

POGA 6991 - POLITICAL RISK ANALYSIS

SUMMER 2015 – Session I – M & W 6-9pm – Keating 104

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PURPOSE

Political risk analysis is defined as the systematic means of assessing and managing the political risks of foreign investment or international business. The scope of political risk can be quite broad. In capital market theory, for example, political risk is often defined as unsystematic risk or all nonbusiness risk. This definition is loose enough to include such unrelated factors as the work habits of foreign laborers or the incidence of internal violence. Other definitions are equally broad, emphases ranging from foreign exchange exposure to the probability of expropriation.

In practice, however, the term political risk refers to the legal and social environment in which a firm has to operate. In assessing political risk, one is not concerned with the likelihood of change *per se*, or even of discontinuous change, but rather with the criteria that the "rules of the game" under which the firm made its calculations of risk and return will not change in such a way as to obviate the original calculations.

The utility of political risk assessment is threefold. First and foremost, it is meant to identify those elements of political risk associated with foreign direct investment. In short, to identify those countries which have the potential of becoming the Irans, Iraqs, or Afghanistans of tomorrow. At the very least, it is meant to provide sufficient warning of mounting political risks to allow a firm to protect itself or to minimize its exposure.

Second, political risk assessment is useful in identifying those countries which have been unnecessarily discounted for political risk, or where the political risk of foreign direct investment has decreased.

Finally, political risk assessment serves to provide a framework in which to compare those countries where the political risk is significant, but not enough automatically to rule them ineligible for foreign direct investment. This middle range of moderate risk countries includes most of the Third World. At best, using such a common framework will only serve to systematize what are in essence subjective judgments. Even this limited step, however, would go a long way in creating a basis for comparing the political risks among different countries.

Political risk assessment is often limited to an exercise in political forecasting. In this view, a firm endeavors to predict trends in a host country over a one year to five year period and then adjusts its business plans accordingly. The forecast can take varying degrees of sophistication, from internal assessment to the use of political risk reporting services, or the use of outside experts and forecasting techniques.

To be effective, a political risk assessment should consist of three interrelated parts. [1] The first task is to identify those elements of political risk associated with a foreign direct investment and to develop an intelligence system to monitor and evaluate changing political conditions in the host country. [2] The second task is to allow a firm to deal with changing conditions of political risk by integrating the political risk assessment with the firm's strategic planning. [3] The third task is to devise strategies to protect the firm from political risk, especially the risk of expropriation.

Assessing the political risks of foreign direct investment involves the analysis of those elements of aggregate or countrywide risk and those elements of political risk specific to the firm or to its project. Countrywide factors can be conveniently grouped under three headings: [1] Domestic climate: The level of national violence as measured by tendencies towards subversion, rebellion, or political turmoil. Among the many variables one might consider here are levels of political violence, the existence of extremist tendencies among political parties, or recurring governmental crises. An increasingly important domestic consideration is the existence or nonexistence of political democracy. [2] Economic climate: An overall assessment of the foreign investment climate. Among the relevant factors are the likelihood of government intervention in the economy, the rate of inflation, unemployment and underemployment rates, persistent balance of payments deficit, external debt levels, and the rate of gross fixed capital formation. [3] Foreign relations: The extent to which a nation manifests hostilities towards another. Among the relevant variables here are the size of the defense budget, the evidence of an arms race, and the incidence of conflict with its neighbors.

READINGS

Ian Bremmer and Preston Keat. *The Fat Tail: The Power of Political Knowledge in an Uncertain World*. With New Preface. NY: Oxford University Press, 2010. ISBN 978-0-19-973727-7

Ian Bremmer. *The End of the Free Market: Who Wins the War Between States and Corporations?* Portfolio/Penguin, 2011 (with new afterward). ISBN 978-1-59184-440-2

RESEARCH PAPER (80%)

Each student is required to undertake a summer session-long original research of political risk analysis on a country of her/his choosing the results of which will be reported in consecutive classroom oral presentations and then submitted in written form (20-25 pages) on the last day of class. The full details of this project will be explained during the first class session.

EXAMINATION (20%)

There is a single short answer examination on the required book readings.

READING SCHEDULE (Subject to change)

May 27 (Wed) – Introduction
June 1 (Mon) – Bremmer/Keat
June 3 (Wed) – Bremmer
June 8 (Mon) – Exam/Lecture
June 10 (Wed) – Lecture
June 15 (Mon) – Orals--Outline
June 17 (Wed) – Orals--Bibliography
June 22 (Mon) – Orals – Detailed Outline
June 24 (Wed) – Orals--Draft
June 29 (Mon) – PAPERS DUE-NO CLASS