1 Introduction
1.1 The problem

Most of the day-to-day activities of people deal with the planning of future developments. As dealing with the future by definition generates uncertainty, decision makers are almost everywhere confronted with this phenomenon. If you enrol in university to study engineering because you are convinced that this will offer you the possibility of earning your living you can never be sure that you will really succeed in doing so. Maybe you will face an economic downturn at the end of your studies so that you cannot find a suitable job. Maybe you will not succeed in the necessary exams to enter the labor market as an engineer. All you can do ex ante is to make an analysis of possible future developments based on the current available information about your personal capabilities and the environment.

Firms planning investments are essentially in the same situation. They will engage in a project when they have the opportunity to make an investment which is expected to be profitable. However, as most of the earnings that are generated by the project will be received in the future, investors can never be sure that their profits are really evolving as it was planned before. Instead they have to face the possibility that the expected revenue stream of the investment is altered. Reasons for these alteration are various. It can be a general economic downturn that renders the investment disadvantageous or it may be technical progress that changes the competitiveness of the product or a major change in consumer taste that unfolds its negative impact on the profitability of the project. For firms engaged in cross-border activities the problem is usually more severe. They are not familiar with the institutional structure and the political environment of the host country and their information and understanding of the history and the culture of the host country often remains limited.

Hence, for international corporations or those that are intending to go abroad the topic of international risk management is essential. It is straightforward to see that the scope of possible risks for foreign investors is wide. The wish to offer a complete assessment of all possible risks for foreign investors would therefore be too ambitious. Instead, this volume focuses on risks that are caused by the political and institutional environment of a host country. In other words, this volume deals with a phenomenon that is referred to as Political Risk or Country Risk in publications on international finance and investment. Thinking of expropriations by host governments all over the world one can easily understand how national politics influence the business environment for international investors in a given country. Although outright expropriations of multinational corporations or catastrophic events like wars and revolutions are most likely the events that cause the biggest attention among observers and analysts, more often the actions of governments influence the revenue stream...
of investors in a more subtle way. Discriminatory taxation or regulation, extensive labor protection, massive corruption or bureaucratic inefficiencies are real world examples for national policies that may adversely affect the profits of foreign investors. Although no outright expropriation these national policies affect the political and economic conditions of every day firm operations implying a direct influence on their profits. In addition to direct governmental action, revolutions, strikes, riots or other forms of civil unrest may endanger the assets of foreign firms or bring production to a halt.

Only citing these few examples it is straightforward to see that national politics establish a basic framework for the business activities of investors. The existing political system and current politics as well as their likely evolution in the future influence the expected profits of investors and affect their incentives to invest in foreign markets. If investors cannot be sure of reaping the full benefits of their projects, incentives to invest are decreasing despite of potentially high future returns. This is in particular the case for investments with long pay-off periods, as it is hardly surprising that investors in those sectors are more severely affected by uncertainty over future developments than investors in footloose industries. Governments that cannot credibly commit not to opportunistically interfere in the investor’s business are shaping incentive structures that are not favorable for investment. The same holds for governments that do not succeed in properly providing basic public goods that are essential for successful business operations as for example public security, property rights protection or legal certainty.

Political risk however, is not a topic that is only relevant for a few multinational corporations. Instead it becomes one of the most relevant problems for developing countries that are eagerly seeking to ensure the external financing of their economic development. As figure 1.1 impressively highlights public capital transfers to developing countries, such as development aid and other transfers, are stagnating while private capital flows approximately increased by factor six during the 90s indicating that relying on public capital transfers is by no means sufficient for developing countries.

The dynamic evolution of private international capital movements rather suggests that the future development perspectives of developing nations will to an enormous extent depend on their ability to attract private foreign investors. However, more than their public counterparts private foreign investors are averse to risks that may endanger their future profits. Despite of the vast increase of international capital flows to developing countries several emerging market crises during the 90s impressively underlined the volatility of international capital flows. International investors quickly react to potential political risks as for example unstable macroeconomic environments or risks of expropriation as well as riots or other forms of social unrest by quickly pulling out their capital. In turn, investors that have been seriously hit by losses due to political risk will hesitate the next time to engage in investment projects in the developing world.
Figure 1.1: Evolution of Public and Private Capital Transfers to Developing Countries (in billions of US$)


Therefore high levels of political risks may seriously endanger successful economic development as current investors may pull out and future investments are deterred. Hence, poor policies and weak institutional frameworks are extremely costly in terms of foregone FDI flows. Consequently developing countries which are in urgent need of foreign investments should make political risk prevention and management one of the priorities of national economic policy.

Despite of many economic problems during the last two decades the countries of Latin America are still interesting markets with a large potential for future growth. During the 90s liberal economic policies increased investor confidence and stimulated private capital flows to the region. However, while writing these lines it seems as if many countries of the region experience serious fallbacks into the past. Recent events in Argentina, that abandoned the dollar parity and witnessed violent social unrest following a severe economic crisis, indicate the importance of political risk analysis for foreign investment projects. Economic and political crisis in Venezuela resulting in large upheavals of opposition groups against the rule of president Chavez paralyzing the entire economy and the continuing presence of large guerilla groups in Colombia are other examples for the need of careful and detailed political risk evaluations. However, it is not always clear what international investors are looking for and what in turn should be the domestic policy preconditions to encourage FDI. Of particular importance are the following questions. Is political risk a major determinant of investment decision by foreign investors? And if yes, to what extent and which political risk factors are decisive for the decisions of

\[1] Diamonte/Liew/Stevens (1998) show that changes in political risk have a higher impact on returns in emerging markets than in developed countries indicating that emerging market investors are more risk averse.
multinational companies? How do political risks emerge? How can political risks be measured and quantified? And eventually, how can political risks be successfully and efficiently mitigated? The following chapters analyze all these questions by quantitative research on a sample of Latin American countries and a qualitative case study on Mexico.

Concerning the analysis of political risks, Mexico is a country of particular interest in the region. The moratorium on international debt in 1982 followed by the deep economic crisis of the 80s resulted in extremely high levels of country risk. However, in a quick economic transformation Mexico managed to become a country with low to moderate country risk ratings during the second half of the 90s. This comparatively rapid gain in investor confidence makes Mexico an interesting and challenging case for studying the extent and the determinants of political risks. The process of radical change from an economy based on import substitution and high protection with low investor confidence to an open economy that successfully attracts large amounts of FDI makes Mexico a fascinating case study to determine the political risk variables that matter the most for foreign investors. Although considered as a raw model for successful economic reform in the beginning of the 90s, the “Tequila-Crisis” in late 1994 preceded by the armed uprising in Chiapas and the assassination of the presidential candidate Colossio are good examples to illustrate that the climate for foreign investors in Mexico still is far from being ideal. But there is more than just that to the Mexican case. Simultaneously to its economic reform program the country embarked on an ambitious political reform program. The dismantling of the semi-authoritarian system established by the ruling revolutionary party and the continuing process of democratization coincide with the economic reform program. It is interesting to analyze if the process of democratization that culminated in the election of Vincente Fox, the first president since 71 years that is not a member of the PRI, affects the level of political risk and the attractiveness for foreign investors. The case study in Chapter 5 pictures the evolution of political risks for foreign investors in Mexico for the period between 1982 and 2003 and identifies the major risks that international investors presently face in the country. It furthermore analyzes how Mexico succeeded in quickly mitigating high levels of risks and regaining the confidence of international investors.

1.2 Concept and Methodology
The second chapter starts with a brief overview of basic concepts in investment theory. Then a brief overview over the modeling of investment decisions under certainty and uncertainty is given where the main focus is on models where investment projects are assumed to be irreversible and firms have the possibility to delay investment decisions. The chapter continues with a brief review of the theory of international capital flows. This part provides definitions and a brief review of the theoretical and empirical evidence on potential determinants of FDI. Furthermore the chapter reviews existing models of political risk and draws conclusion from the models of investment under uncertainty. It closes with a synthesis of the presented models and a
summary of the main hypotheses. Chapter 3 turns to an analysis of the factors that create political risks in host countries and discusses the determinants of risk for foreign investors. At the same time it offers a basic theoretical framework for the analysis of political risk by referring to the theoretical contributions of New Institutional Economics. The second part of Chapter 3 deals with the problem of empirical measurement of political risk and analyzes different potential risk mitigating strategies for host countries. Chapter 4 presents an econometric analysis of FDI flows to Latin American countries. The influence of different political risk factors on FDI is assessed by using a panel of Latin American countries for the period 1982-1997. Chapter 5 analyzes political risk in Mexico for the period between 1984 and 2003 and gives additional qualitative evidence on the relevance of political risk for Latin American countries. Chapter 6 summarizes the main findings of the study, and presents a conclusion as well as an outlook for Latin American countries.