Point / Counterpoint

Should Political Risk Management Be an Active Strategy?

Point **Yes** I think we can agree on a few points. First, it's no secret that the actions of the host government can have a huge effect on the success of companies. Second, this means that every company doing business overseas faces political risk, and that's why companies must develop strategies for political risk management. Third, these strategies can take one of two approaches: active or passive. Naturally, those who advocate active political risk management believe it's the better way to go, and in my opinion, they're right. The more they consult experts who help them predict political problems, the better they are going to manage the corresponding risks.

Now, there's no denying that you may expose yourself to political risk whenever you take an active approach to managing overseas operations. This is why experienced overseas managers rely on not one, but two battle-tested tactics: They turn to statistical modeling to quantify the precise degree of political risk they're facing and they solicit the judgment of local experts to estimate the general degree of political risk they'll have to deal with in a given country.

Relying on either of these approaches endorses the assumption that neither positive nor negative political events in any country are independent or random events: They unfold in observable patterns that let managers make reasonable estimates of the odds of future events. That's why rigorous quantitative analysis and modeling aim to detect, measure, and predict future events that may pose political risk.

If you support active political risk management, you're assuming that if you measure the right set of discrete events, then you should be able not only to calculate the degree of political risk in a given country but also to estimate your odds of facing politically risky disruptions—civil strife, contract repudiation, financial control, regime change, ethnic tension, terrorism, and the like. Granted, this approach requires identifying valid indicators of political risk that can be measured reliably—for example, the number of generals in political power, the pace of urbanization, the frequency and nature of government crises, the degree of literacy, or ethno-lingual fractionalization. But once you have collected the data for the right set of measures, you can objectively estimate your exposure to political risk within a given country as well as across countries.

Political risk indicators have helped global companies monitor developments in individual countries as well as regional markets. Moreover, managers apply data they've collected in one country to benchmark analysis in another country that is experiencing similar processes of political

Counterpoint **No** Your proactive risk-management position fails to observe that many companies refrain from managing political risk directly—for all the right reasons. Instead, they treat political risk as an unpredictable hazard, reasoning that no model, regardless of how systematically it's been specified, can predict the degree of political risk in a country. Granted, models can extrapolate from economic, political, and social reports to generate meaningful insights about who may take office, what polices may be passed, and how these sorts of political events could affect the business environment. Ultimately, these insights make the political system and its risks understandable but by no means predictable.

These insights do not qualify as predictions precisely because of the intrinsic impossibility of reliably measuring uncertain situations. The political world is complex, its inalienable feature is ambiguity, and its tendency to change is high. Compounding these challenges is the range of variables that affect a country's political environment and, more difficultly, the many linkages among them. This situation becomes more difficult as companies head into emerging markets, each marked by its own political peculiarities. Collectively, no matter how powerful the spreadsheet or insightful the expert, the dimensions and evolving dynamic of a political environment defy specification. Rather, managing responsibly with politics and its risks in a foreign market demands resetting cognitive models so that one can deal with the conditions of unpredictable hazards.

Rejecting the hypothesis that one can predict political risk demands that managers find a cost-effective way to hedge their exposure. An approach based on risk management, not risk prediction, becomes the basis for protection. Typically, companies that favor passive risk management outsource the political risk-management process, largely because they reason that they're shielding themselves from political risk by buying political risk insurance. Consider the flexibility they give themselves through this approach. First, they have options to purchase coverage that protects operations from a wide array of political risks, including (but not limited to) government expropriation, involuntary abandonment, and damage to assets due to political violence. Second, they can purchase their political risk insurance from a variety of providers—government agencies, international organizations, and private companies. Here's a short list of leading insurers:

- *Overseas Private Investment Corporation (OPIC)* encourages U.S. investment projects overseas by offering political risk insurance, all-risk guarantees, and direct loans.