English:

POL1005
Evaluating Political Risk

FINAL EXAM
5 December 2016
Trondheim

The exam includes two parts. The first part constitutes 1/3 of the final grade; the second part constitutes 2/3 of the final grade.

Provide short (e.g., one paragraph) descriptions for each of the following five terms:

- Obsolescing Bargaining Mechanism (OBM)
- G-Zero World
- Black Swan
- Expropriation
- Washington Consensus

II. *Answer the following essay question:*

Statoil is looking to invest in an emerging market. What sort of questions should the CEO be asking before s/he sinks any money? How might Statoil manage its political risk in this sort of market/context?

SENSORVEILEDNING

It is important that students provide an explicit and direct answer to the question being asked, and support that answer with citations/quotes from the course's required reading. The point of any exam is to test the candidate's grasp of the required reading. Hence it is important that the student engages the course texts in their response, while explicitly answering the questions or defining the terms.

- **Obsolescing bargaining mechanism**: Terms associated with Vernon (1971), and concerned with the bargaining relationship between markets and host governments. Explicitly defined as "…host governments will behave opportunistically once investments are sunk, but the scope for such opportunism should be constrained if checks and balances are in place. (Jakobsen 2012: 18-19; see also 70-71)
- **G-Zero world**. Reference to Bremmer and Roubinin (2011) article in *Foreign Affairs*. They argue that the world is no longer driven by the G2, G3, G8 or G20 any more. A G-0 world is "one in which no single country or bloc of countries has the political and economic leverage—or the will—to drive a truly international agenda. The result will be intensified conflict on the international stage over vitally important issues, such as international macroeconomic coordination, financial regulatory reform, trade policy, and climate change." (p.2)
- **Black swan** "'is an *outlier*, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an *extreme impact*. Third, in spite of its outlier status, human nature makes us concoct explications for its occurrence after the fact, making it explainable and predictable [*retrospective predictability*].' From Nassim Taleb's (2007) *The Black Swan*
- **Expropriation**: Defined in the lecture (Lecture 4, slide 2) as "governmental action to transfer the ownership of private…assets to the state, with or without compensation" (Jodice 1980: 177). Expropriations refers to when the government action is aimed at one or a few firms (while nationalization is aimed at the whole industry). Strong students will also list the diverse drivers of expropriation (e.g.: International politics; economic interdependence; economic drivers; ideology and domestic politics; nationalism) (Lecture 4, slides 8-13).
- **Washington Consensus**: a set of 10 policy prescriptions considered to constitute the "standard" reform package promoted for crisis-wracked developing countries by Washington, D.C.–based institutions such as the International Monetary Fund, World Bank, and the US Treasury Department. These prescriptions are: 1) budget discipline; 2) changes in state expenditure priorities; 3) tax reform; 4) financial liberalization; 5) market-based interest rate levels; 6) import liberalization; 7) open up to FDI; 8) privatization of SOEs; 9) deregulation; 10) property rights protection. (Lecture 6, slide 8)

ESSAY

> *Statoil is looking to invest in an emerging market. What sort of questions should the CEO be asking before s/he sinks any money? How might Statoil manage its political risk in this sort of market/context.*

This is a challenging question, in that students will need to recognize that Statoil invests in natural resources (oil/gas) and hence is less sensitive to many of the political risk variables as other types of MNCs. For this reason, there are, in effect, three parts to this question, and it is important that students formulate explicit answers to all three, and support them with examples and concepts from the course readings. In particular: how is FDI in primary goods (i.e. Statoil) different than investment in secondary and tertiary goods with respect to political risk; 2) what are the specific risks associated with investment in emerging markets; and 3) what sort of risk management strategy can Statoil pursue when investing in the natural resource sector in an emerging market?

Investments in Primary Goods
The risk calculation for investments in natural resources is different than it is for investments in the secondary and tertiary sector, as the investor does not have the luxury of choosing a different site. In Statoil's case, the oil/gas is located where it is, and the company will need to deal directly, and incorporate, the associated risks. Unlike investors in other goods/services, they cannot choose an alternative production site—one entailing less political risk. In short, Statoil is forced to invest in risky markets, given the nature of its business. The nature of risk calculations for different types of investments is discussed in Jakobsen (2012: 73-77 and 149-51).

Emerging Markets
The second question that needs to be addressed concerns the unique risk characteristics associated with investments in emerging markets. In Lecture 6, slide 18, Jakobsen lists a number of questions for any CEO to ask before s/he invests in emerging markets. This slide assumes that the investment is in, say, manufacturing, where firms can pick and choose between different investment sites. Still, the student should be familiar with these sort of questions as they are related to: a) regime type; b) ideology; c) political constraints; d) policy changes; e) elections and government make-up; and f) exogenous factors. These factors will clearly affect the risk premium associated with investment in these sites. For most MNCs, these would be relevant sorts of questions to ask, and may determine whether or not to invest in the country. For natural resource investments, however, these cannot deter the investment, but necessarily affect the underlying cost/benefit analysis (by adding the potential for additional costs, associated with these risks). As Statoil invests in natural resources, which are linked to territory: they cannot pick and choose between good nations and bad nations, but are drawn to the oil/gas beneath governments. Hence, Statoil's CEO will need to ask more traditional sorts of investment questions, and downplay political risk. E.g. a) how large are the expected reserves? what is cost of retrieving them? what does the distribution network look like? etc. (i.e. prioritize business decisions, not political decisions).

Risk mitigation/management
Because Statoil cannot play investment sites off one another, nor does it enjoy the luxury of ignoring an investment site because it is located in a politically risky context, it needs to consider the political risk at this particular site, and include it as a potential cost of production. The most common strategies for mitigating risk in these types of investment are: a) to diversity Statoil's risk portfolio internationally---balancing politically risky investments in this emerging market with more stable ones elsewhere; or sharing the risk with other actors by forming joint ventures. The strongest students will draw on the casual framework outlined in Figure 2.1 (Jakobsen 2012: 41) to design a risk-mitigation strategy that responds to the sources, actors, project specifics and expected effects.