THE IMPORTANCE OF THE IMPACT OF POLITICAL RISK FACTORS IN SOUTH AFRICA

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Abstract

Political risk factors often impact negatively on the financial results of an enterprise, industry, geographical region or an entire country. In severe cases they may even lead to financial disasters. Previous research (by Essel) identified 10 specific political risk factors which are common to emerging market economies. As South Africa is a developing country with an emerging market economy, these 10 political risk factors should also be present in this country. This paper focuses on the importance of the impact of political risk factors on an agent's total annual claims amount when underwriting political risk insurance in South Africa.

The objective of this research paper embodies the improvement of financial decision-making by a particular enterprise, industry, geographical region or country operating in an emerging market economy, pertaining to the importance of the impact of political risk factors. A literature study as well as an empirical survey was done to achieve the study's objective. The conclusions of this research should also be valuable to other enterprises, industries, geographical regions or countries which operate in an emerging market economy.

Keywords: Breach of Contract, Confiscation, Creeping Expropriation, Currency Inconvertibility, Nationalisation, Non-honouring of Government Payments, Non-violent Civil Unrest, Political Risk Factors, Terrorism, Violent Civil Unrest, War

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1 Introduction and objective of research

Political risk *factors* represent the situations which may lead to political risks and are defined by Brink (2004:18) as "... the probability that business will ... suffer losses ... as a result of stakeholders within a political system's (in)actions or reactions to events, decisions and policies...". She identified 103 political risk factors (2004:2) which may impact on a particular enterprise, industry, geographical region or an entire country. These political risk factors often impact negatively on the financial results of an enterprise, industry, geographical region or entire country and may in severe cases even lead to financial disasters.

According to the research of Essel (2012:71-97 & 135-136) there are some political risk factors which are common to emerging market economies and he identified 10 specific political risk factors in this regard. As South Africa has a developing economy with an emerging market economy and the country recently became a member of the five BRICS countries in the world (MSCI Barra, 2010; SouthAfrica.info, 2011), these 10 political risk factors should also be present in South Africa.

This research paper focuses on the *importance* of the impact of political risk factors in South Africa as one of the emerging market economies of the world. The conclusions of this research paper should also be valuable to the other countries which have emerging market economies. The *objective* of this research is consequently defined as the improvement of financial decision-making by a particular enterprise, industry, geographical region or country which operates within an emerging market economy, focusing on the importance of the impact of political risk factors. To achieve the stated objective, it was necessary to do a literature study, as well as an empirical study to obtain the perceptions of the underwriters of political risk insurance in South Africa. The following sections address the political risk factors identified by Essel which are common in emerging market economies.

2 Political risk factors which are common to emerging market economies

According to the research of Essel (2012:71-97 & 135-136) the following 10 political risk factors are prevalent in emerging market economies, viz.:

- Nationalisation
- Confiscation
- Creeping expropriation
- Currency inconvertibility
- Breach of contract
- Non-honouring of government payments
- War
- Violent civil unrest
- Non-violent civil unrest; and
- Terrorism.

Due attention will be paid to these political risk factors in the following sections.

2.1 Expropriation focusing on nationalisation, confiscation and creeping expropriation

According to Pike (1980:35), expropriation is the political risk factor which provides the most concern to foreign investors in a host country. The term expropriation often has a wider meaning and is often called by other terms, like nationalisation, confiscation and creeping expropriation. Expropriation occurs when a government takes over the control of property by claiming that the act is in the interest of the general public.

Nationalisation usually implies that a government takes over the control of foreign investments by offering only partial compensation for the property concerned and the act of nationalisation is usually aimed at a particular industry or type of property instead of a specific enterprise (Howell, 1998:4; Lloyd, 1974:27). The nationalisation of the mining industry is a classic example in this regard. *Confiscation*, on the other hand occurs when the owner of the property receives no compensation for the property concerned (Lewis, 1979:221).

Recently, a new form of expropriation has evolved, called *creeping expropriation*. This occurs where a government progressively accepts and implements legislation to limit the operations of the owner of property (Robock, 1971:13). The government may have the objective to eventually take over the industry or type of property or to provide more benefits to the general public by acting in this manner (Lewis, 1979:84).

Expropriation is usually based on ideology, nationalism, as well as international and domestic politics and economics (Bremmer & Keat, 2009:125). According to Brink (2004:20), it is possible to anticipate expropriation by analysing these factors. The risk of expropriation can be reduced when democracies exist or where specific political constraints are in force in a country.

It is important to realise that particular conditions must be met for an expropriation to be considered as legal, viz. the property must be located within the host government's borders, the host government should not discriminate against foreign owners when expropriation is implemented, and the general public of the host country must benefit from the property concerned. Especially countries which are hostile towards foreign investments may decide to implement expropriation (Lewis, 1979:64). If the three conditions mentioned are not met, an expropriation may be considered by the international community as illegal and the international community may take action against the particular country by implementing sanctions or other trade embargos.

It is interesting to note that Bradley (1977:75) found that governments are more eager to expropriate larger investments than small investments and that it is more likely that governments target particular industries. Although high-technology industries may be more attractive, low technology industries may be easier to expropriate as they require less knowledge and operational skills to manage and operate than their counterpart. Enterprises in the petroleum and mining industries are often concerned about possible expropriation due to their past experiences as victims of expropriation (Hal Mason, 1974:6; Multilateral Investment Guarantee Agency, 2010:31). Governments should be very careful not to expropriate enterprises which are part of a vertically integrated channel, as the expropriated enterprise may be avoided by the other enterprises in the vertical integrated channel to sidestep the expropriation (Bradley, 1977:81).

Although expropriation may have occurred less frequently during the past decade, Bremmer and Keat (2009:124) are of the opinion that expropriation will remain an important political risk factor. Governments may still apply expropriation when economic recessions prevail to promote the interest of the general public (Galvao, 2001:36).

2.2 Currency inconvertibility

This political risk factor occurs when restrictive legislation pertaining to foreign exchange controls leads to financial losses. According to Howell (1998:4) governments have the power to prevent the conversion of one currency into another currency by enforcing regulations. It must, however, be emphasised that currency fluctuations do not form part of currency inconvertibility (Berlin *et al*., 2003:7; Stein, 1983:20). As currency inconvertibility is of prime importance to banks, they were one of the primary insureds of political risk insurance during the past decade, focusing mainly on the coverage against currency inconvertibility (Coppola & Riordan, 2005:188).

2.3 Breach of contract and non-honouring of government payments

Breach of contract occurs when a country does not adhere to the stipulations of a contract between them and private investors. This may lead to an investor suffering a loss as a result of a government which repudiates the contract. A breach of contract may also cause a non-honouring of government payments, although a breach of contract is possible where no cash flows are involved.

Governments may change their legislative, fiscal or monetary policies from time to time which may lead to a breach of contract and non-honouring of payments (Multilateral Investment Guarantee Agency, 2010:47). Breach of contract is the political risk factor which most concern investors in emerging market economies (Multilateral Investment Guarantee Agency, 2010:31). Cover for breach of contract is often available to investors when foreign investments are made (Berlin *et al.*, 2003:7). Democracies and political constraints may however limit the risk of a breach of contract by governments to a certain extent.

2.4 War and civil unrest

War and civil unrest pose enormous financial consequences to any country and industry, not to mention the impact on individuals. Where war normally refers to conflict between countries, civil unrest has the internal domestic conflict in a country in mind (Howell, 1998:4). When countries go to war, property and human lives are at risk. According to Bunn and Mustafaoglu (1978:1564) as well as Tarzi (1992:443) sudden ideological change in a country, a threat made by another country, the imposition of adverse sanctions against another country, unilateral declaration of independence by a country and pre-emptive strikes made against another country are the main underlying indicators of war. Wars are relatively easy to foresee and coverage against this political risk factor is often available.

Civil unrest which may sometimes lead to violence is usually caused by the internal conflict in a country (Brink, 2004:85). Bremmer and Keat (2009:84) stated that civil unrest refers to societal actions based on a rigorous regime or government instability and crises. It may also have political turmoil, conspiracies, political takeovers as well as internal war in a country in mind (Gurr, 1968:1107). Civil unrest can often be foreseen by monitoring human needs such as drinking water, electricity and housing. Bremmer and Keat (2009:85) found that a male-dominant youth between the ages of 15 and 25 tend to lead to violence. The impact of civil unrest in a country should be properly managed as it can severely impact on the business environment, can force a government to change its policies and can even bring a regime down.

As civil unrest often has a spontaneous nature it is difficult to forecast its occurrence. Some civil unrest can even develop within hours beforehand. Civil unrest may have the potential to be of a high magnitude, and if they are sustained their impact could be enormous on the business environment and the economy of a country. Civil unrest can easily have the same impact in a country as a civil war and may lead to the occurrence of other political and business risks (Bremmer & Keat, 2009:99-100).

According to Kobrin (1978:118), civil unrest tends to occur mostly in informal rural areas, although it has taken place in developing as well as developed countries. Research has however shown that civil unrest mostly occurs in autocratic or state-divided countries where the population is poor (Bremmer & Keat, 2009:92). When a government decentralises its power to local governments, the probability of civil unrest may be decreased. It should however be emphasised that the chance of civil unrest will only be reduced if the local government performs in a competent manner by meeting the demands of the local population to a reasonable extent.

2.5 Terrorism

The following definition of terrorism was provided by the U.S. Department of Defence, viz. "... the calculated use of an unlawful violence ... to inculcate fear; intended to coerce or to intimidate governments or societies in the pursuit of goals that are generally political, religious, or ideological" (Bremmer & Keat, 2009:106). While terrorism is directed at the society at large, guerrilla activities are aimed at government organisations such as military institutions (Brink, 2004:91).

Since the events of 11 September 2001 in the United Stated of America, terrorism is no longer a political risk factor which is associated with emerging market economies only (James, 2004:29). Terrorism is a phenomenon which can escalate easily, such as starting as an uprising of civil disobedience and unrest, becoming a civil war and resulting in a revolution (Berry, 2008:21). It may however be possible to prevent terrorist attacks by employing the necessary analysis and having responsive actions and precautions in place (Bremmer & Keat, 2009:118). These precautions may focus on employing risk management against terrorism as well as obtaining insurance coverage for the detrimental consequences of terrorist attacks.

3 Research methodology

It was already stated that this research paper focuses on the *importance* of the impact of political risk factors in South Africa which is one of the emerging market economies of the world. The *objective* of this research was consequently defined as the improvement of financial decision-making by a

particular enterprise, industry, geographical region or country which operates within an emerging market economy, focusing on the importance of the impact of political risk factors.

The perceptions of the underwriters of political risk insurance in South Africa were obtained to provide empirical evidence concerning the topic of this research. The empirical survey embodied personal interviews, which were conducted with the agents underwriting political risk insurance (known as Sasria insurance) in South Africa. The literature study formed the bases of the questionnaire which was used as an *aide-mémoire* during the personal interviews. After following up, 32 of the available 54 agents participated in the empirical survey. The empirical results obtained appear in the following sections.

4 Empirical results

The empirical results focus on the *importance* of the impact of political risk factors over the past five years, as well as the next five years, on a respondent's total annual claims amount. The descriptive statistics of these empirical results are thereafter discussed. The ranking of the importance of the impact of the political risk factors on a respondent's total annual claims amount is addressed while the Wilcoxon Test is employed to determine whether there are significant differences between the various ratings.

It was stated explicitly during the personal interviews as well as on the questionnaire which was used as an *aide-mémoire* that the five point Likert interval scale forms a continuum. It was therefore possible to assign weights to the answers (Albright, Winston & Zappe, 2002:224-229 & 245). The answers of the respondents received the following weights:

Table 1. Weights for The answers of the respondents

Answers of the respondents:	Weights assigned:
Extremely important	5
Highly important	4
Moderately important	3
Little important	2
Not important	1

The empirical results obtained from the executives who completed the questionnaires are depicted in the following tables (Essel, 2012:135-142). Table 2 shows the importance of the impact of political risk factors over the *past* five years on a respondent's total annual claims amount.

Table 2. Importance of the impact of political risk factors over the past five years on a respondent's total annual claims amount, according to the percep-tions of the respondents

Political risk factors	Extremely important	Highly important	Moderately important	Little important	Not important	Weigh-ted responses
Nationalisation	1	4	3	8	16	62
Confiscation	2	2	4	7	17	61
Creeping expropriation	0	7	5	5	15	68
Currency inconvertibility	2	1	3	8	18	57
Breach of contract	4	1	4	8	15	67
Non-honouring of government payments	3	3	3	6	17	65
War	4	0	3	5	20	59
Violent civil unrest	7	10	6	3	6	105
Non-violent civil unrest	2	7	10	5	8	86
Terrorism	4	1	4	5	18	64

Number of valid responses = 32

The following table depicts the importance of the impact of political risk factors over the *next* five years on a respondent's total annual claims amount.

Table 3. Importance of the expected impact of political risk factors over the next five years on a respondent's total annual claims amount, according to the perceptions of the respondents

Political risk factors	Extremely important	Highly important	Moderately important	Little important	Not important	Weighted responses
Nationalisation	6	9	6	3	8	98
Confiscation	6	8	6	5	7	97
Creeping expropriation	6	9	5	6	6	99
Currency inconvertibility	3	2	6	9	12	71
Breach of contract	4	4	4	10	10	78
Non-honouring of government payments	5	8	5	7	7	93
War	6	0	4	8	14	72
Violent civil unrest	12	15	2	3	0	132
Non-violent civil unrest	4	12	5	6	5	100
Terrorism	8	1	9	8	6	93

Number of valid responses = 32

The empirical information of Tables 1 and 2 is used to calculate the descriptive statistics as it appears in Table 4.

Table 4. Descriptive statistics for the importance of the impact of political risk factors in South Africa on a respondent's total annual claims amount, focusing on the past five years and the next five years

Political risk factors	Past five years		Next five years	
	Weighted mean values	Median values	Weighted mean values	Median values
Nationalisation	1.94	1.5	3.06	3.0
Confiscation	1.91	1.0	3.03	3.0
Creeping expropriation	2.13	2.0	3.09	3.0
Currency inconvertibility	1.78	1.0	2.22	2.0
Breach of contract	2.09	2.0	2.44	2.0
Non-honouring of government payments	2.03	1.0	2.91	3.0
War	1.84	1.0	2.25	2.0
Violent civil unrest	3.28	4.0	4.13	4.0
Non-violent civil unrest	2.69	3.0	3.13	3.5
Terrorism	2.00	1.0	2.91	3.0

The descriptive statistics of Table 4 can be illustrated as follows: the weighted mean value and median value for nationalisation, for example, were 1.94 and 1.5 respectively over the past five years. Concerning the next five years, the weighted mean value and median value for nationalisation are 3.06 and 3.0 respectively. The next paragraphs provide detailed explanations of the related calculations and the employment of the results.

The *weighted mean values*, which are based on the weighted responses of Tables 2 and 3 divided by the number of valid responses viz. 32, can be used to rank the political risk factors in terms of the importance of their impact on a respondent's total annual claims amount. It will then be possible to compare the ranking of the political risk factors for the past five years with the ranking for the next five years based on the perceptions of the respondents (which follows in Table 5).

The *median values* are based on the responses of Tables 2 and 3 and the associated weights. For example, the median value of nationalisation is 3.0 for the next five years. This is calculated as follows by applying the information of Table 3: As the number of valid responses equals 32, the median is 16. The 16th and 17th responses in a declining order of importance

falls in the "moderately important" category of Table 3. This category has a weight of 3 which is therefore the median value of nationalisation for the next five years. The median values can be used to determine whether there is a significant difference between the rating of each political risk factor for the past five years and the rating for the next five years (which follows in Table 6).

The ranking of the importance of the impact of the political risk factors on a respondent's total annual claims amount over the past five years as well as the next five years is depicted in the following table.

Table 5. Ranking of the importance of the impact of the political risk factors on a respondent's total annual claims amount over the past five years and the next five years based on the weighted mean values, in a declining order of importance

Past five years			Next five years		
Weighted mean values	Ranking	Political risk factors	Weighted mean values	Ranking	Political risk factors
3.28	1	Violent civil unrest	4.13	1	Violent civil unrest
2.69	2	Non-violent civil unrest	3.13	2	Non-violent civil unrest
2.13	3	Creeping expropriation	3.09	3	Creeping expropriation
2.09	4	Breach of contract	3.06	4	Nationalisation
2.03	5	Non-honouring of government payments	3.03	5	Confiscation
2.00	6	Terrorism	2.91	6	Non-honouring of government payments
1.94	7	Nationalisation	2.91	6	Terrorism
1.91	8	Confiscation	2.44	8	Breach of contract
1.84	9	War	2.25	9	War
1.78	10	Currency inconvertibility	2.22	10	Currency inconvertibility

The results of the preceding table show that violent and non-violent civil unrest as well as creeping expropriation have been the three political risk factors which had the most important impact on a respondent's total annual claims amount during the past five years based on the perceptions of the respondents. The respondents expect that these three political risk factors will remain the factors which will have the most important impact on a respondent's total annual claims amount during the next five years.

It is however important to emphasise that nationalisation and confiscation moved from respectively the seventh and eighth places in the declining order of importance to respectively the fourth and fifth places. It can therefore be concluded that nationalisation and confiscation may have a more important impact on a respondent's total annual claims amount during the next five years than during the preceding five years.

It was already mentioned that the median values can be used to determine whether there is a significant difference between the rating of each political risk factor for the past five years and the rating for the next five years. The Wilcoxon Test was employed for this purpose by obtaining p-values for the changes in the median values (Ferguson, 1987:406-408). When the p-value of a political risk factor is less than 0.05 it

indicates that the difference which exists between the median value over the past five years and the median value for the next five years of that political risk factor is significant. The results obtained by employing the Wilcoxon Test are depicted in the following table.

The p-vales of nine of the 10 political risk factors which appear in the preceding table have p-values of less than 0.05. The only exception is the political risk factor referring to a breach of contract which has a p-value of more than 0.05. It should further be emphasised that eight of the remaining nine political risk factors have a bigger median value for the next five years than for the past five years, while the political risk factor of violent civil unrest has the same median value for the past five years and the next five years.

It can therefore be concluded that, with the exception of a breach of contract and violent civil unrest, the importance of the impact on a respondent's total annual claims amount should increase during the next five years compared to the previous five years due to the remaining eight political risk factors. The results also show that the importance of the impact of violent civil unrest on a respondent's total annual claims amount should remain the same during the next five years compared to the preceding five years.

Table 6. Wilcoxon Test for changes in the importance of the impact of political risk factors on a respondent's total annual claims amount, focusing on the median values of the past five years and the next five years

Political risk factors	Median values		p-values
	Past five years	Next five years	
Nationalisation	1.5	3.0	0.000355
Confiscation	1.0	3.0	0.000293
Creeping expropriation	2.0	3.0	0.000438
Currency inconvertibility	1.0	2.0	0.016605
Breach of contract	2.0	2.0	0.061885
Non-honouring of government payments	1.0	3.0	0.001696
War	1.0	2.0	0.020880
Violent civil unrest	4.0	4.0	0.000777
Non-violent civil unrest	3.0	3.5	0.018604
Terrorism	1.0	3.0	0.000935

5 Conclusions

The *objective* of this research embodies the improvement of financial decision-making by a particular enterprise, industry, geographical region or country which operates within an emerging market economy, pertaining to the importance of the impact of political risk factors. This empirical research focuses on the importance of the impact of political risk factors on a respondent's total annual claims amount in South Africa, which has an emerging market economy. The results of this research lead to the following main conclusions which should improve the financial decision-making by the relevant parties:

• The political risk factors of violent and non-violent civil unrest as well as creeping expropriation are the three political risk factors which had the *most* important impact on a respondent's total annual claims amount during the *past* five years. The respondents expect that these three political risk factors will remain the factors which will have the *most* important impact on a respondent's total annual claims amount during the *next* five years.

• The empirical results led to the conclusion that nationalisation and confiscation may have a more important impact on a respondent's total annual claims amount during the next five years than during the preceding five years.

• The importance of the impact on a respondent's total annual claims amount should *increase* during the next five years compared to the previous five years due to the following eight political risk factors:
1. Nationalisation;
2. Confiscation;
3. Creeping expropriation;
4. Currency inconvertibility;
5. Non-honouring of government payments;
6. War;
7. Non-violent civil unrest;
8. Terrorism.

• The importance of the impact of violent civil unrest on a respondent's total annual claims amount should remain the same during the next five years compared to the preceding five years.

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