ΚΕΔΙΣΑ KEDISA
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CENTER FOR INTERNATIONAL STRATEGIC ANALYSES

The Quantification of Political Risk

Dragan Vitoric

Research Paper No. 27

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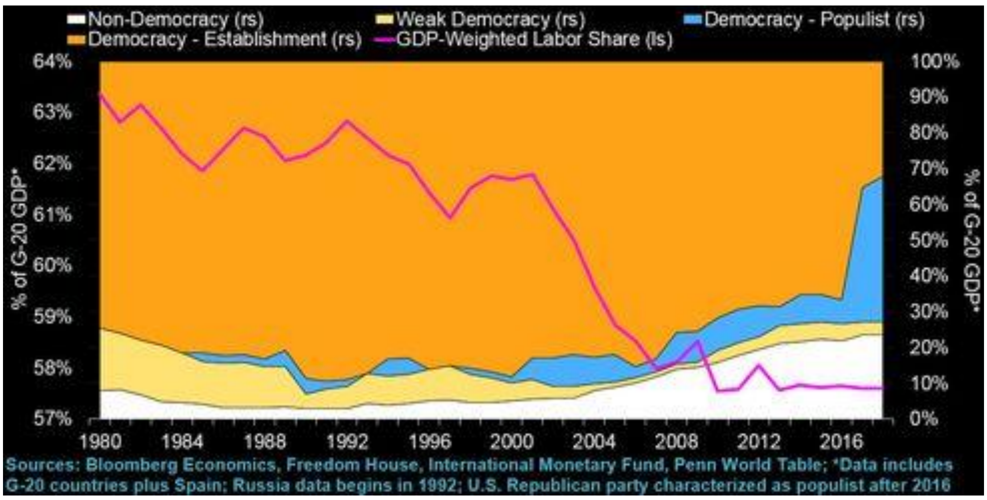
The New Normal and The Quantification of Political Risk

1. Introduction

Living and working in the Global Risk Society, as proposed by Ulrich Beck, assumes the existence within the hyper-competitive world order. Simply put, risk nowadays is both the strategic enabler and the manager of resilience levels of a specific organization, either government or enterprise-based. [1] This can explain the increasing number of companies offering risk analysis and risk prediction services on the market. Businesses today act as diplomats and political actors, often carrying more importance than the national governments, whereas every statement and investment is a political statement. Everything is political today and risk can be traced down to anything. [2]

The world of relatively understandable political risk has disappeared. While it involved autocrats and dictatorships seizing foreign assets and private property, pursuing their own political agendas, nowadays national governments are far more cautious in taking steps that may disturb investors and markets. [3] Additionally, despite governments being still very important players in the business world, the political risk is composed of many loosely related events, including the microscopic changes and activities of individuals. Therefore, the level of political risk faced by business has been alleviated, due to the paradoxical junctures of fierce national competition accompanied by globalization and the interconnectedness. These global dynamics, while making things even more complex and challenging, had been accompanied with the rise of secondary world powers, such as Brazil, India or Vietnam, followed by increased expectations of their citizens[1]. [4]

The understanding of geostrategic and political risks has been going through the rapid changes in the business world, so many executives started reframing their thinking and upgrading the tools of analysis, in an attempt to stay ahead of the uncertainty. While hoping to reap the reward and to exploit the opportunities, decision-makers have also attempted to establish competitive advantage through the process of controlling the political risk. This is a tremendous change when compared to 2013, when many executives, strongly conditioned by the globalized and relatively frictionless world order, openly stated that they did not put significant weight on those types of risks. [5] However, despite the remodeled approach, political actions are often well-beyond business processes, so many managers found themselves unprepared or undertrained for such ambiguity and complexity. Namely, many political risks appear to be low-probability events with their own dynamic and complexity levels. [6]



(Diagram 1: Populism Rising — Share of G-20 GDP by Governing Party)

[1] Careful observation of the Diagram 1, adopted from Bloomberg, may suggest that the highly industrialized countries have recently fallen victim of the rising populism, resulting in the inward orientation of the governments [5].

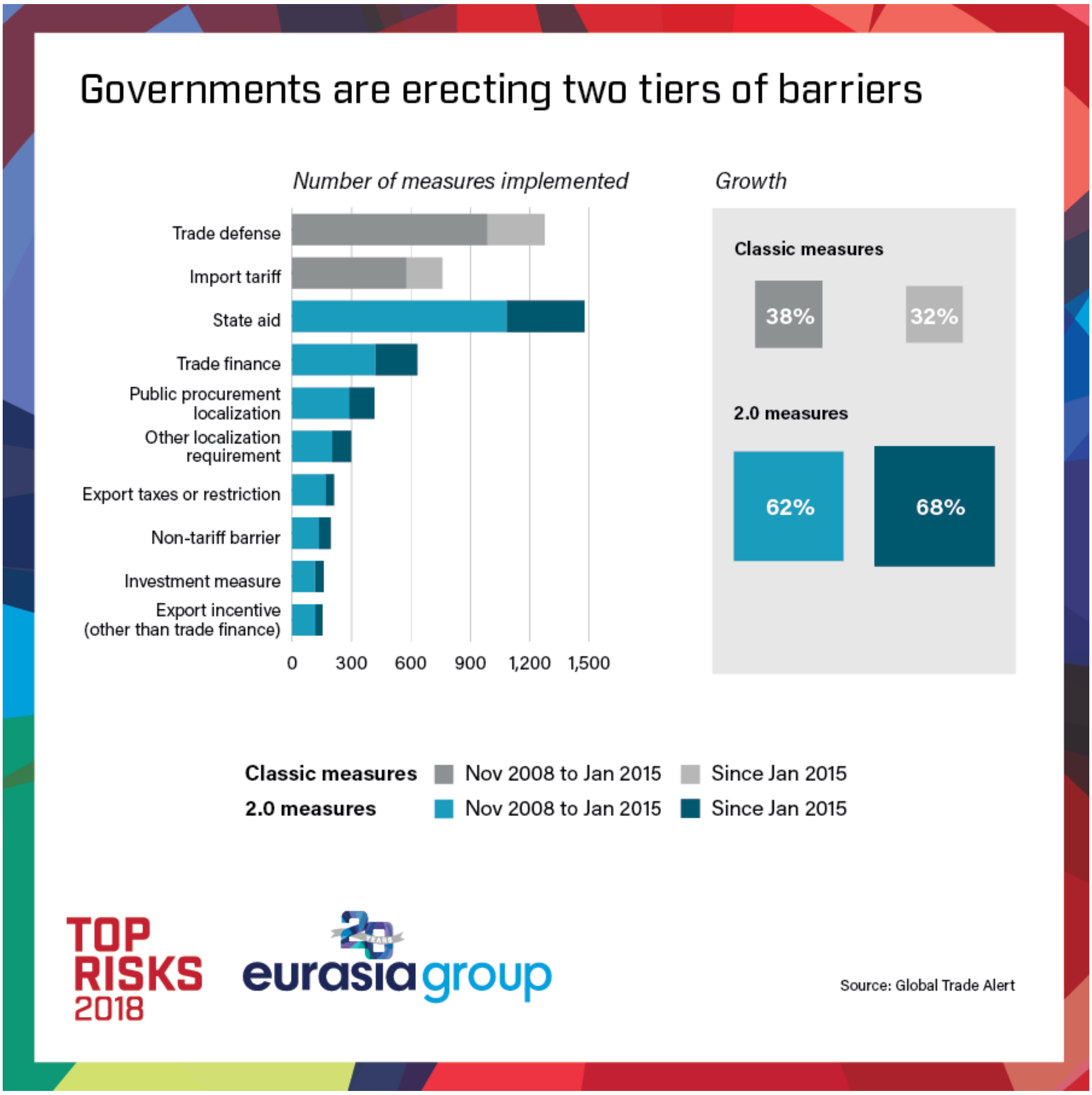
1. A Food for Thought: New Normal and New Global Order is on the horizon in 2019

The international world order today is characterized by enormous levels of plasticity, movements of "red lines", China as the main challenger of the world order, revisionist Russia and hybrid types of warfare. Outdated global institutional arrangements cannot manage the global discontent which is currently subdued due to solid economic growth, resulting in the absence of the destabilization in global markets. [7] For Rice and Zegart, there are at least three megatrends that transform the understanding and the analytical framework of political risk: unstoppable and irreversible changes in politics after the collapse of the Soviet Union, swift pace of innovation in the supply chains, and the exponential pace of the tech revolution. [1] [2] Each of them consists of more details than meets the eye and has more implications than the often-debated situation in Italy, Middle East or, for that matter, Brexit issue, which so far is somewhere between the adjustment of financial markets and open political circus. [8]

Complementing the mentioned megatrends, the Control Risk company has recently offered top five risks for 2019. Sorted by their magnitude, this well renowned company has placed trade confrontation on the first position, disguising the geopolitical dynamics of the USA and China, and expecting to influence the wide geopolitical orbit of the two cyber superpowers. The second position is taken by data regulation, because of the differing philosophies of data usage: the European Union puts greater emphasis on data protection, China advocates the use of data towards the strict, if not absolute society and crowd control (karma quantification), and, finally, the USA argues for the monetization of data. [2] Those approaches are inconsistent, and possibly even conflicting in the medium to long-term. The third risk for the year ahead refers to the change in Washington, namely – the policy making in Washington will enter new era and the bipartisan model will be pressured more than ever, distorting the foreign policy, and in return increasing the volatility levels for the business. The fourth position is taken by the possibility of serious disruption of weather condition and its non-linear demographic consequences reflected in trade, demographics and supply chains. The fifth risk is the globalization that is becoming slower, so the multinationals will encounter frictions, both formal and informal. This would further cause the disruption in supply changes and may lead to global transition phase challenging the predictability and stability, greatly needed in times of crisis. The Eurasia Group has already spotted this in 2018, as presented in Diagram 2 [4].

Presenting the findings of the global geopolitical risk authorities, according to famous business and politics portal, Bloomberg, managers should not exclude the possibility of the Black Swan event. This type of event is explained as deviation from standardized pattern of occurrences, extremely difficult to predict, impossible to control with the devastating consequences, easily explained retrospectively. For more details on this phenomenon, the book by Nassim Nicholas Taleb "*The Black Swan: The Impact of the Highly Improbable*" offers great introduction. The Black Swan event has been often mentioned in politics and finance, possibly suggesting certain tacit relationship between the two. Additionally, the Black Swan event has become one of the most mentioned concepts from the theories that try to explain the New Normal. In the New Normal world, no country or market participant is excluded from the risk analysis, due to its size or supposed potential [9].

Mentioning the smaller countries again, the decisions on many pressing global issues may be brought by the strategically important second-order powers. This tendency may bring imbalance or balance, especially in Africa and Asia, mainly due to the megatrend of change in politics, accompanied by the rising need of the USA, China and Russia to form the alliances with various state-entity in the international arena. The geopolitical order, established after the WWII has ended and has been detached from the first-level politics. [10]



(Diagram 2 – Governments setting the bad examples, source: the Eurasia Group)

2. The Nature of the Political Risk: fine tuning between emotions and Data

The man is rational, and the politics of self-interest is the prevailing force. So it was told. However, the confusing and disorderly dynamics of the New Normal follows different paths, where homo-economicus is not beyond the emotional and behavioral constraints[2]. This is the first aspect of a simplified New Normal model. The second aspect, more mechanistic and seemingly more structured, is nexus composed of Big Data and algorithms. While the first aspect was widely discussed in policy circles during the past decade, the ideology of hyperrationality and the philosophy behind it has only recently started to take the shape, positioning the second concept within the societal dimension. It may be argued that algorithms today construct and deconstruct reality, which is both an opportunity and risk for every society. [11]

[2] Society does learn, and emotions are important part of every learning process. The changing nature and the remodeled understanding of risk may imply the societal emotional shift.

The juncture of both aspects shapes and modifies the nature of every risk, since risk is a socially constructed category and does not operate fully outside of the social context [12]. However, many authors argue that this type of juncture will bring new types of risks that still cannot be fully addressed, mainly due to the lack of regulation in technological domain. [13]

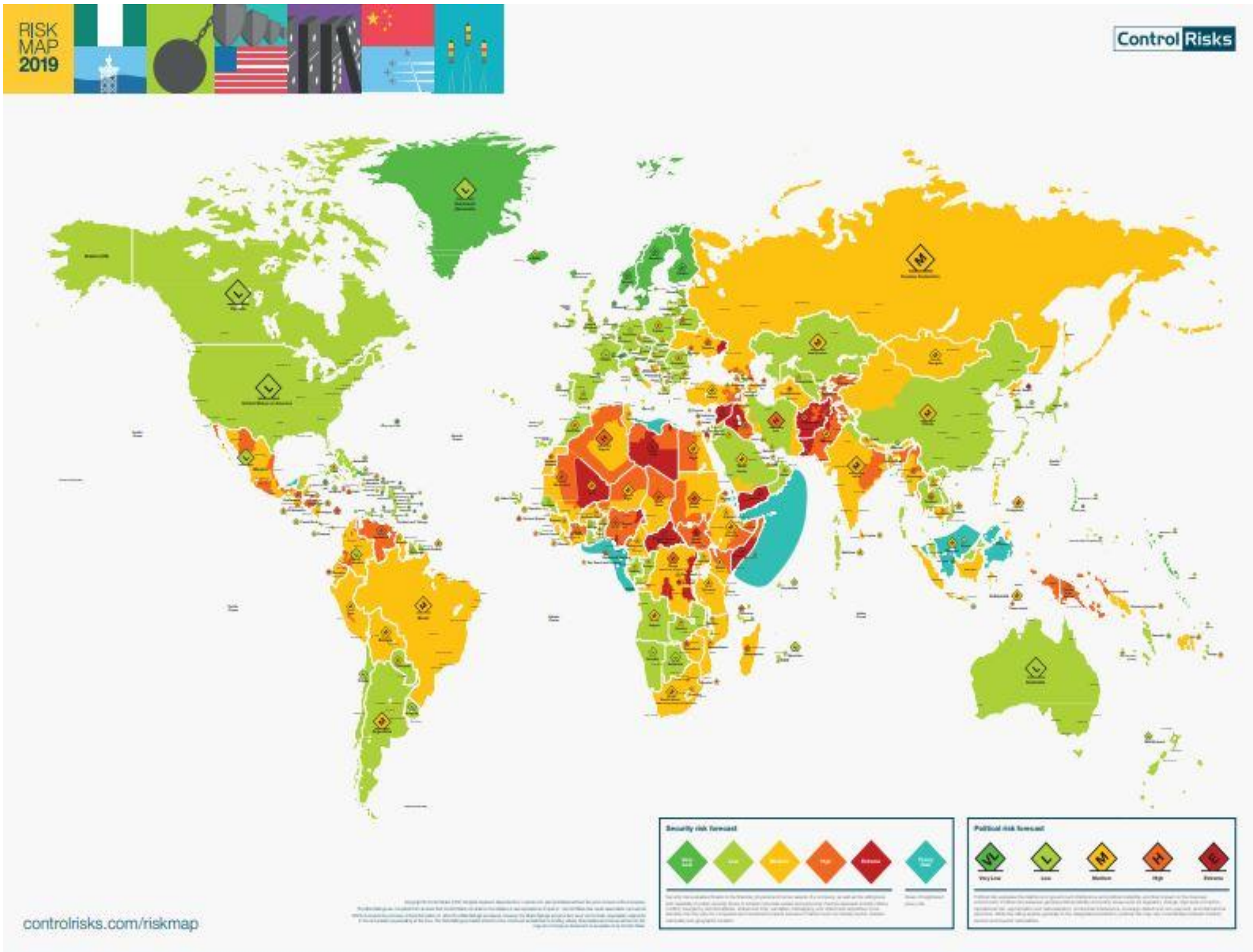
Speaking of political and geopolitical risks, those types of were the essence of micro-situations, especially with countries of developing worlds and frontier markets. Nowadays, highly industrialized societies, with stable structures and robust institutions are not insulated from political and geopolitical risks, according to Ian Bremmer. [7] Eventually, this is the reason why political risk has attracted the attention of many top policy circles ad why it is often graphically presented (see the Diagram 3 where the level of political risk is assigned to every country).

So, what exactly is the political risk and how would it be possible to assess its importance? There is no universal, perfectly rounded definition of political risk. A simple explanation of political risk, relying on the profit – oriented perspective, suggests that political risk reflects the possibility of occurrence of an event or situation that may seriously damage the cash flow of business operation [14].

Today, given the complexity of the environment it can be traced somewhere between the two mentioned aspects – it touches both the emotional and the analytical component of the New Normal. The political risk, at its very core, had the dogma of calculation, consideration of the capital outflow from the USA to Europe, initially being the component of country risk. In other words, the political risk concept, designed after the WWII has emphasized the possibility of country's insolvency.

After the increasing speed of investment and trade, many institutions have developed their own metrics, addressing the various intersections of business and politics, such as Foreign Direct Investments, possible interference of governments in business operations, and innovations in transaction types. The next wave of political risk reconsideration included the undesired political movements that may hinder the cross-border cash flow, swift expropriation of companies' assets, and the possibility of classical warfare[3], both inter and intra-state. Additionally, emotions and behaviour started to be taking seriously in the politics, so they had to be embedded, even if the opportunity to measure and to quantify the emotion or the historical event is very limited. [15] Finally, the political risk has included the Big Data considerations, followed by unprecedent technological advancement, lack of regulation in the cyberworld and assertiveness of the international system challengers.

[3] Classical warfare – the warfare which utilizes military means. There are other forms of warfare, including the political, the economic and/or cyber warfare. Various types of warfare should be accounted for when defining the political risks.



(Diagram 3: Global Risk Map, obtained from the Control Risk, please click the link for more details: https://goo.gl/JqKRzo)

3. **The Need to Quantify**

Markets tend to ignore the political risk when the economy is in a good shape. Put differently, political risks tend to shroud the positive developments in economy when there is a possible triggering event, combined with the economy slowing down, and in a case when investors tend to exaggerate certain political events. However, when the economy is in the boom phase, markets are not that concerned about the political risks, but they put more emphasis on the state of global economy and the fundamental metrics such as employment rates in developed economies, inflation levels, and the trade activity levels. [16] Someone may argue that the solid underpinnings in the global economy lead to the increased risk appetite, and that this change can be negatively affected only with a very strong global shock in politics, therefore political events and disturbances of low to medium magnitude are not of interest when the economy is robust. Policy-makers are aware of this phenomenon, so they have started to seriously account for the political developments. [17]
The second aspect explained in the previous part has projected the need to quantify everything and to capture it in numbers. Sceptics would say that the world today is in the dictatorship of data and measurability. [12]

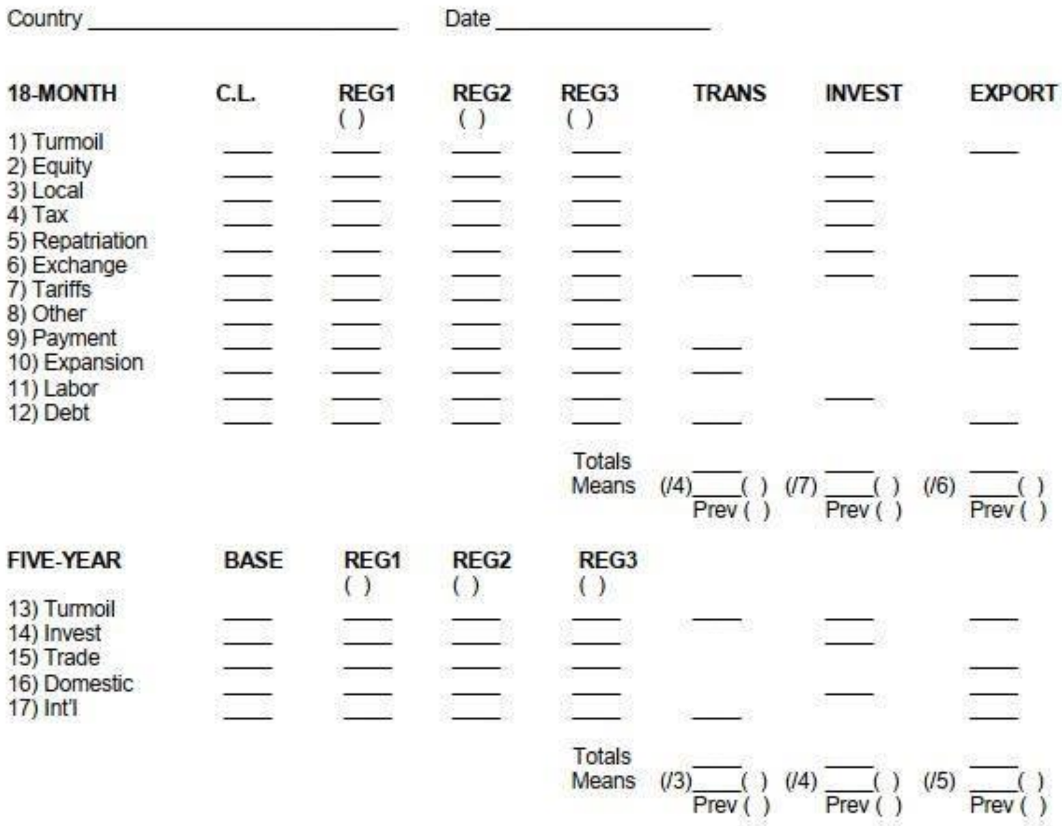
Although in many cases markets are a solid proxy for the overall stability within and outside the societies, the underlying economic situation is not necessarily cointegrated with the political movements. On the contrary, political and business cycles are often desynchronized. The size of the global trade and the change in technology have led to the development of the various tools and metrics that can and should explain and/or predict the current and the future events. As proposed by the PRS Group, a political risk harnessing can be highly profitable, reaping 20% of returns in many frontier markets. [13]

As widely accepted, the risk should be defined, and quantified, thus making a distinction between risk and uncertainty. Destabilizing political events should be measured and quantified, which digitization and the expansion of the algorithm era made possible. Predictability has become more important than the verifiability and causation seems to be less important than correlation. With the two global interconnected waves – the first being technological, the second representing geopolitical recession challenging the affluent societies, the rise of systemic issues that are not connected in any manner require the interpretability and the opportunity to be translated into the investment decision. The numbers are, supposedly, the most effective way of communication, especially in times of datafication and digitalization. This approach, as will be shown, can be criticized on many grounds. The numbers are hardly the best possible proxy for designing and guiding the policy. [12]

4. The Applications: PRS, OECD and GeoQuant

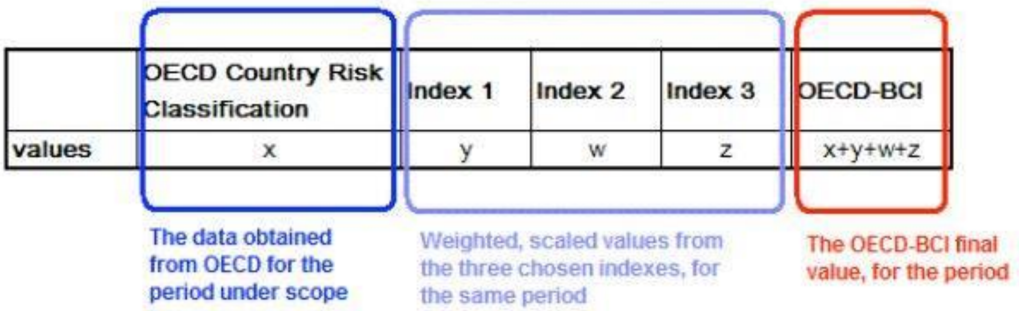
In order to present some aspects of political risk quantification, three examples had have been chosen. Why those three examples? First, there is a steady increase in both the scope and magnitude of the political risk consultancy, while the literature offers a significant number of research papers that are providing various types of methodology, data on political risk indexes, their classification and the measurement. Second, serious companies have developed their own approaches, some of them being highly monetized and offering the expertise for he high-class policy makers, expanding the influence and making profit out of it. Given the multitude of systems and companies, three institutions, with different approaches each complementing the other are presented here.

Arguably, the most recognizable, comprehensive and versatile methodology is done on the behalf of the Political Risk Services, used in major multinational corporations and different organizational types of stakeholders. The analysis of highly advanced PRS methodology would require significant resources, due to heavily monetized products and would be beyond the introductory scope of this report. PRS Group has very comprehensive list of political risk factors, focused on the decision making and providing for the short and medium-term horizon, 18 months and five years, respectively. Additionally, it combines the hard facts with the qualitative analysis and very detailed scenario analysis, which confirms the stance of the Allianz political expert, Ms. Barysch, cited below. The analysis is customizable, opened to interpretation and relies on the traditional forecasting principles and the relatively conservative approach combined with the world – class qualitative analysis. [14] [15]



(Diagram 4: PRS methodology, obtained from the prs.com)

The second example of the political risk quantified is given through the lenses of the OECD, titled OECD – BC index. This approach offers reliability and is supported by OECD brand strength. Namely, OECD – based, Compound Index was initially developed by Jan-Emmanuel de Neve and Felippe Cademarton. This index is relatively conservative, bears similarity with the PRS index (however, this index is outsourced and requires less analytical approach), and presents the improvement in the former OECD Country Risk Classification (a likelihood that a country will continue servicing its external debt), by adding the Alliant Political and Economic Risk Index (risk exposures by business in country, range from 0 to 100, 0 representing the highest risk: trade credit, currency inconvertibility combined with the transfer risk, possibility of strikes, possibility of riots and civil unrests, war and civil war, assets' expropriation, terrorism, legal and regulatory risks), Eurasia Group's Global Political Risk index (the ability of a country to absorb the political shock, ranging from 0 – the most unstable – to 100, accounting for the government, economy, society and security), and the Standard & Poor's Transfer and Convertibility Ratings (indicating the probability of introducing the limits to hard currency transactions within the country's borders). OECD – BCI can be seen on the Diagram 5. [18]



(Diagram 5: the graphical presentation of the OECD – BCI, source: OECD)

Finally, the relatively novel and stimulating approach of the intersection of politics and computer sciences can be seen in the case of GeoQuant, USA political consultancy company that relies on the analysis of high-quality Big Data, political events analysis and has a bit different philosophy, that might be somewhat experimental. This, so called "Real Time Political Risk Management", as proposed by the company, stresses out the importance of political risk, analyses of geopolitical instability, and the difficulty of the political factors identification. Overall, this approach may reflect completely different zeitgeist than the OECD and PRS methodologies. As emphasized previously, the correlation might be the backbone of this approach, leading to the need for serious qualitative analysis. Diagram 6 offers a small insight into the indicator policy uncertainty in UK due to Brexit. While this graphical presentation is like many projections that use the traditional approaches, GeoQuant has reached such conclusions using the Artificial Intelligence, machine learning, different high-frequency paths analysis, algorithms and the analysis of social networks. [19]

(Diagram 6: GEoQuant explanation of Brexit and uncertainty analysis)

5. Conclusion and Criticism

In his famous book "Irrational Exuberance", the renowned economist Robert Shiller suggests that the speculative volatility in the economic domain can be subdued with the policies that are resolving political instability. Namely, political parties should not be banned from competition and participation, since the affluent society relies on complete freedom of expression, having common sense above anything else. In era like this, the common sense and common knowledge are challenged (even prone to manipulation), mainly due to the technological advancements. [20] Openness nowadays is a mixed blessing for the advanced societies since there are no regulatory frameworks in many new domains – cyberspace being one of them. In such environment, the nature of the political risk changed, and the bubbles created and caused by the political risk are equally, if not more damaging to society than ever before. Moreover, if financial derivatives, constructed to expand the reach of the financial industry and to speed up the financialization were the weapons of mass destruction, data nowadays has become the weapon of the reality reconstruction. [21] The tendency of making politics more science than art, insisting on the hard facts in highly sensitive moments can be detrimental to society in era of New Normal. [22]

Besides the new types of risk and the lack of regulatory frameworks, the era of New Normal brings the new vocabulary that may obscure the reality, while attempting to explain the novel types of risks. Therefore, it is not the question if the industry and policy makers need both conservative or experimental tools – they obviously need both – the real question is how to assess the quality of the supposedly novel and breakthrough approaches in an absence of cohesive and functioning system. For example, Katinka Barysch, a political risk expert from the Allianz, mentioned in the previous part, proposes the use of scenario planning as the effective tool for the political risk analysis. According to her, scenario planning is the best complimentary tool going hand in hand with the quantification approaches. [14]

Additionally, regarding the prevalence of the quantification, there are other voices, coming from traditional professions, such as lawyers, coming from the top – notch energy companies. For Johnatan Cahn the political risk, despite being complex and multilayered, cannot be analyzed using Big Data only (policy-makers should even refrain from the extensive use of Big Data), and cannot be easily quantified. It can be even less managed and addressed systematically. The political risk assumptions are too abstract, they may be misleading, and they attain certain contingency levels that are not very helpful for decision makers. Succinctly put, the political risk analysis is still an unstructured issue that requires qualitative expertise and high sensitivity levels, that may come from the area studies, legal practice or any other kind of discipline that insists on the soft skills. The correlation, as the underlying philosophy of Big Data has serious drawbacks, both in technical and methodological sense. [23]

One is certain – political risk today spurs from many seemingly unrelated fields, such as biomedicine, cyberspace, cryptocurrency markets and the (non)traditional state activities. The world nowadays is in state of flux, composed of intense emotional and technological developments. In such world, the political risk will have an increasing importance for every state and non-state actor, especially when it is widely known that the geopolitical cycles move slowly, while the technological developments possess the unprecedent speed.

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