

BY DR. MARVIN ZONIS

## It's the Politics

**B**Y EVERY MEASURE, BUSINESS IS MORE GLOBAL NOW than at any point in human history. The previous era of globalization, between the late nineteenth and early twentieth centuries, was driven primarily by governments. This time around, private-sector trade and investment are fueling global integration. Businesses of all kinds are discovering overseas opportunities, and the label “multinational corporation” has become applicable to so many firms that its usage has faded.

Along with global opportunities come a whole new set of risks. Businesses must now be acutely aware of the forces at work in the countries in which they operate. The risks can be divided broadly into three categories: economic risk, financial risk, and political risk. Ultimately, each of these risks is driven by macro-politics.

### **Economic Risk**

*Procter & Gamble entered Turkey in 1987. By 2001, after about a decade of operation, the company had established substantial market presence, with a large lineup of consumer products, two plants, and roughly \$400 million in annual sales. Then Turkey suffered an economic meltdown. Growth plunged, and, within months, the ranks of the unemployed had swelled by 500,000.*

*With falling demand for consumer products, Procter & Gamble was forced to revise its earnings estimates sharply downward.*

Economic risk—which cut into Procter & Gamble’s revenues in Turkey—impacts investors through fluctuations in the real economy. Its impact is measured by standard economic indicators: gross domestic product (GDP) growth, industrial production, consumer confidence, unemployment, inflation, and so on. Economic risks generally impact firms on the demand side. A study by Mercer Consulting found that “foreign macroeconomic issues” was one of the top ten causes of major stock price drops of Fortune 100 firms. The number one cause of stock drops was “customer demand shortfalls.”

These types of demand-side risks can impact exporters and direct investors, by reducing demand for their products and impacting the ability of buyers to make payments. Indeed, a study by the Export Credit Agency of Belgium found that of cross-border payment defaults, 90 percent were caused by country risk factors (as opposed to default by specific debtors).

In addition, economic downturns have a powerful impact on the value of financial assets, such as stocks and bonds. Finally, a country’s economic performance is of key concern to sovereign lenders. A country whose economy does not grow is likely to run into difficulty paying its debts.

Firms doing business in another country are also exposed to further types of economic risks. Rising labor costs (during an economic boom) can eat into profit margins, and general inflation can drive up the costs of inputs into the production process.

## **Financial Risk**

*For a decade, Indonesia (and much of Southeast Asia) was one of the hottest locations for foreign trade and investment. Indonesia, under President Suharto, enjoyed stability and prosperity for three decades. It experienced no changes in leadership and almost no protests or social unrest of any kind. In July 1997, Indonesian bonds’ spread over U.S. Treasuries—a widely used measure of country risk—was 9.87 percent, less than that of the*

*Czech Republic at 10.77 percent. Then, in only a few months, everything fell apart. Stock and currency markets plunged across the region. In September 1997, Indonesian bond spreads were 44.87 percent, compared with 9.27 percent for the Czech Republic. All told, foreign banks lost \$20 billion in the Asian financial crisis, and Indonesia's political and economic situation has barely improved.*

Financial risk, which led to such huge trading losses in Southeast Asia, appears as turbulence in exchange rates, stock markets, and bond markets.

Investors in foreign stocks and bonds have an obvious interest in financial market performance. But, movements in foreign financial markets can also impact exporters and direct investors, who deal primarily with the “real” economy.

First and most obviously, exchange rate movements determine the value of revenue streams from abroad. This is important for exporters, overseas contractors, and direct investors. An income stream in a devalued exchange rate is worth less when converted into the home currency. In the extreme case, revenues in an inconvertible currency may be worth little or nothing.

Secondly, all types of financial markets (exchange rates, interest rates, and stocks) impact the financial health of overseas business partners. Financial institutions that lend money abroad may find that foreign borrowers are unable to pay back loans after a currency devaluation or stock market crash. Similarly, exporters may face buyers who are unable to pay their bills. Likewise, sovereign lenders are well aware that after a financial crisis an entire country can become insolvent.

Once again though, it is those doing business overseas—the direct investors—who will face the widest variety of risks. Listing on an overseas stock exchange creates exposure to financial markets, as does obtaining financing from foreign banks. Exchange rate risks can impact both the cost of imported inputs and the value of repatriated profits. And of course, the investor's foreign counterparts—whether buyers of goods, sellers of inputs, landlords, employees, stockholders, creditors, and so on—will all be affected by financial market movements.

## Political Risk

*Global mining companies made a killing in Peru during the 1990s. Lured by the economic stability and tax incentives provided by President Alberto Fujimori, they plowed \$8 billion into the country. Then, in the spring of 2000, Fujimori rammed legislation through Peru's Congress that revoked foreign mining companies' tax incentives, reduced their guarantees, and doubled the cost of holding mining rights. To make matters worse, Fujimori and his intelligence chief were forced from office a few months later and discredited. Peru is now examining their rule and finding that many mining companies obtained their contracts through corrupt means. The implications are not yet clear, but the future of foreign mining in Peru is in doubt.*

*In the early 1990s, several U.S. energy companies entered India. By 2000, most of these projects had been abandoned. One U.S. company was forced to obtain 250 bureaucratic clearances for its project, and the state government renegotiated its power purchase agreement four times. In addition, politicians took the company to court on charges of corruption. The company spent some \$27 million in legal and administrative fees before pulling out, after seven years of delays.*

Both the mining companies in Peru and the energy companies in India were victims of political risk. *Political risk* can be defined as uncertainty that stems, in whole or in part, from the exercise of power by governmental and nongovernmental actors. Political instability and politicized government policy pose the best-known political risks. Political violence, expropriation, creeping expropriation, contract frustration, and currency inconvertibility are among typical hazards.

These risks can affect a company's value in many ways. Risks such as expropriation and sabotage can have an impact on a company's assets. Risks such as kidnapping and local hiring requirements can affect personnel. Risks such as social unrest and export requirements can affect operations. Risks such as tax hikes can affect commercial activity, while risks such as capital controls can affect transfers.

This diversity of risks and their effects mean that, operationally, "political

risk” carries different connotations for different companies (and, all too often, for different people within the same company). For instance, a multinational bank holding the sovereign debt of a developing country will be mainly concerned with the country’s macroeconomic policy decisions, since such decisions will directly affect the value of that debt. However, if the bank has no physical presence in the country, it will be far less concerned with risks such as political violence or expropriation.

By contrast, an oil company with a drilling operation in the same country will be deeply concerned with security issues and with its own relationship with the host government. However, if the oil company sells oil outside the country, the country’s macroeconomic policies will have relatively little impact on the oil company’s operations.

## **It’s the Politics**

So what do these three risks have in common? They are all the result of decisions made and structures in place at the highest levels of political power. In developing countries, macro-politics is a critical driver of not just government policy, but also of markets and growth.

Procter & Gamble’s losses in Turkey trace back to an economic crisis that was driven by politics. The country’s reform efforts, backed by the International Monetary Fund (IMF), had sputtered because its three-party coalition government lacked the political will to divest itself of state assets and clean up the corruption-laden state banks. The immediate trigger for the crisis was a public dispute between the prime minister and president over reform of the state-owned banking system.

The Asian financial crisis, in which foreign banks lost so much money, had its origins in politically motivated lending practices that had guided banks throughout the region, a lack of independent institutions and regulatory bodies, and poor leadership. The subsequent meltdown in Indonesia was caused by the monopolization of power in the hands of President Suharto; the country’s ethnic, geographic, and socioeconomic divisions; and the predictable effects of a country in which economic growth does not match rising expectations.

Mining companies in Peru suffered when a corrupt autocrat faced with the prospect of losing power played a populist card. When Fujimori’s regime was ousted, the mining companies suffered because

of their association with a regime whose legitimacy was fragile. The energy companies in India were victimized by the country's federal structure, powerful bureaucracy, plodding judiciary, and hyperactive grassroots organizations.

## **Business Unprepared**

The fact that politics drives so much of what impacts overseas operations is not lost on the business community. But, the globalization of business has not been matched by a concomitant rise in understanding of political forces.

In his recent book, *The Mind of the CEO*, Jeffrey Garten, dean of Yale School of Management and former undersecretary of commerce for international trade, complains that businesspeople remain in the dark about the political trends in the countries in which they operate. Garten points out that, at the end of the Cold War, the business community missed a major opportunity to help the U.S. government deal with new challenges posed by the fall of the Iron Curtain and the emergence of newly independent states in Eastern Europe. He writes: "The U.S. business community, with its global reach, its extensive involvement in emerging markets, its powerful research capabilities, its vast intelligence network—actual or potential—should have known better, but it didn't help much at all."

However, in the words of Garten, even if businesses "recoil at the notion of crossing the line between economics and politics," they understand that political forces shape the environments in which they operate. Developing effective mechanisms for forecasting economic, financial, and policy outcomes on the basis of political drivers will be one of the great challenges for business in the new millennium.

### **About the Author**

Marvin Zonis has been known for his unique analyses of the global economy as well as for educating global business leaders about how to respond proactively to the forces of globalization and political risk. Zonis works with organizations to help them devise and implement e-commerce strategies. He is a professor at the graduate school of business at the University of Chicago. He is also the principal in an international consulting firm, Marvin Zonis & Associates, Inc., which created the Political Stability Index, the first useful quantitative model for assessing country risk.