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POLITICAL RISK AND INVESTMENT DECISION

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Abstract: Multinational corporations consider the political risk of the host country as one of the most important factors in investment decision making. This paper defines political risk making the distinguish of it from political instability, emphasizes the importance of political risk in relation to inward foreign investment and the way of measuring political risk as well as the relevance and importance of perception to political risk assessment.

1. INTRODUCTION

The necessity and importance of foreign investment for strengthening economic stability and quickly evolving towards a developing economy in developing countries has determined interest in foreign investment decisions of multinational corporations. Factors which prompt multinational corporations to enter individual countries have been reported by many studies in a variety of ways.

Some empirical studies have shown that multinational corporations consider the political risk of the host country as one of the most important determinants in investment decision making. This concern is due to the belief that unpredictability and volatility in the political environment of the host market increases the perceived risk and uncertainty experienced by the firm. In turn, this disinclines firms from entering with heavy resource commitments (e.g. wholly owned subsidiary, majority equity participation in joint venture).

2. POLITICAL RISK VERSUS INSTABILITY

We have to note that there is no single universally accepted definition of political risk. It is most commonly conceived in terms of (usually host) government interference with business operation. The term ‘political risk’ refers to the possibility that political decisions and/or events in a country will affect the business climate in such a manner that investors will lose money or not make as much money as they expected when the investment was made.

The existing definitions of political risk focus on the concept of political risk from two different perspectives. One view political risk in terms of governmental or sovereign interference actions. This concept, which is related to all undesired outcomes of political activities of the host government with private businesses, is represented by confiscation, currency repatriation, limits to business transactions and so on. The second perspective identifies political risk as occurrences of any political events imposed upon the firm. The examples are violence, terrorism and guerilla groups.

In the process of defining political risk it is useful to distinguish it from political instability. Instability is a feature of the general environment, whereas risk is something narrower in focus which directly affects the multinational corporations. For example, political instability by an unexpected change in government leadership may not involve political risk for international business. Political stability in itself is not a sufficient guarantee to any economic activity, especially in the absence of favorable economic conditions.

Political risk may be defined more precisely, as “the application of host government policies that constrain the business operations of a given foreign investment”. It may be subdivided into three main categories: transfer risk – concerning risk to capital payments,, operational risk – with threats over local source or content, and ownership control risk – highlighting possibilities of expropriation or confiscation. Moreover, political risk can be defined as the risk of a strategic, financial or personnel loss of a firm because of non-market factors as macroeconomics and social policies (fiscal, monetary, trade, investment, industrial, income, labor and development) or events related to political instability (terrorism, riots, civil war, insurrection). These two-types of non-market factors can be called legal – governmental and extra legal political risk. Legal-governmental risks are caused by events that are considered illegitimate by the existing political system.

The difficulty in finding a proper and commonly accepted definition of political risk has presumably prevented many researchers from contributing to this issue and it is also troublesome for building a solid model easily applicable.

3. POLITICAL RISK AND FOREIGN INVESTMENT

The growing amount of resource commitment assigned to foreign investment by the increasing number of multinational corporations has generated particular interest I assessing the relationship between the foreign investment and factors influencing the investment decision. Among these factors, political conditions have demonstrated to be one of the leading factors in assessing a company's foreign direct investment in a foreign company.

Interviews and surveys of executives of multinational corporations have found political events to be one of the most important factors in foreign investment decision. In particular, executives cite the stability of the host government and the attitude of the host government toward to foreign investment as most important considerations in the investment decision.

There is a negative relationship between political instability and foreign direct investment. After controlling for the effect of economic variables on the flow of foreign investment, the statistical result supported the association between political stability and foreign direct investment is more likely to be conspicuous when there is an economically rooted conflict and the government has sufficient administrative capability to indirectly respond to it.

There are a number of political events which can cause a loss or harm to a business operating in a foreign environment. Nationalization and expropriation became the greatest fears for foreign companies in the developing world during this era. The impact of politics on business operations has almost always been seen in the negative. Unexpected political activity by guerilla or other political groups is another means of political risk. Discriminatory taxation, absence of patent protections, and limits on foreign national employment have also crucial impact on international business in foreign country.

4. POLITICAL RISK ASSESSMENT

A rational approach to foreign investment decision process requires a careful examination by the firm of numerous factors which relate to both the general environment of a proposed investment and the specific operating functions of the firm in that environment. The main element of the environmental analysis is the question of political risk. Most studies of dealing with political risk focus on determining the variables composing that specific risk, or aim to find an association between political events and foreign investment. The significance of political risk is generally acknowledged, but the studies that analyze it are too often vague and difficult to examine and apply in practice.

Analysts providing political risk assessments to multinational corporations have attempted to overcome the problems of accurately predicting future scenarios which incorporate the dualistic, and often incompatible, components of academic theory and business clarity. Various political risk analysis approaches are used either by in-house or outside specialists. These range from qualitative, subjective, and discursive briefings by respected ‘experts” at one end of the spectrum, to quantitative computer-based assessments drawn from a numerical ranking of various societal variables. The more sophisticated quantitative approaches are not significantly different from econometric forecasting used by economists; political risk analysis instead tracks political trends with multivariate data analysis techniques. Objective and subjective methodologies can be integrated in order to allow for the best features of management science to be combined with insights and intuition of regional experts.

Traditional studies assessing political risk and its relation with foreign investment have taken into consideration a variety of data from different countries and industries. This generic perspective has led to a failure in determining reliable assessments of the dimension of political risk and its relationship with investments from outside the host country. Political risk assessment must address both the peculiar characteristics of the host country and attribute of the investment project. The project plays a critical role in determining potential risks because different projects can be differently affected by the political events of a host country.

Some industry types may be more vulnerable than others to specific problems in a country’s political economy, especially if political stability is the major concern. The multinational corporations belonging to different industries do not perceive the same degree of risk when facing the same political turmoil in a given country.

5. MANAGERS’ PERCEPTION ON POLITICAL RISK

The assessment of political risk and more importantly, investment decision, depend upon prevailing attitudes, first impressions, and generalization on single events occurring in the host country. Most managers’ understanding of the concept of political risk, their assessment and evaluation of politics, and the manner in which they integrate political information into decision making are all rather general, subjective and superficial. Many empirical studies supported that the evaluation of political risk is based on generalization and impressionistic knowledge of a developing nation. Experience indicated the executive responsible for international operations of multinational companies rely very little on systematic environmental scanning methods. Executives’ attitudes play a major role in their evaluation of risk and profitability of the investment opportunities.

Finally, we can argue that political risk assessments are not necessarily based on structured decision-making processes. Often times, managers are not provided with, or are unable to interpret, the information required to make the optimal choice.

Most empirical studies assumed that the relevant factors for the measurement of political risk could be adequately captured with archival data. In doing so, researchers disregard the crucial role of the perception of decision-makers. Irrespective of the actual circumstances, the forecasts of the underlying factors on which the prediction are based are frequently judgmental so decision makers take decisions that are based on their own judgment of the situation. Ignoring the decisive influence of perception is a weakness in most political risk studies.

CONCLUSIONS

Political factors are not only determinants which decide whole investment decision. Political, as well as economic stability are necessary conditions to attract direct investment from abroad. Many studies have found the correlation between political factors and investment decision. Accurate political risk evaluation is more important concern for unstable developing countries. Some factors which influence a country's political risk cannot be adjusted at all. Some of factors which decide a country's political risk can be changed in order to lower political risk and promote more foreign investment in the country.

To determine and get rid of the major political barriers and risks to foreign investment development is the first step which developing countries should exercise in order to attract more inward foreign investment.

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