

Techniques of Political Risk Evaluation for Foreign Investment

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Foreign investment, Foreign direct investment, Political risk, Sovereign risk, Quantitative analysis, Qualitative analysis, Multinational corporation

I. Scope of this Paper

The energy crisis of 1973, which shocked the world into sudden recognition of the strategic role of oil, signalled the start of a new era for the world economy. It also created new problems and new opportunities for multinational corporations.

If a multinational corporation is to remain successful, expand its activities, and discover and exploit new opportunities, greater astuteness than ever before will be required on the part of management, as well as better planning and a higher degree of adaptability. Above all, the most important role of management is the performance behavior of decision making which is based on accurate risk forecasts derived from thorough analyses of the political and economic conditions of host countries.

In the process of management decision making for foreign invest-

ment, among the most important determinants are the political risk factors which may threaten the ownership of foreign assets or the multinational's freedom of operations: discrimination, distrust, antagonism, nationalism, and excessive and unreasonable restrictions are the sources of problems which interfere with profitable operations.

No matter how successful a foreign operation is "business-wise", interference from or changes in regulations by the host government can result in a loss of assets or profit potentials. The threat of having foreign assets expropriated is so crucial and permanent a risk, that any steps that can be taken to assess the likelihood of such an action can be of significant importance in protecting assets and in insuring the flow of profits.

There are three types of environmental adversities in relation to foreign investment, which are defined by Zenoff and Zwick as follows:¹⁾

- 1) The possibility of losing company-owned assets and/or freedom to operate in the foreign country as a result foreign government policy;
- 2) The possibility of host country or lending country balance of payments problems which may result in restrictions on the movement of funds between national jurisdictions and result in the loss in the dollar value of assets and profitability of the foreign affiliate, and;
- 3) The possibility of price inflation in foreign localities, thus seriously impeding the firm's ability to conduct successful operations.

In 1980, Mitsui & Co., the second largest Japanese multinational corporation, invested \$700 million in petrochemical plant in Iran. Not

only did this investment fail to produce a return, but Mitsui & Co. eventually even lost their equity participation in the project.²⁾ IBM (International Business Machines) Corporation pulled out of Nigeria at the end of 1978, because of that nation's foreign investment law. It also closed down its operations in India for the same reasons.³⁾

Over the last several years, countless similar incidents have occurred in developing countries. Yet, despite these obstacles, there are often sound financial motives for making such investments. In fact, numerous surveys have indicated that the return on foreign direct investment is often higher than the return on domestic investment. In 1979, Ford Motor Co. showed huge deficits in its North American (Canada and the U. S.) automotive operations. Its U. S. operations alone, which included some rather profitable non—automotive business, showed a loss of \$199 million. On the contrary, all its other operations produced profits of \$1.4 billion.⁴⁾

The largest Japanese multinational, Mitsubishi Corporation, is earning \$150 million per year in dividends from its \$583 million worth of foreign investment, which is a much higher rate of return than from its domestic investment.⁵⁾

These different outcomes depend heavily on the political and economic conditions existing in the host countries. No matter how profitable an investment in a given country may seem from a commercial point of view, political instability may cause serious damage to the investment, particularly in developing countries where political instabilities are more likely to exist.

In the process of management decision making for foreign investment, management collects data on the country in which the investment is to be made. The data should be carefully analysed and evalu-

ated based on certain criteria, which may be either of a subjective or objective nature. This paper will look at the various techniques which are routinely applied in order to assess the degree of political risk of a host country chosen for foreign investment, and will end on a note of caution for risk analysts and the companies which employ them.

II. The Definition of Political Risk

Political risk includes socio—political and economic risks. Commercial risk is not included in political risk, because it is considered to be of the same nature as the risk inherent in any ordinary business investment. On the other hand, socio—political and economic risks are predominant in foreign investment. Political risk is generated by political and social turmoil induced by changes in political powers or by social instabilities. This is a sovereign risk which is, to a greater or lesser degree, predetermined by the autonomy of the host country government. A private investment in a given country is more or less likely to be expropriated or nationalized by the government in power depending on its policies.

The degree of economic risk itself is closely evaluated, to some extent, based on statistical indicators. However, those risk factors which are socio—political in nature are, in most cases, closely related to government policy, and, thus, may not be subject to evaluation based on statistics. Socio—political risk factors are, to a large extent, qualitative in nature, and the degree of risk can best be measured only subjectively, in many cases.

Definitions of political risk that focus on environmental uncertainties or changes can lead analysts of risk to focus their attention too

closely on trying to predict with certainty political changes, and thus, their analyses may be of limited benefit to corporations involved in foreign investment. And further, while analysts have hitherto tended to focus their predictions on a limited number of types of political events——war, expropriations, new exchange controls, etc.——the definition of what constitutes a political risk has been expanding to include numerous other types of risks with which today's corporations, whether directly or indirectly, are faced.⁶⁾

III. Methods of Evaluating Political Risk

The goal of the assessment of risk is to gather data, analyse them, and then provide management with information so that it will be better equipped and able to identify the possible outcome of particular courses of action and to estimate the probability of the occurrence of certain events which might have negative impact on business operations.

This section discusses a simplified framework for the analytical methods frequently employed for evaluating political risk. The discussion focuses on risk which is analysed from the point of view of a private corporation making a foreign investment in developing countries.

Primarily, there are two different types of analytical methods for evaluating investment risk, called, simply, "quantitative analysis" and "qualitative analysis", respectively. The features of these two types of analysis are described below.

A. Quantitative analysis

Quantitative analysis is a method of evaluating countries by rating

in cross-section, using major economic indicators and other social and political factors which are scored according to their degree of risk reflection. This emphasizes the quantitative factors. The advantage of this analytical method is the elimination of subjectivity to some extent. This method is further sub-divided into two systems; one is *the checklist system* and the other employs more sophisticated *advanced quantitative techniques*. These two systems may be differentiated as follows:

1) The checklist system

In this system each country's performance is scored with respect to various indicators or variables. The indicators are often quantitative, in which case the scoring requires no judgement—or even first-hand knowledge—of the country being scored. Where the indicators are qualitative, the scoring involves some subjectivity. The score on each indicator may be aggregated into a summary score for each country using a common set of subjectively determined weights—*the weighted-checklist approach*. It is also possible to weight each variable's contribution equally in determining the final score—*the unweighted-checklist approach*.

The summary score or country rating, which is the bottom line of the weighted checklist approach, is easily interpreted, and cross-country comparisons are simple. Arguably, these features of the weighted-checklist approach may encourage too much reliance on the weighted-checklist's score to the detriment of relevant non-quantifiable factors.⁷⁾

2) Advanced quantitative techniques

There are other quantitative techniques for evaluating investment risk. One of the techniques under development by the Ex-Im Bank is

an approach which tries to overcome some of the problems of the standard checklist system——particularly the subjectivity attending the selection and weighting of the component variables——by choosing the variables and selecting the weights on the basis of standard econometric and statistical tests of predictive accuracy. The World Bank has developed the “two-gap” model. This approach uses two independent estimates provided by econometric techniques.

B. Qualitative analysis

Qualitative analysis is a method of making available the evaluation of risk in terms of quality based on both perceptible facts and a future-oriented perspective on the socio-political and economic factors of the country.

The characteristics of investment risk are essentially quality oriented, and the degree of political risk, for example, is hardly measurable or quantifiable. As a general trend in the business community, management decisions in foreign investment are based to some degree on a combination of both quantitative and qualitative analyses.

Qualitative analysis is also sub-divided, but into three systems, called: *the fully qualitative system*, *the structured qualitative system*, and *the multivariate analytical system*. These may be differentiated as follows:

1) The fully qualitative system

This type of investment risk evaluation system employs qualitative reports regarding the host country's social, political and economic conditions and prospects, gathered from various sources.

In many instances multinational corporations seek to acquire area or country expertise from scholars, diplomats, business executives, or journalists, as well as from specialists, consultants or advisors.⁸⁾ Dr.

Henry Kissinger is retained as an international advisor by the Chase Manhattan Bank, for example. Mobil Oil hires former U. S. Ambassador Christian A. Herter, Jr. as its Vice President. CitiBank's Senior Advisor for International Operations is Irvin S. Freedman, who formerly held several prominent positions with the IMF.

In these cases, assignments include assessment of objectives and personalities of a country's current leadership, the strengths and weaknesses of competing political groups, and the likelihood of new legislation. Management executives of multinational corporations or international banks are heavily dependent on the advice and suggestions of these experts, despite having available a substantial number of analyses employing other methods.

In the use of this approach to the management decision process, a corporation puts implicit faith in the judgment and reports of outsiders. Such an approach has obvious drawbacks, but it can provide management with a better understanding of political realities, and thus, of the risks attendant in undertaking a foreign investment. These reports, however, are quite subjective, because they lack a standard format. Therefore, the criteria for evaluating investment risk will vary in depth and scope from country to country.

2) The structured qualitative system

This type of risk evaluation system is the one most commonly used. The system is referred to as the Delphi Method and offers a more systematic approach to risk assessment than the fully-qualitative system.⁹⁾

First, selected variables or indicators are identified in terms of their assumed reflection of the degree of political risk of the country or countries under consideration. Next, a wide range of experts are

asked to score these variables. Each variable is weighted subjectively in accordance with its importance. Then, scores are aggregated and magnified by the weights to construct a ranked checklist or index.

This system is organized around a standardized country evaluation report, supported by economic statistics which may vary somewhat among countries. The most common rating scheme is a five-grade letter (or number) system, e. g., 'A' through 'E' (or '0' through '4').

By this assessment technique, management is able to classify all countries in which they are interested on a high—, moderate—, or low—risk basis. The checklist or index approach provides management with judgmental data for “go”/“no go” decisions on an investment. However, for this assessment technique to be adequately useful, the following are important factors:

- a) The comprehensive and accurate listing of variables (determinants) of political risk.
- b) The well—seasoned and timely opinions of knowledgeable professionals.
- c) An appropriate mechanism for weighting and combining individual opinions.

If any of these critical factors are missing, the outcome can be erroneous.

3) The multivariate analytical system

New tools and techniques using multivariate analysis not only allow corporate decision makers to examine complex political issues, but also to confirm intuitive impressions based on more subjective approaches.

Multivariate analysis has two uses: to predict future political trends on the basis of current and historical information, and to de-

scribe more fully the underlying relationships affecting a nation state.¹⁰⁾ This approach is an attempt to overcome some of the problems of the checklist system——particularly the subjectivity attending the selection and weighting of the variables. A weighted checklist using econometrically selected variables and weights is likely to have greater predictive accuracy. Nevertheless, this technique is rarely used in foreign investment because of the following reasons: one, because this approach occasionally leads to unrealistic outcomes; and two, because the time and costs of developing an analysis program are quite substantial compared with the benefits of obtaining accurate outcomes. This approach has, so far, been under development in both the academic and banking communities.

In all of the systems mentioned above, fully qualitative, structured qualitative, or multivariate analytic, there is no numerical rating for each country, but merely a descriptive evaluation.

Ford Motor Co. tries to avoid quantifying political risk factors too precisely. In 1977, Ford set up an external environmental evaluation department. Its task is to scan the environment to obtain the data necessary to reach decisions. They do not use any specific inputs exclusively, but try to gather as much information as possible for later distillation. The company tends to evaluate political risk in terms of low, medium or high risk.

By and large, there is no standard or unified approach for political risk evaluation used by multinational corporations or foreign lending institutions. Many of them employ any one or several of the techniques described above in combination.

IV. Political Risk Indices

There are three indices of political risk evaluation published commercially in the U. S. They are: 1) the Business Environment Risk Index (BERI); 2) the Business International Index (BI), and; 3) the World Political Risk Forecast (WPRF). These indices are widely used by multinational corporations and foreign lending institutions in Japan, Europe, and the U. S.

In general, these approaches are, more or less, in the category of quantitative analysis. All relevant socio—political and economic risk factors, including those of a qualitative nature, are quantified and periodically re—evaluated by experts in the social and political sciences, as well as by specialists in economics and other pertinent areas.

Each factor is also given a certain weight in accordance with its degree of risk reflection by each index publisher. These two evaluations, one by the experts and the other by the publishers, are aggregated and consolidated to make up the rating list.

Although the techniques are quantitative, the standards of measuring risk and weightings are based on the subjectivity of the evaluators and publishers. Therefore, the principles employed may exert a heavy influence on the rating forecast results.

It is thought that this approach minimizes the drawbacks inherent in both the qualitative and quantitative evaluation systems. There are, however, two issues to be considered in using these indices for foreign investment. The first issue is that the three indices give conflicting ratings to a given country. For example, a country rated as having “acceptable risk conditions” by one index, may be rated as “moderate risk” by another index. This conflicting rating or evaluation most like-

ly originates from the diversity of principles, evaluation techniques and overall forecast rating systems employed in the indices. Below is a list of specific factors which could cause the outcomes of the three indices to differ from each other:

- 1) The kinds of risk factor variables included;
- 2) The evaluation grading standards (e. g., a 4—grade or 5—grade system)
- 3) The competency of the evaluators;
- 4) The number of evaluators involved in evaluating each country;
- 5) The methods and criteria used for assigning weights;
- 6) The period of future time covered by the forecast.

The next issue is that the rating system and techniques of a given index are standardized, which makes that index uniform and generalized. This implies that the index is not necessarily applicable to all types of foreign investment. Political risk for one investment may not be the same as for another.

Despite all of the shortcomings mentioned above, however, if the strengths and weaknesses of each of the three indices are identified, investors may be able to select the best index or indices to apply to their investments. For example, “A” index may be best fit for analyzing the risks of less capital—intensive manufacturing investments, whereas “B” index may be best applied to a short—term service venture.

Given the above considerations, it is the opinion of this writer that, should this approach be disseminated in the foreign investment community, it would be of significant benefit for foreign investors by minimizing possible financial damages, as well as for investing countries by protecting them from losing their national wealth.

V. Concluding Note

In conclusion, a few notes of caution are advised. Firstly, general studies have shown that analyses of political risk—factors based on cross—sectional country data are of limited use. The main reason this is so is because a political factor which is deemed to reflect investment risk in one country may not necessarily accurately reflect the degree of risk with regard to another country.¹¹⁾

Further, each political risk may reflect a different degree of risk potential contributing to the occurrence of disputes. A quantitative system for evaluating the degree of risk potential of each factor needs to be sought for the purpose of obtaining more significant test values, thus enabling the risk analyst to obtain more accurate forecasts of the investment climate.

Finally, it should be noted that each of the three most common approaches in the decision process as described above, when treated independently, is rarely sufficient for the thorough analysis of political risk. Success is more likely to occur when the various subjective and objective approaches are used in effective combination.

Footnotes

- 1) Zenoff, David B. and J. Zwick, *International Financial Management* (Englewood Cliffs, N. J.: Prentice–Hall, 1969), pp. 28–29.
- 2) Business Week, “Japanese Multinationals Covering the World with Investment”, June 16, 1980, p. 95.
- 3) The Wall Street Journal, “IBM Decides to Withdraw from Nigeria Because of a Foreign–Investment Decree”, June 27, 1978.
- 4) The Wall Street Journal, “Ford Motor Co. Reeling from Huge Losses in Its North American Automotive Operation that Offset Strong Results in All Other Areas”, February 22, 1980, p. 2.
- 5) Business Week, June 16, 1980, op. cit., p. 94.
- 6) Kennedy, Charles R., Jr., *Political Risk Management* (New York: Quorum Books, 1987), p. 5.
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- 8) Rummel, R. J. and D. A. Heenan, “How Multinationals Analyse Political Risk,” Harvard Business Review (January–February, 1978), p. 69.
- 9) Ibid., pp. 69–70.
- 10) Ibid., p. 70.
- 11) Morita, Joseph Y., “Political Risk Evaluation for Foreign Direct Investment to Developing Countries”, Ph. D. Dissertation at Walden University, August, 1981, p. 87.
- 12) Ibid, p. 88.

海外投資のポリティカル・リスク評価方法に関する一考察

海外投資における経営者の意思決定は、ホスト国の政治ならびに経済状態に関する十分な分析から導き出された精度の高いリスク予測を基にして行われる。

ホスト国内における外国資産の所有権や多国籍企業の自由な経済活動を脅かすようなリスク要因の存在が、意思決定の重要な determinants となる。したがって、どのようなリスクが潜在あるいは顕在しているかを調査し、それらをどのような方法で予測するかという問題が提起される。

ポリティカル・リスクは、通常社会・政治的リスクと経済的リスクに分けられる。社会・政治的リスクは政治権力の交代や、社会不安によって誘発された社会的あるいは政治的混乱によって起ることが多い。しかも、sovereign risk であるという特徴がある。経済的リスクについては、統計数字の上からある程度精確に評価することができるが、社会・政治的なリスク要因は、政府の政策と密接に関連しているため、統計的分析を行うには困難を伴う。社会・政治的リスク要因は定性的性質のものが多く、応々にしてリスク度の測定は主観的なものとなる。

ポリティカル・リスク評価においては、データの蒐集、分析そしてそれから得られた情報を経営者に提供し、投資に対する否定的要因発生の確率を予測することが目標である。

ポリティカル・リスクの評価にしばしば用いられている分析方法を簡略化された枠組みに置き替えて考察を加えた。リスク分析は基本的に次の二通りの方法がある。一つは定量的分析(計量分析)法で、他は定性的分析法である。

定量的分析法では、Check-list System と Advanced Quantitative 分析法がある。また、定性的分析法では、Fully Qualitative System, Structured Qualitative System および Multivariate Analytical System がある。

これらの分析法について、実証的側面よりそれぞれの長所・短所に検証を加え、更

に、定量的分析法によるリスク予測の限界と、定量的ならびに定性的分析の相互補完によるリスク評価の意義について考察したものである。

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