Political and institutional environment

Learning Objectives

- What is political system?
- Different types of political system and the state
- Political risks (for business)
- State's intervention of economy
  - National trade policies
  - Supernational trade institution – WTO

Political system

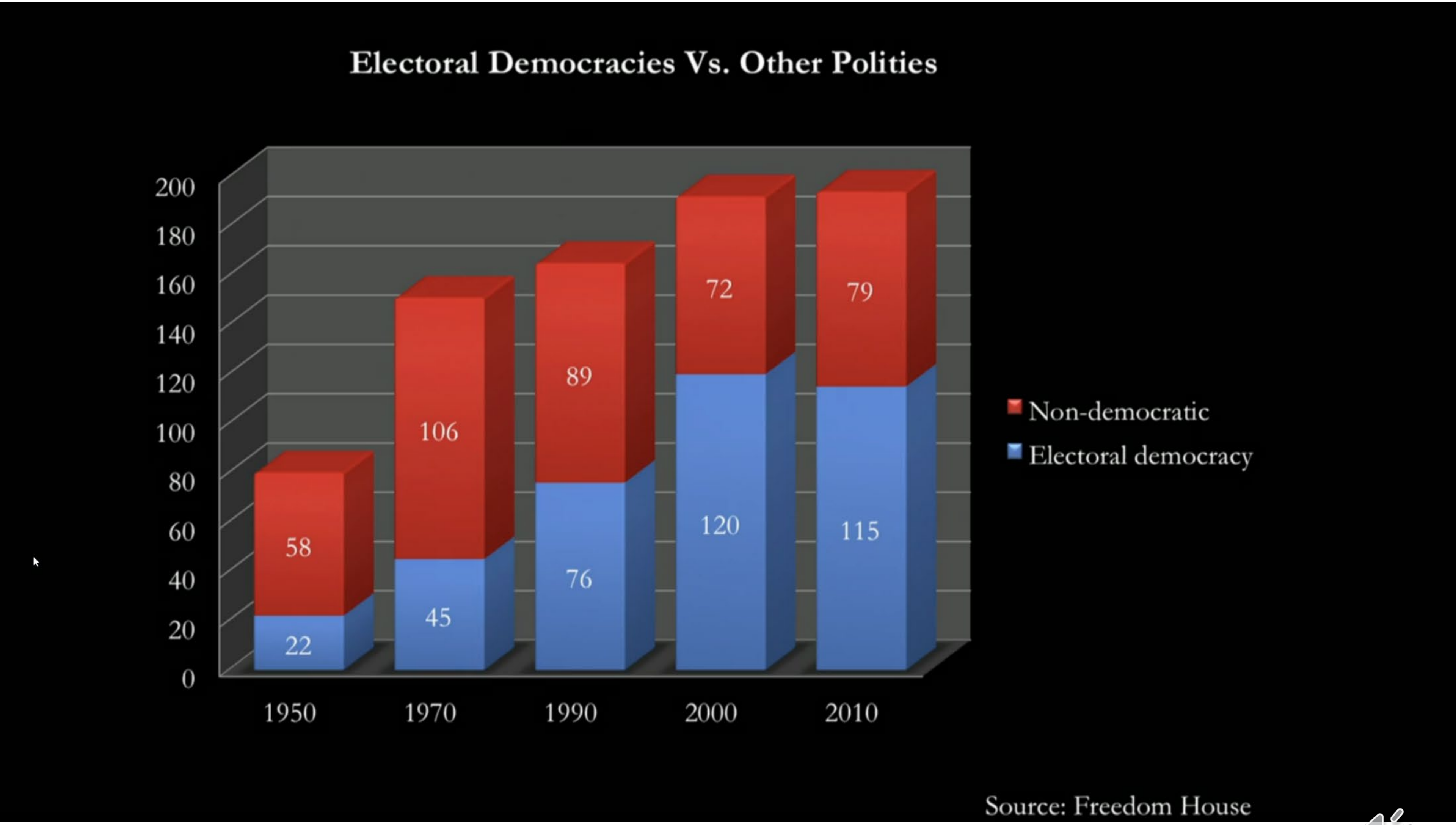
… is a system of politics and government:

- ***Politics*** – process of decision-making that affects all
- ***Government*** – a control mechanism

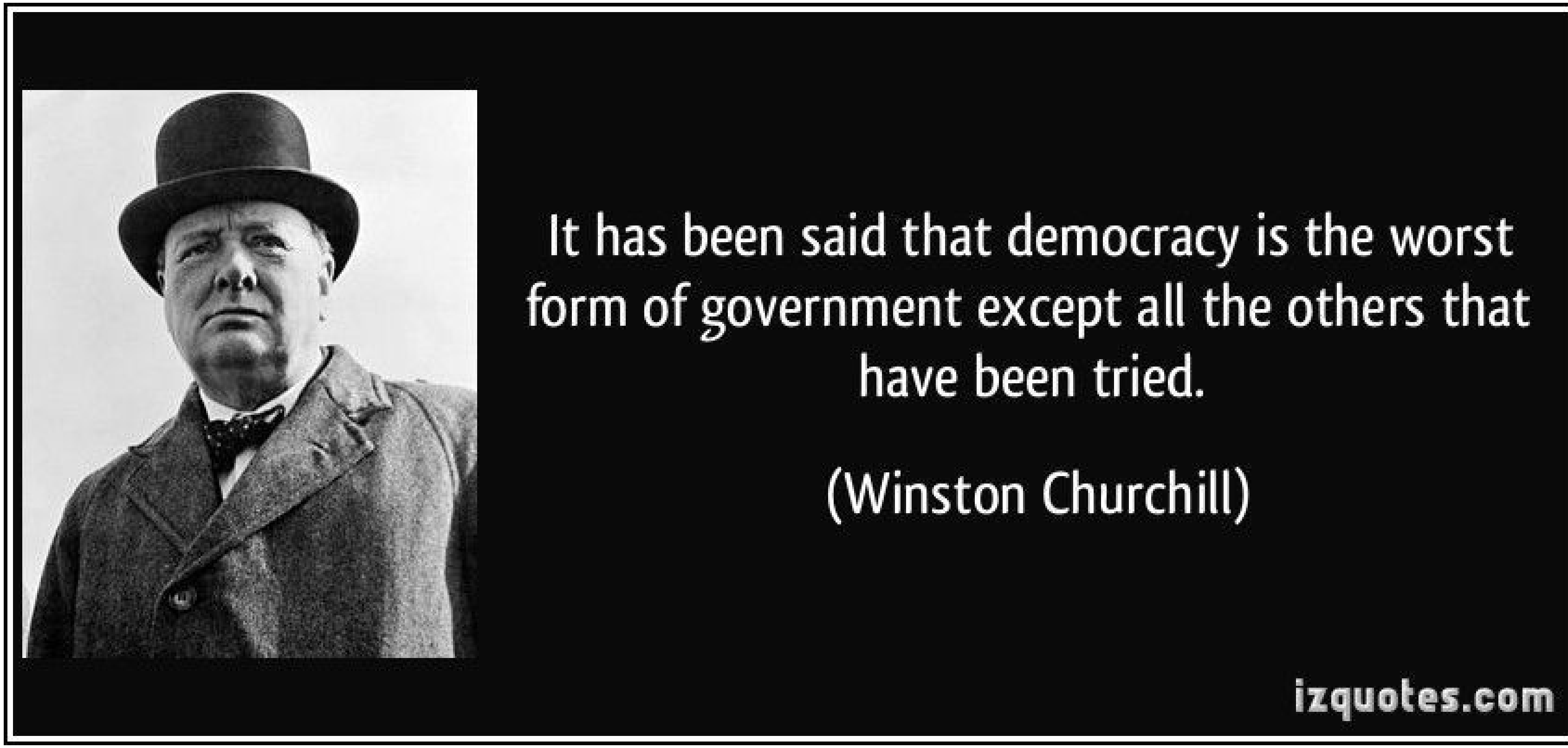
Businesses maximize profit

Political actors (politicians, political parties) maximize ???

Political systems



Democracy: the good



All individuals are rationale and equally competent to use vote to produce the best government subject to checks and balances

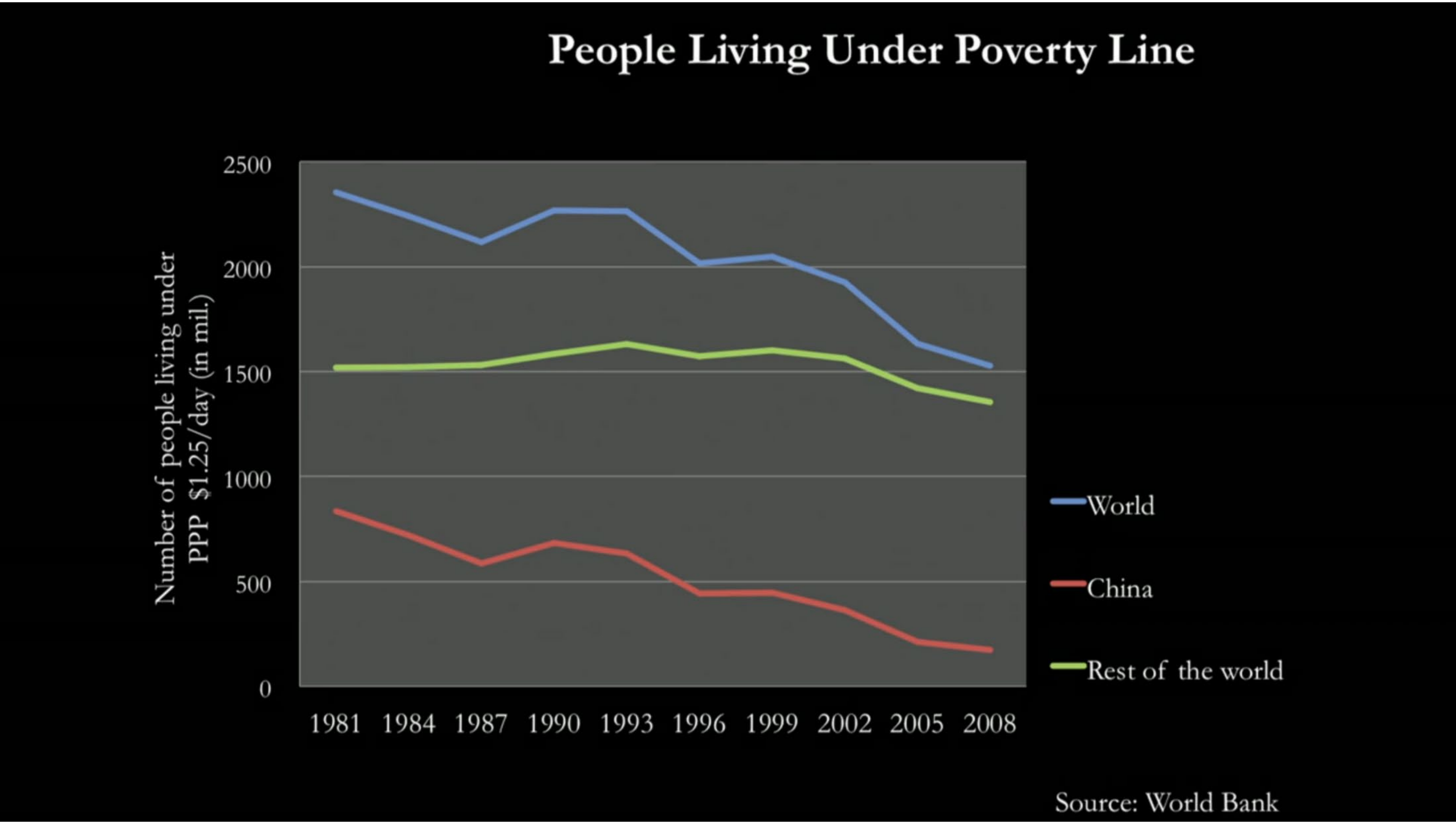
Democracy: the bad

Perpetual cycle of elect and regret?

Autocracy: the bad

https://olc.worldbank.org/content/tale-two-political-systems

Autocracy: the good



A system with proven adaptability, meritocracy, legitimacy

What are the criteria?

- The fundamental purpose of any political system is to ***integrate different groups*** into a functioning, self-sustaining, and self-governing society

- Correspondingly, the decisive test of any political system is ***its ability to unite a society in the face of diverse and divisive viewpoints***. Success supports peace and prosperity. Failure leads to instability, insurrection, and, ultimately, national disintegration.

Political system

Individualism

Democratic

- Citizen participation in decision making
- High level civil rights

Autocratic

- Centralized decision making
- Low level civil rights

Collectivism

Is there a match?

Market

- Invisible hand
- Competitive

Command

- Central planned
- Cooperative

Economic system

Categorizing the state

- ***Regulatory state*** – US, Australia
- ***Welfare state*** – Nordic countries, France, Netherlands, Germany
- ***Developmental state*** – Singapore, S. Korea
- ***Predatory state*** – Iraq under Hussein, Some African countries during the post-colonial era

- And then the ***mixture*** of the above (China, India, etc.)
- And then the ***non-state*** political groups (ISIS, Hamas, etc.)

https://youtu.be/X1DIJpPqDFo

Definition of Political Risk

- The risk that political decisions or events in a country negatively affect the profitability or sustainability of an investment

1. Systemic – affects all firms e.g. changes to tax rates, weakened property rights, freedom restrictions etc
2. Procedural – affects some, not all firms e.g. excessive red tape, corruption, breaches of contract etc
3. Distributive – foreign firms seen as agents of prosperity e.g. tax discrimination, unilateral trade barriers, expropriation of assets
4. Catastrophic – affects all firms e.g. civil disorder, coups, war

Systemic risk examples

Economist.com rankings

Country risk

Selected countries and territories, September 2008 (except where noted)

Least risky

Rank		Score*
1	Switzerland †	12
2	Finland **	14
	Norway **	14
	Sweden ††	14
5	Canada **	17
	Denmark †	17
	Netherlands §	17
8	Germany ††	18
9	Austria **	19
	France ††	19
11	Belgium ††	20
12	Singapore	21
13	Japan **	23
14	Ireland #	24
	Britain	24
	United States †	24

Most risky

Rank		Score
120	Zimbabwe	86
119	Iraq	80
118	Sudan	76
117	Myanmar	75
116	Nicaragua	69
115	Jamaica	68
114	Kenya	66
113	Cuba	64
112	Cambodia	62
111	Côte d'Ivoire	61
	Ecuador	61
	Pakistan	61
	Venezuela	61
	Vietnam	61
106	Syria	60

*Out of 100, with higher numbers indicating more risk. Scores are based on indicators from three categories: currency risk, sovereign debt risk and banking risk.

† May 2008; ** July 2008; †† June 2008; § August 2008; # February 2008

Political instability index: Aux barricades!

- Mar 25th 2009

The

Economist.com rankings

Political instability

Countries, 2009-10 (2007 score, if different)

Most vulnerable

Rank		Score*
1	Zimbabwe	8.8
2	Chad	8.5 (7.5)
3	Congo Kinshasa	8.2 (7.2)
4	Cambodia	8.0 (7.0)
	Sudan	8.0 (6.0)
6	Iraq	7.9
7	Afghanistan	7.8 (6.8)
	Central African Republic	7.8 (5.8)
	Côte d'Ivoire	7.8
	Haiti	7.8 (6.8)
	Pakistan	7.8 (5.8)
	Zambia	7.8 (6.8)

Least vulnerable

Rank		Score
165	Norway	1.2 (0.2)
164	Denmark	2.2 (0.2)
163	Canada	2.8 (1.8)
161	Finland	3.2 (1.2)
	Sweden	3.2 (1.2)
160	Switzerland	3.4 (0.4)
158	Costa Rica	3.5 (1.5)
	Mauritius	3.5 (2.5)
154	Australia	3.6 (0.6)
	Austria	3.6 (0.6)
	Luxembourg	3.6 (0.6)
	New Zealand	3.6 (0.6)

*On a scale of 0-10 whereby 0=no vulnerability and 10=highest vulnerability

Source: Economist Intelligence Unit

Procedural / Distributive risk examples

	Political barrier	Political risk
FDI	▪ Operational license ▪ National security ▪ Ownership structure	▪ Nationalization ▪ Profit remittance
Export	▪ Red tape ▪ Local contents	▪ Non-payment

Managing Political Risk

Political Risk Control	What is it?	Typical owner	Question(s) when considering this control
Portfolio Diversification	Diversify investment portfolio using political risk as a key factor	Chief Financial Officer (CFO) and Business Development Officers	Would diversification increase other risks?
Political Risk Insurance	Insurance policy covering a number or political risk types (e.g., expropriation, political violence, etc.)	Risk Managers	Is insurance available for the political risk in question?
Asset/Personnel Security Management	Management of risks to personnel and assets posed by political violence, terrorism, kidnapping, etc.	Corporate Security Executives	Can the risk be mitigated to acceptable levels? Can it be crisis managed?
Joint Business Ventures	Partner with local company who understands political risk environment and/or is in political favor with government	Strategy and Business Development Departments	Are potential partners suitable from a business perspective?
Lobbying and Prominent Alliances	Legitimate influencing of government policy through industry associations, or strategic advice from former cabinet members, ambassadors, etc.	Board Members	How likely is the influencing strategy to work? How current is the advice to the context we face?
Community Initiatives	Social Investment/Social Responsibility activities (e.g., NGO partnerships, health, education or infrastructure initiatives)	Corporate Social Responsibility Executives/Country Managers	Are suitable local community interlocutors available?
Financial Hedging	Financial instruments (e.g., currency options, forward supply contracts, commodity hedging instruments) to limit financial exposure to political risks	CFOs	What financial instruments would offset or minimize the impact of political risks?
Agile and Resilient Supply Chain	Flexible supply chain—including ability to recruit in new locations—to respond to significant disruptions	Procurement Director	Are alternative supply arrangements practical? Has the supply chain been stress-tested for political risk?

Source: Accenture, 2012. *Managing Political Risk: Controlling loss, finding opportunity*, London.

Why Governments Intervene in Markets

1. Political arguments

- concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)

2. Economic arguments

- concerned with boosting the overall wealth of a nation – benefits both producers and consumers

Political Motives

1. Protecting jobs – the most common political reason for trade restrictions
2. Protecting industries deemed important for national security e.g. communication, food, energy
3. Furthering foreign policy goals (political embargo)
4. Protecting the environment

Econ. Motives: Protecting Infant Industries

- Governments to distinguish between industries worth protecting and those that are not

- Protection can cause domestic complacent towards innovation

- Consumers often end up paying more for products: lack of competition

- Industries often selected for political reasons

- Once in place, protection difficult to eliminate

Econ. Motives: Trade promotion and balance

Trade promotion	Trade restriction
1. Subsidies	1. Tariffs
2. Export financing	2. Quotas
3. Foreign trade zones	3. Embargoes
4. Export promotion agencies	4. Administrative delays
	5. Local content requirements
	6. Currency controls

The WTO

- Established in 1995 as an umbrella organisation for:
  - GATT (General Agreement on Tariffs and Trade)
  - GATS (General Agreement on Trade in Services)
  - TRIPS (Agreement on Trade-related Aspects of Intellectual Property Rights)

- The WTO functions to liberalize trade
  - A negotiation forum
  - A super-national institution that set rules
  - A place for dispute resolution

https://youtu.be/MxONEO23qSc

Key takeaways

1. Political system is a system of decision-making and control mechanisms, aimed at integrating different interest groups in a country
2. Different types of political systems and different types of state
3. Different types of political risks and their examples, and firms respond to them using strategic, tactical, and technical measures
4. States have political and economic motivations to influence the economy
5. National and supernational institutions can promote or hinder trade