption, demographic patterns, labour agitation and worker participation in management, cultural/regional and traditional/modern differences, civil disorder, violence and terrorism, military unrest, external territorial disputes, elites and their relative influence, nationalism and national goals, reform versus retrenchment, adaptations to social revolution, and a political-cultural dimension which includes relations between home country and host country, constraints against upheavals and images of the world. His argument includes examples of how these events have affected particular companies, however, each of these factors may or may not have a bearing on what constitutes political risk for a particular firm. Forecasting by means of this method, or taxonomy would require a large number of experts, and would inevitably include many items taken on faith, due to the selection of frameworks for the analysis of the political system and the associated qualitative analyses.

The significance attached to each of these dimensions of the political system depends on adaptational strategies available to the firm, and measurement methods and theories of comparative politics used by the political risk analyst in establishing correlations and forecasts. Additional weaknesses occur in attempting to assess the external or international dimension of the equation. Raddock's conception of politics as related to the company, is too limited to ascertain the effects of external events on domestic politics, the firm may have international dimensions and structuring which influence its conception of risk, and strategies for the management of political conditions. The international dimension of political risk includes relations between firms as well as home and host countries among themselves and third parties. Although useful as a taxonomic organiser when analysing domestic politics, Raddock's model is inadequate for identifying all relevant aspects of political risk. A model of the firm or investment is essential in determining whether international dimensions should be included in the analysis, and the relative importance of domestic elements to the firm.

Two writers who have attempted to formulate taxonomies of political risk are Pike (1980), and Simon (1982). Pike's approach identifies the investment climate in terms of economic and commercial variables and socio-political variables. He does not theorise about the links between economic and socio-political climates, but notes that economic instability can lead to pressures for policy changes with regard to exchange controls, local equity participation, restrictions on local borrowing, and access limitations. Two categories are proposed for each of the main headings - specific and general. Specific socio-political factors include political stability, attitudes towards foreign investment, expropriation, relations between host and home country, and government incentives and guarantees for foreign investors. More general factors influencing investment climates are culture and language, security and

contractual relations, the judicial system, communications and accounting and legal requirements. Simon's (1982) taxonomy recognises the need to distinguish between external and internal factors. Following Robock's (1971) classification of risks into macro risks and micro risks (i.e. those that affect all companies, and those that affect only certain firms), Simon's framework includes societal and governmental related events at each level of analysis. He identifies risk as "...governmental or societal actions and policies, originating either within or outside the host country, and negatively affecting either a select group of, or the majority of foreign business operations and investments." (Simon, 1982:68) Identifying and forecasting political risk according to Simon's taxonomy would involve an elaborate early warning system for inclusion of political factors into the decision making process by means of probability assessments. (Simon, 1982:69)

#### 4.2.4.2. Critique of Taxonomic Approaches :

The taxonomic approaches to identifying political risk discussed above, based on known cases of political risk, are useful in providing basic check-lists for use by the analyst. However, they generally fall short in explaining relationships between the political environment and the firm and thus offer little more than plausible explanations for aspects of political risk. This has led to a level of analysis problem, evident in the approaches which consider only factors relevant to the internal politics of the host country. Some writers have attempted to circumvent these problems by proposing internal and external dimensions, and providing relevant typologies. However, not all risks apply to all companies equally, the solution adopted by many writers is that proposed by Robock in 1971. His analytical distinction between micro and macro risk pervades the writings on political risk. This dissertation rejects his approach on the grounds that analyses should start with a model of the firm. If this approach is adopted, micro risk includes macro factors - rendering the analysis of what are considered macro factors irrelevant - except as

broad analytic categories for use in identifying directions for research. Relations between economic and socio-political systems are left to the imagination by most of the writers reviewed above. The latter suggesting possible directions for future research in the field of political risk analysis. The next section of this chapter overviews some approaches which have been based on models of the firm before concluding the overview of political risk identification.

#### 4.3. Firm-Centric Models :

A few writers identify political risk in terms of typological models of the firm, and broad categories of business risk - some analyses being more sophisticated in terms of overall structure. Schmidt (1986) argues in favour of definitions which enable the phenomenon to be identified beyond conventional taxonomies. Moving towards an inclusive conception, capable of taking into account company characteristics, he argues that the analyst should consider the firm, who owns it, what technology it uses, and within what economic sector the firm operates. Similar to Root's taxonomy - discussed in Chapter one of this dissertation - Schmidt's typology of risk includes transfer risk, operational risk and ownership risk. He identifies relations between dependent and independent variables in terms of potential consequences arising from policy constraints - consequences which include opportunity as well as risk. Potential consequences are identified by analysing 'The role(s) played by political parties, groups and factions in the political system; prevailing political and economic philosophies; and the general atmosphere surrounding business and government relations.' (Schmidt, 1986:43)

Root's (1972) functional-descriptive model of risks for the firm,<sup>19</sup> classifies risk into two schemas - political/economic and political/social. Transfer and operations risks are classified as political/economic risks, while

ownership-control risks are classified as political/social in nature. Risk is then conceived as policy changes arising from broad changes in the national economy and national society, (Root, 1972:358) as they affect the foreign enterprise. While Root's system represents a major improvement on checklist type classificatory taxonomies of risk - the important reactive dimension has been ignored in his analysis. Firms affect the societies in which they operate, and their activities are also affected by international relations between multinational enterprises - these factors would have to be included in any general model of political risks. Overholt's (1982) conceptual schema uses a similar model; classifying business risk as asset, operations, organisation, and market related - risks arising from organisational conflict. (Overholt, 1982:7) Identifying risks according to this schema involves qualitative analysis of the organisational characteristics of business as it relates to the political environment. Government and opposition groups are analysed according to an organisational framework for the purposes of determining changes which would constitute political risk. Scenarios are developed for government change, and expected impacts on business. Overholt's schema represents a major development in efforts toward the identification of political risk in presenting a model of the risks of a typical corporation. His suggested approach does suffer somewhat from lack of attention to the international dimension of the political risk problem, his shyness with regard to providing detailed references, and his generalised analysis of Brazil.

#### 4.3.1. Chapter Four : Concluding Remarks :

Political risk has been identified in the literature narrowly as expropriation or economic nationalism, as instability and change, according to checklists, and with varying degrees of sophistication with regard to models of the firm. From the preceding discussion, it is clear that identifying political risk is an extremely difficult process if not linked to a model of the firm.

## Chapter Four

With respect to the first dimension of political risk, the analyses above have identified aspects of political risk, often lacking conceptual and operational congruity due to a failure to include the second dimension of political risk. Those which have included the second dimension have neglected important elements of political risk with respect to the influence of the firm on the host society as well as the international dimension. Analyses must also include international factors - with regard to the firm as well as host country. Identifying political risk involves a gamut of methodologies and theoretical approaches, and is limited only by the resources available to a corporation. Chapter five of this dissertation discusses the conceptual schematicisation of political risk in more detail.

4.4. Key Terms for Review :

Political Risk	Change
Instability	Business Risk
Economic Nationalism	
Taxonomies of Events	
Expropriation	

4.5. Chapter Four : End Notes :

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1. (sic) - "...in that country ?"

2. Taxonomy being defined as "...a system of categories constructed to fit the empirical observations so that the relationships among categories can be established." (Nachmias & Nachmias, 1992: 558) The classificatory scope of the taxonomy used in Chapter two is intended to be broad.

3. This is due to theoretical and definitional incongruities between conceptual and operational levels of analysis, debated above. In this regard, see Chapter two for detailed analysis of empirico-historical and conceptual-theoretical factors contributing to this state of affairs; and Chapter one for item by item discussion of some of the pervasive underlying fiduciary frameworks.

4. Simon's (1982), study is particularly explicit regarding temporal identificatory fiduciary frameworks resulting in inductive definitions of political risk. While index related analyses such as BERI and PSSI are examples of methodological/operational incongruency.

5. See bibliography below, and previous chapters.
6. Political change and instability form the implicit basis of earlier statistically based methods such as BERI and BI. WPRF and ASPRO-SPAIR are similarly orientated, although they impose a quantitative superstructure onto a qualitative foundation by means of Bayesian type probability assessments. ASPRO-SPAIR is the only one to posit direct relationships between dependent and independent variables. (See the previous chapter for a detailed analysis.)
7. Refer to Suryadinata, (1987) for a discussion of this, and related political problems experienced by Chinese middleman-minorities trading in Southeast Asia.
8. Findings which have been confirmed by Patrick Crow, (1986:35) with regard to U.S. oil producers in Libya, when the Reagan administration ordered them to cease all operations in that country, by way of retribution for that country's support for international terrorism.
9. An assertion which would certainly be supported by Root, (1972) - though the emphasis of political economists is on power differentials between markets and states, rather than firms and states.
10. Regional dimensions of instability should not be neglected as explanatory or intervening variables. For example Russia's invasion of Afghanistan resulted in decreases of investment flows to neighbouring Pakistan.
11. (As has been discussed in chapter three.)
12. Sanjaya Lall (1991) has noted that strategic shifts have taken place in most former socialist economies since 1989, towards a greater belief in market economy and free flows of capital. (Lall, 1991:251)

13. The latter point (i.e. congruency over time and space), is particularly important to firms contemplating five year investment plans.

14. However, operational definitions require the firm to be included in environmental assessments if macro and micro risks are to be identified and measured.

15. Bradley's study of expropriation revealed the following :

Expropriation by industry 1960-1974:

Industry	Number of expropriations	Percentage of U.S. companies
Oil	84	12
Extractive	38	18
Utilities & Transport	17	4
Insurance & Banking	33	4
Manufacturing	30	1,2
Agriculture	19	
Sales & Service	16	
Land, Property, Constr.	23	

(Bradley, 1977)

16. Cateora, (1971), has noted that conscious strategies of domestication of holdings in host countries may decrease the effects of expropriatory initiatives.

17. Expressed mathematically, the beta subjective probability function is :

$$f(p_{ijk} | r_{ijk}, n_{ijk}) = (p_{ijk})^{r_{ijk}-1} (1-p_{ijk})^{n_{ijk}-r_{ijk}-1} \Gamma(n_{ijk}) \Gamma(r_{ijk}) / \Gamma(n_{ijk}-r_{ijk})$$

$p_{ijk}$  = subjective probability of event i based on consideration of factor j by expert k.

(Bunn & Mustafaoglu, 1978:156)

18. These factors were based on the work of Chalmers Johnson on revolutionary change.

19. i.e. Transfer, operational, and ownership-control.

5. Chapter Five : A Firm-Centric Framework :

5.1. Conceptual Model of Political Risk - Introductory :

In Chapter two, it was demonstrated how disparate definitions of political risk have resulted in idiosyncratic approaches to measurement and identification. Indeed, Stephen Kobrin (1979a) has been prompted to suggest in his reconsideration, that the term 'political risk' should perhaps be dropped from usage. However, the importance of multinational enterprises and foreign investment in the global political economy suggests that political risk analysis should be included in research agendas.<sup>1</sup> In 1990, United States multinational corporations accounted for US\$421,5 billion in direct foreign investment; while total book value of all foreign direct investment was approximately US\$598 billion, in 1984. (Walters & Blake, 1992:105) According to Walters & Blake, '...multinational corporations have become the most visible and the most attacked agents in the global economic system.' (Walters & Blake, 1992:104), yet at the same time, states compete to attract multinationals because of their wealth creating activities. (Strange, 1991) Inevitably, the goals and strategies of states, and other stakeholders, both national and international, and those of firms diverge, compete and conflict - creating political risk for firms involved in international trade or foreign direct investment. The primary aim of this chapter is to explore some of the ways in which political risk analysts have conceptualised linkages between politics and the firm when analysing the potential for risk to business.

The manager seeking to move beyond subjective uncertainty towards an objective understanding of political events as they relate to the firm, requires more than simple taxonomies and typologies of events. Solving this dilemma involves applying more complex conceptual frameworks capable of revealing interdependencies among variables.<sup>2</sup> A number of writers in the field have attempted

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to provide more sophisticated firm-centric predictive conceptual frameworks, rarely succeeding in attaining anything more than a slight improvement on the phenomenological classificatory approaches described and discussed in the previous chapter. (Benchmark efforts include those of : Overholt, 1982; Root, 1972; Simon 1984 and Schmidt, 1986.)

Pragmatically orientated of necessity, conceptual frameworks of political risk attempt :

- (a) to identify, measure and forecast political risk occurrences in relevant countries , (home, host, regional) and
- (b) to ascertain the probability that these occurrences will result in managerial contingencies related to the goals and/or profitability of the firm.

Attempts to attain these objectives have lacked comprehensive explanatory and predictive power - being limited by the constraints of comparative political and social theory,<sup>3</sup> the lack of a dynamically integrative schema of the firm as it relates to the non-commercial business environment, the wide variety of activities in which multinationals are involved and a dearth of empirical research in the field of political risk analysis. Consequently, although they represent an improvement on subjective, seat-of-the-pants approaches, theoretical systems for political risk analysis fall short with regard to the provision of rigorous explanations for and predictions of, the phenomena and their effects on the profitability and goals of business.<sup>4</sup> Nevertheless, considerable though sometimes controversial progress has been made regarding limited aspects of political risk analysis. Progress is gauged in terms of establishing limited taxonomies and predicting occurrences and trends arising from the political system.<sup>5</sup> Some of the better known approaches to establishing boundaries and measurement have been discussed critically, in Chapter three of this work. However, aside from the single-case qualitative scenario analyses such as Overholt's (1982) organisational analysis of Brazil; no for-

mal holistic, overtly systematic theoretical approaches exist for wider application. As was discussed in Chapter two, idiosyncratic conceptual definitions have resulted in circumscribed potentialities and incongruities at the operational level of analysis throughout the 'paradigm'.<sup>6</sup> Identifying the many variables of political risk presents particularly complex dilemmas to the analyst attempting to relate firm to polity. Attempts at measuring the phenomenon have been ineffectual. Whether quantitative or qualitative, theorists' concern about the probabilistic prediction of occurrences emanating from the political environment, has led to a focus which concentrates on acts of government, often generalistic and only implicitly in relation to the firm, or the second dimension of political risk.

The primary objectives of this chapter are : (a) to analyse rigorously, some of the better known attempts to transcend the above-cited theoretical problems; (b) to discuss in more detail the problematique presented by the dichotomous aims of political risk analysts, and (c) to propose a conceptual schema<sup>7</sup> of political risk analysis based on the critique and findings related in this and previous chapters.

#### 5.1.1. An Overview of Firm-Centric Literature :

##### 5.1.1.1. Root and Schmidt : A Comparison :

In the early years of the 'seventies, Franklin Root developed a model including a classificatory system that relates political risk to the firm in three broad descriptive categories : operational, ownership-control and transfer. (Root, 1972:357) These taxonomic categories lack independent explanatory power, but Root has described two additional analytical categories, contending that his taxonomy of risks is causally associated with politico-economic or politico-social factors in the environment within which the firm does business. Root's general scheme for political risk analysis centres on government

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responses to external and internal changes in the host country's national economy and society. Responses are defined in terms of acts, policies, laws, decrees, regulations and administration which affect the foreign enterprise as well as the national economy and society. (Root, 1972: 359) Root recommends the use of a cross-disciplinary mix of analytical techniques within his overall framework. However by way of criticism, as Simon (1984) has noted "...an important obstacle to the systematic study of political risk is the cross disciplinary nature of the subject. It is often difficult for economists, political scientists, business management scholars, legal experts, and sociologists to communicate with each other because their respective training and current interests produce different ways of looking at a problem." (Simon, 1984:124) Of course, Simon is correct in his assessment that political risk analysts are in danger of producing an inter-paradigmatic Tower of Babel - analysis of political risk descending to pure logomachy.<sup>29</sup> The state, or government is of central importance in Root's schema - a limitation prescribed by his definition of the phenomenon of political risk. Political risk as defined for the purposes of this paper is a more pervasive concept with many sub-components at conceptual and operational levels of analysis.

Schmidt's (1986) classificatory taxonomy is derived from Root's, describing risks in the same three general categories. However, the broad categories have been further defined into operational categories by Schmidt. For example, transfer risk includes tariffs on exports, export restrictions, tariffs on imports, import quotas, dividend remittance restrictions, capital repatriation restrictions, and nationality restrictions. Operational risks are classified as price controls, increased taxation, export commitments, local content requirements, local sourcing requirements, local manufacturing requirements, financing restrictions. Ownership-control risks include geographic limitations on investment, economic sector limitations on investment, abrogation of proprietary rights, foreign ownership limitations, pressure for local participation, expropriation and confiscation. According to Schmidt, in order to predict these risks, managers need to "...examine historical policy actions,

existing government posture, and attitudes of opposition groups... (Schmidt, 1986:50) The three categories are in turn related to the organisational structure and characteristics of the investment. He defines investment structure in terms of horizontal, vertical or conglomerate configurations; while investment characteristics are classified into general and specific. His functional classificatory system offers partial insight into the organisational structure of foreign investments in general, however he does not attempt to explain the causes of political risks, or offer a complex model of host society as Root does. Consequently, in terms of broader applicability, his taxonomy is of limited use. However, Schmidt's approach does represent progress in terms of developing a schema for analysing the second facet of risk. Though his focus on specific types of structure obscures the development of a more abstract model with wider applications.

In contrast to Schmidt, rather than offer limited insight into investment type, or the activities of the foreign firm, Root prefers to present three general categories of risk. In addition, he recommends a mix of methods and models for the identification and measurement of political risk.<sup>9</sup> Unfortunately, while recognising correlations between acts of government and politico/social or politico/economic causes, his conceptual model neglects the influence of multinational responses on host economy and society. Therefore the activities of the multinational are not recognised as a reactive factor in the identification and measurement of political risk, by Root. This 'lacuna' constitutes an important omission which could affect the operational validity of his conceptual model. Root appears to have recognised this latter weakness implicitly when he notes that he has omitted business responses and strategies from his article. (Root, 1972:364)<sup>10</sup>

5.1.1.2. William Overholt :

Overholt (1982), has attempted to open the 'black box' of host country politics by means of scenario based, qualitative organisational analysis. In focusing on government, his conception of business risk is similar to both Root's and Schmidt's taxonomies. But his proposal rejects quantitative identification and measurement techniques, and neglects to offer any explicit conceptual schema of the firm as it relates to the political environment. In addition, as is shown below, he has excluded explicit mention of the international dimension of the firm from his organisational analysis, which defines political risk broadly as 'changes in the rules of the game'.<sup>11</sup>

According to Overholt's classificatory system, business risks are defined as asset, organisational, operational and market related. (Overholt, 1982:32) His approach is more sophisticated and dynamic than Root's in terms of defining risk as affecting the four categories of business interest, and allows for more in-depth structured analysis. For example, asset risk is similar to Root's ownership/control category, but is more specific, defining asset risk as arising from nationalisation, wage/price squeezes, inflation/indexing risk, disorder/ambiguous ownership rules, erosion of patent and copyright privileges and seizure of data. Overholt's explanatory model describes causality in terms of economic, social, cultural and international trends which affect the structures of government and opposition coalitions in the host country; the strategies and rules of competition which govern interrelationships between government and opposition;<sup>12</sup> and government decision structures and factions. These interrelated variables in turn affect the degree of change or stability which could be expected and therefore included in analyses of political risk. (Overholt, 1982:61) Root and Schmidt, on the other hand, leave more detailed operational descriptive categories to the individual analyst. All three of the models discussed above offer partial insight into the complex problem of political risk analysis. Root and Overholt have concentrated their analytical

efforts on the first aim of the political risk assessment dichotomy, and as a result, the focus of their analyses overemphasises political causality, as opposed to the prediction of probable effects on the firm. Schmidt approaches the problem from a perspective orientated toward the second aim of risk analysis, however, his study lacks explanatory power with regard to developments in the socio-political system.

#### 5.1.1.3. J.D. Simon :

One approach which is based on the works of a multiplicity of political analysts<sup>13</sup> and which seeks to place the multinational enterprise within a broader environment, is that of Simon (1984). Noting the weakness of government-centric approaches such as those discussed above, Simon proposes to include home and host country environments as well as the international and global environments in his<sup>14</sup> assessment of political risk for multinational enterprises doing business in South Africa. Flows and types of risk are classified into direct and indirect categories, and Simon also distinguishes between industrialised and developing countries, as well as open and closed societies (in this regard, refer to Simon, 1984:27) However, lacking a model of the firm or its interests,<sup>15</sup> Simon's firm-centric schema is of limited application beyond its usefulness as a descriptive typology which may or may not be of use to the analyst considering political risk for a particular firm.

Simon's model becomes an extensive typology of political risk, related to what are described as flows and types of risk within a broader category which classifies them according to whether they are internal or external in origin, direct or indirect in effect, in open or closed societies. (Simon, 1984:129,133,137) For example, a direct-internal risk flowing from host government to multinational enterprise would include events such as nationalisation, indigenisation, recession, licensing regulations and restrictions on remittances. Regardless of causality, each of these events could af-

## Constituting Risk - Linking Politics with the Firm

fect the firm in different ways, which makes assessment difficult. Without a typological model of the firm or its broad interests, risks are difficult to identify and measure by means of Simon's conceptual schema.

Beyond tracing the directional flows of relationships, Simon's conceptual schema says nothing about how to establish causality and therefore has limited predictive and explanatory power (in common with most attempts discussed in this dissertation). Franklin Root's conceptual model is the most satisfactory of those discussed above, in terms of these criteria. He offers an integrated model of the socio-political system and its relationship with the interests of business. However, his broad categories lack the potential for detailed analysis offered by Overholt's taxonomy. Schmidt's rubik-cube type operating-mix, matrix model, while firm-centric, lacks wider explanatory and predictive import in relation to the political system.<sup>16</sup>

### 5.1.2. Constituting Risk - Linking Politics with the Firm :

#### 5.1.2.1. Introductory :

Prior to proposing a conceptual model for the identification and measurement of political risk, the next section of this paper discusses the difficulties of establishing linkages between politics and the firm, in more detail. Political risk<sup>17</sup> can only be identified and measured in relation to the profitability and other goals of the individual firm. However, with the exception of those approaches discussed in the previous section above, analysts' preoccupation with forecasting and prediction has led to a focus of effort which excludes the individual firm and concentrates on theorising about the probable occurrence of events in the political system of the host country,<sup>18</sup> at various levels of aggregation. As Shubik has noted "...risk is only defined in the context of a specific goal structure. It cannot be assessed independently from purpose. Probabilities or the possibility of the occurrence of an event exist independent of purpose. The risk to an individual, given that some

thing occurs, depends upon that individual's goals and resources.' (Shubik, in Herring, 1983:134) In other words, not all political occurrences (such as expropriation or instability), can be classified as political risk for the firm. In Chapter three, it was shown that the human factor is important in regard to perceptions of risk, and the acquisition of information on the external environment. Whether uncertainty is considered as subjective or objective, assessments of political risk are value judgements. Normative or ethno-centric approaches to the identification of political risk seem unavoidable and should be accounted for in models for the analysis of political risk.<sup>19</sup> Probably, the best analyses would include a variety of methods and models, some of which have been described critically in Chapter three; a best method would combine several models, both quantitative and qualitative.

Assessing relationships between the two facets of risk, or cause and effect, involves relating corporate activities to the political environment. In their analysis of strategies for the management of what they describe as non-market failure, Siegwart, Caytas and Mahari have noted that : 'The company is confronted with a dilemma in that it is seldom able to not only sense but also competently evaluate all relevant societal developments at a certain geographical location, although the extent of its involvement would justify such an evaluation.' (Siegwart et al., 1989:7) Gradual or evolutionary changes involving long term trends, do not constitute political risk. (Robock, 1971) By Robock's definition, the trends or changes must be 'difficult to anticipate'. Anticipation being a subjective state, it would be interesting to compare the degree of difficulty of anticipation, with differing levels of specialisation within political risk analysis. Uncertainty and the degree of difficulty of anticipation of change and discontinuity, are essential dialectical criteria in identifying and measuring risk related phenomena.

On the other hand, a definition involving revolutionary change and fundamental societal upheaval would also be too narrow to encompass the more prevalent forms of political risk stemming from policy and legislative

changes. For example, replacement of a military regime by means of democratic elections does not necessarily imply an automatic reduction in risk. Unfavourable exchange rate fluctuations related to this type of event are an example of the type of political risk which can result from reactions to 'headlines'. In addition, the strength and direction of probable covariation of profitability and goals with political change, must be established by the analyst.

### 5.1.3. Conceptual Foundations : A critique :

#### 5.1.3.1. Introductory :

Moving beyond the truism that political risk results from the covariation of the activities of the firm and events in the political environment. This section of the paper discusses the contributions of risk analysts toward a conceptual foundation of the concept in more detail.

#### 5.1.3.2. Conceptual Frameworks Discussed :

As has been discussed in Chapters three and four of this dissertation, various conceptual frameworks exist for the identification and measurement of risk - each influencing the character of assessments in terms of cognition and perception. Political risk has been explicitly linked to the firm conceptually in terms of events and effects (for example, see Bunn & Mustafaoglu, 1978; Howard, 1993; Robock, 1971; Schmidt, 1986; Simon, 1982; Stein, 1983 ). These attempts are often stated in the broadest of terms, with little operational congruity between definitional conceptual components and the empirical world. Robock's conceptual framework which distinguishes between macro and micro risk,<sup>29</sup> has been adopted by many writers in the field, and for that reason it has been critiqued in this section of the analysis. It should be noted that the author of this study considers the distinction to be irrelevant in the context of a firm-centric analysis - and recommends that the concept and

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structure of macro risk could profitably be collapsed into micro risk for the purpose of analysis, identification and measurement. Both macro and micro risk affect the individual company. A firm-centric conceptual schema would thus render the distinction irrelevant. Though insurers may consider the macro-micro aggregation to be essential for rating risks and calculating premiums. Argument in this paper supports the assertion that ratings are best calculated for individual firms.

Socio-political analyses which focus on macro or micro risk neglect to link these events with the activities, profitability and goals of the company; while for firm-centric analyses, the distinction is irrelevant other than as a broad descriptive classificatory typology, on a par with checklist approaches. This dissertation favours firm-centric analyses and (if at all), would recommend the adoption of a macro/micro distinction only as a first step for the purpose of ascertaining 'flags' or key trends in the non-market political environment, to be investigated in more detail in relation to the individual firm.

Robock's conceptual framework of political risk identifies (a) sources of political risk; (b) groups through which political risk could be generated and (c) political risk effects. (Robock, 1971:7) Examples of (a) and (b) are competing political philosophies (nationalism, socialism, communism), the government in power and its operating agencies; and (c) confiscation or loss of assets without compensation. Each of the categories in Robock's chain of causation has been elaborated in the form of checklists of causes, groups and events. The sets of events are sub-classified according to the macro-micro distinction discussed above, and lack the focus which can be obtained by using a conceptual framework of the firm and its operations. (see Overholt, 1982 for an example.) Robock has not attempted to model the environment within which multinationals operate, in the keynote article reviewed for this paper.

5.1.3.3. The Environment :

Simon's analysis commences with an environmental model that places the firm<sup>21</sup> at the centre of four sets of relationships. He perceives four basic environments within which multinationals operate - host country, home country, international and global. Host and home country environments encompass government actions and policies, societal actions and attitudes, local business community actions, legal community rulings and media reports. (The latter category is important for the assessment of risks such as the exchange risks mentioned in this chapter above.)

The international environment includes a checklist of factors, including foreign policies, regional organisations and their policies, the activities of international activists and voluntary private organisations.<sup>22</sup> His analysis of the global environment includes the policies and actions of global organisations, and global developments such as inflation, oil crises, external debt crises and recession. (Simon, 1984:127) Recognising that the factors included on his checklists seldom occur in isolation, Simon attempts to track the flow of risk according to whether it is internal or external to the host country, and according to direction of causality. (See discussion above for additional details.) He also classifies countries into industrialised and developing, open and closed. Political risk is regarded as direct or indirect in origin.

5.1.3.4. 'Opaque Box' of the Firm :

Missing from his analysis are a model of the MNE within the context of his conceptual framework - his MNE<sup>23</sup> remains an 'opaque box' - and a broader schema for socio-political analysis. Overholt (1982), has attempted to explain political stability in terms of a model whereby international economic, social and cultural trends influence the coalitional configurations within government

and opposition in the host country. Analysis within the 'grey box' of the host country is accomplished within an organisational framework which includes leadership, institutions and social bases of regime and opposition. (Overholt, 1982:52) Factors identified as being risk producing are classified by Simon and Overholt, in a manner that would be termed macro, by Robock's criteria in that one could assume their potential importance for all firms.

Caytas, Siegwart and Mahari (1989) concentrate on relations between the multinational company (also envisioned as an 'opaque box') and various groups, and the impact that these relations have on the planning and structuring of corporate activities. Unfortunately, their model does not explain and weigh the relative importance of relations in detail - merely suggesting them graphically, by means of arrows. They recommend a focus on bureaucratic acts and policy changes which could result in managerial contingencies for the multinational corporation. Their list of risks includes domestic participation regulations, imposition of surety obligations, fundamental changes in criminal law, domestic content programs and capital market control. Adopting a definition of political risk which is orientated towards economic planning, policy instability, and lack of security and legal protection; their model wants a detailed conceptualisation of the corporation or the environments within which it operates. Their definition of political risk, '...the frustration of economic planning through forces originating in the non-economic sector...in other terms, manifestations of instability and of a lack of security and legal protection.' (Siegwart et al., 1989:20) is somewhat narrower than that recommended in this paper, which regards corporate characteristics and indigenisation and affirmative action programs as potential risk factors among others.<sup>24</sup>

#### 5.1.3.5. Linking Firm to Polity :

While acknowledging the importance of long term trends, Siegart et al., have failed to produce a conceptual model for the identification and measurement of these trends as political risk.

Green's attempt to simplify the complex task of political risk analysis is based on the work of political scientists David Apter, Dankwart Rustow and Chalmers Johnson. Like Simon, he characterises societies according to whether they are modern or modernising, and then links governmental forms characteristic of these two types, to the risk of radical political change. (Green, 1974:35) An important weakness of his analytical schema is that radical change does not necessarily constitute political risk, neither does he offer explicit explanations for linkages between firm and polity. He does recommend using his 'governmental form' criteria, in conjunction with other methods and models for political risk analysis and forecasting. In fact, methods used in forecasting politico-economic related risks appear to be a great deal simpler, if no more reliable than those used to forecast socio-political events.

Root's economic-political forecasting model links transfer risk with expansive fiscal and monetary policies of the host government. Expansive policies are the cause of domestic inflation, persistent balance of payments deficits and exhaustion of reserves. Host government responses take the form of austerity measures, transfer restrictions and devaluation. (Root, 1972:360) Based on economic models, this policy model would have to be considered in conjunction with studies of the host government, and historical analysis of government responses. (See Overholt, 1982 for an example of organisational analysis.) However, Root's attempt to model the socio-political environment is more generalised, and policy orientated. The dynamics of power distributions and political ideology among social groups affect informal institutions and

the government, which is in turn, responsible for political decision making. At the most abstract and general level, his socio-political model may be useful to the political risk analyst. More empirical research into the direct influence of multinationals on the societies in which they invest, would be desirable before his model of risks could be described as being explanatory and predictive. Akhter and Lusch would agree, '...political processes do not always impinge on the performance of foreign business in all situations, a conceptual understanding and explanation of the purpose, function and process of political risk as related to overall societal structure of foreign business, is required.' (Akhter & Lusch, 1987:86) Root notes, with regard to incorporating probability analyses into decision making, that expected utility or value models could be used in conjunction with strategic responses, to gauge effects of political risk on the activities of the firm.

Akhter and Lusch imply that political risk can be linked to the firm only after consideration of available strategic options. In this regard, Cracco and Boddewyn have argued that strategic responses to nationalist policies can diminish risks for the corporation. For example they have cited that in the case where : 'The behaviour of foreign companies that does not actively promote, is inconsistent with, or goes against the economic and social goals of the host country. The foreign company cannot actively participate in the development of the host country.' (Boddewyn and Cracco, 1972:48) Their strategic adaptive approach, links corporation or firm to the host government in terms of a game theoretic model of action and response, based on careful delineation of present and future costs, benefits and relative strengths. Risks are then analysed in respect of four functional areas of corporate activity - management, finance, marketing and production. After analysis, the firm then devises '...alternative short- and long-run strategies to cope with those eventual political risks and opportunities.' (Boddewyn and Cracco, 1972:54) Potential effects of political risk events are assessed according to strategic

predisposition which differentiates risk from opportunity. Although it should be noted that Boddewyn and Cracco's analysis is consistent with the definition of political risk adopted in this chapter.<sup>25</sup>

Their model of political risks defines risk as propensity for nationalist economic policies, and adaptational potential, and is too narrow for general application in industrialised as well as developing countries. Direct foreign investment, including that from the United States, is more likely to be a manufacturing or service industry located in other advanced industrial states than an extractive industry located in developing countries. (Walters and Blake, 1992:107)<sup>26</sup>

#### 5.1.4. Concluding :

In this section, a number of models for the forecasting and assessment of political risk have been presented. Root, Schmidt and Overholt have presented functional/descriptive taxonomies of the activities of the firm against which the impact of political events may be assessed. While their models represent progress in the field of political risk assessment, they remain phenomenological in orientation and offer poor representations of reality for reasons which have been discussed above. Akhter & Lusch, Boddewyn and Cracco, and Simon have attempted more structured approaches, with limited applicability. Kobrin, (1981) has noted that "...effective political assessment is more likely to result from explicit specification of causal relationships and implementation of systematic analytical procedures than from the development of increased methodological sophistication or elegance." (Kobrin, 1981: 251)<sup>27</sup>

Establishing causal relationships implies a model of the firm which at the least has to be functionally descriptive in terms of types of business risks. In addition, models of the firm intended for use in identifying and measuring

political risk, should include models of the managerial decisional structure and strategic planning functions. Conceptions of political change vary depending on the firm and the choice of political analyst - it is the linkages between political change and political risk which should to be investigated in more detail at the empirical level of analysis. The following section presents a firm-centric model for political risk analysis.

5.1.5. Political Risk Analysis Conceptualised Schematically :

5.1.5.1. Introductory :

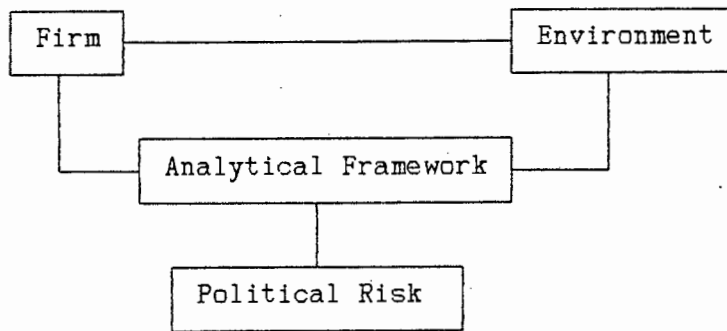


Figure 7. Exhibit 5A. Conceptual Frameworks of Political Risk.

Political risk is defined, identified and measured by the analyst in terms of three conceptual frameworks. First, a conceptual schema of the transnational firm and its activities; second, a conceptualisation of the political environment and patterns of interaction between elements in the environment. Thirdly, these variables are influenced in turn by the theoretical/methodological 'lens' chosen for the analysis. (See Exhibit 5A, above.) The interaction of these elements in terms of definitions of the concept, frameworks for analysis and the empirical, constitutes political risk.

## Political Risk - Conceptual Schema

It follows that a primary concern of the political risk analyst is to define the firm and the environment within which the multinational corporation or firm conducts foreign business operations. (Simon, 1984; Schöllhammer and Nigh, 1978) A useful model of the environment within which transnational corporations or firms conduct business, should include firm-firm, firm-host government/society, firm-home government/society, home government-firm-host government, international organisation-firm-government/society, and firm-firm-government/society relations as well as government/society-government/society relations. (Stopford & Strange, 1991) Political risks arising from these relations are analysed according to the variety of approaches discussed in this dissertation, in relation to the conceptualised firm.

### 5.1.5.2. Descriptive/Functional Conceptualisation of the Firm :

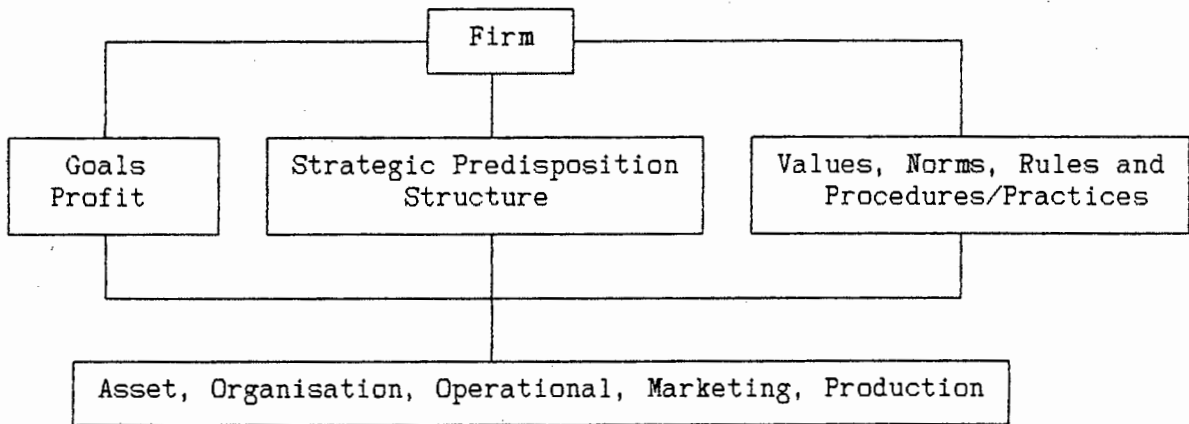


Figure 8. Exhibit 5B. Descriptive/Functional Conceptualisation.

Explicit conceptual frameworks of the firm such as those of Overholt, (1982) and Root, (1972) discussed in detail above and in Chapter four, depict the firm in descriptive/functional terms. They represent an improvement on methods which offer no conceptualisation (or at least partial conceptualisation) of the firm and its activities. Their importance is that they enable the analyst

to describe and classify risks emanating from the environment in terms of their possible effect on the firm. However, as van Agtmael (1976) and Boddewyn and Cracco (1972) have noted, strategic predispositions are intervening variables which must be considered in the political risk measurement process. In addition, political risk has been defined by Robock (1971), and others in terms of change which affects the profitability and/or other goals of the firm. Frameworks of the firm to be used in political risk analysis, should thus include provision for the detailed analysis of the goals, profitability, strategic predisposition, values, norms, rules and operating procedures of firms as they relate to the non-market environment. (See Exhibit 5C, below.)

#### 5.1.5.3. The Environment :

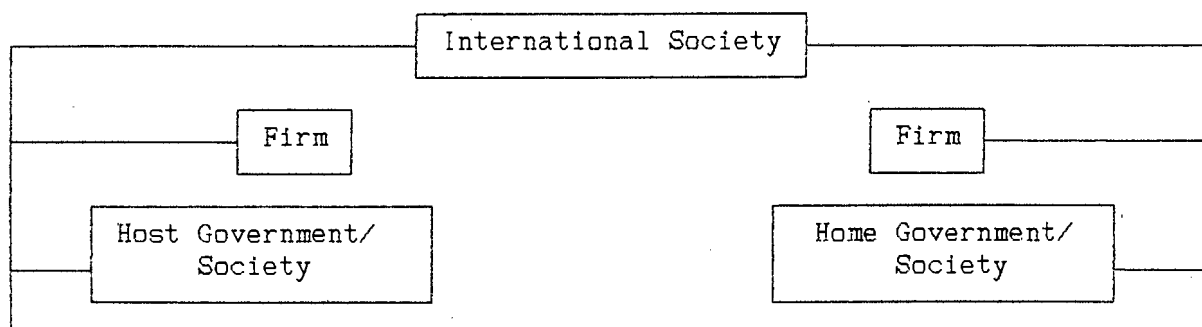


Figure 9. Exhibit 5C. A Conceptual Schema of the Environment.

The environment within which multinationals conduct business has been considered explicitly by Simon (1984), in his analysis of political risk in South Africa. Simon's analysis traces the flow of relations in the environment at government, international and global levels. His conceptual model does not attempt to explain or predict, and has omitted the firm-firm nexus. For the purposes of this study, the environment is conceptualised above in Exhibit 5C. An environmental conceptualisation such as that in Exhibit 5C above, implies a level of analysis problem for the analyst. The level of analysis problem oc-

## Political Risk - Conceptual Schema

curs because the firm operates at sub-national levels as well as at national, international and global levels. Analysts of political risk should take these factors into account when selecting and combining theoretical and methodological approaches for the identification and measurement of political risk. The choice of analytical framework influences how political risk is identified and measured - this has been demonstrated in other parts of this dissertation. The state of the art of political risk analysis thus depends on the state of the art of political and economic analysis.

Conceptual frameworks for the analysis<sup>28</sup> of political risk include methods for measurement and identification, as well as complex explanatory models derived from economics and political science. Refer to Chapters three and four, of this dissertation for a thorough overview of models for measurement and identification. As none of them offer possibilities for rigorous holistic analysis, an integrative approach to identification and measurement of political risk, based on the heuristic value of a particular model or method, should be adopted by the analyst. Refer to Exhibit 5D, below - not intended to be a complete description of available models or methods.

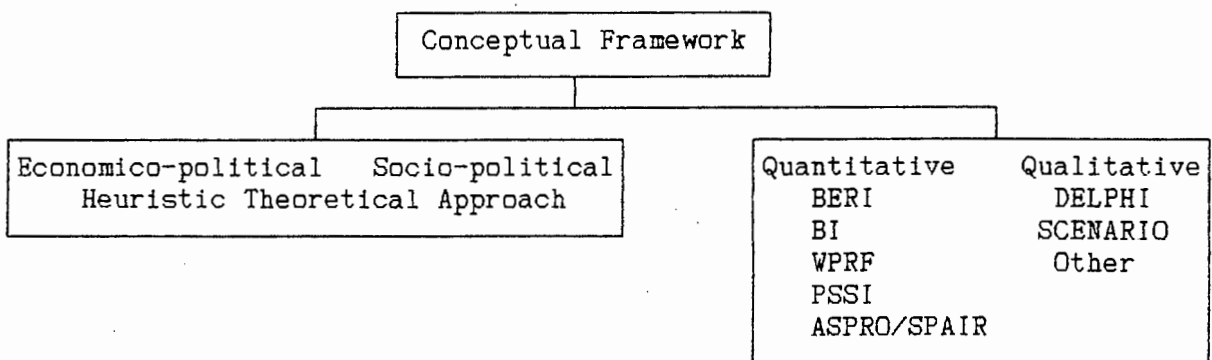


Figure 10. Exhibit 5D. Integrative Conceptual-Analytical Framework

5.2. Chapter Five : Conclusion :

Recognising the importance of political risk analysis for multinational enterprises, this chapter has discussed the problems associated with moving beyond simple taxonomies of events in the host country environment. The firm-centric literature has been overviewed and discussed in depth, in the light of divergent theoretical and methodological approaches to fulfilling the aim of political risk analysts. On a rational-emotive note, political risk is a function of the 'shoulds and musts' embodied in the goals, strategies, values norms and procedures of firms, and the theoretical frameworks used to analyse it. It is also a function of socio-political trends and discontinuities. It is unlikely that political risk analysts will ever escape from the constraints of cognition, perception and political and social theory, therefore, a firm-centric integrative conceptual framework for political risk analysis has been recommended. as a first step in identifying interrelationships. The model allows analysts to select from a range of theoretical frameworks and methods (both qualitative and quantitative) when identifying and measuring political risk originating in the non-economic environment.

5.3. Key Terms for Review :

Descriptive/Functional Conceptualisation Environment Conceptual Framework of Political Risk Conceptual Analytical Framework
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5.4. Chapter Five : End Notes :

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1. Susan Strange has noted the growing importance of firms in the international political economy, and suggested that political economists include the firm in their analyses of structural changes and bargaining. (Strange, 1991, & 1992)

2. In this paper, objective uncertainty is identified with analyses of political risk. However, the author recognises that an investigation based on the analysis of the cognitive-perceptual images of management would probably yield fruitful insight. Certainly, a potentially promising avenue for future research.

3. Root's (1972) approach is based on the works of Macridis and Chalmers Johnson.

4. In this context, theoretical system means "...one that provides a structure for complete explanation of empirical phenomena." (Nachmias & Nachmias, 1992: 40)

## Chapter Five : End Notes

5. Though it should be noted that the method for aggregation into macro and micro cases inherited from the insurance industry has placed constraints on the development of a true firm-centric approach.
6. If political risk analysis can still be termed a paradigm in the mid-nineties.
7. In the sense of an abstract logico-conceptual model.
8. The author of this paper considers the concept of political risk to be contestable, though not essentially contested - and therefore as 'mot juste'.
9. Political/economic risks should be analysed by means of techniques drawn from economics, while political/social risks depend on models from the disciplines of political science, sociology and psychology. Root very wisely leaves the choice of model to the political risk analyst. (Root, 1972:360)
10. Brennglass (1983), has discussed host country/investor impacts in more detail in relation to OPIC insurance, and the possible employment of risk reduction techniques. Potential impact is assessed in terms of '...arrangements with the host country government,...developmental effects such as local capital mobilization, employment, wages and personnel policies, effects on local suppliers, downstream industries and related economic activities, and environmental considerations.' (Brennglass,1983:224. Refer also to Gordon (1974) for a detailed discussion of OPIC risk analysis techniques.
11. Overholt has not acknowledged the many literary sources upon which his work is based - severely diminishing its value to the academic researcher and student of political risk analysis. Nevertheless, being one of the few firm-centric analytical approaches, it should be included in this discussion.
12. Strategies are seen by Overholt as military activity against factions op-

posed to the regime in power; while rules of competition are described as '...very formalised rules of the game for changing tax laws and undertaking other incremental changes in personnel and policies.' (Overholt, 1982:61)

13. Notably, those of Feierabend and Feierabend, Gurr, Allison, Holsti, and James Rosenau.

14. Now somewhat outdated.

15. This is particularly important in assessments of South Africa during the period of sanctions, because of the many adaptive strategic responses and predispositions employed by multinational enterprises, which continued to do business in South Africa, despite constraints which could be classified as political risk if Simon's typological approach were to be applied.

16. See Schmidt, (1986:50).

17. Defined here as : the probability that changes or discontinuities in the political environment will affect the profitability and/or goals of a multinational firm. Robock has stipulated that the changes must be difficult to anticipate, in order to differentiate normal 'evolutionary' change, from instability and change constitutive of political risk. (Robock, 1971:7)

18. For example, see the discussion on models and methodological approaches for the identification and measurement of political risk, in Chapter three of this paper.

19. Schöllhammer and Nigh (1978), support this assertion in their analysis of German foreign direct investment. It was found that relations between Germany and host countries form a significant determinant of foreign direct investment by German firms.

## Chapter Five : End Notes

20. Macro risk is defined as events which affect all foreign companies, while micro risk comprises actions of government or other groups intended to affect only certain companies.

21. (MNE) or Multinational Enterprise.

22. In regard to the latter, Prakash Sethi, Etemad and Luther, have analysed the importance of voluntary private organisations in the globalisation of conflicts with multinational corporations. They quote the example of WHO codes on the international marketing of breast-milk substitutes, as evidence of the growing influence of VPO's in the international arena. (Prakash Sethi et al., 1986:26)

23. Multinational enterprise.

24. Though their work on stakeholders could be of inspirational value for political risk analysts.

25. i.e. whether regarded as opportunity or threat, political risks affect the profitability and/or goals of the foreign firm.

26. Certainly, adaptive potential as well as normative and strategic predisposition, link the firm with politics and therefore with the way political risk is identified and measured, and should be included in models for forecasting political risk.

27. In another paper, Kobrin has noted that 'Further work (both theoretical and empirical) is needed to identify the types of environmental events likely to affect operations, the conditions under which they are likely to do so, and the nature of the specific process through which the effects are transmitted.' (Kobrin, 1979:77)

28. Probabilistic forecasting and historico/descriptive assessment.

6. Chapter Six : Implications of Firm-Specificity :

6.1. Introductory :

In Chapters one and two of this paper, it was demonstrated that empirico-historical trends (Simon, 1984) and fiduciary frameworks (Robock, 1971; Root, 1972; Haendel et al., 1975) have influenced definitions and models of political risk analysis. Definitions are either narrow and phenomenological or taxonomical. Methods of identification and measurement lack operational congruity from case to case. A paradigm has been lost. Yet the possibility of exposure to political risk is a real consideration for firms doing business across borders and sovereign units. (In this regard, refer to Kelly & Philipatos, [1982:35] for the results of a survey of corporate political risk evaluation practices, and Dunning, [1991].) However, an overview of the literature on the subject shows that firms differ greatly in terms of organisational structure, goals, strategic predisposition and business interests. (Refer to Raddock, 1986; Moran, 1985; Eden, 1991; Casson, 1991; Siegwart et al., 1989; Rice & Mahmoud, 1986.)

6.1.1. Firm-Specific Affect :

Political risk was defined in Chapter one, as :

'...objective uncertainty<sup>1</sup> about future socio-political developments and outcomes as related to the profitability, business interests, norms, values, procedures, structures and other goals of the firm.'

## Firm-Specificity : Implications

Empirical and analytical implications of this definition, and the firm-specific conceptual schema recommended in Chapter five, are discussed in more detail in this chapter. Firm-specific 'affect', significant to the processes of identification and measurement at the empirical level of analysis, can be classified as follows :

'Affect'	
Personnel	Organisational
Human Factor	Structure Strategic Predisposition Goals Business Risks Data Sources Profitability Practices/Procedural

Figure 11. Exhibit 6A. Firm-Specific 'Affect'

'Macro'<sup>2</sup> approaches to the analysis of political risk reviewed and discussed in previous chapters neglect the firm, thereby failing to establish definitional/operational congruency in terms of existent definitions. 'Micro'<sup>3</sup> approaches have generally been too specific in terms of structural specifications, or inadequate with regard to constraints emanating from the international environment, to claim wider applications as firm-centric analytical schemas.

## Chapter Six

Political risk is constituted along an environmental continuum between the societal and the firm, and should be identified and measured as such. A comprehensive analytical approach would account for the entire continuum. This paper is intended as a minor contribution to the formulation of a firm-specific approach to the analysis<sup>4</sup> of a greater portion of the continuum than has been possible previously for adherents to the macro-micro classification of risks. Approaches which adhere to the macro-micro distinction are limited in analytical scope, to a single pole. However, analysts following a firm-specific approach need to be aware of societal factors at the opposite pole of the continuum. Indirect disruptions brought about by crises of legitimacy as a result of conflict between central government and regions or traditional elements of a society would be included in this category, for example. Global strategic predispositions may result in interdependencies across nations - the consequences are felt by states and firms alike.<sup>5</sup> Operationally, political risk is constituted societally as well as firm-centrally - nevertheless, it remains identifiable and measurable only in relation to the individual firm.<sup>6</sup>

## Firm-Specificity : Implications

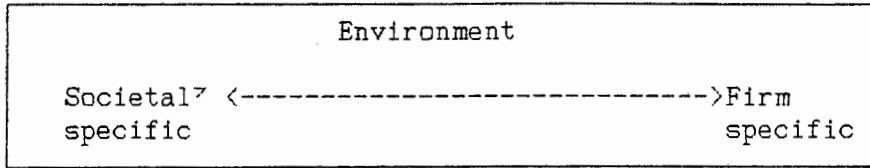


Figure 12. Exhibit 6B. Environmental Origins of Political Risk

For the purpose of this paper, firm-specific risks are categorised as affecting and being affected by the structure, strategic predisposition, goals, profitability, procedures and practices, assets, operations, organisation, production and marketing interests and characteristics of the firm. The degree of constraint<sup>8</sup> or opportunity imposed by risks, depends on the susceptibility or sensitivities and vulnerabilities of the individual firm. The latter can be ascribed in part to a firm's adaptational potential.<sup>9</sup> William Overholt, (1982:37) uses the terms sensitivity and vulnerability in a different context. (Raddock, 1986 offers a similar perspective.)<sup>10</sup> In Overholt's paper, sensitivity refers to implications for the firm of tendencies towards economic nationalism in the host country, and vulnerability to the firm. In this paper, which draws on the literature of interdependence, sensitivity and vulnerability are considered as firm-specific determinants. Though in this dissertation, the potentially reactive<sup>11</sup> nature of firms is freely acknowledged from an analytical perspective. The degree of sensitivity and vulnerability are determined by strategic predisposition and adaptational capacity; by indirect environmental factors as well as by theoretical and methodological constraints.

## 6.2. Firm-Specific Analytical Categories :

### 6.2.1. Structural Considerations :

In this section, the practicalities of structural considerations are explored in more depth from the perspective of firm-specific political risk analysis. The terms multinational enterprise, multinational corporation, transnational corporation, transnational firm and world firm have been used by writers on political risk to describe the organisations which form the subject of this section. (For a brief discussion of this point, refer to Lorraine Eden, 1991:197). In this thesis, the terms have been used more or less interchangeably. However different firms may be structurally,<sup>12</sup> all of them are susceptible to political risk in one form or another.<sup>13</sup> Siegwart et al., have identified additional structural and operational forms - including companies associated by merger, absorption, annexation or combination; cartels, interest groups (syndicates, consortia, pools, profit sharing agreements); export companies and networks of subsidiaries. (1989:4) (Refer also to Strange, 1992:2 and Stevens, 1990:43)<sup>14</sup> Structure<sup>15</sup> is thus an important concern for political risk analysts identifying and measuring risk - and structural form determines the correct term to be used, as well as related susceptibilities during the forecasting period. Even the terms 'multinational' and 'transnational' describe a wide range of institutional and operational structures.<sup>15</sup> For reasons of convenience, the author of this dissertation prefers the term 'transnational firm', or simply 'firm' when establishing the validity of considering structure in the firm-centric approach. The various terms have therefore been used interchangeably in this dissertation when referring to those business entities which operate in the global environment.

6.2.1.1. Diversity of Structure :

In considering the implications for state-firm relations of organisational structure; Wells (1971:98), distinguishes between organisational structures of multinational decisionmaking which are 'highly centralised', and those which are 'loosely knit' systems of subsidiary companies.<sup>17</sup> Within these two broad classifications are organisational structures based on area, and those based on product. Although he does note that the diversity and complexity to be found within multinational organisation structures results in mixtures of the two forms. He presents an analytical framework (somewhat outdated) which distinguishes between manufacturing and extractive enterprises. Similarly, Blake & Walters distinguish between parent-dominant, subsidiary-subservient structures and decisional relationships; international holding companies, and integrated international enterprises. (1992:112) The latter type of structure becoming increasingly prevalent. In common with Wells, they note that these analytical constructs are archetypal - organisations often being composite mixtures of different forms.<sup>18</sup> Another advocate of firm-centric analysis, (Schmidt, 1986:46) classifies investment structures narrowly into three groups - conglomerate, vertical and horizontal. The political susceptibilities of these structures being influenced by another set of variables - related to sector, ownership and technology. Constraints or opportunities are analysed according to whether they are ownership-control, transfer or operational. (Similar to Root, 1972)

Kelly & Philippatos (1982:39) have confirmed some of Wells' hypotheses in their 1982 survey of foreign direct investment practices of U.S. manufacturing enterprises.<sup>19</sup> Interestingly with regard to the analysis of corresponding

## Chapter Six

strategic predispositions, the decision to invest remains at headquarters, being made by the Board of Directors in 66.7 percent of cases. Although it should be noted that state-firm bargaining<sup>20</sup> is conducted among and between individuals. Underlying assumptions from the theory of multinational enterprises regarding motivation for foreign direct investment may account for observer bias in questionnaire construction<sup>21</sup> as well as demand characteristics on the part of the observed; reactive factors which would have to be accounted for by political risk analysts attempting to identify and measure risk. (See Kelly & Philippatos, 1982)

Wells contends that greater degrees of subsidiary autonomy are likely to decrease the potential for government/firm conflict, and vice versa. Inevitably, organisational structures are influenced by historical developments in the patterns of international business - for example, Blake & Walters (1992:107) found that between 1960 and 1990, the percentage of U.S. direct investment in manufacturing rose from 35% to 40%; at the same time, investment in petroleum decreased from 43% to 14%, while service industries and financial institutions accounted for 46% of all U.S. foreign direct investment by 1990. They do not specify whether declines are real or proportional. Nevertheless, these developments are bound to influence the structural arrangements of firms, the ways in which they interact with states, as well as the ways in which constraints due to political risk are identified and measured.<sup>22</sup>

### 6.2.1.2. Structural Affect - Some Empirical Evidence :

Production structure may determine the nature of global or regional interdependencies, and therefore inherent risk. For example, Chrysler adopted a regionally integrated investment structure in South America. The result was a decrease in vulnerability to expropriation in Peru due to Chrysler's

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stranglehold on the supply of essential components. Fifty percent of Chrysler's auto and truck components were supplied by regional sources outside of Peru. (Shapiro, 1981:65; Ring et al., 1990 and Schmidt, 1986) Similarly, in Brazil, Ford plants were dependent on exports to other Ford plants located elsewhere. It is not clear from the literature on political risk, whether these structures resulted from deliberate strategies calculated to reduce political risk, or whether they may be ascribed theoretically to internalisation of production.<sup>23</sup>

The hypothesised relationship between structure, strategic predisposition and political risk is discussed in more depth in another section of this paper. In terms of the structuring of international finance for foreign direct investment, diversified sources of debt capital have been cited by Yaprak & Sheldon, (1984) as examples of investment structuring calculated to diminish the risks to investors. Although, as Brennglass (1983) has noted, the use of multinational financing structures as a means of reducing risk depends on the laws of the host country. In general, multilateral financing structures appear to decrease political risk. (Brennglass, 1983:229) Mathur and Hanagan, (1981) have discerned a relationship between the degree of functional centralisation of investment finance, managerial attitudes and propensities for risk taking behaviour : "... if management's attitude is to avoid foreign exchange risk, then the finance function is decentralised. If management's attitude is to treat foreign exchange risk as another variable, then the finance function is centralised." (1981:24)

6.2.1.3. Structural Constraints Risk, Concluding :

Many of the firms discussed in the preceding sections of this paper are the result of the 'Golden Age', the period between 1945-73, during which global output and trade growth were unprecedented historically. (Kaplinsky, 1991:257) Their organisational structures and proliferation coincide with the patterns of growth and production which occurred during that epoch. The discussion above has outlined some of their organisational forms and structures from the perspective of firm-specific political risk analysis. Structural constraints and opportunities may emanate from decisionmaking structures (Wells, 1971;), production structures (Shapiro, 1981), financing structures, (Mathur & Hanagan, 1981) ownership structures or combinations thereof. In addition, structures are liable to change over space and time.<sup>24</sup>

By the same token, structural patterns are likely to induce reactions in terms of the developmental policies and strategies adopted by host states - further influencing the nature of risk for transnational firms. (Kaplinsky, 1991:257; Dunning, 1991)<sup>25</sup> Structural constraints can thus be characterised by 'affect' or internal aspects of political risk and 'effect' or external influences. It should be noted that structures are liable to change as firms grow/contract and adapt to environmental constraints and opportunities. Projections or forecasts of risk should account for potential change. From the firm-centric perspective, structure should be identified and related to the wider environment<sup>26</sup> if political risk is to be identified and measured in a manner consistent with conceptual and operational definitions. '...risks that managers face are company-specific...Since firms vary in their organisation and competitive position, each company can be differently affected by changing

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political coalitions, shifting national strategies, or specific policies such as import licensing and domestic content regulations. (Austin & Yoffie, 1984:405,406)

Structure should be viewed in conjunction with the other dimensions of the firm-centric approach. For instance, structure may determine strategic predisposition (Refer to discussion elsewhere in this paper) and may be determined by other interests and goals such as profitability, risk avoidance, risk transfer or risk management. The discussion above has alluded to an aspect of political risk which would form the basis of a productive research programme. (Kobrin, 1979a for similar conclusions with regard to the analysis of case studies of expropriations in South America during the era of economic nationalism.) Further empirical evidence would be required prior to general abstract theorisation about structural 'affect', its relationship to political risk and the inclusion of structural considerations in analyses of political risk. Naturally, as political risk has two facets - the cause and probability of occurrence and the source of probable impact - environmental causal factors would be an important consideration in any firm-centric analysis. However, as political risk can only be properly identified and measured in relation to the firm - structure is both a potential cause and source of risk. Techniques for identification and measurement would have to account for this aspect of risk to be operationally congruent with conceptual and definitional requirements. From the perspective of risk management, ability to change the sources of risk through adaptational strategies could enable the firm to avoid the putative consequences of socio-political developments. (Austin & Yoffie, 1984:406)

### 6.2.2. Strategic Predisposition and Goals :

Political risks related to strategic predisposition<sup>27</sup> are dependent on a variety of factors, societal and firm related. Strategic predisposition affects the adaptational capacity<sup>28</sup> of firms, but adaptational capacity may be affected by bargaining power, ownership and production structures, business interests, managerial perceptions and goals or practices dissonant with societal factors, such as host country developmental policy, (Sachdev, 1978:35) increasing worker mobilisation or trends towards increasing economic nationalism. Naturally, the opposite is also true - that strategic predisposition may be a mitigating factor which decreases both sensitivities and vulnerabilities to political risk for a particular firm. Salzman, (1975) has listed ten strategies for managing the risk of expropriation, including restructuring, location of research and development facilities in the home country, diversified production structures, and debt/equity arrangements.<sup>29</sup>

#### 6.2.2.1. Strategic Predisposition - Kennecott and Anaconda :

Perhaps the best known examples of the ways in which strategic predisposition can affect political risk through adaptational strategies adopted by firms, are the cases of Kennecott and Anaconda in Chile (Chaudhuri, 1988; Moran, 1971) and of the oil companies in Venezuela. (Shapiro, 1981) While Anaconda reacted to trends toward economic nationalism by doubling investments in Chile, only to suffer 100% expropriation during the early seventies.<sup>30</sup> (Salzman, 1975) Kennecott adopted a successful transnational strategy during 1964, when it sold a 51% share of its Chilean mining interests to the Chilean government - the mines continuing to be run by Kennecott personnel under a management contract. The overall strategy adopted by Kennecott was to subject

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as little as possible of the corporation's own capital to the risk of nationalisation. Financing of loan guarantees for expansion of mining facilities was accomplished internationally, against future copper production - thereby increasing the number of external stakeholders<sup>31</sup> as a deterrent measure against potential Chilean hostility and unilateral action. After nationalisation of Kennecott's share of the Chilean mining interests during the early seventies, Kennecott was able to resort to international legal recourse by way of contractual enforcement - and Chilean ore carrying ships were seized, as were aircraft of LanChile landing in New York.<sup>32</sup> (Chaudhuri, 1988) Eventually, Kennecott received US\$ 80 million in compensation from the Chilean government. (Moran, 1971)

The experiences of Anaconda and Kennecott appear to indicate that while a firm's predisposition toward strategies of local participation decreases or at least mitigates the risk of expropriation, other related predispositional factors may be as important as equity structures to the identification and measurement of political risk. For Kennecott, successful strategic predispositional responses involved the combination of firm-government and firm-society relations, with flexible production operating structures. In this regard, Mathur and Hanagan have noted that analysts identifying and measuring risk need to consider the balance of risk factors. (Mathur & Hanagan, 1981:27) In the case of oil companies in Venezuela, exploration and management contracts were signed with the Venezuelan government after nationalisation, thus minimising the second facet of risk. (Shapiro, 1981) With regard to the measurement of political risk, in the light of strategic predispositional factors, Mexico has a long history of expropriations of foreign owned firms, yet remains one of the major locations for investment by U.S. firms. Analysis of strategic predispositions as they relate to identifying risk, shows that risk measurement should be considered in terms of impacts on managerial processes, as well

as financial performance. Indicative of the need for a combination of qualitative and quantitative risk measurement techniques consonant with definitional considerations.

#### 6.2.2.2. Risk Transfer Strategies :

Strategic predispositions which favour the transfer of risk via insurance require a balanced approach with regard to identifying and measuring risk. Davies, (1980) has suggested that risk originating from different sources be identified and measured by means of prioritising. Risk to property may have a higher priority than risk to managerial procedures, and thus be measured according to the mitigating effects of transfer strategies only. According to Gordon, OPIC defines risk as follows : 'The risk insured by OPIC is property, the origin of loss category is social, and the risk is pure.' (Gordon, 1973/4: 493) While risk premiums, which start at 0,1% and may reach 6% (Kraar, 1980:88) or more in the case of oil ventures in countries such as Libya, are directly quantifiable, and may be measured as financial constraints - they are inadequate for entire coverage. For example being based on pure risk,<sup>33</sup> they cannot cover non-property risk or the types of speculative constraint covered in the definition of risk which applies in this dissertation.

Risk transfer strategies, and consequently the identification and measurement of political risk depend on the ability of the firm to establish a degree of congruency between the operations of the firm and societal conditions such as developmental aims. Gordon has noted that the normative concern for risk

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reduction that often accompanies risk transfer strategies could lead to firms adopting strategies of risk avoidance, at odds with the aims of organisations such as OPIC which aim to encourage 'development friendly' investment in host countries and industries which may otherwise be classified as high risk. The dangers of perceiving risk exclusively in terms of loss have been discussed in Chapter two, and risk transfer practice seems to indicate that logically, risk must be perceived in terms other than loss.<sup>34</sup>

Akhter & Lusch, (1987:85/6) have noted<sup>35</sup> with regard to strategic predisposition as an ongoing adaptational process, that congruency with the national interests of the host country is the most important factor. According to Ring, Lenway & Govekar, ongoing adaptational processes can be inferred by the political risk analyst from antecedent asset configuration, the historical distribution of responsibilities and management norms. (1990:141) Analysis of political risk would thus entail assessing the flexibility of investment and management policies with regard to the requirements of risk transfer agents. Sachdev has found that firms '...can usually meet many but not necessarily all of the objectives of developing host governments in specific instances.' (1978:35)<sup>36</sup> (Also Shubik, in Herring, 1984:120) Ability to transfer the risks associated with foreign direct investment thus covaries with the ability of a firm to act consonantly with national objectives - though it is not the only factor to consider when assessing strategic predisposition toward the management of political risk as a factor in risk identification and measurement. Stein (1983:22) has listed the following as uninsurable : failure to obtain permits and licenses, illegality, acts or events within the insured's control, failure of performance by the insured, radioactive contamination and/or nuclear explosion, currency fluctuation, war damages and financial default or insolvency of private buyers.

6.2.2.3. Risk Avoidance - Strategic Predisposition :

Strategic predispositions toward risk avoidance may result in inaccurate risk perceptions. The discussion above is not intended to inculcate attitudes of risk avoidance in analysts - rather - strategic predispositions should be considered as a matter of course whenever risks are analysed in the context of possibilities for the adoption of strategies of risk management or risk transfer. Risk avoidance is also inconsistent with operational definitions of political risk that allow for speculative risk to be identified and measured. In cases where methods such as BERI, BI, or WPRF are in use, risk avoidance strategies may be an inevitable consequence. Definitions of political risk which allow for the identification and measurement of political risks inherent in day-to-day operations of transnational firms are inconsistent with risk avoidance strategies. (Gordon, 1973/4:489, discusses of this point in relation to OPIC policy.)

6.2.2.4. Risks to Goals :

Related to strategic predisposition from an analytical perspective, are the firm's goals. Kelly and Philippatos, (1982:31) found in their survey that most U.S. manufacturing companies involved in foreign direct investment do so to overcome tariff barriers (31.4%), gain economies of scale (25.7%), in response to government pressure to produce locally (24.8) and to take advantage of government incentives (24.8).<sup>37</sup> Unfortunately, they have not supplied details of reasons for the largest response category (i.e. Other reasons, 38.1%). Firms also indulge in investment and trade for reasons of internalisation, in order to overcome market imperfections, secure technological leads (Vernon, in Wortzel, 1985), and to secure advantages of ownership or location. National origin affects goals, (Kojima, 1978; Strange, 1992) the figures noted above

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apply only to U.S. based firms. For example, in contrast to American firms, Japanese firms are known to invest internationally mainly for reasons of trade - a fact which affects strategic alliances and state/firm bargaining. State/society-firm linkages will in turn be affected by state/society reactions to the activities attached to the attainment of goals. For example, ISI<sup>33</sup> orientated development strategies may be replaced by policies of export promotion, market liberalisation or even privatisation of state assets expropriated only recently. Goals will also affect issue interdependence in bargaining and adaptational strategies. For these reasons, firm-centric models for risk identification and measurement should include careful analysis of goals as they relate to environments and environmental change.

#### 6.2.2.5. Strategic Predispositional and Goals Risk - Concluding :

In this section of the paper, strategic predisposition has been identified as a consideration for analysts applying a firm-centric approach to identifying and measuring political risk. Strategic predisposition 'affect' influences the ways in which firms perceive risk, and the strategies employed towards risk. Three adaptational strategies discussed widely in the literature are those of risk management or internalisation, risk avoidance and risk transfer. Strategic predisposition or choice of strategy is determined by environmental as well as firm-specific factors such as global change in the first instance or investment goals in the second.

In identifying and measuring political risk, the risk analyst should include detailed analysis of these factors within the context of environmental 'affect'. Likewise, the goals of firms vary from firm to firm - analyses of political risk should account for this fact - one reason why aggregate studies which claim relevance across cases are of limited applicability other than as

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the broadest of measures or 'flags'. The predispositional considerations and goals of firms are so varied that additional study from the perspective of political risk analysts would be recommended. Much of the literature covered in this paper derives from other disciplines - clearly there is a need for deeper study of these aspects of the political risk phenomenon.

In measuring political risk, strategic predispositional factors may affect either the first or the second dimension of risk. The selection of strategy may affect risk projections over time, and the fact that firms do not exist independently of the environments in which they operate could affect risk identification. Structure may be affected by predisposition, and vice-versa. van Agtmael, (1976:30) has noted the influence of bargaining position on strategic predisposition : '... much can be done to minimise losses caused by political decisions or actions by a realistic and candid evaluation of one's bargaining position.' (Refer also to Chakravarthy & Perlmutter, 1985:4) Additional considerations worth further in-depth exploration - unfortunately beyond the scope of this paper, which is not intended to be more than a minor contribution toward firm-centric analysis.

### 6.2.3. Norms, Values, Practices and Procedures :

This section deals with other aspects of the transnational firm as it affects political risk - both societally and internal to the firm. Strategic predisposition and adaptational strategies may become standards of their own, and thus may be classified as norms by political risk analysts. Other norms may be imposed by the home country of the transnational firm - such as the United States Trading with the Enemy Act or the First Hickenlooper Amendment to the Foreign Assistance Act of 1961, which limited United States investment in Namibia as a measure against South Africa. (Wells, 1971:111) (Also : Crow,

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Crow, 1986 for U.S. oil trading measures against Libya.) Beeman & Timmins found, in relation to corrupt practices that 75% of U.S. business leaders had received demands from foreign officers for 'unusual payments' - '...extortion was so common in most nations that it could only be considered a normal cost of doing business.' (1982:10) Examples cited include Prince Bernhardt of the Netherland's involvement with Lockheed.<sup>33</sup> Home country 'norms' such as U.S. ethics requirements could influence the identification of political risk in the home country and should be considered as part of any analysis. Raddock (1986), has also dealt with the problem of corruption with respect to host country politics. Firms with Calvinist or Puritanical values and norms would be susceptible to political risk 'affect' in host countries where corruption permeates the socio-political system.

Ability to 'live with the winners' after incidents of civil disorder also determines political risk for some firms. (Kraar, 1980) (For example Gulf Oil in Angola after the Marxist takeover.) Although the experience of firms remaining in Shanghai after the communist takeover in China indicates the need for ongoing analysis specific to particular environmental circumstances. Ability to establish congruency between host country developmental strategies and policies may be affected by the internal norms and values of the firm - and these should be assessed in conjunction with estimates of adaptational capacity when identifying and measuring expected constraints on the firm. Aspects of political risk which are less tangible, but no less important than considerations of profitability and loss. In other words, firm-specific 'affect' related to the goals, norms values and practices of foreign business may constitute risk in themselves. In view of the definitional fiduciary framework of objective uncertainty discussed in Chapter one, LaPalombara et al., (1976:80) have stated that firms appear '...not to care at all about political factors unless it can be clearly shown how they relate to the

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company's financial condition. Perceiving and measuring the potential effects of political risk essentially in terms of the capital budgeting process or exchange rate fluctuations (Kelly & Philippatos, 1982:34,36; Li, in Rogers, 1983:131; Brewer, 1981; and Micallef, 1981:50 ) is to neglect other important aspects of the phenomenon.

Firm-specific norms affecting the degree of congruency between the activities of the firm and host society include other factors more properly included under the heading of business risks. They include - local participation and profits repatriation practices as well as compatibility of the product with cultural values in the host country and visibility.<sup>40</sup> To the extent that these norms are susceptible to adaptation and change they will affect the way in which political risk is identified and measured by firms. Perspectives on the adaptational potential of norms may vary depending on the locus of risk assessment within the company; political risk assessment services may differ in perspective from the treasury department. (Keegan, 1974)

Practices and procedures may vary in nature from the strictly managerial in nature to the more operational. For example, the practice of providing import substitution may become politically risky where host country ISI development policies are changed in favour of export promotion. Practices such as intra-firm trade, transfer pricing, leading and lagging of payments constitute adaptational strategies to decrease constraints imposed by government barriers. (Eden, 1991:209) Purchasing practices, domestic product displacement,<sup>41</sup> relations with provinces and central government, and local debt practices are other examples of potentially risky procedural aspects of the firm which should be included in analyses of political risk which aspire to account for risks in day-to-day operations. Managerial practices such as 'grand tour' assessments of political risk could also constitute political risk.<sup>42</sup>

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### 6.2.3.1. Norms, Values, Procedures, Practices - Concluding :

Establishing conceptual/operational congruity at the empirical level of analysis implies careful examination of the goals, norms, rules, practices and procedures of the firm. The scope of this project does not allow for in depth analysis of these factors by means of evidence from case studies. However, research strategies in the future should include these aspects of the firm in their analyses of political risk. Transnational firms are also transitional firms, their strategies, structures and other characteristics are liable to covary with changes in the environment within which they operate. Political risk methodologies should account for evolutionary changes and discontinuities in both environment and firm.

### 6.2.4. Asset, Organisation, Operations, Marketing :

#### 6.2.4.1. Introductory Remarks :

The classificatory categories in this chapter are not intended to be mutually exclusive. Complex sets of interrelationships have been simplified for the 'ad hoc' purpose of establishing the validity of a firm-centric approach to the identification and measurement of political risk. For example, regarding the more common organisational structures identified by Walters and Blake, (1992); global expansion has resulted in firms adopting global planning structures, consequently, local and international structures have increasingly merged. At the same time, changes in technology structures have enabled deeper structural rearrangements for firms and states.<sup>43</sup> Structure, strategic predisposition, and regime theory related categories of norms, values, procedures and practices are analytical constructs which function to organise ap-

proaches to the analysis of the types of risk covered in this section of the paper. The complex sets of interrelationships which constitute political risk may fall into any or all of these categories. The nature and direction of causality would have to be assessed in each case by the analyst.

#### 6.2.4.2. Asset, Organisation, Operation and Marketing :

Writers such as Overholt, (1982); Root, (1972) and Schmidt, (1986) have used these categories to organise their analyses of political risk. Their approaches have been discussed in detail in other chapters of this dissertation and therefore will not be covered again at this stage. (See Chapters four and five in particular) The purpose of this section is to include a brief discussion of some empirical supporting data from case studies, in favour of these taxonomies and to recommend that they be retained in firm-specific analyses of political risk. Mitterand's (1981) nationalisation of certain key foreign firms such as AT&T and Honeywell Bull and Chilean copper mine expropriations of the early seventies are examples of political risk which could be classified as asset risk. However, asset risk includes all violations of property (both physical and intellectual) which are politically motivated. (Phillips-Patrick, 1989; Moran, 1981 and Overholt, 1982 for additional details)

Organisational constraints are pervasive, and result from governments' attempts to manage economies and markets. Examples would include affirmative action and management indigenisation regulation; restrictions on hiring and firing;<sup>44</sup> red tape for foreign direct investors requiring prescribed investments or imposing special conditions on foreign investors are examples of organisational constraints. Strategic predisposition and adaptational strategies may be affected by organisational constraints. Threats to the safety of personnel such as kidnapping or extortion would be included in this category.

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Baglini has offered evidence of this type of restraint - he found that in 1980, 57 international corporations reported having an executive kidnapped, and figures produced by the U.S. Conference Board indicate 275-300 incidents each month, involving corporations around the world - these incidents range from extortion, bombing, industrial sabotage and murder to thefts. (Baglini, 1983:64) Unfortunately, he has not offered any suggestions as to the proportion of these incidents which may be attributed to political developments.

Constraints to operations may emanate from the international environment, or they may be isolated incidents within a particular host-country. At the sub-national level currency restrictions, politically motivated labour unrest, restrictions on imports or exports, and production quotas are some of the examples cited by Overholt, (1982) as examples of operations risk. Some of these would be categorised as transfer risk by Root and Schmidt whose risk categories are more broadly stated than those of Overholt. Marketing risks include those discussed above - namely voluntary export restrictions, orderly marketing arrangements. Restrictions which may result from international trends, and relations between host and home or third countries. Other marketing risks would include nationalised minerals marketing. Although it should be noted that the availability of international commodities markets has reduced strategic options available to firms intent on retaining control over marketing.

Asset, organisation, operations and marketing risk could originate anywhere along the state/society - firm continuum. Some may be perceptual in nature and essentially firm-specific, while others may originate in the international environment as a result of bargaining processes between host countries and third party firms. Those writers who have attempted to describe firm-specific approaches to the identification and measurement of political risk have employed

them, based on empirical evidence drawn from case studies. In conjunction with the types of risk outlined above, they are an important consideration which offers theoretical as well as methodological challenges to the analyst. Multi-disciplinary approaches to their analysis, applied on the basis of hermeneutics, or the principles of 'verstehen', would probably succeed best.<sup>45</sup>

### 6.3. Firm-Specificity - Implications : Concluding :

Writers who have observed that risks are firm specific include Overholt, (1982); van Agtmael, (1976); Austin & Yoffie, (1984); Rice & Mahmoud, (1986) and Schmidt, (1986) inter alia. An comprehensive overview of methods and models found in the literature on political risk has concluded that there is no abstract firm-specific model. In this dissertation, the definition of political risk has been broadened beyond considerations of profit and loss, to encompass constraints on the other goals and characteristics of the firm. It has been suggested in this paper that risks are firm-specific. Accordingly, an analytical taxonomy which includes the goals, strategic predisposition, profitability, norms, values, practices and procedures has been discussed in detail in the preceding sections. Empirical evidence has been produced in favour of the argument, based on findings detailed elsewhere in the document.

Firm-specificity has other implications for the political risk analyst contemplating what it has to offer. Terminological issues have been touched on, as have the diverse theoretical and methodological origins of theories of the firm. Political risk analysts, are able to draw from a range of disciplines in identifying and measuring risk from a firm-centric perspective. Firm-specificity has been examined for 'affect' as well as effects along a continuum between state/society and firm. Naturally, risks are also a function of the wider environment. Since many of the methods of identifying and measuring

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political risk concentrate either on the 'macro' or the 'micro' aspects of risk - many risk ratings are inaccurate or inapplicable. Risk rating must include both facets of risk, and the analyst using the framework described in this chapter would need to make 'ad hoc' decisions regarding methods and theoretical approaches.

Of course, measurements and analyses made according to a firm-specific framework remain subjective in nature. However, the principles of intersubjectivity and falsifiability prescribe foundations of knowledge for the risk analyst. Therefore, the fiction of objective uncertainty has been retained for this thesis. It is proposed that the framework outlined in this chapter and in Chapter five offers better prospects for identifying and measuring risks than some of the frameworks and methods based on indices of risk. Additional research in the form of case studies would be required by way of corroboration.

6.4. Key Terms for Review :

Political Risk	Continuum of Risk
Structural Risk	Strategic-Predispositional Risk
Goals Risks	Profitability Risks
Procedural Risk	Operations Risk
Asset Risk	Organisation Risk
Market Risk	Business Risks

6.5. Chapter Six : End Notes :

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1. Objective uncertainty and political risk are synonymous - the result of a formal process of identification and measurement, whereby uncertainties regarding the socio-political environment are related directly to the firm. (In this regard, refer to Zink, [1973:24].)
  2. For example, the phenomenological and taxonomic approaches; BERI, PSSI, and WPRF, critiqued in Chapters two and three.
  3. Such as those of Overholt, (1982) and Schmidt, (1986).
  4. 'Analysis' is the identification and measurement of political risk.
  5. Eden, (1991:218) has noted this point with respect to the need for political economists to include the multinational enterprise in their analyses of

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markets and states. Similarly, Dunning, (1991) has noted further theoretical implications of increasing globalisation with regard to analyses of the competitiveness of nations; competitiveness being determined across a range of nations due to production structures and strategies of globalisation.

6. By implication, the international socio-political policy environment should be included in analyses of smaller firms - a firm-specific forecasting approach which ignored the wider environment would not necessarily include all potential sources of risks. Though it should be noted that risks remain firm-specific in terms of the second facet of risk, no matter what their origin. The analytical challenge is to identify and measure credibly.

7. i.e. Governmental, societal and international stakeholders at all levels of analysis.

8. The word constraint is used here, in keeping with broader 'speculative' definitions of political risk which allow for financial gain and loss, as well as less tangible effects such as those arising from affirmative action or management indigenisation policies in the host country.

9. Which in turn can be categorised as the potential for risk transfer, risk avoidance, or risk management and internalisation. See Crow, (1986) and Much, (1980).

10. The political risk analyst arrives at these judgements from a knowledge of the organisation's political and economic vulnerabilities and from an understanding of the relevant conditions in a targeted country. (Raddock, 1986:3)

11. In the sense that firms can affect and may be affected by the societies in

## Chapter Six : End Notes

which they exist and conduct business.

12. For example, they are not all corporations, some of them are better described as transnationals, while others may have different organisational and legal structures.

13. According to Eden, the largest 600 multinational enterprises generated worldwide (sic. annual) sales of US\$ one billion each and together produced one-quarter of world gross domestic product in 1991. (1991:197)

14. Strange, (1992) has noted the presence of smaller firms and state owned enterprises as well as firms from developing countries in the global environment. These new structural types are significant for political risk analysts in that bargaining power (assets) is specific to the firm - a non-territorial entity - while bargaining assets of states tend to be territorially specific. See discussion below for examples of bargaining implications of structure.

15. Industry, sector and project specificity all imply different institutional and organisational structures and firm-state interdependencies. (Ring et al., 1990:141)

16. Valsamakis et al., have identified three main structural forms within the firm : they are the formal organisational structure, the structure of managerial relations, and the physical structure which includes plant and machinery. (1992) Political risk analysis may require consideration of all of these factors.

17. Prakash Sethi, Etemad & Luther (1986) have noted the influence of corporate decisionmaking structures on court rulings regarding Nestlé's milk for-

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mula.

18. Changes of management structure may mirror technological developments, Eden, (1991) has argued that during the time period when the political risk analysis genre developed, most firms had a three level pyramidal management structure. Overholt, (1982) has recommended the application of this type of analytical format to polities. (or 'regimes' as he prefers to call them) Various authors have advanced competing hypotheses on the effects that other structural changes in the international political economy may have on the relations between states and firms. (Dunning, 1991 and Strange, 1992 for examples)

19.

### Survey Results

% of Respondents	Structure
19.0	Organised globally by geographic divisions
1.9	Organised globally by functional area eg., finance, marketing
34.3	Organised globally by product lines or groups
21.9	Using international division for foreign ops.
22.9	Other (unspecified)

N = 255

Response Rate = 53.5 %

(Kelly & Philippatos, 1982:39)

20. Bargaining power has been defined as '...proprietary technology, worldwide

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market share (economies of scale), and product differentiation.' by Chakravarty and Perlmutter. (1985:4)

21. Refer to question two, (Kelly & Philippatos, 1982:31)

22. The increasing number of 'third world' multinational corporations has inflated the number of multinational corporations to around 10 000 in 1990. (Blake & Walters, 1992) Future political risk research agendas should include these new international actors. Different normative perspectives due to national differences are bound to influence conceptions of political risk for third world firms operating in the developed states.

23. The theory of multinational enterprises attributes the existence of MNE's to ownership, locational and internalisation advantages.

24. For example, Wells (1971) has noted the demise of the international division. While adaptational strategies may alter structure and political risks.

25. NIDL policies, voluntary export restraints and orderly marketing arrangements are examples of these reactive strategies at sub-national and global levels of analysis. Indeed, political risk analysts have neglected to examine the role of transnational firms in the formulation of world trade policy.

26. In Chapter five, the wider environment was defined to include relations between firms, firms and states, states and states, and stakeholders such as VPO's (voluntary private organisations) which make up international society.

27. Defined by Ring et al., as 'The extent to which an organisation exhibits a consistent pattern over time in the choices it makes about the formulation and

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implementation of its strategies. (1990:147)

28. Adaptational capacity may involve a process of bonding with the host society in terms of supporting developmental strategies, (Gordon,1983:228) restructuring, or decoupling issues. Firms are constituent elements of the system and legitimacy within the host society would decrease political risk exposure. (For additional comments on this issue, refer to Akhter & Lusch, 1987:96)

29. In regard to the latter, Bradley has noted that historically the rate of expropriation for joint ventures with host governments, has been ten times greater than that for a 100% U.S. owned subsidiary. (1977:80) Unfortunately, insufficient data precludes further discussion of his point which seems to contradict received wisdom on the subject of joint ventures.

30. 1971 - without compensation.

31. After expropriation, Chile was unable to sell Kennecott copper in the United States, Europe or Japan.

32. By means of writs of attachment. LanChile - the Chilean national air-carrier.

33. Which involves loss or no loss.

34. An interesting case of definitional inconsistency occurs in Grosse & Stack (1983:43) where risk is defined in terms of loss (or pure risk), and then treated as speculative ( i.e. as the chance of gain or loss, or no loss). They write about 'favourable' political risk such as tax reductions and elections of more supportive governments - a form of risk which can only be described as speculative in terms of the first dimension of risk discussed in Chapter one of this dissertation.

35. In support of OPIC policy described above.

36. OPIC policy with regard to development reflects U.S. foreign policy.

37. Figures in brackets denote orders of preference, as well as the number of respondents favouring that particular option.

38. Import Substitution Industrialisation.

39. According to Beeman & Timmins (1982), Bernhardt concluded a secret commission deal by which he was to earn 4% on complete aircraft and 8% on parts sold to the Dutch government.

40. LaPalombara et al., (1976) have noted that American companies doing business in Italy during the early 'seventies preferred to keep low profiles, and so to hide their multinational status.

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41. Chudnovsky, (1979) has noted in regard to the Argentinian pharmaceutical industry, that local producers could be a source of political risk for transnational producers. Local production may give rise to lobbying against the protection of multinational's patent rights.

42. Official 'grand tours' are often accompanied by host government publicity personnel, and may therefore result in biased assessments of political risk.

43. For example, production strategies of global cost leadership may influence planning and production structures with concomitant changes occurring in the asset and organisational structures of firms.

44. Such as those in Japan, (lifetime employment), Korea and Taiwan.

45. Indeed, the literature discussed above in this chapter and in previous sections of the dissertation is drawn from a variety of disciplines, including Psychology, Sociology, Political Studies, Economics, International Business Studies, International Relations Political Risk Analysis and International Political Economy. Kobrin, (1979a) has suggested that additional insights may be gained from Social Anthropology.

7. Chapter Seven : Concluding & Recommendations :

7.1. 'Oscines Abdicunt Aliquid'\* - The myths of Vox Pythia :

The processes of identifying and measuring political risk have been bound conceptually, theoretically, methodologically and empirically to historical trends and fiduciary frameworks. In defining risk and differentiating conditions dominated by stochastics from certainty about a single outcome, this paper has retained the fiducial concept of objective uncertainty. In the interest of parsimony and economy, a distinction has been drawn between subjective uncertainty, objective uncertainty, uncertainty and certainty. Subjective uncertainty is considered to be a state of uncertainty about the probability of future occurrences and outcomes. Objective uncertainty, is the result of a process of identification and measurement along two dimensions of risk - namely the probability of an occurrence and the probable impact on the firm. Under conditions of objective uncertainty, subjective probabilities have been assigned to future occurrences by means of a formal process of analysis. Risk is objective uncertainty in this dissertation.

Historical trends have influenced the development of the concept of political risk in terms of taxonomies of risk, as well as the industry of political risk analysis. These additional fiduciary frameworks have been discussed in depth in the paper. Their impact has been to diffuse the focus of political risk analysis; analytically the result has been a lack of congruency between the conceptual and operational levels of analysis. The numerous taxonomies discussed in previous chapters bear witness to progress, albeit limited in terms of establishing some of the socio-political conceptual components of risk. Methods and models for the identification and measurement of political

risk have caused incongruities at the operational level of analysis - where measuring the impact of politics on the firm has been neglected in favour of attempts to establish comparative cross-country risk ratings.

## 7.2. Recommended Firm-Centric Research Agenda :

Findings detailed in the exploration of the body of literature on political risk analysis in other parts of this paper, have shown that there is a need for a firm-centric conceptual schema for the identification and measurement of political risk. Some preliminary investigations into a possible firm-specific schema have been described in the latter portions of this dissertation. However, a dearth of literature on the subject suggests the following remedies in terms of congruity and future firm-centric research :

(a) Empirical case research into the effects of managerial attitudes on the constitution of political risk for the firm.

(b) Further research into identifying and measuring non-quantitative constraints and opportunities afforded by less tangible aspects of political risk.

(c) Cross-paradigmatic investigations of models of the firm for use in firm-centric analyses of political risk.

(d) Comparative firm-specific case studies of the relationship between external political risk effects and internal affect. Both in terms of identifying political risk, and measuring its impact on the firm.

(e) A reassessment of the types of analyses required by firms from political risk analysts.

### 7.3. Political Risk Analysis, Research Agenda :

In view of the lack of methods and models for identifying and measuring political risk from a firm-centric perspective; this paper has recommended catholicity of theory and method as a temporary strategy. The following agenda for research would yield significant progress within the field :

(a) Investigation of the metatheoretical implications of cross disciplinary research into political risk analysis.

(b) Cross-impact studies of the application of firm-centric approaches, and the possibilities for rating risk across cases.

(c) Further research into the concept of uncertainty within a firm-centric approach.

(d) Reassessment of the utility of political risk analysis for transnational firms in transition.

### 7.4. Some Concluding Thoughts :

Like their sacerdotal counterparts, political risk analysts have created a very credible 'mythology of risk' akin to the ancient auguries originating from flocks of birds flying overhead. Certainly, the portents or birds and

clouds may be real enough, but what do they mean and to whom do they apply? The answers to these two questions depend naturally, upon plausible explanations and predictions of causal relationships over space and time. Requirements met by few of the generally temporally static methods and models reviewed in this paper. By implication for the science of political risk analysis, attaining definitional/operational congruency, depends on the analyst's ability to establish firm-centric inferences and connections.

Accordingly, the main recommendation of this dissertation<sup>1</sup> is that political risk myth-makers must shift the emphasis of identification and measurement to focus on the individual firm within the socio-political environment. Unless pronouncements on political risk<sup>2</sup> are firm-specific, they should be abandoned<sup>3</sup> and consigned to a 'pantheon' of political risk memorabilia. ■

#### 7.5. Chapter Seven : End Notes :

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\* 'The Omens (cries of birds) are Unfavourable to Someone.' In the ancient Roman science of augury, 'alites' were birds which gave omens by their flight; 'oscines' were those which gave omens by their calls. The modern science of Political Risk Analysis has created an equivalent mythology of hazard. (Refer to detailed discussion in Chapters two and three.) In contrast, this paper supports a more speculative, abstract firm-specific 'normative'<sup>4</sup> study of peril than that adopted by contemporary mytho-analytical purists. The latter derive their auguries geocentrically, on the prospects of socio-political developments resulting in trade and loan loss for transnational corporations.

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1. And of writers such as Moran, (1985); Raddock, (1986); Eden, (1991); Casson, (1991); Siegwart, Caytas & Mahari, (1989); Rice & Mahmoud, (1986); Schmidt, (1986) and van Agtmael, (1976). While writers of the 'sovereignty at bay' school, such as Eden (1991) and Strange (1992), advocate bringing the firm back into analyses; political risk analysts arriving at similar conclusions have failed to produce an abstract model for wider analytical applications. For examples of this point, the reader is invited to refer to Schmidt, (1986) and Raddock, (1986); as well as discussion elsewhere in this paper.

2. Whether favourable or unfavourable.

3. General country-specific Delphic ratings and indices such as BERI, BI, WPRF and PSSI should be included in this category, for reasons detailed in Chapters three and five.

4. In the sense that risk identification and measurement is approached in a hermeneutic manner by the analyst, from the perspective of the individual firm, although the scientific method may be employed for analysis of susceptibilities to the socio-political environment.

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