Political risk: Interpreting the International context

Riesgo político: Interpretando el contexto Internacional

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Abstract

Introduction— Since the beginning of the economic opening processes in the 1990s, Investments Have Increased (FDI) worldwide. However, not all countries are proposed as ideal destinations for recipients of FDI, they must have an attractive economic, political, and social landscape, which is studied in this work.

Objective— This research has the objective of studying the influence that political risk may have on the decision-making on the subject of FDI by entrepreneurs, in particular, Colombians

Methodology— A series of decision criteria is proposed from conceptual areas where the inversion problem has been analyzed. A scale of value has been generated for each criterion, which can be studied as means of stochastic multicriteria acceptability analysis.

Results— The analysis results point to the United States as the best destination for Colombian investment, followed by Brazil, the United Kingdom, and Chile, while Panama, Spain, and Mexico are not favored by any weighting.

Conclusions— This work might be helpful in decision-making processes intended to reduce the uncertainty that is proper of the foreign investment environment.

Keywords— International investment; political risk; International political economy; SMAA

Resumen

Introducción— Desde el inicio del proceso de apertura económica en la década de 1990, los flujos de inversión se han incrementado a nivel mundial. Sin embargo, no todos los países se proponen como destinos ideales para ser receptores, éste debe contar con un panorama económico, político y social atractivo cuyo contexto es presentado en este trabajo.

Objetivo— Esta investigación tiene como objetivo estudiar la influencia que el riesgo político puede tener en la toma de decisiones en de flujos de inversión por parte de los empresarios, en particular, los colombianos.

Metodología— Se propone una serie de criterios de decisión a partir de áreas conceptuales donde se ha analizado el problema de la inversión. Se ha generado una escala de valor para cada criterio, que puede ser estudiada por medios de análisis de aceptabilidad multicriterio estocástico.

Resultados— Los resultados del análisis apuntan a Estados Unidos como el mejor destino para la inversión colombiana, seguido de Brasil, Reino Unido y Chile; mientras que Panamá, España y México no se ven favorecidos por ninguna ponderación.

Conclusiones— Este trabajo puede ser de ayuda en los procesos de toma de decisiones tendientes a reducir la incertidumbre propia del entorno de inversión hacia el extranjero.

Palabras clave— Inversión internacional; riesgo político; Política económica internacional; SMAA

I. Introduction

Political risk research and analysis is partly due to the implementation of the economic opening policies promoted by the General Agreement on Tariffs and Trade —GATT—, which is in force since 1947; and to the positioning of the neoliberal economic approach, which influenced the programs of the International Monetary Fund —IMF— at the end of the 80s. These measures allowed the expansion of the free trade capitalist system, bringing along strong economic, financial and commercial interdependence at the world level. In these conditions, the internal stability of the participants is central to the equilibrium of the entire system. This has led to incorporating political risk analysis into business management practices worldwide, especially when it comes to assessing the convenience of the economic activities of a company in a given country.

According to the literature, the topic gained momentum both in academia and the private sector during the 1970s, when it became necessary to understand the relation between economy and politics in the context of events such as the oil crisis of 1974 or the Islamic Revolution of Iran. Despite the many available studies on this topic, it is sometimes considered to have undergone asymmetric progress, in the sense that developed and developing countries are not contemplated from the same perspective, without any theoretical justification [1]. In fact, political risk has been found to equally affect both developed and developing countries [2]. Thus, the current study focuses on the operationalization of the concept of political risk, paying special attention to the variables and the mathematical models employed for its estimation. The latter is attained by integrating variables or criteria selected from the literature and from those employed by MIGA. Finally, the study of the Colombian case is supported on the multicriteria decision making technique SMAA-O. This research has the objective of studying the influence that the political risk may have on the decision-making on the subject of FDI (Foreign Direct Investment) by entrepreneurs, in particular, colombians.

II. Literature Review

MIT proposed one of the first review on political risk [3]. MIGA, which makes part of the World Bank, has defined political risk as:

> [..] the probability of disruption of the operations of companies by political forces and events, whether they occur in host countries or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions not only of governments and political institutions, but also of minority groups and separatist movements [4, p. 19].

Diverse elements have been observed to affect political risk, ranging from clearly governmental ones, through those related to society, to the international context itself. Foreign Direct Investment (FDI) has been observed to be affected by the type of government of the country in question, democratic regimes being more attractive than dictatorships [5], [1]. Still, these authors have found that economic volatility and investment flow variation are much higher in the so-called "intermediate regimes", namely those in which both democratic and dictatorial elements coexist in such a way that the rules of the game are not clearly defined [5], [1]. In a study on FDI investment before and after the military dictatorship in the Republic of Myanmar [6], hypothesized that this parameter might be less strongly influenced by financial than political risk. Positive relations were found between uncertainty and investment losses, on the one hand, and between low institutional quality and political instability, in addition researchs from SU and DU (USA) [7] affirms that political risk is now more important than commodity (input) risk and they do an analysis suggests that nearly 50% of firms avoid foreign direct investment because of political risk, UW and NU examines managers' incentive to play it safe [8], on the other hand.

When assessed through different mathematical models, political risk has been consistently observed to affect business performance. Studies in Singapore found that, in face of political risk, companies tend to cancel or withdraw their investments or to resort to insurance protection [9]. Other studies evaluated the relationship between international political risk (number of international political crises, plus a series of economic variables) and a country's bond price fixation (debt costs), between 1988 and 2007 [10]. This was done by applying a regression model between the two parameters in question, and by obtaining information from the International Crisis Behavior database. Government Bond Yield data were supplied by Datastream and Bloomberg, and Macroeconomic Statistics by the World Bank. Government bond prices were found to correlate directly with international political risk. This is so because the latter increases the risk premium demanded by global bond investors, and this, in turn, determines better government bond yields.

However, as the flow of FDI increases, it appears to be less and less sensitive to political risk, as concluded by other studies at Belgium, following the application of a simple algebraic model [11]. Other factors affecting FDI have to do with corruption and organized crime. In a study in Russia, found that foreign investors prefer regions with relatively lower corruption levels [12]. Nonetheless, they also observed certain political culture affinity between companies originated in corrupted countries and corrupted countries themselves. Along these lines, Spanish scholars analyzed the opportunities resulting from political risk for Spanish multinational companies [13]. By applying a model based on negative binomial regressions (Poisson's model), they found political restrictions not to affect the internationalization process of these companies, whereas corruption seemed to exert a positive influence on it. In turn, the UT in Texas applied several regression models to analyze FDI as a function of organized crime in 32 States of Mexico, from 2004 to 2010 [14]. They failed to find any association between the studied factors in sectors such as agriculture, hunting, forestry and fishing, finance, public utilities, communications, transport and manufactures. Yet, they observed a positive relation in the mining and oil sectors. According to the United Nations Conference on Trade and Development —UNCTAD—, southern markets have lately become attractive for investors, thus showing some of the best economic growth rates worldwide [15], [16]. This is so despite their being territories with complex political conditions, as indicated in World Investment and Political Risk, the report of the Multilateral Investment Guarantee Agency – MIGA [4], it shows the complexity of decision making in the current context of inversion.

More recent researchs between China and Australia identified through a critical literature review and consolidated by pilot studies with 10 international project managers a total of 20 political risk factors [17]. NCU studies indicate the existence of political risk on the example of the Polish capital market and to present the results of own research [18]. The scope of the analysis was focused on the stock market due to its key importance for the capital market. French research measures the impact of political risk on the performance of private participation infrastructure projects in emerging markets [19]. This paper provides new empirical evidence to the intensive debate of whether financial structure is relevant for economic growth [20]. Specifically, we evaluate the role of political risk, development stage and their interactions with the structure of the financial system.

III. Development

A. *Risk Types*

Three very similar risk types are usually calculated in international business, to the point that they are indistinctly referred to as Sovereign Risk, Country Risk, and Political Risk. In short, sovereign risk addresses the possibility to incur in losses in international operations due to the lack of payment capacity of the State. In turn, country risk refers to losses resulting from economic, legal, social or political issues that, in theory, should be under the control of the government. In business environments, as it can be observed, political risk is included within country risk, which is the reason why they are often mixed. However, given its importance, political risk can be measured independently, as explained above.

B. *Decision model*

A model for estimating political risk is presented, following criteria selected from the literature review, which complement those used by MIGA. The importance given to the latter results from the fact that they have enabled surveying 459 executives around the world about their concerns on political risk. A corresponding Likert table was developed for each one of the criteria, 1 representing absolute confidence, and 6 the highest risk, as it is shown below (Table 1).

Criterion 1. Internal armed conflict and/or terrorism

This criterion refers to situations in which there are armed groups acting out of the law against legally constituted governmental forces, as it has been established by the ICRC [21]. Terrorism was defined after the proposal of the UNODC [22], provided that there was no international consensus about its significance. For this reason, it is defined as:

> b) Any act […] intended to cause death or serious body injures to a civil or a non-combatant, when the intention of said act, due to its nature or context, is to intimidate a population or to force a government or an international organization to do something or to refrain from doing it [22, p. 46].

From the standpoint of business activity, these actions have recently attracted the interest of academia [23], due to their increase along the 21st century and the consequent risk of losses [4].

Table 1.
Features of criterion 1.

Value	Characteristics
1	There is not any risk that the State is involved in an internal armed conflict, or that it is attacked by terrorism.
2	There is no risk of internal armed conflict, but there might be sporadic, individual acts of terrorism.
3	There is no risk of internal armed conflict, but there might be acts of terrorism on the part of national or international groups.
4	There was an internal armed conflict in the last 10 years, and there might be acts of terrorism on the part of national or international groups.
5	There is an internal armed conflict, but it is under control by governmental forces, and concentrated in specific areas of the country. There might be acts of terrorism on the part of national or international groups.
6	There is terrorism and/or an internal armed conflict, the actions of which can be directed against public or private companies.

Source: Authors.

Criterion 2. International armed conflict

This criterion refers to situations in which the State actively participates of an international armed conflict (war), be it individually or as part of a coalition. It also estimates the possibility that the country is affected by the development of a conflict in which it does not participate directly. For example, adhering to (or receiving) the application of international economic sanctions, which may result in loss of income, facility damage, loss of capital investments, or interruption of commercial activities, among other outcomes that might directly affect the economic environment of the host country [23], [24].

Table 2.
Features of criterion 2.

Value	Characteristics
1	There is not any risk that the State is involved in an international conflict.
2	The country is not involved in an international conflict, but it might be affected by the development of an existing conflict that involves neighbor countries.
3	The country makes part of a coalition that participates in an international conflict. No war actions are taking place in its territory.
4	The country makes part of a coalition that participates in an international conflict. Its territory can be the theatre of war actions.
5	The country is involved in an international conflict, consequently having received or being the potential object of international sanctions.
6	The state is intervened by a coalition or unilateral action due to escalating violence. It also is subject to international commercial punishment such as embargoes.

Source: Authors.

Criterion 3. Expropriation

Risk assumed by the company in connection with the possibility of losing its assets in the host country. However, the investor might expect some economic compensation [25]. A similar idea is expressed by by scientists from JOD and UK in the sense that expropriation results from discriminatory treatment by the host government [23].

Table 3.
Features of criterion 3.

Value	Characteristics
1	There is not any risk of expropriation.
2	There are sporadic cases of foreign investor expropriation.
3	There are continuous expropriations, but the negotiations leading to indemnification are relatively easy.
4	There are continuous expropriations, and the negotiations leading to indemnification are long and complex.
5	There are continuous expropriations.
6	There is latent risk of expropriation due to the application of extreme left policies on the part of the government.

Source: Authors.

Criterion 4. Restrictions to transfers and convertibility

This particular risk consists in the possibility of losses for foreign investors due to the impossibility to convert local into foreign currency, or to transfer it abroad [4]. This type of restriction on the part of local governments has been interpreted as a result of economic difficulties, lobbying on the part of pressure groups [26], or lack of foreign currency [23]. The table of values for this criterion ranges from 1 to 3:

Table 4.
Features of criterion 4.

Value	Characteristics
1	There is not any risk of transfer or convertibility restrictions.
3-5	Antecedents indicate the use of this type of restriction under extraordinary circumstances.
6	It is a continuous or institutional practice.

Source: Authors.

Macroeconomic data from the World Factbook of the CIA (USA) [27] such as GDP, GDP per capita, foreign investment flow, labor force, unemployment and inflation, all of which are considered to indicate the economic stability of the market under study. Said indicators are indispensable when it comes to knowing the FDI attraction capacity of a country [24], [23], [28].

The following indicators are associated to political stability:

- *Doing Business Ranking*, which is a report prepared by the WEF in order to know the easiness with which a business can be created, based on the evaluation of existing regulations [29]. The parameters it measures are: time and costs involved in the setting of a company and in obtaining the corresponding building permissions; complexity and rigidity of labor legislation; property registry; protection to investors; tax payment; easiness, costs and time involved in international commerce; and contract fulfillment, among other factors related to institutional stability.
- *Index of Economic Freedom*, by the Heritage [30], estimates aspects such as commercial freedom, financial freedom, government expenditure, monetary freedom (inflation and price control), labor regulation, investment freedom, fiscal freedom (taxation level), and property rights protection. These aspects are measured on a scale ranging from 1 to 100, the latter representing the highest independence of the economy from politics.
- *Perception of Corruption Index*, by Transparency International, which measures corruption on a 1 to 100 scale.
- *Global competitiveness ranking*, prepared by the WEF. In it, competitiveness is understood as the set of institutions, policies and factors determining the productivity of a country, which, in turn, generates prosperity and is related to the political stability criterion.
- *Transfer and convertibility risk rating* by S&P, which is done on a scale ranging from D to AAA, the latter representing the optimal situation in terms of the monetary stability of the country.

The analysis of these variables allowed characterizing the selected countries in terms of the criteria evaluated in the current work (Table 6). The scores obtained by the countries under study according to the criteria specified above support each alternative's ordinal ranking (Table 6). Nonetheless, the alternatives can also be graded through the criteria, in which case the DMs rank the alternatives with regard to the criterion required as SMAA-O input. For such purpose, they take into account the least differences in the impact of such criterion on the development of internal or external policies.

Table 5.
Ranking of the studied countries according to the criteria under analysis.

Alternative	Crit. 1	Crit. 2	Crit. 3	Crit. 4	Crit. 5
Brazil	1	1	6	7	7
Chile	2	2	3	5	2
USA	5	7	1	1	3
Spain	6	5	4	4	4
UK	4	6	2	3	1
Mexico	7	3	5	6	6
Panama	3	4	7	2	5

Source: Authors.

IV. Case of Study

In order to establish patterns and frequencies and to predict future behavior, all these criteria have been analyzed over the last few years, the last two ones being considered more important. For such purpose, the most frequent destinations of Colombian capital have been studied according to the mentioned criteria. The Appendix A show the free sources for collecting information to be evaluated

A. *Colombian investment abroad*

A considerable increase in the Colombian capital invested abroad has been observed since 2005 (U$4,795 million), whereas in 2004 the same figure was U$192 million [31]. Since then on, and despite the lack of a stable tendency, the records have systematically overcome those observed before 2005. In fact, this year's figure has been exceeded in three occasions: 2010, 2011 and 2013.

Looking forward to taking a representative sample, a Pareto analysis allowed finding that 74.67% of the Colombian capital invested abroad goes to Brazil, Chile, Spain, United States, England, Mexico and Panama. This group of countries was characterized through the aspects mentioned below, with which the five criteria established for the current research were satisfied:

1) *Application of SMAA-O to support the decision-making process*

SMAA-O, which stands for Stochastic Multicriteria Acceptability Analysis – Ordinal [32], belongs to a family of multi-criteria techniques known as SMAA, originally developed by researchers at UTL in Portugal for public decision environments in which the decision-makers are not willing or not in condition to show their preferences openly [33], [34]. The technique explores the feasible space that favors each one of the alternatives in a given ranking. The inputs of the technique correspond to the grades given to the decision alternatives according to the evaluation criteria. In turn, the outputs are: The Acceptability Index, which estimates the probability of an alternative to have a specific ranking, and the Central Weights Vector, which expresses the weighting centroid favoring an alternative in a particular ranking. SMAA-O allows handling quantitative information associated to an ordinal scale, as in the case of the present work, but it also allows handling cardinal information.

Given that, in practice, multidimensional integrals have to be processed through Montecarlo simulations, use was resorted to JSMAA (version 1.0.2), an open source software developed in JAVA under open source GNU and General Public License v3, which is capable of supporting SMAA-2, SMAA-O. JSMAA calculations require 10 000 iterations, which allow ± 1% accuracy and 95% confidence in the obtained acceptability indexes [35]. In JSMAA, the configuration of the criteria takes into account their deterministic or stochastic nature: qualitative ones, be they ordinal or binary, are represented by exact numbers. It is important to highlight that JSMAA does not require the data to be presented in standardized scales; instead, it captures data in any available scale, thus facilitating and speeding up the configuration of any decision model.

B. *Acceptability Index*

This indicator expresses a comprehensive measurement that integrates all the defined criteria, thus allowing the classification of the alternatives as more or less acceptable. The resulting rankings and acceptability indexes excute the SMAA model in JSMAA for the seven alternatives that are shown in Table 6.

Table 6.
Acceptability index.

id	Alternative	Ranking
1	Brazil	0.24
2	Chile	0.17
3	Spain	0.00
4	USA	0.38
5	UK	0.20
6	Mexico	0.00
7	Panama	0.01

Source: Authors.

C. *Central weight vectors*

Additionally, and for each of the alternatives under study, the set of central weight vectors associated with the favorable weight centroid supporting each alternative was calculated (Table 7).

Table 7.
Central weight vectors.

Alternative	Confidence criterion	Crit 1	Crit 2	Crit 3	Crit 4	Crit 5
Bra	0.75	0.31	0.32	0.12	0.13	0.12
Chi	0.44	0.23	0.26	0.17	0.12	0.23
Spa	1.00	NA	NA	NA	NA	NA
USA	0.88	0.14	0.13	0.28	0.30	0.15
UK	0.60	0.15	0.13	0.18	0.16	0.38
Mex	1.00	NA	NA	NA	NA	NA
Pan	0.09	0.23	0.24	0.05	0.40	0.08

Source: Authors.

V. Analysis of Results and Recommendations

The feasible weight space results point to the United States as the best destination for Colombian investment, followed by Brazil, the United Kingdom and Chile; while Panama, Spain and Mexico are not favored by any weighting. This is the first discrepancy with respect to the reality of Colombian investors, provided that Panama is the second favorite destination of Colombian international expansion processes. Brazil, which, according to the model and from the standpoint of political risk is the second-best option, is actually the seventh option for Colombian companies.

Yet, particular issues associated to the criterion weights supporting each choice can be observed among the countries that obtained the best scores. In the case of the United States and Great Britain, the most satisfying results correspond to criterion 3 (Expropriation) and criterion 4 (transfer and convertibility restrictions), the former country exhibiting higher scores than the latter.

The criteria supporting Brazil in the second position of the ranking are criterion 1 (lack of Internal armed conflict and/or terrorism) and criterion 2 (no intervention in International armed conflicts). Finally, Chile has also suggested as a good alternative due to the minimum risk it implies in terms of criteria 1, 2 and 5, the latter referring to Institutional stability and corruption.

When contrasting these results to the weightings published by the model based on MIGA (where some variables are different) it can be observed that, for the businesspeople consulted by the latter, the first concern corresponds to regulation changes (58%) (which, in the current work can be assimilated to criterion 5: Institutional stability and corruption), closely followed by Transference limitations and convertibility (43%), Civil disturbance (33%) (which can be compared to criterion 1), and Non-honoring of government guarantees (31%). For their part, Expropriation (24%), Terrorism (13%) and War (7%) are left behind.

From this perspective, the results obtained by Brazil and Chile would not be so meaningful as those of the United States and Great Britain, provided that international investors consider Regulations Stability, together with Convertibility and transfer capacity to be more important than Participation in international conflicts or the probability of Terrorist actions.

Studies have assessed the relative importance of different factors when it comes to decision-making by multinational companies. According to some surveys, the five main political risk variables for Canadian companies [26], as ordered by their relative importance, are restrictions to capital, the attitude of the host country, degree of bureaucracy, stability of the ruling party, stability of foreign exchange rates and, finally, regional and international conflict and/or cooperation. In turn, Jordan and Middle East investors' five major priorities are: 1) Demonstrations, riots, and insurrections; 2) War; 3) Economic sanctions; 4) Revolutions and civil wars; and 5) Terrorism. These differences in the order of priorities between Canadian and Jordan businesspeople might indicate that the local and regional contexts of multinational companies define their interests in this respect. For this reason, it is important to weigh the different criteria of Colombian businesspeople holding direct investments abroad.

Despite the fact that political risk has not been clearly defined or analyzed yet, the current research has shown the growing importance of this concept since the decade of the 1970s. Based on a series of criteria obtained from the literature review, two of the main current destinations of Colombian investments abroad, namely the United States and Great Britain, coincide with the present risk measurement. Contrastingly, countries such as Panama, Mexico and Spain were not favored by this political risk analysis, despite the fact that they make part of the group of countries that actually concentrate 80% of the national investment abroad. This might be due to factors that were not analyzed in this work, or to judgment errors on the part of the surveyed investors. This also suggests that the international investment decisions of Colombian businesspeople are not only based on political risk, economic, cultural and even cultural, geographical or legal benefits factors to develop investment are probably more important.

VI. Conclusions

Despite the fact that political risk has not been clearly defined or analyzed yet, the current research has shown the growing importance of this concept since the decade of the 1970s. Based on a series of criteria obtained from the literature review, two of the main current destinations of Colombian investments abroad, namely the United States and Great Britain, coincide with the present risk measurement. Contrastingly, countries such as Panama, Mexico and Spain were not favored by this political risk analysis, despite the fact that they make part of the group of countries that actually concentrate 80% of the national investment abroad. This might be due to factors that were not analyzed in this work, or to judgment errors on the part of the surveyed investors. This also suggests that the international investment decisions of Colombian businesspeople are not only based on political risk, economic, cultural and even cultural, geographical or legal benefits factors to develop investment are probably more important.

For developing countries that, besides being receptors of FDI, are starting to expand their companies abroad, political risk analysis or assessment might not be a priority. However, reviewing the type of criteria studied in this work might be helpful in decision-making processes intended to reduce the uncertainty that is proper of the external environment.

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Appendix A.

Free sources for collecting information to be evaluated.

Criterion 1	Demand the study of the internal politics context of the country for at least the last 5 years. Information can be supported by data from Global Democracy Index: www.eiu.com Perception of Corruption Index: https://www.transparency.org/en/cpi/2020
Criterion 2	Demand the study of the international relations of the country for at least the last 5 years
Criterion 3	Data can be taken for analysis from: The GlobalEconomy: https://es.theglobaleconomy.com/rankings/expropriation_risk/ Index of economic freedom: https://www.heritage.org/index/
Criterion 4	Economy data can be taken from: World Factbook of the Central Intelligence Agency: https://www.cia.gov/the-world-factbook/ Doing Business: https://databank.worldbank.org/source/doing-business Index of economic freedom: https://www.heritage.org/index/ Global competitiveness ranking: https://www.weforum.org/reports/the-global-competitiveness-report-2020 Debt rating: https://datosmacro.expansion.com/ratings

Source: Authors.

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