Measures of Political Risk

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The best available measures of political risk have not performed well in sophisticated analyses seeking to predict currency crises, banking crises, devaluations or expropriation events. For example, work by Jeffrey Frankel and Andrew Rose of the University of California, Berkeley, (Frankel and Rose, 1996) uses macroeconomic accounting measures to predict currency market stability. Although these measures correctly predict 99.4 percent of periods (months) of tranquility in the foreign exchange market for a given currency, they correctly predict only 7.2 percent of periods in which a currency crash occurs. There also exists little statistical evidence to date that subjective risk ratings carry any additional information beyond these macroeconomic statistics (Cosset and Roy, 1991). And yet another striking example of the inadequacy of conventional political risk measures involves the recent East Asian financial crisis. To the surprise of many members of the corporate, policymaking and academic communities, neither accounting nor perceptual measures provided substantial warning of impending crises in Thailand, Indonesia, Malaysia or South Korea in 1998.

There are several reasons for the failure of the traditional political risk measures. The first reason is their retrospective nature. By examining macroeconomic accounting measures or investor and expert perceptions of risk, these measures are all guided more by recent trends than by the fundamental probabilities of interest to investors. If the growth rate in a country increases in the absence of substantive political reform, has the underlying probability of a deleterious policy shift during the next decade or two necessarily changed as well? Moreover, if relatively high growth continues for several

years and foreign investors flock in to take advantage of the growth "miracle," leading to a reduction in the perceived riskiness of the country, has the true risk exposure of the infrastructure investor actually decreased? We suggest that the answer to each of these questions is "no," and that the commonly used macroeconomic and perceptual measures are likely to bear little correlation to the underlying political risk that an investor in a country will actually face in the future.

A second problem, associated primarily with the macroeconomic accounting measures, is that they are subject to manipulation by political actors whose capricious behavior may lie at the root of a country's problems in the first place. For example, looking ahead, how are we to predict whether the current South Korean recovery is sustainable? Has growth increased because the reforms implemented to date have addressed charges of "crony capitalism," or does it represent a short-term boom engineered by the government that obscures the remaining long-term dangers?

A third problem, associated primarily with the perceptual measures, is their tautological nature. It is hardly surprising that less investment occurs in countries that managers perceive to be risky. However, this finding tells us nothing about the fundamental sources of risk. Moreover, perceptual measures can be misleading if managers currently rely on models of political risk that lack the necessary sophistication. For example, private sector investors updated their perceptions of the levels of risk in the East Asian countries discussed earlier based on the magnitude of the initial downturn and the speed of the arrival of the first signs of recovery. It is not at all clear that such indicators have much to say about the actual long-term prospects for investment.

We believe that most of the problems with conventional political risk measures ultimately stem from their lack of focus on the political systems that they purport to measure. However, past efforts at coopting measures of interest to political scientists, such as the level of democracy (versus autocracy) or "political instability" to predict variation in investment behavior (or even economic growth) have met with limited success (Alesina et al., 1992; Barro, 1997; Brunetti, 1997; Campos and Nugent, 1998; Svensson, 1998; Rodrik, 1999). While at first glance it seems reasonable to expect democracies and stable polities to attract higher rates of investment than their less stable or autocratic counterparts do, the reason for the failure of such measures should be apparent when one considers specific cases. Do Lesotho, Russia, Mongolia or Benin, all of which score eight or above (as of 1994) on a commonly used 10-point scale of "democracy," truly provide better investment climates than do Singapore or Taiwan, which respectively scored 2.0 and a 4.8 on the same scale? Or does Zaire, which from the time that it became independent in 1967 until 1994 had no change in the identity of its executive, provide a more attractive investment climate than does Italy, which had twenty-one leadership changes in the same period?

A true prospective measure of political risk might examine past trends in macroeconomic accounting measures and managerial perceptions of risk, but rather than extrapolate from these trends directly, would interpret them in the context of a nation's underlying political and regulatory structures. If a boom is underway and risk perceptions are falling in the absence of credible political guarantees that the policies responsible for the boom will continue in the future, investors should be seriously concerned. However, the relevant political variable of interest to investors is not democracy or instability *per*

se, but rather the ability of the government to craft a credible commitment to an existing policy regime. In the context of the East Asian crisis, for example, an analysis of the structure of the political systems in the affected countries demonstrates substantial potential for arbitrary and capricious policymaking.

Building a Better Measure of Political Risk

Having identified the shortcomings of traditional measures of political risk and suggested the basis for a better measure, we now address the practical issue of how to construct such a measure. That is, how should we characterize underlying political structures in a consistent fashion and, more to the point, measure their ability to support credible policy commitments? Rather than co-opt existing measures of questionable validity, we propose the adoption of a measure that is objectively derived with the explicit goal of measuring the likelihood of changes in the policy regime.

One option is the index developed by the World Bank in its Database of Political Indicators. As described by Beck et. al. (2001), CHECKS2a "counts the number of veto players in a political system, adjusting for whether these veto players are independent of each other, as determined by the level of electoral competitiveness in a system, their respective party affiliations, and the electoral rules." The index yields a minimum score in the absence of an effective legislature. The index score then increases linearly with the addition of subsequent veto points whose political preferences are closer to the opposition[1] than the average of the government using a three-point scale using different methodologies for Presidential (one increase for each legislative chamber and for the President unless elections are held under closed lists and the President's party is the

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[1] The opposition is defined as the largest opposition party in Presidential regimes and the three largest opposition parties in Parliamentary regimes.

largest government party in a particular chamber in which case the President is not counted as a check) and Parliamentary systems (one increase for the Prime Minister and for each party in the government coalition including the Prime Minister's party with a similar reduction as above in the event of closed lists) (Beck et al. 2001).

While the CHECKS2a index takes into account the complex relationship between veto points, party preferences and preference heterogeneity, it also assumes a linear relationship between the number of adjusted veto points and the degree of constraints on policy change. Similarly, the number of adjusted veto points increases linearly in Parliamentary systems with each addition of a party to the ruling coalition without regard to the relative size of the parties in the coalition. Each of these results contradicts the theoretical findings of Tsebelis (2000) which finds diminishing marginal returns to the addition of veto players.

Henisz (2000) provides an alternate measure. The Political Constraint Index (POLCON) similarly begins by assigning those countries without effective veto points with the lowest score. However, Henisz (2000) relies upon a simple spatial model of political interaction to derive the extent to which any one political actor or the replacement for any one actor—e.g., the executive or a chamber of the legislature—is constrained in his or her choice of future policies. The first step in the construction of this variable is the identification, using the Polity IV database (Gurr 2001), of the number of independent branches of government (executive, lower and upper legislative chambers, judiciary and sub-federal institutions) with veto power over policy change in each country. The preferences of each of these branches and the *status quo* policy are then assumed to be independently and identically drawn from a uniform, unidimensional

policy space. This assumption allows for the derivation of a quantitative measure of institutional constraints using a simple spatial model of political interaction.

This initial measure is then modified to take into account the extent of alignment across branches of government using data on the party composition of the executive and legislative branches. Alignment across branches increases the feasibility of policy change thereby reducing the level of political constraints.[2] The measure is then further modified to capture the extent of preference heterogeneity within each legislative branch. Greater within-branch heterogeneity increases (decreases) the costs of overturning policy for aligned (opposed) branched. Possible scores for the final measure of political constraints range from zero (most hazardous) to one (most constrained).

In contrast to the CHECKS2a measures, POLCON does show diminishing marginal returns to the addition of subsequent veto points and the functional form of those diminishing returns is not arbitrary (such as would be the case if the CHECKS2a scores were logged or otherwise mathematically transformed) but rather derived from the spatial model. Similarly, rather than assuming that the addition of a new party to a coalition adds one new veto player, POLCON examines the impact of that party on the fractionalization of the legislature (the probability that two random draws will belong to the same party). This construct as often been used by political scientists to assess the difficulty in managing a coalition. Finally, rather than using different rules to calculate veto points for Presidential and Parliamentary systems, POLCON follows the same methodology but does yield important differences in the scores across these two political systems as Parliamentary systems are characterized by alignment between the executive

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[2] This adjustment accounts for the difference between procedural and substantive vetoes by considering the potential for preference alignment among the actors that control veto points (Heller and McCubbins 1996).

and legislature and tend to have more fragmented legislatures. Thus the differences again emerge from the spatial model rather than ad hoc construction.

Unfortunately, several flaws also characterize POLCON. First, as fractionalization data was not available at the level of the opposition and majority, the fractionalization of the entire legislature was used as an imperfect proxy. Second, while judicial independence is clearly an important check on political discretion, it is unclear whether it emerges or can be sustained independently of an independent legislature and therefore whether it should be treated as a completely independent veto point. Similar criticisms can be levied against the use of sub-federal entities.

Despite these limitations, the political constraint index does directly measure the feasibility of a change in policy given the structure of a nation's political institutions (the number of veto points) and the preferences of the actors that inhabit them (the partisan alignment of various veto points and the heterogeneity or homogeneity of the preferences within each branch). Additionally, it has been calculated for virtually all countries in the postwar period (1960-1998), a companion index (considering only three veto points) is available from 1815 and a new release of the data extends both versions forward to 2001 as well as expand country coverage to as many as 234 nations.