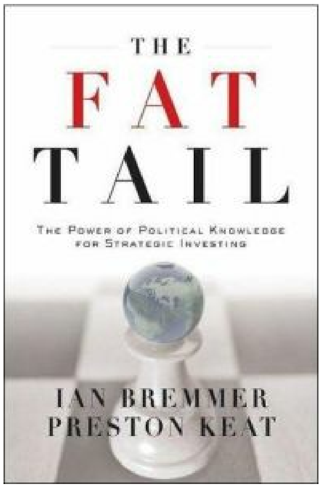

Book The Fat Tail

The Power of Political Knowledge for Strategic Investing

Ian Bremmer and Preston Keat
Oxford UP, 2009
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Recommendation

This timely, concise book provides an introduction to managing and assessing international political risk. Ian Bremmer and Preston Keat downplay the jargon and specialists' terminology, so their book is easily accessible. However, the authors do presume that readers have at least a nodding acquaintance with the facts of international business life. Many recent risk management books focus more on managing market risks. Political risk, while less quantifiable, still presents a challenge and demands effective administrative attention. This book is a valuable addition to the literature on risk management. Its great merit, *BooksInShort* reports, is that it provides a framework for understanding the nature of political risk and a variety of approaches to managing it.

Take-Aways

- "Political risks" stem from domestic or global political events that affect asset values.
- The tails of the political risk bell curve are fat: Calamitous events are more likely than most people think.
- Forecasting "unknown unknowns," events even experts can't know about, is difficult.
- Conversely, many political risks are predictable because politicians and other involved parties publicly announce their agendas ahead of events.
- Strategies for dealing with political risks include "isolating, smoothing, warning, agility, alliances, environment shaping" and using a "devil's advocate."
- Closely analyze the nature of your company's geopolitical environment.
- If your firm is based overseas, give locals a stake in its success.
- To gauge political turbulence, use a combination of quantitative indicators, such as inflation rates, and qualitative assessments, such as corruption or urbanization.
- Decisions that seem irrational in light of economic considerations may be rational with political considerations. Recognize which considerations dominate each situation.
- Although insurance is not a panacea for political risk, it does play an important role.

Summary

Political Risk

The Russian default of 1998 was a stark reminder that devastating events occur with greater probability than a standard, normal distribution suggests. The tails of the political risk bell curve are not thin, indicating a low likelihood of catastrophic upheavals, but fat, meaning a potentially cataclysmic political event is likelier to occur than many imagine. However, corporate decision makers frequently give such fat-tail events much less attention than they merit, mostly because political risks seem complicated, unpredictable, daunting, unquantifiable and, thus, unmanageable.

> "What do we mean by a 'fat tail'? Fat tails are the unexpectedly thick 'tails' – or bulges – that we find on the tail end of distribution curves that measure risks and their impact."

A political risk is any political event that might cause a change in asset values or financial performance. This can be a regulation, a government ruling or a more significant trauma, like a revolt or a terrorist attack. Laws do not mandate political risk management, but ignoring it is imprudent. Political risk exists everywhere, even in developed nations, but it is complex. No one can predict the precise consequences of any given constellation of political forces, but experts often can foresee that major losses are possible or probable. Political risk stems from numerous sources, and risk managers can choose among many tools and analytical approaches to assess it. However, risk assessment is pointless if communication failures and bureaucratic biases keep decision makers from getting the information they need to manage the risks. The 9/11 terrorist attacks are a salient example of the consequences of such biases and failures, in this case by U.S. intelligence.

The Unknown

The conquest of the Aztec empire by a small band of Spanish conquistadors illustrates one of the most important challenges in political risk management: dealing with the utterly unpredictable. Former U.S. Defense Secretary Donald Rumsfeld spoke of "unknown unknowns – the ones we don't know we don't know." Although many scoffed at him, recent history includes numerous examples of such unknowns; from the fall of the Berlin wall to the Islamic world's boycott of Denmark's Arla Foods after a Danish newspaper printed cartoons lampooning the Prophet Mohammed.

> "Any political event that could (directly or indirectly) alter the value of an economic asset can be considered a political risk."

Yet, many political risks are knowable and predictable. In 2005, when Uzbek Central bank shut down Business Bank, the press claimed the closed bank had no warning. But, its investors included the European Bank for Reconstruction and Development, which had a bad relationship with Uzbekistan's government, as well as a group planning to compete against the president's daughter in the mobile phone sector. Therefore, Business Bank's closure hardly qualified as a "black swan" (that is, a highly unlikely event with a tremendous impact). As this case illustrates, often the unknown unknowns are, in fact, not unknown, but ignored.

> "Perhaps the most difficult aspect of all risk management is providing accurate probabilities for events that are both rare and potentially devastating."

Although no standard, invariable model exists for dealing with unknown events, useful methods and approaches include:

- **"Isolating"** – "Don't put all your eggs in one basket" sums up this approach.
- **"Smoothing"** – Distribute risks along the calendar or across the map.
- **"Warning"** – Early detection systems can give advance notice of developing risks.
- **"Agility"** – Maintain a dexterous, flexible infrastructure to improve responsiveness.
- **"Alliances"** – Strategic allies can help defuse criticism and political attacks.
- **"Environment shaping"** – Invest in PR and lobbying to restructure public opinion.
- **"Devil's advocate"** – Test your conclusions against other viewpoints. This might have helped banks that invested in subprime mortgages due to dubious models.

The Geopolitical Stage

Geopolitical events can transform the economic world. Eighteenth century European wars, especially the French invasion of the Netherlands in 1794, helped shift the center of financial gravity from the Amsterdam Bourse to the London Stock Exchange. World War I helped move financial power from London to New York. The Soviet Union's decision to remove its deposits from U.S. banks, helped create the euro market. Analysis of such geopolitical risk is frustrating, often due to the "duration" of threatening events, which can take hundreds of years to unfold. Interest group bias also muddies risk analysis. Further, complex geopolitical risks do not occur in isolation. Some movements, like arms races, affect each other in "feedback loops" and vicious circles.

> "Risk managers can try to eliminate the threat, minimize its likelihood, isolate the event or avoid the risk altogether."

So, companies usually cannot determine the direction of geopolitical events, but they can and should prepare to deal with the consequences. Most corporations operate on a much shorter time horizon than the time frame of geopolitical risks. They do not designate internal divisions to analyze and manage geopolitical events, and they think of geopolitical risk in terms of a normal distribution. Thus, they are not equipped to manage it. To boost their capabilities, they should recognize the existence and probability of risk events, and structure their operations to minimize the impact, for example, by moving out of threatened areas. Companies should plan various risk scenarios, so they are ready to act, and should insure against such risks as expropriations and embargoes. Insurance has its limitations, but it has a role in the political risk management toolkit.

> "There is no template for dealing with the unknown. The cultivation of paranoia can help. Adaptability is vitally important."

Political events can change markets directly and indirectly. Devaluations, default, expropriations and other such issues directly alter market prices and asset trading. Wars, government shakeups, elections and policy shifts all have an indirect effect. To analyze the market impact of political risks, consider these issues:

- **What is the nature of the regime?** – Some countries are "best bets," stable, disciplined, democratic and open to globalization. Others are "potential backsliders," still struggling with instability and lack of security. Some are "resource nationalists," with large reserves of strategic natural resources that often impede the development of democracy and independent institutions. China and its ilk are "authoritarian globalizers," who hope to benefit from globalization without losing any power.
- **What ideological forces are at work?** – Do not confuse election rhetoric with governing policy. Brazil's President Lula da Silva has governed more moderately than anticipated. Legal or institutional considerations can constrict a regime's governing options.
- **What is the composition of the government?** – Know who is in charge of what fields. Turkey's AKP won market confidence with its disciplined economic modernization. The press raised concerns about the party's Islamist roots, but investors looked at its record.
- **How transparent is the government?** – Governments sometimes maneuver information to improve a country's image. Argentina's government manipulated

reports of inflation.

Strife, Rebellion and Failing States

Iran's 1978 Islamic revolution was sudden, but not utterly unpredictable. Countries with a poor, young population are often volatile. To estimate the likelihood of instability, combine quantitative indicators (infant mortality, inflation rates) with qualitative assessments of factors like corruption or urbanization. Here are five categories of domestic instability:

1. **"Revolutions"** – In a revolution, a society's values, institutions, structures and government all change suddenly. Revolutions in Russia in 1917 and in Cuba in 1959 led to expropriations and nationalization. But, the Czech "Velvet Revolution" in 1989 replaced a Communist government with a democratic, market-oriented, liberal regime. Predicting where revolutions are not likely is as important as predicting where they are.
2. **"Civil wars"** – Internal warfare is most likely to occur in poor states with ethnic fault lines and weak governments. In April 2007, twenty civil wars were underway worldwide. Companies naturally avoid civil wars but sometimes the nature of their businesses makes that impossible. Tea Importers, Inc. stayed in Rwanda through its civil war, despite theft, looting and shelling of its processing plant. "You can't move 15 million tea bushes. That's where they are, so that's where we are," said an executive. Political risk insurance helped the company deal with its losses. Skanska, a Swedish firm, operates in numerous unstable countries by managing political risk at the project level. After its involvement in "conflict diamonds" damaged DeBeer's reputation, the diamond conglomerate began repositioning itself in more stable countries to establish a new brand identity.
3. **"State failure"** – Failing states are legally impotent and are beset by murders, genocide, refugees and humanitarian catastrophes. Some firms, like Zimplats, a Zimbabwean platinum extractor, continue to operate even in these situations. These companies may have to supply infrastructure like electrical power. Some may keep skeleton staffs on hand and rebuild the workforce when conditions improve.
4. ***"Coups d'état"*** – Generally executed by military forces, *coups d'état* may involve no violence or killing whatsoever. Corporations often find them less risky and disruptive than revolutions or civil wars. They often occur when the head of state is abroad. Successful coups are generally less destabilizing than unsuccessful coups.
5. **"Riots"** – Mob outbreaks of civil unrest can be spontaneous, extremely destructive and very difficult to forecast. Riots in Tonga in 2006 still depress its economy and tourism.

> "Terrorism will be with us for a long time, if for no other reason than that there will always be disaffected groups and individuals with access to weapons."

Companies should prepare for instability, civil strife and political disputes. Chrysler recognized the risk of expropriation in Peru and reorganized its supply chain so that its plant was no longer essential. Shell operated effectively in high-risk Nigeria by hiring and training local people, many of whom wound up in government service. Shell's network became a valuable asset. After Greenpeace targeted Credit Suisse as part of its campaign against Royal Dutch Shell, the bank developed a political risk monitoring and reporting system to cope with threats to its reputation.

> "Watch the young. Few of the elderly in any society enjoy manning barricades or throwing Molotov cocktails at police."

Terrorism will endure because all it needs is a "disaffected" person or group with "access to weapons." Although irrational, its tactics, such as suicide bombing, may seem logical to its users. Governments find terrorism hard to handle. Policing helps, but "the police must succeed every time; a terrorist group must succeed just once." Military action against terrorists can backfire by raising the profile of an inconsequential group. Accommodating terrorists may yield short-term benefits, but long-term, it is an incentive for more terrorism.

The Risk of Asset Seizure and Hostile Regulations

Expropriation has become less common, but it still accounts for most political risk insurance claims by the U.S. Overseas Private Investment Corporation (OPIC). Expropriation may occur due to political pressure, ideology or nationalism. Generally, it is not a sound economic strategy, though it may give a government quick access to short-term flows of funds. Thus, natural resource expropriation is likelier when prices are high. To deal with the risk of expropriation, companies should ensure that many domestic and international interests have stakes in their projects. Joint ventures, while they have risks, can be useful. Contracts can offer disincentives to expropriation. For example, "build, operate and transfer" agreements ensure that the investment will belong to the government one day anyhow, so it has no reason for premature expropriation.

> "Management of political risk requires a dynamic worldview that includes a combination of flexibility, creativity and demonstrated expert knowledge."

Regulatory risk can be costly even in highly developed economies. Under domestic political pressure, governments may tighten regulatory screws or bar investments in certain sectors. Mexican entrepreneur Carlos Slim gained control of the nation's telecommunications regulations by putting his people in influential places.

> "Warning systems and political forecasting can also be used to better prepare for specific contingencies."

"Obsolescent bargaining theory" offers a framework for understanding the shifting balance of power between governments and multinationals. A government may be in a weak position when it offers incentives to attract a multinational, but once a business invests, transfers technology and trains local workers, the citizenry may dispute the incentives and demand a new deal. Firms can lobby the government, threaten to leave or involve international arbiters, but the utility of these defenses varies. Mining and oil firms have less agility than light manufacturers or software firms.

> "As a general rule, the most successful man in life is the man who has the best information." – Benjamin Disraeli

Often, corporate and government policymakers have access to the data they need to assess and manage political risk, but their ideological and cognitive biases may prevent them from decoding the evidence. The managerial assumption that local people see their interests the same way the company does is a dangerous cognitive bias. What is rational to someone who views the world from a market perspective may be irrational to someone who does not. Political risk management should be part of a holistic risk management system. While harder to quantify, political risks are no less real and no less consequential than other risks. Moreover, globalization is likely to make this dimension of risk management even more crucial in the years ahead.

About the Authors

Ian Bremmer, author of *The J Curve: A New Way to Understand Why Nations Rise and Fall,* is President of the Eurasia Group, where **Preston Keat** is Director of Research.