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Learning to Fly: The Evolution of Political Risk Analysis

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This article analyses the concept of political risk, its evolution and conceptualisation, and explores its utility as a means of understanding political events and processes that can threaten order, stability and continuity in International Relations and disrupt the normal practices of inter-state investment, trade and commerce. More particularly, the article organises the disparate literature that surrounds the concept of political risk such that it might be more rigorously applied as a social science method for understanding political events and their effects upon commercial and strategic activities.

Introduction

> Living at risk is jumping off the cliff and building your wings on the way down.
>
> Ray Bradbury

Since the 1960s a rapidly growing proportion of firms have procured their factor inputs through international outsourcing and offshore component production. By 2003, the number of multinational enterprises (MNEs) in the global economy had grown to 65,000, operating some 850,000 foreign subsidiaries and employing approximately 80 million employees with global sales in excess of US$11 trillion.[1] The extent of overseas activity measured in terms of foreign direct investment (FDI) reflects a similar trend, with the total cumulative value of FDI standing at US$112 billion in 1967, growing to US$4.1 trillion in 1998 and expanding to US$7.1 trillion in 2003—despite interruptions associated with the global economic slowdown (2000), terrorist attacks (2001) and the war on terror.[2] Emblematic of the growing importance of overseas commerce to global gross domestic product (GDP) has been the meteoric rise in the economic power enjoyed by MNEs. As primary agents of globalisation, MNEs have witnessed year-on-year increases in the volume of economic activity they generate, up from less than 5% of global GDP in 1970 to 10% in 2003. However, such figures "underestimate the

1. United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2003* (New York and Geneva: United Nations, 2003).
2. *Ibid*. Further analysis of this trend can be found in Darrel Mahoney, Marie Trigg, Rocky Griffin and Michael Pustay, *International Business: A Managerial Perspective* (Englewood Cliffs, NJ: Prentice Hall, 2001).

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growth of MNEs, since much of their growth is financed internally or from capital markets . . . they now account for up to a third of world output and two-thirds of world trade, with around a quarter of world trade being between branches of the same company".[3]

Not surprisingly, the revenues generated by some MNEs are far greater than the GDP of many states. The combined revenues of the largest 10 MNEs in 2003, for example, exceeded the combined GDP of the world's poorest 100 states, while the annual revenues of Wal-Mart (US$258.681 billion), one of the largest MNEs, are larger than the economy of Belgium (US$245.3 billion), Saudi Arabia (US$188.4 billion), Ireland (US$121.4 billion) and Singapore (US$86.9 billion), as well as the gross national product (GNP) of 168 other states.[4] Ranked in terms of total trade sales, for example, Wal-Mart is China's eighth largest trade partner and is currently responsible for 10% of the US trade deficit with China.[5]

Globalisation provides greater commercial opportunities as well as greater risk exposure in a world still prone to conflict and lawlessness. However, risk exposure to multiple markets and disparate geographical locales has long been a feature of international investment and trade. Extortion and expropriation of the assets of foreign investors can be recorded as far back as ancient Greece and the Roman Empire. In the 17th and 18th centuries, high seas pirates posed continuing risks for the British, Spanish and French mariners importing exotic wares from the new world, while in the 20th century invasion and armed aggression have been frequent occurrences threatening commercial and colonial holdings in Europe, Africa, Asia and Latin America. Risk, or more particularly political risk, is thus a feature with a long history in International Relations (IR). Yet for such an endemic characteristic of the international system it has received scant attention in the academic discipline of IR.[6] In part, this is explained by the predominance of high politics in the 20th century. Recurrent inter-state warfare, combined with the prospects of nuclear confrontation, monopolised intellectual inquiry and theoretical efforts during the Cold War. Low politics, by contrast, tended to be marginalised. In addition, the primacy of the state and the state system has framed the dominant approaches to IR. When non-state actors such as MNEs have been accorded a more central analytical role, commentators have tended to regard them through ideological blinkers. The spate of new-left and dependency approaches of the 1960s and 1970s, for example, viewed MNEs as agents of powerful states (particularly the United States) or as instruments of capitalism. In either case, MNEs were analysed in terms of the impoverishment they brought to developing economies, for the wealth they transferred through profit repatriation to shareholders and corporate headquarters, how their activities destabilised developing countries, created a core–periphery relationship in

3. Jonathan Perraton, David Goldblatt, David Held and Anthony McGrew, "Economic Activity in a Globalizing World", in David Held and Anthony McGrew (eds.), *The Global Transformations Reader* (Cambridge: Polity, 2000), p. 296.

4. World Bank data, GNP 2002, available: <www.worldbank.org/data/databytopic/GDP.pdf>.

5. As quoted in the *Detroit Free Press* (8 July 2003), available: <www.freep.com/money/business/trade8_20030708.htm> (accessed 18 May 2006).

6. Notable exceptions include Rose McDermott, *Risk-taking in International Politics: Prospect Theory in American Foreign Policy* (Ann Arbor: University of Michigan Press, 1998); Yaacov Vertzberger, *Risk Taking and Decisionmaking: Foreign Military Intervention Decisions* (Stanford: Stanford University Press, 1998).

the global economy, and promoted inequality in the global distribution of wealth and power.[7] Much of the literature in IR has thus been ill-disposed to view MNEs as anything other than either marginal or exploitive, predatory agents or subordinate to state actors. Little wonder that few scholars have chosen to view IR through the eyes of MNE actors, and still fewer to devote much time to exploring political risk as a mediating relationship between states and non-state economic actors.[8]

Political risk analysis straddles numerous disciplines that address the relationship between state and non-state economic actors. While not the focus of their subject matter, to varying degrees scholars concerned with developmental politics and economics, political economists concerned with the issues of trade, investment and the activities of multinational enterprise, and students of international business exploring risk and risk exposure and its effects upon the overseas activities of firms, have all grappled with the problem of political risk.[9] The ubiquity of political risk explains its empirical presence despite its conceptual absence in the study of IR.

Political risk is normally understood as a function of IR and as a product that grows out of cross-border activities. Indeed, political risk is intimately connected to the state system and its organising principle of sovereignty. Since 1648, sovereignty has been the guiding principle of the Westphalian system, limiting the juridical scope of regulatory orders, property and individual rights, and exposing individuals, commercial actors and state agents to the vagaries of risk that arise from communitarian-based social, political and economic orders.

Ironically, while globalisation has witnessed the emergence of transnational regimes and the increasing standardisation of international norms and rule-governed behaviour, the depth of these regimes has not been so great as to reverse the pernicious nature of sovereignty and the ubiquity of force, coercion, illegality and extortion, all of which remain within the purview of intra-state jurisdiction. Even where such state excesses have been moderated with the global movement towards liberalisation of financial markets, removal of capital controls, increasing recognition of international property rights and the rollback of protectionist measures, state discretion to transgress

7. A classic example is David Korten's polemic *When Corporations Rule the World* (San Francisco: Berrett-Koehler, 1995). See also, for example, André Gunder Frank, *The Development of Underdevelopment* (Boston: New England Free Press, 1966); Harry Magdoff, *The Age of Imperialism: The Economics of US Foreign Policy* (New York: Monthly Review Press, 1969); Richard J. Barnett, *Global Reach: The Power of Multinational Corporations* (New York: Simon & Schuster, 1975); Susanne J. Bodenheimer, "The Ideology of Developmentalism: American Political Science's Paradigm Surrogate for Latin American Studies", *Berkeley Journal of Sociology*, Vol. 15, No. 3 (1970), pp. 95–137.

8. However, see Robert O. Keohane and Van Doorn Ooms, "The Multinational Firm and International Regulation", *International Organization*, Vol. 29, No. 1 (1975), pp. 169–209; Lorraine Eden, "Bringing the Firm Back In: Multinationals in International Political Economy", *Millennium: Journal of International Studies*, Vol. 20, No. 2 (1991), pp. 197–224.

9. See, for example, Stephan H. Robock, "Political Risk Identification and Assessment", *Columbia Journal of World Business*, Vol. 6, No. 4 (1971), pp. 6–20; Stephan H. Robock and Kenneth Simmonds, *International Business and Multinational Enterprises* (Boston: Richard D. Irwin, 1989); Richard J. Herring (ed.), *Managing International Risk* (Cambridge: Cambridge University Press, 1986); Bent Flyvbjerg, Nils Bruzelius and Werner Rothengatter, *Megaprojects and Risk: An Anatomy of Ambition* (Cambridge: Cambridge University Press, 2003); Howard K. Lax, *Political Risk in the International Oil and Gas Industry* (Boston: International Red Cross, 1983).

these rules has been recurrent, leaving political risk a continuing reality in the international environment.[10]

The Changing Patterns of Political Risk

While the concept of risk through political action has been inherent in the international arena since the time of the ancient Greeks, its most recent intellectual pedigree emerged in the post-war period. In part, this has been a function of increasing capital flows from North America and Western Europe to developing economies.[11] More particularly, of course, interest in political risk developed in response to the dangers posed to these investments. High-profile incidents involving the nationalisation of foreign interests in the Suez Canal (1956), Cuba (1959) and in Chile (1972), as well as the expropriation of land holdings owned by the American United Fruit Company in Guatemala in 1951 and of petroleum extraction assets held by Texaco and Chevron in Nigeria in 1975, all provided demonstrable evidence of the perils faced by international investors.

These concerns tended to abate as the 1970s progressed, due partly to ideological shifts among ruling elites in emerging economies. The utility of private foreign investment capital to economic development and poverty reduction, as well as its centrality to successful modernisation and industrialisation, became the dominant mantra underscoring domestic political legitimacy and regime stability. Many ruling elites in emerging economies thus redirected their efforts to attracting FDI in order to accelerate development and secure regime legitimacy.[12] This was particularly true throughout Asia, where the newly industrialising countries (NICs) of Singapore, Hong Kong, Thailand and Malaysia experienced high growth and massive inflows of FDI. Nonetheless, foreign commercial interests continued to experience expropriation threats, most obviously with the tumultuous events at the close of the 1970s with the Iranian revolution and the prompt nationalisation of its petroleum assets. Indeed, the 1980s produced as many expropriation claims against political risk insurers as the 1970s. Expropriation, however, has been only the most obvious form of political risk. The 1980s also witnessed new forms of political risk associated with a spate of sovereign defaults as a

10. The exploration of risk as a feature of late modernity has been a central motif for recent sociological work by scholars such as Ulrich Beck, *Risk Society: Towards a New Modernity* (London: Sage, 1992); Anthony Giddens, *The Consequences of Modernity* (Stanford: Stanford University Press, 1990); David Harvey, *The Condition of Postmodernity: An Inquiry into the Conditions of Cultural Change* (Cambridge: Blackwell, 1990); Peter Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley, 1996). It should be noted that political risk does not exist merely as a feature of inter-state activity. The constitution of modern polities into distinct sovereignties also creates political risk for domestic economic actors and subjects. The centralisation of power and the ability to wield this power in ways that enhance the juridical reach of the state and its ability to shape the regulatory structure of markets allows political sovereigns to create risk for other actors. Political favouritism, unintended policy consequences, and the illegitimate use of state power are as much a source of risk for domestic actors as they are for international non-state actors.

11. The causal mechanisms facilitating financial liberalisation during this period have been most clearly elaborated by Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1996).

12. For further analysis of this shift in the global risk environment, see Theodore H. Moran, "The Changing Nature of Political Risk", in Theodore H. Moran (ed.), *Managing International Political Risk* (Oxford: Blackwell, 1998), pp. 7–14.

result of the Third World debt crisis that began in Mexico in 1982 and spread throughout Latin America, Africa, and parts of Southeast Asia including Indonesia and Thailand.[13]

More recently, interest in political risk has been boosted by a new wave of international concerns. The five-fold increase in private foreign capital flows from developed to developing countries between 1990 and 1997, for example, exposed private investors to the global vagaries of managed hedge funds and currency instabilities experienced with the Asian financial crisis.[14] This was followed closely by rapid devaluation of foreign investments and currency exposure in Brazil and Argentina, the imposition of capital controls in Malaysia and continuing trepidation over commercial transactions with China. Risk in the 1990s thus centred on the problems of exposure to countries whose institutional capacity and prudential and regulatory structures proved both opaque and unstable. For investors engaged in more complex exposures to such markets, the paucity of internal governance structures and the absence of transparency create obstacles for market participants to gauge the risk environment in which they operate.

The changing forms of political risk are also apparent with the transition in governance structures currently being experienced among many emerging economies. Decentralisation in Indonesia, for example, has complicated the legal and administrative corridors of responsibility, creating numerous avenues for misadventure, malfeasance and nefarious activities by corrupt provincial officials. While in Indonesia this has been articulated as a form of bureaucratic inertia creating administrative and legal bottlenecks for foreign investors, in Brazil it has witnessed renewed forms of expropriation by regional politicians.[15] Domestic political reorganisation evident in many emerging economies, especially transition economies moving tentatively towards more inclusive forms of democratic representation, has generated new avenues to wrest control of resources from foreign investors in ways best described as creeping expropriation. The problem of governance, institutional capacity, and the adequacy of prudential regulation in emergent financial markets thus poses a series of new, critical risk factors, all of which were particularly acute in the 1990s.[16]

The most recent and obvious interest in political risk, however, stems from the events surrounding 11 September 2001 and the turbulence associated with terrorist attacks in the Middle East, Bali, Jakarta, Kenya, Yemen, Istanbul, Madrid and London, the instability caused by geo-political actions in Afghanistan and Iraq, and possible exposure to future terrorist attacks from fallout due to the "war on terror". The events of 11 September 2001 exposed some of the world's leading companies to business continuity risk and the prospect of total loss, not just from the loss of data systems, communications and the destruction of operating infrastructure, but more importantly the loss of human capital and irreplaceable

13. For an excellent overview of this process, see Gerard Epstein, "The Triple Debt Crisis", *World Policy Journal*, Vol. 2, No. 4 (1985), pp. 625–657.

14. See, in particular, Gregory Noble and John Ravenhill (eds.), *The Asian Financial Crisis and the Architecture of Global Finance* (Cambridge: Cambridge University Press, 2000).

15. A good discussion of the Brazilian situation can be found in John Minor, "Mapping the New Political Risk", *Risk Management Magazine*, Vol. 50, No. 3 (2003), pp. 10–18.

16. See Gerard Epstein and Herbert Gintis, "International Capital Markets and National Economic Policy", *Review of International Political Economy*, Vol. 2, No. 4 (1995), pp. 693–718; Jeffry Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance", *International Organization*, Vol. 45, No. 4 (1991), pp. 425–451.

institutional capacity. Thankfully, such dramatic instances are infrequent. However, they illustrate the financial and commercial interdependence of the global risk environment, the interconnection of financial markets and the ability of apparently isolated risk events such as the attacks in Washington and New York to be socially amplified through modern communications media. For example, while the direct economic cost due to physical destruction of buildings and infrastructure amounted to something in the order of US$27 billion, US-wide losses as a result of the subsequent economic downturn ran to US$500 billion, a figure undoubtedly dwarfed by the global economic slowdown.[17]

Furthermore, the varied responses to the attacks, which range from increased military spending, additional force deployment, regime change in "rogue states", and the development of new pre-emptive military doctrines, represent new and perhaps more extensive derivative risks than the attacks themselves posed. The hazards include exposure from force deployment, instability for the global security, political and economic order, and possible "blowback" terrorist attacks in the future. Political risk is thus prone to the distorting effects of amplification through global communications and international media. The amplification of political risk is an unavoidable by-product of globalisation, where the political–strategic–commercial interdependence of national economies acts as a medium through which isolated risk events can be felt in disparate geographic localities but with global ramifications. It is this phenomenon that makes the emerging risk environment unique, and highlights antagonisms in the international order that will undoubtedly act as "risk drivers" well into the future.

Understanding Political Risk

The literature on political risk is diverse and remains at the pre-theory stage of its evolution. Indeed, the vast bulk of political risk literature is readily identified by its preoccupation with the identification of key drivers and variables that comprise political risk and cause its variance. These definitional explorations, however, have been undertaken from discrete disciplinary corners, producing non-contiguous literatures. While the vast bulk of political risk literature is concerned with risk as it affects multinational enterprise, a not insignificant proportion of the literature approaches political risk from the perspective of conflict avoidance and the aversion of state failure, and has been developed by theorists concerned with peace and conflict studies and IR. These two approaches yield different definitional starting points and modes of analyses.

First-generation Approaches: The Catalogue School

By far the dominant conception of political risk relates to its negative consequences for the cross-border investment activities of MNEs; where political risk

17. Robert Looney has estimated the costs for the private business sector (US$14 billion), the federal government (US$0.7 billion), state and local government enterprises (US$1.5 billion), and for the clean-up operation in New York (US$11 billion). See Robert Looney, "Economic Costs to the United States stemming from 9/11 Attacks", *Strategic Insights* (Monterey, CA: Center for Contemporary Conflict, Naval Postgraduate School, August 2002), available: <www.ccc.nps.navy.mil/rsepResources/si/aug02/homeland.pdf>. See also Dean Alexander and Alexander Yonah, *Terrorism and Business: The Impact of September 11, 2001* (Ardsley, NY: Transnational Publishers, 2002).

is seen to arise from actions taken by host governments, government agencies, or political actors in host countries that adversely affects the operations, value or profitability of MNEs. On this understanding political risk is simply the amalgam of "unwanted consequences of political activity", or, more specifically, "the aggregate negative effect of governmental and societal actions and/or inertia on a select group or all foreign concerns operating in or wishing to penetrate a country's market".[18] This conception of political risk analysis informs the work of what might be called the catalogue school, whose practitioners simply develop lists of the possible negative activities of governments in host countries that detract, or have the potential to detract, from business operations, value and profitability.[19] Political risk is conceived as political intrusion into otherwise sanguine, functioning and efficient markets. This approach dominated the initial wave of political risk literature that emerged in the early 1950s and, indeed, continues to exert significant influence today.[20] It is a collective effort to disentangle the multifarious series of non-financial and non-market risks into discrete categories in order that they might be described, assessed, and their effects mitigated.

However, this first-generation approach to political risk is conceptually flawed and of limited methodological value. It assumes a rather simplistic view not just of political processes but also of markets. First, it assumes that markets are perfect or near perfect, prone to equilibrium, self-regulating and otherwise functional. Second, it assumes that markets are independent entities that are forced to interact with non-market actors and non-market signals, thus constructing a bifurcated image of the relationship between political systems and economic markets.[21] The notion of imperfect markets, poor transparency, and activities such as monopoly practices, organisational self-preservation and collusion are excluded from the theoretical purview of such approaches. They imply that markets are not embedded in states or a broader societal polity, and that the latter are intrusive to markets and alien to efficient market operation. This artificially disembeds markets and business relations from their socio-political contexts and sees all political activity as negative, market distorting, and detrimental to business profitability. According to the catalogue school, political risks exist because of politics

18. Anna Zakada-Fraser and Campbell Fraser, "Risk Perception by UK Firms Towards the Russian Market", *International Journal of Project Management*, Vol. 20, No. 1 (2002), p. 99. See also Fred V. Weston and Bart W. Sorge, *International Managerial Finance* (New York: Richard Irwin, 1972), p. 60.

19. For a good example of such a list, which refers to 14 discrete activities, see M. Anaam Hasmi and Turgut Guvenli, "The Importance of Political Risk Assessment Function in US Multinational Corporations", *Global Finance Journal*, Vol. 3, No. 2 (1992), pp. 137–144.

20. See Stephen Kobrin, "Political Risk: A Review and Reconsideration", *Journal of International Business Studies*, Vol. 10, No. 1 (1979), pp. 67–80; David Blake, "The Political Environs of Multinational Corporations", in Ingo Walter and Tracy Murray (eds.), *Handbook of International Business* (New York: John Wiley, 1982).

21. For a good example of how these assumptions inform political risk analysis, see David W. Conklin, "Analyzing and Managing Country Risks", *Ivey Business Journal*, Vol. 66, No. 3 (2002), pp. 37–41. Conklin argues that political risk correlates positively with market intrusion and government regulation. His analysis is consistent with the ideological predispositions informing the work of policy think tanks such as the Fraser Institute in Canada and the Heritage Foundation in the United States. For an excellent critique of these organisations' respective Indices of Economic Freedom, see Lewis Snyder, "Comparing Measures of Economic Freedom: The Good, the Bad and the Data", in Jerry Rodgers (ed.), *Global Risk Assessments: Issues, Concepts and Applications, Book Five* (Riverside, CA: Global Risk Assessments, 2004), pp. 181–228.

and governments, and can thus only be removed by limiting the power and regulatory reach of government.

First-generation approaches to political risk thus render analytically invisible the role of the state as an enabling agent of commercial practice. As economic historians have long recognised, states and their regulatory arms are prescient to market operation and a necessary conduit to ensure the transmission of market information and transparency.[22] Rather than the presence of such actors, it is their absence that increases political risk. The great lesson of the 1997 Asian financial crises, for example, has been to affirm the centrality of functioning political systems and regulatory bodies for sound economic outcomes. Weak state capacity makes for poor economic outcomes, and weak state institutions create conditions prone to market failure or distortion. The recent and continuing emphasis on good governance by leading international agencies such as the International Monetary Fund (IMF) and World Bank, for example, stresses the importance of institutional capacity to support the operation of financial markets, market transparency and probity, and to provide administrative and legal corridors for the transfer of assets, debt, and debt settlement.[23] Without state and institutional capacity, markets very often implode or function inappropriately, and expose participants to risk.[24]

The relatively crude conceptual apparatus offered by first-generation political risk approaches thus leaves little room to develop methodological frameworks that treat seriously political processes and the manner in which they manifest and articulate with markets. Political risk is treated exogenously, as a set of market interventions with negative consequences. The fact that political risk can stem from the absence of effective, functioning political systems leaves this literature bereft of methodological tools to forecast political risk, analyse its likely future dimensions, and to manage its consequences.

Second-generation Approaches: The System–Event School

Second-generation political risk approaches implicitly recognise the limitations of the catalogue school. Delimiting political risk to the activities of governments forecloses consideration of state and system type, and of possible correlations between political systems and political risk.[25] Moreover, intuitive and empirical observation suggests that broad correlates exist between certain types of state and the level and extent of certain political risks. Particular state types, for

22. The classic work in this field is Karl Polanyi's *The Great Transformation* (New York: Octagon, 1975).

23. For further analysis of this shift in attitude towards the role of good governance, see Sanjaya Lall, "East Asia", in John H. Dunning (ed.), *Governments, Globalization and International Business* (Oxford: Oxford University Press, 1997), pp. 414–423. See also Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer and Robert Vishny, "The Quality of Government", *Journal of Law and Economic Organization*, Vol. 15, No. 1 (1999), pp. 222–279.

24. See World Bank, *Reforming Public Institutions and Strengthening Governance* (Washington, DC: World Bank, 2000).

25. See, in particular, Louis W. Pauly, "National Financial Structures, Capital Mobility, and International Economic Rules: The Normative Consequences of East Asian, European, and American Distinctiveness", *Policy Sciences*, Vol. 27, No. 4 (1994), pp. 343–363; Louis W. Pauly and Simon Reich, "National Structures and Multinational Corporate Behaviour: Enduring Differences in the Age of Globalization", *International Organization*, Vol. 51, No. 1 (1997), pp. 1–30.

example, display less stability and are more prone to nefarious political activity, crime, corruption and regime change than are other state types. Different states thus have different political risk profiles, opening up the possibility of developing models that can link system characteristics with the likely development of specific political risk events. For political risk analysis, this holds out the prospect of developing prescriptive social science models able to alert investors, states or stakeholders to future risk events and thereby avoid exposure to them.

Unlike first-generation political risk approaches, second-generation approaches understand the mutually constitutive nature of political systems and markets. On its own, economic growth is no indicator of low levels of political risk. Indeed, economic modernisation can generate political risk in situations where the absence of political development, or the inability of the political system or political elites to accommodate the demands of powerful emerging constituencies, precipitates political crisis and radical political change.[26] Second-generation approaches to political risk are informed by political modernisation theory and the spate of studies surrounding the decolonisation process and the emergence of numerous new, fragile states in the immediate aftermath of the Second World War. While development economists attempted to distil the conditions necessary for economic growth, industrialisation, and a mass consumptive society, political scientists and sociologists were equally at work discerning the conditions necessary for political modernisation, institutional development, and the emergence of mature, liberal democratic societies.[27] What was it that caused societies to develop politically, for political cultures and political institutions to emerge and support complex economic systems and production networks?

The answers come predominantly from the identification of pattern variables endemic to cultural, social, and political modernisation.[28] Developed societies display certain social and political attributes; functional differentiation, specialisation, individual autonomy, adaptation, and increasing complexity. They also display increasing socio-political differentiation facilitating wider freedoms from the bonds of family, locality, and religion (individualism; separation of state and Church; secularism, social atomisation), but set amid integrative dynamics and technologies that otherwise reproduce social orders and create larger society-wide referents beyond familial or clan association (citizenship, nationalism). These evolutionary universals are associated with

26. On this point, see in particular Michael Loriaux, "Capital, the State, and Uneven Growth in the International Political Economy", in Michael Loriaux, Meredith Woo-Cumings, Kent Calder, Sylvia Maxfield and Sofia Pérez, *Capital Ungoverned: Liberalizing Finance in Interventionist States* (Ithaca, NY: Cornell University Press, 1997), pp. 208–229.

27. The most famous scholar of economic modernisation was Walt Rostow, who distinguished between five stages of economic growth. See Walt W. Rostow, *The Stages of Economic Growth: A Non Communist Manifesto* (Cambridge: Cambridge University Press, 1960). In political science, modernisation theory was championed by scholars such as Samuel P. Huntington, *Political Order in Changing Societies* (New Haven, CT: Yale University Press, 1968); Gabriel A. Almond and G. Bingham Powell, *Comparative Politics: A Developmental Approach* (Boston: Little, Brown, 1966); Gabriel A. Almond and James S. Coleman, *The Politics of Developing Areas* (Princeton, NJ: Princeton University Press, 1960).

28. See, in particular, Talcott Parsons, *Economy and Society: A Study in the Integration of Economic and Social Theory* (London: Routledge & Kegan Paul, 1956); Talcott Parsons, *Structure and Process in Modern Society* (Glencoe, IL: The Free Press, 1960).

structural-functional attributes that, if identified, can be transplanted or diffused into emerging societies, helping to quicken the pace of development and avert the social and political ills of political backwardness.[29]

Structural-functional analysis generated a series of studies into the comparative strengths and weaknesses of specific state types, and the political, cultural, regulatory and social environment endemic to their composition, in the process producing comprehensive typologies.[30] For political risk analysts it was only a short step to infer the probability of event scenarios like regime change, revolution, civil disturbance, or the degree of probity associated with specific types of emerging political systems.[31] While not a predictive tool that could be correlated to specific future risk events, structural-functional analysis could provide insights into the risks associated with specific stages in the political modernisation cycle, and of possible trigger points that could pre-empt political instability or derail further modernisation. Second-generation approaches to political risk generally coalesce around what we might loosely term the system–event school. This school stresses the identification of events that have an impact on regime stability and detract from the incumbent regime's capacity to govern, or system characteristics which facilitate the emergence of political events and which detract from system stability, political maturation and legitimacy.[32] Political risk is associated with events such as social or political unrest, expropriation, labour problems associated with strikes, problems associated with profit remittance such as currency controls, or events such as the imposition of import restrictions. These events derive from a specific system type, normally modernising fragile states prone to be captured by domestic constituencies and otherwise not able to exert control and implement policy in the longer term interests of the state as a whole. Captured states, in other words, pursue policies that reflect the narrow sectional interests of ruling elites within emerging states, increasing the political

29. See, for example, Shmuel N. Eisendstadt, *The Protestant Ethic and Modernization: A Comparative View* (New York: Basic Books, 1968); Henry Bernstein, "Sociology of Underdevelopment versus the Sociology of Development", in David Lehmann (ed.), *Development Theory: Four Critical Essays* (London: Frank Cass, 1979), pp. 77–106.

30. The quintessential study in this approach is Almond and Coleman, *op. cit*.

31. See David Mathieson and Leonard Seabrooke, "Risk Assessment and Foreign Investment under Despotic Rule", in George Crowder *et al*. (eds.), *Australasian Political Studies 1997*, Vol. III: *Proceedings of the Australasian Political Studies Association* (Adelaide: Flinders University, 1997), pp. 691–712.

32. For example, Haendel and his colleagues have developed a 15-category model composed of constituent elements which impact on "political system stability". The model is used to generate a "stability index" composed of weighted indicators for socio-economic factors, governmental processes and societal conflict risk indicators. An events approach to political risk analysis is also evident in the work of Bunn and Mustafaoglu, who identify 10 event categories, each with sub-constituent elements that are assumed to have significant operational implications for foreign firms and which originate from imperfect governing structures associated with emerging markets and modernising societies. Likewise, Mortanges and Allers suggest that political risk is composed of events such as social or political unrest, expropriation, labour strikes, and the imposition of currency controls. Dan Haendel, Gerald West and Robert Meadow, *Overseas Investment and Political Risk*, Foreign Institute Monograph Series, No. 21 (Lexington, MA: Lexington Books, 1975); D.W. Bunn and M.M. Mustafaoglu, "Forecasting Political Risk", *Management Science*, Vol. 24, No. 15 (1978), pp. 1557–1567; Charles Pahud de Mortanges and Vivian Allers, "Political Risk Assessment: Theory and the Experience of Dutch Firms", *International Business Review*, Vol. 5, No. 3 (1996), pp. 303–318. See also Janice Monti-Belkaoui and Ahmed Riahi-Belkaoui, *The Nature, Estimation, and Management of Political Risk* (Westport, CT: Quorum Books, 1998).

risks for foreign investors and jeopardising the longer term economic benefits to the country.[33]

For second-generation approaches, political risk exists along a spectrum that ranges from low to high and corresponds roughly to political systems that are undeveloped compared to those that are highly developed.[34] The degree of political risk is therefore a reflection of the capacity of a state and its political system to manage political events, competing sectional interests, exercise legitimacy, and discharge the functions of statehood in a non-violent, stable, orderly, democratic manner. Political risk and the possibility of political instability correlate inversely with the level of modernisation and adaptability of a political system. More importantly, the level of political risk is correlated positively to stress caused by rapid economic modernisation, where the political system can be overstretched to the point of crisis when confronted with complex demands occasioned by rapid development, social dislocation, and the emergence of issues which it does not have the institutional capacity to absorb.

These insights suggest various investment strategies for avoiding political risk. First, identify the system type into which the country falls, then design investment strategies that reflect the political risk "profile" of the country. Thus, in the case of military dictatorships where legitimacy is low, the use of violence ubiquitous, and sudden regime change or popular uprising possible, avoid long-term investments, use short-term investment vehicles, minimise sunk costs, and attempt to contain investments in liquid and easily withdrawn assets. Conversely, emerging societies promise the least political risk, inviting longer term investment and the ability to support higher sunk costs with exposure to fixed infrastructure (mining, production) with relatively low political risk. Not unexpectedly, adaptive systems display the lowest levels of political risk and the highest levels of political stability, able to absorb long-term investments, high sunk costs, and multiple investment exposures.

While second-generation approaches to political risk are a marked improvement over their predecessors in the catalogue school, their achievements have been modest. Part of the problem stems from the use of a circular logic. Low political risk and high political stability are manifest in systems that are developed, predominantly Western, liberal democratic, and capitalist. By definition, any state that displays dissimilar characteristics represents a political risk and the possibility of instability. On this understanding, political risk is attributed to non-Western states, thus betraying what critics allege to be ethnocentric values and neo-imperialist attitudes. Second-generation approaches also display a capricious understanding of political stability and political risk. Why is political instability or regime change necessarily a risk to business? Political stability interrupted by sudden system change to replace despotic dictatorships, for example, generally signifies a reduction in political risk, greater political transparency, and can be the basis for less autocratic intervention into the economy. Moreover, sudden, dramatic political events such as regime change, apart from being infrequent, are not themselves always hazardous to business activity or the operations

33. For an attempt to integrate qualitative assessment methods with quantitative multivariate analysis in predicting instability in Indonesia, see Rudolf J. Rummell and David A. Heenan, "How Multinationals Analyze Political Risk", *Harvard Business Review* (January–February 1978), pp. 67–76.

34. See, for example, Dan Haendel, *Foreign Investment and the Management of Political Risk* (Boulder, CO: Westview, 1979).

of MNEs. For example, regime change in Indonesia with the fall of President Suharto had no immediate consequences for the presence of foreign business interests. Indeed, many welcomed regime change and the possibility of greater economic freedom in the country.

Thus, the conflation of political instability and political risk, while intuitively appealing, is simplistic. While regime instability or sudden regime change can certainly "spook" investors, there are few empirical grounds to infer a strong correlation between regime change, political risk and any impact upon the activities of foreign investors. Indeed, large risk events such as nationalisation or expropriation normally occur under conditions of relative regime and political stability, and reflect state capacity, institutional depth and authority to undertake such activities. Put simply, second-generation approaches to political risk look only at political events and system structure, but cannot establish direct correlations between these events and their impact upon firms. As Stephen Kobrin points out:

> What we are, or should be, concerned with is the impact of events which are political in the sense that they arise from power or authority relationships and which affect (or have the potential to affect) the firm's operations. Not the events, *qua* events, but their potential manifestation as constraints upon firm investments should be of concern.[35]

In part, this problem arises from the system–events school's treatment of foreign investment as a ubiquitous category without allowing for variation in investment type. Different investment types interact with regulatory regimes, political systems, political coalitions and political elites differently, and thus generate different forms of political risk. Attempting to build system-wide correlations and universal theory ignores the fact that not all political events have the same risk implications for foreign investment. In Nigeria, for example, the Royal Dutch Shell Company has successfully operated physical plant, equipment, and pipelines despite widespread civil unrest and continuing political instability—an environment that would be unthinkable for retail chains or manufacturers. The ability analytically to disentangle investment types and then demonstrate causality between political events, political systems and their impact upon various investments thus escapes the system–events approach entirely.

A related problem is the limited comparative application of system–event stability theory. Can the attributes that contribute to political instability in one country be generalised? As Claude Ake has argued, the development of such theory is elusive, since factors that produce instability in one state might not be relevant to other political systems or produce the same type of instability elsewhere.[36] More fundamentally, what is meant by political instability? If it refers to regime change, can it be assumed that this will result in policy change? If not, then why focus on regime change when policy changes are likely to have the greater impact on economic actors? Conversely, should it be assumed that political

35. Stephen Kobrin, "Political Risk: A Review and Reconsideration", *Journal of International Business Studies*, Vol. 10, No. 3 (1979), p. 71. A similar argument is made by Robert Poirier, "Political Risk Analysis and Tourism", *Annals of Tourism Research*, Vol. 24, No. 3 (1997), p. 677.

36. Claude Ake, "Modernization and Political Instability: An Explanation", *World Politics*, Vol. 26, No. 2 (1974), pp. 576–591.

stability promotes policy stability or continuity? Radical policy change often occurs in situations of political stability and reflects regime legitimacy and strong state and institutional capacity to withstand domestic protest and lobby groups. In all, then, political instability might not be the most appropriate variable that needs measuring in order to assess political risk.[37]

Finally, and with obvious hindsight, the system–events school has had few predictive successes. While this is a failure endemic to social science forecasting generally, it nonetheless highlights the analytical limitations of second-generation approaches. One of the greatest political events of the 20th century, for example, the fall of the Soviet Union, went without any prescience on the part of political scientists or IR scholars. Likewise, the fall of Suharto, the popular revolution in the Philippines that disposed President Marcos, the fall of the Shah in Iran in 1979, the rollercoaster of political disruption in the wake of the Asian financial crises, or any number of similar sudden political events, have all escaped forecasting despite several decades of predictive model building. Unfortunately, the great hope of second-generation approaches, especially in terms of better modelling, precision, and the ability to generate prescriptive outcomes, has not been realised.

Third-generation Political Risk Approaches: Method versus Theory

Positivist political science enjoyed wide application from the 1950s to the 1970s, underscored by a desire to replicate the prescriptive and predictive success of the hard sciences and a belief in the infallibility of rationalist-empirical epistemologies. Political risk analysis was no different, actively pursuing approaches aimed at greater predictive power. This desire stemmed from the nature of political events occurring in developing regions, and the political risks typically encountered by foreign investors. Expropriation and nationalisation of foreign interests dominated political risk for the greater part of the post-war period. In 1975 alone, for example, there were 83 recorded cases of expropriation. Developing models or frameworks of analysis that might predict such events thus promised great rewards and was pursued enthusiastically.[38]

By the 1980s, however, a sea change in host government attitudes towards external investment witnessed a marked shift in the types of political risks. From 1981 to 1992, for example, there were only 11 recorded expropriations.[39] Increasingly,

37. Kent Miller, "A Framework for Integrated Risk Management in International Business", *Journal of International Business*, Vol. 23, No. 2 (1992), p. 314. As Stefan Robock observes, "political instability, as represented . . . by an unexpected change in government leadership, may or may not involve political risk for international business". Stefan Robock, "Political Risk Identification and Assessment", *Columbia Journal of World Business*, Vol. 6, No. 4 (1971), p. 8.

38. As José de la Torre and David Necker note, the environmental turbulence of the period "gave extraordinary impetus to the development of in-house capabilities in political and economic assessment among the world's largest international corporations". José de la Torre and David Necker, "Forecasting Political Risks for International Operations", *International Journal of Forecasting*, Vol. 4, No. 2 (1988), p. 229.

39. Moran, *op. cit.*, p. 8. See also J.M. Chermak, "Political Risk Analysis: Past and Present", *Resources Policy*, Vol. 18, No. 3 (1992), pp. 167–178. The decline in political risk arising from expropriation is evident from surveys conducted in 1992. Out of a total of 14 political risk factors, expropriation was ranked at number 12. See M. Anaam Hashmi and Turgut Guvenli, "Importance of Political Risk Assessment Function in US Multinational Corporations", *Global Finance Journal*, Vol. 3, No. 2 (1992), p. 141.

states now compete for FDI and attempt to set in place policies that attract prospective investors. Large risk events such as expropriations, ideologically motivated coups, mercantilist trade policies, or tariff-based protectionist policies (import substitution industrialisation) have been a shrinking feature of the international political economy. These developments, combined with the spate of poor analytical outcomes associated with second-generation approaches to political risk, have witnessed not just a reorientation in political risk analysis but have also changed the expected outcomes from such endeavours. Political risk approaches are now more circumspect in their ambitions. They aim less towards grand theoretical correlations and more towards informed micro-analyses that emphasise the importance of context, and focus on project-level analysis.

These approaches fall into a number of discrete categories and offer very different insights, but all share a general rejection of the grand theoretical tradition of political science. Third-generation approaches to political risk abandon theory for method. Rather than attempt to develop explanatory schema with predictive capacity, they develop methods to evaluate the risk environment in relation to industry- or project-specific applications.[40] This has thrown up a plethora of approaches, all with varying degrees of utility and none enjoying wide acceptance as the pre-eminent approach to political risk analysis. To add to the confusion, numerous consulting firms have also developed various "systems" or risk assessment techniques that infuse the literature, creating a profusion of models all claiming to offer superior insights and greater manoeuvrability with regard to risk avoidance. However, the move towards particularistic micro studies generally reliant on qualitative techniques and emblematic of third-generation approaches has also proved to be disappointing. The main reason is that qualitative approaches remain reliant upon the agility and expertise of particular analysts, and the method of analysis is often deductive. They are difficult to test, a limitation especially acute for governmental and commercial organisations in need of more definitive analysis. The holy grail of political risk theorising—constructing quantitative models that can provide testable propositions, or the construction of data sets that can relate accurate probability indices to specific risk events, policy changes, or country settings—thus remains a highly prized goal, despite its difficulties.[41]

Is there a way beyond this impasse? Can meaningful data sets be generated that successfully correlate risk with structural features in the political composition and political practices of states, their institutions and the cultural or procedural norms that comprise their markets and social, political and juridical systems? This question sets a highly challenging task for political risk analysis. It involves the construction of data sets that allow analysts to examine the relationship between political and economic institutions, as well as the interface between domestic norms, actors, institutions, and external influences.[42]

40. See, for example, David Hertz and Howard Thomas, *Practical Risk Analysis: An Approach through Case Histories* (Chichester: John Wiley, 1984).

41. David Bergner, "Political Risk Analysis: An Asset Now, Soon a Must", *Public Relations Quarterly* (Summer 1982), pp. 28–31.

42. Perhaps the most well-known attempt to construct such a data set was constructed by *The Economist* in 1986. In an article entitled "Countries in Trouble", *The Economist* provided 16 variables that

New Fourth-generation Approaches

Perhaps as a result of information data profusion associated with advances in information technologies, numerous attempts are now being mounted to develop risk data bases that attempt to correlate and/or identify specific trigger points with particular risk events such as humanitarian crises, state failure and ethnic conflict.[43] Not unnaturally, much of the most interesting of this work is being done in the foreign policy and IR fields. Here, a diverse range of projects attempt to develop systematic methodologies for identifying trigger points prescient to various international risks associated with food security and famine, ethnic and religious tensions, civil conflict, inter-state hostilities, energy crises and environmental sustainability.[44]

Many of these organisations are involved in preliminary data collection, seeking to establish sufficient data in order to develop leading indicator models able to identify which sequences of events or triggers are precursors to regime instability, conflict, humanitarian crisis, or any series of other severe events. One of the more innovative (e.g. the Country Indicators for Foreign Policy (CIFP)), has grown out of a geo-political data base originally developed by the Canadian Department of National Defence in 1991.[45] The novelty of CIFP rests in its ambitions to move beyond risk analysis into a fully-fledged early warning system prescient to Canada's humanitarian approach to international affairs. Part of this has involved the development of a modelling technique for assessing country risk based on a cross-national "Index of Severity". The index, however, is not simply a straight cross-national comparison between states but a measure of relative performances between states in order better to identify areas of stress that might be triggers for risk and crisis. The insight of the CIFP Index of Severity is its ability to develop indices measuring the

described current political, social, and economic circumstances in which investors would face risks. The variables were weighted to result in a potential accumulation of 100 "risk" points for any of the 50 countries analysed. *The Economist* used proximity to a trouble spot or superpower, extent of authoritarianism, degree of legitimacy of the government, staleness of the regime, involvement of the military, and extent of current war or civil strife as predictors of future harm to the foreign business. As social circumstances portending trouble, it chose rapid and concentrated urbanisation, extent of corruption, degree of Islamic fundamentalism, and level of ethnic tension as critical predictors. Each, it was argued, foretold problems for the investor. Among these 10 variables, only war was likely to cause direct losses. The other variables are simply precursors to war or other forms of damage. See "Countries in Trouble", *The Economist* (20 December 1986), pp. 25–28. For a full discussion of this approach, see Llewellyn D. Howell, Syed Rizvi and Chris Cogswell, "Political Risk in Southeast Asia: A Perspective through *The Economist* Model", *Journal of Asian Business*, Vol. 9, No. 2 (1993), pp. 19–36; and Llewellyn D. Howell, "Political Risk and Political Loss for Foreign Investment", *The International Executive*, Vol. 34, No. 6 (1992), pp. 485–498.

43. See, for example, Monty G. Marshall and Keith Jaggers, *Polity IV Project: Political Regime Characteristics and Transitions, 1800–1999* (College Park: INSCR Program, Center for International Development and Conflict Management, University of Maryland, 2000), available: <http://bsos.umd.edu/cidcm/inscr/polity>.

44. PIOOM (Interdisciplinary Research on the Root Causes of Human Rights Violations), available: <www.fsw.leidenuniv.nl/index.php3?c=149>; GIEWS (Global Information and Early Warning System), available: <www.fao.org/giews/english/index.htm>; GEWS (Global Early Warning System), available: <http://fugimodel.t.soka.ac.jp.FUG/chapter6/chapter6.html>; GEDS (Global Event Data System); available: <http://geds.umd.edu/geds/>; FAST (Early Recognition for Tension and Fact Finding), available: <www.swisspeace.org/fast/default.htm>; ICG (International Crisis Group), available: <www.icg.org/redirect.cfm>.

45. CIFP (Country Indicators for Foreign Policy), available: <www.carleton.ca/cifp>.

relative performance of a state's capabilities rather than simply generating cross-national comparisons based on absolute performance indicators.

With this important innovation and caveat, the CIFP Index of Severity develops a weighted index of nine composite risk indicators (armed conflict, governance and political stability, militarisation, population heterogeneity, demographic stress, economic performance, human development, environmental stress, and international linkages). In addition, each of these composite indicators can be related to any combination or all of the other composite indicators (to a maximum of 72 potential linkages). The Index of Severity thus assigns a weight to each indicator based on the number of linkages it is expected to have with others and thus its input into overall severity. Similar humanitarian early warning systems are also being evolved by organisations like the International Crisis Group (ICG), whose network of country- and region-based representatives across five continents maintains continual monitoring protocols based on field analysis and high-level advocacy to prevent and resolve deadly conflict. Peace researchers in the Netherlands and Scandinavia are likewise working towards early warning modelling based on collecting sufficient data and evolving trigger-point identification techniques.

Conclusion

In this article we have traced the evolution of four distinct generations of political risk analysis in the post-war period. As we have shown, this particular sub-field has rarely been acknowledged by scholars of IR even though its evolution has in many respects mirrored broader changes in the academic study of global society. Over the years, political risk analysis has expanded beyond its narrow confine as the handmaiden of overseas corporate expansion. As its scope has widened to incorporate the concerns of a diverse range of actors beside MNEs, it has also generated an increasingly sophisticated set of methodological techniques to compensate for the drawbacks of earlier generations of political risk analysis. Today, lead indicator modelling approaches and early warning systems characteristic of fourth-generation approaches harbour obvious utility for various aid agencies, NGOs, and international organisations, as well as governmental bodies. If perfected, they can provide vital and timely information, thereby helping to avert humanitarian crises, ethnic conflict or inter-state hostilities. They thus have enormous practical utility in terms of pre-emptive decision making, humanitarian disaster preparedness and conflict avoidance. In contrast to second-generation approaches that attempt to develop abstract typologies of political systems in terms of their risk characteristics vis-à-vis regime stability, social unrest or conflict propensity, fourth-generation approaches are far more specific and actively seek to correlate particular institutions, trigger points, or event sequences and stresses to particular decision-making practices, crises and outcomes. This represents a level of micro-institutional analysis that, if successful, will be able to correlate institutional type to the probability of risk events, or a sequence of events, stresses, strains and relative capability performances, to crisis episodes and conflict outcomes—a level of analytical precision that always escaped previous approaches.

While still in their formative stages, fourth-generation political risk approaches have spurned a renewed excitement about the potential of finally gaining greater analytical precision and of identifying which institutions matter, how they affect risk episodes and the societal risk environment.[46] This obviously opens up the possibility of institutional engineering to help ameliorate all manner of economic and political ills; economic development and growth, enhancing institutional capacity and effective public policy delivery, increasing public-sector resource efficiency, as well as contributing to better institutional probity and administrative transparency.

46. Whilst long-range forecasting of political risks cannot be assessed in terms of empirically demonstrable accuracy, fourth-generation risk forecasts can be viewed as competitions among developmental sequences cast in provisional terms rather than as general laws. For an epistemological defence of this approach to forecasting, see William Ascher, "Beyond Accuracy", *International Journal of Forecasting*, Vol. 5, No. 4 (1989), pp. 469–484.