

COMPSS 224B: QUANTITATIVE POLITICAL RISK ANALYSIS

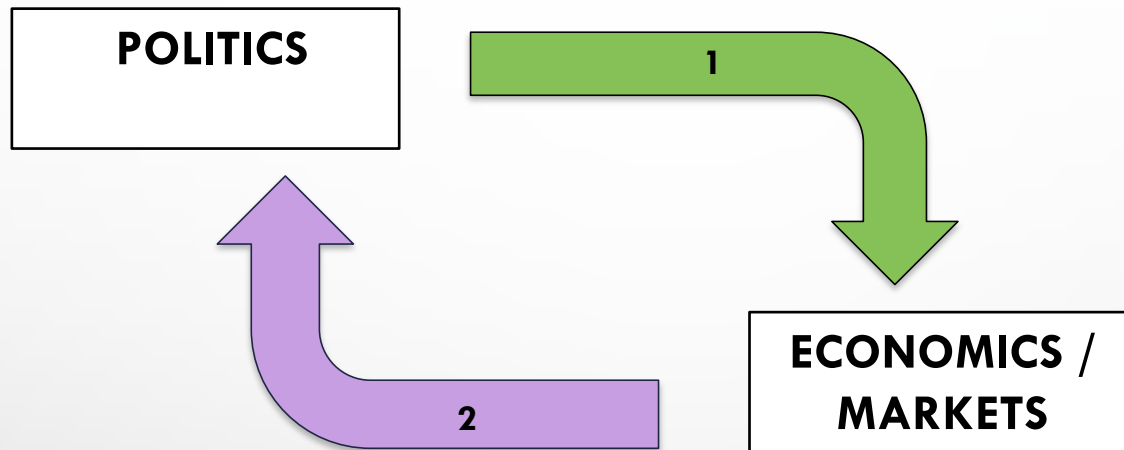
SESSION 1: INTRODUCTION TO COUNTRY/POLITICAL RISK ANALYSIS (1/2)

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KEY CONCEPTS IN POLITICAL RISK

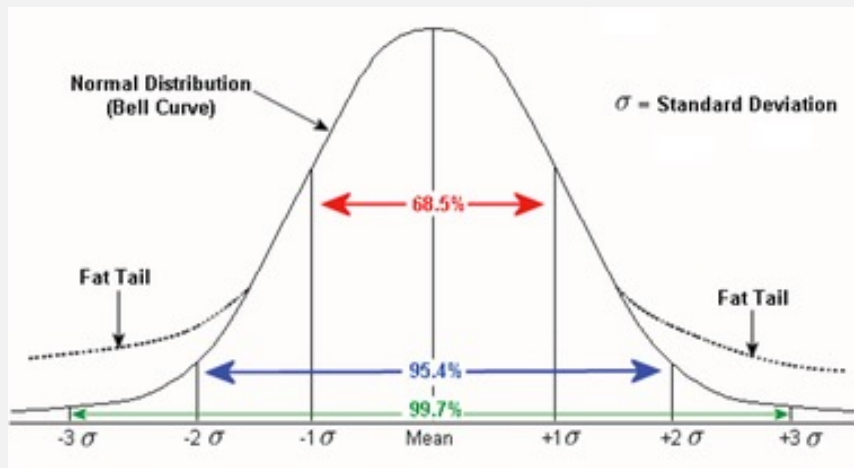
Risk =	Probability (of action/event) X Impact (of action/event)
Political Risk =	Probability of a political action/event X Impact of that change on an economic or market outcome

KEY CONCEPTS IN POLITICAL RISK

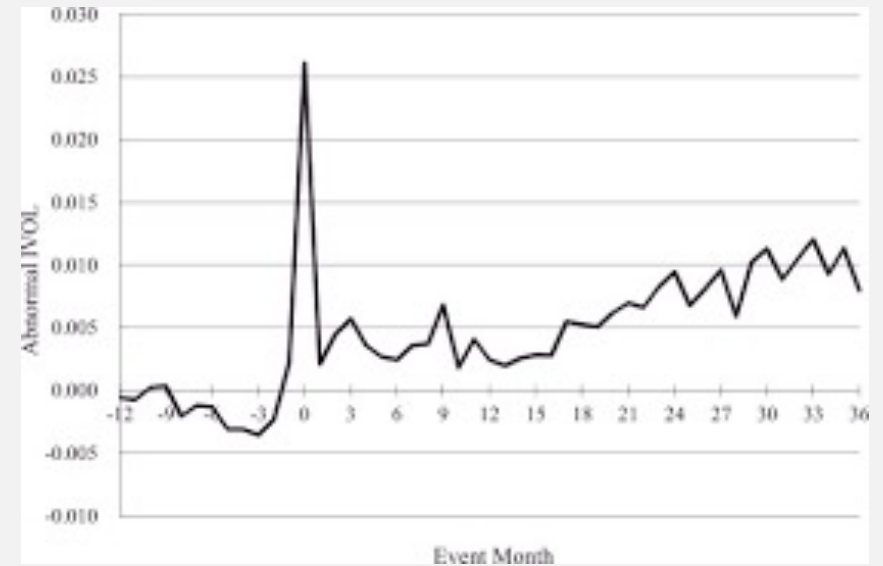


KEY CONCEPTS IN POLITICAL RISK

TAIL RISK / FAT TAILS

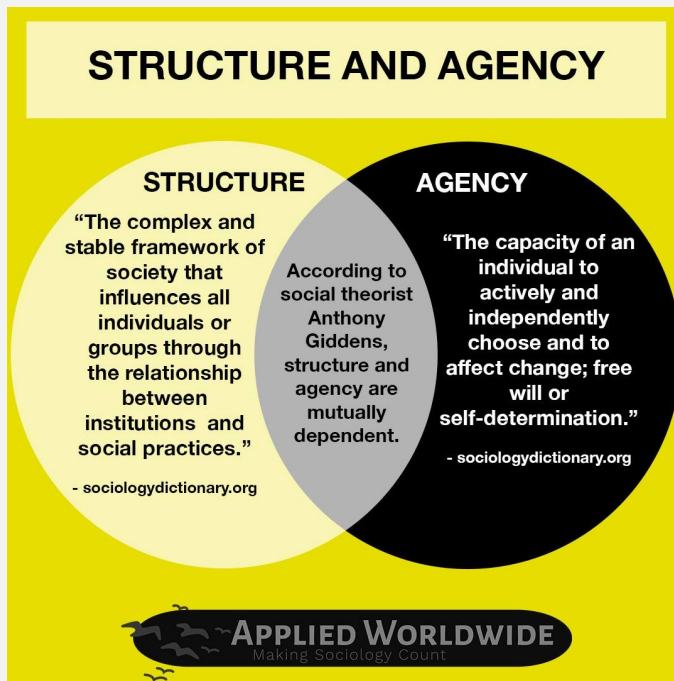


'IDIOSYNCRATIC' RISK / EVENT RISK

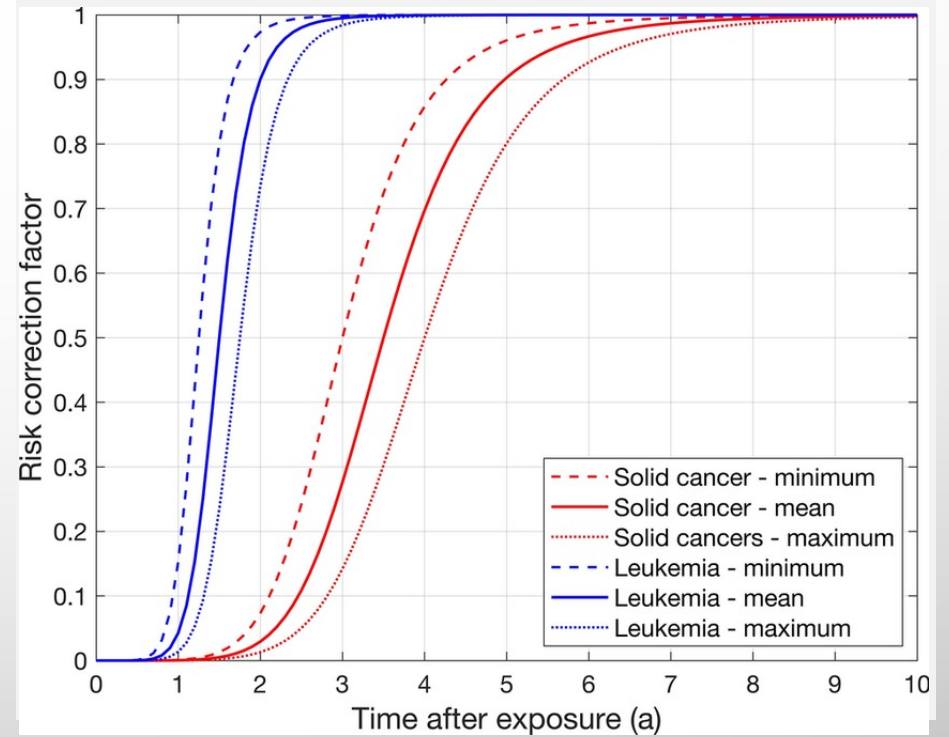


KEY CONCEPTS IN POLITICAL RISK

STRUCTURE VS AGENCY



RISK LATENCY



TYPES AND LEVELS OF POLITICAL RISK

Main types of risk events shocks	Examples
Geopolitical	International wars Great power shifts Economic sanctions and embargoes
Global energy	Politically decided supply and demand issues
Terrorism	Destruction of property Kidnapping/hijackings
Internal political strife	Revolutions Civil wars Coup d'état Nationalism Social unrest (strikes, demonstrations)
Expropriations	Confiscations of property 'Creeping expropriations
Breaches of contract	Government frustration or reneging of contracts Wrongful calling of letters of credit
Capital market risks, currency, and repatriation of profits	Currency controls Political motivated credit defaults and market shifts Repatriation of profits
Subtle discrimination and favoritism	Discriminatory taxation Corruption
Unknown/uncertainty	Effects of global warming Effects of demographic changes Political events that cannot be foreseen

Bremmer and Keat, *The Fat Tail: The Power of Political Knowledge in an Uncertain World*. Oxford University Press, 2009.

TEN TYPES OF POLITICAL RISK

Geopolitics	Interstate wars, great power shifts, multilateral economic sanctions, and interventions
Internal conflict	Social unrest, ethnic violence, migration, nationalism, separatism, federalism, civil wars, coups, and revolutions
Laws, regulations, policies	Changes in foreign ownership rules, taxation, environmental regulations, and national laws
Breaches of contract	Government renegeing on contracts, including expropriations and politically motivated credit defaults
Corruption	Discriminatory taxation and systemic bribery
Extraterritorial reach	Unilateral sanctions and criminal investigations and prosecutions
Natural resource manipulation	Politically motivated changes to the supplies of energy and rare earth minerals
Social activism	Events or opinions that go viral, facilitating collective action
Terrorism	Politically motivated threats or violence against persons and property
Cyberthreats	Theft or destruction of intellectual property; espionage; extortion; and massive disruption of companies, industries, governments, and societies

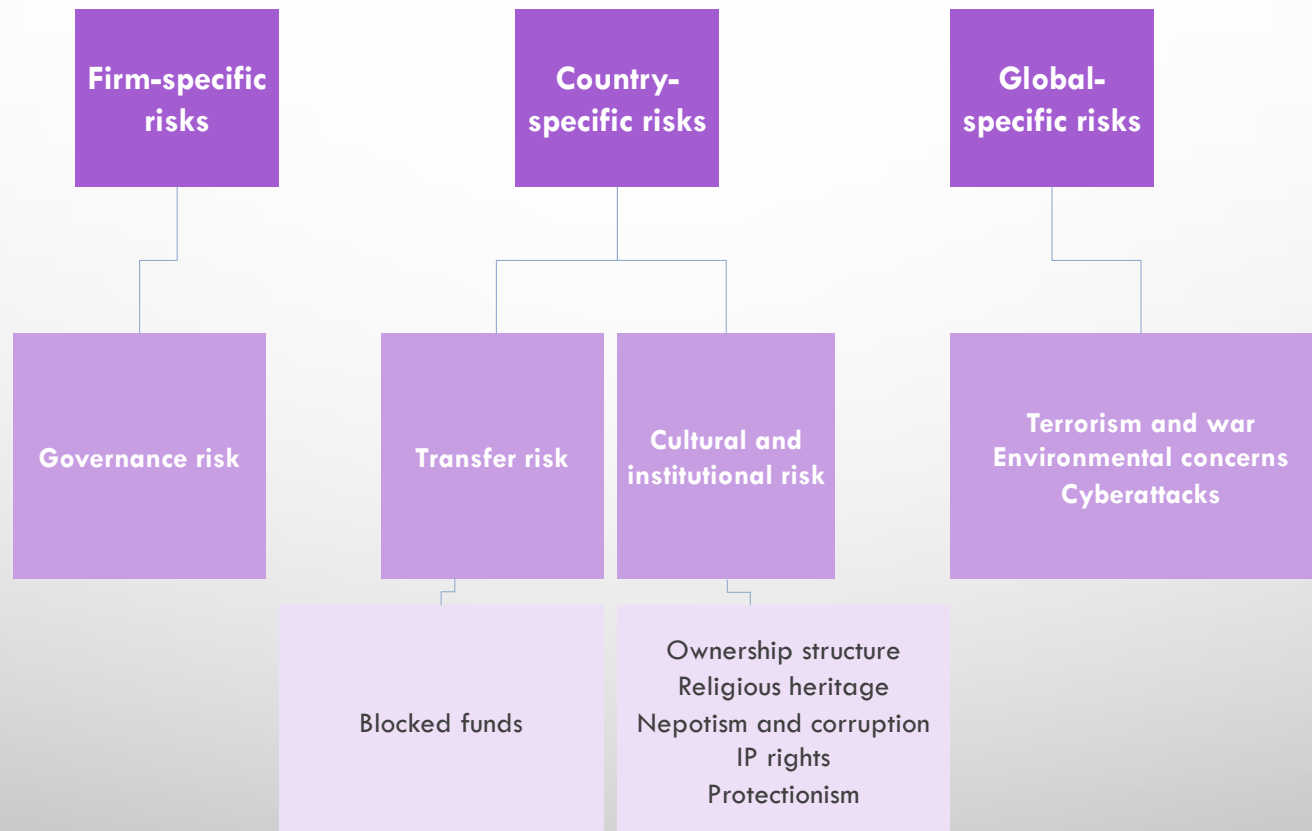
- SOURCE: RICE ZEGART 2018

TYPES AND LEVELS OF POLITICAL RISK

Actor		Type	
		Direct	Indirect
Government	Host government	Expropriation, currency controls	Elections
	Home government	Profit repatriation	Sanctions
Non-Government	Domestic	Strikes	Protests
	External	Boycotts	Wars, attacks

SOURCE: SIMON 1984, AMENDED

TYPES AND LEVELS OF POLITICAL RISK



• SOURCE: MOFFITT ET AL. 2007

TYPES AND LEVELS OF POLITICAL STABILITY

The idea in practice

To minimize risk in your overseas investments, assess the following dimensions of political stability

Government

How strong are the government the rule of law?
Also consider the level of corruption in government. You'll need proxy metrics. For example, to evaluate the integrity of a country's judiciary, ask, Are judges paid a living wage? Do programs exist to inform them about new legislation? Are judges often targeted for assassination?

Security

How stable are the country's geopolitical alliances? How prepared is the nation for emergencies, natural disasters, and internal strife?

Society

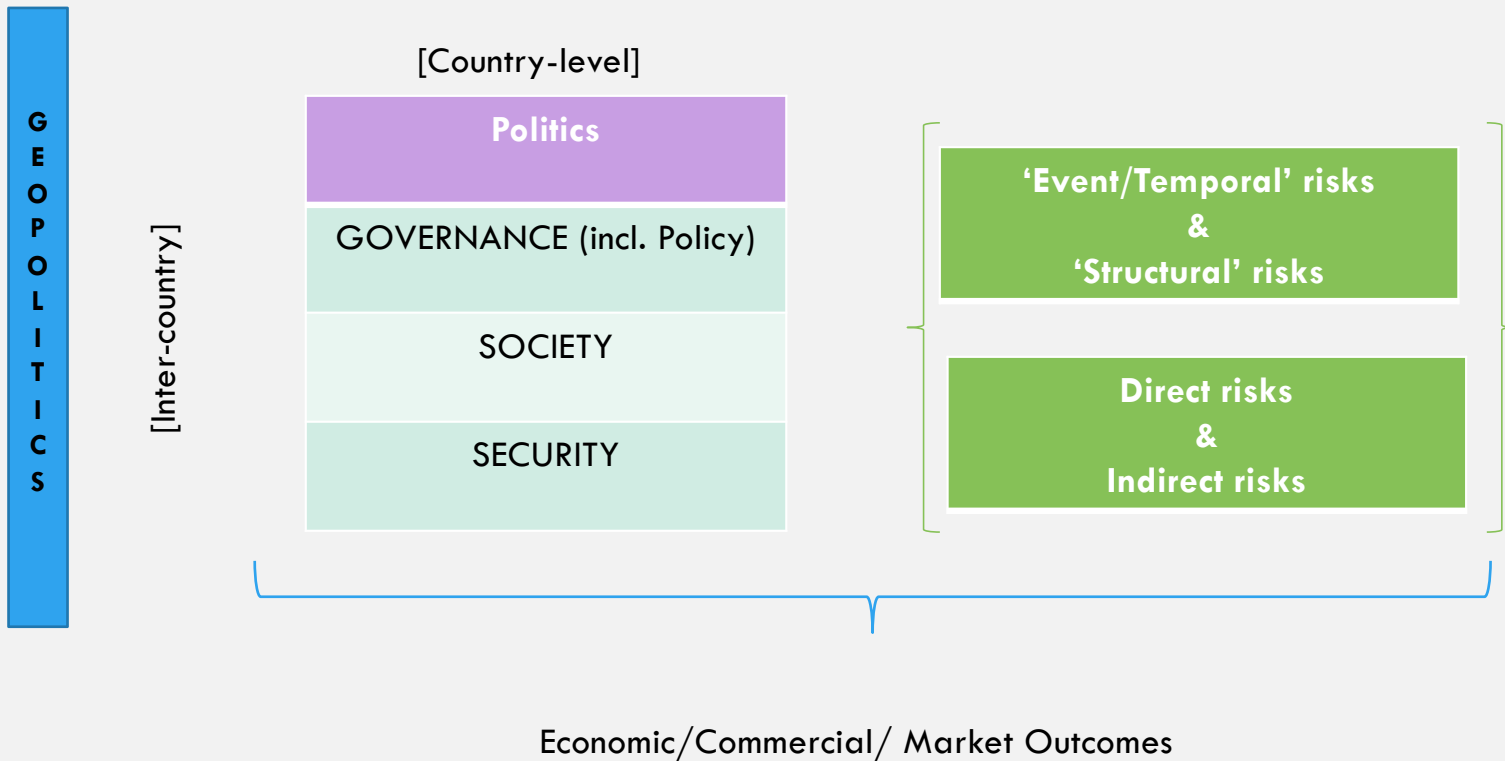
How much social tension exists? How disaffected are the nation's youth? How secure do individuals feel? To find clues, study the percentage of children who regularly attend school. Compare police and military salaries relative to criminal income opportunities. Assess young people's access to medical care, unemployment rates, and imprisonment rates.

Economic

What are the country's fiscal positions, growth and investment, and debt? How economically open is the country? Does its political openness match its economic openness? If not, instability may ensue.

- SOURCE: BREMMER 2005

TYPES AND LEVELS OF POLITICAL RISK: SYNTHESIS



POLITICAL RISKS FOR FINANCIAL MARKETS

Geopolitics

	Direct	Indirect
Governance	Economic policies <ul style="list-style-type: none"> • Monetary • Fiscal • Micro/Investment • Trade 	Political Stability <ul style="list-style-type: none"> • Elections / Regime Change • Political Capacity • Institutional Strength/Quality
Society	Strikes, Protests, Boycotts	Social Stability/ Polarization Human Development/ Human Rights
Security	Sanctions Cyber attacks Trade Wars Supply chain shocks	War (Hot/Cold) Terrorism Crime Geography

POLITICAL RISKS FOR CORPORATES

	Direct	Indirect
Governance	Expropriation Fiscal Risks (taxes, royalties) Macro-policies Regulatory Risks Investment Policies (FDI, tariffs) Currency Convertibility	Political Stability <ul style="list-style-type: none"> • Elections / Regime Change Political Capacity Rule of Law/Corruption
Society	Strikes Boycotts	'Human Development'/Social conditions Protests Civil Unrest
Security	War/Terrorism Sanctions Cyber attacks	'Bad Neighbor'

Geopolitics

EXTERNAL DEBT/CDS

Bonds denominated in a foreign currency (Usually USD or EUR). CDS is insurance against non-payment of a bond denominated in foreign currency.

Most important fact—foreign currency cannot be produced at will.

Economic creditworthiness depends on trade balance; capital inflows/outflows; capital flight; external reserves; and external assistance, which, in turn, implies conditionality.

Loss of external debt service capacity can trigger need for assistance such as an IMF program. Issue becomes political willingness/ability to embrace conditionality; default is effectively the same political dilemma.

Points to note—sovereign external debt has been shrinking (good thing); but means more issuers from frontier markets with weaker political capacity.

Key variables—availability of foreign currency to service debt; and access to payment systems/networks

DOMESTIC BONDS AND INTEREST RATES

Has been big shift into EM local currency denominated issuance for reasons mentioned earlier.

Investors trade debt issues from 1 month to 30 years denominated in the local currency, so they want to know what is going to happen to interest rates at different maturities. Yield curve is the graph of yields at different maturities.

For bonds of very short maturities—what matters is what CB is going to do. For longer maturities, what matters is longer-term expectations of growth, inflation and government fiscal policy.

From a policy viewpoint, note that CBs can be formally tasked with targeting inflation, growth/unemployment, or the exchange rate. So first thing you need to know is what the actual job of the central bank is?

Then watch—are they allowed to do their job? Is there political interference that changes CB policy?

Politics—what to watch—fiscal trajectory, which can be bad for l/t bonds because of growth and higher government borrowing requirement; Interference with CB to push for growth; any move to change targets; CB appointments; concern re: exchange rate from official or other quarters.

More widely—what is inflation/deflation history and tolerance of populace. What is the respective power of anti-inflation vs. anti-deflation parties.

FOREIGN EXCHANGE/CURRENCY

Affected by current account balance = (Trade + interest payment/dividends + remittances)

Affected by capital account balance (global investor appetite for the assets named previously; domestic investor appetite for overseas assets; capital flight)

Hot money or portfolio flows. More volatile. Driven by growth, INTEREST RATES in country and also by global liquidity conditions.

Currency regimes and changes in currency regimes are key variables—hard or soft peg; highly interventionist; free floater; in between.

Politics is often a key factor in exchange rate policy- can result in intervention in fx markets or other measures (taxation/modified capital controls). This is sometimes due to concerns about competitiveness, sometimes due to worries about excessive losses from currency weakness due to fx indebtedness, or concerns about regime stability/popularity. Leads to interesting questions about winners and losers from currency moves.

China now—look at costs/benefits of reserve drawdown.

EQUITIES/EQUITY INDICES

Growth prospects (GDP growth and earnings growth)

Interest rates (because of impact on growth, and because of valuation of future cash flows)

Corporate profits as % of GDP (taxation, wage policies)

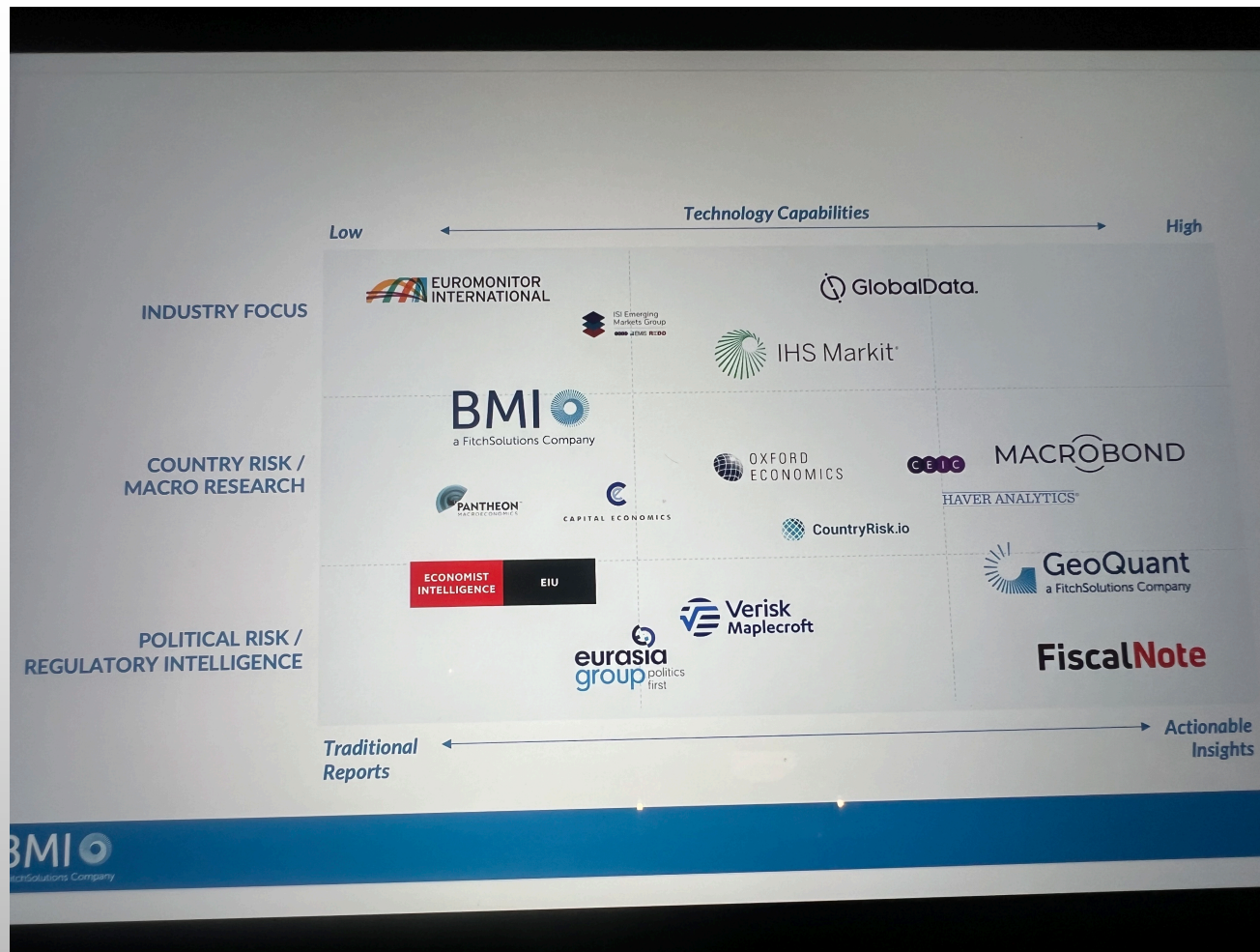
Corporate governance/transparency—rights of minority or foreign shareholders to push change in governance. Transparency of accounts, reporting.

P/E multiples—one way markets gauge if stocks are cheap or expensive. Compare across countries, but also vs. same country government bonds.

High or low P/E can contain clues— (HK, e.g., with low P/E)

Watch index composition—banks; energy companies; exporters; importers; partially or wholly owned SOEs subject to governmental intrusion, interference.

MAJOR PLAYERS: COUNTRY/POLITICAL RISK INDUSTRY



END USERS: FINANCIAL MARKETS

Country Risk Analysts	Reports, Conversations, Data
Market Analysts (Sell side and buy side)	Reports, Conversations, Data
Economists	Reports, Data, Conversations
Risk Managers	Reports, Data, Conversations
Portfolio Manager (Discretionary)	Conversations, Data, Reports
Portfolio Manager (Systematic)	Data
C-Suite	Conversations, Data [Reports = “Thought Leadership”]

WHICH SECTORS REQUIRE POLITICAL RISK ANALYSIS AND INPUTS, AND WHY?



Engineering and construction



Oil, gas and petrochemicals



Pharmaceuticals and healthcare



Information and communications technology



Consumer goods



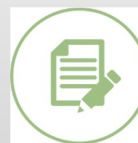
Financial services



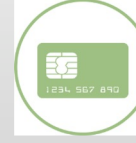
Manufacturing



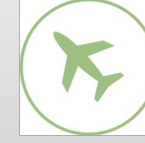
Mining



Government



Insurance

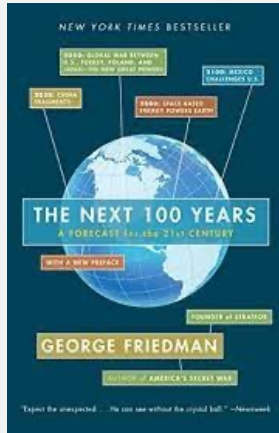


Aerospace and defence

WHO'S INVOLVED WITH POLITICAL RISK MANAGEMENT?

Challenges		Corporate needs	Main functions involved (non-exhaustive)								
			CEO & Board	Practice Lines	Corporate & Business Development	Country & Regional Leadership	Finance & Treasury	General Counsel	Strategy & Risk	Security	Gov. Rel. & Comm's
1	Leadership & Strategy	Corporate Vision & Global Management Regional Prioritization Resource Allocation	✓	✓	✓	✓	✓		✓		✓
2	Market Access	Country Entry & M&A Gov. Engagement Influence Mapping			✓	✓		✓	✓	✓	✓
3	Country Management	Policies & Reg's. IP, Data and Cyberrisk Security Monitoring		✓		✓		✓	✓	✓	✓
4	Ensuring Returns	Reputation & Crisis Management Capital, Currency & Economic Risks	✓	✓		✓	✓	✓	✓	✓	✓

EXPERTS AREN'T GREAT



Davos 2022 | Geopolitics | Geo-economics

5 experts on how to advance global peace and stability in a new era of geopolitics



ian bremmer
@ianbremmer

chance of putin being removed from office: close to zero

until it happens

5:53 PM · Sep 22, 2022 · Twitter for iPhone

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MILITARY & DEFENSE

'More than 50% chance' China will invade Taiwan in the next 10 years, says former US national security adviser

Matthew Loh Apr 19, 2023, 11:51 PM PT

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QUALITATIVE METHODS AND TOOLS

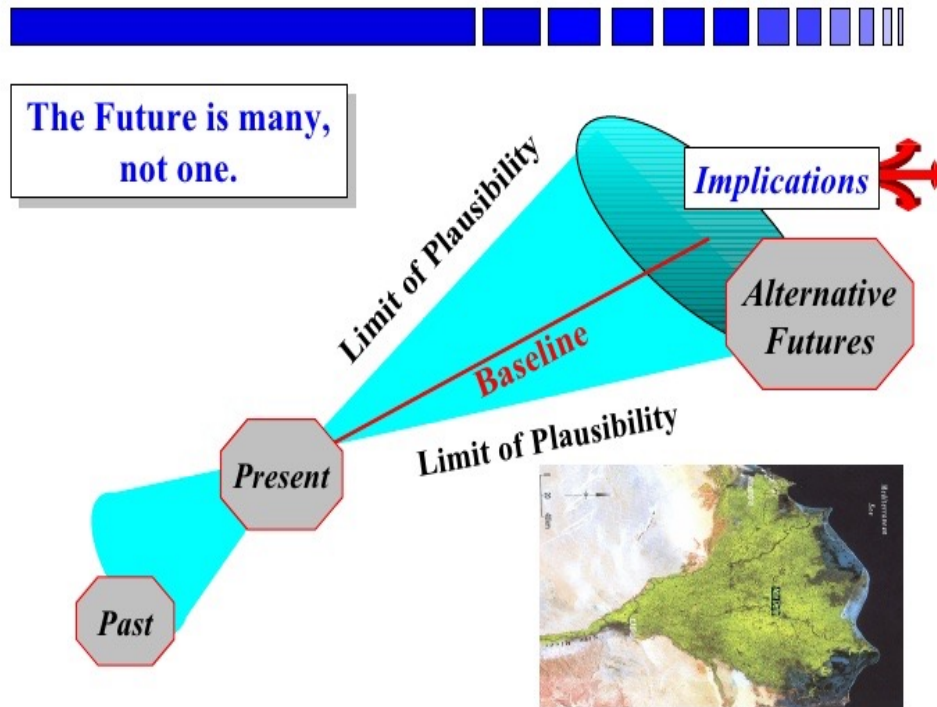
Six Rules for Effective Forecasting

Expert Political Judgment

Scenario Analysis / Assigning Probabilities

QUALITATIVE METHODS AND TOOLS

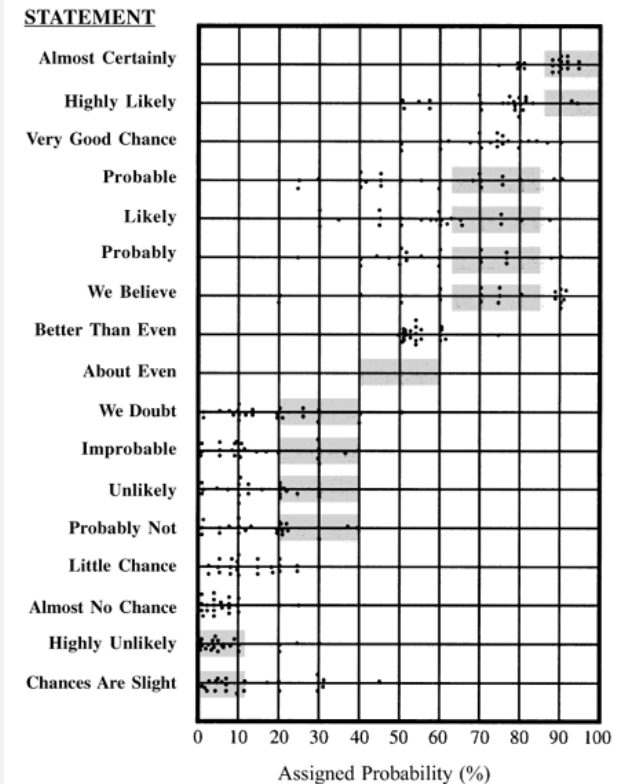
The Cone of Plausibility



Source: Charles Taylor, Army War College

UH FUTURES STUDIES: Preparing Foresight Professionals

Figure 18: Measuring Perceptions of Uncertainty



QUALITATIVE METHODS AND TOOLS

Figure 2 Building Blocks for Scenarios

