

## THE STRUCTURAL INDICATORS SYSTEM USED FOR THE POLITICAL STABILITY ASSESSMENT

Aniela Raluca DANCIU

Zizi GOSCHIN

Academy of Economic Studies Bucharest

[anielaco@hotmail.com](mailto:anielaco@hotmail.com), [zizigoschin@yahoo.com](mailto:zizigoschin@yahoo.com)

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### Abstract

Risk assessment identify situations in which the conditions for a particular kind of conflict are present. The structural indicators included in the model cross nine interrelated issue areas identified as potential "problem areas:" History of Armed Conflict; Governance and Political Instability; Militarization; Population Heterogeneity; Demographic Stress; Economic Performance; Human Development; Environmental Stress; and International Linkages.

### 1. THE IMPORTANCE OF POLITICAL RISK ASSESSMENT FOR INTERNATIONAL COMPANIES

In the contemporary age conditions, the firm's global going across their own country's borders represents a decisive factor of international economy. The current activity a transnational firm which invests across national borders will be influenced by an extremely big number of exogenous and endogenous variables. It can be said that the internalization process represents the most complex form of firm's progress activity, from which combines various financial operations a certain risk dose, management and preparation of human resources to cope with the new demands derived from the firm's registration in the international economic circuit.

Extremely dynamic and important component of international economic fluctuations, the foreign investments have had, in the last decade, a strong impact over the economic increase, the foreign trade and productive structures from almost all over the world. This expansion may be considered a direct consequence of globalization tendencies accentuation manifested on the world.

The globalization of the world economies, and in particular the internationalization of financial markets in the last decades, have dramatically expanded and diversified investment possibilities, leading to numerous new opportunities, accompanied by new risks. Consequently, there has been growing interest in obtaining reliable estimates of the risk of investing in different countries. These concerns have led to the development of the concept of country risk, and even to the regular publication of country risk ratings by various agencies.

Different definitions have been proposed for country risk, i.e. for the risk that a country defaults on its obligations. The existing literature on the topic recognizes both financial/economic and political components of country risk. According to the degree to which some of these components are emphasized, country risk is viewed either from the financial/economic perspective only, or from the combined financial/economic and political perspectives.

### 2. THE STRUCTURAL MODEL FOR THE POLITICAL RISK ASSESSMENT

Risk assessment identify situations in which the conditions for a particular kind of conflict are present.

***The structural indicators including in the model***

The structural indicators included in the model cross nine interrelated issue areas identified as potential “problem areas:” History of Armed Conflict; Governance and Political Instability; Militarization; Population Heterogeneity; Demographic Stress; Economic Performance; Human Development; Environmental Stress; and International Linkages.

The leading indicators uses in the “issue areas” assessment are:

Issue Areas	Leading Indicators
<b>History of Armed Conflict</b>	<ul style="list-style-type: none"> <li>• History of armed conflict including annual conflict and related deaths</li> <li>• Number of Refugees</li> </ul>
<b>Governance and Political Instability</b>	<ul style="list-style-type: none"> <li>• Level of Democracy</li> <li>• Regim Durability (years since regime change)</li> <li>• Restrictions on Civil and Political Rights</li> <li>• Restrictions on Press Freedom</li> <li>• Level of Corruption</li> </ul>
<b>Militarization</b>	<ul style="list-style-type: none"> <li>• Military Expenditure</li> <li>• Military Expenditure (%of GDP)</li> <li>• Fraction of Regional Military Expenditure</li> <li>• Total Armed Forces</li> <li>• Armed Forces per 10.000 persons</li> </ul>
<b>Population Heterogeneity</b>	<ul style="list-style-type: none"> <li>• Ethnic Diversity</li> <li>• Religious Diversity</li> <li>• Risk of Ethnic Rebellion: Lost Autonomy, Political Discrimination, Cultural Discrimination, Strength of Ethnic Identity, Mobilization of Militant Orgs., Support from Kindred Groups</li> </ul>
<b>Demographic Stress</b>	<ul style="list-style-type: none"> <li>• Total Population (Number of Persons)</li> <li>• Population Growth Rate</li> <li>• Population Density</li> <li>• Urban Population (% of Total)</li> <li>• Urban Population Growth Rate</li> <li>• Youth Bulge</li> </ul>
<b>Economic Performance</b>	<ul style="list-style-type: none"> <li>• GDP</li> <li>• GDP Growth Rate (Annual %)</li> <li>• GDP per Capita</li> <li>• Inflation rates</li> <li>• Exchange rates</li> <li>• Foreign Investment</li> <li>• Debt Service</li> <li>• Trade Openness (Trade as a % of GDP)</li> </ul>
<b>Human Development</b>	<ul style="list-style-type: none"> <li>• Access to Improved Water Source</li> <li>• Access to Sanitation</li> <li>• Life Expectancy</li> <li>• Infant Mortality Rate</li> <li>• Maternal Mortality Rate</li> </ul>

	<ul style="list-style-type: none"> <li>• HIV/AIDS</li> <li>• Primary School Enrolment</li> <li>• Secondary School Enrolment</li> <li>• Children in Labour Force</li> </ul>
<b>Environmental Stress</b>	<ul style="list-style-type: none"> <li>• Rate of Deforestation</li> <li>• People per Sq.km of Arable Land</li> <li>• Access to Fresh Water</li> </ul>
<b>International Linkages</b>	<ul style="list-style-type: none"> <li>• Participation in Regional and International Organizations including: Economic Organizations, Military Organizations, UN Organizations, Miscellaneous Organizations</li> <li>• Interstate Disputes, including: Resources and Territorial Disputes, Political and Cultural Disputes</li> <li>• Prevalence of Armed Conflicts across REgion</li> </ul>

Source: *Country Indicators for Foreign Policy(CIFP) Project*, August 2001, The Norman Paterson School of International Affairs, Carleton University

“Structural instability” is considered high in cases where a country has an enduring history of armed conflict, is politically unstable or has unrepresentative or repressive political institutions, is heavily militarized, has a heterogeneous and divided population, suffers from significant demographic and environmental stresses, has had poor economic performance and low levels of human development, and is engaged with the international community in ways that detract from, rather than contribute to, peaceful conflict management.

On the other hand, “structural stability” is considered high in countries that have developed stable democratic political institutions, that respect fundamental human rights, that have successfully managed conflict without resorting to violence, that invest less in the military, that lack profound ethnic or religious cleavages or demographic stresses, that have achieved sustainable levels of economic development as well as healthy social and environment conditions, and that are free from serious external conflicts and threats.

### **The country risk index**

The risk index consists of the weighted average of nine composite indicators, corresponding to the nine issue areas outlined above: armed conflict, governance and political instability, militarization, population heterogeneity, demographic stress, economic performance, human development, environmental stress, and international linkages. Each of the nine composite indicators is derived through averaging the individual risk scores for a number of leading indicators within each issue area.

$$\text{Country Risk Index} = (w_1x_1 + w_2x_2 + \dots + w_9x_9) / (w_1 + w_2 + \dots + w_9)$$

where:

$x_i$  are the values of the nine composite issue area scores;

$w_i$  are their corresponding weights.

Leading indicators within each issue area are themselves assessed in terms of three separate scores: the country’s performance for a given indicator relative to other countries (global rank score); the direction of change for a given indicator, be it improving, worsening, or remaining level (trend score); and the degree of fluctuation in a country’s performance for a given indicator (volatility score).

#### **i) Global Rank Score:**

“Risk potential” is a relative term that has meaning only with respect to a country’s performance and risk *vis à vis* other countries in the international system. Accordingly, each lead indicator is converted to a 9- point score on the basis of its performance relative to a global sample of countries. This global sample of countries is ranked from highest to lowest level of performance, divided into nine equal categories, then assigned score numbers ranging from 1 to 9 based on their rank position within the sample. This scoring procedure is intended to facilitate the identification of key areas of concern, and as a way of directing attention to potential problem areas.

In general, a higher score (in the 7 to 9 range) indicates that the country is performing poorly relative to other countries (i.e. high levels of armed conflict, autocratic governments, poor economic performance, low levels of human development) or that a country’s standing is a cause for concern (i.e. significant youth bulge, high levels of ethnic diversity). A lower score (in the 1 to 3 range) indicates the country is performing well relative to other countries (i.e. no or little armed conflict, democratic governments, strong economic performance, high levels of human development) or that a country’s standing is less of a cause for concern (i.e. no youth bulge, low levels of ethnic diversity). Values in the middle 4 to 6 range indicate moderate levels of performance approaching the global mean.

**ii) Trend Score:**

In addition to a relative measure of a country’s performance within the international system, an assessment of risk also requires consideration of the absolute development of a state’s performance demonstrated by changes over time. The direction of change, whether worsening or improving, indicates whether a country’s performance for a given indicator is even more likely to contribute to conflict potential (i.e. increasing restrictions on civil and political rights, worsening economic conditions, increasing demographic or environmental stresses) or detract from it (i.e. greater respect for civil and political rights, improving economic conditions, decreasing demographic or environmental stresses).

While both long term trends and shorter term trends are relevant to assessing shifts in a country’s performance, the model risk calculation places emphasis upon short term (five year) trends, given that these are assumed to have a more immediate and determining impact upon the processes of conflict development. The model calculates a trend score based on an ideal linear “least-squares” regression line, where the slope of the trend line (whether positive, negative, or zero) is used as a measure of the direction of change. The trend score modifies the base scale by adding a value of 1 to the base scale if the direction of change is worsening, and by subtracting a value of 1 from the base scale if the direction of change is improving. In cases where the trend line has a slope of 0, the base scale is not modified.

**iii) Volatility Score:**

While the trend score assesses whether the short-term trend of a given indicator is improving, worsening, or remaining level, a single linear trend score can in some cases mask high levels of variation in country performance. For this reason, the model risk calculation includes a third measure of “volatility,” which measures the degree of variation from the ideal linear trend line. The degree of volatility is a critical component of the risk assessment calculation, considering that instability across a given indicator (i.e. regime transitions, a massive influx of refugees, fluctuations in military expenditure or foreign direct investment) can have a profoundly destabilizing effect and sharply increase the potential for conflict.

While different statistical measures of variance could be employed for this purpose, the model has opted to use a qualitative assessment of the degree of volatility, based on the observed deviation of the actual year-by year trend over a five year time series from

the ideal linear trend line derived for the trend score. As in the case of the trend score, the volatility score modifies the base scale by adding a value of 2 to the base scale if the degree of volatility is assessed as being “high” and adding a value of 1 to the base scale if the degree of volatility is assessed as being “moderate.” If there has been little or no volatility, the base scale is not modified.

**Calculation of Risk Scores for Leading Indicators:**

Global Rank Score		Trend Score		Volatility Score		Indicator Risk Score (Sum)	
High Concern	9	Worsening	+1	High	+2	Very High Risk	12
	8	No change	0	Moderate	+1		11
	7	Improving	-1	Stable	0		10
Moderate Concern	6					High Risk	9
	5						8
	4						7
Low Concern	3					Medium Risk	6
	2						5
	1						4
						Low Risk	3
							2
							1

It had been estimated that the political risk evaluation represents a fundamental condition for the firm’s success which acts aboard.

The structural indicators system can contribute, in our opinion, at the evaluation of the political stability in a country.

**3. REFERENCES:**

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