

How and Where To Use Political Risk Forecasts

Individuals holding nearly any position of responsibility in an internationally oriented firm can use political risk forecasts. Typical users include the president, vice president, manager, director, planner, finance officer, international officer, security officer, economist, researcher, market analyst, and librarian. This variety is evidence of the importance of political risk information. The many uses also present companies with a challenge to determine how to maximize political risk information throughout the organization, especially in the major areas of need. A discussion of how to apply our risk ratings follows, and a summary of applications appears in Table 1.

COMMODITY AND CURRENCY FORECASTING

Many business managers must make decisions or advise decision-makers on the future prices of currencies, precious metals, and such commodities as wheat, sugar, tin, and bauxite. Some managers make such forecasts because their business responsibilities require it, while others buy and sell against future prices as a direct profit making activity. Such people also subscribe to forecasting services that are based on the analysis of various economic trends. At the same time, they realize the importance of understanding how political events can determine not only underlying trends, but also how buyers and sellers behave and react.

COUNTRY LENDING DECISIONS

Banks, insurance companies, and public institutions, such as export credit agencies, frequently assess the amount of exposure they have in each country in proportion to their total exposure. This assessment may be necessary because of internal portfolio management policies or because of governmental regulations. Country limits are often established and modified according to levels of political and economic risk as well as market factors. Most lenders and insurers recognize the need to assess political factors along with economic data. Many business people use qualitative descriptions of risk, as well as quantitative indicators, as part of the weighting scheme they use to set country limits.

CREDIT MANAGEMENT

A credit manager is concerned not only with collecting bills, but also with establishing terms of credit that may affect the firm's competitiveness. Deciding whether to require a letter of credit for a particular transaction within a given country, for example, requires that the credit manager anticipate political developments. There is a need, therefore, to assess evolving conditions in foreign countries, along with performing the traditional analysis of an individual customer. Credit managers use political risk forecasting to anticipate such risk factors as the potential for the imposition of exchange controls, political upheaval that may lead to capital flight, or a breakdown of administrative processes in a country.

Table 1. Most Frequent Uses of Country and Political Risk Information

| Type of Use | Percent Using |
|--|---------------|
| General background | 51% |
| Evaluating risks to specific projects or investments | 36% |
| Briefing upper-level management | 32% |
| Supplement to other outside sources | 30% |
| Briefing before overseas trips | 28% |
| Strategic planning | 27% |
| Supplement to information from foreign subsidiaries | 25% |
| Briefing colleagues | 21% |
| Making decisions about security | 19% |
| Determining new business opportunities | 18% |
| Identification of key people and institutions | 16% |
| Tempering upper management's "inside information" | 16% |
| Sales or marketing decisions | 15% |
| Supplement to headquarters research and analysis | 15% |
| Preparing for negotiations | 10% |
| Giving perspective to news stories | 9% |
| Planning and evaluating insurance coverage | 9% |
| Assistance in public information activities | 5% |
| Briefing employees going overseas | 4% |
| <i>Source: Political Risk Services Client Survey</i> | |

FINANCE

Treasurer's offices are among the more frequent users of political risk forecasts. Given the constant fluctuation in international currency values and the difficulties encountered in moving capital and profits across national boundaries, the decisions made by a finance officer heavily influence the profitability of most multinational corporations. The procedures leading to financial decisions are among the most sophisticated employed within most business firms. Until recently, however, economic analysis and financial forecasting models dominated such decision making, and the process downplayed the role of political factors. Major political events, such as the Iranian revolution, revolutions in East Europe, and the collapse of Communist control in the Soviet Union, and less spectacular developments, such as regime changes that led to declining currency values, have conclusively illustrated the need for political analysis.

Despite the clear need for such analysis, the generalized and disparate forms of political information from both traditional and newer sources hinder their use in financial decision making. This kind of information is simply not consistent with the precise and sophisticated procedures used for financial decisions. That is why financial officials find concise summaries, comparisons, and rankings useful for assessing the political environments within which various financial decisions must take place.

GOVERNMENT AFFAIRS

Offices dealing with government affairs may have a research function or a public relations function, or both. Whatever the balance of their priorities, government affairs officers look to political risk forecasts to provide an objective, independent perspective. If these offices already have access to analysts specializing in a country, independent forecasts are used as a check on their perceptions and understanding of evolving political conditions. From this perspective and their own analysis, they can develop public relations activities and advise their management on future government actions. Government affairs offices also find political risk forecasts useful as a resource in preparing briefings for top management before their overseas visits.

HEADQUARTERS-FIELD COMMUNICATIONS

The regular and well integrated use of political information is one of the best ways to improve the relationship between field offices and a firm's headquarters. Relations between headquarters and the field often thwart the potential role of local offices as useful sources of information about the country. Typically, headquarters requires field officers to evaluate the country in which they operate. However, it tends to disbelieve their reports, suspecting the field staff of being too optimistic and provincial. For their part, those in the field believe that headquarters never reads the required reports and operates solely on a crisis oriented basis, rather than constantly staying informed about the political environment of its field operations.

The regular sharing and dissemination of information about the climate for business can help alleviate difficulties and problems of communication between headquarters personnel and those in the field. Basing their dialogue on a regular, routine procedure for political risk assessment can help build a consensus on the strengths and weaknesses of the localized political environments. Whether field and headquarters agree with a particular assessment is not as important as a clear

understanding of their individual positions based on regular evaluations. Adopting a format like one described in this book allows for detailed and precise analysis of similarities and differences in viewpoint.

MARKETING

Political events and governmental policies can have a direct impact on stability and growth in current markets and on the potential for new markets. Clients can use political risk forecasts to anticipate patterns in government procurement, regulations affecting imports, and general trends that are influenced by government decisions, such as economic growth, unemployment, and inflation. Marketing analysts assess the degree to which political events may increase market opportunities. They must also stay alert for potential threats and the possibility that turmoil might disrupt transportation, communications, and commercial activities. In some developing economies, particularly where government priorities shift frequently and where sales are highly sensitive to those priorities, a new government or a new policy emphasis can open or close significant markets. For businesses dealing with government buyers, political risk forecasts can provide profiles of individuals and descriptions of domestic political systems that can be essential in formulating sales strategies.

PROJECT DECISIONS

Corporations frequently organize their work around particular projects or marketing activities. The project director or team focuses largely on the commercial viability of each project. The political stability of a country and the trends in its government policies are critically important in assessing the benefits and costs of proposed projects. Political risk forecasts can be used as a basis for making these political assessments, particularly at the initial stage, during the process of selecting countries as potential project sites.

RISK MANAGEMENT

Sometimes assigned to a single office and sometimes decentralized, the function of anticipating major risks can be vital. Risk management officers use political risk forecasts to help determine whether to buy political risk insurance, whether to borrow money locally, and how to structure contracts in a way that minimizes risk. They can use detailed, qualitative descriptions of local political conditions, as well as systematic ratings that allow for country by country comparisons and alert them to changing conditions.

SECURITY DECISIONS

Corporate security often has an image of being essentially an operation encompassing technical hardware and the personnel for enforcement. However, many officials who are responsible for corporate security have the responsibility of providing political risk assessments that are incorporated into the firm's decision making. These officials feel that assessing future political trends is important for planning investments in security equipment and programs. Their estimates keep top management informed about potential risks to the security of new and ongoing operations, as well as personnel security issues.

STRATEGIC PLANNING

Strategic planning involves identifying future trends and analyzing how the corporation can take advantage of those trends. Such analysis traditionally concentrated heavily on economic trends, but since political decisions and events substantially influence these trends, planners now incorporate political risk analysis. Current planning activities involve an attempt to assess the impact of political and economic trends, but strategic planners can find it difficult to incorporate political analysis into their traditional economic and business research. Political analysis, by its nature, is qualitative, dealing with more abrupt and sweeping factors. Many planners have found systematic risk ratings particularly useful because they allow for the cross country comparisons that are an integral part of their analytical approach. Most firms use risk information for many reasons and in several different offices.

Country and political forecasts, summarized in the survey of international business officials in Table 1, have many and varied applications. Organizations can apply analysis methods in different ways to achieve the same goal-anticipating and planning for the political, economic, and financial risks involved in international business.