


**dfe** Centre international de formation européenne  
100 BERLIN BRUXELLES STRASBOURG

## WHERE DOES POLITICAL RISK COME FROM? POLITICAL RISK ASSESSMENT



MICHEL-HENRY BOUCHET  
CIFE 6-8 MAY 2020

## POLITICAL RISK ASSESSMENT

- ▶ **Origins?** Political risk stems from the **threat** related to the exercise of power by a foreign government, its ramifications, and private domestic agents.
- ▶ **Impact?** Arbitrary political decisions, conditions, and events in a country will affect the business climate in such a way that investors, exporters, creditors, as well as domestic residents will confront risks and losses

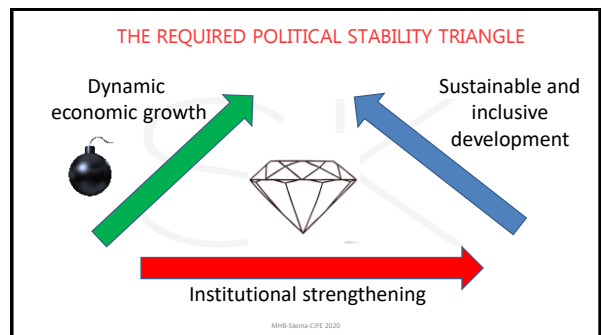
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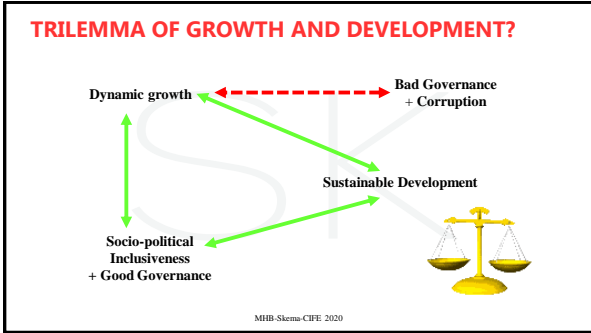
## AMBASSADOR PAUL BREMER (US STATE DEPARTMENT)

- ▶ *Political risk analysis is both an art and a science but many types of risk are amenable to rigorous analysis:*
- ▶ *How resilient is the political system? Is there a tradition of peaceful transitions of power? How robust are the social shock absorbers that provide buffers between individual citizens and governments?*

Harvard Business School Review, 2002

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### Political risk and Threat materialization

**THREAT**

- ▶ Contract repudiation, capital controls, currency inconvertibility, sham contracts and bribery, corruption, blocked funds, ideological shift, political upheaval, strikes, expropriation, nationalization, coup d'état, martial law, revolution, civil strife damage, terrorism, war damage, kidnapping, crimes....

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### Three Sources of Political Risk

<b>Direct «hard risks»</b>	• Risk materialization directly hurts the company: Nationalization, expropriation and confiscation, contract repudiation, sham contracting, bribery and corruption, blocked funds, kidnapping, crimes
<b>Indirect «surrounding risks»</b>	• Risk materialization stems from the hostile environment: Revolution and civil unrest, martial law, terrorism, war damage, ideological and cultural shifts. Capital and dividend remittance constraints, ineffective legal and regulatory systems, non-compliance, strikes, currency inconvertibility, regional crisis and volatility spill-over
<b>Collateral «soft risks»</b>	• Risk materialization is the byproduct of unfavorable interactions between power groups: Legal and ethical risks, protectionism, fiscal uncertainty, wealth gaps, bureaucracy and weak institutions, pressure groups and hostile NGOs, ethnic/linguistic fragmentation

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### WHERE DOES POLITICAL RISK COME FROM?

- Terrorism
- External shock (commodity price volatility)
- Gap between socio-economic and political/institutional evolution
- Cultural fragmentation (riots, government crises, corruption)
- Internal violence and power struggle (martial law, guerrilla warfare...)
- Rapid pace of urbanization coupled with religious fundamentalism
  - Regional contamination
  - Ethnic/linguistic fragmentation
  - Fragmented identity and “archipelagos”

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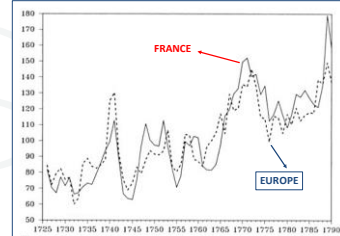
### FOOD STRESS, WHEAT PRICES & REVOLUTIONS: WHAT RELATIONSHIP?

Where does a **revolution** come from?

In the XVIII<sup>th</sup> century, bread constitutes nearly 50% of expenditures of households in France.

- 1788: bad weather and severe drought
- 1789: Necker's alarmist warnings and urgent imports of wheat
- Very cold winter
- 6 pounds of bread cost 12 « sous », the equivalent of one day salary.
- Fast inflation will continue until 1795

Wheat price index in France and in Europe 1725-1790



Source: David Weir, *Annales*, 1991, Vol.46

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### LOOKING FOR THE ROOT CAUSES OF THE 2011 ARAB SPRING?

Wheat Prices in US\$/bushel 2008-2018



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### LOOSENING IDENTITY AND SOCIO-POLITICAL FRAGMENTATION: « THE ARCHIPELAGO »\*

- ▶ Combination of modernization, slower growth, wider wealth gaps, and rapid immigration can produce **eroding national identity and socio-political fragmentation**
- ▶ A « Nation » then becomes a « Country » where a territory is shared by multiple ethnocultural groups with divergent interests
- ▶ Weakening institutions (parties, associations, unions, religious entities...) are unable to **agregate diverse socio-political and cultural interests**, hence growing tensions and violence.

\* See for instance: Jérôme Fourquet, *L'Archipel Français*, Seuil, 2019

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### SAMUEL HUNTINGTON



Political order in changing societies  
*The Clash of Civilization*

• [http://markweatherall.wordpress.com/2009/10/12/political\\_order\\_in\\_changing/](http://markweatherall.wordpress.com/2009/10/12/political_order_in_changing/)

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**HUNTINGTON AND THE ROOT CAUSES OF POLITICAL TURMOIL**

▶ Contrary to the expectations of modernization theory, **violence and instability stem from:**

1. rapid social change
2. Centralized decision-making system
3. mobilization of new groups into politics
4. slow development of political institutions.

▶ As societies modernize, they become more complex and disordered. If the process of **socio-economic** modernization is not matched by a process of **political and institutional** modernization with political institutions capable of managing the stress of modernization—the result is violence!

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**SAMUEL HUNTINGTON**  
**ANALYZING THE ROOTS OF POLITICAL UPHEAVAL**


▶ Primary problem of politics = **lag** in the development of political institutions behind socio- economic change.

▶ Instability = (rapid social change + rising mobilization of new groups into politics) > development of political institutions.



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**POLITICAL DIS/ORDER IN RAPIDLY CHANGING SOCIETIES**



**Process of socio-economic change**

Deficit of strong institution-building capacity + Economic liberalization without social reforms

**EMCs**

*Lag/deficit of institutional strengthening*

**OECD (?)**

Economic growth leads to social development and institutional resilience

**Process of political institutionalization**

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**A DEFICIT IN INSTITUTION-BUILDING ALWAYS LEADS TO SOCIAL UPHEAVAL**



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### ECONOMIC GROWTH + POLITICAL MODERNIZATION IN CHINA?

► Shenzhen = home to economic reform in China?

PM Wen Jiabao: « *Political reform is a necessary companion to economic modernization: without the safeguard of political reform, the fruits of economic reform would be lost* »  
(August 2010)



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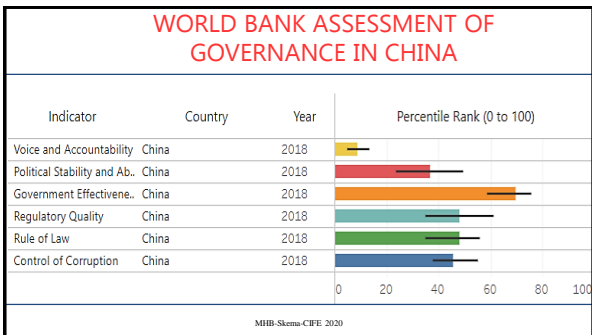
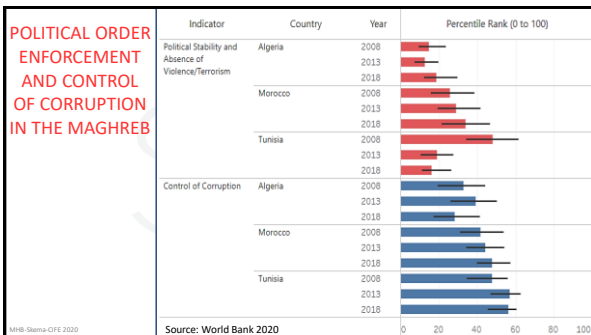
### INSTITUTIONAL STRENGTHENING, ECONOMIC DEVELOPMENT AND POLITICAL STABILITY: CHALLENGING TRIANGLE!

► **Chile's President Bachelet:**  
links between democratic strengthening, economic growth and social protection

► « *In Latin America, there are countries where people are uneasy about the process of economic liberalization, because structural economic reforms were not accompanied by the social policies that were necessary! The problem has not been with open economies per se but rather the lack of action in addressing poverty and social injustice* »



Interview by McKinsey Quarterly, 2007



### WORLD BANK'S STRATEGY OF INSTITUTIONAL STRENGTHENING

*"To achieve our goal of ending extreme poverty, we must focus on people living in countries that suffer **from conflict and fragility**.*

*Our new strategy aims to address the underlying causes of fragility and invest in the long-term development that helps create the conditions for **peace and prosperity**".*

(APRIL 16, 2019 World Bank CEO Kristalina Georgieva)  
<https://www.worldbank.org/en/news/press-release/2019/04/16/world-bank-group-launches-worldwide-consultations-on-future-strategy-for-fragility-conflict-and-violence>

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## MEASURING GOVERNANCE?

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### WORLD BANK: WHAT IS GOVERNANCE?

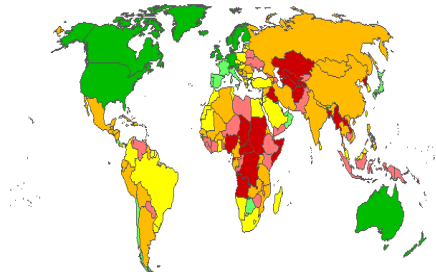
**Governance consists of the traditions and institutions by which authority in a country is exercised.**

This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them with 6 dimensions:

- Voice and Accountability
- Political Stability and Absence of Violence
- Government Effectiveness
- Regulatory Quality
- Rule of Law
- Control of Corruption

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### WORLD BANK'S WORLD MAP OF GOVERNANCE



Source: Kaufman, World Bank



### IBRAHIM INDEX OF GOVERNANCE IN AFRICA

The Index groups governance and political freedom indicators into four main categories:

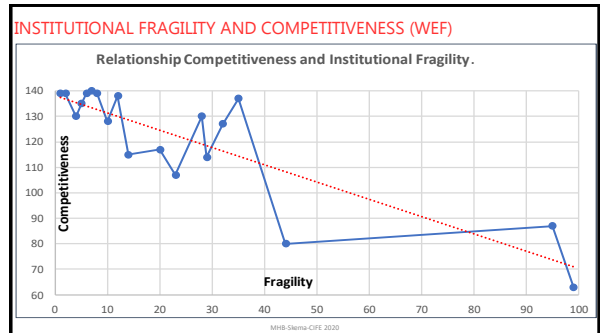
1. Safety and Rule of Law,
2. Participation and Human Rights,
3. Sustainable Economic Opportunity,
4. and Human Development.

Source: <http://www.moibrahimfoundation.org/en/section/the-ibrahim-index>

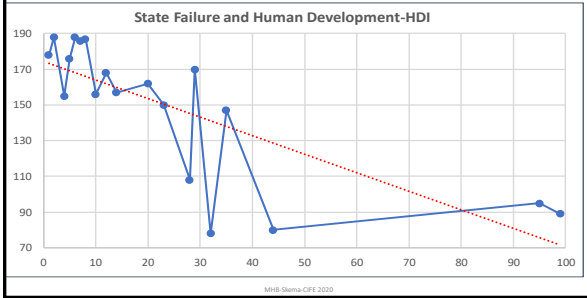
### IBRAHIM INDEX OF GOOD GOVERNANCE IN AFRICA

1 Mauritius	83.0	31 Mali	52.9	57 Nigeria	43.3
2 Seychelles	78.5	32 Mozambique	52.1	58 Liberia	43.2
3 Botswana	75.9	33 Burkina Faso	51.9	59 Togo	42.6
4 Cape Verde	75.5	34 Malawi	51.7	60 Niger	42.3
5 South Africa	71.5	35 Libya	51.5	61 Congo	42.0
6 Namibia	67.3	36 Uganda	50.8	62 Angola	39.3
7 Ghana	64.6	37 Swaziland	50.8	63 Guinea-Bissau	39.1
8 Tunisia	62.1	38 Kenya	50.5	64 Côte d'Ivoire	36.8
9 Egypt	60.5	39 Gabon	50.1	65 Guinea	35.6
10 Lesotho	60.1	40 Madagascar	48.7	66 Equatorial Guinea	34.7
11 São Tomé and Príncipe	58.2	41 Cameroon	48.5	67 Sudan	32.9
12 Benin	56.6	42 Djibouti	48.5	68 Central African Republic	32.7
13 Morocco	56.6	43 Rwanda	47.2	69 Zimbabwe	32.7
14 Senegal	56.3	44 Sierra Leone	46.0	70 Eritrea	31.8
15 Algeria	55.2	45 Burundi	44.7	71 Congo, Democratic Rep.	31.1
16 Tanzania	55.0	46 Cameroon	44.2	72 Chad	28.8
17 Zambia	54.0	47 Ethiopia	43.5	73 Somalia	7.9
18 Gambia	53.0	48 Mauritania	43.4		

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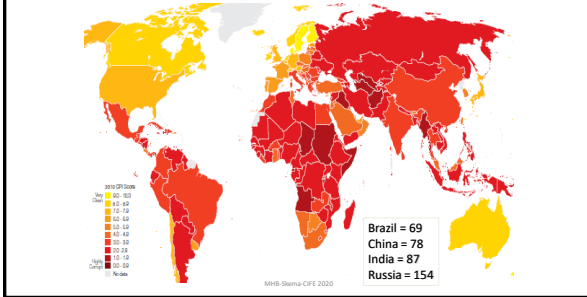
**INSTITUTIONAL FRAGILITY AND HUMAN DEVELOPMENT (UNDP)**



**MEASURING CORRUPTION?**

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**TI WORLD MAP OF CORRUPTION**



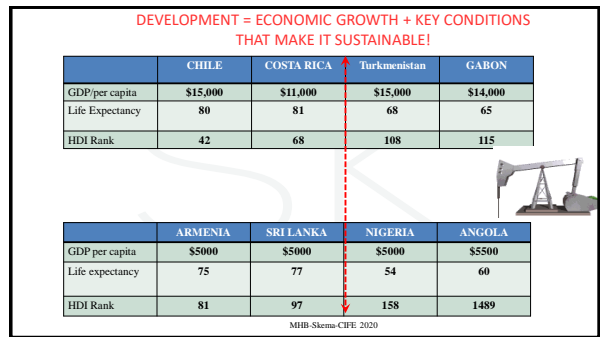
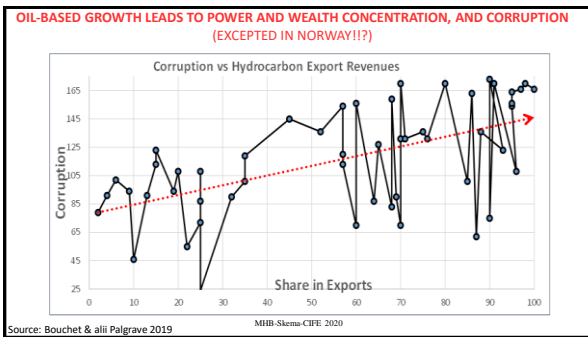
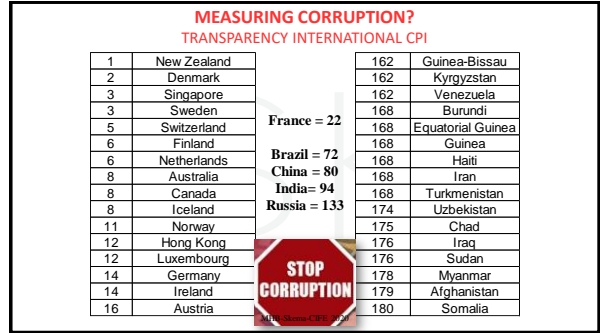
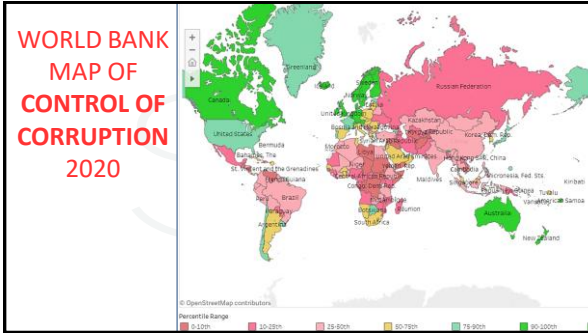
**POLITICAL TURMOIL AND CORRUPTION**

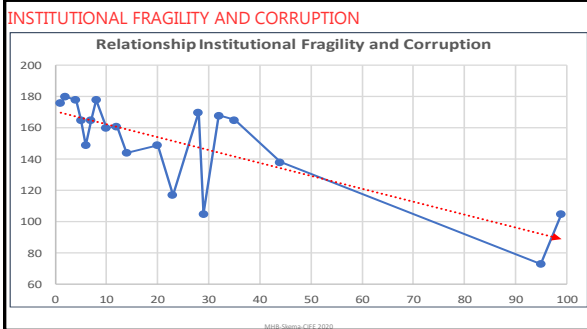
In 2018-19, public anger and legal action over corruption have toppled political leaders in Malaysia, Peru, Slovakia, South Africa, and other countries.

More than 10 percent of nations around the world have experienced corruption-fueled political change in the last five years (Carnegie, 2018). In many countries, corruption has fueled terrorist recruitment and sparked violent insurgencies.

The World Bank estimates \$1.5 trillion in bribes are paid every year, squandering business capital and stymying development.

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## TECHNIQUES TO ASSESS POLITICAL RISK

1. Economic intelligence: in-depth socio-political analysis
2. Checklist approach  
To examine key political factors that affect a country's risk: the **Prince Model**
3. Delphi technique
  - establish surveys
  - collect information and independent opinions
  - analyze results and make predictions
4. Ratings
5. Consultants on political risks

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### 1. INFORMATION SOURCES ON POLITICAL RISK: KEY ROLE OF ECONOMIC INTELLIGENCE

<ul style="list-style-type: none"> <li>▶ MIG (UK)</li> <li>▶ HISCOX</li> <li>▶ PLATUS</li> <li>▶ AON</li> <li>▶ Global Risk Assessments</li> <li>▶ EIU</li> <li>▶ COFACE, OPIC &amp; MIGA, EULER</li> <li>▶ Howell International</li> <li>▶ Control Risks Group: <a href="http://www.crg.com">www.crg.com</a></li> <li>▶ WMRC</li> </ul>	<ul style="list-style-type: none"> <li>▶ Frost &amp; Sullivan</li> <li>▶ US State Department + US CIA</li> <li>▶ Marsh Crisis Consulting</li> <li>▶ University of Maryland Center for Conflict Management</li> <li>▶ Muir Analytics (Threat Watch, Threat Report, Threat Survey)</li> <li>▶ NYA International</li> <li>▶ TAC (France)</li> </ul>
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### 2. POLITICAL RISK ANALYSIS

Mapping out the **power structure** and identifying the roots of political legitimacy:

- ▶ ideological (North Korea)
- ▶ charismatic (Cuba)
- ▶ economic/financial (Brunei)
- ▶ authoritarian populism (Thailand)
- ▶ ethnic (Ivory Coast, Ghana)
- ▶ religious (Iran)
- ▶ military (Burma, Venezuela)
- ▶ patron-client relationships (Togo, Congo, Gabon)

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### 3. POLITICAL RISK ANALYSIS: PRINCE MODEL

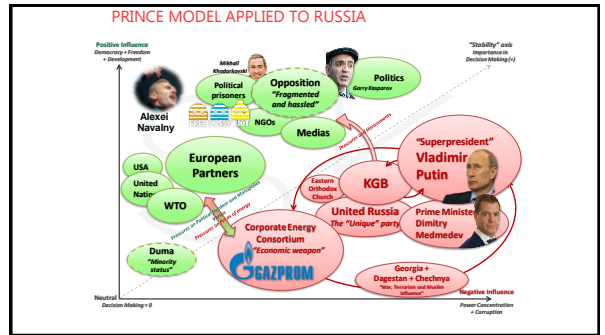
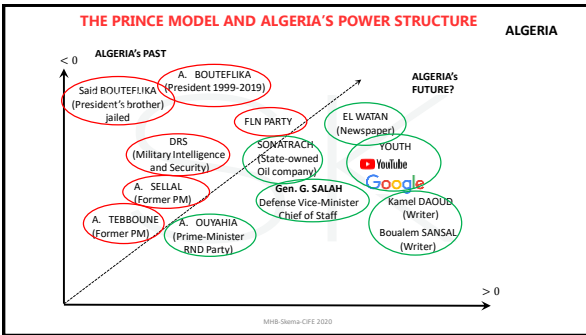
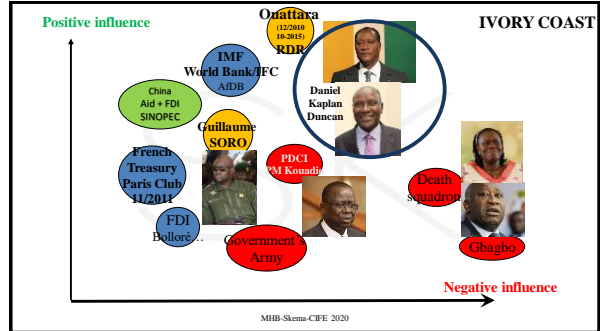
**Frost & Sullivan:** William D. Coplin and Michael K. O'Leary of the firm Political Risk Services.

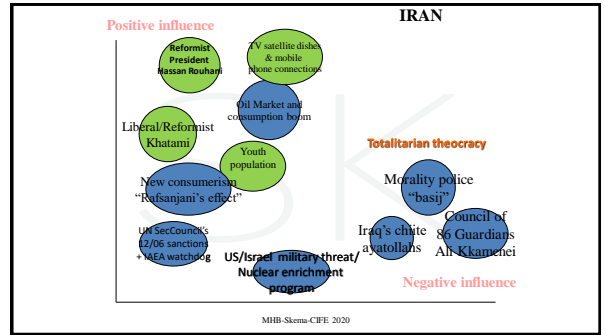
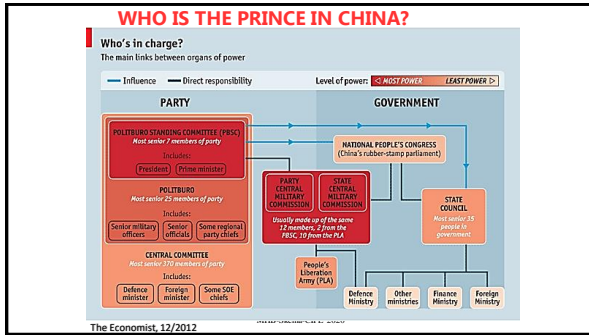
**PRINCE = Probe, Interact, Calculate, and Execute**

Emphasis on the power structure of a nation by identifying key individuals or groups that can influence a specific risk outcome: destabilization, nationalisation, expropriation...

Political risk forecasting model to produce probability of loss from political instability by relating relative importance in decision-making and relative political orientation towards radical or incremental change (+/-)

DATA= <https://www.cia.gov/library/publications/world-leaders-4/world-leaders-c/cote-divoire.html>





### 4. QUANTIFYING COUNTRY RISK

► Ratings and Rankings:

- Can one boil things down to numerical indices, when dealing with culture, politics, and ethnic tensions?
- **Problem of "usability" of rankings: number fetishism leads astray by focusing on statistical Delphi-based analyses that are often subjectively biased, misleading and overly narrow. Lack of insight and qualitative research?** ([www.useit.com](http://www.useit.com) Jakob Nielsen's website)

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### QUANTIFYING COUNTRY POLITICAL RISK

Overall Country Risk Rating = 25% Political Risk Rating + 10% Spill-over Risk Rating + 65% Transfer Risk Rating

Political Factors		Weights
Political factor A		30%
Political factor B		50%
Political factor C		20%

Regional factors		Weights
Financial factor A		30%
Financial factor B		40%
Financial factor C		30%

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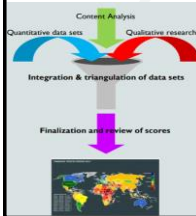
### POLITICAL RISK INDICES

- ▶ Heritage Foundation
- ▶ Freedom House
- ▶ Cato Institute
- ▶ Fund for Peace
- ▶ Transparency International CPI
- ▶ PWCs: Opacity Index
- ▶ LB: Legsi
- ▶ Asiarisk
- ▶ Marsh
- ▶ Fragile state index
- ▶ World Bank (Governance)
- ▶ Euromoney (25%)
- ▶ Institutional Investor
- ▶ IMD
- ▶ ICRG-PRS
- ▶ MIG
- ▶ WMRC
- ▶ University of Maryland
- ▶ Ibrahim Index of Governance

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### THE METHODOLOGY BEHIND THE FRAGILE STATES INDEX

The Fragile States Index produced by The Fund for Peace is a tool in highlighting not only the normal pressures that all states experience, but also in identifying when those pressures are outweighing a states' capacity to manage those pressures.

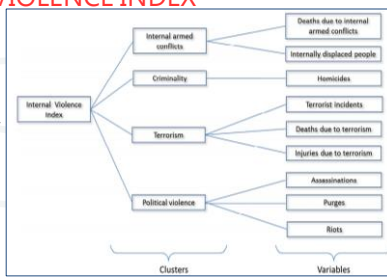


**Annual ranking for 178 countries with 12 political, economic and social indicators** and >100 sub-indicators, coupled with qualitative analysis and expert validation:  
Economic decline, uneven development, brain drain, state legitimacy, public services, human rights, demographic pressures, refugees, external intervention, rule of law...

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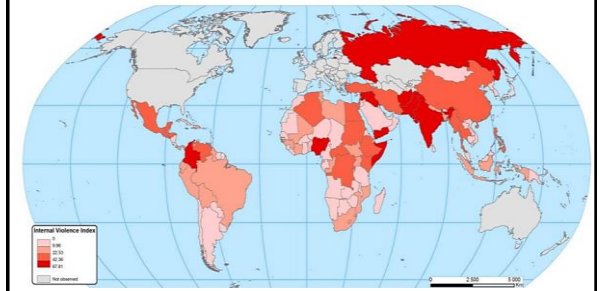
### THE INTERNAL VIOLENCE INDEX

The composite index measures a narrow concept of fragility for 130 developing countries through their level of violence in its many different forms: internal armed conflicts, criminality, terrorism, and political violence: Iraq, Pakistan, Afghanistan, Yemen, Syria, and Nigeria.



MHB-Skema-CIFE 2020 SOURCE: FERDI April 2016: Feindouno / Goujon /Wagner

### THE INTERNAL VIOLENCE INDEX

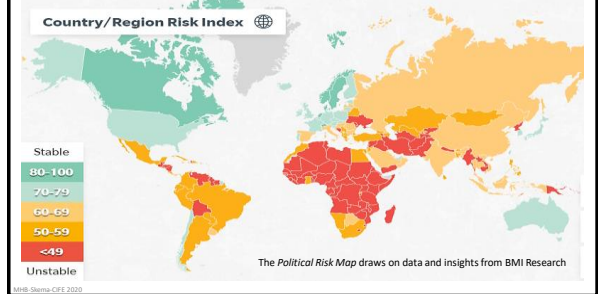


### AON POLITICAL RISK MAP

- ▶ The Aon Political Risk Map measures political risk in 163 locations and territories.
- ▶ Risk ratings are standardized across each location, on a six-point scale ranging from low to very high, with all risks updated once per quarter.
- ▶ EU and OECD countries are not rated in the map!
- ▶ Political risk is calculated as a simple average of six core risk measures :
  1. • Political Violence
  2. • Exchange Transfer
  3. • Sovereign Non-Payment
  4. • Political Interference
  5. • Supply Chain Disruption
  6. • Legal & Regulatory

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### MARSH RISK MAP 2020



### CROSS-COUNTRY POLITICAL RISK MEASURE BY ICRG

Weights	ICRG's Political Risk Assessment Criteria
12	Government Stability
12	Socio-Economic conditions
12	Investment Profile
12	Internal Conflict
12	External Conflict
6	Corruption
6	Military in Politics
6	Religious Tensions
6	Law and Order
6	Ethnic Tensions
6	Democratic Accountability
4	Bureaucratic Quality
100	Total number of points for weighted influence

### THE HERITAGE FOUNDATION: ECONOMIC FREEDOM INDEX

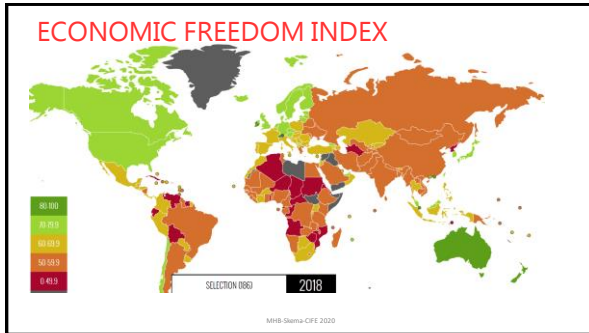
#### Q.3. How do you measure economic freedom?

We measure economic freedom based on 12 quantitative and qualitative factors, grouped into four broad categories, or pillars, of economic freedom:

1. Rule of Law (property rights, government integrity, judicial effectiveness)
2. Government Size (government spending, tax burden, fiscal health)
3. Regulatory Efficiency (business freedom, labor freedom, monetary freedom)
4. Open Markets (trade freedom, investment freedom, financial freedom)

Each of the twelve economic freedoms within these categories is graded on a scale of 0 to 100. A country's overall score is derived by averaging these twelve economic freedoms, with equal weight being given to each. More information on the grading and methodology can be found in the appendix.

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### INDEX OF ECONOMIC FREEDOM

Top 10 Countries			EXPRESSED (100-40)		
RANK	COUNTRY	OVERALL CHANGE	RANK	COUNTRY	OVERALL CHANGE
1	Hong Kong	90.2 0.4 ↑	160	Niger	49.5 -1.3 ↓
2	Singapore	88.8 0.2 ↑	161	Sudan	49.4 +0.6 ↑
3	New Zealand	84.2 0.5 ↑	162	Chad	49.3 +0.3 ↑
4	Switzerland	81.7 0.2 ↑	163	Central African Republic	49.2 -2.6 ↓
5	Australia	80.9 -0.1 ↓	164	Angola	48.6 +0.1 ↑
6	Ireland	80.4 3.7 ↑	165	Ecuador	48.5 -0.8 ↓
7	Estonia	78.8 -0.3 ↓	166	Suriname	48.1 +0.1 ↑
8	United Kingdom	78.0 1.6 ↑	167	Timor-Leste	48.1 +1.8 ↑
9	Canada	77.7 -0.8 ↓	168	Togo	47.8 -5.4 ↓
10	United Arab Emirates	77.6 0.7 ↑	169	Turkmenistan	47.1 -0.3 ↓
			170	Mozambique	46.3 -3.6 ↓

### FREEDOM HOUSE: FREEDOM IN THE WORLD ANNUAL REPORT (1972-)

▶ Since 1972, Freedom House has published an annual assessment of the state of freedom in all countries in the world, based on a checklist of questions on political rights and civil liberties that are derived from the Universal Declaration of Human Rights. Each country is assigned a rating for PR and a rating for CL based on a scale of 1 (best) to 7 (worst).

▶ <http://www.freedomhouse.org/ratings/index.htm>

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