

**Measuring Political Risk as Risks to Foreign Investment:
A Computer-Assisted Model for Analysing and Managing Political Risk**

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DECLARATION

I, the undersigned, hereby declare that the work contained in this dissertation is my own original work and that I have not previously in its entirety or in part submitted it at any University for a degree.

ABSTRACT

As the title suggests, the major challenge that this study faces is to set out and design a model for analysing and enabling the management of political risk as *investment risk* – a model that is both sensitive to and reflective of the comprehensive business and investment climate in a country, not only credit or country risk, or only pure political risk in its narrowest definition.

In reading about past and more recent research in the field of political risk analysis, it becomes clear that many authors begin by noting the diversity and the discrepancies of the existing definitions of political risk, but evidence in political risk insurance shows that the major perceived political risks that investors insure their interests against seem to be confiscation, expropriation and nationalisation. In the light of this study's findings though, a case can be put forward for urging that the conceptualisation of political risk be extended to further include any or all of the micro political risk factors and their indicators that have been identified to ensure that political events do not impact negatively on a foreign company's profitability.

Foreign investors put assets at risk to achieve their objectives and the assessment of these risks, including political risks, is the key to successful operations. Opportunities and risks are often two sides of the same coin and political risk comprises a large part of the environmental forces in terms of the management challenges a Multinational Company (MNC) faces in any investment climate.

A firm's foreign investment strategy deals with the positioning of the organisation in an uncertain host country environment and investment climate. This study attempts to explain how a firm's political risk exposure, which refers to the sensitivity of a firm's projected profitability and operationability in a host country to changes in the investment climate, could be managed and reduced. It is hoped that political risk analysis and management can assist foreign operations in managing the risks that might have otherwise proven to be destructive to profitability and operationability.

It is irresponsible to present a potential investor with a risk assessment that does not incorporate political risk factors and their indicators, let alone environmental, societal and socio-economic risk factor indicators. Ultimately any business climate, regardless of the country being studied, is underwritten by a political system, political climate, political culture and business culture of the system in which foreign business wishes to operate profitably.

What is often labelled as unnecessary and irrelevant detail in risk analysis often results in a lack of using micro risk factors and their indicators and an underestimation of the importance of such micro risk indicators. Hopefully this study takes up the challenge of showing that political risk can be managed and political risk analysis can be made more precise – that it *is* possible to measure and manage political risk.

OPSOMMING

Soos die titel van hierdie studie voorstel is een van die grootste uitdagings die ontwerp van 'n model vir die analise van politieke risiko as beleggingsrisiko – 'n model wat ter selfde tyd sensitief is vir en weerspieëlend van 'n land se algemeen omvattende besigheids- en beleggingsklimaat, en nie slegs suiwer politieke risiko in die nouste sin van die woord nie.

'n Literatuurstudie van meer onlangse navorsing, asook navorsing wat in die verlede gedoen is oor politieke risiko en die analise daarvan, dui daarop dat baie outeurs melding maak van die diversiteit en teenstrydighede in die bestaande definisies van politieke risiko. Die teenwoordigheid van versekering teen politieke risiko wys egter daarop dat die primêre politieke risiko's waarteen beleggers hulle belange verseker meesal nasionalisering en onteiening is, asook die beslaglegging op beleggings. Teen die agtergrond van hierdie studie se bevindinge, kan daar egter 'n saak uitgemaak word vir die verbreding van die konseptualisering van politieke risiko om enige of alle van die mikro-politieke risiko faktorindikatore wat in hierdie studie identifiseer word in te sluit, om sodoende te verseker dat die negatiewe gevolge wat politieke gebeure moontlik mag inhou vir 'n buitelandse maatskappy se belange, sover moontlik beperk word.

Buitelandse beleggers stel bates bloot aan risiko's ten einde voorafgestelde doelwitte te bereik en die assessering van hierdie risiko's, insluitende politieke risiko's, is 'n groot bydraende faktor tot die suksesvolle bedryf van buitelandse beleggings. Geleenthede en risiko's is dikwels twee kante van dieselfde muntstuk en politieke risiko maak 'n groot deel uit van die uitdagende beleggingsomgewing waarin die bestuur van 'n multinasionale korporasie (MNK) daagliks moet funksioneer.

'n Maatskappy se buitelandse beleggingstrategie handel met die posisionering van die organisasie in die onvoorspelbare beleggingsklimaat van 'n vreemde land. Hierdie studie poog ook om te verduidelik hoe die mate waarin 'n firma blootgestel word aan politieke risiko, met ander woorde die sensitiwiteit van 'n firma se voorgenome winsgewendheid en bedryf teenoor veranderinge in die beleggingsklimaat van 'n vreemde land, bestuur en verminder kan word. Daar word gehoop dat politieke risiko analise en die bestuur daarvan 'n bydra kan lewer tot buitelandse besighede se bestuur van hierdie risiko's, wat andersins 'n vernietgende impak kan hê op die winsgewendheid van buitelandse bedrywighede.

Dit is onverantwoordelik om aan 'n buitelandse belegger 'n risiko analise voor te lê wat nie politieke risiko faktore en die daarmee gepaardgaande indikatore insluit nie. Die studie argumenteer verder dat faktorindikatore wat die fisiese omgewing, sosiale asook sosio-ekonomiese faktore aanspreek ook in 'n risiko analise ingesluit moet word. Oplaas is enige besigheidsklimaat, niesteenstaande die land wat bestudeer word, onderskryf deur 'n politieke stelsel, politieke klimaat, politieke kultuur en besigheidskultuur van die stelsel waarin die buitelandse besigheid winsgewende resultate as doelwit het.

Wat dikwels beskou word as onnodige en irrelevante detail in risiko analise lei dikwels tot 'n gebrek aan die insluiting van mikro-risiko faktore en hulle indikatore weens 'n onderskatting van die noodsaaklikheid daarvan om juis sulke mikro-risiko faktorindikatore in 'n risiko analise in te bou. Hierdie studie aanvaar hopelik die uitdaging om te wys dat politieke risiko tog bestuur kan word en dat politieke risiko analise tog meer eksak gemaak kan word – dat dit *wel* moontlik is om politieke risiko te meet en bestuur.

Dedicated to...

Both my Grandfathers

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CHAPTER ONE: Introduction – Background to the Study and Research Framework

After the end of the Cold War and the odd decade of dormancy, political risk analysis has come into its own once again. Political risk and the analysis thereof remains a highly fascinating and extremely interesting phenomenon to research, and the years spent on this study were hardly enough to cover the ever-expanding nature of that which can be deemed inclusive to political risk. This study is the amalgamation of answers to many questions, some of which will be gradually introduced in this chapter.

This introductory chapter serves many purposes and attempts to offer at least some clarity on various questions relating to this study of political risk analysis. One of these purposes lies in developing the main theoretical and empirically practical ideas and motivations that initially prompted this study. Apart from placing the topic of the dissertation in context, the introduction also aims to explain why the topic was decided upon, what the importance and uses of the study can be, as well as its relevance.

Although a more detailed conceptual clarification follows in the second chapter, a working definition of political risk analysis broadly encompasses *the analysis of the possibility that factors caused or influenced by government political decisions or other unforeseen events outside or in a country will affect business climates in such a way that investors will lose money or not make as much money as they expected when the initial decision to investment was made*¹. These factors can be of internal (from inside the host country) or external origin, and can pose macro (generic) and/or micro (specific) risks. What becomes clear as this introductory chapter evolves is how primary ideas ultimately become refined in order to offer a more focused approach to the study. In doing this, a gradual clarification of the concepts and questions will lead to the identification and articulation of the research problem posed in this study. It will also become clear how the overall aims and goals of the research conducted during the study, namely the development of a model for political risk analysis and management, evolve from reading and thinking about the research problem. The development of specific research objectives will be attempted in this introductory chapter, as will the indication of the study's research design and methodology. This

¹ This is a broad definition which aims to show that the factors addressed in this study as agents or indicators of political risk are not purely and necessarily *political* in nature - they can be socio-economic, socio-political, macro economic, financial and even environmental in nature. Indications of an over-powerful, unchecked and unbalanced executive prompts an analysis of the person as well in order to anticipate possible actions, statements or decrees. The consequences and ramifications of unlimited executive power can be illustrated by the recent Zimbabwean example of President Robert Mugabe. Although conceptual details will be offered in chapter two, see the following sources for temporary clarification: Akhter and Lusch, 1987:81-101; Baker and Hashimi, 1988:40-47; Bird, 1986:1-15; Brewer, 1985:3-12; Broadfoot, 1998:1-3; Chermak, 1992:167-178; Coplin and O'Leary, 1994:3-11; Fitzpatrick, 1983:249-254; Frei and Ruloff, 1988:1-24; Kobrin, 1981:251-270; Krayenbuehl, 1985:3-14; Sethi and Luther, 1986:57-68; Simon, 1982:123-143.

chapter will conclude with a description of the main topics to follow in each of the remaining chapters.

1.1 Some Background on Political Risk Analysis

The measurement and observation of political risk depends to a great extent on subjective human judgement which is in some instances a handicap in conducting a political risk analysis. Yet Pidd (1996:47) explains that the term “subjective” should not conjure up thoughts of decisions based on “wild”, “outrageous” or “ludicrous” whims. The use of a designed model for political risk analysis and management, as suggested in this study, aims to ‘balance’ user subjectivity with a model that can reflect researched information to attempt a probable estimation in a more objective sense. It is this study’s understanding that subjectivity relates probabilities involved in the decision-making process to the beliefs of decision makers, and to the information available at the time of making a decision. This also allows for the adjustment of estimates as further information becomes available. Subjectivity can be influenced by improved knowledge, or if previous ideas are shown to be false (Damasio, 1995:1-384; Evans, 1991; Pidd, 1996:47-48; Rosenhead, 1972).

The system of analysis proposed in this study is not an inanimate object – apart from political risk factors and their indicators, it is also made up of people and stakeholders who react, respond and whose views change, including those of the political risk analyst.

In an attempt to quantify traditionally subjective political, economic and social phenomena, quantified data presented as ‘weighted’ factor indicators of risk will be calculated by relaying the information into a model designed to reflect the outcome of an operationalised analysis. This includes the design and use of a computer-assisted² model for the measurement of these risks offered in Chapter Five of this study. This model aims to assist in the decision-making process surrounding foreign investment, where human rationality is limited when operating in conditions of considerable uncertainty (Simon, 1972:1-364)³. It is this uncertainty that the model in Chapter Five attempts to clarify and alleviate somewhat, as it becomes clear that there is a necessity for a focus on developing procedures that may enable foreign investors and/or governments to make better decisions, and to manage the implementation of these decisions (Brewer, 1985:3-12, 337-349; Crain and Tollison, 1990; Goldstein, Reinhart and Kaminsky, 2000:55-72; Makridakis, Wheelwright and Hyndman, 1998)⁴.

² In chapter five, this computer program is illustrated and offered on an accompanying computer disc.

³ Awarded the Nobel Prize for Economics, Simon (1972:1-364) based his ideas of human rationality and decision-making processes on observations of the ways in which decisions are *actually* taken in practice. Our model for political risk analysis aims to assist in this decision-making process and eventual clarification and management of the complex environment in which such decisions are made. See Pidd, 1996:52-56.

⁴ Additionally, see Mueller in Rodgers (eds.), 1988:197-211; Rice and Mahmoud, 1986:12-21; Simon, 1985:132-148; and Somerville and Taffler, 1993:281-297.

Political risk analysis and management is mostly grounded in 'problem solving' theory⁵ (Pidd, 1996:65-69). Before applying a particular method or model of political risk analysis, it is important to ask about its underlying theory (Brummersted, 1988:75-95; Chermak, 1992:167-178; Doyle and Brown, 1988:10-21; Fitzpatrick, 1983:249-254; Sethi and Luther, 1986:57-67; Schoemaker, 1993:193-201; Simon, 1984:123-143). In designing such a model, the relationship(s) between 'hard' (economic) and 'soft' (socio-political) variables should be grounded not only in 'tangible' economics, but in social science knowledge and research as well. Risk models should also be adaptable and flexible, in that they can be reconstructed to suit industry and investor-specific micro circumstances⁶. The use of a certain method of analysis greatly influences the investment decision, as well as the reliability and validity of the eventual product of risk analysis (Akhter and Lusch, 1987:81-101; Bird, 1986:1-16; Clark and Cole, 1975; De la Torre and Neckar, 1988:221-240; Frei and Ruloff, 1988:1-23; Goldstein, Reinhart and Kaminsky, 2000:33-44; Howell and Chaddick, 1994:71-91; Kobrin, 1981:251-271; Miller, 1992:311-331; Robinson, 1972).

Political risk analysis first came to the fore as a recognisable field of interest and practice during the mid-1970's. An initial density in the literature points toward the aftermath of the first oil-crisis ca. 1973. The multi-disciplined⁷ research environment of political risk analysis seemed to have lost its momentum in the 1990's at the end of the Cold War⁸. This does not imply that there is no longer a demand for political risk analyses – quite the contrary. There is certainly a need for new research and novel approaches to the field of political risk analysis and the management of these risks. The environment in which political risk analysis occurs has also become more complex. The balance of power in the New World Order is constantly shifting, and, although some would argue that the presence of a world hegemon can still be felt, it is certainly going to be challenged by a re-invented, self-styled Chinese rival. Multipolarity has replaced bipolarity, new regional groupings have cemented political and economic ideals, and deeply embedded conflicts flare-up repeatedly. Amidst all of this, international trade and the regimes that regulate it can testify to the more complex structure in which political risk analysis operates. Fortunately, social science methods have also become more sophisticated, enabling better projections on the basis of available information, while computers have facilitated the accelerated processing of such information and technology, enabling one to gather the latest information via various electronic resources⁹.

⁵ In Chapter Two, this notion will be investigated and discussed further.

⁶ An example of this adaptability is given in Chapter Five, where the generic model is presented and customised to present an analysis of a specific investment environment.

⁷ Political risk analysis draws on information traditionally assembled by economists, historians, political scientists, behaviouralists, and in our case, environmental economists, strategic managers, financial analysts, international relations theorists, development theorists, international political economists and public policy makers.

⁸ During the literature study, it became clear that the bulk of research and publications on political risk and political risk analysis was mostly done in the 1980's.

⁹ The sensitive balance between credible academic sources for arguments sake, and background, evidential or illustrative information taken from the Internet - among other sources - will always be carefully maintained in the spirit of academic research.

Brewer (1982:5), Simon (1984:24) as well as Coplin and O'Leary (1994:1-11), suggest that some widely used political risk measurements are inadequate in certain respects¹⁰. Many risk ratings pay too much attention to expropriations, confiscations, exchange controls, macroeconomic credit ratings, and government instability in mostly developing countries and emerging economies. The collection of information and eventual analyses are either too intuitive, or too formalised. Furthermore, the use of political risk assessments into capital budgeting analyses tends to be too simplistic.

Preliminary research shows that there is a need to fill the gap in contemporary research with a model that better represents reality. Furthermore, causal relationships and analytical procedures are affected by socio-cultural, political and economic phenomena, and should be incorporated into a framework¹¹ with which to assess political risk.

There has always been a relationship between politics and business, the nature of which can either be exploited, or gravely misunderstood. The connection between the world economy and domestic politics, society and culture cannot be side-stepped, and is the dynamic backdrop against which international business is conducted every day. Misunderstanding the delicate nature of the above relationship may result in inapplicable and useless risk analyses for international credit-lending agencies and governments, borrowing and in-debted countries, banks, structural adjustment initiatives and foreign direct investors. Broadly speaking, the political risk analyst should be able to advise clients on certain investment opportunities and strategies, and be ready with answers regarding complex decision-making environments. Certainly, risks should not only be avoided at all times. By determining the nature and extent of the risks involved, risks can actually be exploited and even possibly profited from depending on the degree to which an investor is risk averse or risk assertive¹².

Political risks are a reality. Evidence thereof lies in the practice of political risk insurance coverage that has been extended to foreign operations by international private banks, political risk insurance companies like Marsh Credit Insurance and Political Risk, AIG Global Trade and Political Risk Insurance Company, FANDZ International Law Group, Meridian Finance Group, City South Limited, Provident Traders, Inc., BINKS Insurance Brokers Limited, Stening Simpson Group, Lex-Tek International, Export Insurance Services, Coface Ireland, Managing Agency Partners and the Multilateral Investment Guarantee Agency (MIGA)¹³ over the past decades. How much risk coverage is needed is something that can be calculated

¹⁰ Also see Mascarenhas and Atherton, 1982:22-31; Radock in Rodgers (eds.), 1988:1-9; as well as Goldstein, Reinhart and Kaminsky, 2000:45-54.

¹¹ "Framing" is a term introduced by Goffman (1974 in Pidd, 1996:76) as a way of explaining how we make sense of events by employing a scheme of interpretation, or a framework.

¹² Chapter Six deals with the management of political risk.

¹³ See <http://www.miga.org>, <http://www.marshcredit.com>, <http://tradecredit.aig.com>, <http://www.fandz.com>, <http://www.meridianfinance.com>, <http://www.cslbrokers.com>, <http://www.providenttraders.com>, <http://www.binks.ca>, <http://www.steningsimpson.com.au>, <http://www.lex-tek.com>, <http://www.exportinsurance.com>, <http://www.coface-ireland.com>, <http://www.mapunderwriting.com>.

by making use of political risk analysis in capital budgeting, for instance. Political risk insurance is a tool that is also used in political risk management strategies. An unfamiliar environment requires attention and assessment before an investment is made. An analytical framework is thus called for, which is manifested in political risk analysis.

As mentioned previously, political risk factors can be of internal (from inside the host country) or external origin, and can pose macro (generic) and/or micro (specific) risks. Political risk analysis also incorporates country risk, upon which will be expanded in Chapter Two of the study, and includes the economic and financial characteristics of a system. Of course, both the unique and the comparable societal and environmental characteristics of a certain system should also be taken into account before one embarks upon a political risk analysis.

The term 'political risks analysis' can be deconstructed as the sum of the probabilities that specific and/or related agents will induce an unforeseen or undesirable consequence or outcome, and the intensity of that result might have a negative impact on foreign business. This can manifest itself as severe financial losses, direct physical damage to infrastructure, a decline in profitability, or threats to the safety of operational personnel. By identifying such agents and by measuring these probabilities, one is conducting political risk analysis.

One of the principal purposes of political risk analysis is to present a political risk forecast, and a consequent goal is to suggest means of managing these risks. In this study, this is done by means of identifying risk factors and by determining the relationship(s) between these factors. By identifying such risk factors, a model is designed for the practice and operationalisation of political risk analysis. In these instances, other criteria should also be accounted for. Such criteria include the types of investments involved, the character of specific industries, the infrastructural environment, and a time frame - how long an investor should wait before commencing operations, or for how long an investment should be made¹⁴.

As a further aim of political risk analysis, the management of these identified risks can be conducted in many broad fashions, or whittled down to suit specific investments or operations¹⁵. Investors can ignore all forecasts and blindly proceed with intended strategies, or investment arrangements can be modified. Better deals can be negotiated with appropriate host institutions, or risks can be managed by direct action. Alliances can be developed, or political risk insurance can be obtained from private institutions, MIGA or the Overseas Private Investment Corporation (OPIC)¹⁶.

¹⁴ For preliminary operationalisations of risk indicators, see the following sources: Akhter and Lusch, 1987:90-99; Anderson, 1991:Chapters 5,7-8; Bird, 1986:6-14; De la Torre and Neckar, 1988:233-239; Krayenbuehl, 1985:26-39; Mueller, 1988:197-211; Radock, 1988:1-9.

¹⁵ See Chapter Five.

This study thus concentrates on political risks that foreign business, be it direct foreign investment, import and/or export operations, private banks, bilateral sovereign loans, joint ventures, or agents operating in host countries might face. In the light of such diverse uses for political risk analysis, a few can be mentioned at this stage. Political risk analyses are used to anticipate such risk factors as the potential for the imposition of, among other things, new exchange controls (*see Er10-Losses form exchange controls*)¹⁷, political upheaval that may lead to capital flight (*see Pr14-Political (in)stability*), or even the breakdown of administrative processes in a country (*see Pr29-Quality of the bureaucracy, and Pr30-Political will*) (Bartholomew, 1990:25; Lahiri and Moore, 1992:23). Comprehensive, valid and trustworthy analyses, comparisons and summaries are useful for assessing the political environments within which various financial decisions for foreign investment must take place. Strategic planning, preliminary viability studies and research, as well as risk management involves identifying trends, and ways in which the foreign investor can take advantage of those trends profitably (Brod, 1992:25; Tarzi, 1992:443-457).

1.2 The Research Problem

There are some very important questions that should guide new and current studies into the conceptualisation, measurement and analysis of political risk. These relate to the notion of political risk itself being made more precise, and revisiting some current models of risk analysis. It is also worth remedying empirical defects that may arise when measuring "soft" variables or political risk factors, which are traditionally regarded as typical of social science - an area infamous for the near impossibility of quantitative measurement.

Certain questions that are central to this study have been identified. Some of these will be further explored and expanded upon as the study allows for this at later stages. They are, briefly:

- How can the notion of political risk be made more precise?
- Why is it that some present models of political risk analysis are insufficient?
- Which empirical problems may arise in the measurement of such "soft" variables or risk factor indicators, as they are traditionally regarded as belonging to social science?
- Which methodological problems may arise, and how can the model for political risk analysis proposed in this study be constructed in such a way that the concepts and variables that follow can be adequately operationalised?

¹⁶ See Howell (ed.), 1998: 451-453 and <http://www.opic.org>.

¹⁷ "Er", "pr" and "sr" refer to economic, political and social risk factors respectively, explained in great detail in Chapter Four and applied in the model in Chapter Five.

- What is the importance of, and problems faced in the sourcing of information for risk analysis and management¹⁸, apart from "book knowledge".
- How can the management of political risk be conducted successfully?

The primary proposition of this study is that a mathematical quantitative model can measure qualitative givens, and eventually present calculated results in the field of political risk analysis. Arrow (in Brodbeck (ed.), 1968:636) is of the opinion that "...any intuitive knowledge can always be reduced to mathematical terms", and one of the challenges of this study is to test this notion.

1.3 Objectives of the Study

There is also a need to enable both country specific and comparative analyses to aid decision-making and manage risk on the part of foreign investors. It must also be shown that so-called "soft" political, social and even environmental factors can be empirically observed, measured and translated into numerical terms and equations, and be represented in a compounded result as a calculated risk. The generic model proposed in this study will prove not only useful for political risk analysis as such, but also useful in mapping strategies for the management of political risk¹⁹. The necessity to consider so-called "soft" variables in decision management processes is reflected in the example used in Pidd (1996:89). In a "rich pictures" diagram, an attempt is made to sketch out the main participants in the decision-making process, and to show their interests and interactions. The idea is to include information that could be regarded as "soft" (such things as people's attitudes, roles and assumptions) as well as "hard" or technical data (such as numerical data).

This study also has a practical objective, which is to present a computer-assisted model²⁰ that can accentuate both isolated events and illustrate and map trends. The model can be manipulated to reflect a "worst-case" scenario, depending on the values fed into the equation. This can be done by choosing to weigh the risk factor indicators in an unfavourable way if so required (where each risk factor has its own set of indicators that may or may not point toward the presence of the particular risk factor) thus reflecting the outcomes and consequences of certain decisions. The weight carried by the various risk factor indicators can also be manipulated - should a client wish that socio-economic factors 'weigh' more

¹⁸ The management of political risk analysis will be dealt with in great detail in Chapter Six of this study, illustrating that, once the decision to invest has been made based on a methodological analysis, the implementation of the decision is less simple, given the various complexities faced in different investment environments.

¹⁹ Mapping is an approach that can be used to help people organise their thoughts around the variety of options they face in making foreign investment decisions (Kelly, 1955 in Pidd, 1996:179). Kelly, 1955 stresses the need to ensure that mapping is used as part of a negotiation process in which the role and views of both the foreign investor (client) and analyst are not ignored. The idea is to use mapping as part of a process of assisting the organisation to commit to some action that will help achieve whatever their goals are found to be. In this case the goal of making a profitable foreign investment decision.

than other indicator types, this can be done by adjusting the weights of the measurements per formula in percentage terms. This will be practically illustrated in Chapter Five of this study.

Some concrete research questions have been posed in the above discussion, but certain aims and research goals have crystallised from these, once again augmenting the relevance and use of the study presented in this dissertation. Scepticism concerning the operationalisation and quantification of non-economic variables, a preference for in-depth single country analyses²¹, and the lack of clearly defined boundaries for political risk analysis precisely because of its multi-disciplinary nature has resulted in the lack of a systemic approach in the field. This scepticism is based on a belief that political risk is too formless and subjective a concept to be exposed to systematic quantitative analysis (Simon, 1984:24)²².

1.4 Aim and Relevance of the Study

The main aim of this study in political risk analysis is to design and present a generic but adaptable model²³ for political risk analysis – one that takes the latest information and technology, new variables, risk factor indicators and formulas, and combines these with a potential foreign investor's²⁴ intuitive judgement and objective expertise (Pidd, 1996:47-48).

Various authors have accentuated the importance of gaining such an "edge" on technological competition, and that the possession of "know-how" can result in greater productivity²⁵. A generic model will be offered in this study, but, in illustrating the flexibility of the model, it will also be shown how the model can be adapted to suit a specific client's needs within a specific industry and environment in order to gauge the comprehensive viability of the potential investment. This is done in Chapter Five.

²⁰ As a technique, computer simulation modelling has been in use in management systems since the 1950's, and its methods have gradually evolved alongside general developments in computing since then. See Pidd, 1996:250, 258.

²¹ Although this study by no means negates the absolute use and need for in-depth single county analysis - and even facilitates this practice by enabling such analyses by means of the suggested model - it does propose, however, that certain benefits can be derived from using in-depth analyses comparatively.

²² Also see Brewer, 1981:5-12; Chermak, 1992:167-178; De la Torre and Neckar, 1988:221-240; Doyle and Brown, 1988:10-21; Mascarenhas and Atherton, 1982:22-31; as well as Sethi and Luther, 1986:57-67.

²³ A conceptual discussion of the term 'model' as used in this study, will follow in more detail in Chapter Two, and Chapter Three will present further clarification regarding the notion of 'modelling'. For the time being, let it suffice to use Pidd's (1996:15) definition of the term 'model' as being "...an external and explicit representation of part of reality as seen by the people who wish to use that model to understand, to change, to manage and to control that part of reality."

²⁴ The aim of the model of political risk analysis presented in this study is to offer a service not only to direct foreign investors as such, but also to offer 'lending-governments' a comprehensive profile of 'borrowing-governments' in an attempt to identify potential default and sovereign risks. Governments can also analyse projects themselves, as Chapter Five will show by illustrating the "Coega" example. Other types of foreign investments can also be serviced in this way, be it capital investments, import/export operations, established operators using agents in host countries, large multinational companies (MNC's), or even smaller firms interested in expanding their operations abroad. Let it be said at this point though, that this study aims to show that not only investors can benefit from using this model, but it can also be of great value for research purposes, country profiling and in the general interest of facilitating the teaching of political risk analysis and management.

The model can also be used as an 'optimisation' tool, in the sense that it can be used during a decision-making process to optimise the outcome of implementing decisions made regarding foreign investment or expansion. It makes sense to use limited financial, physical and human resources as efficiently and as effectively as possible, thus optimally. The political risks identified in this study act as constraints to the decision-making process of whether to follow through on foreign investment initiatives. It follows that an acceptable solution, for instance to the question of whether or not to invest in a particular host country, has to satisfy these identified constraints (Pidd, 1996:217).

If a problem statement involves a 'why' question, in other words, 'why this study is being undertaken', one answer can lie in the suggestion that current widely-used and reputable approaches to political risk assessments are lacking in especially three respects, all of which will be addressed in more detail and expanded upon as the study evolves (Brewer, 1981:5-12 and 1982:5; Chermak, 1992:167-178; Coplin and O'Leary, 1994:1-11; De la Torre and Neckar, 1988:221-240; Doyle and Brown, 1988:10-21; Mascarenhas and Atherton, 1982:22-31; Sethi and Luther, 1986:57-67). It is worth challenging the notion that political risks, or investment risks for that matter, are narrowly regarded as being the nemesis of only emerging economies. A traditional and outdated focus on primarily expropriations, confiscations, exchange controls and government instability within developing countries diverts necessary attention away from other vulnerable countries. Although a few scholars and economists found mounting evidence for an East Asian meltdown²⁶ for example, the eventual financial crisis took even the credit rating agencies by surprise²⁷ (Goldstein, Kaminsky and Reinhart, 2000:45-52). This notion will be investigated further in Chapter Three.

It has also been contended that the methods of gathering or collecting information and intelligence have either been too impressionistic and intuitive, or too formalised and mechanistic in the past²⁸. The importance of research and the development of viability studies cannot be stressed enough. In an interview²⁹ conducted in order to gauge the need and relevance of political risk analysis, it was mentioned that Japanese companies and firms are perceived to spend the most time, effort, manpower and capital in thoroughly researching a potential investment transaction. This might augment their understanding of saving money in the long run – as money spent on research and analyses in the short term can eradicate the possibility of losing millions of dollars in badly researched projects, joint ventures or failed initiatives.

²⁵ Erb, Harvey and Viskanta (1996:29-47) stress the importance of gathering inter-disciplinary and technological intelligence in a highly competitive environment - now even more so.

²⁶ See Krugman (1994:1-12) in his extremely informative explanation of the myth of the Asian 'miracle'.

²⁷ See Goldstein, Kaminsky and Reinhart, 2000:45-52; Fitch IBCA, 1988:1-2; Luce, 1998:1-4; South China Morning Post, 21 January 1998:1-3; Tesoro, 2000:1-2; and The Economist, 15 July 1995 and 13 December 1997. The recent January 2002 "Enron-crisis" in the United States of America, has also prompted criticism against the rating agency Standard and Poor's (Larsen and Wiggins, 2002).

²⁸ See Doyle and Brown, 1988:10-21; Frei and Ruloff, 1988:5-12; Kobrin, 1981:251-270; Mascarenhas and Atherton, 1982:22-32; Sethi and Luther, 1986:57-68; Somerville and Taffler, 1995:281-297; and Swaney, 1996:463-466.

In the same interview it was explained how a certain South African venture did not take the need for thorough research and viability studies seriously, and lost a great deal of capital in an electronics components project.

This study takes a practical approach to measuring and managing political risk manifested as risks to foreign investment, based on a solid theoretical foundation. There lies a great danger in underestimating the importance and necessity of conducting thorough political risk analyses. Billions of dollars can be lost due to ignoring or misinterpreting political risks, as the example of the Asian crisis will show³⁰. Foreign investment is not only about making or losing vast amounts of money. Investments are also made with regards to time and effort spent on strategising and planning, investing in personnel and investments in infrastructure to name but a few aspects that might suffer if political risk is underestimated. If one should 'spend money to make money', spending human and financial resources on thorough and in-depth political risk analyses will be justified regarding future investment returns.

It has also been noted that the integration of political risk assessments into the capital budgeting of organisations interested in expanding abroad tends to be too simplistic³¹. From the above example, the necessity of budgeting for thorough political risk analyses is invaluable, and can prevent unnecessary future losses.

Another problem facing the multi-discipline of political risk analysis is the separation of the 'political' from the 'economic', and even from the 'societal', as especially done by country risk rating agencies. Politics and economics can hardly be separated from one another, as policy makers and representatives of the governed in any country appropriate scarce resources as they see fit, to whom they see fit, and for motives they regard as being sensible. Societal insurgence against lowered government social expenditure can lead to civil dissent for instance, and can be relayed back to politics and decision-making on the part of government officials.

A repatriation of profits policy in a country might be discriminatory against foreign enterprises producing the same goods in which the host country might have a comparative advantage - again, the political decision to discriminate against such foreign organisations may be relayed back to economics (*Er27-Discrimination against foreign business*). Fragmentation along ethnic lines and control over resources,

²⁹ Interview with Dr. Martyn J. Davies in Stellenbosch, Thursday 30 August 2001, 11h00. Dr. Davies is the director of the Asia Project in the Political Science Department at Stellenbosch University, he is also involved with the firm Asia Focus Consulting (Pty) Ltd.

³⁰ In Chapter Three of this dissertation, the Asian Financial Crisis will be used as an example of how current rating mechanisms are lacking as early warning instruments. For background reading in this regard, see the following sources: Bacani, 1997:1-4; Camdessus, 1997:1-6; Crisp, 2001:1-3; Goldstein, 1998:1-7; Goldstein, Kaminsky and Reinhart, 2000:85-94; Griffith-Jones, Cailloux and Pfaffenzeller, 1998:1-5.

language or religious fissures in a once aligned government and internal threats to regime stability also relay back to politics (*Pr24-Demographic and traditional parochialism; Pr23-Organised religion in politics; Pr7-Racial, ethnic, nationality tensions*).

Strategic planning, prior to making foreign investment decisions, usually concentrates heavily on economic trends. Since political decisions and events substantially influence these trends, political risk analysis should be incorporated into these planning exercises. Brod (1992:25) and Tarzi (1992:433-457) explain how many planners have found systemic risk analyses, as presented in Chapter Five, particularly useful because they allow for the cross-country comparisons that are an integral part of an analytical approach.

As mentioned before, trends and current events are also widely used in political risk assessments (Anderson, 1991:48-55; Dieren, 1995; Hammond, 1995; Todaro, 1992:114-135), where trends are reflective of what has been happening in the past, for example:

- If there was evidence of unregulated tropical deforestation, it would be unwise for any foreign organisation dependent on wood pulp for production purposes, to make a long-term investment in a country with a heightened deforestation rate not supplemented by vigorous reforestation (*see Er31-Deforestation rate*). Having to initiate a reforestation program in a host country at an investing organisation's own expense, will be a cost factor that will have to be calculated into the preliminary budget and expenditures of a possible investment project.
- Private Military Companies (PMC's)³² might benefit greatly from 'doing business' in countries like Nigeria, the Democratic Republic of the Congo, Zambia or Angola.
- A foreign company in the business of producing oxygen-enriched breathing aids might profit from a city, like Mexico City or Beijing, that shows a trend toward unregulated and unrestricted emissions of fossil fuels and carbon-monoxide (*see Er32-Carbon dioxide emissions of fossil fuels in millions of metric tons per annum*).
- If access to public education and health facilities is limited, the quality of the future labour pool available to a foreign investor will be relatively unhealthy and uneducated (*see Sr13-Health care, and Er23-Economically active population*).
- The economic impact of AIDS cannot be underestimated as costs will be incurred in the ceaseless training and retraining of employees and in lost man-hours due to illness or laborious trips to hospitals and clinics (*see Er15-Economic impact of AIDS*).

³¹ See Brod, 1992:12; Brewer, 1981:5-12; Frei and Ruloff, 1988:17-19; Rice, 1986:12-21; Schoemaker, 1993:193-213; Simon, 1985:132-148; and Somerville and Taffler, 1995:281-297. Some authors even comment on the need to budget for 'kickbacks' and bribes, or for the expansion of payrolls in order to service covert job descriptions.

³² Professor Willie Breytenbach, of the Political Science Department at Stellenbosch University, shared his findings on 'Resource Wars in Africa' in a seminar held in the second semester of 2000, as part of the 'Political Science Seminars' program.

Coplin and O'Leary (1994:3) stress the need of an analytically structured model to sort through the multitude of elements that contribute to the confusion that characterises politics, society and economics in the vast world of investment opportunities. This study, and the model that it presents as its operationalisation³³, attempts to address this need.

The world is not only facing another century, but another millennium. The changing nature of heightened economic competitiveness will expand to include contenders like international mega-corporations³⁴, country groupings and regional unions, and the phenomenon of the rapidly changing field of technological progression. Nagging threats become serious problems like global climate changes, the size of the world's population, and AIDS. Foreign investors, policy and decision makers, governments and international monetary agencies can no longer primarily rely on mere intuitive judgements or pure country and credit ratings, despite the indisputable role these still play (Brewer, 1982:5; Coplin and O'Leary, 1995:4-11; Simon, 1984:24; Pidd, 1996:60-63).

Didsbury (1993:xi) explains that societies are continuously faced with the consequences of technological change and competition, which have as an effect a greater emphasis on efficacy. An organisation's productivity can be in decline in one country, due to, for instance:

- labour disputes (*see Er3-Stable labour force, Er12-Militancy of organised labour*);
- declining natural resources (*see Er30-Preservation of resources*);
- government restrictions (*see Er5-Repatriation of profits policy, Er6-Foreign equity ownership policy, Er11-Degree of protectionism, Er14-Level of state intervention, Er27-Discrimination against foreign business*);
- a lack of consumerism (*see Er25-Price index, Er24-Change in real wages, Er22-Annual average inflation rate*); or
- socio-politically motivated actions (*see Pr7-Racial, ethnic, nationality tensions, Pr11-Legitimacy crises, P12-Government behaviour, Pr13-Likelihood of social revolution, Pr15-Civil War, Pr20-Erosion of middle class support for the regime*).

Any combination of the above factors can cause an organisation to face financial losses or threaten it otherwise, and the organisation might wish to invest in a more profitable, more productive, financially

³³ See Chapter Five.

³⁴ Like petroleum companies such as British Petroleum, Royal Dutch/Shell Group, and Exxon/Mobil. Others include Nestlé, Unilever, Siemens, Philips Gloeilampenfabrieken and major motor vehicle manufacturers, and electronics manufacturers. Michael Todaro, 1992:471-473 compares the GDP's of some countries with the annual turnovers of large MNC's in his book "Economic Development in the Third World" (Fourth Edition, Longman). Although the data stems from a 1985 sampling, the illustration shows how the annual turnover of some MNC's (especially petroleum related) is larger than the gross national product of some countries with mid-size economies. Granted, 'smaller' countries have relatively small economies, but to service an illustration of the point, the annual turnover of General Motors for example, was larger than the annual product of Switzerland. Toyota Motor's annual product was larger than that of New Zealand's in 1985. Of course, there are advantages to the establishment of MNC's in host countries, but this study would be biased if the disadvantages of such foreign investments were not considered and investigated...this is done in Chapter Two.

more viable operation in another country. With the decision made to invest in operations abroad, decision makers need to confer with political risk analysts as to the needs of the specific investor and industry. In so doing, the country or investment climate that best suits these needs can be identified and the viability of the investment can be assessed.

With this in mind, the model of political risk analysis presented in Chapter Five aims to ease, yet still fortify, the process of conducting political risk analysis. This is devised by compounding and measuring political, economic, socio-economic, societal and environmental factors as political risk factors³⁵, which are of great significance in making decisions regarding foreign investment. The primary users of this model for political risk analysis will find that they can easily implement the user-friendly model themselves, while mathematical accuracy and facts are not compromised, but used simultaneously and objectively with the investor's own experience and expertise - thus marrying quantitative and qualitative elements of political risk.

A political risk analyst can be responsive to the needs and requirements of the investor, but only the investor can really fully fathom these needs, thus narrowing the communication gap that can possibly come to the fore between the investor and the political risk analyst. The model in Chapter Five serves as a suggestion or guide to the investor or decision-maker, where his or her persuasions and free choice are combined with well-researched political risk factors. Even though a computer calculates the risk in this proposed model, the analyst still researches the information and enters or captures the data. The calculations are computerised, but the political risk analyst interprets the results, and advises clients based on these results.

The analysis and management of political risk is a dynamic subject, as both expected and unexpected events constantly take place against a backdrop of shifting trends and sudden occurrences. Naturally much depends on the shape of the world economy and the way in which international politics unfold. Political risk analysis and risk management is not only concerned with the political and economic events that come into play in a country, but also with the sub-national socio-economic dynamic within countries and the impact world events have on them³⁶. Industrialised and newly industrialised countries alike are not exempt from political risk analyses, as the practice of such assessments are not only limited to the study of political risks in developing countries. A 'low risk' environment might actually pose a risk in itself. In such an environment where certain political, economic or social risk factors are not present to infringe on profit-taking, there can be heightened market competition in already saturated markets, and more investors that are more willing to lend or invest money.

³⁵ See Chapter Four of this study.

³⁶ A recent and unthinkable example is terrifying. The attack on the major cities of New York and Washington D.C. of 11 September 2001, targeted financial and government (defence) edifices in the United States of America. The way in which the U.S.A. and its allies (NATO states) react will witness an unprecedented unfolding of world events.

Political risk analyses are widely utilised, and the use thereof borders on the inexhaustible. As far back as 1967, Kahn and Wiener (1967:3) explain that a model for the analysis of political risk should

"...[try] to put [decision] makers in a position to deal with whatever future actually arises, to be able to alleviate the bad and exploit the good...in addition one [should attempt] to design programs able to cope more or less with possibilities that are less likely but that would represent important problems, dangers or opportunities if they materialised."

If a risk assertive or risk averse investor chooses to continue with foreign investment plans after the political risk analysis of a certain country seems to negate the logic of sound foreign investment practice, the investor should at least be equipped with a trustworthy base from which to further plan a political risk management strategy in order to profit from a risky situation. Chapter Six of this study deals with political risk management, but, short of elaborating on the notion as such, risk management as presented in this study will be conceptualised not only in theory but also explained by demonstrating how a political risk analysis model can be used in aiding to manage complexity in order to reduce the risk of making wrong decisions.³⁷

This study will examine existing methods of risk assessments, and will include, among others, the prominent and widely used methodologies of the Standard and Poor's (S&P's) country rating method, as well as that of Moody's Investment Services, the Business Environment Risk Index (BERI), the Bank of America World Information Services, Control Risks Information Services, the Economist Intelligence Unit (EIU), Euromoney, the Institutional Investor, Political Risk Services, and S.J. Rundt & Associates. Other examples of political risk and country risk analyses are those of the Business International (BI) system, and the World Political Risk Forecast (WPRF) (Chermak, 1992:174).

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. Political risks have to be checked constantly and assessments have to be updated continually in order to provide clients with literally the latest and most thorough political risk analyses. Certainly, the above-mentioned reputable ratings are good assessments of country risk analysis as such in themselves, but do not suffice in terms of calculating or comprehensively covering all possible types of risk, and, as this is not their intention, it becomes necessary to design a model with such intent. They are mostly macro risk rating tools, and are very useful to lending and financial institutions, and for macro-economic policy evaluations. The balance of payments sheet, financial indicators, and other macro-economic factors taken into consideration in the above methodologies, do not exist in isolation from the political system of which

³⁷ See Pidd, 1996:12. The author also explains how making a decision (to invest in this case), is often the 'easy' part – implementing the decision and 'pulling it through' is the 'difficult' part. This study will show how a model for political risk analysis can aid in the post-decision-making process, by having identified and calculated possible risks, and thus mapping the way forward in navigating around these risks.

they are a part and in which they function. They are influenced by the same factors used in this study of political risk analysis, if not products of these, where politics refers to the authoritative allocation of (scarce) resources, be they financial or physical - those same resources indicated or shown on the balance of payments sheet. Country risk factors, as accentuated before, are in fact used in political risk assessments.

Country ratings are often mistakably (or in ignorance of the consequences) used for purposes other than those they are actually and expertly intended for. Such ratings are often incorrectly applied as comprehensive reflections of a country's overall investment climate, instead of the purpose they were designed to fulfil - that of *credit* rating. The dangers inherent in such practices are mentioned briefly in this instance, but are further expanded upon in Chapter Three³⁸.

It is irresponsible to present a client with a risk assessment that does not incorporate economic as well as political risk factors, let alone environmental, societal and socio-economic factors of political risk. The balance of payments as a tool for credit risk assessment, although a useful tool in political risk analysis as well, does not suffice for use as the *only* assessment tool. An analysis using this and a few other macro-economic and financial indicators is valid as a country or credit risk analysis, but not entirely reliable as a political risk analysis. Not taking political factors and their indicators into account is taking further risks in an already complex decision-making environment. Not incorporating political risk factors will not 'undo' the impact that the political environment has on foreign investment, or, as in the case of the Asian crisis, the impact that the micro political environment will have on markets. Ultimately the business climate, regardless of the country, is underwritten by the political system, political climate, as well as the political and business culture of the system in which foreign business wishes to operate profitably.

The analysis of historic events in a country³⁹ or of certain current events may lead to a realisation of the circumstances under which harm to foreign investments can occur. The reason for making such a projection is to prepare or warn the investor as to how an organisation can deal with such risks or manage them. With political phenomena as a subject of analysis, the analyst is dealing with the behaviour of those people who make up Government, who legislate, judge and execute the rules and regulations, and influence the making of laws they choose to establish. The political risk analyst also has to take into consideration the social reaction to such government behaviour and rules, as well as the ability of the political system to respond to and cope with the taxing demands on and events in its domestic and international environments.

These taxing demands and inputs into the political system are better dealt with in a highly consolidated

³⁸ Goldstein, Kaminsky and Reinhart, 2000:45-52 express their thoughts on the dangers of using sovereign credit ratings incorrectly.

system that has experienced steadfast and evolutionary political development (*see Pr1-Political system*). The consequent stability thus contributes to a more profitable business environment in which foreign investors can operate - a business environment that is unconditionally linked to the political system of which it is part.

The political risk analyst thus tries to anticipate and calculate the magnitude of loss a potential investor might incur by envisioning the flow of interwoven circumstances under which such losses might occur. Those circumstances are then anticipated against the backdrop of features that pertain to the specific country in question. "The job of a political [risk] analyst, [much] like a stock market analyst, is to identify both risks and opportunities - and then to help find ways of turning high risks into high returns" (Bray, 1994:72). This study not only concentrates on the analysis of political risk, but on the post-analysis management thereof. Yet the analyst needs a map or guidelines that serve as a model in order to guarantee the most effective and trustworthy risk assessment reflective of the identified risk factors that apply to a certain country.

1.5 Research Design and Methodology

Various methodological difficulties arise in conducting political risk analysis. The importance of modelling the analysis so that the concepts, variables and risk factor indicators that follow the modelling process can be adequately operationalised should not be underestimated. Methodological problems experienced in political risk modelling will be addressed in more detail in chapter two. Uncertainties surrounding the validity of political risk analyses relate to the mentioned scepticism experienced with political risk analyses to date. Yet it is possible to measure political risk and to operationalise identified risk factors and their indicators by designing a model in aid of calculating political risk, as this study attempts to show.

Both qualitative and quantitative in nature, one of the main aims of this study is to show how these two approaches can be used in conjunction with one another by 'marrying' the qualitative nature of 'soft' variables and the more quantitative 'hard' variables into comprehensive political, social and economic factors of political risk. The study will show how qualitative variables can be measured and quantified, by attributing a weight to each risk factor's indicators. These weights are then calculated to present a measured, probable chance that political risk might occur. The quantification of both the 'hard' and 'soft' variables actually takes place during the operationalisation phase of the study, that is, in designing and applying the model presented in Chapter Five.

³⁹ This is illustrative of the inter-disciplinary nature of political risk analysis.

This study will span across all three elements of the purposes of social research, these being descriptive, explorative and explanatory (Babbie, 1995:84-86). The units of analysis are mainly taken from two levels of data or observation: from an individual level, and an aggregate (or ecological) level, denoting individual units of analysis and groups respectively. Although the next chapter deals with methodological and theoretical problems encountered in the study, the 'levels of analysis' problem (as opposed to the levels of measurement being the nominal, ordinal, interval and ratio measures, De Vaus, 2001:91-92; Johnson and Joslyn, 1995:91-95) should be mentioned at this stage.

Neuman (2000:132) explains that "a level of analysis is the level of social reality to which theoretical explanations refer", and delimits the kinds of assumptions, concepts and theories that a researcher uses. Levels of analysis relate to the types of observations and measurements that will be applied in the quantification of political risk factors in this study, and to the reliability and validity of the conclusions that will be drawn from these measurements, where reliability refers to dependability or consistency throughout the research process suggesting that the same thing is repeated or recurs under the identical or very similar conditions (De Vaus, 2001:27-31; Johnson and Joslyn, 1995:82-91; Neuman, 2000:164). The term 'validity' as used throughout the study suggests truthfulness and refers to how well an idea about reality "fits" with actual reality (De Vaus, 2001:27-31; Johnson and Joslyn, 1995:82-91; Neuman, 2000:164).

Units of analysis refer to the type of unit a researcher uses when measuring certain phenomena (Neuman, 2000:132). These can be an individual, a group, an organisation, a social category, a social institution or a society. Depending on the type of research question, the unit of analysis can also be a state, a speech made by a political executive or changes in foreign policy over time. Neuman (2000:134) explains that units and levels of analysis are used to design research questions, and that being aware of them helps researchers avoid logical errors.

These levels of analysis errors are actually made up of two fallacies: namely the ecological and individualistic fallacies⁴⁰. The levels of analysis fallacies are important to bear in mind, especially in regard of the fact that macro (balance of payments sheets for instance) and micro factors (industry specific indicators) of political risk do not operate in isolation from one another, but in a 'dependent' fashion, constantly impacting upon one another.

The same can be said for the environments in which these factors operate, namely the macro and micro environments - they are interrelated, and one environment cannot effectively be shielded against events that take place in another. It should be noted that the initial definition of the levels of analysis one is working with, as well as the "environments" they are taken from, is of crucial importance. For each

political risk analysis that is done by using this model, this focus can shift⁴¹. It follows that, in order to enable effective, valid and credible political risk analyses, what should be clearly identified from the outset is precisely which environments and levels of analyses are being addressed in each individual analysis.

For instance, in a political risk analysis of various African states, if the South African political system (*see Pr1-Political system*) is a focal point or unit of analysis in a political risk analysis, then Parliament is a sub-system, the National Assembly is a sub-sub-system, and ANC members on the Arms Appropriation Committee are part of a sub-sub-sub-system. If the focus or unit of analysis reverses and the National Assembly becomes the system, Parliament becomes a super-system, and the South African political system becomes a super-super-system (Mahler, 2000:8-9).

From the above discussion it would be clearly wrong to assert in a political risk analysis, that because one member of the Arms Appropriation Committee is perceived to be guilty of corruption, the entire South African political system is corrupt - unless the South African political system becomes the unit of analysis, and upon investigation, is evidently found to be corrupt (*see Pr25-Corruption/nepotism in government*).⁴²

To ensure the further validity and reliability of this study as explained above (De Vaus, 2001:27-31; Johnson and Joslyn, 1995:82-91; Neuman, 2000:164), extensive research will be done into all possible sources of information. Apart from academic material found in books published by experts in political and country risk analysis, academic journals will also be consulted which span across a wide field of sources indicative of the inter-disciplinary nature of political risk analysis - especially journals relating to business studies and financial services⁴³. Journalistic⁴⁴ and Internet sources will be consulted for the latest examples, background news and information. This should aid in compounding a better understanding of the magnitude of political risk, and will definitely show how inter-disciplinary the practice of political risk analysis truly is.

The proposed model presented in this study can be used to recognise and identify, examine and even

⁴⁰ Chapter Two of this study further explains the 'levels of analysis problem'.

⁴¹ For a good illustration of how focal points or units can change, consult G.S. Mahler's third edition of "Comparative Politics: An Institutional and Cross-national Approach" (Mahler, 2000:8-9).

⁴² For interest sake, refer to Mauro, 1997: "Why Worry About Corruption" in IMF Economic Issues. no. 6 at <http://www.imf.org/external/pubs/ft/issues6/index.htm>.

⁴³ Although such lists will broaden as the study expands, a variety of journals will be consulted, and among many others include: Advances in International Marketing, Risk Management, Lloyds Bank Review, American Political Science Review, Columbia Journal of World Business, Business Futures, Resources Policy, International Journal of Forecasting, World Economic Analysis, Financial Analysts Journal, Academy of Management Review, Journal of Policy Modeling, Management International Review, Journal of International Business Studies, Strategic Management Journal, Journal of Banking and Finance, Journal of Economic Issues and Futures.

⁴⁴ These can be Time Magazine, Newsweek, The Economist, Far Eastern Economic Review, Asiaweek, Sunday Times Business Times, Financial Times, and the Financial Mail.

monitor trends and cycles over a period of several years, permitting observations in political, economic and social changes within a host country over an extended period of time (Babbie, 1995:95)⁴⁵. This does not negate the notion that the model presented in this study can be used for in-depth country comparisons, and can be both synchronic (countries are compared simultaneously at one point in time in an attempt to identify the 'best' country to invest in) and diachronic (where an analysis of a certain country is done across time, thus enabling trend studies) in nature, depending on whether the need for the analysis is an in-depth country approach or a more comparative approach.

The course taken in the research design will follow the steps of observation, conceptualisation, sampling, collecting data, and operationalisation (Babbie, 1995:102-106). Certain limitations to the study are introduced due to the focus of the research conducted, in the sense that the number of risk factors used in the generic model for political risk analysis in Chapter Four has been limited from an inexhaustible pool of risk factors to a certain amount. Limiting the number of risk factors used in the model design illustrates the adaptability function of Chapter Five's generic, broader model in section 5.3. As the refined example and consequent specific model will show in section 5.5, the number of relevant risk factors can be either be further reduced or increased. Yet due to the scope of this study, the risk factors used in the generic model have been limited to those used in Chapter Five. The reason for this being that there is actually an infinite multitude and variety of risk factors that can be used in building a model for political risk analysis. By no means is it asserted that the set of risk factors will be complete or eternal, but will hopefully prove useful, and to which further research might contribute.

Pidd (1996:14) explains that no model can ever be complete and "unless we include the entire universe in our model, there is always the risk that something is missing". In light of this and the necessarily limited scope of the chosen risk factors, this study concedes that there might be a relationship between its area of interest and another part of reality that is missing from the model⁴⁶. The model presented in this study is neither trivial nor fully requisite. Instead, it aims to simplify (not over-simplify, though) and contextualise the complexities of reality-based investment environments.

Although the model is tested in Chapter Five in illustration of its design reliability, Pidd (1996:318) maintains that model validation, if taken to mean a comprehensive demonstration that a model is fully correct, is impossible. Pidd (1996:318) regards validation as an ideal towards which we must strive if we are to be at all faithful to the idea that management science aims to support action in the real world. It is important to note that it matters whether our models are wrong, as this may cause potential investors to embark on action that has very negative consequences. Hence this study realises its responsibility to aim at some form of validation, but recognises that this may be very limited.

⁴⁵ Babbie, 1995:95 explains that trend studies "are those that study changes within some general population over time". In our case, this 'general population' is conceptualised as the generic group of political risk indicators used in this study.

As the methodology of conducting research in social science has grown in sophistication, so too has the ability to improve upon projections resulting from the availability of vast amounts of new information. A great deal of this refers to the way in which the use of computers assists our analytical capability and the accessibility of larger amounts of information, as results can be presented with more ease and more quickly.

1.6 Outline of Remainder of Dissertation

This first chapter served as an introductory chapter to the presented study of political risk analysis. It touches on some of the terms, issues and problems that will be investigated in much greater detail as the study evolves. The problem statement is also addressed in the first chapter, as well as the importance of the study. The second chapter deals with a conceptualisation of the terms used throughout the study, as well as its theoretical approach in an attempt to establish the theoretical base of political risk analysis. It is the contention of this study that political risk analysis is founded in problem-solving and decision-making theory, both of which will be explained in the next chapter. An additional focal point of the second chapter is the sources of data - not only of this particular study, but also of 'good' political risk analyses in general. Chapter Two also addresses various theoretical and methodological problems encountered by political risk analysts, and those encountered in this study as well.

The third chapter deals with current methodologies in risk analysis, and presents as well as discusses some implications for future research on political risk analysis brought to light by the recent Asian Financial Crisis, and also addresses the notion that macro-type rating models did not send off any warning signals. Chapter Four deals with the political risk factors and their indicators used in the study, why these were chosen specifically, how they are weighed as well as how to 'score' these indicators in the presented model.

In the fifth chapter, the mathematics behind the computer-assisted model is presented, the model itself is tested and the results of the testing are expanded upon⁴⁶. Chapter Six introduces the notion of political risk management, which is possible after having identified potential risks by means of the designed model. Important to mention is the idea that the quality of the risk management strategy is only as accurate and reliable as the risk analysis. Thus, the design of the model that is covered by the preceding chapters challenges the model to reflect such accuracy and validity. This study concludes with the seventh and final chapter, which offers some concluding remarks and allows for further discussion relating to further scope for research in the field of political risk analysis.

⁴⁶ See Chapter Two for a detailed conceptual discussion of the term 'model'.

⁴⁷ This model is based on the Microsoft Excel programme.

In conclusion, the ultimate practical objective of this study is thus to offer a computer-assisted model for political risk analysis, accentuating both isolated events and trends. The model can also be manipulated to reflect a "worst-case"⁴⁸ scenario, depending on the values scored into the equations, by choosing to weigh risk factor indicators in an unfavourable way if so required. Weekly results can be tabulated or graphed to illustrate trends or tendencies, and monthly or annual tabulations can show cycles - assisting in anticipating and planning for risks involved in international business.

This model can also be used in a "reverse analysis", or "backward working" fashion. If a client knows exactly what the ideal environment 'looks like' for the viable and profitable implementation of an investment decision, the model and accompanying analytic methodology can be used 'backwards', thus tracing the ideal conditions by means of identifying the ideal weights of the risk factor indicators, and then 'matching' them up with possible investment environments.

One of the challenges faced in this study lies in testing the model it presents, and in doing so, will also investigate the micro risk environment prior to the Asian crisis⁴⁹. It remains to be seen if the model proposed in this study can pick up on micro factors indicative of a looming crisis, and if future "Asian-type crises" can be avoided. Of course, if they do not take place, due to the pre-emptive measures that can be taken on advice of the model, it suggests that this model can also serve as an 'early warning' type instrument in itself. This is valuable in the sense of affirming that the model then also contributes to evaluating investment strategies and risk management planning exercises.

The research conducted throughout this study is also, in Chapter Five (section 5.5), applied within a South African context, thus not only illustrating the study's practical value, but also the notion that political risk analyses can be useful to both and investor and government as a monitoring tool. The changing nature of heightened economic competitiveness in a world slipping in and out of global recession puts even more pressure on the South African government to facilitate not only its own international competitiveness, but at the same time design macro economic policy in an attempt to alleviate the socio-economic suffering of the majority of its citizens. These policies are, naturally, motivated by political manoeuvring and have as a result political implications that in turn impact upon socio-economic South Africa.

In summary, this study offers a comprehensive model for use in political risk analysis. It combines macro and micro risk factor indicators, and draws these political risk factor indicators not only from the political

⁴⁸ Where a model, per definition (see Chapters Two and Three), enables the user to investigate what might happen if a decision is made, one way or another. In explaining Ashby's (1956) principle of *requisite variety*, Pidd, 1996:94 uses the example of a furnace – if a furnace can get too cool as well as too hot, the control system should include some way of detecting and responding to low temperatures as well as to high ones.

⁴⁹ See Chapter Three later in this study, as the Asian Financial crisis is used as a case study to illustrate the point of the dangers involved in not including micro risk indicators in an analysis of macro environments. Also see the Economist, 15 July 1995 and 13 December 1997; the Financial Times, 8 May 1998; Luce, 1998:1-4; South China Morning Post, 1998:1-3; and Tesoro, 2000:1-2.

environment, but also form the economic, financial, physical natural and socio-economic environments. The model can be used to do in-depth country analyses, or can be adapted to enable cross-country comparisons and industry-client specific analyses.

What is often labelled as unnecessary and irrelevant detail in political risk analysis often results in the lack of using micro risk factor indicators, and an underestimation of the importance of such micro risk factor indicators. This study will present an example of political risks that foreign business (be it direct foreign investment, import and/or export operations, private banks, bilateral sovereign loans, joint ventures, agents operating in host countries) or governments might face in their involvement in investment initiatives.

This study takes up the challenge of showing that political risk analysis can be made more precise. It also attempts to remedy empirical defects that arise when measuring “soft” variables, including government behaviour for instance, traditionally regarded as typical of social science – an area infamous for the near impossibility of quantitative measurement.

CHAPTER TWO: Theoretical Approach

This chapter deals with the conceptualisation of terms used throughout the study as well as with its approach in an attempt to establish the theoretical base of political risk analysis. Although mention has been made of some of these terms, those explored in greater detail in this chapter all refer to the practice of political risk analysis as such, in an attempt to gain greater conceptual clarity on the definitive meaning of *political risk* and the *analysis* thereof. These terms include ‘country risk’ and ‘political risk’; ‘problem-solving theory’ and ‘decision-making theory’; the process of ‘analysis’ as such, ‘model’¹, ‘modelling’ and ‘computer simulation’; as well as ‘predicting’, ‘forecasting’, ‘forewarning’ and ‘anticipating’. This chapter will also attempt to further clarify and explain some methodological and theoretical problems encountered in political risk analysis, such as the levels of analysis problems briefly mentioned in the previous chapter.

2.1 Conceptualising “Political Risk”

Although conceptualising the terms used throughout this study entails much more than merely defining them, a ‘definition’² is, in its most basic sense, a description of an object or term that explains how its characteristics make it different from any other object or term. It also clears up the question of what political risk ‘is not’. This chapter will discuss that which makes political risk different from other kinds of risk, like country risk for example. It will also explain those ‘characteristics’ of political risk that will make it possible to recognise such risk in future.³

Chicken (1996:11) defines risk as “...a measure of the uncertainty about the frequency and consequences of unacceptable events”, and risk management (which will be addressed in detail in Chapter Six as “...the sum of the actions taken to try and keep to an acceptable level, the level of risk associated with any activity.” Miller (1991:311) explains further that “risk” has also been commonly assigned to factors either external or internal to a firm that impact on the level(s) of risk experienced by the firm. In his explanation, he actually uses the term “risk” to denote sources of risk. He also uses the term “political risk” as an example in illustrating his point that “risk” can actually refer to “sources of risk”.

Miller (1991:311) uses the example of political risk as a term that links unpredictability in firm

¹ Although briefly touched upon in this chapter, Chapter Three will offer a more in-depth conceptualisation of the terms ‘model’ and ‘modelling’.

² “Define” *vt.* – state contents or meaning, show clearly the form or outline, lay down clearly, mark out (Collins English Dictionary, 1993).

³ The operationalisation of these characteristics takes place in the form of political risk indicators offered in Chapter Four of this study.

The basic political risks that investors insure their interests against seem to be confiscation, expropriation and nationalisation defined as

“an act of expropriation including confiscation, nationalisation, requisition, sequestration and deprivation, by law order or administrative action of the government of the foreign country that:

- expressly and permanently deprives the assured of all or part of its shareholding in the foreign enterprise, or
- expressly and permanently deprives the foreign enterprise and/or the joint venture(s) of all or part of its assets, or
- expressly and selectively prevents or restricts the operation of the foreign enterprise(s) so as to cause the permanent and total cessation of the foreign enterprise’s activities”.⁶

Foreign investment within a host country concomitantly brings with it the need for transferring hard currency in the form of dividends or profits (Dealmaker, 2002:5). During an economic slowdown, political risks could increase due to the need to retain hard currency within the country. A profitable, self-sustainable foreign-owned entity might prove all the more attractive to the host government. It is for this reason that political risk insurance clauses are included to ensure that host government actions do not impact negatively on a foreign company’s profitability⁷.

Selective discrimination manifesting itself as micro risks, that is a law, order, decree, regulation or import/export restriction which is selectively applied by the host government against a foreign investor or organization and not applied against any locally owned entities transacting in similar business, can thus wholly impede the viability and profitability of a foreign (direct) investment. For example, being able to import the necessary drilling equipment to enable the extraction of minerals for export purposes can “make or break” an investment. If any such discriminatory act is enforced the corporate entity can become financially deficient, and as mentioned before, risks of an adverse government action could increase due to the need to retain hard currency within the country during an economic slowdown, for instance (Dealmaker, 2002:5).

Risks within countries can change on a daily basis and a strategic approach to eliminating these can prove invaluable. In a rare case only a small percentage of an asset is ever expropriated, or only part of a license withdrawn. Still, at any stage of a decision-making process or political risk analysis regarding an

⁶ In the past, temporary suspensions on currency inconvertibility and exchange transfer have resulted in certain countries failing to repay debts on loans (Dealmaker, 2002, no.5).

⁷ Political risk insurance as a means of managing political risk will be explored in greater detail in Chapter Six.

performance to specific uncertain environmental components, where uncertainty about environmental and organisational variables reduces the predictability of corporate performance and increases the chances of risk occurring (Miller, 1991:312).

As this study evolves, it becomes increasingly important to start differentiating between country risk as such, and political risk. It is necessary to clearly define the difference between country risk and political risk, as this chapter will suggest that country risk factors could be used as political risk factors as well - but the political risk factors put forward in this study are hardly ever used as indicators of country risk. Although a multi-discipline in its own right, political risk is more specialised than country risk. It is thus useful to mention some of the more widely used terms and scrutinised definitive questions of political risk and political risk analysis.

Many political risk authors begin by noting the diversity and the discrepancies of the existing definitions of the multi-discipline. This might be, in part, due to some critique regarding the work on political risk and the clarification of the concept/definition of political risk as being a problem of nominal versus real definitions⁴. Political risk as such is a nominal definition, as are many other concepts in political science, and that the reason why there is such a contestation in political risk analysis is exactly due to the nature of nominal definitions. This study thus continues in awareness of the limitations that the very nature of nominal definitions can place on empirical studies.

Still, most political risk authors seem to agree that *political risk broadly supposes the probability that business will either earn less money, or suffer losses in profit as a result of decisions and policies made by government* (Brewis, 1985:3; Brummersted, 1988:78; Coplin and O'Leary, 1994:2; Fitzpatrick, 1983:249; Frei and Ruloff, 1988:2; Hertz and Thomas, 1983:3; Howell, 1986:49; Kennedy, 1991:v-vii; Kobrin, 1978:114; Rummel and Heenan, 1978:68; Simon, 1982:4).

Private insurance markets usually define political risk(s) as the *actor omission of a foreign government that deprives a corporation of all or part of its assets, prevents or restricts the performance of a contract, causes restrictions on remittances, or causes loss or physical damage to assets*.⁵ Although International Law recognises the sovereign right of any country to expropriate foreign investment, this can only be enacted if such an action is not discriminatory, taken for a public purpose, taken in accordance with due process and not in violation of specific contractual agreements with the contractor of such licences and concessions (Dealmaker, 2002:3).

⁴ Private consultation with Albert Venter, 14 October 2002.

⁵ This is a definition used by Marsh Private Equity and Merger and Acquisition Services, a London-based company that, among other things, specialises in credit and political risk coverage (Dealmaker, 2002, no.5). Companies that render a comparable service are mentioned in Chapter One.

investment, acquisition, consolidation or lending, it remains imperative to consider the potential damage that such actions can render (Dealmaker, 2002:7)⁸.

Political risk is unfortunately easily confused with country risk, which in turn can be defined more precisely by referring to sovereign, credit and transfer risk, addressed at a later stage of this study. Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to problems arising from *macro-economic* events in a country (Calverly, 1985:3, Coplin and O'Leary, 1994:4-11, Kennedy, 1991:194-241; Krayenbuehl, 1985:3-20). Balance of payments sheets, country credit worthiness, and data on debt servicing ratios are the most widely used tools in country risk analysis. Coplin and O'Leary (1994:4-11) comment that too many current models of risk analysis focus too narrowly on these aspects, and in doing so, disregard combined political, economic and social micro risk factor indicators.

Political risk should be appreciated as being distinct from political instability and political uncertainty, which are "subjective doubt about the occurrence of political events" (Beroggi, 1999:144; Rummel and Heenan, 1978:68, Schneider, 1985:161). Basically, political uncertainty, according to Howell (1986:49), results from an inadequacy of information, whereas political risk is rather a "relatively objective measurement" of the amount of doubt, in contrast to the subjective character of instability and uncertainty. Political instability (*Pr14-Political (in)stability*) refers more to unexpected or unforeseen changes in government policy, or in a government's implementation of power⁹.

Political instability, in this study, is used as one criterion that points toward the possibility of political risk occurring. Foreign investors should be advised to either carefully manage or avoid operating in a context of political conflict that might evolve from political instability. The underlying risk that political instability holds for a foreign organisation is the possibility that political disequilibrium might result in governmental limitations on the escalation of profits (*Er5-Repatriation of profits policy; Er6-Foreign equity ownership policy*).

Not only is political instability a political risk factor that contributes to losses incurred by foreign investments, such losses can also be a result of sudden nationalisation and confiscation actions on the part of the host government (*Er2-Risk of confiscation/expropriation; Er9-Nationalisation of key industries/sectors*), the repudiation of contracts or even a loss of mineral rights for investors in the extraction industry of a host country (*Er5-Repatriation of profits policy*). Another political risk factor would be the imposition of harsh import and export restrictions, currency regulations (*Er10-Losses form*

⁸ The effects may be minimal on the initial balance sheet but the impact can have far-reaching and future consequences. The interruption of business can severely damage public confidence and the failure of management to foresee potential dangers to their assets can result in share prices falling steeply.

⁹ Political instability can be used as a factor of political risk. Instability (a property of the macro environment) can, but does

exchange controls) and controls over employment practices (*Er3-Stable labour force*).

Further losses can be reflected in labour turmoil (*Er12-Militancy of organised labour, Er3-Stable labour force*), lost man-hours, theft, war damage, even acts of subversion, looting or vandalism, or other actions taken in reaction to government policies. To gauge the possible threat of nationalisation and confiscation necessitates not only knowledge of a host country's political structure, but the philosophies and personalities of the political management and its elite should also be taken into consideration (Kennedy, 1991:21-61; Venter, 1997:73-99), as should knowledge of the society, culture and the influence of political ideology and theocracy in the regions of a country where foreign investment is planned to take place.

As explained previously, political risk is not only present in macro environments, but can also be industry (micro) specific (Akhter and Lusch, 1987:90-99; Anderson, 1991:48-55; De la Torre and Neckar, 1988:233-239). It can vary in different industries within a single country, depending on the nature of the foreign investment and the kind of market it wishes to enter. Some organisations may offer goods and services that become crucial to the direct functioning of the host economy, such as electricity companies or food distributors, while others may produce electronic components for computers for export purposes in Export Free Zones (EFZ's). Organisations that play such a critical role must be aware of the danger of being subject to government demands, due to a feeling of resentment against foreign dominance or exploitation by foreign economies.

Confiscations and nationalisation of foreign-owned industries, although aged factors of political risk yet perpetually important, are but two factors of risk in a very expansive political risk spectrum. Subsequent forms of host country interference include insisting on the use of local nationals in management jobs regardless of merit or experience, or encouraging a national boycott of a foreign firm's goods. Sanctions, such as imposing taxes, royalties or other impositions, can be instructed against foreign firms to the point where being a profitable organisation is only possible with great difficulty, if at all. As an example, Feils (2000:129) explains how “[p]olitical risk may alter operating cash flows via discriminatory regulations...”. Non-tariff barriers might include petty quality standards, or over-ambitious health and safety regulations (*Er27-Discrimination against foreign business*).

It is not only the host country that poses risks to investments, but the type of investor and the nature of the investment itself that also brings certain risks into transactions in host countries. For instance, American business as a symbol of western values might suffer boycotts in Islamic countries, and Chinese business people face a greater chance of being kidnapped in Malaysia. Business people are usually associated with

money, and might warrant large ransoms if kidnapped (Macko, 1997:120)¹⁰. Depending on the nationality of the foreign partner, entering into a joint venture with a foreign investor (Chinese or American partnerships for example) can even be risky for the local partner from the host country. These are risks that country risk analyses do not necessarily take into account. They are also risks that, if unplanned for and unmanaged, may pose grave political risks in the sense that losses occur due to otherwise manageable events impacting negatively on foreign business and profitability¹¹.

In order to further conceptualise political risk, the interdisciplinary nature thereof has to be kept in mind¹². An awareness of an investment scenario includes updated knowledge of the country in question's politics, history, culture, law, economics and international relations, as well as knowledge of the investing firm's likely role in the host country's economy. Ironically, this complex interdisciplinary nature of political risk analysis might even have contributed to the gap in research published on risk analysis as such since the early 1990's.

Although political instability and political uncertainty are mentioned as negative contributing factors to political risk, uncertainties can be regarded in a positive light. If risk encompasses any actions of which the consequences are "uncertain", then chances taken in a positive or profitable environment should be rewarding. If these uncertainties are managed accordingly, the possibility of being able to exploit them becomes a reality.

The presence of political risk factors does not necessarily, or by definition, have to show negative results. It can, in fact, expand on positive post-analysis conclusions reached about certain foreign investment ventures. It follows that the presence of manageable levels or 'types' of political risk can even encourage certain investment endeavours. This is why a model of political risk assessment should enable comparative analyses - to compare the results of different country reports, and eventually select the most positive post-analysis result as indicative of an investment opportunity. If uncertainty refers to a lack of predictability¹³, then both positive and negative investment environments present uncertainties that one can strategise around by conducting a political risk analysis.

¹⁰In 1990 there were only ten reported kidnappings, in Malaysia but by the mid-1990s more than 100 a year were reported. This might be underestimated - many of the primarily Chinese victims keep their trauma to themselves, due to fear of the authorities, social embarrassment, or anxiety about repeating the experience. Given the existing evidence of possible army and/or police involvement in kidnap gangs, such reticence is understandable. The investment climate in the Philippines was further dampened by the announcement that a trade delegation of Singaporean businessmen had just cancelled a trip to a trade and investments mission organized by the Philippine-Singapore Business Council. Their decision came in the wake of front-page stories in Manila newspapers that Singaporeans are now major kidnap targets. Similarly, recent media reports of Chinese businessmen and executives abducted by 'kidnap-by-ransom gangs' has scared a group of Taiwanese businessmen who were en route to be at a conference organized by the *Taiwan-Philippines Business Council*. In Colombia, there are currently 1,500 victims of kidnapping (<http://www.americasnet.net>). Also see http://www.pbs/newshour/bb/latin_america/latin_america.html.

¹¹ On 14 February 2002, CNN reported that Hindu protesters marched to the Indian Houses of Parliament in protest against the 'westernisation of Hindu culture'. Valentines Day cards and related paraphernalia were set alight in demonstration.

¹² Chapter One explained how political risk analysis draws information from a variety of disciplines. Further contributors are found in operational research, international marketing and management science.

¹³ Miller, 1991:312 explains how uncertainty about political risk factors reduces the predictability of corporate performance, and thus increases risk.

If political risk supposes the probability that a certain event or factor might impact negatively on the returns of foreign investment, then it should follow that the degree of risk is related to the 'size' of the probability factor. That is, the higher the probability of risk occurring, the greater the risk and the greater the return. Although the traditional focus of political risk analysis seems to be on possible losses, variations from these expectations in the forms of gains from political events or phenomena can also be factored into political risk assessments.

Political risk further suggests *a degree of impact that governmental policies or societal action, originating either within (internal risks) or outside the host country (external risks), can have on foreign business operations and investments.* And where country risk as such "encompasses the total risks, non-business *and* business, that a country offers to foreign investors" (Howell, 1999:33; Leavy, 1984:142), then political risk is a specialised relation of 'country risk.' This explanation offered by Leavy (1984:142) contrasts the notion that country risk mainly focuses on credit or transfer risk. It is also the contention of this study that country risk as practiced by reputable credit rating agencies does, in fact, not sufficiently incorporate non-business risks (like political, social, and environmental risks), and if some do, then to a degree that does not warrant comprehensive risk analysis. Although not called political risk ratings as such, such ratings can be mistakenly used by prospective investors as a comprehensive reflection of a country's investment climate. Due to either a very small or completely absent section on political risks, it is necessary to offer a risk assessment model that can incorporate both country and political risk factors extensively and comprehensively.

The scope of this study specifically focuses on political risk, but in order to further service the contextualisation thereof, it seems only fitting to expand on what country risk is in order to better understand what political risk entails.

2.2 The Difference(s) Between "Political Risk" and "Country Risk"

The main actors in *country risk* as such are countries petitioning for loans, and those (private) banks, states or monetary organisations that are willing to grant those loans. If the borrowing country fails to service the repayment of these debts, or are unable to service the interest on these debts, lending money to such a country would pose a certain degree of risk.

Krayenbuehl (1985:3) defines *country risk* as

“...the possibility that a state or sovereign borrowers of a particular country may be unable to fulfil their obligations towards a foreign lender and/or investor for reasons beyond the usual risks

which arise in relation to all lending and investments.”¹⁴

At the encompassing country level of risk there are essentially two types of risk - sovereign risk and transfer risk (Calverly, 1985:4-21), which also act as political risk factors in the model put forward in this study. These are included to ultimately enable a more comprehensive and overall reflective assessment of a country's investment climate, incorporating both macro and micro economic, political and social risk factors for use in conjunction with established credit rating methodologies, or parts of which can be incorporated into future rating methodologies.

Krayenbuehl (1985:3-4) further explains that *transfer risk* is

“...the risk that a particular country may impose restrictions on remittances of capital, dividends, interest, fees or royalties to foreign lenders and/or investors as part of its economic policy.”

Roberts (1986:2) augments this idea further when he describes how many of these country risks result from inappropriate economic policies that devastate the domestic economy and lead to balance of payments crises or political upheaval (Brummersted, 1986:75-97; Doyle and Brown, 1986:10-21; McCulloch, 1986:121-135; Nye, 1986:13-35; Suzman and Srivastava, 1986:101-120).

It thus follows that creditworthy countries with a good repayment record pose less country risks, and are more likely to receive further loans than countries experiencing problems with creditworthiness (Bird, 1986:1-15; Calverly, 1985:4-21). Most of the reputable credit rating agencies do not conduct political risk as it is defined and modelled in this study, but rather conduct *country risk analysis*. These ratings are expert and excellent reflections of credit rating and credit risk as such, but are often unknowingly applied as reflective of political risks as well.

In cases where some of the credit rating methodologies do in fact incorporate political risk factors, they are mostly limited to ten or fifteen political risk factors, and function better as indicators of country creditworthiness and transfer risk. To use credit ratings as a tool with which to forecast general and comprehensive investment climates is a dangerous practice, as these ratings should rather be used as an indicator of *country risk* at a specific moment in time.

Although a useful factor for political risk analysts as well, a balance of payments sheet itself mostly mirrors the data country risk analysts need in order to establish a country's debt service ratio, loans as percentages of gross domestic product, the size of reserves, or capital and current account credentials. These statistics supply the necessary 'tools' for country risk analysis, but are only some of the list of factors and their indicators that compound political risks. Singapore has an astoundingly impressive

¹⁴ Later in this discussion, we will put forward the notion that an *unwillingness* to repay a loan, although able, is deemed as a *political risk*.

balance of payments record for example, but foreign investment might suffer future losses as workers start lobbying around human rights issues, threatening with possible strikes which may result in lost man-hours, and a consequential drop in productivity and profits (Borsuk, 2001:A13; Huxley, 2001:201; Juan, 2001:157; Lee, 2002:97; Tay, 2001:279; Subramaniam, 2001:65; Wee, 2001:987)¹⁵.

In its broadest sense, country risk as such can be defined as potential financial losses suffered by foreign investors due to problems arising from macro economic events in a country. These events can include, for example, 'bad' monetary and fiscal policy, as well as restrictions on the flow of goods and services.

In reiteration, it is necessary to clarify the difference between country risk and political risk. This study will suggest that all country risk factors can be used as political risk factors as well - but the political risk factors put forward in this study are currently beyond the scope of inclusion as country risk indicators, although it will be suggested that they be included to some degree in future country risk ratings.

Regarding risks for bank loans to governments, the analysis thereof can be called *sovereign risk* analysis, where sovereign risk...

“...arises 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 judgement” (Krayenbuehl, 1985:4)

The premise of sovereign risk analysis is that a government will at some stage either be unable or unwilling to meet its debt repayment obligations. The servicing of loans is not linked to the performance of any particular project or enterprise, but to the government itself. Two questions should thus be asked when assessing the sovereign risk of a borrowing country - whether the government in question has the foreign exchange to enable the repayment of loans, and if so, whether it is willing to spend this money. Sovereign risk thus comes to the fore either when a country cannot repay debts or interest on debt, or when a country is indeed able to repay loans, but is not willing to do so based on, for instance, sudden ideological changes, executive shifts or foreign policy clampdowns. This is indicative of a type of macro environment within which foreign money operates.

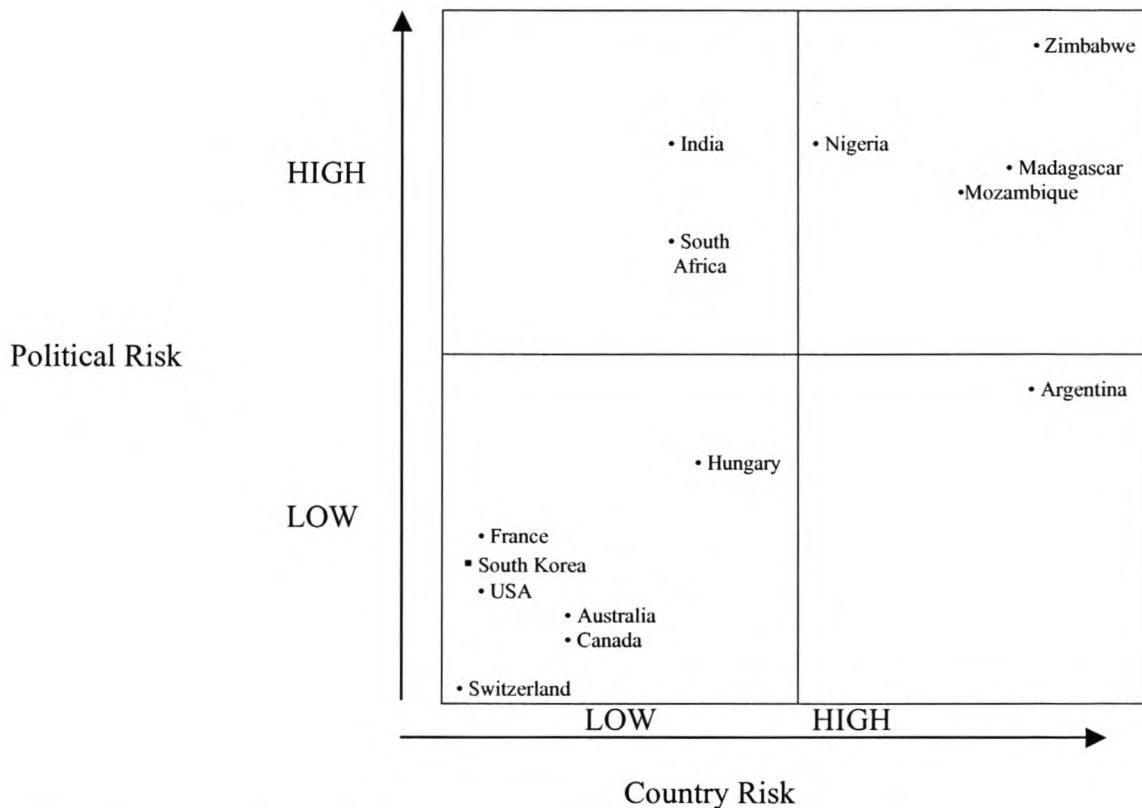
Levels of political risk in a country are not necessarily pegged to levels of country risk and *vice versa*. A country can experience relatively low country risk, but relatively high levels of political risk, like India for instance. It might not default on its loans, but the Kashmir conflict contributes to currently high levels

¹⁵ If Singapore is viewed as being a benevolent dictatorship, one can speculate about the amount of benevolence becoming gradually smaller as Singapore's deficits become larger in a city-state where civil liberties are severely restricted.

of political risk. Often instances of political risk are short-term, in other cases they are prolonged and chronically symptomatic of a specific country.

The countries in the following figure (*figure 2.1*) are used to illustrate the relation of political risk to country risk. In Chapter Five however, concrete figures are presented for South Africa, Hungary, South Korea and India based on the model for political risk analysis put forward in this study.

Figure 2.1: The Relation of Political Risk to Country Risk



It thus follows that, as the figure above tries to illustrate (see *figure 1* above), a country can be unwilling to repay loans (high political risk), but have the ability to do so (low transfer risk). This points toward a political risk problem in the sense that a government is unwilling to repay loans, be it for ideological or other reasons. A country might be willing to repay loans (low political risk), but is not able to do so (high transfer risk). This does not necessarily point toward a political risk situation as much as it does to an amalgamation of various credit difficulties¹⁶ that are included as political risk factors in the study. Still, a case of low transfer risk combined with high political risk needs to be scrutinised very carefully in a country identified as a possible destination for foreign investment.

Transfer risk can be translated as a 'lack of foreign exchange' risk. In this case, a country might be generating a cash flow in local currency that is sufficient to meet debt repayment obligations, but the

government of that country does in fact not have the foreign exchange available to make repayment in foreign currency for servicing the debt. The government in question can literally not transfer the money to the lender, and might thus have a relatively high level of transfer risk (Calverly, 1985:16).

A direct link can be made between the emphasised balance of payments sheet in country risk, and the ability to repay loans. If there are enough capital flows earned by exports, aid donations or new loans, then the ability to repay does exist. Calverly (1985:16) does warn though, that problems in the ability to repay may come to the fore, if international payments cannot balance out without major fluctuations in exchange rates, the level of imports or debt servicing, for example.

It becomes clear that country risk issues occur when there is a breakdown in either a country's willingness or capacity to service a debt (Calverly, 1985:15; Lahiri and Moore, 1992). The distinction between intended willingness and (in)ability to repay is important, though sometimes difficult to differentiate - this is where political risk comes into play. For instance, a country which is able to meet its repayment obligations might be unwilling to do so on political grounds, hence a political risk as this (hostile) action might be indicative of further politically motivated government actions that might impact negatively on foreign business. A loss of trade finance, boycotts, sanctions and the arrest of foreign assets could be an expensive payment in itself for a purely political or ideological end.

Yet it seems that a country's ability to repay loans is usually linked to the political will to do so¹⁷. A borrowing country might not be willing to see a process of structural adjustment through which it is necessary to generate an improvement in the balance of payments. Government might anticipate that cutbacks in social spending could result in civil unrest, thus possibly increasing the levels of political risk within a country in turn.

Country risk thus relies greatly on the components of a country's balance of payments. Often though, fluctuations in these components are really symptoms of more deeply manifested policy problems that are identifiable by doing a political risk analysis of, for instance, displays of earlier mistakes or of deeper underlying problematic trends¹⁸.

Export shortfalls for instance, are reflective of the composition of exports or the dependence on a narrow range of goods and services. Export performance may in turn reflect the structure of the economy, or the

¹⁶ In 1994-1995, the "Tequila crisis" hit Argentina and Brazil. In 1997-1998, the Czech Republic, Indonesia, Malaysia, the Philippines, South Korea and Thailand experienced both a banking as well as a currency crisis (Calvo and Mendoza, 1996:235-264; Cantor and Packer, 1996:1-15 and 247-256; Goldstein, Kaminsky and Reinhart, 2000:63, 82).

¹⁷ To date, although facing critical food shortages, Zimbabwe has not yet been extended an IMF bailout package – probably because the risk that the country might not be willing to repay its loan is relatively high. In contrast, Argentina, South Korea and Thailand have accepted the conditions related to IMF 'rescue' packages.

¹⁸ Although import substitution is a mechanism used in making trade policy, the degree of protectionism rises in cases where host governments subsidise such import substitution practices.

(in)effectiveness of economic management. Capital flight is a result of more piercing issues. Concern over the course of the economy, or political risk posed by domestic political events can encourage the outflow of much needed capital. Despite export shortfalls, capital flight and excessive imports, it is essential to familiarise oneself with the internal dynamics of a country in order to better recognise future problems in these balance of payments components (Mohr and Fourie, 1995:80, 116-117, 131-132, 475, 483-489, 500-502, 145-146, 602-605; Samuelson and Nordhaus, 1992:127-128, 621, 671-674).

Some factors of country risk, which are also used in political risk analysis, have to be understood in the context of each country under consideration. The structure of the economy, economic management, the size and structure of debt, future prospects of exports, domestic and creditor confidence in the government, and the political dynamics of various countries naturally differ. The slow response of a government to an economy in trouble is a political risk factor, where this is usually due to an underlying political weakness that might have prevented, and will in future prevent, strong political and subsequent economic leadership (*Pr5-Economic planning failures*).

Although countries experience cyclical economic patterns often in response to global economic cycles, risk is still mirrored in the alarm that the economic upturn of a certain country will be too slight or too late to deal with the problems it suffers, thus posing risks to foreign investors. Political risk analysis thus has to be conceptualised by expanding on its link to country risk.

2.3 The Analysis of Political Risk

The analysis of political risk not only aids in describing political phenomena in terms of factors of risk, but also tries to explain or understand the occurrence of political risk. The term 'analysis' denotes historic, current, as well as future investigation. Political risk analysis aims to interpret something in terms of its effects. It is a process in which investment potential is measured against the backdrop of certain factors which contribute to the levels of political risk in a certain country. In a very basic sense, should one take political risk factors and apply them to a specific country thereby drawing a conclusion as to whether a country does indeed pose possible political risk to foreign investment, the measurements of political risk factor indicators try to explain the political risk situation in a certain country and a political risk analysis of a certain country is made.

Earlier in the discussion, it was explained that *political risk broadly supposes the probability that business will either earn less money, or suffer losses in profit as a result of decisions and policies made by government*. It is further suggested that *political risk implies a degree of impact that governmental policies or societal action, originating either within (internal risks) or outside the host country (external*

risks), can have on foreign business operations and investments.

So at this stage, a working definition of political risk *analysis* broadly encompasses *the examination and explanation of the possibility that interrelated factors caused or influenced by government political decisions or other unforeseen events in a country will affect business climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to investment was made.*

In order to conduct such an analysis, one needs to isolate the risk factors that will be used when modelling the analysis. A high level of political risk in a certain country can stop an investor from spending any amount of investment capital. These factors and their indicators shall be discussed in great detail later, but in the meantime Martin and McIntyre (1995:345) expand on a few, as does Kuper ((ed.), 1987:34). Some of these factors are states of emergency or rebellion (*Pr16-Declared state of emergency*), lawlessness (*Pr26-Law tradition*), political instability (*Pr14-Political (in)stability*), the erosion of middle class support (*Pr20-Erosion of middle class support for the regime*), border disputes (*Pr8-Border dispute/external conflict*), military uprising (*Pr10-Military unrest*), ineffective fiscal and monetary decisions overwhelmingly influenced by ideology (*Pr22-Ideology as a political factor, Pr5-Economic planning failures, Er17-Confidence in finance ministry*), ill-advised foreign policy moves (*Pr29-Quality of the bureaucracy*), and uncertain leadership succession (*Pr18-Leadership succession crisis*).

Other political risk factors are low levels of adult literacy, uneducated or unemployed politically mobile workers (*Er3-Stable labour force, Er12-Militancy of organised labour, Er23-Economically active population, Er34-Unemployment rate, Sr1-Literacy rate, Sr2-Job mobility impediments, Sr7-Unemployment rate*), and even the depletion of scarce resources (*Er30-Preservation of resources, Er31-Deforestation rate, Er32-Carbon dioxide emissions of fossil fuels in millions of metric tons per annum*). The political and economic threat of AIDS (*Er15-Economic impact of AIDS*) cannot be ignored. Apart from the pandemic causing illnesses that can lead to lost man-hours, it becomes necessary to spend vast amounts of money in re-training new employees to fill positions lost to AIDS. This disease poses a risk to investment capital, especially in regions of the world where the density of the disease is considerably high in the population and consequentially in the workforce.

In order to conduct valid and reliable political risk analyses, one also has to be aware of the pitfalls that an analyst is likely to encounter in order to avoid, accommodate or remedy these problems. Factors that contribute to the validity and reliability of analyses will be mentioned in the following section.

2.3.1 "Good" analyses

Certain criteria have to be met during the process of analysis in order to justifiably state that the results of an analysis can indeed be deemed valid and reliable.

As the model suggests (designed to operationalise the research done in this study¹⁹) the analysis itself must be comprehensive. In seeking to describe, explain and forecast the activities of a potential host country, one would identify risk factors from various levels of analysis, these being the psychological or individual level (the executive and the separation of powers), social or group level (ethnic, racial, national, social tensions), national or state level (economic policy), interstate level (foreign policy), and global level (trade policy). If the host country reacts to policy formulated by another country, such behaviour would occur on an external international level. Of interest on an internal state level, would be the behaviour of the government of a particular host country. Although these levels of analysis will be dealt with in more detail later in the study, it is worth mentioning at this stage that the "ecological fallacy" and "individualistic fallacy" are levels of analysis problems that should be avoided at all costs. The merits of the 'levels of analysis' will also be discussed as the context within which they operate has evolved, and a less rigid vertical application of the levels seems to be developing. Still, by using the units of analysis embedded in the levels of analysis cautiously, valid and trustworthy cross-country comparisons are made possible.

The research that needs to be done in order to formulate an analysis of a political risk situation should be of a comparative nature. Decision-makers interested in investing abroad need to know how specific and different governments and societies are likely to act in given situations. Results of the analysis, if so required, should be presented in such a way as to indicate the significant differences in behaviour of different countries. The analysis should further be constructed in such a way that concepts and the variables that follow can be adequately operationalised, where operationalisation refers to the implementation of procedures required for the empirical identification of concepts (Brummersted, 1988:88-89; Chicken, 1996:255-288; Dahl, 1976:13). The reliability and validity of conclusions drawn from the analysis of political risk factors depend to a great extent on the quality of the operationalisation of those concepts or factors, in other words, on the quality of the identified risk factors as such, not necessarily the quantity, as the scope of this study is limited by the quantity of factors and not their quality. Applicable results assist greatly in the trustworthiness of political risk forecasts.

It is also necessary to keep policy relevance and the nature of the investment in mind when conducting political risk analyses, by means of carefully considering the needs of investors, and how those needs can

¹⁹ See Chapter Five, where the model itself is presented.

be met in the light of gauging industry-specific micro risks. The risk factors under consideration must be useful and specifically designed to aid the decision-maker in considering different investment opportunities. Both internal and external events contribute to the occurrence of political risk, and are constantly influencing the severity and degree to which risk factors influence investments. Perceptions of political risk are also vulnerable to change, as the world economy and international politics constantly unfold into new configurations.

Still, Calverly (1985:56) asserts that political risk analysis has to be based on fundamentals, for without a full appreciation of a certain country's political and economic systems, it is not possible to forecast the likely reaction a potential host country might have to shifting world or even domestic developments. It is also vital to identify key vulnerabilities even if circumstances present themselves at the time as being favourable. Any dependencies pose future vulnerabilities as they are requisites to which dependent countries must adhere; be they reliance on oil imports, the export of single commodities, dependence on capital inflows (*Er10-Losses from exchange controls, Er13-Competitiveness*), a weak political system (*Pr1-Political system, Pr11-Legitimacy crises, Pr18-Leadership succession crisis, Pr30-Political will*), or civil tension and unrest (*Pr7-Racial, ethnic, nationality tensions, Pr13-Likelihood of social revolution, Pr15-Civil war*).

It is often the case that the results of a political risk analysis are seen as representing an average of the likely outcomes of the used factor indicators, but this may not always ring true. If a political risk assessment shows a country as having several potential problems, but no one outstanding vulnerability, then it may be appropriate to judge it as a 'moderately good risk' (Bray, 1994:64-66; Calverly, 1985:56). It may so happen that countries are analysed as posing a low risk situation to foreign investment, but present a single major vulnerability. Singapore offers an investment climate conducive to profitability, especially regarding skilled labour, relatively low labour costs, good operation of profits system and foreign ownership policies, and an extremely well developed business and physical infrastructure. One major political vulnerability would have to be a disregard for basic democratic rights, regulated media, and the ironic benevolence of a one-party state (Borsuk, 2001:A13; Huxley, 2001:201; Juan, 2001:157; Lee, 2002:97; Subramaniam, 2001:65).

Still, Singapore is a moderately low risk country or city-state when it comes to financial returns made on investment (Tay, 2001:279; Wee, 2001:987). A way to deal with uncertainty about where to invest, can be solved by testing or analysing a wide variety of countries in order to compare the results and weigh up the risks, reiterating the importance of cross-country comparable political risk analyses. Money often takes precedence over (political) morals though, and Singapore remains an advisable investment destination as, among other things, an export processing zone in a still stable, though autocratic, political climate (Borsuk, 2001:A13; Henisz, 1999:1-28; Huxley, 2001:201; Juan, 2001:157; Lee, 2002:97;

Subramaniam, 2001:65)²⁰.

2.3.1.1 Sources of information

More time is often spent on the use and classification of information, and not much spent on collecting and sifting through irrelevant information. True, one needs to work through a large amount of sources in order to find useful information, but still, even the best method of analysis cannot produce exact forecasts if the information is dated, lacking, inaccurate, inapplicable or unreliable.

Political risk analysis necessitates a careful regard of the issues that are relevant to the organisation, considering potential foreign investment opportunities, as opposed to spending resources on irrelevant information. The decision-makers in these firms are not always clear on the industry-specific issues of the host country's business environment that need to be analysed.

The choice of 'tool' for the political risk analysis should also be made with care. A generic model of political risk analysis can assist in cross-country comparisons for instance, but should be adaptable to suit a specific client's needs in an attempt to assess industry-specific micro risks within the macro environment. This also greatly contributes to the validity and accuracy of the analysis result²¹.

Furthermore, Coplin and O'Leary (1994:177-178) explain how individuals who study a country and its business climate (country specialists) can provide additional perspective required for political risk analysis. These country specialists can cross-check information, and even add further information or make some useful changes or corrections (Green and Druckman, 1986:85-100; Howell, 1986:47-84).

The necessary experience of established country specialists (ex-diplomats or business people) becomes clear, as they can often gain access to government documents and specialised publications that may contain valuable data. Upon selecting a country specialist for the purpose of political risk analysis, a very important criterion should be the specialist's ability to analyse the political environment of the potential host country, and the application of their knowledge regarding the host country²². Of further importance is the specialist's information base, the length of time he or she has lived in a country, and the quality of governmental and non-governmental contacts that have been made and carefully maintained. Country specialists' areas of expertise should vary. Some have more detailed knowledge about general political conditions of a certain country, while others would be more knowledgeable about business and economics. Together, a range of such specialists can provide interdisciplinary, adequate and very balanced background information, enabling the effective and expert support for political risk analysts in

²⁰ See *The Economist*, 3 November 2001:48 – “Why Bother Voting”.

²¹ See Chapter Five of this study.

²² Thorough research produces valuable data. The interpretation of this data leads to the creation of information, which in turn, can be analysed. The analysis of this information leads to the creation and application of knowledge.

assessing the country under perusal (Green and Druckman, 1986:85-100; Howell, 1986:47-84).

The political perspectives of country specialists must be of an objective nature, so too their analytical style and skills. Still, no political risk analyst is completely and ideally objective, so the criterion should be the ability to be systematic in considering all the factors relating to a political assessment and the clear presentation of the data and information (Marks, 1986:187-194). Coplin and O'Leary (1994:178) recommend the use of individuals who are independent, professional and who have an unbiased commitment to the serious in-depth study of countries.

The importance of country specialists in the sourcing of information for political risk analysis is indeed relevant, as it is also important to reach those people physically involved in the study of the formulation and implementation of a host country's policy decisions. It is also advisable to attempt to get as close as possible to those sources where government regulations are formulated or approved (Green and Druckman, 1986:85-100; Howell, 1986:47-84).

2.3.2 Predicting, forecasting, forewarning or anticipating political risk

Some authors contend that a model of political risk analysis is not about predicting, but about forecasting (Ascher and Overholt, 1985:287; Blair and Romano, 1988:387-396; Brod, 1992:25; Grunberg, 1986:475; Reaves, 1992:357; Rehm and Gadenne, 1990:3; Simon, 1985:132; Zarnowitz and Lambros, 1987:591). Although it will form the basis of this part of the discussion, the terms "anticipating" or "forewarning"²³ are preferably used in this study. Nevertheless, the political risk analyst cannot predict that risk will occur, or when it will happen, but as the literature suggests, can *forecast a probability* upon observing certain trends or current events, and the way in which they come together. According to Coplin and O'Leary (1994:6), "[t]he term risk implies a probabilistic assessment...[political risk analysis] has as its product a forecast." There are elements to the analytical process that prevent the *prediction* of specific events²⁴.

A political risk model cannot predict when risk will occur, because, as Coplin and O'Leary (1994:7) explain, a number of elements of the analytical method and model prevent precise prediction. One is the model itself. Those who design models select different risk factors as representatives of the situations that they believe will precede possible harm to an investor. Social systems are notably complex and some reflective estimates of social attributes are used in any model. The projection of outcomes from a given situation can only be probable, because a complex set of circumstances is necessarily simplified and

²³ The term "predicting" has too much of a definite finality connoted to it. One is left with the impression that, once a prediction has been made, there is no flexibility left in the assessment. Even with the best of models, variables that are not included in the design will still have some effect on the given situation and will reduce the possibility of perfect prediction.

abbreviated in any model. The selection of representative variables and their relationships may not always result in the best possible projection.

The danger in using the terms 'forecast' and 'predict' interchangeably in political risk analysis sets a dangerous trap. A forecast presents an *estimate* of something in the future, a *chance* that a certain country *might* pose a *certain* degree of political risk to a foreign investor. Forecasts differ from predictions in the sense that a prediction foretells a kind of prophecy, and involves making statements about what events *will* occur in the future (Ascher and Overholt, 1985:287; Blair and Romano, 1988:387, 395; Bunge, 1998:188, 195-196; Jones, 1986:195-204; Reaves, 1992:357; Simon, 1985:387-396).

A prediction seems more definite, where a forecast on the other hand, 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 (Brod, 1992:25; Bunge, 1998:188, 195-196; Grunberg, 1986:475; Jones, 1986:195-204; Rehm and Gadenne, 1990:4; Zarnowitz and Lambros, 1987:591). A prediction results in a definite 'yes' or 'no' answer, whereas a forecast can be identified by the use of terms like 'if...then' or 'might' and 'possible'.

The complexity of social phenomena should never be underestimated (Bradley and Scheafer, 1998:96-105; Bunge, 1998:90; Coplin and O'Leary (1994:7). Even with the best of models, the intention of being able to anticipate risk, or enabling an 'early-warning-type' instrument will still be affected by variables that are not included in the design. There is always the possibility that some unforeseen event outside the scope of the analysis' factors will affect the risk processes that result in losses. A flash flood could cause great damage to crops, followed by food riots and the replacement of a democratic government with an authoritative one that imposes strict controls on multinational businesses that deal in food products. Although the prediction of such an event is not quite possible, and the probability that it would happen not very high, the results of such an event does have political ramifications in society that may or may not pose a certain political risk to foreign investment in a certain host country. Contingency planning, should such possibilities arise, can be conducted in scenario developing exercises, in manipulating the weighed factor indicators in the presented model, or in a political risk policy as put forward in Chapter Six.

Additional reasons for choosing to rather use the terms 'anticipate' or 'forewarn' lies in a further element that prevents prediction, that of partial information. Even if an optimal model is used, the information that is applied at the core of the assessment and forecast is inevitably incomplete and possibly even inaccurate. Human intervention also prevents prediction. Even though a political risk assessment is

²⁴ The projection though, is that given a history, "usually" or "there is a high probability that" history will repeat itself. Or given a set of certain current circumstances, a certain outcome has a high probability of following.

provided to a client with the specific intention that investors can somehow prevent the forecast from coming true, many investors may still choose not to follow political risk forecasts.

In addition to these thoughts on the use of the term ‘prediction’, Miller (1991:112-124) explains that the mere notion that MNC’s operate under circumstances of uncertainty and thus risk, the predictability of the broader environment – the political and investment climate – in which the specific industry relevant to the firm is operational is greatly reduced.

Political and economic forecasts can be either passive or active. Passive forecasts are made by political analysts, and foretell what is likely to happen, for instance: “As the world mineral deposits become depleted, the world powers will try to lay their hands on them, if necessary by military force – that is, further oil wars are to be expected” (Bunge, 1998:195; Jones, 1986:195-204). Still, accurate forecasts are difficult to make. Political attitudes are often shallow and more sensitive to comparatively minor disturbances or politically irrelevant factors, like a political executive’s voice, dress, or private life. Political systems are often unstable, either internally, or because of external pressures. Some predictions are also ‘untestable’, in the sense that political events teach us little about the truth or value of such predictions. A more serious reason for the difficulty in making accurate political predictions is the current dearth of ‘good’ political theories and the poverty of empirical political data. This is why many risk analysts prefer to propose scenarios, for instance an optimistic and a pessimistic one. Of all political processes that will have an impact on foreign investment, wars are the least predictable, as they are not limited to military operations, but engage entire communities over vast territories (Bunge, 1998:195-196).

Yet apart from carefully acquiring the relevant information for political risk analysis, it is just as important to recognise the types of countries one will be dealing with.

2.3.3 “Country types”

Regarding ‘country types’, Both Bray (1994:64-66) and Calverly (1985:62-66) have identified different types of countries pertaining to political risk analysis. It is necessary to distinguish the principle country ‘types’, for, if countries can be placed in any of these categories, it becomes possible to compare them with each other in a more meaningful way, thus gauging the level of political risk one country might have in relation to another. Of course, no country is ever categorically only of one certain type. Care should be taken, for instance, not to simply ‘blacklist’ certain countries in prejudice of their being “non-western”. One should always bear in mind that the relativity of these country ‘types’ may further modify or evolve along the background of an ever-changing and dynamic world system, yet it is possible to place countries in groupings in relation to one another. Not only developing countries or emerging markets pose heightened levels of political risks (Bilson, Brailsford and Hooper, 2002:1-27; Furber, 1990; Silbey,

2001:15-22). Political risk factors are present in highly industrialised countries as well, be it in the form of unfavourable trade regulations, varying degrees of xenophobia in the population, environmental degradation, amendments to industry specific standards or even intra-governmental instability and (institutionalised) corruption.

Calverly (1985:62-66) and Evans and Newnham (1992:220-221) categorise countries into advanced industrialised countries, newly industrialised or industrialising countries, primary commodity exporting or developing countries, and the dated terminology of former east bloc countries currently under the process of economic restructuring. Another country grouping includes countries that are 'emerging markets', like those of Mexico, Russia, China, Venezuela, Chile and Brazil. It is contended that this classification or typification should be applied with caution though, exactly because of the danger one faces in committing the 'levels of analysis fallacies' that will be discussed in greater detail later in this chapter.

A highly advanced industrial country like Germany for example, would generally show high levels of per capita income, a small percentage of the population involved in agriculture, low levels of un(der)employment, vast financial and economic resources, political stability, a strong central bank, an established legal structure, individual and strong companies long since independent from government assistance and intervention, a commitment to democracy, and free trade and internationalism²⁵. Should a country similar to this German profile be 'run through' the model presented in this study, the 'test result' should show a country that presents a low political risk environment for foreign investors.²⁶

Still, there are some problems an industrially-advanced country can present to investors - like the excessive growth of the government sector due to increasing welfare payments, and current account deficits with a reluctance to take strong action in order to rectify such an imbalance. Also, a build-up of debt, where debt-servicing payments impose burdens even on the economies of these industrially advanced countries²⁷.

Newly Industrialised Countries (NIC's) have been able to expand their manufacturing²⁸ sectors because they have enjoyed advantageous comparative costs vis-à-vis advanced industrial countries. They have a high level of entrepreneurial skill, an open economy regarding foreign investment, and in most cases, stable regimes. The emergence of NIC's indicates a real shift in productive forces from the North to selected areas in the South, and they stand out for their achievement of self-sustained, export-led economic growth (Evans and Newnham, 1992:220-221; Kim, 1986:180-196).

²⁵ Although under European Union regulations.

²⁶ Still, the recent Helmut Kohl - Christian Democrat scandal in Germany goes to show that corruptive and fraudulent acts are even found in highly industrialised and democratic countries. See Hooper, 2001 and Patterson, 2000.

²⁷ Competition for saturated markets can also hamper foreign investment in industrialised countries.

NIC's like South Korea, Taiwan, Singapore, and Malaysia, and industrialising countries like Indonesia and the Philippines, are recovering from the 1997/8 Asian financial crisis - a phenomenon caused by a myriad of factors which this model aims to be able to forewarn in future. Government backing and state intervention in the economy is quite prevalent in many NIC cases. In this way, such developmental states have also been able to expand their manufacturing sectors because they have enjoyed advantageous comparative costs relative to the advanced industrialised market leaders.

These NIC's also offer a high level of entrepreneurial skill in addition to offering an 'open' economic system regarding foreign investment, and have found a niche in not necessarily the development, but the manufacturing of high-tech, micro-electronic goods. Self-sustained, export-led economic growth has been obtained together with the facilitation of foreign investments and capital inflows by permissive tax policies (Kedlac, 1997:66; Kim, 1986:180-196). Yet the evident success of these NIC's has weakened the concept of "South-South" solidarity of developing countries.

A further consequence of NIC success has been the provocation of a backlash among even advanced industrial countries. One form this has taken is an increase in non-tariff barrier (NTB) protectionism in advanced industrialised countries on the grounds that 'cheap' imports are flooding into markets from the NIC's, becoming an issue raised in World Trade Organisation (WTO) negotiations against the questionable legality of such protectionist measures (Evans and Newnham, 1992:220-221; Kim, 1986:180-196). A second response is to argue that the NIC's have 'graduated' into the 'industrialised world', and that they should cease to be regarded by other countries as still being developing states requiring special consideration with regards to trade regimes and debt rescheduling. Still, it might be necessary to hold back on such hasty reclassifications, especially in light of the Asian crisis effect. It is against these backdrops of global political and economic dynamics that political risk analysis does justice to the fascinating and extremely relevant practice of the multi-discipline (Evans and Newnham, 1992:220-221; Kim, 1986:180-196).

In contrast to NIC's, the majority of developing countries rely on the export of one or more commodities in raw or processed form for foreign exchange earnings, and are thus classified as primary commodity exporting countries or developing countries (Acharya, 1981:109-148; Baer, 1987:275-286; Kearny and Layman, 1986:153-171; Todaro, 1989:41). Smaller industries produce mainly for domestic consumption, in which case these industries are mostly inefficiently run and heavily protected, especially if state-owned. Natural disasters, strange as this may seem, affect the supply of much-needed commodities, as seasonal storms can wipe out entire annual crops, and so too expected national earnings. Augmenting this situation are fluctuations in world prices for certain export commodities as a key element in the risk prognosis of developing countries, and an external-type risk that extraction MNC's for instance, have no

²⁸ Such as cars, trucks, consumer electrical goods, shipbuilding, steel and textiles.

control over apart from the ability to enact contingency management plans.

The current negotiations regarding tobacco regimes can have dire economic consequences for single commodity export countries, where tobacco is the commodity on which entire economies are based. Tobacco accounts for 70% of Malawi's GDP for instance, and is a large, if not sole contributor, to the economy of Tanzania as well (Abrunhosa, 1998:1-3; Beelman, 1999:1-2). Such an external macro risk, like global and even South African tobacco legislation, impacts directly and negatively on abovementioned economies.²⁹

Rapid population growth poses an additional threat to developing countries as it places great pressure on food and water supplies, and also threatens political stability due to the difficulty of generating enough employment opportunities annually. In many instances, development strategies have been suggested and followed which proved to have adverse, if not reversed, effects to those intended. International Monetary Fund-type (IMF) structural adjustment programmes (SAP's) to correct a balance of payments problem for instance, are less likely to be successful in developing countries. Some contributing factors to this can be a lack of political ability (*Pr29-Quality of the bureaucracy, Pr30-Political will*), even if there is a notion of political will, to enforce and manage such programmes successfully. Economic modernisation (*Pr24-Demographic and traditional parochialism*) is also very taxing on a political and commercial infrastructure lacking the necessary and entrenched development and maturity needed to sustain such pressures foreign to the political systems of developing countries.

Government crises of penetration, participation, identity, and distribution can compound and develop into a possible crisis of regime legitimacy (*Pr-11 Legitimacy crisis*). The consequence of such crises can pose grave risk situations, and may develop into incidents of social uprisings, political instabilities and violence aimed at foreign-owned companies and large Multinational Corporations (MNC's) (*Er27-Discrimination against foreign business*). Notwithstanding the danger of large MNC's gaining so much economic influence as to almost 'dictate' the economic policies of host countries in the forms of tax incentives, repatriation of profits, employment regulations and other incentives for foreign investments³⁰.

Former socialist or communist countries under economic reform and restructuring can also be classified as 'emerging markets in transition' (Bunce, 1993:107-138; Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999:111-127; Medvedev, 1992:489-498; Niiseki, 1987:50-56; Tucker, 1987:148; Ulam, 1992:339-347). Previously centrally planned socialist countries present certain unusual difficulties for risk analysis³¹. Finding statistical information on the economy and on political situations proves cumbersome and

²⁹ Tobacco legislation is a global trend adopted by policy makers and health ministries in many countries. Such a global policy trend can impact negatively on domestic economies to the extent of destroying them.

³⁰ This is dealt with in more detail in Chapter Six of this study.

difficult. Another problem is posed by the lack of understanding of the political and economic structure of these countries, and also by the inefficiencies and distortions created by central planning. This poses a problem for political risk analysis, as previously discussed, where wrong or dated information renders the final analysis nothing more than unreliable and unprofessional.

2.3.3.1 *Parameter specification*

Based on the discussion of “country types” above, and before the discussion of models takes place in Chapter Three, it becomes necessary to address the issue of parameter specification due to the adaptable nature of the generic model offered in Chapter Five of this study. As mentioned before, the model presented in this study is compiled from various political risk factors and their indicators, and is also designed to be flexible in the sense that it can be applied to a variety of contexts. This in itself can create a problem for the precision of measurement the model claims to be able to offer.³² The problem lies therein that a set of assumptions underlies the chosen political risk factors and their indicators and the values that are attributed to them – and these assumptions are not necessarily applicable in the same way in different contexts³³. The underlying assumption that also guides the weights that can be attributed to each risk factor indicator of the Chapter Five model, is that consolidated liberal democracies pose less (or lower levels of) political risk. Investors would then, because they are rational decision-makers, in all probability avoid investment climates with high levels of instability and /or corruption.

This assumption is not necessarily true, which is why the generic model is adaptable and flexible, enabling its use in a variety of different contexts once the specific parameters of the particular investment climate has been established in consultation with either a client or a host government. To illustrate, foreign investors are aware of ‘organised chaos’ and might even manipulate this due to their rent-seeking behaviour and the opportunities that can be found in ‘chaotic yet organised’ investment climates.³⁴ Yet one can still apply an adapted, context-specific version of the model in Chapter Five to enable guided and better-motivated decision-making. Based on the generic model, one of the contentions of this study is that a contextual analysis can be whittled down for any investment climate, and that parameters can be specified for any such climate when the need for such a political risk analysis arises.

³¹ Once again – not *all* former socialist or communist countries manifest these characteristics, but in a qualified general sense, this is often the case.

³² This issue is also addressed in Chapter Four of this study, when the notion of measuring political risk is addressed.

³³ Private consultation with Philip Nel, 14 October 2002.

³⁴ Reno (1999:1-260) points out that American investors are interested in the high returns of the Angolan or Nigerian oil industry, or the manufacturing industry in China for example, exactly because investors have developed the ability to exploit bureaucratic ineffectiveness in cooperation with officials (also see Chabal (1999:1-170) “*Africa Works: Political Disorder as Instrument*”). This might raise ethical questions regarding the socio-political conduct of foreign investors, but the point remains that risk assertive investors will often exploit risky situations for higher returns.

2.4 Problem Solving Theory – A Theoretical Grounding

If the interest to invest exists, yet a client is uncertain of the best option, various possibilities can be analysed and compared by means of political risk analysis as a way of managing such uncertainty. The application of management science can be viewed as a rational attempt at problem solving, bearing in mind that such ‘problems’ do not exist in a vacuum, but relate externally to the explicit decision-making environment as well as internally to individuals’ understanding of reality.³⁵

In all decision-making processes, Bunge (1998:317; Beroggi, 1999:144; Chicken, 1986:40) explains, rational agents behave as risk-averse persons intent on minimising uncertainty with the help of expert knowledge. It follows that, if unable to reduce these uncertainties to below some acceptable risk level, the rational agent will refrain from acting, or the foreign investor will refrain from continuing a particular foreign expansion project. Complementing problem-solving theory, decision theory is generally assumed to be the better theory underlying rational decision-making under uncertainty. The major steps of decision analysis are defining the decision statement amongst uncertainty, establishing and evaluating objectives, generating alternatives, and finally comparing and choosing among options (Altier, 1999:77-78; Jennings and Wattam, 1998:1-22). Uncertainty may derive from limited knowledge or from the objectively random nature of the process occurring in or around the decision-making environment in question (Beroggi, 1999:144; Bunge, 1998:317; Rapoport, 1983:321-330). In order to reduce these uncertainties, Chicken (1986:40) suggests taking the steps involved in decision-making, which are conceptualising the idea to invest or expand operations, conduct a feasibility study of the possible outcomes, prepare detailed specification, implementation of the decision, and eventual operation of the preliminary concept.

A political risk analysis, once conducted, draws the decision-maker’s attention to the various problems that political risks might pose to the profitability of the investment. An awareness of the problems is created, and certain management steps can be taken in order to avoid or profit from them. Due to the dynamic nature of political risk(s), problems of political risk do not remain solved after analysis, but they can be monitored and ‘mapped’ by constant application, adaptation and revision of the political risk analysis mechanism or model (Brightman, 1980:9; Bruner; Lane, DiStefano and Maznevski, 2000:26; McCaskey, 1991:135-152).

In problem solving, potential solutions require a consecutive ordering of ideas that can be tested. Since each solution generates different ‘evidence’, the evidence that is most consistent with the facts will indicate the most probable solution. It becomes clear that solving the problem of ‘where to invest’ requires observations in order to find potential solutions. The interaction of these observations with

solutions continues until the best solution ‘squares’ with all the facts, where the function of investigating and exploring potential solutions is to guide the search for relevant facts. Without a few possible solutions, the political risk analyst might become overwhelmed by the sheer number of facts (Brightman, 1980:1-22; Jennings and Wattam, 1998:1-22, 35; Kaufmann, 1991:103-134).

As the words ‘problem’ and ‘solving’ denote, political risk analysis is concerned with situations in which one or more choices must be made, and these choices are often made under conditions of uncertainty and risk (Beroggi, 1999:144-150). If a foreign investor’s future ‘desired state of affairs’ is a successful, profitable multinational corporation with possible subsidiaries in many different host countries, the investor is presented with the problem of how to attain this future scenario, and faces the difficulty of getting from one state of affairs (still in home country) to another (investing in many host countries). Kaufman (1991:103, 106-107) explains that this difficulty is a result of comparing the existing situation with a future imagined state of affairs that constitutes a desirable goal for problem solving. Kaufman (1991:103-104, 106-107) reiterates the above in offering a definition for a problem as “a discrepancy between an existing situation and a desired state of affairs.” It is the intent of this study to address this discrepancy, and offer a means of arriving at the desired future state of affairs – that is, successful foreign investment by avoiding or managing political risks as risks to the attainment and profitability of foreign investment.

In another explanation of problem solving practices, Beroggi (1999:1-5) defines a problem as “the need to investigate changes to a system, where a system is a part of the real world, defined by elements and their relations.” For a foreign investor, changes in the political climate of a host country can result in grave policy risks that might impact negatively on the foreign operation’s viability and profitability. It is imperative to constantly monitor the investment climate in which a foreign organisation is operating for signs of such changes, by measuring and assessing the elements or factors of potential risk not only individually, but also in terms of their influences on one another. The emphasis of this explanation of a problem is on changes in a host country’s investment climate, and needs to evaluate investment options in a way that eventually leads to actions that improve firm profitability. As mentioned above, the relationship between problem solving and decision theory is symbiotic. Where political risk analysis is a first step in decision-making regarding foreign investment optimisation, political risk assessment focuses on problems that call for decisions concerning the implementation of actions (investment), and in a way, deals with decision problems (Altier, 1999:99-150; Beroggi, 1999:1-5).

Such a decision problem can be resolved by the selection of appropriate actions, like investing now or in three years, for up to ten years, in a certain host country; not invest at all, or rather invest in one country and avoid another. However, the host countries under investigation, specifically their investment

³⁵ See ‘subjectivity’ in Chapter One, and the discussion on ‘reality’ above.

climates, change continually to a larger or lesser degree. This process of continual change calls for new decisions, and the fact that the effects of actions can run their course is crucial from a practical point of view and has to be kept in mind by political risk analysts and decision makers. An action might resolve one problem while creating others, requiring the continuous monitoring of a host country's investment climate (Altier, 1999:99-150; Beroggi, 1999:1-5; Jennings and Wattam, 1998:1-22, 35).

To enable the political risk analyst to identify potential actions and to select the best course of action for a specific foreign investment project, the analyst must gain an in-depth understanding of the host country's investment climate as well as the needs of the investor, the elements present in the host country, their relations and the effect they might have on the foreign investment. The analysis of potential political risks within a specific host country is done by collecting data and information and processing them into a meaningful 'picture' of the elements and their relations in the host country (Altier, 1999:99-150; Beroggi, 1999:1-5).

Differing from problems, puzzles³⁶ present a set of circumstances in which there is no ambiguity whatsoever once some thought has been given to what is happening or needs to be done. The issues that need to be faced are entirely clear, the range of options is completely known and there exists a single correct answer to the puzzle. The pieces of a puzzle, once identified and moved around, thus fit in an exact way (Morgan, 1991:81-100; Pidd, 1996:66).

A 'problem' on the other hand, does not have one single correct solution, which makes it different from a puzzle. By solving a 'puzzle', the definition of the answer is complete (Morgan, 1991:81-100). On the level of puzzle solving, it is possible to identify many kinds of research activities that seek to operationalise the detailed implications of the metaphor defining this particular school of thought. Many specific texts, models and research tools are available on this level. Puzzle-solving activities are often linked to favoured metaphors, which are in accord with a favoured view of reality.

In problem solving, if the required investment climate or environment is known to the client, the analyst (by using the model presented in this study) can almost work 'backwards' to find the conditions thought to make up the ideal investment circumstances, as mentioned before (Brightman, 1980:1-22). The risk factor indicators can thus be weighed to explore and identify the ideal 'weight'. They should then, as a result, reflect the identified ideal investment climate. In this way the 'ideal host country' can also be sought and found.

From the above it is clear that a 'problem' is a bit more complicated than a 'puzzle'. The complication arises from the fact that a problem has no single answer that is definitely known to be correct, or for that

matter, even incorrect. At the centre of a problem is an issue that inevitably needs to be addressed, like the question of whether or where to invest or not, which seems fairly unambiguous and relatively straightforward, but rarely has a single correct answer. Despite the way in which the question is construed, the core issue remains the same, namely that of whether and where to invest or not, although there might be several solutions equal in validity (Brightman, 1980: 9-21; Pidd, 1996: 68).

By defining the question and thoroughly qualifying it, or in this case narrowing the investment question down to a specific industry within a specific country (maybe even specifying the time frame and tenure), the answer to the core question will be very different from a vague 'whether and where' question. It all seems to depend on what the question is that is being asked, and how the question is formulated. In the case of political risk analysis though, any solved investment problem will remain solved for only a certain period of time – until a change in the national executive, for instance³⁷.

Schön (1982:1-374) argues that successful problem solving practitioners strive to do two things. They try to relate new experiences to their existing past experiences, thus using a frame³⁸ in order to make sense of a new situation. They also often try to maintain the uniqueness of the current situation. The current situation may well be interpreted based on prior experience or knowledge, yet the good professional does not simply apply a standard response but tries to keep in mind what is different and special about the current circumstances (Brightman, 1980:23-64, 121-160; Pidd, 1996: 78).

Of course, there should be active co-operation between the political risk analyst and a client, at the very least because the two parties bring different insights into the decision-making process. The analyst is familiar with the model and its approaches and applications, and may be able to think about the situation in abstract terms. The client knows the detail and context of his or her specific business and would like to be assured that the political risk analyst's modelling work is of value. Pidd (1996:78) suggests that problem structuring should be a joint process of framing and naming (Gilhooly, 1988:1-178).

In so doing though, Pidd (1996:78-81; Brightman, 1980:23-64) warns about two theoretical pitfalls that should be avoided, and that the analyst and modeller should constantly be aware of. Two of the theoretical problems that one can encounter in conducting political risk analysis and in designing a model for political risk analysis, apart from the levels of analysis, are the dangers of over-simplification and over-elaboration. These issues will be addressed at a later stage in this chapter.

The conceptualisation of 'models' as such and the motivations for designing and ultimately using the

³⁶ In management science, the term puzzle (Ackoff, 1972, 1979) depicts a different way in which the word 'problem' is used.

³⁷ The model for political risk analysis can be seen as the equivalent of a virus scan – by running a 'check' every now and then, 'flashing' indicators of political risk can be identified and further action can be taken in the management of these risks.

³⁸ See Chapter One regarding 'framing'.

Chapter Five model for political risk analysis as presented in this study is explained and discussed in great detail in the next chapter. Still, because this chapter deals with conceptualising the terms used throughout this study, it is important to introduce the term ‘model’ and the idea of model designing in the following section in order to explain what a model is, as well as what its uses are.

2.5 A Model for Political Risk Analysis?

This study assumes that some critical issue is being faced that requires a decision to be taken or some control to be exercised. It does not assume that the decision will be taken immediately nor that rational analysis is the only consideration, but analysis without basic thought and rigour is a waste of time (Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85; Pidd, 1996:9, 15). A decision needs to be made when an individual, a group or an organisation faces a choice in which there is more than one single option. To which country should we expand our operations? What kind of investment should we make? What are the risks that can inhibit project profitability? For how long should the investment be made? For how long should the plans be shelved? What are the chances that an investment will fail due to which kinds of risk factors?

The model adopted in this study offers a decision-making guide as an alternative to other decision-making processes often employed, for example (Pidd, 1996:8):

- *‘Seat of the pants’* decision making, which implies rapid decision making based on intuition, with no real attempt to ponder the consequences of those decisions or actions taken in making them.
- *‘Superstition’* in decision making, used to indicate a mystical belief that examining some other system will shed light on whatever decision is being faced, even when there is clearly no link whatsoever between one decision and the system that is being used as a reference.
- *‘Faith and trust’* in decision-making is used to denote an approach that is close to superstition, but with an important difference: that there is some proper link postulated between the parallel reference system and the decision to be faced. There is thus the suggestion that proper observance of the one will guarantee a favourable outcome in the other.
- *‘Do nothing’*, or the classical ‘head in the sand’ approach implies closing one’s eyes and hoping that the problem will go away or that it will be sorted out in some other way. There are times when taking action might be the best alternative but, paradoxically, one can only know this when one has thought about the consequences of doing nothing.

As mentioned earlier, the model for political risk analysis proposed in this study is offered as an alternative method that will hopefully contribute to easing the process of making decisions under complex circumstances of uncertainty and risk.

2.5.1 “Model”: A conceptualisation of the term

One of the aims and purposes of this study is to demonstrate how a model can be useful in helping to manage complexity in order to reduce the risk of making and implementing wrong decisions (Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85; Jennings and Wattam, 1998:135-149; Pidd, 1996:12). But what is a model? Let it be said at the outset that the model employed in this study should be used to help users navigate through the thinking process, and is by no means a substitute for thinking. This model is a tool to support and extend the power of thinking, and has been kept as simple as possible, in the sense that a complicated model that is poorly employed may be worse than a simple model used as a tool for careful thought.

For the purpose of conceptualising the term ‘model’ as it will be applied in this study, Pidd (1996:12-14; Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85) offers an insightful discussion of the conceptualisation of the term ‘model’, and goes to great length to explain what the term entails³⁹. One of the earliest definitions of the term model, as used in management science, explains that *a model is a representation of reality* (Ackoff and Sasieni, 1968:1-455; Jennings and Wattam, 1998:135-149). Despite its ease of application, this definition does not address the question of why a certain situation necessitates the designing of a model. This is a crucial question to ask when building a model, for if a model is a simplification of reality, such a simplification should be done with an idea of the intended use of the model. The definition of a model can thus be qualified further as a *representation of reality intended for some definite purpose* (Pidd, 1996:13; Bradley and Schaeffer, 1998:198), in this case, for the purpose of making a decision regarding the question of whether to invest in a certain host country or not.

Although slightly more refined, this conceptualisation still does not make a precise statement of a purpose for the model and for modelling as an activity within management science. The model presented in this study aims to assist decision-makers in making better decisions and to exercise better control over their responsibilities. In management science, models are often built to enable a manager to exercise better control or to help people understand a complicated situation. A further qualified definition of model is that *a model is a representation of reality which is intended to be of use to someone charged with managing or understanding that reality* (Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman,

³⁹ For further discussion, see Ackoff and Sasieni, 1968:1-455; Checkland, 1981:1-330; Hammer and Champy, 1993:1-231.

1980:9-21; Carley, 1981:67-85; Jennings and Wattam, 1998:135-149; Pidd, 1996: 13).

This does not necessarily imply that the model presented in this study is solely and exclusively reserved for use by only the managers in a decision-making process. It does depend though, on the nature of the decision-making process employed by different organisations. If, for instance, an organisation adheres to an organisation-wide participatory process in decision-making, then all involved in the process can make use of the model⁴⁰.

The participatory nature of some decision-making processes can thus be included in a more refined definition of model. A model thus becomes *a representation of reality intended to be of use to someone in understanding, changing, managing and controlling that reality* (Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85; Jennings and Wattam, 1998:135-149; Pidd, 1996: 14).

As the conceptualisation of the term 'model' progresses, mention has often been made of the term 'reality'. Subjectivity was mentioned in Chapter One, implying that each individual using the model will have a different idea of what his or her reality should constitute during a decision-making process. Each individual's reality is made up of past experiences as well as an idea of what the future outcome of a decision should encompass, but a single model cannot possibly envelope each individual's own ideas of what 'reality' should constitute⁴¹.

Let us then further define a model as *a representation of part of reality as seen by the people who wish to use the model to understand, to change, to manage and to control that part of reality* (Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85; Jennings and Wattam, 1998:135-149; Pidd, 1996: 14-15).

Relating to the above discussion of individual realities, such individuals experience these realities with a set of internal assumptions that form their mind-sets. The model presented in this study is an external model that helps decision makers (while not negating the internal cognitive tools they use during the decision-making process) navigate through various complexities of the decision-making process. The problems that necessitate the decision-making process in the first place, in this case the problem of investing under various political risks, do not exist in a vacuum, but in people's minds and relate to their expectations and experience of the world. This evolving definition of a model can thus offer the following, in support of Pidd's (1996:13-15; Bradley and Schaeffer, 1998:30-32, 23-42, 199; Brightman, 1980:9-21; Carley, 1981:67-85; Jennings and Wattam, 1998:135-149) discussion...*that a model is an*

⁴⁰ If top-down decision-making is enforced, at least management can use the model.

⁴¹ See the section on limitations of the study in Chapter One.

external representation of reality as viewed by the people who wish to use that model in order to better understand, to change, to manage and to control that part of reality the model is specifically designed for to deal with.

Finally, Bradley and Schaefer (1998:24, 199) add great value to this discussion, especially where it is suggested that a model aids in [political risk] analysis and risk anticipation, by defining a model as

“...[a] formal or informal framework for analysis which seeks to abstract from the complexities of the real world those characteristics...that are crucial for an understanding of the behavioural, institutional and technical relationships [that] underlie [the real world]. The intention is to facilitate the explanation of...phenomena, and...the generation of...forecasts” (The MIT Dictionary of Modern Economics, 1986:24 in Bradley and Schaefer, 1998).

For purposes of this study then, it follows that a model designed for use as a tool for political risk analysis can thus be conceptualised as *an extended representation of a certain potential host country's political and overall business and investment climate as viewed by potential foreign investors, political risk analysts and host governments, that wish to use the model for political risk analysis in order to better understand and comprehend, adapt to, manage and control the identified political risk factors the model is specifically designed for to deal with.*

By conducting a political risk analysis, one is already managing the political risks that might impact negatively on foreign investment. By studying and understanding all the (political) risks involved, one is able to change or adapt investment decisions by continually monitoring the impact identified risks might have on an investment – thus managing and controlling the influence these risks might have on consequential losses in profitability.

Although models aim to ease complex decision-making processes by representing reality, merely defining a model as a simplification of reality would be an underestimation of the intent of modelling. It is these approximations of reality that make a model useful. The question that should be asked though, in anticipation of criticisms against models being a(n) (over)simplification of reality, relates to the degree of simplification that is sensible – bearing in mind that the word ‘reality’ represents that part of the real world that is being modelled. In this case, the complex environment surrounding and infusing the decision-making process of foreign investment. Doyle (1992 in Pidd, 1996:18-23) explains how models should be developed that are as simple as possible and yet are valid and useful for their intended purpose.

The point of a model, being a “framework of analysis that abstracts from the details of the real world, in an attempt to highlight the explanation of phenomena or to obtain forecasts (Bradley and Schaefer, 1998:198; Jennings and Wattam, 1998:135-149), is thus to *make explicit or concrete that aspect of reality*

that is being investigated – the reality of foreign investment decisions. Inferred from the above discussion, the task of the political risk modeller is to take *ill-defined and implicit views of reality and cast them in some form well enough defined to be at least understood and argued over by other people.* This model may need to be presented in a computable form (Ackoff and Sasieni, 1968:1-455; Checkland, 1981:1-330; Hammer and Champy, 1993:1-231; Jennings and Wattam, 1998:135-149; Pidd, 1996:18-23) to allow for rapid experiments on the model, and to enable inferences about the real world as attempted in Chapter Five of this study. Management is not only about decision-making and control, but one cannot negate the fact that these do make up a large part of management tasks and responsibilities. It is hoped that the model presented in this study can make a useful contribution to these two aspects of management. In short, models are ways of applying rational analysis to complex issues.

Still, whatever the type of model in use, it remains important to evaluate a model in order to confirm and ensure that it constantly remains suitable for the purpose for which it was initially built. This process is often called model assessment or model validation, and includes testing a designed model, and constantly monitoring its design and structure to measure its reliability and validity.

2.6 Computer Simulation: Visual Interactive Modelling?

Mention has been made regarding the use of a computer model to aid in the decision- making process of foreign investment. The title of this study mentions “...[a] *computer-assisted model for analysing and managing political risk*”. The basic idea of computer simulation is the use of a model as a basis for exploration and experimentation (Bradley and Schaefer, 1998:32, 38; Chicken, 1996:371378; Jacoby and Kowa, 1980:3-11, 216-240; Jeffries, 1986:218; Jennings and Wattam, 1998:133-135, 150; Kleijnen and Van Groenendal, 1992:1-241; Law and Kelton, 199:1-760; Pidd, 1995, 1996:249). The simulation of a political risk analysis, in this case, should be used because it is cheaper, safer, quicker and more secure than making a foreign investment without exploration, and learning with hindsight that an immense amount of money could have been saved if the investment scenario was played out on a computer model first. By applying the computer model, it becomes possible to establish whether a certain investment will ‘work’ or not, without actually having to make the investment to find the answer.

Computer advances have also allowed for the development of knowledge representation, models that seek to represent human judgement and experience by incorporating the thinking processes of humans. Bradley and Schaefer (1998:32, 38) warn against the explosion of user-friendly software though, and explain that with such software can come increasing pressures to formally justify decisions that are more ‘run of the mill’ in nature. They further warn that models designed for routine situations can be applied in exceptional situations for which they are not designed, and in which they do not function well. Good

models may thus be used for the wrong situation, and in the process, wrong and often costly decisions can be made (Bradley and Schaefer, 1998:38).

This study takes heed of these warnings, and in designing a client-specific simulation model, is actually able to 'test' the investment as such. Of course, one cannot foresee everything and this study concedes that there will always be some events it will not be able to anticipate, but one can make the best use of the risk factors identified in this study in order to map possible probabilities, enabling in turn the ability to measure and anticipate such probabilities.

In using this model that is subjected to known inputs, the effects of these inputs on the analysis are noticed in the (test) results. Based on the above discussion of political and country risk, as well as of the analysis of risk, it becomes all the more clear that the inter-disciplinary nature of political risk makes the consequent analysis thereof suitable to computer simulation. Political risk and the analysis thereof 'fits' the description of Pidd's (1996:250) "features [that] tend to characterise the systems best suited to computer simulation" namely that they are dynamic, interactive and complicated (Bradley and Schaefer, 1998:32, 38; Jacoby and Kowa, 1980:3-11, 216-240; Jeffries, 1986:218-236; Jennings and Wattam, 1998:150; Kleijnen and Van Groenendal, 1992:1-241; Law and Kelton, 1991:1-760; Pidd, 1995, 1996:249).

Political risk is indeed dynamic. Any investment environment is influenced by political risks that display distinctive behaviour known to vary through time. These political risk factors or phenomena are interactive. The investment environment consists of a number of political risks that interact with one another, producing the distinctive behaviour of the specific investment climate. The combination of these factors will inevitably vary, and these interactions will be observable, thus producing the measured and analysed risk.

At this stage of the discussion, after having clarified and defined the main concepts the study will mainly be dealing with, it is necessary to start addressing the possible methodological and theoretical problems encountered in political risk analysis. In order to conduct a political risk assessment, the use of a model like the one offered in Chapter Five is suggested. It follows that methodological and theoretical problems in political risk analysis relate to problems faced in risk modelling.

2.7 Possible Theoretical and Methodological Problems in Political Risk Analysis

Much has been contested regarding theoretical and methodological difficulties encountered in the process of designing and building a model for political risk analysis, especially where the results of such an

analysis are expected to be a valid reflection of political risk. Political risk analysis is a tool that is of incredible value to any organisation or firm interested in pursuing profitable projects in foreign countries. Yet the theories and methodologies behind the process of risk analysis are often lacking. A model for political risk analysis, after all, can only be as good as the components thereof. In the following discussion, the main problems will be highlighted.

2.7.1 *Problems with data, aggregates and model validation*

Pidd (1996:108, supported by Bradley and Schaefer, 1998:5, 7-9, 96-105, 107-156, 161, 184-185; Carley, 1981:79; Marks, 1986:187-194) makes the important assertion that "...[j]ust because data is available it should not be assumed that it is useful." This rings very true, and the discussion on the levels of analysis problems should follow on some thoughts surrounding the problems encountered during analysis and modelling, due to the nature of data and the means of collecting it, as the levels of analysis pertain to the types of data used as well as the various levels from which data is gauged.

Certain validation errors can also occur in model building, contributing to the various theoretical and methodological problems one might face in designing a model for political risk analysis and management. Linked to the mentioned problems of data analysis and (mis)use, is the reliability of data (Johnson and Joslyn, 1995:82-95; Neuman, 2000:164-172). Probably also valid as a limitation to this study, is the notion that it is often not possible nor even desirable to test a complete population about which information is to be gauged. One often needs to make inferences about a population by examining a sample of items from that population (Balci, 1994:53; Checkland, 1995:47-54; Checkland and Scholes, 1990:1-329; Déry, Landry and Banville, 1993:168-183; Gass, 1996:250-158; Law and Kelton, 1991:1-760; Oral and Kettani, 1993:216-234; Pidd, 1996:319; Roy, 1993:184-203; Schruben, 1980:101-105; Willemain, 1995:916-932). Most members of populations vary somewhat and it might be necessary to estimate a statistic of some kind.

The difficulty in this is that no single sample size as an aggregation of a population can possibly contain all the information about that population. Data vital to its interpretation into information can be masked and consequently undetected in this way. Inferences can be made from samples and may, in the light of full and complete information, turn out to be wrong. Depending on the nature of data collected for a country comparison for example, the sources of data must also be taken into account, so too the quality and age of data. In summary, the sample comparison has to be a fair one. The problems entailed in using aggregate data will be addressed further in a following section.

Pidd (1996:106; Bradley and Schaefer, 1998:5, 7-9, 96-105, 107-156, 161, 184-185; Carley, 1981:79) explains that many students, when learning about modelling, insist that progress cannot be made unless

there is some (or more) data available. They assume that the examination of data will provide some clues to extend their understanding. Although exploratory data analysis is a very valuable technique, the previous assumption can prove to be a mistake. Exploratory data analysis is very useful as an approach, but it is no substitute for careful thought and analysis (Evans, 1991; Raiffa, 1982:1-356; Starfield, Smith and Bleloch, 1990:1-206; Willemain, 1994:213-222, 1995:916-932).

A fundamental point that must not be missed is that the model should drive the data, and not vice versa. This means that the analyst should first try to develop some ideas of the model and its parameters, and from this should then think about the type of data that might be needed (Bradley and Schaefer, 1998:5, 7-9, 96-105, 107-156, 161, 184-185; Carley, 1981:79; Pidd, 1996:107). Data must be researched, requested, justified and collected before it can be interpreted. Still, the development of a model should not be dictated by the availability of data. It might be necessary though, to design a simple model and to then collect data to parameterise and test it. It may then be clear that the simple model is fine for the intended purpose, or it may be that the model needs to be refined further⁴².

Despite the above warnings being posted for the use of data, it would be wrong to imply that modelling is best carried out in an abstract way – data should not be ignored. As a start, it is helpful to divide data and information into various groups (Bradley and Schaefer, 1998:23-42; Carley, 1981:67-85; Marks, 1986:187-194; Pidd, 1996:108). First, one should gather preliminary or contextual data and information. Throughout the process of political risk analysis, certain questions are asked that enable the investigation of political risks as such, and the results of these questions may be either qualitative or quantitative in nature (Alvesson and Sköldberg, 2000:18, 214-215; Furlong, Lovelace and Lovelace, 2000:191-192, 525-548; Hammersley, 1993:14-32; Kane and O'Reilly-De Brun, 2001:287-337). In the case of quantitative results, it might be necessary to conduct significant analysis on the data that is produced quantitatively (Bradley and Schaefer, 1998:5). But preliminary data is collected with a view to understanding more about the context of the problem, rather than the development of a detailed model. Preliminary analysis often reveals enough insights for there to be no real need to take a project any further.

If the amount of political risk a foreign investor might face is clearly so significant that the weighing of the first few risk factors negates the possibility of even managing these risks, the preliminary analysis of not even the entire model might suffice in this regard.

The second type of data is that which might need to be collected and analysed in order to further develop the model in some detail after preliminary modelling. This is model parameterisation, or model realisation (Bradley and Schaefer, 1998:23-42; Carley, 1981:67-85; Willemain, 1995:916-932).

⁴² The model is tested in Chapter Five of this study.

Important in this case, once again, is to bear in mind that the model structure should drive the data collection and analysis, not *visa versa*.

Pidd (1996:109) asserts that an old adage among management information systems professionals is that *information is data plus interpretation*.⁴³ He further illustrates this by stating that “[f]or modelling purposes, data is best ordered à la carte rather than table d’hôte.” This relates to the “data fit” of the data being collected and applied to the specific case the certain model was intentionally designed or adapted for.

There is no substitute for proper and well-organised data collection if a useful model is to be constructed. It may also be possible to take existing data and ‘rework’ it in such a way as to account for some of its shortcomings. Model testing can also illuminate discrepancies that exist in the data, which can be taken into account during the modelling revision process (Bradley and Schaefer, 1998:23-42; Carley, 1981:67-85; Pidd, 1996:110).

In the vast majority of cases, data is just a sample of what could be used or might be available. This is true in a number of dimensions (Bradley and Schaefer, 1998:5, 7-9, 96-105, 107-156, 161, 184-185; Carley, 1981:79; Pidd, 1996:110). In terms of the time dimension, when data is being used to build or to test a model, that data will have been collected at a particular time and over a certain period. Yet due to the dynamic nature of politics and its socio-economic as well as socio-political ramifications, it is a contention of this study that a political risk analysis presented as an in-depth country analysis should be revised and re-evaluated on a regular basis – every week, for instance. This way, complacency with a seemingly stable situation can be avoided (Chicken, 1996:282).

The ‘dating’ or ageing of data is extremely important to monitor, especially if the results of a political risk analysis based on a model designed for a specific purpose is used to extrapolate into the future. Data is also a set of observations, and any observation process is subject to errors of different types (Bradley and Schaefer, 1998:5, 7-9, 96-105, 107-156, 161, 184-185; Carley, 1981:79; Pidd, 1996:110). Such errors include recording errors, as well as transcription and analysis errors. This might explain why data can be handled with a certain measure of scepticism – especially if it is readily available.

2.7.2 The levels of analysis

Kobrin (1981:253) explains how the broad range of political risk agents an organisation faces that arise from the political and economic environment of the host country in which a foreign business wishes to operate, can be classified along two dimensions. The first classification encompasses political risks

pertaining to macro risks in the broader environment, and the second to the industry specific micro risks that may affect the physical foreign ownership of invested assets. In its broadest sense, macro risks are those risks that will affect all businesses in a specific country, where micro risks will only impact upon a certain industry, and not on others at all (Venter, 1997:73-99).

Upon selecting types of risk factors for political risk analysis, factors and their indicators are usually amalgamated from various levels. As illustrated above, macro and micro risk factors are selected from different analytical levels. Brummersted (1988:89-91) expands further on this notion by describing these levels as being of psychological, political, societal, interstate and global nature (Alvesson and Sköldberg, 2000:18, 214-215; Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159; Furlong, Lovelace and Lovelace, 2000:191-192, 525-548; Kane and O'Reilly-De Brun, 2001:287-337; Lazarsfeld, 1966:21-53).

The individual or psychological component is made up of factors that relate to the persona, beliefs, attitudes, past experiences and social background factors of political executives, and decision and policy makers (Neuman, 2000:132-134). This tends to be conceptually slightly elusive but justifies serious consideration in cross-national studies of host country behaviour⁴⁴ as policy formulation depends to a large extent on the persona of policy makers (Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159; Masland, 2002:32-37). Brummersted (1988:89-90) uses the effect of leader charisma on foreign policy as an example of human behavioural influences on political risk, which can also influence investment legislation. A charismatic leader might be nationalistic but cognitively unsophisticated. Such a leader can play an influential role in foreign policy and investment policy-making without prior training in conducting foreign affairs. Brummersted (1988:89-90) explains that the foreign policy of such a leader's government is usually unfriendly toward states outside its geographic region, being more assertive in its foreign relations in working to advance the country's role in seeking a place in the world order.

The political element should include variables related to the political operation of a state in the context of the political system (*Pr1-Political system*) within which it operates. Examples may range from the nature of the relation between the legislature and the executive (*Pr2-Separation of powers*), party competition (*Pr3-Openness of political system*), as well as institutional and other group activities that may amount to governmental or societal political risk. The societal components of political risk analysis are included as (*Sr1 – Sr25*) in the model presented in Chapter Five. In this instance, economic factors also gain relevance, like economic performance and growth rate, inflation rates, and the balance of payments. Internal conflict and policy stability are also important in this regard, especially to the functionality and consistent profitability of foreign-owned enterprises in host countries.

⁴³ Own italics used to stress the point that information = data + interpretation.

If the individual, group and stata factors may be viewed as internal factors of political risk, the interstate and global components would be external in nature. Within the interstate components are risk factors that reflect external events to which a state must react by formulating policy, or to which social forces within a state may respond in some way. Interstate trade relations, currency markets, and regional alliances or pacts are role players or units of the interstate level of political risk analysis.

The global component of political risk analysis consists of all international systemic factors that may affect governmental and societal behaviour. Indicators thereof would point toward geographic position and geo-politics, systemic status-rank, and the level of systemic conflict that might influence a host country's stance toward foreign direct investment.

These different levels of analysis are accommodated in the model by the way in which the political risk factors are operationalised. Each identified political risk factor, be it economic, social or political, has its own set of indicators that may or may not literally 'indicate' levels of the risk factor present in a certain country. Giving a risk factor indicator a relatively high rating would indicate the presence of a relatively high level of political risk pertaining to the specific risk factor, whereas a relatively low rating of such risk factor indicators would point toward relatively low levels of that political risk factor perceived to be present in a country. It is thus important to bear in mind that observations made on an individual level should not be generalised, just as observations made on a larger global scale should not be relayed as being an attribute on an individual level of analysis (Alvesson and Sköldberg, 2000:18, 214-215; Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159; Furlong, Lovelace and Lovelace, 2000:191-192, 525-548; Kane and O'Reilly-De Brun, 2001:287-337; Lazarsfeld, 1966:21-53).

Analysts should also be aware of the problem of ethnocentrism, and take care not to fall into its trap (Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159). One can easily, albeit unconsciously, regard events from a 'western-bias', comparing other political systems as second to western-style polyarchies. It is often the case that political risk forecasts reflect an element of normative advice to non-western countries of how a political system 'should actually be run', negating specificities that warrant unprejudiced assessment.

The point that is being made is that political risk factors and their indicators should be operationalised in such a way as to not exceed the level of analysis from which they are taken. As mentioned before, the sourcing of information for political risk analysis is very important, and should be done with care. Aged and incorrect data will naturally impact negatively on the outcome of an analysis, resulting in ill-advised decisions and possibly great financial losses to foreign investment. The more reliable the information is,

⁴⁴ In his article, Masland explains that Thabo Mbeki is feuding with allies, fighting his cabinet, and losing international allies and that his dissent on HIV/AIDS is unravelling his presidency.

the greater the degree of accuracy becomes that can be achieved in political risk analysis. Marks (1988:187, as well as Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159 and Coplin and O'Leary, 1994:177-180) reiterate this point when they explain that the essence of greater accuracy in assessing political risks lies in access to the latest and best possible information.

2.7.2.1 *Ecological and individualistic fallacies*

Briefly touched upon in the preceding section and mentioned in the previous chapter, the 'levels of analysis problem' pertains to ecological and individualistic fallacies that may come to the fore when conducting a political risk analysis. During the process of modelling, two further pitfalls must be avoided, namely over-simplification and over-elaboration, which are also discussed in the following section.

The *ecological fallacy* is easier to understand, and thus easier to avoid, if one steers clear of 'over-generalising'. The ecological fallacy is committed when an observation that is made at the general level (over a large population) is taken and applied to every individual within that population, that is, if data from the broad ecological level is taken and applied to an individual case. It would be false to assume that all developing countries or emerging economies pose high-risk investment environments. This is not necessarily true, as there are developing countries that pose medium or even low risk investment environments. An ecological fallacy involves taking a valid observation or generalisation made on the aggregate level, and assuming that it would always apply to every case on the individual level (De Vaus, 2001:29-31; Johnson and Joslyn, 1995:82-95; Mahler, 2000: 8-9; Neuman, 2000:134).

The reverse of the ecological fallacy is called the *individualistic fallacy*, occurring when an individual-level observation is made, and incorrectly generalised to the aggregate level (Mahler; 2000: 8-9). The individualistic fallacy will be committed if one accepts that, because the Coega Industrial Zone Development and harbour project might pose a relatively high risk to investors, all investment opportunities in South Africa might pose a high risk (Brink:2001).

This study contends that one should proceed with caution and not hinder the validity and reliability of the end result by falling into the 'levels of analysis' trap (De Vaus, 2001:29-31; Johnson and Joslyn, 1995:82-95; Neuman, 2000:134). The importance of this problem is at least recognised by an awareness that observations made on a certain level of analysis, are really only safely used on that level. Despite this, it happens fairly often in all realms of social science research that one has to use data from one level in order to learn about another level – researchers often have to rely on *aggregate data*, as is the case in measuring the level of social development in a country for instance (Bradley and Schaeffer, 1998:96-105, 161; Carley, 1981:79-82, 174; Hammersley, 1993:14-32; Marks, 1986:187-194; Snider, 1986:117-152). By measuring education and health care, only aggregate data is available in the average number of years

of education (*Sr4-Education ratio, and Sr6-Mean period of schooling*), or the average number of hospital beds (*Sr13-Health care*). Still, conclusions drawn from one level of analysis or observation must be used very carefully on another level, and the use thereof must be qualified sufficiently.

The danger of “over assuming” must also be avoided. Two political systems might have the same names, but perform completely different functions. Also, the same structure might have different functions in different political systems. For example, the South African lower house (National Assembly) plays a significant role in the election and appointment of the South African President...but the American lower house (House of Representatives) does not play the same role in the election and appointment of the American Executive (Mahler, 2000: 8-9).

2.7.2.2 Over-simplification and over-elaboration

The dangers of over-simplification during modelling present themselves in many ways. Pidd (1996:79) explains how a model designer often attempts to tackle one aspect of a problem situation in complete isolation from other aspects that may be equally or more important. In a political risk analysis there are many aspects to the problem of political risks that could be tackled, and most of them are interrelated – ignoring the linkages may have undesirable effects on other aspects of the problem. The danger of premature or over-enthusiastic decomposition is that the resolution of one issue may worsen another aspect (Checkland, 1981:1-330).

Another way in which over-simplification may occur is due to the natural tendency to see what one prefers to see, for it is very easy to be bound by frames of which one is not even aware. Upon approaching a new situation, past experiences are also brought into play. Remedies might be applied that fit well with an individual’s own expertise, and one might do this while ignoring other aspects (Pidd, 1996:80). This risk is almost inevitable, especially if it is true that what constitutes a problem is socially and psychologically defined.

In addition to over-simplification, is the danger of over-elaboration or over-complication (Checkland, 1981; Pidd, 1996:80). As established in the preceding discussions regarding political risks, and the analysis and management thereof by using a specially designed model, the complexities that make up the investment environment are interconnected both internally and externally. But where does one draw the boundaries around what is being attempted? Must a political risk analysis for a certain client in a certain industry within a certain host country be comparative in nature, and should it assess the political risk prospects of similar countries over the next 20 years?

The above questions probably depend on the system being studied and also on further questions that need to be answered. It may be true that the complexities of the political risk environment are interrelated in

some way, but there is no doubt that some connections between political risk factors are stronger and more important than others. If the analysis is intended to merely have a short-term impact (say the investment is a quick in-and-out type maximum profit venture), then operating with a basic application of the risk analysis model may suffice. There is a hierarchy of dangers or risk factors in an investment environment – some of these risk factors only come into play or impact on an investment (depending on type, tenure and industry) after a certain period of time and in certain relation to one another. This is also why the identification of trends is an important function of our model. If political unrest is mostly centred around elections, “getting in” or investing after one election and “pulling out” or divesting before the next can be profitable. This of course largely depends on the type of industry, investment and investor. However, things are hardly ever so simple.

2.8 The Reality and Reliability of Political Risk Analyses

Political risk analysts are also concerned with anticipating, or forewarning potential political risk possibilities arising from the political and investment environment. The impact of such political risks varies across firms and projects though, as the ability of such businesses to cope with political risks depends on the interaction and coexistence of political environmental factors, and the risk management strategy and structure of the foreign organisation functioning within this environment. This study maintains that not only is it important to conduct thorough viability studies and political risk analyses, but after this has been done, the contribution of such assessments to political risk management strategy and planning is invaluable. Apart from good political risk analysis, this study also aims to assist in coping with and managing political risk within a host environment in an attempt to foresee and prevent politically risky situations from impeding on firm profitability.

Still, in order to assess or analyse the potential impact of political or economic events on an organisation, one must also be familiar with the nature or tenure of the particular host country's political environment. It then becomes possible to relate a specific detailed report on how the potential political, macroeconomic, societal, environmental and socio-economic climates of a host country are likely to affect a project.

The existing data and models of risk analysis, as mentioned, are limited and include mostly macroeconomic risk factors, measures of social structure and development, and political events that are primarily indicators of instability and/or regime change. The unit of analysis is almost always the nation-state, and there are related problems of reliability, accuracy, validity and comparability (Stubbs and Underhill, 1994; Kobrin, 1981:254). What is needed is a way of conducting industry specific (type, size,

structure, experience with foreign expansion), time specific (short, medium or longer term ventures), and also investment climate specific political risk analyses.

It is, as previously said, vital to acquire knowledge of the political processes within a host country, and country specific expertise contributes greatly to political risk analysis. Of further importance is thorough knowledge of the prospective business itself, its structure and dynamics, technological position, strategic management policies, marketing policies, as well as its financial assets and liabilities. But even before a political risk analysis can be done, there is a problem which requires awareness - that of communication between the country specialists and industry specialists, if and where these specialists are used in conjunction with the political risk analyst. A translation is required of the background, function, outlook, and differences between country and industry specialists. Ideally, these differences should be addressed and bridged prior to the preliminary political risk assessment. These, if not resolved, will surely impact heavily on subsequent risk management exercises⁴⁵, delaying consensus and wasting time in which profits could have been made, or a project could have worked at establishing itself in the host environment of which it will be a future part. The lack of resolving such differences may also have contributed to the gap in political risk analysis research over the past decade.

Political risk analysts face a further problem - that of attempting to conceptually model the processes through which political economic environments actually affect projects. Determining the nature of potential constraints is also a large part of the analytical problem, as is the forecast of the probability of their occurrence. Additionally there is a great deal of uncertainty about the nature of the relationship between the host country's political environment and the nature of the international firm investing in that specific country. Political risk analyses remain uncertain in the sense that they experience difficulty in specifying the set of outcomes that may result from a given event, and attempt to assign probabilities to these. Making this possible is one of the challenges of this study.

Another factor hampering the growth of theory in political risk analysis is the problem of time and financial pressure that companies experience, thus favouring sporadic individual country studies over systematic cross-national analyses. Conceptual frameworks as such are hardly ever developed to aid in the analysis of often expensive data.

As mentioned in the first chapter, a further obstacle to the systematic study of political risk is the interdisciplinary nature of the subject. Both Simon (1982:124) and Kobrin (1981:113-122) note how difficult it often is for experts from various fields of discipline to communicate with each other about information relating to valuable political risk assessments, probably because their respective training and current interests produce different ways of looking at and approaching a problem, and one can see how difficult it

may become to reach a consensual agreement on various points of interest. Still, the power of a good theory lies in its ability to explain various situations in different contexts, as this study shall attempt to illustrate by means of applying problem-solving and decision-making theory to risk management strategies, methods and suggestions. In this way the inter-disciplinary nature of political risk analysis, if all inputs can be harmonised, can in fact add to the validity and overall quality of an eventual analysis.

A crucial and tentative step towards explaining various situations in different contexts, is to identify who the key actors are and to determine how their interactions can affect the formation and potential threat of political risk (Simon, 1982:124). According to Simon (1982:141), preliminary efforts and explanations must be broad enough to account for a multitude of actors, situations and environments that can affect the level and nature of political risk in certain countries. Multinational Corporations (MNC's) are exposed to a number of political risks that originate from a variety of sources. By identifying these key actors, and the manner in which their interactions can result in various kinds of risk situations in different types of countries, the political risk analyst can assist or aid in isolating the early warning signs of stress factors which may causally evolve into factors of political risk⁴⁶

One weakness of a structural analysis of political risk, such as a model, is that it tends to become static. This weakness can only be overcome, as this study will show, by maintaining constant awareness that social patterns are continually evolving as they interact. That is why the model presented in Chapter Five is adaptable and flexible, thus enabling the political risk analyst, together with a potential investor, to add or subtract risk factor indicators or adjust the weights of factor indicators. Of utmost importance is an understanding of the dynamics of social change, how power is won and lost, how consensus and conflict are created or destroyed, and how norms and values may change, sometimes gradually, at other times suddenly. A political risk model should also try to avoid the natural analytical tendency to present institutions as being more 'regular and predictable' in their functioning than they really are.

In the analysis of social actions and reactions, risk analysts should strive to forecast the relative strength of the groups that would play a role in the state's policy arena, the positions they would be likely to take, and the probable outcome or influence this might have on the safety and the profitability of foreign investments in a country⁴⁷. The counter reaction of the state is also of importance, because protest will bring about either a hardening or a modification of state policy, which in turn might be detrimental to the

⁴⁵ In Chapter Six, the notion of political risk management is introduced.

⁴⁶ In their introduction, Coplin and O'Leary (1994:1) call for the examination of current societal attributes and the circumstances under which losses in profitability have occurred before, either in the same country, or in others similar to it, as further contributing to the design of a new political risk model. It follows that if high levels of ethnic tension are often followed by open ethnic conflict, civil strife could result in damage to business or in forced abandonment of the investment not only in developing countries. Such instances are quite prevalent even in technology producing countries like Israel, for example, where deeply entrenched social cleavages bubble to the surface of the political arena at regular intervals.

⁴⁷ Reactions might range from a mere grumbling, laxity in implementation, the undermining of activities, to organised protest, electoral upheaval, or armed efforts to topple the regime in power.

future sustainable activities of foreign organisations (Moody's Investor Service in Coplin and O'Leary 1994:150).

It thus becomes clear that the structures of social interaction are very important in risk analysis. The risk assessment process should include a wide-ranging analysis of the basic patterns of social interaction that characterise society within a country. This may involve using a variety of the traditional concepts like class, status hierarchy, and interest groups, but it is also important to understand and grasp the lines of conflict that run through a society. Some examples of these are the distribution of income and wealth, religious, ethnic or linguistic differences, conflict over lifestyle and ethical norms, or ideological splits reflected in struggles for control of institutions, including the state itself. Fundamentally, a model should try to understand all attempts to create or mobilise power, in whatever form it occurs.

2.9 Concluding Remarks

Chapter Two dealt with the conceptualisation of the most important concepts used throughout the study, and attempted to establish the theoretical base of political risk analysis. Terms explored in greater detail in this chapter all referred to the practice of political risk analysis as such, and an attempt was made to gain greater conceptual clarity on the definitive meaning of *political risk* and the *analysis* thereof. The terms 'country risk' and 'political risk', 'problem solving theory', the process of 'analysis' as such, 'model', 'modelling' and 'computer simulation', as well as 'predicting' and 'forecasting' were all addressed.

The second chapter also attempted to further clarify some of the methodological and theoretical problems encountered in political risk analysis. Although the limitations encountered during the process of research conducted for this study were mentioned in Chapter One, further limitations were touched upon in the second chapter, where the specific contexts of these limitations found a more fitting 'place' in the study.

In Chapter Three, current models of risk analysis are scrutinised. The chapter also presents and discusses some findings in the light of the Asian Financial Crisis, and elaborates on the notion that macro-type models did not send off any 'warning signals'. It discusses some of the political undertones that were evident prior to the crisis, and that became clearer in its aftermath. The crisis is also revisited from a political risk analysis perspective, and mentions some lessons political risk analysts can learn from the Asian contagion.

CHAPTER THREE: Thoughts and Examples on Modelling for Risk Analysis and the Asian Contagion Revisited

Chapter Two explained some of the theoretical and methodological problems that one might come across when conducting political risk analysis. In an increasingly complex and interconnected world, it becomes all the more vital to explore ways in which the possible consequences of decisions and plans can be investigated *before* any action is taken. One way of doing this is to use a model.

The reader should understand that the model presented in Chapter Five of this study is a simplification, an abstraction of features that are deemed to be important, and, although absolute validity cannot be guaranteed, it is certainly something to strive toward. But if used sensibly, this model and its modelling-approach provide an initial way of managing risks and uncertainty regarding potential foreign investment in host countries by identifying probable risk factors and thus creating an awareness of their existence.

The study is also aware of some of the inherent dangers in making use of such a model. The first being a misuse of the model as a *substitute* for human thinking, analysis and intellectual thoroughness.

Secondly, because the model is a simplification of reality – which probably adds to its attraction - there will always be something missing from the final application regardless of how many times it is planned and redesigned, and after a few years one becomes well aware of this. The user(s) of the model should also take this into consideration as a mentioned limitation of the study¹. Even if a model is substantially valid for the task at hand, there may be elements missing from it that imply that analyses based on it can be safely and sensibly ignored. The model presented in this study incorporates the rational and logical consequences that are known or expected to follow from certain actions or factors. If reality is multifaceted, then a model and its results should be as open to questioning as any other product of the human mind and thought process (Beroggi, 1999:36-60; Pidd, 1996:29, 30; Simon, 1976:1-364).

The way in which this dissertation plans to develop explicit specifications of causal relationships and systematic analytical procedures, is by means of designing a model as a representation of reality, a set of assumptions that are employed or applied to enable the study of a particular phenomenon, and testing the coexistence of various indicators of a phenomenon - in this case, those of the levels and nature of political risk present in a given country² (Brodbeck(ed.), 1968:579-600, 635-667; Kuper, 1987:70; Outhwaite, 1987:52-53; Rosenberg, 1988:74, 146, 166-167; Sayer, 1984:162-173). This study presents a model with weighted values given to each political risk factor's indicators, and calculations can be made to present a

¹ That is, the near impossibility of including every single risk factor that can possibly impact on the profitability of a foreign investment in a host country.

² See Chapters Four and Five. These chapters offer an explanation of how the indicators are 'weighed' and attempt to give reasons for these choices. The 'mathematics' of the model is presented in the fifth chapter of this study.

percentage chance that political risk might occur in a certain host country, or in a specific sector or industry within a host country.

In the following section, the complexities of modelling in social science is introduced, as well as the contentious issue of using mathematics to enable calculations based on measurements of qualitative so-called 'soft' variables. A few reputable and established rating methodologies will be examined, many of which are primarily credit rating methodologies. Some include a few political risk factors, and are thus often deemed sufficient analyses of political risk as well.

The reason for briefly analysing these rating methodologies is to show how a comprehensive model for political risk analysis that includes risk factors of economic, social and political nature can be designed to enable a more comprehensive analysis of a certain investment climate or compared climates. As credit ratings are often used unknowingly as an overall reflection of a country's investment climate, this study would like to suggest that the model for analysis in Chapter Five be used in conjunction with existing methodologies, with financial and other viability studies, or be incorporated into future risk analysis methodologies.

This third chapter basically motivates the need for a type of model like the one offered in this study. The way in which its value can be gauged is by revisiting the Asian Financial Crisis from the perspective of political risk analysis. As the discussion will show, it can be contended that the crisis could have been less severe, had credit rating agencies been able to recognise the signs of a looming crisis. The question has to be asked – why were the credit rating agencies not able to assist in forecasting the crisis? The possibility that the methodologies of the ratings are slightly flawed has to be investigated based on the hypothesis that, had they been measuring with the right kind of 'yardstick' or 'tools', they would have picked up on the advent of a financial crisis that spread across the regional cluster to eventually settle far beyond East Asia. The model presented in this study also attempts to incorporate risk factors that can also act as 'early warning' indicators to some extent.

3.1 An Evolution of the Mathematical

Kuper (1987:70) explains that mathematics is a powerful, flexible language and that models are representations framed in mathematical terms. "Mathematics", said the American physicist Gibbs, "is a language" (Brodbeck (ed.), 1968:635). Any meaningful proposition can be expressed in a suitable mathematical form, and any generalisation about social behaviour can be formulated mathematically.

Social science is mostly, but not exclusively, of a qualitative nature, and mathematics of a quantitative

nature - so it seems that the two (social science, of which political risk analysis is a multi-discipline, and mathematics) cannot be reconciled with one another. But Arrow (in Brodbeck (ed.), 1968:636) is of the opinion that "...it is simply not true that mathematics is useful *only* in quantitative analysis". An understanding of a community (which will either benefit from foreign investment or hedge against it) requires knowledge of its religious and social beliefs, and also involves knowledge of the distribution of income, the proportion of government resources devoted to societal needs, and even the population size and growth rate in relation to rates of (un)employment. These then become indicators of the possible occurrence of political risk (Beroggi, 1999:79; Jacoby and Kowa, 1980:3-11, 216-140; Kemeney and Snell, 1962:3-8; Lazarsfeld, 1966:21-53; Lunneborg, 1994:1-5, 18-23, 211-268; O'Linick, 1978:12, 14; Whicker and Sigelman, 1993:1-20, 56-78).

Hare (in Outhwaite, 1987:52) maintains that:

"[t]he fact that both [quantitative] natural and [qualitative] social sciences use models in the same way may suggest misleadingly that they share a common epistemology. The differences emerge when we compare the relation of fact to theory in each kind of science. In the social sciences, facts, at the level at which we experiences them, are wholly the creation of theorising, and/or interpreting."

In designing a model for political risk analysis as presented in Chapter Five of this study, an attempt is made to show how the quantitative nature of mathematics assists the qualitative measurement of social phenomena in political risk analysis by operationalising, contextualising or framing useful qualitative phenomena.

Upon examining a given set of qualitative variables, every individual social scientist might evaluate the relationships between variables differently, and come up with differing results time and time again. The same social scientist might not even come up with the same results twice. But in natural sciences, figures and facts are not open to individual interpretation in the sense of trying to establish the cause-and-effect relation between numbers, they are not open to be thought about "on the level at which [each individual] experience[s] them" (Hare in Outhwaite, 1987:52). This study, aware of the natural science-social science debate, maintains that the two are not necessarily mutually exclusive, and that quantitative and qualitative measurements can be reconciled (Beroggi, 1999:79; Jacoby and Kowa, 1980:3-11, 216-140; Kemeney and Snell, 1962:3-8; Lazarsfeld, 1966:21-53; Lunneborg, 1994:1-5, 18-23, 211-268; O'Linick, 1978:12, 14; Whicker and Sigelman, 1993:1-20, 56-78).

Although the model presented in this study is designed to be quantitative in nature, it does not intend to depreciate the value of other modelling approaches, and is aware of how rational methods can also be

used in other ways to assist an organisation in making decisions regarding the viability of foreign investment(s).

With regards to modelling approaches, *mathematical programming* is a modelling method that is often strongly associated with 'hard' management science, and exemplifies the way in which models can be used in an optimising, linear programming mode (Arntzen, Brown, Harrison and Trafton, 1995:69-93; Beroggi, 1999:79; Cox, Kuehner, Parrish and Qiu, 1993:35-48; Dash Associates, 1995; Frontline Systems, 1995; Grandzol and Traaen, 1995:92-103; LINDO Systems, 1995; Litty, 1994:3, 34-45; Microsoft, 1993; Pidd, 1996:215; Sharda, 1995:64-57; Stanford Business Systems, 1995; Wagner, 1975:1039; Williams, 1993:1-359; Zenios, 1994:122-140).

Other modelling methods include *simulation approaches* that are used in situations in which changes through time loom large and in which entities interact with one another in complicated ways (Beroggi, 1999:36-60; Jacoby and Kowa, 1980:3-11, 216-140; Kemeney and Snell, 1962:3-8; Lazarsfeld, 1966:21-53; Lunneborg, 1994:1-5, 18-23, 211-268; O'Linick, 1978:12, 14; Whicker and Sigelman, 1993:1-20, 56-78). Computer simulation methods have led to an approach known as visual interactive modelling, or discrete event computer simulation (Buxton and Laski, 1962:3; Pidd:1992, 1996:215).

Apart from mathematical programming and simulation approaches, *heuristic approaches* are methods that aim to find ways of tackling problems that are very close to the ideas of 'satisficing' (Simon, 1972:1-364) which assumes that a decision-maker will not attempt to maximize subjective expected utility, but would rather search for options that appear to be 'good enough'. They have in mind a level of aspiration that defines solutions and options that are not only feasible but are also acceptable. Each heuristic application is, to a great degree, rather unique, illustrating the creative way in which some of the limitations of optimisation approaches are overcome (Eglese, 1986, 1990:271-281; Foulds, 1983:927-934; Kischka (et.al.eds.), 2000:21-23; Pidd, 1996:216).

In combination with a mathematical calculation, computer application and the fine tuning or tailoring of a model for specific client needs regarding an industry or sector within a host country, the model presented in Chapter Five of this study is not merely one or the other of the above mentioned approaches – be they of the 'hard' or 'soft' variety - but presents itself as a decision-theoretic application that hopefully compares with the best.

This modelling exercise is also based on some principles offered by Pidd (1996:92-115; Ackoff and Sasieni, 1968:1-455; Gilhooly, 1988:1-178; Raiffa, 1982:1-356; Starfield, Smith and Bleloch, 1990:1-206; Stein, 1974; Willemain, 1994:213-222, 1995:916-932) in an attempt to make sense of the complexities surrounding the decision-making process, which include simplifying the complex situation

3.2 Types of Models

Although the type of model used in this study is relatively mathematical in nature and based on decision-making theory and problem-solving theory, the following section does warrant a discussion of other types of formal models that are used in management science, in the sense that the management of political risks is one of the goals of conducting a political risk assessment. It is important to realize that the value of models and modelling approaches extends way beyond the realm of only mathematical models as such. Apart from decision-theoretic models similar to the model in Chapter Five, there exist, among others, at least three further types of models that can be of great value in managing political risks and warrant some discussion, namely *scenarios*, *business process models* and *soft models* (Beroggi, 1999:36-60; Brightman, 1980:9-22; Davies, 1994:263-278; Pidd, 1996:26, 27).

3.2.1 Scenarios

More qualitative in nature is the process of scenario building. Scenarios are a well-known and widely accepted method of identifying key political and economic risks as well as opportunities, as they allow for the constant comparative analysis of risks and opportunities. This is often done by means of a “best and worst case” future scenario, or a “high road and low road” future scenario, and offer an overarching framework for organized political risk assessment (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201).

Scenario planning is per definition a further response to a perceived increase in uncertainty regarding the evolution of the general economic and political environments within which a company must operate (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:136). Scenarios are not predictions per se, but highlight possible alternative unfolding events and can provide a framework for the study of alternative futures. These instruments of risk modelling are outlines, and, when used in strategic planning, seek to map changes, to identify ‘key branching points’ of the future, and to highlight the major determinants that might cause one future to evolve around another. Scenarios are not exhaustive descriptions of all possible outcomes, but focus attention on the logical dynamics and interaction of unfolding events. In this regard, they can be seen as ‘tools’ for organising perceptions about future environments in which a foreign investment decision might be deployed.

May (1996, 165-166) as well as Rossiter, Karplus and Jones (1986:137) share common themes in suggesting ways of preparing scenarios. May (1996:165-166) explains the major procedural steps in the preparation of scenarios to include the following: identification of the central concerns of the users of the scenarios; identification of the development of the factors that are likely to have the most important

by using a model, starting with a relatively small model and expanding upon it as the modelling process evolves, avoiding laboriously large models³, and avoiding data-mining.

Few people would disagree with the notion that some kind of formal model is involved in most management science, but many imply that only mathematical models are of interest (Hammer and Champy, 1993:1-231; Pidd, 1996:25). This study offers an explanation of other models that can be used in management applications, in, for instance, making decisions about foreign investment as will be shown in the following section. It further contends that although mathematical models are of interest in management science, they should not be exclusively so (Jacoby and Kowa, 1980:3-11, 216-140; Kemeny and Snell, 1962:3-8; Lazarsfeld, 1966:21-53; Lunneborg, 1994:1-5, 18-23, 211-268; O'Linick, 1978:12, 14; Whicker and Sigelman, 1993:1-20, 56-78). Still, making the decision to expand operations abroad to enable envisaged profitability is the "easy part". The question of how to fully implement this decision, and to manage the continual operation of the decision, is the more difficult side of deciding to invest in a particular host country.

The model for political risk analysis presented in Chapter Five of this study, apart from enabling the political risk analysis of a certain host country or sector within a country, also aims to offer a way in which to control or manage the continual operation. The model proposed in Chapter Five can also be seen as a mechanism for measuring the level of a MNC's performance in a host country which can be fed back and compared with the initial target level of performance – in this case, a level of profitability reached within a certain time, concomitant with certain factors that might impede negatively on this set target - like political risks for instance (Davies, 1994:263-278; Pidd, 1996:25).

In cases where such feedback is negative, the differences between the target performance level and the actual level of performance can be used to guide the investment back toward its envisaged profitability (Bradley and Schaefer, 1998:157, 182-195; Davies, 1994:263-278; Pidd, 1996:25). In the light of an earlier discussion on the availability of data and reliable information, such systems depend to a great extent on the availability of information about the investment climate that is fed back to the manager, who in turn is able to compare it with what is wanted and then change the investment criteria accordingly. In this way, the effects that political risks might possibly have on an investment are managed, and the aims of the investment, namely profitability, are closer to being realised. In doing this, investment managers or decision makers can use the Chapter Five model as a measure of what is likely to happen if certain action is taken, or if certain events occur.

³ Raiffa, 1982 in Miser and Quade, 1990 contends that model designers should beware of general purpose, and grandiose models that attempt to include almost everything. Models like that are not easy to validate, to interpret, calibrate statistically, and, most importantly, to explain.

influences on these central concerns in the future; analysing these important factors; assessing the importance and the uncertainty of these factors for the central concerns; selecting the scenario logics, the main theme or assumptions around which the scenarios are to be constructed; developing the scenarios, usually in the form of narratives that present a plausible sequence of events; analysing the impact of the scenarios on the key concerns with which the process began; analysing the implications for policy, and identifying the indicators that will help monitor changes as they occur.

Rossiter, Karplus and Jones (1986:137) offer a further perspective on general sequential method(s) that can be adopted to develop scenarios covering a MNC's business-specific concerns within a host country's investment environment in which levels of political risks are present, be they relatively low or high. These include listing the MNC's business-specific concerns; selecting the key influences, or factors, in the general operating environment which will determine the outcome of the business issues identified; projecting three plausible and internally consistent outcomes for each factor; combining the factor's outcomes and scenarios; and projecting outcomes for each business issue most appropriate to the scenarios (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:137).

To further explain the briefly abovementioned steps in scenario building, the following section will describe the process in more detail.

3.2.1.1 *Preparing a scenario*

Firstly, the *listing of business issues* should be as specific as possible, but not too unwieldy. For a MNC with one major product or interest in a country, a list comprising less than ten issues should be sufficient. For a manufacturing company, a list of business issues might include labour relations, wage costs, export requirements, exchange controls and local buying and hiring requirements. For an oil company, such a list might include the depletion of a resource and licensing policies, the actions of the state oil corporation, gas flaring requirements, environmental legislation and the security of personnel (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:137).

By *selecting the key influences*, the determinants that will largely dictate how the operating issues of concern to a MNC will manifest themselves, are identified. They are the scenario's independent variables and form the core around which a scenario is created. They also force the political risk analyst to make explicit possible assumptions, thereby facilitating agreement with the MNC on the likely outcome of the business issue in question and, where there is disagreement, encouraging the attainment of consensus. For example, an operational concern for a manufacturing company in a host country might be the degree to which it can repatriate its profits. The set of principle factors shaping the issue would include the

government's economic policy and its willingness/ability to stand by that policy (policy stability), the state of the balance of payments, the perceived need for foreign investment, and the host country's degree of exposure to retaliation. For an oil company, a concern would be the amount of oil production it must sell locally at below-world prices. Factors of this issue would include the government's level of commitment to free markets, the rate of growth in local oil consumption, the state of the balance of payments and the general state of the world oil market (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:138).

The *projection of factor outcomes* entails projecting two or three outcomes for each factor, thereby providing a range of possible futures. The more important the issue is to the MNC and the more uncertain the operating environment is, the wider this range should be. In scenario planning, simply pairing together all the optimistic and all the pessimistic outcomes should not establish the bounds for the factor's outcomes for the MNC. The result of such pairings will most likely produce implausible outcomes. As an example, high economic growth and rising oil prices may be an "optimistic" outcome for an oil company, but it runs counter to generally accepted economic theory (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:138-139).

Projecting outcomes for each factor necessarily produces a scenario and there is no discrete step in scenario development in which the factors are combined. Instead, this step acts as a convenient point for checking that the factor's outcomes provide a satisfactory range of possible futures and that they are both internally consistent and plausible (Ingram, 1993:1-10; Oxford Analytica Consultancy and Research, 1997:1-3; Schoemaker, 1993:193-201; Rossiter, Karplus and Jones, 1986:139).

The final step in scenario development is to project outcomes for the company's business issues in light of the outcomes for the issues' factors and to thus *assess the implications of possible scenarios*. While this step is probably the most important as far as the MNC is concerned, it should be reasonably straightforward for the planner to execute. The scenario planner should find that a range of plausible futures for the MNC's business concerns flows smoothly through all the steps, thus providing a clear sense of what the MNC's opportunities and risks will likely be throughout the planning and implementation phases (Rossiter, Karplus and Jones, 1986:139). Scenarios as a management tool for political risk analysis are successful if they clarify the future, identify future problems, are relevant to the organisation's current scope of activities, identify what needs to be changed, are credible and intelligent, developed without the involvement of the ultimate users, and if they are internally consistent and logical.

3.2.2 *Business process models*

When making decisions regarding the type of foreign investment that is to be conducted as well as the country in which this investment is to be made, it is important that the political risk analyst consult with the investor in order to gauge the extent of the investor's operation, as well as the way the investor does, or wants to do, business.

To facilitate this, the political risk analyst together with the investor needs to focus on the business processes as well as the business structure of a firm opting to invest in a foreign country. Where a process is a set of dynamic activities needed to get something done that will add value to the business, the concern of the political risk analyst is not so much *the departments and managers that are needed to ensure the profitability of the investment in a host country*, but rather *the political risk management measures that must be taken to recognize and possibly even profit from possible political risk factors*. Changes in technology have also made it easier to analyse possibilities and likely outcomes that differ from the ways in which they were done in the past (Beroggi, 1999:36-60; Brightman, 1980:9-22; Davies, 1994:263-278; Pidd, 1996:26).

Before the investment process is started, it makes great sense to model the likely investment outcomes in order to discover the essential and sensitive components, or in this case, the political risk factors that might have a possible negative impact on the viability and profitability of an investment.

3.2.3 *Soft models*

Some types of "less concrete" modelling, as Pidd (1996:27) (Also see Brightman, 1980:9-22; Davies, 1994:263-278; Jennings and Wattam, 1998:36; 42) refers to it, are also conducted as management science. Most of these "soft-type models" are intended to aid in clarifying uncertainties involved in management and planning, which in turn have a number of distinctive features.

- There is usually a large quantity of both qualitative and quantitative data and information that needs to be considered. Available data is often incomplete and may be ambiguous in its interpretation. It is also possible to conceive of large amounts of data that one or more participants in the decision-making process might consider important regarding the foreign investment.
- What often stems from disagreement and uncertainty about what exactly should constitute legitimate issues for inclusion in the decision-making process is considerable confusion and lack of clarity about problem definition, like the risks involved in such a decision.
- Especially when working in teams, and where subjective analyses play a role in the use of ideally

objective models, the participants that make up such a strategic team may have conflicting objectives and may be in direct opposition to one another. Apart from the ongoing balance between subjectivity and objectivity, within such a conflict, power relationships are also important and need to be considered if any kind of negotiated consensus is to be reached.

A strategic decision to make a foreign investment in any host country is one that will have a large effect on the continued profitability (if local operations are profitable and losses are not the major drive for foreign investment) of an organization. It could be argued that the development of a foreign investment strategy is a definite attempt at taking control of a company's future by managing or creating possibilities for future profitability in a host country.

Strategic decision-making is rightly considered to be very complex, which is why a quantitative decision-analysis model is proposed as a tool for conducting political risk analysis in an attempt to make sense of, and strategise around, these complexities. The complexity of such a decision has a number of different dimensions that will be explained in greater detail in the following sections.

In constructing a model or tool for political risk analysis, and keeping the abovementioned in mind, a model designer should be aware of his/her role as facilitator as well, and should not take for granted that the participants in the decision-making process all share the same view about the reality of the investment process. The model designer should thus constantly consult with these decision-makers and take into consideration the differing perceptions of those involved.

Strategic management literature suggests that, in decision-making processes regarding foreign investment, differences in interpretation(s) are not unusual but rather commonplace. The model offered as part of this study lends itself toward a decision-theoretic model which allows for risk assessment (Bradley and Schaefer, 1998:81), and is intended to be an objective measurement tool that can be used to help decision-makers find enough consensus over issues to eventually agree on a strategic action for foreign investment. Problem-solving theory and decision theory are risk averse, and are assumed to be the more general theory underlying rational decision-making under conditions of uncertainty.

3.3 Some Possible Problems that can be Encountered in Model Designing

Certain business-industry-type constraints restrict the choice an analyst and his/her client might have in deciding upon the most favourable investment destination, and share a common theme with the methodological and theoretical problems mentioned earlier in the second chapter. These problems are:

3.3.1 *Data problems*

Information is expensive, and cost-cutting often takes place in an effort to save time and money with the result that the quality of data accuracy and reliability is rather poor. Suitable data may not be available, as data is very rarely presented to the investor or risk analyst as such and often needs to be budgeted for in the prospective capital layout. It must be researched and sought, collected, analysed, validated, interpreted, paid for and presented very carefully. It is very important to bear in mind at every stage of the analysis process, that data collected for a certain risk factor or purpose will not necessarily be suitable for another, especially when a time lapse occurs or trends are studied and used as risk factors to be built into the model for political risk analysis - data ages quite quickly, especially depending on what it is one is measuring, like trends for instance or cyclical events. Other examples can be operational costs within a host country, maintenance costs, exchange rates, rates and taxes, rent, and salaries⁴.

Regarding the decision to invest, most decisions have only a finite life and it may be more important to select an option that appears to be robust⁵ and, contrarily, more adaptive than the one that is immediately attractive. Both attributes are valuable and may be preferable to apparently optimal solutions that are attractive at a present moment, but eventually turn out to be dangerous if circumstances change. This also augments the necessity of constantly and vigorously monitoring and analysing an investment climate in any host country for signs of such possible changes in circumstances.

3.3.2 *Constrained choice and modelling for conditions of uncertainty and risk*

The multi-disciplined nature of political risk analysis, based on the conceptual discussion in the previous chapter, assumes that making a decision to invest in a host country is not as simple as merely finding a foreign country with an investment climate conducive to maximising expected returns over two years, for instance. Political risk analysts advise clients about considering circumstances that unknowingly feature constrained choice (Pidd, 1996:43; Raiffa, 1968:1-373; Slovic, 1990:1-555; Watson and Buede, 1987:1-299).

Constrained choice implies the notion that circumstances exist in which, although there probably exists a straightforward and agreed upon decision criterion (maximise profit), there are other aspects to consider as well, like political, economic and social factors of political risk within a host country. These aspects can impact on a foreign investment in such a way that the investor loses money, or does not make as much as anticipated when the decision to invest was made.

⁴ Awareness of this should prompt the investor and decision-makers to negotiate a contract specifying that such prices be fixed on a profitability/percentage scale.

⁵ Pidd, 1996:43 explains that robustness is the ability of a solution or decision to be modified and adapted, or to self-modify as circumstances change.

A way in which to manage these risks is to treat these aspects as constraints to profitability or viability that will be applied before the decision criterion are set. The basic idea is to assess all the options against the constraints by means of conducting a political risk analysis, or by means of creating scenarios, be they “worst” or “best” case scenarios. It is only from within this set of acceptable alternatives, or risk analyses, that the best comparable investment option can be selected.

It is clear that the problem of uncertainty is a major impediment in decision-making and political risks, but can be countered at the epistemological level. While knowledge cannot be used to change the past in any concrete way(s), it is still essential for individuals to utilise past experiences in order to deal with the present as well as with the future. If understood as a cognitive problem, reasoned and defensible decisions in political risks have important implications⁶.

The first would be that justifications for decisions be available before investment decisions are taken; the knowledge for the purpose of justification is bedded in past experience that is always specific with regard to space and time. In contrast, future references require general statements that are not bound by spatial and temporal restrictions.

The second implication would be that the justification for a claim whereby a decision is to be taken cannot be based on the logical relation between past experience and the content of the knowledge claim to deal with the present or the future. Formal logic fails miserably if one attempts to base the future on past experience in a logical way. So logic in and by itself does not overcome the problem of induction. The “induction trap” implies that past experience is logically no guarantee that the future will resemble the past.

A solution to the “problem” of knowledge or the “induction trap” can be offered by explaining that a pattern of relations, which may refer to observable or to normative preferences, once established, is assumed to hold for a particular situation in the environment. Once that assumption is made, the implications of the pattern (which is a formal or a logical structure) can be transferred to the environment to produce the needed anticipation, control or choice. Experience gained by using the pattern provides grounds for training, rejecting or modifying the pattern before future use. Experience justifies the knowledge claim contained in the pattern. The more the experience is tested against reality, the stronger the pattern is assumed to hold. Knowledge can evolve and be justified in the endless cycles of trial and error, application and observation of consequences that the ongoing human situation makes possible. Assuming that patterns that have been created out of past experience will hold for the future, circumvents the “induction trap”. To assume the opposite would be both contrary to human experience as well as self-defeating. In other words, by assuming that no patterns will hold and that the future is entirely

unanticipatable or unpredictable is untenable.

Yet Miller (1991:312) explains the extent to which uncertainty about environmental and organizational variables reduces the predictability of a firm's performance and thus increases risk. Uncertainty can be perceived as pertaining to the general environment or investment climate of a specific host country in which a foreign firm operates, where such uncertainties correspond to factors that affect the business context across industries. This refers to 'macro-type' risks that are not firm or industry specific, but that impact upon all firms and industries within a host country. General environmental uncertainties that may develop into macro risks include political instability (war, revolution, coups, changes in government), government policy instability⁷ (fiscal and monetary reforms, price controls, trade restrictions, nationalisation, government regulation, barriers to earnings repatriation, inadequate provision of public services), macroeconomic uncertainties (inflation, changes in relative prices, foreign exchange rates, interest rates, terms of trade), social uncertainties (changing social concerns, social unrest, riots, demonstrations, small-scale terrorism) and natural uncertainties (variations in rainfall, hurricanes, earthquakes, other natural disasters) (Miller, 1991:313; Venter, 1999:73-99). Where these factors of uncertainty might pose a risk to foreign investors, the model proposed in this study as a tool for political risk analysis attempts to assist investors in identifying and managing these uncertainties.

Pidd (1996:45; Beroggi, 1999:144-150) bases the distinction he makes between risk and uncertainty on an idea that, unless probabilities can be objectively estimated, they should rather not be used. Most people accept that probabilities can be related to ideas of frequency for events that happen many times. Conditions of risk or uncertainty occur when one cannot know with absolute certainty that a particular choice will lead to a particular outcome. There may be no guarantee that any of the investment options analysed by the political risk analyst and considered by the investor are certain. The possibility even exists that the investment might fail completely.

Some authors (Beroggi, 1999:144-150; Raiffa, 1968:1-373, Slovic, 1990:1-555, Watson and Buede, 1987:1-299) make a clear distinction between decisions taken under *uncertainty* and decisions taken under *risk*, although outcomes are non-deterministic in both cases. A *risky* situation would be one in which it was possible to know the probabilities of various events taking place, or the probability factor of certain political risk indicators impacting on a foreign investment. An *uncertain* situation, on the other hand, would be one in which these probabilities cannot be known at all (Beroggi, 1999:144; Pidd, 1996:45). So as a study in political *risk* analysis, and by operationalising qualitative observations, it is implied that at least *some* of the factors that may (or may not, for that matter) possibly impact negatively

⁶ Private consultation with Albert Venter, 14 October 2002.

⁷ Policy uncertainty refers to instability in government policies that impact on the business community. Increasingly, international and domestic events interact to influence policy uncertainty – from labour unrest and raw material shortages, to emission of pollutants in one country that cause acid rain in another.

upon the profitability of a foreign investment can be known by identifying political risk factors and operationalising them by attributing observable and measurable indicators to each political risk factor.

Still, as mentioned in the first chapter of this study, human rationality has its limits⁸, especially when operating under such mentioned conditions of uncertainty (Bunge, 1998:317; Pidd, 1996:52; Simon, 1972:1-364). It is for this reason, among others, that an attempt has been made to design a model as a means of assisting decision-makers to become aware of identified risks as such, and not merely operate blindly under conditions of uncertainty⁹.

In fact, uncertainty about political events (be they leadership succession problems, form(s) of state, government ability or any of the others studied during this research endeavour), or rather political uncertainty about and within a host country, can actually be deemed a political risk factor in itself.

3.3.3 *Limits to rationality*

Apart from Simon's (1972:1-364) proposed notion of "bounded rationality", Pidd (1996:53) takes a number of assumptions about situations in which decisions may have to be made as a point of departure, and Bunge (1998:317) explains that, when faced with a decision-making process, rational agents behave as risk averse individuals intent on minimizing the risks they might face or the impact risks might have on their foreign operations.

There is often considerable uncertainty about, and risk in, the consequences of various choices that might be made and there are a variety of reasons for this. As stated above, information about these consequences may not be available, and may have to be forecasted, extrapolated or modelled as a substitute for (un)available data (Neuman, 2000:179-180). In addition, it is not only the host country and its investment climate that can pose risk(s) to foreign investors, but even competing investors within the same identified industry or sector in a host country. A competitor's activity can thus also impact upon a prospective foreign investment, and it should not be assumed that the decision-maker has complete information about all the viable options. The competitor might even have found more information, or discovered different means to acquire that information, or might even have contrived a way to modify the investment conditions in order to create more options.

⁸ The idea of "bounded rationality" was introduced by Simon in 1972:1-364, who was also awarded the Nobel Prize for Economics. In this bounded rationality, one component of rational decision-making is a systematic search for options that are, it is hoped, feasible. This is in contrast to the classical approach, which seems to assume that a full set of feasible options is known at the outset. "Search" and "satisficing" are the two aspects that are embodied by rational choice.

⁹ The focus of this study is thus on developing a procedure that may enable the making of better decisions by putting forward the idea of rational research operationalised in a computer-assisted model for the analysis of political risk as risks to foreign investments.

Pidd (1996:54, Ackoff and Sasieni, 1968:1-455; Argenti, 1968:1-272; Brightman, 1980:17-18; Mintzberg, 1973:1-298; Raiffa, 1968:1-356; Slovic, 1990:1-555; Watson and Buede, 1987:1-299) concurs by explaining that the complexity of many decision-making problems for foreign investors means that the investor is not able to establish the 'best' course of action, even if all the possible or most viable options are known. This is due, as Pidd (1996:54; Brightman, 1980:17-18) continues, to the limited computational capacity of the human brain. The use of computer-based analysis allows this limitation to be pushed somewhat further away than was the case when Simon first proposed bounded rationality in 1972¹⁰.

It seems that crafting a viable investment strategy and wise decision-making requires the support of both expert intuition as well as rational analysis. Pidd (1996:61; Brightman, 1980:17-18) maintains that neither of the two should be abused or negated, and offers an answer to the question of how the balance between them should be achieved. It follows that an over-reliance on formal reason, as against intuition, can be dangerous – as can the opposite. The role of analysis, as used in political risk analysis, offers an exploration of the possible consequences of different courses of action that can be taken when making a decision to conduct foreign direct investment. Rational analytical approaches do not necessarily provide direction nor do they identify alternatives as such. Being able to predict with complete certainty that events will happen is a rarity indeed.

The usual reaction of the social scientist when confronted with a 'model of reality', is to assert that it is "oversimplified", that it "does not represent all the complexities of realities" ¹¹ (Arrow in Brodbeck (ed.), 1968:637; Brightman, 1980:18), that it does not "explain" the occurrence of political risk (Rosenberg, 1988:166). Of course, there are certain limitations in using quantitative models in social sciences, but the advantages are equally apparent. Pidd (1996:62) infers that "[p]erhaps the role of reason is to test our intuition and perhaps the role of intuition is to prevent paralysis by analysis". On the one hand, it stands to reason that intuitive crafting helps to provide direction and vision, and on the other, analysis helps to make sense of this vision – each one placing and framing the other in context.

In addition to Rosenberg (1988:166), Brightman (1980:9-22), Carter (1972:80) and Pidd (1996:5-116) also explain some of the problems aligned with designing a model for political risk analysis, maintaining that technical problems in a proposed model can render the model inapplicable. These technical problems do not refer to the peculiarities of computers or processing techniques. Where a model is a reflection of reality, technical problems can develop from the basic assumptions that are derived in the structuring of a

¹⁰ Although computers did exist in 1972, the utility and application of the machines of that time cannot compare with the advances in technology since then.

¹¹ The quantifying of qualitative observations is the topic of an ongoing debate...this study aims to show how so-called 'intangible' or 'soft' variables accredited to the field of social science only, can be empirically observed, measured, counted and accounted for.

model, assumptions that may do a gross injustice to reality. They can arise from analyses which are made by the model, but which conceal the basic problem at hand. Furthermore, Carter (1972:80) explains, one of the larger causes of implementation problems may simply lie in the basic inadequacy of the model that is to be taken into use.

The model presented in this study attempts to be as reflective of reality as possible, carefully constructed, user friendly, easy to understand, and by no means does it aim to result in laborious efforts to comprehend its workings. It encompasses political, economic, environmental, societal and socio-economic political risk factors and their indicators. The user attributes a value or 'score' to each indicator in the model when assessing the particular country or industry in question. The range of values is given to the user, as well as a 'guide' as to what circumstances should score how many 'points'. This model tries to identify explicitly and to quantify as far as possible, the mentioned risks that concern a company or any organisation considering foreign expansion or investing abroad.

3.4 Some Existing Models and Methodologies¹²

Due to the mentioned limited scope of this study, although a large number of risk rating methodologies exist, the number of risk ratings used in the following section has been limited to the eleven more prominent rating methodologies. Before setting out to design the model presented in Chapter Five, it was necessary to take a look at current risk rating methodologies and try and see how they can be improved on, if at all. Many of the examples used in the following discussion are indeed purely credit or country risk ratings, and by no means do they even profess to be political risk ratings as well. This might be exactly the point though – one of the challenges of this study was to see if it is possible to design a *comprehensive*, understandable, and relatively easy to use tool for risk analysis. As the title of this study suggests, the idea was to set out and build a model for analysing political risk as *investment risk* – a model that is reflective of the comprehensive business and investment climate in a country, not only credit or country risk analysis, or only pure political risk analysis.

The methodologies that will be briefly analysed in the following section are those that are, according to Coplin and O'Leary (1994) and Howell (ed.) (1998), the most widely utilised methodologies upon which a majority of risk ratings are based – they are discussed in alphabetical order. Although some of the methodologies below are both credit and political risk ratings, it is felt that the political risk factors included in these ratings can be expanded upon. The study attempts this in Chapter Five after taking a

¹² In 1992, Tarzi presented a conceptual scheme for political risk assessment of multinational businesses. Also see <http://www.riskworld.com>; <http://www.fitchibca.com>, www.ipanet.net, www.opic.com, www.oxan.com, www.miga.org, www.asiarisk.com, www.s2a.com, www.companylink.com, www.financialweb.com/sclinks.html, www.hoovers.com, www.investorama.com, www.moneynet.com, www.wsm.com.

look at the following risk rating methodologies, explaining briefly how each rating methodology works, how many political risk factors are included if any (if the methodology is not purely a credit rating tool), adaptability for industry-client specific micro analyses, how the results are calculated, and how the results of the analyses are presented (are they easy to understand and interpret, or does one need a consultant from the relevant firm to further explain them?). A table summarising eleven prominent rating methodologies follows after their descriptions.

3.4.1 Business Environment Risk Intelligence (BERI) S.A.

BERI offers proprietary services as well as multi-client services that include Quick Response, Country Risk Ratings for Exploration and Development of Natural Resources, and Industry-specific country briefings.

BERI provides a complete picture of country risk based on a set of quantitative indices that have been developed and refined over a period of 25 years. A comprehensive Profit Opportunity Recommendation (POR) is an average of three ratings, each on a 100-point scale. The “R Factor” index is also a weighted index that covers a country’s legal framework, foreign exchange, hard currency reserves, and foreign debt. The POR thus represents all aspects of country risk. Risk is calculated for the present, as well as one-year and five-year time frames. The Operations Risk Index (ORI) includes weighted ratings on 15 economic, financial, and structural variables. BERI also offers a Political Risk Index (PRI) composed of ratings on 10 political and social variables. BERI’s Business Risk Service also provides quantitative rankings on government proficiency, labour force evaluation, and market opportunity. Ratings are presented every four months with qualitative information and indices for 50 countries, with additional country coverage for selected indices (Coplin and O’Leary, 1994; Haner and Ewing, 1985; Howell (ed.), 1998: 36; Venter, 1999:78-79; <http://www.beri.com>; <http://www.asiarisk.com>).

The fact that the index is still in use after more than 25 years is evidence enough of its usefulness as a country rating and forecasting index. Granted, the index does include political risk factors that make up an index of their own, but only ten political factors are considered. As in the previous example, and probably in the following examples as well, the BERI index is a very useful country risk rating mechanism, but should not be regarded as a sufficient measurement of political risk within a country. The methodology only rates 50 predetermined countries, and does not allow for industry-specific analyses.

3.4.2 Control Risks Group (CRG)

Control Risks Group (CRG) provides macro level risk assessment in three focal areas, namely Political

Risk, Security Risk, and Travel Risk. Each is rated on a 5-point Likert-type scale ranging from “Insignificant Risk” to “Extreme Risk”. Political stability, economic stability and campaign issues are the political risks that are assessed, and Security Risk takes into account violent/terrorist groups, crime, and border conflict/border war. Travel Risk covers matters such as crime, the possibility of strikes, terrorism and war conditions. The CRG ratings cover 118 countries, and accompanies its ratings with written assessments and tailors its ratings and reports to enable micro level risk, that is, analysing the particular exposures of individual firms investing in specific circumstances (Coplin and O’Leary, 1994; Howell (ed.), 1998:59; <http://www.prsgroup.com>; <http://www.countrydata.com>; <http://www.crg.com>; <http://www.textor.com>).

Political risks include, in an example of a CRG analysis of Turkey (Howell (ed.), 1998:65-94), the political environment, the military and Islamists vs. secularists. Infrastructure, corruption, contracts and tendering process, bureaucracy, legal shortcomings, human rights issues, vested interests and indigenous peoples are factors grouped as operational obstacles. CRG also enables micro-level analyses, and the methodology lists kidnapping and extortion, crime, urban terrorism, sectarian unrest, language, significant security dates and local taboos as comprehensive risk factors.

The risk categories that this methodology places the rated countries in are very descriptive and rather qualitative. Although its scope is broader regarding the amount of pre-determined countries that are rated (118 compared to BERI’s 50), and although the methodology allows for micro-type analyses, the parameters of the Likert-scale-type rating mechanism do not seem to be very flexible.

3.4.3 *Country Outlooks*

In its *Country Risk Monitor*, Bank of America World Information Services evaluates country risk on the basis of 10 economic ratios. An ordinal ranking is created for each of the ratios of 80 countries. A country with the least economic difficulty or problems is given a rank of one, and a rank of 80 is associated with the most economic difficulty. A comprehensive ranking of the averages is then created to provide a picture of relative risk by averaging the ranks across the 10 variables. The *Country Risk Monitor* provides rankings for the current year, historical data for the previous years and projections for the next five years. Apart from being particularly useful for investors in the financial and banking industries, the rankings can also serve as an indicator of stability for firms in other business sectors. Bank of America also provides a *Country Outlook* for each of the 80 countries covered, as well as the rankings and ratios for each of the 10 included variables (Coplin and O’Leary, 1998:15; Howell (ed.), 1998:15; <http://www.bankofamerica.com>; <http://library.dialog.com>).

Each country is ranked according to the following criteria, namely income per capita, governmental fiscal

responsibility, involvement in international trade, strength of trade performance, size of foreign debt, and the country's capacity to pay foreign debt. A benchmark mechanism is also used, and countries are grouped into the categories of problem countries (countries whose international debt is under restructuring), non-problem countries, low income (under \$2500 per capita income), middle income (\$2500 - \$15000), high income (over \$15000), industrial countries, all developing countries, OPEC countries, non-OPEC (oil producing) developing countries, Asia, Latin America, the Middle East and Africa. It seems that a country can thus simultaneously be, for example, a Middle Eastern as well as developing country (Coplin and O'Leary, 1994; Howell (ed.), 1998:15; <http://www.bankofamerica.com>; <http://library.dialog.com>).

This methodology is extremely useful as a country ranking and forecasting tool for credit or country risk. There are only 10 economic ratios though, which leads one to believe that the ratios do not quite offer a comprehensive overview, especially in the sense that they are later 'averaged out'. The information is presented very clearly and concisely, exactly because only 10 ratios are used. In reiteration, it seems a bit problematic that ranks are averaged across the 10 variables as a comprehensive-relative ranking¹³. It does not seem as if this methodology enables industry-client specific analyses.

3.4.4 *Economist Intelligence Unit (EIU)*

The Economist Intelligence Unit's (EIU) Country Risk Service assesses composite country risk for investors through four types of risk, namely Political Risk (22% of the composite), Economic Policy Risk (28%), Economic Structure Risk (27%), and Liquidity Risk (23%). The political risk component includes the two subcategories of *political stability* (represented in the five indicators of war, social unrest, orderly political transfer, politically motivated violence and international disputes) and *political effectiveness* (represented by the six indicators of change in government orientation, institutional effectiveness, bureaucracy, transparency/fairness, corruption and crime). Economic policy risk is determined by rating 27 variables in the five categories of monetary policy, fiscal policy, exchange rate policy, trade policy, and the regulatory environment. Economic structure risk incorporates global environment, growth, current account, debt and financial structure groupings in 28 variables, and liquidity risk is covered by a further 10 variables. In each of the four categories, numerical scores are converted to letter grades ranging from A to E (Coplin and O'Leary, 1994; Howell (ed.), 1998:102; <http://www.theworldin.com>; <http://www.eiu.com>).

EIU also provides "specific investment risk" in the form of Currency Risk, Sovereign Debt Risk, and Banking Sector Risk. These are also rated on a 100-point scale and are converted to a letter grade. The

¹³ Bearing in mind the mentioned difficulties that might be faced when working with and presenting averages as representations or reflections of real trends or impact-events.

CRS ratings are supplemented by extensive data and written assessments on each major category, and the reports cover 100 countries on a quarterly basis, with updates on a monthly basis in the CRS Handbook (Coplin and O'Leary, 1994; Howell (ed.), 1998:8:102; <http://www.theworldin.com>; <http://www.eiu.com>).

Although 11 political risk factors are incorporated into the EIU rating mechanism, the composite of these political risk factors (22%) remains less than the composite of total economic risk indicators, which weigh a total of 78%. Social risk indicators are not included as such, as in the above and some cases below, and the EIU is not quite comprehensive in nature, as the few political risk factors that are included do not lend the methodology to being used as a yardstick for political risk assessment. The mechanism of using letter grades might be confusing, and the increments between the letter grades difficult to explain.

3.4.5 *Euromoney*

This methodology provides qualitative assessments for each of the countries it covers and provides a full country risk rating based on nine individual variables. These include economic data (25%), political risk (25%), debt indicators (10%), debt in default or rescheduled (10%), credit ratings (10%), access to bank finance (5%), access to short-term finance (5%), access to capital markets (5%), and discount on forfeiting (5%). The total score is then scaled over 10 lettered categories (AAA to N/R). The Political Risk assessment is a single indicator created on a 0-10 scale derived from country experts, brokers, and banking officers. It is specifically derived as a risk of non-payment or non-servicing payment for goods and services, loans, trade-related finance and dividends, and the non-repatriation of capital (sovereign risk), and is reported along with the full country risk index. Their reports also include a Corruption Perception Index, with data supplied by Transparency International (<http://www.euromoneyplc.com>; Coplin and O'Leary, 1994; Howell (ed.), 1998:151).

Political risk factors only comprise 25%, albeit more than in the above examples, and the other 75% are made up of economic variables. There is no indication whether these weights are flexible or adaptable, and it does not seem as if the Euromoney rating methodology is applicable for use as a rating mechanism for industry specific micro-type investments.

3.4.6 *Institutional Investor*

Institutional Investor is a credit rating mechanism and addresses the single issue of "creditworthiness" in a 100-point index. Bi-annually, bankers from around the world are asked to rate more than 135 countries on a scale of 0 (very high chance of default) to 100 (least chance of default). The responses from more or less 100 banks are then weighted according to the worldwide exposure of the bank and the level of sophistication of the specific bank's analytical model, and the weighted average becomes the Institutional

Investor's Credit Rating. The ratings are published in both worldwide and regional lists that indicate changes from the previous six months and one-year, and banks are not allowed to rate their own home countries (<http://www.institutionalinvestoronline.com/index.htm>; Coplin and O'Leary, 1994; Howell (ed.), 1998:172).

The issue of creditworthiness is the primary focus of the Institutional Investor rating mechanism and does not include any political risk factors, but this is not the intention at all. Although a good rating measure for credit risk as such, the Institutional Investor rating methodology is by its nature not a comprehensive risk rating methodology.

3.4.7 *International Country Risk Guide (ICRG)*

This rating methodology provides a rating composed of 22 variables in three subcategories of risk, namely political, financial and economic, and a separate index is created for each subcategory. The Political Risk Index is based on 100 points, Financial Risk on 50 points, and Economic Risk on 50 points. The total points from all the indices are then divided by two in order to produce the weights for inclusion in the composite country risk score. The composite scores, ranging from 0 to 100, are then broken into categories from Very Low Risk (80-100 points) to Very High Risk (zero to 49.5 points) (Coplin and O'Leary, 1994; Howell (ed.), 1998:185; <http://www.icrgonline.com>).

The Political Risk Rating is composed of 12 weighted variables covering both political and social attributes and ICRG advises users on means of adapting both the data and the weights in order to focus the rating on the needs of the particular investing firm. Country reports include descriptive assessments and economic data. ICRG provides ratings for 140 countries on a monthly basis (Coplin and O'Leary, 1994; Howell (ed.), 1998:185; <http://www.icrgonline.com>).

This rating mechanism is much more of a political risk analysis methodology and it enables micro-type risk analyses for specific industries as well. It covers 140 countries, includes social attributes and is a good instrument for rating the political risk(s) a country might pose. The indicators are not sufficiently explained though, and it seems as if the investor might have to acquire the services of a political risk analyst or consultant experientially familiar with the ICRG methodology.

3.4.8 *Moody's Investors Services*

Moody's provides a Sovereign Credit Risk Analysis that assesses the ability of countries (sovereigns) to service their future obligations on foreign currency debt securities. While some of the variables analysed might be useful in forecasting other forms of risk, the credit risk rating derived by Moody's is explicitly

focused on this one form of risk and should not be applied for an alternate exposure (Coplin and O'Leary, 1994; Howell (ed.), 1998:265; Nye, 1986:13-35; <http://moodys.com>).

Moody's analysts assess both political and economic variables in establishing credit risk for both short- and long-term projections. In the political category the degree and nature of political intrusiveness on the cultivation of wealth, depth and experience of government bureaucrats, political intrusiveness on economic management, political links with foreign partners, past behaviour under stress, and regime legitimacy are included. For economic fundamentals the nation's resources, resource exploitation, quality of national economic management, structural dependencies on export/import sectors, export mix, international capital flows and austerity programs are examined (Coplin and O'Leary, 1994; Howell (ed.), 1998:265; Nye, 1986:13-35; <http://www.moodys.com>).

The Moody's methodology examines a country's liabilities as a whole, not only the government. Country evaluations include economic statistical data to lend depth to their ratings and specify both absolute and relative debt (Coplin and O'Leary, 1994; Howell (ed.), 1998:265; Nye, 1986:13-35; <http://www.moodys.com>).

Moody's provides a pure sovereign credit risk analysis that assesses the ability of countries, and not their willingness, to repay or service foreign currency debt securities. The rating mechanism is by no means a political risk rating, and should not be used as a mechanism to gauge either generic or industry-specific political risk assessments. In light of the Asian Financial Crisis though, which will be explained in some detail in the following discussion, rating agencies might do well to consider adding at least some indicators of political risk – even if only macro-type political risk indicators are used (Coplin and O'Leary, 1994; Howell (ed.), 1998:265; Nye, 1986:13-35; <http://www.moodys.com>).

3.4.9 Political Risk Services (PRS)

This methodology forecasts risks for investors in a two-stage process. A probability is assigned to the three regimes with the greatest likelihood of assuming power in 18-month and 5-year time frames. For each regime, PRS expert consultants establish the likely levels of political turmoil and of 11 types of intervention that affect the business climate. A consolidated source for all regimes is calculated and converted to a letter grade in three areas of investment, namely financial transfer, direct investment, and export markets. PRS also provides a means of adapting any forecast to the particular exposure of a firm. Variables may be added or omitted by the user, or re-weighted to fit industry or firm attributes (Coplin and O'Leary, 1994; Howell (ed.), 1998:291; <http://www.prsgroup.com>; <http://www.polrisk.com>).

In addition, PRS provides historical backgrounds, actor biographies, and forecast scenarios, as well as

basic data on government structure and economic data. Reports for 106 countries are provided, with monthly updates and complete revisions on an annual basis (Coplin and O’Leary, 1994; Howell (ed.), 1998:291; Venter, 1999:79-80; <http://www.prsgroup.com>; <http://www.polrisk.com>).

Of all the examples cited in the above illustrations, the PRS rating mechanism is probably the methodology that is better geared to enable political risk forecasting as such. The use of a letter grade ‘risk typing’ is confusing though, as the increments to either more or less risk cannot be sufficiently reflected in letter-grading methodologies. The PRS mechanism does allow for both macro- and micro-type political risk analyses though, and probably inherently includes social attributes of countries in its incorporated risk factors.

3.4.10 S.J. Rundt and Associates, Inc.

S.J. Rundt and Associates provides a systematic evaluation of country risk based on three equally weighted composite indicators, namely Socio-Political Risk, Domestic Economic Risk, and External Accounts Risk. These composite indicators are averaged to create an overall country risk score (<http://www.rundtintelligence.com>; Coplin and O’Leary, 1994; Howell (ed.), 1998:375).

Within each measure of risk, country specialists rate a set of variables on a 1-10 scale, with 1 representing the best circumstance and 10 the worst. The Socio-Political Risk category assesses 12 variables, including stability of the government, social stability, and government intervention in the economy. In addition to the score assigned, each variable is given a weight signifying its contribution to overall Socio-Political Risk (<http://www.rundtintelligence.com>; Coplin and O’Leary, 1994; Howell (ed.), 1998:375).

Domestic Economic Risk includes 16 variables, weighted as Socio-Political Risk and graded on a 1-10 scale. External Accounts Risk also includes 16 variables and is similarly scored (<http://www.rundtintelligence.com>; Coplin and O’Leary, 1994; Howell (ed.), 1998:375).

Although socio-political risk factors are included in the S.J. Rundt rating mechanism, they are averaged out with domestic economic and external accounts risks, and the problematic elements of “evening out” or aggregating data as a composite reflection of a country’s risk climate once again come to the fore. In the Chapter Five model, although an average weighted composite figure is also offered, the reason for preferring to use the ‘real percentage chance’ that political risk might occur is explained. The weights of the various composites in the S.J.Rundt methodology are not adaptable either, and it does not seem that provision is made for industry-specific risk analyses in addition to the country risk analysis that this methodology offers.

3.4.11 Standard and Poor's Ratings Group

Standard and Poor's Ratings Group (S&P's) offers ratings in the seven major areas of long-term debt, commercial paper, preferred stock, certificates of deposit, money market funds, mutual bond funds and insurance companies' claims-paying ability. Ratings are based on the consideration of the likelihood of default, the nature and provisions of the debt obligation, and the protection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangements under the laws of bankruptcy and other laws affecting creditor's rights (Coplin and O'Leary, 1994; Howell (ed.), 1998:411; <http://www.ratings.com>; Reuss and Beers, 1998:1-10).

The result of a S&P's rating is a forecast of debt-servicing capacity, incorporating Political Risk (sovereign risk as the *willingness* of a sovereign to repay debt on time) and Economic Risk (default risk as government's *ability* to repay its obligations) (Coplin and O'Leary, 1994; Howell (ed.), 1998:411; <http://www.ratings.com>; Reuss and Beers, 1998:1-10).

Political Risk includes an analysis of the underlying (in)stability in a political system, the social environment and the international relations of a country. Economic risk evaluates the ability to repay obligations based on a country's external financial position, balance-of-payments flexibility, economic structure and growth, management of the economy, and economic prospects. S&P rates countries in each debt category with a triple letter rating system (AAA to D) reflecting least risk (AAA) to most risk (D) for an investor (Coplin and O'Leary, 1994; Howell (ed.), 1998:411; <http://www.ratings.com>; Reuss and Beers, 1998:1-10).

The triple letter rating system used by Standard and Poor's can be confusing, and does not offer a comprehensively reflective rating of a country often required. Also, the seven major areas that this rating mechanism focuses on are mostly economic in nature. Although the S&P rating mechanism allows for the credit rating of companies, these rated companies can never exceed the rating given by S&P to the country the company is in due to 'credit ceilings'. This rating methodology results in a forecast of debt-servicing ability, and includes the risk factors of sovereign risk (willingness to pay). This is not yet sufficient to use as a political risk rating methodology or means of anticipating political risks, and the methodology does not quite offer an 'early warning' mechanism. The suggestion for including micro-type (political risk) indicators is once again augmented by means of illustrating the role rating agencies played in the advent of, and during, the Asian Financial Crisis.

Although some of the rating methodologies illustrated above incorporate indicators of political risk, they still do not sufficiently address the need for the comprehensive use of political risk factors.

Table 3.1: Existing Methodologies

	Number of Countries Rated	Political Risk Factors Included	Kind of Rating	Adaptable for client specificity	Presentation of Analysis	Frequency of Analyses
BERI	50	10	Mostly credit	No	Index	3 pa
CRG	118	3	Mostly credit	Yes	5pt Likert Scale	Daily (electronic)
Country Outlooks	80	None	Credit	No	Country Groupings	1 pa
EIU	100+	22%	Mostly Credit	Yes	Letter Grades	4 pa
Euromoney	180	25%	Mostly Credit	No	Letter Grades	-
II	135	None	Credit	No	0 (worst) –100 (best)	2 pa
ICRG	140	50%	Political Risk	Yes	Very Low - Very High	12 pa
Moody's	35	Some	Credit	No	Letter Grades	-
PRS	106	Yes	Political Risk	Yes	Letter Grades	12 pa updates; 1 pa complete revision
S.J. Rundt	-	33.3%	Some Political Risk	No	1(best) – 10 (worst)	-
S&P	-	As willingness to pay	Credit	Yes	Letter Grades	-

It becomes clear (see *Table 3.1* above) that very few of these rating methodologies offer comprehensive risk ratings. Granted, many of them are per definition country or credit risk rating methodologies, but few are flexible or adaptable to enable client-specific or industry micro-type analyses. Many use letter grades to indicate the rating of a country, which are problematic as such because the true increments of comparable ratings are not easily distinguished between, for instance AAa, Aaa and AAB, whereas the difference between, say, 65% and 60% chance that political risk might occur (as the model in Chapter Five suggests) seems easier to interpret. The model presented in this study is also not rigid in the number or 'type' of countries it can rate. It can be applied as a tool for the in-depth analysis of a single country, or to conduct country comparisons. The weighted values of the political, economic and social factors can be adjusted, as well as those attributed to the risk factor indicators.

The following discussion will also further illustrate the need for a model like the one in Chapter Five, and the lessons learnt from the Asian Financial Crisis¹⁴ are unfortunate but good examples of the scope for new research into political risk analysis, and for models that better reflect and better represent the

¹⁴ The IMF was eventually called in to provide financial support to the amount of US\$35 billion for three countries most seriously affected by the crisis, namely Indonesia, Thailand and Korea. A further US\$85 billion of financing was committed from other multilateral and bilateral sources, although not all of this financing materialised (IMF, June 2000:2-3).

comprehensive reality of different investment climates.

3.5 The Asian Financial Crisis: Revisiting The Case From a Political Risk Analysis Perspective

As the following discussion of the Asian Financial Crisis aims to illustrate, the case for including political risk factors and their indicators in the risk assessment of both countries and specific industries becomes stronger. The idea of a more comprehensive risk assessment model, incorporating political, social and economic risk factors attempts to address some of the lessons political risk analysts can learn from the impacts, repercussions and effects of this crisis.

The study further dares to contend that, had at least some of the micro political factors and their indicators been used prior to the advent and ripening of the said crisis, its economic, political and social ramifications could have been better anticipated and to some extent minimised, if not prevented. As early as 1994, Paul Krugman (1994:1-12) offered some convincing arguments in anticipation of the Asian financial crisis that will be expanded upon further in the following discussion¹⁵. In a manner of speaking, the use of micro risk factors and their indicators as suggested in Chapter Five of this dissertation, could have possibly helped to “soften the blow” of the Asian Financial Crisis. In the following examples, factors are mentioned that were overlooked by credit rating agencies and their clients.

Political governance should be of great concern in risk analysis practices as the bottom-line of any policy, government action, or market sentiment. Deutsche Bank's Kenneth Courtis illustrated this when he said that what is needed is to “constantly survey the world's horizons, make policy changes to adjust - and have them adopted”, referring to stable policy flexibility and policy penetration (Bacani, 1997:1-4)¹⁶. This is but one of the functions the political risk analysis model in this study aims to perform, as certain questions are being asked in retrospect of the Asian crisis. It is the answers to these questions that are being investigated, and that will be incorporated into this study, presented as risk factors in an improved methodological design for an early warning system, or political risk analysis model. As the discussion on the crisis develops, we will offer the application of political risk factors and their indicators as an illustration of how they can be applied.

The aftermath of the Asian financial crisis is important to political risk analysts for a number of reasons, one of them being the major implications for the future development prospects of the affected countries. There may be a major increase in poverty levels in those countries, implying a major trend reversal from

¹⁵ In the political risk analysis model designed in this study, financial indicators are grouped together as economic risk indicators (*Er1-36*). A political risk analysis cannot be complete, reliable and valid without incorporating the ability to measure factors that may contribute to country risk. In future studies of political and country risk analysis, or in discussions surrounding the multi-discipline, mention of the Asian Financial Crisis will no doubt still be made - if not used as an example.

¹⁶ <http://www.asiaweek.com/asiaweek/97/1128/cs1.htm>.

previously high levels of per capita income. This also affects the size of average disposable incomes and the size of targetable markets for foreign investors (*Er23-Economically active population, Er24-Change in real wages, Er34-Unemployment rate, Sr2-Job mobility impediments, Sr3-GINI coefficient, Sr5-GDP per capita income, Sr7-Unemployment rate*). Of course, depending on the type of industry targeted, the mentioned ramifications might pose problems to a greater or lesser extent¹⁷.

Although the implication for developing countries will be explored further as the discussion progresses, the above implies that the benefits of foreign direct investment in the long run are more beneficial to overall economic development than short-term capital solutions. Upon investigating a strategic 'fit' for foreign investors, political risk analysis as part of planning and decision-making becomes very important, as the following will show.

Toward the end of the 1990's, many authors have attempted to explain 'what happened' in East Asia (Bacani, 1997:1-4; Camdessus, 1997:1-6; Crisp, 2001:1-3; Goldstein, 1998:25; Griffith-Jones, Cailloux and Pfaffensteller, Ople, 1999:1-3; Reisen, 1998:1-5; Reyes, 1998:1-3; Shameen, 1999:1-3), and others have speculated on ways of preventing the same from happening elsewhere in the world (IMF, 2000:1-20; Goldstein, Kaminsky, and Reinhart, 2000:95-110). This study contends that the crisis was not purely financial in nature - with hindsight it becomes clear that it had a myriad of micro political and societal underpinnings (FitchIBCA, 1998:1-3; Luce, 1998:1-4; Ranis and Stewart, 1998:1-6; Saludo, 1997:1-4; Tesoro, 2000:1-2). Although Asian in nature, the crisis as understood in this study had a tremendous impact on economies outside of the East Asian region as well.

In the following section, the presence of risk factors that were not purely financial at the advent and in the aftermath of the Asian financial crisis will be identified and explained. These include political risk factors that were part of the undertone of the crisis' contagion effect, and later the study also offers some thoughts on why such political risk indicators should be included in risk rating mechanisms as possible 'early warning' instruments in future.

3.5.1 Evidence of risk factors not purely financial in nature

After reviewing some of the post-crisis literature, it becomes clear that Asian central bankers lacked the experience to manage free floating currencies, and investors pulled out of companies dependent on imports, and out of companies with large loans (*Er16-Efficient banking system, Er17-Confidence in finance ministry*). Corporate bankruptcies were on the rise, and government flaws and inabilities were

¹⁷ Foreign direct investors often turn to political risk analysis for advice on the investment climate in a certain country, and often within certain regions. The given advice should include not only a financial and economic reflection of a country, but necessarily also a political and societal reflection as such factors are all inter-related.

being unearthed (*Pr5-Economic planning failures, Pr25-Corruption/nepotism in government, Pr29-Quality of the bureaucracy, Pr30-Political will*).

Still, the extraordinary records in economic growth attained in East Asian Newly Industrialised Countries (NIC's) had conventional analysts wondering about both economic policy and geopolitics. Literature on global economics prior to 1997 pointed toward three notions (Crawford, 1995:35; Mauro, 1997:5-7; Piggot and Salmon, 1996:57-60; Reich, 1992:23-45), one being the diffusion in world technological advances and that the East Asian NIC's have long since surpassed Western countries in this regard. Secondly, it was thought that the global economic hub would shift away from the United States and Europe, and settle in East Asia. A minority of authors emphasised a third idea, being that the success achieved in Asian economics was in part attributed to economies planned in superiority of democratic and individual rights and freedoms (Crawford, 1995:36) (*Pr1-Political system, Pr3-Openness of political system, Pr11-Legitimacy crises, Pr12-Government behaviour, Pr28-Human rights record/status*).

To enable such a disciplined transformation process, the polities in East Asian NIC's had to endure certain measures as well, limiting the liberation of, among other things, the market place (Crawford, 1995) (*Er1-Degree of liberalisation, Er5-Repatriation of profits policy, Er6-Foreign equity ownership policy, Er7-Privatisation of important industries/sectors, Er11-Degree of protectionism, Er14-Level of state intervention, ER27-Discrimination against foreign business*). Civil liberties and democratic individual rights were limited, and still are to some extent in politically regulated Singapore for instance. Societies accepted strong, often authoritarian, governments and were willing to curb individual rights in the interest of the common good. Economic participation was guided, and immediate consumer rights were forsaken for long-term growth figures that would prove to eventually outperform those in Western societies.

Naisbitt (1996:14)¹⁸ "reveal[ed] the significant business, political, social, and cultural changes that are transforming the nations of [the] region into an economic colossus that will soon become a dominant force in the rest of the world". Unsuspectedly though, this impact was delivered via the Asian financial crisis, and the forecasted transformation experienced a setback.

In Krugman's (1994:1-12) article¹⁹, Kim and Lau (1994) conclude that "the hypothesis that there has been no technical progress during the post-war period *cannot* be rejected for the four East Asian newly industrialising countries" (Krugman, 1994:7). Another author (Young in Krugman, 1994:1-12) noted that "once one allows for their rapid growth of inputs, the *productivity performance* of the ' [Asian] Tigers' falls "from the heights of Olympus to the plains of Thessaly" (Krugman, 1994:7).

¹⁸ Naisbitt's book *Megatrends Asia*, was published in 1996 as the Asian crisis was waiting in the wings.

¹⁹ Mentioned above, Paul Krugman pioneered critical thought on the rapid success of Asian economies, and wrote "The Myth of Asia's Miracle"(1994:1-12). As early as 1982 a Harvard graduate student, Yuan Tsao, found little evidence in *efficiency* growth in East Asia (Krugman:1994:1-12).

Krugman equates what was happening in pre-1997 Asia to the period of rapid and impressive Soviet growth during the late 1950's and some of the 1960's. He carried on to warn those that were so enthusiastic about Asia's boom that (Krugman, 1994:2):

"Rapid Asian growth is less of a model for the West than many writers claim, and the future prospects for that growth are more limited than almost anyone now imagines...we may be revisiting an old error. We have been here before...few people now remember how impressive and terrifying the Soviet empire's economic performance once seemed."

An illustration of the similarities between the East Asian NIC's and the Soviet Union of the 1950's lies in the achievement of rapid growth through the mobilisation of resources, and not by gains in efficiency (*Er4-Domestic economic strength, Er8-GDP, Er14-Level of state intervention, Er21-Economic growth rate, Er36-Government expenditure*). In both cases, there is evidence of growth in inputs like labour and capital - especially in capital in the East Asian NIC case.

It seems that it was just a matter of time before an Asian 'growth ceiling' was reached, and with certain contributing factors, shattered upon itself. With hindsight, growth rates were illustrative of an occurrence that could not have been sustained, and there were tremendous upward changes in figures that could not have been repeated. Once the inputs contributing to these astonishing growth rates were exploited, 'run away' progression seems to have left inexperienced policy and decision-makers in its wake. The point is reiterated that "growth [could] be explained by increases in measured inputs. There [was] no sign at all of increased efficiency" (Krugman, 1994:6).

What Krugman (1994:1-12) also found very interesting, was that several of the East Asian "tigers" had become significant exporters of capital. The reason he found this odd, was because the exporting of capital apparently signified that these economies were rapidly achieving 'advanced-country' productivity - despite the fact that these East Asian economies still paid their workers wages well below advanced country levels (*See Er24-Change in real wages, Er34-Unemployment rate*).

Krugman looked for a more viable explanation for why East Asian economies were exporting capital. He concluded that "it is, however, perfectly reasonable if growth in East Asia has been primarily input driven, and if the capital piling up there is beginning to yield *diminishing* returns" (Krugman, 1994:1-12 emphasis added) (*Er13-Competitiveness*).

Despite his suspicions, even Krugman (1994:12) was cautious to overstate his case. He leaves one with a relatively open-ended argument, affirming that "barring a catastrophic political upheaval, it is likely that

growth in East Asia will continue to outpace growth in the West for the next decade [1994 - 2004] and beyond" (Krugman, 1994:12). He does concede the point though, that the growth East Asia might experience up to 2010 will not be at the pace of the pre-1997 years. Yet with the current corporate scandals and the possibility of an economic slowdown in the United States pointing toward a looming American recession, his thoughts on the economic health of "the West" might not have been overshot by too much.

One of the most disturbing aspects of the Asian financial crisis, apart from not having been able to forecast it, was the fact that it started and festered in a region inclusive of the most successful developing countries over the last thirty years. It was also deep and prolonged, and witness to a runaway contagion. It was the size and scope of the experienced crisis that literally shook the world and saw the bottom dropping out of equity markets as far as Brazil, Russia and America²⁰. Some degree of an Asian financial crisis could probably not have been avoided, but circumstances preventing an accurate and timely forecast from being made prompts one of the contentions of this study, namely that the circumstances leading to the advent of the crisis could have been picked up on much earlier, thus limiting the *magnitude and scope* of the eventual crisis, and restricting the contagion somewhat (Cherian and Perotti, 2001:359).

Yet the question that warrants further discussion is why the credit rating agencies were not able to forecast the Asian Financial Crisis, and, even if they suspected the advent of a crisis, there seemed to be no overt signs of concern.

3.5.2 *The role of credit risk agencies and the Asian Financial Crisis*

Reputable credit risk agencies were unable to make an accurate and timely forecast of events that witnessed the advent of the Asian financial crisis in June 1997²¹ (FitchIBCA, 1998:1-13; Luce1-4, 1998; Tesoro, 2000:1-2)²². Still, the reliance placed on ratings by investors and government as a substitute for an own risk assessment is alarming, given the relative limitations, often methodological, of sovereign ratings in comparison to the impact these results have on global markets.

²⁰ The literature suggests that there were three main interrelated origins of the crisis; one of these being financial-sector weaknesses in Asian emerging economies combined with 'easy' global liquidity conditions. Another was growing concerns about external-sector problems and a third was contagion from Thailand - first to the three larger economies of the ASEAN-4 (Indonesia, Malaysia and the Philippines), then to North Asia (South Korea, Taiwan, Hong Kong and Japan), and finally to other countries ranging from Brazil to Russia.

²¹ For one, their lack of acknowledging that something was wrong in Asia is definitely a contributing factor to the cause and contagion of the crisis. Ratings did not drop, not even slowly. When word got out that Asia was in financial turmoil, ratings were still not decreased. Only after the crisis had ripened (18 months) did ratings drop - and then suddenly and severely, from investment grade to junk status in most cases.

²² Also see The Economist (15 July 1997, 13 December 1997), The Financial Times (8 May 1998), South China Morning Post (21 January 1998).

Goldstein, Kaminsky and Reinhart (2000:49) assert that "...rating agencies should do better in predicting [even] currency and banking crises in developing countries (since financial crises are more closely linked to the probability of sovereign default there than in industrial countries)". They further challenge the notion that credit ratings should be expected to be leading indicators. Rating agencies receive fees from the borrowers they rate, and because downgrades can subject the agencies to charges of having precipitated a crisis, some argue that credit ratings are apt to behave as lagging indicators of crises, with downgrades coming only after credit crashes (Goldstein, Kaminsky and Reinhart, 2000:50).

Moody's Investors Services see the analytical objective of sovereign risk assessment as:

"to answer a single question – one that is as simple to pose as it is ultimately difficult to answer – '[w]ill borrowers from a particular country have access to the foreign currency they need to be able to service their future obligations on foreign-currency debt securities?' In other words, what is the likelihood of an international default?" (Howell (ed.), 1998:265).

In an on-going debate, it is argued that on the one hand, credit rating agencies failed to forecast the Asian financial crisis. On the other hand, it is argued that there was nothing they could have done about it. As shown above, most credit rating agencies provide assessments about the ability of foreign borrowers to repay loans and service future obligations on foreign currency debt. Although some of the variables provided in the methodology used by rating agencies include factors relating to the political system, it is still the contention of this study that some political risk factors were either overlooked, and/or underestimated, or excluded from current risk rating models, and that they should be included in an improved model as an early warning system for future use.

Goldstein (1998:19) maintains that "...to judge from most market indicators of risk, private creditors and rating agencies were asleep prior to the outbreak of the [Asian] crisis." Suffice it to say that a more comprehensive indication of risk is needed. As documented before (Radlet and Sachs, 1998:22-26 and the World Bank, 1998), sovereign ratings issued by Moody's and Standard and Poor's remained unchanged during the 18-month run-up to the crisis. The sovereign ratings issued by Euromoney and Institutional Investor did not perform well either. The same could be said for stand-alone credit ratings for some individual Asian banks.

The competencies of credit risk agencies lie in the area of credit or sovereign default analysis, and differ from the competencies necessary for political risk analysis. Credit analysis modelling is still largely based on financial indicators, and incorporating political risk factors in their analyses is something with which they have hardly any prior experience. Country risk agencies often expand into a market without a tight grasp on the complexities involved, and without being fully aware of the impact of their ratings.

It becomes possible to present two alternative speculations as to why market signals did not produce warnings of a looming crisis much earlier, one being that creditors did not have accurate information on the creditworthiness of borrowers, pointing towards the problem of government transparency and reliability of information, as well as the previously-mentioned problems relating to data²³. The other speculation was that creditors expected governments to bail them out in case of trouble.

Of course, credit ratings are often used mistakenly as being reflections of political and social conditions in countries as well, apart from presenting a rating of a country's creditworthiness. Political and social risks are not shown in all instances, and a country with a high credit rating may mistakenly be perceived as politically 'safe' as well²⁴.

Still, in the case of the Asian crisis, the credit rating agencies were somewhat at fault by suddenly and dramatically lowering country ratings 'after the fact'. In this case it could be said that they fell short of monitoring creditworthiness and updating risk ratings. In their defence though, they also had to contend with a (lack of) available information, a 'herding instinct' concomitant with market sentiment, and professional chance taking.

These costly failures have not tainted the credibility and profitability of credit risk agencies though. One can expect the role that these agencies play to become even more important as the globalisation of investment markets, improved technology and deregulation lead to greater freedom of investment and more widespread movement of capital flows (Asian Development Bank, 2001).

The main concern in the above discussion is that the existing rating methodologies were not able to 'pick up' on the underlying and preceding political circumstances that surrounded and even contributed to the advent of the financial crisis. In the following section, a case will be made for the necessity of either including micro political risk factors and their various indicators in credit rating methodologies in future, or to use a model like the one in Chapter Five in conjunction with existing rating mechanisms in an attempt to prevent such a contagion from spreading again.

3.5.3 Lessons for Political Risk Analysis: The politics of the Asian Financial Crisis

As explained above, despite the financial nature of the Asian crisis, it might be possible to prevent such future crises by including micro political risk factors and their indicators in rating methodologies as a type of 'early warning' mechanism. Unfortunately only with hindsight does it become clear that there were

²³ External debt turned out to be much larger, and international reserves much smaller, than indicated by publicly available data.

²⁴ Which they are in most cases, but credit rating agencies do not always warn the users of these ratings that they are just that: credit ratings.

political undertones present prior to and during the Asian Financial Crisis. Political leadership and governments in every country that contracted the effects of a spreading contagion felt the consequences of the crisis. The following section examines some of the lessons that can be learned, and is revisited from the perspective of political risk analysis.

The Asian crisis brought across many expensive yet invaluable lessons. One of these, as Goldstein (1998:66) explains, is the fact that, in an atmosphere of political instability, consequential uncertainty about reform and wide-ranging contagion, the overshooting of exchange rates and equity prices can be much larger than previously thought. It seems that this political instability was ignored by credit rating agencies and by the managers of financial institutions. Goldstein (1998:45) asserts that there is nothing like a crisis to motivate a rethink of the adequacy of the existing crisis prevention/management architecture, and expensive lessons are the ones learned the quickest.

Economically, the main factors contributing to rapid economic progress in East Asian countries included a free enterprise environment (*Er1-Degree of liberalisation*), export orientation (*Er13-Competitiveness*), high levels of capital investment, productive use of labour (*Er3-Stable labour force*) and a large pool from which to pick and choose among managerially-skilled individuals. Data presented by Ranis and Stewart (1998:9) report a strong decline in the proportion of the population classified as 'poor' on the basis of their private income²⁵.

The link between economics and politics remains a tight one through fortunate and less fortunate times. Of course, political events result in certain economic decisions being made, in the same sense that economic events have certain political consequences. As the Asian financial crisis spread, and the contagion matured to include Northeast Asia, political repercussions were becoming evident, and policy makers were facing the consequences of their actions. For example, as the previous South Korean Finance Minister lost his office as a result of bad decision-making, a new South Korean Minister of Finance and Economy took office on the 19th of November 1997. Lim Chang Yuel took over from ousted Minister of Finance and Economy Kang Kyong Shik, and all measures against the crisis that were prepared by the ousted politician were dropped due to his dismissal²⁶ (Sprague and Nakarmi, 1997:1-3) (*See Er17-Confidence in finance ministry, Pr18-Leadership succession crisis*).

²⁵ Contributing cultural or social factors to East Asian success were a co-operative relationship, a susceptibility to order, moral responsibility, strong family ties, a strong work ethic and a strong orientation toward entrepreneurship.

²⁶ If Korea was caught off guard by the Asian crisis due in part to lacking ministerial adequacy and ability, Lim Chang Yuel makes up for it with years of political and financial experience. The new Minister speaks fluent English, which supposes that Kang did not. Furthermore, the new Minister spent years as a finance ministry bureaucrat negotiating the opening of Korea's markets to the OECD and the US. He is also Seoul's former alternate executive director to the IMF (Sprague and Nakarmi:1997:1-3).

Initially, the new minister's recovery package excluded an appeal to the International Monetary Fund (IMF) for a bailout. But former Korean Prime Minister Nam Duck Woo was of the opinion that "South Korea has lost the capability to solve the crisis on its own. There is no alternative but to seek an IMF loan...this may be painful in the short run, but will make the economy healthy in the long run" (Sprague and Nakarmi, 1997:1-3)²⁷.

As in other countries strongly affected by the Asian crisis, South Korea had long-standing serious weaknesses in its financial sector and in prudential oversight of banks. Much of this is linked to *government-directed* lending to large corporations or 'chaebols' (Goldstein, 1998:21), large equity holdings by banks, lax accounting procedures, and a lack of transparency on the part of banks and corporations - all pointing toward bad management on the part of officials and financiers. Furthermore, the most important 'chaebols', heavily funded by the South Korean government, either posted losses in 1996, or declared bankruptcy.

With hindsight, post-crisis analysis shows that government inability (*pr4-Public accountability of government, Pr5-Economic planning failures, Pr29-Quality of the bureaucracy*) on the part of all governments involved was also a culprit in the contagion - a micro risk or political risk factor that was overlooked. The rating agency Fitch IBCA admitted that the notion of government inability should have been introduced as a factor worth measuring (FitchIBCA, 1998:1-2; Luce, 1998:1-3), and admitted that government ability in these cases was greatly overestimated. It also 'takes the blame' for not realising that something was amiss, that, although the balance-of-payments and short term lending figures flashed no warning signals, the use of micro indicators or political risk indicators could have forewarned the rating agency. Planning and strategic management could have started in anticipation of a crisis, and if this could not have been avoided, the ramifications thereof could have been greatly reduced.

Admittedly, the Asian crisis was primarily a financial crisis, impacting upon banking and currency sectors throughout the affected area - but in the above example, a rating agency admits that government (in)ability should be measured and incorporated as a factor in country risk analysis - thus further strengthening the case for a more comprehensive model of political risk analysis. This does not suggest that a political risk analysis model can forecast a financial crisis, but it can surely serve as an early warning system that might prompt financial analysts to subsequently look in different (or the right) places for signs of possible danger. The model presented in this study attempts to combine country risk indicators with the admittedly overlooked micro indicators of political risk.

²⁷ Interestingly enough, ex-Minister Kang was also rumoured to have been opposed to an IMF bailout (Sprague and Nakarmi:1997:1-3).

To illustrate the stance taken in this study further, that the use of political risk factors can make a difference in a more comprehensive way, some comments by Goldstein (1998:12) and Griffith-Jones (et. al., 1998:5) are used to strengthen the argument. Goldstein (1998:12) writes that

"[t]here was excessive government ownership of, and/or government involvement in, banks. Banks often became the 'quasi-fiscal' agents of governments, providing an oblique mechanism for channeling government assistance (off-budget) to ailing industries" (*Er14-Level of state intervention*).

The International Monetary Fund (IMF) World Economic Outlook (1997) also notes inadequacies in the prudential regulation and supervision of financial institutions as a major source of the financial systems weakness. The IMF adds:

"...limited experience among financial institutions in the pricing and managing of risk, lack of commercial orientation, poor corporate governance, and lax internal controls, all in the face of movements toward liberalisation and increased competitive pressures, had contributed to imprudent lending including lending associated with relationship banking and corrupt practices" (*Er16-Efficient banking system, Er17-Confidence in finance ministry*).

With the exception of Singapore and Hong Kong (Kim and Mei, 2001:1003-1016), the amount of capital that banks had at their disposal could not cover the risks involved in the environment in which they operated. There was also a strong manifested expectation that depositors and creditors would get bailed out if these banks got into trouble. Evidently though, bank supervisors did not have the authority, or the mandate (Goldstein, 1998:12; Griffith-Jones et. al., 1998:5) to counter strong political pressures for regulatory forcefulness. In addition to this, the quality of public disclosure and transparency was very poor (*Pr4-Public accountability of government, Pr12-Government behaviour*).

It follows that a variety of political risks were at play here. One of these can be found in the evidence pertaining to the public's lack of access to information regarding the status of the institutions they bank with, and another points toward the issue of transparency. Disclosure of information and institutional transparency - or the lack thereof - can be measured to varying degrees as political risk factors (*Pr12-Government behaviour*). The less transparent institutions are, the less access the public has to information, the more weary an analyst should become of the possibility that political risk indicators might show themselves in heightened levels of the possibility that risk might occur (*Er37-Financial sector (de)regulation(s)/sanctions*).

3.5.3.1 *The role of government (in)ability in dealing with the crisis*

The following question thus warrants further exploration, namely why governments were incapable of dealing with the onslaught of the crisis, and the management thereof. What factors, political and/or institutional, contributed to government inability or unreadiness? And how was fiscal (mis)management at fault?

A further political risk factor, which can be measured by political risk indicators as shown in this study, is the size of the role that a government plays in the banking sector (*Er14-Level of state intervention*). In the case of the Asian crisis, it is evident that the larger the role a government plays in the banking sector, and the more far-reaching government interference or intervention is in the banking sector, the higher the chances of the occurrence of political risk become. This, coupled with long-standing weaknesses in banking and financial supervision, saw a contributing factor present itself at the advent of the Asian crisis.

As the crisis ripened, the governments involved were not up to the task of dealing with the crisis or managing the devastating effects thereof. The contagion effect ascribed to the Asian crisis is grounded in the impact of globalisation and economic inter-relatedness. Apart from the fact that the contagion spread across the Asian banking cluster, economies 'removed' from this cluster were affected as well. Be it in banking or government authorities, policy and decision makers were unable to manage the ramifications of the effects the crisis had on poorly contrived policies (*Pr5-Economic planning failures, Pr11-Legitimacy crises, Pr12-Government behaviour*).

As fiscal discipline is also a factor included in this study as an economic risk indicator in political risk analysis (*Er17-Confidence in finance ministry*), it seems fitting to comment on the alleged fiscal discipline practiced in these countries. This gave lenders the confidence that, should local financial institutions encounter difficulties, the public sector (government) would have the resources to provide assistance²⁸.

Although some, but not all of the causes contributing to the Asian crisis were market related, policy reaction and penetration (*Pr12-Government behaviour*) should still have been questioned. Literature suggests further that the *quality* of the investment in these countries was less impressive than the *quantity* (Bacani, 1997:1-4; Crisp, 2001:1-3; Crowell and Hamilton, 1998:1-4; Krugman, 1994:1-12; Ople, 1999:1-3; Reisen, 1998:1-3; Reyes, 1998:1-4; Saludo, 1997:1-4; Shameen, 1999:1-3; Sprague and Nakarmi, 1997:1-3; Tsang Yam-Kuen, 1999:1-3). Corporate governance was very poor and much of the private investment was directed toward over-ambitious infrastructure projects (*Er20-Sound physical*

²⁸ It did not, and here political risk comes into play. If government ability had been monitored and included in rating practice, a forewarning could have been possible - how long could these tigers keep it up?

infrastructure), or inefficient government monopolies (*Er9-Nationalisation of key industries/sectors, Er11-Degree of protectionism*). Once again, government inefficiency does not show up separated from the ramifications thereof in rating reports.

3.5.3.2 Challenges for post-crisis governments

Notwithstanding its financial character, the Asian crisis presents the region's political leadership with certain challenges. Despite the call for more openness and competitiveness in technological skills, "domestic openness" might contribute to regional recovery and prevention of future problems. This illustrates a call for more domestic transparency, modern legal frameworks, the elimination of (the perception of) corruption, and the building of strong modern institutions founded in stable political institutions. Without strong, stable political institutions, economic modernisation cannot be dealt with and the stress on the system overloads its capacity to deal with the inputs (Mahler, 2000:15-22).

Regarding disabled governance that East Asia experienced during the crisis, the private sector cannot be held responsible for functions that surely pertain to the public sector. Social cohesion and resource distribution, be it health care or education, are things the private sector cannot be held accountable for.

The importance of political will (*Pr30-Political will*) must not be underestimated either and is also a factor contributing to the measurement of political risk in this study. A lack of political will is decidedly negative, as opposed to a positive commitment by government and its "tools" as an expression of political will. Not only is constitutional and limited government a manifestation of political will, but so too is responsible government - government making promises that it can actually keep, and policies that are truly in the national interest and not in the interest of private corporations (*Pr4-Public accountability of government, Pr12-Government behaviour, Pr29-Quality of the bureaucracy*).

A most important challenge for governments in post-crisis Asia is to provide stability and "balance" for their various countries. A very important point for political risk analysts to bear in mind is that, coupled with rapid economic growth, is also heightened public expectation. As mentioned before, government has to equip itself with the ability to deal with the quantity and quality of public inputs. Having political will also implies the legitimacy and authority to enforce carefully planned, or "wilful" policy.

Public popularity and responsible government are difficult to achieve together, and one does not presuppose the other. Responsible government, even with a popular mandate, usually has to deal with unpopular policies and demands, even if these are in the best interest of the nation. But economic reform and the overhaul of a finance sector is not a popularity contest, albeit in the public interest. Government effectiveness in appeasing public opinion and remaining responsible simultaneously is no mean feat.

Maintaining domestic confidence among political succession, high levels of debt and fragile banks necessitates strong and grounded institutions manifested in high levels of political development.

The answer to the question of what drives market sentiment remains elusive. Definite contributing factors are political and macro economic speeches in which underlying executive sentiments and ideologies may spark market runs, as well as regime outputs or behaviour. The link between 'the political' and 'the economic' is a familiar one...but the days where governments were accountable *only* to the electorate are over. Governments are becoming increasingly accountable to market confidence as well. Inputs to the system are not only public anymore as markets also place demands on the political system. Governments are warned to check what they publicise in case the market gets driven downward, or market expectations become realities.

A further challenge faced by post-crisis political leadership, is the salvaging of public institutions. From the above discussion it becomes quite clear that only efficient and able public institutions can deal with system overloads (Mahler, 2000:15-22). The quality of the employees the public sector can attract, and the extent to which they are compensated, should be revised. Domestic "brain drains" from the public into the private sector have hampered the ability of institutions to deal with heightening demands and expectations. A slackening in the quality of any institutional infrastructures for public policy is disconcerting. Institution building requires patience and sustainability and is something that a government should be able to push on with over time. Public sector salaries should not only be competitive in order to attract qualified people, but also to *distract* public officials from the temptation of being corrupted.

Public confidence in the system also contributes to its legitimacy. Public confidence is nurtured and maintained through accountable, responsible and responsive government (*Pr3-Openness of political system*). Public institutions should act as one mechanism through which people are included, in turn making them feel part of the decision-making process and contributing further to the legitimacy of the political system (*Pr11-Legitimacy crisis*). The distribution of labour between the public and private sector should also be clear - in other words what the role of the civil service should be, and what should be handed over to the private sector (*Er14-Level of state intervention*). This can also contribute to the enriching of decision-making in both these spheres, as can a system of checks and balances, and the separation of powers of an autonomous legislature, executive and judiciary (*Pr2-Separation of powers*).

Leadership quality plays an unmistakably big role in the management of the political system - a broader environment in which markets and big business operate. A goal of the leadership in the East Asian region for instance, should be to attract people of high calibre. A reciprocal relationship would be the ideal

between these individuals and the institutions - a rewarding working environment in exchange for highly capable and able employees.

In terms of the relevance of this study and model, and in learning from the experiences of the Asian Financial Crisis, Goldstein (1998, 65-67; Griffith-Jones et. al., 1998:16, 17-27) expands on further valuable lessons learnt. Notwithstanding the importance of including micro risk indicators in an improved early warning system based of the poor performance of credit rating agencies, there are other important issues to consider.

A focal point that should enjoy some attention is the development of capital markets, and a means to monitor these as risk indicators inclusive to the model for political risk analysis as suggested in this study (Perry and Robertson, 1998:131). Despite the use of macro economic indicators, financial indicators are useful tools that not only reflect the activities of financial markets and its players, but also give some indication of the otherwise overlooked political or systemic undertones or undercurrents.

The extent to which countries in the East Asian region are involved in the Asia Pacific Economic Community (APEC) for instance, can be a useful measurement tool for the purposes of this study. Not only the extent, but also the way in which APEC is "used", or the quality of the relationship between APEC and its member countries is an interesting indication of individual countries' willingness to restructure and implement an economic and political overhaul²⁹.

Notwithstanding the financial relief that the International Monetary Fund (IMF) provided, the social ramifications of these packages have interesting relevance for political risk analysis, as socio-economic and societal factors are also included in the model presented in Chapter Five.

3.5.4 In the wake of the contagion: The social impact of the crisis

To be able to understand the relevance that IMF rescue packages have for political risk analysis in the sense that these packages brought financial relief but also certain social impacts, it is necessary to start with an overview of IMF actions in assisting contagion-struck countries to overcome their various crises.

This is a case in which political risk literally comes into play. IMF packages have many strings attached, and the impacts of Structural Adjustment Programs (SAP's) have been documented in the past (Goldstein, 1998:33; Todaro, 1989:78). SAP's often have more adverse effects than the intended positive impact on

²⁹ Of course, foreign direct investment is but one layer in the foundation of a country's economic structure, as is the notion of economic nationalism so successfully practiced by East Asian countries in the past. Still, activity within APEC can stimulate *effective* and not necessarily sizeable investment and market flows. These flows can be intra-regional, but can also bring Japan and the United States into play.

developing countries. Also, as Goldstein (1998:33) explains, the support provided by official financing has to be accompanied by policy changes and reforms. These changes are often not accepted or understood by those hardest hit in crisis situations - the public. As the impact of IMF reforms filter through, reactions can vary from civil uprisings to civil war and xenophobia, as economic hardship becomes political and channelled against government (*Pr7-Racial, ethnic, nationality tensions, Pr13-Likelihood of social revolution, Pr14-Political (in)stability, Pr15-Civil war*).

One can wonder why the Asian countries waited so long for help from the IMF. The cost of IMF borrowing, inclusive of the costs of IMF conditions, is not very high in the sense of deterring sovereign borrowers from counting on the IMF as a safety net in case of an emergency. This might be a reason why 'Asian crisis countries' allowed the situation to ripen to the extent that the IMF stepped in. On the other hand, in the case of developing countries, sovereigns enter into agreements with the IMF knowing that they have no intention of servicing these loans, or even the interest on them (*Er29-Debt service burden*). Here sovereign risk comes into play or the willingness to service loans, as included as a political risk indicator in the study³⁰.

Due to the contraction of economic activity and the higher cost of living (*Er4-Domestic economic strength, Er8-GDP, Er21-Economic growth rate, Er24-Change in real wages, Er25-Price index*), ordinary citizens in the crisis countries will need to make more substantial sacrifices to overcome the crisis, not excluding the possibility that these citizens hold government responsible for their increased financial burdens, especially if large domestic and foreign lenders escape their share of the burden. If government put up the funds for rescue packages, which were borrowed from the IMF, it is the broad public that bears the brunt in the form of higher taxes to enable their government to service loans (*Er18-Real interest rate, Er22-Annual average inflation rate*)³¹.

The importance of responsible and accountable government (*Pr4-Public accountability of government, Pr11-Legitimacy crises, Pr12-Government behaviour*) cannot be stressed enough in this regard. Fiscal tightening and the restructuring of supervisory laws regarding banks, corporations and other financial institutions is an important indicator of levels of political risk. But it is the (in)ability of government officials (*Pr29-Quality of the bureaucracy, Pr30-Political will*) to make policy decisions based on these 'safe' practices that heightens a risk situation.

The impact on the people experiencing the fall-out from the Asian financial crisis can by no means be disregarded or underestimated. Since the advent of the crisis, bankruptcies were mounting, which directly

³⁰ Debtor countries feel ideologically (*dependencia*) that the industrial nations owe them at least this much or, that an appeal to the morals of IMF officials will touch a nerve in a plight for debt restructuring or the total scrapping thereof.

³¹ Explaining to these people why the class of investors that made bad lending decisions are walking away unscathed, is the task of the same government that allowed it to happen in the first place.

translated into the loss of jobs (*Er34-Unemployment rate, Sr7-Unemployment rate*). As economies stalled, investors pulled out of stock markets, banks were closed under the surmounting weight of bad loans, and depositors saw savings inaccessible for months (*Er16-Efficient banking system*)³². Economist Laksaman Sukardi of the Econit Research Center was quoted as saying that "[s]ocial unrest has become almost certain" (Bacani, 1997:1-4).

As an example of the possible social risk ramifications that investors might face, namely that of a social uprising and demonstrations, on October 20 1997 a mostly middle-class crowd of approximately 4 000 protesters were outside Government House to witness the Thai Prime Minister accept *pro forma* resignation letters of 48 cabinet members (*Pr20-Erosion of middle-class support for the region*). Protestors were demonstrating against job losses and wage cuts caused by the fall-out from the then still ripening crisis (*Er24-Change in real wages, Er34-Unemployment rate*).

Southeast Asia enjoyed rapid growth during the boom years, but what is asked for now with hindsight, is a drastically different kind of leadership. One that can push and enforce unpopular policies, resist vested interests, and survive public outrage and social uprising without quelling the spirit of such actions - a valuable part of public political participation and a sign of healthy political culture. This calls for a government that can be responsible even if unpopular, and able to hedge against the onslaught on its legitimacy. The public, with tremendous socio-economic pressures, should consent to being governed by such institutions, and not coerced. The test of leadership during a crisis is surely a question of capable government and something that could have been monitored and measured by micro risk indicators in a well-designed political risk analysis³³.

Again, the study dares to contend that, had at least some of the micro political factors and their indicators been used prior to the advent and ripening of the East Asian Financial crisis, the economic, political and social ramifications of the crisis could have been better anticipated and minimised to some extent.

³² Mere portions of monies were salvaged from large accounts. Individuals who borrowed on credit to purchase luxury items dumped these liabilities at a fraction of the price. The supermarket, gas station, doctor's office and school cashier upped prices to unaffordable heights.

³³ The Nation, a Bangkok English-language daily, pronounced on the Thai PM: "He flip-flops on issues...Chavalit is, in short, not a leader" (Saludo; 1997:2 – www.asiaweek.com). Virabongsa Ramangkura, deputy premier in charge of the IMF program, told Asiaweek (1997:2 – www.asiaweek.com): "At this difficult time, every country needs a strong, credible leader." Australian PM John Howard was reported to have said: "As in Southeast Asia, government can have decisions forced on them if they do not take responsible decisions" (Asiaweek, 18 February 2000, vol.26, no. 6).

3.6 Concluding Remarks

The Asian financial crisis, coupled with the role the IMF played in its aftermath, cannot be exempt from an investigation founded in political risk analysis. Had certain sentiment been known during the crisis build-up, hedge actions could have been taken. The region could have at least braced itself for the fall.

In light of the above discussion, and by using the example of the Asian Financial Crisis, it can be said with hindsight that it is important to consider political factors when designing a comprehensive model for political risk analysis. The roles of inherent political instability and regional influences and inter-relatedness should never be underestimated. A distinction should be upheld between sovereign debt and private debt, the quality of financial sector supervision should be monitored, and the composition of foreign borrowing should be analysed. Large current-account deficits and long-standing economic weaknesses should be monitored. Also, it should be recognised that no risk factor or indicator, no matter how small or insignificant it seems, should be ignored. On its own it might seem harmless but the nature and impact of its relations to other risk factors can spark off an event to the extent of contagion illustrated in the preceding example.

The link between politics and economics becomes quite clear. One expects to see East Asian political systems, along with their economies, tested and transformed by the crisis. These changes will be welcomed by some and rejected by others, but ignored by none. Indonesia's economic adjustment, for instance, might be hindered if links between top politicians and their cronies do not dissolve. As economies evolve, so do politics, and vice versa. Leaders are quite aware of the fact that if they do not adapt with the times, they risk losing their mandate.

The danger, however, lies in how carefully these leaders can juggle crisis management and popular support because, with the sacrifices that everyone will be making in adjusting after the crisis, governments will face more vocal protests and demands for a greater say in policy making. Complementing strong leadership should be stable and independent institutions able to deal with these public inputs and demands without buckling under the weight of a systems overload.

The issue of more democracy in an Asian "Wiederaufbau" is a contentious one. In times of crisis, the national interest might clamp down on such things as personal freedoms and civil liberties as governments tighten the reigns on economies³⁴. Also, government protection and slack regulation for the well-connected (*Pr25-Corruption and nepotism in government*) can augment the problem. What is called for is a government more accountable to its electorate and more responsive to its needs with

³⁴ Of course the crisis was of financial mismanagement of which a great contributor was the notion of "easy money" and bad navigating on the part of the "get out quick" teams.

responsibility...even if it means being unpopular. In the above discussion, it was shown how limited government accountability, the degrees of transparency, responsiveness and responsibility are all political risk indicators that should be included in a political risk analysis model³⁵.

Other factors that countries can be measured on that should greatly reduce the risk of crises include closing insolvent institutions like finance companies, increasing capital requirements, easing foreign-ownership limits and restrictions, and supervisory practices that are on a par with international standards (Goldstein, 1998:24; Griffith-Jones et. al., 1998:19). These are also factors that have been incorporated as economic indicators of political risk in this study.

Some other financial restructuring measures agreed upon with the IMF that can be translated into factors influencing the occurrence of political risk, include tight loan classification and bank licensing rules and bankruptcy laws that meet international standards; guidelines for the assessment of owners, board members and managers of financial institutions; tight banking supervision laws, prudential regulations, strong rules governing disclosure, auditing and accounting practices; a deposit-insurance scheme in place; and at least a strategy in place for privatising institutions experiencing high levels of state intervention (Goldstein, 1998:25). Once again, the notion is augmented that high levels of state intervention might point toward a high probability of political risk occurring.

Of further importance is the stability and ability of central banks. The answers to some questions regarding central banks are important. To what extent is the central bank insured? How are they managed? What does management look like? What is are management's qualification(s)? Who 'runs' the bank, or who is in charge? What is the level of central bank independence, or what are the levels of state intervention, if any? What is the size of the foreign reserve? How many months can be 'covered' by the central bank? Does it uphold the banking and financial supervisory laws it holds forth?

This chapter furthermore, offered a discussion on model designing, the uses of a variety of models in management science, and the relevance of these underpinnings for constructing a model for political risk analysis. It also scrutinized, presented and discussed some findings of importance to political risk analysts in the light of the recent Asian Financial Crisis and touched on the observation that macro-type models and methodologies did not send out any warning signals.

In the following chapter, Chapter Four, the political risk factors that have been touched upon so far in the study are presented in their own right together with motivations for choosing their indicators. The ways in which they are weighted and scored are also explained.

³⁵ In the sense that the less of it there is, the higher the chances of political risk occurring.

CHAPTER FOUR: Political Risk Factors and their Indicators

The previous chapters offered a motivation for the importance and relevance of the multi-disciplinary field of political risk analysis. The study also presented a theoretical and conceptual discussion of the foundation(s) of political risk analysis by establishing the multi-discipline's theoretical base, an in-depth conceptualisation of the terms used throughout the study, sources of data and 'good' political risk analyses, the difference(s) between forecasting and predicting, as well as some theoretical and methodological problems associated with political risk analysis. As the study evolved, it looked at some presently-used methodologies of country and political risk assessment, and presented some findings in the light of the recent Asian financial crisis, showing that valuable lessons can be learned by investigating the crisis from a political risk analysis perspective.

In introducing the notion of the use of risk factors in a model for political risk analysis, Anderson (1991:48-55; Carley, 1981:166) offers some thoughts on the choice of factors for political risk analysis purposes. One criterion for 'good indicators' of political risk factors implies that the factor indicator itself, or the information from which it is calculated, should be, and be made, readily available. This is particularly important for developing countries, where the resources to collect and process statistical information are limited. The rationale behind this is that factor indicators, for which information is difficult and/or expensive to collect, are much less likely to be put into practice than indicators for which the information can be easily and cheaply collected.

The risk factors should also be relatively easy to understand, and should reflect something measurable, something believed to be important or significant in its own right, or should reflect or represent something important beyond what the factor itself is a measurement of (for instance, life expectancy figures might be used to indicate the general state of health of the economically active population). This is what constitutes an actual factor indicator, rather than just a figure or a statistic. One way to build up a set of risk factors is to decide which are the most important problems to keep track of, again emphasising the importance of gauging a client's specific needs to enable micro-type analysis. Depending on the nature of the client, risk factors and their indicators can also be designed and chosen to be industry specific, as irrigation agriculturalists or beverage producers would be interested in knowing if their investment could run the risk of water restrictions, or the indirect pollution of underground water reserves. These environmental risks can influence government policy on such related issues, and inherent political risks relating to the government's authoritative allocation and distribution of scarce resources, as well as policy effectiveness and penetration, come to the fore.

Although the links with political risk factors have been indicated throughout the previous discussions, this chapter is going to show how the research is operationalised by introducing the risk factors that have been chosen for the model as such. Explaining the significance of the risk factors and their indicators, as well as how they are weighed and scored in the model, motivate these choices. Of further importance is the idea that the risk factors explained are all included in the generic model offered in the fifth chapter. Depending on the requirements of a certain client and the particulars of the investment, some of these risk factor indicators can be adapted or even excluded from a client-specific analysis model for a certain industry. The flexibility and adaptability of the model, in the sense that the choice of indicators from the generic pool offered below (apart from the subjective flexibility of the weights), can be made in consultation with an investor, will also be illustrated in the next chapter by means of simulating a client-specific risk analysis exercise. The time-spans (six to eighteen months or one to five years) in certain risk factor indicators are also flexible, depending on the urgency of the situation and the sentiment of the investor.

4.1 Measuring Political Risk

Political risk analysis per definition implies the ability to anticipate the kinds and degree of risk a foreign investor might face in a certain country. Such an analysis should ideally present an investor with accurate and truthful answers to some of the following questions: Will our investment be safe? Will our people be safe? What would and should our bargaining position be? Does the host government want us there? Does it merely tolerate us, or does it really need us? And which possible politically-induced changes to the investment environment could affect the success of our investment? The model in Chapter Five aims to offer answers to these questions by enabling the measurement of political risk as possible risks to foreign investment.

Political risk analysts have to be able to recognise signs that can act as clues to possible situations in which risk can occur for the potential investor. There is a myriad of criteria that can result in political risk, although not necessarily. Political instability for example, does not as a rule always pose a risk for foreign investment, but it might result in political risk if other contributing factors augment a risky situation. These 'clues' or 'signs' are indicative of the presence or absence of particular political risk factors.

The structural sequence for indicators can, according to Horn (1993:11) be represented as

"observations organised systemically to provide data that contain basic information and can be ordered into statistics, either quantified at cardinal/fixed interval scales, or non-quantified in ordinal ranking, further processed into indicators designed to express structure or change of

phenomena related to social and scientific concerns."

For instance, education and learning are in themselves not indicators of a country's level of social development. Basic examples of indicators of education and learning would be a student:teacher ratio, the percentage of a population that has secondary education, a population's average years of schooling, or literacy rates.

Systemically organised observations present data that can be scaled numerically, as attempted in this study. For example, on a scale from zero to thirty, a country's education ratio of student:teacher can be either very bad (30), or very good (0)¹, where 26 students per teacher is a satisfactory ratio. In this way, an indicator of a country's level of education and learning is presented in order to express such phenomena as related to political risk concerns of a certain country. If the indicators for a concept are not specified with sufficient richness and accuracy, the concept itself cannot be of much use, like 'education and learning'. In addition, writes Meehan (1971:39), precise identification of a set of indicators is not useful if the connection between indicator and concept is unclear or biased. This study presents the reader with a set of guidelines in order to explain the operationalisation of chosen indicators, and to illustrate a clear link between the indicator and the concept of which it is a measurement.

The scope for further study in the field of measuring political risk allows for a more in-depth investigation into the abovementioned precision of a set of indicators used for analysing political risk. The arbitrary nature of political risk analysis can be remedied by incorporating standardised and transparent values already attributed to political indicators. There was a surge in good databases² during the past decade or so that measure political attributes and thus enable comparative studies³. Although this study is aware of these standardised measurements, it admits to the aim of addressing the challenge of attempting to build a unique and comprehensive model for political risk analysis independent from these measurements. This is however, quite possibly a limitation to this study, and an even more advanced study should without a doubt further address remedying the more arbitrary and nominal nature of that which can be defined as political risk. This could simplify political risk analysis even more, as well as reduce the arbitrary nature of analyses.

¹ Although the value "1" could be a point of departure, it is assumed that "0" is applicable in cases where a risk factor indicator is not relevant to a certain case. This is explained in more detail in section 4.4.

² See *Database of Political Institutions (DPI)* at <http://www.ideas.uqam.ca/data/Papers/wopwobago2283.html>; *Political Regime Characteristics and Transitions, 1800-1999* at <http://www.bsos.umd.edu/cidcm/inscr/polity>; *Freedom in the World Country Ratings 1972/73 to 2000/01* at <http://www.freedomhouse.org/ratings/>; and *Governance Matters II – Updated Governance Indicators for 2000/2001* at <http://www.worldbank.org/wbi/governance/pubs/govmatters2001.htm>.

³ Private consultation with Philip Nel, 14 October 2002.

4.1.1 The careful use of aggregate data

The following section will introduce some of the factors that were used in designing the model presented in Chapter Five. This section also explains how many of these factors and their indicators can be measured by means of using aggregate data. Although the dangers involved in using aggregate data as measurements were discussed in a previous chapter, it remains the way in which every country of the world is reflected on paper - by compounding the lowest and highest scaled measurements into an average, and is also a way in which countries can be compared with one another. Statistical data can be manipulated by means of aggregating and averaging figures to fit a framework of political risk concerns, which is in itself easiest to come by, the easiest to work with, the cheapest and eventually also more reliable.

Nevertheless, as mentioned before, the arguments for and against the use of individual and aggregate data are familiar in the field of comparative studies (Anker, 1990:373; Pidd, 1996:5-116). In political risk analysis, one finds activities such as urbanisation (Carley, 1981:130-172), industrialisation and consumption that cannot be expressed in terms of individual attributes, but which are better expressed as average or aggregate figures. The availability of aggregate data over long periods of time is also an important factor in trend analysis favouring the use of aggregate data, since almost all countries collect and publish a wide variety of socio-economic, political and demographic data (Bunge, 1998:37, 90; Carley, 1981:104-106). In the study of developing countries, where survey analysis is often politically and subjectively suspect, aggregate data analysis published by the World Bank for instance, can play a useful role in generating objective information for political risk analyses which are relevant to the country being studied. But in experience many of the figures used and presented as country statistics in such indices are only estimates - proving that figures for certain countries (in most cases developing countries) remain hard to come by.

One of the basic problems of using aggregate data in analyses is the matching of empirical measures with theoretically meaningful concepts. It is not always easy to find risk indicators that retain the same meaning from country to country, considering that the relationship of analytical findings to the 'real world' depends heavily on the accuracy of the measurements and the consistency of definitions over the units being studied (Arminger, Bradley and Schaefer, 1998:90, 199; Bunge, 1998:159; Clogg and Sobel, 1995:39,77; Rapoport, 1983:393; Reaves, 1992:19, 67; Messick, 1968:108). On the one hand, the results attained by using a generic model to conduct a comparative risk analysis between an industrialised and a developing country can be skewed, but on the other, if one uses a different model to measure political risk in such countries respectively, one is rather conducting in-depth analyses and not comparative analyses as such.

The various levels of analysis represented by the model present problems of their own as explained in preceding chapters. Although a lot of scope is covered, some complications still remain in using, for example, the state level of analysis in comparative analyses. Gross averages and aggregates frequently mask substantial international variations and deviations, especially in developing countries where, as an example, the will of the political elite often do not correspond at all to the needs of those being governed. If the per capita income of Mozambique is published as being US\$260 (World Bank, 1995), this figure masks those Mozambicans who earn a 'below average' income (US\$100) per annum, as well as those in privileged financial positions. Often, governments do not include 'peasants' in statistical calculations, possibly due to them having been left out of census exercises, or a case of government inability to calculate population figures. Government or government-subsidised institutions often manipulate data in order to present a 'rosier picture' than what should be reflected in reality. It becomes clear that the problems of comparisons, of aggregate data analysis and that of cross-level analysis are interrelated. Apart from hard economic factual figures such as per capita income and balance-of-payment statements, other indicators of risk may include geopolitical considerations (Levinsohn, 2002:38-43) such as the proximity of the specific country to a trouble spot⁴ or a suspected 'rogue' state.

Of another nature are social indicators like rapid and concentrated urbanisation that is a consequence of other symptomatic factors that have to be analysed during the political risk analysis process⁵, and causes of political risk are infrequently attributed to only one event or tendency in a country. Other contributing factors that play a role in levels of political risk can be fractionalisation in a country by language, cultural, ethnic or religious groups and the power these factions have to disrupt or place great strain in the form of demands on the political system. Restrictive or coercive methods required to retain or maintain power and regime stability be it (il)legitimate also play a role, as does the mentality of government and the governed, including for instance xenophobia, nationalism, fanaticism, corruption, nepotism and the (un)willingness to compromise. Social conditions include population density and resource distribution, health concerns (of which AIDS is extremely topical not only because of its disastrous economic threat), as well as the mobility, organisation and power of political forces under an influential, fiercely ideological government. Societal conflict in the form of demonstrations, strikes and violence are symptomatic of political risk, as is instability as perceived by unconstitutional changes, unlimited government, kidnappings and hostage situations, assassinations and guerrilla activities.

As mentioned before, political risks not only encompass politics, but also economics, socio-economics,

⁴ For instance, the current events in Zimbabwe do not bode well for foreign investment in the Southern African region, despite NEPAD attempts to reflect the contrary and foster 'good governance' on the African continent.

⁵ In the case of Mexico, roughly one quarter of the Mexican population has settled in Mexico City due to problems federal government has in the distribution of resources, and the president's power over these resources. The stress this places on the political system heightens with raised social expectations, notwithstanding the environmental and health impacts of this rapid and uncontrolled urbanisation trend. The effects of this literally "spills over" the United States border (Mahler, 2000:302-324).

social and societal factors, environmental factors, as well as the nature and industry-specific scope of the particular business involved in foreign investment initiatives. As these elements are constantly undergoing change, the assessment of risk necessitates detailed analysis of the various features of particular cases. The reality of time and costs, however, often limit the depth and scope of analysis. There is thus often a need for political risk indicators and analysis model(s) that are easy to handle and readily available, without compromising the integrity, validity, quality and accuracy of a political risk assessment. The following section explains how the factors and indicators used in the model were chosen, and motivates their inclusion.

4.2 Choosing Political Risk Factors and their Indicators

Some of the issues that one should be aware of when deciding upon the inclusion or exclusion of political risk factors and their indicators in a risk analysis model will be touched upon in the following discussion. As the discussion evolves, it will also become clear that many risk factors represent those that foreign investors are the most concerned about and that are readily available in existing political and country risk literature, and are concerns that most investors have in common. Other risk factors are related to these main concerns, although less obvious. The factors are not in any particular hierarchical order, since it is felt that each risk factor is significant, and that the particulars of a specific environment can spark any one of the factors. In section 4.5 of this chapter, the significance of each risk factor chosen for inclusion in the Chapter Five model is explained in some detail.

As Anderson (1991:48-55; Chicken, 1986:97) explains, economies do not exist in isolation of politics, or purely for their own sake. They have effects on the future of the environment and societies which are of definite importance, as society and the environment provide the inputs and resources any economy is reliant upon, be they labour or natural resources. Thus the 'human' and 'natural' perspectives of economics imply the use of social and environmental factors to enable the measurement of a country's economic performance, alongside such factors as capital and current accounts, account deficits, reserves and gross national product statistics (Nash, 1994:70).

It is also important to take the nature of a society into consideration when planning to invest in a specific country. Apart from macro statistics, it is important to be aware of the culture one will be conducting business in. Different cultural perspectives invariably affect the direction of negotiations in various countries. This question becomes more intricate as it becomes less clear whether negotiations are conducted according to 'western' or local customs (Bartholomew; 1990:25, Olivier; 1996:10-12, Whitmeyer; 1996:59). Bray (1994:71) explains that it may be required to adapt to Islamic banking codes in some Middle Eastern countries. Olivier (1996:10-12) is mostly concerned with a trend resulting from

"a mixture of unfriendly officialdom and some hair-raising experiences" which has made investors, especially from "western companies" in the People's Republic of China, wearier (Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999:246-264; Lane, DiStefano and Maznevski, 2000:249, 469; Wang and Tiong, 1999:190 and 2000:242).

Because the model presented in Chapter Five can be applied to conduct comparative analyses, one would think that a single set of risk factors would be used for such cross-country comparative analyses. Yet different factors will be more significant in some countries than in others, and there will always be cases where there is a need to highlight additional risk factors not relevant for worldwide comparisons. Still, it would be wrong to exclude risk factors on the grounds that the contrasts they show are too stark, and to say that completely separate sets of factors should be regarded as appropriate for both developed and developing countries (excluding indicators for the loan default factor when rating a developing or highly-indebted country, as omitting these will not improve the investment climate). This would negate the cross-country nature of political risk analysis in enabling comparisons of two or more countries. Granted, should an in-depth study of a certain country be required by a foreign investor, the political risk analyst would serve that client best by excluding, choosing and using specific factors and their indicators best suited for a specific country, industry or time-span of the investment (short, medium or long term). Suffice it to say that this study makes both in-depth country and micro industry analyses possible, but presents a model that also enables cross-country comparison and analysis.

Political risk factors should reflect reality, not merely present those aspects of reality that can be evaluated easily, and should not have to carry an automatic evaluation (Anderson, 1991:48-55; Carley, 1981:166). It does not always have to be 'good' if it goes up, or 'bad' if it comes down (*Sr15-Life expectancy*); or always 'good' if it comes down, and 'bad' if it goes up (*Er22-Inflation rate*).

Also, an indicator does not have to be original or new. Nothing stops the risk analyst from choosing a familiar indicator, such as the infant mortality rate as an indicator of the state of a nation's health services. Using socio-economic, societal and environmental indicators, and not just purely financial indicators, is a valid means of evaluating economies as well as the economic *prospects* of countries, which invariably influence the political and investment climate of a country and its people as the interrelatedness of politics and economics, as well as social conditions become clear (Anderson, 1991:49).

As mentioned and explained before, political risk analysis involves components of both macro risk and micro risk (Venter, 1999:76), and risk factors are drawn from these components in order to conduct both a generic-type and specific-type political risk analysis. Model flexibility and adaptability accommodate both these components, as the model will aim to show. Chapter Five will present a generic 'macro-type' model (section 5.3), as well as an 'industry specific-type' model (section 5.5). The following section will

start to explain the choice of risk factors and their indicators, bearing in mind that earlier sections of this study mentioned having to limit the amount of factors one can draw from an inexhaustible 'pool' of political risk factors.

4.2.1 Sources of political risk factors and their indicators

The purpose of political risk analysis is to point out problems and to give advice as to how one should approach the country in which a company is interested in pursuing certain opportunities. In evaluating political risk, it is often found that an examination of a country's economy presents a different set of problems from an assessment of political stability as such.

Among the important factors Raddock (1986:2; Bunge, 1998:107, 407) investigates, is the repatriation of capital and remittance of profits. The question justifying such indicators is founded in the (in)ability of prospective investors to get their money out of a host country. The political risk analyst should advise investors as to how to manage such limitations. Yet, if a country faces a currency conversion crisis, or if there is a reason to suspect a repudiation of contracts, investors should be advised not to approach such investment climates without the necessary and essential protection. A possible way of managing such risks would be insuring foreign investments against political risks.

The 'economics of political risk' is not a contradiction in terms. If government makes decisions or rules as to the economic systemisation of a country, policy is made. And where policy is made, politics is involved. Decisions have been made in the past, often without consulting the populace somehow, regarding the economic route that a country might take under authoritarian rule or under a dictatorship, as in the people's Republic of China, or even the 'benevolent' dictatorship of Singapore (Anderson, 1988:25; Anderson and Boettke, 1993:101; Decalo, 1985:209; Pusic, 1994:383; Robertson, 1987:2; Whitmeyer, 1996:59).

Further risk factors may include an extremely uneven distribution of wealth between individuals and between cities and rural areas, a high debt burden coupled with near zero economic growth, an adult work force of which only 50% is adequately employed or might have AIDS, an acute population growth problem, a large number of politically aware young people entering an overburdened job market, an outmoded land tenure system, hyper urbanisation and consequent urban over-population.

Add to these factors severe economic jolts, which stem in part from global conditions, and political risk analysis is called for, as well as a deserved look into the dimension of socio-political interaction. For argument sake, take a country of which the social structure in general and its political system in particular are characterised by a patron-client relationship through which political non-conformists are co-opted into

the system, and which assures top-down control. The people seem to respect power and central authority. Each person in a position of authority is limited by authoritative and paternalistic powers above them. The patron-client relationship is so well developed that in most instances local grievances involving everything from health clinics to sewerage are settled by appeal to the local authority. In such cases, vocal critics of the system at the grassroots level are usually co-opted into it (De Haan and Siemann, 1996:339; Gyiman-Brempong and Traynor, 1996:695; Raddock, 1986:7-9).

An apparently low level of interpersonal trust tends to militate against the formation of collective groupings that might pit themselves against the macro-system. Family consciousness is strong and will normally take precedence over other social and political obligations - a factor which also works against a person taking the risk of joining or forming a political organisation that is apt to get his or her family into trouble. Also, the existence of large, extended families in urban areas tends to dispel feelings of displacement or estrangement that might otherwise contribute to anti-social behaviour in a political form (Dale and Davies (eds.), 1994:41-74; Lidenberg, 1990:397; Mukonoweshuro, 1990:555; Raddock, 1988:7-9).

In assessing political risk, Multinational Company's (MNC's) must give ample weight to such elements of political control and to the mentioned cultural constraints against successful challenges to the existing order, be it one of authoritarianism, tyranny or even dictatorship. In the above example, threatening urban conditions that pose risks like an unstable and dense population, health risks, unemployment, increased political awareness and a broad network of communication are often counter-balanced by stabilising cultural elements and by the absence of significant organisational structures that can serve as alternatives to the ruling party.

Managing economics as a contributor to political risk levels is certainly one of the most important factors in political risk analysis. Macroeconomic and fiscal policy, economic planning strategy and the broad framework for the development path of a country are determined by decisions taken by governments. This framework is a major determinant of the economy's performance and flexibility and is closely bound up with the political structure in which foreign investors are interested when considering the most profitable investment climate.

4.3 Political Risk Factor Indicators as a Measure of...

Initially, as a phase one or "overview-analysis", an evaluation of the *macro-political* as well as economic environment of a host country is necessary. Some of the questions that need to be addressed in such an initial analysis, for which indicators have to be identified in order to recognise the risk factors pertaining

to these factors, include the nature and stability of government, the institutional functionality of government (if not functioning well, personalities – on an individual level of analysis – might become more important), identifying the key personalities, identifying the decisions-makers and their power base, the stability of investment regulations, and economic pressure on government and its policies from the political opposition or other power.

At the very least, the abovementioned questions relate to questions of political and economic stability, and operational obstacles. These include questions about the political environment, the military, human rights issues, infrastructure (including communication and transportation), corruption, contracts and tendering processes, vested interests, the bureaucracy, indigenous peoples, legal shortcomings, crime, kidnapping and extortion, border conflicts or war, and urban terrorism (especially as part of a micro analysis, against a tourist industry, for instance).

If required, a second phase or “specific-analysis” complements macro-political risk assessments by identifying risks associated with the particular project itself. Micro-analysis addresses the issue of determining the best structure for a proposed project or investment. These issues include retaining sufficient control if a company is involved in a partnership with a local firm, the reputation, background and political connections of a company’s partners, and cultural nuances a company should be aware of when embarking on business transactions in a foreign country.

Other micro-analysis type issues include the strategies that can be implemented to strengthen support for the project, the political conditions of the relevant geographical location, the relationship between central government and regional government, the attitude of local communities toward the proposed project, the presence of any armed opposition groups in the area (their attitudes toward the presence of a foreign company, the security risks to people and operations), the ‘winners and losers’ from the proposed project, sectarian unrest, the police, local taboos and even the availability of pharmaceuticals and emergency care.

4.3.1 ...the major risk factors of concern to most foreign investors

What the bulk of literature on political and country risk analysis has in common are overlapping areas that are of major concern to foreign investors. This leads one to believe that there are certain major risk factors that most foreign investors have in common. These risk factors are a good departure point when choosing risk factors for inclusion in a political risk analysis model. Consequent risk factors might seem less significant, but are by no means less important, as they are very closely related and causally linked to the major risk factors the following section will explain.

Literature suggests that political stability, political effectiveness, monetary policy, exchange rate policy,

trade policy, fiscal policy, the regulatory environment, the global environment, debt, growth, the financial structure, current account and liquidity of a host country are the overarching concerns of foreign investors⁶. Each of these concerns will be discussed individually in the following section. Also, in some cases where the glossary does not encompass terms that might require further clarification, the following discussion should assist in contextualising such terms.

Political stability (Pr5, Pr7, Pr8, Pr9, Pr10, Pr13, Pr14, Pr15, Pr16, Pr18, Pr20, Pr21, Pr22, Pr26, Pr36, Sr1, Sr8, Sr9, Sr11, Sr18, Sr19, Sr23)

In its broadest sense, political stability can be measured by monitoring incidents of war (internal and external conflict), social unrest, orderly political transfers, politically motivated violence, government stability, policy stability, socio-economic conditions, military in politics, religion in politics, law and order, ethnic tensions and international disputes. Government stability is a measure of both the government's ability to carry out its declared programme(s), as well as its ability to hold office. This is influenced by the type of governance, the cohesion of the government and governing party or parties, the proximity of the next election, government's command of the legislature and popular approval of government policies (although popularity and responsibility are often juggled).

Regime legitimacy also contributes to political stability. A political system under fundamental stress from severely disaffected groups and the laws of the land being questioned might pose strains on the legitimacy of a regime. A change in government that would bring to power a set of leaders with a different political philosophy or a new strategy of economic development that could undermine investor confidence and upset policy continuity, does not bode well for foreign investors. If a change of regime brings to power supporters of debt repudiation, a country's investment climate will surely not remain untouched.

Political effectiveness and accountability (Pr2, Pr3, Pr4, Pr11, Pr17, Pr26, Pr28, Pr29, Pr30, Pr32, Er14, Er37)

Investor confidence in a country is usually boosted in cases where political institutions are responsive to challenges, resilient to shocks and flexible under pressure. For example, the management of debt obligations in both favourable and unfavourable economic circumstances also indicates political effectiveness – even more so, if, under adverse conditions, authorities have been able to draw up and implement a coherent program of economic restraint. Of concern in this case is change in government

⁶ These have mostly been gauged from the following contributors to the literature on political and/or country risk: Akhter and Lusch (1987:81-101), Anderson (1991: Chapters 5, 7-8), Baker and Hashimi (1988:40-47), Bartlett and Ghoshal (eds.) (2000:1-354), Bernhard and Leblang (2002:316), Bilson, Brailsford and Hooper (2002:1-27), Bird (1986:1-17), Brewer (1981:5-12, (ed.) 1985:3-12,337-349), Brummersted (1988:75-95), Calverly (1985:4-21), Chermak (1992:167-178), Coplin and O'Leary (1986, 1994), De la Torre and Neckar (1988:221-241), Erb, Harvey and Viskanta (1996:29-46), Fitzpatrick (1983:249-254), Frei and Ruloff (1988:1-24), Galvao (2001:35-42), Harms (2002:250-262), Howell (1998:3-465, 1999:33), Kim and Mei (2001:1003-1016), Kobrin (1978:113-122, 1981:251-270), Krayenbuehl (1985:3-20), Leonard (2001:491-506), Levinsohn (2002:38-43), Mohr and Fourie (1995:1-476), Samuelson and Nordhaus (1992:1-749), Sethi and Luther (1986:57-67), Simon (1985:134-148).

orientation in the sense of business orientation (from pro-business, for example), institutional effectiveness, the quality of the bureaucracy, transparency and fairness, democratic accountability, corruption and crime.

As a political system, the essential features of an accountable democracy include a systemic transparent government or executive that has not served more than two successive terms, free and fair elections for the legislature and executive as determined by a constitution or statute, the active presence of more than one political party and a viable opposition, evidence of checks and balances among the legislature, executive and judiciary, evidence of an independent judiciary and evidence of the protection of personal liberties through constitutional or other legal guarantees. As a measure of how responsive government is to its people, it is assumed that the more democratic a society is, the more accountable it is, and is in turn probably less susceptible to sudden or explosive political shocks.

Dominated democracy (Pr1, Pr6, Pr12, Pr18)

Signs of a dominated democracy include a government or executive that has served more than two successive terms, free and fair elections for the legislature and executive as determined by a constitution or statute, the active presence of more than one political party, some evidence of checks and balances among the legislature, an independent judiciary, and the protection of personal liberties.

De facto and de jure one-party state, and autocracy (Pr1, Pr6, Pr12, Pr18)

Features of a *de facto* one-party state are a government or executive that has served more than two successive terms, or where the political/electoral system is designed or distorted to ensure the domination of governance by a particular government or executive, the holding of regular elections as determined by a constitution or statute, evidence of restrictions on the activity of non-government political parties, disproportionate media access between governing and non-governing parties, harassment of the leaders and/or supporters of non-government political parties, the creation of impediments and obstacles affecting only the non-government political parties, and electoral fraud. The amalgamated presence of any of these signs can also point to a *movement toward a de facto* one-party state.

Identifying features of a *de jure* one-party state are a constitutional requirement that there be only one governing party and a lack of any legally recognised political opposition. Furthermore, where leadership of the state is assumed by a group or single person, without being subject to any franchise, either through military might or inherited right, evidence of an autocratic state exists.

Socio-economic conditions (Sr1, Sr8, Sr10, Sr18)

This features as an attempt to measure the quality of human capital and general public satisfaction, or dissatisfaction for that matter, with a government's economic policies. It is assumed that the greater the

public dissatisfaction with a government's policies, the greater the chances that the government will be forced to change its policies, possibly to the detriment of foreign business. In the model, socio-economic conditions cover a broad spectrum of factors including infant mortality, medical provision, housing and interest rates. It is also assumed that different factors will carry different weights in different societies. As an example, a three percentage point rise in unemployment can have a highly significant political impact in a country that has enjoyed an unemployment rate of, say, 4%. The same rise would probably go unnoticed to the public in a country where unemployment is for instance in excess of 30%.

Internal and external conflict (Pr7, Pr8, Pr13, Pr15, Pr33, Sr23)

Internal conflict is an indication of political violence in a country and its actual or potential impact on governance. A low risk rating should be given to a country where there is no evidence of armed opposition to the government and the government does not indulge in arbitrary violence – directly or indirectly – against its own people. It is assumed that a high-risk rating is given to a country embroiled in an on-going civil war. Intermediate ratings are awarded on the basis of whether a threat is posed to government and business, or only business (kidnapping for ransom), whether acts of violence are carried out for a political objective, whether such groups are composed of a few individuals with some support, or are well-organised movements operating with the tacit support of the people they represent, whether acts of violence are sporadic or sustained, and whether they are restricted to a particular locality or region, or are carried out nationwide. Membership of regional organisations or bodies that imply a certain economic status may provide a cushion of support in times of stress and a commonality of interest in general policy matters. Political factors that create ties of alliance with major industrial powers that would offer safety in the form of continued access to funds when other sources are closed off also reduce risks to foreign investors.

The measure of external conflict is an assessment of both the risk to the incumbent government and to investment. It can range from qualitative-type conflict like trade restrictions, embargoes, and geopolitical disputes, to armed threats, exchanges of fire on and across borders, foreign supported insurgency and full-scale war. External conflicts can adversely affect foreign business in ways ranging from restrictions on operations, to trade and investment sanctions, to distortions in the allocation of economic resources and violent change(s) in the structure of society.

Corruption (Pr12, Pr25)

Corruption within the political system is a threat to foreign investment for several reasons. It distorts the economic and financial environment, it reduces the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability, and introduces an inherent instability into the political process of a country. The most common form of corruption met by business directly is financial corruption in the form of demands for special payments and bribes connected with

import and export licenses, exchange controls, tax assessments, police protection or even loans. Such corruption can make it difficult to conduct business effectively and in some cases may force the withdrawal or withholding of an investment.

Job reservation, nepotism, excessive patronage and suspiciously close ties between government and business are especially risky to foreign business in the sense that they can lead to popular discontent, unrealistic and inefficient controls of the state economy and encourage the development of a black market. The greatest risk in such corruption is that, at some point, it can become so overwhelming that a major scandal can provoke a popular backlash, resulting in a fall or overthrow of the government, a major reorganising or restructuring of the country's political institutions, or a breakdown in law and order that can render a country ungovernable.

Military in politics (Pr10, Pr19)

As the military is not popularly elected, its involvement in politics even at a peripheral level, reduces democratic accountability and can be quite significant. A situation in which the military becomes involved in government because of an actual, created internal or external threat, would imply the distortion of government policy in order to meet this threat, for example, by increasing the defence budget at the expense of other budget allocations. The threat of a military coup can force an elected government to change policy or cause its replacement by another government more agreeable to the military's wishes. A military coup or threat of a coup may also represent a heightened risk if it is an indication that the government is unable to function effectively and that the host country therefore presents an uneasy environment for foreign business.

A military regime as such poses the highest risk. In the short term a military regime may provide new stability and reduce business risks, but in the long term, the risk will probably rise, due to the system of governance becoming corrupt(ed), and partly because the continuation of such a government is likely to create an armed opposition. Military participation in government, to varying degrees, might be a symptom rather than a cause of underlying difficulties within a country.

Religious tensions (Pr7, Pr23)

These may stem from the domination of society and/or governance by a single religious group that seeks to replace civil law by religious law and to exclude other religions from the political and/or social process, the desire of a single religious group to dominate governance, the suppression of religious freedom, or the desire of a religious group to express its own identity, separate from the country as a whole. The risk involved in such situations range from inexperienced people imposing inappropriate policies, through to civil dissent and civil war.

The quality of the bureaucracy (Pr29, Er17, Er37, Er40)

The institutional strength and quality of a country's bureaucracy tends to minimise revisions of existing policy when governments change. Less risky to foreign investors are countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. In such instances, the bureaucracy tends to be somewhat autonomous from political pressure and usually has an established mechanism for recruitment and training. Countries lacking in these respects tend to pose more risks to foreign investors because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions.

Furthermore, inexperienced and corrupt public officials can delay economic plans or reforms and undercut policy intentions by siphoning off resources from the legitimate pursuit of wealth creation. Signs of bureaucratic quality include efficient and effective distribution of resources, policy delivery and middle levels of government bureaucracy staffed with competent civil servants who can translate policy into action with a minimum of delay and drain on public resources. The presence of well-trained and experienced technocrats among the political and managerial elite of a nation, adept at managing internal and external debt, also contributes toward a quality bureaucracy.

Monetary and fiscal policy (Pr17, Er37, Er38, Er40, Er41)

A country's political system can enhance or detract from a nation's ability to create wealth and thus to maintain strong export earnings needed to meet future foreign debt servicing. Low risk countries have laws and a judicial system conducive to commerce, capital investment, and the release and protection of creative economic energies. In such cases, fiscal or administrative rules do not hamper the efficient flow of goods, services and capital, and entrepreneurs in export industries are rewarded and not penalised by tax laws or even cultural biases. It is also in some cases necessary to assess whether the officials in charge of economic management are prepared to recognise and respond to both economic and financial problems in a timely manner, the Asian Financial Crisis being a case in point.

Extensive or unwarranted involvement of political considerations in the policy process can lead to a failure to meet debt-servicing obligations. Highly politicised key agencies of government usually generate more risk, as is the case where a central bank is not able to act independently of the political process, but rather acts as a tool for partisan decision-makers.

The inflation rate itself, the direction of the inflation rate, policies that favour savers, the ability to boost interest rates, monetary stability, the use of indirect instruments of monetary policy, real lending rates, boom/bust scenarios and financial liberalisation are measures of monetary policy. The ratio of public-sector budget balance to GDP, cumulative years of a public-sector budget balance, government's ability to generate tax revenue, public debt as a part of the GDP as such, as well as the direction of public debt as

a part of GDP plays a role in measuring the quality of fiscal policy penetration.

Exchange rate policy and trade policy (Er1, Er10, Er11, Er13, Er26, Er28, Er33)

In this case, the real appreciation of the exchange rate, the evaluation of real appreciation, the exchange rate regime, a change in prospects, expectations of a regime change, interest differentials, and the black market or dual exchange rate come into play. With regards to trade policy, the degree of trade liberalisation and exports as a percentage of GDP is of importance.

Growth within a global environment (Er8, Er13, Er21)

A host country's record of national savings as part of the GDP, fixed investment as part of the GDP, pension system, investment efficiency, average real GDP growth, latest real GDP growth, global short-term interest rates, global real GDP growth, international financial support and the "contagion effect" are measurements of the global environment.

Current account and debt (Er26, Er28, Er29, Er35)

Cumulative years of a current account deficit, the direction of the current account, the magnitude of the current account, the current account deficit as such, a reliance on single raw material export, reliance on single export category and the annual rate of growth of export receipts are measures in this case. A history of debt default, total external debt against exports, the debt-service ratio, and interest due against exports are measures that are debt-related.

Financial structure and liquidity risk (Er26, Er28, Er36, Er38, Er40, Er41)

An asset price decline, the performance of bank stocks, incidence of bank failures, banking sector ratings, reliance on external debt and government involvement in the banking sector play a role in this case. The following are used as a measure of a host country's funding base: external short-term debt against exports, percentage decline in actual official reserves, percentage decline in forecasted official reserves, net direct investment against financing requirements, import cover, ration of "means" to "spending", net portfolio inflows against financing requirements, M2 supply and reserves, access to the capital markets, net liquidity as months of import cover and the domestic debt maturity structure.

4.4 Political Risk Factors and their Indicators Used for this Study

In the following section the political, economic and social indicators used in the model of political risk analysis are offered as operationalisation of the research⁷. Together with each mentioned indicator, a

⁷ In cases where the motivations for choosing these factors and indicators do not have text references, these are based on subjective assumptions.

means of measuring these indicators is offered, in other words, what ‘signs’ to look out for that will indicate the presence or development of a risk factor or factors that might pose possible present and future political risk to an investor. It is also explained how these indicators can be weighed, and the figure next to each indicator represents that indicator’s contributing ‘weight’ in calculating possible risk when using the model.

The values of the weights that are attributed to each risk factor and its indicators is purely subjective and, in illustration of the model’s built-in adaptability and flexibility, can be adjusted to suit a client-specific model. For instance, an investor can choose to have Pr10 (*Military unrest*) weigh 100 instead of 150, or might choose to add or subtract some of the indicators that point toward the presence of military unrest, which might also alter the weighted value of Pr10. This will happen in the generic model (section 5.3) in cases where only some of the risk factor indicators are relevant to a certain country, and thus rated as such. As an example, Singapore might necessarily score lower (hence better) on Pr10 (*Military unrest*) than, for instance, England, where labour is much more mobile and unionised. In these cases, not scoring an indicator accounts for the value of 0.

4.4.1 Political Risk Factors: Political

Pr1 - Political system (220)

- Autocratic single party system (*Rate between 31 and 50*)
- Democratic multi-party system (*Rate between 0 and 20*)
- One-party dominant democratic system (*Rate between 21 and 30*)
- Regulated democratic multi-party system (*Rate between 21 and 30*)
- Dictatorship in a non-party system (*Rate between 41 and 50*)
- Socialist central planning system (*Rate between 31 and 40*)

Within a political system, political and civil groups and institutions (or subsystems) are connected with one another, enabling the analysis of the system as such (Bunge, 1998:167; Mahler, 2000:11-14; Papadopoulos, 2001:35-58). This pre-supposes their existence and presence within a system especially in the case of civil society. The important connection among these institutions is power, and the relationships that define the levels and nature thereof. These relationships or power patterns are what is of concern to the foreign investor. The ‘rules’ that govern the way in which a democratic multi-party system is organised is more conducive to foreign investment, presupposing an open economy and society. This stands in contrast to the ‘rules’ that govern the power patterns in a one-party dominant democratic system for instance, where policy is probably largely uncontested and inputs mostly limited. The branches of government are probably not autonomous, and levels of government accountability low (Venter, 1999:89).

Pr2 - Separation of powers (150)

- Degree of autonomy and independence of legislative, executive and judicial powers (*High degree, rate between 0 and 10, moderate degree, rate between 11 and 30; low degree, rate between 31 and 50*)

- Degree to which legislature, executive and judiciary check and balance powers (*High degree, rate between 0 and 10; moderate degree, rate between 11 and 30; low degree, rate between 31 and 50*)
- Trend of development of an over-powerful executive (*Negative trend, rate between 0 and 10; possibility, rate between 11 and 30; positive trend, rate between 31 and 50*)

It is assumed that the over-centralisation of power is dangerous, and that political power should be held in check and balanced. Although the functions and powers of legislatures vary within respective political systems, the power to pass legislation is vested in this institution, thus supposedly negating instances of executive dictates or policy decrees. Legislatures allow for the expression of public sentiment and manifest the social system in the form of legislative decisions. Political decision-making resides in the office of the executive, where the executive is – in some cases – also *a* lawmaker, and not *the* lawmaker. Although legal systems and courts are system-specific, it is assumed that they remain explicitly excluded from the political arena (Collie, 1988:427-458; Huntington, 1971:7-31; Mahler, 2000:70-137; Venter, 1999:89).

Pr3 - Openness of political system (250)

- Competitiveness of political system (*Very open and competitive, rate between 0 and 10; possibility for competition, rate between 11 and 30; closed political system, rate between 31 and 50*)
- Multiple competing elites and interest groups can determine public policy through bargaining and compromise (*Yes, rate between 0 and 25; no, rate between 26 and 50*)
- Public accessibility regarding inputs (*Very accessible, rate between 0 and 10; conditional, rate between 11 and 30; no access, rate between 31 and 50*)
- Responsiveness, and responsibility of government (*High degree, rate between 0 and 10; moderate, rate between 11 and 30; low, rate between 31 and 50*)
- Transparency of decision-making process and policy environment (*Very, rate between 0 and 10; hardly, rate between 11 and 30; not at all, rate between 31 and 50*)

In an open political system elites, civil society and political parties compete for recognition of their inputs in and influence of the ‘rules’ that organise a political system. The degree of competitiveness is a measure of the level of political openness, as well as the degree to which competition can take place for determining public policy by bargaining and compromise. This links up with the degree of access the public has to participate politically, government responsiveness to the public, as well as government responsibility. A responsible government acts in the best interest of the public regardless of popularity and can be held accountable for policy promises by societal expectation. The more open a political system is, the more transparent its decision-making process and policy environment is – making it more stable and predictable for the foreign investor (Dale and Davies (eds.), 1994:41-74; Venter, 1999:89).

Pr4 - Public accountability of government (150)

- Strength of public protector and/or auditor general (*Very strong; rate between 0 and 10; conditional power, rate between 11 and 30; none, rate between 31 and 50*)
- Degree of functioning oversight mechanisms (*Highly functional, rate between 0 and 10; conditional, rate between 11 and 30; useless, rate between 31 and 50*)
- Separation of private and public spheres (*High degree of separation, rate between 0 and 10; conditional, rate between 11 and 30; low degree, rate between 31 and 50*)

It is assumed that a government should be held responsible for both its actions as well as its inactions. Policy shifts should be explained, and, if anticipated expectations are not met, government should offer rational reasons for such failures. A public protector or auditor-general that is intimidated by the state,

implies a government that does not deem itself publicly accountable. Oversight mechanisms, such as parliamentary oversight, should act as a check and balance in the name of public accountability. The separation of the public and private spheres should be concrete and not conditional to government fancy (Venter, 1999:89).

Pr5 - Economic planning failures (100)

- Success or failure in meeting economic targets and deadlines promised by the political leadership (*Extreme failure, rate 50; complete success, rate 0*)
- Instances of misleading economic planning and policies (*Infrequent, rate between 0 and 25; frequent, rate between 26 and 50*)

Reasons for planning failures include deficiencies in plans and their implementation, insufficient and unreliable data, unanticipated economic disturbances (external and internal), institutional weaknesses, and a lack of political will (Todaro, 1989:528-530). Repeated failures in meeting economic plans or promises imply 'bad' economic policy and, if domestically caused, a symptom of policy inefficiency, inability and incompetence. In all probability, government accountability for such failures becomes less pronounced and irresponsible economic targets are used in speeches made on political platforms around elections. Such cases of misleading economic policies are probably popular in the short term but when social expectations are not met, conditions for social uprising are contributed to (Bunge, 1998:412).

Pr6 - Form of government (110)

- If previous government was toppled by a military coup (*Rate between 31 and 50*)
- If a state of emergency results in interim government (*Rate between 21 and 30*)
- If a political system is undergoing transformation toward a multi-party government or if multi-party elections are pending (*Rate between 11 and 20*)
- Stable government (*Rate between 0 and 10*)

In this case, it is assumed that the factors relevant to establishing a country's form of government indicate government stability. In cases where a change in executive leadership leads to drastic policy change, instability is heightened. On the other hand, in cases where a change in political leadership sees a steady continuance of policy, government stability is evident (Bunge, 1998:201; Dale and Davies (eds.), 1994:41-74).

Pr7 - Racial, ethnic, nationality tensions (150)

- If collective groupings (liberation movements) hedge against the political system (*Rate between 41 and 50*)
- No legitimacy for government (*Rate between 31 and 40*)
- Sudden changes in political party allegiances and/or alliances (*Rate between 11 and 20*)
- Occurrences of racially or ethnically motivated violence in past six months (*Rate between 21 and 30*)
- If none of the above prevail (*Rate between 0 and 10*)

It is assumed that these kinds of tensions are less prevalent in homogenous societies than in countries where the political distribution of resources and voting is sometimes found to occur along ethnic lines. Ethnic clashes are often politically motivated and often blamed on ethnic bias within government. Battles of autonomy for ethnic regionalism are not only common in developing countries, as evident in Basque Spain. The level of government legitimacy as expressed by various ethnic groups is often manifested in

occurrences of racially or ethnically motivated violence, and often around election time (Venter, 1999:90).

Pr8 - Border disputes/external conflict (110)

- If a territorial dispute is started in order to divert attention from domestic economic problems (*Rate between 31 and 50*)
- An oil company drills in contested waters or similar economic exploitation in disputed areas (*Rate between 21 and 30*)
- Long standing claims to historic territory currently under legitimate jurisdiction of a neighbouring state (*Rate between 0 and 20*)
- If none of the above prevail (*Rate between 0 and 10*)

Wars of secession are a good example and a case in point would be that of Eritrea. Having seceded from Ethiopia in 1993, sporadic battles have continued and the final borders have only recently been drawn. The result of this secession leaves Ethiopia landlocked and Eritrea with a harbour, where such a port is a very important infrastructural resource, enabling access to and from Eritrea for the exchange of goods (Venter, 1999:88).

Pr9 - Political terrorism (110)

- High intensity terrorist activity in past six months (*Rate between 31 and 50*)
- Moderate intensity terrorist activity in past six months (*Rate between 21 and 30*)
- Low intensity terrorist activity in past six months (*Rate between 0 and 20*)
- If none of the above prevail in past six months (*Rate between 0 and 10*)

The distinction between political terrorism and guerrilla action can be unclear. The assumption however, is that terrorism is the use or threat of violence or violent means in order to coerce a government, authorities or entire populations by inducing fear. Terrorism seeks to influence political policy and behaviour of a government through extra-normal means, usually having tried and exhausted conventional political options like negotiations and efforts at diplomacy. Terrorism is strongly influenced by perspective though as some terrorist acts are often labelled acts of national liberation. Terrorism is also used for more random acts of violence like environmental and nuclear terrorism, terrorism aimed at multinationals, lobbying for environmental concerns, against foreign policy issues or for the release of political prisoners (Bunge, 1998:211). Terrorist targets are usually civilian and responsibility is often claimed for such attacks; if not, the purpose of the attack is somewhat defied. On the other hand, guerrilla action tends to focus attention on government targets, usually military targets, rather than random civilian targets. Any such acts are significant because they offer fundamental challenges to the institutions of a government and operate outside the system, rejecting the means of the political system to handle their demands (Clutterbuck, 1977:21; Mahler, 2000:171-174; O'balance, 1979:1-8; Thackrah, 1987:215).

Pr10 - Military unrest (150)

- Past history of military unrest (*Rate between 31 and 50*)
- Threat of military take-over if severe economic deterioration prevails (*Rate between 21 and 40*)
- If the military command stages a coup due to immobility in military ranks or an absence of benefits of remuneration (*Rate between 11 and 30*)
- Acts of unwarranted military prestige (*Rate between 0 and 20*)
- No offensive military capability or intention (*Rate between 0 and 10*)

An explanation of the role of the military in politics shows that it is not only participation that is crucial for governments, but also the type of participation that takes place. The assumption is that within a political system, the military agrees to accept the consequences of the policy-making process and accepts a subordinate (but not insignificant) role in the political system. In military regimes, military leaders still face the same problems as executives of civilian governments do, that is keeping military underlings loyal and preventing an overthrow of the military power. The role of the military in a political system is affected by a country's political culture, history and tradition – literature suggests that in some Latin American countries the idea of a military coup, if not desirable, is definitely recognised as a statistical probability (Mahler, 2000:171; McDonough, 1983:188-218).

Pr11 - Legitimacy crises (240)

- If there is a lack of homogenous national identity (*Rate between 21 and 30*)
- If there is a lack of distribution of resources (*Rate between 31 and 50*)
- If there is a lack of public participation (*Rate between 31 and 50*)
- If there is a lack of policy enforcement (penetration) (*Rate between 21 and 40*)
- If uncontrolled and rapid urbanisation overtakes government functions (*Very debilitating, rate between 31 and 50, less debilitating, rate between 0 and 30*)
- If the political system is open and competitive (*Rate between 0 and 20*)

The assumption is that, the higher the level of government legitimacy, the higher the level of public consent to be governed, the less chance there is of legitimacy crises, political violence and social uprising. Every country experiences these crises during their process of political development though. After hundreds of years of political development many countries are established and stable in that sense. Countries with prolonged legitimacy crises and especially relatively 'young' countries (post-colonial) are cases in question. The terms 'political development' and 'political modernisation' are often used interchangeably. Identity crises imply that individuals have trouble describing themselves politically, which result in problems of associating themselves with government. Policy penetration refers to government's ability to follow through on and enforce its decisions. Governments that are not able to do this are assumed to be less stable. Too little public participation may result in a lack of legitimacy, just as too many demands made on the political system may overburden a government that is supposed to respond to such inputs. The inequitable distribution, or even insufficiency of material resources like food, medical supplies, housing, water and electricity, is a great concern in many developing countries. A society in which a group feels that it is not receiving its due share of material benefits from government, is more prone to uprising (Carley, 1981:130-172; Huntington, 1968:12; Mahler, 2000:16-19; Winter and Bellows, 1977:352-353).

Pr12 - Government behaviour (300)

- Degree of accountability of government (*More accountable, rate between 0 and 25; less accountable, rate between 26 and 50*)
- Degree to which limited or constitutional governance is practised (*Unconstitutional, rate between 31 and 50; constitutional, rate between 0 and 30*)
- Degree of transparency of policy environment (*More transparent, rate between 0 and 20; less transparent, rate between 21 and 50*)

- Degree of responsiveness (*More responsive, rate between 0 and 25; less responsive, rate between 26 and 50*)
- Degree in which responsible governance is practised (*More responsible, rate between 0 and 25; less responsible, rate between 26 and 50*)
- Level of public intervention in the private spheres (*High level of interventionism, rate between 26 and 50; low level of intervention, rate between 0 and 25*)

As a cross-reference to Pr4, the assumption is that the more responsibly a government governs the more likely it will account for its actions, expenditure and policy decisions. Constitutional government implies limited government, where there are boundaries to government involvement (in the private sphere, be it business or individual) and there are certain things a government ‘just can’t do’. This does not imply that a government with a constitution governs constitutionally (Zimbabwe). Many of the most constitutional government do not have a written constitution as such (Great Britain). A high level of political transparency assumes that government probably allows for large amounts of public input – in terms of both quantity and quality (Venter, 1999:89).

Pr13 - Likelihood of social revolution (150)

- If a regime is threatened due to societal will (*If result is expected to be positive, rate between 0 and 20; if inconsequential, rate between 21 and 30; if negative, rate between 31 and 50*)
- If a social revolution will alter the prospects advantageously or disadvantageously for investors (*Advantage, rate between 0 and 20; inconsequential, rate between 21 and 30; disadvantage, rate between 31 and 50*)
- If post-revolutionary society is altered ideologically (*Positively, rate between 0 and 20; inconsequential, rate between 21 and 30; negatively, rate between 31 and 50*)

A revolution typically involves a changing of one government, or type of government, for another, involving a sudden and often illegal attempt to change the regime of a state or other political organisation in which large sections of the population are involved as participants. On the other hand, revolutions might seek to restore legality against a regime that has violated a country’s laws and such a revolution might thus not be deemed as an ‘illegal’ action. A mass revolution (French, Russian, American, Chinese) is sometimes referred to as a *jacquerie*, and involves significant and radical changes in the ruling class, whereas a *coup d’etat* is a sudden seizure of power from ‘above’ instead of using the masses from below. In many cases, the leader of a coup was often very close to the centre of power, a member of cabinet, or often a minister of defence (Mahler, 2000:171-172; Venter,1999:91).

Pr14 - Political (in)stability (250)

- Implication of major political events like elections or scandals (*Positive, rate between 0 and 25; negative, rate between 26 and 50*)
- State of flux or political (dis)equilibrium (*Stable, rate between 0 and 25; unstable, rate between 26 and 50*)
- Unforeseen shifts in government policy (*Positive, rate between 0 and 25; negative, rate between 26 and 50*)
- Unforeseen shifts in government’s execution of power (*Positive, rate between 0 and 25; negative, rate between 26 and 50*)
- Governmental allowances or constraints on profit-taking (*Positive, rate between 0 and 25; negative, rate between 26 and 50*)

After a politically scandalous event has become public for instance (Helmut Kohl in 2000), a time of political uncertainty and instability usually sets in because the public as well as a government reaction has

yet to manifest itself. In a parliamentary system, executive scandal can lead to a 'fallen' government as support for the prime minister discontinues, and even developed countries are not exempt (as the resignation of the Dutch government in April 2002 shows). The important thing is that in countries where the erosion of political institutions has set in, chances are that such systems are more vulnerable to instances of political instability and political disequilibrium. For a foreign investor, sudden changes in government policy point toward political instability and potential for further unanticipated shifts (contract repudiation, cancellation of licences).

Pr15 - Civil War (200)

- If domestic conflict within the boundaries of a country involves civilians (*Rate between 30 and 50*)
- If civilians of different ethnic or religious origins are at war (*Rate between 30 and 50*)
- If civilians are at war for historic territory (*Rate between 30 and 50*)
- Incidence of internal civil strife (*Low incidence, rate between 0 and 25; high incidence, rate between 26 and 50*)

Incidences of civil war, or any armed conflict for that matter, pose threats to foreign investors in the form of malicious damage or infrastructural damage to property, looting or personal threats. In many cases, civil war is often limited to certain areas within a country, but does not negate the possibility of guerrilla or terrorist attacks. Resource wars are often civil wars as well, where powerful warlords battle for control over diamond resources (DRC) and oil fields. The activities of private military companies (PMC's) in a country may indicate the presence of civil war as well (Venter, 1999:91).

Pr16 - Declared state of emergency (170)

- If a state of emergency is expected or has been announced in the past eighteen months (*Rate between 20 and 30*)
- If a country has a history of emergency situations (*No, rate between 0 and 25; yes, rate between 26 and 50*)
- If declaring a state of emergency implies a political clampdown (*Rate between 31 and 40*)
- If a state of emergency is declared as a last resort to end long-standing instability (*Rate between 41 and 50*)

The fact that it is or was necessary to declare a state of emergency is worrying in itself. Other degrees include a state of rebellion and the extreme case of a fallen state (Somalia). In some cases, martial law can be imposed, curfews and state of emergency laws imposed. Often called to prevent or counter political upheaval, a state of emergency also implies tightening of trade policy, a possible closing of markets, import and export controls as well as exchange controls.

Pr17 - Relation: economic expectations vs. reality (80)

- Government success rate in fulfilling promises (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Incidence of unrest due to unfulfilled economic expectations (*Low, rate between 0 and 20; high, rate between 21 and 40*)

Economic expectations publicised by government should be based on rational factors. The disparity between the economic reality in which consumers (the public) live and government economic expectation should not be large. Expectations are notional views about certain variables like future interest rates,

prices or tax rates and are said to be rational if they are not systematically wrong or 'biased', and if they use all available information. Adaptive expectations are formed on the basis of past behaviour (Kischka (et.al. eds.), 2000:363; Mohr and Fourie, 1995:191-192, 219, 448-449, 521; Samuelson and Nordhaus, 1992:736).

Pr18 - Leadership succession crisis (270)

- If a country has a history of authoritarian political structure (*Rate between 31 and 40*)
- If a leadership vacuum is anticipated in the next eighteen months (*Rate between 21 and 40*)
- If a national social identity crisis occurs as a result of leadership succession (*Rate between 10 and 30*)
- If political civil unrest is a result of leadership succession (*Rate between 31 and 40*)
- If public scandals forces leadership succession (*Positive change, rate between 0 and 20; negative implications, rate between 21 and 40*)
- Expected re-election or smooth transition (*Rate between 21 and 40*)
- Successor to executive familiar and gradually introduced (*Advantageous results, rate between 0 and 20; disadvantageous, rate between 21 and 40*)

In a country that has shown a tendency for unlimited executive terms of government, the lack of an identifiable successor to an executive is alarming. Terms of office are often entrenched in a constitution, but unlimited executive power with no means of checking or balancing such power, can steamroll amendments through an incapacitated legislature (Venter, 1999:90).

Pr19 - Military in politics (120)

- If government is under military control (*Rate between 21 and 40*)
- If political leadership habitually wear uniform in public (*Rate between 31 and 40*)
- Are boundaries of military responsibility well-defined or ill-defined (*Well-defined, rate between 0 and 20; ill-defined, rate between 21 and 40*)

The role of the military in politics has always been a contentious one, and can include rising or dropping government expenditure on defence, to military coups and revolutions. In many cases the military is regarded as the elite institution in developing countries. It is a structure that can be highly significant in shaping the type and style of political participation permitted in a country. In many instances political leaders are more concerned with what the military reaction will be to their decisions than with the reactions of legislatures, the courts or the public. The maintenance of civilian control in developing countries is a sensitive issue, especially in cases where political institutions have not yet reached high levels of development and stability. The key seems to be setting limits within which military leaders and members of the army accept a government's definition of appropriate areas of responsibility. Military rule has negative correlations with economic development and often results in political decay (Mahler, 2000:170-171).

Pr20 - Erosion of middle class support for the regime (80)

- Level of economic and social deterioration (*Low levels of deterioration, rate between 0 and 20; high levels of deterioration, rate between 21 and 40*)
- An erosion of popular trust and confidence in government (*High levels of confidence, rate between 0 and 20; low levels of confidence, rate between 21 and 40*)

The assumption is that, within a democracy at least, government enjoys support from the majority of the middle class. If this support declines, it can be seen as a symptom of discontent with government behaviour or policy output. In some developing countries, support from the disadvantaged masses also

ensures continued office, but with less of a means of policy coercion behind it. Nevertheless an erosion of popular consent and confidence in government is troublesome for a continuous and stable policy mandate (Kotze, 2000:79-95; Raddock, 1986:4).

Pr21 - Unconstitutional change of government (100)

- If a violent change of government has occurred in past five years (*Rate between 21 and 30*)
- If more than one violent change of government has occurred in the past five years (*Rate between 31 and 40*)
- If peaceful, yet unconstitutional change of government has occurred in the past five years (*Rate between 0 and 20*)
- If no unconstitutional changes have taken place (*Rate between 0 and 10*)

An unconstitutional change in government is closely correlated with instances of political violence in the form of a (military) coup or revolution, or even an assassination. Statistically though, the past occurrence of unconstitutional and unanticipated changes in government raise the potential for such change(s) to take place again. The assumption is that instances of such changes are in direct negative correlation with political and government stability (Venter, 1999:91).

Pr22 - Ideology as a political factor (80)

- Degree of influence of secular ideology on government policies (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- If anti-systemic government policies prevail (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Ideology gives a government its sense of purpose, and thus relates directly to the critical components of a government's relation to political ideas and political behaviour. Political ideology is often cited as a contributing factor to political risk. Different from credit risk, a country might be able to service its international loans or repay its debt but might refrain from doing so. In turn, it follows that a country might be able to lend money to another but refrains from doing so citing reasons that are ideological in nature (Bunge, 1998:197; Venter, 1999:89).

Pr23 - Organised religion in politics (80)

- Degree to which religion is a factor in government policy formulation (*High degree, rate between 21 and 40; low degree, rate between 0 and 20*)
- If anti-systemic government policies prevail (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Organised religion in politics can be extreme as in the case of the Taliban in Afghanistan, or manifest itself as praying before political meetings, or as inherent values like those of Buddhism or Zen. Religious minorities are often underrepresented in legislatures, but, be that as it may, the assumption is that the role of an official should remain that of representing the public. Trouble sets in when the public good is compromised by religious zeal in politics (Venter, 1999:89).

Pr24 - Demographic and traditional parochialism (320)

- Do social problems pose a challenge to the viability of government (*No, rate between 0 and 20; inconsequential, rate between 11 and 30; yes, rate between 31 and 40*)
- If parochial values and structural elements in government contrast negatively with modern ideas and institutions in society (*Rate between 11 and 30*)
- Level of conflict of central government with modern elements of society (*Rate between 21 and 40*)
- Level of conflict of central government with traditional elements of society (*Rate between 21 and 40*)

- If clashes between tradition and modernity in society lead to incidents of violence (*Low incidence, rate between 0 and 20; high incidence, rate between 21 and 40*)
- Is urbanisation controlled, or does it place a burden on the state system to provide social needs (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Can institutional and physical infrastructure handle rapid urbanisation (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- A destabilising dense urban population (*Rate between 31 and 40*)
- If demographic and traditional parochialism either do not occur, or are not destabilising (*Rate between 0 and 10*)

Demographic change is part of the evolutionary process of economic modernisation. As countries develop from being predominantly agrarian in nature to becoming technologically sophisticated, the demographics also change. This process is usually slow and stable. But developing countries are forced to catch up with modernised industrial countries in order to become competitive in international markets. Sudden changes in the demands for production have seen a decline in rural populations and increasing demands placed on urban centres. Uncoupled with political development, clashes between tradition and modernity in society can lead to incidents of violence. Uncontrolled urbanisation often places a burden on the state system to provide for mounting social needs and institutional and physical infrastructure often fall short of handling rapid urbanisation by a destabilising dense urban population (Bunge, 1998:37; Carley, 1981:130-172).

Pr25 - Corruption/nepotism in government (100)

- If corruption exceeds the bounds of people's acceptance (*Rate between 21 and 40*)
- Companies have to budget for bribery (*Rate between 21 and 40*)
- Incidence of corruption and nepotism low (*Rate between 0 and 20*)

Having mentioned the race for modernisation, of great potential significance may be the influence of 'rich-country' social and economic standards on developing country salary scales, elite lifestyles, and general attitudes toward the private accumulation of wealth. Such attitudes can often breed corruption in a privileged minority. The effect of corruption is that it creates vulnerability among countries in which forces largely outside their control can have decisive and dominating influences on their overall economic and social well-being. Causes of corruption include trade restrictions, government subsidies, price controls, multiple exchange rate practices and foreign exchange allocation schemes, low wages in the civil service, natural resource endowments and sociological factors. Consequences of corruption include lowered investment and retarded economic growth, misallocation of talent, reduced aid flows, loss of tax revenue, adverse budgetary consequences, lower quality of infrastructure and public services and a distorted composition of government expenditure. Transparency International, as well as Gallup International both publish annual ratings or corruption indices, and are both a good measure of the perception of corruption within countries and industries (Kischka et.al.(eds.), 2000:363; Lane, DiStefano and Maznevski, 2000:469-477; Todaro, 1989:42,43; Venter, 1999:91).

Pr26 - Law tradition (110)

- If a tradition of order and the rule of law prevails (*Rate between 0 and 20*)
- If a culture of lawlessness exists (*Rate between 21 and 40*)

- Level of protection of investments under the sovereign law of a host country (*High, rate between 0 and 20; low, rate between 21 and 40*)
- If government manages to uphold peace and stability (*Rate between 0 and 10*)

The authoritative allocation of resources with which politics is concerned deals with laws. The rule of law protects individuals from government and from one another, as a system of rules and regulations that maintains order in society and government business, thus organising both the public and private sphere. No government or executive should be above the law. The socio-economic explanation that crime levels and the degree of lawlessness in a country are directly correlated (Bunge, 1998:90; Carley, 1981:167-168; Kischka et.al.(eds.), 2000:23), are often offered together with observations of a culture of non-payment in some societies. Past unexpected government repudiation of contracts or remittance policy changes also place a government's adherence to the rule of law in question. It is assumed that a country that engages in international trade is party to many international trade regimes and complies with the international standard rule of law.

Pr27 - Status of the media (130)

- If public access to international media broadcasts is controlled (*No, rate between 0 and 15, yes, rate between 16 and 30*)
- If persecution of journalists for criticising government prevails (*No, rate between 0 and 15; yes, rate between 16 and 30*)
- Level of institutionalised media censorship (*Low, rate between 10 and 20; high, rate between 21 and 30*)
- Level of voluntary self-censorship by media (*Low, rate between 10 and 20; high, rate between 20 and 30*)
- Media freedom uninhibited (*Rate between 0 and 10*)

The degree to which a government 'allows' freedom of speech indicates its willingness to limit its power over such public mechanisms. It is assumed that a government or executive that is prone to limiting media freedom is probably also very sensitive to criticism. Censorship laws and rules regulating public access are also an indication of government tolerance to foreign influences and might even indicate to a greater or lesser degree the role that ideology or even religion might play in politics. The status of the media basically reflects the freedom accorded to the news media to report and editorialise (Borsuk, 2001:237; Venter, 1999:89; Wolfsfeld, 1984:363)⁸.

Pr28 - Human rights record / status (65)

- Signatory of United Nations Declaration of Human Rights Accord (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- If basic human rights are denied due to racial, ethnic or political affiliations (*Rate between 20 and 30*)
- If basic human rights are upheld or enshrined in the constitution or Basic Law (*Rate between 0 and 5*)

As an indication of the adherence to the international standard rule of law, a country's human rights record also serves the purpose of indicating levels of government tolerance when challenged or threatened. A country's human rights status is also used as a benchmark for acceptance into international

⁸ Reports on the passage of a law in Singapore that allows punishment of foreign news broadcasters deemed to be engaging in the domestic politics of Singapore.

organisations and can even serve as a non-tariff trade barrier (<http://www.africainstitute.org>;
<http://www.amnesty.org/web/ar2000web.nsf>).

Pr29 - Quality of the bureaucracy (120)

- Are government functions efficient and timely (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Is internal communication functional (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Does government misappropriate funds to the peril of public services (*No, rate between 0 and 15; yes, rate between 16 and 30*)
- Are academic professional qualifications of civil servants questionable and/or of low levels (*No, rate between 0 and 15; yes, rate between 16 and 30*)

As the size and scope of the bureaucracy is quite extensive in any country, in many developing countries the bureaucracy or government is the main employer and a vehicle for job creation. By measuring the amount of state-owned enterprises (SOE's) in a country, the extent of a bureaucracy can be gauged. Bureaucratic delays cost foreign investors large amounts of money. Top-level appointments in any bureaucracy are often political appointments and reshuffling of offices can be expected around election time. The function of a bureaucracy is basically to administer the policy of the executive and to advise that office, not to make policy of its own as bureaucracies are not elected by popular franchise. The growth of bureaucracy is often worrisome, but often deemed necessary in order to administer increasingly complex social policy (Beetham, 1987:58; Heady, 1984:59; Lefort, 1986:96; Mahler, 2000:117-119; Weber, 1978:196).

Pr30 – Political Will (65)

- Public officials are career civil servants (*Rate between 0 and 10*)
- Public officials are not in office for self-enrichment (*Rate between 0 and 10*)
- Policy is designed and enforced in the best interest of the public (*Rate between 0 and 15*)
- Lack of political will (*Rate between 16 and 30*)

A cause of planning failures is not simply a lack of domestic economic potential within a country nor even inadequate administrative capacity. Poor plan performance and the growing gap between plan formulation and implementation can also be attributed to a lack of commitment and political will on the part of many developing country leaders and decision-makers. Political will further entails political courage to challenge powerful elites, internal conflicts and interest groups. It also includes the will to extract public revenue from the more accessible sources to finance projects, especially development projects in developing countries. It is assumed that levels of political will are relatively higher in decision and policy makers that show strong leadership (Todaro, 1989:529, 535, 555, 641).

Pr31 - Member state of international organisations (30)

- Member state of the United Nations, World Trade Organisation, World Tourism Organisation, International Telecommunications Satellite Organisation, European Union, Organisation of Petroleum Exporting Countries, SADC, African Union, SACU, ASEAN, NAFTA, NEPAD (*Active member, rate between 0 and 15; non-active member, rate between 16 and 30*)

Membership of multilateral, or even bilateral agreements for that matter is an indication of international compliance. Conditions for and prerequisites of membership often involve factors like democratic principles, a free and open market, a 'clean' human rights record and political stability. Multilateralism

involves a policy of acting in concert with other countries to achieve certain objectives (Evans and Newnham, 1992:205). Membership also indicates a commitment to 'openness' and an acknowledgement of the increasingly interdependent nature of international business.

Pr32 - Domestic openness (120)

- Domestic transparency (*Perception of domestic transparency high, rate between 0 and 10; low, rate between 11 and 20*)
- Modern legal frameworks (*If followed as such, rate between 0 and 10; if not, rate between 11 and 20*)
- Adherence to International Law (*If adhered to, rate between 0 and 10; if not, rate between 11 and 20*)
- Steps to eliminate the perception of corruption (*If such steps in place and effective, rate between 0 and 10; if such steps in place but ineffective, rate between 11 and 20; if no attempt to eliminate or curb corruption, rate between 21 and 30*)
- Building of strong modern institutions founded in stable political institutions (*If in place, rate between 0 and 10; if signs of development, rate between 11 and 20; if lacking, rate between 21 and 30*)

The assumption is that the more 'domestically open' a society is, the more tolerant it will be to foreign business. The nature of government policy directly influences the level of domestic openness as a whole (Bunge, 1998:354).

Pr33 - Geographic position (130)

- Geopolitics (*If host country is in a favourable geopolitical position, rate between 0 and 10; if host country is in a vulnerable but manageable geopolitical position, rate between 11 and 20; if host country is in vulnerable and unmanageable geopolitical position, rate between 21 and 30*)
- Systemic status-rank (*If climbing, rate between 0 and 10; if sustainable high, rate between 11 and 20; if dropping rate between 21 and 30; if very low, rate between 31 and 40*)
- Position in systemic conflict (*If not involved in systemic conflict, rate between 0 and 10; if a mediating force in systemic conflict, rate between 11 and 20; if direct party to systemic conflict, rate between 21 and 30*)
- Regional vulnerability (*Low degree of regional vulnerability, rate between 0 and 15; if high degree of regional vulnerability, rate between 16 and 30*)

Geopolitics is a method of foreign policy analysis that seeks to understand, explain and predict international political behaviour primarily in terms of geographical variables such as location, size, climate, topography, demography (Bunge, 1998:37), natural resources and technological development and potential (Levinsohn, 2002:38-43). The idea that political identity and action is determined (more or less) by geography can play a role in political risk analysis to a larger or smaller degree (Evans and Newnham, 1992:111-112). The contagion effect of the Asian Financial Crisis is also a case in point that illustrates the effect that regional location and vulnerability can have (Heaney and Hooper, 2001:299-312). Regional tendencies can also be monitored in an attempt to identify signs that countries, as yet untouched by events within a region, might be on their way to the same circumstances.

Pr34 - Contract repudiation by government (210)

- Cancellation of operating licenses (*No instances of cancellations, rate between 0 and 10; infrequent and selective instances of cancellations, rate between 11 and 20; frequent and unexpected instances of cancellations, rate between 21 and 30*)
- Cancellation of import and/or export licences (*No instances of cancellations, rate between 0 and 10; infrequent and selective instances of cancellations, rate between 11 and 20; frequent and unexpected instances of cancellations, rate between 21 and 30*)
- Cancellation of concession agreements (*No instances of cancellations, rate between 0 and 10; infrequent and selective instances of cancellations, rate between 11 and 20; frequent and unexpected instances of cancellations, rate between 21 and 30*)

- Restrictions on remittances (*No restrictions, rate between 0 and 10; varying degrees of restrictions, rate between 11 and 20; high degree of restrictions, rate between 21 and 30*)
- Retraction of drilling rights (*No past retractions, rate between 0 and 10; event-related past retractions, rate between 11 and 20; frequent and unmotivated retractions, rate between 21 and 30*)
- Government adherence to a Power Purchase Agreement (*Lawful compliance, rate between 0 and 15; failure to comply, rate between 16 and 30*)
- Creeping expropriation (*No evidence of creeping expropriation, rate between 0 and 10; slow and manageable creeping expropriation, rate between 11 and 20; unmotivated expropriation, rate between 21 and 30*)

The assumption is that the more cases of contract repudiation and license cancellations there have been in the past, the greater the chance of it occurring in the future, and the lower the levels of political, government and policy stability are. In such instances, the provisions that can be made for hedging against such events, by particularly including this in a contract during negotiations, does not really hold fast. In such cases, political risk insurance coverage is probably the better option, or even agreeing to extortion in order for such events ‘not to happen’ (Brewer, 1986:226-234).

Pr35 - Selective Discrimination (210)

- Ability to import the necessary equipment (*Investor able to import, rate between 0 and 10; imports negotiable, rate between 11 and 20; inability to import necessary equipment due to government restrictions rate between 21 and 30*)
- Ability to export (extracted minerals) (*Investor able to export, rate between 0 and 10; exporting negotiable, rate between 11 and 20; inability to export necessary equipment due to government restrictions rate between 21 and 30*)
- Degree of financial deficiency (*Government restrictions do not lead to financial deficiency of investment, rate between 0 and 15; restrictions lead to high levels of deficiency, rate between 16 and 30*)
- Forced abandonment in past eighteen months (*No forced abandonment of investments in the past, rate between 0 and 10; trend of forced abandonment subsided, rate between 11 and 20; forced abandonment eminent or current, rate between 21 and 30*)
- Forced divestiture in past eighteen months (*No forced divestiture of investments in the past, rate between 0 and 10; trend of forced divestiture subsided, rate between 11 and 20; forced divestiture eminent or current, rate between 21 and 30*)
- Deprivation of mobile assets in past eighteen months (*No deprivation of mobile assets in the past, rate between 0 and 10; trend of forced divestiture subsided, rate between 11 and 20; forced divestiture eminent or current, rate between 21 and 30*)
- Intellectual property rights disputes in past eighteen months (*No disputes in the past, rate between 0 and 10; possibility of flare-up in disputes, rate between 11 and 20; disputes lead to abandonment and divestiture, rate between 11 and 30*)

Selective discrimination is also a phenomenon that can hardly be expected, but it is possible to look for the ‘types’ of industries that have been discriminated against in the past, to look for the reasons why, or the events that led up to such discriminatory practices, and to strategise around them in anticipation. Foreign operations that are very profitable actually run a greater risk of experiencing selective discrimination, ironically enough because of their apparent prosperity, and political risks may alter operating cash flows via discriminatory regulations (Feils, 2000:129).

Pr36 - Political violence (270)

- Revolutionary uprising in past eighteen months (*No instances of revolutionary uprisings in the past, rate between 0 and 10; active and mobile revolutionary press or civil society keeps government in check, rate between 11 and 20; past trend of uprising as frequent reactionary force, rate between 21 and 30*)
- Rebellion in past eighteen months (*No instances of rebellion in the past, rate between 0 and 10; rebellion has led to change in government, rate between 11 and 20; past trend of rebellion, rate between 21 and 30*)

- Insurrection in past eighteen months (*No instances of insurrection in the past, rate between 0 and 10; insurrection has led to change in government, rate between 11 and 20; past trend of insurrection, rate between 21 and 30*)
- Hostile acts in past eighteen months (*No instances of hostile acts in the past, rate between 0 and 10; hostile acts has led to policy changes, rate between 11 and 20; high frequency of hostile acts, rate between 21 and 30*)
- Enforcement of belligerent power (*State does not practice coercive governance, rate between 0 and 10; government threatens with but doesn't revert to state-violence, rate between 11 and 20; state-violence used against citizenry is political in nature, rate between 21 and 30*)
- Instances of terrorism in past eighteen months (*No instances of terrorism in the past, rate between 0 and 10; acts of terrorism has led to policy changes in government and manifested as attacks on civilian targets, rate between 11 and 20; high frequency of terrorist acts without responsibility taken, rate between 21 and 30*)
- Instances of mobilism and riots in past eighteen months (*No significant trend in political rioting or rioting is area-bound, rate between 0 and 10; rioting around policy speeches, scandals and elections, rate between 11 and 20; high frequency of political rioting, rate between 21 and 30*)
- Instances of civil commotion and demonstrations in past eighteen months (*Civil commotion is organised, expected and within acceptable levels, rate between 0 and 10; commotion is volatile and instant, rate between 11 and 20; civil commotion erupts into violence, rate between 21 and 30*)
- Instances of malicious damage and looting in past eighteen months (*No instances, rate between 0 and 10; low instances, rate between 11 and 20, high instances focussed on the presence of foreign business of MNC's, rate between 21 and 30*)

Instances of political violence include acts of terrorism, guerrilla warfare and revolution as methods of political 'participation'. Although often restricted to a certain area or areas within a country, the spin-offs of international occurrences can be brought close to home. The implications to foreign business, as well as domestic business, can vary to certain degrees – from limitations in supplies necessary for production, interrupted government services, damage to physical property, kidnapping or even complete abandonment of the operation.

Pr37 - Elections (260)

- High voter turnout (*If high due to civil duty and participation, rate between 0 and 10; if high due to intimidation, rate between 11 and 20*)
- Low voter turnout (*If low due to complacency, rate between 0 and 15; if low due to lack of organisation or due to rigging, rate between 16 and 30*)
- Election laws (*Election laws internationally comparable and constitutional, rate between 0 and 10; election laws questionable, rate between 11 and 20; election laws not adhered to or do not exist, rate between 21 and 30*)
- Internationally compliant (*Elections are compliant with international standards, rate between 0 and 15; not compliant, rate between 16 and 30*)
- Open for scrutiny (*Election monitors and observers allowed into the host country if necessary, rate between 0 and 15; sanctioned or not allowed at all, rate between 16 and 30*)
- Intimidation and violence (*No reports of voter-intimidation or violence, rate between 0 and 15; frequent reports, rate between 16 and 30*)
- Irregularities (tampering, vote counting) (*No suspected irregularities, rate between 0 and 10; suspected irregularities, rate between 11 and 20; proven irregularities, rate between 21 and 30*)
- Press (*Total press freedom in election coverage, rate between 0 and 10; sanctioned press coverage, rate between 11 and 20; press intimidated, harassed and prevented from covering election, rate between 21 and 30*)
- International acceptance of result (*If accepted, rate between 0 and 10; if accepted with reservations, rate between 11 and 20; if unaccepted, rate between 21 and 30*)

The assumption can be made that, in the months preceding and following a national election, or any election for public office, the more politically stable a country is, the less incidences of political violence, intimidation and unforeseen policy changes and constitutional amendments there will be. Sudden changes in election laws, as well as irrational executive decrees also contribute to the degree of irregularity surrounding an election. The degree to which government policy is protected around

election-time, is an assumed indicator of government tolerance, competitiveness within the political system and overall political openness of a country. The more 'untouchable' a government and its decisions become, the less competitive a system becomes and the less tolerant it will probably be of public and private opposition.

4.4.2 Political Risk Factors: Economic

Er1 - Degree of liberalisation (120)

- Central Bank practices managed floating, only intervenes when necessary (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Are imports kept in line with exports, is trade balance negative or positive (*Positive, rate between 0 and 20; negative, rate between 21 and 40*)
- Does Central Bank only intervene to stabilise foreign exchange rates (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

It is assumed that an open economy engages in international trade of goods and capital with other countries and floats its currency on the open international market. Central bank activities include buying or selling government bonds to influence bank reserves, the money supply and interest rates (Bernhard and Leblang, 2002:316; Mohr and Fourie, 1996:80, 142, 479; Samuelson and Nordhaus, 1992:743).

Er2 - Risk of confiscation / expropriation (80)

- Country has a past five year record of confiscating foreign-owned enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Ideas of nationalisation flare up periodically and pose a threat to foreign-owned enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)

The risk of confiscation or expropriation implies the acquisition of privately owned assets by the state. A clear distinction is made between transfer of ownership of existing privately held assets to the state for political and ideological reasons and the role of government in establishing productive capacity. Nationalisation may be attractive to certain politicians and groups of voters or workers who want to increase their power, but nationalisation often results in large bureaucracies, inefficiency and political interference (Mohr and Fourie, 1995:55, 476-477). Government involvement might also come about as a result of bankruptcy in a major private industry or government might cite ideological reasons as a factor in the creation of SOE's (Todaro, 1989:568). Compensation for nationalised foreign enterprises are usually determined by the manner in which the property was acquired in the first place, the historical and replacement costs of the confiscated assets, the nature and record of the enterprise's relations with the government and people of the confiscating country prior to confiscation, and the financial benefits and economic returns that have already been reaped prior to the confiscation (Todaro, 1989:497). As mentioned previously, foreign enterprises that prove to be extremely profitable might actually run the risk of being confiscated due to their financial attractiveness.

Er3 - Stable labour force (280)

- If there is a shortage of skilled labour (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Are restrictions concerning the employment of expatriate personnel acceptable (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

- Is labour organised as an influential political force (*Less influential, rate between 0 and 20; highly influential, rate between 21 and 40*)
- Degree of corporatism (*High degree, rate between 21 and 40; low degree, rate between 0 and 20*)
- Impact of consequential split between government-labour alliance (*Disadvantageous, rate between 21 and 40; advantageous, rate between 0 and 20*)
- Degree of militancy and mobility of organised labour (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Is labour legislation liberal (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Although this factor can also be grouped as a political risk factor of political risk, it is placed under economic political risk factors due to the loss in profit and financial productivity that might be incurred due to labour instability. It is assumed that a labour force is that group of people 16 years of age and older who are either employed or unemployed, where labour is the exercise of human mental and physical effort in the production of goods and services. The quality of labour is usually linked to the notion of human capital that refers to the skill, knowledge, health, nutrition, and attitude to work of a labour force. It follows that an abundant labour supply results in a high quantity in labour but not necessarily high quality. Remuneration of labour is affected by factors not directly linked to labour market conditions, like taxation and workers' views as to what constitutes a living wage or a reasonable standard of living. Factors that affect the labour force participation rate (LFPR) include the age distribution of the population (the greater the proportion of the population in the 16-64 age group, the greater the labour force), retirement rules and the availability of social security (compulsory retirement tends to reduce the LFPR), social, cultural, religious or other conventions about the role of women in society (in a country where women are free or encouraged to work outside the home, the LFPR is higher), the availability of household appliances and childcare centres (enabling women to take up paid employment outside the home) and the level of development and structure of the economy (countries where light industry and services are important will have higher female (and total) LFPR's than countries whose economies are dominated by mining and heavy industry, for instance (Kischka et.al.(eds.), 000:363; Mohr and Fourie, 1995:37, 42, 138-139, 397, 412-414, 614, 652).

Er4 - Domestic economic strength (120)

- Size of average disposable income (*Large, rate between 0 and 10; average, rate between 11 and 20; small, rate between 21 and 40*)
- Inflation rate hikes correspond to wage increases (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Trends in consumerism (*Decline, rate between 21 and 40; rise, rate between 0 and 20*)

It is assumed that, the larger the average disposable income of a household, the larger the role that consumers play in influencing what domestic markets produce, which in turn determines economic strength. If wage increases counterbalance rising inflation, consumerism remains stable, as does the average disposable income. A decline in consumer spending is often seen as an indication of a weakening economy.

Er5 - Repatriation of profits policy (160)

- Transferability of profits out of the host country (*Easy, rate between 0 and 20; difficult, rate between 21 and 40*)

- Degree of convertibility of local currency (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Is there a trend towards repudiation of contracts (*High incidence, rate between 21 and 40; low incidence; rate between 0 and 20*)
- Are alternatives to restrictions on repatriation viable or not (*Viable, rate between 0 and 20; not viable, rate between 21 and 40*)

Higher taxes on corporate profits in developing countries restrict profit-taking, but can be raised disproportionately to corporate activity, exactly due to the fact that there is relatively less overall corporate activity in such countries (Brewer, 1986:226-234; Kischka et.al. (eds.), 2000:363).

Er6 - Foreign equity ownership policy (160)

- Can investors' stake in an enterprise be larger than 50% (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is less control acceptable in the hope of getting quick approval from the authorities (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Can local partners delay approval of business plans of foreign partners (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Allowance of international arbitration agreements (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

It is assumed that the larger a host country's share in a foreign enterprise, the larger the profit-taking is for the host country. In some host countries, foreign investors agree upon less control of their investment in turn for the expeditious approval of their operation by government. Where the assumption of an operation is delayed due to local partners stalling the process, the amount of money lost in an unproductive waiting period can hardly be 'made back'. Countries that allow or acknowledge international arbitration agreements are usually less prone to instigating such delays and insisting on more than 50% ownership of foreign operations or enterprises (Mohr and Fourie, 1995: 476-477, 594).

Er7 - Privatisation of important industries / sectors (160)

- Host country favours monopolies and state enterprises over private enterprises (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- 'Large' private sector is protected by tariff barriers, monopolies or government contracts (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Does private sector rather serve as routing for uncontrolled foreign exchange outflows (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Have previously nationally owned enterprises been privatised to improve service (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

It is assumed that privatisation implies the preponderance of private ownership of the means of production and the selling of public assets (corporations) to private business interests, thus facilitating the transfer of ownership and control from the public to the private sector. In some host countries, state owned enterprises (SOE's) are still favoured due to a lack of private incentive to engage in promising economic activities because of uncertainty about the size of local markets, unreliable supply sources, a lack of technology and a lack of skilled labour. Developing countries might favour privatisation initiatives in order to expand employment and facilitate the training of the labour force and they might be able to increase export earnings by creating export industries (Todaro, 1989:568). Privatisation also enables the financing of increased government expenditure where tax burdens are already very high. Government ownership is often less efficient than private ownership and it follows that the role of the

government in an economy should be reduced, creating more scope for private ownership and private initiative. Losses of inefficient SOE's are often a major source of budget deficits and other fiscal problems (Kischka et.al. (eds.), 2000:363; Mohr and Fourie, 1995:55, 476-477, 594).

Er8 - GDP (200)

- A declining GDP would result in subsequent social intolerance of government (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Relative value of goods and services is acceptable (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Expenditure to produce goods and services is at an acceptable level (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Income received from producing goods and services is at an acceptable level (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Level of general and secondary economic activity (*High, rate between 0 and 20; moderate, rate between 10 and 30; low, rate between 21 and 40*)

The Gross Domestic Product (GDP) of a country, as a measure of production, income and expenditure, refers to the total output produced inside a country during a given year. This contrasts with Gross National Product (GNP), which is the output produced by factors owned by the country (Mohr and Fourie, 1995:91-100, 108, 110; Samuelson and Nordhaus, 1992:737).

Er9 - Nationalisation of key industries / sectors (200)

- Efficiency of state-owned enterprises (*Efficient, rate between 0 and 20; inefficient, rate between 21 and 40*)
- Are state-owned enterprises monopolistic and protected from competition (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Are state-owned enterprises politicised, run and staffed by government supporters or retired military personnel (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Are state-owned enterprises export-oriented and competitive (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Are state-owned enterprises geared for positive expansion and development (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

Direct government control may be required to ensure prices are not set above the cost of producing the output. Goods that have a high social benefit are usually provided at a price below their costs or even free, thus the private sector has no incentive to compete for the production of such goods. SOE's are often used as initial instruments of capital formation when private savings are very low – based on the rationale that investment breeds further investment. For reasons of income distribution, government may locate enterprises in certain sectors, particularly in 'backward' economic areas where there is little or no private incentive to create economic activity. SOE's are also used as instruments of gaining national control over strategic sectors of the economy such as defence, for instance. Profitability of SOE's is usually low, as they have to pursue both commercial and social goals (goods offered below cost as subsidy, or hiring extra labour to meet national employment objectives) (Todaro, 1989:567-569).

Er10 - Losses from exchange controls (130)

- If currency conversion crises prevail (*Rate between 21 and 40*)
- Central Bank manages to stabilise domestic currency against international exchange rates (*Rate between 0 and 20*)
- Fixed exchange rate prevails under high inflation (*Rate between 10 and 30*)

- Currency depreciation (*Anticipated and controlled, rate between 0 and 20; uncontrollable and rapid, rate between 21 and 40*)

It is assumed that currency depreciation takes place when a country's currency declines in value relative to other foreign currencies (Samuelson and Nordhaus, 1992:734). This might be profitable for the exporting of goods and services but foreign operators that have to import machinery essential to their productivity in a host country experiencing rapid currency devaluation or a weakening currency will face financial difficulty. In some cases, a currency is so weak that there is no demand for it on the foreign exchange market and local earnings cannot be converted due to a lack of currency buyers. Where earnings are in US Dollars though, the repatriation of those earnings are problematic in cases where host governments restrict the repatriation if those dollars in an effort to 'keep them in the country' (Dealmaker, 2002:5; Samuelson and Nordhaus, 1992:734).

Er11 - Degree of protectionism (240)

- Private enterprise is overly protected by tariffs (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Monopolies are protected from competition (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Non-tariff barriers hedge against competition (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Are government contracts the primary income of an industry (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Is import substitution subsidised (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Do quotas, licensing or bureaucratic delays hedge against foreign investment (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Any policy adopted by a country to protect domestic industries against competition from imports, most commonly a prohibitive or non-prohibitive tariff, quota or non-tariff barrier (like transport costs and health regulations) imposed on such imports, are protectionist in nature and negate the flow of free trade. Tariffs not based on sound economics include mercantilist ideological underpinnings, tariffs for special interest groups, competition from cheap foreign labour, import relief and retaliatory tariffs (anti-dumping) (Samuelson and Nordhaus, 1992:677-690). Infant industries and SOE's are often protected in this manner and are based on the rationale of economic nationalism and import substitution industrialisation (Mohr and Fourie, 1995:436).

Er12 - Militancy of organised labour (160)

- Organisation and mobility of labour (*No consequence, rate between 0 and 10; some consequence, rate between 11 and 20; serious consequence, rate between 21 and 30; extremely serious consequences, rate between 31 and 40*)
- Is membership of a labour organisation compulsory (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Willingness of labour to negotiate rationally with management (*Willing, rate between 0 and 20; unwilling, rate between 21 and 40*)
- Confrontation between rival labour organisations is reason for incidents of violence (*No, rate between 0 and 20; yes, rate between 21 and 40*)

Unions affect wages by restricting the labour supply, bargaining for standard rates, following policies designed to shift productivity or the demand schedule for labour upward, and by countering the monopsony and monopoly bargaining power of employers (Samuelson and Nordhaus, 1992:249-263).

Official trade unions can prove to be a strong political and economic force in especially corporatist-type policy agreements. Former trade union leaders occupying important political offices after an election, is indicative of the prominent role of labour union movement in a country. Trade unions serve as a countervailing force to the bargaining power of employers – major points of reference in strike action include what other workers are ‘getting’, the employer’s ability (and willingness) to pay, changes in the cost of living and overall productivity (Mohr and Fourie, 1995:37, 42, 138-139, 397, 412-414, 614, 652).

Er13 - Competitiveness (240)

- Degree of export-led orientation followed in the economy (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Import substitution resulted in subsequent exports (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is there a large number of domestic buyers and sellers of products produced locally (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Degree of interventionist measures practised domestically by government (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Degree of mobility of factors of production domestically (*High, rate between 0 and 20; low, rate between 21 and 40*)
- Are buyers and sellers free to enter and leave the domestic market (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

It is assumed that competitiveness is an important feature of an ‘open economy’, or market capitalism, as competition occurs on each side of the market – among suppliers (sellers) on the one hand, and buyers (consumers) on the other. Competition among sellers protects consumers against exploitation and promotes efficiency and growth. Such competition also creates order among suppliers, as successful competitors are more profitable. But because competition is not always free and fair (Mohr and Fourie, 1995:51-53; Smith, 1776:130), interventionist practices and protectionism tends to be the result of inequality and instability. Imperfect competition refers to markets in which perfect competition is not possible due to at least one seller or buyer being large enough to affect market prices by monopsony (being the only buyer), oligopoly or monopolistic competition. In such cases, competitive equilibrium can never be reached and is probably not pursued either. There are, however, a multitude of government policies that can encourage competition, including antitrust policies, minimising the barriers to competition, competition from foreign firms, competitive bidding for contracts, the removal of regulatory or other constraints to competition and allowing smaller businesses to enter established areas (Samuelson and Nordhaus, 1992:179-194, 732).

Er14 - Level of state intervention (320)

- Is government economic planning centralised (*Marginally, rate between 0 and 20; largely, rate between 21 and 40*)
- Is there strict government control of import licenses (*Less restrictive, rate between 0 and 20; more restrictive, rate between 21 and 40*)
- Level of government control of new investment in terms of general or production targets (*Low, rate between 0 and 20; high, rate between 21 and 40*)
- Are banks state-owned (*Some, rate between 0 and 15; mostly, rate between 16 and 30; all, rate between 31 and 40*)
- Are state-owned banks selective in directing credit to certain sectors (*Not selective, rate between 0 and 10; moderately selective, rate between 11 and 25; very selective, rate between 26 and 40*)

- Are industry and agricultural sectors state-owned / controlled (*Some, rate between 0 and 10; mostly, rate between 11 and 25; all, rate between 26 and 40*)
- Is entrepreneurship promoted (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- To what extent are inflexibility and inefficiency results of central planning (*Some, rate between 0 and 20; large, rate between 21 and 40*)

The roles of SOE's have been mentioned before, as have the measures of privatisation, nationalisation and competitiveness. Government intervention can also include the activity of government buying or selling its currency on the foreign exchange markets in order to affect its currency's exchange rate (Samuelson and Nordhaus, 1992:739). Government might justifiably intervene economically in order to keep the prices of basic foodstuffs low as part of a policy to assist the poor, to avoid the exploitation of consumers by producers or to avoid 'unfair' prices and to combat inflation (Mohr and Fourie, 1995:221). High levels of government intervention and centralised planning point toward a certain type of state system and government organisation (one-party dominant state, autocracy, dictatorship) and stands in complete contradiction to *laissez-faire* practices.

Er15 - Economic impact of AIDS (200)

- Is AIDS a destabilising factor in the economy of the host country (*No, rate between 0 and 20; yes, rate between 21 and 40*)
- Is government policy toward AIDS realistic (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Will the infrastructure in the host country be able to cope with the consequences of AIDS (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is AIDS a threat to the economic security of the host country (*Yes, rate between 0 and 20; no, rate between 21 and 40*)
- Is AIDS a threat to regional economic security and stability (*Yes, rate between 0 and 20; no, rate between 21 and 40*)

It is assumed that labour is a very important factor of production in any country and for any foreign investor. It has also been explained that the health of a labour force directly impacts upon and contributes to the quality of a labour force, and thus directly impacts upon its levels of productivity. It follows that the destabilising effect that HIV/AIDS will have on labour forces, productivity, economies and profitability is highly significant and an unavoidable given. Government policy toward the pandemic in terms of expenditure as well as welfare and health policy, including economic contingency plans and strategy, also indicates the degree of government responsibility and political will to deal with the realities of the issue, and the quality and nature of its policies (Ostergard, 2002:333-350).

Er16 - Efficient banking system (180)

- Is the existence of state-owned banks complementary to privately owned banks (*To large extent, rate between 0 and 15; to some extent, rate between 16 and 30*)
- Are interest rates realistically determined (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Is Central Bank competency recognised (*Internationally, rate between 0 and 15; regionally, rate between 16 and 30*)
- Are personal funds available on request (*Immediately, rate between 0 and 15; on application, rate between 16 and 30*)
- Is foreign exchange available on request (*Immediately, rate between 0 and 15; on application, rate between 16 and 30*)
- Are private banking facilities sophisticated, internationally competitive and comparable, and safe (*Yes, rate between 0 and 15; no, rate between 16 and 30*)

It is assumed that the competence of a Central Bank or Reserve Bank, as well as the competency of commercial and savings banks, are an indication of the efficiency of a country's banking system and functional financial sector. A Central Bank is an institution established by government, responsible for controlling a country's money supply and credit conditions, and for supervising the financial system – especially commercial banks. A commercial bank acts as a financial intermediary between individuals and companies on the one hand and the Central Bank on the other. A Central Bank is, among other things, responsible for the implementation of monetary policy, and, as the monetary authority, issues money, acts as a 'banker's bank', as a banker for government, as a custodian of a country's gold and other foreign reserves, and formulates as well as implements monetary policy (Mohr and Fourie, 1995:426; Todaro, 1989:544). Commercial banks hold savings or fixed (time) deposit and money market deposit accounts, sell traveller's cheques and perform other financial services like lending to individuals, firms and even countries (Samuelson and Nordhaus, 1992:730, 737). Financial institutions in many developing countries are highly unorganised, often externally dependent and spatially fragmented. The ability of these governments to regulate the national supply of money is further constrained by the openness of their economies and by the fact that the accumulation of foreign-currency earnings is a significant but highly variable source of domestic financial resources (Bernard and Leblang, 2002:316; Todaro, 1989:542).

Er17 - Confidence in finance ministry (60)

- Is competency of finance minister recognised (*Internationally and domestically, rate between 0 and 15; regionally, rate between 16 and 30*)
- Confidence in policy penetration (*High, rate between 0 and 10; medium, rate between 11 and 20; low, rate between 21 and 30*)

It is assumed that high levels of domestic and international levels of confidence in a country's finance ministry is an indication of high levels of domestic and international confidence in a country's macroeconomic and fiscal policy. Even better though, are cases in which such confidence is concomitant to policy penetration and execution and the reaching of realistically set goals. Ministerial flexibility, competence and agility are also tested in cases where policy that was not necessarily faulty but was still ineffective, was adapted in order to remedy ineffective policy.

Er18 - Real interest rate (90)

- Is interest rate minus inflation rate low or high (*High, rate between 0 and 15; low, rate between 16 and 30*)
- Levels of the cost of borrowing money (*Low, rate between 0 and 15; high, rate between 16 and 30*)
- Is the real interest rate coupled with a low inflation rate (*Yes, rate between 0 and 15; no, rate between 16 and 30*)

It is assumed that an interest rate is the price paid for borrowing money for a period of time, usually expressed as a percentage of the principal per year – in other words, an interest rate is the cost of borrowing money. The real interest rate is the nominal interest rate less the rate of inflation, and shows signs of increase if monetary policy is tightened in reaction to a high inflation rate (Samuelson and Nordhaus, 1992:500, 739). It is assumed that higher interest rates will discourage the borrowing of

money and encourage saving and investment, but in developing countries investment decisions are often not very sensitive to interest rate movements (Todaro, 1989:543).

Er19 - MIGA signatory (30)

- Is the host country a signatory to the Multilateral Investment Guarantee Agency (*Full, rate between 0 and 15; conditional, rate between 16 and 30*)

As a signatory of this agreement, a host country implies the ability as well as the willingness for international compliance. As a debtor nation, being a MIGA signatory (among other things) lends creditworthiness (Brewer, 1986:36-45).

Er20 - Sound physical infrastructure (240)

- Can goods be transferred and delivered on time by air, road and rail (*To large extent, rate between 0 and 15; to a lesser extent, rate between 16 and 30*)
- Are there often electricity supply problems (*Not often, rate between 0 and 15; often, rate between 16 and 30*)
- Condition of public roads (*Good, rate between 0 and 10; fair, rate between 11 and 20; poor, rate between 21 and 30*)
- Availability of storage and warehousing capacity and facilities (*Readily, rate between 0 and 10; adequate, rate between 11 and 20; scarce, rate between 21 and 30*)
- Are volumes of new property developments or industrial construction sites in relation with general economic developments (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Are regular flights in and out of the host country reliable (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Are repairs to damaged property or infrastructure regularly undertaken (*Regularly, rate between 0 and 15; not so regularly, rate between 16 and 30*)
- Are roads maintained and networks improved (*Improved, rate between 0 and 10; maintained, rate between 11 and 20; neglected, rate between 21 and 30*)

It is assumed that a healthy and growing infrastructure indicates possibilities and a base for further capital accumulation. New factories, machinery, equipment and materials increase the physical “capital stock” of a nation and make it possible for expanded output levels to be achieved. These directly productive investments are supplemented by investments in what is often called social and economic ‘infrastructure’, like roads, electricity, water and sanitation supply, as well as in communications which facilitate and integrate economic activities (Todaro, 1989:115, 271, 284, 553). This might also indicate high and expansive levels of taxation though, raised in order to finance the development and maintenance of such infrastructure.

Er21 - Economic growth rate (150)

- Is there a trend toward a declining annual growth rate (*Slow decline, rate between 0 and 15; rapid decline, rate between 16 and 30*)
- Is there a trend toward an increasing annual growth rate (*Fast increase, rate between 0 and 15; slow increase, rate between 16 and 30*)
- Does economic growth create employment (*High level, rate between 0 and 10; jobless growth, rate between 11 and 20; low level, rate between 21 and 30*)
- Are measures being taken to reverse temporary decline in economic growth (*In time, rate between 0 and 10; just in time, rate between 11 and 20; too late, rate between 21 and 30*)
- To what extent is economic growth in irreparable decline (*Some extent, rate between 0 and 15; large extent, rate between 16 and 30*)

The economic growth rate reflects the increase (or decrease or stagnation) in the total output of a nation over time, and is usually measured as the annual rate of increase in a country's real GNP (Samuelson and Nordhaus, 1992:735). A country's factors of production, as well as growth in efficiency are of importance in reflecting a country's growth rate. Although one expects economic growth to be coupled with higher levels of employment, 'jobless growth' is also possible despite economic expansion. In this instance, an increase in production takes place without an accompanying increase in employment.

Er22 - Annual average inflation rate (120)

- Is escalation rate of inflation rapid or slow (*Slow, rate between 0 and 15; rapid, rate between 16 and 30*)
- Can the investor safeguard against a rising inflation rate by means of contract, or in the manner in which the organisation structures itself in the host country (*To large extent, rate between 0 and 15; to some extent, rate between 16 and 30*)
- Are sudden rises of the inflation rate a reflection of present distortions (*Trend will moderate, rate between 0 and 15; trend will intensify, rate between 16 and 30*)
- Do rapidly rising prices signify a continuation of social and political problems associated with allocative inefficiency (*To some extent, rate between 0 and 15; to large extent, rate between 16 and 30*)

Two definite effects of inflation are a redistribution of income and wealth among different classes, and distortions in the relative prices and outputs of different goods, or in output and employment for an economy as a whole. Inflation affects income and assets, randomly redistributing wealth around the population with little significant impact on any single group (unlike taxation). Unanticipated rises in inflation redistributes wealth from creditors to debtors (favouring those who have borrowed money), while an unanticipated decline in inflation has the opposite effect (favouring those who have lent money). Because of the 'costs' of inflation, containing inflation is one of the prime targets of a government's macroeconomic policy – unbalanced inflation distorts relative prices, tax rates, and real interest rates (Kischka et.al.(eds.), 2000:363; Samuelson and Nordhaus, 1992:594-595, 599).

Er23 - Economically active population (90)

- Percentage of people between the ages of 16 and 65 years exceeding that of people between the ages of 0-15 years, and 66 years and above (*If trend is positive, rate between 0 and 15; if trend is negative, rate between 16 and 30*)
- Measure of economically active population having easy access to health facilities and education (*Large measure, rate between 0 and 15; small measure, rate between 16 and 30*)
- Percentage of the economically active population having completed a secondary education (*High, rate between 0 and 15; low percentage, rate between 16 and 30*)

Included in measurements of the economically active population as a means of production, some inherent factors are included. Population growth and disease should be controlled and health and nutrition improved to enable workers to be more productive and to prevent a loss in man-hours due to sick leave (paid) or lengthy hospital visits. Workers' education should be improved, their rate of illiteracy reduced, and their skills level raised, as educated people become more productive workers who can use capital more effectively, adopt new technologies, and learn from mistakes (Samuelson and Nordhaus, 1992:697). Signs of a 'brain-drain' indicate symptoms of skilled members of the labour force having exhausted their efforts within a home economy.

Er24 - Change in real wages (90)

- Do real wages rise advantageously in relation to a rising inflation rate (*Yes, rate 0 and 15; no, rate between 16 and 30*)
- Do changes in real wages result in labour protest (*Seldom, rate between 0 and 15; often, rate between 16 and 30*)
- Do changes in real wages have disadvantageous social ramifications (*Seldom, rate between 0 and 15; often, rate between 16 and 30*)

Where a nominal wage is the amount of money actually received by a worker per hour, day, month or year, the real wage is the quantity of goods and services that can be purchased with the nominal or money wage. A higher inflation rate and no relative rise in real wages impacts negatively on the amount of goods and services that a worker can purchase (Mohr and Fourie, 1995:392).

Er25 - Price index (150)

- Are rapid increases in the price index prevalent (*No, rate between 0 and 15; yes, rate between 16 and 30*)
- Does indexation reduce the immediate effects of price increases (*Constantly, rate between 0 and 15; sporadically, rate between 16 and 30*)
- To which degree are causative factors of inflation constant (*Lesser degree, rate between 0 and 15; large degree, rate between 16 and 30*)
- Is the government winning or losing the battle against inflation (*Winning, rate between 0 and 15; losing, rate between 16 and 30*)
- To what extent is government neglecting economic matters in favour of political aims (*Lesser extent, rate between 0 and 15; large extent, rate between 16 and 30*)

The consumer price index (CPI) is an index or reflection of the prices of a representative “basket” of consumer goods and services. The CPI thus represents the cost of the “shopping basket” of goods and services of a typical or average household (as consumers with more or less of a disposable income) (Bunge, 1998:136; Mohr and Fourie, 1995:112-115, 128-130, 617-620, 623; Samuelson and Nordhaus, 1992:744). In this case as well, the impact of a rise in the inflation rate will result in the same basket of goods and services costing more, or in a consumer being able to purchase less goods and services for the same amount of money. The inflation rate is measured by the annual percentage change in the CPI. Of course, a drop in inflation is always welcome, but a stable rate of inflation is less worrying than a rapid increase or uncontrollable rise in inflation, implying that inflation can be uncontrolled as well, where government is not fighting inflation due to a lack of resources, will or competence.

Er26 - Current budget ratio (CBR) (210)

- Is size of country's public sector in decline or on the increase (*Decline, rate between 0 and 15; increase, rate between 16 and 30*)
- Does government use same form of price intervention or special subsidies (*Few, rate between 0 and 15; many, rate between 16 and 30*)
- Does the CBR express a moderate to very high government budget deficit (*Moderate, rate between 0 and 10; high, rate between 11 and 20; very high, rate between 21 and 30*)
- Does the CBR express persistently high negative or positive values (*High positive, rate between 0 and 10; moderate, rate between 11 and 20; high negative, rate between 21 and 30*)

The balance of trade account is the part of a country's balance of payments that deals with merchandise or visible imports and exports. When services (invisibles) are included, the total accounting for imports and exports of goods and services is called the balance on the current account (Samuelson and Nordhaus,

1992:730). A surplus on the current account indicates a net inflow of foreign capital into a country, whereas a deficit indicates a net outflow of capital due to, for instance, divestiture or financial sanctions (Mohr and Fourie, 1995:116-117, 131-132, 484-485; Venter, 1999:92).

Er27 - Discrimination against foreign business (170)

- Do non-tariff barriers prevent or improve the profitability of foreign investment (*Improves, rate between 0 and 15; prevents, rate between 16 and 30*)
- To what extent are licenses for foreign investors subject to discrimination in allocation of export and other licenses (*To lesser extent, rate between 0 and 10; to large extent, rate between 11 and 20*)
- Inclusion of foreign investors in quotas (*Included, rate between 0 and 10; not included, rate between 11 and 20*)
- To what extent do bureaucratic delays purposefully keep foreign investors out of the market (*Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20*)
- Acquisition of a visa for entry / residence in a host country (*Difficult, rate between 11 and 20; easy, rate between 0 and 10*)
- To what extent are foreign investors forced to adhere to prescribed hiring practices (*Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20*)
- Are company taxes moderate or very high (*Moderate, rate between 0 and 10; high, rate between 11 and 20*)
- Are product boycotts held against foreign produce (*Seldom, rate between 0 and 10; often, rate between 11 and 20*)

It is assumed that measuring the degree of discrimination against foreign business(es) in a host country, is reflective, among other things, of a country's general investment climate.

Er28 - Adequate international reserves (60)

- Does host country own enough in foreign reserves to cover three months worth of government expenses (*More than enough, rate between 0 and 10; less than sufficient, rate between 11 and 20*)
- Does a sizeable surplus or deficit prevail in the balance of payments (*Surplus, rate between 0 and 10; deficit, rate between 11 and 20*)
- Do imports exceed exports or does the opposite prevail (*Exports exceed, rate between 0 and 10; imports exceed, rate between 11 and 20*)

It is assumed that a country has adequate international reserves in its balance of payments, if an economy can sustain itself for at least three months (ideally more) should all factors of production come to an abrupt halt.

Er29 - Debt service burden (120)

- Does the host country have a good or bad reputation of default on international debts (*Good, rate between 0 and 10; bad, rate between 11 and 20*)
- Is international creditworthiness questionable or satisfactory (*Satisfactory, rate between 0 and 10; questionable, rate between 11 and 20*)
- Does debt service burden constitute more or less than 50% of GDP (*Less, rate between 0 and 10, more, rate between 11 and 20*)
- Does debt service burden exceed exports (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Does debt service burden prevent social and economic development (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Is debt service burden more than GDP (*No, rate between 0 and 10; yes, rate between 11 and 20*)

Whereas government inability to repay foreign debt is a credit risk, a government's unwillingness to repay debt is a political risk. In developing countries, government expenditure in terms of welfare, health, education, infrastructure and poverty relief programmes place enough of a burden on an often already strained budget. In some cases, the interest on foreign loans can hardly be serviced, and the

percentage of GDP used to repay loans outweighs public expenditure and percentage growth in the GDP. A country's debt service ratio as a percentage of exports is calculated as the year's sum of interest and principal repayments on external public and publicly guaranteed debt as a percentage of exports of goods and services (Bradley and Schaefer, 1998:115; Clegg, Ibarra-Colado and Bueno-Rodriguez, 1999:83-110; Coplin and O'Leary, 1998:302, Venter, 1999:92).

Er30 - Preservation of resources (100)

- Is extinction of species adequately controlled, monitored and hedged against (*Adequately, rate between 0 and 10; inadequately, rate between 11 and 20*)
- Has government formulated and implemented adequate environmental plans (*Adequate, rate between 0 and 10; inadequate, rate between 11 and 20*)
- Is population growth a threat to the preservation of resources (*No threat, rate between 0 and 10; substantial threat, rate between 11 and 20*)
- Levels of water contamination (*Low, rate between 0 and 10; high, rate between 11 and 20*)
- Does government practise development within national environmental legislation (*Yes, rate between 0 and 10; no, rate between 11 and 20*)

A country's potential for economic growth is greatly influenced by its physical resource endowment and consequently the protection thereof. Government regulations and policy should control harmful externalities like air and water pollution, strip mining, hazardous wastes, unsafe drugs and foods and radioactive materials. Apart from threatening the health of the workforce, which is a valuable factor of production, the sustainability of physical resources, another factor of production, is also threatened (Beckman, 2002:183-195; Samuelson and Nordhaus, 1992: 42, 311, 313-314, 430-431; Todaro, 1989:20, 203-204, 592-593).

Er31 - Deforestation rate (60)

- Is deforestation adequately controlled (*Adequate, rate between 0 and 10; inadequate, rate between 11 and 20*)
- Is deforestation adequately coupled with reforestation programmes (*Adequate, rate between 0 and 10; inadequate, rate between 11 and 20*)
- Is the rate of reforestation higher or lower than that of deforestation (*Higher, rate between 0 and 10; lower, rate between 11 and 20*)

Attention has previously been drawn to the necessity of preserving natural resources as an exhaustible factor of production. One reason for negative growth of per capita food production in developing countries includes insufficient and inappropriate innovation, cultivation of marginal and sensitive lands, severe deforestation and erosion without reforestation and misguided pricing and marketing policies (Todaro, 1989:295).

Er32 - Carbon dioxide emissions of fossil fuels in millions of metric tons per annum (60)

- Do government regulations result in a decline or increase of carbon dioxide emissions (*Decline, rate between 0 and 10; increase, rate between 11 and 20*)
- Do successful government plans to regulate such emissions exist (*Yes, rate between 0 and 10; no, rate between 11 and 20*)
- Does a result of such emissions lead to incidence of acid rain (*Low incidence, rate between 0 and 10; high incidence, rate between 11 and 20*)

Interestingly enough, it is rather free market economies that 'need' these regulations. In addition, population becomes a problem in relation to the availability and utilisation of scarce natural and material resources. Some argue that industrialised nations should curtail their excessive consumption of natural resources, instead of asking less developed nations to control population growth (Samuelson and Nordhaus; 1992:42, 311, 313-314, 430-431; Todaro, 1989:20, 203-204, 592-593).

Er33 - Terms of trade (120)

- Are terms of trade favourable or unfavourable (*Favourable, rate between 0 and 10; unfavourable, rate between 11 and 20*)
- Is rate of trade growth high or low (*High, rate between 0 and 10; low, rate between 11 and 20*)
- Does international trade feature as a large or moderate share of GDP (*Large, rate between 0 and 10; moderate, rate between 11 and 20*)
- Are levels of imports and exports consistent with both a satisfactory economic growth rate and a financing gap which can be met (*Consistent, rate between 0 and 10; inconsistent, rate between 11 and 20*)
- To what extent is export promotion supported by government (*Large extent, rate between 0 and 10; lesser extent, rate between 11 and 20*)
- Is a competitive exchange rate maintained (*Yes, rate between 0 and 10; no, rate between 11 and 20*)

Terms of trade (in international trade), reflects the 'real' terms at which a nation sells its export products and buys its import products. It equals the ratio of an index of export prices to an index of import prices. It can be argued that trade tariffs have true economic merit if tariffs move the terms of trade in favour of a (developing) country, already suffering structural difficulty. If terms of trade deteriorate, it will be due to imports rising faster than exports, or because export prices have fallen faster than import prices. This can lead to a decrease in real income growth, or to actual economic decline (Evans and Newnham, 1992:316, Samuelson and Nordhaus, 1989:668, 686, 747).

Er34 - Unemployment rate (100)

- Relation of unemployed percentage of the economically active population to the employed (*Does not exceed, rate between 0 and 10; exceeds, rate between 11 and 20*)
- High unemployment coupled with a low per capita income (*If positive, rate between 0 and 10; negative, rate between 11 and 20*)
- High per capita income coupled with low unemployment (*If positive, rate between 0 and 10; negative, rate between 11 and 20*)
- High employment rate is coupled with high inflation rate (*If positive, rate between 0 and 10; negative, rate between 11 and 20*)
- High unemployment is coupled with low inflation (*If positive, rate between 0 and 10; negative, rate between 11 and 20*)

A decline in economic growth can contribute to an increase in unemployment. In an industrialised country, a 3% rise in unemployment can have a much more disastrous shock effect than the same rise in a developing country, where it might be seen as 'par for the course'. Creating jobs for a growing population is also a concern for developing countries and job creation initiatives often demand large amounts of government expenditure, notwithstanding poverty relief, health and welfare programmes. High and sustained unemployment rates often indicate the possibility of a large and growing informal economy or sector – where individuals do not pay tax, cannot find employment in the formal sector and are often engaged in illegal activities. Measurements of unemployment should be taken on aggregate, as members of the economically active population can be underemployed, or become involuntary, voluntary,

frictionally, seasonally, structurally or cyclically unemployed as opposed to being 'gainfully employed' (Clegg, Ibarra-Colado and Bueno-Rodriquez, 1999:83-110; Mohr and Fourie, 1995: 128, 411, 609-615; Samuelson and Nordhaus, 1992: 572-583, 737, 748).

Er35 - Loan default / unfavourable loan restructuring (60)

- Are structural adjustment programs (SAP's) being implemented at a high or moderate social cost (*Moderate, rate between 0 and 10; high, rate between 11 and 20*)
- Are levels of service interest accumulated on debt acceptable (*Acceptable, rate between 0 and 10; not acceptable, rate between 11 and 20*)
- Good or bad reputation of servicing international loans (*Good, rate between 0 and 10; bad, rate between 11 and 20*)

Where loan default is a result of a country's inability to repay loans, credit risk comes to the fore, as opposed to loan default due to sovereign risk, or an unwillingness to repay loans despite an ability to do so. SAP's are mechanisms conditional to IMF loans, bailouts or support that euphemistically suggest policy shifts in macroeconomic and often political policy within a debtor country. *Dependencia* theorists have put forward arguments for the scrapping of 'Third World debt', arguing that the debt burden on developing countries prohibits any other form of government expenditure aimed at economic and social development – the logic is that, once the debt has been scrapped, developing countries can start socio-economic upliftment programmes with a clean slate, rid of the debt-backlash (Todaro, 1989:78-81, 100-107). The other side of the argument states that it is not the debt burden holding developing countries back but a domestic inability to conduct macroeconomic management. Loan restructuring is a point of contention at many IMF conferences and is often used as a bargaining chip, like the favourable restructuring of Pakistani debt in return for allowing the United States to commence military manoeuvres against Afghanistan.

Er36 - Government expenditure (100)

- Is level of public expenditure on defence high or acceptable (*Acceptable, rate between 0 and 10; high, rate between 11 and 20*)
- Does level of government expenditure on defence support the augmentation of military institutional power (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Is level of public expenditure on health acceptable (*Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20*)
- Is level of public expenditure on education acceptable (*Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20*)
- Is government expenditure organised along ethnic, language or social lines (*No, rate between 0 and 10; yes, rate between 11 and 20*)

Government spending is essentially a political issue and is related to political objectives rather than to the level of income. There is often pressure on government to spend more on education, housing, health, and on safety and security than on defence. Government spending and taxes are the essential ingredients of the budget and the main instruments of fiscal policy. Government's economic activity involves three important flows, namely government expenditure on goods and services, taxes levied on (and paid by) households and firms, and transfer payments or the transfer of income and expenditure from certain

individuals and groups to other individuals and groups (the poor) (Kischka et.al. (eds.), 2000:363; Mohr and Fourie, 1995: 79, 550-554; Samuelson and Nordhaus, 1992:24, 298-300, 319-322, 368).

Er37 - Macroeconomic policy (90)

- Sound macroeconomic policy (*Macroeconomic policy gauged as sound both domestically and internationally, rate between 0 and 10; macroeconomic policy developing for improvement, rate between 11 and 20; macroeconomic policy expectations not realistic, rate between 21 and 30*)
- Balance of payments record (*Budget surplus and high level of reserves, rate between 0 and 15; deficit and inadequate reserves, rate between 16 and 30*)
- Savings rates (*High savings rates, rate between 0 and 15; low savings rates, rate between 16 and 30*)
- Levels of capital investment (*High levels of capital investment, rate between 0 and 15, low levels of capital investment, rate between 16 and 30*)

It is assumed that macroeconomics focuses on aggregate economic behaviour and the aggregate performance of the economy regarding output, income, the price level, foreign trade and unemployment among other factors. Economic production (factor and goods markets), income and spending are features that are interdependent in an economic system, and the organisation of those interdependent links, as well as the (un)successful management thereof and the effects by government, are reflections of (un)sound macroeconomic policy. Steps taken to reduce inflation, for instance, include restraining the growth of real output and raising unemployment, or by putting controls on prices and wages. Where the result is a period of stagnation, government has to convince the public of its responsible governance. With rational expectations and flexible prices and wages, anticipated government policy cannot affect real output or unemployment. A country's macroeconomic goals can be reached by effective policy on expenditure and taxation (fiscal policy), monetary concerns, foreign economic activities and incomes policies (Bunge, 1998:141, 407; Mohr and Fourie, 1995:18-19, 63, 65, 74; Samuelson and Nordhaus, 1992:3, 396, 403, 598, 648-649, 740; Todaro, 1989:7, 220; Venter, 1999:92).

Er38 - Financial sector supervision (180)

- Supervisory practices (*If on par with international standards, rate between 0 and 15; if of questionable standards, rate between 16 and 30*)
- Foreign ownership limits and restrictions (*If limits and restrictions are easing, rate between 0 and 16; if tightened, rate between 16 and 30*)
- Capital (liquidity) requirements (*If liquidity requirements are increasing, rate between 0 and 15; if slackened, rate between 16 and 30*)
- Closing insolvent institutions (*If insolvent institutions are closed responsibly, rate between 0 and 15; if oversight results in insolvent institutions not being closed, rate between 16 and 30*)
- Sanctioning of financial practice (*Financial practice sanctioned and scrutinised, rate between 0 and 15; if unsanctioned, rate between 16 and 30*)
- (De)regulation of financial sector (*High degree of financial sector transparency, rate between 0 and 15; low levels of transparency, rate between 16 and 30*)

One such supervisory practice includes fractional-reserve banking, a regulation whereby financial institutions are legally required to keep a specified fraction of their deposits in the form of deposits with the Central Bank (or in vault cash). A benchmark average would be a requisite of 12% of checking deposits in reserves. By imposing high fixed legal reserve requirements, government can better control the money supply (Harms, 2002:377-380; Samuelson and Nordhaus, 1992: 508, 737).

Er39 - Vulnerability spread (90)

- Reliance on oil imports (*Flexible level of vulnerability to oil supply and prices, rate between 0 and 15; high level of reliance on oil imports and consequent vulnerability, rate between 16 and 30*)
- Export of single commodity (*Many commodities exportable, rate between 0 and 15; single commodity exported concomitant to high level of commodity market and climate vulnerability, rate between 16 and 30*)
- Reliance on single commodity (*Degree of market and climate sensitivity of single commodity low, rate between 0 and 10; if sensitive but manageable, rate between 11 and 20; if highly sensitive, rate between 21 and 30*)

In cases where a country is a 'single commodity exporter', it is assumed that the degree of vulnerability is relatively high, not only vulnerable to changes in exchange rates or (international) market prices, but also in the sense of climatic vulnerability. If dependent on a single crop export, a cyclical storm can wipe out an annual harvest and directly impact upon potential earnings from such a crop (tobacco, corn, pepper, vanilla, coffee). Another factor is urbanisation. Where a country is dependent on the agricultural sector for export earning, the depopulation of rural areas and migration toward urban areas impacts negatively on agricultural production. Ideally, the production of goods and services in a country occurs in the primary sector (where raw materials such as agricultural, fishing, forestry and mining products are produced), secondary sector (the manufacturing part of the economy where raw materials and other inputs are used to produce other goods), and the tertiary sector (comprised of the services and trade sections of the economy). Ironically, many countries export raw materials, only to have to import manufactured products from other countries made by using the same raw materials exported in the first place (Carley, 1981:130-172; Mohr and Fourie, 1995:43).

Er40 - Stability and ability of central banks (160)

- Extent of central bank insurance (*Adequately insured, rate between 0 and 15; insurance spread inadequate, rate between 16 and 30*)
- Qualifications, profile and competence of central bank management (*Proven highly competent, rate between 0 and 15; low levels of competence, rate between 16 and 30*)
- Level of central bank independence and levels of state intervention (*High level of independence and low level of interference, rate between 0 and 15; low level of independence and high level of interference, rate between 16 and 30*)
- Size of foreign reserve in months-worth coverage (*In excess of three months, rate between 0 and 10; less than three months, rate between 11 and 20; insignificant level of foreign reserves, rate between 21 and 30*)
- Are banking and financial supervisory laws upheld (*At all times and in all instances, rate between 0 and 10; occasionally, rate between 11 and 20; laws exist but are not upheld, rate between 21 and 30; laws do not exist at all, rate between 31 and 40*)

Although the role(s) of Central Banks have already been mentioned, the management thereof is also an important issue. Just as government ability and competence of government officials are directly related to government performance, policy formulation and output, management of a Central Bank has to be experienced, competent and flexible in order to conduct sound monetary management and to adapt policy where necessary to avoid crises.

Er41 - Fiscal prudence (220)

- Loan classification and bank licensing (*Tight loan classification and bank licensing rules upheld, rate between 0 and 10; rules exist but are not upheld, rate between 11 and 20; rules do not exist at all, rate between 21 and 30*)

- Bankruptcy laws (*Laws meet international standards, rate between 0 and 10; laws exist but are not internationally comparable, rate between 11 and 20; no bankruptcy laws exist, rate between 21 and 30*)
- Guidelines for the assessment of owners, board members and managers of financial institutions (*Guidelines well established, internationally valid and enforced, rate between 0 and 10; guidelines exist but are not enforced, rate between 11 and 20; no existing guidelines, rate between 21 and 30*)
- Banking supervision laws and regulations (*Tight banking supervision laws and prudent regulations are enforced, rate between 0 and 10; such laws and regulations exist but are not enforced, rate between 11 and 20; no laws and regulations exist, rate between 21 and 30*)
- Strong rules governing disclosure, auditing and accounting practices (*Strong governing rules are enforced, rate between 0 and 10; rules exist but are not enforced, rate between 11 and 20; no such rules exist, rate between 21 and 30*)
- Deposit-insurance scheme in place (*A functional deposit-insurance mechanism or scheme is in place, rate between 0 and 10; such a scheme exists but is not likely to function, rate between 11 and 20; no such scheme or mechanism is in place, rate between 21 and 30*)
- Privatisation of institutions experiencing high levels of state intervention (*Strategies are in place for privatisation and met with little resistance, rate between 0 and 10; strategies in place met with resistance, rate between 11 and 20; no such strategies are in place but talks have commenced, rate between 21 and 30; no such strategies exist, rate between 31 and 40*)

It is assumed that this also acts as a reflection of a country's governance ability and competence. Compliance with international standards also raises domestic and international trust of the finance ministry and the regulation of the fiscal sector. Notwithstanding rules, laws, supervisory and regulatory practises being in place, these still need to be enforced with accountable oversight (Samuelson and Nordhaus; 1992:341, 534-535).

4.4.3 Political Risk Factors: Social

Sr1 - Government investment in human capital (110)

- Level of government investment in quality of labour (*High levels of investment with positive results, rate between 0 and 20; high levels of investment, but ineffective, rate between 21 and 40; no signs of government investment in human capital, rate between 41 and 60*)
- Financing of skills development projects (*Employer can claim skills levy back form government, rate between 0 and 25; if another system of skills development is in place, rate between 0 and 25; if system of skills levy is not in place, nor any other such system, rate between 25 and 50*)

In a basic sense, human capital is the stock of technical knowledge and skill embodied in a nation's workforce, resulting from investments in formal education and on-the-job training (Bunge, 1998:239; Samuelson and Nordhaus, 1992:738). The quality of a country's labour force is almost more important than the quantity of labour. The quality of labour is usually described as 'human capital' which refers to the skill, knowledge, and health of a workforce. Education, training and experience are all determinants of human capital (Mohr and Fourie, 1995:37). Cultural outlooks, attitudes toward work as well as a desire for self-improvement also contribute toward the quality of human capital in a country. The nature and character of a country's human resources (culture, tradition, religion, ethnic and tribal fragmentation) are important determinants of its economic structure and differ not only among countries, but within them as well. Investment in human resources can improve the quality of a labour force and thereby have the same or a more powerful effect on economic production as an increase in physical quantity. Formal schooling, vocational and on-the-job training programs, as well as adult and other types of 'informal' training and education may be more effective in developing human skills and resources, as a result of

direct investments in buildings, equipment and materials (books, computers, science equipment). The concept of investment in human capital is associated with improving the quality and thus productivity of a workforce and economy (Todaro, 1989:20, 115-116).

Sr2 - Literacy rate (30)

- Is the literacy rate of the economically active population higher or lower than 50% (*Higher, rate between 0 and 15; lower, rate between 16 and 30*)

The quality of education is a problem in many developing countries, and the assumption is that there is a positive correlation between educational quality in a country and the quality of human capital. In education, low levels of literacy, significant school dropout rates and inadequate and often irrelevant educational curricula and facilities are often the case. Literacy, in this case, does not simply refer to alphabetical literacy, but to numerical literacy as well. The quality of scientific and mathematical skills in a developing country's workforce is often quite low. In some cases this is not only due to the quality of education, but also to a 'brain-drain' phenomenon (Shonfield and Shaw, 1972:53-66; Todaro, 1989:35, 335).

Sr3 - Job mobility impediments (60)

- Does public sector education lag behind education in business, engineering and science (*Immeasurably, rate between 0 and 10; measurably, rate between 11 and 20; seriously, rate between 21 and 30*)
- Has a pool of educated but discontented people developed, demanding appropriate employment (*Low measure of discontent, rate between 0 and 10; moderately discontent, rate between 11 and 20; large measure of discontent, rate between 21 and 30*)

The assumption is that, the higher the level or degree of job mobility impediment, the bigger the chance that demands for appropriate employment might occur. It follows that, within a country, the higher the degree of job mobility impediment, the more chance there is of a significant 'brain-drain' of skilled labour in the form of technicians, medical professionals, scientists and engineers among other highly trained individuals taking place.

Sr4 - Gini coefficient (60)

- If the Gini coefficient is between 0.30 (highly equal distribution of income) and 0.70 (highly unequal distribution of income) (*Rate between 11 and 20*)
- If the Gini coefficient is lower than 0.30 (*Rate between 0 and 10*)
- If the Gini coefficient is higher than 0.70 (*Rate between 21 and 30*)

The Gini coefficient acts as an aggregate numerical measure of income inequality within a country ranging from zero (perfect equality) to one percent (perfect inequality). The higher the value of the coefficient, the higher the inequality of income distribution, and it can be assumed that sentiments relating to relative deprivation can be manifested in crime statistics, among other figures pertaining to the socio-economic climate and circumstances of a country. Income inequality indicates the existence of a disproportionate distribution of total national income among households, whereby the share going to 'rich' persons in a country are far greater than that going to poorer persons. This is largely due to differences in the amount of income derived from ownership of property and to a lesser extent the result

of differences in earned income. The significance of such a measurement for foreign investment lies therein that the higher the coefficient, the greater the chance that government may try to remedy this by imposing wealth taxes, higher corporate taxes and steeply progressive income practices (Kischka et.al.(eds.), 2000:363; Todaro, 1989:152-153, 157, 628). Economic growth is also probably reliant on the means and effort of a wealthy minority, with the majority of a population placing more of a burden on growth. It is assumed that the higher the Gini coefficient in a country with an open free market capitalist system (as opposed to a socialist system where income equality is contrived), the more sluggish growth might be.

Sr5 - Education ratio - student:teacher (30)

- Is the ratio less or more than 26 pupils per teacher (*Less, rate between 0 and 15; more, rate between 16 and 30*)

The assumption is that, the lower the student:teacher ratio, the more intensive schooling is in terms of time and effort, as well as attention given to individual learners. This might contribute to higher education quality as smaller classes probably also enjoy more abundant resources (books, etc.). School fees might be higher though, but it is assumed that a lower ratio contributes to higher educational quality, higher levels of investment in human capital, and eventually a better quality workforce (Todaro, 1989:35, 330-356).

Sr6 - Per capita income (30)

- Is a positive or negative annual growth rate of per capita income prevailing (*Positive, rate between 0 and 10; stagnant, rate between 11 and 20; negative, rate between 21 and 30*)

Income per capita is calculated by dividing the total GNP of a country by the total population. Per capita income is often used as an economic indicator of the levels of living and development. However, it can be biased, in the sense that it does not take into account income distribution and the ownership of the assets that are employed to generate part of that income. The assumption is that, the higher the per capita income, the larger disposable income is (correlated to a market for consumer spending), and the higher the level of living (Mohr and Fourie, 1995:125; Todaro, 1989:28, 128-129, 197-200, 553)

Sr7 - Mean period of schooling (60)

- If mean period of schooling exceeds 10 years (*Rate between 0 and 10*)
- If mean period of schooling is ten years (*Rate between 11 and 20*)
- If mean period of schooling is less than ten years (*Rate between 21 and 30*)

Employers tend to select by level of education when faced with an excess of applicants. It is assumed that the longer the mean period of schooling is in a country, the higher the quality of human capital in the labour force probably is. A country with high dropout rates probably has a workforce with lower levels of human capital quality. In addition to 'manpower planning' needs, the public can also exert tremendous political pressure for the expansion of school places (not only primary schools) in developing countries. Government expenditure on education in many cases, is relatively high, but becomes problematic when high levels of expenditure are not coupled with high levels of competence in the management of

education policy effectiveness. The proposition that educational expansion promotes and probably even determines the rate of overall GNP growth remains unquestioned. The expansion of educational opportunities contributes to aggregate economic growth by creating a more productive labour force, providing income-earning opportunities for teachers and related industries (printers, uniform manufacturers), creating educated leaders and by encouraging 'modern attitudes' (Todaro, 1989:35, 115, 333, 335, 345).

Sr8 - Unemployment rate (30)

- Percentage rise in the unemployment rate during the last quarter (*Low, rate between 0 and 15; high, rate between 16 and 30*)

It is assumed that individuals who are willing and able to work, but who have not got jobs, are unemployed in the formal economy. The number of unemployed people can be expressed as a percentage of the total number of people who are willing and able to work in the formal economy, not including the underemployed. It is assumed that the higher the unemployment rate the lower levels of living are, and the more inefficient or inadequate the utilisation of labour is within a certain country. Coupled to population growth, as labour supply expands, jobs will have to be created at an equivalent pace and the GDP should grow relative to these rates. Prospects for dealing with frustrated, anxious and increasingly vocal, educated, yet unemployed people are worrisome. But unemployment problems in developing countries have much more complex causes than in industrialised countries, and are more difficult to solve – even more so if leadership and policy is inadequate and overwhelmed. High rates of unemployment are often linked to high crime rates as well (Harms, 2002:250-262; Kischka et.al.(eds.), 2000:23; Mohr and Fourie, 1995:109; Todaro, 1989:38-39, 237-259).

Sr9 - Attitude toward foreign businesspeople / visitors (120)

- Is acquiring a visa a laborious, expensive and difficult task (*No, rate between 0 and 15, yes, rate between 16 and 30*)
- Are travellers harassed at airports, i.e. by (military) personnel (*Not at all, rate between 0 and 10; moderately, rate between 11 and 20; frequently, rate between 21 and 30*)
- Do frequent attacks on tourists and foreigners prevail (*Infrequently, rate between 0 and 10; frequently, rate between 11 and 20; excessively rate between 21 and 30*)
- Are tourist concessions implemented, i.e. tax refunds (*Equal to international norms, rate between 0 and 10; less than norm, rate between 11 and 20; not at all, rate between 21 and 30*)

Attitude toward foreign business people or visitors also acts as an indication of tolerance within the investment climate, as well as the openness of the political system as a whole.

Sr10 - Acceptable quality of life (90)

- Access to public services (*Easy, rate between 0 and 10; conditional, rate between 11 and 20; difficult, rate between 21 and 30*)
- Level of crime rate (*Low, rate between 0 and 10; moderate, rate between 11 and 20; high, rate between 21 and 30*)
- Is life expectancy in excess of an average of 66 years (*In excess, rate between 0 and 15; less than, rate between 16 and 30*)

There is a positive correlation between the level of education and per capita income and an individual's quality of life. What further contributes to quality of life are low crime levels and easy access to the

provision of government or public services like safe drinking water, electricity, health services and hospitals, emergency services, pharmaceuticals, welfare services, education and training. It is also assumed that life expectancy is positively correlated to quality of life – the higher life expectancy is, the higher the quality of life seems to be. In developing countries, climate and disease detract from the quality of life and life expectancy has been dealt a serious blow by TB, malaria, cholera, starvation and especially by HIV/AIDS (Carley, 1981:34-45; Daily Mail and Guardian, 31 May 2002; Kischka et.al. (eds.), 2000:23).

Sr11 - Urbanisation rate (150)

- Rapid rate of urbanisation places increased pressure on government spending, i.e. infrastructure (sewerage, roads, electricity), housing and the maintenance of law and order (*Moderate pressure, rate between 0 and 10; increasing pressure, rate between 11 and 20; exceptional pressure, rate between 21 and 30*)
- Urbanisation rate results in a decline in the productivity of the agricultural sector (*Moderate decline, rate between 0 and 10; increasing decline, rate between 11 and 20; extensive decline, rate between 21 and 30*)
- Is urbanisation controlled, or does it place a burden on the state system to provide social needs (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- Can institutional and physical infrastructure handle rapid urbanisation (*Yes, rate between 0 and 15; no, rate between 16 and 30*)
- A destabilising dense urban population (*Rate between 21 and 30*)

Apart from limited access to the commercial agricultural sector in many developing countries, impoverished subsistence farmers and other parts of rural populations are migrating to urban centres of economic activity in the hope of ‘a better life’. Opportunities for earning wages and higher incomes in urban areas are attracting often uncontrollable amounts of people. Informal settlements around urban areas are growing rapidly and the quality of life in such settlements is very poor (Carley, 1981:34-45; 130-172). This is often due to government not being able to render the necessary services to people in such areas as a result of sheer numbers and cost/expense. Municipal services are overtaxed and the burden placed on the state is not only manifested in an over-supply of labour, but in an over-supply of the needy. Government actions to curb hyper-urbanisation can include creating an appropriate rural-urban economic balance, the expansion of small-scale labour-intensive industries, the elimination of factor-price distortions and an expanded provision of family planning and rural health services (Carley, 1981:130-172; Todaro, 1989:285-286; Venter, 1999:91).

Sr12 - Population growth percentage per annum (40)

- Does the percentage of population growth per annum exceed the percentage of employment growth per annum (*No, rate between 0 and 10; yes, rate between 11 and 20*)
- Does number of live births per annum exceed the number of deaths per annum (*No, rate between 0 and 10; yes, rate between 11 and 20*)

The correlation between population growth, economic growth and unemployment has already been mentioned, but a negative population growth can have a disadvantageous effect on a country. If a population is ageing, the social welfare burden on the state to raise revenue for pension payouts increases. An ageing population also correlates negatively with not only the quality, but also the actual size of the labour force. Many developing countries find it increasingly difficult to supply basic services to a rapidly

growing population, and problems with distributing these resources also contribute to rapid urbanisation trends. Although the developing world comprises more than three-quarters of the global population, the rate of consumption of resources is far higher in industrialised countries than in developing countries (Carley, 1981:130-172; Fullbrook, 2000:92, Venter, 1999:91)⁹.

Sr13 - Average calorie intake (20)

- If average calorie intake is less than 2100 per day (*Rate between 11 and 20*)
- If average calorie intake is more than 2100 per day (*Rate between 0 and 10*)

As an indicator of the overall rate of human development, the average calorie intake of individuals within a country also points toward the quality of life (Carley, 1981:34-45), health and life expectancy of especially infants, notwithstanding the overall quality of human capital and the labour force in general. Being able to provide food for individuals is one of the most basic responsibilities of government – a lack in ability to do so points toward resource distribution problems and can result in questionable government legitimacy. In some cases populations face starvation as a direct result of political management (for example North Korea, Zambia and Zimbabwe) (Daily Mail and Guardian, 31 May 2002).

Sr14 - Health care (150)

- If the ratio of population per doctor is less than 4000 (*Rate between 0 and 5*)
- If the ratio of population per doctor is between 400 and 4800 (*Rate between 6 and 15*)
- If the ratio of population per doctor exceeds 4800 (*Rate between 16 and 20*)
- If the ratio of nurses per doctor exceeds 2 (*Rate between 0 and 10*)
- Accessibility of health care facilities and health care professionals (*Very accessible, rate between 0 and 25; not accessible, rate between 26 and 50*)
- Realistic government health policy (*Realistic, rate between 0 and 25; unrealistic, rate between 26 and 50*)

Health care also acts as an indicator of government's ability to provide, manage and distribute resources in a country. Factors that can influence the doctor:patient:nurse ratio are population growth, number of facilities and a 'brain-drain'. Many man-hours are often lost due to workers having to make laborious trips to clinics, doctors or hospitals that are difficult to reach (physically by vehicle or on foot), or 'better quality' facilities being situated in mostly urban areas. Government health care policy is also an indication of overall government performance, accountability and responsibility. Unrealistic government policy toward HIV/AIDS, for example, prompts questions about the quality, nature and rationale of decision-making in a country, both from domestic as well as international parties (Shonfield and Shaw, 1972:94-118).

Sr15 - Life expectancy (30)

- If life expectancy exceeds an average of 66 years (*Rate between 0 and 10*)
- If life expectancy is less than an average of 66 years (*Rate between 11 and 20*)

As a measure of overall quality of life (Carley, 1981:34-45) in a country, life expectancy also measures the effectiveness of a government's health policy and the enforcement thereof, as well as the management

⁹ Steps taken by the government of Singapore to increase birth rates includes offering a bonus of \$300 for a second child.

of “common-good” health resources like state hospitals. The availability of medicines and pharmaceuticals are also inherent in these risk factor indicators of the overall quality of human capital of a country.

Sr16 - Infant mortality rate (30)

- If the infant mortality rate exceeds 48 per 1000 live births (*Rate between 11 and 20*)
- If the infant mortality rate is less than 48 per 1000 live births (*Rate between 0 and 10*)

In terms of deaths related to malaria and cholera, climate plays a large role in infant mortality. But the infant mortality rate is also an indicator of overall human development and a government’s ability to raise the quality of life (Carley, 1981:34-45), life expectancy and the overall quality of human capital.

Sr17 - Telephones per 1000 people (15)

- If the number of telephones exceeds 130 per 1000 people (*Rate between 0 and 5*)
- If the number of telephones is less than 130 per 1000 people (*Rate between 6 and 10*)

It is assumed that the frequencies of telephones per 1000 people will differ in urban and rural areas. Nevertheless, the number of telephones per person is taken to be a measure of the number of telephone lines (assuming that each line has a telephonic instrument). As an indicator of technological development (Bunge, 1998:239) and the potential for technological development, telephones:people is a useful measurement. One can go further and extrapolate the potential number of Internet users, the size of the industry surrounding the use of landlines, fibre optics, the Internet and cellular phones. Related industries can involve telecom providers, hardware (computers, advanced telephone systems) and software providers, network providers, as well as cellular phones and service providers. It might not even be that far-fetched to assume that people making use of these services, might in all probability also own television sets (<http://www.undp.org/hdro>).

Sr18 - Population access rates (40)

- If facilities can be reached on foot or by the local means of transport within one hour by at least 50% of the population (*Rate between 6 and 10; if more than 50%, rate between 0 and 5*)
- If at least 79% of the population has access to health services (*Rate between 0 and 5; if less, rate between 6 and 10*)
- If at least 69% of the population has access to safe water (*Rate between 0 and 5; if less, rate between 6 and 10*)
- If at least 36% of the population has access to sanitation (*Rate between 0 and 5; if less, rate between 6 and 10*)

This correlates to government ability to provide basic and advanced services, and the mentioned distribution of resources that, if ineffective, can probably lead to rapid urbanisation (Carley, 1981:130-172) and even legitimacy problems for government.

Sr19 - Provision of public services (25)

- Is the provision of public services unreliable, sporadic and vulnerable to incompetence (*Rate between 6 and 10*)
- Does a culture of non-payment for public services prevail (*Rate between 6 and 10*)
- If public services are reliable (*Rate between 0 and 5*)

A large part of government expenditure is usually (or should be) spent on the provision of basic municipal and public services. Where the public is taxed in order to finance the provision of such services, it is quite understandable that individuals would expect to see the effect of the provision thereof. Where payments of rates and taxes are halted in order to show discontent in the quality of services, or non-acceptance of politically motivated name changes of cities and provinces, measures of public consent can point to disapproval of political policy, government management or governance as such. It is assumed that high taxes should correlate with high level of government performance and quality services. The provision of safety and security services is an extremely important measurement of government policy objectives. An ineffective and demoralised police service is in most cases the result of very poor salaries and wages. The 'closing down' of crime prevention units like that of child protection, for instance, is an unfortunate indicator of weak overall government performance.

Sr20 - Global Human Development Rating (HDI) (17)

- If HDI rates a country in the 'high' category - averaging 0.916 (*Rate between 0 and 2*)
- If HDI rates a country in the 'medium' category - averaging between 0.570 and 0.759 (*Rate between 3 and 5*)
- If HDI rates a country in the 'low' category - averaging 0.389 (*Rate between 6 and 10*)

A country's human development rating is indicative of life expectancy, quality of life (Carley, 1981:34-45), level of education, access to services and overall quality of human development, as well as the quality of the labour force. It can also be indicative of a government's performance in realising efforts made at raising a country's level of human development and the effectiveness of development policy and initiatives. The eventual relation between political and governmental efforts at raising overall human development in a country, and the eventual HDI reading, can result in government accounting for the discrepancy between theory and practice, even the misappropriation of funds set aside for development projects as opposed to mere incompetence in managing such projects (<http://lib.stat.cmu.edu/datasets/humandevol>).

Sr21 - Daily newspapers number of copies per 1000 people (10)

- If there is an average of 96 copies per 1000 people (*Rate between 0 and 5; if less, rate between 6 and 10*)

The newspapers:people ratio is, among other things, indicative of the status of the press. It is assumed that the larger the variety of newspapers, in a variety of languages within a country, and the more autonomous these papers are, the higher the levels of media freedom are in a country. The harassment and imprisonment of journalists and editors critical of a government is, of course, also an indication of government tolerance toward criticism and the status of media freedom. Industries relating to the press are the printing industry and advertising industry, and the more demand there is for media, the more journalists find employment. One can also assume that those purchasing a newspaper can read it, leading one to believe that the demand for printed media correlates with the literacy rate of a country. It can

further be assumed that the demand for media indicates a desire for information, knowledge and empowerment and that an informed public is a less ignorant public (<http://www.undp.org/hdro>).

Sr22 - Radio receivers per 1000 people (10)

- If there is an average of 350 radio receivers per 1000 people (*Rate between 0 and 5; if less, rate between 6 and 10*)

Most of what has been mentioned regarding telephones and newspapers also applies to the radio:people ratio. Yet one should be aware of the fact that individuals might purchase radios because they are unable to read – due to illiteracy or impaired vision. Radios are also much cheaper than television sets and operating a radio does not presuppose access to electricity within a household. The assumption is that listening to news reports on a radio contributes to new-learning and acquired information. Radios imply that there are radio stations that employ both trained and unskilled workers, sell airtime and probably encourage local musicians and artists to develop material.

Sr23 - Social consciousness of government (60)

- Investment in social capital and entrepreneurship (*Actions in place for the investment in developing social capital and entrepreneurship are showing results, rate between 0 and 10; actions are under development but not yet implemented, rate between 11 and 20; no such actions in place, rate between 21 and 30*)
- Openness/competitiveness in technological skills (*Development of technological skills results in technological competitiveness and openness, rate between 0 and 10; development programme is in early stages, rate between 11 and 20; development of and investment in technological skills not a priority, rate between 21 and 30*)

Previous discussions have dealt with the factors that contribute to high or low levels of human capital quite extensively. However, the social consciousness of government also relates to the level of arts and culture in a country and to a society in which there is a demand for both performing and visual arts. In many countries with pressing social upliftment and welfare issues, subsidies and expenditure on arts and culture (keeping theatres operational as well as university departments of drama, music and art) is in drastic decline. This is quite ironic as, due to high illiteracy rates in developing countries, theatre is, for example, often an effective way of delivering educational messages relating to health and the prevention of crime (Shonfield and Shaw, 1972:33-52). Apart from this, the social consciousness of government reaches as far as human rights issues, provision for the elderly, animal protection legislation and welfare, environmental protection (in terms of both fauna and flora), cultural and ethnic bias, genocide and even infanticide. Expenditure on orphanages (especially AIDS orphans) and hospices, where there is both an ability and willingness to spend, also relates to levels of government social conscience and consciousness.

Sr24 – Societal uprising (120)

- Violence, demonstration(s) aimed at MNC's (*No past instances, rate between 0 and 10; trend is subsiding, rate between 11 and 20; instances flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances of uprisings, rate between 31 and 40*)
- Instances of collective subversion, looting, vandalism (*No past instances, rate between 0 and 10; trend is subsiding, rate between 11 and 20; instances flare-up around political events, policy speeches and*

scandals, rate between 21 and 30; frequent and unexpected instances of uprisings, rate between 31 and 40)

- Malicious damage (*No past instances, rate between 0 and 10; trend is subsiding, rate between 11 and 20; instances flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances of uprisings, rate between 31 and 40)*)

Some societies are less complacent and more mobile when it comes to demonstrating discontent with government policy or action. Bunge (1998:189) explains that a vigorous populist movement engages in a society if the society faces extremely serious social issues, the ruling classes and traditional political parties are unable or unwilling to address these issues so that large popular groups feel alienated from them and even the state, and if the movement is headed by a charismatic manipulator of public opinion. Demonstrations aimed at MNC's are often the result of job-cuts or wage related issues. But a growing trend in international organised interest groups, and in some cases pressure groups, is on the rise.

Sr25 - Climate (40)

- Is country situated in tropical or subtropical climatic zone (*If no, rate between 0 and 20; if yes, rate between 21 and 40)*)

It is a historical fact that almost every successful example of modern economic growth has occurred in a temperate-zone country (Todaro, 1989:129). The extremes of heat and humidity in many countries contribute to deteriorating soil qualities and the rapid depreciation of many natural goods. These conditions also contribute to the low productivity of certain crops, the weakened regenerative growth of forests, and the poor health of livestock and human beings. Extreme heat and humidity also cause discomfort to workers and weaken their health, reducing their desire to engage in strenuous physical work, and generally resulting in lower levels of productivity and efficiency (Todaro, 1989:129).

4.5 Concluding Remarks

In this chapter, the political, economic and social risk factor indicators of political risk that were used in designing the model that is offered in the next chapter were presented. In order to weigh the indicators though, it was necessary to show what it was that the model intends to measure. The choice of each particular risk factor and its indicators was thus explained, what each individual indicator's significance is, as well as what it is each indicator points toward. In explaining each political risk factor, it is hoped that at least some guidance is given when rating these risk factor indicators in the model.

Not only did this chapter explain the choice of political risk factors and their indicators as well as their significance and properties, but hopefully it also served as an illustration of the interrelatedness of political, social and economic phenomena in any country – that these can hardly be separated from one another. The inter-disciplinary nature of political risk analysis came to the fore again in this chapter. The indicators that were chosen are founded not only in political events and financial economic statistics, but

also in the socio-cultural characteristics of different countries, their various histories, trends, as well as their positions in current global events.

The next chapter expands further on the operationalisation of this research endeavour and shows how the fourth chapter was the starting point for the study's final product, namely the model itself. Chapter Five presents a generic model that can measure the macro-types of political risks of a country in an in-depth macro-type analysis. In addition and, as an example, a South African example is used – the Coega Industrial Development Zone and Deep Water Harbour Project – and an industry-specific political risk analysis of this micro investment environment for potential foreign investors is offered. The test results of both the generic and client-specific model are presented in the fifth chapter, and the significance of these results are also expanded upon.

CHAPTER FIVE: Presenting and Testing a Model for Political Risk Analysis

This chapter presents the mathematics and calculations behind the model itself and also tests the model for political risk analysis. Although the increments for rating the indicators of each risk factor are explained in Chapters Four and Five, the glossary might assist in further clarifying terms that are not quite clear.

During the second phase of testing, an example is used that tests the flexibility and adaptability of the model as such. By taking a South African industry-specific example, namely the Coega Industrial Development Zone and deep-water port project, a specific analysis of the investment climate and ensuing political risks is made by using a micro-type, tailored model for the specific case study. In simulated consultation with a potential client, the political risk analyst and client decide together which are the most relevant and applicable risk factors to choose from the generic model's pool of factors.

5.1 The Mathematics of the Model

The model represents a *real percentage chance* that political risk might occur, as well as an *average percentage chance* that risk might occur. Also included is a category *total percentage chance* that risk might occur. These are explained in more detail shortly. The formulas for these calculations are written in two different ways in both cases, almost as a way to “double check” the eventual figures.

Although three ways of calculating the percentage chance that political risk might occur are offered, the assumption the study would like to stress is that the value representing the *real percentage chance* that risk might occur, in other words the weighted value(s), is the value deemed most reflective and most representative.

The assumption that this study dare makes is that the mathematical formulae as well as the measurement scale¹ that is developed can be representative of a chance or probability that political risk will impact negatively on firm profitability. However, this should raise questions regarding the theory of probability² and the mathematics of large numbers³.

¹ This being an interval scale for measuring political risk, although an ordinal scale (with say, only two values per risk factor indicator) might be more appropriate in an even further refined model building exercise, with an even more advanced research base to work from.

² The theory of probability is one of the most widely used branches of mathematics in practice in decision-making – especially so in financial risk, ie. the life insurance industry.

³ Private consultation with Albert Venter, 14 October 2002.

The problem with political risk and the theory of large numbers lies therein that political risk events are not “fair” in their occurrence - there is neither an even chance nor a large number of comparable political risk events that can be calculated in any given situation. Also, as mentioned in Chapter Two, political risk is not a real definition, but nominal in nature. Political risk as such is rather a metaphor than an actuality that can be calculated in terms of probability theory, and the study is aware of this. One cannot have a frequency distribution of political risk events, with a normal distribution curve⁴ and read off from this curve the probability that an event will occur. So, in political risk, terms such as *likelihood*, *chances* and *probability* are judgements, rather than mathematical calculations). The model presented in this study however, still vies that one can make the degree or impact that political risk(s) might have more “tangible”, and can, in turn be used to make a judgment about the probability of risk occurring based on the result of the analysis.

5.1.1 A key to the symbols

The symbols can be explained as follows:

Pr(1-37) = The sum of political risk factor indicators of political risk as weighted by the analyst or rater
Er(1-41) = The sum of economic risk factor indicators of political risk as weighted by the analyst or rater
Sr(1-25) = The sum of social risk factor indicators of political risk as weighted by the analyst or rater

TotalPr = The sum of the weighted political risk factor indicators
TotalEr = The sum of the weighted economic risk factor indicators
TotalSr = The sum of the weighted social risk factor indicators

5.1.2 Weights attributed to the political, economic and social factors

For purposes of testing out the model, the sum of political risk factor indicators of political risk are weighted as 50% of the real percentage chance that political risk might occur, economic risk factor indicators weigh 30% and social risk factor indicators 20%.

These weights are flexible though and a client or investor that is using the model can choose to have economic risk factor indicators weigh 40% or even 50% for instance, according to the importance a client or investor attaches to these risk factor indicators. Indicators can also be added in the case of a micro-type, client-specific analysis.

⁴ A limitation of this study is that it does not present a distribution curve of political risks. Although not the intention of this study, it is indeed a theme that can be regarded in the light of scope for further studies in the theory of political risk analysis.

5.1.3 Real percentage chance that political risk might occur

In the first instance, the real percentage chance that political risk might occur is calculated as follows:

$$\left(\left\{ \left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) \left(\frac{1}{2} \right) \right\} + \left\{ \left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) \left(\frac{1}{3} \right) \right\} + \left\{ \left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right) \left(\frac{1}{5} \right) \right\} \right) \left(\frac{100}{1} \right)$$

In the second instance, the real percentage chance that political risk might occur is calculated as follows:

$$\left(\left\{ \left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) \left(\frac{1}{2} \right) \right\} \left(\frac{100}{1} \right) \right) + \left(\left\{ \left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) \left(\frac{1}{3} \right) \right\} \left(\frac{100}{1} \right) \right) + \left(\left\{ \left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right) \left(\frac{1}{5} \right) \right\} \left(\frac{100}{1} \right) \right)$$

5.1.4 Average percentage chance that political risk might occur

In the first instance, the average percentage chance that political risk might occur is calculated as follows:

$$\frac{\left\{ \left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) \left(\frac{100}{1} \right) \right\} + \left\{ \left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) \left(\frac{100}{1} \right) \right\} + \left\{ \left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right) \left(\frac{100}{1} \right) \right\}}{3}$$

In the second instance, the real percentage chance that political risk might occur is calculated as follows:

$$\left\{ \frac{\left(\frac{\text{Pr}(1-37)}{\text{Total Pr}} \right) + \left(\frac{\text{Er}(1-41)}{\text{Total Er}} \right) + \left(\frac{\text{Sr}(1-25)}{\text{Total Sr}} \right)}{3} \right\} \left(\frac{100}{1} \right)$$

5.1.5 Total percentage chance that political risk might occur

The total percentage chance that risk might occur is calculated as follows:

$$\left(\frac{\text{Pr}(1-37) + \text{Er}(1-41) + \text{Sr}(1-25)}{\text{Total Pr} + \text{Total Er} + \text{Total Sr}} \right) \left(\frac{100}{1} \right)$$

5.1.6 The scaled percentages

Although a percentage as the ‘size’ of the chance that political risk might impact negatively on a foreign investment is quite self-explanatory, the percentages can also be scaled if an investor should choose to do so in addition to the calculated figure. The percentages of chance that political risk might occur can thus be scaled in the following manner:

Table 5.1: Incremental Risk Scale for Investment

Percentage Chance that Political Risk Might Occur	Incremental Scale
0%-10%	Highly Advisable
11%-20%	Advisable
21%-30%	Very Low Risk
31%-40%	Relatively Low Risk
41%-50%	Low to Medium Risk
51%-60%	Relatively Medium Risk
61%-70%	Medium to High Risk
71%-80%	Relatively High Risk
81%-90%	Unadvisable
91%-100%	Highly Unadvisable

5.2 The Model for Political Risk Analysis

In this section, the model proposed by this study for use as a ‘tool’ enabling the analysis of political risk analysis is presented. The analyst or rater literally rates or attributes a value to each risk factor indicator. Throughout the entire process, the model is calculating the risks and eventually calculates the real as well as average percentage chance that risk might occur. This model is uni-dimensional in the sense that, although economic and social risk factors are also included as political risk factors, all risk factors and their indicators included in the model measure the same thing, or the single construct of political risk (Neuman, 2000:176).

The correlations have been designed to imply that the higher a rating is of a certain risk factor, the larger that risk factor’s contribution will be to the eventual percentage chance that risk might occur. Each individual using the model and rating the factor indicators attributes a value to each indicator on the indicated scale⁵. For example, in *Er27-Discrimination against foreign business: To what extent do bureaucratic delays purposefully keep foreign investors out of the market (Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20)?* An individual that perceives such delays as a lesser

⁵ This model is concerned with the relationship between the risk factor indicators, and, the fact that they are weighted, is to enable the quantitative analysis of political risk (Neuman, 2000:17).

influence can attribute a value to the factor indicator on a scale from 0 to 10 – where 0 would be no extent at all and 10 the highest rating of a ‘lesser extent’.

In some cases, for example in *Pr1-Political system*, only one option can be chosen, but the ratings have been designed in such a way as to accommodate the value attributed to the indicators of the risk factor *Pr1 – Political system*. A one-party dominant democracy will rate ‘higher’ than, for instance, a multi-party democracy. The indicators of this risk factor are thus mutually exclusive indicators (Neuman, 2000:176), implying that only one indicator can be rated in the case of *Pr-1*. A political system cannot be a one-party dominant democracy and a multi-party democracy at the same time as the two are mutually exclusive.

In the case of *Pr14-Political (in)stability*, there is an indicator of this risk factor that measures unforeseen shifts in government policy (*positive, rate between 0-25; negative, rate between 26-50*). Although unforeseen shifts in government policy is not necessarily a good thing as such, the notion that such shifts can at least have positive results might warrant a rating closer to 25 than 50, but not closer to 0.

In the case of *Er12-Militancy of Organised labour* for instance, an interesting case in especially the South African context comes to the fore. There is a risk factor indicator that measures compulsory membership of a labour organization (*no, rate between 0 and 20; yes, rate between 21 and 40*). Although membership of a labour organisation is not compulsory in South Africa, one would think the rating should be closer to 0. Membership is often influenced by the advantages attached to being a card-carrying member of a labour union or being intimidated into joining a labour union and paying membership fees. These are rather social coercive sanctions than compulsory rules that would warrant a rating of closer to 20 than 40, but not closer to 0 for South Africa in this case.

In certain cases, it may not be possible for the rater or user of the model to provide a value for a certain risk factor indicator. The data might not be available (as has been explained in Chapters Two and Three of this study) or it might be of suspicious origin, aged or unreliable. The user of the model can make up for the ‘missing data’, constantly bearing the very important point in mind that missing data can be a serious problem because the validity and reliability of the eventual results can be severely jeopardised. As a solution, the indicators for which information is missing can be eliminated, the average scores for indicators where data is present can be substituted, data based on non-quantitative information about the indicators can be inserted, or a totally random value can be inserted (Neuman, 2000:179). As stated next to some of the risk factors, only some (but more than one) of the risk factor indicators might be relevant – in such cases, irrelevant indicators can be scored 0. As these risk factors indicators are indicative of political risk levels, and high levels of political risk are less conducive to the profitability of investment, it follows that the lower the score, the lower the perceived level of investment risk might be. In other

words, if a risk factor indicator that measures the intensity of terrorist activity (an indicator of *Pr9-Political terrorism*), is completely irrelevant when analysing the perceived level of political risk in a certain country, the indicator is either not scored at all or scored 0, a low score is compounded out of a possible weight of 160, thus contributing to a low risk rating for that country.

The model itself is now presented in 5.3 in the following section. Each risk factor indicator is provided with rating increments, and Chapter Four can be consulted if some of the factor indicators are unclear. The glossary included at the end of the study can also be consulted to assist in further clarifying the context(s) of some of the risk factor indicators.

5.3 Political Risks as Risks to Foreign Investment

5.3.1 Political Risk Factors of Political Risk

Total (Pr1-Pr37):	5740	Average percentage Pr:	0
Your Pr Total:	0	Real percentage Pr:	0

<u>Pr1 Political system (220)</u> (Rate only one indicator)	Your scores Pr1
<> Autocratic single party system (Rate between 30 and 50)	
<> Democratic mutli-party system (Rate between 0 and 20)	
<> One party dominant democratic system (Rate between 10 and 30)	
<> Regulated democratic multi-party system (Rate between 20 and 30)	
<> Dictatorship in a non-party system (Rate between 40 and 50)	
<> Socialist central planning system (Rate between 30 and 40)	
Total Pr1	0

<u>Pr2 Separation of powers (150)</u> (Rate all the indicators)	Your scores Pr2
<> Degree of autonomy and independence of legislative, executive and judicial powers (High degree, rate between 0 and 10, moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)	
<> Degree to which legislature, executive and judiciary check and balance powers (High degree, rate between 0 and 10; moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)	
<> Trend of development of an over powerful executive (Negative trend, rate between 0 and 10; possibility, rate between 11 and 30; positive trend, rate between 31 and 50)	
Total Pr2	0

<u>Pr3 Openness of political system (250)</u> (Rate all the indicators)	Your scores Pr3
<> Competitiveness of political system (Very open and competitive, rate between 0 and 10; possibility for competition, rate between 11 and 30; closed political system, rate between 31 and 50)	
<> Multiple competing elites and interest groups can determine public policy through bargaining and compromise (Yes, rate between 0 and 25; no, rate between 26 and 50)	
<> Public accessibility regarding inputs (Very accessible, rate between 0 and 10; conditional, rate between 11 and 30; no access, rate between 31 and 50)	
<> Responsiveness, and responsibility of government (High degree, rate between 0 and 10; moderate, rate between 11 and 30; low, rate between 31 and 50)	
<> Transparency of decision-making process and policy environment (Very, rate between 0 and 10; hardly, rate between 11 and 30; not at all, rate between 31 and 50)	
Total Pr3	0

<u>Pr4 Public accountability of government (150)</u> (Rate all the indicators)	Your scores Pr4
<> Strength of public protector and/or auditor general (Very strong; rate between 0 and 10; conditional power, rate between 11 and 30; none, rate between 31 and 50)	

<> Degree of functioning oversight mechanisms (Highly functional, rate between 0 and 10; conditional, rate between 11 and 30; useless, rate between 31 and 50)	
<> Separation of private and public spheres (High degree of separation, rate between 0 and 10; conditional, rate between 11 and 30; low degree, rate between 31 and 50)	
Total Pr4	0

Pr5 Economic planning failures (100) (Rate all the indicators)	Your scores Pr5
<> Success or failure in meeting economic targets and deadlines promised by the political leadership (Extreme failure, rate 50; complete success, rate 0)	
<> Instances of misleading economic planning and policies (Infrequent, rate between 0 and 25; frequent, rate between 26 and 50)	
Total Pr5	0

Pr6 Form of government (110) (Rate only one indicator)	Your scores Pr6
<> If previous government was toppled by a military coup (Rate between 31 and 50)	
<> If a state of emergency results in interim government (Rate between 21 and 30)	
<> If political system is undergoing transformation toward multi-party government, or if multi-party elections are pending (Rate btw. 11 and 20)	
<> Stable government (Rate between 0 and 10)	
Total Pr6	0

Pr7 Racial, ethnic, nationality tensions (150) (Rate relevant indicators)	Your scores Pr7
<> If collective groupings (liberation movements) hedge against the political system (Rate between 41 and 50)	
<> No legitimacy for government (Rate between 31 and 40)	
<> Sudden changes in political party allegiance and/or alliance (Rate between 11 and 20)	
<> Occurrences of racially or ethnically motivated violence in the last six months (Rate between 21 and 30)	
<> If none of the above prevail (Rate between 0 and 10)	
Total Pr7	0

Pr8 Border disputes/external conflict (11) (Rate relevant indicators)	Your scores Pr8
<> If a territorial dispute is initiated in order to divert attention away from domestic economic problems (Rate between 31 and 50)	
<> An oil company drills in contested waters or similar economic exploitation in disputed areas (Rate between 21 and 30)	
<> Long standing claims to historic territory currently under legitimate jurisdiction of a neighbouring state (Rate between 0 and 20)	
<> If none of the above prevail (Rate between 0 and 10)	
Total Pr8	0

Pr9 Political terrorism (160) (In past six months - rate relevant indicators)	Your scores Pr9
<> Intensity of terrorist activity (If high, rate between 31 and 50; if moderate, rate between 21 and 30; if low, rate between 0 and 20)	
<> If such activity does not prevail (Rate between 0 and 10)	
<> Government expenditure on terrorist defense (Very high, rate betw. 31 and 50; moderate, rate between 21 and 30; low, rate between 0 and 20)	

Total Pr9 0

Pr10 Military unrest (250) (Rate relevant indicators)	Your scores Pr10
<> Past history of military unrest (Rate between 31 and 50)	
<> Threat of military take-over if severe economic deterioration prevails (Rate between 21 and 40)	
<> If the military command stages a coup due to immobility in ranks or an absence of benefits of remuneration (Rate between 11 and 30)	
<> Acts of unwarranted military prestige (Rate between 0 and 20)	
<> Little offensive military capability or intention (Rate betw. 0 and 10)	
<> Level of military involvement in government (High, rate between 26 and 50; low, rate between 0 and 25)	
<> Mobilisation of military in order to enforce executive will (Rate between 26 and 50)	
Total Pr1	0

Pr11 Legitimacy crises (240) (Rate relevant indicators)	Your scores Pr11
<> If there is a lack of homogenous national identity (Rate between 20 and 30)	
<> If there is a lack of distribution of resources (Rate between 30 and 50)	
<> If there is a lack of public participation (Rate between 30 and 50)	
<> If there is a lack of policy enforcement (penetration) (Rate between 20 and 40)	
<> If uncontrolled and rapid urbanisation overtaxes government functions (Very debilitating, rate between 30 and 50, less debilitating, rate between 0 and 29)	
<> If the political system is open and competitive (Rate between 0 and 20)	
Total Pr1	0

Pr12 Government behaviour (300) (Rate all the indicators)	Your scores Pr12
<> Degree of accountability of government (More accountable, rate between 0 and 25; less accountable, rate between 26 and 50)	
<> Degree to which limited or constitutional governance is practised (Unconstitutional, rate between 30 and 50; constitutional, rate between 0 and 29)	
<> Degree of transparency of policy environment (More transparent, rate between 0 and 20; less transparent, rate between 21 and 50)	
<> Degree of responsiveness (More responsive, rate between 0 and 25; less responsive, rate between 26 and 50)	
<> Degree to which responsible governance is practised (More responsible, rate between 0 and 25; less responsible, rate between 26 and 50)	
<> Level of public intervention into the private spheres (High level of interventionism, rate between 26 and 50; low level of intervention, rate between 0 and 25)	
Total Pr1	0

Pr13 Likelihood of social revolution (150) (Rate relevant indicators)	Your scores Pr13
<> If a regime is threatened due to societal will (If result is	

expected to be positive, rate between 0 and 20; if inconsequential, rate between 0 and 30; if negative, rate between 31 and 50)	
<> If a social revolution will alter the prospects advantageously or disadvantageously for investors (Advantageously, rate between 0 and 20; inconsequential, rate between 0 and 30; disadvantage, rate between 31 and 50)	
<> If post-revolutionary society is altered ideologically (Positively, rate between 0 and 20; inconsequential, rate between 0 and 30; negatively, rate between 31 and 50)	
Total Pr1	0

Pr 14 Political (in)stability (250) (Rate relevant indicators)	Your scores Pr 14
<> Implication of major political events like election or scandals (Positive, rate between 0 and 25; negative, rate between 26 and 50)	
<> State of flux or political (dis)equilibrium (Stable, rate between 0 and 25; unstable, rate between 26 and 50)	
<> Unforeseen shifts in government policy (Positive, rate between 0 and 25; negative, rate between 26 and 50)	
<> Unforeseen shifts in government's execution of power (Positive, rate between 0 and 25; negative, rate between 26 and 50)	
<> Governmental allowances or constraints on profit-taking (Positive, rate between 0 and 25; negative, rate between 26 and 50)	
Total Pr1	0

Pr 15 Civil War (200) (Rate relevant indicators)	Your scores Pr 15
<> If domestic conflict within the boundaries of a country involves civilians (Rate between 30 and 50)	
<> If civilians of different religious or ethnic origins are at war (Rate between 30 and 50)	
<> If civilians are at war for historic territory (Rate between 30 and 50)	
<> Incidence of internal civil strife (Low incidence, rate between 0 and 25; high incidence, rate between 26 and 50)	
Total Pr1	0

Pr 16 Declared state of emergency (220) (In last 18 months - rate relevant indicators)	Your scores Pr 16
<> If a state of emergency is expected or has been announced (Rate between 20 and 30)	
<> If a country has a history of emergency situations (No, rate between 0 and 25; yes, rate between 26 and 50)	
<> If declaring a state of emergency implies a political clampdown (Rate between 31 and 40)	
<> If a state of emergency is declared as a last resort to end long-standing instability (Rate between 41 and 50)	
<> If a state of emergency results in a 'failed state' (Rate between 41 and 50)	
Total Pr1	0

Pr17 Relation of economic expectation vs. economic reality (80)	Your scores Pr17
<> Government success rate in fulfilling promises (High, rate between 0 and 20; low, rate between 21 and 40)	
<> Incidence of unrest due to unfulfilled economic expectations (Low, rate between 0 and 20; high, rate between 21 and 40)	
(Rate both indicators)	
Total Pr1	0

Pr18 Leadership succession crisis (270) (In past 18 months - rate relevant indicators)	Your scores Pr18
<> If a country has a history of authoritarian political structure (Rate between 31 and 40)	
<> If a leadership vacuum is anticipated (Rate between 21 and 40)	
<> If a national social identity crisis occurs as a result of leadership succession (Rate between 10 and 30)	
<> If political civil unrest is a result of leadership succession (Rate between 31 and 40)	
<> If public scandals forces leadership succession (Positive change, rate between 0 and 20; negative implications, rate between 21 and 40)	
<> Expected re-election or smooth transition (Rate between 21 and 40)	
<> Successor to executive familiar and gradually introduced (Advantageous results, rate between 0 and 20; disadvantageous, rate between 21 and 40)	
Total Pr1	0

Pr19 Military in politics (120) (Rate all indicators)	Your scores Pr19
<> If government is under military control (Rate between 21 and 40)	
<> If political leadership habitually wear military uniform in public (Rate between 31 and 40)	
<> Definition, setting and adherence to military boundaries (Well defined, rate between 0 and 20; ill defined, rate between 21 and 40)	
Total Pr1	0

Pr20 Erosion of middle class support for the regime (80) (Rate all indicators)	Your scores Pr20
<> Level of economic and social deterioration (Low levels, rate between 0 and 20; high levels, rate between 21 and 40)	
<> An erosion of popular trust and confidence in government (High levels of confidence, rate between 0 and 20; low levels of confidence, rate between 21 and 40)	
Total Pr 2	0

Pr21 Unconstitutional change of government (100) (In past 5 yrs - rate one indicator)	Your scores Pr21
<> If one violent change of government has occurred (Rate between 21 and 30)	
<> If more than one violent change of government has occurred (Rate between 31 and 40)	
<> If peaceful, yet unconstitutional change of government has occurred (Rate between 0 and 20)	
<> If no unconstitutional changes have taken place (Rate between 0 and 10)	
Total Pr 2	0

Pr22 Ideology as a political factor (80) (Rate both indicators)	Your score Pr 22
<> Degree of influence of secular ideology on government policies (Low, rate between 0 and 20; high, rate between 21 and 40)	
<> If anti-systemic government policies prevail (No, rate between 0 and 20; yes, rate between 21 and 40)	
Total Pr2	0

Pr23 Organised religion in politics (80) (Rate both indicators)	Your score Pr 23
<> Degree to which religion is a factor in government policy (High, rate between 21 and 40; low, rate between 0 and 20)	
<> If anti-systemic government policies prevail (No, rate between 0 and 20; yes, rate between 21 and 40)	
Total Pr2	0

Pr24 Demographic and traditional parochialism (360) (Rate relevant indicators)	Your score Pr24
<> Do social problems pose a challenge to the viability of government (No, rate between 0 and 20; inconsequential, rate between 0 and 30; yes, rate between 31 and 40)	
<> If parochial values and structural elements in government contrast negatively with modern ideas and institutions in society (Rate between 11 and 30)	
<> Level of conflict of central government with modern elements of society (Rate between 21 and 40)	
<> Level of conflict of central government with traditional elements of society (Rate between 21 and 40)	
<> If clashes between tradition and modernity in society lead to incidents of violence (Low incidence, rate between 0 and 20; high incidence, rate between 21 and 40)	
<> Is urbanisation controlled (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Does urbanisation place a burden on the state system to provide social needs (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Can institutional and physical infrastructure handle rapid urbanisation (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> A destabilising dense and urban population (Rate between 31 and 40)	
<> If demographics and traditional parochialism either do not occur, or are not destabilising (Rate between 0 and 10)	
Total Pr2	0

Pr25 Corruption/nepotism in government (100) (Rate relevant indicators)	Your scores Pr25
<> If corruption exceeds the bounds of people's acceptance (Rate between 20 and 40)	
<> Companies have to budget for bribery (Rate between 20 and 40)	
<> Incidence of corruption and nepotism low (Rate between 0 and 20)	
Total Pr2	0

Pr26 Law tradition (110) (Rate relevant indicators)	Your scores Pr26
<> If a tradition of order and the rule of law prevails (Rate between 0 and 20)	
<> If a culture of lawlessness exists (Rate between 21 and 40)	
<> Level of protection of investments under the sovereign law of a host country (High, rate between 0 and 20; low, rate between 21 and 40)	
<> If government manages to uphold order and stability (Rate between 0 and 10)	
Total Pr2	0

Pr27 Status of the media (130) (Rate all indicators)	Your scores Pr27
<> If public access to international media broadcasts are controlled (No, rate between 0 and 15; yes, rate between 16 and 30)	
<> If persecution of journalists for criticising government prevails (No, rate between 0 and 15; yes, rate between 16 and 30)	
<> Level of institutionalised media censorship (Low, rate between 10 and 20; high, rate between 21 and 30)	
<> Level of voluntary self-censorship by media (Low, rate between 10 and 20; high, rate between 21 and 30)	
<> Media freedom uninhibited (Rate between 0 and 10)	
Total Pr2	0

Pr28 Human rights record/status (65) (Rate relevant indicators)	Your scores Pr28
<> Signatory of United Nations Declaration of Human Rights Accord (Yes, rate between 0 and 15; no, rate between 16 and 30)	
<> If basic human rights are denied due to racial, ethnic or political affiliations (Rate between 20 and 30)	
<> If basic human rights are upheld or enshrined in a constitution or Basic Law (Rate between 0 and 5)	
Total Pr2	0

Pr29 Quality of the bureaucracy (120) (Rate all indicators)	Your scores Pr29
<> Are government functions efficient and timely (Yes, rate between 0 and 15; no, rate between 16 and 30)	
<> Is internal communication functional (Yes, rate between 0 and 15; no, rate between 16 and 30)	
<> Does government misappropriate funds to the peril of public services (No, rate between 0 and 15; yes, rate between 16 and 30)	
<> Are academic professional qualifications of civil servants questionable and/or of low levels (No, rate between 0 and 15; yes, rate between 16 and 30)	
Total Pr2	0

Pr30 Political will (65) (Rate relevant indicators)	Your scores Pr30
<> Public officials are career civil servants (Rate between 0 and 10)	
<> Public officials are not in office for self-enrichment (Rate between 0 and 10)	
<> Policy is designed and enforced in the best interest of the public (Rate between 0 and 15)	
<> Lack of political will (Rate between 16 and 30)	
Total Pr3	0

Pr 31 Member state of international organisations (30) (Rate indicator)	Your scores Pr31
<> Member state of eg. United Nations, World Trade Organisation, World Tourism Organisation, International Telecommunications Satellite Organisation, European Union, Organisation of Petroleum Exporting Countries, Southern African Development Community, Organisation for African Unity, Southern African Customs Union, ASEAN, North American Free Trade Agreement (Active member, rate between 0 and 15; non-active, rate between 16 and 30)	
Total Pr3	0

Pr32 Domestic openness (120) (Rate all the indicators)	Your scores Pr32
<> Domestic transparency (Perception of domestic transparency high, rate between 0 and 10; low, rate between 11 and 20)	
<> Modern legal frameworks (If followed as such, rate between 0 and 10, if not, rate between 11 and 20)	
<> Adherence to International Law (If adhered to, rate between 0 and 10; if not, rate between 11 and 20)	
<> Steps to eliminate the perception of corruption (If such steps in place and effective, rate between 0 and 10; if such steps in place but ineffective rate between 11 and 20; if no attempt to eliminate or curb corruption, rate between 21 and 30)	
<> Building of strong modern institutions founded in stable political institutions (If in place, rate between 0 and 10; if signs of development, rate between 11 and 20, if lacking, rate between 21 and 30)	
Total Pr3	0

Pr33 Geographic position (130) (Rate all the indicators)	Your scores Pr33
<> Geopolitics (If host country is in favourable geopolitical position, rate between 0 and 10; if in vulnerable but manageable position, rate between 11 and 20; if in vulnerable and unmanageable geopolitical position, rate between 21 and 30)	
<> Systemic status-rank (If sustainably high, rate between 0 and 10; if climbing, rate between 11 and 20; if dropping, rate between 21 and 30; if very low, rate between 31 and 40)	
<> Position in systemic conflict (If not involved in such conflict, rate between 0 and 10; if a mediating force in systemic conflict, rate between 11 and 20; if direct part to such conflict, rate between 21 and 30)	
<> Regional vulnerability (Low degree of regional vulnerability, rate between 0 and 15; high degree, rate between 16 and 30)	
Total Pr3	0

Pr34 Contract repudiation by government (210) (Rate all indicators)	Your scores Pr34
<> Cancellation of operating licences (No such instances, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20; frequent and unexpected instances, rate between 21 and 30)	
<> Cancellation of import and/or export licences (No such instances, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20 frequent and unexpected instances, rate between 21 and 30)	
<> Cancellation of concession agreements (No such instance, rate between 0 and 10; infrequent and selective instances, rate between 11 and 20; frequent and unexpected instances, rate between 21 and 30)	
<> Restrictions on remittances (No restrictions, rate between 0 and 10; varying degrees, rate between 11 and 20; high degree, rate btw. 21 and 30)	
<> Retraction of drilling rights (No past retractions, rate between 0 and 10; event-related past retractions, rate between 11 and 20; frequent and unmotivated retractions, rate between 21 and 30)	
<> Government adherence to a Power Purchase Agreement (Lawful compliance, rate between 0 and 15; failure to comply, rate betw. 16 and 30)	
<> Creeping expropriation (Few instances, rate between 0 and 15; many instances, rate between 16 and 30)	
Total Pr3	0

Pr35 Selective discrimination (210) (In past 18 months - rate all indicators)	Your scores Pr35
<> Ability to import the necessary equipment (Investor able to import, rate between 0 and 10; imports negotiable, rate between 11 and 20; inability to import necessary equipment due to government restrictions, rate between 21 and 30)	

<> Ability to export (extracted minerals) (Able to export, rate between 0 and 10; negotiable, rate between 11 and 20; inability to export due to government restrictions, rate between 21 and 30)	
<> Degree of financial deficiency (Government restrictions do not lead to financial deficiency of investment, rate between 0 and 15; restrictions lead to high levels of deficiency, rate between 16 and 30)	
<> Forced abandonment (No forced abandonment in the past, rate between 0 and 10, trend has subsided, rate between 11 and 20; eminent or current, rate between 21 and 30)	
<> Forced divestiture (None in the past, rate between 0 and 10; trend subsiding, rate between 11 and 20; eminent or current, rate betw. 21 and 30)	
<> Deprivation of mobile assets (None in past, rate btw. 0 and 10; trend subsided, rate betw. 11 and 20; eminent or current, rate between 21 and 30)	
<> Intellectual property rights disputes (None in the past, rate between 0 and 10; possibility of flare-up, rate between 11 and 20; disputes lead to divestiture and abandonment, rate between 21 and 30)	
Total Pr3	0

Pr36 Political violence (270) (In past 18 months - rate all indicators)	Your scores Pr36
<> Revolutionary uprising (None in the past, rate between 0 and 10; active and mobile revolutionary press or civil society keeps government in check, rate between 11 and 20; past trends of uprising as frequent reactionary force, rate between 21 and 30)	
<> Rebellion (None in the past, rate between 0 and 10; rebellion has led to change in government, rate between 11 and 10; past trend of rebellion, rate between 21 and 30)	
<> Insurrection (None in the past, rate between 0 and 10; has led to change in government, rate between 11 and 20; past trend of insurrection, rate between 21 and 30)	
<> Hostile acts (None in the past, rate between 0 and 10; has led to policy changes, rate between 11 and 20; high frequency of hostile acts, rate between 21 and 30)	
<> Enforcement of belligerent power (State does not practice coercive governance, rate between 0 and 10; government threatens with but does not revert to state-violence, rate between 11 and 20; state-violence used against the public is political in nature, rate between 21 and 30)	
<> Instances of terrorism (None in the past, rate between 0 and 10; led to policy changes and manifested as attacks on civilian targets, rate between 11 and 20; high frequency of acts without responsibility taken, rate between 21 and 30)	
<> Instances of mobilism and riots (Civil commotion organised, expected and within acceptable levels, rate between 0 and 10; commotion volatile and instant, rate between 11 and 20; erupts into violence, rate betw. 21 and 30)	
<> Instances of malicious damage and looting (None, rate between 0 and 10; few instances, rate between 11 and 20; many focussed on the presence of foreign businesses or MNC's, rate between 21 and 30)	
Total Pr3	0

Pr37 Elections (260) (Rate all indicators)	Your scores Pr37
<> High voter turnout (If due to civil duty and participation, rate between 0 and 10; if due to intimidation, rate between 11 and 20)	
<> Low voter turnout (If due to complacency, rate between 0 and 15; if due to lack of organisation or rigging, rate between 16 and 30)	
<> Election laws (Internatioanlly comparable and constitutional, rate between 0 and 10; questionable, rate between 11 and 20; not adhered to or do not exist, rate between 21 and 30)	
<> Internationally compliant (Elections compliant with international	

standards, rate between 0 and 15; not compliant, rate between 16 and 30)	
<> Open for scrutiny (Monitors and observers allowed into host country if necessary, rate between 0 and 15; sanctioned or not allowed at all, rate between 16 and 30)	
<> Intimidation and violence (No reports, rate between 0 and 15; frequent reports, rate between 16 and 30)	
<> Irregularities (tampering, vote counting) (No suspected irregularities, rate between 0 and 10; suspected, rate between 11 and 20; proven, rate between 21 and 30)	
<> Media (Total media freedom in election coverage, rate between 0 and 10; sanctioned, rate between 11 and 20; intimidated, harassed and prevented from covering election, rate between 21 and 30)	
<> International acceptance of result (Accepted, rate between 0 and 10; if accepted with reservations, rate between 11 and 20; unaccepted, rate between 21 and 30)	
Total Pr37	0

5.3.2 Economic Risk Factors of Political Risk			
Total (Er1-Er41):	5780	Average percentage Er:	0
Your Er Total:	0	Real percentage Er:	0

Er1 Degree of liberalisation (120)	(Rate all risk factors)	Your scores Er1
<> Central Bank practices managed floating, only intervenes when necessary (Yes, rate between 0 and 20; no, rate between 21 and 40)		
<> Are imports kept in line with exports, is trade balance negative or positive (Positive, rate between 0 and 20; negative, rate between 21 and 40)		
<> Does Central Bank only intervene to stabilise foreign exchange rates (Yes, rate between 0 and 20; no, rate between 21 and 40)		
Total Er1		0

Er2 Risk of confiscation/expropriation (80)	In past 5 years - rate both ind.)	Your scores Er2
<> Country has a past record of confiscating foreign-owned enterprises (No, rate between 0 and 20; yes, rate between 21 and 40)		
<> Ideas of nationalism flare up periodically and pose a threat to foreign-owned enterprises (No, rate between 0 and 20; yes, rate between 21 and 40)		
Total Er2		0

Er3 Stable labour force (280)	(Rate all indicators)	Your scores Er3
<> If there is a shortage of skilled labour (No, rate between 0 and 20; yes, rate between 21 and 40)		
<> Are restrictions concerning the employment of expatriate personnel acceptable (Yes, rate between 0 and 20; no, rate between 21 and 40)		
<> Is labour organised as an influential political force (Less influential, rate between 0 and 20; highly influential, rate between 21 and 40)		

<> Degree of corporatism (High degree, rate between 20 and 40; low degree, rate between 0 and 19)	
<> Impact of consequential split between government-labour alliance (Disadvantageous, rate between 20 and 40; advantageous, rate between 0 and 19)	
<> Degree of militancy and mobility of organised labour (Low, rate between 0 and 20; high, rate between 21 and 40)	
<> Is labour legislation liberal or not (Yes, rate between 0 and 20; no, rate between 21 and 40)	
Total Er3	0

Er4 Domestic economic strength (120) (Rate all indicators)	Your scores Er4
<> Size of average disposable income (Large, rate between 0 and 10; average, rate between 11 and 20; small, rate between 21 and 40)	
<> Inflation rate hikes correspond to wage increases (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Trends in consumerism (Decline, rate between 21 and 40; rise rate between 0 and 20)	
Total Er4	0

Er5 Repatriation of profits policy (160) (Rate all indicators)	Your scores Er5
<> Transferability of profits out of the host country (Easy, rate between 0 and 20; difficult, rate between 21 and 40)	
<> Degree of convertibility of local currency (High, rate between 0 and 20; low, rate between 20 and 40)	
<> Is there a trend towards repudiation of contracts (High incidence, rate between 20 and 40; low incidence; rate between 0 and 20)	
<> Are alternatives to restrictions on repatriation viable or not (Viable, rate between 0 and 20; not viable, rate between 20 and 40)	
Total Er5	0

Er6 Foreign equity ownership policy (160) (Rate all indicators)	Your scores Er6
<> Can investors' stake in an enterprise be larger than 50% (Yes, rate between 0 and 20; no, rate between 20 and 40)	
<> Is less control acceptable in the hope of getting quick approval from the authorities (No, rate between 0 and 20; yes, rate between 20 and 40)	
<> Can local partners delay approval of business plans of foreign partners (No, rate between 0 and 20; yes, rate between 20 and 40)	
<> Allowance of international arbitration agreements (Yes, rate between 0 and 20; no, rate between 20 and 40)	
Total Er6	0

Er7 Privatisation of important industries/sectors (160) (Rate all indicators)	Your scores Er7
<> Host country favours monopolies and state enterprises over private enterprises (No, rate between 0 and 20; yes, rate between 20 and 40)	
<> 'Large' private sector is protected by tariff barriers, monopolies or government contracts (No, rate between 0 and 20; yes, rate between 20 and 40)	
<> Does private sector rather serve as routing for uncontrolled	

foreign exchange outflows (No, rate between 0 and 20; yes, rate between 20 and 40)	
<> Have previously nationally owned enterprises been privatised to improve service (Yes, rate between 0 and 20; no, rate between 20 and 40)	
Total Er7	0

Er8 Gross Domestic Product (GDP) (200) (Rate all indicators)	Your scores Er8
<> A declining GDP would result in subsequent social intolerance of government (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Relative values of goods and services is acceptable (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Expenditure to produce goods and services is at an acceptable level (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Income received from producing goods and services is at an acceptable level (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Level of general and secondary income activity (High, rate between 0 and 20; moderate, rate between 10 and 30; low, rate between 21 and 40)	
Total Er8	0

Er9 Nationalisation of key industries/sectors (200) (Rate all indicators)	Your scores Er9
<> Efficiency of state-owned enterprises (Efficient, rate between 0 and 20; inefficient, rate between 21 and 40)	
<> Are state-owned enterprises monopolistic and protected from competition (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Are state-owned enterprises politicised, run and staffed by government supporters or retired military personnel (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Are state-owned enterprises export-oriented and competitive (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Are state-owned enterprises geared for positive expansion and development (Yes, rate between 0 and 20; no, rate between 21 and 40)	
Total Er9	0

Er10 Losses from exchange controls (13) (Rate relevant indicators)	Your scores Er10
<> If currency conversion crises prevail (Rate between 21 and 40)	
<> Central Bank manages to stabilise domestic currency against international exchange rates (Rate between 0 and 20)	
<> Fixed exchange rate prevails under high inflation (Rate between 10 and 30)	
<> Currency depreciation (Anticipated and controlled, rate between 0 and 20; uncontrollable and rapid, rate between 21 and 40)	
Total Er10	0

Er11 Degree of protectionism (240) (Rate all the indicators)	Your scores Er11
<> Private enterprise is overly protected by tariffs (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Monopolies are protected from competition (No, rate between 0 and 20; yes, rate between 21 and 40)	

<> Non-tariff barriers hedge against competition (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Are government contracts the primary income of an industry (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Is import substitution subsidised (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Do quotas, licensing or bureaucratic delays hedge against foreign investment (No, rate between 0 and 20; yes, rate between 21 and 40)	
Total Er1	0

Er12 Militancy of organised labour (160) (Rate all the indicators)	Your scores Er12
<> Implications of organisation and mobility of labour (No consequence, rate between 0 and 10; some consequence, rate between 11 and 20; serious consequence, rate between 21 and 30; extremely serious consequence, rate between 31 and 40)	
<> Is membership of a labour organisation compulsory (No, rate between 0 and 20; yes, rate between 21 and 40)	
<> Willingness of labour to negotiate rationally with management (Willing, rate between 0 and 20; unwilling, rate between 21 and 40)	
<> Confrontation between rival labour organisations is reason for incidents of violence (No, rate between 0 and 20; yes, rate between 21 and 40)	
Total Er1	0

Er13 Competitiveness (240) (Rate all the indicators)	Your scores Er13
<> Degree of export-led orientation followed in the economy (High, rate between 0 and 20; low, rate between 21 and 40)	
<> Import substitution resulted in subsequent exports (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Is there a large number of domestic buyers and sellers of products produced locally (Yes, rate between 0 and 20; no, rate between 21 and 40)	
<> Degree of interventionist measures practised domestically by government (Low, rate between 0 and 20; high, rate between 21 and 40)	
<> Degree of mobility of factors of production domestically (High, rate between 0 and 20; low, rate between 21 and 40)	
<> Are buyers and sellers free to enter and leave the domestic market (Yes, rate between 0 and 20; no, rate between 21 and 40)	
Total Er1	0

Er14 Level of state intervention (320) (Rate all the indicators)	Your scores Er14
<> Is government economic planning centralised (Marginally, rate between 0 and 20; largely, rate between 21 and 40)	
<> Is there strict government control of import licenses (Less restrictive, rate between 0 and 20; more restrictive, rate between 21 and 40)	
<> Level of government control of new investment in terms of general or production targets (Low, rate between 0 and 20; high, rate between 21 and 40)	
<> Are banks state-owned (Some, rate between 0 and 15; mostly, rate between 16 and 30; all, rate between 31 and 40)	
<> Are state-owned banks selective in directing credit to certain sectors (Not selective, rate between 0 and 10; moderately selective, rate between 11 and 25; very selective, rate between 26 and 40)	

<p>↔ Are industry and agricultural sectors state-owned/controlled (Some, rate between 0 and 10; mostly, rate between 11 and 25; all, rate between 26 and 40)</p>	
<p>↔ Is entrepreneurship promoted (Yes, rate between 0 and 20; no, rate between 21 and 40)</p>	
<p>↔ To what extent are inflexibility and inefficiency results of central planning (Some, rate between 0 and 20; large, rate between 21 and 40)</p>	
Total Er1	0

Er15 Economic Impact of AIDS (200)	(Rate all the indicators)	Your scores Er15
<p>↔ Is AIDS a destabilising factor in the economy of the host country (No, rate between 0 and 20; yes, rate between 21 and 40)</p>		
<p>↔ Is government policy toward AIDS realistic (Yes, rate between 0 and 20; no, rate between 21 and 40)</p>		
<p>↔ Will the infrastructure in the host country be able to cope with the consequences of AIDS (Yes, rate between 0 and 20; no, rate between 21 and 40)</p>		
<p>↔ Is AIDS a threat to the economic security of the host country (No, rate between 0 and 20; yes, rate between 21 and 40)</p>		
<p>↔ Is AIDS a threat to regional economic security and stability (No, rate between 0 and 20; yes, rate between 21 and 40)</p>		
Total Er1		0

Er16 Efficient Banking System (180)	(Rate all the indicators)	Your scores Er16
<p>↔ Existence of state-owned banks complementary to privately owned banks (To large extent, rate between 0 and 15; to some extent, rate between 16 and 30)</p>		
<p>↔ Are interest rates realistically determined (Yes, rate between 0 and 15; no, rate between 16 and 30)</p>		
<p>↔ Is Central Bank competency recognised (Internationally, rate between 0 and 15; regionally, rate between 16 and 30)</p>		
<p>↔ Are personal funds available on request (Immediately, rate between 0 and 15; on application, rate between 16 and 30)</p>		
<p>↔ Is foreign exchange available on request (Immediately, rate between 0 and 15; on application, rate between 16 and 30)</p>		
<p>↔ Private banking facilities sophisticated, internationally competitive and safe (Yes, rate between 0 and 15; no, rate between 16 and 30)</p>		
Total Er1		0

Er17 Confidence in finance ministry (60)	(Rate both indicators)	Your scores Er17
<p>↔ Is competency of finance minister recognised (Internationally, rate between 0 and 15; regionally, rate between 16 and 30)</p>		
<p>↔ Confidence in policy penetration (High, rate between 0 and 10; medium, rate between 11 and 20; low, rate between 21 and 30)</p>		
Total Er1		0

Er18 Real interest rate (90)	(Rate all indicators)	Your scores Er18
<p>↔ Is interest rate minus inflation rate low or high (High, rate between 0 and 15; low, rate between 16 and 30)</p>		
<p>↔ Levels of the cost of borrowing money (Low, rate between 0 and 15; high; rate between 16 and 30)</p>		
<p>↔ Is the real interest rate coupled with a low inflation rate (Yes, rate between 0 and 15; no, rate between 16 and 30)</p>		

Total Er1

Er19 MIGA signatory (30) (Rate the indicator)

Your scores Er19

<> **Is host country a signatory to the Multilateral Investment Guarantee Agency** (Full, rate between 0 and 15; conditional, rate between 16 and 30)

Total Er1

Er20 Sound physical infrastructure (240) (Rate all the indicators)

Your scores Er20

<> **Can goods be transferred and delivered on time by air, road and rail** (To large extent, rate between 0 and 15; to a lesser extent, rate between 16 and 30)

<> **Are there often electricity supply problems** (Not often, rate between 0 and 15; often, rate between 16 and 30)

<> **Condition of public roads** (Good, rate between 0 and 10; fair, rate between 11 and 20; poor, rate between 21 and 30)

<> **Availability of storage and warehousing capacity and facilities** (Readily, rate between 0 and 10; adequate, rate between 11 and 20; scarce, rate between 21 and 30)

<> **Are volumes of new property developments or industrial construction sites in relation to general economic developments** (Yes, rate between 0 and 15; no, rate between 16 and 30)

<> **Are regular flights in and out of the host country reliable** (Yes, rate between 0 and 15; no, rate between 16 and 30)

<> **Are repairs to damaged property or infrastructure regularly undertaken** (Regularly, rate between 0 and 15; not so regularly, rate between 16 and 30)

<> **Are roads maintained and networks improved** (Improved, rate between 0 and 10; maintained, rate between 11 and 20; neglected, rate between 21 and 30)

Total Er2

Er21 Economic growth rate (150) (Rate all indicators)

Your scores Er21

<> **Is there a trend toward a declining annual growth rate** (Slow decline, rate between 0 and 15; rapid decline, rate between 16 and 30)

<> **Is there a trend toward an increasing annual growth rate** (Fast increase, rate between 0 and 15; slow increase, rate between 16 and 30)

<> **Does economic growth create employment** (High level, rate between 0 and 10; jobless growth, rate between 11 and 20; low level, rate between 21 and 30)

<> **Are measures being taken to reverse temporary decline in economic growth** (In time, rate between 0 and 10; just in time, rate between 11 and 20; too late, rate between 21 and 30)

<> **To what extent is economic growth in irreparable decline** (Some extent, rate between 0 and 15; large extent, rate between 16 and 30)

Total Er2

Er22 Annual average inflation rate (120) (Rate all indicators)

Your scores Er22

<> **Is escalation rate of inflation rapid or slow** (Slow, rate between 0 and 15; rapid, rate between 16 and 30)

<> **Can an investor safeguard against a rising inflation rate by means of contract, or in the way an organisation structures itself in the host country** (To large extent, rate between 0 and 15; to some extent, rate

between 16 and 30)	
<> Are sudden inflation rate rises a reflection of present distortions (Trend will moderate, rate between 0 and 15; trend will intensify, rate between 16 and 30)	
<> Do rapidly rising prices signify a continuation of social and political problems associated with allocative inefficiency (To some extent, rate between 0 and 15; to large extent, rate between 16 and 30)	
Total Er2	0

Er 23 Economically active population (90) (Rate all indicators)	Your scores Er23
<> Percentage of people between the ages of 16 and 65 years exceeding that of 0-15 years, and 66 years and above (If trend is positive, rate between 0 and 15; if trend is negative, rate between 16 and 30)	
<> Economically active population having easy access to health facilities and education (Large measure, rate between 0 and 15; small measure, rate between 16 and 30)	
<> Percentage of the economically active population with a secondary education (High, rate between 0 and 15; low percentage, rate between 16 and 30)	
Total Er2	0

Er 24 Change in real wages (90) (Rate all indicators)	Your scores Er24
<> Do real wages rise advantageously in relation to rising inflation rate (Yes, rate between 0 and 15; no, rate between 16 and 30)	
<> Do changes in real wages result in labour protest (Seldom, rate between 0 and 15; often, rate between 16 and 30)	
<> Changes in real wages have disadvantageous social ramifications (Seldom, rate between 0 and 15; often, rate between 16 and 30)	
Total Er2	0

Er25 Price index (150) (Rate all indicators)	Your scores Er25
<> Are rapid increases in the price index prevalent (No, rate between 0 and 15; yes, rate between 16 and 30)	
<> Does indexation reduce the immediate effects of price increases (Constantly, rate between 0 and 15; sporadic, rate between 16 and 30)	
<> To which degree are causative factors of inflation constant (Large degree, rate between 0 and 15; lesser degree, rate between 16 and 30)	
<> Is the government winning or losing the battle against inflation (Winning, rate between 0 and 15; losing, rate between 16 and 30)	
<> To what extent is government neglecting economic matters in favour of political aims (Lesser extent, rate between 0 and 15; large extent, rate between 16 and 30)	
Total Er2	0

Er26 Current budget ratio (120) (Rate all indicators)	Your scores Er26
<> Is size of country's public sector in decline or on the increase (Decline, rate between 0 and 15; increase, rate between 16 and 30)	
<> Does government use some form of price intervention or special subsidies (Few, rate between 0 and 15; many, rate between 16 and 30)	
<> Does the CBR express a moderate to very high government budget deficit (Moderate, rate between 0 and 10; high, rate between 11 and 20; very high, rate between 21 and 30)	
<> Does the CBR express persistently high negative or positive values (High positive, rate between 0 and 10; moderate, rate between 11 and 20; low positive, rate between 21 and 30)	

11 and 20; high negative, rate between 21 and 30)		
Total Er2		0

Er27 Discrimination against foreign business (170) (Rate all indicators)	Your scores Er27	
<> Do non-tariff barriers prevent or improve the profitability of foreign investment (Improves, rate between 0 and 15; prevents, rate between 16 and 30)		
<> Licenses for foreign investors subject to discrimination in allocation of export and other licenses (To lesser extent, rate between 0 and 10, to large extent, rate between 11 and 20)		
<> Inclusion of foreign investors in quotas (Included, rate between 0 and 10; not included, rate between 11 and 20)		
<> Bureaucratic delays purposefully keep foreign investors out of the market (Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20)		
<> Acquisition for a visa for entry/residence in a host country (Difficult, rate between 11 and 20; easy, rate between 0 and 10)		
<> Foreign investors forced to adhere to prescribed hiring practices (Lesser extent, rate between 0 and 10; large extent, rate between 11 and 20)		
<> Are company taxes moderate or very high (Moderate, rate between 0 and 10; high, rate between 11 and 20)		
<> Are product boycotts held against foreign produce (Seldom, rate between 0 and 10; often, rate between 11 and 20)		
Total Er2		0

Er28 Adequate international reserves (60) (Rate all indicators)	Your scores Er28	
<> Does host country own enough in foreign reserves to cover three months worth of government expenses (More than enough, rate between 0 and 10; less than sufficient, rate between 10 and 20)		
<> Does a sizeable surplus or deficit prevail in the balance of payments (Surplus, rate between 0 and 10; deficit, rate between 11 and 20)		
<> Do imports exceed exports or does the opposite prevail (Exports exceed, rate between 0 and 10; imports exceed, rate between 11 and 20)		
Total Er2		0

Er29 Debt service burden (120) (Rate all indicators)	Your scores Er29	
<> Does the host country have a good or bad reputation of default on international debts (Good, rate between 0 and 10; bad, rate between 11 and 20)		
<> Is international creditworthiness questionable or satisfactory (Satisfactory, rate between 0 and 10; questionable, rate between 11 and 20)		
<> Does debt service burden constitute more or less than 50% of GDP (Less, rate between 0 and 10, more, rate between 11 and 20)		
<> Does debt service burden exceed exports (No, rate between 0 and 10; yes, rate between 11 and 20)		
<> Does debt service burden prevent social and economic development (No, rate between 0 and 10; yes, rate between 11 and 20)		
<> Is debt service burden more than GDP (No, rate between 0 and 10; yes, rate between 11 and 20)		
Total Er2		0

Er30 Preservation of resources (100) (Rate all indicators)	Your scores Er30
<> Is prevention of extinction of species adequately controlled (Adequately, rate between 0 and 10; inadequately, rate between 11 and 20)	
<> Has government formulated and implemented adequate environmental plans (Adequate, rate between 0 and 10; inadequate, rate between 11 and 20)	
<> Is population growth a threat to the preservation of resources (No threat, rate between 0 and 10; substantial threat, rate betw. 11 and 20)	
<> Levels of water contamination (Low, rate between 0 and 10; high, rate between 11 and 20)	
<> Does government practise development within national environmental legislation (Yes, rate between 0 and 10; no, rate between 11 and 20)	
Total Er3	0

Er31 Deforestation rate (60) (Rate all indicators)	Your scores Er31
<> Is deforestation adequately controlled (Adequate, rate between 0 and 10; inadequate, rate between 11 and 20)	
<> Is deforestation adequately coupled with reforestation programmes (Adequate, rate between 0 and 10; inadequate, rate between 11 and 20)	
<> Is the rate of reforestation higher or lower than that of deforestation (Higher, rate between 0 and 10; inadequate, rate between 11 and 20)	
Total Er3	0

Er32 Carbon dioxide emissions of fossil fuels in millions of metric tons per annum (60) (Rate all indicators)	Your scores Er32
<> Do government regulations result in a decline or increase of carbon dioxide emissions (Decline, rate between 0 and 10; increase, rate between 11 and 20)	
<> Do successful government plans to regulate such emissions exist (Yes, rate between 0 and 10; no, rate between 11 and 20)	
<> Does a result of such emissions lead to incidence of acid rain (Low incidence, rate between 0 and 10; high, rate between 11 and 20)	
Total Er3	0

Er33 Terms of trade (120) (Rate all indicators)	Your scores Er33
<> Are terms of trade favourable or unfavourable (Favourable, rate between 0 and 10; unfavourable, rate between 11 and 20)	
<> Is rate of trade growth high or low (High, rate between 0 and 10; low, rate between 11 and 20)	
<> International trade features as a large or moderate share of GDP (Large, rate between 0 and 10; moderate, rate between 11 and 20)	
<> Are levels of imports and exports consistent with both a satisfactory economic growth rate and a financing gap which can be met (Consistent, rate between 0 and 10; inconsistent, rate between 11 and 20)	
<> To what extent is export promotion supported by government (Large extent, rate between 0 and 10; lesser extent, rate between 11 and 20)	
<> Is a competitive exchange rate maintained (Yes, rate between 0 and 10; no, rate between 11 and 20)	
Total Er3	0

Er34 Unemployment rate (100) (Rate all indicators)	Your scores Er34
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<> Relation of unemployed percentage of the economically active population to the employed (Does not exceed, rate between 0 and 10; exceeds, rate between 11 and 20)	
<> High unemployment coupled with a low per capita income (If negative, rate between 0 and 10; positive, rate between 11 and 20)	
<> High per capita income coupled with low unemployment (If positive, rate between 0 and 10; negative, rate between 11 and 20)	
<> High employment rate is coupled with high inflation rate (If positive, rate between 0 and 10; negative, rate between 11 and 20)	
<> High unemployment is coupled with low inflation (If positive, rate between 0 and 10; negative, rate between 11 and 20)	
Total Er3	0

Er35 Government expenditure (100) (Rate all indicators)	Your scores Er35
<> Is level of public expenditure on defence high or acceptable (Acceptable, rate between 0 and 10; high, rate between 11 and 20)	
<> Does level of government expenditure on defence support the augmentation of military institutional power (No, rate between 0 and 10; yes, rate between 11 and 20)	
<> Is level of public expenditure on health acceptable (Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20)	
<> Is level of public expenditure on education acceptable (Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20)	
<> Government expenditure organised along ethnic, language or social lines (No, rate between 0 and 10; yes, rate between 11 and 20)	
Total Er3	0

Er36 Loan default/unfavourable loan restructuring (60) (Rate all indicators)	Your scores Er36
<> Are structural adjustment programmes being implemented at high or moderate social costs (Moderate, rate between 0 and 10; high, rate between 11 and 20)	
<> Levels of service interest accumulated on debt (Acceptable, rate between 0 and 10; not acceptable, rate between 11 and 20)	
<> Good or bad reputation of servicing international loans (Good, rate between 0 and 10; bad, rate between 11 and 20)	
Total Er3	0

Er37 Macroeconomic policy (90) (Rate all indicators)	Your scores Er37
<> Sound macroeconomic policy (Domestically and internationally, rate between 0 and 10; policy developing for improvement, rate between 11 and 20; policy goals not realistic, rate between 21 and 30)	
<> Balance of payments (Budget surplus and high level of reserves, rate between 0 and 15; deficit and inadequate reserves, rate between 16 and 30)	
<> Savings Rates (High rates, rate between 0 and 16; low, rate between 16 and 30)	
<> Levels of capital investment (High, rate between 0 and 15; low, rate between 16 and 30)	
Total Er3	0

Er38 Financial sector supervision (180) (Rate all indicators)	Your scores Er38
<> Supervisory practices (On par with international standards, rate between 0 and 15; questionable, rate between 16 and 30)	
<> Foreign ownership limits and restrictions (If easing, rate between 0 and 15, if tightened, rate between 16 and 30)	

<> Capital (liquidity) requirements (If requirements are increasing, rate between 0 and 15; if slackened, rate between 16 and 30)	
<> Closing insolvent institutions (If closed responsibly, rate between 0 and 15; if lack in oversight results in insolvent institutions not being closed, rate between 16 and 30)	
<> Sanctioning of financial practice (Sanctioned and scrutinised, rate between 0 and 15; low levels of transparency, rate between 16 and 30)	
Total Er3	0

Er39 Vulnerability spread (90) (Rate all indicators)	Your scores Er39
<> Reliance on oil imports (Flexible vulnerability to supply and prices, rate between 0 and 15; high level of reliance on oil imports and consequent vulnerability, rate between 16 and 30)	
<> Export of single commodity (Many commodities exportable, rate between 0 and 15; single commodity exported concomitant to high level of commodity market and climate vulnerability, rate between 16 and 30)	
<> Reliance on single commodity (Degree of market and climate sensitivity of single commodity low, rate between 0 and 10; if sensitive but manageable, rate between 11 and 20; if highly sensitive, rate between 21 and 30)	
Total Er3	0

Er40 Stability and ability of central banks (160) (Rate all indicators)	Your scores Er40
<> Extent of central bank insurance (Adequate, rate between 0 and 15; inadequate, rate between 16 and 30)	
<> Qualifications, profile, competence of central bank management (Proven competent, rate between 0 and 15; low levels of competence, rate between 16 and 30)	
<> Central bank independence and levels of state intervention (High level of independence and low level of interference, rate between 0 and 15; low level of independence and high level of interference, rate between 16 and 30)	
<> Size of foreign reserve in months-worth coverage (In excess of three months, rate between 0 and 15; insignificant level of foreign reserves, rate between 16 and 30)	
<> Are banking and financial supervisory laws upheld (At all times and instances, rate between 0 and 10; occasionally, rate between 11 and 20; laws exist but are not upheld, rate between 21 and 30; laws do not exist at all, rate between 31 and 40)	
Total Er4	0

Er41 Fiscal prudence (220) (Rate all indicators)	Your scores Er41
<> Loan classification and bank licensing (Tight rules upheld, rate between 0 and 10; rules exist but are not upheld, rate between 11 and 20; rules do not exist at all, rate between 21 and 30)	
<> Bankruptcy laws (Meet international standards, rate between 0 and 10; laws exist but are not internationally comparable, rate between 11 and 20; no bankruptcy laws exist, rate between 21 and 30)	
<> Guidelines for assessment of owners, board members, managers of financial institutions (Well established, internationally valid and enforced, rate between 0 and 10; guidelines exist, but are not enforced, rate between 11 and 20; no existing guidelines, rate between 21 and 30)	
<> Banking supervision laws, regulations (Tight laws, prudent regulations are enforced, rate between 0 and 10; exist but are not enforced, rate between 11 and 20; no laws and regulations exist, rate between 21 and 30)	
<> Strong rules governing disclosure, auditing, accounting practices (Are enforced, rate between 0 and 10, exist but are not enforced, rate between 11 and 20; no such rules exist, rate between 21 and 30)	

<> Deposit-insurance schemes (In place and functional, rate between 0 and 10; exists but unlikely to function, rate between 11 and 20; no such schemes exist, rate between 21 and 30)	
<> Privatisation of institutions with high levels of state intervention (Strategies in place and met with little resistance, rate between 0 and 10; strategies in place met with resistance, rate between 11 and 20, no strategies in place but talks have commenced, rate between 21 and 30; no strategies exist, rate between 31 and 40)	
Total Er4	0

5.3.3 Social Risk Factors of Political Risk			
Total (Sr1-Sr25):	1402	Average percentage Sr:	0
Your Sr Total:	0	Real percentage Sr:	0

Sr1 Government investment in human capital (110) (Rate both indicators)	Your scores Sr1
<> Government investment in quality of labour (High levels of investment with positive results, rate between 0 and 20; high levels, but ineffective, rate between 21 and 40; little or no signs, rate between 41 and 60)	
<> Financing of skills development (Skills levies can be claimed back from government, rate between 0 and 25; another system of skills development is in place, rate between 0 and 25; if system is not in place, nor any such system, rate between 26 and 50)	
Total Sr1	0

Sr2 Literacy rate (30) (Rate the indicator)	Your scores Sr2
<> Is the literacy rate of the economic active population higher or lower than 50% (Higher, rate betwn. 0 and 15; lower, rate betwn. 16 and 30)	
Total Sr2	0

Sr3 Job mobility impediments (60) (Rate both indicators)	Your scores Sr3
<> Public sector education lags behind education in business, engineering and science (Immeasurably, rate between 0 and 10; measurably, rate between 11 and 20; seriously, rate between 21 and 30)	
<> A pool of educated but discontented people developed, demanding appropriate employment (Low measure of discontent, rate between 0 and 10; moderately discontent, rate between 11 and 20; large measure of discontent, rate between 21 and 30)	
Total Sr3	0

Sr4 GINI coefficient (60) (Rate one indicator)	Your scores Sr4
<> GINI coefficient is between 0.30 (highly equal distribution of income) and 0.70 (highly unequal distribution of income) (Rate betw. 11 and 20)	
<> If the GINI coefficient is lower than 0.30 (Rate between 0 and 10)	
<> If the GINI coefficient is higher than 0.70 (Rate between 21 and 30)	
Total Sr4	0

Sr5 Education ratio - student:teacher (30) (Rate the indicator)	Your scores Sr5
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<> Is the ratio less or more than 26 pupils per teacher (Less, rate between 0 and 15; more, rate between 16 and 30)	
Total Sr5	0

Sr6 GDP per capita income (30) (Rate the indicator)	Your scores Sr6
<> Is a positive or negative annual growth rate of per capita income prevailing (Positive, rate between 0 and 10; stagnant, rate between 11 and 20; negative, rate between 21 and 30)	
Total Sr6	0

Sr7 Mean period of schooling (60) (Rate one indicator)	Your scores Sr7
<> If mean period of schooling exceeds 10 years (Rate between 0 and 10)	
<> If mean period of schooling is 10 years (Rate between 11 and 20)	
<> If mean period of schooling is less than 10 years (Rate between 21 and 30)	
Total Sr7	0

Sr8 Unemployment rate (30) (In last quarter - rate the indicator)	Your scores Sr8
<> Percentage rise in the unemployment rate (Low, rate between 0 and 15; high, rate between 16 and 30)	
Total Sr8	0

Sr9 Attitude toward foreign businesspeople/visitors (120) (Rate all indicators)	Your scores Sr9
<> Is acquiring a visa laborious, expensive and difficult (No, rate between 0 and 15; yes, rate between 16 and 30)	
<> Are travellers harassed at airports i.e. by (military) personnel (No, rate between 0 and 10; moderately, rate between 11 and 20; frequently, rate between 21 and 30)	
<> Do attacks on tourists and foreigners prevail (Infrequently, rate between 0 and 10; frequently, rate between 11 and 20; excessively, rate between 21 and 30)	
<> Are tourist concessions implemented (Equal to international norms, rate between 0 and 10; less than the norm, rate between 11 and 20; not at all, rate between 21 and 30)	
Total Sr9	0

Sr10 Acceptable quality of life (90) (Rate all indicators)	Your scores Sr10
<> Access to public services (Easy, rate between 0 and 10; conditional, rate between 11 and 20; difficult, rate between 21 and 30)	
<> Level of crime rate (Low, rate between 0 and 10; moderate, rate between 11 and 20; high, rate between 21 and 30)	
<> Is life expectancy in excess of an average of 66 years (In excess, rate between 0 and 15; less than, rate between 16 and 30)	
Total Sr10	0

Sr11 Urbanisation rate (150) (Rate relevant indicators)	Your scores Sr11
<> Rapid rate of urbanisation places increased pressure on government spending, i.e. infrastructure (sewerage, roads, electricity, housing and the maintenance of law and order) (Moderate pressure, rate between 0 and 10; increasing pressure, rate between 11 and 20; exceptional pressure, rate between 21 and 30)	
<> Urbanisation rate results in a decline in the productivity of the	

agricultural sector (<i>Moderate decline, rate between 0 and 10; increasing decline, rate between 11 and 20; extensive decline, rate between 21 and 30</i>)	
<> Is urbanisation controlled, or does it place a burden on the state system to provide social needs (<i>Yes, rate 0 and 15; no, rate between 16 and 30</i>)	
<> Can institutional and physical infrastructure handle rapid urbanisation (<i>Yes, rate between 0 and 15; no, rate between 16 and 30</i>)	
<> A destabilising dense urban population (<i>Rate between 20 and 30</i>)	
Total Sr1	0

Sr12 Population growth percentage per annum (40) (Rate both indicators)	Your scores Sr12
<> Does the percentage of population growth per annum exceed the percentage of employment growth per annum (<i>No, rate between 0 and 10; yes, rate between 11 and 20</i>)	
<> Does number of live births per annum exceed the number of deaths per annum (<i>No, rate between 0 and 10; yes, rate between 11 and 20</i>)	
Total Sr1	0

Sr13 Average calorie intake (30) (Rate one indicator)	Your scores Sr13
<> Average calorie intake is less than 2100 per day (<i>Rate bt. 11 and 20</i>)	
<> Average calorie intake is more than 2100 per day (<i>Rate bt. 0 and 10</i>)	
Total Sr1	0

Sr14 Health care (150) (Rate relevant indicators)	Your scores Sr14
<> If the ratio of population per doctor is less than 400 (<i>Rate between 0 and 5</i>)	
<> If the ratio of population per doctor is between 400 and 4800 (<i>Rate between 6 and 15</i>)	
<> If the ratio of population per doctor exceeds 4800 (<i>Rate between 16 and 20</i>)	
<> If the ratio of nurses per doctor exceeds 2 (<i>Rate between 0 and 10</i>)	
<> Accessibility of health care facilities and health care professionals (<i>Very accessible, rate between 0 and 25; not accessible, rate between 26 and 50</i>)	
<> Realistic government health policy (<i>Realistic, rate between 0 and 25; unrealistic, rate between 26 and 50</i>)	
Total Sr1	0

Sr15 Life expectancy (30) (Rate one indicator)	Your scores Sr15
<> If life expectancy exceeds an average of 66 years (<i>Rate between 0 and 10</i>)	
<> If life expectancy is less than an average of 66 years (<i>Rate between 11 and 20</i>)	
Total Sr1	0

Sr16 Infant mortality rate (30) (Rate one indicator)	Your scores Sr16
<> If the infant mortality rate exceeds 48 per 1000 live births (<i>Rate between 11 and 20</i>)	
<> If the infant mortality rate is less than 48 per 1000 live births (<i>Rate between 0 and 10</i>)	
Total Sr1	0

Sr17 Telephones per 1000 people (30) (Rate one indicator)	Your scores Sr17
<> If the number of telephones exceeds 130 per 1000 (Rate btw. 0 and 10)	
<> If the number of telephones is less than 130 per 1000 people (Rate between 11 and 20)	
Total Sr17	0

Sr18 Population access rates (40) (Rate all indicators)	Your scores Sr18
<> If facilities can be reached on foot or by the local means of transport within one hour by at least 50% of the population (Rate between 6 and 10; if more than 50%, rate between 0 and 5)	
<> If at least 79% of the population has access to health services (Rate between 0 and 5; if less, rate between 6 and 10)	
<> If at least 69% of the population has access to safe water (Rate between 0 and 5; if less, rate between 6 and 10)	
<> If at least 36% of the population has access to sanitation (Rate between 0 and 5; if less, rate between 6 and 10)	
Total Sr1	0

Sr19 Provision of public services (25) (Rate all indicators)	Your scores Sr19
<> Is the provision of public services unreliable, sporadic and vulnerable to incompetence (Rate between 5 and 10)	
<> Does a culture of non-payment for public services prevail (Rate between 5 and 10)	
<> If public services are reliable (Rate between 0 and 5)	
Total Sr1	0

Sr20 Global Human Development Rating (HDI) (17) (Rate one indicator)	Your scores Sr20
<> If HDI rates a country in the 'high' category - averaging 0.916 (Rate between 0 and 2)	
<> If HDI rates a country in the 'medium' category - averaging between 0.570 and 0.759 (Rate between 3 and 5)	
<> If HDI rates a country in the 'low' category - averaging 0.389 (Rate between 6 and 10)	
Total Sr2	0

Sr21 Daily newspapers number of copies per 1000 people (10) (Rate the indicator)	Your scores Sr21
<> If there is an average of 96 copies per 1000 people (Rate between 0 and 5; if less, rate between 6 and 10)	
Total Sr2	0

Sr22 Radio receivers per 1000 people (10) (Rate the indicator)	Your scores Sr22
<> If there is an average of 350 radio receivers per 1000 people (Rate between 0 and 5; if less, rate between 6 and 10)	
Total Sr2	0

Sr23 Social conscious(ness) of government (60) (Rate both indicators)	Your scores Sr23
<> Investment in social capital and entrepreneurship (Actions in place are showing results, rate between 0 and 10; action under development but not yet implemented, rate between 11 and 20; no actions in place, rate between 21 and 30)	
<> Openness/competitiveness in technological skills (Development thereof results in openness and competitiveness, rate between 0 and 10;	

development in early stages, rate between 11 and 20; not a government priority, rate between 21 and 30)		
Total Sr2		0

Sr24 Societal uprising (120) (Rate all the indicators)	Your scores Sr24
<> Violence, demonstration(s) aimed at MNC's (None, rate between 0 and 10; trend is subsiding, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40)	
<> Instances of collective subversion, looting, vandalism (None, rate between 0 and 10; trend is subsiding, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40)	
<> Malicious damage (No past instances, rate between 0 and 10; trend is subsiding, rate between 11 and 20; flare-up around political events, policy speeches and scandals, rate between 21 and 30; frequent and unexpected instances, rate between 31 and 40)	
Total Sr2	0

Sr25 Climate (40) (Rate the indicator)	Your scores Sr25
<> Is country situated in tropical or subtropical climatic zone (No, rate between 0 and 20; yes, rate between 21 and 40)	
Total Sr2	0

AVERAGE PERCENTAGE CHANCE THAT RISK MIGHT OCCUR: 0

Average percentage chance that risk might occur TEST VALUE: 0

REAL PERCENTAGE CHANCE THAT RISK MIGHT OCCUR: 0

Real percentage chance that risk might occur TEST VALUE: 0

TOTAL RISK AS A PERCENTAGE CHANCE THAT RISK MIGHT OCCUR: 0

5.4 The Coega Example

This example is based on the comprehensive model for political risk analysis offered in section 5.3 of this chapter. Most of the information used for researching this section was taken from relevant websites pertaining to the topics and from the printed media. Because the example is so current, not much has been published in journals or books per se. As explained before, the model used in section 5.3 can be adapted to enable an industry/client-specific political risk analysis by only including or adding the most relevant risk factors and their indicators in consultation with the potential investor.

What the Coega experiment will attempt to illustrate, based on the discussions offered in the study so far and gleaned from the generic model offered in section 5.3, is that it is possible to analyse and measure the types and levels of risk a potential investor might face in any country or with any project. The Coega example is used due to its relevance to the South African context. Let it be said though, that the political risks are measured that pertain to the Coega project as such and the environment of this example only. It would be inadvisable as well as dangerous to make generalised deductions from this example about the South African government and investment climate in general.

As mentioned before, Didsbury (1993:xi) explains that societies are continuously faced with the consequential pressures of technological change and competition which in turn place greater emphasis on efficacy. An organisation's productivity might be in decline in one country due to labour disputes, declining natural resources, government restrictions, a lack of consumerism, socio-politically motivated actions or a combination of various other factors. This can cause financial losses or threaten the organisation which might prompt it to invest in a more profitable, more productive or financially more viable operation in another country.

5.4.1 Explaining the example

This example aims to impartially and objectively investigate the possible benefits of the proposed R4.2 billion Coega Industrial Development Zone (IDZ) and deep-water port from the perspective of a potential foreign investor interested in investing in a metallurgical site as part of the Coega development. Despite an initial lack of foreign investment, it seems as if Ferrostaal (a German multinational company) has recently committed itself to building one of its two South African stainless steel plants at Coega (<http://www.coega.co.za>)¹.

As explained in Chapters One and Two of this study, an encompassing definition of political risk analysis broadly suggests the analysis of the possibility that factors caused or influenced by government political

decisions, or events in a country, will affect business climates in such a way that investors will lose money or not make as much money as they expected when the initial decision to invest was made. An unfamiliar environment requires attention and assessment before an investment is made. The risk factors and their indicators used in identifying and measuring the political risks involved in the Coega project can be taken, in simulated consultation with the potential investor, from a comprehensive list of risk indicators that are manifested as measurements of risk within a risk analysis model. As this example aims to show, the importance of using micro risk factor indicators will become clear.

In applying the above definition to the Coega experiment, the following example will analyse the extent to which factors caused or influenced by political decisions (which include macro economic policy) made by the South African government, or by other unforeseen events outside of South Africa or in the country, can possibly affect investor confidence surrounding the Coega business climate in such a way that investors might lose confidence in the viability and ability of reaching projected production and profit extrapolations.

For the sake of the simulated experiment, the risk factors used in section 5.5 were selected by a potential investor as reflective of this investor's major business concerns. Apart from an on-and-off global recession and sluggish South African economic growth rate (*er8*)², billions of Rand are to be spent on the Coega development as part of government's initiative to attract foreign direct investment. At the same time, government is balancing concerns over the current budget ratio (*er9*), the adequacy of international reserves (*er10*) and a debt service burden (*er11*). Other concerns that come to the fore upon examining the Coega environment albeit indirectly, are the overall quality of the bureaucracy (*pr12*), the stability of the labour force (*er1*), per capita income (*sr1*), rapid urbanisation (*sr4*), population growth (*sr5*), as well as the overall impact on human development (*sr9*) in the Eastern Cape Province and the overall legitimacy (*pr6*) of the outcomes of the policy environment surrounding the Coega decision-making process. In the following discussion, it might become clear why these risk factors are identifiable as relevant choices for the Coega experiment.

This example can be seen as a source of information, aims to reflect many views, but critically, yet objectively, attempts to analyse the policy environment in which decisions are made regarding the Coega development in the Eastern Cape Province.

¹ This article was posted on the 22nd of November 2001.

² These symbols refer to the risk factors used in an analysis of the project in section 5.5 of this chapter. Also make use of the model available on the accompanying computer disc in this regard.

5.4.2 *Rationale behind the Coega Industrial Development Zone and deep-water port*

The rationale behind the Coega project lies in the South African government's eagerness to attract foreign direct investment (FDI) into the country (*er2, er3, er5*) (<http://lowtax.net>). One of the major initiatives that has been set up, apart from the Small and Medium Enterprises Development Programme (SMEDP)³ and other incentives offered by the Industrial Development Corporation (IDC), is the establishment of various Industrial Development Zones (IDZ's)⁴. Sites already identified for, or already used as IDZ's include Richmond, East London (Buffalo City)⁵, Saldanha Bay, Durban, Johannesburg International Airport, and Coega which lies 20 kilometres outside Port Elizabeth.

The Coega project grew out of the idea of constructing a zinc refinery in the Eastern Cape, and planning focussed on the Coega area in combination with the 'unshelving' of a 20-year-old plan for the construction of a harbour to make use of the deep-water channel at Coega. The development of the combined harbour, zinc refinery and IDZ proposals were announced in December 1996 (<http://www.coega.org/documents/history>).

5.4.3 *Analysis of the investment environment*

The proposed deep-water port and IDZ at Coega is said to be a primary beneficiary of the 'arms-deal' offset (*er15*)⁶. Joe Modise, the Minister of Defence who at the time was about to leave office, signed an agreement with the German submarine consortium Ferrostaal to purchase three vessels at a cost of R4.5 billion. In return, Ferrostaal would construct a steel mill and augment the viability of the Coega IDZ site (Allan, 2001:<http://www.psam.ru.ac.za>). Ex-Minister Modise signed an agreement with the German consortium two months before the Ministerial Committee responsible for the deal had been briefed on its fiscal and economic impact (*pr2, pr3, pr4, pr7, pr9*) (Allan, 2001:<http://www.psam.ru.ac.za>).

Ex-Minister Modise was the head of Harambee Investment Holdings that bought 30% of shares in the BKS group in August 2000. BKS is one of South Africa's biggest firms of consulting engineers, and

³ Government is also keen to stimulate domestic investment, believing that this is the key to foreign investment, as international investors, to a certain degree, follow the sentiment and mood of their domestic counterparts. A number of Spatial Development Initiatives (SDI's) or 'investment corridors' have also been put in place to establish conditions that will be attractive to both domestic and international investors.

⁴ IDZ's are industrial estates built with the purpose of providing facilities and services to export-oriented industries. Often linked to international airports or ports, they are compared to Export Processing Zones. EPZ's fall outside of domestic customs zones and legislation and are able to import items free of customs and trade levies, and to also export such items. More information regarding these incentives is available from the Board for Regional Industrial Development, Private Bag X86, Pretoria, 0001.

⁵ The official green light has been given for the establishment of an IDZ in East London (Buffalo City) (see <http://saep.org>).

⁶ Business Day notes the conflict of interest when "people benefit financially in a private sector capacity from decisions made while wearing public officials' hats" see Business Day, 28 September 2001 - "Second take: Coega project sets off old alarm bells".

established, as well as partially owns a company called Khuthele Projects⁷. In November 1999, the Coega Development Corporation (CDC) announced that it had appointed Khuthele Projects as the engineering consultants responsible for conducting the integrated transportation study for the Coega IDZ.

At the time of researching the Coega example, Paul Jourdan was serving on the board of directors of the CDC of which the chairperson was Moss Ngoasheng. He was also the special economic advisor to the (then still) Deputy President Thabo Mbeki during the period of the Defence Review that decided to acquire new military equipment. Jourdan also provided Mbeki with advice during the selection of preferred bidders, the negotiations with suppliers and the awarding of final contracts. Mbeki chaired the Ministerial Committee that decided on and presented the final recommendations on arms procurement to Cabinet for approval (*pr2, pr3, pr4, pr7, pr9*) (<http://www.saep.org>). Paul Jourdan, together with Jayendra Naidoo and Vana Pillay, was also on the International Offers Negotiating Team (IONT), promising that the arms deal would deliver jobs and investment to the Eastern Cape and Coega before Cabinet approved the arms deal (Allan, 2001:<http://www.psam.ru.ac.za>)

In July 2001, The Minister of Trade and Industry, Alec Erwin, acknowledged that the CDC had not yet been issued with an IDZ operators permit and that the Coega location had not yet been designated as an IDZ in compliance with the law⁸ (Allan, 2001:<http://www.psam.ru.ac.za>). But Portnet (a South African SOE) took over the construction of the deepwater port at Coega (*er4, er6*), despite earlier misgivings regarding the viability of the proposed Coega facility (<http://www.saep.org>; Allan, 2001:<http://www.psam.ru.ac.za>)

Portnet's private foreign partners were brought into the project, namely P&O Nedlloyd and infrastructure company TCI who have relocated about 300 families from the Coega area. The Human Rights Commission started investigating claims of the removals being inprocedural, forceful and unlawful (*pr4*), this despite the HRC's cash-strapped operations (Amato, 2001:<http://www.saep.org>). The HRC has since 'dropped' its campaign against these removals at Coega.⁹

Despite the CDC having been allocated R185 million in public funds by the Eastern Cape provincial government in 2001 alone (*er15*), no public record of the amount of funding received from national government exists¹⁰. Furthermore, Billiton cited the East Asian crisis¹¹ and the withdrawal of Coega partner Mitsui as the main reasons for withdrawing from the project in 1998 (<http://www.billiton.com>),

⁷ See <http://www.psam.ru.ac.za> - Colm Allan

⁸ What is of crucial importance here is that, in order to even apply for an operator's permit, CDC has to demonstrate "legal and physical access to an international port".

⁹ Communication with Boyce Papu of SAEP, Thursday, 18 October 2001

¹⁰ See Colm Allan (<http://www.psam.ru.ac.za>).

¹¹ See "Withdrawal of Mitsui Consortium from proposed South African zinc project", 4 December 1998, <http://billiton.com>. In addition to the Asian financial crisis, there is a worldwide overcapacity in steel production at the moment, combined with a flagging demand in steel and related products. See "Consolidation or bust for steel" Business Day, 28 September 2001.

but has since entered into a joint venture with Mozal in Mozambique and has advertised a variety of positions¹². Yet it seems that Ferrostaal is now committed to building two stainless steel plants in South Africa, at least one of which will be based at Coega (<http://www.coega.co.za>). A road bridge that will cost R100 million is also going to be built at Coega by the year 2004 (<http://www.coega.co.za>).

At the time of the decision to pay for the construction of the Coega port and infrastructure, Mafika Mkwanazi, the Transnet deputy-managing director, was a beneficiary of the arms procurement deal. At the time of researching the Coega example, he was a shareholder and director of Kgorong Investment Holdings (*pr2, pr3, pr4, pr7, pr9*) (Business Day, 4 October 2001). Kgorong secured a R220 million sub-contract to provide tracking radar on the corvettes as part of a joint venture with European Aeronautics Defence and Space (EADS) and South African Defence supplier Reunert.¹³

After resigning as Transnet managing director in March 2001, Saki Macozoma bought a 10% share in Safika Holdings, a company co-founded by Moss Ngoasheng²⁴ (<http://news24.com>). He also joined the board of directors of Safika Technology Holdings. Ngoasheng is a director of Safika Holdings and owns 41% of the company and the CDC has awarded tenders to operators with which Ngoasheng's company has business relationships (*pr2, pr3, pr4, pr7, pr9*) but the dates on which these contracts were awarded are not indicated (Allan, 2001:<http://www.psam.ru.ac.za>).

A much tighter regulatory framework is required to prevent commercial conflicts of interest from influencing public decision-makers. Government's decision to exclude the Special Investigating Unit (SIU) from the arms probe effectively prevents the investigation into the issue of profiteering from commercial conflicts of interest (Allan, 2001:<http://www.psam.ru.ac.za>). The SIU was the only public protection agency with the power to effectively investigate the awarding of sub-contracts (*pr3*) as the Auditor General and Public Protector are powerless to investigate the financial affairs of the CDC due to its being a private company¹⁴ (Cull, 2001; Makgale and Bridge, 2001:<http://www.saep.org>).

5.4.3.1 Possible immediate and long-term impacts of the project

The benefits that will result from the project might come at a massive cost in terms of public expenditure (*er15*) and the natural environment. Costs that have to be covered include construction of the harbour, the IDZ facilities, the purchasing of land, the resettlement of people living at the proposed site and the

¹² See The Mail and Guardian, Friday 12 October 2001

¹³ Business Day, 4 October 2001.

²⁴ Ngoasheng has rebuffed what he calls allegations by the watchdog Public Services Accountability Monitor (PSAM) that a company in which he holds shares benefited from contracts awarded by CDC (see "Coega chair denies graft", <http://www.news24.com> and "Coega chairman denies shady deals", 28 July 2001, <http://www.inet.co.za>). Also see the Mail and Guardian of 27 July 2001 - "New claims at Coega: The CDC has awarded a number of contracts to business partners of the company's chairperson".

purchasing of two major existing businesses, namely the saltworks¹⁵ and abalone farm, as well as marketing, management and development costs¹⁶ (*er15, sr6*).

Air pollution constraints might also be placed on the project. The development framework for the IDZ envisages the development of a metallurgical cluster, two metal industry clusters, and two mineral and construction clusters in the IDZ – but these developments might be limited due to possible air pollution constraints (*er12, er13*) (<http://www.saep.org>; Allan, 2001:<http://www.psam.ru.ac.za>).

The Coega project might also have an effect on tourism, and in particular, the Greater Addo National Park expansion that is currently being undertaken by South African National Parks (SANP) as the Coega site literally borders the Addo park. Land purchases for this development have already commenced as has the relocation of elephants. If the amount of visitors to the Addo Park expands from 40 000 to 200 000 annually as is projected due to the extension of Park facilities, the Addo Park could generate in the region of 16 000 sustainable jobs in the Port Elizabeth area (Allan, 2001:<http://www.psam.ru.ac.za>).

A growing industry in the eastern Cape is mariculture which has considerable scope for development as an export industry. Abalone and oysters are high value export crops and depend on exceptionally clean water and air (*er12*). The full development of the proposed farms at Hougham Park would have created in excess of 500 jobs, but the proposed Coega IDZ can lead to the possible removal of these farms¹⁷ (<http://www.coega.org/documents/positionagriculture.htm>).

Local agriculture¹⁸ and citrus interests have also expressed two concerns. Firstly, over the impact of air pollution that would be generated by the heavy industrial facilities proposed for the project as the export focus of the local citrus industry means that it faces increasingly rigorous international standards. The Eastern Cape citrus industry earned about R706 million in 1997, employs roughly 19 000 people directly, and over 65% of this industry is located in the Coega and Sundays River Valleys¹⁹ (<http://www.coega.org/documents/positionagriculture.htm>). The second major concern to agriculture is the consumption of water by the industries proposed for the IDZ as the scarcity of water is a constraint to the expansion of citrus farming in the area (<http://www.coega.org/documents/positionagriculture.htm>).

¹⁴ The Auditor General is presently, however, investigating its legal mandate that would allow for a forensic audit of the CDC's financial statement - this audit seems to be welcomed by the CDC. In this regard, see also Patrick Cull, Eastern Province Herald, 9 August 2001; and <http://www.saep.org>.

¹⁵ The existing saltworks in the Coega river valley employs 100 people. The saltworks will not be able to function if the Coega project proceeds.

¹⁶ Costs surrounding the Coega development have been estimated at around R4.2 billion. Government would have spent R3 million for each job created at Coega. The construction of the Coega project might well cost over ten times the annual national government expenditure on HIV/AIDS.

¹⁷ The Environmental Impact Report for the harbour conducted in 1997 concurred with the view that mariculture at the existing Coega location would be incompatible with the Coega IDZ.

¹⁸ Of importance are the studies that were conducted by Dr. Amanda Botha (University of Stellenbosch) and Dr. John Cooke (University of Natal). Some of Dr. Botha's findings were excluded from one of the few eventual documents that were made public. See <http://www.coega.org/documents/positionagriculture.htm> - "The threat to agriculture".

A number of significant concerns of the Algoa Bay Fisheries have also been identified if the Coega project proceeds (<http://www.coega.org/documents/positionfisheries.htm>). Commercial fishery (trawling and chokka fisheries) generate in the region of R100 million in income annually. A conservative estimate of the Algoa Bay linefishery indicates that it contributes R65 million in income to Port Elizabeth, and employs 3900 people (*er12, er14, sr2*) (<http://www.coega.org/documents/positionfisheries.htm>).

5.4.3.2 Possible impact(s) on human health

In studying the planning and documentation surrounding the development of the Coega project, there seems to be a lack of concern for the health of the communities that will be forced to live in close proximity to the proposed IDZ. An increased burden of the overtaxed health services of especially the Eastern Cape might be a result of increased cancer and respiratory illnesses in individuals living in the proposed Coega area (*sr3, sr6, sr7, sr8*) (<http://www.coega.org/documents/positionhealth>).

No study has ever been undertaken for the project that assesses the cumulative impacts of the existing pollution combined with the proposed industries at the site²⁰ (<http://www.coega.org/documents/positionhealth>). There has been no public information regarding the pollutants that are to be measured and whether the CDC or an independent consultant is conducting the monitoring. No data from the background monitoring has ever been released to the public, and the true extent of the problem thus remains largely unknown (*sr3, sr6, sr7, sr8*) (<http://www.coega.org/documents/positionhealth>). Interesting to note though, is the recent legal action that has been instigated by the people of Prieska against British asbestos mining company Cape Plc.²¹ (*sr3, sr6, sr7, sr8*).

5.4.3.3 Possible environmental impacts

Ecological resources that are constitutionally protected are also under threat. The marine life of Algoa Bay, and the St. Croix Island group in particular as the site of the St. Croix Marine Reserve²², represent the habitat of a number of endangered species (<http://www.coega.org/documents/positionecology.htm>). The salt pans at Coega are an important wetland as the feeding and resting grounds for thousands of Palaearctic waders during their summer migration to the southern hemisphere. Coega Kop, where mining is proposed for the harbour, has at least one endemic plant species as well as several rare and threatened species.

¹⁹ See <http://www.coega.org/documents/positionagriculture.htm>

²⁰ In 1997, N.G. Scarr, Assistant Director of Environmental Protection at the Eastern Cape Ministry of Economic Affairs, Environment and Tourism brought these problems to the attention of the Coega Implementing Authority (now the CDC), by explaining that there is a potential of a totally untenable scenario at Coega with respect to the dispersion (or lack thereof) of aerial pollutants, and that it needs to be thoroughly investigated as a matter of urgency.

²¹ It is being asserted that, although Cape Plc was aware of the health hazards and long-term respiratory cumulative effects of asbestos mining, the company did not heed these warnings regarding its operations in Prieska. The lawsuit is the first of its kind, where a British company is being sued for damages from outside Britain.

In addition, the suspension in late September 2001 of John Carr by the Department of Minerals and Energy as a result of complaints being levelled against him by the CDC, illustrated the CDC's ability to wield coercive influence over government departments (*pr3*) (<http://www.saep.org>; Allan, 2001:<http://www.psam.ru.ac.za>). Carr has publicly insisted that the CDC comply with national regulations that govern mining permits and environmental management. Portnet intends to mine materials needed for the construction of the harbour from the Coega Kop, raising fears among conservationists about the extinction of a unique ecosystem and endangered plant species, as well as the destruction of a very rare rock outcropping (<http://www.coega.org/documents/positionecology.htm>).

The violation of ecological conditions might be somewhat disconcerting. As the process of development of the project proceeds, it seems that the conditions in question have been abandoned rather than faced up to (<http://www.coega.org/documents/positionecology.htm>). Conditions, which include the location of the Coega harbour and its distance from the St. Croix Island group²³ and the lack of serious regard for the environmental "No-Go Areas", might also raise concern²⁴ (<http://www.coega.org/documents/positionecology.htm>).

Of further concern, is the apparent secrecy surrounding the implementation of the Environmental Management System (EMS)²⁵ that has been designed for the project. It does not seem as if opportunity was provided for public input into this process, and it appears that a majority of environmental studies have never been made available to the public (*pr3, pr4, pr7*) (Freight and Trading Weekly, 20 August 1999). It also seems as if the implementation structure of the EMS might represent a conflict of interest between the commercial and environmental aspects of the Coega project, as the Coega Development Corporation (CDC) supervises the implementation of the EMS. Regarding environmental concerns expressed by the above-mentioned stakeholders, there seems to be a lack of will to seriously manage the environmental impacts and risks of the Coega project (*pr11*) (Freight and Trading Weekly, 20 August 1999; (<http://www.coega.org/documents/positionecology.htm>)).

The Coega project commenced in February 2001, and, in the light of the above illustration, some argue that these developments might take place in disregard of national environmental legislation (*pr10*), where the National Environmental Management Act states that:

²² A specialist study on the islands clearly states that the island may be categorised as a Category 1a Protected Area (Strict Nature Reserve: protected areas managed for science) under the World Conservation Union's (IUCN) Classification System.

²³ The original Environmental Impact Assessment set a safe distance at 1500m to 2000m. In its submission to the 2000 public participation process, Portnet revealed that the Coega harbour would now be located closer than 500m to the islands.

²⁴ The original impact assessments conducted for the project highlighted a number of areas where the development of the project should be prohibited or limited.

²⁵ Themba Koza, the Coega Environmental Manager at the time of researching this example, calls for a balance to be struck between the environment and the socio-economic needs of the region (Freight and Trading Weekly, 20 August 1999).

"(7) Procedures for the investigation, assessment and communication of the potential impact of activities must, as a minimum, ensure the following:

- (a) Investigation of the environment likely to be significantly affected by the proposed activity and alternatives thereto;
- (b) Investigation of the potential impact, including cumulative effects, of the activity and its alternatives on the environment, socio-economic conditions and cultural heritage, and assessment of the significance of that potential impact;
- (c) Investigation of mitigation measures to keep adverse impacts to a minimum, as well as the option of not implementing the activity;
- (d) Public information and participation, independent review and conflict resolution in all phases of the investigation and assessment of impacts."

From the above it might seem as if the CDC and government have failed in an investigation of alternatives, the investigation of cumulative impacts, the facilitation of meaningful public participation, in conducting independent reviews, in adequately assessing the impacts of the Coega project, and in maintaining an acceptable measure of transparency and accountability throughout the decision-making process (*pr3, pr4, pr7, pr10*).

5.4.4 The identified potential political risk factors

The above discussion brings certain risk factors into play for the foreign investor interested in investing in a metallurgical operation in the Coega Harbour and Industrial Development Zone project. Notwithstanding the fact that interest groups from many different backgrounds have voiced concern in independent studies and documents, as well as in the press, the environment surrounding the Coega development project seems to be very closed to public scrutiny indeed (*pr3, pr4*).

After consulting with a potential foreign investor, and gleaning the client-specific needs as well, the following risk factors can be identified as especially relevant to the case of the Coega Harbour and IDZ in the light of the above discussion, and have been taken from the pool of risk factors and their indicators offered in the generic model in this chapter²⁶. These political risk factors and their indicators are applied in section 5.5 to follow, and the Coega experimental client-specific model is also presented on the accompanying computer disc.

Political Indicators of Political Risk Analysis

Total (pr1-pr11): 1795

Score (1185)

- Pr1 Political system (220)
- Pr2 Separation of powers (150)
- Pr3 Openness of political system (250)
- Pr4 Public accountability of government (150)
- Pr5 Economic planning failures (100)
- Pr6 Legitimacy crises (240)
- Pr7 Government behaviour (300)
- Pr8 Relation of economic expectation vs. economic reality (80)
- Pr9 Corruption / nepotism in government (100)

²⁶ See section 5.3 for the operationalisation of these risk factors.

Pr10 Law tradition (140)
Pr11 Political will (65)

Economic Indicators of Political Risk

Total (er1-er15): 2350

(Score 1101)

Er1 Stable labour force (280)
Er2 Repatriation of profits policy (160)
Er3 Foreign equity ownership policy (160)
Er4 Privatisation of important industries / sectors (160)
Er5 Competitiveness (240)
Er6 Level of state intervention (320)
Er7 Sound physical infrastructure (240)
Er8 Economic growth rate (150)
Er9 Current budget ratio (120)
Er10 Adequate international reserves (60)
Er11 Debt service burden (120)
Er12 Preservation of resources (100)
Er13 Carbon dioxide emissions of fossil fuels in millions of metric tons per annum (60)
Er14 Unemployment rate (100)
Er15 Government expenditure (80)

Social Indicators of Political Risk

Total (sr1-sr9): 472

(Score 336)

Sr1 GDP per capita income (30)
Sr2 Unemployment rate (30)
Sr3 Acceptable quality of life (90)
Sr4 Urbanisation rate (150)
Sr5 Population growth percentage per annum (40)
Sr6 Health care (50)
Sr7 Population access rates (40)
Sr8 Provision of public services (25)
Sr9 Global Human Development Rating (HDI) (17)

5.5 Coega: Risky Business or Economic Jumpstart? Political Risks as Risks to Foreign Investment

5.5.1 Political Factors of Political Risk Analysis			
Total (pr1-pr11):	1795	Average % Pr:	66.01671
Your Pr Total:	1185	Real percentage PR:	33.00836

Pr1 Political system (220) (Rate only one indicator)		Your scores Pr1
<> Autocratic single party system (Rate between 30 and 50)		
<> Democratic mutli-party system (Rate between 0 and 20)		
<> One party dominant democratic system (Rate between 10 and 30)		30
<> Regulated democratic multi-party system (Rate between 20 and 30)		
<> Dictatorship in a non-party system (Rate between 40 and 50)		
<> Socialist central planning system (Rate between 30 and 40)		
Total Pr1		30

Pr2 Separation of powers (150) (Rate all indicators)		Your scores Pr2
<> Degree of autonomy and independence of legislative, executive and judicial powers (High degree, rate between 0 and 10, moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)		
<> Degree to which legislature, executive and judiciary check and balance powers (High degree, rate between 0 and 10; moderate degree, rate between 11 and 30; low degree, rate between 31 and 50)		25
<> Trend of development of an over powerful executive (Negative trend, rate between 0 and 10; possibility, rate between 11 and 30; positive trend; rate between 31 and 50)		25
Total Pr2		75

Pr3 Openness of political system (250) (Rate all indicators)		Your scores Pr3
<> Competitiveness of political system (Very open and competitive, rate between 0 and 10; possibility for competition, rate between 11 and 30; closed political system, rate between 31 and 50)		
<> Multiple competing elites and interest groups can determine public policy through bargaining and compromise (Yes, rate between 0 and 25; no, rate between 26 and 50)		25
<> Public accessibility regarding inputs (Very accessible, rate between 0 and 10; conditional, rate between 11 and 30; no access, rate between 31 and 50)		40
<> Responsiveness, and responsibility of government (High degree, rate between 0 and 10; moderate, rate between 11 and 30; low, rate between 31 and 50)		40
<> Transparency of decision-making process and policy environment (Very, rate between 0 and 10; hardly, rate between 11 and 30; not at		

all, rate between 31 and 50)	40
Total Pr3	185

Pr4 Public accountability of government (150)	(Rate+F77 all indicators)	Your scores Pr4
<> Strength of public protector and/or auditor general (Very strong; rate between 0 and 10; conditional power, rate between 11 and 30; none, rate between 31 and 50)		40
<> Degree of functioning oversight mechanisms (Highly functional, rate between 0 and 10; conditional, rate between 11 and 30; useless, rate between 31 and 50)		40
<> Separation of private and public spheres (High degree of separation, rate between 0 and 10; conditional, rate between 11 and 30; low degree, rate between 31 and 50)		40
Total Pr4		120

Pr5 Economic planning failures (100)		Your scores Pr5
<> Success or failure in meeting economic targets and deadlines promised by the political leadership (Extreme failure, rate 50; complete success, rate 0)		40
<> Instances of misleading economic planning and policies (Infrequent, rate between 0 and 25; frequent, rate between 26 and 50)		40
Total Pr5		80

Pr6 Legitimacy crises (240)	(Rate all indicators)	Your scores Pr6
<> If there is a lack of homogenous national identity (Rate between 20 and 30)		30
<> If there is a lack of distribution of resources (Rate between 30 and 50)		40
<> If there is a lack of public participation (Rate between 30 and 50)		40
<> If there is a lack of policy enforcement (penetration) (Rate between 20 and 40)		30
<> If uncontrolled and rapid urbanisation overtaxes government functions (Very debilitating, rate between 30 and 50, less debilitating, rate between 0 and 29)		40
<> If the political system is open and competitive (Rate between 0 and 20)		15
Total Pr6		195

Pr7 Government behaviour (300)	(Rate all indicators)	Your scores Pr7
<> Degree of accountability of government (More accountable, rate between 0 and 25; less accountable, rate between 26 and 50)		30
<> Degree to which limited or constitutional governance is practised (Unconstitutional, rate between 30 and 50; constitutional, rate between 0 and 29)		40
<> Transparency of policy environment (More transparent, rate between 0 and 20; less transparent, rate between 21 and 50)		40

<> Degree of responsiveness (More responsive, rate between 0 and 25; less responsive, rate between 26 and 50)
<> Degree in which responsible governance is practised (More responsible, rate between 0 and 25; less responsible, rate between 26 and 50)
<> Level of public intervention into the private spheres (High level of interventionism, rate between 26 and 50; low level of intervention, rate between 0 and 25)

	40
	35
	40
Total Pr7	225

Pr8 Relation of economic expectation vs. economic reality (80) (Rate all indicators)

<> Government success rate in fulfilling promises (High, rate between 0 and 20; low, rate between 20 and 40)
<> Incidence of unrest due to unfulfilled economic expectations (Low, rate btw. 0 and 20; high, rate btw. 20 and 40)

Your scores Pr8	
	25
	25
Total Pr8	50

Pr9 Corruption/nepotism in government (100) (Rate all indicators)

<> If corruption exceeds the bounds of people's acceptance (Rate between 20 and 40)
<> Companies have to budget for bribery (Rate between 20 and 40)
<> Incidence of corruption and nepotism low (Rate between 0 and 20)

Your scores Pr9	
	35
	30
	20
Total Pr9	85

Pr10 Law tradition (140) (Rate all indicators)

<> If a tradition of order and the rule of law prevails (Rate between 0 and 20)
<> If a culture of lawlessness exists (Rate between 20 and 40)
<> Level of protection of investments under sovereign law of a host country (High, rate between 0 and 20; low, rate between 21 and 40)
<> If government manages to uphold order and stability (Rate between 0 and 40)

Your scores Pr10	
	15
	30
	10
	20
Total Pr10	75

Pr11 Political will (65) (Rate all indicators)

<> Public officials are career civil servants (Rate between 0 and 10)
<> Public officials are not in office for self-enrichment (Rate between 0 and 10)
<> Policy is designed and enforced in the best interest of the public (Rate between 0 and 15)
<> Lack of political will (Rate between 16 and 30)

Your scores Pr11	
	10
	10
	15
	30
Total Pr11	65



5.5 Economic Factors of Political Risk

Total (er1-er15):	2350	Average % Er:	46.85106
Your Er total:	1101	Real percentage ER:	14.05532

Er1 Stable labour force (280) (Rate all indicators)

<> If there is a shortage of skilled labour (No, rate between 0 and 20; yes, rate between 21 and 40)	30
<> Are restrictions concerning the employment of expatriate personnel acceptable (Yes, rate between 0 and 20; no, rate between 21 and 40)	20
<> Is labour organised as an influential political force (Less influential, rate between 0 and 20; highly influential, rate between 21 and 40)	30
<> Degree of corporatism (High degree, rate between 20 and 40; low degree, rate between 0 and 19)	25
<> Impact of consequential split between government-labour alliance (Disadvantageous, rate between 20 and 40; advantageous, rate between 0 and 19)	20
<> Degree of militancy and mobility of organised labour (Low, rate between 0 and 20; high, rate between 21 and 40)	30
<> Is labour legislation liberal or not (Yes, rate between 0 and 20; no, rate between 21 and 40)	10

Your scores Er1	
	30
	20
	30
	25
	20
	30
	10
Total Er1	165

Er2 Repatriation of profits policy (160) (Rate all indicators)

<> Transferability of profits out of the host country (Easy, rate between 0 and 20; difficult, rate between 21 and 40)	15
<> Degree of convertibility of local currency (High, rate between 0 and 20; low, rate between 20 and 40)	10
<> Is there a trend towards repudiation of contracts (High incidence, rate between 20 and 40; low incidence; rate between 0 and 20)	5
<> Are alternatives to restrictions on repatriation viable (Viable, rate between 0 and 20; not viable, rate betwn. 20 and 40)	0

Your scores Er2	
	15
	10
	5
	0
Total Er2	30

Er3 Foreign equity ownership policy (160) (Rate all indicators)

<> Can investors' stake in an enterprise be larger than 50% (Yes, rate between 0 and 20; no, rate between 20 and 40)	10
<> Is less control acceptable in the hope of getting quick approval from the authorities (No, rate between 0 and 20; yes, rate between 20 and 40)	30
<> Can local partners delay approval of business plans of foreign partners (No, rate between 0 and 20; yes, rate between 20 and 40)	20
<> Allowance of international arbitration agreements (Yes, rate between 0 and 20; no, rate between 20 and 40)	10

Your scores Er3	
	10
	30
	20
	10

Total Er3	70
------------------	-----------

Er4 Privatisation of important industries/sectors (160)	(Rate all indicators)
--	-----------------------

<> Host country favours monopolies and state enterprises over private enterprises (No, rate between 0 and 20; yes, rate between 20 and 40)
--

<> 'Large' private sector is protected by tariff barriers, monopolies or government contracts (No, rate between 0 and 20; yes, rate between 20 and 40)
--

<> Does private sector serve as routing for uncontrolled foreign exchange outflows (No, rate between 0 and 20; yes, rate between 20 and 40)

<> Have previously nationally owned enterprises been privatised to improve service (Yes, rate between 0 and 20; no, rate between 20 and 40)

(Rate all indicators)

Your scores Er4

20
15
10
10

Total Er4	55
------------------	-----------

Er5 Competitiveness (240)	(Rate all indicators)
----------------------------------	-----------------------

<> Degree of export-led orientation followed in the economy (High, rate between 0 and 20; low, rate between 21 and 40)
--

<> Import substitution resulted in subsequent exports (Yes, rate between 0 and 20; no, rate between 21 and 40)
--

<> Is there a large number of domestic buyers and sellers of products produced locally (Yes, rate between 0 and 20; no, rate between 21 and 40)

<> Degree of interventionist measures practised domestically by government (Low, rate between 0 and 20; high, rate between 21 and 40)

<> Degree of mobility of factors of production domestically (High, rate between 0 and 20; low, rate between 21 and 40)
--

<> Are buyers and sellers free to enter and leave the domestic market (Yes, rate between 0 and 20; no, rate between 21 and 40)
--

Your scores Er5

10
10
10
20
20
25

Total Er5	95
------------------	-----------

Er6 Level of state intervention (320)	(Rate all indicators)
--	-----------------------

<> Is government economic planning centralised (Marginally, rate between 0 and 20; largely, rate between 21 and 40)

<> Is there strict government control of import licenses (Less restrictive, rate between 0 and 20; more restrictive, rate between 21 and 40)
--

<> Level of government control of new investment in terms of general or production targets (Low, rate between 0 and 20; high, rate between 21 and 40)

<> Are banks state-owned (Some, rate between 0 and 15; mostly, rate between 16 and 30; all, rate between 31 and 40)

<> Are state-owned banks selective in directing credit to certain sectors (Not selective, rate between 0 and 10; moderately selective, rate between 11 and 25; very selective, rate between 26 and 40)
--

<> Are industry and agricultural sectors state-owned/controlled

Your scores Er6

35
20
20
5
5

(Some, rate between 0 and 10; mostly, rate between 11 and 25; all, rate between 26 and 40)	10
<> Is entrepreneurship promoted (Yes, rate between 0 and 20; no, rate between 21 and 40)	10
<> To what extent are inflexibility and inefficiency results of central planning (Some, rate between 0 and 20; large, rate between 21 and 40)	30
Total Er6	135

Er7 Sound physical infrastructure (240) (Rate all indicators)	Your scores Er7
<> Can goods be transferred and delivered on time by air, road and rail (To large extent, rate between 0 and 15; to a lesser extent, rate between 16 and 30)	5
<> Are there often electricity supply problems (Not often, rate between 0 and 15; often, rate between 16 and 30)	3
<> Condition of public roads (Good, rate between 0 and 10; fair, rate between 11 and 20; poor, rate between 21 and 30)	25
<> Availability of storage and warehousing capacity and facilities (Readily, rate between 0 and 10; adequate, rate between 11 and 20; scarce, rate between 21 and 30)	15
<> Are volumes of new property developments or industrial construction sites in relation with general economic developments (Yes, rate between 0 and 15; no, rate between 16 and 30)	25
<> Are regular flights in and out of the host country reliable (Yes, rate between 0 and 15; no, rate between 16 and 30)	3
<> Are repairs to damaged property or infrastructure regularly undertaken (Regularly, rate between 0 and 15; not so regularly, rate between 16 and 30)	20
<> Are roads maintained and networks improved (Improved, rate between 0 and 10; maintained, rate between 11 and 20; neglected, rate between 21 and 30)	20
Total Er7	116

Er8 Economic growth rate (150) (Rate all indicators)	Your scores Er8
<> Is there a trend toward a declining annual growth rate (Slow decline, rate between 0 and 15; rapid decline, rate between 16 and 30)	15
<> Is there a trend toward an increasing annual growth rate (Fast increase, rate between 0 and 15; slow increase, rate between 16 and 30)	25
<> Does economic growth create employment (High level, rate between 0 and 10; jobless growth, rate between 11 and 20; low level, rate between 21 and 30)	20
<> Are measures being taken to reverse temporary decline in economic growth (In time, rate between 0 and 10; just in time, rate between 11 and 20; too late, rate between 21 and 30)	25
<> To what extent is economic growth in irreparable decline (Some extent, rate between 0 and 15; large extent, rate between 16 and 30)	5

Total Er8	90
------------------	-----------

Er9 Current budget ratio (120) (Rate all indicators)

<> Is size of country's public sector in decline or on the increase (Decline, rate between 0 and 15; increase, rate between 16 and 30)
<> Does government use some form of price intervention or special subsidies (Few, rate between 0 and 15; many, rate between 16 and 30)
<> Does the CBR express a moderate to very high government budget deficit (Moderate, rate between 0 and 10; high, rate between 11 and 20; very high, rate between 21 and 30)
<> Does the CBR express persistently high negative or positive values (High positive, rate between 0 and 10; moderate, rate between 11 and 20; high negative, rate between 21 and 30)

Your scores Er9

15
15
25
20

Total Er9	75
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Er10 Adequate international reserves (60) (Rate all indicators)

<> Does host country own enough in foreign reserves to cover three months worth of government expenses (More than enough, rate between 0 and 10; less than sufficient, rate between 10 and 20)
<> Does a sizeable surplus or deficit prevail in the balance of payments (Surplus, rate between 0 and 10; deficit, rate between 11 and 20)
<> Do imports exceed exports or does the opposite prevail (Exports exceed, rate between 0 and 10; imports exceed, rate between 11 and 20)

Your scores Er10

15
15
10

Total Er10	40
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Er11 Debt service burden (120) (Rate all indicators)

<> Does the host country have a good or bad reputation of default on international debts (Good, rate between 0 and 10; bad, rate between 11 and 20)
<> Is international creditworthiness questionable or satisfactory (Satisfactory, rate between 0 and 10; questionable, rate between 11 and 20)
<> Does debt service burden constitute more or less than 50% of GDP (Less, rate between 0 and 10, more, rate between 11 and 20)
<> Does debt service burden exceed exports (No, rate between 0 and 10; yes, rate between 11 and 20)
<> Debt service burden prevents social and economic development (No, rate between 0 and 10; yes, rate between 11 and 20)
<> Is debt service burden more than GDP (No, rate between 0 and 10; yes, rate between 11 and 20)

Your scores Er11

5
10
5
10
10
5

Total Er11	45
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Er12 Preservation of resources (100) (Rate all indicators)

Your scores Er12

<> Is prevention of extinction of species adequately controlled (Adequately, rate between 0 and 10; inadequately, rate between 11 and 20)	20
<> Has government formulated and implemented adequate environmental plans (Adequate, rate between 0 and 10; inadequate, rate between 11 and 20)	20
<> Is population growth a threat to the preservation of resources (No threat, rate betwn. 0 and 10; substantial threat, rate between 11 and 20)	10
<> Levels of water contamination (Low, rate between 0 and 10; high, rate between 11 and 20)	10
<> Does government practise development within national environmental legislation (Yes, rate between 0 and 10; no, rate between 11 and 20)	20
Total Er11	80

Er13 Carbon dioxide emissions of fossil fuels in millions of metric tons per annum (60) (Rate all indicators)	Your scores Er13
<> Do government regulations result in a decline or increase of carbon dioxide emissions (Decline, rate between 0 and 10; increase, rate between 11 and 20)	15
<> Do successful government plans to regulate such emissions exist (Yes, rate between 0 and 10; no, rate between 11 and 20)	15
<> Does a result of such emissions lead to incidence of acid rain (Low incidence, rate betwn. 0 and 10; high incidence, rate betwn. 11 and 20)	10
Total Er13	40

Er14 Unemployment rate (100) (Rate all indicators)	Your scores Er14
<> Relation of unemployed percentage of the economically active population to the employed (Does not exceed, rate between 0 and 10; exceeds, rate between 11 and 20)	10
<> High unemployment coupled with a low per capita income (If positive, rate between 0 and 10; negative, rate between 11 and 20)	15
<> High per capita income coupled with low unemployment (If positive, rate between 0 and 10; negative, rate between 11 and 20)	15
<> High employment rate is coupled with high inflation rate (If positive, rate between 0 and 10; negative, rate between 11 and 20)	10
<> High unemployment is coupled with low inflation (If positive, rate between 0 and 10; negative, rate between 11 and 20)	15
Total Er14	65

Er15 Government expenditure (80) (Rate all indicators)	Your scores Er15
<> Is level of public expenditure on defence high or acceptable (Acceptable, rate between 0 and 10; high, rate between 11 and 20)	20
<> Does level of government expenditure on defence support the augmentation of military institutional power (No, rate between 0 and 10; yes, rate between 11 and 20)	5
<> Is level of public expenditure on health acceptable (Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20)	20
<> Is level of public expenditure on education acceptable	

(Acceptable, rate between 0 and 10; unacceptable, rate between 11 and 20)	20
Total Er15	65

5.5.3 Social Factors of Political Risk

Total (sr1-sr9):	472	Average % Sr:	71.18644
Your Sr Total:	336	Real percentage Sr:	14.23729

Sr1 GDP per capita income (30) (Rate the indicator)

<> Is a positive or negative annual growth rate of per capita income prevailing (Positive, rate between 0 and 10; stagnant, rate between 11 and 20; negative, rate between 21 and 30)

Your scores Sr1

	25
Total Sr1	25

Sr2 Unemployment rate (30) (Rate the indicator)

<> Percentage rise in the unemployment rate (Low, rate between 0 and 15; high, rate between 16 and 30)

Your scores Sr2

	20
Total Sr2	20

Sr3 Acceptable quality of life (90) (Rate the indicators)

<> Access to public services (Easy, rate between 0 and 10; conditional, rate between 11 and 20; difficult, rate between 21 and 30)

<> Level of crime rate (Low, rate between 0 and 10; moderate, rate between 11 and 20; high, rate between 21 and 30)

<> Is life expectancy in excess of an average of 66 years (In excess, rate between 0 and 15; less than, rate between 16 and 30)

Your scores Sr3

	25
	25
	25
Total Sr3	75

Sr4 Urbanisation rate (150) (Rate the indicators)

<> Rapid rate of urbanisation places increased pressure on government spending, i.e. infrastructure (sewerage, roads, electricity), housing and the maintenance of law and order (Moderate pressure, rate between 0 and 10; increasing pressure, rate between 11 and 20; exceptional pressure, rate between 21 and 30)

<> Urbanisation rate results in a decline in the productivity of the agricultural sector (Moderate decline, rate between 0 and 10; increasing decline, rate between 11 and 20; extensive decline, rate between 21 and 30)

<> Is urbanisation controlled, or does it place a burden on the state system to provide social needs (Yes, rate 0 and 15; no, rate between 16 and 30)

<> Can institutional and physical infrastructure handle rapid urbanisation (Yes, rate between 0 and 15; no, rate between 16 and 30)

<> A destabilising dense urban population (Rate between 20 and 30)

Your scores Sr4

	25
	0
	25
	25
	25
Total Sr4	100

Sr5 Population growth percentage per annum (40) (Rate the indicators)

- <> Does the percentage of population growth per annum exceed the percentage of employment growth per annum (No, rate between 0 and 10; yes, rate between 11 and 20)
- <> Does number of live births per annum exceed the number of deaths per annum (No, rate between 0 and 10; yes, rate between 11 and 20)

Your scores Sr5	
	15
	5
Total Sr5	20

Sr6 Health care (50) (Rate the relevant indicators)

- <> If the ratio of population per doctor is less than 400 (Rate between 0 and 5)
- <> Ratio of population per doctor is between 400 and 4800 (Rate between 6 and 15)
- <> If the ratio of population per doctor exceeds 4800 (Rate between 16 and 20)
- <> If the ratio of nurses per doctor exceeds 2 (Rate between 0 and 10)

Your scores Sr6	
	5
	6
	16
	5
Total Sr6	32

Sr7 Population access rates (4) (Rate all indicators)

- <> If facilities can be reached on foot or by the local means of transport within an hour by at least 50% of the population (Rate between 6 and 10; if more than 50%, rate between 0 and 5)
- <> At least 79% of the population has access to health services (Rate between 0 and 5; if less, rate between 6 and 10)
- <> If at least 69% of the population has access to safe water (Rate between 0 and 5; if less, rate between 6 and 10)
- <> If at least 36% of the population has access to sanitation (Rate between 0 and 5; if less, rate between 6 and 10)

Your scores Sr7	
	5
	5
	6
	10
Total Sr7	26

Sr8 Provision of public services (25) (Rate all indicators)

- <> Is provision of public services unreliable, sporadic and vulnerable to incompetence (Rate between 5 and 10)
- <> Does a culture of non-payment for public services prevail (Rate between 5 and 10)
- <> If public services are reliable (Rate between 0 and 5)

Your scores Sr8	
	10
	10
	5
Total Sr8	25

Sr9 Global Human Development Rating (HDI) (17) (Rate relevant indicators)

- <> If HDI rates country in 'high' category - averaging 0.916 (Rate between 0 and 2)
- <> If HDI rates country in the 'medium' category - averaging between 0.570 and 0.759 (Rate between 3 and 5)
- <> If HDI rates country in 'low' category - averaging 0.389 (Rate between 6 and 10)

Your scores Sr9	
	2
	5
	6
Total Sr9	13

AVERAGE PERCENTAGE CHANCE THAT RISK MIGHT OCCUR:	61.35141
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REAL RISK AS A PERCENTAGE CHANCE THAT RISK MIGHT OCCUR:	61.30096
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TOTAL RISK AS A PERCENTAGE CHANCE THAT RISK MIGHT OCCUR:	56.79012
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5.6 Results of the Coega Example

If the real percentage chance that risk might occur is:

$$\left\{ \left(\frac{\text{Total Pr}(1-11)}{1795} \right) \left(\frac{1}{2} \right) \right\} + \left\{ \left(\frac{\text{Total Er}(1-15)}{2350} \right) \left(\frac{1}{3} \right) \right\} + \left\{ \left(\frac{\text{Total Sr}(1-9)}{472} \right) \left(\frac{1}{5} \right) \right\} \left(\frac{100}{1} \right)$$

And total percentage chance that risk might occur is:

$$\left(\frac{\text{Total Pr}(1-11) + \text{Total Er}(1-15) + \text{Total Sr}(1-9)}{1795 + 2350 + 472} \right) \left(\frac{100}{1} \right)$$

And average percentage chance that risk might occur is:

$$\left\{ \frac{\left(\frac{\text{Total Pr}(1-11)}{1795} + \frac{\text{Total Er}(1-15)}{2350} + \frac{\text{Total Sr}(1-9)}{472} \right)}{3} \right\} \left(\frac{100}{1} \right)$$

Then according to the calculations of the model in section 5.5:

Average percentage chance that risk might occur = 61.34%

Real percentage chance that risk might occur = 61.30%

Total percentage chance that political risk might occur = 59.79%

It can thus be assumed that there is a possibility that the potential foreign investor might face a 61.30% (*real percentage*) chance that factors caused or influenced by political decisions (which include macro economic policy) or unforeseen events outside of South Africa or in the country, might affect investor confidence surrounding the Coega business climate in such a way that the investor might lose confidence in the viability and ability of reaching projected production and profit extrapolations.

This section illustrated the operationalisation of the research conducted to enable this study and showed how it is possible to measure and analyse political risk by means of the model used in section 5.3. In section 5.5, it was shown how the generic model could be streamlined to suit the needs and requirements of a potential investor, by applying a tailor-made client-specific model to enable the political risk analysis of a specific potential investment. In the following section, the test-results of the comprehensive model offered in section 5.3 are offered and explained.

5.7 Concluding Remarks

The study concentrated on political risks that foreign business, be it direct foreign investment, import and/or export operations, private banks, bilateral sovereign loans, joint ventures or agents operating in host countries; as well as both home and host governments, might face. Yet even after testing the model for political risk analysis proposed in this study, it remains clear that the measurement and observation of political risk still depends to a great extent on subjective human judgement. But instead of being a handicap in conducting a political risk analysis, a quantitative, valid and reliable model for political risk analysis (and it is hoped that the one presented in this chapter is such), that uses subjective and experiential human expertise can greatly contribute to a very useful and accurate measurement of political risk in order to eventually manage the potential impact of such risks.

In the final analysis, it is hoped that the main aim of this political risk analysis study, which was to design and present a generic but adaptable model for political risk analysis that takes the latest information and technology, new variables, indicators and formulas, and combines these with a potential foreign investor's intuitive judgement and objective expertise, was indeed reached and operationalised in the model presented in this chapter.

In the next chapter, it will be shown how political risks can be managed, once they have been identified and measured.

CHAPTER SIX: Political Risk Management

Foreign investors put assets at risk to achieve their objectives and the assessment of these risks, including political risks, is the key to successful operations. Weighing up opportunities versus potential losses becomes possible after an initial political risk assessment. Of course, the nature of risks an investor might face depends upon the type of project, the factors present in a host country's investment climate that are associated with the project, cultural prevalence, and the individuals that make up the organisation. Opportunities and risks are often a double-edged sword, and the management of political risks is but one of the challenges a multinational company (MNC) faces in a host country.

A firm's foreign investment strategy deals with the positioning of the organisation in its uncertain host country environment and investment climate. As such, organisational strategic choices determine the size of a firm's exposure to uncertain environmental and organisational components that impact on company performance. This chapter will attempt to explain how a firm's political risk exposure (the sensitivity of a firm's projected profitability and operationability in a host country to changes in the investment climate) can be managed and reduced.

Formulating and designing a political risk policy as a means of managing political risk is a key point in this chapter. So far in this study, a lot of time has been spent on identifying, analysing and measuring political risk. These are very important to any investor in finding the most viable investment opportunity and being aware of the political risks involved. Now that it has been shown that this can indeed be established, based on the outcome or result of a political risk analysis by using the Chapter Five model, an investor can now be advised regarding ways in which the political risks present in a chosen investment environment can be curbed or minimised, if not completely avoided.

Not much has been written on the management of political risk as such, but this study has taken some existing ideas embedded in management science and adapted them to the needs of political risk management. It offers some ideas regarding the management of political risk once these risks have been identified in the light of the characteristics of multinational corporations (MNC's), challenges for management, orientation toward host-countries, political forces, MNC-host country relations, MNC strategies, integrative and protective management techniques, managing the role-players in foreign direct investment, political risk insurance, political risk policy design, and political-risk-balance management.

6.1 Introducing Political Risk Management

The analysis of political risk, by means of applying the model offered in Chapter Five, now makes it possible for investors to take the assessment results and ponder the further viability of the investment. This is done in the light of the strategies that will have to be implemented in order to manage these risks and thus ensure that the profitability of the investment can indeed be secure. Foreign (direct) investment, the establishment or expansion of operations in a foreign country with the transfer of capital, is not only a means of expanding a firm's competitive advantage. Producing in another country is also a remedy to some investment problems often experienced by firms considering foreign investment as a means of avoiding certain hassles, like difficulties experienced in exporting to some countries due to tariffs imposed on products entering a country. Manufacturing a product might require natural resources that are available only in certain areas of the world, and establishing access to these resources becomes imperative. Competition often drives domestic firms to improve efficiency and decrease the costs of production. Firms might venture into countries where the cost of producing these goods (or services) is relatively cheaper in terms of capital expenditure, energy, natural resources or labour. Unlike capital, many of these factors are still not mobile and therefore firms necessarily have to seek these resources rather than attract them (Czinkota, Ronkainen, Moffett and Moynihan, 1998:55).

The fact that capital has become extremely mobile enables foreign (direct) investment despite the fact that some of the resources mentioned before are not. But where large amounts of capital are at stake, the management of that capital and its final product(s) is of extreme importance. Hopefully this study of political risk analysis and management will be able to assist foreign operations in managing the risks that might have proven destructive otherwise.

Yet the true overall cost of risk in foreign direct investment rarely includes the costs of political risks. This is very disconcerting, as very restricted views of the costs of political risks are taken that may lead to grave misunderstandings about the real economic significance of political risk (Kennedy, 1991:120-137). This is often due to a lack of awareness of all the components of risk, and an absolute belief in the conventional costing of investment risk in particular industries or organisations of a host country.

Establishing operations in foreign countries not only gives a company access to new markets and specialised resources, it also opens up new sources of information and knowledge to stimulate future product development, and broadens the options of strategic moves and countermoves the company might make in competing with its domestic and international rivals. This competition often takes place in uncertain environments and politically risky investment climates. With new opportunities come the challenges of managing strategy, organisation, and operations that are innately especially complex,

diverse and uncertain due to the foreign investment climate that domestically experienced firms encounter in host countries. Political risk management is thus taken to be the sum of the actions foreign investors or MNC's take to try and keep at an acceptable level the degree or measure of investment risk associated with their activities. These activities include the implementation of the initial idea of expanding abroad, government reaction to these activities, or even specific policy actions that may impact negatively on the profitability of a firm's idea of expanding abroad, or any number of factors measured in the study (Bartlett and Ghosal, 2000:1; Chicken, 1996:11).

Among the noteworthy recent trends in foreign direct investment and expansion operations, has been the emergence of *service* MNC's and a shift away from traditional ownership patterns between the parent company and its worldwide operations in various host countries, to a new and varied set of financial, legal, and contractual relationships with different foreign affiliates. As mentioned in previous chapters of this study, it is assumed that the notion of "foreign investment" is not restricted to only production facilities as such. The MNC's of American Express, Accenture, Microsoft, and Fuji Bank for example, are just as significant as Hitachi, Unilever and IBM.

To illustrate the inclusion of these kinds of MNC's, Bartlett and Ghoshal (2000:3) explain that the United Nations (UN) definition of what an MNC "is", has also evolved. An MNC used to be defined as an enterprise "which controls assets, factories, mines, sales offices, and the like in two or more countries." This definition has expanded, and currently an MNC is defined (Bartlett and Ghoshal, 2000:3) as:

"an enterprise (a) comprising of entities in two or more countries, regardless of the legal form and fields of activity of those entities, (b) which operates under a system of decision-making permitting coherent policies and a common strategy through one or more decision-making centres, (c) in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of the others, and, in particular, to share knowledge, resources, and responsibilities with others."

As mentioned before, among the earliest motivations that drove companies to invest abroad was the need to secure key supplies, market-seeking behaviour and access to low-cost factors of production. Of course, these attractive factors in foreign countries did not come without a host of significant problems. Early international expansion of MNC's often took place without clearly defined global objectives or well-developed international strategies, despite the motivations of economic, technological, and social developments that made internationalisation essential for a company to survive in a particular business. It became clear that being a *multinational* rather than a national company brought important advantages of competitive positioning (Bartlett and Ghoshal, 2000:5-9; Kennedy, 1991:v-vii).

As explored in previous chapters, an MNC faces certain macroeconomic risks that are outside its control and which may be country-specific, regional, or worldwide in scope. These include events such as wars and natural disasters, as well as random movements in wage rates, interest rates, exchange rates and commodity prices as shown in Chapters Four and Five of the study.

As established before, the political risks that an MNC faces arise from, among other things, the policy actions and reactions of a host government. In light of the inseparable relationship between business, economics and politics, the net effect of government policy actions and reactions are often indistinguishable from the effect of macroeconomic forces. Still, from a management perspective at least, the two are distinguishable in the sense that macroeconomic risks are uncontrollable, but political risks are, to some extent, partially controllable or can at least be managed by MNC action and even reaction, as this chapter hopes to show.

An MNC also faces certain competitive risks that arise from the uncertainties of host country competitor's responses to its strategies, as well as internal resource risks. Such risks come to the fore in cases where an MNC's strategy requires resources that the company does not have, cannot acquire, or cannot spare. A key resource risk for most firms is managerial talent, but resource risks can also arise from lack of appropriate technology, or even capital (Bartlett and Ghoshal, 2000:244; Kennedy, 1991:v-vii).

It seems that the common characteristics of these types of risks are that they vary across countries and that they change over time. This makes flexibility the key strategic political risk management requirement for MNC's, since the diversity and volatility of host country investment environments create both opportunities and risks that should be considered jointly.

After pondering the results of a risk assessment, investors presumably take some kind of action as a result. They may choose to proceed with the project and ignore the risks, or consider them as risks that need to be taken. They may attempt to modify the arrangements or circumstances of their investment. For example, if one part of a country is experiencing civil strife, they may opt to operate in a part of the country that is less dangerous, thus leaving the risky area until the situation changes (Coplin and O'Leary, 1994:4-11; Howell (ed.), 1998:10).

But host country governments can argue that political risk analyses, a first-step in establishing a political risk management strategy for an MNC, are inaccurate because "ethnic tension" did not turn into "civil strife" and subsequent war damage. However, this is by no means an indication that the particular risk was not there. It may have been avoided or managed – either by the investor or the host government – to such an extent that potential harm was avoided or eliminated (Coplin and O'Leary, 1994:4-11; Howell

(ed.), 1998:9).

Some introductory examples of managing political risk include negotiating a better deal with the host country government. If there is a high level of government interference in personnel decisions prior to the investment for example, the investor can seek (and obtain) a variation in convertibility limits or in tax levels in exchange for accommodating the host government. This can only be done, however, if the investor knows the social environment of the personnel issues and its implication for business operations (Coplin and O'Leary, 1994:4-11; Howell (ed.), 1998:10).

As an example of active political risk management, investors can develop alliances within the host country and even within the government that can elevate their position and help avoid the risk circumstances. This may be risky in itself if the faction or government they have aligned themselves with falls into disfavour (Coplin and O'Leary, 1994:4-11; Howell (ed.), 1998:10).

Now that the notion of political risk management has been touched upon in the introduction to this chapter, the discussion will proceed with explaining the characteristics of MNC's, in that they not only experience political risk as such, but that they might even contribute to a host country's level of potential political risk by prompting government reaction to MNC behaviour. The following section will also introduce ways that MNC's can deal with political risks, and suggests ways of managing them by means of formulating a political risk policy, for example.

6.2 Characteristics of the MNC: In the Line of Fire or the Firing Squad?

The most fundamental difference between an MNC and a national company is based on the social, political and economic contexts in which they exist. Many national companies remain inside domestic borders and conduct importing and exporting of goods and services, other companies might relocate, and some have branches or operations in many different countries. MNC's face diverse and conflicting demands and pressures in multiple host countries, due to differing social and cultural norms, government regulations, customer tastes and preferences, and the social and economic structures of the businesses as such (Bartlett and Ghoshal, 2000:15).

For most issues, the state represents the ultimate rule-making authority against which no appeal is feasible. Consequently, MNC's face the additional and unique element of risk, being the political risk of operating in countries with different political philosophies, legal systems, and social attitudes toward private property, corporate responsibility and free enterprise. Furthermore, MNC's are required to

measure and maintain financial results against fluctuating currencies and shifts in exchange rates. This must be accomplished in an organization that is divided by barriers of distance and time, and impeded by differences in language and culture (Bartlett and Ghoshal, 2000:15).

MNC's are exposed, either directly and willingly or indirectly and unwillingly, to both the cooperative and conflicting events occurring within and among countries, as they are constantly confronted with the ripple effects resulting from uncontrollable forces at play beyond home country borders. Furthermore, MNC's attract a lot of attention, especially in developing countries, as wielders of economic power when bargaining¹ with governments of host countries (Brummersted, 1988:76; Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Lecraw, 1984:35-41; Poynter, 1982:9-25).

This attention is augmented by the increasing interdependence that accentuates the direct impact that non-governmental interests can have on the policy-making process(es) of governments, and there is an ever-increasing trend of direct interaction between corporate entities like MNC's and host governments². The political role of MNC's has also been enhanced by pervasive economic and moral issues such as trade distribution, the allocation of declining reserves of raw materials, continued access to global markets, protection of the physical environment, investment in human capital, and surveillance over emerging technologies (Brummersted, 1988:76; Mahini, 1988:189-200).

Apart from their capabilities MNC's have certain vulnerabilities as well. They can be manipulated by both home and host governments, and direct investment creates a trans-national interdependence that governments may exploit in order to exact some form of concession. Also, whether intended or not, MNC activity has given rise to conflicts of jurisdiction and problems of territoriality in such affairs as antitrust, trade restrictions, capital controls and taxation policy. They have had major effects on the flow of trade and money since a significant portion of international trade takes the form of intra-enterprise transactions between MNC's (Brummersted, 1988:77; Kobrin, Basek, Blank and La Palombara, 1980:32-47; Kraar, 1980:26).

Still, national governments remain the most important wielders of power in the international system and state sovereignty tends to 'win out' in determining the conditions under which such business firms are allowed to operate. MNC's face the problem of continually evaluating their relative situations regarding both specific host countries and the general international climate in an effort to minimise their risks abroad (Brummersted, 1988:76; Vernon, 1971:26-59).

¹ Bargaining takes place for concessions, licenses, contractual agreements, remittance allowances, tax concessions and tenders.

² Where corporatism is practiced, bargaining takes place between government, business and labour.

6.2.1 Challenges for MNC management

MNC's, by nature and definition, use global strategies to achieve the benefits of cost reductions, improved quality of products and programmes, enhanced customer preference and increased competitive leverage (Kennedy, 1991:v-vii; Yip, 2000:392). Yet global strategy can incur significant management costs through a necessary increase in coordination, reporting requirements, and even additional core staff. It can actually reduce the effectiveness of the firm in individual host countries if over-centralisation hurts local motivation and morale (Yip, 2000:394).

Managing MNC's demands a perspective that can see opportunities and risks across national boundaries and functional specialities, and a skill to coordinate and integrate activities across these barriers to capture the potential benefits. This implies involvement in a variety of diverse activities, of which the balance will vary considerably depending on the nature of the business and the MNC's administrative heritage (Bartlett and Ghoshal, 2000:705).

6.2.1.1 MNC orientation toward host countries

Ethnocentric attitudes of MNC's in host countries are revealed in the communication process where "advice", "counsel", and directives flow from headquarters to the subsidiary in a steady stream, bearing the message 'if it works in a home country, it should also work just as well in a host country'. On the other hand, polycentric firms are those that, by experience or by the inclination of a top executive (usually one of the founders), begin with the assumption that host-country cultures are different. They assume that since people are different in each country, standards of performance, incentives and training methods must be different, and local environmental factors are given greater weight. Polycentrism is encouraged by employing local marketing managers, but the personnel policy also reveals the fact that no local manager can seriously aspire to a senior position at headquarters (Perlmutter, 2000:75-77).

The advantages of ethnocentric management are revealed in the short term, as organisation is simpler, and there is a higher rate of communication of knowledge and know-how from the headquarters to new markets. There is also more control over appointments to senior posts in subsidiaries. Polycentrism's costs are wasted due to duplication, decisions to make products for local use but which could be universal, and also due to inefficient use of home-country experience. The risks in this case include an excessive regard for local traditions and local growth at the expense of global growth. On the other hand, the advantages of polycentrism are an intense exploitation of local markets, better sales since local management is often better informed, more local initiative for new products, more support from the governments of host-countries and good local managers with high morale (Perlmutter, 2000:80-81).

An important strategic task facing managers of all MNC's is how to respond to the specific environments of the different countries in which their company operates. As explained before, national environments differ in terms of political systems, government regulation of domestic and foreign companies, social norms and cultural values. These national differences should prompt managers to rather be sensitive and responsive to national, social, economic and political differences in the host countries in which they operate (Perlmutter, 2000:99; Kennedy, 1991:1-20; Vernon, 1971:26-59).

6.2.1.2 MNC's and host governments – mutual benefits...

While cultural differences among countries have been an important localising force, diverse demands and expectations of home and host governments as well as hostile negotiations have probably been the most severe constraint to the global strategies of many companies (Bartlett and Ghoshal, 2000:99; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

Yet MNC's and host governments can still bring mutual benefits to each other. To the host government, the MNC can represent an important source of funds, technology and expertise that could help further national priorities such as regional development, employment, import substitution and export promotion. To the MNC, the host government can represent the key to local-market or access to resources that provide new opportunities for profit, growth, and improvement of its competitive position (Bartlett and Ghoshal, 2000:99; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

6.2.1.3 ...or mutual aggressors

A disadvantageous relationship between host governments and MNC's often arise from the differences in the motivations, objectives, and evaluation criteria adopted by the two partners. To be effective global competitors, MNC's typically try to improve their economic efficiency and attempt to gain strategic positions that give them leverage over other companies. MNC's often seek the ideal recipe of the important operating objectives of unrestricted access to resources and markets throughout the world, the freedom to integrate manufacturing and other operations across national boundaries, and the unimpeded right to coordinate and control all aspects of the company on a worldwide basis. It follows that MNC's rather concentrate on the disadvantages of various government restrictions on their operations (Bartlett and Ghoshal, 2000:100; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

The host government, on the other hand, constantly seeks to develop an economy that could survive and prosper in a competitive international environment. At times, this objective might lead to the designation of another company (perhaps a 'national champion') as its standard bearer in a specific industry, bringing

it into direct competition with an MNC³. Although both parties might be partners in the search for global competitiveness, the MNC usually hopes to achieve it within its global system, while the host government strives to capture it within its national boundaries, thereby often leading to conflict and mutual resentment (Bartlett and Ghoshal, 2000:100; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

The potential for conflict between the host government and the MNC arises not only from economic, but also social, political and even cultural issues. Even without the maliciousness of some MNC's that blatantly try to manipulate host government structures or policies⁴, they can still represent a political threat due to their size, power, and influence - particularly in developing economies (Doz and Prahalad, 1980:152-153).

Potential for conflict is also inherent in the different measurement systems adopted by the two partners. Due to their objectives being fundamentally economic in nature, MNC's can assess their situation and measure their performance in essentially economic and competitive terms. Host governments, on the other hand, define their goals in terms of social, political and economic outcomes, and measure performance against socio-economic, and not just economic criteria. Given the potential differences between economic and social returns, these differences in measurement criteria lead to significant differences in their evaluation of alternative courses of action (Bartlett and Ghoshal, 2000:101; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

Due to these different objectives, motivations and measures, MNC-host government relationships are often seen as a 'zero-sum game' in which the outcome depends on the balance of power between the MNC and the host government, where governments control access to local markets for which MNC's compete, and MNC's in turn have financial, technological and managerial resources for which national governments compete. The rapidly growing power of global companies can be perceived as a threat, not only by other companies but by various national governments that see their social and economic policies being upset by rising import penetration (Bartlett and Ghoshal, 2000:101; Doz and Prahalad, 1980:152-153; Kennedy, 1991:62-76; Poynter, 1982:9-25; Vernon, 1971:26-59).

6.2.1.4 Receptive multinational strategies

Ideally, in addition to the definition of the MNC presented earlier, multinational industries are worldwide businesses in which the national differences in cultural, social and political environments make multiple national industry structures flourish. Success in this case is typically achieved by companies that follow

³ IBM faced such difficulties in its relationship with the French government, which spent decades trying to build a viable national computer industry.

⁴ For example, ITT's attempt to overthrow the Allende government in Chile.

multinational strategies of building strong and resourceful national subsidiaries that are sensitive to local market needs and opportunities, and strategically manage an eventual 'fit' with a host country's political and policy environment (Bartlett and Ghoshal, 2000:105, 106; Fagre and Wells, 1982:9-23; Lecraw, 1984:35-41).

Yet each different host country in which an MNC functions is probably chosen as the destination for foreign investment due to four broad attributes, and these attributes can be viewed as major contributors to a (host) country's investment climate, namely factor conditions, demand conditions, related supporting industries, and importantly, firm strategy, structure and rivalry. Porter (1990:223) expands upon these as follows. Factor conditions refer to a host country's position in factors of production, such as skilled labour or infrastructure, which is necessary to compete in a given industry. Demand conditions refer to the nature of the home market demand for the industry's product or service. Related and supporting industries encompass the presence or absence in the host country of supplier industries and other related industries that are also internationally competitive. Finally, firm strategy, structure and rivalry refer to the conditions in the host country governing the way in which companies are created, organized, and managed, as well as the nature of domestic rivalry (Fagre and Wells, 1982:9-23; Lecraw, 1984:35-41; Porter, 1990:223).

These four factors often motivate a foreign investor's choice to proceed with, shelve or cancel plans to invest in operations in a host country. All four of these factors may pose possible political risks to the investor though, as seen in the previous chapters of this study.

It follows that, in the case of factor conditions, labour might be abundant, but the majority of the labour force might only be semi-skilled or even unskilled and uneducated, innumerate or illiterate, or unhealthy. Labour might be highly mobile, militant and unionised, and might be a very strong political pressure group easily angered and difficult to negotiate with. In host countries with strong corporatist structures for example, labour relations are highly politicised. Physical infrastructure might be poorly maintained or of a very low quality for that matter. Harbours and ports can be inefficient, rail networks unreliable, petrol in low supply, and the number of navigable roads very few.

The nature of home market demand for a foreign company's service or product might be one of no-demand, due to possible product boycotts. Demonstrations against MNC's might take place due to a switchover to capital-intensive production resulting in hundreds of lay-offs, human rights issues in the home country or in support of political prisoners.

The absence of related and supportive industries for a specific investor in a host country might be due to

government policy, in the sense that selective discrimination favours certain types of industry and not others, and import substitution policies might also keep certain industries and businesses out of ‘the market’.

The nature of corporate and bankruptcy law, tax laws and employment practices strongly influence the conditions in the host nation that govern how companies are created. The repatriation of profits policy, restrictions on profit-taking, levels of foreign equity ownership policy, power of contracts and the overall attitude toward foreign business are also political factors that might pose potential risks to firm strategy and structure.

When an MNC’s biggest rival is the host government itself, the political issues a foreign firm has to contend with necessitates the careful management of the highly sensitive issue of profiteering without alienating a host government (Fagre and Wells, 1982:9-23; Lecraw, 1984:35-41).

On the one hand, advocates of government support for industry frequently propose policies that would actually impact negatively on companies in the long term and only create the demand and expectation of more support⁵. On the other hand, advocates of a diminished government presence ignore the legitimate role that a government plays in shaping the context and institutional structure surrounding companies and in creating an environment that stimulates companies to gain competitive advantage (Fagre and Wells, 1982:9-23; Lecraw, 1984:35-41; Porter, 2000:233).

6.3 Political Risk Management

By making use of the model offered in Chapter Five of this study, one is already starting to manage the possible political risks a foreign investment might face, by identifying and analysing the severity and type of these potential political risks. In the following section, the study will look at possible ways of managing political risks and the threat that such potential risks might pose, including the integrative and protective management techniques that an MNC might use to manage the impact of political risk, political risk insurance, the formulation of a political risk policy, as well as political-risk-balance analysis. It will also touch upon certain strategies that both government’s and MNC’s can follow in an attempt to reduce and manage not only the impact that political risk might have on a country’s investment climate, but also the roles that both the MNC and the host government play as potential risk catalysts or agents.

⁵ Almost along the same lines as those that criticized the IMF bail out in post-crisis South East Asia. The rationale of the critics was that countries would in future expect such bailouts, and thus not practice stricter financial supervisory practices and adjustment procedures in the comfort of knowing the IMF would jump in anyway (Goldstein, 1998:33-45).

6.3.1 *Integrative and protective management of political risks*

Two ways of reducing the impact that political risk might have on a foreign firm include integrative and protective techniques (Gregory, 1988:101). Integrative techniques are concerned with reducing the frequency of loss and their main aim is to influence relations with institutions and actors in the political environment. Protective techniques are constructed to reduce the severity of loss and aim to protect the key internal strengths of the MNC (Gregory, 1988:102).

Integrative techniques are aimed at increasing the integration of the foreign venture into the host society; the premise being that the more integrated a foreign venture is, the less it will be perceived by the host country as being 'foreign' to that specific environment. It follows that the frequency of loss caused by political risks might possibly be reduced. Integrative political risk management techniques can be subcategorised into relations with the host government and other political groupings, relations with local economic groupings and internal management practices designed to increase integration with the host society. Examples of such techniques are policies dealing with local sourcing, distribution and employment; the sharing of ownership with the host government, local firms, and/or local citizens; careful selection and training of expatriate managers to ensure a cultural match; and cultivating close ties with government in an attempt to ensure some compatibility between the goals of the firm and the host government (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

However the over-reliance on such integrative techniques can cause system-wide damage that will lessen the MNC's ability to compete effectively in both the world and host country markets. The strength of an MNC stems from its ability to engage in worldwide optimisation and standardisation, which enables it to realise efficiencies not available to a local firm. Although the frequency of loss is reduced through the (almost) exclusive use of integrative techniques, the severity of loss can be increased in the event of a dramatic change, such as expropriation. The integrative technique of locating all parts of the manufacturing process in the host country, for example, can actually encourage expropriation⁶ (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

Protective techniques are designed to discourage host government interference, or in the event of interference, minimise the firm's potential losses. Protective techniques generally provide for the non-integration of the foreign operations into the host country environment. The subcategories of protective techniques are related to the functional areas of the firm and include logistics, production, marketing,

⁶This occurred in Peru in the case of an automobile company.

financial, and general management policies. Examples of protective techniques are locating the research and development facilities and essential parts of the manufacturing process outside the host country, multiple sourcing locations, controlling distribution and transportation, raising capital from various sources (host government, local banks, international financial institutions) and limiting host country nationals to symbolic and non-strategic positions in the subsidiary. But an over-reliance on these techniques may lead to a pattern of frequent loss, since the host government might identify such a firm as a potentially hostile entity despite the fact that such techniques will enable the firms to reduce the severity of loss (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

Ideally, MNC's should attempt to develop a risk management strategy that includes both integrative and protective management techniques for every host country where the MNC operates a project. The use of integrative techniques will enable firms to respond to both the demands of a host country's political environment and the opportunities that the environment presents. Additionally, protective techniques will aid firms in protecting their essential competitive strengths, and support them in minimising the severity of losses in the event that high levels of political risk might occur and impact negatively on the profitability and operationability of MNC's.

Examples of integrative techniques used by firms in the natural resources industry include promoting good relations with host government, engaging in contractual and joint venture relations with host governments, careful expatriate selection and local sourcing. Protective techniques in the same industry would range from financial techniques⁷, to subcontracting and farming out blocks, vertical integration and withholding the technological edge if possible (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

In the oil industry for example, integrative techniques in managing political risks include having a local partner with political connections, good labour policy and maximising the training of nationals of the host country. Protective measures would include securing a possible financial contract with a major oil company (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

Regarding the engineering and consulting industry for instance, further examples of integrative techniques include the selection of a local partner, the selection and training of expatriates, training local

⁷ These range from involving other companies in a project, even though the profit will be less, maximising debt financing, raising capital from various international sources, maintaining a certain ratio of internationally funded projects, refusing to bid on large projects in countries with high debt ratios and entering new countries in gradual steps.

engineers, maintaining close communication with the host government and local sourcing, while protective techniques include financing techniques as well as diversification of a large firm (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

In the manufacturing industry, integrative political risk management techniques include joint ventures with local partners or the issuing of equities with large firms, export promotion, local sourcing and distribution, close communication with the host government and the careful selection and training of expatriates. Protective measures include maintaining full ownership (including technology), maintaining a technological edge, intra-company sourcing and the diversification or globalisation of large firms (Doz and Prahalad, 1980:152-153; Fagre and Wells, 1982:9-23; Gregory, 1988:102; Lecraw, 1984:35-41; Perlmutter, 2000:75-77; Poynter, 1982:9-25; Vernon, 1971:26-59).

6.3.2 Managing role players in foreign direct investment

As the Coega example illustrated in Chapter Five of this study, there are a variety of role-players involved in the decision-making and implementation process of a foreign direct investment project in the form of building a chemical plant, for example. Chicken (1998:12-40), illustrates a way of managing all the role players and the likely outcomes of their actions by identifying them and attributing possible actions to each relevant party. In addition, Altier (1999:97-98) describes the steps involved in implementing the decision to 'make' such a direct foreign investment, in explaining these steps as formulating the plan statement, identifying the objectives and stake-holder components of the plan, scheduling the events and times, revisiting the components and if necessary suggesting alternatives, performing objectives tests, redrafting the plan and performing an analysis review.

As an example of such planned implementation, and the identification of the various role-players that are involved therein, one can use the example of constructing a chemical plant as a foreign direct investment operation, much like the metallurgical plants that are envisioned for the Coega development.

Within the investment environment of a host country's manufacturing and industrial sector, the most likely sector for locating the building of a chemical plant, the role players involved include the home country's chemical company itself (or one of the chemical companies), the national host government (in terms of regulators and planning authorities), local government, international authorities, international financiers, insurance, pressure groups, the public and the media. As role players, these parties can also become potential factors of political risk as seen in previous chapters.

The home country's *chemical company*, as the foreign direct investor and the primary group, will involve project managers, consultants, financiers, contactors and labour relations specialists in the decision-making and implementation processes of the investment project. As their main functions, project managers, consultants and financiers will probably have the responsibility of proposing and implementing the project as such and solving any initial problems that may arise in that regard. The contractors will probably provide the services required for physically building the plant, and the labour relations specialists will be endowed with protecting labour interests (Chicken, 1998:12-40; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

On the part of *national government*, health and safety authorities will assess the proposal and inspect the installation to confirm that it satisfies national safety regulations, and pollution inspectors will also assess the proposal and inspect the installation to confirm that it satisfies national environmental regulations. The planning authority will determine whether or not the installation is acceptable on the proposed site (Chicken, 1998:12-40; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149). Safety and environmental regulations are often adhered to in the realm of *international guidelines* and within acceptable measures of, for instance, the World Trade Organisation (WTO), the International Labour Organisation, (ILO) or the United Nations (UN).

International banks are also involved in a project of such magnitude, in the sense that capital and funding is provided either directly to the chemical company, for example, or to the other financial institutions involved in the project (Alifano, 1984:12-13; Chicken, 1998:12-40; Euromoney, 1980: 9-12; McCulloch, 1986:121-135; Suzman and Srivastava, 1986:101-120). Should political risk impact negatively on this project to the extent that it loses profitability and might even have to shut down, the project will default on servicing the capital funding extended to the project as such – in this case, political risks result in credit risk as well.

If the risks are acceptable, *insurance companies*, brokers and underwriters will provide cover against the potential direct and indirect losses the chemical plant might face, including political risks if risk levels are perceived as being relatively high and the investors are advised to take out political risk insurance (Chicken, 1998:12-40; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

Public pressure groups, like environmental pressure groups for instance, will most likely present their views on the acceptability of the proposal. The *broader public* might also either support or oppose the proposal, which can be augmented by the role the *media* plays in making the views that all the parties are expressing about the proposal widely known (Chicken, 1998:12-40; Davidson and Haspeslagh, 1982:131-

The evaluation of the true total costs of investment risk in such cases must take into account not only the costs of technical and economic factors involved, but also those of socio-political factors that are important comprehensive risk factors to any foreign investment. Furthermore, evaluation of the total costs of investment risks should take into account the potential losses that *each risk* can result in outside the investment project itself, since the investment functions within a broader investment environment. This would include the implications for other parts of the industry and other parts of the polity and economy in general. Any assessment of the implications of risk must clearly show the range of uncertainty associated with the findings of the assessment. It becomes clear that before there is real commitment to a project, there should be an audit of all the risks involved. This audit, like the method for risk analysis proposed in this study, should be aimed at identifying the whole spectrum of associated technical, economic and socio-political risks as well as their cost implications (Chicken, 1998:12-40; Davidson and Haspelslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

Possible economic risk factors thus pertaining to a host country, that should be considered in the case of the chemical plant as foreign direct investment for instance, are competition, terms of trade, export and import controls, taxation, economic instability, interest rates, exchange rates, cash inflow and the adequacy of capital supplies. Technical risk can be identified as being product adequacy for the specific host country market, production efficiency compared with competition within the specific industry, safety problems, environmental problems and supply problems. Socio-political risk will include legal constraints, employment regulations, contractual obligations, public opinion, national and international stability, protection against fraud and political stability. These factors are explained in great detail in Chapter Four and are explored throughout this study.

The internal risk factors within a company are usually characterised by the financial strength of the organisation, the risks inherent in the company's operations and the size of the organisation itself, including its workforce (Chicken, 1998:122-123). They include the firm's capability to supply the product, the financial strength of the project and the adequacy of the supply of its funds, operating costs, costs of inputs and future plans as economic factors. Technical concerns include the question of internal conditions satisfying national regulations and requirements, if the quality of the product satisfies regulations and market requirements, and the development of new products. Regarding the socio-political factors inherent in the firms that might pose risks, the adequacy of the workforce and internal organisation, protection against fraud, adequacy of training programs and problems with the general public feature very strongly. In identifying the abovementioned risks, a very important first step has already been taken in managing an investment project at the pre-contract phase, bearing in mind that the

required scope of risk assessment changes at each stage of the investment project (Chicken, 1998:122-151; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

At the pre-contract phase, all the technical, economic and socio-political factors are identified and assessed and acceptable solutions to possible problems are developed. The assessment, for which a model can be used like the one in Chapter Five, should attempt to identify all the problems that have to be solved to bring the project to fruition and operate successfully. Another important function of the assessment is to identify the total cost of the project and the time-scale in which funding will be required for earnings to rise (Chicken, 1998:122-151; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

Raising the funding requires risk assessments appropriate to the source from which the funding has to be drawn, which may include investors, financial institutions, a company's internal resources or a government source. In all cases it is important that the amount of funding likely to be required is clearly stated and possible variation in expenditure clearly explained (Chicken, 1998:122-151; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

Once the decision has been made for the project to go ahead, the monitoring of risks becomes more important. During the 'implementation to operation' period of the foreign investment, the concern of the monitoring function will be to monitor the accuracy of the initial risk assessments. Once the project is in operation, the concern of the risk monitoring process will be to monitor changes that may develop in either the internal or external environment of the project, in case the project should be modified or even abandoned (Chicken, 1998:122-151; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

Even at the end of the project and after many years, the risk assessment will have to determine the magnitude of the risks that an organisation may still have to deal with. These risks might include paying the difference after corporate tax hikes, paying fines for environmental damage, paying back initial loans, pensions, or claims against the project for harm they may have suffered, the cost of leaving the site clean or even maintaining the safety of a contaminated site, like that of a metallurgical or chemical plant, for an extended period of time (Chicken, 1998:122-151; Davidson and Haspeslagh, 1982:131-132; Kennedy, 1984:99-108; Kennedy, 1991:138-149).

6.3.2.1 Ways in which host governments can contribute to a favourable investment climate

Porter (2000:233-234; Mahini, 1988:189-200) maintains that a host government's 'proper role' should be that of catalyst and challenger – to encourage both domestic and foreign companies to higher levels of

competitive performance. However, host governments should not hinder or hamper the amplification and transmission of the positive factors of demand and factor conditions, related and supporting industries, firm strategy, structure and rivalry as discussed above. In situations where such factors are restricted by government policy, higher instances of political risk will probably be measured. Indirectly, government can stimulate the conditions that motivate foreign companies within host countries to strive toward higher levels of competitiveness. But the same government might actually have a direct impact on heightened levels of political risks a foreign company might face in a host country.

Competitive time for companies and political time for government also differ, and only in investment climates where the two are reconciled, are relatively low levels of political risk probably present. Porter (2000:234; Mahini, 1988:189-200) explains that it often takes more than a decade for an industry to create a competitive advantage, as the process entails the long upgrading of human skills, investing in products and processes and penetrating foreign markets. In politics though, a decade can be an eternity. Most governments, notably those governing developing countries under popular governance, favour policies that offer easily attainable short-term benefits that are not necessarily the responsible options. These benefits might refer to subsidies, protection and arranged mergers, which are unfortunately the same policies that might in fact retard long-term innovation and competitiveness⁸.

In avoiding such a direct contribution to potentially higher levels of political risk, Porter (2000:234-235; Mahini, 1988:189-200) suggests some basic principles that a host government can embrace in order to play a supportive role in creating a favourable investment climate and eventual national competitiveness. In their most basic sense, these factors can feature as focusing on specialised factor creation, avoiding intervening in factor and currency markets, enforcing strict product, safety, and environmental standards, sharply limiting direct cooperation among industry rivals, promoting goals that lead to sustained investment, deregulating competition, enforcing strong antitrust policies and rejecting managed trade.

Specialised factor creation

Governments, even more so governments of developing countries, have the critical responsibilities for fundamentals like the primary and secondary education systems, basic national infrastructure and research in areas of broad national concern such as health care. Although industrialized countries have 'graduated' from these material issues to more post-material issues, developing countries still face many difficult challenges in fulfilling even these fundamental responsibilities. Unfortunately, these kinds of generalized efforts at factor creation rarely produce competitive advantage. Yet it would be premature to conclude that developing countries will never fully satisfy these basic responsibilities and thus 'graduate' to the

⁸ Deregulating a protected industry, for example, will lead to bankruptcies sooner, and to stronger more competitive companies only later.

ability of focusing government expenditure on more advanced and specialised factors that translate into competitive advantage (Porter, 2000:234-235).

Mechanisms that ultimately create the factors that yield competitive advantage are specialised apprenticeship programs, research efforts at universities connected with an industry, trade association activities, and most importantly, the private investments of companies. These specialised factors of competitive advantage creation are more likely to be apparent in countries with low levels of political risk. The sentiment that political risk mostly occurs in developing countries can be based on the notion that governments in developing countries are either struggling to meet the fundamental responsibilities of primary governance, or lack the political will to see these responsibilities met (Porter, 2000, 234-235).

Intervention in factor and currency markets

By intervening in factor and currency markets, governments probably hope to create lower factor costs or a favourable exchange rate that will help companies compete more effectively in international markets. Yet these policies are often counterproductive and work against the upgrading of industry and the search for more sustainable competitive advantage (Porter, 2000:235).

Product, safety and environmental standards

Strict government regulations in this regard, but not irrationally so as to create the idea of enforcing protectionist non-tariff barrier policies, can enhance a country's investment climate by stimulating and upgrading domestic demand. Stringent standards for product performance, product safety and environmental impact pressure industries to improve quality, upgrade technology and provide features that respond to consumer and social demands. The adherence to such government regulations by industries is also a measure of policy penetration on the part of government, where it follows that the policies of a legitimate government are likely to be more penetrative and the consent to be governed by a legitimate government is more likely to be higher in (host) countries with lower levels of political risk⁹ (Porter, 2000:235).

Limited direct co-operation within industries

In the belief that independent research by rivals is wasteful and duplicative, that collaborative efforts achieve economies of scale, and that individual companies are likely to under-invest in research and

⁹ Unfortunately in developing countries, social concerns precede environmental concerns. By 2006, it is envisaged that the lead content in (South African) petrol will be much lower than present levels. Older vehicles will either not be able to run on this fuel or will have to be fitted with converters like catalysts. The cost to the average South African will either be a new vehicle, no vehicle or costs of converting vehicle engines. Government should expect dissatisfaction (SABCTV News, 15 May 2002, 19h00). Due to thin plastic being less biodegradable, the South African government wants to impose the regulation of switching over to thicker plastics especially for retail plastics (shopping bags). The plastics industry will have to capitalize on new machinery, convert old machines at great expense, or see non-corporate plastics operations shut down resulting in the loss of many jobs. Although a good policy environmentally, the social costs might outweigh the environmental advantages (see <http://www.sabcnews.com> for more information).

development because they cannot reap all the benefits, governments often embrace the idea of more direct cooperation. But companies rarely contribute their best scientists in such cases and usually spend more on their own private research in the same field anyway. Typically, governments only make modest financial contributions to cooperative projects (Porter, 2000:235). This becomes problematic in developing countries once again, where research is needed in the fields of primary health care for instance, to enable the fight against preventative illnesses like cholera as well as malaria and tuberculosis. The health of a labour force, and thus the quality of social capital in a host country, greatly impacts upon the investment climate it is perceived to offer.

Yet under certain limited conditions, cooperative research can be beneficial, provided projects are in areas of basic product and process research, and not in subjects closely connected to an industry's sources of advantage. Cooperative research should not be enforced or prescribed, and should be only indirect, channelled through independent organizations to which most industry participants, including foreign operations, have access (Porter, 2000:236).

Promotion of goals that lead to sustained investment

Government plays a vital role in shaping the goals of investors, managers, and employees through policies in various areas and should aim to encourage sustained investment in human skills, innovation and physical assets, where MNC's are also agents of such kinds of investments. One of the most powerful tools for raising the rate of sustained foreign investment is a tax incentive for long-term capital gains¹⁰ (Porter, 2000:236).

Deregulation of competition

Regulation of competition through such policies as maintaining a state monopoly, controlling entry into an industry or fixing prices are not only political risks in themselves, but also have strong negative consequences. Profitability and innovation are stifled as companies become more preoccupied with dealing with regulators and protecting what they 'already have', and this can make the industry less dynamic, less desirable to buyers and suppliers, and ultimately makes the investment environment less attractive to foreign investors¹¹ (Porter, 2000:236).

Reject managed trade

Rather than promoting innovation in a nation's industries, managed trade could result in an investment climate for inefficient companies. Government trade policy should pursue open market access to every foreign nation. Trade policy should not be a passive instrument – it should not exist merely in response to

¹⁰ This is usually five years or more.

¹¹ Deregulation and privatisation on their own will not succeed without vigorous domestic rivalry though – and that requires a strong and consistent antitrust policy.

complaints or work only for those industries that have enough 'political clout'. Such policy should not have a long history of injury or defensive policy retaliation nor should it serve only industries in distress. Trade policy should seek to open markets and at the same time address emerging industries and incipient problems (Porter, 2000:236). .

6.3.2.2 Ways in which MNC's can appease (host) governments

The MNC's strategic challenge is, on the one hand, to exploit the sources of global competitive advantage without succumbing to the potential threats that higher levels of political risk in a host country might pose, and being an agent of political risk itself on the other - causing a host government in turn to impose restriction on remittances, for instance. These sources of global competitive advantage are national differences, scope economies and scale economies and can be utilised by an MNC in order to optimise global efficiency and international flexibility, as well as worldwide learning (Bartlett and Ghoshal, 2000:242). The challenge is to create global competitive advantage by operating in foreign countries whilst managing potential political risks that might impact negatively on MNC profitability (Doz and Prahalad, 1980:152-153; Lecraw, 1984:35-41; Mahini, 1988:189-200; Vernon, 1971:26-59).

Furthermore, the successful global competitor manages its business in various countries as a single system, not as a portfolio of independent positions (Hout, Porter and Rudden, 2000:356). The most obvious leverage an MNC obtains from a host country market is the volume that market contributes to the company's overall effectiveness (Hout, Porter and Rudden, 2000:356).

Create pressure for innovation

Part of an MNC's foreign investment strategy should be to take benevolent advantage of the host country in order to create an impetus for innovation. MNC's can sell to the most demanding and sophisticated buyers and channels, seek out those buyers with the most difficult needs, establish norms that exceed the toughest regulatory hurdles or product standards, source from the most advanced suppliers and treat their host country employees as permanent employees in order to stimulate the upgrading of skills and productivity (Porter, 2000:237).

Seek out the most capable competitors as motivators

The best managers respect and study their competitors. In order to stay dynamic, MNC's should make meeting healthy challenges part of the company's norm. Lobbying against strict product standards indicates that management has diminished aspirations (Porter, 2000:237). In the same sense, government officials lobbying against stricter oversight regulations indicate the possibility that political will is lacking in such an official, as is the will to follow norms and standards.

Establish early warning systems

MNC's can take actions that assist them to see the signals of change and act on them, thereby getting an advantage on the competition. Just as the model presented in Chapter Five enables analysing and anticipating policy changes that might impact negatively on the profit-taking of foreign investors and even possibly operating functions, MNC's can find and serve buyers with the most anticipatory needs, find investment climates or host countries where regulations foreshadow emerging regulations elsewhere, bring some 'outsiders' into the management team and, as an example, maintain ongoing relationships with research centres (Porter, 2000:237).

Contribute to improving the national investment climate

MNC's have a direct interest in making the host country investment environment a better platform for success and part of their responsibility in this regard is to play an active role in working with buyers and suppliers in supporting them to upgrade and extend their own operations. The health and strength of the host country industries will only enhance the MNC's own rate of innovation and eventual competitive advantage. Leading companies also take explicit steps to create specialised forces like human resources, scientific knowledge or infrastructure. MNC's can also hasten innovation by putting their operations where there is a network of sophisticated buyers, important suppliers, or specialised factors-creating mechanisms, such as universities or laboratories (Doz and Prahalad, 1980:152-153; Lecraw, 1984:35-41; Mahini, 1988:189-200; Porter, 2000:237-238; Vernon, 1971:26-59).

Welcoming domestic rivalry

Managers complain easily about excessive competition and argue for mergers and acquisitions that will produce economies of scale and critical mass. Yet, in the long term, industry rivalry contributes to the creation of sustainable competitive advantage. It is more advantageous for a foreign company to hasten globalisation and supplement home-based disadvantages than merge with leading host country competitors. Tapping into selective advantages in other nations in a responsible and sensitive manner can contribute to creating and sustaining a competitive advantage (Porter, 2000:238).

6.3.3 Political risk insurance

Firm's purchase (or invest in) insurance to protect themselves against property and casualty losses as well as against product liability suits. Apart from private insurers, government-sponsored agencies (like the American Overseas Private Investment Corporation - OPIC) and multilateral organisations (like the Multilateral Investment Guarantee Agency - MIGA) provide insurance policies protecting foreign direct investments against expropriation of assets, civil strife, war and currency inconvertibility (Brewer, 1988:36-41; Coplin and O'Leary, 1994:4-11; Dealmaker, 2000: 1-10; Howell (ed.), 1998:10, 451-453).

Perhaps the most common form of risk management is to obtain political risk insurance. This type of insurance is available in both public and private sectors and is widely held by international investors and businesses (Coplin and O'Leary, 1994:4-11; Howell (ed.), 1998:10; Kennedy, 1991:21-61). OPIC insurance was originally provided under the auspices of the US Agency for International Development (AID) and supports the argument that political risk need not lead to limitations on investment. Risk analysis offers advice to the investor on how to manage risk in a world full of political and social danger but which is also full of extraordinary opportunity. OPIC's level premium rates for all countries covered are an indication that international investment is being encouraged, despite the difficulties to be faced. Both risk-averse and risk-assertive investors are not necessarily avoiding risk but are taking advantage of the knowledge gleaned from political risk analyses to deal with societies in the same manner that investors would deal with economic or financial uncertainties. Political risk analysis and political risk management are therefore intricately and intimately intertwined (Brewer, 1988:36-41; Coplin and O'Leary, 1994:4-11; Howell (ed.), 1998:10, 451-453; Kennedy, 1991:21-61).

6.3.3.1 Private political risk insurers

Marsh Private Equity Mergers and Acquisitions Services, for example, is a private company based in London that extends political risk coverage in the form of political risk insurance policies.

Often an investment is made on the agreement and purchase of an operating license or concession. If that agreement is cancelled in any way or contractually changed, the investment itself may no longer be of any value. Requirements for insurance clauses to counteract any such governmental measures are growing and are proving to be all the more effective. Changes to a licence or concession can be a method utilised by governments to remove what they may see as competition and can thus effectively result in a form of expropriation (or Creeping Expropriation – a slower form of expropriation over time), albeit allowing the investor to retain title to an asset that no longer retains its economic feasibility (Alifano, 1984:12-13; Dealmaker, 2002:1-22; Euromoney, 1980:9-12; Kennedy, 1991:21-61).

Other so-called “add-on” clauses, such as forced abandonment and forced divestiture have proved of interest to investors and financiers, especially in the light of internal problems in areas such as Indonesia over the past few years (Venter, 1999:73-99).

Political risk insurance can also be obtained from the following private political risk insurers, namely AIG Global Trade and Political Risk Insurance Company, FANDZ International Law Group, Meridian Finance Group, City South Limited, Provident Traders, Inc., BINKS Insurance Brokers Limited, Stening

Simpson Group, Lex-Tek International, Export Insurance Services, Inc., Coface Ireland, and Managing Agency Partners¹². Of great significance though, is OPIC and MIGA.

6.3.3.2 *The Overseas Private Investment Corporation (OPIC)*

As an application of risk management, taking out insurance coverage against political risk is common practice. OPIC is a self-sustaining United States government agency that supports American private investment in developing nations and emerging market economies around the world by selling financial services that are not commercially available. These services include long-term political risk insurance and limited resource project financing. The insurance category of “political violence” was already added to coverage for inconvertibility and expropriation in 1971 (Coplin and O’Leary, 1994:4-11; Howell (ed.), 1998:451).

OPIC can offer up to US\$200 million in political risk insurance for any one project. Clients are exclusively American companies and government-to-government aid or grants are not provided. Demand for OPIC services has increased due to the demand for large-scale private sector infrastructure projects in developing countries. OPIC helps small US businesses make investments in new markets, offering the kind of support that small businesses need in order to bring their goods and services abroad (Coplin and O’Leary, 1994:4-11; Howell (ed.), 1998:452).

OPIC supports business projects in virtually every industrial and economic sector including agriculture, energy, construction, natural resources, telecommunications, transportation and distribution as well as in banking and services. It provides political risk insurance to US investors, contractors, exporters and financial institutions involved in international transactions. Insurance is available for investments in new ventures or expansions of existing enterprises and can cover equity investments, parent company and third party loans and loan guarantees, technical assistance agreements, cross-border leases, assigned inventory or equipment and other forms of investment. Coverage is also available for contractors’ and exporters’ exposures, including unresolved contractual disputes, wrongful calling of bid, performance, advance payment and other guarantees in favour of foreign buyers and other risks (Coplin and O’Leary, 1994:4-11; Howell (ed.), 1998:452).

OPIC insurance covers the political risks of currency inconvertibility, expropriation and political violence. Currency inconvertibility refers to the deterioration of the investor’s ability to convert profits, debt service and other remittances from local currency to US dollars. Coverage compensates investors if new currency restrictions prevent the conversion and transfer of remittances from insured investments.

¹² See <http://marshcredit.com>, <http://tradecredit.com>, <http://www.fandz.com>, <http://www.meridianfinance.com>, <http://www.cslobrokers.com>, <http://www.providenttraders.com>, <http://www.binks.com>, <http://www.steningsimpson.com>, <http://www.lrx-tek.com>, <http://www.exportinsurance.com>, <http://www.coface-ireland.com>, <http://www.mpaunderwriting.com>.

Currency restrictions may take the form of new, more restrictive exchange regulations or a failure by exchange controls authorities to act on an application for hard currency. OPIC inconvertibility coverage insures earnings, returns of capital, principal and interest payments, technical assistance fees and other similar remittances related to insured investments in eligible projects. The coverage does not protect against the devaluation of a country's currency. Rather, OPIC insures investors against the consequences of conversion restrictions that occur after an insurance contract is issued (Coplin and O'Leary, 1994:4-11; Howell (ed), 1998:542-453).

Expropriation refers to loss of an investment due to expropriation, nationalisation or confiscation of an enterprise by a foreign government. This includes 'creeping' expropriation, which involves government actions that deprive the investor of fundamental rights in a project for a period of at least six months. The coverage excludes losses due to lawful regulatory or revenue actions by host governments and actions provoked or instigated by the investor in a foreign enterprise.

6.3.3.3 The Multilateral Investment Guarantee Agency (MIGA)

The Multilateral Investment Guarantee Agency (MIGA), a World Bank initiative, is designed to promote and protect direct investment projects in developing countries. MIGA protects investors by issuing guarantees against several types of non-commercial (political) risks, including host government restriction on currency conversion and transfer; expropriation or other host government actions or inactions that deprive investors of control of substantial benefits from their investments, repudiation of government contracts, armed conflict or civil unrest, and possibly other types of non-commercial risks that would be approved for coverage in the future (<http://www.miga.org>; Brewer, 1988:36).

A variety of risks are covered by MIGA, the first of which is transfer risks, implying difficulties in converting currencies for transfer of profits, fees and other funds out of the host country back to the home country. Also covered is the risk of expropriation or other measures that would deprive a corporation of ownership or control of an investment. Creeping expropriation is included as well as the more traditional and classic forms of expropriation (Kennedy, 1991:21-61). Non-discriminatory measures that are commonly applied by government in order to regulate economic activity are exempt from coverage¹³ (<http://www.miga.org>; Brewer, 1988:39).

Another type of risk covered is breach of contract by the host government. Such coverage applies when an investor does not have resources to an adequate legal proceeding for having a claim decided and enforced. MIGA coverage will also protect against losses from wars and civil disturbances, including

¹³ Coverage against the risk of devaluation or depreciation of currency is prohibited by the MIGA convention of 1987.

revolutions, insurrections, coups and other organised forms of violence (<http://www.miga.org>; Brewer,1988:40).

Only developing countries that become members of MIGA are eligible sites for projects that could be covered by MIGA guarantees, and only parent firms from member countries, both developed and developing, are eligible for coverage by MIGA guarantees. New equity investments and non-equity direct investments of a medium to long-term nature are eligible for coverage by MIGA guarantees. In addition to traditional equity-type investments, MIGA may also cover other forms of direct or quasi-direct investments such as certain forms of profit sharing, service, management and turnkey contracts as well as leasing and technology transfer arrangements. Only new investments, including reinvested earnings and expansion or modernisation of existing facilities are eligible for coverage (<http://www.miga.org>; Brewer, 1988:40).

MIGA seeks to guarantee investments for which comparable coverage is not available from the private market in political risk insurance and does not aim to compete with it. Still, MIGA coverage could be provided for lengthy periods of time, since private political risk coverage is usually limited to a very short time period, such as one to three years (<http://www.miga.org>; Brewer, 1988:41).

Apart from providing guarantee programs, MIGA is also a source of information for MNC's regarding opportunities for projects and is a source of technical advice to governments concerning their investment policies. MIGA is also an international forum for the discussion of investment policies and problems and contributes in a variety of ways to the reduction of barriers to international direct investment and improved investment climates (<http://www.miga.org>; Brewer, 1988:41).

Another significant function of MIGA is that it actually reduces the risks associated with direct investment projects in developing countries through its impact on host government policies. Provision is made for offering technical advice and assistance to improve the conditions for investment in member countries and to remove impediments to the flow of investments to them. It is also reasonable to suppose that governments will be less likely to undertake actions (or avoid actions) constituting the risks against which MIGA would be issuing guarantees. It can be assumed that an MNC would be reluctant to become involved in a situation in which MIGA would have to pay claims as a result of that host government's actions (<http://www.miga.org>; Brewer, 1988:41).

6.3.4 *Formulating and designing a political risk policy*

The lack of literature on political risk policy formulation was not viewed as a limitation but the

introduction of this notion was rather seen as a challenge that can be taken up in this study. Not planning for political risk management implies a degree of ignorance of local conditions in a host country, insensitivity to possible changes in the particular industry's investment climate both in and outside of the host country and a lack of acknowledging the relevant stakeholders in decision-making processes, be they MNC employees, the host government or the broader public.

An MNC can draft and uphold an independent policy on the way in which it views, experiences, hedges and manages the political risks with which it either deals on a daily basis or might see as potential risks in future. Managers of foreign operations in host countries should have a political risk policy that explains to the organisation and the host country how the MNC aims to deal with political risks. Every MNC or foreign enterprise should draft a political risk policy in the early planning stages and amend this policy throughout the post-analysis implementation phase (or abstention phase, if it is felt that the investment should be shelved until certain monitored conditions change).

Such a political risk policy or strategy for an organisation includes a design of the operation and subsequent governance of the organisation in its environment. In this case, it would be the investment climate of the industry and the host country, as well as the international investment climate itself at any given time (Bunge,1998:382). Most managers of firms implement already established corporate policy and rarely inquire into the nature of such a policy. Such neglect is unwise, as sudden and even expected changes in the policy environment of a host country, changes in technology, social structure, national legislation, public attitudes or even the international environment may require drastic and quick policy and strategy changes.

The goal of a political risk policy should be to assist the foreign organisation in laying down its specific role(s) in managing political risks by applying suitable organisational principles and techniques. These might include how potential political risks are to be identified, assessed, measured, monitored and anticipated in future. Of course, the main goal of an MNC is to make profit. But this primary goal need not be incompatible with adhering to the national laws of a host country nor with employment-equity practices and programs for investment in human capital. In order to avoid product boycotts or demonstrations, an MNC can be a socially beneficial organisation in the sense that, for instance, it contributes to the social quality of a labour force or by delivering useful commodities at affordable local prices for domestic consumption. An MNC will also reduce the political risk it might be perceived as posing to a national government by combining profit with service and performance accountability (Bunge,1998:383).

From the discussions so far it should also become clear that political risk is not 'aimed' at foreign

companies operating in host countries. It is not only a host country's investment climate and policy environment that poses political risks to foreign investors. The MNC itself, or foreign firms operating in host countries, can also pose accompanying political risks and should guard against being perceived as an agent of political risk. An important point to bear in mind is that an MNC is by definition foreign to a host country. It operates in social, political, societal and economic conditions that differ by varying degrees from those of the home country. An MNC's political risk policy is most probably based on the firm's global strategy, and in guarding against being a political risk itself, Lane, DiStefano and Maznevski (2000:197) advise MNC's to consider the way in which the local culture will interpret an MNC's investment strategy – if it is acceptable (although different from what was originally intended), and secondly, if the MNC has the commitment and patience to follow through with its global strategy and concomitant political risk policy.

Responsible managers of MNC's, especially when dealing with political risks, should not rely on improvisation and resort to 'improvising if and when political risk hits' (Bunge, 1998:386), but rather plan ahead, monitor, forecast, anticipate and budget so that, in case the anticipated political risks might hit, the MNC will 'survive' the risk situation short of disinvestment. Political risk management entails the constant updating of these plans in an attempt to adapt the organisation to internal and external socio-political and socio-economic changes, and in doing so, favour flexible over rigid planning, assuming that MNC's have the resources (financial and human) to plan and act with flexibility (Bunge, 1998:386).

Large corporations do not merely forecast risk in anticipation thereof but plan in the event thereof, setting their goals, designing scenarios, conducting analyses and monitoring their operations actively. Some organisations are less successful in such an endeavour, often due to having a more hierarchical and ethnocentric structure within a host country, as a consequence of which their plans and policy-making processes exclude participation and criticism, are based on insufficient local knowledge and are rigid rather than adaptive. Organisational and management rigidity is often unavoidably concomitant with excessive size and centralisation, as both lean towards inertia, bureaucratisation, alienation and waste (Bunge, 1998:386-387).

Bunge (1998:400) reiterates an earlier point that business, economics and politics cannot be separated from one another, by explaining that "[e]veryone knows that business is conducted not in a political vacuum, but in close interaction with the body politic". He goes on to explain that it is no secret that politicians, statesmen and civil servants are beleaguered and tempted by business lobbies and that political campaigns are occasionally funded by corporations expecting reciprocity. In a political risk policy, it is advisable to include an organisational code of conduct regarding the issue of interaction between business and politics. Such interaction is bound to be synergetic at times and confrontational at

others.

In a policy for political risk management, provision should be made for the right to influence macroeconomic and social policy makers, though, as the privileged party, not secretly but openly and in concert with labour and consumer groups. In the long term more is to be gained from a mediocre but fair deal than from huge profits obtained through crafty deal-brokering (Bunge, 1998:401).

6.3.4.1 Elements of a political risk policy

Apart from the use of the model suggested in Chapter Five as a means of identifying potential client- and/or industry-specific investment risks and planning for political risk management, there are some guidelines that can be considered when composing a political risk policy for an MNC (Lane, DiStefano and Maznevski, 2000:441-443). These guidelines should be adapted to every specific host country, even for the same MNC. They contain measures of flexibility that should enable an MNC's political risk policy to deal with changes in less stable policy environments and investment climates.

Firstly, identify the stakeholders that have an interest in, or will be affected by, the foreign operation. These could be the shareholders, the home country government, the host country government, customers, suppliers, employees, natural resources and the physical environment as well as trade unions. In this process, the stakeholders and their interests in the foreign project can be comprehensively identified.

Secondly, once the stakeholders have been identified, the MNC's responsibilities and obligations to these stakeholders can be analysed. Where MNC actions can influence or spark political risks, like demonstrations and boycotts, it is important to remember that MNC's have multiple groups of shareholders in addition to their own investors in the firm. Apart from the economic, managerial and legal decisions, managers also have to consider any ethical issues that might be linked to different religions and cultures in different host countries.

In formulating a political risk policy, the third step makes provision for the constant monitoring and analysis of a host country's policy environment, specifically with regards to the impact its policies might have on a specific industry's and host country's overall investment climate. Unsubstantiated assertions, posing as policy analysis, might result in MNC's adapting political risk policies to political and policy rumours, which, in so doing, may be to their detriment. Make provision for the consideration of multiple and even opposing viewpoints but they should be examined carefully. The costs and benefits of any MNC (in)action to all stakeholders should be weighed with great attention to detail.

Fourthly, it should be considered whether there are options the MNC has not yet identified. In trying to

identify possible action, the MNC should avoid characterising decisions using false dichotomies, like either/or characterisations that do not have to be win/lose positions. The statement “We need to pay the bribe or lose the license” portrays a situation as win/lose, but this does not necessarily have to be so. Such a position might be the result of initial analysis not being as complete as it could have been. An MNC should attempt to strive for win-win situations when composing a political risk policy. An attempt has to be made to find a way of solving a problem that satisfies all parties involved and allows the MNC to fulfil its obligations. Obligations to stakeholders include, among others, meeting the expectations of national government, policy makers, labour unions and environmental lobbyists, without losing sight of the MNC’s own goals.

As a fifth guideline that can be used when formulating a political risk policy, ‘culture’ should not be used as an excuse for not trying to “do things the proper way”. Decision-making criteria that should be included in this instance are doing the best for all stakeholders involved, fulfilling obligations, observing local and national laws as well as contracts, not to be deceitful and avoiding physical, social, political and economic harm to a host country. An MNC should also observe in its political risk policy a constant attempt at leading the way in the area of global, social and political responsiveness and accountability.

The aim of a political risk management technique, like formulating and adhering to a political risk policy, is to reduce a firm’s exposure and vulnerability to political risks without having to drastically change the firm’s strategy.

Avoidance of political risk occurs when management considers the risk associated with operating in a given country to be unacceptable. Risk avoidance involves exiting through divestment of the assets and capital that were committed to a specific host country. For a firm not yet participating in a certain industry and market within a host country, avoidance implies postponement of market entry until the political uncertainties or risk factors within that specific industry decrease to acceptable (investable) levels. A strategy of participating in only low risk environments is a primary facet of risk avoidance (Miller, 1991:322-323).

MNC’s may also seek to control important political risk factors in order to reduce the impact they might have on the firm as such. Such control strategies can include political activities (lobbying for or against laws, regulations of trade restraints), gaining market power or undertaking strategic moves that threaten competitors and governments into more predictable behaviour patterns. This is a very aggressive strategy and the grasp that large MNC’s have on host governments of developing countries might only serve to worsen the reputation MNC’s have of holding government policy hostage (Miller, 1991:323).

On the other hand, cooperation can be distinguished from controlling political risk in the sense that cooperative responses to political risk involve multilateral agreements, rather than unilateral control as a means of managing possible political risk. Cooperative strategies of managing risk include long-term contractual agreements with host governments, voluntary restraint and compliance with host country laws and regulations, alliances or joint ventures with domestic firms or even with the host government (Miller, 1991:323).

A further strategic response to political risk that can be incorporated in a firm's political risk policy is managerial moves to increase organisational flexibility within a host country. This involves the MNC's ability to adapt to substantial, uncertain and fast-occurring policy changes that might have a meaningful impact on a firm's performance in a host country. Flexibility increases when firms actually decrease the cost of organisational adaptation to deal with political risk factors. Unlike control and cooperation strategies that attempt to increase the predictability of important political risk factors, flexibility responses increase a firm's internal responsiveness while leaving the predictability of political risk factors unchanged. Geographic diversification and multinational production, as well as flexible input sourcing, labour force size and skills and the flexibility of plants and equipment contribute to a firm's attainment of a flexible risk management strategy (Miller, 1991:324).

A political risk policy can prove to be a truly valuable instrument for an MNC within a host country. The fact that a firm has such policy guidelines is already an indication to the host government and the host society, that an MNC is aware of its status in a foreign country and that it can influence a host country's policy environment and overall investment climate to a greater or lesser degree.

6.3.5 Political-risk-balance management

Despite a firm's best efforts to anticipate, measure and calculate political risks that a foreign investment might face, minimising the impact of unforeseen risk and controlling the consequences of risk on a given project, remains the primary concern of risk management and control exercises.

A political-risk-balance analysis for a foreign investment project can be completed for the host country's investment climate as a whole. The main role players in this climate, apart from government (in)actions as already established, include competitors, economics and the markets as such.

In a typology explained by Jennings and Wattam (1998:179), its application to political risk management can be realised. Four probabilities are identified and means of action are offered. For the purpose of political risk management, these "probabilities of political risk impact" are established after political risk

analyses have been conducted and can be illustrated as follows:

Figure 6.1: Probabilities of Political Risk Impact

		A	C
Probability of risk	High	High probability/low impact	High probability/high impact
	Low	B Low probability/low impact	D Low probability/high impact
		Low	High
		Impact of risk	

Adapted from Jennings and Wattam; 1998:179

In case A, the impact of political risk is usually acceptable and it will not be cost effective to take any preventative action although the probability of risk is relatively high. Despite the probability of political risk being relatively high, the ‘types’ of political risks that are relevant in this case are probably of a ‘low-impact’ nature. The political risks are probably manageable by adhering to a political risk policy that contains contingency plans and that is flexible to adapt to changes in the investment climate on short notice. Such political risks would not include expropriation or forced abandonment, for instance.

In case B, due to the potentially damaging impacts that political risk might have on the organisation or the project, contingency plans should be prepared and the input (financial, human resources, time) into making these plans will be relatively high. This type of foreign investment should be pursued if the political risks are manageable and if resources (financial, human resources, time) are made available, either through capital budgeting or financing. Due to the high probability of political risk occurring with relatively high impact risks, investment should be pursued if adequate insurance coverage has been extended to the project, if the benefits of investment success will far outweigh the degree of political risks faced, if management is experienced and able to organise in such an investment climate and if the resources necessary for the projects function can not be found anywhere else.

In case C, where the probability of political risk occurring is low as well as the impact those political risks might have, the management of these political risks can be conducted at relatively low cost to the MNC with the aid of a political risk policy and a contingency plan. Whether or not any action is taken will depend on the cost effectiveness of the action as such, as the probability and impact of political risks do not warrant such extensive actions as in case B.

A case D situation can be particularly disconcerting to an MNC. In such a case, although the chances of political risk occurring are relatively low, the impact that such a risk might have on the odd chance of it occurring, is incredibly high (expropriation, forced abandonment, repudiation of contracts or the cancellation of licenses). Action must be taken to not only enable the aversion of impending political risks, but also the recapitalisation of losses.

By evaluating these cases the most effective political risk control mechanisms can then be selected in the post-analysis phase, thus allowing amendments to be made to an MNC political risk policy, or capital budget, should something go wrong. Risk can thus be minimised by reducing the impact that risk might have on a project by looking for contingency or alternative methods of provision for the project. It follows that risk is associated with the ways of solving or providing a solution and implementation for change in a projects approach or planning for risk and its eventualities. By being aware and informed, and by evaluating the associated risks, the problem domain is explored and the consequences of success as well as of failure are known and understood. (Jennings and Wattam, 1998:180).

6.3.5.1 Expatriation and repatriation of personnel

In all of the above cases, apart from financial and physical capital, human capital (human resources) also plays a large role in the sense that it is the MNC's employees (at all levels) that actually drive the operation. These employees can either be instated as locals from the host country as mentioned in the discussion above, or can be expatriate. Although the use of expatriate personnel has been mentioned before, the operations of an MNC in a foreign country is very dependent on its personnel of which many individuals are often repatriated from the MNC's home country.

Expatriate managers of MNC's in host countries often find themselves especially torn between an allegiance to the parent firm and their allegiance to the local foreign operation (Black and Gregersen, 1992:283). Faced with this dilemma, expatriate managers end up directing their allegiance too far in one direction or the other, and this in itself can pose serious risks for MNC operations in a host country as it creates serious costs and consequences for both themselves and the organisation. Additionally, the high competitive pressure, great geographical distances and wide cultural diversity of global operations, combined with ineffective management by expatriates, can set off a cycle that erodes or might even destroy an MNC's global competitive position, the ramifications of which can actually result in heightened levels of political risk.

Black and Gregersen (1992:283) explain this cycle starting with an unbalanced allegiance that can lead to a variety of failures during and after international assignments. As managers hear about these failures, firms find it increasingly difficult to attract top international candidates and increasingly worse candidates

are sent overseas, producing even worse organisational results and/or failed careers. This further limits the pool of willing and qualified candidates and, over time, the firm's international competitive advantage erodes.

The political risks inherent in such a downward spiral probably become more apparent by the time an MNC's competitive advantage starts to suffer. By the time profitability declines, MNC's start to take chances by diverting from their planned global strategy and political risk policy. This might take place in the form of bribing government officials to ensure contracts, defaulting on loans, not being able to honour contractual deadlines tendered and contracted for, cutting wages of employees, tax evasion, slackening labour and safety regulations, hiring unqualified personnel in order to pay lower wages, defaulting on quality controls and environmental regulations and ignoring industry policy and government regulations for the sake of remaining operational among drastic losses in competitive advantage and profitability.

It follows that, when an MNC becomes a threat in a host country, host governments might retaliate by shutting down an MNC's operations due to irregular practices, and its contracts might be cancelled or licences revoked¹⁴. Labour unions might call local employees to strike, thus augmenting losses even further by losses in man-hours and productivity. Legal action might be taken against MNC's that are disregarding environmental regulations, resulting in national policy changes or even possible hikes in corporate taxes and fines to recover damages. National laws might even be amended by the national legislature in order to ensure that such practices do not happen again. A host country's attitude toward foreign (direct) investment might be negatively influenced and may heighten the level of political risks for future investors, illustrating how an MNC itself can impact negatively on a host country's investment climate.

Selecting the 'right people' for the specific positions within the MNC in a certain host country, training them, and sending them (and their families) to their foreign posting is only the first step of repatriation. What might also become problematic is reintegrating these employees into the company after the foreign assignment so that the company can continue to benefit from their international experience and expertise. The international assignment may be an important vehicle for developing global managers, achieving strategic management control, coordinating and integrating the global organisation, and learning about international markets and competitors, as well as foreign social, political and economic situations. Yet employees that have benefited from such assignments need to be "debriefed" and repatriated with care in order for the firm to take advantage of their unique background (Lane, DiStefano and Maznevski, 2000:213).

¹⁴ Kennedy, 1991:21-61 offers two such examples, namely those of the Sigma corporation in Iran, and Occidental and Belco Petroleum in Peru. Both are cases of managing political instability and expropriation risk.

6.4 Concluding Remarks

In managing the complexities involved in making decisions to conduct foreign investment and then implementing these decisions, the idea is to develop some definition of the problem that is to be tackled, without losing sight of the relationship between the problem itself and interrelated factors that may or may not, to a greater or lesser extent, impact on the implementation of such a decision. By identifying the political risks that are involved in the implementation of a foreign investment decision through political risk analysis, structure is given to the complexities of the decision and, in so doing, one becomes familiar with the political risks involved and uncertainty is thus lessened.

Thus, although a political risk analysis or assessment is a first step in giving substance to a foreign investment decision, it is also itself a way of managing the political risks that are involved by identifying them. The structuring of the complexities involved in an investment decision, or the 'problem', goes on throughout the life of an investment project or operation. Even after implementing the investment decision, setting up operations or starting the factory, the management of the investment risks never ends. Political risk analysis is a constant given throughout the life of a foreign investment – an assessment constantly explores, identifies and questions the levels and nature of the political risks involved in a project, makes an analysis and reflects on the most suitable way of continually managing these political risks by means of any of the above, or as a combination of the above mentioned political risk management strategies and techniques.

CHAPTER SEVEN: Summary and Concluding Remarks

This study set out to design a comprehensive model for political risk analysis. In order to do so though, one had to think of how to go about measuring something as elusive as ‘political risk’. The study started out by establishing what political risk encompasses and had to find out what it entails, what other authors thought it meant, and, maybe even more importantly, what it did not mean. Once the study established what it perceived as being a conceptualisation of ‘political risk’, it became necessary to start thinking about how one could measure it. So the concept had to be ‘unpacked’ or ‘broken down’.

If political risk supposes the probability that a certain event or factor might impact negatively on the returns of foreign investment, it further suggests *a degree of impact that governmental policies or societal action, originating either within (internal risks) or outside the host country (external risks), can have on foreign business operations and investments.*

It became all the more clear over the years that there are a myriad of factors, each with its own risk indicators that can cause political risk, and, depending on how severe these factors are, the level of political risk these compounded factors constitute. Because the presence of these factors point toward the possibility that a potential for the occurrence of political risk exists, the severity or degree to which they are present in a country can be measured by their “indicators” because they indicate to us, or point toward, the probability that political risk might occur.

But these risk factor indicators had to mean something. The study set out to correlate the measured values of the political risk indicators to the degree of political risk, the level of risk present, or the ‘size’ of the chance that risk might occur. This was not always easy, especially because, in the first instance, one often had to measure things there were no “numbers” for. It was relatively easy to incorporate quantitative economic values, like the balance of payments, interest and inflation rates or the average percentage with which wages have either decreased or increased in a given year, but measuring the militancy of labour or government legitimacy was a completely different and very challenging task. Also, “a lot” of one kind of risk factor was not always necessarily a bad thing as “a little” of another was not always a good thing. For example, “a lot” of illiteracy is surely not a good thing, especially when one thinks about the consequences of illiteracy and the contribution thereof to potential levels of risk. In the same sense, “too little” political will is definitely not a good thing either, whereas “too little” inflation or a small budget deficit is not necessarily a bad thing.

Once one starts to think about political risk factors and their indicators, and how to “weigh” them, the kind of model that could be designed became clear. After being convinced that it is possible to allocate

numerical value to so-called “soft” risk factor indicators by explaining the implication of each risk factor, and weighing each indicator on an individual scale, it was feasible to build a model that made it possible to measure and calculate the real percentage chance that political risk might occur. The reason for wanting to measure the degree of political risk is not only to analyse political risk and thus be able to recognise its presence and anticipate it in future, but to also, and very importantly, create the ability to manage the impact of political risk in cases where it could not be avoided.

The principal purpose of this study of political risk analysis was to present a way of being able to anticipate political risk and the consequent goal was to suggest means of managing these risks. Chapters Five and Six hopefully addressed these purposes adequately, where the management of these identified risks can be conducted in many broad fashions, or whittled down to suit specific investments or operations. Apart from these uses for political risk analysis (risk identification, anticipation and management), other uses were also mentioned, like conducting both country specific and comparative analyses. Primarily, the model for political risk analysis presented in this study hopefully alleviates at least some of the complexity of a decision-making environment regarding foreign investment. Although uncertainties surrounding the validity of political risk analyses still relate to the scepticism experienced with measuring qualitative variables in political risk analyses, this study tried to aid in compounding a better understanding of the magnitude of political risk by showing how multi- and inter-disciplinary the practice of political risk analysis truly is. Students of political risk agree that such risk is affected not only by *political, social and economic phenomena*, but also by *environmental and socio-cultural* factors, and also agree that these factors should be incorporated into a variety of frameworks to enable the assessment of political risk in a specific country or countries.

It is irresponsible to present a potential investor with a risk assessment that does not incorporate political risk factors and their indicators, let alone environmental, societal and socio-economic risk factor indicators. Ultimately any business climate, regardless of the country being studied, is underwritten by a political system, political climate, political culture and business culture of the system in which foreign business wishes to operate profitably.

What is often labelled as unnecessary and irrelevant detail in risk analysis often results in a lack of using micro risk factors and their indicators and an underestimation of the importance of such micro risk indicators. Hopefully this study did indeed take up the challenge of showing that political risk analysis can be made more precise.

7.1 The Conceptualisation of “Political Risk”

In reading about past and more recent research in the field of political risk analysis, it becomes clear that many authors begin by noting the diversity and the discrepancies of the existing definitions of political risk, but evidence in political risk insurance shows that the major perceived political risks that investors insure their interests against seem to be confiscation, expropriation and nationalisation. In the light of this study's findings though, a case can be made for urging that political risk insurance clauses be extended to further include any or all of the micro political risk factors that have been identified to ensure that political events do not impact negatively on a foreign company's profitability. The cost of such insurance can also be scaled to the result of an analysis like the kind made possible by this study, where a real percentage chance can be calculated. Thus, a percentage relating to that of the calculated chance of risk occurring can be used to calculate risk coverage as a percentage of the overall cost of capital investment.

This study also tried to clarify some of the confusion relating to the respective natures of political and country risk. Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to problems arising from *macro-economic* events in a country that are uncontrollable yet often inevitable. Political risk, on the other hand, recognised as factors caused by government policy action or reaction, can to some extent, at least as put forward in the sixth chapter, be managed if not avoided.

As *Figure 2.1* illustrated in the second chapter, a country might be willing to repay loans (low political risk), but may not be able to do so (high country risk). This does not necessarily point toward a political risk situation as much as it does to an amalgamation of various credit difficulties, but a case of low transfer risk combined with high levels of political risk needs to be questioned. What has been shown in the second chapter though, is that political risk and the analysis thereof cannot be adequately conceptualised without expanding on its link to country risk.

Although easy to use interchangeably, political risk should be appreciated as being distinct from political instability and political uncertainty, where political instability can be seen as but one criterion that points toward a possibility of political risk occurring. As an example, the underlying risk that political instability holds for a foreign organisation is the possibility that political disequilibrium might result in regulations hampering the escalation of profits or limiting profit taking.

Political risk is present in both macro-generic environments, as well as in industry or microenvironments. Although macro political risks are 'types' of risk that affect operations throughout an entire country, micro-types of risks affect only some businesses in different ways, or some more than others. Also, it is not only the host country that poses risks to investments, but the type of foreign investor and the nature of

the foreign investment itself can also present the foreign transaction or 'investment deal' with certain risks.

Although political instability and political uncertainty are mentioned as negative contributing factors to levels of political risk, uncertainties can, on occasion, be regarded in a positive light. In some cases, 'less than positive' results of a political risk assessment can even encourage certain investment endeavours in risk assertive investors. This is why a model of political risk assessment should enable comparative analyses - to compare the results of different country risk profiles and eventually select the most positive post-analysis result as an investment opportunity in consultation with investors on an individual basis.

7.2 Political Risk: In the Final Analysis

In offering a method of analysis for political risk, this study not only described political phenomena in terms of the factors of political risk, but also tried to explain or understand the occurrence of political risk and the 'recognition' of risk in the future. Political risk analysis aims to interpret something in terms of its effects, it is a process in which investment potential is measured against the backdrop of certain factors which contribute to the levels and type of political risk present in a certain country.

Where it was suggested that political risk implies a degree of impact that governmental policies or societal action, originating either within (internal risks) or outside the host country (external risks), can have on foreign business operations and investments, a working definition of *political risk analysis* broadly encompasses the assessment of the possibility that factors caused or influenced by government political decisions or other unforeseen events in a country will affect business climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to investment was made.

Although both internal and external events contribute to the occurrence of political risk and are constantly influencing the severity and degree to which risk factors influence investments, 'good' political risk analysis necessitates a careful regard of the specific issues that are relevant to every individual organisation considering potential foreign investment opportunities. The choice of tool for each political risk analysis should thus be chosen with care. A generic model of political risk analysis can assist in cross-country comparisons for instance, but should be adaptable to suit a specific client's needs in an attempt to assess industry-specific micro risks within the host country's macro environment.

Once conducted, a political risk analysis draws the potential foreign investor or decision-maker's attention to the various problems that political risks might pose to the viability of the investment. Where

political risk analysis is a first step in decision-making regarding foreign investment optimisation, analyses focus on problems that call for the making of decisions concerning the implementation of actions (risk management), and, in a way, already start the process of dealing with problematic and complex decision-making.

Thus, by conducting a political risk analysis, one is already managing the political risks that might impact negatively on foreign investment. By studying and understanding all the political risks involved, the political risk analyst is able to advise an investor in terms of changing or adapting investment decisions by continually monitoring the impact identified risks might have on a certain investment – thus managing and controlling the influence these risks might have on consequential losses in profitability.

7.3 Circumventing the Problems of Political Risk Analysis

Although models aim to ease complex decision-making processes by representing reality, merely defining a model as a simplification of reality would be an underestimation of the intent of modelling and the result of using the model. The complex environment surrounding and infusing the decision-making process of foreign investment, necessitates the use of models as ways of applying rational political risk analysis to complex issues.

During the development and design phase of this model-building exercise, it was found that any model could only be as reliable as the components it is made of. The sources of data used when applying a model is an extremely important aspect to monitor, especially if the results of a political risk analysis based on a model designed for this purpose is used for extrapolation to enable the anticipation of political risk analysis occurring in future. Ultimately validation errors can also occur in model building, contributing to the various theoretical and methodological problems that were faced in designing a model for political risk analysis and management. Because these problems were discussed and illustrated in the chapter preceding the model as such, it was, to some extent at least, possible to circumvent these issues in the final product.

In examining existing credit and political risk ratings in order to gauge the current extent of rating methodologies (see *Table 3.1*), it was found that existing methodologies of country and political risk analysis are limited and include mostly macroeconomic indicators (as credit risk ratings do per se), measures of social structure and development, and political events that are primarily indicators of instability and/or regime change. What this study tried to present in Chapter Five is a way of conducting not only macro-type risk analyses, but also industry-specific (type, size, structure, experience with foreign

expansion), time-specific (short, medium or longer term ventures) as well as investment climate-specific political risk analyses.

This study faced a further problem, namely attempting to conceptually model the process through which political and economic environments actually affect projects. Determining the nature of potential constraints is a large part of the analytical problem as is the forecast of the probability of their occurrence. Adding to an analyst's uncertainty is the nature of the relationship between the host country's political environment and the nature of the international firm investing in that specific country. In designing this model for political risk analysis, one has to remain aware of the weakness of a structural analysis of political risk, such as a model, in that it tends to become static. So the model in Chapter Five has been designed with a built-in flexibility, as weights of factor indicators and timeframes (the past one, six or twelve months or even years) can be adapted to the specifications of the investor.

7.4 What Was Learnt From Other Models and Methodologies

As the operationalisation of the research and final product of this study, the fifth chapter presents a model with weighted values given to each factor indicator of political risk, and calculations can be made to present a real, average or total percentage chance that political risk might occur in a certain host country, or in a specific industry sector within a host country.

It is important to realize that the value of models and modelling approaches extend beyond the realm of only mathematical models as such. There exist, among measurement tools like scenarios for instance, other kinds of models that are of great value in management science, namely business process models and soft models. Scenarios are a well-known and widely accepted method of identifying key political and economic risks and opportunities, as they allow for the constant comparative analysis of such risks and opportunities.

The model offered as part of this study seems to lend itself toward a decision-theoretic model which allows for risk assessment and aims to present an objective measurement tool that can be used to help decision-makers find enough consensus over issues to eventually agree on a strategic action for foreign investment. Problem-solving theory and decision theory (upon which this model is based) are risk averse in the sense that they offer means or ways of designing strategies for managing political risk analysis and are assumed to be the more general theory underlying rational decision-making under conditions of uncertainty.

Yet, despite the best efforts at analysing and managing political risks, there may still be no guarantee that any of the investment options analysed by a political risk analyst and considered by the investor are certain. Political risk analysis also operates from the assumption that the world is not deterministic. To consider non-deterministic outcomes though, one has to model a tool for political risk analysis by resorting to ideas of probability. Still, the role of analysis, as used in political risk analysis, is to offer an exploration of the possible consequences of different courses of action that can be taken when making a decision to conduct foreign direct investment.

7.5 What The Asian Financial Crisis Can Teach Political and Credit Risk Analysts Alike

As this discussion on the crisis developed, we offered the application of political risk factors and their indicators as an illustration of how they can be used in order to anticipate the occurrence of such events in future. The aftermath of the Asian financial crisis is important to political risk analysts for a number of reasons, one of them being the major implications for the future development prospects of the affected countries which are often dependent on direct foreign investment and extremely large loans.

In an on-going debate, it is argued that credit rating agencies failed to forecast the Asian financial crisis. Although some of the variables provided in the methodology used by rating agencies include factors relating to the political system, this study still contends that political risk indicators are either overlooked and/or underestimated or excluded from current risk rating models, and suggest that they be included in an improved model or early warning system for future use.

Granted, the competencies of credit risk agencies lie in the area of credit or sovereign default analysis and differ from the competencies necessary for political risk analysis. But credit ratings are often used mistakenly as being comprehensive reflections of political and social conditions in countries as well.

The assumption that political events result in certain economic decisions being made is beyond dispute, but economic events also see certain political consequences. With hindsight, post-crisis analysis shows that government inability on the part of all governments involved was also a culprit in the contagion - a micro risk or political risk factor that was overlooked.

The underlying political factors present before and during the Asian crisis prompted this study to look for factors, political and/or institutional, that contributed to government inability or unreadiness to deal with the crisis and found that governments are becoming increasingly accountable to market confidence as well.

The test of political leadership during and after a crisis is surely a question of capable government, and is something that could have been monitored and measured as part of an 'early-warning' indicator by micro risk indicators in a well-designed model for political risk analysis. The Asian financial crisis, coupled with the role the IMF played and its continuous aftermath, cannot be exempt from an investigation founded in political risk analysis. Political governance should be of great concern in risk analysis practices as the bottom-line of any policy, government action or market sentiment.

By no means does this study suggest that a political risk analysis model can forecast a financial crisis, just as a credit risk rating methodology cannot measure political risk. But hopefully this model can serve as part of, or in conjunction with, an early warning system that might prompt financial analysts to subsequently look in other places as well for signs of possible danger.

7.6 Recognising Political Risk

Political risk analysis per definition implies the ability to measure the amount and type of risk a country might pose for a foreign investor. As political risk analysts, we have to be able to look for and recognise signs that can act as clues to possible situations in which risk can occur for the potential investor. There is a myriad of criteria that can, although not necessarily, result in political risk. These 'clues' or 'signs' are the potential risk factor indicators.

As this study attempted to show, systematically organised observations present data that can be scaled numerically. Statistical data, which is the easiest to come by, the easiest to work with, the cheapest and eventually also more reliable and widely acceptable, can be manipulated by means of aggregating and averaging figures to fit a framework of political risk concerns.

Apart from the problems associated with using aggregate data, it was found throughout this study that the various levels of analysis represented by the model in Chapter Five presented problems of their own. As an investigation into these issues became deeper, it was found that the problems of comparisons, of aggregate data analysis and that of cross-level analysis are interrelated. The study also revealed that causes of political risk are infrequently attributed to only one event or tendency in a country and that political instability does not necessarily always translate into political risk. More often than not, the level of political risk in a country is rather an outcome of combined 'risky situations', amalgamated under certain circumstances.

As mentioned quite often, political risk encompasses not only politics, but also economics, socio-economics, social and societal factors and environmental factors as well as the nature and the industry-specific scope of the business involved. As these elements are constantly undergoing change, the assessment of risk necessitates detailed analyses of the various features of particular cases by means of a flexible model. What was found, however, was that the reality of time and costs often limit the depth and scope of analysis. It would be wise for future students of political risk and risk modellers to find indicators that are easy to handle and readily available, without compromising the integrity, validity, quality and accuracy of a political risk assessment.

The study suggests that one criterion for 'good risk factor indicators' of political risk is that the factor indicator, or the information from which it is calculated, should itself be, and be made, readily available. This is particularly important for developing countries where the resources to collect and process statistical information are limited and thus not regularly publicised or one hundred percent valid (not that all countries do not "round-off" their figures). The rationale behind this is that factor indicators, for which information is difficult and/or expensive to collect, are much less likely to be put into practice than factor indicators for which the information can be easily and cheaply collected.

Also, risk factor indicators and their direction ('up' or 'down' as related to being a 'good' or 'bad' thing) should be relatively easy to understand, and should reflect something measurable, something believed to be important or significant in its own right, or reflect or represent something important beyond what the factor indicator itself is a measurement of (for instance, life expectancy figures might be used to indicate the general state of health of the economically active population). One way to build up a set of factor indicators from an inexhaustible pool of risk factors, is to decide which are the most important problems to keep track of, again emphasising the importance of gauging a client's specific needs to enable micro-type analysis.

The 'economics of political risk' is not a contradiction in terms. If government makes decisions or rules as to the economic systemisation of a country, policy is made. And where policy is made, politics is involved. In assessing political risk, Multinational Company's (MNC's) must give ample weight to elements of political control as well as to various cultural constraints on the control and influence they can wield in a host country, here "host" implies precisely that the foreign investor is indeed a guest in any country other than the home country. Using economics as a contributor to political risk is certainly one of the more important factors in political risk analysis. A country's macroeconomic policy provides a framework of the economy's performance and flexibility and is closely bound up with the political structure which foreign investors are interested in when considering the most profitable investment climate.

7.7 It Is Possible to Measure Political Risk...

In researching this topic, it was found that political stability, political effectiveness, monetary policy, exchange rate policy, trade policy, fiscal policy, the regulatory environment, the global environment, debt, growth, the financial structure, current account and liquidity of a host country seem to be the overarching concerns of foreign investors. The presented model for political risk analysis included, amongst others, further measurements of political stability, political effectiveness and accountability, political systems, socio-economic conditions, internal and external conflict, corruption, military in politics, religious tensions, the quality of the bureaucracy, monetary and fiscal policy, exchange rate and trade policy, growth within the global environment, current account and debt, financial structure and liquidity risk as measures of political risk.

The fifth chapter explained how the model for political risk was designed and “put together”. The accompanying computer disc shows how the generic model works and how it can measure the levels of potential political risk in any country. By using the Coega example, it was also shown how the model, because it is flexible and adaptable, could become a tailor-made model for use in industry and/or client-specific political risk analyses. The model enables the calculation of a *real percentage chance* that political risk might occur, as well as an *average percentage chance* and *total percentage chance* that risk might occur.

Due to the weighted values of the total political, economic and social risks being weighted in calculating real percentage chance, the preferred real percentage chance calculation was used in the study as the most reflective value of the calculated probability that political risk might occur. In both the generic and specific model, total political, economic and social risk(s) are weigh(t)ed as 50%, 30% and 20% respectively. But due to the proven flexibility of the model, an investor can choose to weigh these differently and have the indicators weigh, for instance, 60%, 20% and 20% respectively, or 40%, 35% and 25%, etc.

Although the real percentage chance calculation is preferred, the average and total values are nevertheless useful. They are two additional ways of testing and measuring levels of political risk and are an indication of the parities between real, average and total political risk. These parities should not differ more than approximately three percent either way.

Foreign investors put assets at risk to achieve their objectives and the assessment of these risks, including political risks, is the key to successful operations. Opportunities and risks are often two sides of the same coin and political risk comprises a large part of the environmental forces in terms of the management challenges an MNC faces in any investment climate.

A firm's foreign investment strategy deals with the positioning of the organisation in an uncertain host country environment and investment climate. In the sixth chapter, the study attempted to explain how a firm's political risk exposure, which refers to the sensitivity of a firm's projected profitability and operability in a host country to changes in the investment climate, could be managed and reduced. It is hoped that political risk analysis and management can assist foreign operations in managing the risks that might have otherwise proven to be destructive to profitability and operationability. One can thus view political risk management to constitute the sum of the actions a foreign investor or an MNC takes to try and keep at an acceptable level the degree or measure of investment risk associated with their activity in a host country.

By the very nature of their definition, MNC's face the additional and unique element of risk, being the political risk of operating in countries with different political philosophies, legal systems, and social attitudes toward private property, corporate responsibility and free enterprise. Furthermore, MNC's attract a lot of attention, especially in developing countries, as wielders of economic power when bargaining with governments of host countries.

In thinking about managing political risk, it was found that the relationship between MNC's and the host governments can be either mutually beneficial or mutually detrimental. This relationship can also manifest itself in cases where especially governments of developing countries become increasingly vulnerable to the power that large MNC's wield, just as MNC's can bear the brunt of host government power.

The study suggested that possible means of managing political risks and the threat that such potential risks might pose include integrative and protective management techniques that an MNC might use to manage the impact of political risk, political risk insurance, formulating a political risk policy, as well as political-risk-balance analysis. It also touched upon certain strategies that both government's and MNC's can follow in an attempt to reduce and manage not only the impact that political risk might have on a country's investment climate, but also the roles that they both play as possible risk agents, and thus manage their relationships with each other.

7.9 Scope For Further Study

There still remain some very important questions that should guide further research into the conceptualisation, measurement and analysis of political risk and political risk management, and relate to the notion and conceptualisation of political risk itself being made more precise.

A challenge that was not covered in any great detail in this study, but intends to by no means distract from its importance, is the perception that political risks, or investment risks for that matter, are narrowly regarded as being the nemesis of only emerging economies. There lies a great danger in underestimating the importance and necessity of conducting thorough political risk analyses, even in highly industrialised countries.

Where sovereign default risk is reflected in the macro-economic indicator of the balance-of-payments sheet, a factor often used as an indication of political risk as well, even developed countries can reflect at least some level of risk in this regard. Since political decisions (like foreign policy and trade policy formulation) and events substantially influence balance of payments trends, political risk analysis should rightly be incorporated into risk assessments of industrialised countries as well.

Political risk analysis and risk management is not only concerned with the political and economic events that come to the fore in a country, but also with the sub-national socio-economic dynamic within countries and the impact world events have on them. Industrialised and newly industrialised countries alike are not exempt from thorough political risk analyses, as the practice of such assessments is not only limited to the study of political risks in developing countries. A 'low risk' environment can actually pose certain types of risks themselves (high safety regulations, tough labour and environmental regulations, saturated markets, a limited pool of skilled, available, and inexpensive labour and expensive capital and technological intensive operations). Political risk analyses can always be widely utilised and the use thereof borders on the inexhaustible.

There is also further scope for research regarding testing the more complex contingency relations between the many uncertain dimensions of host country environments and MNC's strategic responses. Uncertainty seems to be treated as a single construct, which it is not, and often one type of uncertainty is isolated in an MNC's strategic response to the exclusion of others. A more comprehensive response is needed by MNC's, and the ways of formulating such comprehensive strategies can be aided by further research into the designing of political risk policies. This seems to imply that much of the literature on risk and uncertainty is not quite precise in its theoretical statements about organisational

response to uncertainties because of its failure to specify the particular uncertainties of interest (Miller, 1992:327-328).

As mentioned before, the scope for further study in the field of measuring political risk allows for a more in-depth investigation into the abovementioned precision of a set of indicators used for analysing political risk. The arbitrary nature of political risk analysis can be remedied by incorporating standardised and transparent values already attributed to political indicators. There was a surge in good databases during the past decade or so that measure political attributes and thus enable comparative studies. Although this study is aware of these standardised measurements, it admits to the aim of addressing the challenge of attempting to build a unique and comprehensive model for political risk analysis independent from these measurements. This is however, quite possibly a limitation to this study, and an even more advanced study should without a doubt further address remedying the more arbitrary and nominal nature of that which can be defined as political risk. This could simplify political risk analysis even more, as well as reduce the arbitrary nature of analyses.

In addition, there is also scope for research regarding the effect of political risk factors on financial markets, where the movements and reactions of these markets might prove to be a result of ensuing political risk. Strike action, wage stand-offs and lost man-hours and man-days, due to labour disputes, directly influence the pricing of shares and stock. The stock and equity price information that traders have at their disposal regarding international markets are constantly complemented with, among others, *Reuters'* information regarding the latest announcements and current events. For instance it is quite interesting to witness the movement of markets after the United States unemployment figures have been announce or after the announcement that European Union negotiations have produced certain expected and unexpected results. Announcing interest rate cuts or hikes also sees movement in the markets as does the advent of strike action. The effect of technological advances in specific industries will impact directly on industry participants, where these technological advances are often the result of trade agreements between countries as the sharing of technological know-how becomes a spin-off of various trade agreements.

The scope for further research into political risk analysis and management is close to inexhaustible. Every single indicator identified in this study can justify a study in its own right.

GLOSSARY¹

- Absolute advantage** The ability to produce a good or service more cheaply than it can be produced elsewhere.
- Absolute poverty** A situation where a population or section of a population is able to meet only its bare subsistence essentials in order to maintain minimum levels of living.
- Accuracy** The level of exactness possible for achieving the given objective, not that which is theoretically possible.
- Agrarian system** The pattern of land distribution, ownership, and management, also the social and institutional structure of the agrarian economy. Concentrations of large tracts of land are usually in ownership of a few powerful landlords.
- Agricultural sector** Comprises agriculture, forestry, hunting and fishing.
- Antitrust legislation** Laws prohibiting the monopolisation, restraints of trade, and collusion among firms to raise prices or inhibit competition.
- Appropriate technology** A technology that is appropriate for existing factor endowments.
- Area expertise** Knowledge of the basic systems in a particular region or market.
- Asset** A physical property or intangible right that has economic value. Important examples are plant, equipment, land, patents, copyrights, and financial instruments such as money or bonds.
- Asset ownership** The ownership of land, physical capital, human capital and financial resources which generate income for owners thereof.
- Autarchy** A closed economy that attempts to be completely self-reliant.
- Balance of (international) payments** A statement showing all a nation's transactions with the rest of the world for a given period. It includes purchases and sales of goods and services, gifts, government transactions, and capital movements.
- Balance of trade** The part of a nation's balance of payments that deals with merchandise (or visible) imports or exports. When "invisibles" or services are included, the total accounting for imports and exports of goods and services is called the balance on the current account.
- Balanced trade** A situation where the value of a country's exports and the value of its imports of visible items are equal.
- Bank (commercial)** A financial intermediary whose prime distinguishing feature until recently was that it accepts checking deposits. Also, it holds savings or time deposits and money market deposit accounts; sells traveller's checks and performs other financial services; and lends to individuals and firms.
- Basic needs** A term used by the ILO to describe the basic goods and services (food, shelter, clothing, sanitation, education etc.) necessary for a minimum standard of living.
- Bias** A predisposition or prejudice that acts to influence external data towards conforming to pre-existing interpretations.
- Boycott** A collaboration to prevent a country from carrying on international trade by preventing or obstructing other countries from dealing with it. MNC products can also be boycotted within a host country.
- Brain drain** The emigration of highly educated and skilled professional and technical manpower from mostly the developing to the developed countries, usually for the purpose of improving their incomes or living conditions.
- Budget (government)** A statement showing, for the government in question, planned expenditures and revenues for some period (typically one year).
- Budget deficit** For a government, the excess of total expenditures over total receipts, with borrowing not included among receipts. This difference (the deficit) is ordinarily financed by borrowing.
- Budget surplus** Excess of government revenues over government spending; the opposite of budget deficit.

¹ The following sources were consulted in setting up the glossary: Beroggi, 1999; Bradley and Schaefer, 1998; Brummersted, 1988; Carley, 1985; Chicken, 1996; Czinkota, Ronkainen, Moffet and Moynihan, 1998; Evans and Newnham, 1992; Evans, 1991; Mohr and Fourie, 1995; Samuelson and Nordhaus, 1992; Todaro, 1989.

Business Strategy How a business, or strategic business unit competes in a particular market.

Calorie requirement Refers to the calories needed to sustain the population at normal levels of activity and health, taking account of its age and gender distributions, average body weights and physical environment.

Calorie supply (daily per capita) Calculated by dividing the calorie equivalent of the available food supplies in a country by its total population.

Capability A set of business processes, often cross-functional, that serves customer needs, providing superior value.

Capital (goods, equipment) (1) In economic theory, one of the triad of productive inputs (land, labour and capital). Capital consists of durable produced goods that are in turn used in production. The major components of capital are equipment, structures, and inventory. When signifying capital goods, reference is also made to real capital. (2) In accounting and finance, "capital" means the total amount of money subscribed by the shareholder-owners of a corporation, in return for which they receive shares of the company's stock.

Capital account The portion of a country's balance of payments table that shows the volume of private foreign investment and public grants and loans that flow into and out of a country over a given period.

Capital accumulation Increasing a country's stock of real capita (net investment and fixed assets)

Capital flight The flow of private funds abroad because investor believe that the return on investment or the safety of capital is not sufficiently ensued in their own countries.

Capitalism An economic system in which most property (land and capital) is privately owned. In such an economy, private markets are the primary vehicles used to allocate resources and generate incomes.

Cash account The 'balancing' portion of a country's balance of payments table showing how cash balances (foreign reserves) and short-term financial claims have changed in response to current and capital account transactions.

Cash flow The amount of cash (on hand or in banks) that a company has.

Casual employment Employment on an ad hoc basis without regular hours or a wage contract (mostly in the informal sector).

Central (reserve) bank A government-established agency responsible for controlling the nation's money supply and credit conditions and for supervising the financial system, especially commercial banks. These national banks implement governmental policies regarding the value of their currencies.

Centralisation The concentrating of control and strategic decision-making at headquarters.

Centralised planning The determination by the state of what shall be produced and how factors of production shall be allocated among different uses. This is done in the "centre" of power and then dictated to various sections of the economy and society.

Choice Act of deciding between alternatives.

Civil law A compilation of laws, or set of rules, set forth in a listing called a code.

Closed economy An economy in which there are no foreign trade transactions or any other form of economic contacts with the rest of the world.

Commitment The degree to which an individual feels an emotional or affective attachment to a decision and is therefore likely to support its implementation. May be a function of involvement.

Communism At the same time (1) an ideology, (2) a set of political parties, and (3) an economic system. A communist economic system is one in which private ownership of the means of production, particularly industrial capital, is prohibited (for such ownership of capital goods is believed to lead to the exploitation of workers). In addition, communism holds that income should be distributed equally, or more ideally, according to "need". In today's communist countries, most land and capital are owned by the state. These countries are also characterised by extensive central planning, with the state setting many prices, output levels, and other important economic variables.

Comparative advantage (in international trade) The law of comparative advantage says that nations should specialise in producing and exporting those commodities that it can produce at relatively lower costs, and that it should import those goods for which it is a relatively high-cost producer. Generally the ability to produce a good or a service more cheaply, relative to other goods and services, than other countries can.

Conditionality Usually refers to the requirements imposed by the IMF that a borrowing country undertakes fiscal, monetary, and international commercial reforms as a condition to receiving a loan for balance of payments difficulties.

Confiscation Similar to expropriation in that it results in a transfer of ownership from the firm to the host country, but differs in that it does not involve compensation for the firm.

Constraint A condition or requirement placed upon the solution to a problem, e.g. capacity, availability, and market demand.

Consumer price index (CPI) A price index that measures the cost of a fixed basket of consumer goods in which the weight assigned to each commodity is the share of expenditures on that commodity by urban consumers.

Consumption In macroeconomics, the total spending by individuals or a nation on consumer goods during a given period. Strictly speaking, consumption should apply only to those goods totally used or enjoyed within that period. In practice, consumption expenditures include all consumer goods bought, many of which last well beyond the period in question (furniture, clothing and automobiles). Total private consumption is assumed to be directly related to the level of aggregate personal income.

Corporate income tax A tax levied on the annual net income of a corporation.

Corporation The predominant form of business organisation in modern capitalist economies. A corporation is a firm owned by individuals or other corporations. It has the same rights to buy, sell, and make contracts as a person would have. It is legally separate from those who own it and has "limited liability".

Correlation Two variables are correlated if the value that one variable takes on systematically changes as the level of the other variable changes.

Credit (1) In monetary theory, the use of someone else's funds in exchange for a promise to pay (usually with interest) at a later date. The major examples are short-term loans from a bank, credit extended by suppliers, or commercial paper. (2) In balance-of-payments accounting, an item such as exports that earns a country foreign currency. Created whenever an asset is decreased, a liability is increased, or an expense is decreased.

Creditor nation Country with a balance of payments surplus.

Creeping expropriation A series of acts or regulations that gradually and together limit the exercise of ownership rights.

Cultural risk The risk of business blunders, poor customer relations, and wasted negotiations that results when firms fail to understand and adapt to the cultural differences between their own and host countries' cultures.

Cultural shock The more pronounced reactions to the psychological disorientation that most people feel when they move for an extended period of time in a markedly different culture.

Currency Coins and paper money, usually differ from country to country.

Current account balance The difference between (a) exports of goods and services plus inflows of unrequited official and private transfers, and (b) imports of goods and services plus unrequited transfers to the rest of the world. Included in this figure are all interest payments on external public and publicly guaranteed debt. Portrays that market value of a country's "visible" (eg. commodity trade) and "invisible" (eg. shipping services) exports and imports with the rest of the world.

Death rate (crude) Annual number of deaths per 1,000 population.

Debt outstanding (external public) The amount of public and publicly guaranteed loans that has been disbursed, net of cancelled loan commitments and repayments of principal.

Debt renegotiation Changing the terms of existing loans, usually by extending repayment dates without increases in nominal interest rates.

Debt service The sum of interest payments and repayments of principal on external public and publicly guaranteed debt.

Debtor nation Country with a balance of payments deficit.

Debt-service ratio Ratio of interest and principal payments due in a year to export receipts for that year.

Decentralised planning Regionalised or sectoral planning as opposed to planning at the centre.

Deficit spending Government expenditures on goods and services and transfer payments in excess of its recipients from taxation and other revenue sources. The difference must be financed by borrowing from the public.

Demographics The characteristics of people, i.e. age, income, gender, marital status, occupation, level of education, etc.

Demography The study of the behaviour of a population.

Depreciation (of a currency) A nation's currency is said to depreciate when it declines relative to other currencies. The opposite of a depreciation is an appreciation, which occurs when the foreign exchange rate of a currency rises.

Deregulation Removal of the government regulation of a company or industry to stimulate competition.

Devaluation A decrease in the official price of a nation's currency, as expressed in the currencies of other countries or in terms of gold. The opposite of devaluation is called revaluation, which occurs when a country raises its official foreign exchange rate relative to gold or other currencies.

Developing countries Mostly in Asia, Africa, South America and the Middle East, these countries are mainly characterised by low levels of living, high population growth rates, low levels of per capita income and general economic and technological dependence on developed countries.

Development The process of improving the quality of all human lives by raising living standards; the establishment of social, political and economic systems and institutions that promote human dignity and respect; and increasing people's freedom to choose.

Development plan The documentation by a government planning agency of the current national economic conditions, proposed public expenditures, likely developments in the private sector, a macroeconomic projection of the economy, and a review of government policies. Many developing countries publish five year development plans to announce their economic objectives to their citizens and others.

Direct investment Transactions between investors and enterprises in the control or ownership of assets in a foreign economy.

Disposable income Roughly take-home pay, or that part of the total national income that is available to households for consumption or saving. More precisely, it is equal to GNP less taxes, business savings, and depreciation plus government and other transfer payments and government interest payments. Basically the income that is available to households for spending and saving after personal income taxes have been deducted.

Distribution In economics, the manner in which total output and income is distributed among individuals or factories (the distribution of income between labour and capital).

Diversification A market expansion policy characterised by growth in a relatively large number of markets or market segments.

Division of labour A method of organising production whereby each worker specialises in part of the productive process. Specialisation of labour yields higher total output because labour can become more skilled at a particular task and because specialised machinery can be introduced to perform more carefully defined subtasks. Originally from Adam Smith's Wealth of Nations.

Domestic company A company that operates only within its own (home) country.

Economic growth An increase in the total output of a nation over time. Economic growth is usually measured as the annual rate of increase in a nation's real GNP, or real potential GNP. Generally the steady process by which the productive capacity of the economy is increased over time to bring about rising levels of national income.

Economic infrastructure The underlying amount of capital accumulation embodied in roads, railways, waterways, airways, and other forms of transportation and communication plus water supplies, financial institutions, electricity and public services such as health and education. The level of infrastructural development in a country is a crucial factor determining the pace and diversity of economic development.

Economic plan A written document containing government policy decisions on how resources shall be allocated among different uses in order to attain and maintain a targeted rate of economic growth over a certain period of time.

Economic policy Statement of objectives and the methods of achieving these objectives (policy instruments) by government, political parties, business concerns, etc. Examples of objectives can be full employment, high levels of economic growth, reducing income and regional inequalities, and maintaining price stability. Policy instruments are fiscal, monetary and financial policy, and legislative controls.

- Economic system** The organisational and institutional structure of a country's economy, including the nature or resource ownership and control.
- Effectiveness** Achieved when actions have the desired result.
- Efficacy** To deliver a solution that is justified as a means to an end.
- Efficiency** To produce or do something with the minimum input while obtaining the maximum output; the achievement of total efficiency might be illusionary, but maximum efficiency might be a goal.
- Employed** Persons are employed if they perform any paid work, or if they have jobs but are absent due to illness, strike or vacation.
- Environmental impact analysis** Seeks to identify and evaluate all the impacts a decision might have on the environment, and embraces a consideration of all aspects of the environment (physical, atmospheric, biological, social, economic, cultural, political).
- Equity participation** Multinational minority ownership in companies that have strategic importance to them.
- Essential definition** A definition that captures the essence of an idea.
- Ethnocentric** Tending to regard one's own culture as superior, tending to be home-market orientated.
- Ethnocentrism** The tendency to consider one's own culture superior to others.
- Exchange control** A government policy designed to restrict the outflow of domestic currency and prevent a worsened balance of payments position by controlling the amount of foreign exchange that can be obtained or held by domestic citizens. Often results form overvalued exchange rates. Basically controls on the movement of capital in and out of a country, sometimes imposed when the country faces a shortage of foreign currency.
- Exchange rate** The rate at which central banks will exchange one country's currency for another (the official rate).
- Expectations** Views or beliefs about uncertain variables (such as future interest rates, prices, or tax rates). Expectations are said to be rational if they are not systematically wrong (or "biased") and use all available information. Expectations are said to be adaptive if people form their expectations on the basis of past behaviour.
- Export dependence** A situation in which a country relied heavily on exports as the major source of finance needed for carrying out development activities. This is the situation of many developing countries that need to export primary products in order to earn valuable foreign exchange.
- Export incentives** Public subsidies, tax rebates and other kinds of financial and non-financial measures designed to promote a greater level of economic activity in export industries.
- Export promotion** Purposeful governmental efforts to expand the volume of a country's exports through export incentives and other means in order to generate more foreign exchange and improve the current account of its balance of payments.
- Exporting** The sale and delivery of tangible goods to another country.
- Exports (of goods and non-factor services)** Represent the value of all goods and non-factor services sold to the rest of the world; including merchandise, freight, insurance, travel, and other non-factor services. Basically goods or services that are produced in the home country and sold to another country. Imports are simply flows in the opposite direction – into the home country from another country.
- Expropriation** The taking of foreign owned property by the state.
- Factors of production** All inputs into the production process, including capital, labour, land and technology. Resources or required to produce a good or service. Basic categories of factors of production are land, labour and capital.
- Final good(s)** A good that is produced for final use and not for resale or further manufacture.
- Financial liberalisation** Eliminating various forms of government intervention in financial markets, thus allowing supply and demand to determine the level of interest rates, for example.
- Financial risk management** The management of a firm's cash flows associated with the three basic financial prices of interest rates, exchange rates and commodity prices.

- Firm (business)** The basic, private producing unit in a capitalist or mixed economy. It hires labour and buys other inputs in order to make and sell commodities.
- Fixed exchange rate** The exchange value of a national currency is fixed in relation to another (usually the U.S. Dollar), not free to fluctuate on the international money market.
- Flexible exchange rates** A system of foreign exchange rates among countries wherein the exchange rates are predominantly determined by private market forces (supply and demand) without government's setting and maintaining a particular pattern of exchange rates. Also sometimes called floating exchange rates. When the government refrains from any intervention in exchange markets, the system is called a pure floating exchange-rate system.
- Flexible institutions** Institutions that are self-responsive or can be made to respond to changing (development) requirements.
- Floating foreign exchange rate** Foreign exchange rates that respond quickly to market forces of supply and demand.
- Foreign aid** The international transfer of public funds in the form loans or grants either directly from one government to another (bilateral assistance), or indirectly through the vehicle of a multinational assistance agency like the World Bank.
- Foreign exchange** Claims on a country by another held in the form of currency of that country. Foreign-exchange systems enable one currency to be exchanged for (or converted into) another, thus facilitating trade between countries. Currency or other financial instruments that allow one country to settle amounts owed to other countries.
- Foreign exchange rate** The rate, or price, at which one country's currency is exchanged for the currency of another country. A country has a fixed exchange rate if it pegs its currency at a given exchange rate and stands ready to defend that rate. An exchange rate that is not fixed is said to float.
- Foreign policy** Public policy concerned with relationships with other countries.
- Foreign reserves** The total value (usually expressed in dollars) of all gold, dollars and Special Drawing Rights held by a country as both a reserve and a fund from which international payments can be made.
- Free trade** A policy whereby the government does not intervene in trading between nations by tariffs, quotas, or other means. Trade in which goods can be imported and exported without any barriers in the form of tariffs.
- Frictional unemployment** Temporary unemployment caused by changes in individual markets. It takes time, for example, for new workers to search among different job possibilities; even experienced workers often spend a minimum period of unemployed time moving from one job to another. Frictional is distinct from cyclical unemployment, which results from a low level of aggregate demand in the context of sticky wages and prices.
- Full employment** A term that is used in many senses. Historically it was taken to be that level of employment at which no (or minimal) involuntary unemployment exists. Today, economists rely upon the concept of the natural rate of unemployment to indicate the highest sustainable level of employment over the long run.
- Gini coefficient** An aggregate numerical measure of income inequality ranging from zero (perfect equality) to one (perfect inequality). It is graphically measured by dividing the area between the perfect equality line and the Lorenz curve by the total area lying to the right of the equality line in a Lorenz diagram. The higher the value of the coefficient, the higher the inequality of income distribution; the lower it is, the more equitable the distribution of income.
- Global company** A business organisation that operates in more than one country.
- Goal** A level of attainment for an objective, possibly specifying a time period for its achievement.
- Government debt** The total of government obligations in the form of bonds and shorter-term borrowings. Government debt held by the public excludes bonds held by quasi-governmental agencies such as the central bank.
- Gross domestic product (GDP)** Measures the total final output of goods and services produced by the country's economy during a given year – within the country's territory by residents and non-residents, regardless of its allocation between domestic and foreign claims. Contrasts with GNP, which is the output produced by factors owned by the country.
- Gross national product (GNP)** Measures the total domestic and foreign output claimed by residents of a country. It comprises gross domestic product plus factor incomes accruing to residents from abroad, less the income earned in the domestic economy accruing to persons abroad.
- Gross national product (nominal)** The value, at current market prices, of all final goods and services produced during a year by a nation.

Gross national product (real) Nominal GNP corrected for inflation.

Group A collection of two or more people whom, through interaction, share common perceptions, goals and forms of social control.

Hedging A technique for avoiding a risk by making a counter-move or by counteracting the outcomes of a risk.

Human capital The stock of technical knowledge and skill embodied in a nation's work force, resulting from investments and expenditure in formal education, health care and on-the-job training.

Import substitution A deliberate effort to replace major consumer imports by promoting the emergence and expansion of domestic industries. Requires the imposition of protective tariffs and physical quotas to get the new industries started. Restriction of imports in order to allow domestic firms an opportunity to grow and prosper.

Importing The purchases and receipt of tangible goods from another country.

Income The flow of wages, interest payments, dividends, and other receipts accruing to an individual or nation during a period of time (usually a year).

Income gap The gap between the income accruing to the bottom poor and the top rich sectors of the population. The wider the gap the greater the inequality in income distribution.

Income inequality The existence of disproportionate distribution of total national income among households whereby the share going to rich persons in a country is far greater than that going to the poorer persons. This is largely due to the amount of income derived from ownership of property and to a lesser extent the result of differences in earned income. Capital gains tax is a policy instrument geared to remedy this. Inequality of personal incomes can be reduced by steeply progressive income and wealth taxes.

Income per capita Total GNP of a country divided by the total population. Per capita income is often used as an economic indicator of the levels of living and development. It can be a biased index though, because it takes no account of income distribution and the ownership of the assets that are employed to generate part of that income.

Income tax (personal) Tax levied on the income received by individuals, either in the form of wages and salaries or income from property, such as rents, dividends, or interest.

Incomes policy A government policy that attempts directly to restrict wage and price changes in an effort to slow inflation. Such policies range from voluntary wage-price guidelines to outright legal control over wages, salaries and prices.

Industrialisation The process of building up a country's capacity to "process" raw materials and to manufacture goods for consumption or further production.

Industrialised countries The now economically advanced capitalist countries of Western Europe, North America, Australia, New Zealand and Japan. These were the first countries to experience sustained and long-term economic growth.

Industry A group of firms producing similar or identical products.

Infant industry A term given to a newly established usually set up behind the protection of a tariff barrier as part of a policy of import substitution. Once the industry is no longer an infant, the protective tariffs are supposed to disappear but they often do not.

Infant mortality The deaths among children between birth and one year of age, measure the number of these deaths per 1,000 live births.

Inflation General price-increases as reflected in the consumer price index. More generally, the phenomenon of rising prices.

Inflation (rate) The percentage annual increase in a general price level. Hyperinflation is inflation at extremely high rates. Galloping inflation is a rate of 50, 100, or 200 percent annually. Moderate inflation is a price level rise that does not distort relative prices or incomes severely.

Informal sector That part of the urban economy of developing countries characterised by a small competitive individual and family firms, petty retail services, labour intensive methods of doing things, free entry, and market-determined factor and production prices. It often provides a major source of urban employment and economic activity.

Information Data and any summaries or inferences derived from data, put into useable form.

Innovation A term particularly associated with Joseph Schumpeter, who meant by this (1) the bringing to market of a new and significantly different product, (2) the introduction of a new production technique, or (3) the opening up of a new

market. Includes the introduction of new social and institutional methods of organisation and management commensurate with modern ways of conducting economic activities.

Inputs Goods and services, like raw materials, labour, used in the process of production.

Institutions Norms, rules of conduct and generally ways of doing things. Social institutions refer to well-defined and formal organisations of society that govern the way society operates, while political institutions refer to the systems that govern the operations of government of a particular society.

Insurance A system by which individuals can reduce their exposure to risk of large losses by spreading the risks among a large number of persons.

Interest The payment (or price) for the use of borrowed funds. The return paid to those who lend money.

Interest rate The amount that a borrower must pay a lender over and above the total amount borrowed expressed as a percentage of the total amount for the funds borrowed. The price paid for borrowing money for a period of time, usually expressed as a percentage of the principal per year.

International competitiveness The ability of a firm, an industry, or a country to compete in the international marketplace at a stable or rising standard of living.

International Labour Organisation (ILO) One of the United Nations functional organisations based in Geneva whose central task is to look into problems of world manpower supply, its training, utilisation, domestic and international distribution etc. Its aim is to increase "world output" through maximum utilisation of available human resources and thus improve levels of living for people.

Intervention An activity in which a government buys or sells its currency in the foreign exchange market in order to affect its currency's exchange rate.

Investment (1) Economic activity that forgoes consumption today with an eye to increasing output in the future. It includes tangible capital (structures, equipment, and inventories) and intangible investments (education, human capital, research and development, health). Net investment is the value of total investment after an allowance has been made for depreciation. Gross investment is investment without allowance for depreciation. (2) In finance terms, investment has an altogether different meaning and denotes the purchase of a security, such as a stock or bond.

Investment (domestic) That part of national income or expenditure devoted to the production of capital goods over a given period of time. "Gross" investment refers to the total expenditure on new capital goods, while "net" investment refers to the additional capital goods produced in excess of those that wear out and need to be replaced.

"Invisible hand" A concept introduced by Adam Smith in 1776 to describe the paradox of a laissez-faire market economy. The doctrine holds that, with each participant pursuing his or her own private interest, a market system nevertheless works to the benefit of all as though a benevolent invisible hand were directing the whole process.

Involvement The degree to which an individual participates in and is able to influence and/or determine a given decision.

Joint venture Participation of two or more companies in an enterprise to achieve a common goal.

Labour force Describes economically active persons, including the armed forces and the unemployed, but excludes housewives and students. Usually that group of people 16 years of age and older who are either employed or unemployed.

Labour productivity The level of output per unit of labour input, usually measured as output per man-hour or man-year.

Labour supply The number of workers (or more generally, the number of labour-hours) available to an economy. The principal determinants of labour supply are population, real wages and social traditions.

Laissez-faire The view that government should interfere as little as possible in economic activity and leave decisions to the marketplace. As expressed by classical economists such as Adam Smith, this view held that the role of government should be limited to (1) maintenance of law and order, (2) national defence, and (3) provision of certain public goods that private business would not undertake (public health and sanitation).

Land In classical and neo-classical economics, one of the three factors of production (along with labour and capital). More generally, land is taken to include land used for agricultural or industrial purposes as well as natural resources taken from above or below the soil.

Leadership The capacity to influence others without recourse to threats or punishment.

Less developed country (LDC) A country with a per capita income far below that of “developed” countries.

Letter of credit Undertaking by a bank to make payment to a seller upon completion of the conditions set forth in the letter of credit.

Levels of living The extent to which a person, family or group of people can satisfy their material and spiritual wants.

Liabilities In accounting, debts or financial obligations owed to other firms or persons.

Life expectancy (at birth) Indicates the number of years newborn children would live if subject to the mortality risks prevailing for the population at the time of birth.

Linear programming A mathematical model for normative decision making, in which objectives and constraints are represented by equations and inequalities; the objective is then maximised, subject to the constraints.

Literacy The ability to read and write. Literacy rates are often used as one of the many social and economic indicators of the state of development within a country.

Literacy rate Percentage of population aged 15 and over able to read and write.

Loans The transfer of funds from one economic entity to another that must be repaid with interest over a prescribed period of time.

Long run A term used to denote a period over which full adjustment to changes can take place. In microeconomics, it denotes the time over which firms can enter or leave an industry and the capital stock can be replaced. In macroeconomics, it is often used to mean the period over which all prices, wage contracts, tax rates, and expectations can fully adjust.

Macroeconomics Analysis dealing with the behaviour of the economy as a whole with respect to output, income, the price level, foreign trade, unemployment and other aggregate economic variables. That branch of economics that considers the relationships among broad economic aggregates (national income, saving, investment, consumption, expenditure, employment, money supply). It is also concerned with determinants of the magnitudes of these aggregates and their rates of change through time.

Malnutrition A state of ill health resulting from an inadequate or improper diet – usually measured in terms of average daily protein consumption.

Market An arrangement whereby buyers and sellers interact to determine the prices and quantities of a commodity. Some markets take place in a physical location, other markets are conducted over the telephone or are organised by computers.

Market economy An economy in which the what how and for whom questions concerning resource allocation are primarily determined by supply and demand in markets. In this form of economic organisation, firms motivated by the desire to maximise profits, buy inputs and produce and sell outputs. Households, armed with their incomes, go to markets and determine the demand for commodities. The interaction of firms’ supply and households’ demand then determines the prices and quantities of goods. A free private-enterprise economy governed by consumer sovereignty, a price system, and the forces of supply and demand.

Market share That fraction of an industry’s output accounted for by an individual firm or group of firms.

Market transparency Availability of full disclosure and information about key market factors such as supply, demand, quality, service, and prices.

Method A process of working which maps out stages, tools and techniques.

Methodology The process of following a method laid down, or practiced.

Microeconomics Analysis dealing with the behaviour of individual elements in an economy, such as the determination of the price of a single product or the behaviour of a single consumer or business firm. That branch of economics concerned with individual decision units, like firms and households, and the way in which their decisions interact to determine relative prices of goods and factors of production and how much of these will be bought and sold. The market is the central concept in microeconomics.

Minority participation Participation by a group having less than the number of votes necessary for control.

Model A formal framework for representing the basic features of a complex system by a few central relationships. Models can take the form of graphs, mathematical equations and computer programs. A framework of analysis that abstracts from the details of the real world, in an attempt to highlight the explanation of phenomena or obtain forecasts. The area of concern or domain mimicked or copied to extract essentials of behaviour, hence study the model rather than actually directly.

Modernisation ideals Ideals often regarded as necessary for sustained economic growth, and include rationality, economic planning, social and economic equalisation, and improved institutions and attitudes.

Monetary policy The objectives of the central bank in exercising its control over money, interest rates, and credit conditions. The instruments of monetary policy are primarily open-market operations, reserve requirements, and the discount rate.

Money The means of payment or medium of exchange.

Money supply The narrowly defined money supply (M1) consists of coins, paper currency, plus all demand or checking deposits; this is narrow, or transactions money. The broadly defined supply (M2) includes all items in M1 plus certain liquid assets or near-monies – savings, deposits, and money market funds.

Monopoly A market situation in which a product that does not have close substitutes is being produced and sold by a single seller - a commodity is supplied by a single firm.

Monopolistic competition A market structure in which there are many sellers who are supplying goods that are close, but not perfect, substitutes. In such a market, each firm can exercise some effect on its product's price.

Monopsony A market in which there is a single buyer, a "buyers monopoly".

Multinational Company (MNC) A company that operates internationally to earn profits on a global basis with headquarters in one country but branch offices in a wide range of both developed and developing countries.

National expenditure Total expenditure on final goods and services in an economy over a given time period.

National income Total monetary value of all final goods and services produced in an economy over some period of time, usually a year.

National security The ability of a nation to protect its internal values from external threats.

National sovereignty Provides a government with the right to self-determination, independence and autonomy.

Net exports In the national product accounts, the value of exports of goods and services minus the value of imports of goods and services.

Net investment Gross investment minus depreciation of capital goods.

Net national product (NNP) GNP less an allowance for depreciation of capital goods.

Newly industrialised countries (NIC) A small group of countries at a relatively advanced level of economic development with a substantial and dynamic industrial sector with close links to the international trade, finance and investment system.

Nominal interest rate The interest rate paid on different assets. This represents a dollar return per year per dollar invested. Compare with the real interest rate, which represents the return per year in goods per unit of goods invested.

Non-tariff barriers Barriers to trade, other than tariffs. Examples include buy-domestic campaigns, preferential treatment for domestic bidders, and restrictions on market entry of foreign products such as involved inspection procedures. Barriers to free trade that take forms other than tariffs such as quotas, sanitary requirements for imported meats and dairy products.

Normative A statement of what ought, or ought not to be.

Normative decision-making Prescriptive modelling of decision, in order to identify the "best" decision in a particular situation; contrasted to descriptive models that describe the process through which a decision is made.

Objective A direction in which to develop organisational performance, e.g. improved profitability, less risk, higher quality.

Observation A research method that gathers information that relies on observation of an activity as it occurs.

Oligopoly A situation of imperfect competition in which an industry is dominated by a small number of suppliers.

- Open economy** An economy that engages in international trade (imports and exports) of goods and capital with other countries and has extensive financial and non-financial contact with the rest of the world. A closed economy is one that has no imports or exports.
- Open system** A system that receives inputs, transforms those inputs and exports outputs.
- Operating risk** The danger of interference by governments or other groups in one's corporate operations abroad.
- Opportunity cost** The additional cost of taking one action as compared to another, or the benefits or revenues foregone by pursuing one course of action rather than another.
- Optimal solution** The value imputed to a constraint, e.g. for a resource constraint the improvement in the value of the objective function by acquiring one or more unit of the resource.
- Outward-looking development policies** Policies that encourage free trade, the free movement of capital, workers, enterprises and students, welcoming to multinational corporations (MNC's) and an open system of communications.
- Ownership risk** The risk inherent in maintaining ownership of a property abroad. The exposure of foreign owned assets to governmental intervention.
- Per capita income** The income of a country divided by the number of its citizens.
- Per capita** The average dollar value of exports and imports for each person in a country.
- Perception** The active psychological process that selects and organises physiological stimuli into meaningful patterns.
- Personal savings rate** The ration of personal savings to personal disposable income, in percent.
- Policy making** The final step in the information cycle; the choice and implementation of an act that brings the earlier stages of the information cycle to bear in affecting the real world.
- Political risk** The risk of loss by an international corporation of assets, earning power, or managerial control as a result of political actions and reactions in the host country investment environment.
- Political will** A determined, deliberate, purposeful, independent decision on or choice of a course of action by persons in political authority, such as elimination of inequality, poverty and unemployment through various reforms of social, economic, and institutional structures. Lack of political will is often said to be one of the main obstacles to development and the mains reason for the failure of many development and economic plans.
- Population growth** The rate at which a given population grows over a period of time (one year).
- Poverty** Where the "poverty line" is the minimum adequate standard of living.
- Poverty gap** Roughly the sum of the difference between poverty line and actual income levels of all those living below that line.
- Price index** An index number that shows how the average price of a bundle of goods has changed over a period of time. In computing the average, the prices of the different goods are generally weighted by their economic importance (by each commodity's share of total consumer expenditures in the consumer price index).
- Primary products** Products derived from all extractive occupations namely foodstuffs and raw materials.
- Private foreign investment** The investment of private foreign funds, more often in the economy of a developing nation, usually in the form of import-substituting industries by MNC's.
- Privatisation** A policy of shifting operation of government owned enterprises to private ownership to cut costs and ensure more efficient services. Preponderance of private ownership of means of production. Selling public assets (corporations) to private business interests.
- Productivity** A term referring to the ratio of output to inputs (total output divided by labour inputs is labour productivity). Productivity increases if the same quantity of inputs produces more output. Labour productivity increases because of improved technology, improvements in labour skills, or capital deepening.
- Productivity growth** The rate of increase in productivity from one period to another.

Profit (1) In accounting terms, total revenue minus costs properly chargeable against the goods sold. (2) In economic theory, the difference between sales revenue and the full opportunity cost of resources involved in producing the goods. The difference between the market value or output and the market value of inputs that were employed to produce that output. The difference between total revenue and total cost.

Profit maximisation Making as large as possible a firm's chances of reaching and maintaining profitability.

Property rights Property rights define the ability of individuals or firms to own, buy, sell, and use the capital goods and other property in a market economy.

Protectionism Any policy adopted by a country to protect domestic industries against competition from imports (most commonly a tariff or quota imposed on such imports).

Public good A commodity or service that if supplied to one person can be made available to others at no extra cost. A commodity whose benefits are individually spread among the entire community, whether or not particular individuals desire to consume the public good. Contrasted with public goods are private goods, which if consumed by one person, cannot be consumed by another person.

Public sector That portion of the economy whose activities (economic and non-economic) are under the control and direction of the state. The state owns all the resources in this sector and uses them to achieve whatever goals it might have.

Qualitative Factors that are difficult to measure but that are important to a given problem.

Quantitative Numbers and values attributable to a problem area that can vary.

Quota A physical limitation on the quantity of any item that can be imported into a country.

Ratio Measurement scales on which addition, subtraction, multiplication and division are all meaningful (mass, length, time).

Rationality A concept concerned with logical and systematic processing of data, seen to be objective in nature. One of the foundations on which traditional or Western economic theory is built. The notion of rationality as one of the modernisation ideals means that replacement of age-old traditional practices by modern methods of "objective" thinking and logical reasoning in production, distribution and consumption.

Real income The income that a household or firm receives in terms of the real goods or services it can purchase.

Real interest rate The interest rate measured in terms of goods rather than money. It is thus equal to the money (or nominal) interest rate less the rate of inflation.

Real wages The purchasing power of a worker's wages in terms of goods and services. It is measured by the ratio of the money wage rate to the consumer price index.

Recession A downturn in real GNP for two or more successive quarters.

Redistribution policies Policies geared to reducing inequality of incomes and expanding economic opportunities in order to promote development.

Regulation Government laws or rules designed to control the behaviour of firms. The major kinds are economic regulation (which affects the prices, entry, or service of a single industry, such as telecommunications) and social regulation (which attempts to correct externalities that prevail across a number of industries, such as air or water pollution).

Renewable resources Natural resources that can be replaced so that the total supply is not fixed for all time as in the case on non-renewable resources.

Research and development (R&D) A scientific investigation with a view toward improving the existing quality of human life, products, profits, factor of production or knowledge.

Reserves (bank) The portion of deposits that a bank sets aside in the form of a vault or cash or non-interest earning deposits with Central (reserve) Banks.

Reserves (international) Every country holds at least some reserves, in such forms as gold, currencies of other countries, and special drawing rights. International reserves serve as "international money", to be used when a country encounters balance-of-payments difficulties. The sum of a country's holdings of gold.

Resource allocation The manner in which an economy distributes its resources (its factors of production) among the potential uses so as to produce a particular set of final goods.

Resource balance The difference between exports and imports of goods and non-factor services.

Resource endowment A country's supply of factors of production, normally supplied by nature.

Resources (human and physical) Factors of production used to produce goods and services to satisfy wants. Land and capital are frequently referred to as physical resources, and labour as the human resource.

Risk A situation in which the probability of obtaining some outcome of an event is not precisely known. Known probabilities cannot be precisely assigned to these outcomes but their general level can be inferred. A risky situation would be one in which one of the outcomes involves some losses to the decision maker.

Risk averse A person is risk averse when, faced with an uncertain situation, the displeasure from losing a given amount of income is greater than the pleasure from gaining the same amount of income.

Risk spreading The process of taking large risks and spreading them around so that they are but small risks for a large number of people. The major form of risk spreading is insurance.

Sanction Specific trade measures such as the cancellation of trade financing or the prohibition of high technology trade.

Saving That part of income that is not consumed; in other words, the difference between disposable income and consumption.

Savings The portion of disposable income not spent on consumption by households plus profits retained by firms. Savings are normally assumed to be positively related to the level of income (personal or national).

Savings ratio Savings expressed as a proportion of disposable income over some period of time. It shows the fraction of national income saved over any period. The savings ratio is sometimes used synonymously with the average propensity to save.

Scenario building Identifying crucial variables and determining their effects on different cases or approaches.

Search Investigation to identify existing solutions for a problem and/or to create new solutions.

Services Comprises economic activity other than industry and primary goods production. The export and import of all types of services.

Simulation Driving a model of a problem through a set of stated 'spaces' in a shortened timescale.

Social benefits Gains or benefits that accrue or are available to the society as a whole rather than solely to a private individuals (policing, health).

Social coast The cost to society as a whole of an economic decision, whether private or public. If social costs exceed private costs, the misallocation of resources might be the result.

Socialism A political theory that holds that all (or almost all) the means of production other than labour, should be owned by the community. This allows the return on capital to be shared more equally than under capitalism.

Special Drawing Right's (SDR's) A form of international financial asset – referred to as "paper gold" – created by the IMF and designed to supplement gold and dollars in settling international balance of payments accounts.

Specialisation A situation in which resources are concentrated in the production of a relatively few commodities rather than being used for a wider range of commodities.

Stakeholders All those groups, organisations and individuals who have an interest in the present and future activities of an organisation.

Standard of living The level of material affluence of a group or nation, measured as a composite of quantities and qualities of goods.

State Political entity comprising of a territory, population, a government capable of entering into international relations, and a government capable of controlling its territory and peoples.

State-owned enterprises (SOE's) Public corporations and para-statal agencies owned and operated by the government. A corporate form that emerged in non-Communist countries, primarily for reasons of national security and economic security.

Structural adjustment loans Loans by the World Bank designed to foster structural adjustment in developing countries by supporting measure to remove excessive governmental controls, getting factor and product prices to better reflect scarcity values and promoting market competition.

Subsidy A payment by government to a firm or household that provides or consumes a commodity.

Sustainable development Development that does not deplete non-renewable resources nor diminish the quality of life of anyone over time.

Tariff A levy or tax imposed upon each unit of a commodity imported into a country.

Technological progress Increased application of new scientific knowledge in form of inventions and innovations with regard to capital, both physical and human.

Terms of trade (international) The ratio of a country's average export price to its average import price. A country's terms of trade is said to improve when the ratio increases, and to worsen when it decreases (when import prices rise at a relatively faster rate than export prices). The "real" terms at which a country sells its export products and buys its import products. It equals the ration of an index of export prices to an index of import prices.

Tools The set of techniques or procedures used to analyse a given problem area.

Trade barrier Any of a number of protectionist devices by which countries discourage imports. Tariffs and quotas are the most visible barriers, but in recent years non-tariff barriers (NTB's) such as burdensome regulatory proceedings have replaced more traditional measures.

Trading partners Other countries with which a country does business.

Traditional (Western) economics The economics of capitalist market economies characterised by consumer sovereignty, profit maximisation, private enterprise, and perfect competition. The major focus is on the efficient allocation of scarce resources through the price system and the forces of supply and demand.

Transfer payments (government) Payments made by a government to individuals, for which the individual performs no current service in return. Examples are social security and unemployment insurance.

Transfer risk The danger of having one's ability to transfer profits or products in and out of a country inhibited by governmental rules and regulations.

Underdevelopment An economic situation in which there are persistent low levels of living in conjunction with absolute poverty, low per capita incomes, low rates of economic growth, low consumption levels, poor health services, high death and birth rates, vulnerability to and dependence on foreign economies, and limited freedom to choose between variables that satisfy human wants.

Underemployment A situation in which persons are working less, either daily, weekly, monthly, or seasonally, than they would like to work.

Unemployment (1) In economic terms, involuntary unemployment occurs if there are qualified workers who would be willing to work at prevailing wages but cannot find jobs. (2) A worker might be unemployed if he or she is not working, or either waiting for recall from layoff or has actively looked for work in the last four weeks.

Unemployment rate The percentage of the labour force that is unemployed.

United Nations (UN) A global organisation with the basic aim of cultivating international cooperation and hence ensuring that any conflicts or misunderstandings between or among countries would be resolved by peaceful means.

Urbanisation Economic and demographic growth process of urban areas. Rapid migration from rural to urban areas often results in hyper urbanisation.

Vested interest (groups) Groups of persons that have acquired rights or powers in any sphere of activities within a nation or in international affairs which they often struggle to guard and maintain. These can be political elites, landlords, and wealthy private local and foreign investors.

Wealth The net value of tangible and financial items owned by a country or person at a point in time. It equals all assets less all liabilities.

Welfare state A practice whereby the government of a mixed economy uses its fiscal and regulatory policies to modify the market distribution of income and to provide service to the population.

World Trade Organisation (WTO) Established on Jan. 1, 1995, the legal and institutional foundation of the multilateral trading system.

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