Investing in a Dangerous World: a New Political Risk Index

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Abstract

"Today's political risks are not the classic risks associated with communist takeovers or post-colonial outbursts of anti-foreign sentiment. They are more subtle, arising from legal and regulatory changes, government transitions, environmental and human rights issues, currency crises and terrorism. Because these risks are subtle (often occurring at the same time as the government is declaring the country "open for business") they are often hard to manage"[3]. An effective index of political risk must take into account the different dimensions affecting the attractiveness of a country to foreign business. In this paper we develop a new conceptual framework to identify the main components of political risk and the key indicators to measure them. The resulting political risk score is robust and more able than existing political risk ratings to assess the multidimensional complex nature of political risk.

Keywords: Political risk, Expropriation, Transfer, Political violence, FDI.

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[3] Wilkin, Minor (2001).

Introduction

The recent dispute between ENI, an Italian oil firm, and the Kazakh government over the exploitation of the oil field of Kashagan is the latest in a long list of cases where foreign investments have been threatened by government decisions or political violence acts. In April 2006, the Venezuelan government took control of the Jusepin and Dacion oil fields operated by French firm Total and Italian ENI, after they refused to change their operations into joint ventures with the state oil firm PDVSA. Under a protocol signed on December 21, 2006 the Russian government forced the entry in the Sakhalin Energy project of the state oil company Gazprom as the major shareholder, with the stakes of the other three shareholders (Shell, Mitsui and Mitsubishi) being diluted. In Nigeria, "oil pipeline breaks due to vandalism and sabotage have almost doubled, from 497 to 895, between 1999 and 2004 and product loss due to pipeline ruptures has grown steadily from 179,000 to 396,000 metric tons over the same period – a figure roughly equal to four super tankers"[4].

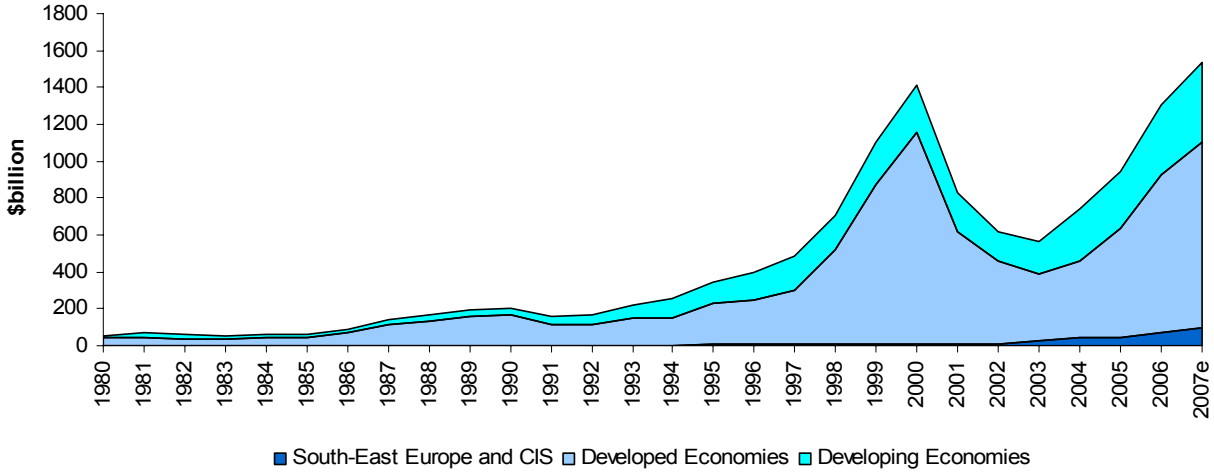
Recently, overseas investment seems to have become a risky business, despite the decade-long declining trend in political risks as a result of an increasing flow of foreign capitals chasing opportunities in new markets. After the fall of the Berlin Wall and the end of the Cold War, globalization, the growing international nature of investment projects, and the "unbundling of global production"[5] have increased the range of profit opportunities. Foreign Direct Investment (FDI) has become a key source of external finance for both emerging and developing countries. According to UNCTAD data, in 2006-07 the value of FDI to emerging and developing countries surged dramatically, reaching an estimated $540 billions, twice the 2000 figure. Trends in global FDI flows have been markedly positive, as shown in Figure 1: FDI flows increased significantly between 1980 and 2000, with an acceleration in the

[4] http://forums.csis.org/africa/?p=61.
[5] Baldwin (2006).

mid-1990s. They experienced a remarkable slowdown, because of the US recession, between 2001 and 2003, and started to rise again since 2004 surpassing the $1,411 billion level reached in 2000 with a record-high $1,537 billion in 2007.

However, more opportunities for investing abroad mean a higher level of risk associated with foreign investment operations. The possibility of exploring new markets leads investors to approach frequently unknown environments, characterized by higher levels of uncertainty.

Figure 1. FDI inflows at global level, 1980-2007.



Source: UNCTAD, *World Investment Report 2007*; www.unctad.org/wir.

The above-mentioned recent events highlight the changing nature of political risks. "Creeping expropriation", defined as the act of a government squeezing a project by taxes, regulation, or changes in law is rapidly becoming an important source of risk for foreign investors. The number of these cases has been growing in the last decades, along with the increasing role played by the State in the economy of resource-rich emerging countries. One of the main reasons explaining this trend, in particular in the energy sector, is the policy of some governments (such as those of Venezuela, Russia, and Bolivia) to take full control over natural resources. Over the last decade, these governments changed the rules governing their tax system,

royalties, and contracts. This has substantially increased the level of uncertainty faced by foreign companies operating in their countries.

Political risks associated to FDI are likely to continue to rise in the near future. The tensions reflect three basic facts: (i) the startling gaps in income between rich and poor countries, which provides political incentives for a backlash against foreign investment within poor host countries; (ii) the growing scramble for natural resources reflecting the rising resource demand from China and other emerging economies; and (iii) the increasing attention to environmental threats at the global scale, which put many natural-resource-based FDI projects under increased scrutiny and expose them to much greater controversy.

This is reflected in risk perception among investors: a recent global survey on 602 senior executives from multinational corporations around the world, conducted by the Economist Intelligence Unit (EIU) in June 2007, reports higher political risk perception for investment activities. Almost half of the respondents cite political risk, before corruption and infrastructure bottlenecks, as the main investment constraints. More than 90% expects risks to increase moderately or substantially over the next five years.[6]

Against this backdrop, the aim of this paper is to provide new insights on how to measure political risks. The paper presents a new indicator of political risk and its subcomponents. The first section of the paper outlines the definition of political risk. The second section explains the methodology adopted for the construction of the index: it provides a conceptual framework for measuring political risk and its underlining factors and highlights the different steps to link the selected indicators to

[6] Sachs (2007).

each political risk subcategory. Finally, section three presents the main results and section four concludes.

1. Definition of Political Risk

It is possible to define political risk as the whole of decisions, conditions or events of political nature able to trigger directly or indirectly a financial loss or a physical damage for an investment project.[7] In other words, this is the risk of incurring losses when investing in a foreign country as a result of changes in the country's political structure or policies, such as tax laws, tariffs, expropriation of assets, restriction in repatriation of profits, or episodes of political violence. For example, a company may suffer such losses in the case of expropriation, tightened foreign exchange repatriation rules, or social turmoil. This definition of political risk highlights the qualitative nature of the variables that drive country risk. Social and political factors are difficult to measure, especially in developing countries characterized by unstable legal and political systems and by weak institutions. In addition, potential and sudden changes in government can increase the uncertainty and the level of risk with regard to the attitude of local authorities towards foreign investors and projects. A fundamental variable, then, is the duration of FDI projects: in most cases, the longer the investment period, the higher the exposure to such risks.

We identify three main categories of political risk following Hamada and Haugerudbraaten (2004): expropriation, transfer, and political violence risk.

a) Expropriation risk refers to losses due to measures taken or approved by the host government that deprive the investor of its ownership or control over its

[7] Hamada *et al.* (2004).

investment, or, in the case of debt, result in the project enterprise being unable to meet its obligations to the lender.

In fact, it is possible to argue that the risk of expropriation has changed considerably in nature since the 1970s, when it was not unusual for governments to seize assets without compensation. Today, expropriation or "wealth deprivation" could take different forms: it could be direct, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright physical seizure. Expropriation could also occur through interference by a State in the use of that property or with the enjoyment of the benefits, even where the property is not seized and the legal title to the property is not affected. The measures taken by governments have a similar effect to expropriation or nationalization and are generally termed "indirect" or "creeping" expropriation.[8] More generally, "creeping expropriation" occurs when investors are deprived of their fundamental rights in their investment by governmental acts.

b) Transfer risk refers to the inability to convert local currency (capital, interest, profits, royalties, and other remittances) into foreign exchange for transfer outside the host country.

The level of this risk usually depends on the possibility of converting the local currency: the more difficult is to convert the currency the more likely is that restrictions on the free circulation of capitals exist. Measuring transfer risk can be difficult, especially when *de facto* capital movement restrictions prevail. In fact, dealing with transfer risk means very often assessing the country economic performance.

[8] Yannaca-Small (2004).

c) Political violence risk refers to losses from damage to, or the destruction and disappearance of, tangible assets and politically motivated acts of war or civil disturbance in the host country, including revolution, insurrection, *coups d'état*, sabotage, and terrorism. It is also caused by an interruption of project operations essential to the overall project financial viability and obligations to lenders.

A fourth subcategory of political risk has also been considered in the literature, although it is not completely separate from a broad definition of expropriation risk as the one used here: the "breach of contract" risk, which refers to the potential losses resulting from government termination of contracts without compensation for existing investments. The risk arises if the government of the host country, or a state-owned enterprise in that country, does not comply with the contract. For example, a host country government may unilaterally cancel its contracts with a given firm.

The historical analysis of claim cases highlights the role played by the three main categories of political risk. A study conducted by the Multilateral Investment Guarantee Agency (MIGA) shows a general reduction of claim events linked to political risk in the period 1971-2000. Transfer risk was the most frequent risk type between 1971 and 1990, whereas in the 1990s expropriation was the most common form of political risk for FDI projects. In 1991-2004, 85% of claims paid by OPIC were linked to expropriation.[9]

The political risk concept has shifted significantly since economic and political changes at global level have affected the nature of risk-generating events. On the one hand, globalization and financial integration have increased the degree of

[9] Jensen (2005).

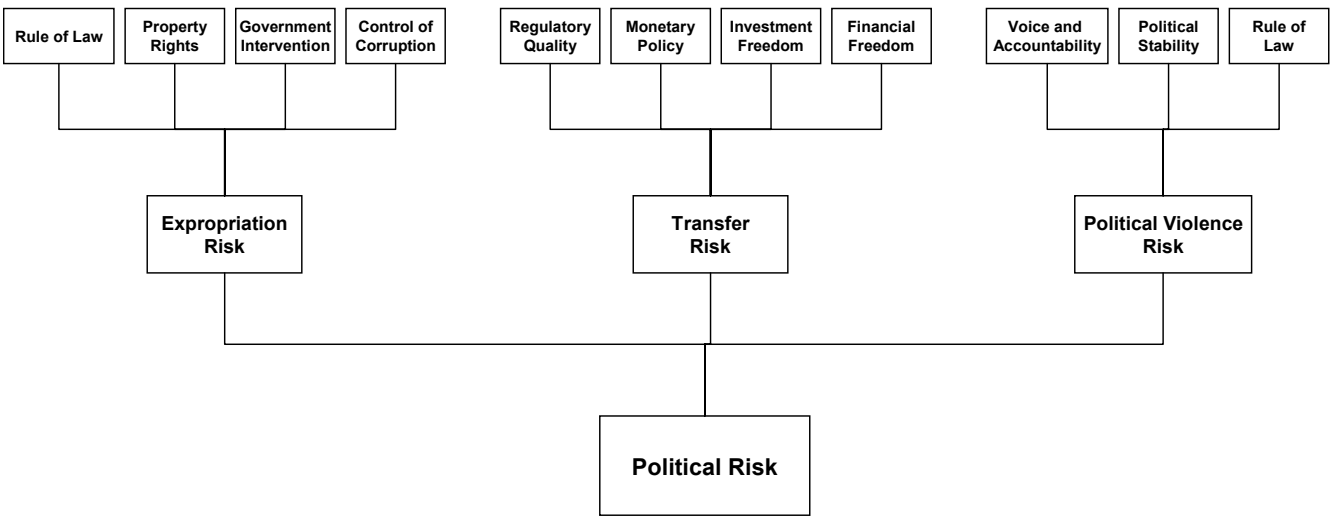
dependence on international financial markets raising the costs, in terms of credibility, of detrimental actions to foreign investors. On the other hand, the changing global geopolitical structure, resulting from the end of the Cold War and the subsequent "clash of civilizations", [10] has increased the degree of instability in several areas of the world, triggering new conflicts.

2. A New Political Risk Indicator: Conceptual Framework

The aim of this paper is to estimate an appropriate index of political risk, which implies the choice of an adequate number of explicative variables within a comprehensive conceptual scheme (see Figure 2).

The conceptual framework below highlights the key factors that, according to the prevailing literature, affect the different components of political risk.

Figure 2. Political Risk: A conceptual scheme.



[10] Huntington (1993).

The main difficulty in using the framework for operational purposes is the limited availability of data and the qualitative nature of most variables related to political risk, such as government intervention, effectiveness of the regulatory system, degree of corruption, voice and external accountability of the host governments, level of political stability, and rule of law.

Expropriation risks depend, directly or indirectly, on the degree of effectiveness of the State (and its judicial system) and the involvement of the government in the strategic sectors of the economy.[11] The theoretical literature assumes that local governments' incentives to expropriate depend on the difference between the benefits of obtaining income from foreign capital and the opportunity costs of expropriation. Under these assumptions, Eaton and Gersovitz (1984) present one of the most influential approaches to expropriation risk. Host governments have the incentive to expropriate in order to maximize the national income. The natural consequence is a suboptimal level of FDI in the host country, which in turn reduce income. Thomas and Warroll (1994) extend this idea to an infinite-horizon economy and characterize the set of self-enforcing agreements between the host government and a multinational company. The key is that the host government may have a short-term gain by reneging on the contract and expropriating output or capital at any point but longer term losses. The degree of expropriation risk depends on the balance between factors affecting both short-term and medium-term results in the government utility function.

Aguiar, Amador and Gopinath (2006) focus on expropriation cyclical properties. Governments have incentives to protect the wages of domestic workers, who do not have access to financial markets and are subject to output risk. The government can obtain resources from taxing multinational company profits (which the authors

[11] Yannaca-Small (2004) and Kamga Wafo *et al.* (1998).

interpret as an indirect form of expropriation) and redistributing them as lump sum transfers to workers.

Keefer and Knack (2002), Quan Li (2005) and Azzimonti and Sarte (2007) show how the expropriation of FDI is political and directly related to the nature of political institutions. Secure property rights, a State providing only true public goods and a high level of political stability have a negative correlation with expropriation. In particular, Azzimonti and Sarte focus on the level of political instability (referring to the frequency by which groups alternate in power) and its effects on expropriation risk and FDI level. They show a positive correlation between political instability and expropriation. A government with a low probability to remain in power has greater incentives to expropriate and benefit from its short-term gains.

Today transfer risk's concept is strictly related to second and third generation financial crises. Krugman (1999) and Allen (2003) analysed recent financial crises, highlighting how restrictions on foreign capital movements are stronger during shocks. On the one hand, macroeconomic *status* is an important variable defining the risk of transfer in a country as economic performance affects the likelihood of transfer restrictions on foreign capitals. On the other hand, the presence of political constraints on the governments' power to act unilaterally on foreign capital movements also has an impact on the level of transfer risk. In this study, we assume that the political dimension of transfer risk prevails in the current economic environment, dominated by flexible exchange rate regimes.[12]

Political violence determinants include the extent of income inequalities within the economy and the overall social and political conditions in the host countries. Sambanis (2004) shows how the diffusion of poverty within the society affects the

[12] Hamada *et al.* (2004).

frequency of political violence episodes. Collier *et al.* (2003) show the impact on violence risks of governments' inability to implement development policies, to guarantee an effective political participation inside the system, and to enforce contracts. Quan Li (2005) also show empirically that political violence is the natural consequence of high levels of political instability. For these reasons in the construction of the overall political risk index, we consider variables strictly related to: (i) the level of legitimacy and stability of the government; (ii) the entity of internal and external conflicts; and (iii) the religious, ethnic and language divisions in the economy.

To implement the definition of risk discussed above we use the Governance Indicators, calculated by the World Bank Institute (WBI), and the Heritage Foundation's Index of Economic Freedom (HER). WBI indicators are based on several variables measuring the perception of governance, drawn from 33 separate data sources constructed by 30 different organizations. WBI assigns these individual measures of governance to categories capturing six dimensions of governance and use an unobserved components model to construct six aggregate governance indicators. Data sources consist of surveys of firms and individuals, as well as the assessments of commercial risk rating agencies, non-governmental organizations, a number of multilateral aid agencies, and other public sector organizations.[13] The Heritage Foundation's Index of Economic Freedom (HER) measures economic freedom, defined as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. To measure economic freedom and rate each country, the authors use 10 specific dimensions of freedom.[14]

[13] For details about the WBI database see Annex A. For an exhaustive analysis on WBI data see also: www.worldbank.org/wbi/governance .
[14] For details about the HER database see Annex A. For further documentation see also: http://www.heritage.org/research/features/index/chapters/htm/index2007_chap3.cfm .

The last step of our analysis entailed establishing a link between these indicators and each political risk. Following our conceptual framework, we built the **expropriation risk** index on the basis of the following WBI and HER variables:

1. **Rule of Law (RL)**: measuring the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence (source WBI);
2. **Property Rights (PR)**: it is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the State (source HER);
3. **Government Intervention (Effectiveness) (GI)**: measuring the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (source WBI);
4. **Control of Corruption (CC)**: measuring the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests (source WBI).

For **transfer risk**, we identified the following four variables, as the key dimensions able to explain the concept:

1. **Regulatory Quality or lack of Regulatory Burden (RQ)**: measuring the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development (source WBI);
2. **Monetary Freedom or Monetary Policy (MP)**: it combines a measure of price stability with an assessment of price controls. Both inflation and price

controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market (source HER);

3. **Investment Freedom (INV)**: it is an assessment of the free flow of capital, especially foreign capital (source HER);
4. **Financial Freedom (FIN)**: it is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an efficiency burden (source HER).

For **political violence**, the only variables involved in the calculation of the index are the following:

1. **Voice and Accountability (VA)**: measuring the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media (source WBI);
2. **Political Stability and lack of violence, crime and terrorism (PV)**: measuring perceptions of the likelihood that the government will be destabilized or overthrown, also by unconstitutional or violent means, including domestic violence and terrorism (source WBI);
3. **Rule of Law (RL)**: measuring the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence (source WBI).

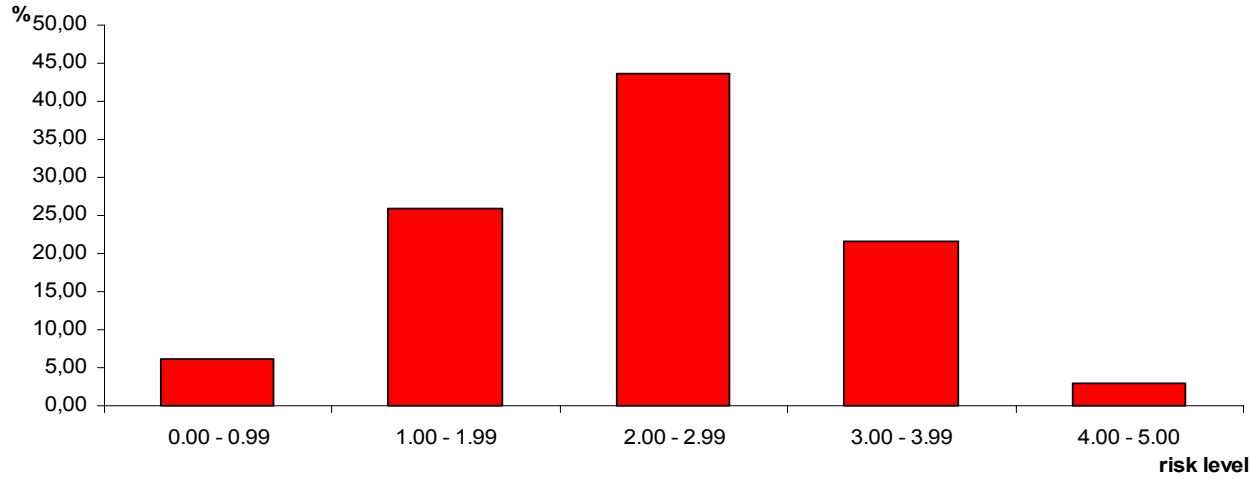
On the basis of the above indicator and the theoretical fundamentals we estimated each political risk indicator and the overall index. For expropriation risk and transfer risk the index is the average value of its components, while for political violence risk the index is the result of a weighted average in which PV is the main factor reflecting the overarching importance of political factors. The overall index is the

average of its subcomponents. Every indicator is converted in a 0 to 5 scale, with higher scores for higher levels of political risk.

3. The results

The overall political risk index covers 209 advanced, emerging and developing countries[15] and has a mean value equal to 2.4. The median (Me) is equal to 2.5, showing that the distribution is close to symmetric. The distribution of political risk has a negative kurtosis (Kurt = -0.5), thus the function is platykurtic, i.e. it has a smaller "peak" around the mean and "thin tails". Figure 3 highlights this result, showing the distribution of five major classes of risk. About 6% of the sample (13 countries) has a risk rate lower than 1, while 54 countries (26% of the sample) have a score ranging between 1 and 1.99. The third group is the largest with 91 countries (43% of the sample), with overall scores between 2 and 2.99. Finally, 45 countries (22% of the sample) are included into the fourth group and only 6 (3% of the sample) have a rate higher than 4.

Figure 3. Distribution of countries by Overall Political Risk Index (in percent).



Source: SACE elaboration on WBI and HER 2007 data.

[15] A list of the countries is reported in Annex B.

The results (Table 1) show that the African region is the riskiest area in the world. Sub-Saharan Africa, in particular, has the highest values for each political risk subcategory and an overall value equal to 2.96. North Africa and Middle East follow as the second and third riskiest areas in the world with an average overall score equal to 2.82 and 2.77 respectively. These are followed by Asia scoring 2.69 and CIS and Other Europe with an overall index equal to 2.47. Latin America is on average a medium-risk area (2.21), while Oceania can be considered a medium-low risk zone with the exception of transfer risk.

Taking into consideration the median values of the index (which are less sensitive to extreme values), the results do not change significantly, with the exception of Asia and CIS and Other Europe, whose overall scores reach 2.96 and 2.68 respectively, and Middle East whose index falls to 2.51.

Table 1. Political risk rating by region.

Region	EXP	TRA	VIO	OVERALL	MEDIAN
Asia	2,73	2,53	2,80	2,69	2,96
CIS & Other Europe	2,67	2,30	2,47	2,47	2,68
EU	1,40	1,29	1,59	1,42	1,51
Latin America	2,35	1,98	2,30	2,21	2,19
Middle East	2,66	2,54	3,12	2,77	2,51
North Africa	2,91	2,59	2,96	2,82	2,90
North America	0,71	1,16	1,53	1,13	1,13
Oceania	2,26	2,54	1,65	2,12	2,14
Sub-Saharan Africa	3,19	2,69	3,00	2,96	2,86
WORLD	2,53	2,25	2,49	2,42	2,53

Source: SACE elaboration on WBI and HER 2007 data.

If we analyze Asia and CIS and Other Europe excluding the most developed countries in this region[16] results change significantly: Asia scores on average 3.10 becoming the riskiest zone in the world, while CIS and Other Europe's overall score reaches 2.90.[17]

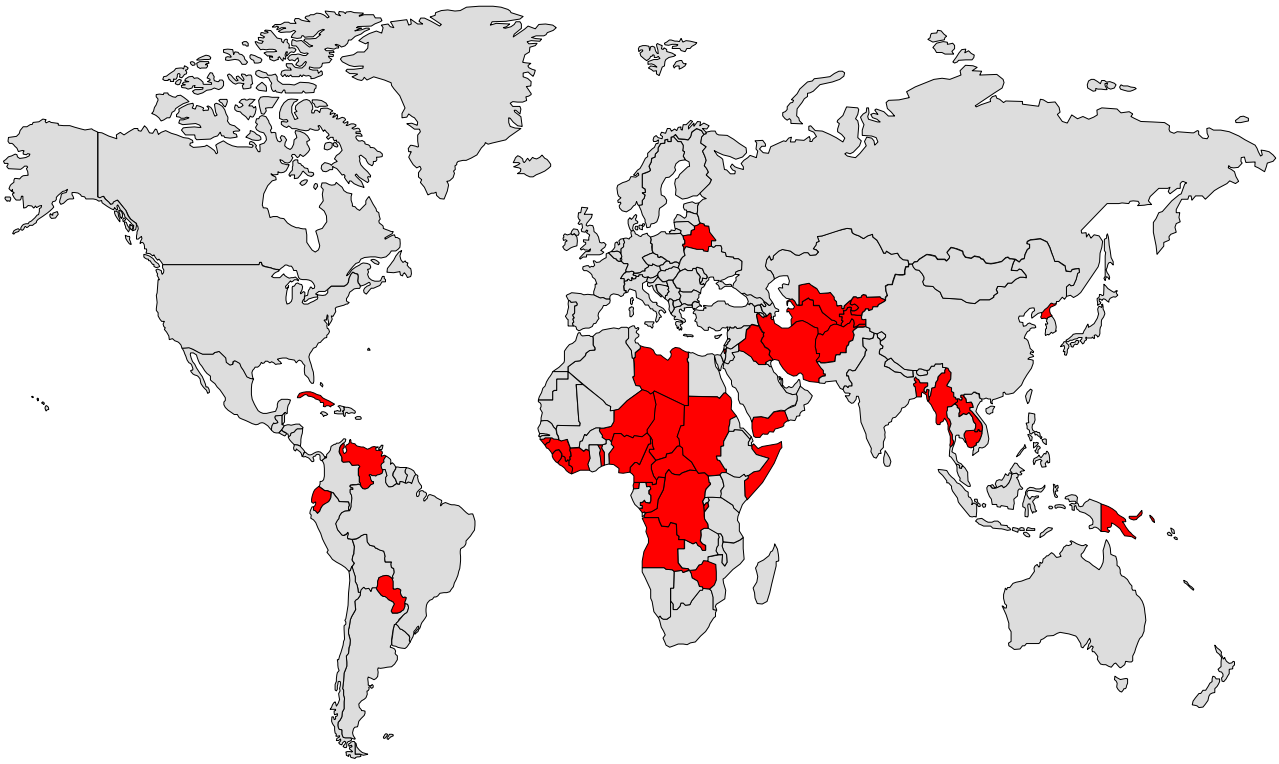
[16] Asia without Brunei, South Korea, Taiwan, Macao, Japan, Singapore, Hong Kong.
[17] CIS and Other Europe without Monaco, San Marino, Andorra, Liechtenstein, Norway, Switzerland, Iceland.

Expropriation risk is particularly high in Sub-Saharan Africa, North Africa and Middle East, where the risk rate is medium-high and very close to 3.20 (Figure 4).

Transfer risk (Figure 5) reaches the highest levels in Africa, Middle East, Asia and Oceania, where the scores range between 2.69 and 2.53.

For political violence risk (Figure 6), Africa and Middle East have a risk score close to 3.00, while Asia reaches 2.80. These areas remain the riskiest zones in the world with regard to civil conflicts and social turmoil, especially because of the instability of African governments, the role of terroristic groups in the Middle East area and the legacy of the Cold War, especially in Central and South-East Asia.

Figure 4. Expropriation risk global map: highest risk countries (first quintile) in red.

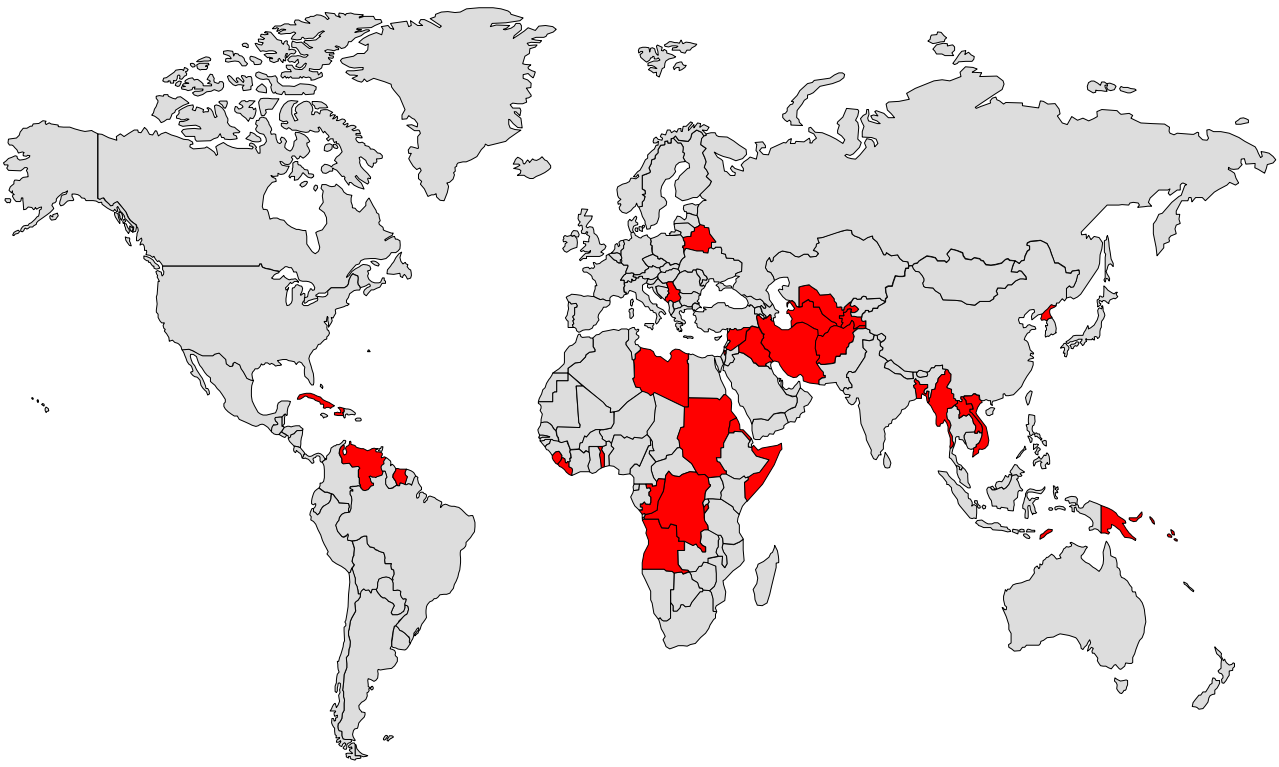


Source: SACE elaboration on WBI and HER 2007 data.

The countries with the highest scores in terms of overall political risk also have the highest rankings for the three subcategories of risk. This is not an unexpected result, but it is interesting to notice which are the riskiest countries for each risk type.[18]

Somalia shows the highest overall score and it is the riskiest country in the world for what concerns all risk generating events. **Iraq** ranks second in the overall index and also for political violence risk. **Afghanistan, Congo Democratic Republic, Zimbabwe, North Korea, Sudan, Myanmar**, **and Uzbekistan** have the highest scores in every risk subcategory and, therefore, their overall political risk scores are among the highest considering developing countries.

Figure 5. Transfer risk global map: highest risk countries (first quintile) in red.



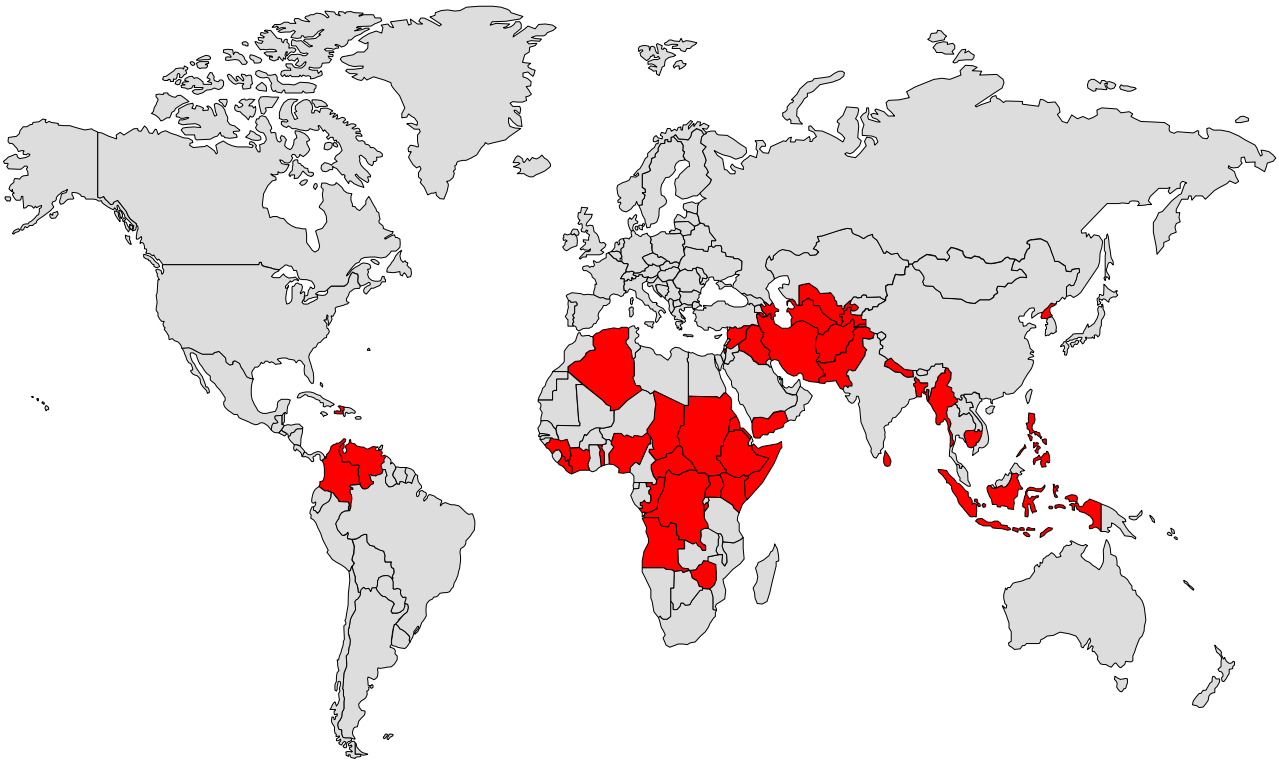
Source: SACE elaboration on WBI and HER 2007 data.

[18] For details see Annex B.

Haiti, Venezuela, Cuba, Ecuador, **and Bolivia** have the highest scores among Latin America's countries, with the exception of **Cuba**, for political violence risk, where **Colombia** ranks in the top quintile.

Moving to the CIS and Other Europe region, **Uzbekistan**, **Turkmenistan**, **Belarus**, **Tajikistan** and **Azerbaijan** are classified as high-risk countries, especially for expropriation and political violence risks. Also **Russia** remains in the high-risk country group owing to high expropriation risk. **Serbia, Ukraine, Montenegro, Moldova**, and **Bosnia-Herzegovina** are the riskiest countries in "Other Europe". **Bosnia-Herzegovina** ranks in the first positions for expropriation risk, while **Serbia** and **Montenegro** have high transfer risk.

Figure 6. Political Violence risk global map: highest risk countries (first quintile) in red.



Source: SACE elaboration on WBI and HER 2007 data.

In Asia, after Afghanistan, North Korea and Myanmar the riskiest countries are **Timor-Leste, Nepal, Bangladesh, Laos, Pakistan**, and **Papua New Guinea**. All these countries are among the riskiest in the world for every category, with the exception of Pakistan that has a low score for transfer risk.

The Solomon Islands are the only medium-high risk business recipient in Oceania, which is a medium-risk area. Only **Fiji, Tonga and Marshall Islands, Kiribati and Tuvalu** have an overall score higher than 2.19.

Africa is the riskiest region. Exceptions are **Botswana** and **Cape Verde** having a low risk score, **Mauritius** and **South Africa** with a medium overall score. The same applies to **Bahrain, Israel, Oman, Kuwait, Qatar**, and **United Arab Emirates** in the Middle East area.

In Latin America, **Chile** has a better risk rating performance than some European countries and also **Uruguay, Costa Rica** and **Puerto Rico** are low risk recipients.

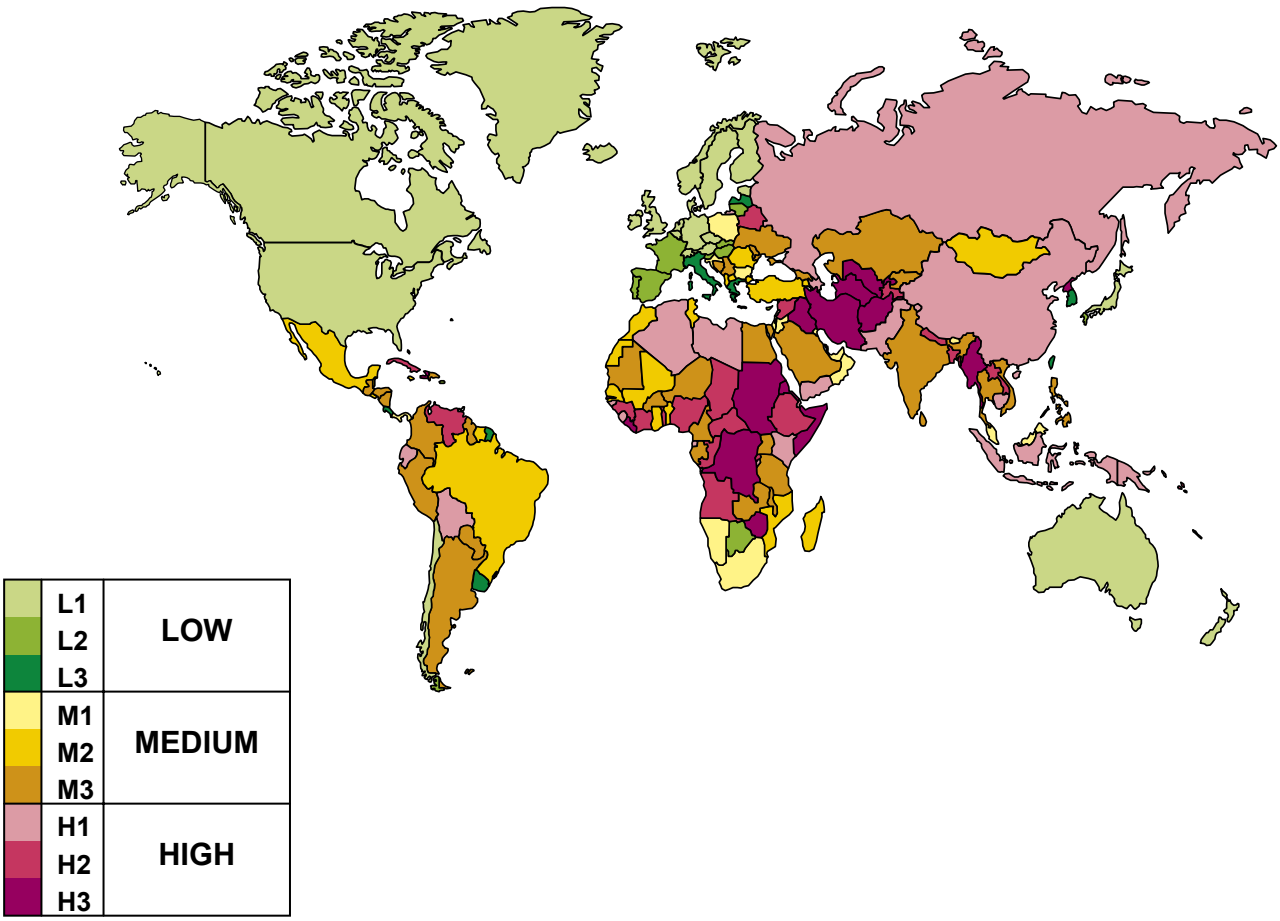
In order to represent the statistical distribution of the index coherently with SACE Country Risk methodology, we classified the countries according to nine risk categories (three for high risk – spanning from lower-risk H1 to higher risk H3, three for medium risk – from M1 to M3, and three for low risk levels – from L1 to L3).

Table 2. Nine risk categories.

Category	From	To
H3	3,60	5,00
H2	3,29	3,60
H1	2,97	3,29
M3	2,66	2,97
M2	2,34	2,66
M1	2,03	2,34
L3	1,71	2,03
L2	1,40	1,71
L1	0,00	1,40

Source: SACE.

Figure 7. Overall Political Risk Index global map.

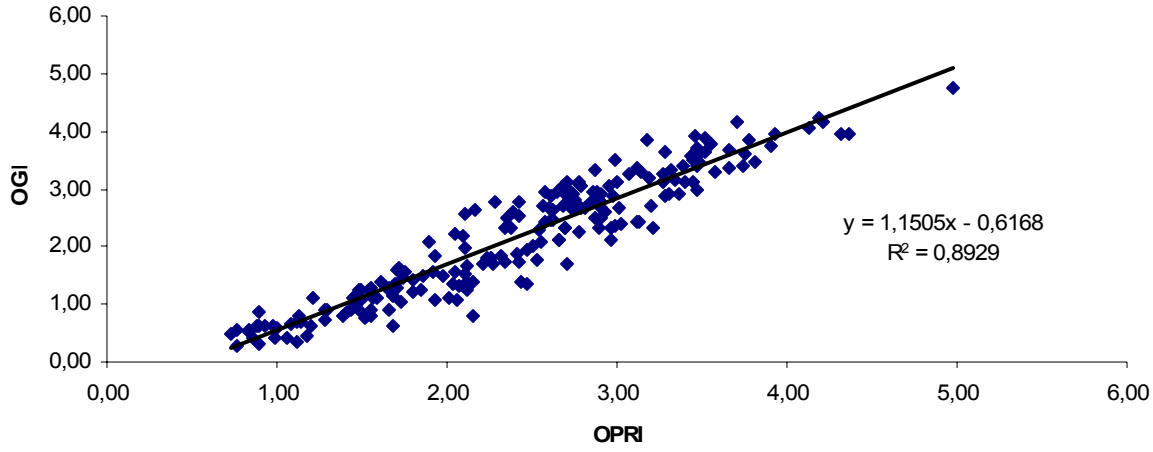


Source: SACE.

The last step of our analysis is to assess the robustness of the overall political risk index (OPRI). To this end, we compare the performance of our rating results with other available indexes. As mentioned in the introduction, to our knowledge, there is no existing indicator that measures directly expropriation, transfer, and political violence risk. Therefore, we consider the Global Insight Overall (GIO) index, that gauges country risk in 203 different countries through six different dimensions: political, economic, tax, operational, and security. The comparison is made with the GIO index rather than its political component since legal, operational, and security features are most relevant for our purpose.

Since Global Insight indicators are built on a 1-to-5 scale, we converted them into a 0-to-5 scale. The relation is quite strong and the graphs show a clear positive correlation between our measures of risk and Global Insight's indexes. The correlation coefficient between the overall Global Insight index and our political risk indicator is 0.945.

Figure 8. Overall Political Risk Index and Overall Global Insight Indicator scatter plot.



Source: SACE elaboration on WBI and HER 2007 data and Global Insight.

Looking at the differences, there is an important feature to stress: according to our index **Russia** and **Indonesia** rank among the riskiest countries for expropriation risk, while they perform much better in the GIO index, ranking among the medium-risk countries. This shows that our indicator better captures expropriation risk in such countries, which are characterized by a high level of country risk, and are particularly risky in terms of (creeping) expropriation, as recent episodes in both Russia and Indonesia (see the D-Natuna Alpha[19]) highlight.

Another way to test the performance of our index with respect to the GIO indicator is investigating the number of claims paid by political risk insurance providers. We use OPIC data for the period 2000-06. The ten countries for which claims were paid

[19] See http://www.reuters.com/article/companyNewsAndPR/idUSJAK16825020070105.

are: Colombia, India, Afghanistan, Venezuela, Sudan, Indonesia, Ethiopia, Haiti, Eritrea, and Argentina. In eight cases (Colombia, India, Afghanistan, Venezuela, Sudan, Indonesia, Haiti and Eritrea) our indicator assigns a higher risk than Global Insight, in one case (Ethiopia) the rank is the same, while only for Argentina it is the GIO score that performs better.

Table 3. Number of claims paid by OPIC (2000-06): OPRI and GIO ranking.

Country	Number of claims paid by OPIC	OPRI ranking*	GIO ranking*
Colombia	10	60	75
India	5	91	110
Afghanistan	2	3	7
Venezuela	2	20	26
Sudan	2	7	8
Indonesia	1	47	95
Ethiopia	1	34	34
Haiti	1	14	17
Eritrea	1	11	21
Argentina	1	82	71

* 203 countries.
Source: OPIC, Global Insight and SACE databases.

4. Final Remarks

"Today's political risks are not the classic risks associated with communist takeovers or post-colonial outbursts of anti-foreign sentiment. They are more subtle, arising from legal and regulatory changes, government transitions, environmental and human rights issues, currency crises and terrorism. Because these risks are subtle (often occurring at the same time as the government is declaring the country "open for business") they are often hard to manage".[20]

The main difficulties in political risk analysis are linked with the **qualitative nature** of several dimensions involved in the conceptual definition of this risk. Managing

[20] Wilkin, Minor (2001).

political risk means dealing with variables hard to measure, since they are affected by economic and political changes at global level.

On the one hand, globalization and financial integration processes have increased the degree of **dependence** on international financial markets of each country raising the costs, in terms of credibility, of detrimental actions to foreign investors. On the other hand, the global geopolitical structure resulting from the end of the Cold War and to the subsequent "clash of civilizations", has increased **instability** in several areas of the world, triggering new ethnic and religious conflicts.

Today, there is a common consensus in literature in defining political risk as the whole of decisions, conditions or events of political nature able to give birth directly or indirectly to a financial loss or a physical damage for an investment project. Expropriation, transfer and political violence are the main risk-generating events able to affect the degree of political risk in a country.

The nature of risk has however shifted significantly over time. "Creeping" or indirect expropriation events have replaced traditional direct expropriation cases. Transfer risk decreased over the last decades but remains linked, above all, to second and third generation financial crises. The influence of political factors has been acknowledged as a key determinant of these crises by the recent literature.

In this paper we developed a conceptual framework to identify the sub-components of political risk and the key indicators able to measure them. The resulting political risk score is more able than existing political risk ratings to assess the multidimensional nature of political risk.

Annex A

The main data sources used in this paper are the Governance Indicators, provided by the World Bank Institute (WBI), and the Heritage Foundation Index of Economic Freedom (HER).

Governance is defined as the set of traditions and formal and informal institutions that determine how authority is exercised in a particular country for the common good. The concept, therefore, encompasses three different dimensions: the process of selecting, monitoring, and replacing governments; the capacity to formulate and implement sound policies and deliver public services; and the respect of citizens and the State for the institutions that govern economic and social interactions among them. For measurement and analysis, the three dimensions in this definition are unbundled to comprise two measurable concepts for each of the dimensions above, for a total of six governance components:

1) Voice and External Accountability that is, the government's preparedness to be externally accountable through their own country's citizen feedback and democratic institutions, and a competitive press, thus including elements of restraint on the sovereign.
2) Political Stability and lack of violence, crime, and terrorism.
3) Government Effectiveness (or Government Intervention) which includes the quality of policymaking, bureaucracy, and public service delivery.
4) Lack of Regulatory burden.
5) Rule of Law which includes the protection of property rights and judiciary independence.
6) Control of Corruption.

To construct these 6 aggregate indices, the World Bank Institute draws data from 33 separate sources constructed by 30 different organizations covering 250 individual variables which measure perceptions of governance. The authors present the point estimates of the dimensions of governance as well as the margins of error for each country. They use an Unobserved Component Model (UCM) to aggregate the various responses in the broad 6 clusters. This model treats the "true" level of governance in each country as unobserved, and it assumes that each of the available sources for a country provides noisy "signals" of the level of governance. The UCM, then, constructs a weighted average of the sources for each country as the best estimate of governance for that country. The weights are proportional to the reliability of each source. The resulting estimates of governance have an expected value (across countries) of zero, and a standard deviation (across countries) of one. This implies that virtually all scores lie between -2.5 and 2.5, with higher scores corresponding to better outcomes. These 6 clusters are used to capture countries' relative position with each other.

The coverage is extended on 212 countries for all dimensions. The indicators were created in 1996, they are updated every two years and are available in Kaufmann *et al.* (2007).

The second statistical source for the proposed political risk indicator is the Heritage Foundation Index of Economic Freedom (HER), edited in collaboration with the Wall Street Journal. According to this index, economic freedom is defined as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. To measure economic freedom and rate each country, the authors of the Index use 10 specific freedoms, some as composites of even further detailed and quantifiable components:

1. Business Freedom: the ability to create, operate and close an enterprise quickly and easily. Burdensome, redundant regulatory rules are the most harmful barriers to business freedom.
2. Trade Freedom: it is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.
3. Monetary Freedom: it combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.
4. Freedom from Government: it is defined to include all government expenditures and state-owned enterprises. Ideally, the State will provide only true public goods, with an absolute minimum of expenditure.
5. Fiscal Freedom: it is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on income and the overall amount of tax revenue as portion of GDP.
6. Property Rights: it is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the State.
7. Investment Freedom: it is an assessment of the free flow of capital, especially foreign capital.
8. Financial Freedom: it is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an efficient burden.
9. Freedom from Corruption: it is based on quantitative data that assess the perception of corruption in the business environment, including levels of governmental legal, judicial and administrative corruption.
10. Labour Freedom: it is a composite measure of the ability of workers and businesses to interact without restriction by the State.

All 10 factors are equally important to the level of economic freedom in any country, i.e. the factors are equally weighted. In addition, the Index offers a simple composite value based on an average of the 10 freedoms. Each one of the 10 freedoms is graded using a scale from 0 to 100, where 100 represents the maximum freedom. The grading scale is continuous, that is scores with decimals are possible.

Many of the 10 freedoms are based on quantitative data that are converted directly into a score. In addition, the Heritage Foundation establishes five categories of countries according to their performance:

a) Free: countries with an average overall score between 80 and 100;
b) Mostly Free: countries with an average overall score between 70 and 79.9;
c) Moderately Free: countries with an average overall score between 60 and 69.9;
d) Mostly Unfree: countries with an average overall score between 50 and 59.9;
e) Repressed: countries with an average overall score between 49.9 and 0.

The rating system was created in 1995, it covers 161 countries and it is updated annually.

Annex B

Country rating for risk subcategory and for overall political risk:

Country	Exp	Tra	Vio	Overall	Category
SOMALIA	4,66	5,20	5,07	**4,98**	**9**
IRAQ	4,18	3,96	4,94	**4,36**	**9**
AFGHANISTAN	4,21	4,20	4,54	**4,32**	**9**
Congo, Dem. Rep. (Zaire)	4,07	4,01	4,55	**4,21**	**9**
ZIMBABWE	4,15	4,55	3,87	**4,19**	**9**
KOREA, NORTH	4,17	4,88	3,34	**4,13**	**9**
SUDAN*	3,70	3,65	4,43	**3,92**	**9**
MYANMAR	4,18	3,87	3,66	**3,90**	**9**
UZBEKISTAN	3,68	3,43	4,32	**3,81**	**9**
LIBERIA	3,63	4,14	3,57	**3,78**	**9**
ERITREA	3,30	4,37	3,58	**3,75**	**9**
TURKMENISTAN	4,04	3,83	3,35	**3,74**	**9**
WEST BANK GAZA	3,44	3,67	3,99	**3,70**	**9**
HAITI	4,10	2,93	3,96	**3,66**	**9**
IRAN	3,55	3,74	3,68	**3,65**	**9**
TIMOR-LESTE	3,37	3,97	3,39	**3,57**	**8**
CENTRAL AFRICAN REPUBLIC	3,88	2,73	4,04	**3,55**	**8**
CHAD	3,85	2,57	4,14	**3,52**	**8**
GUINEA	3,70	2,79	4,04	**3,51**	**8**
VENEZUELA	3,58	3,24	3,64	**3,49**	**8**
NIGERIA	3,63	2,72	4,10	**3,48**	**8**
ANGOLA	3,78	3,33	3,31	**3,48**	**8**
COMOROS	3,57	4,02	2,83	**3,47**	**8**
CONGO	3,91	2,96	3,55	**3,47**	**8**
IVORY COAST	3,77	2,29	4,34	**3,47**	**8**
BURUNDI	3,58	3,07	3,71	**3,45**	**8**
NEPAL	3,33	2,80	4,22	**3,45**	**8**
BANGLADESH	3,49	3,11	3,74	**3,44**	**8**
BELARUS	3,69	3,63	2,98	**3,43**	**8**
CUBA	3,52	3,75	2,92	**3,40**	**8**
TAJIKISTAN	3,51	2,91	3,75	**3,39**	**8**
SYRIA	3,31	3,32	3,47	**3,37**	**8**
TOGO	3,66	2,89	3,47	**3,34**	**8**
ETHIOPIA	3,20	2,83	3,94	**3,32**	**8**
LAOS	3,73	3,13	3,06	**3,31**	**8**
SIERRA LEONE	3,88	2,87	3,10	**3,29**	**7**
PAPUA NEW GUINEA	3,47	3,20	3,18	**3,28**	**7**
YEMEN	3,38	2,69	3,75	**3,27**	**7**
PAKISTAN	3,32	2,45	4,05	**3,27**	**7**
LIBYA	3,62	3,11	2,88	**3,21**	**7**
AZERBAIJAN	3,34	2,78	3,50	**3,20**	**7**
EQUATORIAL GUINEA	3,77	2,60	3,19	**3,19**	**7**
GUINEA-BISSAU	3,72	2,63	3,18	**3,18**	**7**
SOLOMON ISLANDS	3,20	3,63	2,58	**3,14**	**7**
RUSSIA	3,28	2,83	3,30	**3,13**	**7**
ECUADOR	3,46	2,59	3,30	**3,12**	**7**
INDONESIA	3,24	2,68	3,42	**3,11**	**7**

BOLIVIA	3,31	2,62	3,27	**3,06**	**7**
ALGERIA	3,09	2,65	3,33	**3,02**	**7**
CAMBODIA	3,58	2,27	3,21	**3,02**	**7**
LEBANON	3,13	2,10	3,76	**3,00**	**7**
RWANDA	3,03	2,78	3,16	**2,99**	**7**
CHINA	3,11	2,73	3,13	**2,99**	**7**
KENYA	3,29	2,25	3,39	**2,97**	**7**
PHILIPPINES	3,05	2,47	3,39	**2,97**	**6**
VIETNAM	3,37	2,90	2,62	**2,96**	**6**
SRI LANKA	2,66	2,66	3,53	**2,95**	**6**
SERBIA	2,91	2,87	3,02	**2,93**	**6**
GUATEMALA	3,35	2,12	3,25	**2,91**	**6**
COLOMBIA	2,96	2,10	3,65	**2,90**	**6**
CAMEROON	3,46	2,21	3,04	**2,90**	**6**
UKRAINE	3,24	2,64	2,83	**2,90**	**6**
PARAGUAY	3,46	2,19	3,05	**2,90**	**6**
EGYPT	2,83	2,62	3,24	**2,90**	**6**
MOLDOVA	3,03	2,62	3,01	**2,88**	**6**
SAO TOME AND PRINCIPE	3,12	3,27	2,24	**2,88**	**6**
NIGER	3,41	2,26	2,93	**2,87**	**6**
KAZAKHSTAN	3,32	2,44	2,83	**2,87**	**6**
DJIBOUTI	3,37	2,25	2,98	**2,86**	**6**
UGANDA	3,18	1,94	3,42	**2,84**	**6**
HONDURAS	3,32	2,09	3,02	**2,81**	**6**
BOSNIA-HERZEGOVINA	3,38	2,10	2,88	**2,79**	**6**
GABON	3,14	2,47	2,74	**2,79**	**6**
BURKINA FASO	3,18	2,39	2,78	**2,78**	**6**
MONTENEGRO	2,90	2,90	2,53	**2,78**	**6**
NICARAGUA	3,37	1,98	2,96	**2,77**	**6**
MAURITANIA	3,17	2,14	2,95	**2,75**	**6**
TONGA	2,96	3,28	1,99	**2,75**	**6**
MALAWI	3,14	2,46	2,64	**2,74**	**6**
ZAMBIA	3,16	2,54	2,52	**2,74**	**6**
SWAZILAND	2,97	2,30	2,94	**2,74**	**6**
MARSHALL ISLANDS	3,11	3,46	1,64	**2,73**	**6**
ARGENTINA	3,06	2,54	2,58	**2,73**	**6**
GUYANA	2,99	2,20	2,99	**2,73**	**6**
SAUDI ARABIA	2,48	2,50	3,14	**2,71**	**6**
KYRGYZ REPUBLIC	3,53	2,43	2,16	**2,71**	**6**
DOMINICAN REPUBLIC	3,13	2,49	2,48	**2,70**	**6**
PERU	3,02	1,90	3,18	**2,70**	**6**
TANZANIA	3,04	2,30	2,75	**2,69**	**6**
GAMBIA	3,16	2,26	2,63	**2,68**	**6**
GEORGIA	3,03	1,83	3,17	**2,68**	**6**
INDIA	2,52	2,57	2,90	**2,66**	**6**
THAILAND	2,49	2,31	3,19	**2,66**	**6**
MALI	3,07	2,37	2,49	**2,65**	**5**
SURINAME	2,61	2,85	2,42	**2,63**	**5**
MACEDONIA	3,01	1,88	2,97	**2,62**	**5**
ALBANIA	3,20	1,78	2,86	**2,61**	**5**
BENIN	3,21	2,31	2,31	**2,61**	**5**
FIJI	2,88	2,41	2,51	**2,60**	**5**
LESOTHO	2,77	2,57	2,40	**2,58**	**5**
MOZAMBIQUE	3,12	2,30	2,32	**2,58**	**5**

ARMENIA	3,07	1,69	2,93	**2,56**	**5**
BRAZIL	2,73	2,34	2,58	**2,55**	**5**
SENEGAL	2,75	2,16	2,73	**2,55**	**5**
MOROCCO	2,77	2,00	2,82	**2,53**	**5**
TURKEY	2,41	2,20	2,91	**2,50**	**5**
MEXICO	2,67	1,93	2,83	**2,48**	**5**
SEYCHELLES	2,47	3,13	1,82	**2,47**	**5**
TUNISIA	2,22	2,57	2,53	**2,44**	**5**
KIRIBATI	2,36	3,51	1,40	**2,42**	**5**
MADAGASCAR	2,68	2,07	2,51	**2,42**	**5**
ROMANIA	2,85	2,04	2,37	**2,42**	**5**
BELIZE	2,63	2,25	2,34	**2,41**	**5**
MONGOLIA	3,08	2,02	2,08	**2,39**	**5**
GHANA	2,55	2,27	2,31	**2,38**	**5**
JAMAICA	2,71	1,68	2,69	**2,36**	**5**
EL SALVADOR	2,74	1,63	2,66	**2,34**	**5**
MALDIVES	2,59	2,24	2,20	**2,34**	**5**
JORDAN	2,25	1,85	2,85	**2,32**	**4**
TUVALU	2,26	3,29	1,31	**2,29**	**4**
BULGARIA	2,77	1,79	2,25	**2,27**	**4**
PANAMA	2,82	1,60	2,37	**2,26**	**4**
CROATIA	2,63	1,92	2,14	**2,23**	**4**
NAMIBIA	2,64	2,10	1,89	**2,21**	**4**
KOSOVO	3,13	n.a.	1,26	**2,20**	**4**
VANUATU	2,41	2,62	1,47	**2,17**	**4**
MALAYSIA	2,01	2,21	2,24	**2,15**	**4**
UNITED ARAB EMIRATES	1,97	2,36	2,11	**2,15**	**4**
POLAND	2,28	1,96	2,13	**2,12**	**4**
NAURU	2,78	n.a.	1,47	**2,12**	**4**
TRINIDAD AND TOBAGO	2,30	1,52	2,55	**2,12**	**4**
KUWAIT	2,08	2,02	2,25	**2,11**	**4**
BHUTAN	1,88	2,67	1,78	**2,11**	**4**
SOUTH AFRICA	2,11	1,85	2,37	**2,11**	**4**
GRENADA	2,21	2,06	2,05	**2,11**	**4**
MICRONESIA	2,44	2,35	1,48	**2,09**	**4**
BAHRAIN	1,99	1,44	2,77	**2,07**	**4**
QATAR	1,93	2,36	1,90	**2,06**	**4**
SAMOA	2,10	2,53	1,52	**2,05**	**4**
ISRAEL	1,60	1,60	2,93	**2,04**	**4**
OMAN	2,03	1,95	2,12	**2,03**	**4**
GREECE	2,09	2,07	1,87	**2,01**	**3**
COSTA RICA	2,20	2,05	1,66	**1,97**	**3**
PALAU	2,46	n.a.	1,44	**1,95**	**3**
AMERICAN SAMOA	1,94	2,15	1,71	**1,93**	**3**
ITALY	2,24	1,53	2,03	**1,93**	**3**
URUGUAY	1,83	2,13	1,79	**1,92**	**3**
CAPE VERDE	1,89	2,13	1,67	**1,90**	**3**
SAN MARINO	2,28	n.a.	1,45	**1,87**	**3**
FRENCH GUIANA	1,69	1,66	2,21	**1,85**	**3**
BRUNEI	2,08	1,54	1,91	**1,84**	**3**
KOREA, SOUTH	1,73	1,71	1,96	**1,80**	**3**
GUAM	1,78	1,90	1,71	**1,80**	**3**
MONACO	1,97	n.a.	1,57	**1,77**	**3**
LATVIA	2,09	1,43	1,74	**1,76**	**3**

ANTIGUA AND BARBUDA	1,62	1,90	1,71	**1,74**	**3**
MAURITIUS	1,92	1,65	1,62	**1,73**	**3**
TAIWAN	1,65	1,62	1,88	**1,72**	**3**
PUERTO RICO	1,84	1,55	1,72	**1,70**	**2**
DOMINICA	1,80	1,60	1,71	**1,70**	**2**
LITHUANIA	2,16	1,23	1,69	**1,69**	**2**
VIRGIN ISLANDS (U.S.)	1,42	1,90	1,74	**1,69**	**2**
SLOVAKIA	2,08	1,27	1,71	**1,68**	**2**
MACAO	1,85	1,41	1,73	**1,66**	**2**
SLOVENIA	1,80	1,69	1,49	**1,66**	**2**
HUNGARY	1,76	1,52	1,69	**1,66**	**2**
MARTINIQUE	1,69	1,66	1,50	**1,62**	**2**
BOTSWANA	1,71	1,55	1,52	**1,59**	**2**
NETHERLANDS ANTILLES	1,53	1,66	1,50	**1,56**	**2**
FRANCE	1,26	1,72	1,68	**1,55**	**2**
ST. VINCENT AND THE GRENAD.	1,60	1,60	1,46	**1,55**	**2**
PORTUGAL	1,49	1,62	1,54	**1,55**	**2**
CZECH REPUBLIC	1,73	1,19	1,71	**1,54**	**2**
SPAIN	1,42	1,25	1,87	**1,51**	**2**
REUNION	1,51	1,41	1,57	**1,50**	**2**
ST. KITTS AND NEVIS	1,63	1,50	1,34	**1,49**	**2**
BAHAMAS	1,19	1,76	1,49	**1,48**	**2**
ST. LUCIA	1,52	1,42	1,50	**1,48**	**2**
BARBADOS	1,15	1,82	1,42	**1,46**	**2**
CYPRUS	1,26	1,26	1,82	**1,44**	**2**
ARUBA	1,35	1,66	1,29	**1,44**	**2**
BERMUDA	1,44	1,17	1,62	**1,41**	**2**
JAPAN	1,25	1,53	1,37	**1,38**	**1**
CHILE	1,07	1,27	1,53	**1,29**	**1**
MALTA	1,03	1,58	1,23	**1,28**	**1**
CAYMAN ISLANDS	1,26	1,17	1,40	**1,28**	**1**
ESTONIA	1,26	0,73	1,65	**1,21**	**1**
UNITED STATES	0,87	0,96	1,78	**1,21**	**1**
ANDORRA	1,19	1,17	1,15	**1,17**	**1**
ANGUILLA	0,99	1,17	1,25	**1,14**	**1**
BELGIUM	1,00	0,92	1,47	**1,13**	**1**
LIECHTENSTEIN	1,05	1,17	1,13	**1,12**	**1**
GERMANY	0,73	1,26	1,35	**1,11**	**1**
NORWAY	0,44	1,76	1,04	**1,08**	**1**
CANADA	0,56	1,36	1,27	**1,06**	**1**
AUSTRIA	0,63	1,17	1,19	**1,00**	**1**
SINGAPORE	0,42	1,17	1,37	**0,99**	**1**
UNITED KINGDOM	0,65	0,69	1,59	**0,98**	**1**
AUSTRALIA	0,57	0,90	1,34	**0,93**	**1**
SWEDEN	0,48	1,08	1,14	**0,90**	**1**
NETHERLANDS	0,59	0,75	1,35	**0,90**	**1**
HONG KONG	0,77	0,50	1,40	**0,89**	**1**
IRELAND	0,81	0,62	1,20	**0,88**	**1**
SWITZERLAND	0,43	1,22	0,92	**0,86**	**1**
ICELAND	0,35	1,31	0,84	**0,83**	**1**
NEW ZEALAND	0,44	1,02	1,03	**0,83**	**1**
LUXEMBOURG	0,61	0,80	0,90	**0,77**	**1**
DENMARK	0,32	0,71	1,26	**0,76**	**1**
FINLAND	0,35	0,95	0,90	**0,74**	**1**

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