Political risk assessment: arguments for and against

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The purpose of this essay is to critically assess the importance of undertaking political risk assessment prior to entering a country. The essay will look at both arguments for and against political risk assessment. The external political environment is now increasingly recognised by MNCs as an important factor which has lead to the increase in emphasis on political risk assessment as a managerial function (Yin, Sikorski & Phuong, 2003). Political risks faced by firms can be described as the risk of a strategic, financial, or labour loss for a firm as a result of macroeconomic and social policies or events related to political instability like terrorism or war. In the essay political risk is assessed in terms of macroeconomic policies, social policies and external events to develop the merits of political risk assessment. The disadvantages of political risk assessment are then discussed before arriving at a conclusion about the validity and importance of political risk assessment in today's dynamic and global environment.

Firstly, the value of political risk assessment can be inferred from the Government's existing and expected macroeconomic policies. Specific regulations and their potential impact on firms will be assessed. According to Nel (2009), if the Government imposes an equity restriction, the firm may be forced to share its equity with other firms; for example if the Government forbids full ownership of a company by multinationals, firms which want to enter as wholly-owned subsidiaries may have to find local partners by force which may give rise to conflicts and withdrawal of the firm from the particular country in the long-run. Government regulations can also restrain certain types of hiring, with respect to investor country nationals or with respect to ethnic group hiring, amount of personnel in management

positions, and fixed daily hours of employment. The Government can also exercise tax discrimination and decide to enforce its laws on certain parties only and not on others if it adopts a nepotistic approach favouring some organisations to others and thus giving a competitive edge to a firm's competitors as is the case in South Africa where multinationals are always subject to unfair treatment by the Government (Venter, 2005).

In addition, the Government may impose a repatriation restriction which will restrict the transfer of funds by Multinationals to their home country. Moreover exchange controls imposed by the Government will limit the amount of foreign currency firms can exchange in a day which may affect the cash flow of the business. New and unexpected tariffs, often resulting from confrontations between governments and economic systems, are one of the significant add-on costs that can affect the firm which wants to import raw-materials from other countries and export its finished goods to other countries (Nel, 2009). Clark, Tunaru (2001) presented a model that measures the impact of political risk on portfolio investment. They argue that portfolio investment values and cash flows are significantly affected when political change causes unanticipated discontinuities in the business environment.

Secondly, unexpected events and conflicts may influence the profitability and well-being of a firm in a foreign country. A study by Morales, Gamberger, Smuc & Azuaje (2009) proposed the degree of political stability as the new and important determinants of FDI entry decision making. Moreover the research reults of another study by Yin, Sikorski & Phuong (2003) suggests an increase in the perceived level of political risks of investing in a country when it is subject to sociopolitical instability like riots, strikes and

assassinations merge. Governmental ties with other countries also influence political risk; for example terrorism has largely affected businesses in the US due to the twin towers bombings and businesses in India and Madrid due to train bombings. Terrorism appears to affect the level of economic activity in certain countries. For example, after the outbreak of terrorism in Spain's Basque region in the 1960s, per-capita GDP fell about 10% relative to a control region without terrorism. (Czinkota, Knight, Liesch & Steen, 2010).

Over the years, many frameworks have been used by companies to analyse political risks. By the late 1970s three methods of country risk assessment were developed which are still in use today: the qualitative report (fully or structured), the checklist or rating and quantitative methods. The fully qualitative analysis gives information in a nonstandardized, descriptive format. This format allows freestyle evaluation of a country's economic, political and social conditions. However, it does not readily allow comparisons among countries and the discussion tends to be retrospective and dependent upon the subjective, personal judgments of the analyst who writes the report. The structured qualitative format is very similar to the fully qualitative method except its format is standardised and augmented with economic statistics to facilitate country comparisons and to assess a country's performance over time (Schroeder, 2008). On the other hand, a study examining the perceptions of decision-makers of Singapore companies operating in ASEAN measures political risk by an assessment of how managers perceive the sociopolitical conditions in the host country and the likely effect on the business climate (Yin, Sikorski & Phuong, 2003).

Despite the clear benefits of undertaking political risk assessment, it may not be a very useful tool to all managers and in all investment situations. Firstly, a study by Nel (2009) criticises the discipline of political risk as being a soft science which is difficult to measure and questions the validity of the emperical analysis of political risk. The study further analyses the reliability of current risk assessment approaches to accurately measure political risk. Secondly, Yin, Sikorski & Phuong (2003) argues that past political risk literateure over-emphasise on the negative implications of political risk. According to them, managers should look at both foreign political opportunities as well as threats and they should not think of political risk as potentially having a purely negative impact on their businesses. Past emphasis on negative political risk may be a culture-bound approach that has been drawn from the assumptions of American business culture regarding the adversarial relationship between businesses and Governments.

Therefore, it can be concluded that firms which undertake poilitical risk assessment tend to ignore the potential benefits of future Governmental actions on their business. The uncertainties associated with a foreign environment can be interpreted as political risk. Uncertainty evaluation is itself subjective in the sense that the decision situation, environmental events and their impact on the organisation, cannot be objectively defined; the situation is as perceived by the decision-maker. Therefore, it may exist not in the outside world but in the eye and mind of the beholder. Because of the importance of information processing and its effect on political risk,

analysing political risk should also focus on identifying where managers' perceptions of politically related risks seem to be distorted or biased.

Thirdly, too much emphasis on political risk assessment tends to destroy business optimism and the willingness of managers to take risks by investing in a country with a low to medium risk profile. They tend to overlook the actual opportunities offered by the country in terms of its customer base, resources and other factors. They are more stringent in choosing full control modes like Foreign Direct Investment and prefer to look for local partners. This can be illustrated by the case of South Africa whereby the Government has been prudent and pragmatic in macro-economic management since it came to power. In 2005, the macro political risk image of South Africa was portrayed as being of a medium risk category. The serious political risks, such as war, coup d'etat, violent racial, sectarian and ethnic conflict were considered low. South Africa's history of political unstability has led to a psychology of deep-seated distrust by wealthy foreign investors in the long term political risk of the country (Venter, 2005). Fourthly, managers tend to interprete the results of political risk assessment wrongly. They look at the results as a whole and do not attempt to link them to their particular industry and company.

From the above discussion, it can be concluded that political assessment is an important tool for managers when deciding to enter a country. It gives them an insight about the potential impact of Government's major social and macroeconomic policies on their businesses. Policies like tax changes, tariffs and exchange rate controls have significant impact on businesses' profitability. Other factors which are usually not under the Government's

control can impact businesses such as war, strikes. However, the reliability of political risk assessment have been questioned as it is difficult to measure and is often interpreted by managers in the wrong way by making them focus too much on the negative impact of Government’s actions and ignore opportunities. From the above, it can be concluded that political assessment is a must before entering a country as the factors mentioned above can have a significant impact on a business, however managers should be careful not to overestimate results when political assessment is carried out.