



# **COMPSS 224B: QUANTITATIVE POLITICAL RISK ANALYSIS**

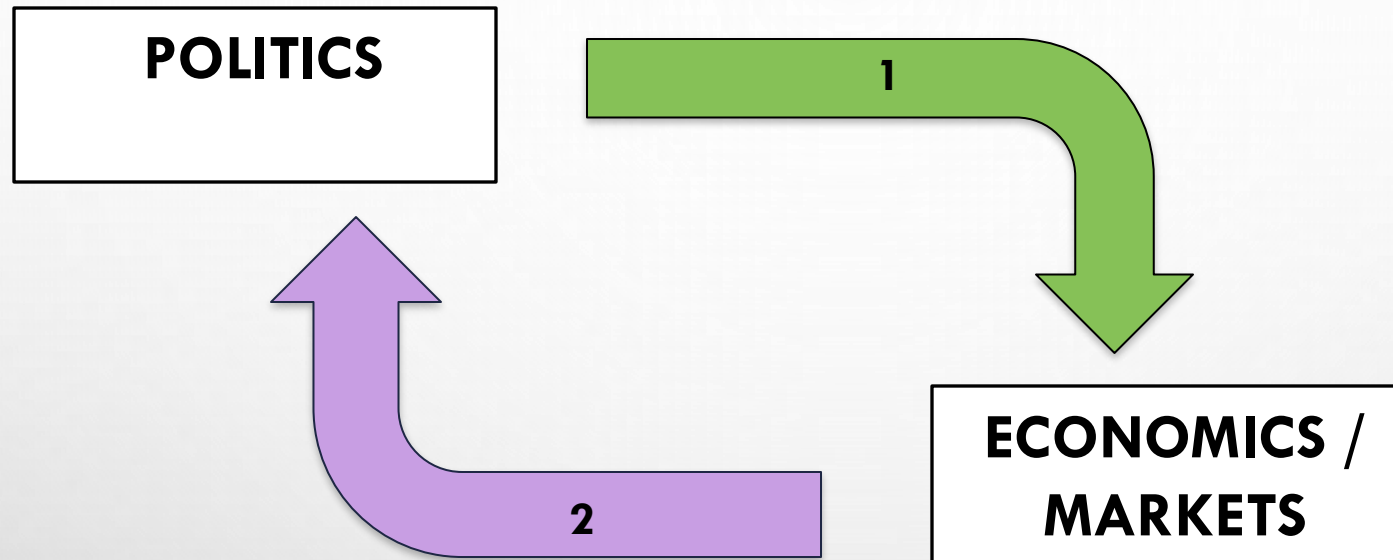
SESSION 1 /2: INTRODUCTION TO COUNTRY/POLITICAL RISK ANALYSIS

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# KEY CONCEPTS IN POLITICAL RISK

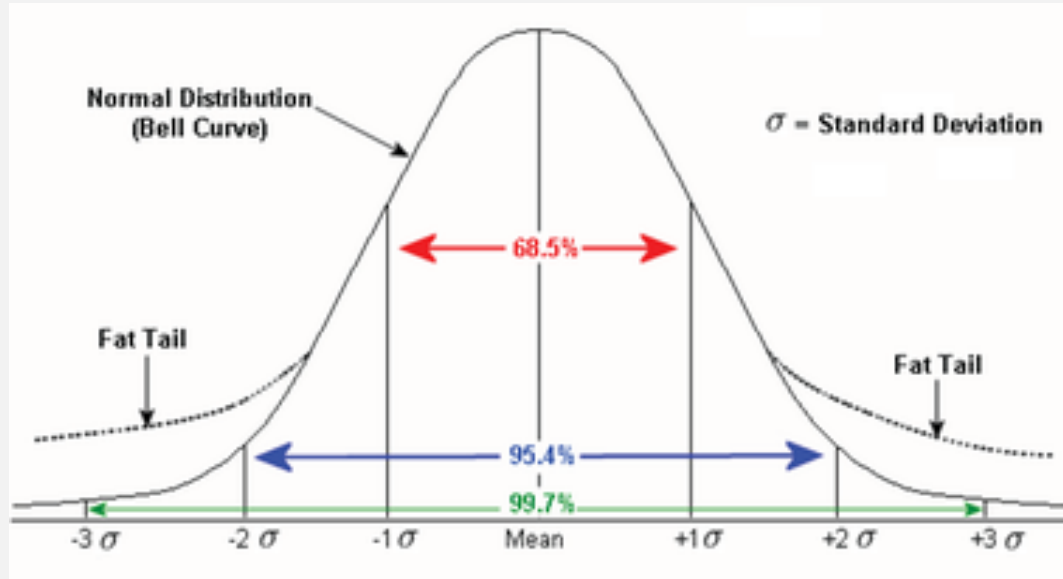
<b>Risk =</b>	<b>Probability (of action/event)</b> <b>X</b> <b>Impact (of action/event)</b>
<b>Political Risk =</b>	<b>Probability</b> of a political action/event <b>X</b> <b>Impact</b> of that change on an economic or market outcome

# KEY CONCEPTS IN POLITICAL RISK

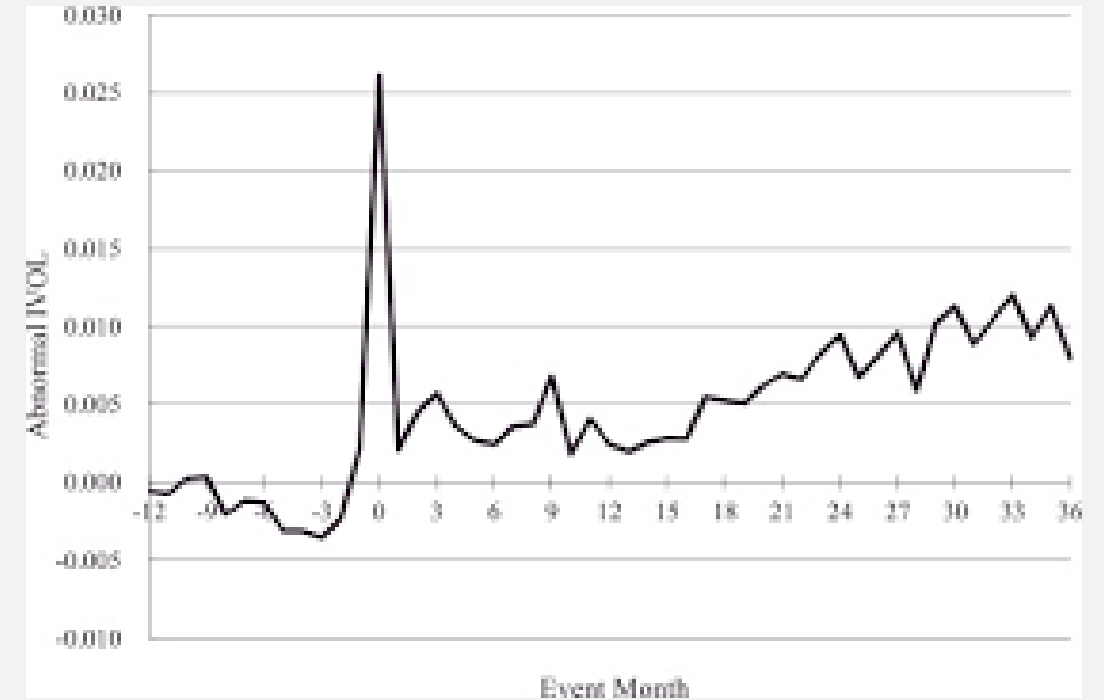


# KEY CONCEPTS IN POLITICAL RISK

## TAIL RISK / FAT TAILS

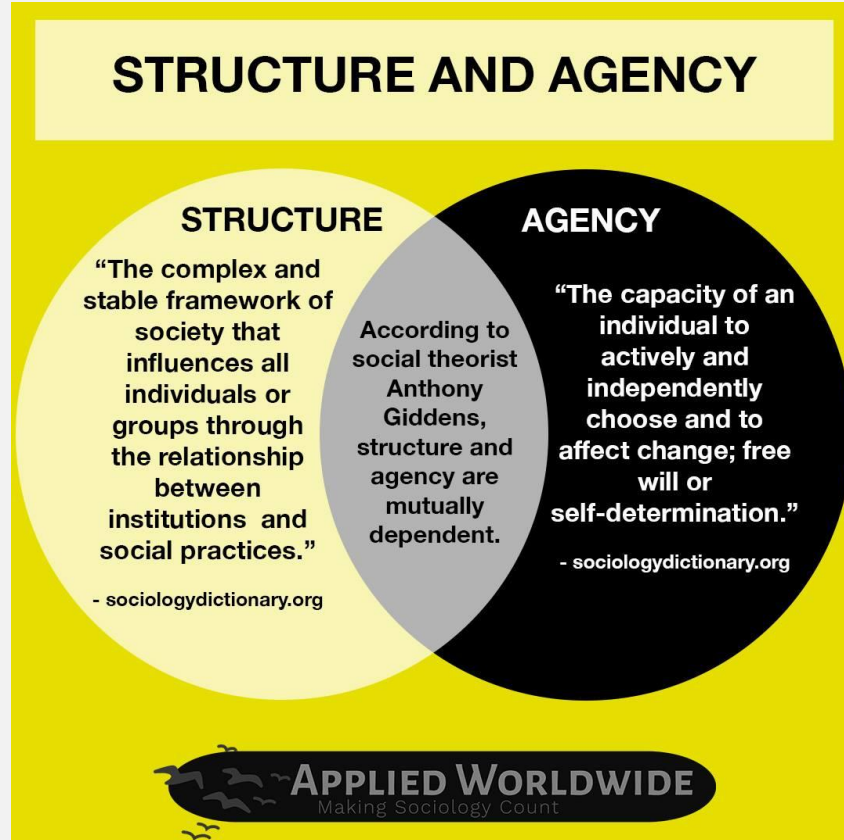


## 'IDIOSYNCRATIC' RISK / EVENT RISK

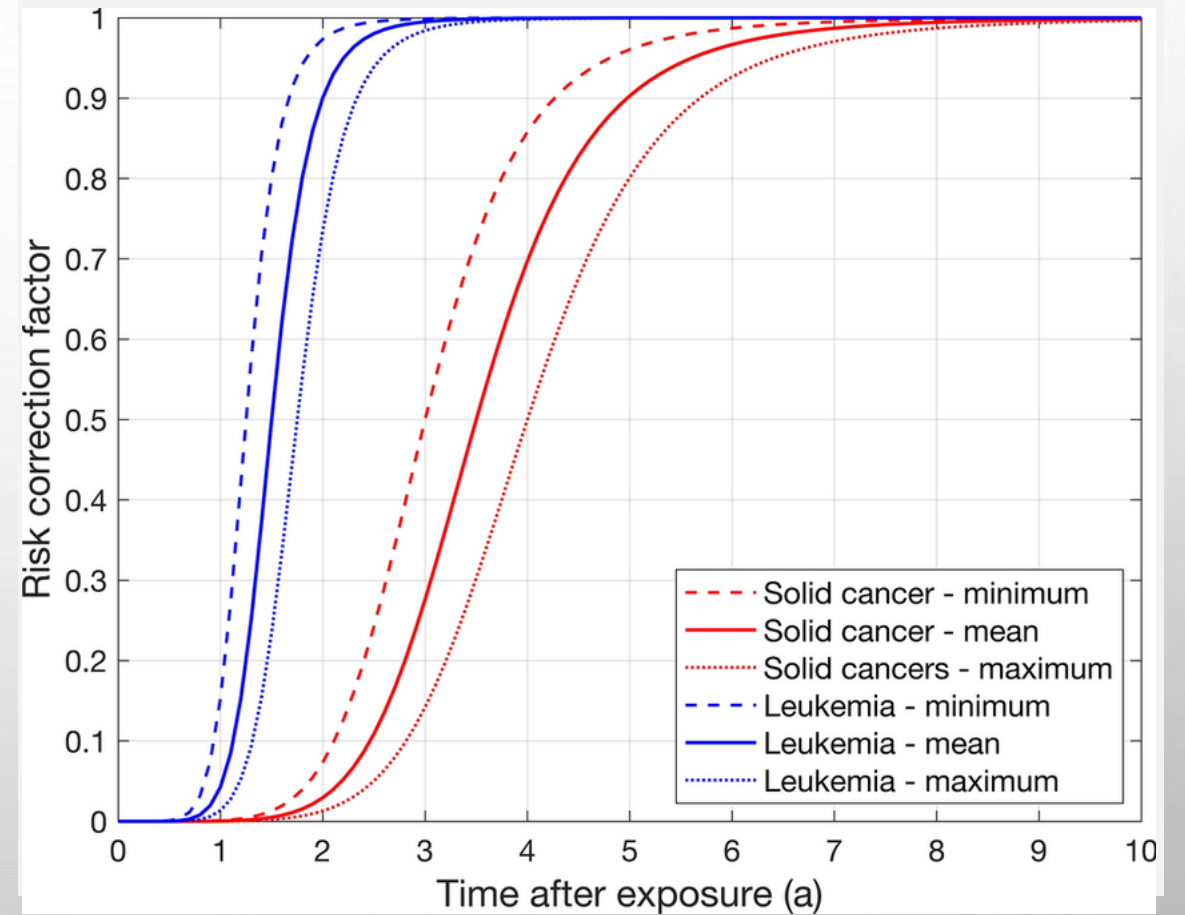


# KEY CONCEPTS IN POLITICAL RISK

## 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

# TEN TYPES OF POLITICAL RISK

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

- SOURCE: RICE ZEGART 2018

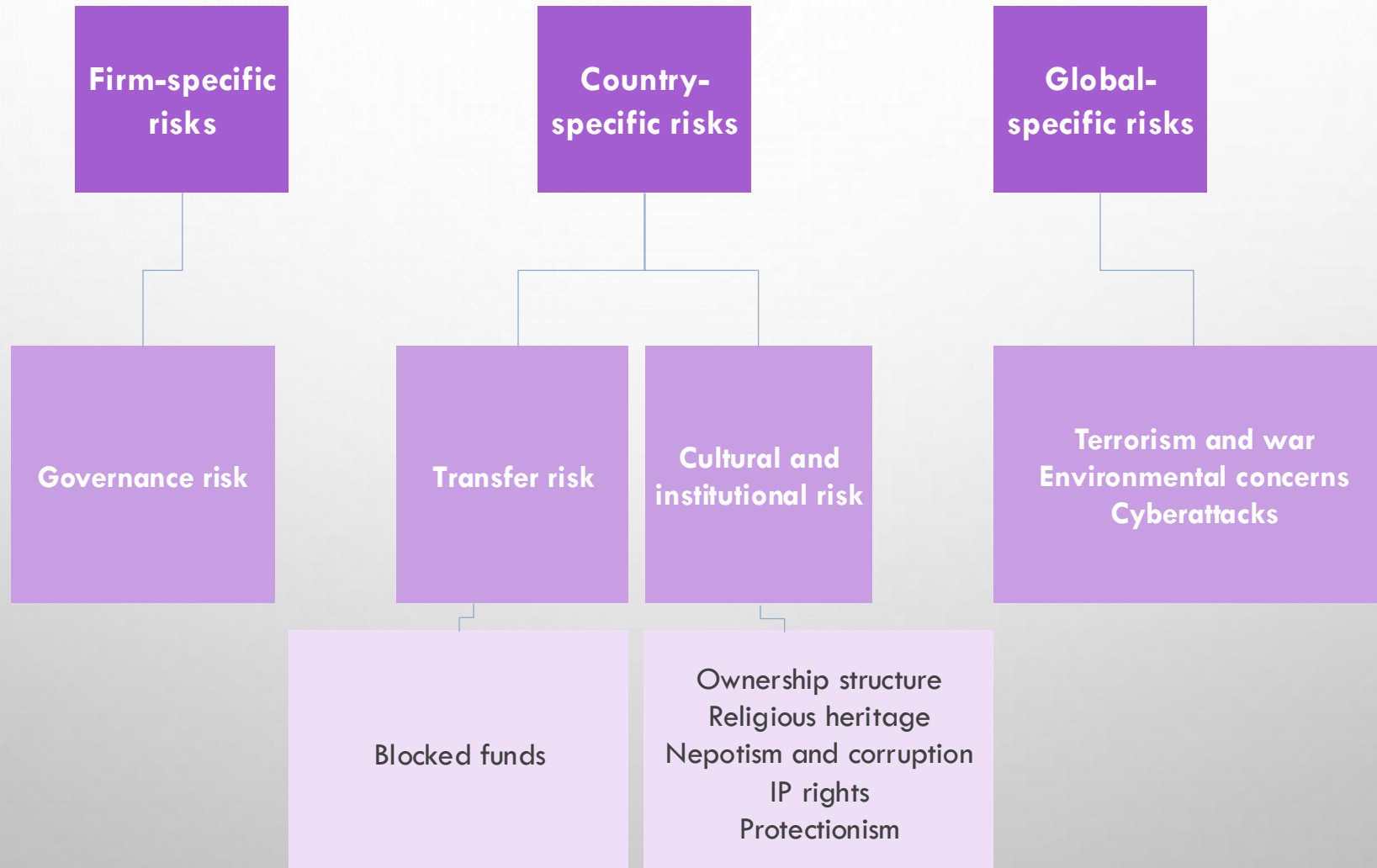
# TYPES AND LEVELS OF POLITICAL RISK

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



# 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?

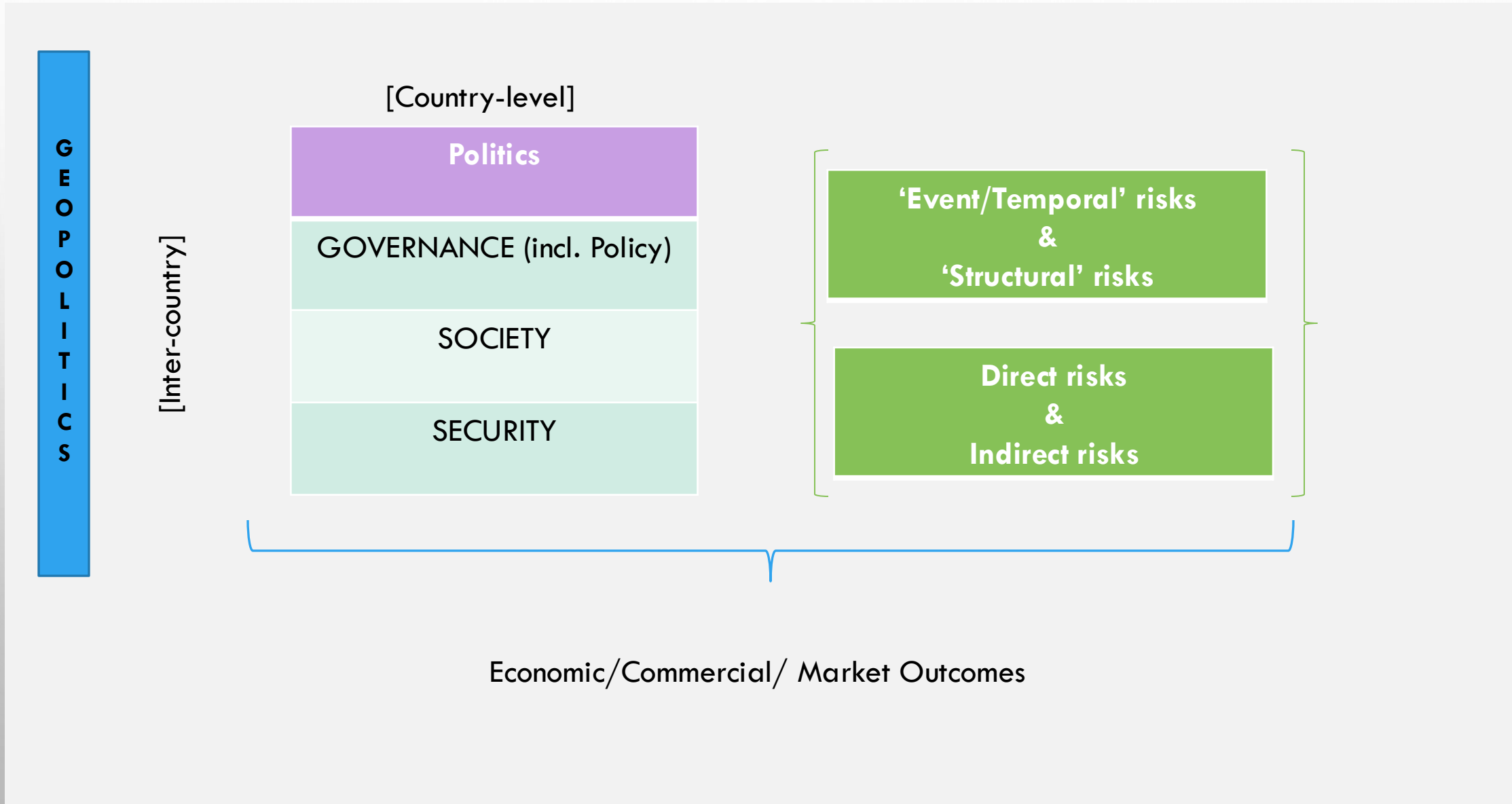
### Society

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.

# TYPES AND LEVELS OF POLITICAL RISK: SYNTHESIS



# POLITICAL RISKS FOR FINANCIAL MARKETS

## Geopolitics

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

# POLITICAL RISKS FOR CORPORATES

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

# 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)

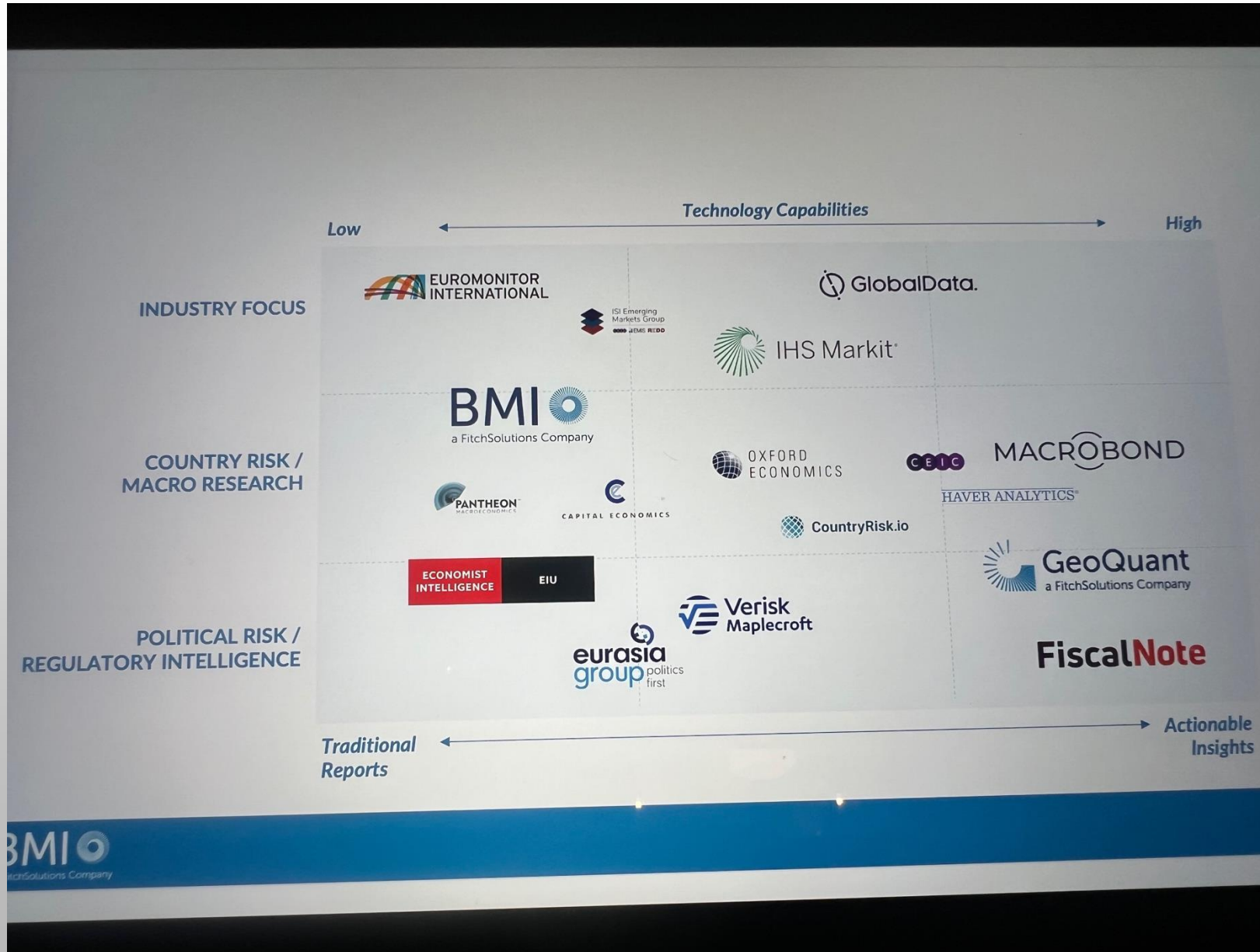
Corporate governance/transparency—rights of minority or foreign shareholders to push change in governance. Transparency of accounts, reporting.

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

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

# 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**

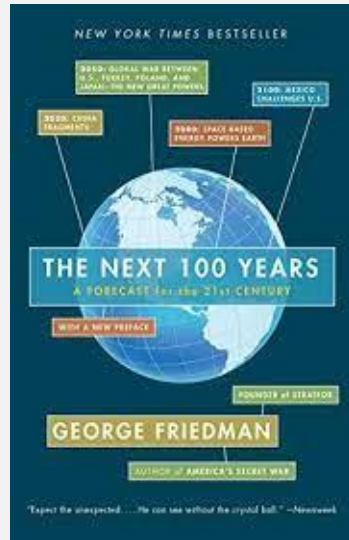


**Aerospace and defence**

# 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



WORLD  
ECONOMIC  
FORUM

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

Figure 18: Measuring Perceptions of Uncertainty

## STATEMENT

Almost Certainly

Highly Likely

Very Good Chance

Probable

Likely

Probably

We Believe

Better Than Even

About Even

We Doubt

Improbable

Unlikely

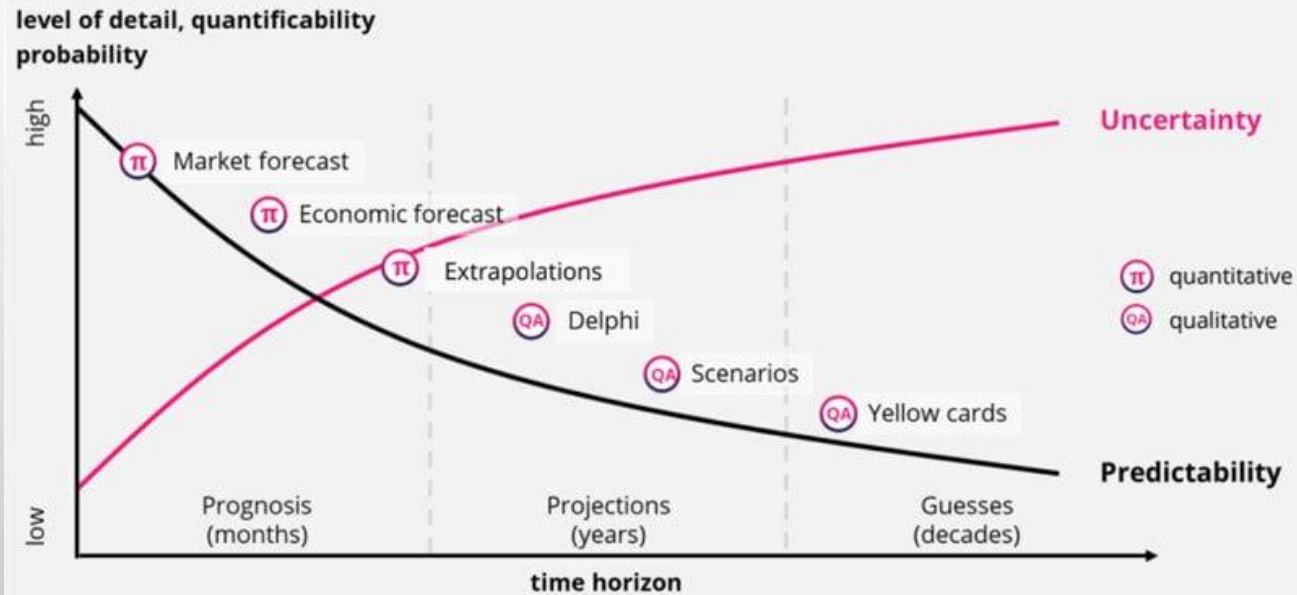
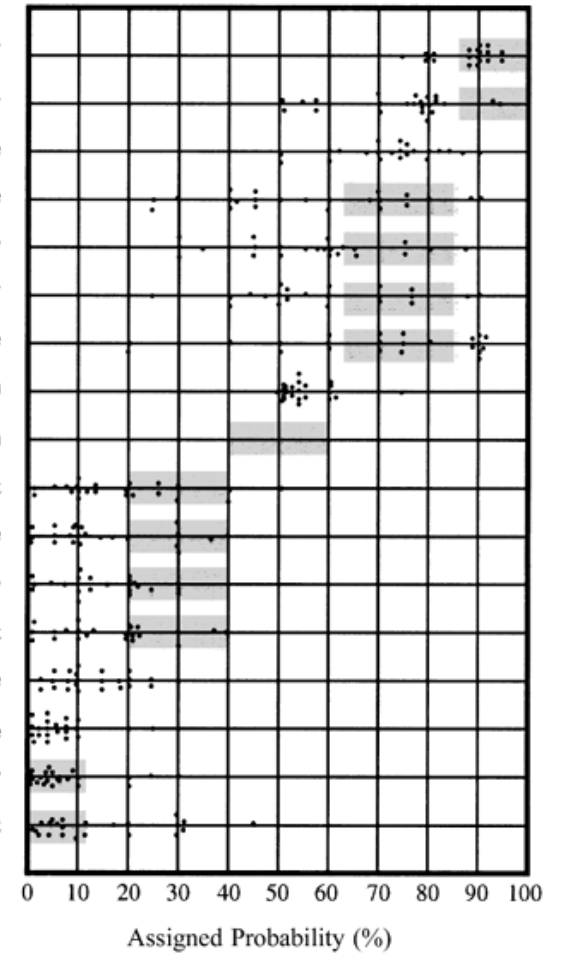
Probably Not

Little Chance

Almost No Chance

Highly Unlikely

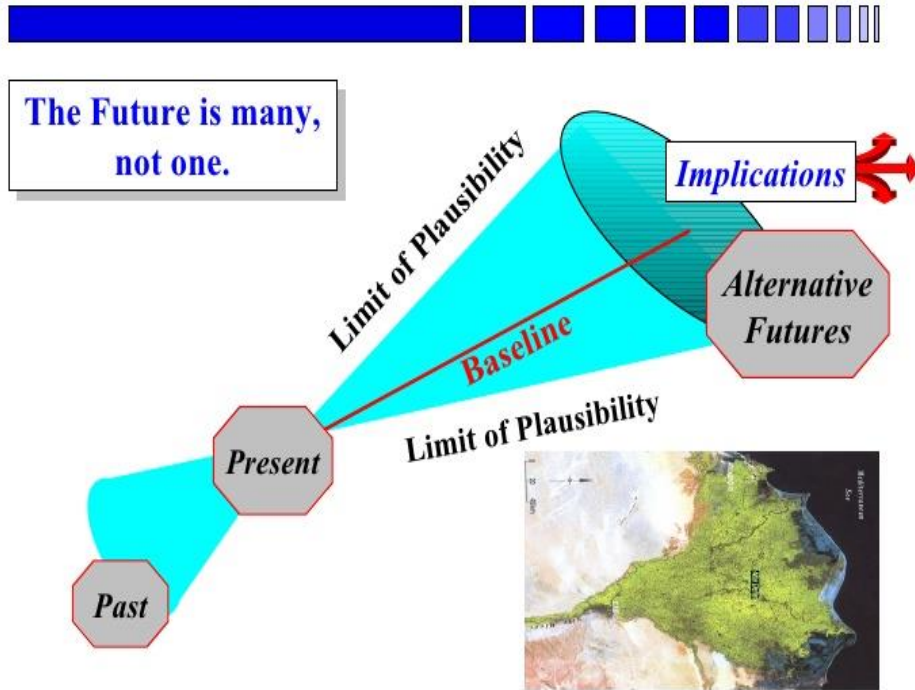
Chances Are Slight





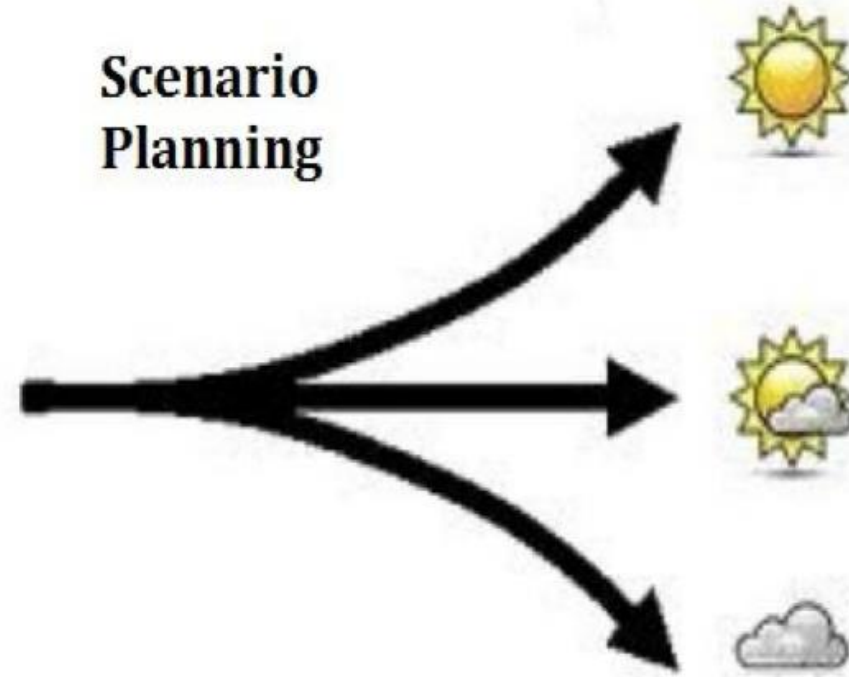
# QUALITATIVE METHODS AND TOOLS

## The Cone of Plausibility



Source: Charles Taylor, Army War College

UH FUTURES STUDIES: Preparing Foresight Professionals



History doesn't repeat, it rhymes

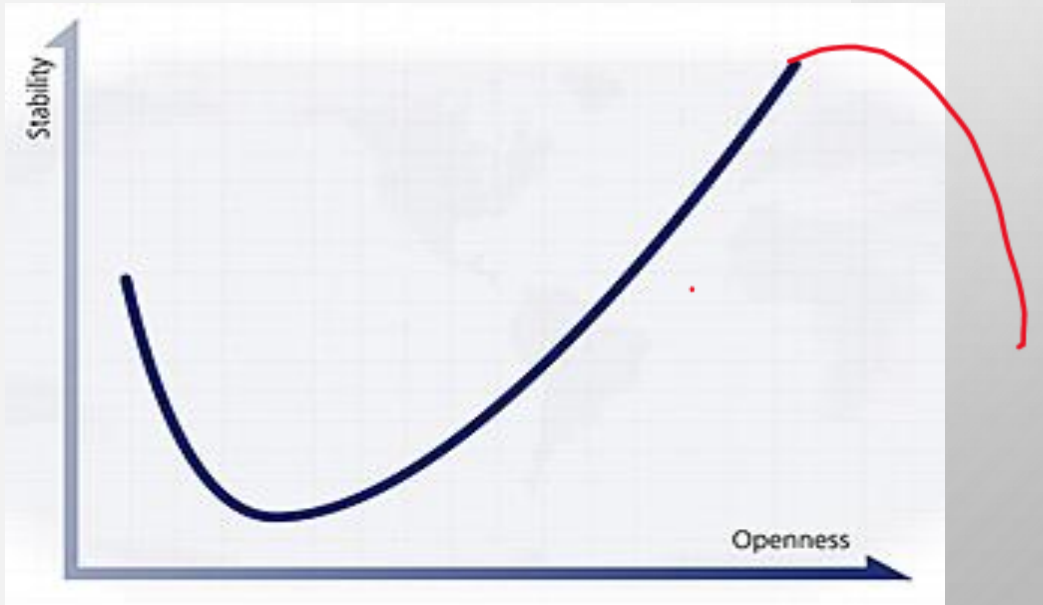
Broader cone > narrower cone . . . Make it plausible, not probable

Beware the S curve

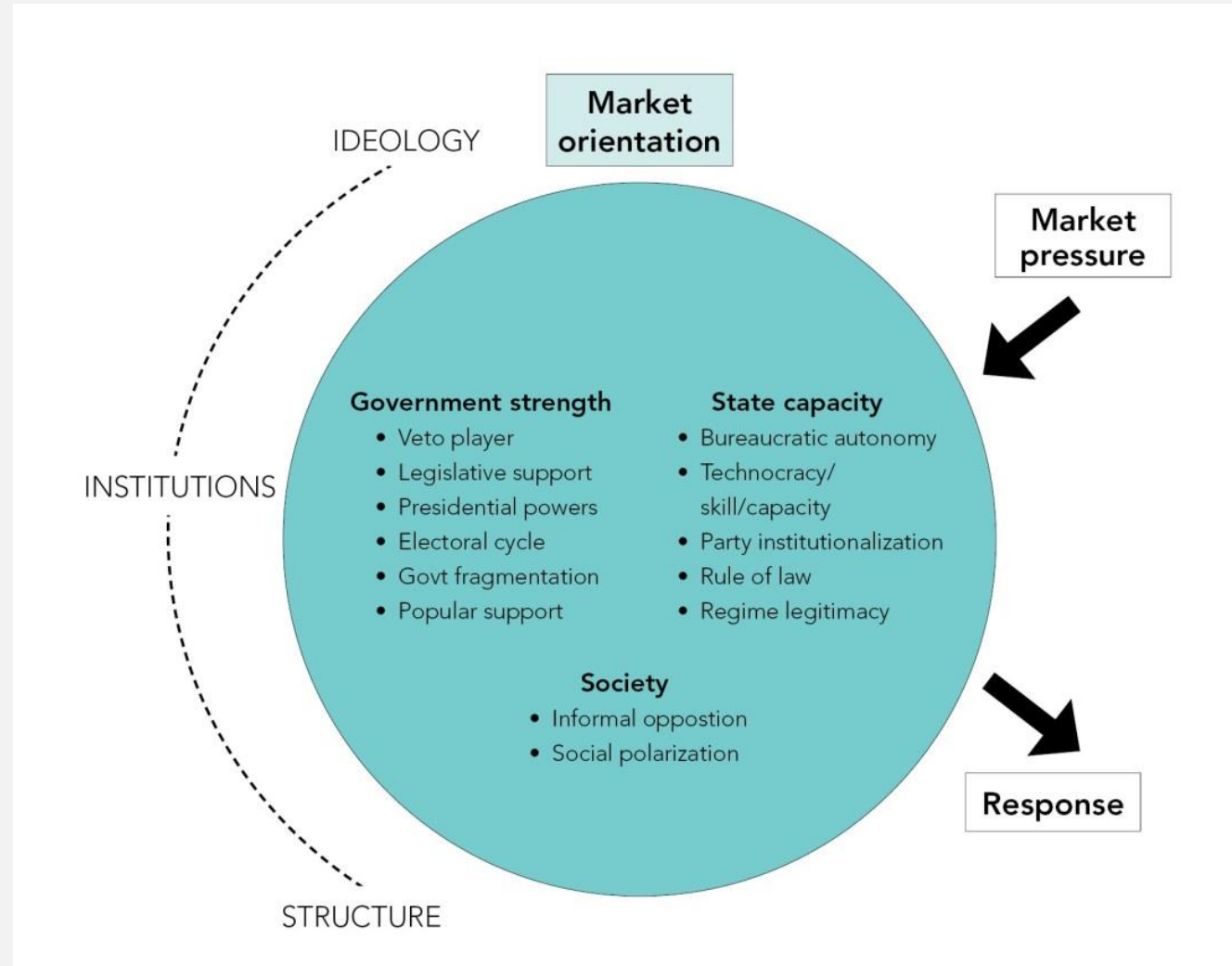
"Sticky priors" are the enemy

# DEVELOPED VS. EMERGING MARKETS

- “WEAK GOVERNMENT” HYPOTHESIS
  - ALL ABOUT INSTITUTIONS ...
  - POLITICAL CAPACITY
  - “DEMOCRATIC PREMIUM” (OR DISCOUNT?)
  - STRUCTURAL INSTABILITY AROUND ELECTIONS. WHY?



# MEASURING AND DEFINING POLITICAL CAPACITY



# [GEO]POLITICAL RISK TO FINANCIAL MARKETS

- SANCTIONS AND BOYCOTTS
  - ‘WEAPONIZATION OF FINANCE’
- TRADE WARS
- THUCYDIDES'S TRAP
- COMMODITY SHOCKS

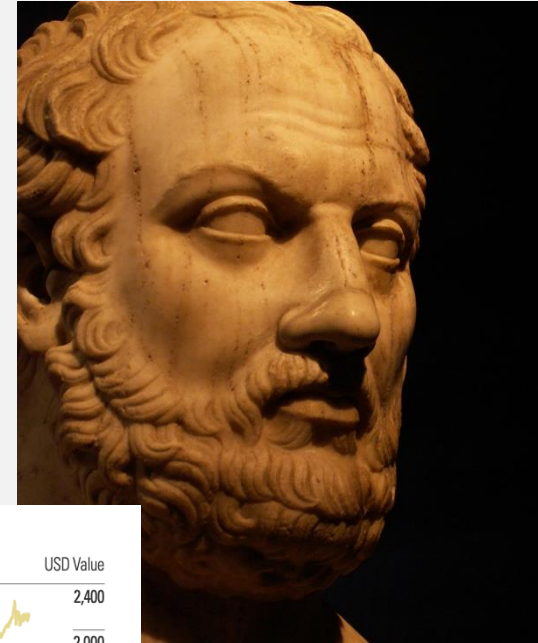
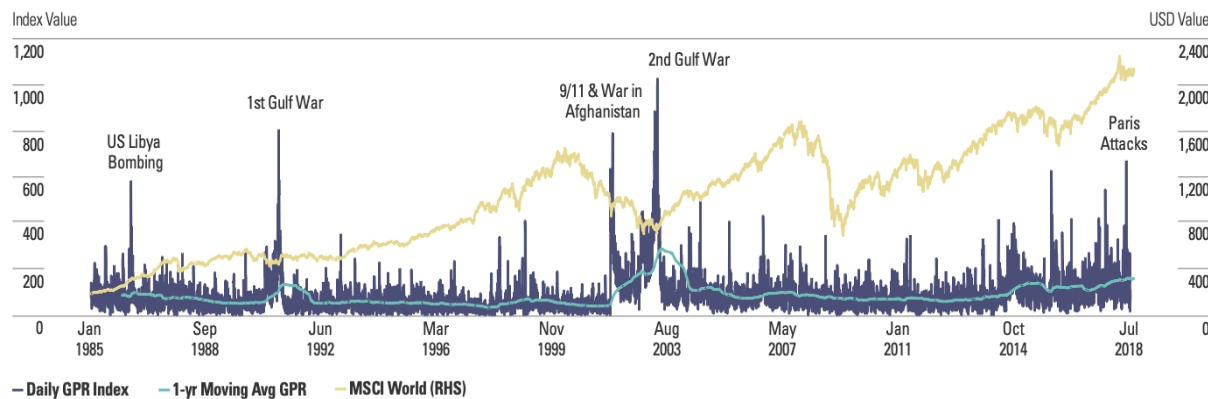
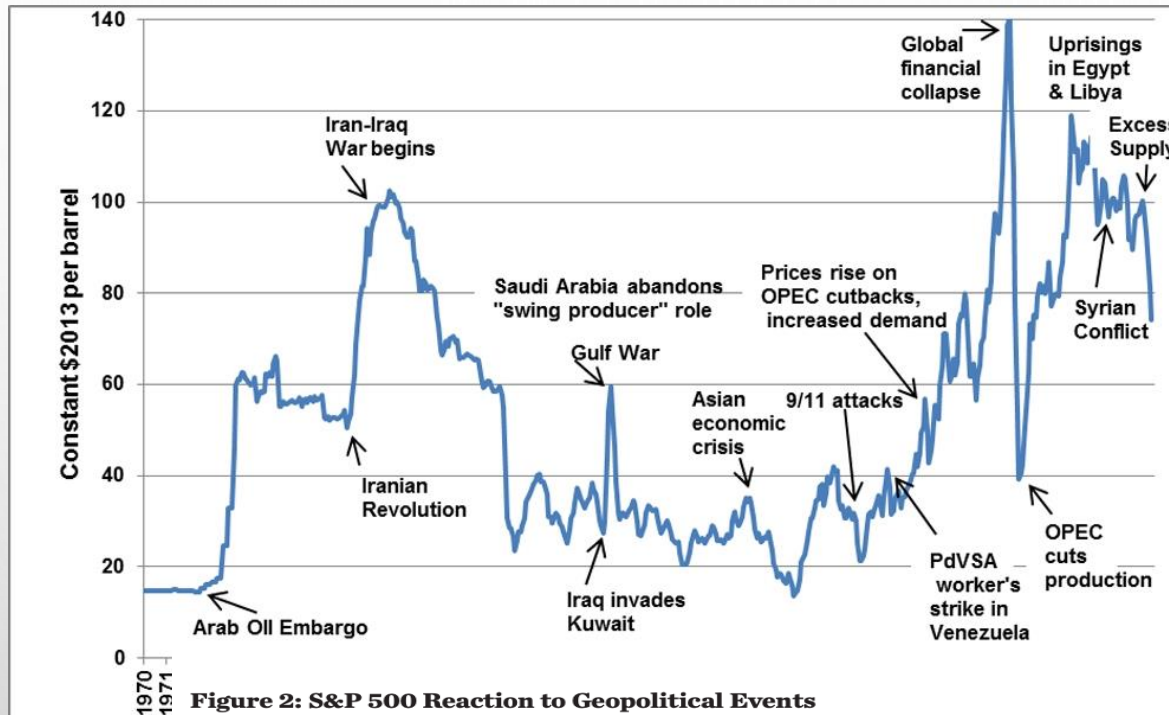


Figure 1: Geopolitical Risk Index versus MSCI World 1985–2018



Source: State Street Global Advisors (SSGA) Research using GPR index data from <https://bc.edu/matteo-iacoviello/gpr.htm#home> and MSCI World data from Bloomberg.  
Past performance is not a guarantee of future results.

# [GEO]POLITICAL RISK TO FINANCIAL MARKETS



Event	Dates of Market Reaction	Cumulative Decline During Reaction (%)	Performance, 1 Month After Reaction (%)	Performance, 1 Year After Reaction (%)	Trading Days to Recoup
US Operation in Cambodia	29 April–14 May 1970	-7.8	-1.40	+35.5	75
October War & Oil Embargo	6–26 October 1973	-1.4	-13.3	-37.1	1,576
Iranian Hostage Crisis	2–7 November 1979	-2.6	+7.7	+29.3	3
US Invasion of Panama	13–19 December 1989	-2.9	-1	-3.6	7
Iraq Invades Kuwait	2–23 August 1990	-13.6	-0.8	+28.4	115
US Embassy Bombings in Africa	7–14 August 1998	-2.5	-3.1	+25.2	2
9/11 Attacks	11–21 September 2001	-11.6	+12.8	-13.7	24
Arab Spring Reaches Libya	20 February–19 March 2011	-4.8	+2.0	+6.4	27
Annexation of Crimea by Russia	February–March 2014	negligible effect on markets			

Source: SSGA Research, Bloomberg. Past performance is not a guarantee of future results.

# MAIN THEMES IN CORPORATE POLITICAL RISK

Fixed capital vs. (more) mobile capital

“Strategic” sectors (home vs. host)

Physical Assets, Operations, Customers

Wide Universe of Fiscal & Regulatory Risks

FDI & Currency



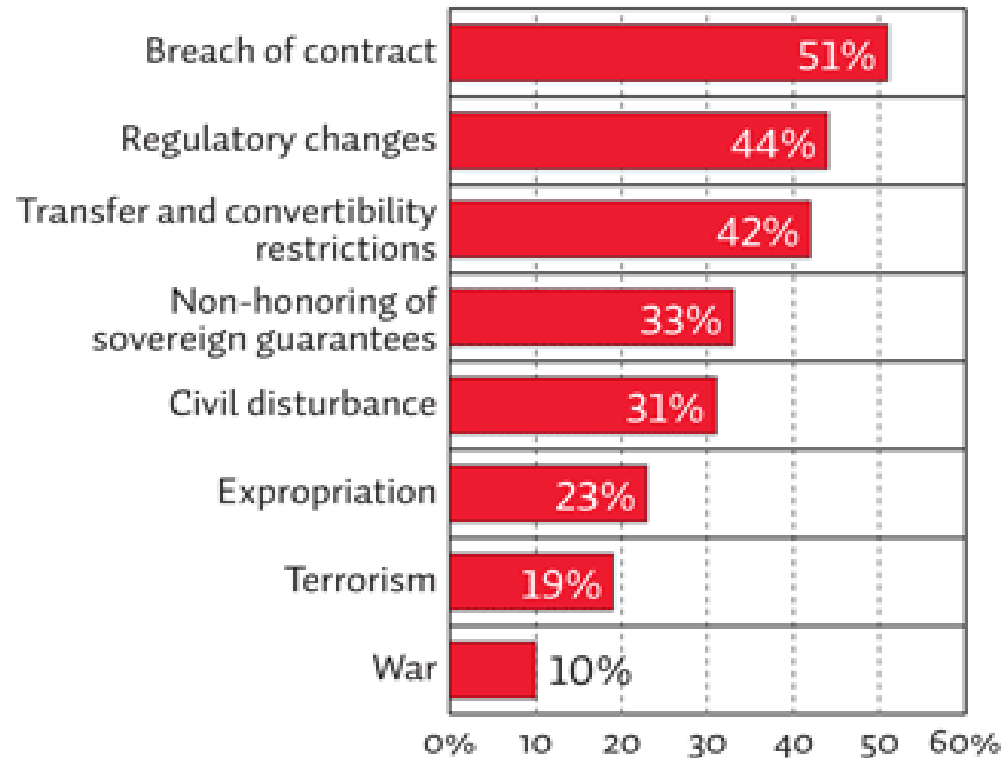
# POLITICAL RISKS FOR CORPORATES

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

# POLITICAL RISKS FOR CORPORATES

## THE TOP EMERGING-MARKET HAZARDS

THE MOST COMMONLY CITED POLITICAL RISKS IN DEVELOPING COUNTRIES OVER THE NEXT THREE YEARS

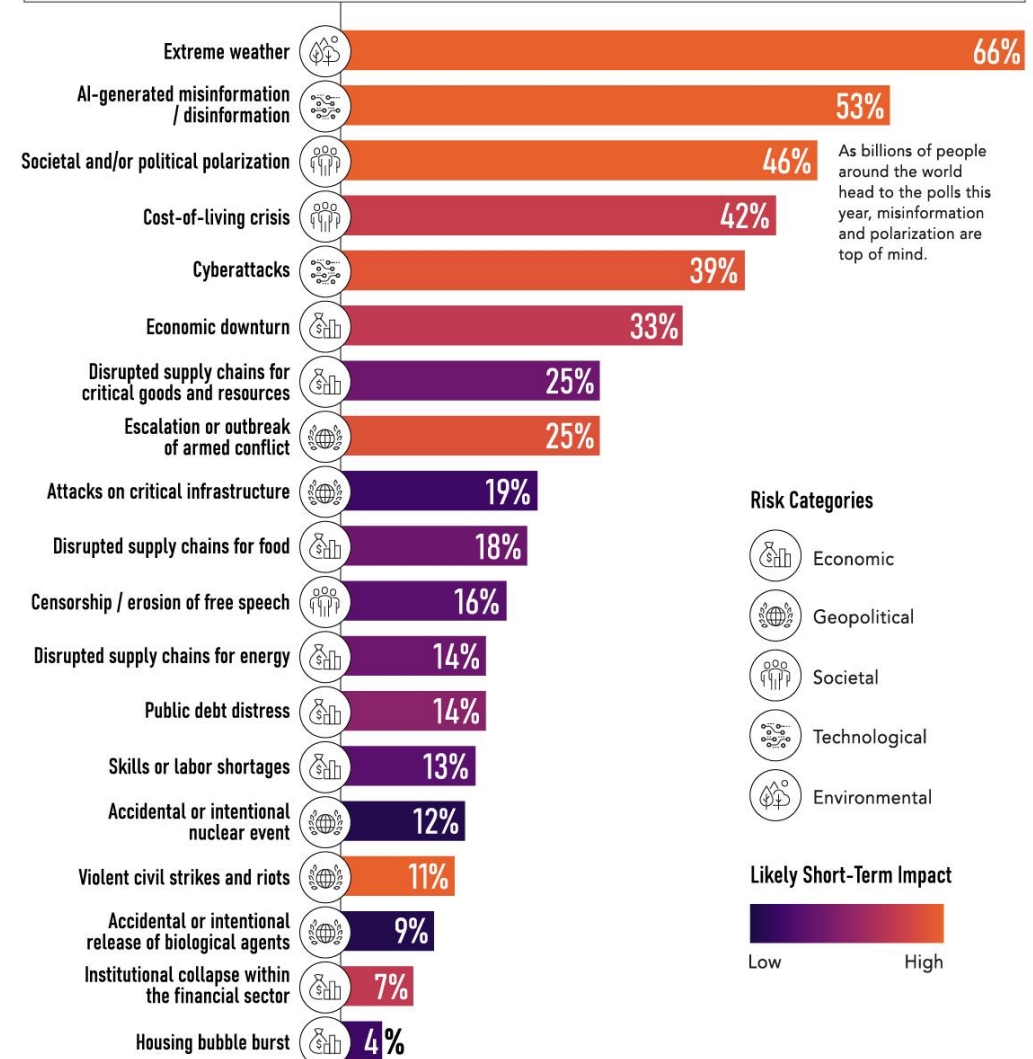


Source: Multilateral Investment Guarantee Agency survey of investors, 2010

## THE TOP GLOBAL RISKS IN 2024

The World Economic Forum surveyed 1,490 leaders on the top global risks in 2024 and their potential scale of impact.

Q Please select up to five risks that you believe are most likely to present a material crisis on a global scale in 2024.





# REGULATORY RISKS

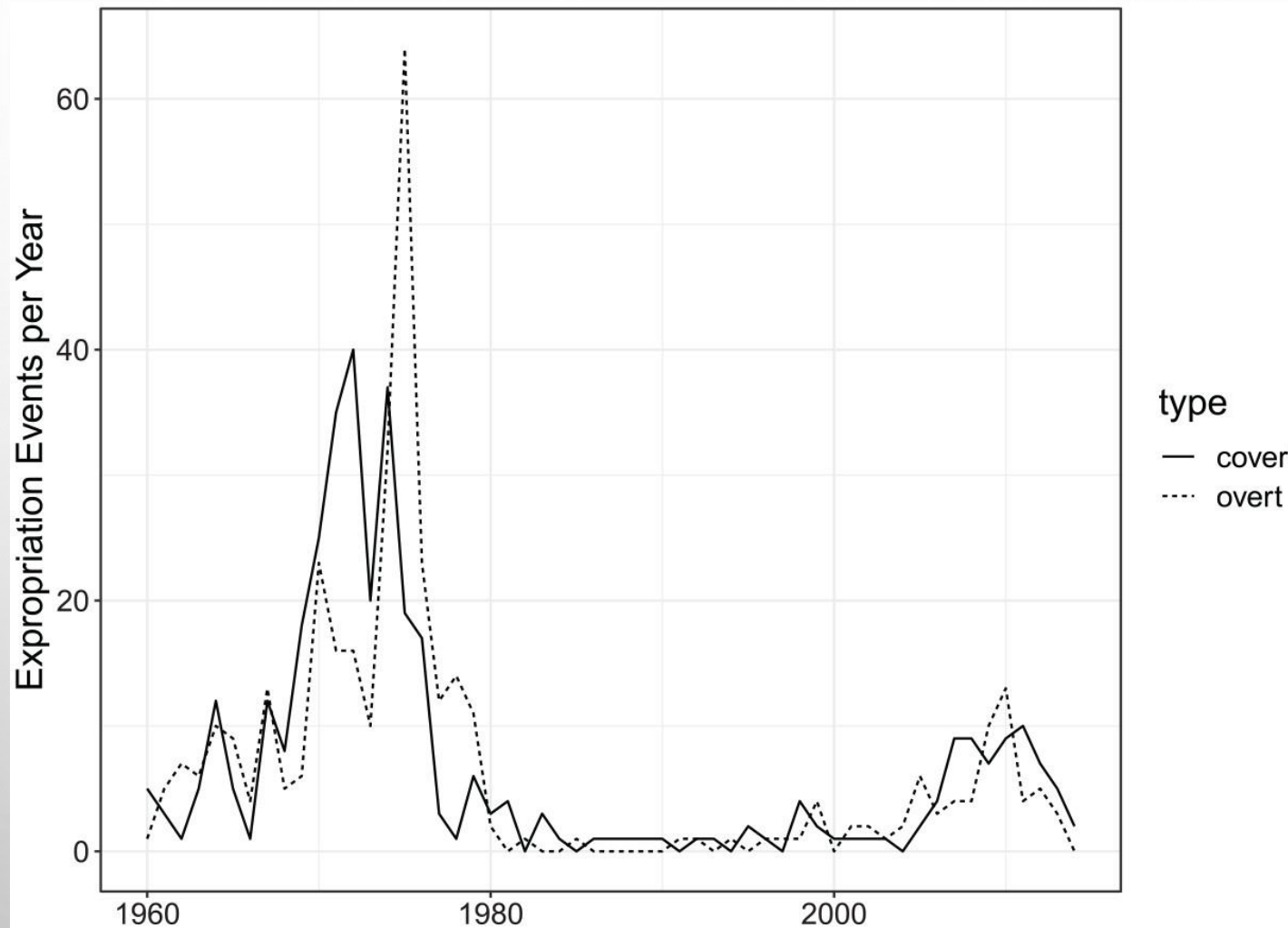
## • TYPES

- Currency convertibility / controls
- Trade barriers
  - Tariff
  - Non-tariff
- Equity restrictions / quotas
- FDI restrictions
- Labor Regulations
- Environmental Regulations
- Community Development Regs

## • DRIVERS

- Development models / Ideologies
  - State Capitalism
  - Developmental State
  - Strategic Sectors
- Geopolitical Rivalries
  - See above
- Institutions / Rule of Law
  - Capacity / Effectiveness
  - Regulatory discrimination
  - Bureaucratic / State capture
- Local Politics
  - Protection of vested interests
  - Panics and mentalities

# POLITICAL RISKS FOR CORPORATES



Esberg, J., & Perlman, R. (2022). Covert Confiscation: How Governments Differ in Their Strategies of Expropriation. *Comparative Political Studies*, 56(1), 3-35.

# EXPROPRIATION AND ‘CREEPING’ EXPROPRIATION



# PHYSICAL & SECURITY RISKS

## **War, civil war, insurgency, violent protests, etc**

- Physical Assets / Corporate Infrastructure & Personnel
- Supply Chain / Transport Infrastructure
- Customers
- Case Study: Libya, Iraq, Nigeria

## **Sanctions & Boycotts**

- Operations / Supply Chain
- Customers
- Case: Russia

## **Strikes**

- Physical Assets / Corporate Infrastructure & Personnel
- Case: South Africa

# RISK MITIGATION

## Political Risk Insurance

- Currency Convertibility/Transfer
- Expropriation
- Destruction of Property due to political violence
- Renege on Sovereign Guarantees



## Treaties, Trade Deals and Arbitration

- BITs
- ICSID



## Free carry / B-O-T contracts / PPP

- Mumbai-Pune Expressway



# RISK MITIGATION

**Strategic Market Entry**

**Joint Ventures**

**Corporate Diplomacy and CSR**



## Mode of entry of International Expansion

Year	Country	Mode of Entry
1991	Mexico	50% Joint Venture Cifra
1994	Brazil	60% Joint Venture Lojas Americana
1994	Canada	Acquisition Woolco (weak player)
1995	Argentina	Wholly owned Subsidiary
1996	China	New opening, JV, Acquisition
1998	South Korea	Adquisition
1999	U.K.	Acquisition of ASDA
2002	Japan	Acquisition Seiyu
2002	Germany	Acquisition of Wertkauf and Spar
2007	India	Joint Venture
2011	Southern African Countries	Acquisition of Massmart Holding Limited

