

**REVISITING THREE POLITICAL  
RISK FORECAST MODELS: AN  
EMPIRICAL TEST**

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**Dedicated to.....**

My late mother Gerda Kotzé

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## ABSTRACT

The discipline of political risk analysis has often been criticised as a 'soft science'. As the title of this study suggest, the major challenge of this study is set out to provide an empirical analysis of political risk and to prove that political risk can indeed be measured. The aim of this study is to provide an empirical analysis of political risk by testing the reliability of current risk assessment approaches to accurately forecast political risk. There have not been many attempts to test the reliability of political risk assessment models. However, Howell & Chaddick (1994) tested the reliability of three (EIU, PRS and BERI) political risk assessment models to accurately forecast risk projections in the period 1982-1994. This study will revisit the test done by Howell & Chaddick (1994) in order to determine the reliability of three forecast models.

In order for forecasts to be reliable, forecasts must be justified and defended by applying practical logic. Practical logic implies that theory be tested against real world experience. Hence, a reliable analysis will require that actual losses be tested against theory. Therefore, in addressing the connection between theory and actual losses, this study will correlate losses incurred in the period 1994-2004 with theory.

Due to the nominal nature of the concept political risk, there has been a lack of consensus in the field on what constitute political risk. This study will provide a conceptual clarification of political risk. A brief discussion of the underlying theoretical background in political risk is required in order to understand the concept of political risk and terms thereof. Hence, this study will establish a theoretical base of political risk analysis.

This study argue that low political risk encourage foreign direct investment. The relationship between political risk and foreign direct investment will be analysed in this study. It is hoped that in light of this study's findings, a case can be putt

forth that multi-national corporations can use political risk analysis to minimise exposure to losses and as an extension of political risk analysis, multi-national corporations can use political risk insurance to hedge against political risks.

The outcomes of this study aim to prove that political risk can be empirically tested and measured and that the analysis of political risk is essential to successfully manage political risks.



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## **Chapter One Introduction, Background to the study and Research Framework**

Foreign enterprises enter a host country to achieve the ultimate business goal: to maximise profit with minimal risk. Host governments, however, allow the entry of foreign enterprises to advance their own domestic, political and economic goals. Therefore, foreign investment relationships with host countries are inherently political (Tarzi, 1992:433).

Domestic governments' intervention in the affairs of foreign enterprises arise from different concerns, including

“societal considerations such as regulating prices, imports, exports, foreign exchange, increasing national employment, developing local resources, expediting inward technology transfer, and placating important political constituencies” (Akhter and Choudhry, 1993:43).

These interventions can pose political risks to the investor. Howell (1998:3) defines political risk as the “possibility that political decisions or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when investment was made”.

Political risk is typically described as the likelihood that events in the political and social environment of an enterprise will cause financial, strategic or personnel losses to the firm. Risks such as expropriation, inconvertibility of currency, war damage and civil strife damage can pose loss to a foreign enterprise.

This study will focus on the explanatory power of three political risk models for foreign direct investors. Foreign direct investment (FDI) is more subject to political risk than indirect equity (portfolio) investments, since direct investments are difficult to disengage when the investment climate in a state becomes unfavourable (Lee and Powell, 1999:2).



There have not been many attempts to test the reliability of current models of political risk to project actual losses. Howell and Chaddick (1994) compared the 1986 projections of The Economist Intelligence Unit (EIU), Political Risk Services (PRS), and Business Environmental Risk Index (BERI) against real losses incurred in the 1987-1992 period. Howell and Chaddick tested political risk forecasts against actual losses.

Howell and Chaddick's findings were that there is a variation between the three models to accurately forecast political risk. The study will draw on the work of Howell and Chaddick (1994) to test the reliability of the same models in the years since the last test was undertaken to accurately forecast political risk. The actual losses tested at the time referred to forecasts undertaken in 1986.

## **1. 1. Background to Political Risk Analysis.**

The evolution of political risk analysis has been a complex process in the past few decades. In the late 1960s, the first writings on political risk and political risk analysis started appearing in American foreign policy (Kobrin, 1982:62). In the pre-OPEC, era political risk analysis was not deemed a priority in corporate decision-making. In this era, political risk analysis was in its early phases of conceptual studies and political risk was deemed a soft science due to the qualitative nature of early studies.

It was only in the OPEC era in the 1970's that political risk became a high priority in corporate decision making. Moreover, the advent of the first oil-crises in 1973 marked an era where political risk analysis gained momentum (Brink, 2002:3). This era characterised the introduction of more quantitative methods of political risk analysis. The era of the 1970s were characterised by oil and financial crises and companies suffered significant losses due to political risk. In addition, the end of this era, the 1980s, marked the introduction of political risk insurance initiatives. The rise in the direct use of political risk analysis in this period is due to a number of changes experienced in international business. These changes, to mention a few, include the

losses incurred from the fall of the Shah in Iran, the growing popularity of foreign investment, the rise in conflict in the cold war and the changing political spectrum in the aftermath of the cold war.

In the 1990s, there was a decline in the direct use of political risk analysis, which can be attributed to a number of causes. Firstly, companies failed to incorporate the results of political risk analysis into the corporate decision-making process. Secondly, the number of losses incurred by multinational corporations (MNCs) in the 1970s and 1980s led to retrenchments by MNCs, resulting in a lower need for political risk analysis. Thirdly, many companies experienced the profit-squeeze, resulting in the cut-down of political risk analysis. Lastly, the lack of credibility of political risk analysis due to perceptions of political risk analysis as a 'soft science' (Howell & Chaddick, 1994:71).

Business and politics in the 21<sup>st</sup> century have been transformed in countless ways. The political environment of the 21<sup>st</sup> century is determined by economic growth and market expansion, whereas, the political environment in previous eras was determined by a quest for territory, ideological power struggles and a battle for balance of power. Moreover, the political environment in the 21<sup>st</sup> century has been transformed by the disappearance of borders and internationalisation. Prior to the 1990s, many countries pursued the goal of self-sufficiency. Conversely, in the 21<sup>st</sup> century, countries pursue goals of market integration and policies that increase or attract foreign trade and investment.

The same has been the case for business in the 21<sup>st</sup> century. With the transition of local markets into global economies, there has been an increase in stakeholder expectations and an increase of competing priorities. Prior to the 1990s, political risks associated with government interventionist policies were considerable (Conklin, 2002:37). These types of political risk often termed 'traditional risk,' include risks such as nationalisation, expropriation and war damage. However, these risks remain in the 21<sup>st</sup> century, because state sovereignty cannot be deligitamised or eliminated. Equally

important, is that government actions and events still influence business in a globalised world. Governments still have autonomy within their country borders. Therefore, foreign investors are still at risk when operating abroad. Evidently, as more and more companies expand globally, there is a greater need for and an increase in the direct use of political risk analysis in the 21<sup>st</sup> century.

The 21<sup>st</sup>-century has marked the prominence of non-traditional business risks such as corruption, terrorism and climate change. This is not to say that traditional risks do not pose a threat to business. There are countries that still pose risks such as civil war, civil unrest and expropriation. Countries that are still hampered by traditional political risk include Iraq, Afghanistan, Colombia and Nigeria. Risks have become more complex and uncertain. This is due to the interconnectivity and interdependence. Thus, political risks are more global in scope. Cleary and Malleret (2006:49) explain that “as connections among firms, markets and states have increased so markedly, the effects – and unintended consequences – of an event are felt more widely and rapidly than before”. The interconnected nature of the global political economy has led to a more intense co-operation and competition; this in turn has led to a much higher rate of intervention of all actors involved in the global arena. As a result, threats emerging in one environment can spread to another environment and disrupt the system of which different environments form part (Cleary & Malleret, 2006:44-49).

Cleary and Malleret (2006:48) contend that “interconnectivity exponentially increases uncertainty”. Hence, the political risk environment has become complex and increasingly difficult to analyse and comprehend. Consequently people have become more aware of political risks and political risk analysis has been shifted to a high priority in corporate decision-making. By taking a comprehensive approach to political risk, corporate decision-makers can enhance its ability to grasp the implications and interdependencies between political risk events and other risks considerations within the interconnected environment of business and politics (Chambers & Jacobs, 2007:61). On the contrary, corporate decision-makers have increasingly placed

emphasis on the analyses and assessment of uncertainty that investors face due to anticipated and unanticipated political risk.

On the whole, MNCs are facing a host of new and unexpected challenges as they expand abroad. Political risk analysis provides a systematic framework to identify and evaluate the likelihood and impact of individual political events that can disrupt business. Moreover, the objective of political risk analysis is to provide a higher degree of operational efficiency by anticipating contingencies that might pose a threat to a business's strategy and objectives. With political risk analysis a company can make more reliable and accurate decisions about international operations. As a result, political risk analysis enable a company anticipate the implications of political change, thereby identifying both opportunities and risks stemming from political uncertainty and instability. In addition, corporate decision makers can mitigate risks and improve profitability of an investment by using evaluations gained from political risk analysis (Chambers & Jacobs, 2007:60).

## **1. 2. Research Question and the Research Problematique: Aim and Relevance of the Study.**

Political risk analysis, as a discipline, has often been criticised as being a 'soft science'. The critique against political risk analysis argues that, due to its qualitative nature, political risk analysis is subjective and thus biased. On the contrary, over the past two decades, political risk analyses have developed as a discipline into a more systematic analysis. This implies a combination of both 'soft science' (qualitative methods) and 'hard science' (quantitative methods). Typical methods applied in political risk analysis include any qualitative method, standardised checklists, scenario development, any quantitative method, structured qualitative formats, statistical analysis, computerised models and delphi techniques (Frei & Ruloff, 1988:5). Political risk analysis thus applies a synergy of methods.

Political risk analysis implies a probabilistic assessment, meaning that the product of the analysis is a forecast (Howell, 1998:9). In addition, the goal of analysing political risk is to forecast losses. This analysis implies the identification of variables, determination of their relationships to each other, establishing their contribution to a particular situation, then projecting the future for the purposes of a specific application (Howell, 1998:5).

The goal in forecasting is to determine both the variables and which combination is likely to result in the threat of loss; the combination includes weights assigned to the variables (Howell, 1998:5). The risk-weighted variables are evaluated by using complex statistical techniques to derive a final figure of the risk involved, which can be expressed either in numbers or a letter grade.

Consequently, the forecasting of political risk results in an index; the weights included in the index are related to underlying different theories according to the type of models used (Howell, 1998:5). So, the task of the modeler is to link theory with loss. The most common statistical methods used in determining the weights of each variable within the index include correlation and regression analysis.

The aim of the political risk analyst is to control the events resulting in loss. The first step in controlling events is to identify causal relationships. This requires the availability of knowledge which in turn requires experience (Meehan, 1998:88). Thus, the key to a successful risk analysis is grounded in real world experience.

Pitfalls experienced in the precise prediction of these events that result in loss include a number of elements of the analytical method and model, the complexity of social phenomena, partial information and human intervention (Howell, 1998: 9).

The aim of this study is to address the first pitfall mentioned above. This involves the model used for predicting risk. Howell explains that socio-political systems are notably complex and some representative approximations of societal and political attributes are utilised in a model,

“The projection of outcomes from the situation becomes probabilistic because a) a complex set of circumstances is necessarily simplified and abbreviated in any model, and b) the selection of representative variables and their relationships may not be the optimal one” (Howell, 1998:9).

Thus, the reliability of these models to successfully represent the social and political system as a whole in order to identify causal relations of events leading to loss comes into question. Similarly, the connection between theory and loss will be as accurate as the prediction of the model.

The underlying problem of this study is based on the above premise; the premise questions whether a model can accurately predict losses for the investor. Thus, the purpose of this study is to determine whether models can accurately predict losses for the investor. Based on this problem the research question addressed in this study is how reliable and valid are three models (EIU, PRS and BERI) to accurately forecast political risk.

### **1. 3. Objectives of the Study.**

This study attempts to test three models that claim to forecast political risk. A previous attempt to test three models was made by Howell and Chaddick (1994) to test the reliability and validity of three risk assessment models. This study will draw on the work of Howell and Chaddick to test the reliability of three current risk models. In order to test the reliability, this study will mimic the test done by Howell and Chaddick (1994). The aim of this study is to test projected political risks against actual losses incurred from 1996-2004. The inquiry will test the consistency and rationale of the ratings provided by three models. In testing the consistency and predictive power of these ratings, the predictive power of the ratings will be established.

The study will determine the variation between three models, namely: Economist Intelligence Unit (EIU), Political Risk Services (PRS) and the Business Environmental Risk Model (BERI) model. The logical and structural properties of the three models will be considered in the study in order to evaluate those properties with respect to the task of forecasting.

The methodology underlying the political risk analysis process is one of practical logic in which forecasts must be justified and defended. The study aims to investigate whether real world experience shows if the three models can accurately and reliably forecast political risk. In testing the reliability and validity of the three models, the study will address the connection between theory and profit or loss for foreign investors.

The importance of closely examining both theory and methods is critical. Poor theory or method could result in inaccurate ratings and consequent losses for investors. Moreover, inaccurate ratings could mar the reputation of potential host states and the investment opportunities offered, with consequent loss of investor confidence and FDI flows. The study will correlate real losses with theory to empirically determine the accuracy of forecasts.

#### **1. 4. Research Design and Methodology.**

McNabb (2004:xxxv) defines the research activity as “the process of systematically acquiring data to answer a question or solve a problem”. In solving a research problem or question, it is necessary to consider the design and methods used when attempting to solve a problem. The design and methods used in the research process determines the type of outcomes expected.

This study is an empirical and statistical analysis of political risk models, and combines both quantitative and qualitative methods. In a quantitative study, the goal is to test a hypothesis; the test is done by use of numerical data. The theory applied in a

quantitative study is causal and deductive. The goal of the analysis is to relate data to the hypothesis being tested.

In contrast, the goal in a qualitative study is to discover meaning; the data used in aid to exploring meaning typically includes verbal and textual data. The theory applied in a qualitative study is context bound and inductive. The goal of the analysis is to extract and organise themes into a coherent unit.

This study is a quantitative inquiry into political risk analysis; qualitative methods are used to provide a theoretical background. Quantitative research entails the collection of numerical data and as exhibiting a view of the relationship between theory and research as deductive (Bryman, 2004:62). Deductive theory represents the relationship between theory and social research in the most common view; this implies that the researcher deduces a hypothesis into operational terms (Bryman, 2004:62). In order to deduce a hypothesis into operational terms, the researcher translates the concepts related to the hypothesis into the data being tested. Bryman and Cramer (2002:54) describes *operationality of concepts* as “specifying the procedures that will permit the differences between individuals in respect of the concept(s) concerned to be precisely specified”. This means that a concept’s meaning is standardised.

Quantitative designs make use of numbers as data, and uses mathematical or statistical testing to calculate results, the latter of which is used in this study. Due to the social nature of politics, an introduction of statistical testing is required in order to comprehend the empirical testing of the three proposed models. This study, therefore, relies on statistical testing of variables and not assumption based theories. In light of this, this study rejects the deterministic approaches to causality and data in this study is treated in a probabilistic manner.

As mentioned earlier, this study makes use of both qualitative and quantitative. Therefore, this study aims to test a hypothesis and discover meaning of practices, events and actors related to the research question. The primary data used in this study



is numeric. This study will determine the reliability and validity of three current risk assessment models through statistical testing. Numeric data used in the analysis includes country ratings, weights assigned to variables and statistical data, statistical data will be used to validate the analysis. Numeric data will include statistical modeling and testing of political risk indices which will be provided by Statcon (Statistical Consultation Services), University of Johannesburg.

A qualitative design will be applied in chapters two to four. This will include secondary data that consists of case studies, archival resources like corporate position papers, working papers, country reports/profiles. A literature review of relevant literature will be included. Text data includes discourse and content analysis done by the researcher. Where possible, the study will be complimented with interviews with 'multiple experts' in the field. A questionnaire is used in chapter five in order to gather relevant expert opinion where necessary.

#### **1. 5. Outline of the Remainder of the Study.**

The study will consist of six chapters. Chapter two will introduce the concept of political risk. It aims to clarify the concept of political risk and will also provide the conceptualisation of terms thereof. Chapter two aims to present a theoretical base for political risk analysis. This chapter will focus on theory and methods of risk analysis; this includes the different approaches to risk analysis. It will also focus on the different dimensions of risk analysis and the methodological problems in forecasting risk. In addition, this chapter will explore the relationship between politics and economics in order to provide an understanding of the dynamics between politics and business.

The third chapter will introduce the topic of foreign direct investment. Low political risk encourages foreign direct investment. Through the use of political risk analysis, an investor can minimise losses. This chapter will explore the relationship between political risk analysis and foreign direct investment. In addition, it will examine the stakeholders involved in foreign direct investment and how they influence the success

of a business venture. This section will provide insights into an investor can successfully manage stakeholder relationships.

This study will suggest that as an extension of political risk analysis, multi-national corporations can use political risk insurance to manage political risks. Chapter four will explore political risk insurance as a method to mitigate investors' political risks.

Chapter five will test the variation between three current models of political risk by revisiting the work done by Howell and Chaddick (1994). This will include the statistical testing of data. This chapter will interpret the results gained from statistical testing.

The final chapter will summarise the results of this study. This chapter will conclude with the main findings of the study and state whether political risk can be empirically tested, measured and successfully managed.



## **Chapter Two      Introduction**

This chapter attempts to present a theoretical base of political risk analysis. It deals with the clarification of political risk analysis and the conceptualisation of terms thereof. It explores the plethora of definitions of risk and political risk, the origins of political risk and the problems in defining political risk. The chapter attempts to distinguish between political risk and country risk, the dimensions of country risk, specifically, sovereign risk and transfer risk, will be discussed.

In order to establish the theoretical base of political risk analysis, it is necessary to understand the relationship between politics and economics. The relationship between politics and economics will therefore be explored. Concepts like political instability and uncertainty will be explained in this section. The main focus of this thesis is to determine the validity and reliability of three political risk models. Therefore, this chapter aims to examine the concept's reliability and validity, which will be done by comparing empirical concepts and social research.

In attempting to establish the predictive power of political risk models, political forecasting and political prophecies will be discussed. This chapter will determine if control over future events is possible, and concludes with a description of political risk analyses and political risk assessment as a discipline. A brief overview of approaches to evaluate political risk will be provided.

### **2.1. Clarification of concepts**

#### **2.1.1. Risk**

Risk arises from uncertainty surrounding every day life. It involves considering whether or not to take a certain action. For individuals, risks of everyday life consist of ill health, injury, death, accidents, damage and to or theft of

possessions. These risks can be controlled by taking out insurance, medical aid coverage, exercising, and securing ones property.

Tulloch and Lupton (2003:18) approximate a formal definition of risk as being “a neutral phenomenon which may have a good or negative result”. Traditionally, risk has been defined as the realization of unwanted, negative consequences of an event. It involves the chance, possibility, or probability of loss (Friedman & Kim, 1988:64). Put simply, risk is understood as a potential problem. This negative view has been challenged in the past decade as being too restrictive and incomplete, especially when considering opportunities. Nairne (1997:28) supports this by stating that “measures of risk, whether quantitative or qualitative, are measures of opportunity”. Risk, thus, involves an uncertain condition or event that has a negative or positive effect on achieving some objective. Therefore, the positive aspects of risk deserve as much attention as the negative aspects of risk (Frei & Ruloff, 1988:2).

Chartered Institute of Management Accountants (2003:193) define risk as “a condition in which there exists a quantifiable dispersion in the possible outcomes from any activity”. Risk is something all businesses must recognize, assess and manage, as they will all encounter risk. Through a certain degree of risk some potentially profitable opportunities can be exploited (Chartered Institute of Management Accountants, 2003:193).

Vlek & Stallen (1981:27) list six definitions of risk common in literature and consider it to be:

1. the probability of loss;
2. the size of the possible loss;
3. a function- mostly the product of probability and size of loss;
4. equal to the variance of the probability distribution of all possible consequences of a risky course of action;

5. the semi variance of the distribution of all consequences, taken over negative consequence only, and with respect to some adopted reference value; and
6. a weighted linear combination of the variance of and the expected value of the distribution of all possible consequences.

The plethora of definitions of risk is problematic. Singleton and Hovden (1987:27) argue that these “definitions are context free and they only refer to abstract terms such as probability and loss”. Singleton and Hovden (1987:27) further contend that, “except in some simple situations, the various objective aspects of risk...cannot be measured but have to come from expert judgment”. It is then important to ask whether context free approaches are valid and reliable. The scope of this study specifically focuses on the validity and reliability of current approaches to political risk analysis; this will be further elaborated upon in the next section of this chapter.

This study is a quantitative inquiry into political risk analysis. Quantitative research entails the collection of numerical data and as exhibiting a view of the relationship between theory and research as deductive (Bryman, 2004:62). Deductive theory represents the relationship between theory and social research in the most common view; this implies that the researcher deduces a hypothesis into operational terms (Bryman, 2004:62). In order to deduce a hypothesis into operational terms, the researcher translates the concepts related to the hypothesis into the data being tested. Bryman & Cramer (2002:54) describes *operationality of concepts* as “specifying the procedures that will permit the differences between individuals in respect of the concept(s) concerned to be precisely specified”. This means that a concept’s meaning is standardised.

Risk is a nominal concept and is, therefore, difficult to operationalise. The concept of risk must be clarified in terms of the context and dimension- for example, country risk, political risk etc.. The purpose of the next section is to

reflect this awareness of the distinction between the different types of risk that may be incurred by multinational firms.

### **2.1.2 Political Risk**

Defining political risk is problematic due to a lack of consensus of what constitutes political risk (Brummersted, 1988:78; Friedman & Kim, 1988:64; Kobrin, 1979:67; Simon, 1982:62). Brink (2002:24) explains that this is due to the difficulty of clarifying the concept 'political risk'. Like most concepts in politics, the concept 'political risk' is a nominal concept and is a limitation for empirical study (Brink, 2002:24). A nominal concept is a concept in name and thought and not reality (Cambridge, 2003:841). The term political risk is further complicated by a semantic confusion with concepts like 'political uncertainty' (the most typical example), political instability, and country risk (Friedman & Kim, 1988:64). This will be explained later in the study.

Political risk encompasses political events and government interference. For a political risk to be a risk, it must be unanticipated (Oseghale, 1993:13). There exists diversity in the definition of political risk. Some authors of political risk analysis refer to political risk as a loss, other refer to political risk as unpredictability or uncertainty, some refer to risk arising from environmental factors and some authors refer to political risk as continuities or discontinuities of political change in the business environment. However, most authors view political risk in terms of an event occurring in the business environment usually associated with an act of government which has unwanted consequences for the enterprise (Kobrin, 1979:68).

Most literature defining political risk in political risk analysis overlaps Howell and Chaddick's (1994:71) definition of political risk as

"the possibility that political decisions, events, or conditions in a country, including those that might be referred to as social, will affect the business environment in such a way that investors will lose money or have a reduced profit margin".

The origin of political risks can be internal (within a country) or external (resulting from outside influences).

It is important to note that these events that influence the profitability of a business venture are political in nature. In order to understand the effects that political risks have on business enterprises, it is essential to decompose political risks in events and factors. Bunn and Mustafaoglu (1978:1558) define 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”. It must be noted that the consequence of an event depends on the nature and conditions under which it occurs and the characteristics of the investment (Kobrin, 1979:69). Bunn and Mustafaoglu (1978:1559) define a political risk factor as “any set of circumstances which influences the occurrence of a political risk event”. They further conclude that “when an event is defined carefully...a set of factors can be identified as being precursive”.

Howard (1993:13) also highlights the importance of political risk events in political risk analysis by asserting that the theoretical description of a political risk consists of a differentiation between risk events and risk effects. Howard (1993:13) defines a risk event as “a discrete occurrence... transpiring in the environment”, and a political risk effect as “the manner in which the event manifests itself upon the multi-national enterprise in question...”.

Political risk events are generated through groups such as government in power and its operating agencies, parliamentary operating groups, non-parliamentary opposition groups, parliamentary opposition groups, non-organised common interest groups, foreign governments or intergovernmental groups (Robock, 1971:66). Channon and Jalland (1979: 66) assert that political risk events is classified by the types of intervening bodies such as the host government, the home government and a supra-national authority.

Tarzi (1992:444) suggest a frame of reference for risk evaluation to identify and define political risks by supporting the decomposing of political risks into political factors and political risk events. There exists a relationship between the variables within the frame of reference; this relationship is causal- i.e. variables within the sequence are isolated and causally linked. The frame of reference represents the characteristics of the particular political risk. The framework consists of a political risk event which is the dependent variable, which is influenced by a political risk factor. The risk factor is the political risk cause and is an independent variable. Tarzi (1992:445) explains that the political risk factor to the political risk event as being the “predominant vector” and that it “indicates the causal relationship between dependent and independent variables”.

After breaking down political risks into political risk events and political risk effects, political risks can be further broken down into macro and micro risks. Macro risks, which are systemic in nature, involve the political system at large and consist of actions and policies affecting all foreign enterprises in a given country (Tarzi, 1992:445, Simon, 1982:66). Micro risks are specific to an industry, firm or project and thus aimed only at selected fields of business (Frei & Ruloff, 1988:3). Tarzi (1992:445) describes micro risks as “specific changes within the public policy/regulatory environment of the host country which, if these occur, would have a negative effect on the profitability of the investment project”. Figure 1.1 and 1.2 illustrates a frame of reference adapted from Tarzi (1992) as an alternative model for political risk assessment.



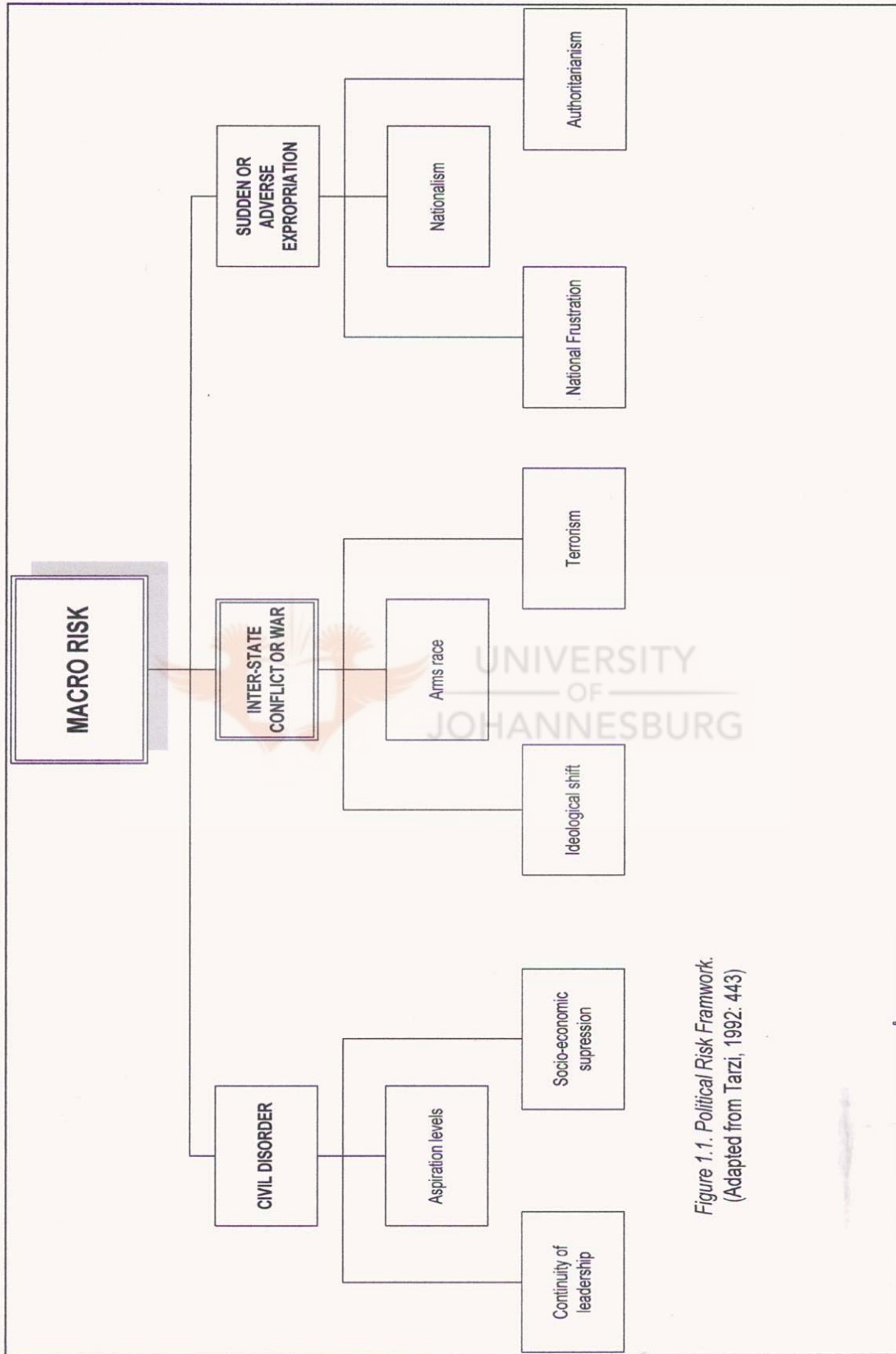


Figure 1.1. Political Risk Framework.  
(Adapted from Tarzi, 1992: 443)

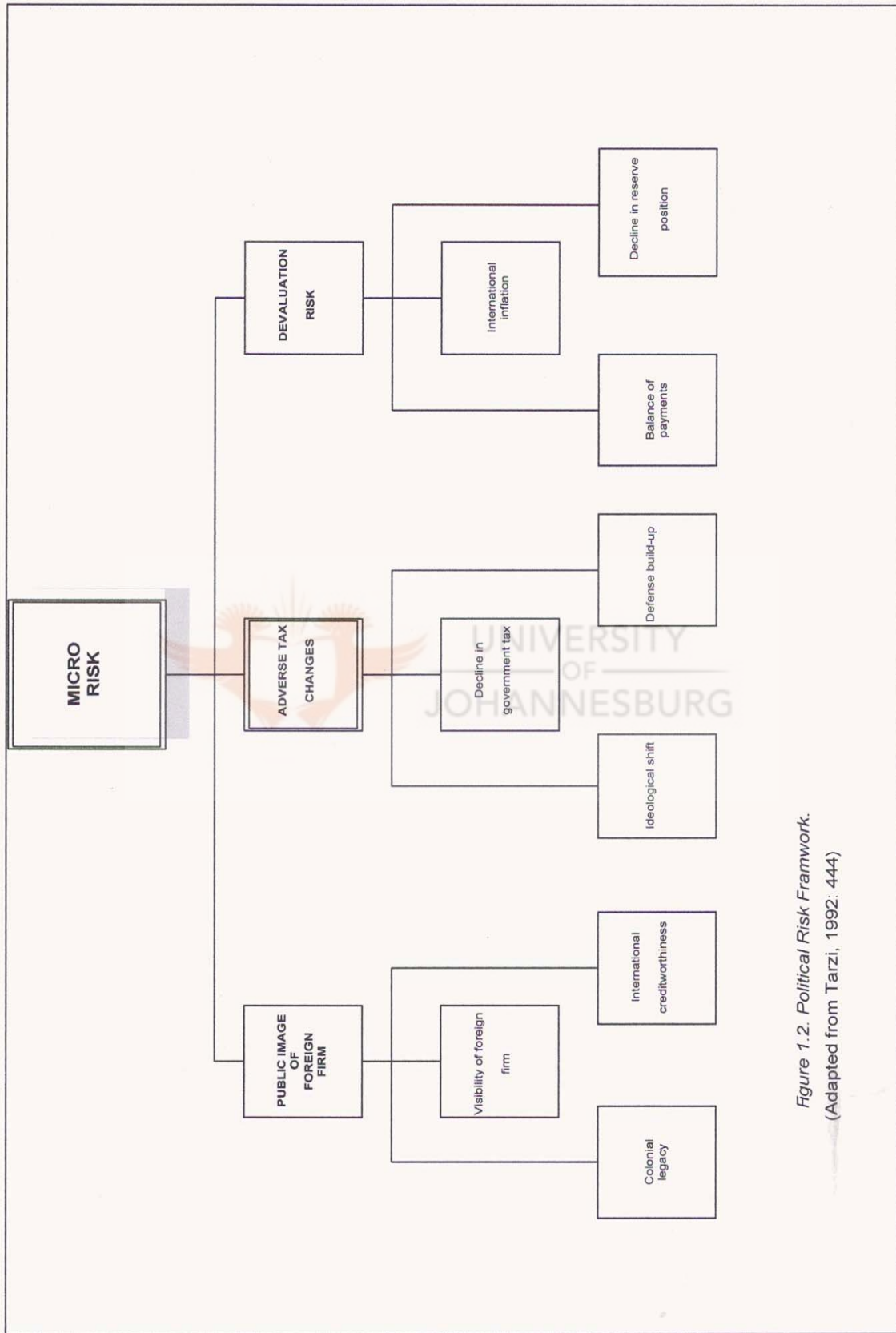


Figure 1.2. Political Risk Framework.  
 (Adapted from Tarzi, 1992: 444)

### 2.1.3 Political Instability and Uncertainty.

Political risk analysts must be wary of confusing the concepts political risk and political instability and uncertainty. Political risk is distinct though related to political instability and political uncertainty. Brink (2002:26) explains that “political risk is a relatively objective measurement of the amount of doubt”, whereas political uncertainty and political instability is “a subjective doubt about the occurrence of political events”. Friedman and Kim (1988:64) maintain that “political instability is a critical property of the environment in that it represents the environmental degree of change”. Political risk is not a property of the environment; thus, political risk can occur in the absence of political instability and vice versa. Brink (2002:26) states that “political instability can be used as a factor of political risk...instability a property of the macro political environment can, but does not necessarily always, cause or result in risk”. Political instability refers to unexpected or unforeseen changes in government policy, or in a government’s implementation of power (Brink, 2002: 26).

According to Root (1972:354-365), “uncertainty refers to the possible occurrence of an event, whereas risk refers to probability estimates of the occurrence of an event”. The nature of political uncertainty refers to the puzzling lack of sureness or absence of strict determination of political life (Cioffi- Revilla, 1998:3). Weimer and Vining (2005:119) contend that “risk involves contingencies (state of nature) with known probabilities, and uncertainty involves contingencies with unknown probabilities”.

Uncertainty is a characteristic of all political life because it concerns social behaviour affecting people and how they are governed. Cioffi-Revilla (1998:5) maintains that “uncertainty means that, in politics, outcomes are neither predetermined (with probability 1) nor impossible (with probability 0), but lie somewhere in between”. This is due to the ‘indeterminate’ nature of decisional acts. According to Cioffi-Revilla, this ‘indeterminacy’ makes uncertainty

consequential, ubiquitous and ineradicable. According to Dahl (1984:6) “systemic political analysis can reduce some of that uncertainty”.

Friedman and Kim (1988:64) argue that “uncertainty is a critical characteristic of an organisation’s environment which may be defined as a lack of information about future events so that alternatives and their outcomes are unpredictable”. Being a phenomenon present in the environment and not a characteristic of the environment, risk, therefore, cannot exist without an organisational entity or business project. But political uncertainty can, however, exist without an organizational entity, this is the same for political instability (Friedman & Kim, 1988:64).

Political risk, political uncertainty and political instability are three distinct but interrelated phenomena though interrelated. A political risk assessment cannot rely solely on political uncertainty or political instability as a reflection of the overall political risk in a country.

#### **2.1.4 Country Risk.**

Country risk can be broadly defined as “potential financial losses due to problems arising from macro-economic and/ or political events in a country” (Calverly, 1985:3). Country risk is the risk associated with undertaking transactions within a particular country, or holding assets in that country. Sources of risk can be political, social or economic instability. Frei & Ruloff (1988:3) define country risk as “encompassing the total risks, non-business (alpha-risks) and business (beta-risks), that a country offers to foreign investors”.

Calverly (1985:163) identifies six principle areas of risk which need to be considered in country risk, namely:

1. Possible major devaluation;
2. Major recession;

3. Major shift in economic policy;
4. Nationalist pressure on multi-national companies;
5. Civil or political unrest could disrupt the economy; and
6. Domestic banking crises.

There are two types of risk at the country risk level: transfer risk and sovereign risk. These risks also act as political risk factors (Brink, 2002:30). There are various definitions of sovereign and transfer risk. Sovereign risk can be defined as “the risks associated with the granting of loans to foreign governments”, while transfer risk can be defined as the risk that a particular country may impose restrictions on remittances of capital, dividends, interests, fees, or royalties to foreign lenders and/or investors as part of its economic policy (Krayenbuehl, 1985:4; Frei & Ruloff, 1988:3). Calverly (1985:3) defines sovereign risk as

“the risks for bank loans to governments or for loans with a government or for loans with a government guarantee...it is the risk that the government at some stage will be either unable or unwilling to meet its obligations...whether the government has the foreign exchange to pay and, whether it is willing to do so”.

Krayenbuehl (1985:4) concede that sovereign risk can be described as

“arising from the special risk associated with a sovereign loan, which is a loan to, or guarantee by, a government (or some government guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action- i.e. the borrower might claim immunity from the process or might not abide by a judgment”.

In short, sovereign risk implies a default on bank loans.

Calverly (1985:3) defines transfer risk as “the possibility that even though the project is generating a cash flow in local currency which is sufficient to meet obligations, the government does not have the foreign exchange available to make the foreign currency remittance for servicing debt”. This risk is important to multi-national companies since it affects remittance of profits. Transfer risk thus represents a lack of foreign exchange and that the debtor cannot transfer the money to the lender.

As mentioned earlier, transfer risk and sovereign risk act as political risk factors in political risk models. Political risk is thus a specialised relation of 'country' risk. However, country risk, as practised by credit rating agencies, does not sufficiently incorporate political risk (Brink, 2002:27).

Calverly (1985) identifies four types of country risk problems (i.e. sovereign and transfer). They are listed in ascending order of severity.

1. Deterioration of perceived country risk;
2. Late payments;
3. Rescheduling; and
4. Write-offs due to moratoria, repudiation, renegotiation, etc..

Brink (2002:31) suggests that "all country risks factors can be used as political risk factors". However, levels of political risk in a country are not necessarily pegged to levels of country risk and vice versa. Brink (2002:32) explains that a country might be unwilling to repay loans (high political risk), but have the ability to do so (low transfer risk).

Thus, country risk problems occur when there is no ability or willingness to service debt. Calverly (1985:15-19) explains that it is difficult to differentiate between willingness and ability to pay. A country with the ability to meet its commitments might be unwilling to do so on political grounds, perhaps because of a political shift or because of disapproval of the loans for political or ideological reasons. But the consequent loss of trade finance and possible seizure of assets abroad could be a heavy cost to pay for a purely political or ideological end. Hence if the ability to repay is there the willingness will usually follow easily.

The ability to pay is usually linked to the balance of payments, whereas the willingness to pay is usually linked to the cost and benefits of the country to not meeting its financial obligations. Often, the fluctuations in the components of the

country's balance of payments are really more deeply manifested policy problems, such as, displays of earlier mistakes of deeper underlying problematic trends (Brink, 2002:33). Howard (1995:11) supports this through asserting that "poor policies indicate weak performance".

Country risk is often linked to political instability. It is important to note that political instability is a political risk factor. Howard (1995:7) suggests that the tendency to equate country risk with political instability should be resisted because political risks have many origins that may have nothing to do with instability; political risk may arise even where there is a stable government. There are three key aspects of political risk in relation to country risk, namely: 1. Interactions between political developments and economic policy; 2. Radical political change and 3. Interactions between political developments, foreign confidence and capital inflows (Calverly, 1988:114). In order to understand the relation of country risk to economic risk, it is important to understand the relationship between economics and politics. This point will be elaborated in the next section of this chapter.

Calverly (1988:3) identifies six levels of analysis in country risk,

1. Structure of economy;
2. Economic Management;
3. Size and structure of debt;
4. Structure and prospects for exports;
5. Domestic and creditor confidence in the government; and
6. Political structure.

Country risk indicators often include: export/import growth rates, inflation rates, currency depreciation, real GNP growth, domestic credit expansion, money growth, volatility of foreign exchange earnings, level of debt, level of interest payments, total bank debt, debt service ratio, monetary, fiscal and micro-economic policy and control, hospitality to private and foreign capital. Important

socio-economic indicators in country risk analysis include, GDP per capita, birthrate, population growth rate, adult literacy, urban population, population density and labour in agriculture. The most important aspects in a country risk framework include trade strategy, the level and type of state involvement, approaches to pricing, investment priorities and financial structure (Calverly, 1988:67).

A relationship exists between political risk and country risk. Political risks can result in country risk. Country risk involves the balance of payments, balance of payment problems can result in political risk. The evaluation of country risk when anticipating FDI helps to establish a clearer indication of a companies' exposure to political risk in a particular host country. Most country risk indicators reflect the overall credit and business climate of a country. Similarly, political risk indicators reflect the overall political climate of a country which has an impact on country risk. For example, a determining factor in country risk is the policy environment of a country, which is a result of political motivations and decision making.

An understanding of the relationship between politics and economics is needed in order to compare of country risk analysis and political risk analysis. Politics and economics have in common- the exercise of influence to affect the distribution of particular values, such as power, prestige or wealth (Kegley & Wittkopf, 2004:18). Political risk is “the possibility that political decisions or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when the investment was made”, whereas country risk is “of a larger scale, incorporating economic and financial characteristics of a system in the same effort to forecast situations in which foreign investors will encounter problems in specific national environments” (Howell, 1998a:1). It is thus clear that country risk involve more business (i.e. economic) risk, but these risks are subject to influence or can result as a symptom of political risk and vice versa with political risk except that political risk is non-business risk.



The multi-discipline of political risk analysis causes problems when trying to separate the political from the economic for they are inseparable. This is also the case with the 'societal'. Economic problems can cause 'societal insurgence' against government social expenditure can lead to civil dissent, for instance, and can be relayed back to political and economic policy. Although a distinction between economic and political determinants of events can be made, they are obviously interrelated for politics largely determines the framework of economic activity (Kobrin, 1979: 69).

The analysis of political risk is dynamic and depends on the shape of the world economy and the way, in which international politics unfold. For instance, the production and distribution of wealth directly affect the distribution of political power. Cioffi-Revilla (1998:5) maintains that "political decisions can be defined as the 'sovereign' collective decisions from which the individual is *less likely* to escape, because of both their spatial extension and their coercive intensity". The discipline of economics is the social science which examines how people choose to use limited or scarce resources. Economics focuses on production and the exchange of this production. Economic analysis and political analysis often looks at the same questions, but economics focuses less on issues of state power and national interest and more on issues of income, wealth and individual interest. According to Lasswell, the discipline of politics involves the study of "who gets what, when, how and why" (in: Kegley & Wittkopf, 2004:18). For Heywood (1997:4), politics- in its broadest sense- is the "activity through which people make, preserve and amend the general rules under which they live". Politics is defined in various ways, such as: the exercise of power and authority, the exercise of power, the authority, the making of collective decisions, the allocation of scarce resources and the management of conflict and cooperation (Heywood, 1997:4).

The relationship of politics and economics in a globalised arena brings us to the complexity of interdependence. The increasing global economic interdependence tends to mean increasing vulnerability (Brummersted, 1998:75). For instance, a change in pricing, a disruption of supplies, or a shift in the international environment has the potential for dislocating entire economies, ways of life, worldwide systems of production, employment, sales distribution, finance and investment (Manning, 1977).

The interconnectedness of politics and economics can better be understood through the study International Political Economy (IPE). IPE is the study of international affairs that focuses on the elements of complex interdependence that define many of the most pressing problems in the world. The need to study IPE arises because many important contemporary questions cannot be addressed from the standpoint of a single discipline or by the analysis of actors and actions that take on a particular level of analysis- individual, state or international system (Balaam & Veseth, 2001:3).

IPE is not a tightly defined, exclusive discipline with an established methodology; it is rather a set of issues which need investigating. IPE does not replace the single established disciplines of politics and economics, but rather acts as a platform for these disciplines to interact and unite. To fully grasp the fundamental nature of society IPE is therefore useful in risk analysis. The rationale behind political risk analysis remains the fact that political dynamics and ever-changing business climates constantly influence and change investment opportunities and profitability (Brink, 2002:14).

Political risk analysts can only benefit from the study of IPE as it provides a better understanding of human behaviour and system analysis in both politics and economics, which enables a clearer assessment of change in economics, politics and society. IPE represent the interconnected relationship of politics and

economics. It is evident that a change in activity in economics can lead to a change in activity in politics and vice versa.

## **2.2. Theory of Political Risk Analysis.**

To comprehend the necessity of political risk analysis in business and decision-making, an understanding of the underlying theory of political risk analysis is essential. Since, the main focus of this study is to test the reliability and validity of current political risk assessment models. In order to do this, a better understanding is needed of empirical research and social research. The dynamics of forecasting as a method of political risk analysis will be explained in this section. This section concludes with an overview of methodological problems experienced in political risk analysis.

### **2.2.1. Quantitative Research versus Qualitative Research.**

The main purpose of this study is to test the validity and reliability of three current political risk models. An analysis of the underlying foundations of empirical research (qualitative research) and social inquiry (quantitative research) is needed to understand validity and reliability. In research, there exists a quantitative-qualitative debate; that is, which approach is best for political analysis. Skeptics of the quantitative approach argue that behavioural phenomena cannot be measured and contained as variables for testing; they do not deal in data and believe that conclusions cannot be proved or disproved (Brummersted, 1998:81).

Quantitative analysis seeks to compare and generalize, confirming or falsifying experiments through repetition. Past experience serves as an indicator of a future occurrence of an event; thus quantitative analysis maintains that behavioural patterns serve as a guide to motivation. Quantitative designs are usually based on deductive methods of reasoning, which involve the formulation

of hypotheses that identify the constructs, methods and relationships to be measured (Du Plooy, 2002:82). Qualitative designs are usually inductive; inductive reasoning begins with a literature review of primary sources, which usually consist of observations made by researchers (Du Plooy, 2002:82)

According to Brummersted (1998:83) “qualitative description serves as a necessary antecedent to the derivation of data”. Thus, a synthesis of the quantitative and qualitative approaches is necessary in predicting political risk.

Political risk analysis combines both approaches. Political risk analysis recognizes/identifies through inquiry and then adds/counts the repeated recognition. A quantitative analysis is not possible without a qualitative inquiry as an event cannot be counted before it is identified. The synthesis of the quantitative and qualitative approaches entails the conceptualisation and operationalisation of risk assessment (Brummersted, 1998:81). Singer (1990:112) emphasise that “we cannot construct and test models in the scientific sense of the word without data, and we cannot efficiently generate or acquire data without close attention to the models we now have, and to the theories we hope they will become”.

This study aim to test the predictability of three political risk models. The probability of the occurrence of the selected political risks within the three models will be determined through multiple-expert opinion. The variability between dependant and independent variables will be tested to measure the reliability of the data. The following section gives an overview of important concepts like probability, variability, validity and reliability of the methods and their properties used in this study.

According to Singleton and Hovden (1987:111), “the basic risk concept involved in the objective evaluations...and in the subjective judgments...is in both cases related to an aggregated measure of probability and magnitude of actual

negative effects". Howard (1993:22) states that "all risks are specific probabilities at any discreet time". *Probability* refers to the likelihood of something to happen; if a risk is recognized, it is likely to happen. It can be contended that probability is the numerical measurement of likelihood. Vose (2001:20) maintains that "probability is used to define a probability distribution, which describes the range of values the variable may take, together with the probability (likelihood) that the variable will take any specific value".

Risk has a number of possible outcomes with probabilities. Caution must be taken against the confusion of possibility and probability. Singleton and Hovden (1987:66) define the two concepts: "possibility refers to the range of outcomes measured by a positive integer greater than one; if there is only one possibility, no decision is required" whereas, "probability measured by numbers in the range 0-1 describe likelihoods of particular specific outcomes". Singleton & Hovden (1987:66) contend that "risk is the sum of probabilities of the undesirable outcomes, again the number in the range 0-1". Probability, along with the possible outcomes, describes the *variability* of something (Vose, 2001:20).

One of the essential requirements of empirical research is that information or data collected during a research study be scored accurately and consistently for results to be reliable and valid. Variables that appear in a research hypothesis or research question are transformed into concrete indicators. Variance between independent variables and dependent variables are referred to as *variability*. In predicting the outcome of future events, there are two components that influence the ability of precise prediction, namely variability and uncertainty.

Variability is a phenomenon that can be measured, analysed and explained. Uncertainty is a lack of knowledge or the level of ignorance. To solve the problem of uncertainty and random variations, mathematical methods and concepts from the theory of probability are used. Methods used in (interdisciplinary) risk analyses include Bayesian approaches and stochastic methods (Singleton &

Hovden, 1987:14). It is important to note that quantitative models cannot explain all variations in ratings across countries. As rating agencies often state, qualitative social and political considerations are important determinants (Canter & Packer, 1997:77).

Vose (2001:18) asserts that variability is the effect of chance and explains the concept variability as compared to tossing a coin,

“If I toss the coin once, I will have a head (H) or a tail (T), I will have (H) or (T) with probability of 50%... If I toss the coin twice, I have four possible outcomes {HH, HT, TH, TT}, each with probability 25% because of the coin’s symmetry. We cannot predict with certainty what the tosses of a coin will produce because of the inherent randomness of coin toss”.

Variability is, thus, characterised by randomness.

Total uncertainty is the combination of variability and uncertainty and erodes prediction of the future. The reason for keeping variability and uncertainty separate in a risk analysis model is that it is mathematically more correct. When mixing variability and uncertainty, only a reasonable estimate of the total uncertainty is derived, and it cannot be established in total certainty how much variability and how much uncertainty exist, these differences are important (Vose, 2001:23).

In measuring risk in investment, Shim & Siegel (2001:179) suggest that “risk is the variability of possible returns...greater return is required for higher risk”. Shim and Siegel (2001:179) conclude that “risk can be measured by the standard deviation, which is a measure of the dispersion of the probability distribution of possible returns”.

In applying empirical methods to social inquiry, all findings have to be reliable and valid. Reliability means that a measure must be stable and consistently produce the same measurements or findings over a period of time (Du Plooy, 2002:121). Unreliability of a measure can result from example vagueness,

fluctuations in findings, irrelevance or random errors (various factors that cause subjects to contribute to the unreliability of a measure (Du Plooy, 2002:121).

Kaplan (2004:75) defines reliability in a mathematical sense as being “a coefficient based on variance components in a statistical model”. A coefficient is a correlation that measures the amount of coincidence or association between things (Du Plooy, 2002: 121). In other words, reliability measures the consistency of scores (Kaplan, 2004: 77). Thus, reliability is a question of data quality.

There exists a number of different reliability tests. Du Plooy (2002:122-123) lists and explains the different types of reliability:

- **Test-retest reliability:** This test measures stability. The same test is administered to the same group or subject on two different occasions, and the reliability is determined by comparing the consistency of scores.
- **Alternate-forms reliability:** The alternate-form assesses the equivalency component of reliability. A common pool of measurements is divided among different forms, which are given to the same group of respondents.
- **Split-half reliability:** When methods are used, the measurements are divided into two parts. Each half is scored differently and the consistency is checked between these two scores. This method is suitable for assessing the internal consistency among items.
- **Item-to-total reliability:** Each item in a measurement is correlated with all the items in the measurement. This method is particularly useful when testing measurements during a pilot study, because any item that scores zero (0) when correlated with other items, points to the likelihood that the item is testing something completely different from the other items, and that it should be deleted from the final measure.
- **Intercoder reliability:** This method is usually applied in a content analysis to determine how reliable the interpretation (or coding) of content is, especially if two or more observers analyse the same content. In other words, intercoder reliability is determined by calculating the average correlation among codes to

determine the equivalency with which the measurement procedures, rules or categories (specified by the operational definitions) are applied by coders.

- **Computer programs:** When a measure contains items that can be scored as either correct or incorrect, computer programs are useful.

Validity is a measure to test the degree to which the measurement used actually measures what is intended or claimed to have been measured. By claiming that a measure is valid, reliability is implied; a measure can thus not be valid if it is not reliable (Du Plooy, 2002:124). Validity is a question of appropriateness of data (Kaplan, 2004:77). Reinard (1994:240) define validity as “the consistency of a measure with some outside criterion or standard by which to judge the test”. In other words, validity represents an external form of evidence. Du Plooy (1994:124) states that “validity depends on how closely the operational definitions overlap the theoretical definitions of the phenomena being measured”.

Validity, thus, entails that a finding or measurement has to be operationally consistent with the theoretical foundations of the hypothesis or research question. Kaplan (2004:84) argues that

“the practice of validation aims to ascertain the extent to which an interpretation of a test is conceptually and empirically warranted and should be aimed at making explicit hidden ethical and social values that influence that process”.

The different types of validity tests include,

1. **Face validity.** Face validity is sometimes called content validity and refer to the representativeness of the items or types of events that is included in a study (O’leary & Coplin 1975:50).
2. **Criterion validity.** Criterion validity applies two methods in measuring outside criteria namely concurrent validity and predictive validity. In concurrent validity a new measurement is correlated with a measure of the same thing that has been previously validated, whereas predictive validity is the degree to which a measure predicts known groups in which the phenomenon or construct being researched must exist (Du Plooy, 2002:126).



3. **Construct validity.** Construct validity asks if that which was intended has, in fact, been measured. The answer to this question is established in the degree to which our attempt to measure an item or an event is correlated with other persons' independent attempts to measure the same phenomena using different indicators. The assessment of construct validity is a complex process which involves both content-related evidence and criterion-related evidence (Du Plooy, 2002:126). Wimmer and Dominick (1997:56) explain that construct validity "involves relating a measuring instrument to some overall theoretic framework to ensure that the measurement is actually logically related to the other concepts in the framework".

Data is used via indicators to infer the presence and strength of the variable in a given 'real world', empirical setting (Singer, 1990:117). In order to establish reliability and validity of a study, indicators are tested. Singer (1990:117) maintains that "the purpose of an indicator...is to help us generate a data set from whose magnitudes and values we can validly infer the values of the actual phenomena that interest us". Reliability then tests the quality and accuracy (completeness) of indicators. Reliability further entails clarity, explicitness and precision of coding rules. The less ambiguity, the higher the reliability of an indicator.

Singer (1990:121-122) identifies three types of errors in factual material. The first is "systematic distortion of facts", which entails misleading information. The second problem is that of "random errors, often resulting from carelessness, naiveté, and incompetence at the origin or the reportage, or in typographical and transcribing errors, or even in efforts to correct systematic error". The third problem concerns the sources consulted for the data; that is, "incomplete compilations". This can involve insufficient, missing or uncorrelated data.

Accurate and empirical statistical data is a prerequisite in political risk analysis. Problems experienced with data can range from fragmented databases to

inadequate data. The biggest problem concerning data is the access and availability of sufficient or appropriate data. The biggest challenge to the political risk analyst, thus, remains the acquisition of valid and reliable data.

This study will combine qualitative and quantitative methodology, and will start with an inductive review of literature of primary sources and observations made by researchers in the field, comprising of chapters one to four. The study will provide a deductive analysis of three models of political risk analysis in chapter five. The deductive analysis in chapter five will test interrater reliability and internal consistency of the three models. Chapter five will make use of multiple regression to test the variation between the three models. The predictability of the data will be tested in chapter five. Chapter five aim to mimic the test by Howell and Chaddick (1994) to compare the results of their study of 1982-1994 to the results of this study of 1994-2004. The variation between the two tests will be compared to determine whether the three models provide valid and reliable ratings over two different periods of time.

### **2.2.2. Predicting the Future**

The analysis of political risk involves an anticipation of a future event; this require that a prediction of the future is made. Therefore, political risks are derived on the basis of the political risk analysts's expectations. A prediction is an observation at a specific time and place to support a particular description. It is based on observed or unobserved past or present predictions.

Justifiable predictions must be criticisable, testable with reference to the real world and communicable. A justifiable expectation is generated by organising experience into a valid pattern, combining that pattern with a particular observation and making a calculation regarding the anticipated outcome of the expectation. A prediction that cannot be justified with reference to real world experience is a prophecy. Future prediction can be made with forecasts,

classifications or theories. The following section provides insight into the three methods of predicting the future. It is necessary to be familiar with the differences between these methods in order to generate justifiable expectations of the occurrence of anticipated political risks.

### **2.2.3.1 Forecasting in Political Risk Analysis**

The primary objective of political risk analysis is the projection of risk, through causal analysis, thus connecting the future with historical attributes (Howell, 1998a:5). Political forecasting is a sequential process in which political trends and interrelated socio-economic trends are integrated. A political forecast involves the analysis of political risk factors, where the outcome determines the political risk.

Hlope and Kuhlman (1981:235) suggest that:

“a ‘good’ forecast is not one which attempts to suggest a definite outcome in a highly fluid and uncertain situation....A ‘good’ forecast...is one that exposes where uncertainties prevail and sets forth a range of outcomes contingent upon intervening events or information”.

Thus, uncertainty concerns the occurrence of events and the probable outcomes of the supposed courses of action. Forecasts are linear projection with multiple independent variables (Howell, 1998b :46).

Haner (1979:19) lists a number of applications of political forecasting:

1. Predicting political conditions in a country for which an investment is proposed or will be operating for a period of years;
2. Estimating probabilities for seriously modified conditions, such as a coup d'état, the election of a radical left government, or a war;
3. Determining the effect on profit performance of the investment if a serious change in assumed political conditions occurs; and
4. Judging the net impact of political change on predicted cash flow from the investment for the selected period.

Howell (1998b:46) classifies political forecasts into four basic types:

1. **Type I**, deals with the current situation. It includes correlations from current attributes of countries. A list of attributes that are deemed significant correlations of future trouble are scored to create an index (score) that should project to an equivalent level of danger (and loss) to the firm. The Economist model is an example of a model that makes use of this strategy.

2. **Type II**, asks what the situation will be and asks experts to project attributes out into the future. In each projection, it is the task of the country expert to extrapolate from the present to the future. An example of a model that makes use of this type of forecast is the Business Environmental Risk Index (BERI).

3. In **Type III**, forecasts project the losses of the actions that account for the losses themselves out into the future. The process skips the intervening stage of trying to first project whether there will be ethnic tension at some point in the future and then whether the tension will result in civil strife and damage. This type of forecast thus assesses the likely occurrence in the future (BERI's Operations Risk Index (ORI)).

4. In **Type IV**, future governments are projected by the analyst (stage 1) and then the behaviours of those governments toward business are similarly projected (stage 2). This type of forecast projects effect of likely governments in future points and thus projects behaviours. The Political Risk Services' (PRS) Prince Model makes use of this method of forecasting.

Political forecasts make use of different methods of analysis. These methods include extrapolation, regressions, leading indicators and multiple- source forecasting. These methods are commonly used as the foundation of forecasts. Forecasts can make use of one method or a combination of methods to strengthen the approach or these methods can be a technical limitation to forecasts.

### *i. Extrapolation*

Ascher and Overholt (1983:121) define extrapolation as “the projection of a historically based quantitative trend at a constant rate”. The constant rate refers to any quantitative measure of change. Historical data points are rarely linear of nature. This makes historical data arbitrary in time. Ascher and Overholt (1983:121) explain the nature of extrapolation as “severely atheoretical. The numbers do the talking. The procedure is largely explicit. It obviously dispenses with efforts to introduce theory into the forecasting effort”. The efforts of extrapolation to dispense of theory are limiting to the behaviour of politics.

### *ii. Regressions*

Regression analysis is the technique of prediction of one trend based on its relationship with one or more other trend. Regression makes use of analysis of multiple levels of variables. Ascher and Overholt, (1983:71) explain “the relationships can hold within one case for the ‘time series’ variables for that case or across case... These presumed relationships are linear”.

Regression does introduce theoretical considerations in presumed relationships. The primary focus of regression is that “certain trends are primarily determined or conditioned by one or a few other trends (Overholt, 1983). Regression is concerned with linear relationships.

Regression has two limitations as a forecasting method:

“The first is that the constant that link the predicted trend to the basic trends reflect the past and the present structure of the system, so that if this structure changes there is no reason to expect that the constants would still represent the relationships among trends. The second vulnerability of regression is that validity depends not only on whether the relationships between the predicted trend and each of the basic trends are correct, but also on the projection of each of these basic trends” (Ascher and Overholt, 1983: 71)

### *iii. Leading indicators*

Leading indicators are based upon the direction of change in a trend dependant on the past changes in the direction of other trends. Leading indicators are an inductive examination of indicators over time. Leading indicators as a method limits forecasts in the regularities in sequencing. These regularities are complex and irregular. This method cannot estimate the magnitude of the direction of change (Ascher and Overholt, 1983:74).

### *iv. Multiple-source forecasting*

Multiple-source forecasting is the compilation of several other sources. It also involves the processing of other forecasts. It is the efforts of combining the results of expert interaction (Ascher and Overholt, 1983:75).

Coates (1994:308) identifies several reasons forecasts tend to fail:

- 1. Unexamined assumptions** entail unknown, embedded or tacit assumptions of individuals. For example: ideological beliefs or societal assumptions.
- 2. Limited or misplaced expertise:** This is the failure of expert judgments. A classic example is Admiral Leahy's "The (atomic) bomb will never go off, and I speak as an expert in explosives" advice to President Truman.
- 3. Lack of imagination** refers to incapable imagination to see likely response to new capability and hence tend to harp on assumed negative. The negative, bad and disruptive are easier to imagine than the positive or beneficial. People generally display limited experience in promoting positive images of the future.
- 4. Neglect of constraints** is often associated with self-delusion, which often leads to neglect of important factors.
- 5. Excessive optimism** concerns new developments or investments. A new development or investment is a zero-generation and is likely to only mature in its fifth or sixth generation; therefore the process of introduction is likely to be slower than anticipated.
- 6. Mechanical extrapolation of trends** can cause problems because it only has value as the basis for asking what could happen to distort or disturb the extrapolation.

**7. Over-specification.** Frequently the solution to a problem or opportunity for new development is so specified in details that it is impossible to take seriously.

In testing political forecasts against real world experience, Ascher and Overholt (1983) list seven properties that are desirable in forecasts. These properties serve as *ceteris paribus* rules in forecasts and include: plausibility testing, capacity for counterintuitive implications, comprehensiveness, sensitivity to nuances, capacity to incorporate well-founded theory and simplicity. The capacity of plausibility testing ensures the discard or altering of results that are misspecified, improperly applied, or wrong. The capacity for counterintuitive implications separates the systematic prediction from conventional wisdom. This strengthens application to empirical experience. Ascher and Overholt (1983:63) believe that “plausibility testing ensures that the explicitness of methods separates the person from the algorithm”. Comprehensiveness of forecasts entails the contextuality, whether all factors are integrated. Sensitivity to nuances involves paying attention to small things in theory application.

The explicitness of procedure has three objectives. First, it guarantees assessment of prediction methods. Second, the biases of the forecaster are illuminated through following steps of procedure. Third, testing allows a development of a framework to go on to other tasks. The capacity to incorporate well-founded theory considers whether the theory is sound. Simplicity of models makes models easier to employ; the simpler the approach, the easier they are to assess in terms of consistency and the plausibility of their underlying assumptions.

A political risk analyst cannot entirely predict the future, the future can only be anticipated upon observing certain trends and events, and in the way they come together (Brink, 2002:39). In projecting future outcomes, there two types of methods of future projections namely: forecasts and predictions through prophecies. Brink (2002: 40) defines a forecast as “an *estimate* of something in

the future, a *chance* that something *might* happen” and a prediction foretells a prophecy and involves making statements of an event that will occur, involving a ‘yes’ or a ‘no’. Brink (2002:40) contends that “a prediction seems more definite, whereas a forecast...includes a probability factor and is based on sound rational foundations, empirical evidence, scientific theory and formal procedures that include the process of systematic information gathering”.

A forecast is created by locating two or more things whose values have covaried systematically in the past. The relation is generalized to create the forecast. Since the forecast contains no causal assumption, it cannot be acted upon and, therefore, cannot be tested experimentally. It is the assumption contained in the generalized proposition that is actually tested by an experiment and not the action flowing from that assumption. The justification for forecasts consists entirely in references to past experience. Forecasts are adequate only for predicting and in cannot be used as a basis for action (Meehan, 1988:30).

### **2.2.3.2. Classifications**

Meehan (1988:74) defines a classification as “a generalised statement of the properties shared by all members of some class of things”. Classifications are generalised, and have a predictive ability because they apply to past and future events. Meehan (1988:75) explains that “Classifications consist of a set of variables and rules for specifying the limits of the values that each variable can take. How precisely the rules can state these limits depends on the characteristics of the things classified”. Thus, classifications are based on experience.

#### *i. Limitations of classifications*

Firstly, classifications must be generalised from experience, and must therefore have characteristics available. Secondly, predictions depend on the ability of the observer to identify all the properties of the observation. This can make the



quality of the observation poor (Meehan, 1988:76). Classifications are generally referred to as concepts and summarises what is known.

### **2.2.3.3. Theories**

Prediction with theories as a political prophecy implies prediction through causality (see Appendix A, page 11-13, for a discussion on causality). A theory is a set of variables whose variables are linked by rule. The set of variables has been 'isolated' from the rest of the environment and incorporated into a pattern. Within the pattern, changes in the value of any variable can be accounted for completely by the changes in the other variables, given the rules included in the pattern. Theories allow the purposeful manipulation of independent variables that will cause a change in a dependant variable. Theories thus force a logical pattern on a set of variables. Every effort to change the course of events needs a theory. This theory is developed to repeat. A theory needs direct experience, a concept and knowledge (Meehan, 1998:31).

#### *i. The limitations of theories*

Theories isolate a set of variables from the world and link it to rules so that change in one variable will lead to change in another variable. These isolations are impossible in practice; there will always be external influences. This gap between logic and experience is called the *Fudge Factor*. The Fudge Factor is a test of the accuracy of the theory and is based on the *Ceteris Paribus* rule, that all else will remain or all other things are equal. The influences of these external factors on the operation of the theory are readily managed by inserting a Fudge Factor or Ceteris Paribus clause between the theory and the environment. The strength of the influences lumped together in the Fudge factor is a measure of the theory's reliability (Meehan, 1998:31).

#### **2.2.3.4. The Induction Problem**

Political forecasts are limited by access to reliable knowledge for decision-making. These limitations are firstly caused by a sensory limitation. Secondly, forecasts are limited by the Metaphorical River of time. The Metaphorical River of time implies that experience is specific to time and place. Future referencing needs general statements. The future is a result of present practice. Decisions and actions are, thus, a cognitive problem.

There are numerous implications of the induction problem. Firstly, decisions need justification. Secondly, knowledge for the purpose of justification needs future reference. Lastly, justification of an assumption on grounds of the logical relationship between past experience and the content of knowledge of the present and the future, fail.

Logic cannot overcome the induction problem. Past experience cannot guarantee recurrence in the future. Forecasts must use non-logical methods to predict events. The cognitive implication of the induction problem is an interaction between causality versus morality. Knowledge should be accumulated in the *media res* and not the *tabula res*.

#### **2.2.3.5. The possibility of control over future events**

The control of an event is to produce or inhibit a certain event in the future. The purpose of political risk analysis is to anticipate the control of certain future events; a political risk is identified with the goal to control it when it occurs in the future, control can be for example through insurance, avoidance or mitigation. Meehan (1988:88) states that “control over the course of events depends on the availability of knowledge, obviously, which in turn requires an organization of experience that will both formulate and fulfill specific human purposes”. Control can only be achieved in a pattern of experience.

Control over events can be exercised through causal linkages. A causal relation is “an assumption, that assumption must in due course be justified” (Meehan, 1988:88). Such usage of casual linkages corresponds with experimental science and can be tested under laboratory conditions or in real-world use because the nature of the assumption allows the structure to be tested in action. Meehan (1988: 89) explains the meaning of causality as “two or more variables or factors are said to relate causally if their values are linked by rule in such a manner that deliberately changing the value of one variable will change the value of the other variables in predictable ways”. This allows one to control events in the environment or to produce or prevent a particular future outcome. The concept of causality in a scientific context will be explained in chapter five.

Control is only possible in environments of structures or procedures, which comprise of variables. These variables are linked through a set of rules and limiting conditions. Once a pattern is established, the rules incorporated into the pattern make up a logic or calculus. The logic supplies predictability to the pattern. The logic in a set of rules allows manipulation of the values of variables. The logic can then provide control over real-world affairs if it is systematic and observatively fit for the identified purpose. The structures and processes involved in forecasts allow manipulation and control over future events.

Political forecasts involve the systematic prediction of events through present trends and consist of an analysis of trends and events. This is accomplished through the use of technical methods. Forecasts are limited by methods. The availability of testing accommodates these limitations.

The test of predictions strengthens the plausibility of predictions. This reliability ensures that predictions are fit for their purpose to be applied to empirical experience. The systematic and procedural nature of forecasts and prophecies allows control over future events.

Thus, control over future events is possible where experience is organised into patterns that link two or more variables, this pattern of experience justifies the causal relation assumed to connect them. Risk analysis seeks to provide an overview of the future; in order to do this, the risk analyst must be familiar with the logic of forecasts and causality.

### **2.3. Methods of Political Risk Analysis**

Risk management has been a fundamental motivation for development of social and governance structures over the last 10,000 years (Mc Daniels & Small, 2004:1). Political risk assessment is the continuous process of identifying and analysing risk events, the process of which is cyclical. Risks are analysed, as soon as they are identified, which leads to the identification of additional risks. The objective is to gather as much information (data) as possible to judge the probability of the occurrence and impacts of risk. The focus of the analyses is on the cause of the risk and not the symptoms.

Political risk analysis provides a framework for characterising political risks, and forms the base of political risk assessment to allow control and management. It determines the likelihood of the occurrence of risks. The results from risk assessment form the basis for most risk management actions. Political risk analyses provide decision-makers with early warning signals of serious political risks (Venter, 1999:74). Political risk management capabilities must include the ability to respond to risks that are known and well understood, and the ability to detect and anticipate new risks.

The primary objective of risk analysis is to forecast losses; the second is to suggest means of managing the risk or avoiding the loss. The risk assessment process requires interaction between causality and choice in order to obtain control over discontinuous events through general statements; general

statements that apply to the future must be justified and defended (Venter, 1998:74).

Nairne (2004:29-30) suggests that, while no widely accepted methodology for anticipating and assessing political risk has emerged, any approach should fulfill at least six basic requirements:

1. Identify social, political and economical factors that may adversely or positively affect a country's business environment;
2. Identify social political and economic factors that may adversely or positively affect a sector or project's viability within this environment;
3. Measure and aggregate factors in a rigorous manner (a structured quantitative model tailored to institutional applications);
4. Systemise risk estimates allowing for comparisons (or risk equivalents) across countries, sectors, and projects;
5. While imposing a discipline on the selection, weighting and analysis of variables, the model must nevertheless be flexible, forward-looking and predictive; and
6. Disaggregate estimates allow for identification of viable opportunities in (and within) markets where traditional risk indicators perform erratically and exceed comfortable margins, but also mask sector- or project-specific possibilities.

According to Mc Daniels & Small (2004:290) all attempts to reduce or control risks are based on two requirements, "on the one hand, risk managers need sufficient knowledge about potential impacts of the risk sources under investigation and the likely consequences of the different decision options to control these risks". They further contend that "on the other hand, they need criteria to judge the desirability or undesirability of these consequences (of the people affected)". Criteria of desirability are reflections of social values (Mc Daniels & Small, 2004: 290). Risk is thus an analytical and normative concept because of the value of the recognised casual relationship between an event and

its consequence. Knowledge and values are important components of decision-making.

Friedman & Kim (1988: 67) lists the main problems found when analysing political risk;

1. Lack of clear definitions, reliable and valid measures of variables, and theories;
2. Little predictive validity that any forecasting work inherently has;
3. Overemphasis on dramatic events, and
4. Treatment of subjective estimates as objective data.

Risk management is fully integrated with risk analysis and risk assessment. It is important that the risk analyses are suitable as input to the decision-maker (Singleton & Hovden, 1987:42). According to Mc Daniels and Small (2004:223), "risk management involves decisions about how to take account of impacts occurring over time, including (in some situations) analysis of the consequences of current decisions that will accrue over decades or centuries or even millennia". Frei and Ruloff (1988:13) identify five functions of political risk analysis: 1. assessment of the situation; 2. explaining the situation, 3. prediction; 4. costing alternatives; and 5. decision-aids for risk management. Risk assessment and risk analysis are two processes that occur jointly and, as an integrated discipline, focus on multiple ways of making decisions in the face of uncertainty and variability and the decision rules for choosing one option over the other.

Risk assessment commonly involves: collecting information on countries and events, compiling data, creating and running a documentation service, setting up a data base, evaluation of periodical information services, application of simple indicators or composite indicators (indices), scaling, construction of typologies, classification, multi-dimensional scaling, diagrams, cognitive mapping, systematic evaluation, correlations, regression or multiple regression (Frei & Ruloff, 1988:13).

There are three approaches to evaluating political risk. The first is a fundamental political risk analysis using a structural functional analysis of the political system; the second is an indicators indexing approach; and the third, a scenario writing approach. The evaluation of political risk is undertaken on the grounds of a political theory or theories of political behaviour.

The first method of evaluating political risk involves a structural analysis of political risks. In section 2.1.2., the theoretical make-up of a framework for analysing political risk was explained. Figures 1.1 and figure 1.2 illustrate the framework. Section 2.1.1. proposes an alternative model of risk assessment by Tarzi (1992).

The indices approach or commonly referred to as the summary indicators approach, presents ratings on countries on the basis of various factors of political risk. The relative weights of these ratings are derived from questions and answers. These rating scales could be useful in discerning and monitoring events related to politics, economic well-being, and regulatory environments of the host countries that are important to a multi-national corporation (Tarzi, 1992: 437).

Ascher and Overholt (1983:133) refers to the indicators approach as *quantitative indicators* approach and describes it as being “a summary measure of events or conditions, such as measures of government capability, levels of violence, military preparedness...employed either to account for discrete outcomes or to reflect their effects”. Quantitative indices aggregate data into categories. (Ascher & Overholt, 1983:134) explain that, to aggregate data, is “to condense information”. Quantitative indices are limited in the sense that they provide holistic rankings, ignore industry or firm specific factors and very seldom forecast changes in the environment (Kobrin, 1979:76).

Aggregate indices often make use of linear relationships; this is problematic because blurred distinctions in the political world are fatal. (Ascher & Overholt, 1983:134) explains “the ‘lumping’ process of aggregation generally permits only rudimentary relationships between summary measures to show through”. When condensing information, information regarding the relationships among facets in a category are destroyed. Therefore, the exploration of factors is limited. (Ascher & Overholt, 1983: 135) contends, that in working with aggregate indices, “the temptation to ‘let the figures do the talking’ by allowing vaguely linear trends to extrapolate themselves can be very overwhelming”. The systematic methods for forecasting political risk typically result in an index, composed of a variety of weighted variables that is an additive sum for the country as a whole and for any type of foreign investment (Howell, 1998a:5).

A popular method in political risk analyses is to combine indices with measurement scales. Du Plooy (2002:127) defines a scale as “the conceptualisation of the operational definition, to provide numerical measurement”. Scaling involves the identification of several components of a concept, which are combined as indicators into a summary score. Scaling is thus a statistical measure of a concept.

Du Plooy (2002:127) contends that scaling frequently involves:

- Counting the frequency of an occurrence;
- Comparing two units or groups or changes that occur in one group; and
- Ranking quantitative or qualitative unit of analysis;

Examples of typical scales used in indices include the likert scale, guttman scale, thurstone scale and the semantic differential scale. Chapter five will provide an in-depth discussion of three popular indices, namely: The Business Environmental Index (BERI), The Economist intelligence Unit (EIU) and Political Risk Services (PRS).



Scenarios are used as a method of political risk analyses and forecasting. This study will not make use of scenarios; it is explained under this section only to provide an overview of different methods available to the political risk analyst. Scenarios are best suited for situations with the need for diversity. Scenarios are narratives regarding alternative anticipated futures, and avoid the approach that only one outcome is possible. Scenarios try to be more or less right, rather than utterly wrong. Schoemaker (1993:195) defines scenarios as “focused descriptions of fundamentally different futures presented in coherent script-like or narrative fashion”.

Scenarios are popularly used in strategic management. Scenarios are Hegelian in their philosophical premise, meaning they are dialectical. Scenario writing serves as a tool for generating debate on possible negative and positive outcomes, and consists of gathering propositions on how a system is likely to evolve and then examining the consistency of each set of propositions, discarding inconsistent combinations. Schoemaker (1993:194) contends that “scenarios decompose complex phenomena into more analysable subsystems”. The objective of scenario writing is to develop a story of how the future might evolve. Scenarios present a sequence of anticipating future events and, therefore, prevent contradiction and paradox.

Sunter (2001:1) defines scenarios as “possible futures visualized as a story of the future that help the strategist to conceptualise the conditions that the organization will be confronted with it in the future and that falls outside the scope of statistical forecasting”. Thus, scenarios sketch possible futures. Multiple scenario analysis serves as an important tool to examine fundamental uncertainties (Schoemaker, 1993:194). Unlike predictions, scenarios provide a platform for debate and conjecture, underpinned by real possibilities.

Scenarios are useful in the management of change, and aim to counter biases through a better understanding of uncertainties, thereby making scenarios

comprehensive. Uncertainty is thus limited, but this does not give the scenario probabilistic prominence (Schoemaker, 1993:196). Even if the predictive power of scenarios' is low, they serve as stimulation to alternative strategies to be applied to contingencies.

Schoemaker (1993:197) suggest the general framework for constructing scenarios:

1. Define issues, time frame, scope and decision variables. Review the past to get a feel for degrees of uncertainty and volatility.
2. Identify major stakeholders or actors who might have an interest in these issues, those actors who could be affected or those actors who could influence matters. Identify their roles and power positions.
3. List current trends that will influence variable(s) of interest. Constructing a diagram is useful.
4. Identify key uncertainties; explain how events interrelate.
5. Construct two forced scenarios by placing all possible positive outcomes in one scenario, and by placing all possible negative outcomes in one scenario.
6. Assess the internal consistency and plausibility of these artificial scenarios.
7. Eliminate combinations that are not credible or impossible, and create new scenarios until you have achieved internal consistency. Make sure these scenarios cover a wide range of outcomes.
8. Assess the revised scenarios in terms of how the key stakeholders would behave in them. Where appropriate, identify topics for further research that would provide for stronger support of your constructed scenarios.
9. After completing additional research, re-examine the internal consistencies of the learning scenarios and assess whether certain interactions should be formalized via a quantitative model. If so, use this model to run some Monte Carlo simulations after obtaining subjective uncertainty ranges (or entire distributions) for key independent variables.

10. Re-assess the range of uncertainty of the dependant (i.e. target) variables of interest, and retrace Steps 1 through 9 to arrive at decision scenarios that might be given to others to enhance their decision making under uncertainty.

Within this framework, uncertainty is of concern to the extent to which the casual structure is unknown. The quality of casual reasoning merits the scenario, the more cohesive, and the more credible. Scenarios serve as consensus building.

## **2.4. Conclusion**

Defining political risks is problematic because political risk is a nominal concept. This chapter examined the problems in defining political risk, and provided consensus on the definition of it. Political risk is the possibility that political decisions or events in a country will affect the business environment in such a way that investors will lose money or not make as much money as they expected. The theoretical makeup of political risks were analysed in this chapter. A frame of reference, by Tarzi (1992) was suggested as an alternative model for risk analysis. Political instability and uncertainty were clarified in this chapter. Country risk and its dimensions were discussed in order to arrive at a comparison of political risk and country risk. The level of analysis, origin and types of country risk were the chapter distinguished between the concept political risk and country risk.

The underlying theory of political risk analyses was presented in this chapter. The background of political risk analyses was briefly overviewed by exploring the interdependence of politics and economics. The quantitative and qualitative properties of political risk analysis were also examined. The conceptualisation and operationalisation of political risk analyses and political risk assessment was then explained. Important concepts highlighted and clarified in this chapter include variability, indicators, probability, data, validity, indicators and validity.

This chapter examined the different properties of empirical science and social science. This provided the foundation of the research design in this study.

The application of political forecasting and the possibility of control over future events were assessed and the problems experienced in political forecasting were examined. This chapter concludes with a brief overview of the three approaches to evaluate political risk. The three approaches include a fundamental political risk analyses using a structural functional analysis of the political system; the second is an indicators indexing approach; and the third is a scenario writing approach. These approaches were discussed to provide the political risk analyst with the basic tools to risk analysis.



### **Chapter 3**

### **Political Risk and Foreign Direct Investment**

Low political risk encourages FDI. Political risk analysis can minimise a company's exposure to political risk by providing the investor with predictability of political risk events and actions that would affect the success of a business venture and, in turn, maximise the sustainability of business operations by assessing political risks. Hence, MNCs use political risk analysis to minimise losses. Therefore, political risk analysis is an important tool for protection against loss in FDI. As this study aims to test the reliability and validity of three current risk assessment models, it is necessary to understand the relationship between political risk analysis and FDI. Consequently, an understanding of the relationship between political risk analysis and FDI will provide the risk analyst with a greater understanding as to how government decisions influence FDI, thereby providing an efficient analysis of political risk.

In addition, Howell and Chaddick (1994:71) assert that "Political risk analysis... is a critical interface between the world of politics and economics". The relationship between political risk and FDI is an important element of international business and politics; it largely affects both the public and private realms of international relations. The main purpose of this chapter is to investigate the relationship between political risk and FDI and to indicate the necessity of political risk analysis in FDI. This will be done by exploring the ways in which government decisions influence the flow of FDI and how FDI influence domestic politics.

In order to examine the relationship between political risk and FDI an overview of what constitutes FDI and its characteristics will be presented. The process of FDI as a product of globalisation will be discussed to indicate the operation of FDI. FDI will be analysed as a product of globalisation. This will require an overview of the agents of FDI- namely: multi-national corporations and the host country- which have expectations of each other. Political risk analysis determines how government decisions influence business. In any case, the relationships between

the agents involved in FDI greatly determine business operations. For instance, a good relationship between an MNC and a host government implies that, there is a greater chance that both actors fulfill the expectations they harbour. Therefore, it is necessary to effectively manage relationships with stakeholders. In addition, it is necessary to be familiar with the possible expectations of actors, which may arise in FDI, notwithstanding the fact that there are measures in place that scrutinise the operations of the actors involved in FDI. Examples of such measures include the corporate social responsibilities of companies, and the international law on the involvement of host countries in FDI. In conclusion, this chapter will investigate the corporate social responsibilities of multi-national corporations and the international law related to foreign investment that governs state actions.

### **3.1. Foreign Direct Investment**

In order to clarify the meaning of FDI, it is necessary to define what constitute an investment. An investment can be defined as “every kind of asset owned or controlled, directly or indirectly, by an investor” (UNCTAD 2000: 408). This includes the following:

An enterprise, (being a legal person or any other entity constituted or organised under the applicable law of the Contracting Party), whether or not for profit, and whether private or government owned or controlled, and includes a corporation, trust, partnership, branch, joint venture, association or organisation;

Shares, stocks or other forms of equity participation in an enterprise, and rights derived there from;

Bonds, debentures, loans to and other form of debt of an enterprise and rights derived there from;

Rights under contracts, including turnkey, construction, management, production or revenue-sharing contracts;

- a. Claims to money and claims to performance;
- b. Intellectual property rights;
- c. Rights conferred pursuant to law or under contract, including rights conferred by licenses, authorisations, and permits.

- d. Any other tangible and intangible, movable and immovable property, and any related property rights, such as leases, mortgages, liens and pledges, unless such assets lack the characteristics of an investment (UNCTAD, 2000:408)

Thus, an investment includes assets owned by an investor. The definition of an *Investor*:

“covers natural persons as well as legal persons or any other entity constituted or organised under applicable law of a Contracting Party. It also clarifies that the legal entity may be one organised for profit or it may be one which is not organised for profit such as, charitable institutions or societies. Again, the legal entity may be private or it may be owned or controlled by the Government. It includes *inter alia*: 1) a Corporation, 2) a Trust, 3) a Partnership, 4) Sole proprietorship, 5) Joint Venture, 6) Association” (UNCTAD, 2000:409).

There are numerous definitions of FDI. However, all the definitions of FDI share the same characteristics. UNCTAD (2003:232) define FDI as

“the sum of all investments by non-residents in the reporting economy in three categories: 1. original investments of equity capital, 2. reinvestment of earnings, i.e. the direct investor’s share in proportion to direct equity participation of earnings not distributed dividends of affiliates or earnings that are not remitted to the direct investor, and 3. by intracompany loans which are from a foreign ‘parent’ to a subsidiary within the country”.

According to Comeaux and Kinsella (1997:xix), FDI refers to “direct control of either assets or an enterprise in a foreign country through ownership of a substantial portion of the assets or enterprise”. These assets consist of private capital flows that range from inter-company debt and equity capital to reinvested earnings (Jensen, 2003:588). UNCTAD (2003:231) supports this by describing FDI as

“an investment involving a long-term relationship and reflecting a lasting interest with control by a resident entity in one foreign economy, the foreign direct investor or parent enterprises in an economy other than that of the foreign direct investor”.

Büthe and Milner (2005: 6) embraces the above mentioned clarification of FDI by asserting that “FDI involves the acquisition or creation of productive capacity, which implies a long-term perspective and involves some assets that cannot be

moved without experiencing a considerable loss". In summary, defensible usage of the term FDI is the following: "private capital flows from a parent firm to a location outside of the parent firm's home nation that engages in direct long-term productive activities overseas" (UNCTAD, 2003; Büthe & Milner, 2005; Jensen, 2003; Comeaux & Kinsella, 1997).

There exist a number of determinants of FDI. Importantly, The International Monetary Fund (IMF) recognises the threshold of foreign investment as direct (FDI) when the investor holds 10 per cent or more of the equity of an enterprise. This ownership threshold, usually between ten and twenty-five per cent per unit, distinguishes FDI from so called 'portfolio investment' (Comeaux & Kinsella, 1997:xx). In addition, Foreign investment in the form of loans and equity can be indirect (portfolio investment) or direct (FDI). Portfolio investment thus entails indirect investment. FDI only occurs through the mutual consent of two rational actors, namely: the MNC and the host government. Portfolio investment can leave host economies vulnerable to capital flight. In such a case, it is easy for investors to withdraw their money. However, in the case of FDI, the commitment of the MNC is in the location of personnel and plant; investors are both less likely and less able to flee at the first sign of trouble (McGuire, 1999:153). Portfolio investment is insignificant to the purpose of this study. A brief description of the term is provided only for the purpose of clarifying what type of investment FDI constitutes by distinguishing direct (foreign) from indirect (portfolio) investment.

The determinants of FDI largely depend on the underlying objectives and motivations of the investment. The motivations of the investment vary from the type of investment, the industry type and the type of investment. Van Ryckeghem (1998:71) maintains that foreign investors prefer to invest in countries that:

- Grow rapidly,
- Have a big domestic market,
- Have a low public sector deficit,
- That is privatised,
- Are relatively open, and



-Are competitive in terms of real wages and real effective exchange rates.

The above-mentioned determinants remain the most favoured circumstances to attract FDI. However, there is one exception: FDI is not only attracted to economic giants with large domestic markets, but also to countries of all sizes at different stages of development. Countries from all over the world have attracted FDI more than 5 per cent worth of Gross Domestic Product (GDP) (IFC & FIAS, 1997:2-3). The degree of FDI in a country is determined by the sum of the Annual inward FDI inflows into a given country as a percentage of GDP (Büthe & Milner, 1997:42). The Gross Domestic Product (GDP) of a host country indicates the economic strength of that country. In addition, inward FDI refers to the FDI that the host country receives or allows into their country. Outward FDI involves investments that flow from a home country to another host country.

Trends in FDI indicate a significant change in the flow of FDI. Manufacturing and production no longer only take place in developed countries with big domestic markets, but has shifted to developing countries instead. In addition, more and more MNCs invest in production and manufacturing in developing countries to benefit from low-cost labour, low-cost production, low-economic rents and exploitation of new markets. In many cases, these unexploited markets offer opportunities of establishing monopolies in these unexploited markets. The local competitors often do not possess the advanced technology, skills, infrastructure, capital and manufacturing techniques of established, competitive markets.

The International Finance Corporation and Foreign Investment Advisory Service (IFC & FIAS, 1997:20) conducted a review of historical trends in FDI, concluding the following:

- Countries at every stage of development can attract FDI across a wide range of sectors from developing countries as well as industrial countries;
- The largest economies naturally attract FDI, but experience shows that it can be an important part of even the smallest, poorest countries' economy;

- The volume and direction of FDI flows respond to the national and international policy environment; and
- Current trends toward integration of the global economy provide a stronger impetus than ever towards FDI in developing countries for those countries that are open to it.

The most important determinant of FDI is globalisation. Since FDI is shaped and operationalised through globalisation, the phenomenon of globalisation has led to an increase of FDI. The aim of this study is to test three political risk models in FDI. To do this, the nature of the international arena, which is shaped and characterised by globalisation, will be examined.

The recent trends of the 1990s and the twentieth-century towards globalisation have led to the sharp increase of FDI flows worldwide. FDI takes place in a borderless, integrated and interdependent world, and, as a transnational process, is a product of globalisation. Globalisation is not simply an economic phenomenon (Holton, 1998:11). Over the past decade, globalisation has become an integral part of all social, economic and political life. This is due to cultural, social, scientific, political, international trade and finance exchanges and technological exchanges that are enabled by globalisation (Todaro & Smith, 2006:578).

A definition of globalisation is required in order to comprehend the nature of the FDI. Holton (1998:15) describes globalisation as involving

“the ways in which we understand, experience, and act within the world and not simply the large transnational structures that form the subject matter of political economy or international relations”.

In contrast, Kegley and Wittkopf (2004:21) provide a more comprehensive approach to globalisation, defining it as

“the integration of states through increasing contact, communication and trade, creating a holistic, single global system in which the process of change increasingly binds people together in a common fate”.

On the whole, a general usage of the term globalisation includes “the integration of the global community into a single society without barriers or national boundaries” (Kegley & Wittkopf, 2004: 21).

Moreover, globalisation implies a process of integration of local economies into a global economy, globalisation has led to the transformation of international social, economic and political life into a ‘global village’. Kegley and Wittkopf (2004: 269) define the global village as “a popular image used to describe the growth of awareness that all people share a common fate, stemming from a macro perspective that the world is an integrated and interdependent whole”. As a result, the consciousness of the ‘global village’ has enabled new relationships in politics, especially in areas of ‘high politics’.

To illustrate, the newly-formed relationships contribute to the resolution of issues that have featured on the international agenda for a very long period. As an example, among these issues, inter-state conflict has the highest priority. The so-called ‘borderless’ world has helped resolve some territorial disputes. Consider how global integration and the global consciousness of democracy contributed to the restoration of world-order after the Cold War.

There have been a number of critical developments that have been critical in global integration, which have shaped the nature of FDI. For instance, Van der Westhuizen (2002:165) lists a number of developments that have been critical in global integration, namely: technology, finance and credit, FDI, MNCs, trade-in goods and services, migration of labour, and transnational policy regimes. Of these developments, the service sector has enjoyed the most development in the past twenty years and development in technology and information and finance and credit has experienced major expansion and growth. Furthermore, integration in communication and technology, generally known as the ‘global information age’ makes knowledge and information more accessible. Instant

world wide communication enables greater sufficiency in political decision making and transactions in FDI.

FDI is mainly concentrated in global finance. Financial flows now exceed the volume of trade, and it continues to grow (Kegley & Wittkopf, 2004:283). Recent trends in FDI flows indicate a sharp increase in FDI. Global FDI outflows in 2005 were remarkably high at \$779 (UNCTAD, 2006:3). Services, including finance, accounted for 64% of global FDI outflows. The expansion of FDI commenced after the 1980s when FDI exploded by roughly 400% over six years- greater than previous levels of growth of trade (Van der Westhuizen, 2002:166). Hence, reduced regulatory barriers between states and lower cost of communications, travel, and transportation, have resulted in a higher degree of international financial market integration (Bartram & Dufey, 2001:1).

A definition of global finance is in order. Kegley and Wittkopf (2004:283; Cohen, 1996) define global finance as “all types of cross-border portfolio-type transaction –borrowing and lending, trading of currencies or other monetary claims, and the provision of commercial banking or other financial services. It also includes capital flows associated with FDI –transactions involving significant control of producing enterprises”.

Bartram and Dufey (2001:1) state that “policy-induced capital market liberalisation, such as abolition of capital exchange controls in most countries, permits an ever growing volume of international financial flows”. Moreover, Transnational banks (TNBs) have contributed to globalisation and financial integration. TNBs are the top banking firms whose financial activities cross state borders. They provide loans to the private sector which help make capital highly mobile.

The mobility of capital has also led to an increase in FDI, the nature of which has been shaped by the instant accessibility to. According to the capital mobility hypothesis, “MNC’s movement of investment capital has led to the globalisation

of finance” (Kegley & Wittkopf, 2004:284). International capital flows are further driven by “a divergence in population trends between developed and developing countries” (Bartram & Dufey, 2001:1).

Developed countries are characterised by ageing populations with significant needs for private capital accumulation, whereas developing countries have relatively young populations and require persistent and high levels of investment in order to create jobs and raise standards of living, in line with the aspirations of their impatient populations (Bartram & Dufey, 2001:2).

However, FDI not only stimulates capital mobility, but trade. FDI and trade interact in a number of ways, as FDI stimulates import and export and is closely related to the phenomenon of intra-trade between the different establishments of transnational firms (Tharakan & Van Den Bulcke, 1998:70).

Overall, the process of global economic integration is driven by market forces and political transactions (Lechner & Boli, 2003:160). The integration of transnational political economy has been the characteristic mode since the 1960s. This change is reflected in the fact that the growth of transnational flows such as FDI have been increasing more rapidly than the rate of the growth of exports (Holton, 1998:53).

In figures 3.1. and 3.2., Dunning (1998:81) identifies some of the most important changes that took place as a product of globalisation. These changes has shaped the global emerging environment and therefore provided a platform for FDI.

*Figure 3.1. The global emerging environment as perceived by national governments:*

- Renaissance of the market system.
- Growing structural integrations of the global economy.
- Enhanced mobility of wealth creating assets.
- Increasing number of countries approaching 'take off' stage in development.
- Convergence of economic structures among advanced countries and some industrialising countries.
- Changing criteria by which governments are evaluating FDI.
- A better appreciation by governments of the costs and benefits of inbound and outbound international business.

*Figure 3.2. The emerging global environment perceived by firms:*

- Increasing need to exploit global markets (e.g. to cover escalating R&D costs).
- Competitive pressures to procure inputs (raw materials, components, etc.) from cheapest possible sources.
- Regional integration has prompted more efficiency seeking FDI.
- Growing ease of trans-border communications and reduced transport costs.
- Heightened oligopolistic competition among leading firms.
- Opening of new territorial opportunities for FDI.
- Need to 'tap into' foreign sources of technology and organisational capabilities; and to exploit economies of agglomeration.
- New incentives to conclude alliances with foreign firms.
- Changes in significance of particular locational costs and benefits.

- Need to better balance the advantages of globalisation with those of localisation.

Not only has globalisation shaped FDI, it has created a systemic transformation of politics because the distribution of power between states and markets are being contested by (multi-national) firms, (transnational) civil societies and various private and public international organisations (Van der Westhuizen, 2002:165). The result being one free-world market not governed by state or MNC and a constant bargaining between the two factions; the bargaining is for economic strength to further underlying objectives. This has shaped the relationship between FDI and political risk. The relationship includes a bargaining relationship between actors (the MNC and the host government). Hence, the globalised nature of FDI has impacted on the objectives of actors involved in FDI. For instance, underlying objectives of states include public interest or national interest, to further national wealth or to further self-interest of corrupt or authoritarian officials, or the use of economic leverage for the purpose of growth, development and reconstruction. Underlying objectives of firms typically include the maximisation of profit.

As a result, the advent of globalisation has created a division between international economies and national politics. The consequence of this division is the increasing heterogeneity of political risk to which trans-national organisations (TNCs) are exposed (Nairne, 1997:24).

It is against this background of FDI as a product of globalisation that now, more than ever, government decisions influence the success of a business venture. This is due to the fact that the integrated global environment that in which FDI functions, is dynamic and any change in one part of the global environment will have an effect in another part. Thus, MNCs are more exposed to risks due to the global nature of FDI. Consequently, low political risk encourages FDI and MNC's use political risk analysis to minimise losses. Hence, there exists a relationship

between FDI and political risk analysis, implying that political risk analysis reduce losses in FDI. Equally, political risk analysis determines how government decisions influence FDI.

To comprehend the influence government decisions on FDI, it is necessary to investigate the reasons governments impose threats to FDI. For instance, governments might impose subtle threats to business ventures which include changes in regulation, taxation, tariffs, fees, selected law enforcement and property rights, being the most central of political risks. Oseghale (1993:3) states that political risks like expropriation, confiscation, and nationalisation of foreign investment by the host country, have had the most negative impact on FDI. States that have tight control of the economy commonly impose barriers like exclusion of foreign investors from land ownership and restrictions on the use of expatriate labour which can deter FDI.

Restrictions by host governments have been imposed for many reasons. An example of this is concerns over excessive foreign influence and loss of national wealth. The desire of this is to promote indigenous entrepreneurship, and to achieve a transfer of technology and management techniques (IFC & FIAS, 1997:2). Domestic policies of host countries greatly influence FDI.

Host countries impose restrictions for a number of reasons. Firstly, countries fear the risk of foreign control. Countries fear that MNCs that have broader objectives would lead them into decisions that are not in the best interest of the host country. Secondly, countries fear the possible inhibitions on local enterprise. Countries control foreign investors to keep opportunities open for local enterprises. Lastly, countries impose restrictions to capture rents. Bargaining over the division of profits is one way for a country to capture economic rents, thereby exploiting its natural resources and consequently sharing ownership with foreign investors (IGFC & FIAS, 1997:31).



To understand the influence government decisions have on FDI, it is necessary to investigate the relationship between the political and business system in a country. A country's overall environment can be divided into two subsystems: the political system and the business subsystem; these two systems constantly interact with each other, adjusting to each other to ensure homeostasis of the overall system (Oseghale, 1993:43). FDI and political risk are systemic activities that form a part of a whole; FDI and political risk are processes within this system. FDI is a process within the business system, while political risks are processes within the political system. For instance, when a change occurs in the political subsystem (like a change in the tax structure), the business subsystem will respond to the change by, for instance, a reduction in their output. Any change in the political sphere will thus influence business and in turn influence FDI. MNCs under the threat of political risk may either increase or decrease their investments in the host country to decrease their overall risk exposure. FDI, in turn, affects global politics, for it requires national governments to reappraise their domestic macro-organisational policies and to take a more systemic approach to the implementation of these policies (Tharakan & Van Den Bulcke, 1998:5).

The political subsystem consists of the government, groups and individuals, whereas the business subsystem consists of companies, institutions and unions (Oseghale, 1993:44). Calverly (1985:117-118) identifies the main elements of the political structure of a country. These elements can influence FDI:

- i. *Class structure*: wealthy rural landowners, poor rural landowners, rural labourers, business owners, urban middle class, urban working class-working class, elite, urban underemployed/casual labour or government workers.
- ii. *Institutions*: constitution (e.g. parliaments etc), civil service (bureaucracy), military, religious institutions, labour unions, central bank.
- iii. *Individuals*.

- iv. *Mechanisms of control:* popular support, corruption, repression, involvement of opposition groups, economic growth.

The economic policy of the host country influences the flow of FDI. Therefore, it is necessary to keep in mind that a state has certain responsibilities and the state's first priority is the national interest. Thus, the state would use their economic role to ensure that the public interest is served. The economic role of the state includes:

- i. System of law, taxation, financial regulation and establishment of a monetary unit.
- ii. Development, wholly or partly, of basic infrastructure such as roads, railways, ports, airports, education and health facilities.
- iii. Large development/infrastructure projects such as mines, irrigation, industrial, dams, agriculture etc.
- iv. Planning can involve control over import licenses, new investments or production targets.
- v. State-owned banks often aimed at directing credit to certain sectors.
- vi. State-owned enterprises in industry and agriculture.

*(Source: Calverly, 1985: 72-73).*

Other issues that affect the flow of FDI commonly include: inadequate functioning of the legal system which is not sufficient for investment, security of loans, access to land, ownership restrictions, foreign exchange and host countries' unequal treatment of investors.

The relationship between political risk and FDI is a complex one. One of the key determinants of the relationship between FDI and political risks is government policies. Government policies influence the flow of FDI. The reason for this is that a government's policy determines the framework in which business operates and the regulations to which business is submitted to. Government policies determine

the conduct of business. A government has the authority to change policies at any time and to any effect. A minor change can totally derail an investment.

In another case, the FDI policy of the host country can influence the operations of MNC's. FDI regulatory measures can include, for example, ownership structure, resource allocation, tax and tariff incentives, foreign exchange control, pricing policy, performance requirements, sectorial preferences and administrative procedures (Tharakan & Van den Bulcke, 1998: 137).

In addition, a MNC can respond to change in host government policies by reducing FDI. Therefore, host government policies determine the behaviour of MNCs. In addition, MNCs fear that government might 'change the rules of the game'. It is not the rules itself that constitute a risk but the possible changes the rules would bring about (Oseghale, 1993: 55). Thus, a change in government policy would invoke a response by an MNC.

Consider China, the largest developing-country host for FDI (IFC & FIAS, 1997:2). External policy is an important element in developing national economies. China is an appropriate example of the dynamic interaction between national policy and FDI. Since the Chinese government opened up its economy to FDI in 1979, they have introduced a number of incentives to attract FDI, FDI in China has stimulated enormous developments and growth in the country (Tharakan & Van Den Bulcke, 1998:138). These incentives form part of the process of liberalization. This process of liberalisation involves upgrading of locational resources, the 'marketisation' (the creation of institutional infrastructure) of resource allocation, the building up of a legal system geared to market transaction, the decentralization of macro-economic management, the liberalisation of ownership control and the introduction of performance requirements (Tharakan & Van Den Bulcke, 1998:138).

Host governments change policies for two reasons. Firstly, when they realise that FDI stimulates development; these countries use FDI to enhance socio-economic development. In difficult economic situations, some countries bring MNCs within their national borders to have them under their firm control; in fact, some host governments convert the profits of MNCs as a source of funds for economic growth (Oseghale, 1993:48). Secondly, there are a number of countries that change policies in order to block investment from their countries; these countries follow 'protectionist' policies. McGowan and Nel (2002:356) define protectionism as "national economic policies designed to curb imports, in order to promote the domestic production...usually achieved via high tariffs and/or non-tariff barriers, such as import quotas". This implies that exports exceed imports. Protectionism is usually accompanied by mercantilism, which is a state policy that centers on the idea of accumulation of national wealth in order to increase state power and involves active intervention by the state in the market.

MNCs are attracted to liberalised markets with minimum state intervention. A high degree of state intervention in the market makes the business climate highly volatile for MNCs. Governments that impose stringent controls or regulation on FDI and trade for the matter have the potential to derail an entire foreign or multi-national venture.

The effectiveness of government policies is reflected in the efficiency of public finance and the servicing of macro-economic circumstances since the macro-economic circumstances provide an indication of the priorities, decision-making, consistency, predictability and efficiency of the government which represent the political power in the country. If a country can not service its accounts, the possibility exist that the government will try and find other ways to manage negative finance which may pose a threat to the operation of FDI, because the given government may use political risks to try generate finance to service its accounts, the given government might impose capital restrictions, as any form of

economic leverage provides a country with power that could hinder business flow which may result in a loss of profit for the MNC.

Moreover, a country's macro-economic circumstances reflect the ability of the country's financial situation to fulfill its obligations. The macro-economic circumstances of a host country consist of the trade strategy, the level and type of state involvement, approaches to pricing, investment priorities and financial structure (Calverly, 1985:67).

In analysing the effective assessing the macro-economic circumstances, Kern (1985:23-25) suggests the 'acid test' on public finance which reflects the macro-economic circumstances of the host state:

- Payment of interest and repayment of principle as a percentage of export earnings on goods and services. This ratio should not exceed 25 per cent.
- Outstanding government debt as a percentage of GDP. Debt divided by GDP x 100 should not exceed 40 per cent, which points to long-term financial problems.
- Total debt as a percentage of exports should not exceed 100 per cent.
- Current account deficit as a percentage of GDP should not exceed 7,5 per cent of GDP.
- Government budget deficit as a percentage of GDP should not exceed 3 per cent of GDP.
- Tax, as a percentage of GDP, should not exceed 30 per cent, which points to low government involvement in the economy and moderate government consumption.

As mentioned earlier, when considering how government decisions influence the flow of FDI, it is important to consider how policy changes affect MNCs. In considering the effect that a change in government policy has on a MNC, it is important to understand policy uncertainty. Policy uncertainty is a concern for foreign investors. Policy uncertainty involves a lack of information on the content

of certain policies and refers to doubts and suspicions generated by changes in politics or the political system. It can be expressed through the volatility of institutional frameworks or in the volatility of outcomes (Snider, 2004:186).

Ingram (1974) suggests that adverse changes in host government policies toward MNCs are closely linked to economic instability. This is still the case today. A government's first reaction to economic difficulties is to divert problems to maintain the status quo of public order as a prevention of civil unrest which could turn into civil uprising that might attempt to overthrow the government, or ultimately pose a threat to the government of the day. Countries in economic distress may, for instance, invoke expropriation measures or nationalise enterprise to cope with domestic economic pressures. Oseghale (1993:490) contends that "given the significance of macro-economic stability for legitimacy, one can understand why some governments change their policies towards MNCs in periods of economic instability". This is relevant to political instability in regards to adverse change in policy. Due to political instability, a government might change policies in order to divert attention away from internal problems towards MNCs and invoke sympathy from the public (Oseghale, 1993:53).

To illustrate, Kobrin (1979:74) concluded in a study of 48 countries, testing the relationship between FDI flows and intrastate conflict, that

"political conflict has the highest probability of affecting foreign investors when it is of a nature and occurs under conditions which are likely to motivate relevant changes in government policy".

Another contributor to change in government policy is inter-nation conflict or co-operation. Oseghale (1993:59) argues that if a MNC perceives "a deterioration in the relationship [of the host and home government], MNCs will reduce their investment within the host country". In the case of conflict, a host government can impose restrictions on the MNC and the home government can compel MNCs to abandon their operations in the host country (Oseghale, 1993:58).

Consider a country's foreign policy. A country's foreign policy determines the 'rules of the game' for all international relations, interactions and interests. A foreign policy of a country involves a rational decision-making process. The decision-making process is a rational choice, which weighs up goals and alternatives to reach the best decision possible to achieve the highest goals (Kegley & Wittkopf, 2004:74).

Kegley and Wittkopf (2004:79) state that, although "domestic policy traditionally referred to governmental decisions affecting people's behaviour within state's borders and foreign policy to external relations", in a globalised world of state interdependence, the home policy has many consequences abroad and foreign activities heavily influence a state's internal affairs. It is clear that the relationship between domestic politics, international politics and FDI is a complex one. FDI is not only influenced by discontinuities and change in domestic policy, but also by discontinuities and change in foreign policy. Therefore, it is evident that there exists a relationship between FDI and political risk. Political risk encompasses domestic and foreign variables. Foreign variables can include, for instance, inter-state conflict.

As mentioned earlier in this chapter, FDI involves a bargaining process between a MNC and a host government. The next section will provide an overview of MNCs and the host government.

### **3.2. Actors in Political Risk and FDI.**

This section provides an overview of the actors involved in FDI. These actors include MNCs and host countries. This section aims to outline the roles these actors fulfill.

### **3.2.1 Multi-National Corporations and the Host Country.**

In the post world war two trade system, the international architecture was all about the liberalisation of trade. The firm-state relationship revolved around protection of the home market, and the primary goal was to sustain domestic producers. Trade politics is about tariff protection for domestic firms. The international architecture of today is characterised by investment and the goals of firms have shifted from the home markets to cross-border markets.

FDI is the story of large MNCs (Balaam & Veseth, 2001:348). Most FDI and a good deal of trade, technology, information transfer between nations is carried out by MNCs. 'Multi-national' implies that such enterprises operate in many countries and can switch activities between them (Holton, 1998:10). MNCs are economic entities involved in productive activities in two or more countries, they have their headquarters in their country of origin, called their home country and expand (this expansion is FDI) overseas by building or acquiring affiliates in other countries, called the host country (Balaam & Veseth, 2001:347). Kegley and Wittkopf (2004:173) define MNCs as "business enterprises organised in one society with activities in another growing out of direct investment abroad".

MNCs have three choices of financing subsidiaries or affiliates: they can finance from local sources, such as host country debt and equity markets; international equity and bond markets; or fund from internally generated sources such as the parent's reserves (Hooper, 2004:140).

In its home country, a MNC is considered a resourceful economic giant. Activities of MNCs are closely monitored by different groups within the home country, including the government, to see if the MNC is contributing to the country's objectives. When activities of a MNC diverge from the expected behaviour, pressures are applied to change the MNC's behaviour (Akhter & Choudry,



1998:48). One example of such a monitoring group is the United Nations for Trans-National Corporations (TNCs).

Dunning (1993:109) identifies four reasons for MNC's activities: market-seeking, resource-seeking, efficiency-seeking, strategic asset-seeking. Firms seek access to foreign markets to enjoy competitive advantages. Balaam and Veseth (2001: 351) argue that the most important element in the explanation as to why firms invest abroad is that "the firm possesses some firm-specific competitive advantage". *Firm-specific competitive advantage* implies that the firm has the ability to overcome the disadvantage of doing business in another country against foreign firms that are more familiar with their local environment.

Advantages that make firms competent to move overseas can include the large size and market power of the MNC, thus enabling them to obtain financial capital easily and at favorable terms (Balaam & Veseth, 2001: 351). MNCs enter host countries because of the advantages the location has to offer. The firm can obtain information about customers more easily in the host country. The location enables a firm to respond more quickly to changes; the firm enjoys lower labour costs and is able to avoid trade barriers.

Once an MNC has made a fixed investment, they cannot move to another country without incurring losses. A firm's exposure to political risks depends to a great extent on the industry and type of investment. A MNC in the manufacturing industry has a greater risk exposure to expropriation, as the investment is in more tangible assets and property rights play a determining role in the potential profitability of the venture compared to a MNC in a capital intensive industry, where transfer risk poses a greater threat to the profitability of the venture.

Political risk analysis can reduce a MNC's exposure to risk by forecasting political risks. After identifying political risks, the most common strategies by MNCs to manage political risk in general include:

- i) The MNC adapts and conforms to government policies;
- ii) Resort to polity, by acting informally behind the scenes- for instance, with the World Bank;
- iii) Withdraw from country or avoid country;
- iv) Restructure with a serve strategy, involving the scale of equity and its replacement by management-service contracts;
- v) Restructure as a joint venture;
- vi) Insure the project with a political risk insurer or trade-credit risk insurer; and
- vii) Try lobby government, or other groups and institutions.

(Hooper, 2004:141-147, Kennedy 1998).

As mentioned earlier, the relationship of the MNC and the host government is a bargaining one, the MNC might put pressure on the state to reduce barriers in exchange for technological innovation, integrated production, etc. that the firm offers. The MNC usually stipulate terms for their capital investment, which the host country can accept, decline or dictate. The terms can involve special political favours not available to others in commerce; state subsidies, exemption from taxation, government suppression of workers or special status as export enclaves free of import duties. MNCs that stipulate these terms usually have the strongest bargaining power when it is dealing with a small, poor country, desperate for industrialisation (Greider, 2004:160).

Furthermore, the relationship between the MNC and the host government is asymmetrical. "The MNC is unable to prevent the host country's government from changing the contractual base on which the initial investment was first made" (Hooper, 2004:141; Sachs, 1983).

In conclusion, MNCs are active contributors to globalisation and are advocates of globalisation. Some of these MNCs have sales revenues that exceed the gross domestic product of many countries in the world (Balaam & Veseth, 2001:348). These companies' primary goals are to maximize stakeholders' welfare. MNCs have an interest in both economic and political stability. They make long-term investments and prosper in a stable environment that allows them freedom of trade and movement and capital (Vincent, 2002:158). When MNCs invest in a country, the relationship is mutually beneficial for both the MNC and the host government. The host government will, for instance, benefit from technological innovation and gain taxes while the MNC gains profit.

### **3.2.2 International Compliance and Fair Practices.**

The relaxation of state borders dispersed state's control over business transactions within national borders, making it easier for actors in the international arena to indulge in unfair practice at the expense of others. Therefore, regulation of international investment has become vital to maintaining international order. The next section presents an overview of current approaches to the regulation of international order.

A player's reputation is viewed as a summary of its opponent's current beliefs about the player's compliance strategy or set of strategies in connection with various commitments. A damaged reputation of noncompliance can make it difficult for a state to enter into a future agreement with a MNC or vice versa (Downs & Jones, 2002:100). States and MNCs possess a single, unitary reputation. Downs and Jones (2002:100) support this argument by asserting that, "...states possess a single reputation for cooperation that characterises its expected reliability in connection with every agreement to which it is a party". States and MNCs may adhere to conventions for reasons of reciprocity, which is mutual advantage: a state may gain benefits of development and a MNC may gain from the long-term profit benefits. An international actor should, therefore,

take great care in its relationships and harbor a credible reputation of compliance. A player's reputation influences other actors willingness to engage in sustainable transactions, be it a state or a MNC.

### 3.2.2.1 Corporate Social Responsibility (CSR)

Globalisation offers many opportunities to companies, but also poses many risks due to uncertainty. In order to effectively manage risks in the global arena, corporate decision-makers have to be familiar with the ever-changing environment in which companies function. This globalised environment was discussed earlier. Not only is the environment important to effectively manage risks, but an understanding of the relationships within this environment is necessary.

Apart from the traditional risks, such as political, economic, financial and technological that companies may encounter, there exists the overlapping nature of traditional risks within the global environment. This is known as the PEST perspective on risk (Kytte & Ruggie, 2005:9). Kytte and Ruggie (2005:9) explain this as "the increasing complexity of international business also means that risks at the global level are much more likely to crosscut categories, so they need to be addressed from multiple perspectives simultaneously". This means that a political risk may have an economic effect, or a social risk may have a political effect. Thus, the term PEST is the abbreviation for political risk, economic risk, social risk and technological risk. The different risks in this framework will not be analysed for the purpose of this study. Only an explanation of the framework and its relevance to political risk analysis and FDI will be discussed.

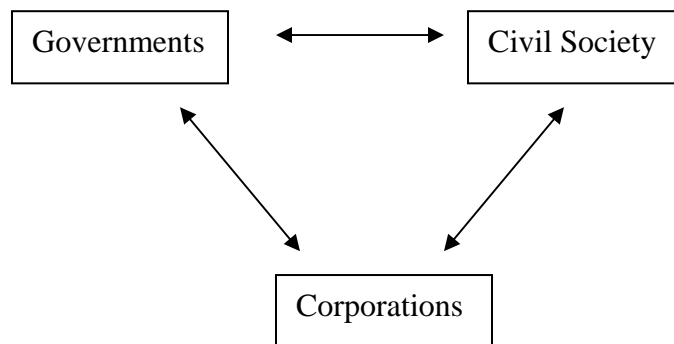
To understand the role that CSR play in political risk analysis and FDI, it is necessary to understand the environment in which the different risks in the PEST framework interplay. Globalisation has created a global operating environment that is different to national or local levels (Kytte & Ruggie, 2005:9). This operating

environment has resulted in complex relationships between MNCs, host governments and stakeholders. The relationships between these factions inherently influence the context in which business takes place. CSR can play a central role in this context (Kytte & Ruggie, 2005:2). CSR provides a platform and framework to manage these relationships.

To understand the importance of CSR, it is necessary to provide a brief explanation of the importance of relationships between MNCs, host governments and stakeholders. Firstly, a definition of a stakeholder is in order to clarify the importance of CSR. Kytte and Ruggie (2005:3) define a stakeholder as “any person, group or organisation that can place a claim on a company’s attention, resources or output”. Stakeholders are social actors who exert a powerful influence worldwide. They are pressure groups that form coalitions to challenge corporate behaviour and government policies on the global level (Kytte & Ruggie, 2005:3). Moreover, as MNCs expand their reach within the global economy, MNCs experience an increased exposure to these social actors.

Stakeholders are part of the civil society. Kytte and Ruggie (2005:3) contend that the concept of civil society includes “voluntary and not-for-profit organisations, philanthropic institutions, social and political activist networks, community groups and related organisations”.

**Figure 3.3. The Global Operating Environment**



(Source: Adapted from Kytle and Ruggie, (2005:4).

The above figure illustrates the global operating environment within the global economy. It depicts the dynamic interplay among companies, host governments and the civil society. Each actor can pressure the others, through various levels of influence, and use these levers in response to the activities of others to trigger a desired change in the overall system (Kytle & Ruggie, 2005: 3-4). Kytle and Ruggie (2005:4) explain that this “push and pull of these sectors constitutes a dynamic system within which global companies must now operate, posing both new risks but also opportunities”. Hence, the relationships between these actors play a significant role in the success of FDI. Therefore, sustainable relationships between these actors will contribute to a more favourable investment environment. If a company does not have sustainable relationships with civil society, civil society can exert power through protests, boycotts, change in purchasing patterns or even influence government policies (Kytle & Ruggie, 2005:4).

Goulbourne (2003:3) maintains that

“for MNCs to maintain sustainable profit-maximising investments, it is necessary for them to consider how they can increase both transparency and accountability in their operations to avoid negative social, political and economic effects”.

In order for a MNC to be accountable, it is necessary that their operations be transparent and that they maintain sustainable relationships with international actors. Adopting a CSR program will mitigate against the risk of fatal relationships within the international arena. CSR provides companies with a framework to manage stakeholder and government relationships in order to avoid conflict with these actors (Goulborne, 2003; Kytte & Ruggie, 2005).

By integrating CSR policies into corporate decision making companies can ensure greater transparency and accountability of their operations, thereby, avoiding conflict with other actors through sustainable relationships.

With the ever-changing business global business environment and the increasing prominence of MNCs, the pressure of CSR on MNCs has increased. MNCs must satisfy civil society's demands for ethical performance, legal and regulatory directives, and the profit maximization of stakeholders, to prevent negative publicity and to avoid neglecting stakeholders interest (Nairne & Gora, 2004:156).

One initiative to promote good corporate citizenship is the Global Compact. The Global Compact, initiated by the United Nations (UN), is an initiative that calls on business leaders, trade unions, labour standards and the environment. This initiative demands, firstly, that MNCs support and upholds the Universal Declaration of Human Rights and that they do not support or engage in the abuse of human rights. Secondly, it is expected of MNCs to uphold freedom of association and collective bargaining. MNCs are expected to make sure their hiring and firing policies do not discriminate on grounds of creed, race, ethnic origin or gender. It is expected of MNCs to make sure they are not employing underage children or forced labour. Lastly, it is expected of MNCs to contribute to the usage of environmental friendly products and technology and encourage environmental development (Robinson, 2004:191-192).

According to the 1999 *Millennium Poll on Corporate Social Responsibility* among 25000 respondents in 23 countries, a significant proportion (56%) said their impression of companies is shaped by corporate citizenship than either brand quality (40%) or business fundamentals (34%). A further 20% of respondents reported either rewarding or punishing companies on their social performance (Nairne & Gorna, 2004:157). How a company upholds its social responsibility has a great affect on its success.

It is now unusual for MNCs not to be members of CSR-oriented organisations (Henderson, 2004:195). MNCs are less reluctant to comply with international rules by joining CSR organisations. This way, the state and the MNC have a greater degree of protection against unfair practices. A range of treaties and conventions, relating in some manner to CSR, have been developed under the auspices of the UN and other inter-governmental, non-governmental (NGOs) and other international organisations, either directly or through ratification by domestic legislation. Some create legal obligations enforceable against MNCs (Nairne & Gorna, 2004:160). Examples of CSR organisations include the World Business Council for Sustainable Development, the Prince Wales Business Leaders Forum and CSR Europe. Industrialised courts are allowing actions brought by workers and stakeholders from developing countries against MNCs for environmental damage and human rights abuses (.Nairne & Gorna, 2004:159). It is, thus, vital for MNCs to uphold their social responsibilities, as this will determine their reputation.

#### 3.2.2.2 International Law and States

As MNCs have social responsibilities, states are compelled by certain codes and conventions to comply with certain responsibilities in the way they treat MNCs.

The effect of international law on states' behaviour should be of central concern in political risk analysis, as the reasons states comply to laws, treaties, policies



and conventions is of great significance to investors. A state's credibility to adhere to rules can either attract investment or investors may choose to avoid states with a reputation of non-compliance and restrictive behaviour.

There are a number of determining factors when it comes to determining a country's willingness and ability to comply with international codes of conduct. Firstly, a state's regime type matters: a democracy is more likely to have participatory characteristics. Democratic political institutions are associated with high levels of FDI, and are characterised by having less restrictive measures. Jensen (2003:594) asserts that "democratic institutions can be a mechanism by which to decrease political risks". Democratic governments have been found to be more credible in making agreements in the international arena. The reason for this is credibility. This is based on the number of veto players (chambers of legislature, supreme court, separation of executive and legislative branches of government or federal actors) in a society (Jensen, 2004:594).

Democratic governance is an important feature here. Johnson (2004: 11) defines governance as being "the relationship between the state to civil society and the market". Democracies aim, and are more likely, to provide "good governance". The "goodness" of the governance is the attitude and commitment of the leadership elite. Economic development and good governance usually go hand-in-hand (Johnson, 2004:11-12). In a democracy, citizens have the capacity to replace stale, corrupt or weak leaders through electoral mechanisms; therefore, a democracy is more likely to have 'good governance' (Jensen, 2003:595).

Democratic political institutions allow higher levels of cooperation between states, which may also allow for higher levels of cooperation between states and MNCs (Jensen, 2003:594). The second matter of significance that motivates states to comply is *rule of law*. Domestic systems that value rule-based decision making and dispute resolution are more likely to respect laws and rules internationally.

International Law requires effective organisation of the community of States. The UN declaration on Rights and Duties of States adopts and proclaims fourteen basic rights of the state. Article 13, stipulate:

“every state has the duty to carry out, in good faith, its obligations arising from treaties and other sources of international law, and it may not invoke provisions in its constitution or its law as an excuse for failure to perform this duty”.

Therefore, international law “is not unlike constitutional law in that it imposes legal obligations upon a government that in theory the government is not free to ignore or change” (Fisher, 1998:30). States that fail to comply with international law face severe costs to the nation’s reputation and perception as a trustworthy member of the international community, and it is difficult for states to enter into future agreements in the international community (Downs & Jones, 2002:100).

The methods of regulating investments internationally include bilateral and multilateral investment treaties and conventions and applies to states (ambassadors of states), MNCs (stakeholders and private bodies), and NGOs (public representative entities). Bilateral Investment Treaties (BITs) include agreements for the promotion and protection of investments between countries and companies. The agreements deal with issues like:

- treatment of investments;
- compensation for losses;
- settlement of disputes between contracting parties, bodies of dispute settlement include the International Center for the Settlement of Investment Disputes (ICSID) and the Ad Hoc Court of Arbitration;
- application of other provisions;
- consultation and amendment;
- entry into force, duration and termination;
- transfer of funds;
- subrogation;
- most favourable treatment;
- general exceptions; and
- scope of applications.

(Source: UNCTAD, 2000)

There are numerous conventions on investments; below are the most significant conventions that are included in UNCTAD (2000). The *Draft Convention on Investments Abroad* makes decisions through an Arbitral Tribunal. The *Draft NGO Charter on Transnational Corporations* stipulate codes of conduct. The *International Agreement on Investment* by the Consumer Unity Trust Society (CUTS), which was prepared for the UNCTAD Round Table, which applies to Ambassadors and NGOs on a multilateral framework on Investment. This framework is the most complete, explanatory and comprehensive framework and deals specifically with environmental issues, human rights and corporate rights. *Towards a Citizens' MAI* is an alternative approach to developing a global investment treaty based on citizens' rights and democratic control; it stipulates operating principles, citizens' rights, state obligations and corporate responsibilities. The *Core Standards* by the World Development Movement (WMD) is based on the belief that MNCs must be regulated.

The IMF's "Articles of Agreement" are the first and most powerful international agreement to obligate signatories to particular standards of monetary conduct. The rules stipulated in Article VII ("General Obligations of Members") prohibit restrictions on the making of payments and transfers for current international transactions and foreign exchange. Article VII provides a right of access to foreign exchange for residents and non-residents. A credible commitment to the rules makes a country a desirable investment venue.

However, no international commercial law supersede the sovereignty of the state, no international process can require performance of a contract (Rogers & Johnson, 2004:19), and there are many cases where the uncertainty of non-compliance of states is a major concern. In these cases, the need for political risk analysis is greater. International law does not provide the entire solution to an investor seeking to reduce the political risks, of an investment, but the laws and political climate of the host state play an important role. A solid understanding to

international law which is related to political risk is vital to any investor seeking to reduce risk (Comeaux & Kinsella, 1997:xxix).

The case for legal protection of a MNC's investment is a complex one. The trickiest of cases is the right of expropriation, which is a sovereign right. If the state determines that the state and national interest is best served by taking a piece of property it will be taken, international law can be used to secure compensation, but in some cases compensation is not sufficient for the losses made (Johnson, 2004: 19).

What complicates the case of expropriation is that there are different forms of expropriation (nationalization, confiscation, creeping expropriation), and it is difficult to determine what constitute expropriation. Generally, expropriation refers to the taking of property for public purposes. It is difficult to determine if a confiscation is in national interest or not. In order to comprehend what constitutes expropriation, it is important to understand the concept of property and property rights. According to Judge Rosalyn Higgins of the International Court of Justice, the conceptual aspects of property have not been fully explored under international law. To understand the case for expropriation; it is necessary to clarify the property and property rights. Property broadly refers to "realty, personalty, tangibles and intangibles such as rights under contracts", Property rights refer to the "ownership of property" (Comeaux & Kinsella, 1997:2). Comeaux & Kinsella (1997:2) assert that property comprises three elements: *usus* (the right to use), *fructus* (the right to the fruits of the property, such as interest or rentals), and *abuses* (the right to dispose of, or sell property). Any interference by a government with the property and the property rights constitute a political risk.

A sovereign country has the right to expropriation when the expropriation is non-discriminatory for public purpose accompanied by full compensation; if an expropriation consists of the above characteristics it is legal under international

law (Comeaux & Kinsella, 1997:5). In many expropriation cases, it is not clear whether the taking of property is non-discriminatory. In most cases, it is since countries nationalise assets of foreign control rather than assets of local control. Governments hide behind public interest and most of the time it is almost impossible to challenge this function of government. Although governments provide compensation for the taking of property, the MNC will always be at loss, for a FDI is made with long-term goals of profit-maximization, which will not be realised.

Nationalisation is the general impersonal form of expropriation which the state uses larger interests of society to advance a program of economic or social reform. This usually consists of the taking of all foreign investment or all foreign investment of an industry to acquire ownership of wealth and natural resources, as well as the means to production, which is used to perform a social function (Comeaux & Kinsella, 1997:7).

Confiscation refers to the seizure of property by a state without compensation, usually to punish the owner for who he is or for what he has done. This is seen as an illegal expropriation under international law (Comeaux & Kinsella, 1997:7).

The most difficult expropriation to determine if it is legal or illegal is De Facto Expropriation. This is often referred to as 'creeping' or 'indirect' expropriation. De facto expropriation refers to a series of hostile actions that cumulatively deprive the investor of the value of its investment. This is not necessarily the taking of property, but commonly involves restrictions and controls and tax regulatory measures. De Facto expropriation involves a series of actions that result in expropriation and assets are not seized directly (Comeaux & Kinsella, 1997:8).

Critics of MNC's argue that MNC's transactions across borders are leading to the demise of the nation state and are ultimately breaking down the sovereignty of the state. McGuire (1999:147) argues that, in many ways, the "international

economy is more, not less, regulated than ever. Business activity is under national and supranational scrutiny”, which rings true as the global economy is an interaction between ‘corporate strategies and government regulatory regimes’. The political role of firms is not a new phenomenon; firms have always been political actors, and they have control over resources, property, wealth, capital, power of production and productive capacity, which always gives them input into government policy. The international business architecture is governed by detailed conventions, frameworks, treaties and policies, which are not developed over night, but established through trial and error of the past. Thus, the state’s sovereignty is not declining as it has evolved (or in some cases still evolving) towards a new world order.

### **3.3. Conclusion**

The aim of this chapter was to explore the relationship between political risk analysis and FDI. An overview of FDI provided insight into the nature of FDI. This included the restrictions on FDI and the motivations for restrictions on FDI and the circumstance’s that makes a country attractive to FDI were listed.

This chapter standardised a definition of FDI as private capital flows from a parent firm’s home nation that engages in direct long term relationships. FDI is attracted to countries of all sizes and at different stages of development. A number of determinants of FDI were discussed in this chapter. An overview of trends in FDI was provided. Recent trends in the development of FDI suggest that globalisation has led to a sharp increase in FDI. Hence, FDI was discussed as a product of globalisation. It was contended in this study that globalisation involves the dynamic integration of all social, political and economical life. This process of international integration has been critical in shaping the nature and frequency of FDI.

In order to establish the relationship between FDI and political risk it is necessary to understand how government decisions influence the flow of FDI. The actors (MNCs and host countries) involved in FDI were discussed in order to determine the link between FDI and political risk analysis. It was contended in this chapter that low political risk encourage FDI and MNCs use political risk analysis to minimise losses. A favourable investment environment within a host country thus attracts FDI. It was contended in this chapter that political risk analysis is a necessity to the success of an investment. Consequently, FDI is reliant on political risk analysis and political risk analysis determines a foreign investments exposure to loss. In conclusion, there exist a relationship between political risk analysis and FDI.



## **Chapter 4.**

## **Political Risk Insurance.**

An investor can reduce its exposure to political risk by avoidance, mitigation, or insurance. Total avoidance of investment is not advisable, since the upside of risk is opportunity. There are numerous benefits when a high risk investment is managed sufficiently so as to avoid losses. High risk investment usually takes place in a market where there is little or no competition and, in many cases, a great demand for the service or product the investment has to offer. If these investments are successful, companies enjoy dominance in the market in which it functions.

Mitigation of risk by means of reduced spending, short-term operations, isolation or low-cost establishments or supplies can reduce the quality of the investment and prevent the optimisation of profit. The purchase of political risk insurance (PRI) on the other hand is the most direct, simplest and effective way to reduce exposure to political risk (Comeaux & Kinsella, 1997:151). Comeaux and Kinsella (1997:151) argue that “political risk insurance is the most direct and simplest step an investor can take to reduce its exposure to political risk”.

If a company chooses to ignore risk, the losses could be tantamount; a single expropriatory act can erase many years of good business (Poloz, 2007). However, if an investor chooses to pass on the venture due to high political risk, the investor would pass on growth opportunities. Political risk insurance is an important instrument for investors because it protects investors from politically motivated acts that can affect the viability of the investment. Political risk insurance is an important extension of political risk analysis. Since, identifying and analysing sources of political risk and rating them is only one part of the task, the other part is to develop mitigants that will reduce risk (Poloz, 2007). Political risk insurance is one of the most common forms of risk management (Brink, 2002:245). The main aim of this study is to analyse the reliability of current risk assessment models. In addition, it is equally important for a political risk analyst



to be familiar with ways of mitigating risk. In any event, the political risk analyst must provide a level of confidence about an investment to the investor. Omura (2005:internet source) agrees that the political risk analyst plays a vital role in the inception of a investment by explaining that the combination of a strong political risk analysis and political risk insurance provides “investors with the confidence to enter high-risk markets with a better understanding of country conditions and the knowledge that potential losses arising from political risk” can be reduced by effective political risk insurance. The main purpose of this chapter is to argue for the reduction of political risks by means of PRI.

#### **4.1. Political Risk Insurance: An Overview**

PRI is an effective cross-border management tool. Not only is PRI a method to mitigate risk, but it can also “increase a sponsor’s ability to attract scarce loan financing” (Omura, 2005:internet source). In many cases, the efficiency of an investment is determined by the insurance guarantees, because insurance reduces the exposure of the investment to risk. The purpose of PRI is to mitigate and absorb risk. The commercial benefits of PRI enables improved access to finance. Not only does PRI enable a company to do greater business by providing an investor with greater confidence through protection in the event of the occurrence of loss, but it also provides risk management when accessing new markets. Moreover, PRI also provides an investor access to knowledge held by the insurance market in structuring transactions.

This section aims to define basic concepts of insurance. These concepts will include insurance, insurance policy, premiums, reinsurance and underwriting. In exchange for payment of a specified sum of money, called the ‘premium’, the insurance company agrees to pay for certain types of losses or damage as specified by the contract. When a loss occurs, which meets all of the requirements described by the terms of an insurance policy, the loss is said to be ‘covered’ by that policy. Regular payments or premiums, thus, provides against

contingencies that might result in loss. Insurance is a sum paid out as compensation for damage or loss, whereas 'to insure' would be to secure the payment of a sum of money in the event of loss or damage (Moodley & Clive Middlemas, 2005). It would then suffice to say that PRI is a form of risk management primarily used to hedge against the risk of potential financial loss, and a defensible definition of insurance is the equitable transfer of the risk of a potential loss, from one entity to another, in exchange for a premium and duty of care (interview, Lilly Moodley Credit Guarantee & Clive Middlemas AIG, 2005).

An insurance policy is a legally binding contract between an insurance company and the person, commonly called the policy holder, who purchases the policy is referred to as the insured. A premium is an amount paid for a contract of insurance; this consists of the sum of the investment including interest. The premium is above the usual or nominal price which attaches special value to provide, or acts as an incentive at the occurrence of contingencies. Reinsurance is the spreading of risk when the insurance company covers its insured, and then in turn seeks insurance from underwriters on the coverage it provided. Insurers almost universally purchase reinsurance to protect themselves against excessively large accumulations of risk in a single area and to avoid catastrophic depletion of their own capital (Moodley & Middlemas, 2005).

To underwrite a risk is to sign and accept liability under an insurance policy. The underwriter, therefore, undertakes to finance and support the insurance. An example of such an underwriter is Lloyds of London and Swiss company and Munich reinsurers. The insurance company, therefore, reinsures the risk with an underwriter. Loss includes events that result in an interruption of project operations essential to overall financial viability. When investment is considered a loss; the insurer will pay the book value of the total insured equity investment.

There are different types of political risk policies and different types of political risk insurers. In order to optimally protect an investment venture against political

risk, it is necessary to seek coverage from the most suitable political risk insurer that would be more accommodating in designing the most suitable political risk policy for the investors need. The next section aims to provide an overview of credible political risk insurers.

#### **4.1.2. Political Risk Insurance Providers**

PRI is typically available from private insurers like American International Group (AIG), Credit Guarantee (South African Insurance Company), and from public insurers including state-owned enterprises like Overseas Private Investment Company (OPIC) and multi-lateral agencies like Multilateral Investment Guarantee Agency (MIGA) and South African Special Risks Insurance Association (SASRIA).

What distinguishes PRI from traditional insurers are the two different sources of political risk insurance- namely private and public insurance- and the different goals of the two sources of insurance. The private PRI market's goal is purely profit, whereas, the public PRI market involves government agencies whose interest is to encourage investment in other countries in order to stimulate growth and development (Lempres, 2004:1). The next section aims to differentiate between private PRI providers and public PRI providers.

##### **4.1.2.1 Private Political Risk Insurance**

The private insurance sector is characterised for its flexibility and speed of insurance coverage execution (Jenkins, 2002:3). Private coverage is more flexible, can be customised to meet the needs of a particular investment, and can often be negotiated in days because private insurers are not bound by the same policy constraints as state-sponsored insurers. The negotiations of the terms of the policy are generally more flexible (Comeaux & Kinsella, 1997: 183). Government sponsored programs offer lower fees than private market insurance.

The private PRI market generally offers two types of risk coverage, asset coverage and contract coverage (sometimes referred to as trade coverage).

Asset coverage generally includes:

- Confiscation, Expropriation, Nationalisation and Deprivation (CEND). This is the core of PRI, and protects against selective and discriminatory acts by the host government, causing permanent loss of benefit of a venture without fair compensation;
- Forced Divestiture: requires permanent divestiture of a shareholding in a foreign enterprise by the investor's own government, or by a foreign government;
- Forced Abandonment: abandonment of a foreign enterprise arising from a deteriorating security situation;
- Arbitration Award Default: the government defaults on an obligation arising from an arbitration award.
- Import or Export License Cancellation, Embargo: the prevention of import or export of goods or technology from any country due to the cancellation of previously obtained import or export licenses, or prohibition due to embargo; and
- War and Political Violence. Physical damage to the assets of a foreign operation or inability to continue debt service due to strikes, riots, civil commotion, malicious damage, war, civil war, or terrorism (Galvao, 2001:7).

Contract coverage risk generally includes:

- Currency inconvertibility: the inability of the host country or central bank to exchange deposits of local currency representing principal, interest, earnings, dividends and management fees deposited by a foreign enterprise for exchange to a designated foreign currency;
- Exchange transfer risk: the risk of the host government or central bank blocking or refusing to transfer deposited funds in the host country to a designated foreign location;

- Contract frustration: The non-fulfillment of a contract due to political events, including import or export license cancellation, embargo, government buyer nonpayment or repudiation, expropriation (CEND), currency inconvertibility, war or non-honouring of a letter of credit; and
- Unfair calling of guarantee or wrongful calling of guarantee: The unfair drawing down of an on-demand standby letter of credit posed as a bid, advance payment, warranty, or performance guarantee by a government entity or, a fair drawing where the contract terms are unfulfilled due to a political risk (Galvao, 2001: 8).

Terms offered by private insurers are significantly shorter than the public sector and usually range from one to three with underwriting limits that range from \$5 million to \$300 million per risk. Criticism against private insurers accuse private insurance for being too short term. Due to the short terms, the availability of private insurers to offer reinsurance for coverage provided by national programs is reduced (Comeaux & Kinsella, 1997: 183).

Many private insurers are becoming more flexible with their terms and underwriting that they offer. Changes in term and underwriting limit structure have marked significant growth in the private sector. Some of these changes include:

- Zurich insurer's recent increase in its underwriting limit for PRI to \$80 million per risk, with a term of up to 15 years, and its trade credit limit of up to \$35 million, with a term of up to 15 years, and its trade credit limit to \$35 million, with a term of up to seven years;
- AIG's per-risk capacity is currently \$80 million, with a term of up to 15 years;
- Sovereign insurers underwrites individual political risks on a stand alone basis with limits of up to \$125 million on a 15 year term;
- ACE Global Markets currently offers up to \$60 million in expropriation coverage, with a term of up to 10 years; and

- Chubb & Son N.J. currently offers its basic coverage on confiscation, expropriation and nationalisation, with limits of up to \$50 million and terms of up to 10 years (Hofmann, 2006:2).

PRI premiums are based on a number of factors depending on the nationality of the investor, the risk associated with the host country, the size of the investment, risks covered by the insurance and the structure of the investment (Comeaux & Kinsella, 1997:183).

As explained earlier in this chapter, political risk insurers often reinsure risks to protect themselves from financial depletion; insurers spread the risk with the financial support of underwriters. Underwriting political risk is a very different process to most other types of insurance. Joachim Osinski, director and head of political risk at Gerling credit insurance explains that,

“you are analysing many different factors across the world and there are many uncertainties. It is part art, part science. You have just got to get a feeling for the information you have and evaluate it” (Jenkins, 2002:28).

Underwriters apply political risk analysis to all pending claims; the process of risk analysis is similar to that of traditional political risk assessment.

In considering an insurance policy, underwriters look at salient factors such as the ownership structure of the project, the importance of the specific industry to the economy of the host country, the nature of the business, the project’s viability as a foreign-owned enterprise, the applicant’s experience in emerging markets and the relationship between the investor’s home country and host country, legal protections offered by the specific host country to foreign investors, country liquidity, economic outlook, regulatory risks and political risks (Hofmann, 2006:2,3). AIG provide a risk rating narrative guide that offers comprehensive current and reliable ratings on a company’s profile in considering an insurance policy or coverage of a claim (rating guide available on request of author of this study). The profile includes data on financial quality of the business,

management quality, financial sources, probability of default and an analysis of the specific industry or sector.

The next section aims to provide an overview of two private PRI companies' risk analysis methodology, risk assessment, socio-political role, investments and risk coverage.

#### **4.1.2.2. Credit Guarantee Insurance Corporation of Africa Limited**

Credit Guarantee is a South African company. Registered in 1956, it was established by a number of banks and insurance companies and commenced operations in 1985. Credit Guarantee provides South African exporters with credit insurance facilities. For the past decade, Credit Guarantee has provided credit insurance facilities to the value of R102 billion (US\$23 billion) on an average exchange rate. Today, Credit Guarantee is the leading insurer on the African continent with a South African market share of some eighty per cent. It carries an AA rating for its claims paying ability, and is ISO 9001:2000 accredited. Its largest shareholder is Mutual & Federal Company Ltd., the second largest short-term insurer in South Africa - itself a subsidiary of Old Mutual Group (Credit Guarantee, 2004:5).

Credit Guarantee's vision is to provide the market with the best credit insurance solutions obtainable. Their mission to their clients is unrivalled. Expert credit insurance solutions, their mission to their shareholders is sustainable return on investment and growth, professional standards of underwriting, and an excellent reputation. Credit Guarantee's mission to society is of the highest ethical and moral standard. Their mission involves commitment to and the practice of good corporate governance, and commitment to the provisions of the Financial Sector Charter (Credit Guarantee, n.d).

Credit Guarantee continuously evaluates and monitors countries' risks and political risks and advise their clients of changes in their countries' risk and political risk profiles. Credit Guarantee is in constant contact with international bodies as well as their re-insurers to ensure that their information is accurate and current. Credit Guarantee sets credit limits on each of their client's foreign customers by obtaining information from credible sources, including Credit Bureaux, an overseas partner, and customers themselves. Credit Guarantee has a dedicated team of underwriters who analyse and interpret information and establish realistic credit limits (Credit Guarantee, n.d).

Credit Guarantee is a member of the Berne Union and has abided by the guidelines set by the Berne Union. By associating closely with fellow insurers in the Berne Union or similar groupings, such as the ICIA and PASA, the company have been able to benefit immensely from trends in the industry and experience gained through actual transactions with countries where they have just started doing business (Coles, 2000:2). International rating agency Global Credit Rating (GCR) has reaffirmed Credit Guarantee's claims paying ability with strong protection factors. Risk is modest, but may vary slightly over time due to economic and/ or underwriting conditions (Credit Guarantee, 2000:13).

Although the commercial risks of any transaction are carried out by Credit Guarantee and its re-insurers, the political risks are carried out by the South African government as part of its program of encouraging exports, and thereby generating foreign exchange income and creating employment. The company purchases its reinsurance requirements on an annual basis according to its core business exposures. As a risk management process, the Credit Guarantee's net risk exposure is limited to an internationally acceptable percentage of their net worth. This exposure is carefully monitored to ensure adequate coverage at all times (Credit Guatantee, 2004:18). The risks covered by Credit Guarantee include:

- Importation; any law which prevents or restricts the importation of goods;



- Transfer; the lack of foreign exchange or any law which prevents or restricts payments from the importing country;
- Conflict: war, hostilities, civil war, rebellion, or revolution outside of the exporting country;
- The insolvency of the buyer is a result of sequestration order, surrender of the buyer's estate, a winding-up order, statutory compromise or arrangement, or judicial order against the buyer;
- Protracted default; the failure of the buyer to pay an undisputed debt within six months of due date; and
- Repudiation; unwarranted failure or refusal of a buyer to take delivery of goods (Source: Credit Guarantee, n.d.).

Credit Guarantee offers short-term domestic credit insurance which covers risks for all companies selling goods or services on a credit basis in South Africa, and can be extended to cover sales within the monetary area; the credit terms of this service do not exceed 180 days. Credit Guarantee offers medium- to long-term insurance that underwrites risks where credit terms granted to foreign buyers for the export of capital goods and services generally exceed two years. This medium to long term coverage provides insurance against loss of investments made by South African companies in foreign countries. Other services provided by Credit Guarantee include the Alternative Risk Transfer (ART) that involves risk financing solutions that promote greater risk management awareness and strategic risk management principles in businesses, which enables clients to retain much higher levels of risk without seriously impacting on their balance sheet. ART solutions also free up working capital by establishing the optimum amount of capital required for preventative measures, predictable risks and catastrophic losses. Credit Guarantee's latest developments include the following: credit limits can be issued in the major foreign currencies, there is no longer a South African content requirement for goods exported, and export policies which reduce administrative procedures (Credit Guarantee, n.d).

Credit Guarantee maintains a sound reputation through its years of operation. Credit Guarantee fully support the recommendations made by the King Committee on Corporate Governance (see Appendix for recommendations). In terms of the Financial Sector Charter, Credit Guarantee has made a commitment to invest in human resource development, increase the number of black directors at board level for ratio-population representation, implement a leadership program for black matriculants, implement a target procurement strategy to enhance percentage of purchases from BEE suppliers, mobilise resources for empowerment financing, direct a percentage of funds to corporate social investment and consumer education programs, and have a black minimum percentage of black ownership, measured both at holding company and direct level (Credit Guarantee, 2004:13).

Credit Guarantee subscribes to the principles of responsible corporate citizenship and has adopted a number of social programs in the area of education and training. These social responsibility programs include:

- A bursary scheme to assist deserving pre- and post matric learners who are unable to finance their own studies;
- Contributing to the SA Conservation Education Trust which provides support for environmental issues and relevant training of rural people;
- Support for the Ebenezer Care Centre, a home for abandoned children and elderly people; and
- A formalised donation budget, under the control of the financial director, which supports a number of charities and other deserving causes

(Source: Credit Guarantee, 2004:15).

Credit Guarantee was one of the first South African credit insurers to introduce domestic trade credit cover, the first South African credit insurer with international affiliations and the first South African financial institution to achieve ISO 9001:2000 certification for quality management throughout their entire operation. Credit Guarantee was also one of the first credit insurance companies in the

world to qualify for ISO 9001:2000 and was first to introduce an online credit management system (Cregalink), (Credit Guarantee, n.d.)

Credit Guarantee ensures the promotion reliable information. Coles (2000:3) list a number of problems experienced with reliable information necessary for claim decisions:

- Lack of a source of information;
- The length of time needed to obtain information;
- The reliability of the information;
- The reliability of the opinion given;
- Accounts are often not audited, but if they are, the auditing systems are not up to standard, sometimes they may not be a recognised auditing house;
- Auditors or information bureaus can be bribed to give a favourable opinion;
- Laws governing the registration and management of companies are sometimes deficient and are often not applied effectively;
- It may take a long time to effect title to fixed assets taken as security; and
- Having paid a claim, difficulties may be encountered in recovering payment from the debtor because there is no effective collection agency which can work on your behalf.

The above problems exist for any insurer but particularly when transacting business in a country for the first time when the insurer has had no or very little prior contact with the country before, and does not know the country's business ethics (Coles, 2000:4).

Credit Guarantee advises countries to enact a number of protocols to prevent the pitfalls of unreliable information mentioned above. These include:

- Ensuring that there is an effective commercial code and that divergence from it are punished adequately;

- Ensuring that Company Law is applied equitably and consistently;
- Instituting, maintaining and monitoring the auditing profession; and
- Ensure that the legal system works, that judgements are executed promptly and that there is respect for the law (Coles, 2000:5)

Credit Guarantee assists their clients by facilitating them in advisory procedures that upholds the above protocols, thereby playing a vital role in attracting investment and lowering risk.

#### **4.1.3. Public Political Risk Insurance**

What differentiates public PRI from private PRI is that the emphasis is on the soundness of investments, the developmental impact of investments and its long-term cover (Shihata, 1988:19). Almost all developed states sponsor political risk insurance to encourage investment and development, and do not have a mandate for profit. The value of public PRI goes beyond just providing compensation for loss, public PRI can be seen as an act of goodwill and confidence, and contributes to investment conditions and guaranteed investment may attract additional investments. It also enhances investor confidence and contributes to a positive impression of the host countries receptiveness to foreign investment (Shihata, 1988: 20).

Government subsidised insurance is generally less expensive, and can also be issued for much longer, but is often bound by policy constraints which inhibits their flexibility of negotiating policies (Comeaux & Kinsella, 1997:184). These policies are made on terms mutually beneficial to both the investor and the host country, with the approval of the host government, and after ascertaining consistency with its laws, adequate safeguards would be in place to protect the system against possible abuses (Shihata, 1988:19). State sponsored insurance provides coverage in instances where it would otherwise be unobtainable. The Overseas Private Investment Company (OPIC), for example, requires that

companies must first have attempted to obtain insurance in the private market (Lempres, 2004: 2).

Government subsidised insurance usually needs a bilateral agreement with a country to operate there. This means better advocacy in settling disputes and contesting the actions of a sovereign. (Lempres, 2004:2). The involvement of a public PRI agency will obviously reduce possibilities of arbitrary action on the part of the host country, sometimes preventing the loss from occurring at all, and, in the event that it should occur, mitigating the extent of the loss (Shihata, 1988:20).

An example of a government subsidised PRI agency is the Overseas Private Investment Company (OPIC). The next section aims to provide an overview of the content of the PRI OPIC offer, and the nature and operation of the agency.

#### **4.1.3.1. Overseas Private Investment Company**

Established under the Foreign Assistance Act in 1969 to take over political risk insurance functions from U.S. Agency for International Development (AID), OPIC is a self-sustaining government agency (Comeaux & Kinsella, 1997:153). OPIC supports American private investment to developing and emerging economies and expands development impact by evaluating new projects against a measurable set of developmental standards. To ensure that OPIC is fulfilling its mandate, every project is objectively scored for its expected results on 26 developmental indicators within broad areas such as human capacity building, private sector development and infrastructure improvement. The 26 indicators are broken into three categories. Category one covers job creation, training, local procurement, corporate social responsibility, and equal employment opportunity. These five indicators are highly weighted impacts that should be achievable on any project, regardless of sector or the country's level of development. Category two covers twenty additional, and more viable, development indicators within such broad areas as human capacity building, private sector development,

resource leveraging, social effects, infrastructure improvements, macro-economic and institutional effects, technology and knowledge transfer. Category three adjusts for the host country's per capita GNP, reflecting both OPIC's priority to steer investment into the poorest countries and the reality that nations most in need often lack the capacity to support the higher level benefits of economic development (OPIC, 2004).

Apart from using the scoring matrix to rate development impact of every supported project, OPIC applies two additional indicators derived from project scores to measure the agency's own performance. The first of these is the development dollar, which measures the amount of development that results from OPIC-supported projects. It is calculated by adjusting the dollar value of OPIC projects by development score, where 100 represents a highly developmental project. Adjusting the \$5.1 billion total value of OPIC's 2004 projects scored on the matrix by the year's weighted average development score yields \$4.87 billion in development dollars. The second of these new indicators measures *development dollars per administrative dollar*, which is the amount OPIC spends to make a project happen. The FY 2004 ratio of 117.8 development dollar speaks to the efficiency with which OPIC is delivering its products and services (OPIC, 2004:10).

To complement the agency's mandate, OPIC has set up an office for investment policy that monitors the wider value of the agencies involvement in a project (Watson, 2002:1). OPIC has issued insurance coverage to NGOs, the International Rescue Committee (IRC), to carry out humanitarian assistance, refugee resettlement, and retraining programs in 19 developing countries. OPIC transforms private capital into a force multiplier for leveraging host countries' domestic savings and investment capacity. One way they accomplish this is by negotiating bilateral agreements that provide investor protections and encourage host countries to establish sound business practices, market-oriented public policies, and incentives for local entrepreneurship.

OPIC generally supports private-sector projects with an emphasis on development projects. To qualify for OPIC insurance, projects must meet specific criteria, including no negative effect on environment, no negative effect on specific economy of host and home country and no negative effect on workers (Hofmann, 2006:2). OPIC requires a bilateral agreement with the specific country to write insurance. These agreements include that the host state must approve projects to be insured, OPIC will be subrogated to the rights of the insured in the event of payment of a claim and OPIC will dispose of local currency through the United States government channels in the host country (Comeaux & Kinsella, 1997:161). OPIC rejects countries that, for instance, defy workers's rights. It also rejects projects that cause a loss of jobs in the United States. Projects are checked for their environmental impact, some risks require an environmental impact assessment to be posted for public comment, and the bigger risks need approval from the board (Lempres, 2004:2). Projects are examined whether the project will lead to development of skills for local workers and transfer of technology to the local economy, and whether the project will stimulate other local enterprise (Comeaux & Kinsella, 1997:161).

OPIC welcomes enquiries from U.S. companies of all sizes, although the amount of business they do with small investors has grown increasingly. This is reflected in the increase in demand for OPIC's small business insurance wrap, a streamlined political risk policy available to U.S. companies receiving OPIC Small Business Center loans of up to \$10 million (Hofmann, 2006:2). The smallest insurance contract in OPIC's history was issued in Afghanistan in 2003- it was less than \$40000 in coverage.

OPIC insurance is available to:

- Citizens of the U.S.;
- Corporations, partnerships or other associations created under the law of the U.S., its states or territories, and beneficially owned by U.S. citizens. OPIC

deems a corporation organised under the laws of the U.S. or its states and territories to be beneficially owned by U.S. citizens if more than 50% of each class of its issued and outstanding stock is owned by U.S. citizens either directly or beneficially;

-foreign corporations at least 95% owned by investors eligible under the above Criteria; and

-other foreign entities that are 100% U.S. owned.

(Source: Howell, 1997 :4).

Insurance is available for investments in new ventures or expansions of existing enterprises, equity investments and loans, parent company and third party loans and loan guaranties, technical assistance agreements, cross-border leases, assigned inventory or equipment, contractors's and exporters's exposures, including unresolved contractual disputes, wrongful calling of a bid, performance, advance payment and other guaranties posted in favour of foreign buyers and other forms of investment (Howell, 1997:452). OPIC covers investments if the investment is new, a privatization, or an expansion or modernisation of an existing plant or investment; existing operations are eligible if the investor contributes additional capital for modernisation and expansion (Comeaux & Kinsella, 1997:160).

OPIC has developed specialised insurance coverage for the following industries or type of investments: financial institutions, leasing, oil and gas, natural resources, and contractors and exporters (Comeaux & Kinsella, 1997:158). Insurance for specialised risks peculiar to a specific project are available upon request and will be rated on a case-by-case basis. OPIC must give preferential treatment to investments in countries with a per capita annual income in 1986 of less than \$984 U.S. dollars (Comeaux & Kinsella, 1997:161).

OPIC insurance premiums are based on rate schedules which are determined on the type of investment and the type of coverage which usually vary up to one-



third based on the risk profile, and the term of an insurance policy may extend a maximum of 20 years, OPIC will only insure and pay claims on 90% of the loss (Comeaux & Kinsella, 1997:162-166).

The risks covered by OPIC include one or more of the following;

1. Currency inconvertibility, which is the inability to convert profits and other remittances into U.S. dollars;
2. Expropriation, which is the confiscation of the investor's property by the host state; and
3. Political violence, which includes war, revolution, insurrection and civil strife (Comeaux & Kinsella, 1997:154).

OPIC started offering standalone terrorism coverage, in August 2003 that last for ten years. This product has deserved a great deal of interest since the September 11<sup>th</sup> terrorist attacks in the United States has increased the perception of political risk which has helped to increase demand for political risk, coverage (Lempres, 2004:2).

OPIC pays compensation to two types of losses: business income losses (BIC) and asset coverage. BIC protects investors's share of income losses resulting from damage to the property by political violence. It also covers income losses resulting from specific sites outside the insured facility. This type of coverage is called an "off-site" rider. Howell (1997:453) explains that the compensation of this type of coverage is "based on what the project would have realised in net income but for the damage, plus the project's continuing, normal operating expenses which must be paid during the time the damage is being repaired". Compensation is also made for expenses that reduce the business income losses, compensation is paid until productive capacity can reasonably be restored, not to exceed one year (Howell, 1997:453).

*Asset coverage* compensates for loss of or damage to tangible property caused by political violence. Compensation is based on the investor's share of the adjusted cost of the property or replacement cost; replacement cost can be paid up to twice the investor's share of the lost or damaged property's original cost, provided the property is actually replaced within three years (Howell, 1997:453). The adjusted cost is defined as "the least of the original cost of the item, the fair market value at the time of loss, or the cost to repair the item" (Howell, 1997:453).

The nature and operation of OPIC provides insight into PRI and the difference between the public and private PRI sector. The next section provides a brief overview of the relationship between the private and public PRI sector.

Although government agencies are policy constrained, they have become a lot more flexible by cooperating with the private insurance market. Since 1997, the private and public sectors have been working together, using their combined expertise to explicitly increase coverage (Seib, 2003:2). The private insurance market and public insurance market now cooperate more frequently on deals. Private insurers are positive about having government agencies on deals when it comes to advocacy, for government agencies bring extra clout when it comes to contesting the actions of a sovereign. Seib (*ibid*) compares public insurers to private insurers by arguing that private insurers "are commercial entities, affected by their own market cycles, plunges in capital and investment losses" and will not cover high risks outside their countenance. Seib (*ibid*) further adds private insurers "can respond quickly to change, they have strong underwriting expertise and are relatively unconstrained by policy". Public insurers, on the other hand, "are almost immune to market cycles, do not need immediate return and have an abundance of capital, which means they can afford to take a chance on some big risks" (Seib, *ibid*). Seib (*ibid*) projects the public insurance as having "considerable leverage with other government bodies, both internal and external". As a result, Gerald West, a director of MIGA (Multilateral Investment Guarantee

Agency), asserts that “public and private partnerships allow more risk sharing, provide greater capacity for clients and supply more coverage by leveraging private capacity”.

#### **4.2. The Current State of Political Risk Insurance.**

The next section aims to provide an overview of the current state of the PRI industry and, in doing so, aims to express the necessity of PRI in business. A report by AON Corp’s Trade Credit and Political Risk practice group estimates that political risk has increased since 11 September, 2001 from \$200 billion to \$800 billion in 2003, and \$1 trillion in 2004 in reduced corporate spending, investments and growth. The effect of political risk in the business environment, thus, has a tremendous impact on the liquidity of an operation. These statistics show the necessity of PRI and that insurance as a mitigating tool can lessen, absorb or eliminate such losses that arise from political risks.

The increased awareness of the need for political risk has contributed to the increase in demand for political risk. The exact extent of increase in demand is hard to pin down because the political spectrum itself changes almost daily (Jenkins, 2002:1). What is clear is that political risk is ultimately governed by a different cycle to traditional insurance; the level of FDI determines the demand for PRI and the trends in PRI is influenced by the cycle and trends of foreign investment (Loney, 2003:1).

What is particularly encouraging is the great emphasis being placed on the investment climate in discussions about PRI. For the first time, governance, strengthening institutions, reducing transaction costs, and narrowing the business gap, to name a few, are taking centre stage. The pressure has been greater on developing countries to create an environment conducive to attracting and sustaining investments (Omura, 2007:internet source).

More and more companies are turning to PRI to protect themselves against the unpredictability of cross-border trade and investment (Bond, 2005:1). As mentioned earlier, the level of foreign investment determines the demand in PRI, and the past decade has marked a significant increase in foreign investment and, thus, increased the demand for PRI (Loney, 2003:1). Dyson (2005:1) supports this by stating that “the supply and demand of PRI are not correlated with what drives traditional property or casualty rates”. Another source of demand that has led to the increase in international investment is the development of emerging markets and the large amount of privatisation in developing countries (Loney, 2003:2). Daniel Riordan, managing director of Zurich North America’s emerging market division, explains this source of demand from emerging markets, “companies have to invest in emerging markets to maintain adequate levels of return”. Riordan contends that “companies cannot rely on their domestic markets to bring enough growth to satisfy shareholders” (Loney, 2003:1).

Among the number of significant reasons for the increase in demand for PRI, political instability stands out (Dyson, 2005:1). Since 2001, the international arena has been a risky place for exporters and investors. Political events that have contributed to the rise in political instability include:

- September the 11<sup>th</sup> 2001 terrorist attacks on the USA;
- Iraqi war to topple Saddam Hussein;
- Afghanistan war as a quest to locate and capture Osama Bin Ladin and Al Qaeda operatives;
- Recent election disputes in the Ukraine, 2004; and
- Zimbabwe’s land reform implementation under the rule of President Mugabe.

Dyson (2005:2) argues that, despite the political unrest in the international arena, “companies are becoming far more willing to invest in projects and bonds in emerging markets and sell to buyers in those countries. The greater the amount of investment in emerging markets, the greater the demand for insurance”.

According to Hofmann (2006:1), the political risk market eases as supply outpaces demand. Hofmann (2006:1) states that “decreased demand and increased capacity have created a buyer’s market for the PRI industry, particularly for standard coverage against nationalisation and expropriation”.

According to Daniel W. Riordan, executive vice-president and managing director of emerging market solutions for Zurich Financial Services Group Washington, the PRI market has “been soft for a while, probably for a year or more. Since the terrorist attacks of September 11, 2001, there has been less demand and more capacity coming in”. Paul Aird, a risk manager at private insurance company Bechtel Corp. in Houston, and John Salinger, president of AIG Global Trade & PRI Co. Inc., a unit of American International Group Inc. in New York, agree that the market has been quite soft in the past year, Salinger explains that “there’s a great deal of liquidity in the world and it’s very competitive, and that has led to what I would characterise as soft conditions” (Hofmann, 2006:2).

Price Lowenstein, president and chief executive officer of Hamilton, Bermuda-based Sovereign Risk Insurance Ltd., a unit of ACE Bermuda Insurance Ltd., adds to the above by asserting that

“in general, it is soft, with the exception of certain countries where capacity is tight. Although we do have capacity in these countries, we do see supply-and-demand imbalance in some key countries such as Nigeria, for certain sectors in Russia and Angola” (Hofmann, 2006:2).

Stephen Capon, head of country and credit risk management, political risk and credit for ACE Global Markets in London, which also participates in the Lloyd’s of London market, notes that “whilst there has been a surge in the demand for trade finance coverage, demand for more ‘traditional political risk coverage such as expropriation has fallen some”. Capon warns that “the markets have just been so benign...but old issues, such as government interference in contracts, haven’t gone away regardless of how benign the international landscape seems” (Hofmann, 2006:2).

The willingness for insurers to take on high risks and the availability of capacity shows that the PRI market is thriving. However, the underwriting market is not static and can change at any given time as the world political situation changes (Dyson, 2005:1-4).

Increasingly, managing political risks through PRI, has made risks a normal part of the corporate decision-making process for companies that invest abroad (Omura, 2007:internet source). As a result, the international investment profile has become more lucrative due to the many opportunities of offshore investment. The reason for this is that investors are seeking alternative investment destinations other than their home countries, thereby increasing the amount of risk to which an investor is exposed. But, investors have become more cautious of doing business in a foreign country, knowing that even under optimal conditions, there can always be a possibility of a risk that can affect the turnaround of an investment. Thus, investors have been turning to the PRI industry for protection. Investors rather purchase PRI than avoid an investment because political risk is most apparent where opportunities are the most apparent. Investors use PRI to enhance confidence in environments that are more risky, but have greater returns (Poloz, 2007:internet source). Therefore, PRI is used by investors to manage risks and improve prospects.

Conversely, investors do not only seek coverage for high risk investment environments, but also for low risk countries. For example, not too long ago did countries like Mexico, Brazil, Venezuela and Argentina earned high credit ratings and low political risk ratings, with the effect that USA promoted free trade to these countries. Not long thereafter, these countries experienced political and social difficulties leading to economic crises, economic recession and political turmoil, consequently, causing significant losses to a large number of investors (Louvaris, 2002:internet source). Louvaris (2002, *ibid*) adds that “they (companies) know that even under the best of conditions, there is always a risk

that customers will be unwilling to pay for goods they purchased or deliver the goods they promised”.

Without PRI companies run the risk of write-offs of contracts and even bankruptcy. As Louvaris (2002: internet source) explains, “PRI can help protect a company’s balance sheet against write-offs for the non-performance of contracts due to political events”. Therefore, with the right insurance partner, a political risk policy can be a good source of protection against risk.

#### **4. 3.Conclusion**

In order for an investor to have effective returns on an investment, a political risk analysis has to be accompanied with a political risk insurance policy to enhance the outcomes of offshore ventures. This chapter discussed the reasons for PRI being necessary. It argued that the purchase of political risk insurance is one of the most effective ways to reduce a company’s exposure to political risk. Not only does the success of an investment depend on the effective analysis of the fundamental drivers that lead to losses arising from political risk, but a mitigation tool is necessary to hedge against contingencies in cross-border investments. As a risk mitigation tool, PRI helps provide a more stable environment for investments.

It was indicated that the right type of political risk insurance provider and the right type of political risk insurance policy is essential to ensure optimal outcomes of an investment. As a result the different types of insurance providers and the products they offer were discussed. In addition, this chapter compared private political risk insurers to public political risk insurers. The type of insurer and product depends on the type of investment. On the one hand, private insurers are characterised for their flexibility and speed of insurance coverage. These types of insurers often have higher coverage fees at shorter coverage terms and are profit driven. On the other hand, public political risk insurers’ mission is to

encourage investment and development. These types of political risk insurers are characterised by their low coverage fees and longer coverage terms. Moreover, these political risk insurers provide coverage in instances where it would be otherwise unobtainable. However, these types of transactions are bound by policy constraints and the speed of execution is much slower.

The benefits of PRI were also discussed. Not only does PRI provide a unique safety net in the event that government actions disrupt business, but the PRI industry can mediate disputes between investors and host countries. Moreover, PRI helps opening up difficult or frontier markets to clients. Also, PRI increases a company's profile to gain access to finance by securing finance and loans.





## **Chapter Five    Revisiting Three Political Risk Forecast Models: An Empirical Analysis**

There have been few attempts to test the reliability of current models of political risk to project actual losses. This study attempts to test political risk forecasts against actual losses, thereby addressing the question of reliability. Earlier efforts to address the question of reliability by assessing projection techniques did not make direct comparisons of different political risk models (Howell & Chaddick, 1994:71).

This study draws on the work of Howell and Chaddick (1994) to compare the 1996 projections of the Economist Intelligence Unit (EIU), Political Risk Services (PRS), and Business Environmental Risk Index (BERI) against real losses incurred in the 1994-2004 period. Howell and Chaddick's (1994) findings were that there is a variation between the three models to accurately forecast political risk. This study will repeat the test done by Howell and Chaddick (1994), based on 1986 predictions, to test the reliability of the same models in the 10 years since the last test was undertaken to accurately forecast political risk (consult Appendix A for a discussion on statistical methods and concepts). The study will focus on the reliability of the three current political risk models to predict political risk for investors.

### **5.1. An Assessment of Three Approaches: Howell and Chaddick (1994)**

Howell and Chaddick (1994:71) argue that there has been a lack of credibility of Political Risk Analysis since its inception. There are numerous reasons for the lack of credibility, the most prominent being the perception that the field of political risk analysis is considered a 'soft science' (Howell and Chaddick, 1994:71). Although many risk assessments have a quantitative base, few efforts were made to demonstrate the reliability of political risk projections. Howell and Chaddick's (1994) study attempted to address the question of reliability of

political risk projections. Howell and Chaddick's analysis correlates the five year projections of three political risk assessment sources namely, EIU, PRS and BERI, with losses incurred over the period, 1982-1994 (Howell & Chaddick, 1994:71).

In testing the reliability of forecasting, the task is to theoretically link the acts resulting in loss to the causes of the loss by establishing an index of losses due to political risk. In order to do this, a list of loss actions must be constructed, which would include the acts or events that are political in nature that result in the respective loss. Howell and Chaddick (1994:73) explain that "the modeler would try to envision the circumstances under which these events will occur". In projecting the circumstances under which these events or actions play out, the modeler would construct a list of variables; in other words, political risks that would be the cause of loss (Howell & Chaddick, 1994:73).

As noted above, "a measure of loss due to political reasons was needed to test the model and theory, in this case employing multiple correlation and regression" (Howell & Chaddick, 1994:73), so, Howell and Chaddick (1994) started the assessment of three approaches by creating a "measure of loss" index. The loss index is based on actual losses incurred in the 1982-1994 period. The sample used was 36, which was derived from the number of countries where losses incurred. Howell and Chaddick (1994:74) conducted interviews with businesspeople and government officials, consulted written reports and Overseas Private Investment Corporation (OPIC) insurance claims. Based on a review of the above-mentioned sources, the researchers constructed an index of loss by assigning a value on a scale from zero to ten. Zero would be indicative of no losses to the foreign investor where ten would indicate total loss to foreign investors. In Howell and Chaddick's (1994) analysis, the loss scores have been treated statistically as the dependant variable (Howell and Chaddick, 1994:71-74). The next section will outline the descriptive statistics for each model used in Howell and Chaddick's (1994) analysis.

### 5.1.1. Economist Intelligence Unit

The first model in the analysis carried out was the EIU model. The EIU method chose six political variables worth a total of 50 points in weight, and four social variables worth 17 points to construct a risk total index (Howell & Chaddick, 1994:78). The variables employed in this model will be discussed in the next section.

The risk total index is the primary indicator of overall risk to the investor. Consequently, the issue Howell and Chaddick (1994: 78) is addressing is, “how good a projector of losses is the risk total index?”. Howell and Chaddick (1994) began their assessment of the adequacy of the model with a simple correlation between the risk total index and the loss index.

The correlation results for the risk index and the loss index of the model EIU was relatively low, whereas the level of significance is very high. The correlation does not indicate a particularly strong relationship; the correlation is 0.33 with significance at the 0.053. There exists a high level of variation in the data, because the correlation results are not significant at the 95% level. Since more than 89% of the variance in the loss data remains unexplained by known variance in the index, this would lead an investor to have little confidence in the EIU forecast.

The variance in the composed index occurs mostly due to multi-collinearity, which indicates that the variables are overlapping. Lynch (2003, internet source) explains that

“multi-collinearity is a problem with being able to separate the effects of two or more variables on an outcome variable. If two variables are significantly alike, it becomes impossible to determine which of the variables accounts for variance in the dependent variable”.

In other words, multi-collinearity implies that variables have a linear relation to each other. Multi-collinearity can lead to unreasonable coefficient estimates, large standard errors and consequently, bad interpretation or inference (Lynch, 2003:internet source). Lynch (2003:internet source) suggests that, in order to “solve the problem, omit the variables that are alike and then combine offending  $x$  variables into a reduced set of variables”. In an effort to sort out the relationships among variables and intercorrelations among the independent variables, the authors (Howell & Chaddick, 1994) applied stepwise regression, to eliminate some of the variables from the analysis and partialling out relationships between others, thereby providing the model with a fair degree of predictability. By applying stepwise regression, seven of the variables provide a multiple correlation of 0.67, thereby explaining 45% of the variance in the loss indicator (Howell & Chaddick, 1994:78).

### **5.1.2. Business Environmental Risk Index**

The second model used in the assessment was the BERI model. The BERI method employs ten variables, which are divided into three categories. These categories will be explained in the next section of this chapter. The risk total index for BERI can create a possible 100 points. The ten variables can be assigned up to seven points. A seven would represent no risk, and a zero would represent a high degree of risk. For instance, a country with an optimal investment environment will be assigned as many as 70 points. An additional 30 points can be assigned to the index. The additional points are bonus points for countries with a favourable investment environment. Therefore, constructing a possible total of 100 points in the risk index.

The correlation of the risk total index and the loss index for BERI was 0.51 with significance at the 0.01 level, leaving 26% of loss variance explained. Similar to the EIU, the high level of variance is due to the high degree of intercorrelation among the variables in the BERI model. After restructuring the model through

multiple regressions, the findings point out that the BERI model appears more consistent, as the multiple correlation of 0.73 explains 53% of variance. In other words, the restructured BERI index provides a better forecast than the EIU model. By applying stepwise regression, eight variables provide a multiple correlation of 0.73, explaining 53% of the variance (Howell & Chaddick, 1994:79-84).

### **5.1.3. Political Risk Services**

The PRS model constructs an index on a probable eighteen month forecast and a probable five year forecast, which then provides a letter grade projecting political risk. Forecasts are done by area specialists of more than 250 people. PRS employed 12 variables in this study. The variables will be explained in the next section.

Like the EIU and the BERI model, the dependant variable used is the loss data. With a sample of 36 countries, the correlation for PRS yielded 0.57 at a significant level of 0.01%. The correlation levels between variables are considerably lower than that in the BERI model. This is an indication that the PRS model employed variables with more relevance than the BERI model. For example, five variables in the BERI model accounted for 50% of variance, whereas five variables in PRS accounted for 67% of variance. In review, of the three models, the PRS accounts for the greatest explained variance at a level of 74% while remaining at under the 0.05% level (Howell and Chaddick, 1994:87). After applying stepwise regression, the PRS model explains 74% of the variance. The restructured model included eight of the PRS variables (Howell and Chaddick, 1994:88).

The variance amongst the models is a result of multicollinearity, which, as explained earlier, implies overlapping explanation of the variables. Howell and Chaddick (1994) applied stepwise regression to eliminate the overlapping

models. In the process of partialling out relationships amongst the variables, the model gains considerable credibility (Howell & Chaddick, 1994:78). Following the process of multiple regression, the models were restructured to including the variables listed in the table bellow.

*Table 6.1. Restructured Models.*

<b>The Economist</b>	<i>Mltr</i>	<u>R 2</u>
Bad Neighbours	0.36	0.13
Islamic Fundamentalism	0.44	0.21
Authoritarianism	0.56	0.31
War/Armed Insurrection	0.59	0.35
Ethnic Tension	0.63	0.39
Urbanisation Pace	0.66	0.44
Generals in Power	0.67	0.44
<b>BERI Model</b>		
Regional Political Forces	0.45	0.22
Radical Left Government	0.65	0.42
Measures to retain power	0.65	0.42
Ethnic Tension/Religious Groups	0.68	0.47
Dependence to a Hostile Major Power	0.71	0.5
Instability/Non-constitutional changes	0.72	0.52
Societal Conflict	0.72	0.53
Social Conditions	0.73	0.53
<b>PRS Model</b>		
Exchange Controls	0.32	0.10
International Borrowing Liability	0.47	0.22
Payment Delays	0.70	0.49
Labor Cost Expansion	0.80	0.64
Repatriation Restrictions	0.82	0.67
Equity Restriction	0.84	0.71
Tariff Imposition	0.86	0.73
Personnel/Procurement Interference	0.86	0.74

Source: Howell & Chaddick (1994:88)

In restructuring the models with multiple regressions, Howell and Chaddick (1994: 88) included variables according to their inter-correlations. The regression results for each model are listed above. Note that, for each model, the variables are listed in order of their combined and cumulative explanation of the variance in the dependent variable (losses). *Mltr* represents the multiple correlation results

and  $R^2$  represents the coefficient of determination, that is the squared multiple correlation, which can be interpreted as the per cent of variance in the dependent variable explained by the known variance of the included independent variables (Howell & Chaddick, 1994:88).

The multiple regression results for seven variables in the EIU model explain 45% of the variance. Similarly, the multiple regression for BERI are again revealing, five of the ten variables in the BERI model accounts for 50% of the loss data. This is indicative that the BERI restructured model provides a better prediction rate than the EIU model (Howell and Chaddick, 1994:79-83). When restructuring the PRS model, the results were indicative that the PRS model is more likely to provide an accurate projection of risk. The PRS model is the most reliable when decomposed, as the overall restructured model explains 74% of the variance (Howell & Chaddick, 1994:88).

The method of multiple regression was applied to determine scores for variables being tested within the three models. The method of multiple regression is used to enhance reliability. The overall restructured model explains 74% of the variance in the loss index; this is an improvement over the other models.

In conclusion, Howell & Chaddick (1994:89) argue that “risk projections should correlate with subsequent losses”. The EIU model only explained 11% of variance, whereas the BERI explained 26% of variance and the PRS model explained 43 % of variance. Evidently, the results from Howell and Chaddick’s (1994) analysis indicate that the models did not correlate with losses. These results are indicative that correlations are lacking in the model and therefore require a more detailed assessment. It is evident then, that there exists variation among the models to accurately forecast political risk. According to Howell and Chaddick (1994:89), forecasting of political risk is therefore possible only by restructuring the models.

## **5.2. Testing the Variation Between Current Risk Assessment models**

As this study revisited Howell and Chaddick's (1994) assessment of three political risk models and mimics the analysis carried out by Howell and Chaddick (1994), the same steps were undertaken in the assessment of three models. While Howell and Chaddick (1994) assessed losses over the period 1982-1994, this study assesses the period thereafter, 1994-2004.

In order for the analysis to be reliable, credibility of results had to be ensured. This was done by using expert data and the measurement of interrater reliability (see Appendix A, page 23-24, for a discussion on reliability). The analysis made use of three sets of data. To ensure credibility, the data sets were compared against each another to measure the variation between the items. The significance of correlations is indicative of the predictive power of the models (see Appendix A, page 3-9, for a discussion on correlation). The first set of data, a cumulative risk index, was composed of the claims paid out by OPIC. These claims of the maximum insured amounts are politically based losses and were used as the dependent variable. The second set of data consists of ratings provided by three rating agencies. The third set is the index of the three models, the models of which were completed by multiple experts in the form of a questionnaire. The questionnaire tests interrater reliability in order to determine whether experts were consistent in their ratings. The data sets will be explained in further detail in the next section.

As mentioned throughout this study, Howell and Chaddick (1994) tested PRS, BERI and EIU against real losses. This study added three additional models to the test of the reliability of the three proposed risk assessment models. The main reason for this is due to problems encountered in this study. Therefore, additional methods and data were used in this study in order to ensure the reliability of results.



The main problems encountered in repeating the study done by Howell and Chaddick (1994) were the accessibility of data and a difference in sample size. Howell and Chaddick (1994) used data for each country and for each model provided by their agencies. In other words, each rating agency EIU, BERI and PRS supplied the Howell & Chaddick (1994) with the uniquely designed ratings according to each model. These rating agencies do not design such reports on an individual basis as in the case of the researcher, but rather provide either a country report or profile according to a composite economic, financial and political index. Therefore, this study made use of ratings provided by multiple experts. The experts provided ratings for each country with the use of a questionnaire, included the three models (see appendix C). The expert had to generate ratings for the specified variables of each model for each country. Multiple experts assigned ratings to each country according to the methodology used by each model. Howell and Chaddick (1994) emphasise the importance of a reliable expert by explaining that

“any forecast of future trends and occurrence is open to vague thinking and ‘crystal balling’, but it is in this phase of the forecasts that the experience and expertise of the specialist is most necessary”.

Just as with quantitative forecasting, a depth of experience is required of the analysts as well as intimate knowledge of the current situation”.

In other words, the experts must have experience in the field and must have ‘hands’ on knowledge of the past and current situation of each country. The respondents were carefully selected according to their knowledge and experience of each country. The extent of each multiple expert’s knowledge will be explained in the next section. In order to ensure reliability of each expert, an alternative test of interrater reliability was applied. The statistical requirements of interrater reliability is that four raters or questionnaires have to be compared in order to run a correlation analysis. Hence, this study relied on the rating of four experts. The task was to determine whether the models are a good projector of risk. In order to determine whether multiple expert opinion were reliable, the models within each questionnaire was correlated with each other.

The second problem encountered in this study was a difference in this study's sample size compared to the sample size used in Howell and Chaddick (1994). Where Howell and Chaddick (1994) used a sample size of 36, this study applied a sample of 14. The reason for this is the loss data. In the period 1982-1994, 36 countries incurred a considerable loss, following this period only 14 countries incurred a considerable loss. A word of caution is in order with regard to sample size. Predictions based on small samples tend to be unstable; by utilising all the data rather than a small subset, the prediction can be improved (Kirk, 1999:186).

The reason for this is that correlation measures the relationship between the magnitude and significance of relations between two variables, depending on the sample size ( $n$ ). In addition, the significance level is concerned with the probability of error involved in rejecting the idea that the relation in question does not exist in the population. Thus, it gives an indication of

“how likely it is to obtain a relation of a given magnitude, or larger, from a sample of a given size, assuming that there is no such relation between those variables in the population” (StatSoft, Internet source).

In other words, every good measure of relations between variables must take into account the overall differentiation of individual scores in the sample and evaluate the relation in terms of, relatively, how much of this differentiation is accounted for by the relation in question (StatSoft, Internet source).

Therefore, the significance of a relation between variables depends on the sample size. This can be explained through the observations within a sample. If there are very few observations, then there are respectively few possible combinations of the values of the variables, and thus the probability of obtaining by chance a combination of those values indicative of a strong relationship is relatively high (StatSoft, Internet source).

In other words, the probability of a random deviation of a particular size decreases with the increase of a sample. In addition, if a relationship between

variable in question is objectively small, then there is no way to identify such a relation in a study unless the research sample is correspondingly large. Thus, if a relation is large, it can be found to be significant even in a small sample. Furthermore, the smaller the relation between the variables, the larger the sample size that is necessary to prove it to be significant. In conclusion, statistical significance then represents the probability that a similar outcome would be obtained if the entire population was to be tested (StatSoft, internet source).

In view of the above, it was necessary for this study to use a larger sub-set of data in order to overcome the pitfalls of a small sample size. Therefore, this study added three additional models in order to increase the sub-set of data correlated with the losses. This study chose the Country Indicators for Foreign Policy (CIFP), Freedom House and PRS risk projections (PRS/ICRG) models. The models were selected on their similarity to the three models tested by Howell and Chaddick (1994), and are briefly discussed in the next section. CIFP was most similar to EIU, Freedom House was most similar to BERI, and PRS/ICRG was most similar to PRS.

A risk total index was constructed for all six models. These risk total indices were correlated with the loss risk index. Following the correlation results, a regression analysis was applied.

In addition to the three sets of data, profiles were compiled on each country according to the various political, economic and investment factors. These factors are all overlapping to the factors included in the three proposed models. Data was collected on a continuous basis throughout the study. Data consist of industry news, current affairs and archives. Data was obtained from archives from various sources such as Political Risk Services, AIG, Credit Guarantee, OPIC, Polity Reports, Country Indicators for Foreign Policy, World Bank, Euromoney, Reactions ratings, Fitch ratings, Moody's ratings, and Sovereign

Rating Agency. The country reports were compiled to assist the researcher in comparing the outcomes of each set of data for each given country on a case by case basis. The reports provide an overview of each country's political, economic, and financial and investment situation during the period 1994-2004 (country reports reports are available on request of author).

### **5.2.1. Political Based Losses**

This study made use of longitudinal data for the period 1994-2004 on a sample of 14. The sample was drawn from countries that incurred real losses during the period 1994-2004 (Germak, 2005). A cumulative index of loss was constructed for the sample of 14 countries. These countries were selected because they had the highest loss in the given period internationally.

The countries included in the loss index include Afghanistan, Belarus, Colombia, Dominican Republic, DRC, Ethiopia, India, Indonesia, Jamaica, Rwanda, Sierra Leone, Sudan, Ukraine and Venezuela. Hard data on actual losses are difficult to obtain due to confidential privilege that political risk insurers have to their clients. Therefore, firms are reluctant to share data on losses. Loss data is provided courtesy of the Overseas Private Insurance Corporation (OPIC), and consists of claims resolved by cash settlements and guarantee amounts. OPIC provided this study with all the companies' contracts and claims from 1994-2004. These were constructed into an index, due to agreement in terms of confidentiality with OPIC, this study is not able to make known the amounts paid out public. The claims resolved by cash settlements was averaged into a percentage amount of loss, which depicts the percentage of loss to foreign investors. On a scale of 0-100%, 0 would represent no recorded loss to foreign investors and 100% would represent maximised losses to foreign investors.

The claims that are covered by OPIC include inconvertibility of currency, expropriation, war damage and civil strife. The risks covered by OPIC are

overlapping with all of the risks included in the three models. Each claim is unique and has been treated separately by OPIC due to different political, economic and financial factors.

A brief discussion of each model's variables and their relative weight is necessary to comprehend how their advisory listing of favourable and unfavourable investment environments was derived (Howell & Chaddick 1994: 76). Hence, the following sections aim to provide an overview of the variables employed in each model.

### **5.2.2. Country Ratings**

The second set of data consist of three sets of country ratings. Country ratings was provided by three rating agencies, namely, Political Risk Services (PRS), Country Indicators for Foreign Policy (CIFP) and Freedom House. These ratings were provided for each country, (refer to appendix B for country ratings from each rating agency). The methodology of each rating system will be briefly described in the next section.

#### **5.2.2.1. Political Risk Services (PRS/ICRG)**

Data for the second set was purchased from a commercial rating agency PRS (Ruthig, 2006). The product purchased is known as the International Country Risk Guide (ICRG). This product applies the original Coplin O' Leary Rating System to produce country reports.

Note that there are no ratings for Rwanda and Afghanistan (see appendix B). This is due to the fact that the two countries were not covered by PRS. Often, when a country is a very high risk zone or when it is impossible for agencies to gain access to these countries and data sources the country will be off-cover. The same applies to other rating agencies, as will be noted there are other off-covers for certain indicators by CIFP.

The aim of the political risk rating is to provide a means of assessing political stability of the countries covered by PRS on a comparable basis. The minimum number of points assigned by each component is zero, while the maximum number of points depends on a fixed weight given to the component. In every case, the lower the risk point total, the higher the risk, and the higher the risk point total, the lower the risk (ICRG, 2007).

The risk guide lists a number of points for 12 components (see appendix B for risk guide). The different components measured in the index are listed and described below. (ICRG, 2007).

*a. Government Stability.*

The measure of government stability is an assessment of both the governments' ability to carry out declared program(s), and its ability to stay in office. The sub-components measured under this component are government unity, legislative strength and popular support (ICRG, 2007).

*b. Socioeconomic Conditions*

This component is an assessment of the economic pressures at work in society that could constrain government action or fuel social dissatisfaction. Sub-components measured under this component include unemployment, consumer confidence and poverty (ICRG, 2007)

*c. Investment Profile*

The investment profile involves an assessment of factors affecting the risk to the investment that is not covered by other political, economic or financial components. Sub-components measured under this assessment include contract viability or expropriation, profits repatriation and payment delays (ICRG, 2007).

#### *d. Internal Conflicts*

This component is an assessment of political violence in the country and its actual or potential impact on governance. The highest rating is given to those countries where there is no armed or civil opposition to the government and the government does not indulge in arbitrary violence, direct or indirect, against its own people. The lowest rating is given to those countries embroiled in ongoing civil war. The sub-components taken into account in this assessment include civil war or coup threat, terrorism or political violence and civil disorder (ICRG, 2007).

#### *e. External Conflicts*

External conflicts measures both the risk to the incumbent government from foreign action, ranging from non-violent external pressure - like diplomatic pressures, withholding of AID, trade restrictions, territorial disputes and sanctions - to violent external pressure like cross border conflicts to all out war. The sub-components measured under external conflicts include war, cross-border conflict and foreign pressures (ICRG, 2007).

#### *f. Corruption*

This component assesses corruption within the political system. Such corruption is a threat to foreign investment for several reasons. Firstly, it distorts the economic and financial environment. Secondly, it reduces the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability. Lastly, it introduces inherent instability into the political process (ICRG, 2007).

In fact, the most common form of corruption met directly by business is financial corruption. This form of corruption commonly manifests in the form of demands for special payments, bribes connected with import and export licenses, exchange controls, tax assessments, police protection and loans (ICRG, 2007).

Consequently, the PRS method is concerned with actual or potential corruption in the form of excessive patronage, nepotism, job reservations, 'favour-for-favours', secret party funding and close between politics and business. Hence, PRS contend that these forms of corruption are potentially of much greater risk to foreign business in that they can lead to popular discontent, inefficient and irregular controls on the state economy, and ultimately encourage the development of the black market (ICRG, 2007).

*g. Military in Politics*

PRS asserts that the military is a diminution of democratic accountability and therefore high military participation in government can have serious implications for government policy. In most cases, military participation in government may be a symptom rather than a cause of underlying difficulties a country or a government (ICRG, 2007).

*h. Religious Tension*

Religious tensions may stem from the denomination of society and/or governance by a single religious group that seeks to replace civil law with religious law. As a result, other religions are excluded from the political and/or social process. The desires of a single religious group to express its own identity separate from the country as a whole, poses a threat. The risks in these situations range from inexperienced people imposing inappropriate policies through civil dissent, to civil war (ICRG, 2007).

*i. Law and Order*

Law and order are assessed separately. The law sub-component is an assessment of the strength and impartiality of the legal system, whereas, the order sub-component is an assessment of popular observance of the law (ICRG, 2007).



*j. Ethnic Tension.*

This component is an assessment of the degree of tension within a country attributable to race, nationality or language divisions (ICRG, 2007).

*k. Democratic Accountability*

Democratic accountability is a measure of how responsive the government is to its people, on the basis that the less responsive it is, the more likely it is that the government will fall peacefully into a democratic society, but evidently into a non-democratic one. This component therefore measures the type of governance (ICRG, 2007).

*l. Bureaucracy*

The institutional strength and quality of the bureaucracy is another shock absorber that tends to minimize revisions of government policy when governments change. Therefore, high points are given to countries where bureaucracy has the strength and expertise to govern without the drastic changes in policy or policy interruptions in government services. In low risk countries, the bureaucracy tends to be somewhat autonomous from political pressure and have an established mechanism for recruitment and training. Countries that lack the cushioning effect of a strong bureaucracy receive low points because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions (ICRG, 2007).

The second index's methodology of country ratings used in the second data set in the testing of the variation between the three current risk assessment models will be discussed in the next section.

#### **5.2.2.2. Country Indicators for Foreign Policy**

CIFP draws on research by numerous data sources ranging from Food and Agricultural Organisation (FAO), Freedom House, International Institute for Strategic Studies (IISS), Joint United Nations Programme on HIV/AIDS

(UNAIDS), Stockholm International Peace Research Institute (SIPRI), Transparency International (Corruption Perception Index), World Health Organisation (WHO), United Nations Development Programme (UNDP), United Nations High Commissioner for Refugees (UNHCR), United Nations Statistical Division, United Nations University (UNU), United Nations Central Intelligence Agency, University of Maryland, Centre for International Development and Conflict Management (CIDCM), Uppsala University (Conflict Data Project), World Bank (World Development Indicators) and the World Governance Research Indicators Data Set.

CIFP provides ratings for countries in five issue areas. These issue areas include armed conflict, level of democracy, regime durability, corruption level and ethnic risk. These are described below.

*a. Armed Conflict*

Armed conflict consists of two sub-components. Firstly, this component aims to measure the history of armed conflict and the intensity of conflict. The conflict intensity level is divided into three levels. The first is a minor-armed conflict, which requires at least 25 battle-related deaths per year and fewer than 1000 during the course of the conflict. The second level is the intermediate armed conflict which requires at least 25 battle-related deaths per year and an accumulated total of at least 1000 deaths, but fewer than 1000 per year. The last level is categorized as war and requires at least 1 000 battle-related deaths per year. Lastly, the armed conflict indicator measures the total number of displaced populations and refugees within a country (Carleton, 2005).

*b. Level of Democracy*

The level of democracy measures the overall polity score. Democracy is conceived as involving three interdependent factors. Firstly, the presence of institutions and procedures through which citizens can express effective preferences about alternative policies and leaders. Secondly, the existence of

institutionalised constraints on the exercise of executive power. Thirdly, the guarantee of civil liberties to all citizens in their daily lives and in acts of political participation (Carleton, 2005).

*c. Regime Durability*

This indicator is assessed according to the number of years since the most recent regime change, which is defined by a three-point change in the overall polity score over a period of three years or less. In calculating the Regime Durability Score, the first year during which a new polity is established is coded as the baseline year zero and each subsequent year adds one to the value of the Durability variable (Carleton, 2005).

*d. Corruption Level*

The corruption level reflects the statistical compilation of perceptions of the quality of governance of a number of survey respondents, non-governmental organisations, commercial risk rating agencies and think tanks (Carleton, 2005).

*e. Ethnic Risk*

The ethnic risk variable encompasses the population heterogeneity. This component firstly measures the ethnic diversity and religious diversity within a country. Thereafter, an assessment of the ethnic risk is made. The assessment measures the risk of a ethnic rebellion. This entails the likelihood that a politically active ethnic identity group will initiate rebellion against the state. This is measured on the basis of the collective incentive of a group, the capacity for joint action and external opportunities (Carleton, 2005).

The next section will provide an overview of the last index in the second data set namely, the Freedom House rating agency.

### 5.2.2.3. Freedom House

Freedom House provides a annual evaluation of the state of global freedom through the use of a Freedom in the World Survey. The survey includes both analytical reports and numerical ratings of countries. The survey measures the freedom of a country by assessing two broad categories, namely: political rights and civil liberties. Political rights enable people to participate freely in the political process. This includes the right to vote and compete for public office and to elect representatives who have a decisive vote on public policies. Civil liberties include the freedom to develop opinions, institutions and personal autonomy. These factors influence investments in the sense that it determines restrictions and limitations that the type of governance in a state has on the investment environment (Freedom House, Internet source).

The political rights and civil liberties index covers all areas of the following variables:

- The Electoral process;
- Political Pluralism and Participation;
- Functioning of government;
- Policy change;
- Freedom of Expression and Belief;
- Associational and Organisational Rights;
- Rule of Law; and
- Personal Autonomy and Individual Rights.



### 5.2.3. Expert Data

The aim of this study is to test the reliability of current risk assessment models. In order to test the reliability of the proposed models, the variation amongst the models had to be tested. This was done by making use of expert data. The three models- PRS, BERI and EIU- were incorporated into a questionnaire. Multiple experts from related fields completed the questionnaire accordingly. The inter-rater reliability was tested to determine whether the experts agreed on the ratings.

The purpose of the questionnaire is to establish the consistency between current political risk assessment models (see appendix C). Respondents had to provide ratings for the countries that incurred losses in the period 1994-2004. Thus, ratings were given for the period 1994-2004. The respondents provided an overall rating for the period 1994-2004 where countries were consistent 1994 to 2004; if country ratings have not been consistent in this period, respondents provided a rating for both 1994 and 2004.

In order to test the interrater reliability of the models, expert opinion from four experts were required. The first expert is a diplomat who specialise in historical studies and foreign affairs. The second expert is an international brand manager for a leading MNC and has firsthand experience in all the countries included in the sample. The third expert is a credit risk analyst for one of the top financial institutions, Barclay's and the remaining expert is a specialist in the field of international relations. This analyst specialises in security, conflict, interstate relations and diplomacy.

The three models were tested according to the methodology originally applied in each model. This section will outline the three models, the methodology and explain the indicators used in each model.

### 5.2.3.1. The Economist

The Economist employed six political variables worth a total of 50 points in weight and four social variables worth 17 points to represent the origins of what is generally called “political risk”. They are described briefly below.

Indicators employed by the Economist:

- **Bad Neighbours** (3 negative points)

This refers to the country’s situational context. Being near any superpower almost automatically means trouble in that superpowers tend to control their peripheries, often with the use of force. Trouble spots are those with a history of being ‘disturbed’ or with historically continuous violence.

- **Authoritarianism** (7 points)

Whether totalitarian or authoritarian, the lack of democracy in a state bodes ill: even rigid totalitarian control is only a temporary holding pattern; disruption and probably violence will seethe underneath.

- **Staleness of Leadership** (5 points)

The argument is that a leader needs about five years to get his or her bearings and a grip on the situation, but after 10 years he begins to get detached and stale. Complacency accompanies entrenchment, along with corruption, disdain and delay.

- **Illegitimacy** (9 points)

Legitimacy implies an uncoerced and positive acceptance on the part of the population of a state. Political risk is a function of the gap between acceptability and a government’s persistence in power.

- **Generals in Power** (6 points)

In response to instability or the lack of competent civilian authority (or the military’s perception of competent), military authorities often step in and take control themselves. The Economist argues that most military people do not know how to govern or how to step aside gracefully.

- **War/Armed Insurrection** (20 points)

War, the greatest impacting force of any of the variables selected, clearly penetrates the investment picture in a number of ways. Apart from the obvious destruction of physical facilities, war disrupts the economy and brings about losses in a number of other ways. Raw goods and supplies are delayed or diverted to war use.

- **Urbanisation Pace** (3 points)

When the urbanisation process is too rapid, or is too concentrated on a single city, a number of problems accompany the shift. These include 'idleness and crime', an expansion of the drug trade, and economic irregularities, such as in the pricing of food. It is not the urbanisation itself, but rather the process and its effect on the society that threatens the foreign investor.

- **Islamic Fundamentalism** (4 points)

The Economist argues that Muslim radicals could pose a risk to investors; the risk is especially high where the investors are foreign and not Muslim.

- **Corruption** (6 points)

Corruption can distort the economy in ways that the best investor awareness or even power cannot accommodate.

- **Ethnic Tension** (4 points)

Ethnic, religious and racial tension provide an environment in which simple industry does not suffice. It may redirect government attention, invoke restrictions on investors, restrict labour resources, or result in open conflict. Governments may fall on the basis of its convolutions.

(Howell & Chaddick, 1994:76-78).

### **5.2.3.2 Business Environment Risk Index**

The BERI Index is based on scores assigned to 10 political variables by experts, and is clearly identified as being socio-political. Each of the 10 BERI variables can be assigned as many as seven points by the expert analyst. A seven

represents optimal circumstance, the least amount of risk. An optimal, without-risk, situation would be represented by a 70.

The 10 variables are divided into three categories: 'internal causes of political risk', 'external causes of political risk' and 'symptoms of political risk'. An additional value may be assigned to any of the first eight internal or external variables if the condition reflected by the variable is notably favourable for business operations. The total of these bonus points may range as high as 30, making a maximum of 100 points possible if the risk conditions were absolutely perfect.

*Internal Causes of Political Risk:*

- **Fractionalisation of the political spectrum and the power of these factions.** This political variable represents divisions among political or ideological perspectives in the society, with numbers of perspectives seen as representing a threat to consistency and regularity in political processes. When strength is added to numbers, the score to be assigned is reduced.
- **Fractionalisation by language, ethnic or religious groups and power of resulting factions.** Risk would be increased by a compounding of the divisions, as well as by increased power of the distinct groups. This variable parallels the 'ethnic tension' variable employed in *The Economist* model.
- **Restrictive measures required to retain power.** This variable can be equated to the 'authoritarianism/totalitarian' variable in *The Economist* model. The existence of authoritarianism or the use of coercive measures reflects the prospects of arbitrary action, abrupt changing of rules, and alienation due to a government's handling of the implementation of decisions. While alienation most directly represents the latter, the business firm might be more concerned by the decision-making structure that would or could choose to make use of such measures.



- **Mentality, including xenophobia, nationalism, corruption, nepotism and inclination to compromise.** There are some cleavages between subgroups of this set. Xenophobia and nationalism, and perhaps willingness to compromise, indicate mentality. Xenophobia and nationalism relate to willingness to compromise. Corruption and nepotism are related and indicate willingness to compromise. Willingness to compromise might co-exist with corruption for example. Nevertheless, the expert must give a single score for mentality, blending the five factors.
- **Social conditions including extremes in population density and the distribution of wealth.** This variable parallels *The Economist's* 'urbanisation' variable. It includes crime, unemployment, drug use, illiteracy and health conditions. The wealth distribution entails the disparity between levels of society.
- **Organisation and strength of forces for a radical left government.** The power of opposing factions can pose a risk to the government of the day.

*External Causes of Political Risk:*

- **Dependence or importance of hostile major forces.** This variable closely parallels the variable 'bad neighbours' in *The Economist* model, indicates a concern about major power involvement.
- **Negative influence of regional political forces.** This variable represents the concern for violent regional forces. This variable is parallel to the variable 'bad neighbours' in *The Economist* model. This concern also involves past colonial ties.

*Symptoms of Political Risk.*

- **Societal conflict, demonstrations, strikes and street violence.** This civil strife variable is encompassed by *The Economist's* 'war and civil strife' variable. Concern is with the nature of the environment of business operations.

- **Political instability, non-constitutional changes, guerrilla wars, etc.** Instability is one of the most enduring concerns of firms doing business outside of their own domains. Political stability is thus the focus. (Howell & Chaddick, 1994:82-83).

### 5.2.3.3. Political Risk Services

The indicators used in the PRS model relate to the situations of potential loss for foreign investors in the country being analysed. In the case of each of the indicators, the probabilities are that “a major loss will be sustained by foreign business in the next eighteen months or in the next five years” (Howell and Chaddick, 1994:84).

The PRS model employs the following variables”

- **Political turmoil probability.** Political turmoil can be described as actions taken in the political sphere of a society that does not fully adhere to rules of law or social norms. “Civil strife” comes to reflecting the same phenomenon, although the turmoil will not necessarily involve the level of outright violence that is associated with strife.
- **Equity Restrictions.** Equity can be forcibly shared, after the fact of investment through imposition of new regulations.
- **Personnel or procurement interference.** Government regulations can restrict certain types of hiring, with respect to investor country nationals or with respect to ethnic group hiring, numbers in management positions, and daily hours of employment. Similar restrictions can be placed on sources for procurement.
- **Taxation discrimination.** Preferential taxes can be given and lifted, not always through an adjudicated process.
- **Repatriation restrictions.** The specific problem of inconvertibility appears as one of the variables of direct concern in the PRS template.

- **Exchange controls.** Although exchange controls can result in a variety of limitations and associated losses, it is also one of the direct sources of inconvertibility.
- **Tariff imposition.** New and unanticipated tariffs, often resulting from confrontations between governments and economic systems, are one of the significant add-on costs that can affect the trader. Some tariffs are intended to generate income, often compensating for budget losses or deficiencies that have come about as a result of poor government planning.
- **Non-tariff barrier imposition.** Like tariffs, non-tariff barriers are generated in cross-national economic conflicts. Unlike tariffs, they are not likely to be created as purely income earning devices.
- **Payment delays.** Imposed limitations on the movement of funds to cover costs.
- **International borrowing liability.** Government policies often result in circumstances where borrowing is a necessity to maintain programs that brought that government to office or help it retain its place of power. While some borrowing is a function of the situation as a previous government has provided it, it is at least partly a matter of retaining power along with an effort to make viable economic adjustments.
- **Fiscal or monetary expansion.** Monetary policy can be a function of mistakes or poor planning by the government in other aspects of the economy.
- **Labour cost expansion.** Some labour cost expansion may be a result of efforts to mollify political sectors of the society.

(Howell & Chaddick, 1994:85).

An economic forecast worksheet is provided to be completed by the expert. When completing the provided economic forecast worksheet, for “1994”, the expert provides the figure for the most recent year for which a reasonable estimate of real growth of GDP, inflation, and the account balance for 1994 for

each country is available. These 1994 risk or restriction levels are scaled as follows:

<u>Risk level</u>	<u>Value</u>
Low	=0
Moderate	=1
High	=2
Very High	=3

The second listing represents the forecast of probability as at end 2004. These listings are scaled as follows:

<u>Forecast</u>	<u>Value</u>
Less=	-1.0
Slightly less=	-0.5
Same=	0.0
Slightly more=	+0.5
More=	+1.0
Much More=	+2.0



Note that the variables employed in CIFP overlap with the variables employed in the other models. In the first case, the variables employed in CIFP, the level of democracy and corruption level is similar to the political and governance indicators in Freedom House. Secondly, all four variables in CIFP, armed conflict, level of democracy, regime durability and corruption level; are similar to all the variables in EIU. For instance, armed conflict is similar to war or armed insurrection. Level of democracy is similar to authoritarianism, illegitimacy, staleness of leadership and generals in power. Both CIFP and EIU employ the variables corruption and ethnic risk. The variables, armed conflict, level of democracy and regime durability are similar to all the variables in BERI. In BERI, fractionalisation of the political spectrum is similar to level of democracy in the CIFP model. Ethnic risk in CIFP is similar to the indicator- fractionalisation by language, ethnic or religious groups and powers resulting from these factions -in

the BERI model. Lastly, the variables armed conflict and level of democracy are similar to the variables employed in PRS. For instance armed conflict is explanatory for political turmoil probability and level of democracy is indicative of government policies and regulations that have adverse affects like equity restrictions, personnel or procurement interference, taxation discrimination, tariff imposition, non-tariff barrier imposition, international borrowing liability and fiscal, monetary and labour cost expansion.

### 5.3. Descriptive Statistics

This section will provide an overview of the results of testing the variation between three risk assessment models. The testing of the data was done by Statistical Service Consultation (Statcon, University of Johannesburg), by making use of SPSS 14.01 for Windows®, software.

As with Howell and Chaddick (1994), an index of loss was created. As explained earlier, this was derived from the claims that OPIC paid out to investors. The first step included the testing of each set of data separately in order to calculate an average percentage into raw scores. These raw scores for each data set were constructed into a risk total index. Table 6.2 on the next page illustrates the different indices for each data set. Take note that the countries that do not have a score are off-cover and no data is available. The first column labelled **Losses** in the table, represents the loss index of the percentages of the claims paid out by OPIC. Thus, this column is treated as the independent variable employed in this study. The second column labelled **CIFP**, represents the CIFP risk assessment indicators for each country. The third column labelled **FH**, represents the ratings from Freedom House. The fourth column, labelled **PRS/ICRG**, represents the ratings provided by PRS rating agency. The last three columns represent the EIU, BERI and PRS models.

Table 6.2. Loss index and risk total indices.

country	Losses	CIFP	FH	PRS/ICRG	EIU	BERI	PRS
<b>Afghanistan</b>	50	8.25	6	.	55.2	14.63	14.19
<b>Belarus</b>	100	6.43	6	62	26	33.38	13.69
<b>Columbia</b>	43.67	5	4	53.5	32.7	32.38	13.88
<b>Dominican Republic</b>	100	.	2	60	13.7	38.88	18.13
<b>DRC</b>	88.42	7.83	6	40	46.8	19.5	20.19
<b>Ethiopia</b>	100	7.26	5	53	45.8	21.88	16.93
<b>India</b>	91.42	5.92	2	64	30.85	35.5	15.94
<b>Indonesia</b>	100	6.44	3	51.5	28.05	31.38	15
<b>Jamaica</b>	100	3.17	2	70	10.6	49.25	13.25
<b>Rwanda</b>	0.87	6.85	7	.	44.8	19.5	16.5
<b>Sierra Leone</b>	100	6.65	4	58	45.3	18.5	19.56
<b>Sudan</b>	37.84	6.95	7	50.5	60.4	9.88	20.31
<b>Ukraine</b>	100	6.3	4	60	25.45	41.38	17.25
<b>Venezuela</b>	6.05	4.6	3	49.5	34.05	35.88	15.98

The second step in testing the current political risk assessment models, as mentioned earlier, is a separate test from Howell and Chaddick (1994). This step is the test of interrater reliability where the three proposed models- EIU, BERI, PRS are correlated with each other. Cronbach's Alpha was employed in this step. The table below illustrates the results for the correlations of the models.

The correlation results for the model EIU indicated a very strong correlation between the other models, with a correlation of .909. The results for the BERI model indicated an exceptionally strong correlation at .930. The last model, PRS, had a weaker correlation than EIU and BERI, nevertheless the correlation .715 of the PRS model is still correlated with the EIU and BERI models. Consequently, the correlation result for the three models indicates that the models are correlated and there exist a very low degree of variation. Therefore, there exists a high degree of inter-rater reliability. This high degree of interrater reliability is indicative of the reliability of the experts.

Table 6.3 Reliability of Experts.

### Economist

Reliability Statistics	
Cronbach's Alpha	N of Items
.909	4

Item-Total Statistics		
	Corrected Item-Total Correlation	Cronbach's Alpha if Item Deleted
K_1_1	.751	.899
K_2_1	.897	.843
K_3_1	.895	.844
K_4_1	.661	.928

### BERI

Reliability Statistics	
Cronbach's Alpha	N of Items
.930	4

Item-Total Statistics		
	Corrected Item-Total Correlation	Cronbach's Alpha if Item Deleted
K_1_2	.845	.912
K_2_2	.966	.875
K_3_2	.808	.941
K_4_2	.824	.913

### PRS

Reliability Statistics	
Cronbach's Alpha	N of Items
.715	4

Item-Total Statistics		
	Corrected Item-Total Correlation	Cronbach's Alpha if Item Deleted
K_1_3	.576	.625
K_2_3	.481	.665
K_3_3	.456	.688

K_4_3	.531	.636
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The third step in testing the reliability of the models is correlating the risk total indices with the loss index. Pearsons R was used to measure the correlations. Table 6.4 indicates the results for the correlation test. As indicated in the table, all the risk total indices are correlated with the loss index. However, the PRS model is not significant at the 0.01 or 0.05 level. Therefore, PRS is not a good projector of political risk on its own. Due to a difference in the sample size, the PRS model did not have a significant correlation; this is where the sample size became a problem. This is due to missing data where countries are off-cover. As a result the sample size was smaller for the cases with missing data. Therefore, the sample was compromised by grey areas in the data where countries were off-cover and no data was available. The CIFP risk total index accounted for the greatest amount of explained variance with a correlation of 0.923, only having 7.7% of the variance unexplained (see Appendix, page 20-22, for a discussion on variance). This is a strong correlation and is significantly high in comparison with the remaining indices in the analysis. The correlation analysis tests the correlation of each risk total index with the loss index. The correlation results are contradicting to the results of Howell and Chaddick (1994). Howell and Chaddick's (1994) findings concluded that the models are not a good projector of risk on their own, and by applying regression, can the reliability of the models be increased (see Appendix A, page 15-20, for a discussion on regression). All the models in the correlation analysis are significantly correlated with the loss index accept for the PRS model. Therefore, the next step in the analysis applied stepwise regression.



Table 6.4. Correlations

Correlations								
		Losses	CIFP	FH	PRS/ICRG	EIU	BERI	PRS
Losses	Pearson Correlation	1	.030	-.408	.427	-.448	.354	.028
	Sig. (2-tailed)		.923	.148	.167	.108	.215	.926
	N	14	13	14	12	14	14	14
CIFP	Pearson Correlation	.030	1	.708(**)	-.582	.771(**)	-.805(**)	.479
	Sig. (2-tailed)	.923		.007	.060	.002	.001	.098
	N	13	13	13	11	13	13	13
FH	Pearson Correlation	-.408	.708(**)	1	-.539	.767(**)	-.786(**)	.273
	Sig. (2-tailed)	.148	.007		.070	.001	.001	.346
	N	14	13	14	12	14	14	14
PRS/ICRG	Pearson Correlation	.427	-.582	-.539	1	-.676(*)	.660(*)	-.529
	Sig. (2-tailed)	.167	.060	.070		.016	.020	.077
	N	12	11	12	12	12	12	12
EIU	Pearson Correlation	-.448	.771(**)	.767(**)	-.676(*)	1	-.956(**)	.465
	Sig. (2-tailed)	.108	.002	.001	.016		.000	.094
	N	14	13	14	12	14	14	14
BERI	Pearson Correlation	.354	-.805(**)	-.786(**)	.660(*)	-.956(**)	1	-.513
	Sig. (2-tailed)	.215	.001	.001	.020	.000		.061
	N	14	13	14	12	14	14	14
PRS	Pearson Correlation	.028	.479	.273	-.529	.465	-.513	1
	Sig. (2-tailed)	.926	.098	.346	.077	.094	.061	
	N	14	13	14	12	14	14	14
** Correlation is significant at the 0.01 level (2-tailed).								
* Correlation is significant at the 0.05 level (2-tailed).								

The third step in testing the variation amongst current risk assessment models involves a regression analysis. Multiple regression was applied to all the subsets of data in order to measure the strength of the relationships amongst the models.

Table 6.5. Regression Results

Table 5 Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.848(a)	.719	.297	31.17993
2	.846(b)	.715	.431	28.06289
3	.828(c)	.686	.477	26.89413
4	.792(d)	.627	.467	27.15003
5	.740(e)	.548	.435	27.95941
a Predictors: (Constant), PRS, FH, PRS/ICRG, CIFP, EIU, BERI				
b Predictors: (Constant), PRS, FH, PRS/ICRG, CIFP, EIU				
c Predictors: (Constant), FH, PRS/ICRG, CIFP, EIU				
d Predictors: (Constant), FH, CIFP, EIU				
e Predictors: (Constant), CIFP, EIU				

In brief, the model summary in table 6.5 represents the regression results. As illustrated in the model summary, all the data subsets (R) fall into the same range (a-e). The regression average thus indicates that the data subsets are correlated with each other.

As illustrated in table 6.5, the strongest models in the regression are the CIFP and the EIU model. The CIFP and EIU models are the only models that are explanatory to the other models. They are the only models that are overlapping or collinear to the other models.

Table 6.6 below outlines the collinearity regression results. Stepwise regression is applied in order to eliminate multicollinearity amongst the models. The table indicates how of the dependent variable (losses) is explained by the models. Therefore, the task is to determine which model is the most explanatory of the losses. The most explanatory model would eliminate the other models due to its overlapping nature.

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-111.648	282.014		-.396	.712		
	CIFP	27.440	12.653	1.010	2.169	.096	.324	3.087
	FH	-8.439	9.380	-.414	-.900	.419	.332	3.008
	PRS/ICRG	1.899	1.797	.406	1.057	.350	.476	2.102
	EIU	-2.394	2.368	-.944	-1.011	.369	.081	12.414
	BERI	-.747	3.332	-.230	-.224	.834	.067	14.922
	PRS	2.994	5.360	.193	.559	.606	.591	1.692
2	(Constant)	-162.618	150.213		-1.083	.328		
	CIFP	28.134	11.042	1.035	2.548	.051	.345	2.902
	FH	-7.885	8.144	-.386	-.968	.377	.357	2.799
	PRS/ICRG	1.929	1.613	.413	1.196	.285	.478	2.090
	EIU	-1.954	1.193	-.770	-1.637	.162	.257	3.890
	PRS	3.319	4.644	.213	.715	.507	.638	1.568
3	(Constant)	-97.135	114.066		-.852	.427		
	CIFP	30.067	10.259	1.107	2.931	.026	.367	2.728
	FH	-9.263	7.583	-.454	-1.222	.268	.378	2.643
	PRS/ICRG	1.559	1.464	.333	1.065	.328	.534	1.874
	EIU	-1.846	1.134	-.728	-1.627	.155	.261	3.828
4	(Constant)	15.520	43.043		.361	.729		
	CIFP	28.743	10.281	1.058	2.796	.027	.372	2.688
	FH	-9.325	7.655	-.457	-1.218	.263	.378	2.643
	EIU	-2.316	1.055	-.913	-2.196	.064	.308	3.247
5	(Constant)	19.934	44.169		.451	.664		
	CIFP	25.151	10.142	.926	2.480	.038	.405	2.467
	EIU	-2.946	.947	-1.162	-3.112	.014	.405	2.467

a Dependent Variable: 1996-2004: Claims resolved by cash settlement and guaranties - Political risk: % of Guaranty Amount paid

In determining which model is the most explanatory of the dependant variable (losses), the analysis is interested in the final model. The closer the t is to 2, the more explanatory the model, indicating a significance of 95%. The CIFP and the EIU models are the strongest and explain 95% of the losses (dependant variable). As indicated in the table, the CIFP and the EIU models are the closest

to 2 with a correlation coefficient of 2, 467 for both models. Therefore, the CIFP and the EIU models are the most overlapping with the rest of the models, and the CIFP and EIU form the best model together.

Howell and Chaddick (1994:89) assert that “if theory and data is appropriate, there should be at least some significant correlation between the projection and actual losses”. The correlation results indicated that the models had a significant correlation at the 95% level except for the PRS model. Therefore stepwise regression was applied to determine which model would be the most collinear to the other models and significantly correlated with the losses. The CIFP and EIU were significantly correlated with the losses and replace the other models, due to their unique contributions into the regression models. When considering the CIFP and the EIU models earlier in the model, it was noted that the CIFP and the EIU model employs most of the variables in the other models. Theory and data in this case is appropriate and there is a correlation between the projection and actual losses.

#### **5.4. Conclusion**

This study tested the variation among current risk assessment models. The results of this study were quite different to the findings of Howell and Chaddick (1994). Howell and Chaddick (1994) concluded that there exists variation among current risk assessment models to accurately forecast political risk.

This study followed similar procedures in testing the variation between three risk assessment models in Howell and Chaddick (1994). However, there was a considerable difference in two areas of this study compared to Howell and Chaddick. Due to limitations of the study, namely inability to access hard data and a difference in sample size, additional methods were introduced in order to bridge these limitations. Additional methods required alternative data, for which questionnaires were used and the interrater reliability of multiple experts were

tested. In order to overcome the pitfalls of a small sample size, this study enlarged the subsets of data to be correlated with losses, by adding an additional three models to the test of the reliability of three current risk assessment models.

The models of Howell and Chaddick (1994) indicated a great amount of variation, with PRS being the most predictable. Their findings indicated that EIU is the weakest model when decomposed.

The results of this study indicated that risk projections were correlated with subsequent losses. All the models were correlated with the loss index. However, all the models were had a correlation at the 95% significance level, except for the PRS model. Of all the models, the CIFP model accounted for the most explained variance. With a correlation of 0.923, the CIFP model only had 7.7% unexplained variance. The findings indicated that there exists a very low degree of variation between the models. The regression results proved CIFP and EIU to be the most predictable models and the PRS model accounted for the most unexplained variance. Contrary to Howell and Chaddick's (1994) findings, the results of this study indicate that the forecasting of political risk can work based on actual losses and although the models are more predictive combined; the models assume a consistent relationship with each other.

When an investor anticipates investing in another country, the investor is exposed to numerous uncertainties surrounding the host country. In addition, the investor faces a variety of risks when operating in a foreign country. An investor has to be familiar and prepared for political aspects that can pose a threat to the success of a business venture. Political events and developments in a foreign country often have crucial implications for foreign investments. Risks from political sources can harm an investment and can result in losses for the investor. Political changes that can affect business include, for instance, issues like competency of government, transparency and predictability of legal and regulatory systems and institutional effectiveness. Therefore, it is important for an investor to develop a methodology by which the business can better apply information on a country to assess the impact of political change within a country on the companies' investments and operations.

Political risk analysis aids a company in addressing the above mentioned uncertainties when entering a foreign country. Furthermore, political risk analysis assists corporate decision-making to strategically predict political risks and prepare political risk management programmes. Similarly, political risk analysis provides an in-depth analysis of the totality of risk, how it will affect the interests of the company and how a company can hedge against risk.

Moreover, it minimises a companies' exposure to loss by identifying, evaluating, assessing and managing political risk. Political risk analysis further applies a systematic framework to evaluate the impact and likelihood of political events. Thus, by utilising political risk analysis, the investor can expect an appropriate risk-adjusted rate of return of capital for an investment.

This study attempted to test three current political risk assessment models. A previous attempt to test three models was made by Howell and Chaddick (1994) to test the reliability and validity of three risk assessment models. In order to test the reliability of current risk assessment models, this study attempted to mimic the test done by Howell and Chaddick (1994). This study tested projected political risks against actual losses incurred in the period 1994-2004. The inquiry tested the consistency and rationale of the ratings provided by three models. In testing the consistency and predictive power of these ratings, the predictive power of the ratings was measured.

The study aimed to determine the variation between three models, namely: the Economist (EIU), PRS and the BERI models. The logical and structural properties of the three models were considered in the study in order to evaluate those properties with respect to the task of forecasting.

The methodology underlying the political risk analysis process is one of practical logic in which forecasts must be justified and defended. The study aimed to investigate whether real world experience shows if the three models can accurately and reliably forecast political risk. In testing the reliability and validity of the three models, the study addressed the connection between theory and profit or loss for foreign investors. This study correlated real losses with theory to empirically determine the accuracy of forecasts.

In analysing the underlying consistency and rationale of ratings provided by three models, it is necessary to define political risk. Chapter two provided a theoretical base of political risk analysis, and clarified the term political risk and the conceptualisation thereof. Defining political risk is problematic because the concept of political risk is a nominal one. This chapter examined the problems in defining political risk, it also provided consensus on the definition of political risk.

Political risk can be defined as the possibility that political decisions or events in a country will affect the business environment in such a way that investors will lose money or not make as much money as they expected. The theoretical description of a political risk consists of a differentiation between risk events and risk factors. A political risk event is a discrete occurrence transpiring in the environment, whereas a political risk factor includes any set of circumstances which influence the occurrence of a political risk event. A political risk event is never considered in isolation; after identifying the political risk event, the task is to evaluate the political risk effects. A political risk effect describes the manner in which the political risk event manifests itself.

Thus, the goal of political risk analysis is to identify and define political risks by decomposing political risks into political risk factors and political risk events. Political risks are then further divided into micro risks, macro risks, internal risks and external risks. Micro risks are specific to the industry, the firm or the project, while macro risks entail the risks pertaining to the political system at large. Conversely, the origin of a political risk can be internal where a risk results from within a host country. On the other hand, a political risk can be external in origin, where political risk is a product of influences outside of the host country.

As a result the task of the political risk analyst is to firstly identify the internal and external sources of political risk. Secondly, the modeler has to identify the factors leading to political risk events and the effects of the political risk events. Lastly, the modeler has to construct a systematic framework to evaluate the impact and likelihood of political risk events.

In analysing political risk, the analyst must be wary of confusing political risk with political instability and political uncertainty. Chapter two distinguished between political risk, political uncertainty and political instability. Political risk, political uncertainty and political instability are three distinct phenomena although



interrelated. A systematic political risk analysis can reduce uncertainty about the political environment when anticipating investing in another country.

Furthermore, political risk is a specialised relation of country risk. Country risk analysis does not sufficiently assess risks related to the political environment of a country. Therefore, the political risk analyst must be familiar with the country risks of a host country. Chapter two discussed country risk as a specialised relation of political risk. In addition, it is equally important to understand the interconnected relationship between politics and economics. Chapter two highlighted the interdependent nature of politics and economics.

The main purpose of this study was to test the validity and reliability of three current political risk models. An analysis of the underlying foundations of empirical research (qualitative research) and social inquiry (quantitative research) was therefore needed in order to test the validity and reliability of current risk assessment models. Chapter two discussed the underlying qualitative and quantitative nature of political risk analysis. This included theory on qualitative and quantitative methods, forecasting of future events and the possibility of control over future events.

Low political risk encourage Foreign Direct Investment (FDI). Through utilising political risk analysis, MNCs can reduce their exposure to political risk, thereby minimising losses. There exists a relationship between political risk and FDI. Political risk is an important element of international business and international politics; it largely affects both the public and private realms of international relations. In order to test the reliability and validity of current risk assessment models, it is necessary to comprehend the nature of political risk and FDI. The political risk analyst has to be familiar with the both the investment environment and the political environment within a country. Therefore, it is necessary to comprehend the relationship between political risk and FDI. Chapter three investigated this relationship. The purpose of this chapter was to indicate the

necessity of political risk analysis in FDI, by exploring the ways in which government decisions influence the flow of foreign direct investment and how foreign direct investment influence domestic politics.

In order to examine the relationship between political risk and FDI an overview of the nature of FDI was presented. The process of foreign direct investment as a product of globalisation was discussed to illustrate the operation of foreign direct investment.

### **6.1. Political Risk and Foreign Direct Investment**

FDI involves productive capacity and private capital flows from a parent firm in the home country to a location outside of the country. FDI implies a direct long-term relationship with a host country. It only occurs with the mutual consent of two rational actors, namely the MNC and the host country. FDI is generally attracted to countries of all sizes at different stages of development. Moreover, a review of historical trends in FDI indicate that:

- Countries at every stage of development can attract FDI across a wide range of sectors from developing countries as well as industrial countries;
- The largest economies naturally attract FDI, but experience shows that it can be an important part of even the smallest, poorest countries' economy;
- The volume and direction of FDI flows respond to the national and international policy environment; and
- Current trends toward integration of the global economy provide a stronger impetus than ever towards FDI in developing countries for those countries that are open to it (IFC & FIAS, 1997:20).

FDI take place in a borderless, integrated and interdependent world; as a transnational process, FDI is a product of globalisation. The recent trends of the 1990's and the twentieth century towards *globalisation* have led to the sharp increase of FDI flows worldwide.

The phenomenon of globalisation has led to an increase of FDI. The aim of this study is to test three political risk models in foreign direct investment. In order to do this, the nature of the international arena, which is shaped and characterised by globalisation, in which political risk functions, was examined in chapter three.

The changing global emerging environment has had an enormous impact on the functioning of business. The effect has been structural integrations in the global economy. The result of this is a one free-world market not governed by state or MNC and a constant bargaining between the two factions. The bargaining is for economic strength to further underlying objectives. Underlying objectives of states include public interest or national interest to further national wealth or to further self-interest of corrupt or authoritarian officials, or the use of economic leverage for the purpose of growth, development and reconstruction. Underlying objectives of firms typically include the maximisation of profit.

The advent of globalisation has created many opportunities for investment. However, the changing environment has also created more exposure to risk due to the transnational nature of international political economy. Any change in the political environment of a host country has an effect on business operations. Therefore, political risk analysis has become an integral part of corporate decision making.

Furthermore, political risk analysis evaluates and assesses changes that are constantly taking place in the global business and political environment. Both MNCs and host countries can benefit from FDI. MNCs constantly have to adapt to changes in the political spectrum; political risk analysis can aid MNCs in this process. In addition, countries are increasingly attempting to attract FDI for national benefits. Hence, the relationship between FDI and political risk is that of an interdependent one.

In order to effectively manage risks in the global arena, corporate decision-makers have to be familiar with the ever-changing environment in which companies function. The relaxation of state borders dispersed state's control over business transactions within national borders, making it easier for actors, both MNCs and the host country, in the international arena to indulge in unfair practice at the expense of others. Therefore, regulation of international investment has become vital to maintaining international order. Both MNCs and the host country must comply with practices to increase transparency and effectiveness in their operations in order for both actors to optimally benefit from FDI. Chapter three provided an overview of fair practices and conventions. These conventions serve as guidelines for MNCs and host countries to actively contribute to a favourable international investment environment.

The purpose of this chapter was to indicate the necessity of political risk analysis in FDI, by exploring the ways in which government decisions influence the flow of FDI and how FDI influence domestic politics. As mentioned earlier, MNCs use political risk analysis as a method to minimise losses. In addition, political risk analysis is a means to identify and evaluate political risks. After identifying and evaluating the risks involved in a certain business venture, it is important to take steps to hedge against the forecasted risks. Political risk insurance is a method to spread risk, thereby mitigating the possible adverse effects of political risk. Chapter four provided an overview of political risk insurance as a mitigation tool.

## **6. 2. Political Risk Insurance**

Chapter four of this study argued that the purchase of political risk insurance is one of the most effective ways to reduce a company's exposure to political risk. Not only does the success of an investment depend on the effective analysis of the fundamental drivers that lead to losses arising from political risk, but a mitigation tool is necessary to hedge against contingencies in cross-border investments.

Moreover, as a risk mitigation tool, PRI helps to provide a more stable investment environment for investments. The past two decades have marked an increase in the demand for PRI. Investors have become more aware of the risks involved in investing abroad. Also, more and more investors are purchasing PRI to hedge against risk.

This study concluded that the right type of political risk insurance provider and the right type of political risk insurance policy is essential to ensure success of an investment. Hence, this study provided an overview of the different types of insurance providers and the products they offer. In addition, this study compared private political risk insurers to public political risk insurers. On the whole, the type of insurer and product depends on the type of investment.

In conclusion, the PRI industry plays a mediating role in the event of disputes between investors and host countries. Not only does PRI increase a company's profile to gain access to finance by securing finance and loans, but it also helps to open difficult or frontier markets to clients.

In light of the outcomes of this study, it can be argued that as an extension of political risk analysis, MNCs use political risk insurance to successfully minimise exposure to losses. Therefore political risk can be successfully managed.

The main purpose of this study is to test the reliability of current risk assessment models to accurately forecast political risk. The research question addressed in this study is "how reliable and valid are three models (EIU, PRS and BERI) to accurately forecast political risk". Chapter five of this study empirically tested political forecasts against actual losses.

### **6.3. Three Current Risk Assessment Approaches**

There have not been many attempts to test the reliability of political risk models. Howell and Chaddick (1994) attempted to test the reliability of three (BERI, EIU and PRS) current risk assessment models. In their analysis, they correlated the risk projections of three models with losses incurred for 1982-1994. In the initial step of the analysis, they constructed a measure of loss index in an effort to theoretically link the acts resulting in loss to the causes of loss. The index was constructed out of losses due to political risk. Howell and Chaddick (1994) constructed the index with a sample of 36 countries. The next step in their analysis correlated the loss index with the risk projections of three models.

The first model used in their analysis was the Economist Intelligence Unit (EIU) model. They constructed a risk total index of political variables of the EIU model. Thereafter, the risk total index was correlated with the loss index. The correlation results for the EIU model indicated that 89% of the variance in the loss data was unexplained. The correlation of 0.33 was not significant at the 95% significance level.

The variance in the data occurred mostly due to multi-collinearity. In an effort to sort out the relationships among variables, the authors applied stepwise regression to the analysis. The stepwise regression results now explained 45% of the variance in the data, thereby providing the model with a fair degree of predictability.

The correlation results for the second model used in the analysis, the Business Environmental Risk Index (BERI) model only explained 26% of the variance, with a correlation result of 0.51 at the 0.01 significance level. This is a stronger projection than the EIU, but is still not a good estimator on its own. The findings

appeared more consistent after restructuring the model with stepwise regression. The data now explained 53% of the variance with a multiple correlation of 0.73.

The last model used in the assessment, Political Risk Services (PRS) accounted for more of the variance than the other models used in the analysis. With a correlation of 0.57 at a significance level of 0.1%, after restructuring the PRS model, the data for this model accounted for 74% of the data. Of the three models the PRS model is the most reliable when decomposed. The findings of Howell and Chaddick indicated that the risk projections did not correlate with subsequent losses. Thus, there existed a high degree of variation amongst the models.

### **6.3.1 Testing the Variation Between Risk Assessment Models**

As mentioned earlier, this study mimicked the analysis of Howell and Chaddick (1994). It correlated the losses in the period 1994-2004 with risk projections. The loss index was constructed out of a sample of 14 countries.

The ratings for the three models were generated by use of a questionnaire. Therefore, the interrater reliability of multiple experts was tested in order to determine whether the raters agreed on projections. The correlation results for the interrater reliability analysis indicated a strong relationship between the experts. Therefore, the raters were reliable due to the fact that the results were correlated.

The main problems encountered in this study were the lack of accessibility to data and a small sample size. In order to overcome these pitfalls, it was required that this study generated alternative data sets in order to overcome the small sample size. Predictions based on small samples tend to be unstable. Thus, as an alternative, this study added an additional three models to the analysis in order to increase the data subsets that were compared to the loss index. The

models used in the analysis included BERI, PRS, EIU, Country Indicators for Foreign Policy (CIFP), Freedom House (FH) and PRS/ICRG ratings.

The next step in the analysis correlated the risk totals for each model with the loss index. All the risk total indices were correlated at the significant 95%. Only the PRS index was not at the significant 95% level. Therefore, the PRS is not a good projector of political risk on its own. Since there were cases where countries were off-cover and no data was available for these countries, the sample size for the PRS model was considerably smaller compared to the other models. The problem of a small sample size explains the low level of significance for the PRS model. Of all the models in the analysis, the CIFP was the most significant at a correlation of 0.923. This model, therefore, accounted for the greatest explained variance. Therefore, the CIFP model is a greater predictor of political risk on its own.

In order to determine which model is the most explanatory of the losses, stepwise regression was applied. The most explanatory model would eliminate the other models based on the level of multi-collinearity. After applying stepwise regression, the CIFP and Economist model were the strongest models in the regression model. The correlation coefficient for CIFP and the Economist of 2.467 indicated that the two models are strong projectors of risk on their own. The models explained 95% of the losses (the independent variable). Therefore, these models are strong predictors of political risk due to their unique contributions into the regression model.

Howell and Chaddick (1994:89) contend that “if theory and data is appropriate, there should be at least some significant correlation between the projection and actual losses”. In this case, theory and data was appropriate and the results of this study proved a correlation between the projection and actual losses. The findings indicated that the models were correlated with actual losses. All the models were correlated with losses, at the 95% level of significance, except for



the PRS model. In other words, all the models were correlated with losses but one model, the PRS, was not significant. Therefore, the PRS model was not a good projector of risk on its own. In order to increase the reliability of the models stepwise regression was applied. Stepwise regression was applied in order to eliminate overlapping models amongst the models. The CIFP and EIU model had the highest level of multi-collinearity amongst the models. Therefore, theory and data was appropriate in this study.

In conclusion, since theory and data was appropriate in this study, it can be contended that the tested models are reliable and valid to accurately forecast political risk as opposed to the findings of Howell and Chaddick (1994). Therefore it can be contended that political risk can be measured and empirically tested.



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## **APPENDIX A**

### **CLARRIFICATION OF STATISTICAL CONCEPTS AND METHODS.**

This appendix provides an outline of the statistical concepts employed in the testing of the three proposed models in this study. It does not aim to provide an in-depth analysis of the formulas, computation, or calculation of certain concepts. Furthermore, as social scientists it is not necessary to be familiar with the formulas and calculations, the role of the social scientist is to have an understanding of the elementary concepts and this does not include the responsibilities of a statistician.

#### **1. Elementary Concepts**

Statistics is the theory and method of analysing quantitative data obtained from samples of observations in order to, study and compare sources of variance of phenomena, to help make decisions to accept or reject hypothetical relations between phenomena, and aid in making reliable inferences from empirical observations (Roy, 2001). The ultimate goal of statistical analysis is measuring the relations between variables. Variables are defined as “a quantity or force, which, throughout a mathematical calculation or investigation, is assumed to vary or be capable of varying in value” (Byrne, 2002:29). In short, variables are things that are measured in social and natural science. Measurement implies the assignment of numbers as the units of analysis (Bryman & Cramer, 2001:54). Measurement is the process of observing and recording the observations that are collected as part of a research effort (Anon1, internet source). In effect, variables are either measured to be controlled or manipulated. This implies that empirical research strive towards the manipulation of variables, this is called the independent variable, and the measurement of the effects of this manipulation on others, this measurement is only registered, this type of variable is called a dependent variable (StatSoft, internet source).

The relations between variables are commonly referred to as correlations. In addition to the relations between variables, variables are viewed in the context of data analysis. Hair et.al, (2005:5) explains that “data analysis involves the identification and measurement of variation in a set of variables, either among themselves or between a dependent variable and one or more independent variables”. When working with two or more variables, multiple measurements are applied to the variables. This type of measurement is referred to as multivariate measurement (Hair et al, 2005:4). Thus, the analysis of multiple variables is called multivariate analysis. There exist a number of multivariate techniques. These techniques include different methods of, for instance, regression and variance. The different types of multivariate techniques include: factor analysis, multiple regression, multiple discriminant analysis, logistic regression, canonical correlation, multivariate analysis of variance and covariance, conjoint analysis, cluster analysis, perceptual mapping, correspondence analysis, structural equation modeling and confirmatory factor analysis. This study makes use of an analogy of an analysis of variance (ANOVA) and multiple-regression.

As mentioned earlier, the goal of statistical testing is to investigate the nature of correlations between variable, the next section will provide a basic overview correlations.

## **1.1 Correlation**

Bryman & Cramer (2002:169) define correlation as entailing “the provision of a yardstick whereby the intensity or strength of a relationship is gauged”. Thus, correlation indicates both the strength and the relationship between variables. It describes both the strength of an association between variables. Association between variables implies that “the value of one variable can be predicted, to some extent, by the value of the other” (Anon2, internet source). The correlation thus implies a linear relation between variables.

In order to derive an estimate of the strength and relationship of variables, correlation coefficients are calculated. Anon2 (internet source) explains that “the square of the size of the correlation coefficient is the fraction of variance of one variable that can be explained from the variance of the other variables”. Furthermore, the correlation squared ( $r^2$ ) is the numerical measure of the degree to which patterns in X and Y correspond (Koop, 2000:25). In other words, when two variables vary together, they are correlated. A change in the one variable is accompanied by a change in the other. The correlation coefficient thus employs a quantitative estimate of the association present between variables. Koop (2000:33) explains this association, by asserting that “correlation is a property that relates two variables together”.

Specific uses of correlation include,

- a) Determining reliabilities, for instance when comparing two raters or the same raters' observations of behaviour to determine whether they agree.
- b) Determining validity, for instance, if a score is highly correlated with another score, it can be contended that the score is a predictor of the other score.
- c) In the case of prediction, a set of procedures similar to correlation called regression is used for predicting one variable from one or more other variables.

Since it is the aim of political risk analysis to forecast outcomes of risk scenarios in a reliable and valid manner- the above properties of correlation, is important to the aim of this study -which is to test the predictability, validity and reliability of three current risk assessment models.

Correlation is a statistical method that tests numerical data. The numerical symbol that represents correlation is  $r$ . Koop (2000:24) lists the numerical properties of correlation as follow:

- a)  $r$  always lies between  $-1$  and  $1$ , which may be written as  $-1 \leq r \leq 1$ .
- b) Positive values of  $r$  indicate a positive correlation between  $X$  and  $Y$ . Negative values indicate a negative correlation,  $r=0$  indicates that  $X$  and  $Y$  are uncorrelated.
- c) Larger positive values of  $r$  indicate stronger positive correlation.  $r=1$  indicates a perfect positive correlation. Larger negative values, meaning more negative values, of  $r$  indicate a stronger negative correlation, thus  $r=-1$  indicates perfect negative correlation.
- d) The correlation between any variable and itself, for example the correlation between  $Y$  and  $Y$ , is  $1$ .

In light of the above a negative correlation implies; that the relationship between two variables fluctuate in such a manner that as one variable's values tend to increase, the other variable's values tend to decrease. In the case of a positive correlation, the opposite takes place; as one variable's value increase, the other variable's values increase (StatSoft, internet source). The properties of negative and positive correlations will be expanded on in the next section.

In evaluating the correlation between variables, it is not only important to measure the strength or magnitude of the correlation, but it is also important to determine the significance the correlation. The next section will explain the significance of a correlation.

### **1.1.2 Significance of a correlation**

Statistical significance of a result is the probability that the observed relationship or a difference in a sample occurred by chance and that in the population from which the sample was drawn, no such relationship or difference exist. In other words, the statistical significance gives an indication about the degree to which the results are 'true' (StatSoft, internet source). The statistical value is represented as the  $p$ -value, which is the standard measure.

The value of the  $p$ -value represents a decreasing index of the reliability of the result. In other words, the  $p$ -value is a measure of the probability of error involved in accepting results as valid. Thus, the higher the  $p$ -value, the less reliable the relation between the variables (StatSoft, internet source).

In statistical analysis scatter plots are used to determine the relationship between two variables. A scatter plot is a graph of paired  $X$  and  $Y$  values (Pagano, 1994:109). Scatter diagrams allow three aspects of a relationship to be recognised. Firstly, it determines whether the relationship is linear. A linear relationship between two variables is one in which the relationship can be most accurately presented on a straight line (Pagano, 1994:110). Secondly, it determines the direction of the relationship, whether it is positive or negative. Lastly, it measures the strength of the relationship (Bryman & Cramer, 2002:172).

When working with correlations it is essential to create scatter plots to avoid issues influencing correlation measures. Firstly, it avoids the issue of linearity, by employing variables on a straight, monotonic line displaying the association between variables in a linear fashion. The alignment of variables is called the regression line. If a relationship is nonlinear it is meaningless to compute  $r$ , therefore it is required to investigate scatter diagrams and then compute  $r$  (Bryman & Cramer, 2002:172). Thus, when working with correlations, the goal is to have variables linearly associated. Secondly, scatter plots eliminate limited restricted and truncated) ranges. Limited ranges refer to situations in which the sample is somehow limited and results in an underestimated  $r$ . Thirdly, in the case of extreme groups, an overestimated  $r$  is avoided. Lastly, to avoid extreme scores that often result in an overestimated  $r$  when using small sample size (Plonsky, internet source).

The amount of scatter in the diagram is indicative of the strength. As indicated in the diagrams below, if the pattern of points moves downwards on the scatter-diagram the relationship is negative, if it moves upwards, it is positive. In the case of a straight line; the relationship is a perfect relationship, this means the correlation is perfect, if there is a large scattering where no pattern is visible; there is no relationship (Bryman & Cramer, 2002:170).

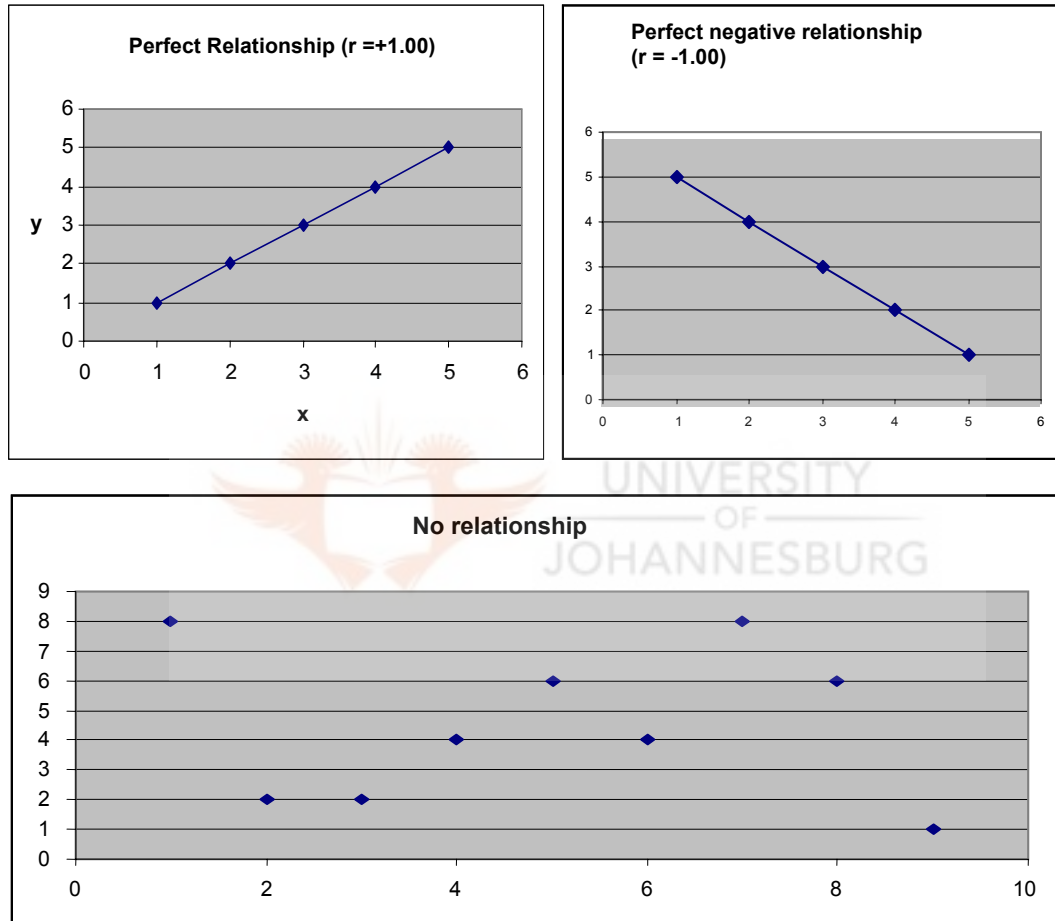


Figure 1.1 (Bryman & Cramer, 2001:172-173)

As explained earlier, the correlation coefficients range from -1.00 to +1.00. The coefficient -1.00 would represent a perfect negative correlation, where +1.00 would represent a perfect positive correlation, and the value 0.00 would represent a lack of correlation.



If the relationship is not straight but curves at one or more points, it is curvilinear, if a relationship is not linear, a measure like Pearson's  $r$  is employed (Bryman & Cramer, 2002:172). The techniques applied in constructing scatter plots in the measure of statistical significance is also applied to Pearson's  $r$ . Pearson's  $r$  will be explained in the next section of this chapter.

The test of significance is based on the assumption that the distribution of the residual values, that is the deviations from the regression line, for the dependent variable  $y$  follows the normal distribution, and that the variability of the residual values is the same for all the values of the independent variable  $x$  (StatSoft, internet source).

In addition, the normal distribution represents a general feature of empirical reality. It thus represents 'truths' about the general nature of reality. This means that the normal distribution is a representation of the natural state of what is being tested. The normal distribution would be represented by a bell-shaped curve on a histogram (see figure 1.1). The mean is the statistical term for average and it is associated with the middle of a distribution (Koop, 2000:18). The dispersion between from the mean is measured through the standard variation, commonly referred to as the variance. If a small dispersion is exhibited, there is a small amount of standard deviation, whereas, when a large dispersion would represent a large amount of standard deviation.

Correlation measures the relationship between the magnitude and significance of relations between two variables, depending on the sample size ( $n$ ). In addition to this, the significance level is concerned with the probability of error involved in rejecting the idea that the relation in question does not exist in the population. Thus, it gives an indication of "how likely it is to obtain a relation of a given magnitude, or larger, from a sample of a given size, assuming that there is no such relation between those variables in the population" (StatSoft, internet source).

In other words, every good measure of relations between variables must take into account the overall differentiation of individual scores in the sample and evaluate the relation in terms of, relatively, how much of this differentiation is accounted for by the relation in question (StatSoft, internet source).

Therefore, the significance of a relation between variables depends on the sample size. This can be explained through the observations within a sample. If there are very few observations, then there are respectively few possible combinations of the values of the variables, and thus the probability of obtaining by chance a combination of those values indicative of a strong relationship is relatively high (StatSoft, internet source).

In other words, the probability of a random deviation of a particular size decreases with the increase of a sample. In addition, if a relationship between a variable in question is objectively small, then there is no way to identify such a relation in a study unless the research sample is correspondingly large. Thus, if a relation is large, then it can be found to be significant even in a small sample. In addition to this, the smaller the relation between the variables, the larger the sample size that is necessary to prove it to be significant. In conclusion, statistical significance then represents the probability that a similar outcome would be obtained if the entire population was to be tested (StatSoft, internet source).

## **1.2. Pearson's R**

Pearson's Product Moment Correlation, more commonly referred to as Pearson's  $r$ , is at the core of most multi-variate analytical techniques and have frequently been applied in political studies in electoral coalitions (Archdeacon, 1994:106).

Pearson's  $r$  is used when working with non-metric data. The most common use of Pearson's  $r$  is when working with interval or ratio variables (Bryman & Cramer, 2002:170). Interval or ratio data implies that there are more than two categories of variables and that the distances between the categories are equal. The logical requirement of Pearson's  $r$  is that the pattern of correlated values between the variables is a product of their relationship with each other rather than of their separate relationship with a common third variable (Archdeacon, 1994:107).

Pearson's  $r$  assumes that two variables are measured on at least interval scales and it determines the extent to which values of two variables are proportional to each other. If a variable is proportionally related, it means that it is linearly related. Thus, the correlation is high if it can be summarized by a straight line, sloped either upwards or downwards (StatSoft, internet source). Bryman & Cramer (2002:173) supports this by asserting that Pearson's  $r$  "allows the strength and direction of linear relationships between variables to be gauged".

Pearson's  $r$  varies between +1 and -1, and a relationship of +1 or -1 would indicate a perfect relationship, be it negative or positive, between two variables (Bryman & Cramer, 2002:173). Thus, the closer  $r$  is to either -1 or +1, the closer it is to one, which indicates a relationship. The closer it is to one, the further it is away from zero, zero would indicate no relationship. As the covariation between variables becomes more erratic, the correlation coefficient rises from -1 or falls from 1 (Archdeacon, 1994:103). The reason that Pearson's  $r$  assumes a perfect relationship negative or positive respectively, because the correlation coefficient does not depend on specific measurement units used (StatSoft, internet source).

Furthermore, correlation coefficients assume a measure of covariance. Covariance measures the extent to which the values of a pair of variables fluctuate together. Lomax (2001:176) defines covariance as "a source of variation not controlled for in the design of the experiment, but the researcher believes to

affect the dependent variable, in course performance". Thus, covariance assumes a relationship between variables and measures the amount of variance. Pearson's  $r$  was developed as a measure to standardise the covariance in terms of the standard deviations of the variables involved (Archdeacon, 1994: 101). Consequently, Pearson's  $r$  is used when measuring linear data, it is applied in prediction when using regression analysis.

### 1.3. Causality

The goal of political risk analysis is to control future events. As mentioned in chapter two, political risk anticipates the control of future events through establishing causal relationships in order to predict the future, so that political risk factors or events can be mitigated, absorbed, avoided, isolated or managed. In addition to this, is the practical application of causality.

Causality also referred to as causation, is a multi disciplinary term that has a long history in fields like philosophy, history, sociology and science. In order to operationalise the concept of causality for the purpose of this study, it is necessary to draw on the literature of some of the generalisations of the term causality.

Karpin'ski (1990:35) distinguishes between causal analysis as *probabilistic* and *deterministic*. A probabilistic analysis is applied to empirical data. Deterministic analysis is based on assumptions and usually pertains to theories. Karpin'ski (1990:35) contend that "a statistical relationship is not a sufficient condition of a causal link, but it may be a symptom of such a link". The conditions of a probabilistic analysis require that the statistical relationship does not cease to exist when variables under consideration are isolated. The isolation of variables often takes form of the clause *ceteris paribus*, meaning 'other factors being constant' (Karpin'ski 1990: 117). In addition to this, Karpin'ski (1990: 87) explains that experimental research "exerts...influence upon reality and observes and

registers the consequences”. This is in line with the laws of experimental research, which include the manipulation of some variables and the measurement of such effects on other variables. In contrast to the probabilistic approach, conditions under a deterministic value require a cause and effect pattern where cause is not later than effect (Karpin’ski, 1990:35).

In addition, Hoover (2001) draws on the work of David Hume (1739, 1754, 1777) and distinguishes between causal analysis as either *constant conjunction* or *probabilistic causality*. Constant conjunction share similarities to Karpin’ski’s (1990) deterministic causality in the sense that it is based on deterministic theory and cause and effect. The connection between cause and effect is a customary conjunction. The idea of customary conjunction is based on experience and knowledge. This implies a relation between a set of facts (Hoover, 2001:8-12). In other words, the future is predicted and controlled through this relation based on experience and knowledge (Snyman, 2002:81). Therefore, it can be contended that causality is a generalisation from repeated experience and does not exist in isolation. Hoover (2001:11) explains that the constancy of conjunction on an established set of knowledge would anticipate control over future events. However, Hoover (2001: 11) criticise constant conjunction as a method of causal inference, as being based on *chance*, and therefore does not warrant prediction.

Furthermore, Hoover (2001:9) also displays skepticism for the constant conjunction method because this method is limited due to threats of the induction problem. As explained in chapter two the induction problem is a limitation of knowledge an experience.

In contrast to the constant conjunction as a method of causal inference, “probabilistic accounts look for relationships that tend to hold on average and for the most part” (Hoover, 2001:14). This probabilistic method of causal inference is identical to the probabilistic method described by Karpin’ski’s (1990). In addition to this, it can be contended that probabilistic causality is a method that observe

data in light of which variables are causally relevant to induce change in another in contrast to the cause and effect method of deterministic approaches (Hoover, 2001: 15). Furthermore, probabilistic methods make use of causal structure that is governed by parameters imposed on variables through boundary conditions (Hoover, 2001: 44-45). This is in line with Karpin'ski's (1990) explanation of causality according to statistical conditions, as mentioned above.

As mentioned throughout this study, this study is a quantitative study that tests the reliability and predictive power of three current risk assessment models. This study therefore relies on statistical testing of variables and not assumption based theories, in light of this, this study rejects the deterministic approaches to causality and data in this study is treated in a probabilistic manner. In light of this, it would suffice to define causality as entailing a change, under probabilistic conditions, in one variable that will cause a change in another variable/s. In practical terms, changes in X cause changes in Y.

In addition to the above, it is important to take note of a common error of inferring causation from correlation (Kirk, 1999:160). Kirk (1999:160) asserts that "it is easy to fall into the trap of inferring causality from correlation, especially when one variable occurs before the other". This generally occurs when highly significant correlations are interpreted as causal. There are several possible interpretations of correlations, these are illustrated in the table 1. Possibility (a) asserts that the condition of X determines the condition of Y. Possibility (b) asserts that the opposite is true, Y is a cause of X. The third possibility (c) maintains that some third variable influences both X and Y. Lastly, possibility (d) assumes a complex of interrelated variables influence X and Y, two or more of these situations may occur simultaneously (King & Minium, 2003:142).

**Table 1. Possible relationships between variables X and Y that correlate.**

Possibility	Symbols
a.	$X \rightarrow Y$
b.	$X \leftarrow Y$
c.	$X \leftarrow A \rightarrow Y$
d.	$B \rightarrow C \rightarrow X$ $B \rightarrow Y$

(own interpretation from King & Minium, 2003: 142)

In addition to the above, spurious correlations often result in the error of inference of causation on correlations. This type of correlation exist in a relationship where two events are associated because both are caused by the same prior event rather than because one causes the other (Hage & Meeker, 1988:23).

Furthermore, a correlation is not the same as cause, as correlation only provides estimates of covariance, which is that, two variables are related (Bryman & Cramer, 2002:174). Another important fact worth considering is that “while a correlation indicates that there is a relationship between two variables; it does not explain why that relationship occurs” (McLaughlin, 2002:248). Therefore it cannot be determined from an estimate of a correlation that one variable causes the other (Pagano, 1994:154).

Regression is an extension of correlation to cases of three or more variables that introduces an aspect of causality (Koop, 2000:23). Regression will be explained in the next section.

#### **1.4. Regression.**

Regression is related to correlation in the sense that it is concerned with the strength of association between variables, almost all calculations are similar to that of correlation. However, regression is concerned with specifying the nature of the relationship between variables (Levin & Fox, 2006:358).

In addition to the above, regression attempt to predict the value of Y based on the value of X. Regression attempts to utilize the correlation between X and Y to make very specific predictions of the Y value (Sprinthall, 2003:389). The variable whose value is known is called the independent variable and the variable whose value is to be determined is called the dependent variable. In relation to correlation, the relation between X and Y specifies how much information about Y is contained in X. The higher the correlation, the more information about Y is contained in X (Sprinthall, 2003: 389).

To understand regression, a definition of prediction is required. McLaughlin (2002:225) defines prediction as “a guess about what value an event drawn from a specified population will have on a given variable”. In other words, prediction is a speculation of the outcome of a certain event or change. It would then suffice to say that a prediction assumes that the future of an effect is anticipated and forecasted. In essence, prediction anticipates a direction of causality.

Although prediction by regression anticipates a direction of causality it does not equal causality. It is merely a method of making ‘better-than chance’ predictions and pointing into the direction of causality (Sprinthall, 2003:389). As in the case of the error of inferring causation on correlation, the same applies to regression. Gujarati (2003:696) confirms, “the existence of a relationship between variables does not prove causality or the direction of influence”.

In brief, regression analysis is a statistical forecasting model that can predict the outcome of a given key variable, based on the interactions of other related variables, commonly referred to as explanatory variables.

As with correlation, the aim of regression is to determine whether a relationship between variables is positive or negative. A positive relationship indicates that there is a direct relationship between variables and a negative relationship points



to an inverse relation between variables (Pagano, 1994:112). Levin and Fox (2006:359) confirms this by explaining that

“regression involves placing or fitting a line through the scatter of points: If the line is drawn accurately, the value of a (the Y-intercept) would be the location where the line crosses the Y axis. The value of b (the slope) would correspond to the incline or rise of the line for a unit increase in X”.

This line is called the regression line. The regression line is therefore the equation between x and y (Koop, 2000:38). McLaughlin (2002:233) defines a regression equation as “expressing the relationship between the known value of a predictor variable, x, and the predicted value of variable y, based on the correlation between the two variables. A linear regression equation has the form,  $Y=a+bX$ ”. The regression line is represented by the same values and mechanisms as in correlation plots such as statistical significance and pearson’s r. The regression line is the called the prediction line, the general rule in statistical testing is that pearson’s r typically measures how tightly the points in a scatter plot cluster around the regression line (Sprinthall, 2003:390).

Levin & Fox (2006:363) argue that the assumptions underlying regression are the same as those for Pearson’s r. These assumptions are the basic requirements for both regression and Pearson’s r and include:

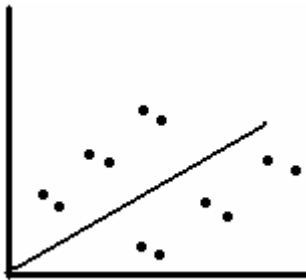
- i) It is assumed that both variables are measured at the interval level.
- ii) A straight-line relationship is assumed. If this s not the case, there are various transformations (which are more advanced than this study) that can be used to make the relationship into a straight line. Also, if extremely deviant cases are observed in a scatter plot, these should be removed from the analysis.
- iii) Sample members must be chosen randomly to employ test of significance.
- iv) To test the significance of the regression line, one must also assume normality for both variables or else have a large sample.

(Levin & Fox, 2006:363).

A word of caution is in order in regards to sample size. Predictions based on small samples tend to be unstable, by utilizing all the data rather than a small subset, prediction can be improved (Kirk, 1999:186).

In addition to the above, Sprinthall (2003:390) asserts that in order to make predictions, three important facts about regression must be known. These include the extent of the scatter around the line, the slope of the line and the point where the line crosses the Y axis (Sprinthall, 2003:390).

Firstly, the extent of the scatter around the regression line, the closer the points on the scatter plot cluster around the regression line, the higher is the resulting correlation between X and Y, and the more accurate is the resulting prediction (Sprinthall, 2003:390). Consequently, the higher the correlation, the more accurate is the prediction because more information about Y is being carried in X (Sprinthall, 2003:391). As illustrated in figure 1.2, the regression line is the line that lies closest to the data points and pearson's  $r$  measures the closeness of the data points, or scatter, to each other.



**Figure 1.2. Regression line (McLaughlin, 2002:236).**

Secondly, the manner in which the regression line tips, or slopes, greatly affects the prediction (Sprinthall, 2003:391). The slope of a regression line reflects the degree to which the predicted variable, Y, increases or decreases as the predictor variable, X increases, in the regression equation,  $Y=a+bX$ , the value  $b$  represents the slope (McLaughlin, 2002:233). Sprinthall (2003:392) explains that

by knowing the sign of the slope is not enough. The degree of the slope is necessary for accurate prediction. The degree of the slope is the measurement between a positive or negative positive value. Sprinthall (2003:392) concludes that the degree of the slope is determined by the amount of change in Y that accompanies a given change unit change in X.

Finally, with regards to the point where the regression line crosses the Y axis, to make a prediction, the point where the regression line crosses the ordinate must be known (Sprinthall, 2003:392). Thus, the value of y when X is equal to zero must be established (Sprinthall, 2003:392). This is called the Y-intercept. McLaughlin (2002:233) define the Y-intercept as being “the predicted value of Y when the value of the predicted variable X is 0. In the regression equation, the value a represents the Y-intercept”.

The simultaneous use of two or more independent variables in predicting a dependant variable is called multiple regression (Kirk, 1999:200). The concept of normal regression referred to as simple linear regression is thus extended to the use of two or more variables, thus implying multiple regression. Hence, when confronting multi-variate problems, those in which several variables are intercorrelated with one another, multiple regression is applied (Sprinthall, 2003:405).

Instead of simply attempting to determine how much information about Y is contained in X (the goal of Pearson's R), a multiple regression establishes how much information about Y is contained in  $X_1$ ,  $X_2$ ,  $X_3$ , and so on (Sprinthall, 2003:405). The calculations of multiple regression as a generalisation of regression are quite complex, so computers are almost always used (Levin & Fox, 2006:376).

When working with multiple variables, the researcher often does not know which independent variables should be taken into account, the researcher then applies

an automatic selection procedure. This selection procedure is done through the use of computer programmes. The different selection procedures include pairwise, listwise, stepwise, backward and forward. The selection is an advanced step that, done by computer programmes and therefore won't be discussed in detail.

Pairwise selection deletes missing cases, meaning missing cases will only be excluded for each pair of variables (Bryman & Cramer, 2001:178). Listwise deletion of missing data implies that the correlation coefficients will only be produced on those cases for which data are available for all the variables (Bryman & Cramer, 2001:178). In backward elimination of variables, variables are deleted from the model based on their minimal contribution to the prediction criterion variables (Lomax, 2001:64). In the case of forward deletion of variables, variables are added or selected to the model based on their maximal contribution to the prediction of the criterion variable (Lomax, 2001:64).

The stepwise selection procedure is a modification of the forward procedure, but in every step all the regression coefficients must be significant, or the variable is eliminated (Lomax, 2001:64-65). The stepwise procedure can combine the backward and the forward procedure.

Analysis of variance and regression analysis share a commonality, in that both approaches seek to analyse the impact of independent variables on explanatory variables. The next section introduces the concept of analysis of variance.

### **1.5 Analysis of Variance.**

The analysis of variance (ANOVA) is an extension of the t-test. The t-test determines the difference between sample means by testing whether the mean of one population is different from the mean of another population (McLaughlin, 2002:448). The t-test is a standard error test that compares two means. The

difference between ANOVA and the t-test is that ANOVA measures multiple group cases and the t-test only compares to groups. The t-test as a standard error test is interrelated with the standard deviation. The t-test measures the difference between sample means by comparing the standard deviation between groups of scores to the deviation within each group of scores (McLaughlin, 2002:449). In short, the t-test reflects the deviations within groups and between groups.

As mentioned above, ANOVA as an extension of the t-test share the same assumptions and methods. ANOVA generates statistics, labeled the f-test or f-ratio, which is the same as the t-test, that compares the degree to which the sample means differ from each other to the degree to which the scores within a sample differ from each other (McLaughlin, 2002:478).

In contrast to the t-test the f-ratio compares the means of more than two values. The higher the f-ratio, the greater the likelihood that the sample contain more than one population, whereas a lower f-ratio indicate a greater chance that the sample represent one population (Sprinthall, 2003:344).

Apart from the f-ratio, variability within a sample is a determining factor in calculating variance. Kirk (1999:459) defines ANOVA as “a procedure for determining how much of the total variability among scores to attribute to various sources of variation and for testing hypothesis concerning some sources”. In short, ANOVA is used to determine whether variations are due to variability between or within methods. ANOVA is concerned with the differences between means and not the variations, the name analysis of variance comes from the way the procedure uses variances to decide whether the means are different (Anon3, Internet source).

Like the t-test, the analysis of variance assumes that only the mean of the scores is affected by the independent variable and not the variance (Pagano, 1994:374).

Hence a change in the independent variable will have an effect on the variance between groups. Pagano (1994:378) explains this by adding that “as the effect of the independent variable increases, the differences between the samples mean means increase”.

Variability implies that scores vary in an experiment (Hinton, 2004:113). ANOVA is used to measure the variance within and between groups of a sample and not the direction. Thus, ANOVA compares the scores within a sample (Hinton et al., 2004:150). King and Minium (2003:390) define within group variation as the “variation of scores around the mean in a single treatment condition”. King and Minium (2003:391) further contends that between group variations imply “variation among the means of the different treatment conditions”. The definition of within group variation implies that scores can vary only because of inherent variation, whereas between group variations, means can vary because of inherent variation and treatment effect (King & Minium, 2003: 390-391). The initial step of measuring the total variation between and within groups is called the *sum of squares* (Levin & Fox, 2006:270).

ANOVA pre-requires a number of assumptions. The assumptions of ANOVA are similar to the fundamental assumptions of regression analysis. Firstly ANOVA requires that all samples are randomly selected. Secondly, it is required that regression is linear. Thirdly, it is required that all values are normally distributed. Lastly, it is required that variance be homogenous for all treatments (Lomax, 186-191).

As mentioned earlier, this study makes use of the computer program called SPSS, in SPSS, ANOVA performs a number of options, and these options include:

- i). Test for equality or homogeneity of regression slopes.
- ii). Use of multiple variates and covariates.
- iv). To analyse complex designs.

- v). Options for unique, hierarchical and experimental methods.
- vi). To provide adjusted and unadjusted means and procedures for testing contrasts.  
(Lomax, 2001:197).

### **1.6. Reliability.**

The different methods of reliability were discussed in chapter two. The main aim of this study is to test the reliability of three current risk assessment models, in testing reliability two tests of reliability was applied in this study. The first test is that of internal reliability and inter-rater or inter-coder reliability, and the second test is split-half (cronbach's alpha).

Internal reliability is used when multiple items is applied in a test. Split-half reliability determines whether each item or unit measures a single idea (Bryman & Cramer, 2001:62). SPSS uses split-half reliability and applied *cronbachs alpha* in this study. SPSS is brilliant for analysing questionnaires for it enables the comparison and exposure of relationships within in and amongst items being tested (Hinton, et al., 2004:356).

This study made use of multiple expert opinions, hence the questionnaire's inter-rater reliability was measured. The consistency of the respondents answers was compared. Within a questionnaire the internal-reliability is measured by splitting the answers in half and comparing the correlations and relationship of data sets (Hinton, 2004:302).

Cronabch's alpha is based on the number of items and the inter-item correlation (Hinton et al, 2004:357). As mentioned earlier cronbach's alpha measures whether all items are testing the same idea. This single idea is called a true score. And a complete reliable true score ranges from one to a unreliable score of zero. In some cases it can dip below zero (Hinton, et al, 2004:357). Therefore

a high correlation between items will indicate a reliable true score and instances of some random error or a completely reliable test, whereas a low correlation is indicative of an unreliable or completely unreliable test. It is thus clear that cronbach's alpha share the same assumptions as previous discussed linear regression and multiple regression for it employs correlation analysis (Hinton, et al, 2004:357).

Thus, cronbach's alpha will increase when correlations between the items increase. Hence, the coefficient is called the internal consistency of the test (Hinton, 2004:302).





## APPENDIX B

### 1. Country Indicators for Foreign Policy (CIFP)

#### Armed Conflict

1: low risk, 9: high risk

Country	1996	1997	1998	1999	2000	Global Rank Score
Afghanistan	8	7	8	8	7	7.6
Belarus	*	*	*	*	*	*
Colombia	6	7	6	6	6	6.2
DRC	3	8	8	7	*	6.5
Ethiopia	9	7	2.5	9	9	7.3
India	9	9	9	9	9	9
Indonesia	4	5	5	4	3	4.2
Jamaica	*	*	*	*	*	*
Rwanda	6	6	7	7	2	5.6
Sierra Leone	6	6	5	7	8	6.4
Sudan	8	8	9	8	6	7.8
Ukraine	*	*	*	*	*	*
Venezuela	3	*	*	*	*	3

#### Level of Democracy

1: strong democracy, governance and political stability, 9: weak

Country	1996	1997	1998	1999	2000	Global Rank Score
Afghanistan	8	8	8	8	8	8
Belarus	6	8	8	8	8	7.6
Colombia	3	3	3	3	3	3
DRC	*	*	*	*	*	*
Ethiopia	6	6	6	6	6	6
India	2	2	2		2	2
Indonesia	8	8	8	8	3	7
Jamaica	2	2	2	2	2	2
Rwanda	8	8	8	8	7	7.8
Sierra Leone	8	8	8	8	8	7.4
Sudan	8	8	8	8	8	8
Ukraine	4	3	3	3	4	3.4
Venezuela	3	3	3	3	3	3

#### Regime Durability

1: high durability, 9: low durability

Country	1996	1997	1998	1999	2000	Global Rank Score
Afghanistan	9	9	8	8	8	8.4
Belarus	9	9	8	8	8	8.4
Colombia	2	2	2	2	2	2
DRC	9	9	9	9	9	9
Ethiopia	9	8	8	8	7	8

India		2	2	2	2	2
Indonesia	2	2	2	2	9	3.4
Jamaica	2	2	2	2	2	2
Rwanda	9	8	8	8	7	8
Sierra Leone	3	9	9	9	9	7.8
Sudan	5	5	5	5	5	5
Ukraine	6	6	6	6	5	5.8
Venezuela	3	3	3	3	3	3

### Corruption Level

1: low score on corruption, 9: high score on corruption

Country	1996	1997	1998	1999	2000	Global Rank Score
Afghanistan	*	*	*	*	*	*
Belarus	6	6	5	*	*	5.7
Colombia	7	9	9	7	7	7.8
DRC	*	*	*	*	*	*
Ethiopia	7	*	*	*	*	7
India	8	8	8	7	7	7.6
Indonesia	8	8	9	9	9	8.6
Jamaica	6	5	*	*	*	5.5
Rwanda	*	*	*	*	*	*
Sierra Leone	*	*	*	*	*	*
Sudan	*	*	*	*	*	*
Ukraine	8	7	9	*	*	8
Venezuela	8	8	9	7	8	8

### Ethnic Risk

1: low risk of ethnic rebellion, 9: high risk

Country	Global Rank Score(Single Measure)
Afghanistan	9
Belarus	4
Colombia	6
DRC	8
Ethiopia	8
India	9
Indonesia	9
Jamaica	*
Rwanda	6
Sierra Leone	5
Sudan	7
Ukraine	8
Venezuela	6

\* no rating available for country, country is off cover and no data is available.

**2. FREEDOM HOUSE**  
**Table of Independent**  
**Countries**

Trend Arrow	Country	PR	CL	Freedom Rating
↑	DRC*	6	6	Not free
	Rwanda	7	5▲	Not free
	Sierra Leone	4	4▲	Partly free
	Belarus	6	6	Not free
	Jamaica	2	3	Free
	Ukraine	4	4	Partly free
	Indonesia	3	4	Partly free
	Ethiopia	5	5	Partly free
	Sudan	7	7	Not free
	Colombia	4	4	Partly free
↓	India	2	3	Free
	Afghanistan	6▲	6▲	Not free
	Venezuela	3	4▲	Partly free
	Dominican Republic	2	2	Free

**PR:** Political rights

**CL:** Civil liberties

**1:** Most free

**7:** Least free

↑↓: Indicates general trend in freedom

▲▼: Indicates a change in political rights or civil liberties since the last survey

\* : Congo (Kinshasa)



### 3. Political Risk Services (PRS/ICRG)

#### POLITICAL RISK POINTS BY COMPONENT - MARCH 2004

*This table lists the total points for each of the following political risk components out of the maximum points indicated. The final columns in the table show the overall political risk rating (the sum of the points awarded to each component) and the change from the preceding month.*

COUNTRY	A	B	C	D	E	F	G	H	I	J	K	L	Political Risk Rating	Rating in 02/04	Monthly Change	
	A	Government Stability				12					G	Military in Politics		6		
	B	Socioeconomic Conditions				12					H	Religious Tensions		6		
	C	Investment Profile				12					I	Law and Order		6		
	D	Internal Conflict				12					J	Ethnic Tensions		6		
	E	External Conflict				12					K	Democratic Accountability		6		
	F	Corruption				6					L	Bureaucracy Quality		4		
Belarus	10.0	2.5	5.5	10.0	10.5	2.0	5.0	4.5	4.0	5.0	2.0	1.0	62.0	62.0	0.0	
Colombia	8.0	4.0	8.5	3.5	8.5	3.0	2.0	5.0	1.0	5.0	3.0	2.0	53.5	53.5	0.0	
DRC	9.0	1.0	6.0	7.0	9.0	1.0	0.0	4.0	1.0	1.0	1.0	0.0	40.0	40.0	0.0	
Dominican Republic	7.0	4.0	8.0	9.5	9.5	2.0	3.0	5.0	2.0	4.0	5.0	1.0	60.0	59.0	1.0	
Ethiopia	7.5	2.0	7.0	9.0	7.5	2.0	1.0	5.0	5.0	2.5	4.0	1.0	53.5	53.5	0.0	
India	9.0	3.5	9.5	8.5	9.5	2.0	4.0	2.5	4.0	2.5	6.0	3.0	64.0	62.5	1.5	
Indonesia	8.5	3.5	6.0	7.5	11.0	1.0	2.5	1.0	2.0	2.0	4.5	2.0	51.5	51.5	0.0	
Jamaica	8.5	5.0	9.5	9.5	11.0	1.5	6.0	6.0	1.0	5.0	4.0	3.0	70.0	70.0	0.0	
Sierra Leone	11.0	2.0	7.0	10.5	10.5	2.5	2.5	4.0	3.0	2.0	3.0	0.0	58.0	56.5	1.5	
Sudan	10.0	2.5	7.5	8.5	10.0	1.0	0.0	2.0	2.5	2.0	3.5	1.0	50.5	48.0	2.5	
Ukraine	8.0	5.0	6.0	9.5	9.5	1.0	5.0	5.0	4.0	4.0	2.0	1.0	60.0	59.5	0.5	
Venezuela	8.0	3.0	4.0	7.0	9.5	1.5	0.5	5.0	1.0	5.0	4.0	1.0	49.5	49.5	0.0	

## APPENDIX C

### 1. The Economist

The Economist chose six political variables worth a total of 50 points in weight and four social variables worth 17 points to represent the origins of what is generally called “political risk”. They are described briefly below.

- **Bad Neighbours** (3 negative points)

This refers to the country’s situational context. Being near any superpower almost automatically means trouble in that superpowers tend to control their peripheries, often with the use of force. Trouble spots are those with a history of being ‘disturbed’ or with historically continuous violence.

- **Authoritarianism** (7 points)

Whether totalitarian or authoritarian, the lack of democracy in a state forebodes ill: even rigid totalitarian control is only a temporary holding pattern; disruption and probably violence will seethe underneath.

- **Staleness of Leadership** (5 points)

The argument is that a leader needs about five years to get his or her bearings and a grip on the situation but after 10 years he begins to get detached and stale. Complacency accompanies entrenchment, along with corruption, disdain and delay.

- **Illegitimacy** (9 points)

Legitimacy implies an uncoerced and positive acceptance on the part of the population of a state. Political risk is a function of the gap between acceptability and a government’s persistence in power.

- **Generals in Power** (6 points)

In response to instability or the lack of competent civilian authority (or the military’s perception of competent), military authorities often step in and take control themselves. The Economist argues that most military people do not know how to govern or how to step aside gracefully.

- **War/ Armed Insurrection** (20 points)

War, the most impactful of any of the variables selected, clearly penetrates the investment picture in a number of ways. Apart from the obvious destruction of physical facilities, war disrupts the economy and brings about losses in a number of other ways. Raw goods and supplies are delayed or diverted to war use.

- **Urbanisation Pace** (3 points)

When the urbanisation process is too rapid, or is too concentrated on a single city, a number of problems accompany the shift. These include ‘idleness and crime’, an expansion of the drug trade, and economic irregularities, such in the pricing of food. It is not the fact of urbanisation itself but rather the process and its effect on the society that threatens the foreign investor.

- **Islamic Fundamentalism** (4 points)

The Economist argues that Muslim radicals could pose a risk to investor; the risk is especially high where the investors are foreign and not Muslim.

- **Corruption** (6 points)

Corruption can distort the economy in ways that the best of investor awareness or even power cannot accommodate.

- **Ethnic Tension (4 points)**

Ethnic, religious, and racial tension provides an environment in which simple industry does not suffice. It may redirect government attention, invoke restrictions on investors, restrict labour resources, or result in open conflict. Governments may fall on the basis of its convolutions.

Scores are assigned to how countries rate in 2004:

Table 1 *The Economist*

Note: Scores are weighted: maximum score in parentheses with zero indicating no risk and higher levels up to the specified maximum. Higher scores thus mean higher risk.

Country	neigh(3)	auth(7)	stal(7)	ille(9)	gene(6)	war(20)	urban(3)	islam(3)	corr(6)	ethn(4)	totl
ex: China	0	1	1	2	0	2	0	0	2	2	11
DRC											
Rwanda											
Dmn Rep											
Sierra Leone											
Belarus											
Jamaica											
Ukraine											
Indonesia											
Ethiopia											
Sudan											
Colombia											
India											
Afghanistan											
Venezuela											

## 2) BERI.

The Business Environment Risk Intelligence (BERI) Index is based on scores assigned to 10 political variables by experts. The BERI Index is clearly identified as being socio-political. Each of the 10 BERI variables can be assigned as many as seven points by the expert analyst. A seven represents optimal circumstance, the least amount of risk. An optimal, without – risk situation would be represented by a 70.

The 10 variables are divided into three categories: ‘internal causes of political risk’, ‘external causes of political risk’ and ‘symptoms of political risk’. An additional value may be assigned to any of the first eight internal or external variables if the condition reflected by the variable is notably favourable for business operations. The total of these bonus points may range as high as 30, making a maximum of 100 points possible if the risk conditions were absolutely perfect. The expert is expected to provide scores as at 1994 till 2004. Please complete the textboxes provided next to each variable.

### *Internal Causes of Political Risk:*

- **Fractionalisation of the political spectrum and the power of these factions.** This political variable represents divisions among political or ideological perspectives in the society, with numbers of perspectives

seen as representing a threat to consistency and regularity in political processes. When strength is added to numbers, the score to be assigned is reduced.

	1994:	2004:
Ex. Egypt	6	0
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

- **Fractionalisation by language, ethnic or religious groups and power of resulting factions.** Risk would be increased by a compounding of the divisions, as well as by increased power of the distinct groups. This variable parallels the 'ethnic tension' variable employed in *The Economist* model.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

- **Restrictive measures required to retain power.** This variable can be equated to the 'authoritarianism/ totalitarian' variable in *The Economist* model. The existence of authoritarianism or the use of coercive measures reflects the prospects of arbitrary action, abrupt changing of rules, and alienation due to a government's handling of the implementation of decisions. While alienation most directly represents the latter, the business firm might be more concerned by the decision-making structure that would or could choose to make use of such measures.

	1994:	2004:
DRC:		

Rwanda:  
 Dominican Republic:  
 Sierra Leone:  
 Belarus:  
 Jamaica:  
 Ukraine:  
 Indonesia:  
 Ethiopia  
 Sudan:  
 Colombia:  
 India:  
 Afghanistan:  
 Venezuela:

- **Mentality, including, xenophobia, nationalism, corruption, nepotism and inclination to compromise.** There are some cleavages between subgroups of this set. Xenophobia and nationalism, and perhaps willingness to compromise indicate mentality. Xenophobia and nationalism relates to willingness to compromise. Corruption and nepotism are related and indicate willingness to compromise. Willingness to compromise might co-exist with example corruption. Nevertheless, the expert must give a single score for mentality, blending the five factors.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

- **Social conditions including extremes in population density and the distribution of wealth.** This variable parallels *The Economist's* 'urbanisation' variable. This variable includes crime, unemployment, drug use, illiteracy and health conditions. The wealth distribution entails the disparity between levels of society.


	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		



Indonesia: Ethiopia Sudan: Colombia: India: Afghanistan: Venezuela:
---

- **Organisation and strength of forces for a radical left government.** The power of opposing factions can pose a risk to the government of the day.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		



*External Causes of Political Risk:*

- **Dependence or importance of hostile major forces.** This variable closely parallels the variable 'bad neighbours' in *The Economist* model. This variable indicates a concern about major power involvement.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

- **Negative influence of regional political forces.** This variable represents the concern for violent regional forces. This variable is

parallel to the variable 'bad neighbours' in *The Economist* model. This concern also involves past colonial ties.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

*Symptoms of Political Risk.*

- **Societal conflict, demonstrations, strikes and street violence.** This civil strife variable is encompassed by *The Economist's* 'war and civil strife' variable. Concern is with the nature of the environment of business operations.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		
Indonesia:		
Ethiopia		
Sudan:		
Colombia:		
India:		
Afghanistan:		
Venezuela:		

- **Political instability, non-constitutional changes, guerrilla wars etc.** Instability is one of the most enduring concerns of firms doing business outside their own domains. Political stability is thus the focus.

	1994:	2004:
DRC:		
Rwanda:		
Dominican Republic:		
Sierra Leone:		
Belarus:		
Jamaica:		
Ukraine:		

Indonesia: Ethiopia Sudan: Colombia: India: Afghanistan: Venezuela
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### ***Political Risk Services***

The indicators used in the Political Risk Services model relate to the situations of potential loss for foreign investors in the country being analysed. In the case of each of the indicators, the probabilities are that “a major loss will be sustained by foreign business in the next eighteen months or in the next five years.

- **Political turmoil probability.** Political turmoil can be described as actions taken in the political sphere of a society that does not fully adhere to rules of law or social norms. “Civil strife” comes to reflecting the same phenomenon, although the turmoil will not necessarily involve the level of outright violence that is associated with strife.
- **Equity Restrictions.** Equity can be forcibly shared, after the fact of investment through imposition of new regulations.
- **Personnel or procurement interference.** Government regulations can restrict certain types of hiring, with respect to investor country nationals or with respect to ethnic group hiring, numbers in management positions, and daily hours of employment. Similar restrictions can be placed on sources for procurement.
- **Taxation discrimination.** Preferential taxes can be given and lifted, not always through an adjudicated process.
- **Repatriation restrictions.** The specific problem of inconvertibility appears as one of the variables of direct concern in the PRS template.
- **Exchange controls.** Although exchange controls can result in a variety of limitations and associated losses, it is also one of the direct sources of inconvertibility.
- **Tariff imposition.** New and unanticipated tariffs, often resulting from confrontations between governments and economic systems, are one of the significant add-on costs that can affect the trader. Some tariffs are intended to generate income, often compensating for budget losses or deficiencies that have come about as a result of poor government planning.
- **Non-tariff barrier imposition.** Like tariffs, non-tariff barriers are generated in cross-national economic conflicts. Unlike tariffs, they are not likely to be created as purely income earning devices.
- **Payment delays.** Imposed limitations on the movement of funds to cover costs.
- **International borrowing liability.** Government policies often result in circumstances where borrowing is a necessity to maintain programs that brought that government to office or help it retain its place of power. While some borrowing is a function of the situation as a

previous government has provided it, it is at least partly a matter of retaining power along with an effort to make viable economic adjustments.

- **Fiscal or monetary expansion.** Monetary policy can be a function of mistakes or poor planning by the government in other aspects of the economy.
- **Labour cost expansion.** Some labour cost expansion may be a result of efforts to mollify political sectors of the society.

An economic forecast worksheet is provided bellow to be completed by the expert. When completing the provided economic forecast worksheet, for “1994”, provide the figure for the most recent year for which you have a reasonable estimate of real growth of GDP, inflation, and 1994 account balance. The first number in the first blank next to the 12 variables is obtained from current listings. These 1994 risk or restriction levels are scaled as follows:

<u>Risk level</u>	<u>Value</u>
Low	=0
Moderate	=1
High	=2
Very High	=3

The second blank represents the forecast of probability as at end 2004. Filing in the second and blanks for all 12 variables are scaled as follows:

<u>Forecast</u>	<u>Value</u>
Less=	-1.0
Slightly less=	-0.5
Same=	0.0
Slightly more=	+0.5
More=	+1.0
Much More=	+2.0

<b>PRS Risk projections for DRC</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Rwanda</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Dominican Republic</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

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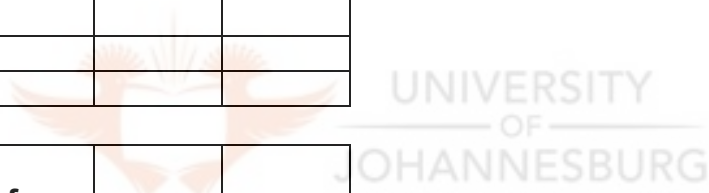
<b>PRS Risk projections for Sierra Leone</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		

Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Belarus</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Jamaica</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Ukraine</b>		
	1994	2004
Turmoil		



Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Indonesia</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

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<b>PRS Risk projections for Ethiopia</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		

Foreign Debt		
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<b>PRS Risk projections for Sudan</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Colombia</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

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<b>PRS Risk projections for India</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		



Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Afghanistan</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		

<b>PRS Risk projections for Venezuela</b>		
	1994	2004
Turmoil		
Equity Restrictions		
Local Operations Restriction		
Taxation Discrimination		
Repatriation Restrictions		
Exchange Controls		
Tariff Barriers		
Other Barriers		
Payment Delays		
Fiscal/Monetary Expansion		
Labour Costs		
Foreign Debt		