

# Political and Economic Risk Analysis

## Case study of Macedonia

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**Abstract:** Bhalla (1983) developed Foreign Investment Risk Matrix (FIRM) as one step of the political risk analysis process, where he uses political and economic risk measures in the foreign direct investment decision making. However, countries with population less than 5 millions or income per capita less than \$500 are excluded from consideration because of the insufficient market size. Knowing that Macedonia has population around 2 million and \$9.000 income per capita, this research will attempt to determine its position in the Risk Matrix by using available and reliable data on internet.

**Keywords:** political risk, economic risk, Foreign Investment Risk Matrix.

## 1 Introduction

In this paper we will analyse Macedonian risk position in the two-dimensional matrix, using readily available measures of political and economic risk. Bhalla (1983) described a four-step process that can be used for country risk analysis and the first step is called the Foreign Investment Risk Matrix (FIRM). This matrix allows a multinational company to rate countries basing on the risk and using only political and economic risk measures. Most of the researchers do not include countries with less than 5 million population or less than \$ 500 income per capita. Macedonia is part of the first group with population around 2 million. This paper will use the idea for country risk analysis from Bhalla's model and the extended version from McGowan Jr. and Moeller.

Talking about country risk, we can say that it is related to changes that might occur in the business environment in one country that will likely reduce the profitability of the foreign investment. The main two components of country risk that investors need to consider are political risk and economic risk for that country.

## 2 Literature review

### 2.1 Risk categories

Many researchers have tended to separate country risk into categories. Some of them agreed on six major risk categories that are shown below. Many of the categories overlap with each other, knowing the interrelationship between the domestic economy and political system in the countries and with the international community. Al-

though many risk analysts do not agree with this list, and believe that the main two categories include economic risk and political risk. These are the six major categories:

- I. Transfer Risk
- II. Exchange Rate Risk
- III. Location Risk
- IV. Sovereign Risk
- V. Economic Risk
- VI. Political Risk

*Transfer Risk* is the risk arising from a decision by a foreign government to restrict capital movements<sup>1</sup>. This kind of restrictions might make a situation where it will be difficult to repatriate profits, dividends, or capital. The right of the government to change capital movement rules at any time can affect all types of investments in the country. This risk is analyzed as a function of a country's ability to earn foreign currency and quantifying it remains difficult, since it can be forced by a purely political response to another problem.

*Exchange Risk* is the risk that will affect the investment by changes in exchange rates. This risk, basing on the economic theory guides can be analysed in a one to two year period, since the short time exchange risk is driven by currency trading momentum and can be eliminated through various hedging mechanisms and futures arrangements.

Exchange risk can be identified with transfer risk, since a sharp depreciation of the currency can reduce some of the imbalances that lead to increased transfer risk.

*Location Risk* is the risk caused by spillover effects caused by problems in a region, in a country's trading

<sup>1</sup> The National Association of Business Economists, 2000

partner, or in countries with similar perceived characteristics. This risk can be defined from country's trading partners, international trading alliances, country size and borders, and the distance from economically/politically important countries.

*Sovereign Risk*<sup>2</sup> is the probability that government will refuse to comply with the terms of a loan agreement during economically difficult or politically volatile times. It can be related to transfer risk when the government runs out of foreign exchange, or political risk when the government will decide not to respect its obligation because of political reasons.

*Economic Risk* is the risk when we have major change in the economic structure, that will bring changes in the expected return of investment. This risk can arise from changes in fundamental economic policy goals or country's comparative advantage. It's connected with the political risk, since both deal with policy in the country.

*Political Risk*<sup>3</sup> comes from the changes in a country's political structure or its policies, such as tax laws, tariffs, expropriation of assets, or restriction in repatriation of profits. It can occur because of attitude of consumers in the host country where some consumers are very loyal to locally manufactured products. The most common action is the one from the host government, where they can impose special requirements or taxes, restrict fund transfers, and subsidize local firms. Or the opposite, governments lack of restrictions. Another actions that might lead to political risk is the blockage of fund transfers for the MNCs or currency inconvertibility when the MNC parent may need to exchange earnings for goods if the foreign currency cannot be changed into other currencies. War or even the threat of war, can have devastating effects and represent political risk. Also bureaucracy and corruption can complicate business, increase the its cost or reduce revenue.

## 2.2 Foreign Investment Risk Matrix

Bhalla's country risk analysis process has four-steps. The *first step* is to create the *foreign investment risk matrix* where we can determine the countries that provide a stable political environment and have economic potential for a investment. *Second step* will create country risk profile for the selected countries in the first step. After

that, he suggested to create a foreign investment risk analysis for each project for each country in the *third step*. The *fourth step* will create risk audit that will monitor and re-evaluate the environment on a continuous basis and to inform the MNC for changes in economic and political stability in the country.

Bhalla's previously mentioned two-dimensional matrix has four categorical variables for each political/economical risk. Country political risk is categorised into four categories: A being stable, B being moderately unstable, C being volatility unstable, and D being substantially unstable. Economic risk is categorised into four categories: category one indicates acceptable risk, category two indicates moderate risk, category three major risk, and category four specifies unacceptable risk. Measures that he uses for the political risk are government stability, frequency of changes in government, and the attitude of the public for the government leaders and institutions. For the economic risk Bhalla used market potential for the company's products, demographic characteristics and infrastructure of the country, the economic breadth of income, GNP per capita, and the economic growth potential.

Bhalla (1983) argues that income per capita and the distribution of income per capita are the most important variables in determining both economic and political risk because income per capita reflects both the underlying economy and the effectiveness of the political management. Both the level of income per capita and the distribution of income per capita effect economic and political risk. More evenly distributed income per capita reduces both economic and political risk.

Using this four by four two-dimensional matrix, Bhalla rated countries in sixteen different categories. Countries with political stability and acceptable economic risk would be in the upper left corner and those with political instability and unacceptable economic risk would be in the lower right corner.

In this paper, we will demonstrate how to use Bhalla's matrix and the extended version by McGowan Jr. and Moeller where they only use readily available measures that can be easily found on internet.

## 3. Case study of Macedonia

This research is conducted for Macedonia, country that in most of the cases is left out of the country risk analysis

<sup>2,3</sup> [www.businessdictionary.com](http://www.businessdictionary.com)

because of the population number that is around 2 million citizens. Basing on the previous research from

McGowan Jr. and Moeller, Macedonia was ranked using this variables for the political risk: attitude of the government toward foreign direct investment (FDI), conflict degree of the country, and perceived corruption within

the country. Also three variables were used to measure the economic risk: gross national income per capita, inward FDI potential, and the inflation rate. All of those variables are available on internet and are reliable since they all come from dependable and respected sites that rank countries every year and use reliable methods.

The Attitude of Government toward FDI can be measured by the Index of Economic Freedom, with the sub-index for Capital Flows and Foreign Investment. Some information can be found on Heritage internet site ([heritage.org](http://heritage.org)). The sub-indexes must be subtracted by five, since the Indexes of economic freedom are highest at one and lowest at five. In the case of Macedonia, this measure index is 2.

Conflict Barometer published by the Heidelberg Institute of International Conflict, available on site (<http://hiik.de>), gives information about the degree of country conflict. This variable for Macedonia is 2.

Perceived corruption is calculated by Transparency International on a yearly basis, using the Corruptions Perceptions Index. The index is a weighted average of a number of indexes and surveys of perceived corruption. The CPI is transformed by dividing the published value by two. Perceived corruption for Macedonia is 1.6, knowing that the starting value is 3.8.

Gross national income per capita data are available from World Development Indicators report which is published by the World Bank and can be found on (<http://web.worldbank.org>). Here we assign:

- five for a high income economy,
- four for an upper middle income economy,
- three for a lower middle income economy,
- two for a low and middle income economy,
- one for a low income economy.

Macedonia's GNI per capita rating is 3.

FDI Potential is measured by using UNCTAD's Inward FDI Potential Index ([www.unctad.org](http://www.unctad.org)) which is an equally weighted average of the values (normalized to yield a score between zero, for the lowest scoring country, and one, for the highest) including 12 different variables:

- GDP per capita,
- Growth rate of GDP for ten years,
- Exports to GDP,
- Average number of telephone lines per 1000 citizens,
- Commercial energy use per capita,
- R&D spending to GDP,
- Proportion of tertiary students in the population,
- Country risk,
- World market share in exports of natural resources,
- World market share of imports of parts and components for automobiles and electronic products,
- World market share of exports of services, the share of world FDI inward stock.

Since this index has value from zero to one, it can be transformed by multiplying the published values by ten and dividing them by two. Macedonia's value is 0.6.

Inflation Rate can be measured by the Index of Economic Freedom, sub-index for Monetary Policy. Here the sub-index is subtracted by five, since the index is highest at one and lowest at five. The Monetary policy index is based on the inflation rate for the previous ten years in the country. This variable for Macedonia is 0.5% but subtracted from 5 is 4.5.

After we determined the values for economical and political risk, we used them to find the total political and economical risk for Macedonia.

**Table 1: Economical and Political risk factors for Macedonia**

<b>Political Risk Factors</b>	Rating	Weight	R×W
Host government attitude	2	35%	0.70
Conflict	2	35%	0.70
Corruption	3.8	30%	1.14
<b>Total</b>		<b>100%</b>	<b>2.54</b>
<b>Economic Risk Factors</b>	Rating	Weight	R×W
GNI per capita	3	30%	0.90
FDI potential	0.6	35%	0.21
Inflation rates	4.5	35%	1.50
<b>Total</b>		<b>100%</b>	<b>2.61</b>
Total Risk Factor	Weight	Value	W×V
<b>Political Risk</b>	60%	2.54	1.52
<b>Economic Risk</b>	40%	2.61	1.04
<b>Total</b>			<b>2.56</b>

Following the Bhalla's model and the extended model by McGowan Jr. and Moeller we created a two dimensional graphic. One dimension is economic risk and the other dimension is political risk, both of them scaled from one to five. After that we used the values

from Table 1 to find the position of Macedonia. Like we can see in Figure 1, Macedonian position is in the lower left corner, just for comparison with the countries that are acceptable for foreign direct investment and are in the upper right corner.

After we had calculated the political risk dimension and economic risk dimension, we positioned Macedonia in the Foreign Investment Risk Matrix. (Figure 1.) Its position in the uncertain region tells us that Macedonia might represent a country for a direct foreign investment only in a case when there are no other countries that are available for FDI or in a case when the MNC wants to participate in this market at any cost. This position can be easily changed by further analysing of that country, that will help in the decision making for investment. The closeness to the unacceptable region might represent a threat, but knowing that the country is going through massive economical and political changes, it can be expected to see Macedonia's risk position in FIRM to be closer to the acceptable region in the next years.

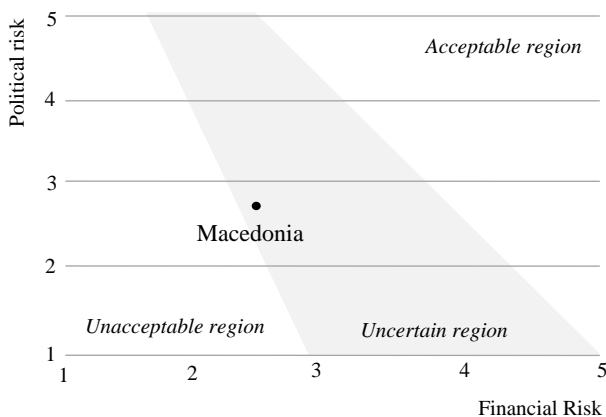


Figure 1. Foreign Investment Risk Matrix - Macedonia's position

## 4. Conclusions

Foreign investment is of great importance for a small country like Macedonia. Being in the Balkan part of Europe, for some MNC's means a lot, especially when they have to make investment decision and they have in mind the war past and instability of that region. Although that is history and Macedonia, like some other countries in that region, has moved far forward from that image, still this country is not part of any risk analysis, because of the number of the population.

With the importance of investment, the need for political and economic risk analysis comes too. Many countries are open for FDI, some of them have just opened, and also there are those that are hostile to foreign direct investment. In any case MNCs need specific ratings of the risk of the countries, rather than the general ratings that can be found from some assessment services. Knowing that there is available information on internet, and having in mind the most important risks – economic and political, any MNC can analyse country risk, following Bhalla's country risk analysis process and extended version of FIRM from McGowan Jr. and Moeller.

Multinational corporations need to be able to determine the countries that offer the best economic conditions and political stability that ensures production and sale for a long run. Political risk usually can result from government actions and economic risk can result from changes in the micro or macroeconomic stability. For both of them, MNCs desire less instability.

The Foreign Investment Risk Matrix used in this research represents a good framework and any MNC can use it to analyze both, political and economic risk. Any MNC can specify its own values, that are more likely connected to their specific investment in a specific country. For this research, as a guidance we used values that are specific for initial country research and previously recommended by other researchers. Basing on those six independent variables used in this paper, we can rate countries as acceptable for foreign direct investment, unacceptable, and countries that provide uncertain environments and need further study before accepting/rejecting them from our investment decision. In the end, FIRM helps MNC decision maker to eliminate countries and make the right investment decision.

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