Political Risk: Countering the Impact on Your Business

by Ian Bremmer

Executive Summary

- Business decision-makers must understand the political dynamics within the emerging market countries in which they operate.
- We can measure a state's stability—the ability of its government to implement policy and enforce laws despite a shock to the system.
- Essential to managing any type of risk is the development of a detailed and effective hedging strategy.
- Companies should not accept too much risk exposure within any one country or region.
- Rules of the game can change quickly in developing countries, and the cultivation of "friends in high places" isn't always a strong enough hedge.
- Operating in some developing countries comes with reputational risks at home.
- Too many companies have historically relied for insight into local politics and culture on employees who have lived in a particular country for only a short time—or have even merely traveled there.
- Those doing business in developing states need to have credible emergency response plans in place when events outside their control shut down supply chains, prevent local workers from coming to work, or otherwise disrupt operations.
- Developing strategies to recruit and train local managers serves several useful purposes.
- Devoting a share of profits to investment in local schools and universities, infrastructure, and charities can generate stores of goodwill, which is sometimes essential for cooperation with local workers and government officials.
- In some countries, foreign companies should be wary of transferring proprietary information to local partners or developing it inside the country.
- A foreign firm must look beyond what its local competitors are capable of producing today. It must anticipate how those capabilities are likely to develop over time.
- Conditions sometimes force companies to cut their losses and head for the exit. Ensuring that process is as painless and inexpensive as possible forms a crucial part of any sound risk mitigation strategy.
- Political risk can be managed. It should not be avoided altogether.

Introduction

Over the past several years, and across a broad range of companies, corporate decision-makers seeking opportunities overseas have learned that it is not enough to have a knowledge of a foreign country's economic fundamentals. They also have to understand the forces and dynamics that shape these countries' politics. This is especially true for emerging markets, where politics matters at least as much as economic factors for market outcomes. Of course, understanding that political risk matters is one thing. Knowing how to use it is another.

Stability

Starting with the basics, when committing a company to risk exposure in an emerging market country, it's essential to understand how political risk impacts the underlying strength of its government. There are two key elements to consider: stability and shock. Shocks are especially tough to forecast, because there are so many different kinds and because shocks are, by definition, unpredictable. We can't know when an earthquake will strike Pakistan, an elected leader will fall gravely ill in Nigeria, or a previously unknown group will carry out a successful terrorist attack in Indonesia.

But we can take the measure of a state's stability, which is defined as a government's ability to implement policy and enforce laws despite a shock to the system. The global financial crisis, a potent shock, has inflicted heavy losses on Russia's stock market. But Prime Minister Vladimir Putin has amassed plenty of political capital over the past several years, and President Dmitry Medvedev, his handpicked successor, basks in Putin's reflected glow. Neither need fear that large numbers of Russian citizens will turn on them

anytime soon. In addition, a half-decade of windfall energy profits has generated more than $500 billion in reserves, ready cash that can be used to bail out stock markets, banks, and, if necessary, an unpopular government. That's why, for the near-term, Russia will remain stable.

Pakistan is a different story. The country's newly elected government has a range of rivals and enemies. Inflation, power shortages, and a wave of suicide attacks have undermined the ruling Pakistan Peoples Party's domestic popularity. The financial crisis leaves the country at risk of debt default, forcing the government to negotiate a loan package with the International Monetary Fund that could impose austerity measures—the kind that helped topple civilian governments in Pakistan in the 1990s. The country is less stable than Russia, because it is much more vulnerable to the worst effects of shock.

President Luiz Inácio Lula da Silva has bolstered Brazil's stability over the past several years by quelling fears of left-wing populism with responsible (and predictable) macroeconomic policies. The Chinese Communist Party's ability to generate prosperity at home via three decades of successful economic liberalization has helped its leadership to build durable near-term stability.

But Nigeria's future stability remains at the mercy of President Umaru Yar'Adua's failing health as historical tensions between northern Muslims and southern Christians combine with ongoing security challenges in the oil-rich Niger Delta region to prevent his government from building a national reputation for competence, vision, and strength. Iran's theocrats and firebrand president Mahmoud Ahmadinejad have effectively used the international conflict over the country's nuclear program to shore up support for the government in the face of high inflation and gasoline rationing. Underlying political factors in all these countries have a substantial impact on stability—and, therefore, on the country's business climate.

Diversify

Yet it is not sufficient to possess broad insights into state stability. If corporate decision-makers are to design a credible business strategy that mitigates political risk and maximizes profit opportunities, they have to look deeper at the vulnerabilities that are peculiar to each country, each province, each community. Essential to managing any type of risk is the development of a detailed and effective diversification strategy. Given the political volatility within many developing world states—countries that will generate a large share of global growth over the next several decades—this kind of strategy is especially important. Even within a country as relatively stable as China, a closer look at internal political dynamics can identify various kinds of risk.

Two years ago, US officials worried publicly over a spike in sales of Russian arms to China. Dire predictions of a developing Russian–Chinese military axis became commonplace. But in 2007, sales of Russian arms to China fell by some 62%. Was it because the two governments had some sort of behind-the-scenes falling out? Did the Chinese leadership suddenly doubt the quality of Russian-made products? In reality, the arms sales slowed because China had mastered the design of many of the weapons, and Chinese companies began to produce them in sufficient quantities that demand for foreign-made weaponry fell sharply.

This is a cautionary tale, one that reminds us that any company betting heavily on long-term access to Chinese consumers (or to customers in many other developing countries) may be making a big mistake. There is plenty of money to be made in China for the next several years, but putting too many eggs in a single basket remains as risky as ever. For businesses with supply chains in China and other developing states, it's also important to build redundancies that are not overly exposed within any one region within these countries.

There are other, less obvious, components of a solid diversification strategy. Multinational companies should use all the leverage that their home governments and international institutions can provide to ensure that the governments of the countries in which they accept risk exposure protect their intellectual property rights, enforce all local laws intended to safeguard their commercial interests, and maintain open markets. Rules of the game can change quickly in developing countries, and the cultivation of "friends in high places" isn't always by itself an effective plan.

Know the Country

Gaining insight into a country's political, economic, social, and cultural traditions is essential for a successful risk mitigation strategy. Where should this insight come from? Too many companies have historically relied on employees who have lived in a particular country for only a short time—or may even have done no more than travel there. Turning to the guy who backpacked through country X during college for useful information about its politics and culture—not as rare a phenomenon as you might think—is no substitute for the knowledge that can be gained from local workers themselves and from trained political risk analysts.

Design an Emergency Response

Generally speaking, emerging market countries are more vulnerable than rich world states to large-scale civil unrest, public health crises, and environmental disasters. Those doing business in developing states need credible emergency response plans in place when events outside their control shut down supply chains, prevent local workers from coming to work, or otherwise disrupt operations. Some businesses have designed technology plans that allow workers to work from home. In cases when circumstances force foreign workers to leave the country, locals should have the necessary training and skills to assume their responsibilities for an extended period. The added expense and time for training are well worth the cost. In some countries, they're essential.

Invest in Local Workers

Developing strategies to recruit and train local managers serves several useful purposes. First, it gives the host country government an investment in the success of a foreign-owned business. Every job created by a foreign firm is one that local government doesn't have to create. All governments want to keep unemployment at a minimum. Second, it gives local citizens a stake in the foreign company's success and helps to build solid relationships within the community. Some multinational firms have formed mutually profitable partnerships with local colleges and universities that give companies a fertile recruiting ground and ambitious students opportunities for work.

Invest in Their Communities

Devoting a share of profits to investment in local schools and universities, infrastructure, and charities can generate stores of goodwill, which is sometimes essential for cooperation with local workers and government officials. Yet, sensitivity to the local culture matters too. In many developing states, suspicions that Western (especially American) companies have a political or ideological agenda can undermine efforts to promote trust. Contributions to local quality of life should be seen to come without strings attached.

Protect Intellectual Property

In some countries, foreign companies should be wary of transferring proprietary information to local partners or developing it inside the country. Forging alliances with local partners in joint ventures often serves as an effective risk mitigation strategy, but today's partner can become tomorrow's competitor, and a foreign firm can't always count on local courts or officials to safeguard its assets. Ironically, some foreign multinationals with long-term plans to remain inside a particular emerging market country have invested in local innovation. In the process, they have given locals an incentive to press their own government for stronger legal protections for intellectual property rights. Others have pooled their lobbying efforts with both local businesses and other foreign firms. When lobbying a government, strength in numbers can make a difference.

Know the Local Competition

Successful firms understand their comparative advantages. But a foreign company must look beyond what its local competitors are capable of producing today. It must anticipate how those capabilities are likely to develop over time. Identifying the markets in which a firm's core competencies are likely to deliver profits for the foreseeable future is essential for long-term risk mitigation strategies.

In many emerging market countries, local companies are often better at large-scale efficient manufacturing than at designing products, marketing them, and delivering them to the customer. Knowing how quickly the local competition can climb the value chain helps with the design of an intelligent, long-term business strategy.

Know Where to Find the Exits

Many companies have made lots of money in emerging markets. But as Wall Street veterans like to say, “Don't confuse brilliance with a bull market.” Some companies have gotten away with ignoring the need for solid risk-management strategies and have simply ridden the wave produced by the inevitable rise of emerging market economies.

Yet, as skepticism of globalization grows in some developing countries, as their governments respond to domestic political pressure by rewriting rules to favor local companies at the expense of their foreign competitors, and as the challenges facing multinational companies operating inside these countries become more complex, it's important to have an exit strategy. There are plenty of developing states that are now open for business and investment. They have different strengths and vulnerabilities. Too much risk exposure in any one of them can create unnecessary risks. Conditions sometimes force companies to cut their losses and head for the door. Ensuring that this process is as painless and inexpensive as possible forms a crucial part of any sound risk mitigation strategy.

Don't Forget the Power of Perception

Operating in some developing countries comes with reputational risks at home. Several US companies have faced tough domestic criticism for doing business with governments that are accused of violating international labor, environmental, and human-rights standards. For a company's leadership, clearly communicating what the company will and won't do to gain market access in certain countries—and strict adherence to these standards of conduct —can help to minimize this risk.

Political Risk Insurance

As a last resort, a firm can purchase political risk insurance from providers like the Multilateral Investment Guarantee Agency, an arm of the World Bank, or the US government's Overseas Private Investment Corporation. But this should be a last resort strategy, because high premiums, substantial transaction and opportunity costs, and the complexities of establishing a valid claim have taught many companies that it is far more cost-effective to prevent or pre-empt bad outcomes than to rely heavily on plans to cope with their aftermath.

A Little Tolerance Is a Good Thing

It's useful to remember that having a good exit strategy does not require you to use it. Doing business in developing states comes with risk. But refusing to enter these markets or pulling out at the first sign of trouble comes with a high cost to opportunity. Foreign companies will be earning solid profits within emerging market states for many years to come. Political risk can be managed. It should not be avoided altogether.

More Info

Books:

- Bracken, Paul, Ian Bremmer, and David Gordon (eds). *Managing Strategic Surprise: Lessons from Risk Management and Risk Assessment*. New York: Cambridge University Press, 2008.
- Howell, Llewellyn D. (ed.). *Handbook of Country and Political Risk Analysis*. 3rd ed. East Syracuse, NY: Political Risk Services Group, 2002.
- Moran, Theodore H. (ed.). *Managing International Political Risk*. London: Blackwell Publishing, 1999.
- Moran, Theodore H., Gerald T. West, and Keith Martin (eds). *International Political Risk Management: Meeting the Needs of the Present, Anticipating the Challenges of the Future*. Washington, DC: World Bank Publications, 2007.
- Wilkin, Sam (ed.). *Country and Political Risk: Practical Insights for Global Finance.* London: Risk Books, 2004.

Articles:

- Bremmer, Ian, and Fareed Zakaria. “Hedging political risk in China.” *Harvard Business Review* 84:11 (2006): 22–25.
- Henisz, Witold J., and Bennet A. Zelner. “Political risk management: A strategic perspective.” Online at: www.management.wharton.upenn.edu/henisz/papers/hz_prm.pdf
- “Insuring against political risk.” *The Economist* (April 4, 2007). Online at: www.economist.com/finance/displaystory.cfm?story_id=8967224.
- “Integrating political risk into enterprise risk management”: Online at: www.pwc.com/extweb/pwcpublications.nsf/docid/EAB01AC994713716852570FF006868B6
- Stanislav, Markus. “Corporate governance as political insurance: Firm-level institutional creation in emerging markets and beyond.” *Socio-Economic Review* 6:1 (2008): 69–98.

Websites:

- Eurasia Group, global political risk advisery and consulting firm: www.eurasiagroup.net
- Multilateral Investment Guarantee Agency (MIGA)’s Political Risk Insurance Center: www.pri-center.com
- PricewaterhouseCoopers: www.pwc.com. Enter “political risk” in search box to find articles and resources.

See Also

Best Practice

- How to Manage Emerging Market Risks with Third Party Insurance
- Measuring Company Exposure to Country Risk
- Measuring Country Risk
- To Hedge or Not to Hedge

Viewpoints

- Viewpoint: Thierry Malleret

Checklists

- Comparative and International Financial Regulation
- International Comparisons of Company Law
- Understanding and Calculating RORAC, RAROC, and RARORAC

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