

The Impact of Political Risk on Foreign Direct Investment

Alba Kruja, Blerta Dragusha

MSC. ALBA KRUIJA, DR.SC. BLERTA DRAGUSHA

Abstract

Even though other forms of risk, such as economic risk and financial risk have been studied quite extensively, political risk has not received much attention owing primarily to lack of data. Among other components of country risk, political risk is more critical in importance and more multifaceted in impact, becoming more prominent especially in developing countries. It's that reason why our first task is to include the political risk and some of its components that are found to be significant in the empirical studies in the evaluation of FDI, and not only the level of political risk but also its changes over time. Regarding the effects of political risk on FDI inflow, this paper shows the multitude of ways by which the different expressions of political risk may influence both positively and negatively the value of investment opportunities and the decisions of firms to invest. This paper looks at the effect of political risk on FDI by using a systematic approach of factor analysis, in reducing the number of variables into their underlying factors and then generating factor scores. Then it uses a panel regression approach combined with factor analysis to examine the relationship, and which particular aspect of political risk contributes more towards deterring FDI inflow. Similar to most studies in the empirical literature on FDI flows, the logarithm for investment flows and the independent variables is used.

“Capital is a coward. It doesn’t go where it perceives danger”
–Anonymous investor in Zimbabwe, 10 May 2010

Key Words: Political Risk, Foreign Direct Investment, Foreign Direct Investment Inflow.

1. Introduction

The main purpose of this paper is thus to examine a much wider range of indicators for political risk and to identify the relative importance of these indicators for FDI inflows after controlling for some other relevant determinants of observed changes in FDI flows. Accordingly, the paper focuses on (1) whether changes in the above-mentioned policy-related variables increase or decrease FDI inflows significantly, and (2) which are the policy-related variables that have the biggest impact on FDI flows?

Covering a time span of 11 years in our analysis, we find that only few indicators for political risk and institutions are closely associated with FDI. These are government stability, law and order, and quality of the bureaucracy. The goal of this paper was to explore in detail the role of political risk and institutions in host countries as determinants of foreign direct investment.

2. Literature Review

In a research study titled *“Why doesn’t capital flow from rich to poor countries?”* Alfaro et al. (2008) highlights political risk as the major factor that influences the foreign investors.

Butler and Joaquin (1998) develop a model of political risk that shows how political risk impacts the cost of capital for an investment. In the Butler-Joaquin model, the impact of a political risk change on the cost of capital of the investment depends on the impact of the political risk change on the expected return of the investment and the covariance of the return on the investment and the return on the market. If the expected impact of the change in the political environment on expected future cash flows is negative and if the covariance between the expected future cash flows from the investment and the return on the market is negative (positive), the effect of a political risk change is to increase (decrease) the cost of capital for the investment. If the expected impact of a change in the political

environment has a positive impact on expected future cash flows and the covariance between the cash flows from the investment and the return on the market is positive (negative), the effect of a political risk shock is to increase (decrease) the cost of capital for the investment. The impact of a political risk change is determined by the impact of the change on the expected rate of return and the covariance of the return on the investment and the return on the market (McGowan et. al., 2013, p.29).

Bhalla (1983) shows that a change in political risk can result from political changes due to elections, revolts, recessions, or wars, and the resultant change in political risk can lead to expropriation, higher taxes or tariffs, reduced FDI incentives, local ownership requirements, local content requirements, or currency inconvertibility. The net effect may be the loss of assets, the termination of operations, reduced after-tax income, higher import costs, reduced revenue, management restrictions, higher operational costs, or an inability to repatriate funds. Macro-economic mismanagement by the government can lead to higher inflation and higher interest rates leading to higher costs, planning difficulties, and higher interest costs. Other types of political difficulties such as labour unrest or strikes can lead to higher production costs and production interruptions. *Multinational corporations* need to determine future risks to an FDI from political risk and future risks from the country's economic environment, both of which affect the profitability and riskiness of FDI (McGowan et.al., 2013, p.3).

There are reasons to believe that the relation between home-country political risk and FDI might be opposite to that which has been most frequently hypothesized, as a result of firms' greater access to capital and outward investment-friendly policies in lower-risk countries. It is certainly conceivable that firms operating in countries with higher internal political instability have, *ceteris paribus*, higher incentives to internationalize, as they seek to escape domestic instability (Aguar et.al, 2012, p.3).

If political risk is diversifiable, then it will not affect investors' required returns or the firm's capital costs even though it may affect project cash flows. In contrast, if political risk is shared by many or all assets, then required returns will reflect these systematic, non-diversifiable risks. This impacts the cost of capital on investments that are exposed to market-related political risk (Butler et.al, 1998, p. 599–607).

Political risk in international capital budgeting is best taken into account at the *ex ante* stage by the break-even probability approach. This involves

estimating the probability of occurrence of a particular political risk factor such that the present value of the project moves from being positive to being zero. The generalized formula for the break-even probability always equals:

NPV of investment (base case) / Present value of forgone cash flows following implementation of political risk factor

That is, political risk can be allowed for by dividing the net present value by the present value of forgone cash flows following implementation of political risk factor (Buckley, 1996, p.413-419).

Table1: Major constraints to foreign investment over the next three years percent

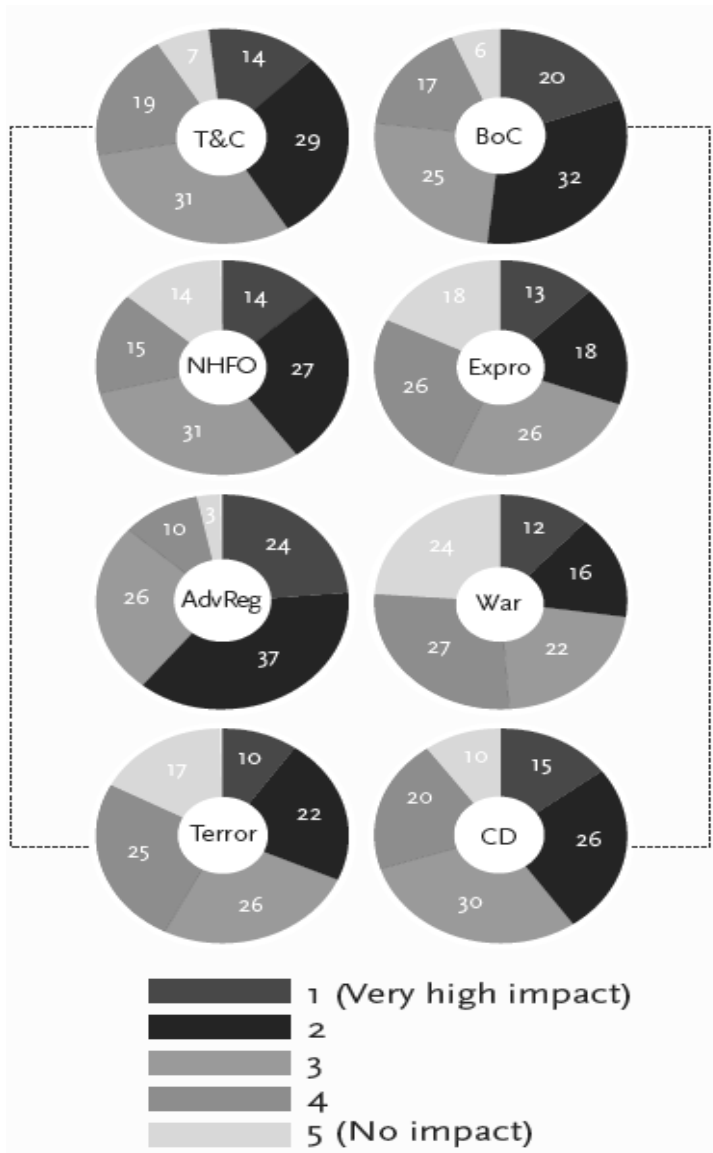
	2010	2011	2012	2013
Number of respondents	94	316	438	459
Limited size of the market	9	7	7	5
Lack of investment opportunities	7	-	-	-
Poor infrastructure	9	11	8	7
Lack of qualified staff	10	17	18	18
Lack of financing for investments in these countries	5	11	13	13
Political risk	21	18	22	19
Macroeconomic instability	16	15	20	21
Lack of information on the country's business environment	2	-	-	-
Weak government institutions/red tape/corruption	19	13	8	10
Other	2	2	1	1
Increased government regulation in the aftermath of the global financial crisis	-	5	3	4

Source: MIGA-EIU annual political risk surveys.

The figure below (Figure 1) shows the impact of political risk on foreign investors (percentage) using these variables:

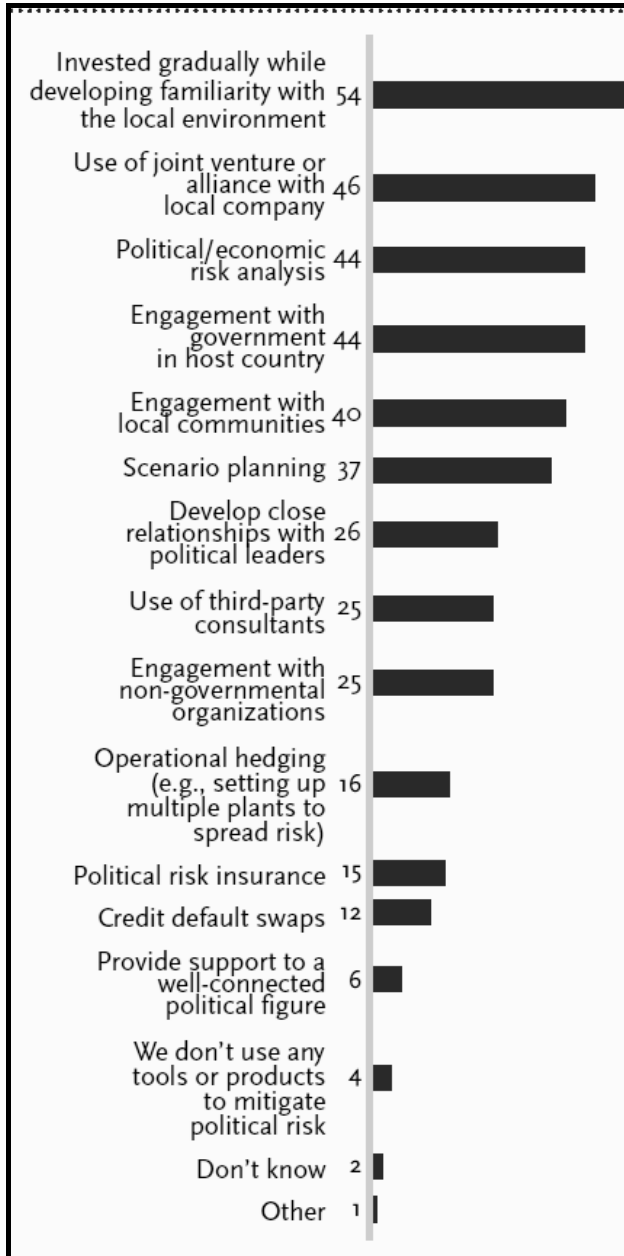
- T&C - Transfer and convertibility restrictions
- BoC- Breach of contract
- NHFO- Non-honouring of financial obligations
- Expro- Expropriation
- AdvReg- Adverse regulatory changes
- Terror- Terrorism
- CD- Civil disturbance

Figure 1: Impact of political risk on foreign investors (percent)



Source: MIGA-EIU Political Risk Survey, 2013.

Figure 2: Tools/mechanisms used to mitigate political risk when investing in developing countries (percentage)



Source: MIGA-EIU Political Risk Survey, 2013.

3. Basic concepts on political risk

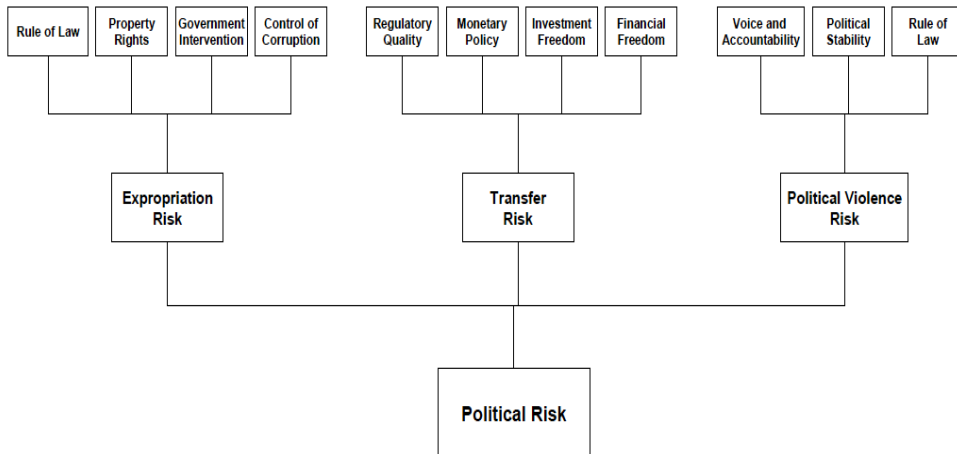
“Today’s political risks are not the classic risks associated with communist takeovers or post-colonial outbursts of anti-foreign sentiment. They are more subtle, arising from legal and regulatory changes, government transitions, environmental and human rights issues, currency crises and terrorism. Because 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”.

Wilkin, Minor (2001)

Because of the importance and significance of political risk for FDI, political risk definition must become one of the essential tasks of international investors. Moreover a definition of political risk is a prerequisite for any kind of analysis on it. Thus, in considering the relationship between political risk and FDI, it is first necessary to recall what political risk is and to relate it to its sources. Political risk, like all other risks, has an adverse effect on any economy. Even though other forms of risk, such as economic risk and financial risk have been studied quite extensively, political risk has not received much attention owing primarily to lack of data.

3.1. The history of political risk

Reception of the concept of political risk in economic literature is historically linked to the political events of 1960's whereby new independent countries tried to overcome their lack of capital by simply taking over the foreign subsidiaries of multinationals. On the other hand, the reception of the concept of political risk in economic literature was also due to the surge of collective economic theory (Marxism) at the beginning of the 20th century, which led in most industrialized countries and in LDCs countries to nationalization and political control over the activities of multinationals. In the 1960's confiscation, expropriation and nationalization became critical concerns for companies with foreign operations. These increased concerns about political risk were treated in economic literature mostly in the conceptual framework of the relations between host countries and multinational enterprises (Ursprung, 1998, p.15).

Figure 3: Political Risk: A conceptual scheme

Source: SACE.

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

The potential dependence of a project on its external political environment is divided into two components; vulnerability and cost. Vulnerability is expressed by the probability that a political event that has an effect on the project will occur. In this way vulnerability is not defined in terms of joint probability. Rather, vulnerability is defined in terms of events. Examples are changes in tax regimes or change in the regulatory structure. The political dependence of investment projects can be analyzed with the aid of the following two-by-two matrix in the form of a reduced "prisoner dilemma" (Ursprung, 1998, p.38).

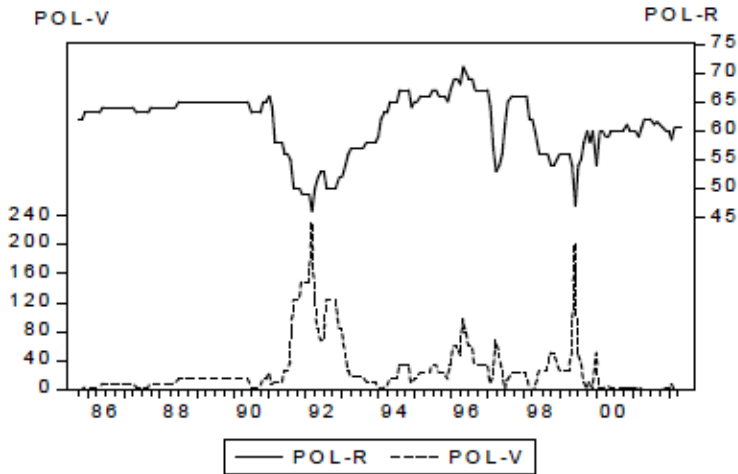
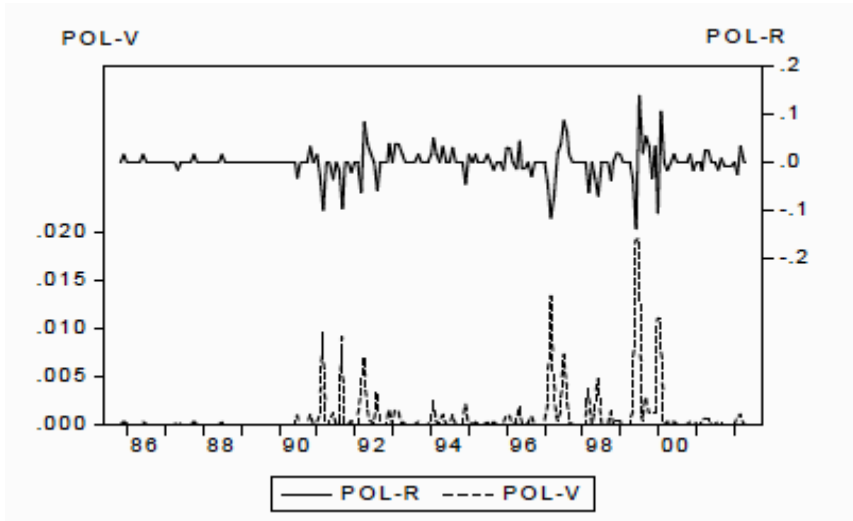
Table 2: The Agmon's political dependence matrix

		High	Low
		Vulnerability	
Cost	High	Political risk is important	
	Low		Political risk can be ignored

Source: Agmon (1985, p. 60-61).

3.2. Political Risk in Albania

Albania has a reasonably flat index for each risk rating index, but with two dramatic falls for each index and high associated volatilities. The first fall occurred in 1991, which saw the collapse of the Communist Regime, and the second was in 1997, due to the collapse of the economy-wide pyramid schemes. **Albania Political stability index (-2.5 weak; 2.5 strong):** For that indicator, The World Bank (govindicators.org) provides data for Albania from 1996 to 2012. The average value for Albania during that period was -0.34 points with a *minimum of -0.67 points in 1998* and a *maximum of -0.03 points in 2008*.

Figure 4a: Risk Rating Indexes and Volatilities for Albania**Figure 4b:** Risk Returns and Volatilities for Albania

Source: University of Western Australia, 2002.

Note: Risk returns (R) and their associated volatilities (V) refer to the rates of change in the respective risk rating indexes

3.3. How does political risk indicate in the business environment?

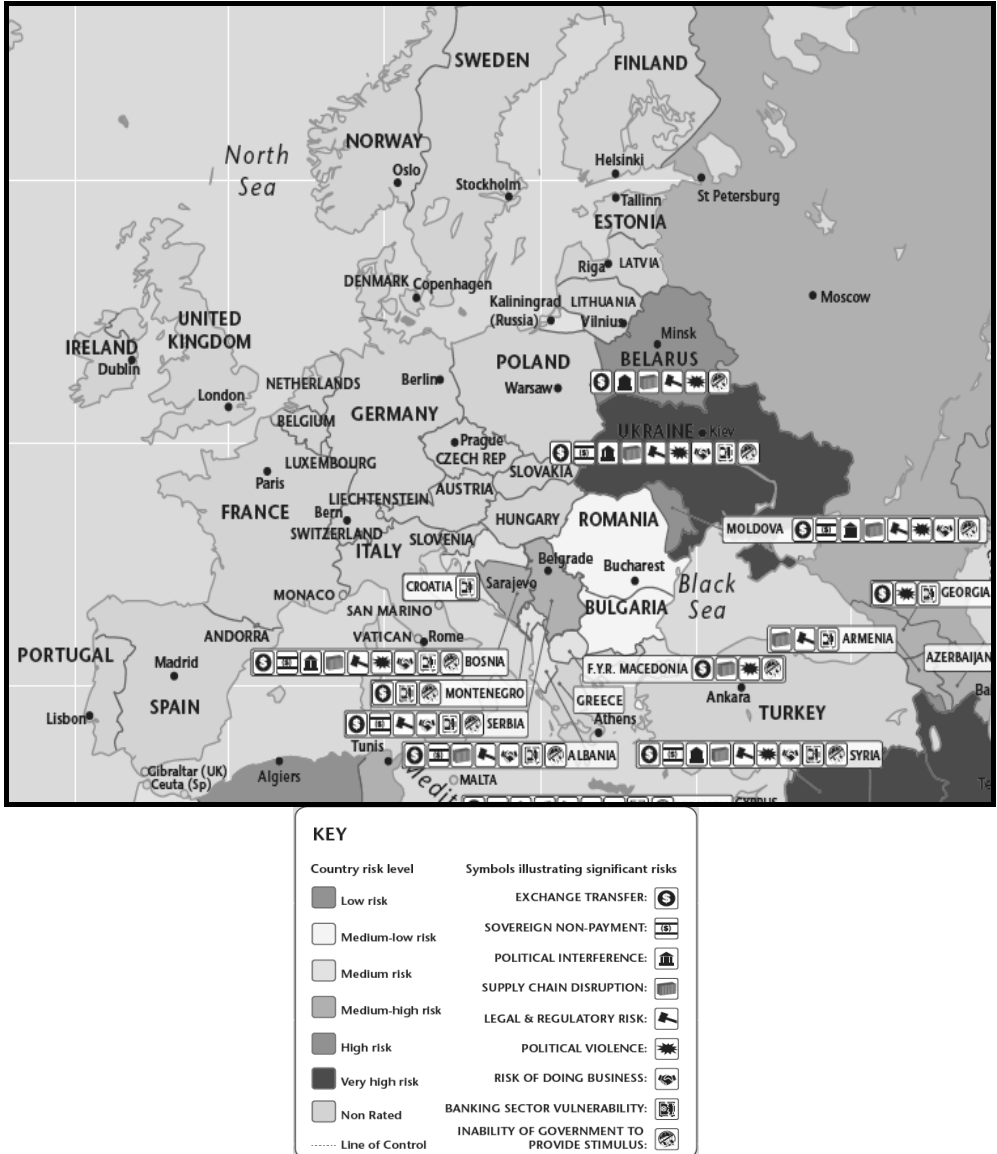
Political Environment

We are all aware that in Albania's political environment is highly polarized and this is reflected also sensitive to business activity. The way things work favours political clienteles. Moreover, there are businesses for which people can discuss a political business cycle type (thrive when their political strength is in power, and survive or are stagnant when power is opposing force). The political environment affects the investment climate, in partnerships with foreign companies and the image that is created for Albanian products. For industries not to mention quite heavy you hit the fall of the image due to political problems (Hebeja, 2013, p.6).

3.4. Risk factors in a business and their impact on the Albanian businesses

Risk factors for a business can be factors in the business environment (external) factors or the business itself. Every business is associated with risks arising due to economies, financial and economic system, culture and laws of the country where it operates. Also every business has its characteristics, unique and specific, unless you add value to business, reduce or increase exposure to risk. Albanian Business presents dynamic characteristics of a business, generally flexible, focused mainly on services (80%) and organized in micro or small enterprises (99%). They commit less capital, thus being flexible to change (Hebeja, 2013, p.5).

Figure 5: Political risk map



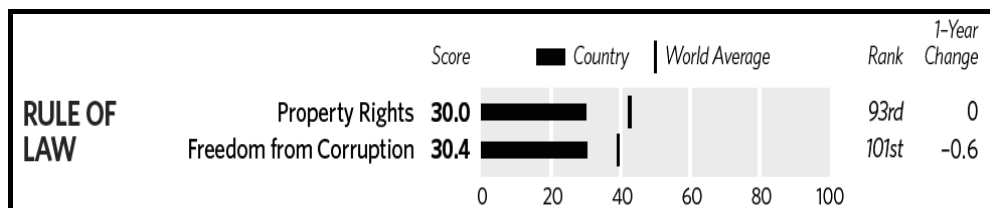
Source: AON, 2014.

As it seems from this political risk map published by AON, country risk level for Albania is medium, with this significant risk: exchange transfer,

sovereign non-payment, supply chain disruption, legal & regulatory risk, risk of doing business, banking sector vulnerability, inability of government to provide stimulus.

A weak regulatory environment, opaque government procurement rules, a culture of impunity, and political interference make it difficult for the judiciary to deal with high-level and deeply rooted corruption in Albania, a major transit country for human trafficking and illegal arms and narcotics. Protection of intellectual property rights is weak, and Albania still lacks a clear property rights system, particularly for land tenure.

Figure 6: Rule of Law



Source: Heritage Index, 2014.

4. FDI in Albania

Foreign Direct Investment is cumulative net inflows of FDI capital as registered in the reporting country's balance of payments statistics, note: the International Monetary Fund recommends the reporting of 3 kinds of direct investment capital, but countries do not always collect data for each. By International Monetary Fund (IMF) standards, however, FDI consists of the sum of (1) new equity purchased or acquired by parent companies in overseas firms they are considers to control (including establishment of new subsidiaries) (2) reinvestment of earnings by controlled firms, and (3) intra-company loans from parent companies to controlled firms. As Albanian economy has changed from a centrally planned to a market oriented one, FDI is seen as an important component of the transition process toward a market-led economic system, since it contributes to the development of a country through multiple channels (Kukeli et al., 2006; Kukeli, 2007). With its developing market economy, Albania offers many opportunities for investors-property as labour costs are low, the young and educated population is ready to work, and tariffs and other legal restrictions are low in many cases and are being eliminated in some others

(Albinvest, 2003). The progress made by Albania through these years is quite remarkable but it still has a long way to go (Kaleshi and Solanki, 2010). Referring to the same study of Kaleshi and Solanki (2010), the initial foreign investment in Albania were used by the GOA to develop infrastructure in order to attract more foreign investment.

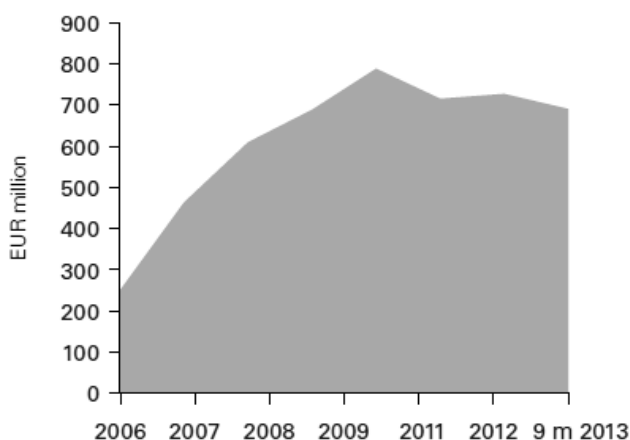
According to Millar, Clegg and Chrysochoidis, 1997 exist five types of FDI:

- 1- The first type relates to those FDI that are used to gain access to specific production factors such as resources, technological knowledge, patents or goodwill that is owned by a company in the country host. In Albania this can be illustrated with the example Turkish company 'Kurum' which deals with the production and exporting Albanian steel products.
- 2- The second type includes FDI, which performed to gain access to cheaper factors of production, such as workers power. Typical example for Albania are businesses such as clothing firms *tremaglia* Italian firm in Durrës, which exploits the labour force Albanian qualified as provides a cost minimization due to relatively lower wages.
- 3- The third type of FDI relates to firms that compete in international level by undertaking a series of investments in countries in which they compete. This form of organization through Joint Venture in order to gain access into the ranks of the products of each other. Asuch case may be the Albanian leading aluminium company, which has al Pespa committed FDI in neighbouring countries like Italy, Bosnia and Herzegovina and Macedonia.
- 4- The fourth type is related to FDI aimed at domestic consumers' access to this kind IHG prites.ne-art effort is to provide all products and services for customers receiving the same way as they provide for domestic consumers can mention investors. Here AMC companies Cosmote and Vodafone, which recently succeeded to offer the same services in Albania offering even wireless in their base country Greece.
- 5- Fifth type of FDI terms of trade associated with diversified regional integration.

Furthermore, in 2000, Albania ratified the Marrakesh Agreement and became signatory to the World Trade Organization's Trade Related

Intellectual Property Rights (TRIPS) agreement. In addition, Albania has signed the Convention of the Multilateral Investment Guarantee Agency (MIGA). MIGA provides for investment guarantees against certain non-commercial risks (e.g. political risk insurance) to eligible foreign investors for qualified investments in developing member countries. Along with the MIGA Convention, Albania has signed the New York Convention of 1958 (on the recognition and enforcement of foreign arbitral awards) and the Geneva Convention on Execution of Foreign Arbitral Awards. The Overseas Private Investment Corporation (OPIC), a US-government sponsored entity, can make available insurance and project finance resources to US investors in Albania. OPIC's three main activities are risk insurance, project finance and investment funds (Doing Business in Albania, 2014).

Figure 7: Foreign Direct Investment (2006-2013)



Source: Bank of Albania.

Even though political risk could be a threat to foreign investors; it can be managed through some operating strategies with the help of International Institutions such as World Bank, OECD who give recommendations towards reduction of political risk in developing countries as below:

- Improvement of investment policy in host country;
- Creation and setting up of a new multilateral insurance agency for political risk;

- Creation of an organization for arbitration and conciliation of investment disputes;
- Inclusion of the rules of the World Trade Organization to the international investment domain.

5. Empirical Results

Using statistical techniques such as regression model sum serves to model the relationship that exists between two or more explanatory variables, considered as independent variables, and one dependent variable. Each value of the independent variable x , is associated with a value of the dependent variable y . Formally, the model of multiple linear regression, given in observations, is:

$$y_i = \beta_0 + \beta_1 x_{i1} + \beta_2 x_{i2} + \dots + \beta_p x_{ip} + \epsilon_i \text{ for } i=1, 2, \dots, n.$$

Target in a regression analysis is to estimate the average of the dependent variable when given values of the independent variables, the parameter (or parameters partial) must be statistically significant to be a good model, which can be used to draw a conclusion about a phenomenon or prediction.

The ICRG rating system comprises of 22 variables, representing three major components of country risk, namely economic, financial and political. These variables essentially represent risk-free measures. There are 5 variables representing each of the economic and financial components of risk, while the political component is based on 12 variables. Political risk rating measures the political stability of a country, which affects the country's ability and willingness to service its financial obligations. The 12 political risk variables are as follows:

- (i) Government Stability;
- (ii) Socio-economic Conditions;
- (iii) Investment Profile;
- (iv) Internal Conflict;
- (v) External Conflict;
- (vi) Corruption;
- (vii) Military in Politics;
- (viii) Religious Tensions;
- (ix) Law and Order;

- (x) Ethnic Tensions;
- (xi) Democratic Accountability;
- (xii) Bureaucracy Quality.

The model that will appreciate in our paper is presented as follows:

$$FDI = \beta_0 + \beta_1 \text{Voice_Account} + \beta_2 \text{Political_Stabi} + \beta_3 \text{Government_Effe} + \beta_4 \text{Regulatory_Qual} + \beta_5 \text{Rule_of_Law} + \beta_6 \text{Control_of_Corr}$$

Through the use of the program 'Gretl' is defined the bond that exists between variables obtained in the study, namely by taking the following results:

Table 3: Regression Results. The dependent variable is the FDI variable
N=11 R²=0.97

Coefficient	Independent variables	Standard error	Statistics - t-	P> t	
Constant	20.7106	16.2253	1.2764	0.27087	
Voice_Account	-33.4877	18.0285	-1.8575	0.13680	
Political_Stabi	16.8148	6.52453	2.5772	0.06151	*
Government_Effe	89.0841	27.5035	-3.2390	0.03170	**
Regulatory_Qual	8.2237	7.22216	1.1387	0.31841	
Rule_of_Law	127.406	28.1368	4.5281	0.01059	**
Control_of_Corr	-9.83025	10.386	-0.9465	0.39749	

Source: author's own calculations.

From the evaluation we see that in our model of 11 total observations, we have obtained a R² (0.97) very good, which means that 97% of the variation in FDI level is explained by the explanatory variables. Also resulting coefficients from the regression model are expected to sign the "structural" equation, concluded that only political stability, government effectiveness, and rule of Law are important and have effect on FDI. Also their size is quite reasonable. For more detailed results of this test, refer to Table in the Annex.

6. Conclusions and recommendations

- Because of the importance and significance of political risk for FDI, political risk definition must become one of the essential tasks of international investors. Moreover a definition of political risk is a prerequisite for any kind of analysis on it. Thus, in considering the relationship between political risk and FDI, it is first necessary to recall what political risk is and to relate it to its sources. Political risk, like all other risks, has an adverse effect on any economy. Even though other forms of risk, such as economic risk and financial risk have been studied quite extensively, political risk has not received much attention owing primarily to lack of data.
- Any country evolving policies for foreign direct investment should avoid inconsistency, develop clear priorities, evolve policies over time, match the speed of deregulation with the rate of economic growth, keep actions and statements consistent, make reforms genuine, and avoid excess political influence in the liberalization process.
- For foreign investors, the primary concern about political risk (PR) in host countries is the adverse impact it may have on a firm's profitability. Such adverse events originate in governmental discriminatory and regulatory policies, the expropriation of assets, and events emanating from the political system of the host country that may disrupt business operations, damage assets or endanger employees.
- It is certainly conceivable that firms operating in countries with higher internal political instability have, *ceteris paribus*, higher incentives to internationalize, as they seek to escape domestic instability.

List of References

- Aguiar, S. (2013), *Foreign direct investment and home-country political risk. The Case of Brazil*, Nucleo de Investigacao em politicas economicas, Universidade do minho.
- Aisen, A., Veiga, F.J. (2001), *How does political instability affect economic growth?*, Working Paper No.5/2010.
- Brewer, T. L. (1985), *Political Risk in International Business, new Directions for Research, Management and Public Policy*, Praeger, New York.

- Buckley, A. (1996), *Multinational Finance*, Pearson Education Limited, England.
- Butler, K. C. (1998), *A note on political risk and the required return on foreign direct investment*, *International Business Studies*, Vol.29, No.3, pg 599-607.
- Butler, K. (1998), *A Note on Political Risk and the Required Return on Foreign Investment*. *Journal of International Business Studies* 29 (3), pg 599-607.
- Buthe, T. (2008), *The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through International Trade Agreements?*, *American Journal of Political Science* 52 (4), pg 741-762.
- Chase C. D., Kuhle J. L., Walther C. H. (1988), *The relevance of political Risk in Direct Foreign Investment*, *Management International (MIR)*, Vol. 28, 1988/3, pg 31-38.
- Hebeja, G. (2013), *Risku politik. Koncepti dhe realiteti shqiptar*. Available from:<http://www.scribd.com/doc/126908902/GRisku-Politik-koncepti-Dhe-Realiteti-Shqiptar-1> [Accessed: 23 February, 2013].
- Howell L., Lewelly D., and Chaddick B. (1994), *Models of Political Risk for Foreign Investment and Trade, an Assessment of three Approaches*, *Columbia Journal of World Business*, Vol XXIX, Nr 3, pg 70-91.
- Kobrin, S. (1978), *Political Risk: A Review and Reconsideration*. *Journal of International Business Studies* 10 (1), pg 67-80.
- McGowan, C. (2013), *A Model for Making Foreign Direct Investment Decisions Using Real Variables for Political and Economic Risk Analysis*, *Managing Global Transitions*.
- Nonnemberg, M., Cardoso, M., *The Determinants of Foreign Direct Investment in Developing Countries*. *Transnational Corporations* 5, pg 67-105.
- Oetzel, J.M., Bettis, R.A. & Zenner, M.(2001), *Country risk measures: How risky are they?*, *Journal of World Business*, 36(2), pg 128-145.
- Root, F.R. (1972) *Analyzing political risks in international business*, in *The Multinational Enterprise in Transition*, Kapoor, A. & Grub, P.D. (eds.) Darwin Press: Princeton, NJ, pg 345-365.
- Tallman, S. (1988), *Home Country Political Risk and Foreign Direct Investment in the United States*. *Journal of International Business Studies* 19 (2), pg 219-233.
- Ursprung, H. (1998), *Political Risk and Foreign Direct Investment*, University of Konstanz.

APPENDIX 1

Model 1: OLS, using observations 1-11

Dependent variable: FDI

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>	
const	20.7106	16.2253	1.2764	0.27087	
Voice__Account	-33.4877	18.0285	-1.8575	0.13680	
Political_Stabi	16.8148	6.52453	2.5772	0.06151	*
Government_Effe	89.0841	27.5035	-3.2390	0.03170	**
Regulatory_Qual	8.2237	7.22216	1.1387	0.31841	
Rule_of_Law	127.406	28.1368	4.5281	0.01059	**
Control_of_Corr	-9.83025	10.386	-0.9465	0.39749	

Mean dependent var	6.272727	S.D. dependent var	2.973611
Sum squared resid	2.354123	S.E. of regression	0.767158
R-squared	0.973377	Adjusted R-squared	0.933442
F(6, 4)	24.37411	P-value(F)	0.004103
Log-likelihood	-7.128826	Akaike criterion	28.25765
Schwarz criterion	31.04292	Hannan-Quinn	26.50193