



Managing Risk in an Unstable World

As emerging markets generate greater shares of global supply and demand, companies need better methods to weigh political risk against financial reward.

by Ian Bremmer

Countries in turmoil elbow one another off the front page at a dizzying pace: Lebanon follows Ukraine follows Sudan follows Argentina. Companies, meanwhile, fear unpredictable change, even as they seek profit from the opportunities change creates—a freshly privatized industry in Turkey, recently tendered oil blocks in Libya, a new pro-Western government in the former Soviet republic of Ukraine. To help weigh dangers against opportunities, corporations mulling foreign ventures routinely consult economic risk analysts. But basing global investment decisions on economic data without understanding the political context is like basing nutrition decisions on calorie counts without examining the list of ingredients.

Reassuring data on countries' per capita income, growth, and inflation—the bread and butter of economic risk analysis—often obscures potential threats from other sources. Iran's parliament, for example, last year passed legislation that complicates foreign companies' abilities to plant stakes in that country's telecom sector. The 2003 revolution in Georgia altered the strategic calculus for investment in Caspian Sea energy development. The Kremlin's politically motivated prosecution of business tycoon Mikhail Khodorkovsky sent a chill through Russia's oil market. And Brazil's

government is pressing both its agencies and its citizens to adopt open-source software, a policy that could inflict some nasty wounds on Microsoft and other technology companies.

These are examples of *political risk*, broadly defined as the impact of politics on markets. Political risk is influenced by the passage of laws, the foibles of leaders, and the rise of popular movements – in short, all the factors that might politically stabilize or destabilize a country. The significance of any given risk, of course, depends upon the context of the investment decision. A hedge fund manager worries about developments that could move markets tomorrow, while the leader of a corporation building an overseas chemical plant needs a longer view. Strategists evaluating emerging markets must be especially vigilant (in fact, an emerging market may be defined as a state in which politics matters at least as much as economics). But even those businesses active only in developed nations should factor political risk into their planning scenarios.

Most companies are already navigating the choppy waters of globalization, and none, presumably, are sailing blind. But corporate leaders may lack the sophisticated understanding this very complex subject requires. Political risk analysis is more subjective than its economic counterpart and demands that leaders grapple not just with broad, easily observable trends but also with nuances of society and even quirks of personality. And those hard-to-quantify factors must constantly be pieced into an ongoing narrative within historical and regional contexts.

This article will help corporate leaders become better appraisers of information about the myriad shifting influences on global investments. Armed with that understanding, business strategists can minimize risks and seize opportunities far beyond their home shores.

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Politics Is Everyone's Business

Corporations with investments in such opaque countries as Zimbabwe, Myanmar, and Vietnam have long understood how political risk affects their bottom lines. In fact, historically, some of the business world's best political risk analysis has come from multinational corporations, like Royal Dutch/Shell and American International Group (AIG), that have entire departments dedicated to the subject. But today, any company with exposure in foreign markets needs early, accurate information on political developments. There are four principle reasons for this.

First, international markets are more interconnected than ever before. Tremors following a market shock in Argentina are quickly felt in Brazil and Venezuela, but they also rumble through Thailand. In 1997, capital flight from Southeast Asia roiled markets around the world. If China's rapidly growing economy overshoots a soft landing and crashes into recession, the impact on Chile, Russia, India, and the United States will be measurable within hours. China's political decisions today will have dramatic long-term effects on its markets. Companies with exposure anywhere in the world that China does business ignore those decisions at their peril.

Second, for good or ill, the United States is making the world a more volatile place, and that has changed risk calculations everywhere. The attacks on the World Trade Center in New York put foreign affairs and security front and center of federal government policy. Washington has shown its willingness to aggressively preempt threats to American security and national interests. The U.S. military has demonstrated an unprecedented capability to respond to international shocks—and to create them.

Third, the offshoring trend is growing. Businesses shift some operations to countries where labor is cheap—but the labor is cheap for a reason. In countries such as India (an established offshoring destination) and Kenya (an emerging one), living conditions for the working classes can be harsh, and there is greater

threat of unrest than in developed countries with their large, relatively prosperous middle classes. Offshoring presents other risks as well. The Chinese government, for example, is already cavalier about intellectual property rights and shows signs of becoming more so. Companies moving manufacturing and other functions there may be hard-pressed to protect some of their most valuable intellectual assets.

Fourth, the world is increasingly dependent for energy on states troubled by considerable political risk—Saudi Arabia, Iran, Nigeria, Russia, and Venezuela among them. As global supply struggles to keep pace with rising demand, political instability in these oil-producing states can quickly produce shocks all over the world.

It is difficult to imagine a business that is not affected by at least one or two of these developments. And corporations' exposure will only grow as supply chains become more global and developing countries increasingly participate in international trade.

What Economics Can't Tell You

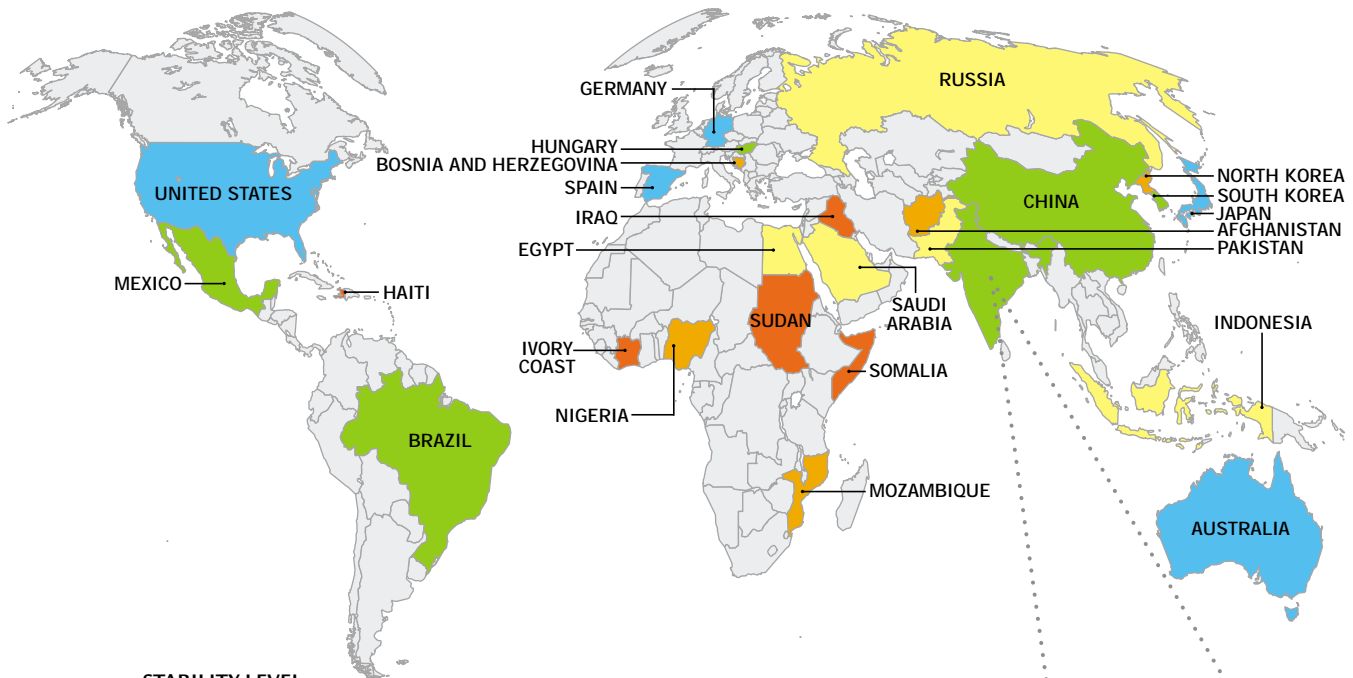
Economic risk analysis and political risk analysis address two fundamentally different questions. Economic risk analysis tells corporate leaders whether a particular country *can* pay its debt. Political risk analysis tells them whether that country *will* pay its debt. Two examples illustrate this distinction.

When 35-year-old Sergei Kiriyenko replaced Viktor Chernomyrdin as prime minister in March 1998, Russia's economy seemed to be emerging from post-Soviet era turmoil. Inflation had been reduced to single digits, the economy was growing, and the government appeared committed to a moderate reformist path. Economic analysts saw clear skies.

But political analysts recognized that an obstructionist parliament intended to block Kremlin attempts to tighten fiscal policy and streamline tax collection. They saw that an absence of consensus was producing incoherent monetary policies and that the absentee, alcoholic president wasn't going to enforce

Political Risk at a Glance

Political risk measures the stability of individual countries based on factors grounded in government, society, security, and the economy. Emerging markets are generally in the moderate- to high-stability range. The map shows how some countries scored in March 2005.



- STABILITY LEVEL**
- MAXIMUM [80-100]: Australia, Germany, Japan, Spain, United States
 - HIGH [60-79]: Brazil, China, Hungary, India, Mexico, South Korea
 - MODERATE [40-59]: Egypt, Indonesia, Pakistan, Russia, Saudi Arabia
 - LOW [20-39]: Afghanistan, Bosnia and Herzegovina, Mozambique, Nigeria, North Korea
 - FAILED STATE [0-19]: Haiti, Iraq, Ivory Coast, Somalia, Sudan



Anatomy of India's Political Risk

National stability scores are plotted over time and comprise dozens of measurements, ranging from hard economic data on growth and investment to more amorphous assessments of youth disaffection and corruption. At the beginning of this year, India was hovering between moderate and high stability. (The numbers used to obtain each average have been rounded off.)

FACTORS AFFECTING STABILITY	STABILITY SCORES (0-100)			COMMENTS
	Jan 2005	Feb 2005	Mar 2005	
GOVERNMENT (such as strength of current government, rule of law, and level of corruption)	67	64	62	Political missteps by the government led to poor performance in state elections and strengthened opposition parties.
SOCIETY (such as social tension, youth disaffection, and health, education, and other services)	58	58	58	Low per capita income and literacy levels lead to a low human development index. Simmering social tensions keep the society score low.
SECURITY (such as level of globalization, geostrategic condition, and emergencies and disasters)	53	48	48	Peace talks with Pakistan and China have eased security fears. But a Maoist insurgency in Nepal and continuing Kashmir violence keep the score low.
ECONOMY (such as fiscal condition, growth and investment, and external sector and debt)	75	75	76	Economic growth and expanding trade keep the numbers healthy. The fiscal deficit remains a worry.
Cumulative National Stability Score	63	61	62	

Source: Deutsche Bank Eurasia Group Stability Index (DESIX), March 2005

discipline on an increasingly chaotic policy-formulation process. When oil prices fell, political analysts underlined the country's lack of fiscal discipline as a cause for immediate concern.

In short, political analysts produced a darker – and more accurate – portrait of Russia's market instability in the period leading up to the financial crisis of 1998. When Russia ultimately defaulted on international debt and devalued the ruble, companies that had studied both economic and political risk weathered the storm with far fewer repercussions than those that had relied on economic analysis alone.

In other instances, political risk analysts have been able to detect the silver linings in economists' dark clouds. The value of Brazilian bonds and currency fell sharply in 2002 when it became clear that Luis Inacio Lula da Silva would be elected that country's president. In earlier campaigns, Lula had criticized the International Monetary Fund and Brazil's fiscal conservatives, whom he accused of widening the gap between rich and poor. Comparisons of Lula with Cuba's Fidel Castro and Venezuelan president Hugo Chávez spooked economic risk analysts, who feared that the election of Brazil's first

“leftist” president would produce a politically driven market crisis.

But many political analysts considered such an outcome unlikely. In Lula they saw not an ideologue or a theoretician but a man who made his name as a tough, pragmatic labor negotiator. They observed in his campaign an inclusive, conciliatory electoral strategy. They heard in his speeches a determination not to allow Brazil to fall into the kind of financial crisis that had inflicted so much damage on Argentina. And so they argued that Lula's victory would be more likely to produce political and economic stability. If Lula won, they predicted, his government would enfranchise the poor. And he would keep his campaign promise to reserve an IMF-established percentage of tax revenue for the repayment of debt, instead of spending it on social programs and make-work projects.

The political analysts were right. Lula won the election and kept his promises of fiscal discipline. Within weeks, Brazilian bonds staged a dramatic recovery.

Why China Keeps Us Up at Night

China bestrides the world of political risk like a colossus. Many experts tout it as the great investment opportunity of the new millennium, but it is also a great unknown. Among the questions political risk analysts are studying: Can China's explosive economic growth survive its corrupt and inefficient political system? Do the country's political leaders agree that preparations for a soft landing to avoid recession are necessary? Would reform that opens its political process make China more stable or less?

China's continued expansion depends on the central government's capacity to handle complex economic transitions and avoid instability. At the same time, the state must juggle huge security, demographic, and political challenges. Imminent agricultural, banking, and urban policy reforms will probably produce even more complex management problems for the country's dysfunctional bureaucracy.

China appears to be inching toward instability as reforms strain the relationships between national and regional leaders, increasing the probability of an economic shock followed by a political one. Complicating matters, China's bureaucracy lacks the administrative control necessary to modulate the pace of an economic slowdown.

Analysts of economic risk tend to base projections for China's growth rates on its past performance. But there are few countries for which past performance is so poor a predictor of future results. With a few notable exceptions, such as the 1989 protests in Tiananmen Square, social unrest in modern-day China has been rare. But the risk of popular unrest is going up as a result of widening income inequality, slowing – although still intense – economic growth, and continuing official abuse and corruption. The urban unemployed and migrant workers could stage protests; rural rebellion over land reclamations and onerous administrative fees could escalate. China's leaders might then clamp down on the media, religious groups, use of the Internet, and other forms of expression and communication. Faced with international criticism, the government could become more antagonistic and dogmatic about issues of concern to the United States and East Asia.

The probability of such events occurring in the short-term is low, but China's risk indicators suggest it is rising.

Strength Against Shocks

In both Russia and Brazil, political analysts focused on how a specific leadership change would affect the country's *stability* – the unit of measure for political risk. A nation's stability is determined by two things: political leaders' capacity to implement the policies they want even amidst shocks and their ability to avoid generating shocks of their own. A country with both capabilities will always be more stable than a country with just one. Countries with neither are the most vulnerable to political risk.

Shocks themselves are another important concept in political risk. They can be either internal (demonstrations in Egypt; a transfer of political power in Cuba) or external (thousands of refugees fleeing from North Korea into China; the tsunami in Southeast Asia). The presence of shocks alone, however, is not a sign of instability. Saudi Arabia, for example, has produced countless shocks over the years but has so far ridden out the tremors. It will probably continue to do so, at least in the near

term: The nation is built on political and religious fault lines, but its strong authoritarian control and deep pockets allow the Saudi elite to adapt to quite dramatic changes.

Saudi Arabia's relative stability is grounded in its capacity to withstand shocks; other countries depend more on their capacity not to produce them. Kazakhstan's political structure, for example, is less supple and adaptable than that of Saudi Arabia. But the country also stands much further from the epicenter of political earthquakes.

Clearly then, two countries will react differently to similar shocks, depending on how stable they are. Say an election is held and a head of state is chosen but the victory is challenged by a large number of voters, and the nation's highest judicial body must rule on a recount. That happened in the United States in 2000 without any significant implications for the stability of the country or its markets. When similar events erupted in Taiwan in 2003 and Ukraine in 2004, however, demonstrations closed city streets, civil violence threatened, and international observers speculated on the viability of those nations' economies.

The 2000 U.S. elections point to another complicating factor in political risk: the relationship between stability and openness. The United States is stable because it is open – information flows widely, people express themselves freely, and institutions matter more than personalities. Consequently, the nation weathered its election controversy without a Wall Street panic; investors knew the problem would be resolved and that the outcome would be broadly perceived as legitimate.

But other countries – such as North Korea, Myanmar, and Cuba – are stable because they are closed. What's more, the slightest opening could push the most brittle of these nations into dangerous territory. Twenty minutes' exposure to CNN would reveal to North Korean citizens how outrageously their government lies to them about life outside; the result might be significant unrest. And while there is considerable world pressure on closed countries to

Why Saudi Arabia Keeps Us Up at Night

Saudi Arabia's stability is under fire from religious and secular forces. Islamic extremists hope to undermine the legitimacy of the royal family. Real unemployment is estimated to be between 20% and 25%; frustrated, jobless young men are flocking to mosques and schools where religious leaders thunder against the infidels. Western nations, meanwhile, are calling on the royals to move toward political liberalization. And the flight of expatriates will eventually take its toll on the Saudis' ability to diversify their economy.

Such volatility complicates financial deals – particularly those that take years to assemble – and extends the exposure to political risk over time.

But while companies with long-term investments must worry, short-term investors in Saudi Arabia have less cause for concern. That's because oil money stabilizes the political system, and the royal family can count on those revenues for years to come. Yes, oil supplies are a tempting target for terrorists; but the country's oil infrastructure is isolated from population centers, and redundancies in the pipeline system make it almost impossible to inflict lasting damage with a single blow. In addition, the national oil company has the technology, the trained engineers, and the spare capacity to continue producing significantly more than 9 million barrels per day. Finally, in light of concerns that foreign governments might freeze Saudi assets following September 11, 2001, a great deal of money flowed back into the kingdom, providing the House of Saud with more ready cash.

Clearly, any project in Saudi Arabia that needs a decade to show a profit is deeply problematic. But those willing to brave volatility in the near term may profit from opportunities that more risk-averse companies forgo.

open up, the transition from a stable-because-closed state to a stable-because-open state is inevitably marked by instability. Some nations, for instance South Africa, survive that transition. Others, like the Soviet Union, collapse.

Plotting where nations lie on the openness-stability spectrum, and in which direction they are heading, is tricky. And no country poses a greater challenge than China, which appears equally at home on two different points along this range. Politically, China is stable-because-closed; it is a police state with absolute control over public expression. For example, security forces severely restricted media coverage of the recent death of Zhao Ziyang, a relatively progressive politician, in order to prevent the kinds of uprisings sparked by the deaths of Chou En-lai in 1976 and Hu Yaobang in 1989. Economically, how-

ever, China is opening at a rapid clip, as diplomats and negotiators globe trot in search of new trade relationships to feed the country's growth.

When a country is politically closed but economically open, something has to give. Whether China's political system will follow its economic trend line or vice versa is a fascinating and hotly contested subject in the political analyst community. (See the sidebar "Why China Keeps Us Up at Night.")

Corporate executives, however, generally focus on more immediate concerns when assessing a country's ripeness for investment. Broadly speaking, decision makers must know three things: How likely is it that a shock will occur? If likely, when will it probably occur? And how high are the stakes if it does?

The greatest risk, not surprisingly, is when shocks are likely, imminent, and

have widespread consequences. All three conditions exist in North Korea, which has remained stable only by resisting movement toward market economics and more open government. North Korea's stability is so dependent on Kim Jong Il and the country's military elite that any threat to their safety could destroy the regime and destabilize the entire region very quickly. And the stakes are high because the most valuable products North Korea has to sell – military and nuclear components – tend to produce political shocks.

In other nations, shocks are likely and expected to occur relatively soon, but the stakes for world markets are much lower. Fidel Castro, for example, is 78, and the fate of the revolution after his death is unclear. Castro's hard-line younger brother Raul might assume power, but he is also in his 70s; if he replaces Castro, political uncertainty will build until the next transfer of power. Similarly, if a reformer like Carlos Lage steps forward to begin a process of

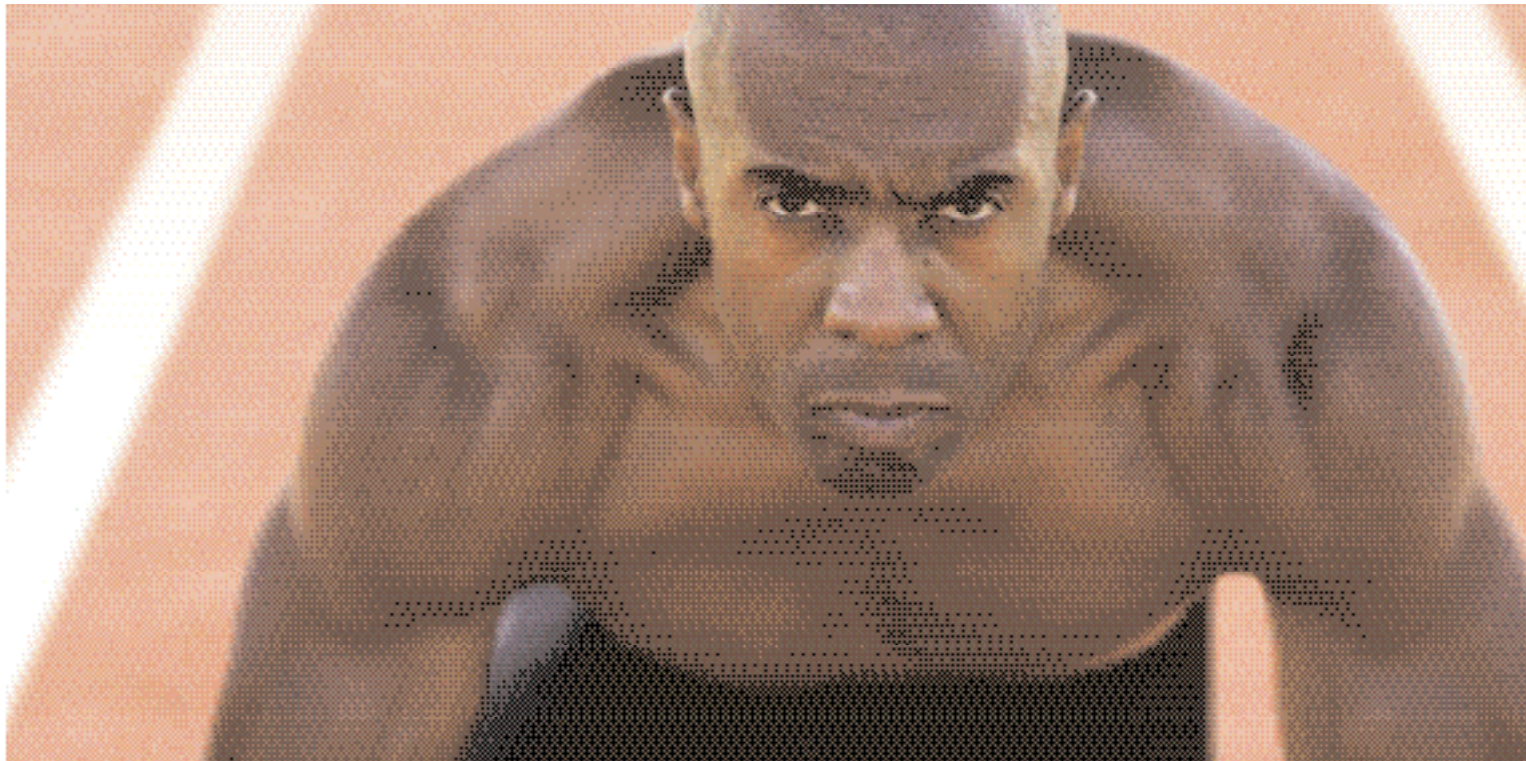
gradual opening, the release of long-repressed dissent could spark violence. So either outcome will probably produce instability. But because Cuba is not an exporter of nuclear technology, oil, or any other vital resource, the shock's effect on world markets will be minor.

Risk by the Numbers

Speculation on the outcomes of these and other scenarios appears in numerous publications, but corporations debating operational or infrastructure investments abroad need more objective, rigorous assessments than those found in the op-ed pages. Companies can either buy political risk services from consultants or, like Shell and AIG, develop the capacity in-house. Either way, a complete and accurate picture of any country's risk requires analysts with strong reportorial skills; timely, accurate data on a variety of social and political trends; and a framework for evaluating the impact of individual risks on stability.

The Analysts. Politics never stops moving, and risk analysts must be able to follow a nation's story as it develops. Usually, that means being on the ground in that country. And in the case of a particularly opaque regime, it can mean being there a very long time. Some information is published in official reports or in the media, but analysts will gather most of their intelligence from primary sources: well-connected journalists in the local and foreign press, current and former midlevel officials, and think tank specialists.

Companies should bear in mind that political analysis is more subjective and consequently more vulnerable to bias than its economic counterpart. One danger is that analysts with their own political opinions may view their research through a particular philosophical scrim. In addition, political analysts will probably have subject-matter – as well as nation-specific – expertise that can color their reports. A Taiwan analyst with a background in security, for example,



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Make it happen

may overemphasize such risk variables as cross-strait tensions and the growing imbalance of military power between Taiwan and China. An Eastern Europe analyst studying social unrest may insist that demonstrations by pensioners have the largest political impact on the government. As decision makers peruse analysts' reports, they should be alert for any potential bias and correct for it.

The Data. Because of their very nature, political risk variables are more difficult to measure than economic variables (although in some countries, such as China and Saudi Arabia, even the reliability of government-produced economic data is open to question). Politics, after all, is influenced by human behavior and the sudden confluence of events, for which no direct calibrations exist. How do you assign numbers to such concepts as the rule of law?

To accurately quantify political risk, then, analysts need proxies for their variables. Instead of trying to measure the independence of a nation's judi-

ciary, for example, analysts can determine whether judges in a particular country are paid a living wage, whether funded programs exist to inform them about new legislation, and whether – and how often – they are targeted for assassination. Political risk analysts also study the percentage of children who regularly attend school, how police and military salaries compare with criminal opportunities, and how much access to medical care is available in towns with populations of 10,000 to 50,000 people. They look at such statistics as the unemployment rate for people between the ages of 18 and 29 and determine how many of them are in prison. And, of course, they add economic variables to the mix: per capita income, balance of payments, and national debt.

Taken together, this often anecdotal information reveals much about a country's underlying sources of strength or vulnerability. Comparing data from neighboring countries provides a good sense of where shocks from unstable

nations might rumble into stable ones. Comparing a single nation's data points over time tells the analyst whether that nation is becoming more stable or less so, and how quickly.

The Framework. Different companies and consultancies will have different methods for measuring and presenting stability data. We at Eurasia Group have developed a tool that incorporates 20 composite indicators of risk in emerging markets. Distributed as part of a strategic relationship with Deutsche Bank, the Deutsche Bank Eurasia Group Stability Index (DESIX) scores risk variables according to both their structural and temporal components. Structural scores highlight long-term underlying conditions that affect stability. They then serve as a baseline for temporal scores, which reflect the impact of policies, events, and developments that occur each month.

The indicators are organized into four equally weighted subcategories: government, society, security, and the economy. Ratings for all four subcategories

Less mouth.
More muscle.

are aggregated into a single composite stability rating, which is expressed as a number on a scale of zero to 100—from a failed state to a fully institutionalized, stable democracy. (See the exhibits “Political Risk at a Glance” and “Anatomy of India’s Political Risk.”)

Very often, the numbers that make up the stability rating are as interesting as the stability rating itself. Consider Turkey, whose March 2005 stability rating was 60, five points lower than Brazil’s and two points higher than Russia’s. Within that composite number, components are moving in opposite directions.

Specifically, Turkey’s government rating rose as a consequence of the European Union agreement to open accession talks with Ankara in October 2005.

necessity, companies in the energy industry, for example, have demonstrated a high tolerance for risk, relying on mitigation techniques to manage their exposure. By contrast, light manufacturers and midsize companies in industrial supply chains tend to bide their time to see how situations evolve. And pharmaceutical corporations generally shy away from investment when presented with infrastructure or intellectual property risks.

Companies making extended commitments in unstable nations must give top priority to long-term risk—issues related to demographics and natural resources, for example—when making decisions. In May 2004, Japan’s Sumitomo Chemical agreed to a \$4.3 billion joint venture with Saudi Aramco to build

to mitigate the risk—recruiting local partners, for example, or limiting R&D in nations with leaky intellectual property protection. In addition, a growing number of commercial and government organizations now offer insurance against political risks such as the expropriation of property, political violence, currency inconvertibility, and breach of contract. (Such insurance is expensive, however, because risks are so hard to assess.) Otherwise it’s mostly a matter of hedging—locating a factory in Mexico as well as Venezuela, say, so as not to bet the entire Latin America strategy on a single opaque regime.

Finally, it is worth remembering that though instability translates into greater risk, risk is not always a bad thing. Political risk in underdeveloped countries

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Prime Minister Recep Tayyip Erdogan’s administration now has greater incentive to continue reforms that strengthen the independence of Turkey’s institutions, increase media freedom, and protect the rights of minority groups—such as Turkish Kurds—who might otherwise provoke unrest. Turkish membership in the EU would also bind the country more closely to European institutions, further increasing stability.

Yet Turkey’s security rating is pushed lower by the continued presence of Kurdistan Workers’ Party militants in northern Iraq. Ankara worries that the Kurds—empowered by the Iraqi elections—may try to regain control of the oil-rich northern Iraqi town of Kirkuk, which would provide the financial basis for an independent Kurdish state. A Kurdish state on Turkey’s borders would likely fan separatist flames in that country’s own Kurdish population.

Once You Know the Odds


How companies apply such analysis obviously depends upon their industry, strategy, and risk tolerance profile. Of

a major petrochemical plant at Rabigh in Saudi Arabia. The plant isn’t scheduled to open until 2008, so Sumitomo is particularly vulnerable to such pernicious demographic trends as the exodus of technical talent and the joblessness of young men.

Sumitomo’s risk tolerance is already being tested by an Islamic extremist campaign of kidnapping and beheading foreigners who do business in the country. But while violence and corruption dominate headlines, such near-term risks are much exaggerated. (See the sidebar “Why Saudi Arabia Keeps Us Up at Night.”) In fact, although Saudi Arabia—and China, too—may be risky bets for companies engaged in ventures that won’t see profitability for a decade, in the short run there is money to be made. Among others, General Motors, Kodak, and a number of investment banks have already done so—though they’ve stumbled a bit in the process.

Once companies have determined that a particular investment is worth the danger, they can use traditional techniques

nearly always carries an upside because such nations are so unstable that negative shocks can do little further damage. On the stability ladder, for example, Afghanistan and Cambodia simply don’t have far to fall; only favorable external conditions—such as debt relief from the developed world or loans from international institutions—could have much effect on their political stability. For some companies, that could make investments in such countries an attractive part of an enterprise risk portfolio.

Politics has always been inseparable from markets; the world’s first transnational trade organizations were moved by the political waves of their time. Today, goods, services, information, ideas, and people cross borders with unprecedented velocity—and the trend is only intensifying. For company leaders seeking profit in places that are socially, culturally, and governmentally alien, the complementary insights of political and economic risk analysts are vital. 

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