

# Development In Business Simulation & Experiential Exercises, Volume 18, 1991

## POLITICAL RISK: A SIMULATION FOR BUSINESS PRACTITIONERS

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### ABSTRACT

The International Political Risk simulation is designed to introduce practitioners to the topic of political risk and its role in international business. International business people must not only evaluate market variables (target markets, distribution costs, promotion costs, etc.) but must also have a thorough grasp of the political risk dimensions that may influence their international strategy. The simulation is structured to emphasize political risk as a strategy variable for international expansion. A decision-making environment of uncertainty is used as practitioners gather, analyze, and formulate an international expansion strategy, based on limited information and resources. The simulation is a unique way to introduce the topic of political risk as an international strategy variable in a seminar setting. The game also gives practitioners a “feel” for decision-making in an international environment.

### INTRODUCTION

The political risk simulation is a small group decision-making exercise developed for use in corporate settings. Groups are formed to emulate the data gathering and decision-making processes concerning international expansion of a company under limited time, information, and financial resources. Once in the small group environment, leaders are chosen to organize the decision process. Each group is given a general end limited description of four countries along with \$4,000 that can be used to purchase information concerning the political risk climate of the countries. After the information has been gathered and analyzed, the groups must choose among the four countries a target for a foreign direct investment. The class as a whole then has the opportunity to evaluate and compare the expansion strategies of each of the groups and to analyze the experience.

### THE STRUCTURE OF THE GAME

The key to the success of the simulation is the director’s thorough understanding of the objectives, structure, and procedures that are outlined. The director Should stress the fact that this is an exercise designed to give the participants a ‘general feeling’ of what it would be like to assess the feasibility of locating a plant in a foreign host country, under the constraint; of limited time and resources. The director of the simulation should explain to the class that tie simulation is intended to:

- a. create an experience which allows the group to explore the concept of political risk.
- b. give participants the experience of working in a small decision-making group.

### Political Risk Lecture

Before the simulation begins, the director will need to become familiar with the explanation of what political risk encompasses (see Appendix A). This 15-to 20-minute introduction to political risk can be lengthened or shortened depending on the director’s preferences. The political risk lecture that accompanies the simulation is structured so that the director can introduce the concept of political risk and explain its moderating role on the international decision making process. Key topics presented in the lecture are: (1) a general introduction to the importance of evaluating political risk, (2) when it is appropriate to analyze the political risk climate of a country, (3) an explanation of the differences between political instability and political risk, and (4) the role of information in the formulation of international risk strategy. Assigned readings could enhance the simulation (see the References).

### Group Selection

After introducing political risk to the participants, the director should:

- a. divide the participants into groups of four or five.
- b. explain that each group will make a decision concerning the location of a new plant in a foreign country.
- c. explain that the simulation is based on the premise that each group will have limited resources time, information, and money. The limitations on each group’s resources come in the following form: 30 minutes of decision making time and \$4,000 per country to purchase specific information about the country. \$4,000 is not sufficient to purchase all of the available information about each country.
- d. give each group a brief profile describing the four countries they can invest in; Alpha, Omega, Tau, and Beta (see Exhibit B).
- e. along with the country profiles, the groups will receive a list of six information categories, from which they can purchase up to \$4,000 worth of information (thus the limitations of information and financial resources). The information that can be purchased is shown in Exhibit C.

The director should explain to each group that the first decision to be made is to appoint a “political risk officer.” Appointment of a “political risk officer” simulates the situation that occurs in most companies. A political risk analyst is not usually a political risk expert hired to provide information and analysis to general management; rather, an employee without formal training or expertise in that area is simply chosen to perform that function. Although the larger multinational companies will employ a skilled political risk specialist, in most companies the person is appointed from within the existing organization’s personnel (Kobrin 1982). The role of the political risk officer is to act as a repository of

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political risk information and to facilitate the decision-making process.

The second decision that must be made by the group concerns which of the six information categories to purchase:

- a. the purchase decision should be based on the group's analysis of which of the six information categories will provide the most helpful information for assessing the political risk climate of a particular country.
- b. after all of the information has been gathered and analyzed, the group must come to some agreement on which one of the four countries is the most appropriate location for their new plant.

## Time Frame for the Simulation

- A. General explanation of the simulation (5 minutes).
- B. Brief lecture on political risk (1525 minutes).
- C. Divide the participants into groups:
  1. explain the purpose of the groups.
  2. explain the information gathering process.
  3. distribute the country profiles and information categories (10 minutes).
- D. Send the groups to designated areas to make preliminary decisions concerning:
  1. appointment if a political risk officer.
  2. which countries to seek more information about.
  3. which of the six information categories to purchase (10 minutes).
- E. The political risk officer should proceed to the information center and purchase the desired information (5 minutes).
- F. Political risk officers return to designated group areas with purchased information. Assessment of the political risk climate and the final decision on the country in which to locate a company plant should occur (20 minutes).
- G. All of the groups should return to the general meeting room for discussion of the simulation. Discussion should center around the group decision process and why each country and category of information was chosen (153C minutes).

## Pricing Structure

Each group is allocated \$4,000 per country to buy additional information to supplement the country profiles. The director should note that this is not enough money to buy all of the information categories; this simulates the limited information most companies gather about potential hosts for foreign direct investment. The director should stress to the participants that the capital allocations for one country cannot be applied to another country.

### PRICE SHEET FOR INFORMATION CATEGORIES

Economic Information	\$ 500.00
Political Information	1,500.00
Expropriation History	2,000.00
Social Tension	1,500.00
Type of Government	500.00
Investment Climate	<u>1,000.00</u>
	\$7,000.00

## Administrative Matters Space

There should be enough rooms to accommodate the number of individual groups in the political risk game. If possible, the rooms should be centrally located. If a central locale can be established, this will speed up the process of moving back and forth from the small group discussion areas to the cannot area during the simulation.

## Number of Participants

There are no firm limitations on the number of participants that the simulation can accommodate. However if the groups are larger than five people, portion of the group interaction process may be reducing the desired results of the simulation.

## Materials

The director should ensure that all of the materials required to play the game are available at the appropriate time and place. The director will have the added responsibility of studying and/or customizing the lecture on political risk (See Exhibit A). In addition, the following materials are required:

- a. Director's Manual includes the instructions for running the simulation, the lecture on political risk, the country profiles, and the six information categories.
- b. The director will need one set of four country profiles per group (5 groups 5-sets of four country profiles). This general information is provided, free, to each group (See Exhibit B).
- c. The director will need one complete set of purchasable information categories per group (5 groups = 5 sets of six categories: each group may want category 1, so you would need 5 copies of number 1, while 1 group may want category 2. The director needs to be prepared for the maximum number of purchases per category, which depends on the number of groups.) (See Exhibit C)
- d. A watch or clock for keeping track of the progress of the simulation.
- e. A chalk board with chalk.

## CONCLUSION

"Political Risk" is an important component of international marketing strategy, but a difficult concept to grasp in the abstract. Domestic or "home country" strategy is based on an understanding of the Situation variables that may influence the introduction of a product into a new market. These situational variables are the foundation for the formulation of international Management strategies. The international business practitioner must also be aware of other key variables that be use analyzed and incorporated into their strategy evaluation criteria i.e., the impact of culture, political risk. By simulating the manager's decision-making environment dealing with the variable of political risk, this game provides:

- a. a method of introducing political risk as an international strategy variable, at an Intuitive level, which is much less abstract than a lecture or case study approach.
- It a realistic simulation of the environment in which international business decisions must be

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Made. This environment is characterized by insufficient information about key strategy variables that may influence international marketing opportunities, and limited time in which to make a decision: both of these characteristics are reflected in the simulation.

- c. a small group decision-making environment, requiring exchange of ideas and understanding of one of the variables that will impact the international business decision making process.

## APPENDIX A DISCUSSION OF POLITICAL RISK

### Corporate Concern with Political Risk

Although business people have always had to concern themselves with political actions that might affect their business, corporate concern with the political risks of doing business abroad has increased significantly in recent years. This concern certainly seems warranted. Since 1970 foreign direct investments have been expropriated in 69 developing countries. Dramatic events such as the revolution in Iran, the Sandinista revolution in Nicaragua, and the military action of the United States in Panama have attracted widespread attention to political risk.

The heightened concern with political risk has been reflected in an outpouring of articles in the business press, a great deal of academic attention, and the establishment of a number of consulting firms offering to help managers to come to grips with political risks abroad. It is both reasonable and prudent for companies to make political risk analysis a part of their foreign investment decision process.

### When is Political Risk Analysis Appropriate?

We can imagine an assessment of political risks as being prompted by any of several scenarios. Imagine, for example, that we are a small company, and have been exporting a product over a number of years to Freelandia, a small country in Latin America. We have done well. So well, in fact, we are planning to build a plant in Freelandia to manufacture our products locally. We plan to both sell our products in the local Freelandia market and export from Freelandia to all of our other Latin American customers. Before making this investment, a political risk assessment is called for. Why? As an exporter to Freelandia, our political risks are relatively low. Assuming at the very worst a confiscation of an entire shipment, damages to the company may remain relatively small. A capital investment, however, is hostage to the will of the government of Freelandia. Once our costs are sunk, we can do very little to move them elsewhere.

### Political Instability and Political Risk

Political risk is commonly equated with political instability: aren't changes in foreign governments the source of political risk? Certainly that is the lesson from Iran.

Other cases, however, are not so clear cut. For example, the Marxist Sandinistas after taking over in Nicaragua expropriated foreign investments in only three sectors of the economy: banana, insurance, and mining sectors. Other than that, the Sandinistas have expropriated only selected individual foreign

Investments that have proved particularly irksome to them for one reason or another

The evidence, then, is somewhat mixed. It seems fairly clear, however, that political instability that is, a change in government isn't necessarily the equivalent of political risk. What the businessperson must be worried about is changes in policy that affect the business environment in which he/she operates.

### The Role of Information

To make a political risk assessment of a target country, either prior to a foreign investment or as a result of a change in government that might entail an increase in the risk of political policy change, we need information.

Unless the target country is quite closely related to the home country both culturally and geographically, as is Canada, the information we wish to obtain about the political situation may be either unobtainable under any reasonable conditions or expensive (either financially or in time required) to obtain.

### Simulating Decisions About Political Risk

We hope to accomplish two goals by having you participate in this simulation. On the one hand, we want to explore with you what we call the uncertainty factors of political risk analysis. By uncertainty factors we mean the following:

- a. can you determine, with a reasonable amount of certainty, that the information you have obtained on the political situation in a target country is relevant and will help you make a reasonable forecast of the political climate; and
- b. can you determine, with a reasonable amount of certainty, that the information you have obtained on the target country is correct?

At the same time, our second goal is to demonstrate what we call the cost factor of obtaining information about the political situation in a foreign country.

## APPENDIX B PROVIDED COUNTRY PROFILES

### COUNTRY PROFILE ALPHA

In recent years the country's economy has thrived. The typical Alphan lifestyle has been transformed to a blend of the past and present. But, tradition still dominates; and life in Alpha follows the seasons as it has done for thousands of years. One will find this in the cuisine, style of dress and even in the literature.

### General Facts

- a. the total land area of Alpha is only slightly smaller than California.
- b. principal industries are: trade and services, manufacturing, mining, agriculture, forestry and fishing.
- c. imports: petroleum, liquefied natural gas, coal.
- d. before doing business, the Alphans like to know the people they are doing business with.

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- e. Alphans admire sincerity and they are generally unnerved by the directness and bluntness common in U.S. business relations.
- f. Alphans think tradition is important; however, they have shown an aptitude for assimilation and the adoption of foreign ideas and techniques.

## COUNTRY PROFILE-TAU

The territory of Tau extends almost 650 miles from north to south and 700 miles from east to west. In the majority of the western states and the central part of the six northern states the landscape is mostly made up of high plains areas and surrounding broad valleys. Tau has a tropical climate with relatively high temperatures throughout its wet and dry seasons.

Tau has a varied cultural heritage with influences from the local history and influence from western European and Middle Eastern cultures. English is the official language of Tan, but indigenous tongues also exist.

### General Facts

- a. Tau's rural population is very large, with most of the people involved in agriculture.
- b. because of high unemployment there is an approximate 8% annual growth rate in the urban population.
- c. men outnumber women in the labor force by a factor of two to one.
- d. principal industries are: petroleum, agriculture, manufacturing, mining and quarrying.
- e. principal exports are: food stuffs, minerals, oil.
- f. most foreign business people will be dealing with the upper class of the Tauan population.
- g. a firm may have to get used to the 'take it slow' attitude and make many successive contacts before any business can be transacted.
- h. the Tau people are used to dealing with English traditions in business; one should be professional in manner, well dressed and honor given titles.

## COUNTRY PROFILE-BETA

Beta is an arid coastal strip 10 to 100 miles wide. This narrow landmass supports much of the country's population with the aid of irrigation. The country's main population base is in two major cities. These cities are approximately eight miles apart. The country is bounded by a large mountain range and highlands. Beta is a country rich in tradition, with the Betan society holding a deep sense of honor to family members.

### General Facts

- a. Principal exports are: fishmeal, cotton, sugar, coffee, copper, crude petroleum.
- b. Principal imports are: foodstuffs, machinery, transport equipment, iron, steel, pharmaceuticals.
- c. The bulk of the Betan population is located at the foot of the social ladder.
- d. At the top of the social ladder is a small, elite group of wealthy and influential people.
- e. The industries in Beta are state controlled.
- f. The state has title to all mineral rights in the country.

## COUNTRY PROFILE OMEGA

Central Omega has wide plateaus, wit) hot dry summers and cool winters. High mountains ring the interior of the country. Population density is mostly concentrated in the urban areas. The relatively fast population growth of Omega has given the country an increasingly young, mobile population. Social class stratification seems to be determined by whether you live in the city or the country. The cities are home to the elite and represent the modern, richer sector of the economy. For most Omegans, social life revolves around the family. Family loyalty overrides most other obligations, and one's honor and dignity are traditionally tied to the family.

### General Facts

- a. The upper class has high status, political influence, a commercial background, and is very westernized.
- b. Members of the upper class speak at least one foreign language, and are well acquainted with details of Europe.
- c. Main exports: clothing, textiles & fabrics, oil, machinery, tobacco.
- d. Main imports: crude oil, chemicals, iron and steel, cereals.
- e. Industrial growth can be attributed to a great increase in exports.

## APPENDIX C PURCHASED DECISION INFORMATION ALPHA

### POLITICAL INFORMATION

- a. All foreign corporations with a fixed place of business in Alpha are subject to the Alphan corporate tax law.
- b. After the recent death of a major leader, the government of Alpha has remained relatively stable.
- c. Key policy goals are tax reform, market liberalization and a high country profile in international affairs.
- d. Tax reform will be major issue in the upcoming year.
- e. Agricultural imports have been liberalized.
- f. A major leader in the business community was indicted on charges of foreign exchange abuses and bribery.

### EXPROPRIATION

No expropriations since 1980.

### ECONOMIC INFORMATION

- a. the GNP growth rate was 4.3 percent over the previous year.
- b. average annual growth rate of the gross domestic product (GDP) = 3.5 percent.
- c. consumer price index (total increase over the past four years) = 12 percent.
- d. the discount rate at the central bank = 5.0 percent.

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## SOCIAL TENSIONS

There has been no major social tensions in the last ten years. The only stress on the Alphan culture has come from its youth. The 'younger generation' has wanted to modernize certain cultural aspects of the Alphan way of life faster than family and political leaders deem proper.

## TYPE OF GOVERNMENT

Under the premise that sovereignty rests with the people, a constitutional monarchy under a multiparty parliamentary system exists in Alpha. The judiciary branch is completely independent of the rest of the formal political system. Other than the death of a major leader, the political system in Alpha has been stable for 35 years.

## INVESTMENT CLIMATE

Over the last five years, it has been increasingly difficult to prevent foreign investment in Alpha. Alphan firms are themselves eager to bolster their positions. Total income from overall U.S. direct investment in Alpha increased by 100 percent in 1986 over the 1985 figures with income up in all sectors. The rate of return for U.S. direct investment (income over book value) in Alpha was 28.7 percent overall. The Alphan government is very receptive to businesses locating in the country; the opposite is true about imports that could damage local manufacturing operations.

## PURCHASED DECISION INFORMATION

### TAU

## POLITICAL INFORMATION

Tau's past has been rocked by constitutional interference by Britain, civil war, and warring political factions. The most important event in recent history was in August 1985, when a military leader, end head of Tau's eighty thousand-man army, overthrew the government. The new government combines military and civilian advisors. The new military government announced intentions to transfer all power to an elected civilian government by 1992.

## EXPROPRIATION INFORMATION

None since 1980.

## ECONOMIC INFORMATION

- average annual growth rate for GDP 3.4 percent.
- consumer price index (total increase over the past four years) 124 percent.
- discount rate at the central bank = 8 percent.
- d. unemployment rate 9 percent.

## SOCIAL TENSIONS

Religious rivalries appear to have intensified, especially in the northern part of the country. This factor, combined with the likelihood of unfulfilled worker's expectations in the aftermath of a discontinued wage freeze, could easily spark civil unrest. Many observers believe that the new government could head off many of these potential problems,

## TYPE OF GOVERNMENT

At the present time Tau has a military government with civilian advisors. An elected government is promised in 1992. All political parties have been banned since 1984~ prior to this there were six active political parties in Tan. The judicial system has been weakened by the military regime, but the framework of a Supreme Court with 15 justices and a Federal Court of appeals is still in place.

## INVESTMENT CLIMATE

The government regards an increased level of foreign investment as a vital component of its strategic adjustment program and says it will gear policies toward improving the climate for foreign investment and developing specific legislative provisions. The government is committed to making the process of investment and the repatriation of income simpler and quicker under the new industrial Plan. There has been little foreign investment in Tau since the weakening of oil prices in 1982 led to tighter import controls and a domestic economic recession.

## PURCHASED DECISION INFORMATION

### OMEGA

## POLITICAL INFORMATION

The Omegan political system is based on a highly competitive multiparty system. Four fifths of the electorate support one of two main political parties. The balance of votes is shared by several minor parties that have pursued extremist objectives of the left and right. Neither of the two major parties has been able to earn the electorate mandate outright and, hence, has had to rely on a marriage of convenience. Parties are forbidden to exert partisan influence on the civil service, the armed forces, and other defense organizations.

## EXPROPRIATION INFORMATION

None since 1980.

## ECONOMIC GROWTH

- GNP growth rate = 7.0 percent.
- GDP growth rate = 4.7 percent.
- consumer price index (total increase over the past four year) = 95 percent.
- d. unemployment rate = 16 percent.

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- e. discount rate at the central bank = 52 percent

## SOCIAL TENSIONS

Religious and ethnic tensions and active left and right extremists have caused endemic violence. Martial law, imposed in 1978, was lifted in 1984. The military formally transferred power to the government in 1983. Omega has been embroiled in disputes with two of its neighbors since 1974.

## TYPE OF GOVERNMENT

Until 1978 Omega had a civilian government. In 1980 there was a military coup that was legitimized, on a transitional basis, by national referendum in November 1982. Civilian government was restored following parliamentary elections in November 1983.

## INVESTMENT CLIMATE

One of the most important components of the new government's economic policy is the recognition of the need to improve the traditionally unfavorable environment for foreign investment. The government's current investment program has opened a number of fields to foreign investment, most notably banking, agriculture and mining. According to the U.S. Department of Commerce, the R.O.I. on U.S. direct investments averaged 17.7 percent in 1985, 13.8 percent in 1986, and 13.5 percent in 1987.

## PURCHASED DECISION INFORMATION BETA

## POLITICAL INFORMATION

Beta's governmental structure is a constitutional republic. There are five major political parties; the environment is complicated by having to deal with the Marxist left. Two Marxist terrorist groups have become stronger, expanding into the capital city, where they commit frequent bombings and assassinations of military and police officers and political leaders.

## EXPROPRIATION INFORMATION

In August 1985, petroleum contracts with Occidental, Oxy-Bridas, and Belco Petroleum were rescinded. Although the government later reached agreements with Occidental and Oxy-Bridas, this did not happen with Belco, who was expropriated. In 1986, Nestle was forced to sell its entire holdings to local shareholders.

## ECONOMIC INFORMATION

- a. GNP growth rate 8.5 percent.
- b. GDP growth rate = 3.4 percent.
- c. consumer price index (total increase over the past four years) = 1180 percent.
- d. rate of discount at the central bank = 60 percent.
- e. unemployment rate 9.2 percent.

## SOCIAL TENSIONS

General social tensions are being caused by the conflicts between the Marxist left wing and the government supporters. The overall economic climate is not helping to ease the problems of the people. The rising inflation rate is also causing a strain on the people of Beta.

## TYPE OF GOVERNMENT

The structure of the Betan government is a constitutional republic, composed of a president, two vice-presidents, and a council of ministers. Because of the challenges of the Marxist left, the government is slowly weakening.

## INVESTMENT CLIMATE

The rhetoric of the current administration has been consistently nationalistic, although the president of Beta emphasizes that foreign capital is welcome and needed in Beta, as long as it is channeled according to the country's stated development needs. Furthermore, the severe lack of investment in 1987, combined with the current balance of payment crisis, militate for a more encouraging environment for foreign investors, at least in target sectors.

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