

How the J Curve can help companies to understand and manage political risk*

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The J Curve is a framework that analyzes political development within twelve countries which have economic growth opportunities, but pose vastly different kinds of challenges for policy makers and businesses that are expanding globally. Each nation's relative position on the curve is dynamic, subject to multiple variables and pressure points that determine its political and economic openness.

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The J Curve can help companies to evaluate the impact of political development on important business factors such as investment timing, opportunity assessment, operating stability, supply chain stability, and contractual breaches.

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In today's global business environment, management of political risk is central to corporate strategy and understanding where a country sits on the J Curve is a crucial first step to making better decisions about how, when, and where to invest internationally. Incorporating political risk assessment into the business decision process does not have to be a complex or daunting task. Learn the five key steps companies can take.

What is the J Curve?

The J Curve: A New Way to Understand Why Nations Rise and Fall, by Ian Bremmer, offers a new framework with which to answer the following questions: How can we better understand the natural processes that erode the power of authoritarian regimes and nourish open governance? How can the international community harness the energies of globalization to help these states manage their transitions toward greater harmony with the world around them? As global markets become increasingly linked, foreign policy begins to directly affect business interests locally and globally. The answers to these questions will not only help policy makers create more effective foreign policies; they will help business leaders better realize the benefits of globalization while managing their international risk exposure.

Why is the J Curve important for businesses?

Corporations are now innovating away from the traditional multinational business model of vertical integration and investment in predominantly developed and stable states. This new corporate structure—in which companies outsource or offshore plants and personnel while keeping research, development, and design in their home base of operations—is rapidly giving way to a truly global production model. As a direct consequence, a growing number of companies are exposed to a wider variety of political risks in many more places than ever before. In short, the business value chain is significantly longer and more complex and exposed to increased risk and variability. Moreover, the rate of change continues to accelerate, so today's risks are taking new shapes and posing new threats and opportunities with each new day.

The J Curve offers business leaders with varying risk tolerances and investment time horizons a new framework with which to assess their companies' international opportunities and develop a sounder political risk management strategy. This analysis is increasingly critical, because part of what makes emerging markets so attractive—pent-up demand in a country opening to foreign trade, investment, and cultural influence—is also what makes them unstable. A country's present and future position on the J Curve provides companies a new way of evaluating the relative attractiveness of individual markets, political risks to transnational supply chains, and the suitability of individual governments as commercial partners.

How the J Curve works

Imagine a graph on which the vertical axis measures stability and the horizontal axis measures political and economic openness, both to the outside world and within the state's borders. Each nation whose level of stability and openness we want to measure appears as a data point on the graph. These data points, representing a cross-section of countries, produce a "J" shape. Nations to the left of the dip in the J are less open; nations to the right are more open. Nations higher on the graph are more stable; those that are lower are less stable.

In general, the stability of countries on the left side of the J Curve depends on individual leaders or a small community of elites. These states remain stable in large part because their governments restrict peoples' access to ideas and information. The stability of states on the right side of the curve depends on institutions—parliaments independent of the executive, judiciaries independent of both, and the interest groups that help ensure that government is responsive to demand for change. These states are able to withstand internal conflicts because their citizens (and international investors) know that political and social problems within them will be peacefully resolved by political institutions, and that the electorate will broadly accept the resolution as legitimate. But each nation's relative position on the curve is dynamic, subject to multiple variables and pressure points.

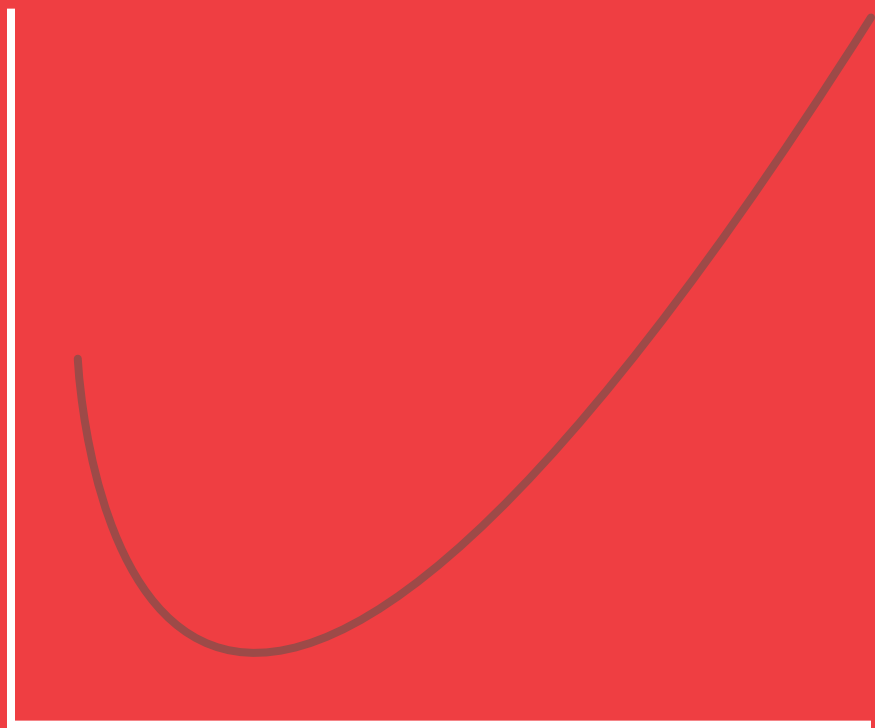
The shape of the J Curve reveals that passage from the left to the right side requires a drop into a valley that separates them. For a nation that is “stable because it is closed” to become “stable because it is open,” it must survive a period of potentially dangerous instability. There are no shortcuts, because authoritarian elites cannot be quickly replaced with institutions whose legitimacy is widely accepted. In other words, North Korea’s Kim Jong-Il cannot be as easily replaced as South Korea’s president. Some of these states, like apartheid-era South Africa, survive that journey. Others, like Yugoslavia or the Soviet Union, do not. China is the most interesting current case of a country on the cusp of the transition from the left to the right side of the curve, and thus receives special attention in the book. While nations will find the transition treacherous, multinational corporations can adopt methods to mitigate the adverse business consequences.

The J Curve analyzes political development within North Korea, Cuba, Saddam Hussein’s Iraq, Iran, Saudi Arabia, Russia, South Africa, Yugoslavia, Turkey, Israel, India, and China. These countries have economic growth opportunities but pose vastly different kinds of challenges for policy makers and businesses that are expanding globally

The J Curve looks at North Korea, Cuba, Saddam Hussein’s Iraq, Iran, Saudi Arabia, Russia, South Africa, Yugoslavia, Turkey, Israel, India, and China.

Data points, which represent a cross-section of countries, produce a “J” shape.

stability



openness

Understanding & managing political risk

Political risk factors impact investment timing decisions

Even before Goldman Sachs estimated that the largest emerging economies would outpace G7 growth over the next 40 years, corporations were rushing to invest in China and India. Lower production costs make the two nations more or less equally attractive in the eyes of many investors. Yet, the J Curve reveals important differences in the quality of their near- and long-term investment environments.

A company debating expansion or initial entry into a new country will want to consider how the country's position on the curve influences the scope and timing of an investment. Consider, for example, a diversified telecommunications and technology company that both manufactures equipment and operates telecommunications services. The company is simultaneously considering market entry and new manufacturing locations in China and India and needs to compare the true production costs of each.

India established itself on the right side of the J Curve on August 15, 1947, when Jawaharlal Nehru set the newly independent country on a path toward multiparty democracy. This defining political choice has provided the nation (in which 35 different languages are spoken by at least one million people each and ethnic and caste divisions remain) with political stability that has stood the test of time. But Nehru also charted a course toward a model of development where economic controls and planning are concentrated in the central government. Over time, this highly centralized system was vulnerable to corruption and created a lack of autonomy at the state level. By contrast, China's more autocratic system assures investors a level of commitment and efficiency that India cannot.

A key decision factor for the telecommunications company in choosing a country in which to establish operations is the country's ability to assist (or at least not impede) infrastructure development. China, with its relatively efficient and consistent government, might seem to be the obvious choice over India. However, social and political tensions are rising as the country opens itself to foreign influences, and the telecommunications industry is the main conduit for the introduction of these ideas. If the Chinese government were to clamp down on telecommunications providers as the country went through its transition, such a move would detract from China's attractiveness for infrastructure investment.

Another key decision point is the country's policies, regulations, and enforcement mechanisms regarding intellectual property rights. China's poor reputation on intellectual property protection would suggest that the country would be unattractive to a manufacturer producing high technology, patented telecommunications devices and components. These issues pose less of a challenge in India. However, as India's standard of living grows, the costs of producing goods and services there rises. The cost of producing labor intensive, low value added goods in China is also increasing, but the increase is marginal by contrast with India. At the same time, China's entry into the WTO in 2001 put pressure on the country to heighten its enforcement of standards of intellectual property rights. China is likely to be a more cost effective destination for manufacturing than India in the longer term, with comparable intellectual property protection. These situations should cause companies to reassess their approaches to capital allocation, selection of business partners, and even their fundamental business model.

Evaluating the path to “openness” allows companies to assess the stability of the business environment

Although multinational corporations cannot change the politics of a given nation, they can certainly be prepared and establish contingency plans to protect investments. The J Curve reveals why China faces greater long-term political stability challenges than India does. China's long-term challenges are significantly influenced by its historical lack of political and social “openness,” a measure of the extent to which a nation is open to the free flow of people, ideas, information, goods, and services across both internal and external borders. A lack of openness may not produce market-moving instability in the short run, but, over time, pressure for change builds within a closed system. The subsequent instability can generate sudden and catastrophic results, such as widespread social protests and reactionary government crackdowns on liberalizing influences.

China's authoritarian political system has opened the country to enormous amounts of foreign investment. But economic dynamism and the growth of a middle class increases public demand for political reform. Durable foreign trade ties, including WTO membership, force reform of Chinese commercial law and greater regulatory consultation with Chinese consumers. They also give the central government incentives to respect international safety and environmental standards. At the same time, more and more Chinese citizens are gaining access to information and communications technology that allows them to coordinate their interests independent of state control. These trends create tension with the more closed elements of China's society. China will face difficulties shifting from the left to the right side of the curve without transitioning through a destabilizing dip.

World leaders, including business leaders, can help raise China's entire curve, and accordingly diminish the risks, by advocating for an effective WTO process and cautious reforms. Companies doing business in and with China will need to develop contingency plans and techniques to cope with this changing environment. Longer-term investors in India, by contrast, are much less likely to suffer exposure to such risks.

China cannot increase openness without decreasing stability.

Evaluating political risk factors helps with assessing new market opportunities

The tensions between Iran's ruling religious conservatives and its young, more modernist population underline the demographic tensions that matter for long-term investors. Ayatollah Ruholla Khomeini established the Islamic Republic in 1979 on two principles: political rejection of the Shah's oppression and assertion of Iran's identity as the beating heart of an Islamic revolution. He sought to purge the country of what he considered the impurities of the Shah's US-supported regime by banning satellite dishes, Western music, and alcohol—closing it, as far as possible, to outside influence. A US economic embargo further isolated the country.

Iran has since undergone a significant demographic shift. Today, some 70 percent of Iranians are not old enough to remember the revolution, much less the Shah's repression. Conservative social restrictions have become increasingly unpopular. In 1997 these social pressures led to the election of Mohammad Khatami, who won the presidency on a platform that emphasized rule of law and the restoration of civil society at the expense of the ruling clerics. Much of Khatami's domestic support came from Iran's post-revolutionary generation who, thanks to the partial opening of the country, enjoyed greater access to Western trends, ideas, and popular culture.

In response, the clerical establishment frustrated Khatami's most ambitious attempts to open Iran to global markets. Over the last several years, the mullahs' ability to manipulate the country's electoral process and to bar would-be reformers from access to political influence has consolidated conservative control of government and further isolated Iran. Nearly thirty years of social and economic isolation have left the country with high levels of unemployment and pent-up demand for Western goods and services. Automotive companies, in particular, are looking to Iran as a growth market.

Investors hoping to profit from this demand—and Iran’s energy wealth—have much at stake in the country’s latent domestic conflict. Will rising global oil prices and the revenues oil brings Iran’s government persuade the ruling elite that it can afford to resist the need to attract foreign investment? And, will Western policy, particularly around the nuclear issue, bolster the mullahs’ efforts to further isolate their country? Conversely, will wealthy Iranians be empowered to put renewed pressure on their government to reform? Will the playing field favor companies willing to ignore Iran’s politics and to invest on the government’s terms? The J Curve reveals that—imposed from without or within—Iran’s isolation cannot last forever. How long can Iran resist the energies of global change?

Evaluating political risk factors helps stabilize supply chains

As multinational corporations become more globally integrated, supply chains face a wider array of risks—both short and long term. Outsourcing has become “multi-sourcing,” as companies build portfolios of suppliers across several countries. Companies are also now establishing hubs for strategic activities in countries with supportive regulatory environments and deep reserves of talented, well-educated, high-skilled workers. A shock to one link in this lengthening chain can now disrupt production with unprecedented ease. Companies need to develop plans and practices to mitigate these risks and provide operational redundancies.

Politically and socially stable countries on either the right or left side of the curve are less likely to produce their own shocks. They are also able to respond effectively when external shocks such as geopolitical conflicts, embargoes, health crises, and labor unrest hit home. But stability in left- and right-side states is not created equal. The relative steepness of the left side of the curve underscores the point that relatively closed states can fall into dangerous political instability far more quickly than right-side states do, with obvious implications for investors exposed to the risks these countries generate.

A state's capacity to plan for and absorb shocks is vital for the companies exposed to risk within it. Over the next few years, reasonably stable left-side-of-the-curve, oil-producing states may be forced to absorb a number of shocks. Syria may face serious divisions within its ruling elite. Venezuela could experience a return to widespread labor unrest. A drop in the price of oil may drain the coffers of oil producers like Russia, Saudi Arabia, and Iran. Can the government in such a country mobilize resources during a crisis? Is critical infrastructure—electricity generation, roads, railways, and communications—well developed and protected by redundancies? How might a leadership transition influence the country? How likely are domestic unrest or an environmental catastrophe to undermine government protection of supply chains? The J Curve offers a framework with which to answer these questions.

Evaluating political risk factors protects against contractual breaches

Trust, security, and shared values are important qualities in any long-term relationship, no less so when the relationship is with a foreign government. But governments and foreign investors often rush headlong into dubious partnerships. To attract and retain foreign investment, some states offer incentives—expedited approval processes, tax breaks, and policy changes—to enhance their competitive advantages over their neighbors. But the J Curve illustrates why investors should look behind the curtain to determine how vulnerable these states—and investments in them—are to fundamental political risk.

The governments of countries that are prone to sudden changes in position on the J Curve often make poor long-term business partners. Simply put, a regime that attempts to quickly bolster stability via a sharp upward shift on the left side of the curve—by declaring martial law, for example—is more prone to breaking contractual promises, explicit or unspoken. Investors whose risk tolerance leads them into states that lack a durable legal infrastructure form relationships in such states at their peril. The Venezuelan government's bid to consolidate control of its energy sector offers one compelling example.

There are others. The events that followed the 1997–98 financial crisis in Indonesia—a relatively stable state—illustrate the perils of partnering with a government during a period of instability. Like many emerging markets, Indonesia has a poor track record of protecting the interests of private investors. Historically, foreign investors bypassed the state and sought out well-connected local business partners with seemingly substantial political capital. But the value of these relationships disappeared in the late 1990s with a change in national leadership.

By 1997, President Haji Mohamed Suharto’s grip on authoritarian control of his changing country was no longer sure. The Asian financial meltdown suddenly released accumulated social pressures and ousted the military dictator after 38 years in power. B.J. Habibie, Suharto’s vice president and close friend, replaced him. To consolidate his political position, Habibie launched a broad campaign against the rampant corruption that had plagued Suharto’s regime—an effort that included an audit of all private power contracts with the government. The audit agency found evidence of corruption, collusion, and nepotism in all 27 contracts, and voided all of them. The J Curve illustrates that the enormous resultant losses sustained by foreign investors were entirely predictable. Companies with the foresight to see these risks could have mitigated them by refusing preferential treatment in their contracts with Suharto’s regime, and by developing relationships with Habibie’s supporters that would have allowed them to renegotiate terms when he came to power.¹

Experienced investors faithfully perform due diligence on their private business partners. Investors often believe that with limited transparency they cannot apply the same scrutiny to the foreign countries in which they invest. In fact, it is possible to perform reasonable due diligence in emerging markets.

Although business executives realize that cultural and economic conditions have a profound impact on strategic and operational decisions, many companies tend to be less effective than they should in acquiring and leveraging knowledge of the political environment to inform strategic imperatives.

1 Witold J. Henisz and Bennet A. Zelner, “Political Risk Management: A Strategic Perspective,” in *International Political Risk Management: The Brave New World*, Thomas Moran, ed. The World Bank (2004), pp 154–170.

Steps to assess & manage political risk

Executives of global companies are clearly challenged regarding how best to assess political risk, factor it into their investment decisions, and use the knowledge to help improve global business performance. But in today's global business environment, management of political risk is central to corporate strategy, and understanding where a country sits on the J Curve is a crucial first step to making better decisions about how, when, and where to invest internationally.

There are a number of steps companies can take to support the development of a systematic approach to political risk management.

- 1. Start at the top.** Take responsibility for setting comprehensive guidelines, goals, expectations, and measures for political risk at the senior management and board levels. A formal structure for risk assessment should be factored into decision making about global strategy and ongoing operations.
- 2. Manage political risk to improve performance.** Politics can create opportunity just as often as it introduces risk. Executives should keep their eyes open to both.
- 3. Communicate political risk to optimize decision making.** Make the organization aware of risks at every level of the organization.
- 4. Assess risks before taking action to deliver value.** Use multiple sources to create a balanced, objective picture of the risks at hand. Use these scenarios to consider how potential outcomes could affect investments when making market entry, growth, and exit decisions.
- 5. Use systematic political risk management to protect investments.** Begin actively monitoring political risk before the company makes an investment and maintain awareness of the political environment to support ongoing operations.

Five steps to more effective political risk management:

1. Start at the top
2. Manage risk
3. Communicate risk
4. Assess risks
5. Stay aware

Long-term sustainable success internationally depends in good part on a company's ability to grasp the implications of political risk and apply them to business risk. This means moving beyond avoidance and anxiety about political risk toward a structured way of seeing it as a precursor of both economic risk and opportunity. By embedding political risk considerations in normal business processes, companies enable management to make better decisions regarding global expansion, sourcing, branding, intellectual property protection, community and government relations, operational structures, and other business issues that arise in complex international markets.

Incorporating political risk assessment into the business decision process does not have to be a complex or daunting task. For example, corporate business development teams making market entry, exit, or ongoing capital allocation decisions can use political risk scenario planning to help predict how the complex interrelationships between actors, trends, and uncertainties as outlined in *The J Curve* will impact an investment over time.

Economic capital analysis is another approach that allows risk managers to assess the probability and impact of political risks across their portfolios and factor quantitative assumptions into decision making to reflect the economic impact of risk. Using this method, companies can map their political risks, connect them to business risks, and evaluate the residual risks under different mitigation scenarios.

But political risk management generates the greatest value when companies consider it all along the value chain, from shifts in the labor environment that impact companies' ability to hire and retain workers (such as changes to the social welfare system), to laws that constrain or broaden the ability to engage in certain research and development activities, to customs regulations that speed or impede the distribution of goods. A senior executive's ability to gather objective information about political risks and communicate it effectively throughout the organization plays a key role in building an effective, company-wide risk management strategy.

To learn more about how your organization can benefit from political risk management, download our latest thought leadership paper *How managing political risk improves global business performance*, at www.pwc.com/politicalrisk.

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