RATING INVESTMENT RISKS ABROAD

Multinational corporations considering overseas investment would do well to make use of a political forecasting system that assesses the stability of foreign governments.

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A multinational corporation invests in a plant in an African country. During the fourth year of the plant's existence, just as maximum profits are attained and expected to be realized for a number of years, a leftist takeover of the government results in the nationalization of the plant. Could this turn of events have been forecast? If possible political obsolescence had been taken into consideration and a thorough evaluation system used, the situation might have been anticipated and avoided. The capital would have been allocated to a less risky political climate and profits would still be flowing.

It is no longer realistic to use only commercial and technological assessments as planning inputs, for the life of any venture may be cut short by political disruption. Executives are recognizing that political forecasts made at the time of the investment decision are critical to the continuing success of multinational operations. Experiences in the 1970s with nationalization and regulation changes that seriously cut profits highlight the

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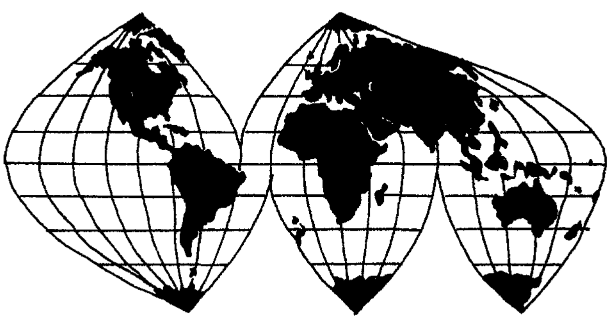
need for greater precision in predicting political conditions. Events in Iran, the takeover of ITT by the regime in Chile, the "Indianization" scheme which caused IBM and Coca-Cola to leave India, and Nigeria's recent efforts to muscle out companies that have dealings with South Africa are all cautionary tales illustrating the need for a dependable system of political evaluation as a tool in investment planning.



POLITICAL FORECASTING

The application of political forecasting to corporate planning involves:

1. Predicting political conditions in a country for which an investment is proposed or will be operating for a period of years (the company standard for the payback period or the time used for a present value analysis).
2. Estimating probabilities for seriously modified conditions, such as a coup d'état, the election of a radical left government, or a war.
3. Determining the effect on profit performance of the investment if a serious change in assumed political conditions occurs.
4. Judging the net impact of political change on predicted cash flow from the investment for the period selected.

The political forecasting system outlined here can help corporations avoid the potential disasters of political change. Such a system, illustrated in the figure on page 20, involves the systematic examination of ten variables, eight causes and two symptoms, at the present time and at two points in the future. The evaluation is done from the foreign investor's viewpoint. Ratings represent a total of "scores" for the ten variables and tend to be much more accurate than a broad subjective judgment for a particular country. The political situation in a given country is estimated by applying numbers on a scale of zero (no problem) to 7 (prohibitive problems) to the eight causes and two symptoms.

EXPLAINING VARIABLES

The following examination of the ten variables in the accompanying figure includes examples of political situations that merit ratings.

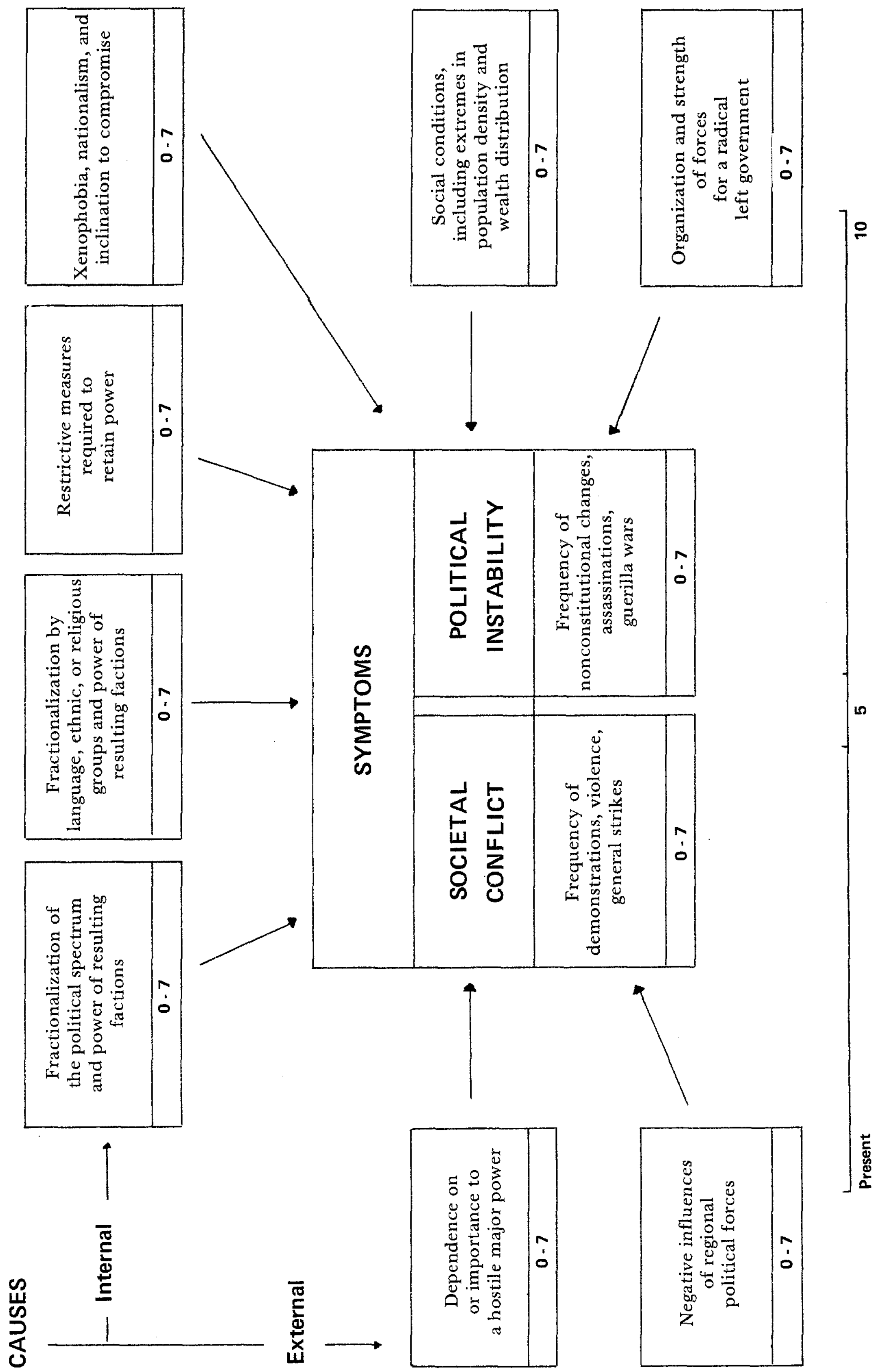
Internal Causes of Stress

– **Fractionalization of the political spectrum and power of resulting factions.** Political power dispersed among several opposing parties leads to disruptive changes in government (Italy, Portugal, Turkey).

– **Fractionalization by language, ethnic, or religious groups and power of resulting factions.** Hostile groups undermine stability and promote discontinuity (Eritrea, South Africa, India, Iran, Spain, Northern Ireland).

– **Restrictive measures required to retain power.** Extreme measures are used to contain opposition, such as press censorship, political imprisonment, election fraud or no elections at all (the change of leadership in Ghana based on election fraud, the recent cycle of military governments in Bolivia, President Marcos' measures in the Philippines, Argentina's authoritarian junta).

– **Xenophobia, nationalism, inclination to compromise.** Preference for the local over the foreign investor and possibilities of indigenization programs and nationalization are present ("francification" policies affecting Quebec-



A Framework for Political Risk Evaluation based businesses, indigenization programs in Nigeria and Brazil, the many restrictive components of the ANCOM Pact).

– **Social conditions, including extremes in population density and the distribution of wealth.** The birth rate exceeds the economic growth rate, wealth is poorly distributed, overcrowded urban areas experience unrest (Egypt, Indonesia, Mexico, Nigeria).

– **Organization and strength for a radical left government.** A strong possibility exists for a leftist takeover and subsequent nationalization (Chile in 1971, Portugal in 1973, preelection France in 1978, Afghanistan in 1978).

External Causes

– **Dependence on or importance to a hostile major power.** Stability is ultimately threatened from the outside as leftist governments gain power in neighboring countries (South Korea, Taiwan, Saudi Arabia).

– **Negative influence of regional political forces.** Possibilities exist for border wars, embargoes, discriminatory tariffs, and cancellation of work permits that would drain an economy and disrupt operations. (Recently in Tanzania, Lonrho was ordered to sell all of its assets to the Tanzanian National Development Corporation because of its alleged breaking of United Nations sanctions against Rhodesia. Executives of Lonrho were known to favor the ultimate leadership of Nkomo in Rhodesia, whereas Tanzanian President Nyerere backs the more radical Mugabe. Negative regional influences are also seen in Mauritania, Mozambique, and Thailand).

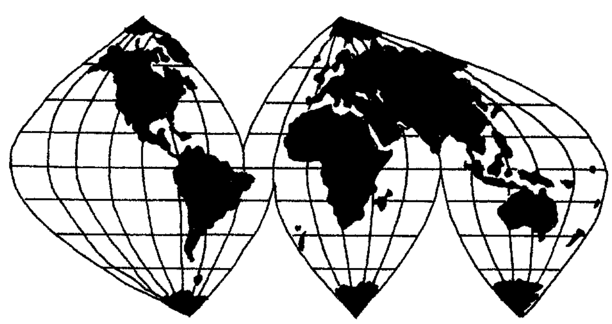
Symptoms of Problems

– **Societal conflict.** Frequency of demonstrations, violence, general strikes create a poor business climate, discontinuity, and a resulting reduction of profits (Colombia, Nicaragua, Pakistan, Spain).

– **Political instability.** Nonconstitutional changes, assassinations, and guerrilla wars are frequent (Bolivia, Ghana, Madagascar, Mauritania).

HOW THE SYSTEM WORKS

The political risk rating system involves two steps. Initially, the ten variables are rated from 0-7 for three separate periods: the present and two future periods, such as five and ten years in the future. The higher the subtotal, the worse investment conditions are. The result will range from no political risk (zero) to completely prohibitive risk (70) for each of the three periods.



The second step involves allocating up to 30 additional points to causes that should be given additional weight because of their overwhelming impact on overall political risk. This step involves the discretionary application of risk points to causes needing more weight than possible within the 0-7 scale. The accumulated maximum risk for both steps would be 100 if a country were thought to have the worst possible rating in every case.

No country should be excluded from the second step. It is probable that in an analysis of the United States, few of the points for additional weighting would have to be used.

Nevertheless, this portion of the system is essential. It becomes more obvious in the examples given in the table below.

CATEGORIES OF RISK

From three trials which were conducted during 1977-78, involving evaluations of twenty countries by business and banking executives and political scientists, four categories of political risk emerged:

1. **Minimal Risk: 0-19 rating points.** In these countries political developments and changes in government will not lead to changes in laws, regulations, practices seriously adverse to business. No major sociopolitical disturbances are expected. Examples at the present time include Germany (17), Japan (18), and the United States (15).

2. **Acceptable Risk: 20-34.** Political developments which are seriously adverse to business have occurred in the past, but the government in power, or one which might gain power, is unlikely to impose such laws, regulations, and practices. Sociopolitical disturbances are a minor factor in evaluations of the country. Examples at the present time include Brazil (31), Canada (26), France (27), and Sweden (28).

3. **High Risk: 35-44.** Political developments seriously adverse to business have occurred or could happen in the near future. Laws, regulations, and practices inhibiting the earning and remitting of profits exist or have a high probability of existing. Major sociopolitical disturbances are occurring periodically. Examples at the present time include Indonesia (44), Nigeria (41), South Africa (42), and Spain (37).

4. **Prohibitive Risk: Over 45.** Political conditions severely restrict business operations. The earning and remitting of profits are difficult or impossible because of government regulations and practices. Loss of assets through expropriation or nationalization is possible. Major sociopolitical disturbances are part of daily life. Examples at the present time include Ghana (57) and Pakistan (46). It is interesting to note that in trials run during mid-1978, Iran received a risk score of 51. Ratings from the first step totaled 30 points. In the second step, 21 discretionary risk points were earned: 8 for restrictive measures

Causes Selected by Respondents for the Second Step*

	Present		*+5 Years*		*+10 Years*	
	France	*Spain*	*France*	*Spain*	*France*	*Spain*
Organization and strength of forces for a radical left government	4	5	4	8	4	12
Fractionalization of the political spectrum and power of resulting factions	4	5	4	5	5	3
Average of rating points allocated to other causes	2	3	2	4	2	5
Total second step rating points	10	13	10	16	11	20
Total first step rating points	17	24	21	25	22	25
Total points	27	37	31	41	33	45

*Ratings given are the result of 9 respondents per country in a trial.

USING THE RATING PANEL

The number (n) of people rating each country should be at least five. More are preferable because as the standard deviation (σ) for the average rating per cause/symptom exceeds 0.750, reliability begins to decrease. One way to reduce bias and to improve the level of confidence is to exclude the high and low rating from the calculations, and use the mean of the remaining figures as indicated below:

n = 10

0 - 0

1 - 1

2 - 6

3 - 2

4 - 1

5 - 0

6 - 0

7 - 0

	Average using n	Average using n - 2*
	2.3	2.25
Standard deviation	σ = .781	σ = .433

*Ratings 1 and 4 are deleted.

to retain power, 7 for social conditions based on extremes in wealth distribution, and 6 for fractionalization between the leadership and the general population because of religion.

The trials showed pessimism about the future. The average for the present was 32, but the "+5 years" average was 36 and the "+10 years" was 38. South Africa's expected deterioration in the future had an influence on the statistics (successively worse in each trial), but most of the countries moved slightly higher for each period.

FINDING GOOD ANALYSTS

Obviously the training and experience of the evaluating personnel are crucial to the success of the ratings. Members of the rating panel should be experts on the country they are evaluating; ideally they should have had actual experience in the country and should be fluent in that country's language. The quality of the ratings increases dramatically when panel members have had direct experience within a country's borders and have spent time monitoring that country's socio-political situation.

Corporate assessment of political risk can be greatly enhanced by the adoption of a rating system that examines ten separate variables. Rather than broadly estimating political risk as a single category, thereby encouraging subjective evaluations, companies now have a uniform basis for assessment when they consider whether or not to undertake major investments abroad. Thus overall company strategy can be developed from a more objective perspective. ☐