

# WHERE DOES POLITICAL RISK COME FROM?

## POLITICAL RISK ASSESSMENT

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## 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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## WHAT IS « GOOD GOVERNANCE »?

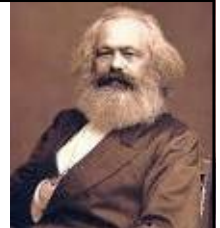
XIV<sup>o</sup> century Sienna: the allegory of **Good Government** =  
Balance between Wisdom, Justice, Strength, Prudence, and Peace



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## MARXIST APPROACH TO DEVELOPMENT AND CLASS STRUGGLE



- ▶ The developing forces of production give rise to increasing conflict with the existing social relations of production = class struggle.
- ▶ The **state** does not represent the interests of 'the people' or a common 'general will'. Nor is it a force which stands above or beyond the clash of class interests.
- ▶ The State = Instrument of class rule, nothing but 'a committee for managing the common affairs of the whole bourgeoisie'.
- ▶ Capitalism will inevitably lead to increasing class polarisation and class conflict.

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## DANIEL BELL

Sociologist and professor emeritus at Harvard University.

Bell was among the original New York Intellectuals, a group of anti-Stalinist left-wing writers. Best known for his contributions to post-industrialism.

Masterworks: *The End of Ideology* (1960), *The Cultural Contradictions of Capitalism* (1976) and *The Coming of Post-Industrial Society* (1973)



### The post-industrial society:

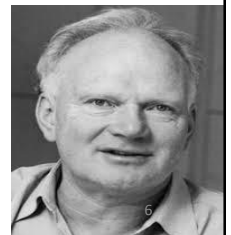
- ▶ Polarization and social tensions between work and consumption pressures: capitalism is inherently **instable**
- ▶ Centrality of the new science-based industries
- ▶ Rise of new technical elites and the advent of a new principle of stratification

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## ULRICH BECK: "WORLD AT RISK" IN A MODERN SOCIETY

- ▶ Modernization challenges the institutions and structures of traditional societies in the name of individual freedom and autonomy.
- ▶ What began to emerge in the late 20th century was a radical shift in western societies from a culture where meaning and identity were grounded in loyalty to traditional institutions and structures to one in which meaning and identity are grounded in the self as the primary agent of meaning.
- ▶ The paradox in late modern society is that risk might be increasing due to technology, science and industrialism rather than being abated by scientific and technological progress.
- ▶ The **world risk society** is full of hazards and insecurities induced by modernization itself:
  1. Globalization
  2. Individualization
  3. Gender Revolution
  4. Underemployment
  5. Global risks (ecological crisis and the crash of global financial markets)



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## Political risk and Threat materialization



- ▶ 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



### Direct «hard risks»

- **Risk materialization directly hurts the company:** Nationalization, expropriation and confiscation, contract repudiation, sham contracting, bribery and corruption, blocked funds, kidnapping, crimes

### Indirect «surrounding risks»

- **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

### Collateral «soft risks»

- **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
- 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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## 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.



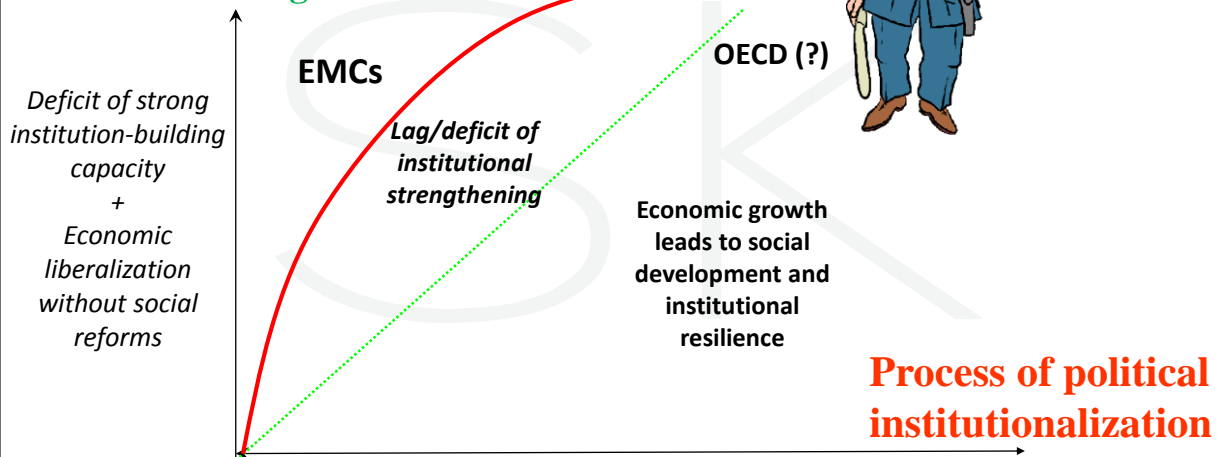
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**POLITICAL DIS/ORDER IN RAPIDLY CHANGING SOCIETIES**



**Process of socio-economic change**



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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

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## 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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## 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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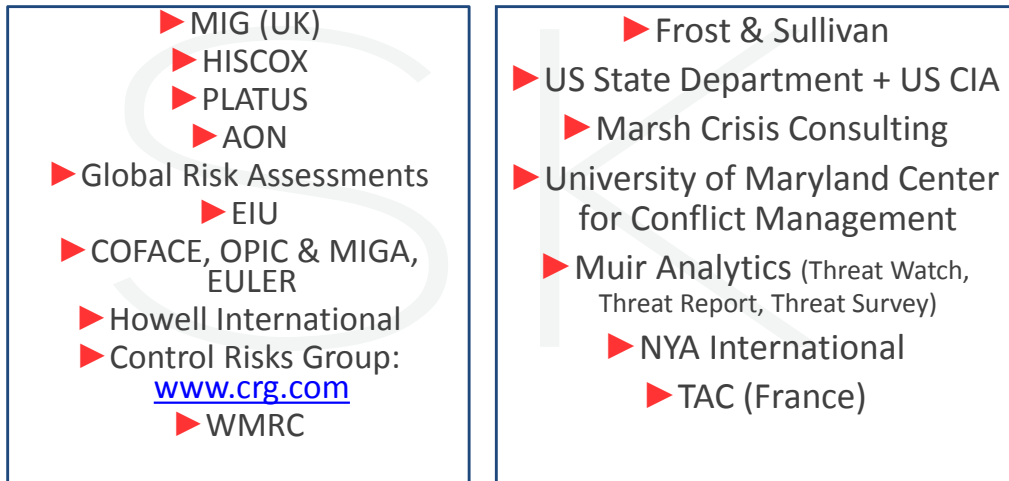
## TECHNIQUES TO ASSESS POLITICAL RISK

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**



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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

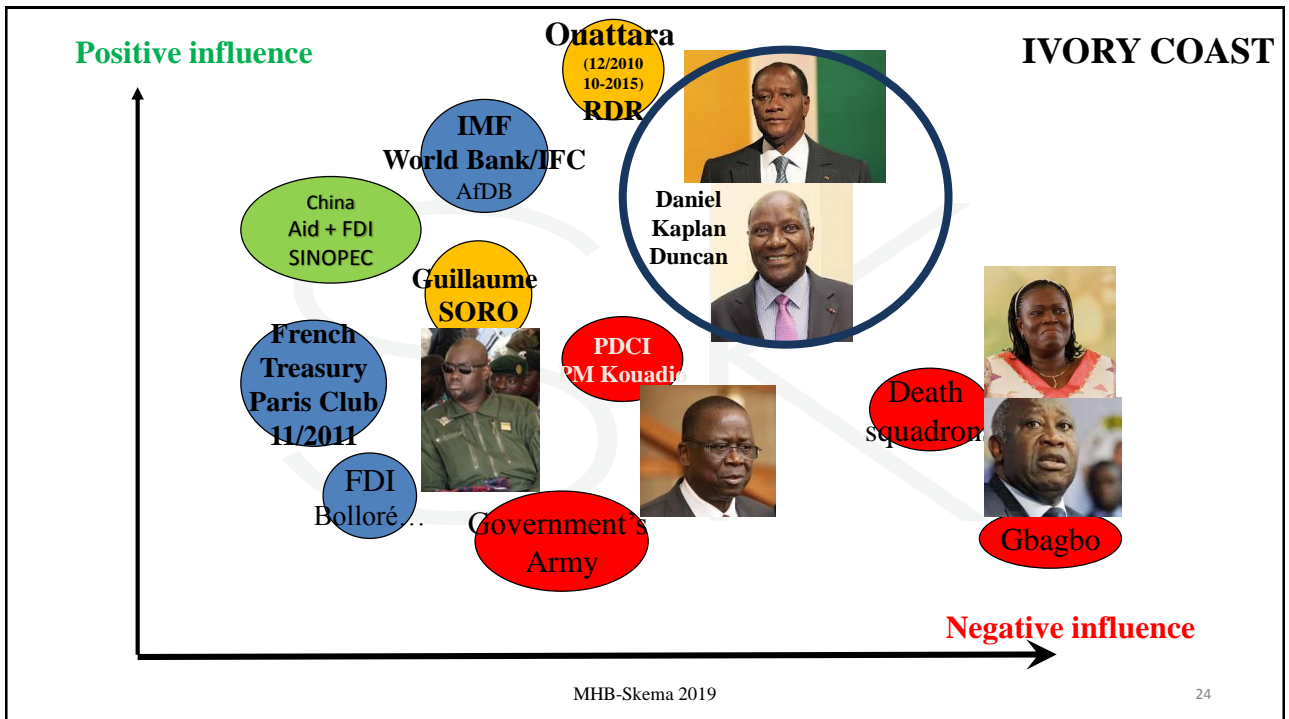
**Frost & Sullivan:** William D. Coplin and Michael K. O’Leary of the firm Political Risk Services.

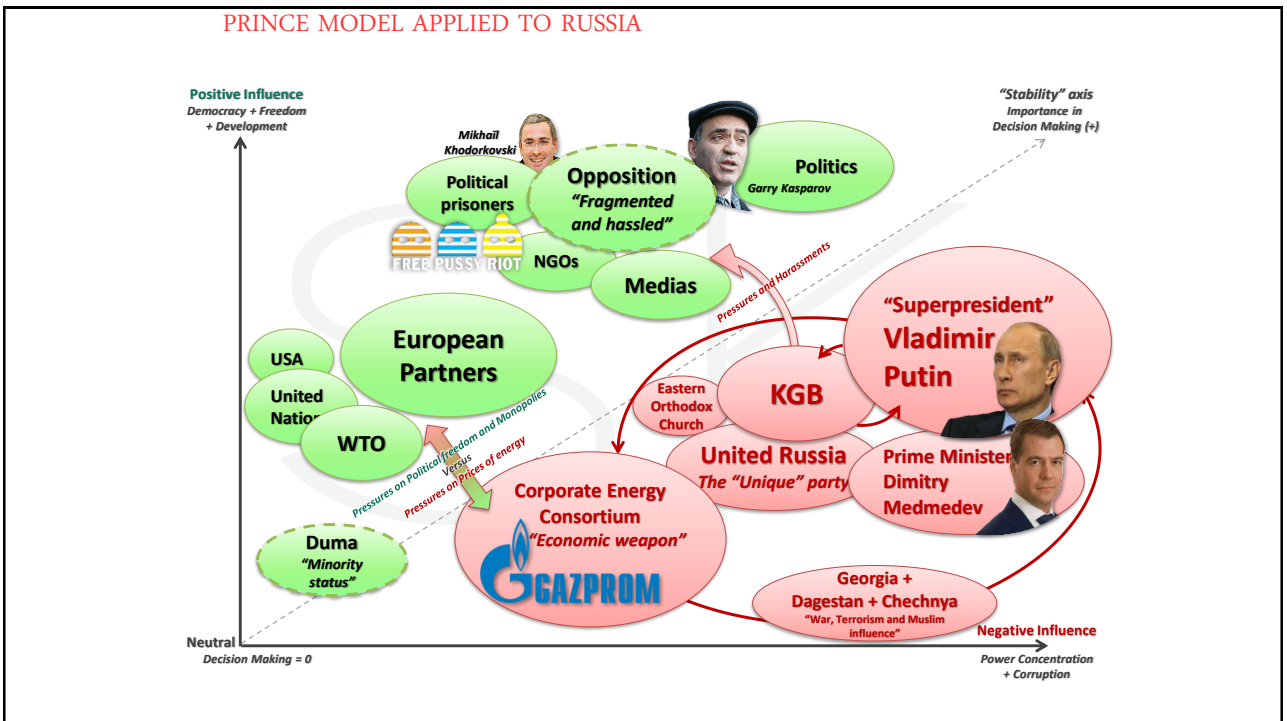
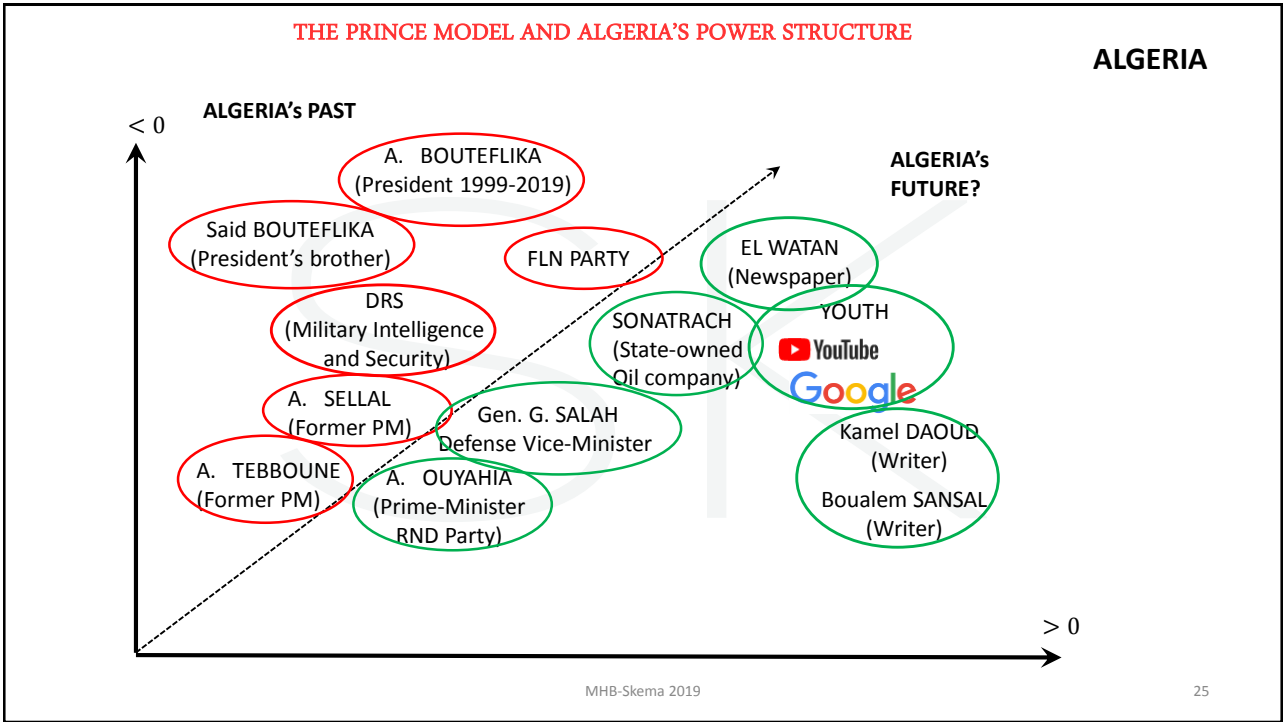
**PRINCE = Probe, Interact, Calculate, and Execute**

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

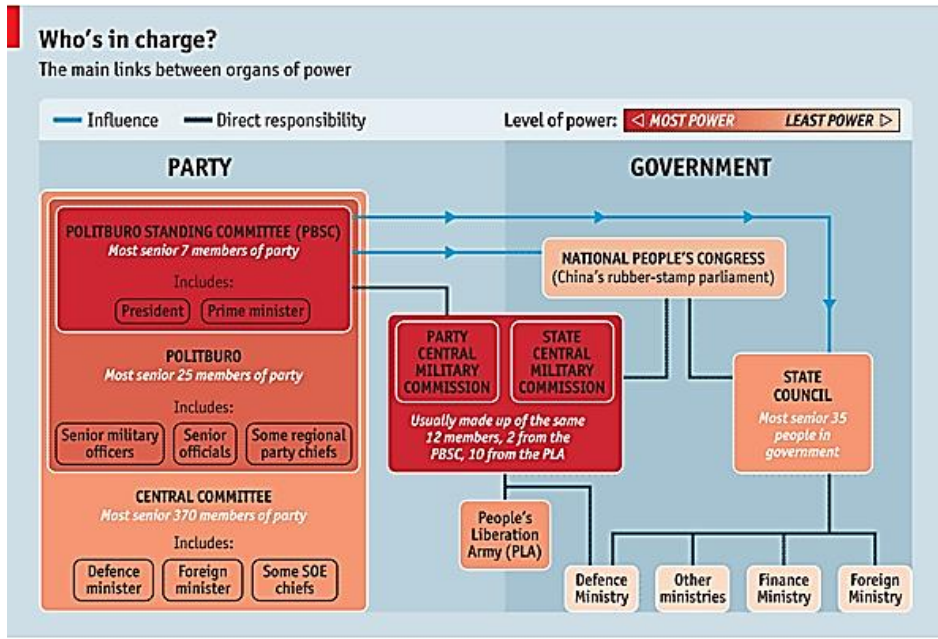
Political risk forecasting model to produce probability of loss from political instability by relating relative importance in decision-making and relative political orientation towards radical or incremental change (+/-)

DATA= <https://www.cia.gov/library/publications/world-leaders-1/world-leaders-c/cote-divoire.html>



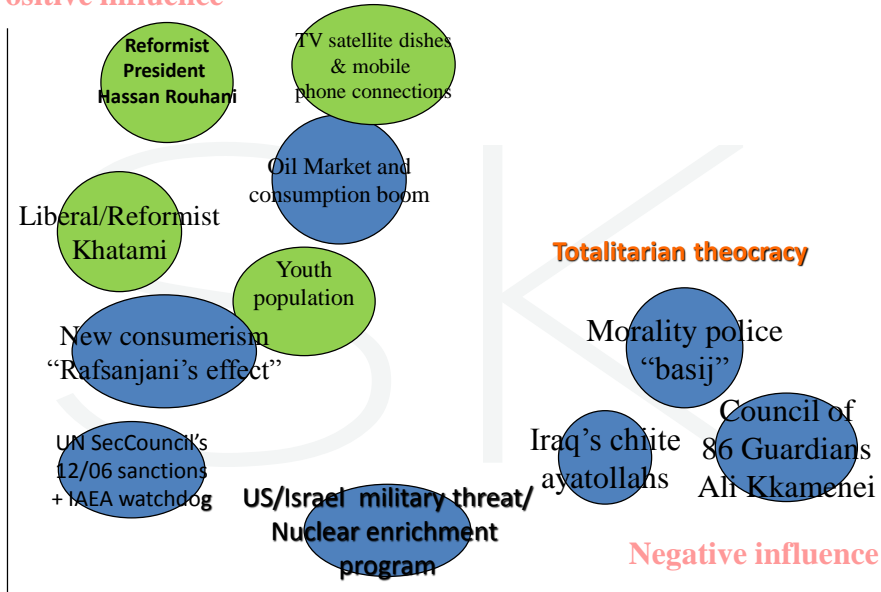


## WHO IS THE PRINCE IN CHINA?



### Positive influence

## IRAN



## 4. QUANTIFYING COUNTRY RISK

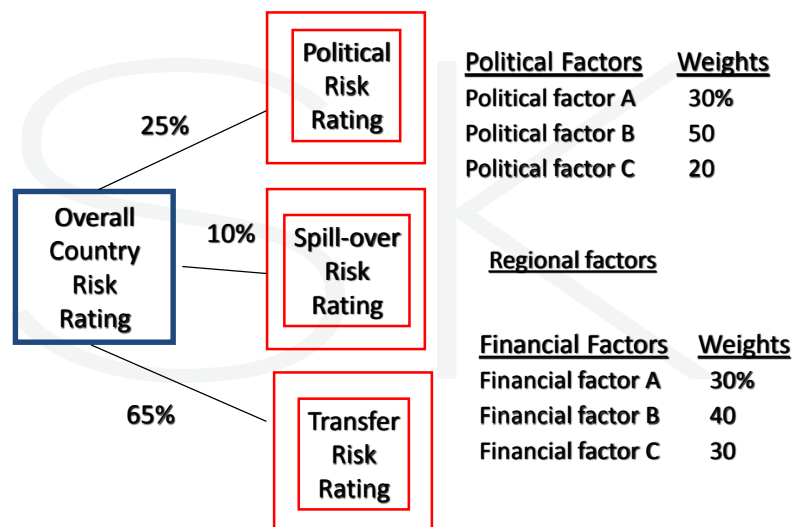
### ► Ratings and Rankings:

- 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



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## POLITICAL RISK INDICES

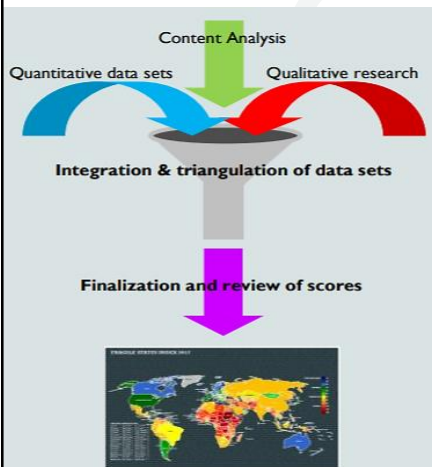
- ▶ Heritage Foundation
- ▶ Freedom House
- ▶ Cato Institute
- ▶ Fund for Peace
- ▶ Transparency International CPI
- ▶ PWCs: Opacity Index
- ▶ LB: Legsi
- ▶ Asiarisk
- ▶ Marsh
- ▶ World Bank (Governance)
- ▶ Euromoney (25%)
- ▶ Institutional Investor
- ▶ IMD
- ▶ ICRG-PRS
- ▶ MIG
- ▶ WMRC
- ▶ University 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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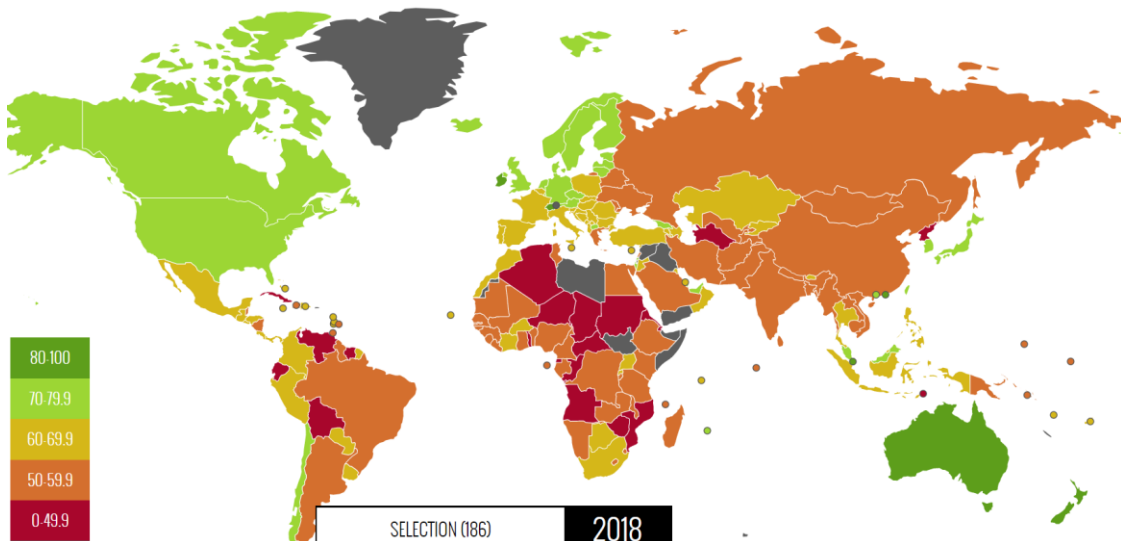
## CROSS-COUNTRY POLITICAL RISK MEASURE BY ICRG

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
<b>100</b>	<b>Total number of points for weighted influence</b>

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## ECONOMIC FREEDOM INDEX 2018



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## THE HERITAGE FOUNDATION: ECONOMIC FREEDOM INDEX 2018

### 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 2018

### Top 10 Countries

RANK	COUNTRY	OVERALL	CHANGE
1	Hong Kong	90.2	0.4
2	Singapore	88.8	0.2
3	New Zealand	84.2	0.5
4	Switzerland	81.7	0.2
5	Australia	80.9	-0.1
6	Ireland	80.4	3.7
7	Estonia	78.8	-0.3
8	United Kingdom	78.0	1.6
9	Canada	77.7	-0.8
10	United Arab Emirates	77.6	0.7

### REPPRESSED (49.9-40)

RANK	COUNTRY	OVERALL	CHANGE	RANK	COUNTRY	OVERALL	CHANGE
160	Niger	49.5	-1.3	171	Djibouti	45.1	-1.6
161	Sudan	49.4	+0.6	172	Algeria	44.7	-1.8
162	Chad	49.3	+0.3	173	Bolivia	44.1	-3.6
163	Central African Republic	49.2	-2.6	174	Zimbabwe	44.0	0.0
164	Angola	48.6	+0.1	175	Equatorial Guinea	42.0	-3.0
165	Ecuador	48.5	-0.8	176	Eritrea	41.7	-0.5
166	Suriname	48.1	+0.1	177	Republic of Congo	38.9	-1.1
167	Timor-Leste	48.1	+1.8	178	Cuba	31.9	-2.0
168	Togo	47.8	-5.4	179	Venezuela	25.2	-1.8
169	Turkmenistan	47.1	-0.3	180	North Korea	5.8	+0.9
170	Mozambique	46.3	-3.6				

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## FREEDOM HOUSE:

FREEDOM IN THE WORLD ANNUAL REPORT (1972-2015)

- ▶ 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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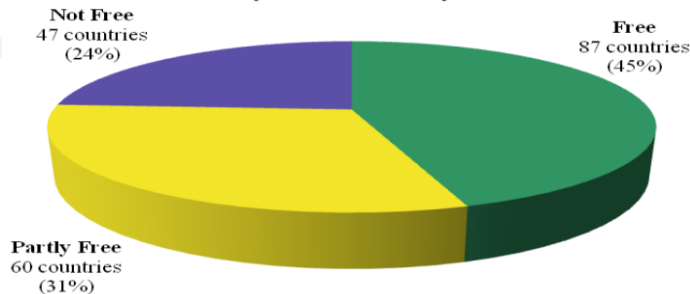
### Free countries (87)

- ▶ Australia, Finland
- ▶ Malta, Slovenia
- ▶ Uruguay, Bulgaria
- ▶ Chile, Costa Rica
- ▶ Mauritius, Poland
- ▶ Indonesia, Benin
- ▶ Botswana, Brazil

### Not Free countries (47)

- ▶ Cameroon, Congo
- ▶ Haiti, Iran
- ▶ China, Vietnam
- ▶ North Korea, Burma
- ▶ Cuba, Saudi Arabia
- ▶ Syria, Turkmenistan
- ▶ Libya, Sudan
- ▶ Somalia

Country Breakdown by Status



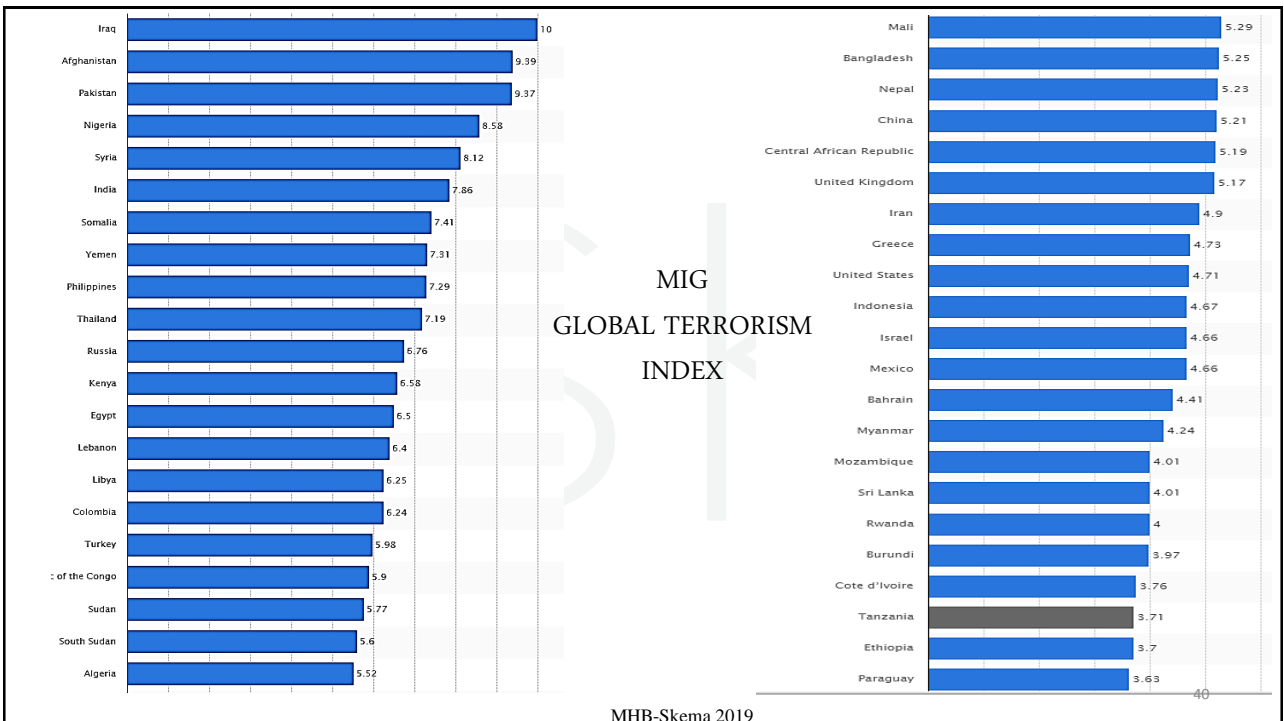
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## MERCHANT INTERNATIONAL GROUP

- ▶ Founded in 1982, it specializes in strategic research and corporate intelligence, focusing on risks and threats that confront companies worldwide.
- ▶ MIG operates in over 100 countries.
- ▶ [www.merchantinternational.com](http://www.merchantinternational.com)

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## 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.

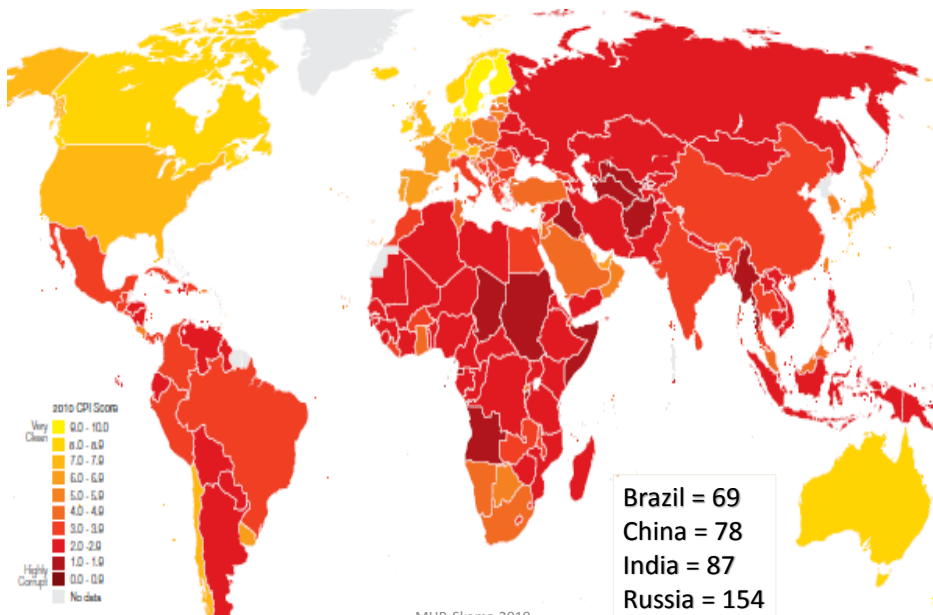
More than 10 percent of nations around the world have experienced corruption-fueled political change in the last five years (Carnegie, 2018). In many countries, corruption has fueled terrorist recruitment and sparked violent insurgencies.

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

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## TI WORLD MAP OF CORRUPTION



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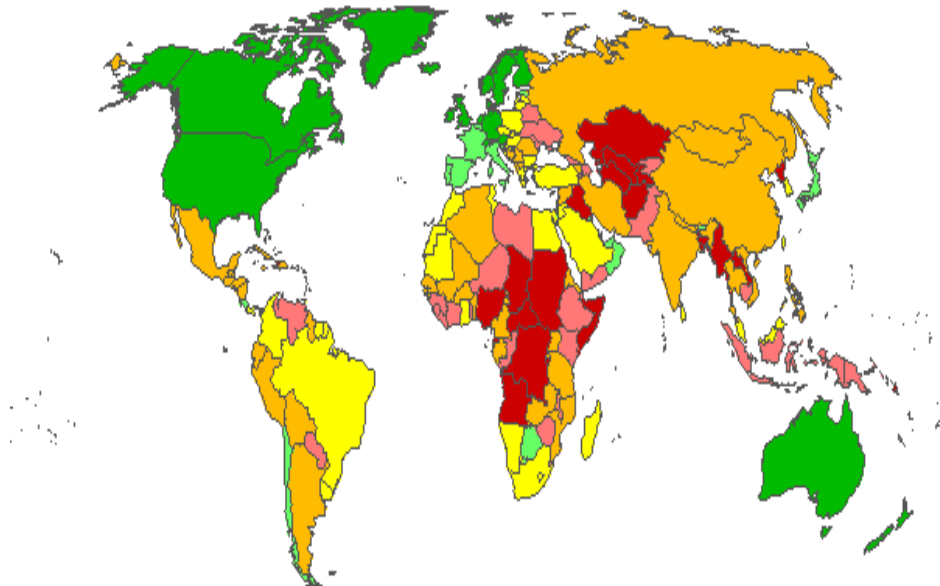
## MEASURING CORRUPTION? TRANSPARENCY INTERNATIONAL CPI

1	New Zealand		162	Guinea-Bissau
2	Denmark		162	Kyrgyzstan
3	Singapore		162	Venezuela
3	Sweden		168	Burundi
5	Switzerland	<b>France = 22</b>	168	Equatorial Guinea
6	Finland	<b>Brazil = 72</b>	168	Guinea
6	Netherlands	<b>China = 80</b>	168	Haiti
8	Australia	<b>India = 94</b>	168	Iran
8	Canada	<b>Russia = 133</b>	168	Turkmenistan
8	Iceland		174	Uzbekistan
11	Norway		175	Chad
12	Hong Kong		176	Iraq
12	Luxembourg		176	Sudan
14	Germany		178	Myanmar
14	Ireland		179	Afghanistan
16	Austria		180	Somalia



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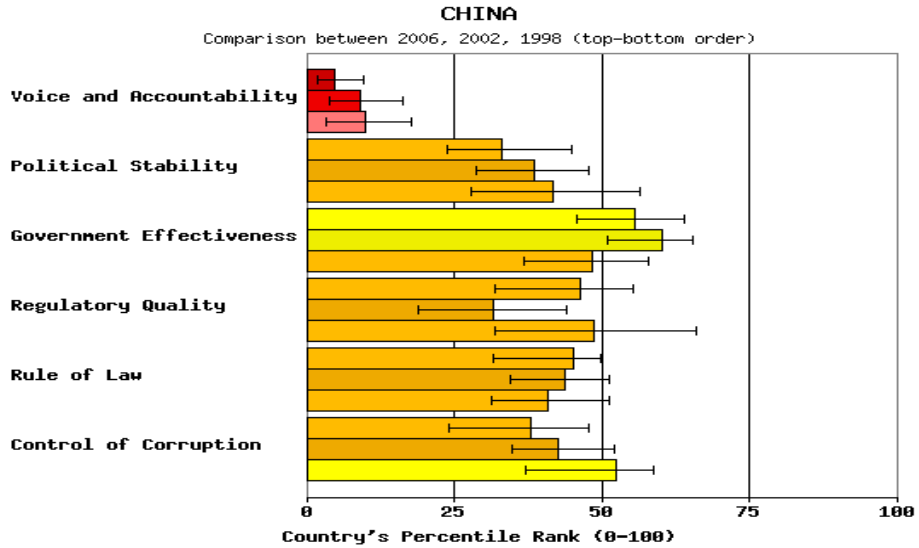
## WORLD BANK'S WORLD MAP OF GOVERNANCE



Source: Kaufman, World Bank

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## WORLD BANK ASSESSMENT OF GOVERNANCE IN CHINA



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## 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>

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## IBRAHIM INDEX OF GOOD GOVERNANCE IN AFRICA

1 Mauritius	83,0	19 Mali	52,9	37 Nigeria	43,3
2 Seychelles	78,5	20 Mozambique	52,1	38 Liberia	43,2
3 Botswana	75,9	21 Burkina Faso	51,9	39 Togo	42,6
4 Cape Verde	75,5	22 Malawi	51,7	40 Niger	42,3
5 South Africa	71,5	23 Libya	51,5	41 Congo	42,0
6 Namibia	67,3	24 Uganda	50,8	42 Angola	39,3
7 Ghana	64,6	25 Swaziland	50,8	43 Guinea-Bissau	39,1
8 Tunisia	62,1	26 Kenya	50,5	44 Côte d'Ivoire	36,8
9 Egypt	60,5	27 Gabon	50,1	45 Guinea	35,6
10 Lesotho	60,1	28 Madagascar	48,7	46 Equatorial Guinea	34,7
11 São Tomé and Príncipe	58,2	29 Comoros	48,5	47 Sudan	32,9
12 Benin	56,6	30 Djibouti	48,5	48 Central African Republic	32,7
13 Morocco	56,6	31 Rwanda	47,2	49 Zimbabwe	32,7
14 Senegal	56,3	32 Sierra Leone	46,0	50 Eritrea	31,8
15 Algeria	55,2	33 Burundi	44,7	51 Congo, Democratic Rep.	31,1
16 Tanzania	55,0	34 Cameroon	44,2	52 Chad	28,8
17 Zambia	54,9	35 Ethiopia	43,5	53 Somalia	7,9
18 Gambia	53,0	36 Mauritania	43,4		

IIBD-OKCHA 2017