
Rethinking Political Risk: History and Prospects

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Abstract:

Purpose: We study the research question on the theory, policy and prospects of political risk in international economics.

Design/Methodology/Approach: We follow a qualitative political economy analysis due to the interdisciplinary nature of the question, and not only to the difficulties of measuring it. Political risk can be an alteration or introduction of prohibitive taxation, embargoes, civil wars, disbanding of licences, abduction of personnel or their families, expropriation and any government actions that dissolve an agreement. The study introduces a few measurements of political risk.

Findings: The study indicates the difficulties the definitions have innately. It argues that the measurements are subjective and far from satisfactory in determining the extent of value of political risk. Moreover, the subjective models use quite different approaches to determine the risk. The problem is even more acute in the era of financialization, radical uncertainty and the digital revolution. Today, business planning is not only difficult (by its very nature long term) but also dominated by the operating framework of the global capital market shaped by the technocrats of independent central banks and fund managers who impose discipline on governments in their "market". The prospects for political risk seem to depend on democratization, especially of the finance.

Practical Implications: Since there is no theoretical model for the interpretation of political risk, it is not scientifically valid for businesses to predict it within the framework of (mainstream) economics alone. Hence, the limitation of quantitative answers. Strong interdisciplinary gnoseology with a focus on political analysis and social change are necessary as a complement to economics and institutions for rational business decisions.

Originality/Value: The paper contributes to the resurgent debate on the literature of economic planning.

Keywords: Global finance, MNC, public (country) risk, business planning, financialization.

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1. Introduction

Political or country risk is a term in international economic relations that has evolved significantly in the post-World War II era. During the period of the Bretton Woods agreement until its de facto collapse in 1971 (de jure 3/1973), there was no real discussion of it, since international transactions were mainly concerned with the current account balance for most countries that had signed the treaty in 1944.

However, the birth of the European Monetary System (EMS), as early as 1972 but officially since March 1979, replaced the Bretton Woods system of fixed but adjustable exchange rates within the European Economic Communities (EEC). The later started as a customs union (as early as 1958), with free international trade only within them, and a common wall of protectionism towards third countries.

However, there were no flows of direct or indirect investments at that time. With the establishment of the European Union (EU) since 1993 the European member countries follow the USA, Great Britain and Japan in liberalizing not only their trade of goods and services, but also their financial flows now, which allowed foreign direct investments (FDI) and those of portfolios. Therefore, mainly for the so-called Western societies since about the mid-1990s there has practically been a significant issue of political risk in international investment and/or speculation.

The political risk of an asset invested abroad refers to the probability of contingency related to political changes or instability in the destination country. Political risk is also known as country or even “geopolitical” risk. It could be originated from changes in types of jurisdictions relevant to foreign investments” (fixed or portfolios) property rights, such as the alteration of governments and legal frames or even the power of sovereignty, war fears and the like. Economic policy (taxes, spending) and regulations (labor or foreign market, intellectual royalties) can breed political risks of which some can be insured by specialized organizations.

Theoretically, if there is (1) free international trade in goods and services, (2) financial capital that can move between countries towards the highest returns, for a given risk (including political risk) and liquidity, and (3) knowledge that can be diffused internationally so that each country has access to new productive technologies, then there will be no reason for international income differences (real per capita income) to last long. However, the above fundamental economic conditions for alleviating income inequalities internationally are always subject to the constraints of the *political factor* of each country.

Moreover, as the recent experience of the wars in Europe and the Middle East and other international challenges shows, the *geopolitical* factor and the corresponding power relations (not only economic interests) determine the political risks. We will not address this factor in the paper, although we recognize the interdisciplinary nature of the subject.

The international financial crisis of the Asian tigers in 1997-’98 showed that currency risk can be rapidly transformed into country risk (with asset deflation) and therefore that business risk in international investment has many dimensions including politics (Eichengreen, 2017).

However, it is the global financial crisis 2007-09 (GFC-2008) and the resulting triggered Eurozone debt crisis of 2010-15 that confirmed to us the scientific validity of Minsky’s dictum “stability breeds instability” (Minsky, 1986) about the endogeneity of economic fluctuations and their contagion effects on countries or associations of countries (see, EU) that, in addition, are institutionally incomplete and therefore vulnerable to speculative attacks (e.g, 1992-93 EMS, 2010-15 EMU).

Then, the political risk (in addition to structural real core-periphery EU differences) that the institutional investors of the financial markets did not recognize in the euphoria of the first decade of the euro, then turned into a panic, firing their animal spirits when they realized the heterogeneity of the structure and especially the architectural imperfection of EMU, i.e., (1) the non-existent central budget to recycle surpluses; (2) member countries issuing bonded debt in a currency they do not control; (3) the ECB not having a lender of last resort authority.

What has it finally taught us? that even economically developed country associations such as the Eurozone may well face the painful consequences of defaulting states and financial systems, if they do not wisely include their political integration as the first goal in the hierarchy for their prosperity (De Grauwe, 2022).

In this paper we will show how difficult it is to define the concept of “political or country risk” in international economics.

In addition to the economic difficulty, modern political science, mainly founded in the 17th century Enlightenment (where God=0, Community=0, Individual=infinity, and rational⁵ behavior with logic and scientific observation) (Ziakas, 2010), downgrades “democracy” to the “elected monarchy” that we have in Western societies even today. However, the ancient Greeks discovered democracy as a “polis”, i.e. “another way of gathering, institutionally and functionally homologous to the truth”. Nevertheless, they considered *truth* what is not hidden from the light, does not decay or die; therefore it is a “how” and not a “what”; they found this before Christ in the imitation of the “way of governing everything” (Heraclitus) and after Christ in “loving freedom” (Yannaras, 2011). The word “politics” comes from the polis-democracy.

⁵*With criterion the principles of utilitarian efficiency, such as authority, contracts, the majority principle and in any case individual interest (on the basis of homo economicus) in the satisfaction of utilitarian needs only. The need “to make life true”, i.e., to imitate that which does not decay, does not die, well, it does not exist in 20th century modernity, much less in today’s postmodern nihilism (Yannaras, 2011).*

This Greek democracy “lived” in various degrees and extent in the Greek Ecumene, during the Hellenistic times, the Eastern Roman state, Byzantium and generally the “Greek Cosmosystem” (Contogeorgis, 2023) until 1833⁶ when the political regime of Western Europe, that of the “nation-state” with a constitution of “elective monarchy” was imposed in Greece. What is interesting for our work here is that “polis-republic” is the root of the word “politics”⁷ which meant the “sport of truth” of the citizens who participated in it.

Further, democracy in Greek means “*universal freedom*”, i.e. cumulative, individual, and social and political freedom, so only then do we speak of “full citizens” and not just “consumers” or even “homo economicus” (Contogeorgis, 2013). A citizen is one who “accepts the honor of participating in the sport of truth.” Politis (citizen), is the opposite of the concept of the “idiot” who for the Greeks was useless, since he is considered to be concerned only with the “own” of his house, i.e. he is interested in individual freedom only, as an end in itself (Yannaras, 2019).

In short, the meaning of the word “politics” for the Greeks is in the opposite of what is considered today in our Western societies, where it is expressed by the power of policy makers substituting society (which “idiates”) in the political system of the elected monarchy.

In this context, this paper examines the concept of political risk within the scope of the international economics and policy.

In the next section we justify the approach of the paper. In the third core section it is presented and also discussed the most important relevant literature, while the fourth ends with concluding remarks.

2. Research Methodology

Due to the nature of the research question (RQ) “on the theory, policy and prospects of political risk” we follow a qualitative political economy analysis. It is not only the lack of statistical data that leads us to this methodology.

In the post-2008 global financial crisis era and the financialization of economies (at least in the West), the need for business planning is now greater. Radical uncertainty and the digital revolution in the production and distribution of goods and services are dramatically reducing the time for sustainable investment. Especially if the latter are made abroad which adds to the political risk geopolitics with the revision of the

⁶The Greeks did not experience the Middle Ages, but the Ottoman occupation from 1453 to 1821.

⁷Πόλις=Δημοκρατία (=Democracy) → Πολίτης (=Citizen) → Πολιτική (=Policy or Politics) → Πολίτευμα (=Constitution or Polity) → Πολιτισμός (=Civilization= hierarchy of human needs).

international order of WW2 makes them even more risky. This logic is in the core of the financialization phenomenon which gradually dominates our economies and appears in four versions, 1/another form of capital accumulation, the financial one, which drives competition mainly in the financial markets; 2/shareholder value, which radically changes the management of companies, since managers and shareholders tend to have now the same interests; 3/every day finance, where the citizens should become investors; 4/change in the calculating practices of the credit rating agencies, dominated by the structured finance ratings approach (Mader *et al.*, 2020; Besedovsky, 2018; Van der Zwan, 2014; Epstein, 2005).

The relevant literature explains why is more profitable now short-run portfolio investments or even speculation with derivatives based on financial innovations' products and has been becoming legally possible by politics.

Nowadays, the very changing nature of our market-dominated countries with the interaction between politicians and firms in the global capital market, the analysis of political risk must be theoretical in principle (Krippner, 2011). That is why we chose the qualitative one of political economy.

3. Literature Review

Political risk, or country risk, is a difficult term to define. In general, it refers to the "risk of adverse consequences arising from political events" (Butler and Joaquin, 1998, p. 599). When a business invests in a foreign country, it runs the risk of the country "changing the rules of the game" on it.

The foreign country's political structure or policies may change, resulting in unexpected consequences for the investing firm. For example, a foreign government may alter its tax laws or tariffs, or it may decide to nationalize private assets -- actions which may cause significant losses to the company. Political stability/instability is therefore a factor that companies must take into consideration before making international investments. As Jean-Claude Cosset and Jean-Marc Suret (1995) note,

The considerable increase in the volume of world trade and foreign investment in recent decades has resulted in a need by foreigners for more information on the operating environment of those countries where they have made investments or exported. In addition to assessing economic and social developments, there is a need for assessing political conditions and risks (p. 303).

Though this conclusion may seem obvious, putting it into practice is far from an exact science like physics; however, the interdisciplinary view should be the normality in economics which belong to the social sciences and more specifically to the ontological among them, along with history and sociology (Karassis, 2010). In addition, today is more necessary taking into account geopolitical aspects of

international business. Firms must grapple with important questions such as: how does one measure political risk; and how accurate are these measurements?

In this paper, we will address these issues, seeking a more precise definition of the term “political risk.” This paper will also address the necessity of factoring political risk into international investment decisions while noting the problems firms might encounter when attempting to do so.

Political or geopolitical risk can be caused by a wide variety of events, some foreseeable and others not. As we move increasingly toward a global economy, assessing such risks is becoming ever more crucial for companies seeking to expand their businesses in new, overseas markets. Before risking a large sum of capital on a foreign investment, an investor should be aware of the political situation in that particular country.

If there is a high level of political instability in the region (e.g., it is a war zone or the leadership stands to be overthrown in a coup d'état), the political risk to the investor can be considerable. As Thomas Brewer notes (1983), “A country that is engaged, for example, in a protracted conflict with other nation-states is more likely to impose exchange controls for foreign policy reasons than is a neutral country” (p. 163).

War or civil strife can cause damage to the firm's in-country assets and a new leader there might enact unfavorable economic policies for that company or expropriate its assets altogether. During the Cold War, for example, nationalization and expropriation of assets by socialist or communist governments were of major concern to investors in the developing world (Howell, p. 4). If the country is relatively stable, on the other hand, its economic policies might consequently be relatively stable as well; an investment in that country should therefore be less risky.

When dealing with the social sciences (in this case, both political and economic sciences), it is often difficult to quantify factors and make objective conclusions. Systems for quantifying political risk have been devised, though their results do not always concur. There is much disagreement as to what factors should be considered as falling under political risk, and even more disagreement over how to assess these factors, since such assessments are inherently subjective⁸.

Public insurance companies like the U.S. government's Overseas Private Investment Corporation (OPIC) and the World Bank's Multilateral Investment Guarantee Agency (MIGA) offer insurance to cover political risk. Private insurers like the American International Group (AIG) and Johnson and Higgins also insure

⁸*Sometimes subjective knowledge or view of the reality of so-called “experts” is more appropriate than a well-founded theory; for instance, could one trust a senior dollar dealer for tomorrow's price, despite an economist's estimates based on the Uncovered Interest Parity (UIP) model.*

companies for this type of risk. These companies insure against loss for a wide range of political causes for the investor, including “*unilateral termination of a contract by a government, payment defaults, license cancellations, embargoes, war or civil war, default on an arbitration award, and government acts, laws, decrees, or regulations that result in breach or alteration of an agreement*” (p. 4).

In some countries, companies also run the risk of having a manager or family member kidnapped by political groups (e.g., guerilla groups). The cost of retrieving these hostages can be millions of dollars. Shipping industry has become a “classical” example in this case over the last two decades or so.

Another form of political risk that investing companies may face is discriminatory action against them by the host government in the form of taxes or ethnic quotas. Alain Chevalier and Georges Hirsch, in the *Journal of the Operational Research Society*, provide a chart enumerating some of these discriminatory policies (1981, p. 601), such as:

- (1) Authorize only joint-ventures (in which the foreign-firm owns a minority interest);
- (2) Levy special taxes or duties on public services;
- (3) Bureaucratic hurdles and red-tape;
- (4) Encourage a boycott against the products or the personnel of the company.

Due to the various forms of political risk, it is often difficult to pinpoint an exact definition and thus an exact method of forecasting such risk. As Mark Fitzpatrick put it in a 1983 edition of the *Academy of Management Review*, “The evolution of a body of knowledge concerned with the definition and assessment of political risk has been uncoordinated, due to the absence of a consensus regarding the conceptual framework on which to develop” (p. 249).

Many have attempted to categorize different types of political risk as differentiating that which is manageable and can be diversified away, and that which is unpredictable or unavoidable. Ultimately, each company or risk advisory firm will develop its own model of political risk assessment.

These models may use different criteria and analyze different factors, but they all make forecasts of political risk based on historical or current data about political trends and the probability of political upheavals occurring. The problem is getting worse since the “radical uncertainty” prevails in global business, especially nowadays or during the 21st century, and demands developing “forward looking” expectations (Kay and King, 2020).

Since such assessments are based on the social sciences, these models and forecasts are far from perfect. Some political actions may be caused by unforeseen events (e.g., a natural disaster devastates a country, causing it to suffer economic turmoil,

which, in turn, causes civil unrest resulting in the downfall of a democratic government). Other times, there might be insufficient data available to make accurate political predictions.

As Brewer (1983) notes in the *Journal of International Business Studies*, “the measurement of political risk needs to be more precise. Previously used measures have been based on imprecise concepts of the pertinent risks, and they have been contaminated by the inclusion of extraneous variables in the operational indicators” (p. 161).

In addition to the lack of consensus on how to measure political risk, the extent to which managers apply their awareness of political risk in their investment decisions differs depending on the individual manager. Some of them might simply ignore the political risk entirely when making investment decisions while others might alter their investment activities considerably because of the political risk involved. Additionally, though they may recognize such political risk, investors may decide that the opportunities outweigh the risks and go ahead with an investment anyway.

This latter theory concurs with the investment philosophy alluded to in Cosset and Suret’s journal article “Political Risk and the Benefits of International Portfolio Diversification” (1995). They note that “Errunza and Losq (1987) contend that investors should not avoid the politically unstable regions of the world because investments in these markets might provide returns that outweigh the risks” (p. 303).

We see this idea demonstrated in the conclusions drawn by Kenneth Bollen and Scott Jones (1982) in their study of political instability’s effect on foreign direct investment in the motor vehicle industry from 1948 to 1965. They addressed the issue of whether political instability in a country diminished the chances of said country receiving investments for motor vehicle production, and they came up with a *negative* -- they could not find a strong correlation between the two. They theorized that [t]here are at least three plausible reasons for this finding.

First, even if many motor vehicle manufacturers did not invest in production because of a country’s level of political instability, at least one firm might find the market potential worth the risk. As a result, a country could still become a producer even though some firms were discouraged by the political instability of the society (p. 1084).

The second reason presented in this paper refers to the problem mentioned above regarding insufficient data: “Second, as other authors have indicated (Root; Stobaugh), available information regarding political instability can be incomplete and inaccurate. Hence,” Bollen and Jones conclude, “there may be a significant difference between perceived and actual political risk” (p. 1084). More general, the diagnosis of “reality” still be a philosophical problem but with serious practical-economic implications.

Thus, the reality's perception isn't a matter of science, ideology or ethics; it's primarily the hierarchy of human needs, i.e., it's primarily the result of the hierarchy of human needs, i.e., the civilization, that determines the "worldview", and thus the economic perception, of managers (Yannaras, 1989; Gligorić, 2021)

The third reason addresses the potential incongruity between factors that are recognized as indicative of political instability and the subjective risk perception of a firm's management. In other words, something that is gauged as political instability in one of the models mentioned earlier therefore "may not be the same as political risk as perceived by investors" (p. 1085).

Still, it is argued, political risk can affect investors in significant ways. It "affects the value of a multinational corporation through changes in future cash flows and investors' required return," according to Butler and Joaquin (1998) in their "Note on Political Risk and the Required Return on Foreign Direct Investment" (p. 599); they also argue that the impact of political risk is directly related to the extent to which this risk is diversifiable.

In the context of the capital asset pricing model, investors care only about political risks that cannot be diversified away by holding the market portfolio of all assets. Asset-specific risks are not of consequence because they can be diversified away at the portfolio level. Only risks that are systematically related to the market portfolio are reflected in the required return on investment.

If political risk is diversifiable, then it will not affect investors' required returns or the firm's capital costs even though it may affect project cash flows. In contrast, if political risk is shared by many or all assets, then required returns will reflect these systematic, non-diversifiable risks. (p. 600).

According to this view, a well-diversified global investor might scarcely care about political risk since it may be diversified away.

This study develops a model to measure political risk's effect on expected project return ($E[R_p]$) according to the following equation (1):

$$E[R_p] = E[R_0] + E[I_d R_d] + E[I_n R_n]. \quad (1)$$

Where: R_p = return on project with political risk, R_0 = return on investment that is free of political risk (i.e., the project's expected value and covariance with the market are independent of political events), R_d = return on investment with diversifiable political risk, R_n = return on investment with non-diversifiable political risk, and I_d and I_n are indicator variables such that $I_d = 1$ if a diversifiable, non-market related event triggers political risk and is 0 otherwise and $I_n = 1$ if a non-diversifiable market-related event triggers political risk and is 0 otherwise" (p. 601).

The project's effect on the overall portfolio risk of an investor depends on the covariance between the project return and the investor's relevant market return. This is then divided by the variance of market return to yield the project's beta, which is a measure of systemic risk that is subsequently used to estimate required return (as in the Capital Asset Pricing Model) (p. 601).

Butler and Joaquin conclude that the "impact of political risk on required return now depends on its expected consequences $E[R_n]$ and on how the likelihood of a political shock varies with the relevant market return" (p. 602).

Consequently, political sources of risk increase the cost of capital when the return consequences of the political shock [are] positively correlated with the return on the relevant market portfolio ... If a political shock is expected to reduce return (as is often assumed for a firm operating in foreign markets), then required return is higher if market return and the likelihood of a political shock are negatively correlated (p. 602).

To illustrate this, their study points to the phenomenon whereby host governments facing economic turmoil often impose extra restrictions on foreign-owned firms (e.g., Brazil faced a stock market collapse in 1997 and then imposed a 25% tariff on non-Mercosur imports).

The political sources of risk decrease the cost of capital when the opposite occurs and "the return consequence of political shock is negatively correlated with the return on the market portfolio" (p. 603). For example, countries facing economic problems like a falling stock market will sometimes take out loans from the International Monetary Fund requiring them to make economic reforms primarily designed to materially benefit multinational corporations by reducing tariffs and other barriers to international trade and investment.

As we see from this study, the effects of political risks depend heavily on the government involved and the correlation between political shocks and market returns.

Another consideration is how well-diversified the global investor is. If a new party is elected to power in one country (this particular study uses the Labour Party in the U.K. as an example), this will affect cash flows, but the extent to which it will affect a multinational firm's cost of capital will depend on whether the firm's investments are concentrated or diversified.

If 100% of an investor's funds are in this one country, then the political source of risk might be very significant, but if one's portfolio is diversified among uncorrelated economies across the globe, then this country-specific risk may be quite inconsequential. In other words, "the cost of capital is affected only to the extent that

the risk ... is non-diversifiable when measured against the relevant market portfolio” (p. 603).

This idea that a global investor would be wise to diversify his or her investments among politically diverse countries is expanded upon by Cosset and Suret (1995) in the *Journal of International Business Studies*.

The evidence on the benefits of international investment in developing markets once more lends support to the arguments in favor of international diversification: lower portfolio risk arising from low correlations across countries and higher returns arising from faster-growing economies (p. 302).

This article purports to demonstrate the benefits of a multinational business investing in a portfolio of politically risky countries by evaluating the effects of political risk constraints on the performance of a portfolio of international stocks. The conclusion of Cosset and Suret’s study was that “the main benefit of the inclusion of high political risk countries in an international portfolio is in terms of reduced overall portfolio risk. This reduction in the portfolio volatility reflects low correlation coefficients between returns in high and low political risk countries” (1995, p. 301).

To conduct this analysis, Cosset and Suret had to use a quantifiable measure of perceived political risk, which they acquired from the monthly Political Risk Services. As mentioned earlier, there is no consensus on how to measure political risk. Alain Chevalier and Georges Hirsch, in their 1981 article “The Assessment of the Political Risk in the Investment Decision,” identify this problem:

Managers wishing to invest abroad must collect as much information as possible on the political, economic, and social situation of the host country ... However, there is a lack of coordination between these various sources; obviously, this is detrimental to companies and the country (p. 599).

The next issue deals with the likely changes in administrative measures foreign governments may make concerning the rights of foreign investors in their countries. These measures include the probability of a host government confiscating property or imposing restrictive measures that limit a subsidiary firm’s freedom of operation (e.g., prohibiting the transfer abroad of dividends or interest) (p. 604).

The data that is used for the above analysis, according to Chevalier and Hirsch, come from a “panel of bankers, experts, and some of the people nominated to sit on the board and/or run the future venture abroad” (p. 603). This type of assessment appears to be subjective, and Chevalier and Hirsch do indeed acknowledge that “each firm must accordingly carry out a *subjective* assessment of the political, administrative, or social risks run in each of the political situations outlined above” (p. 604) (emphasis added).

The subjective nature of assessing political risk is extremely relevant because it can result in different assessments that depend on who does the analysis. This is largely a factor of political science being among the “soft sciences,” i.e., its findings are often not quantifiable or empirically testable. Thomas Brewer (1983) addresses this issue when he attempts to define political sources of risk:

Political sources of risks emerge, therefore, from changes in the human interaction in which power, conflicts, and value allocations are central. Although these interactions commonly occur within formalized governmental processes, politics is not limited to government; political interactions occur throughout society. We need models of political processes that will enable us to understand and predict political tendencies and variations and their effects on the types of risk that are of interest. Models of politics are unfortunately intellectually primitive in comparison with models in economics and the physical and biological sciences. Models of politics are often expressed only in verbal rather than mathematical terms. Their variables are often not clearly defined, at either a conceptual or an operational level. The relationships among the variables are often not clearly specified. Hypothesized relationships have frequently not been rigorously tested by reproducible empirical research (pp. 162-163).

When Cosset and Suret (1995) did their research, as mentioned above, they used a method of quantifying political risk. They obtained this data from *Political Risk Services*, which publishes monthly assessments of the perceived political risks of different countries. Though these countries are given precise, quantifiable grades and ratings based on these perceived risks, the forecasts themselves are inherently flawed, as they are determined by very subjective means. They describe the source of their information as follows:

We use the monthly political risk ratings of Political Risk Services as measures of perceived political risk. Political Risk Services (henceforth PRS), formerly Frost & Sullivan, is one of the world’s leading agencies providing assessments of political risk. PRS’s monthly newsletter, *Political Risk Letter*, publishes monthly forecasts of political risk in eighty-five countries. These forecasts rely on independent judgments from over 250 country experts in the United States and overseas. The PRS political risk report for every country is compiled from information provided by a team of three to seven country specialists. Specifically, country specialists forecast the three political regimes most likely to hold power and their probabilities for the eighteen-month and five-year horizons. Each expert also assesses the impact of each regime scenario on political turmoil, restrictions on international business, trade restrictions policies, and economic policies. Using the Prince general political forecasting model developed by Coplin and O’Leary, these forecasts are aggregated and weighted into political risk ratings (p. 305).

Although they use an ostensibly accurate mathematical model to forecast political risk, the input for this model comes from teams of “specialists” and “experts” who subjectively determine what they think are the “most likely” political eventualities.

Nevertheless, based on this subjective information, they devise a ratings system for countries on a scale of A+ (for the least risky countries) to D-, and what follows is an explanation of these ratings. Please note once again the use of terms such as “reasonable chance” and “likelihood,” which are indicative of the uncertain nature of these forecasts.

- A Countries: No exchange controls, repatriation restrictions, or other barriers to financial transfer; and little likelihood that controls will increase in the forecast period.
- B Countries: Modest or sporadic delays in financial transfers; a reasonable chance that delays will be high in the forecast period.
- C Countries: Modest to heavy delays and even blockage of financial transfer; a reasonable chance that barriers will increase; and little chance that they will decrease within the forecast period.
- D Countries: Heavy exchange controls and long delays in the transfer of currency; little chance that conditions will improve within the forecast period. (p. 305).

A cursory glance at such a chart would not necessarily indicate the subjective nature of these ratings, but, as noted above, despite whatever mathematical model is ultimately used, the inputs remain necessarily subjective. Country risk assessments might therefore be different depending on who is performing the assessment and the criteria used to determine the country’s perceived riskiness.

This is evident in a study done by Jean Roy and Jean-Claude Cosset (1991) entitled “The Determinants of Country Risk Ratings” in which they define a country risk rating as an “indicator of the likelihood that a sovereign borrower will default on its debts” (p. 135). In this paper, Roy and Cosset attempt to replicate the country risk assessments of two leading international publications, *Euromoney* and *Institutional Investor*. They acknowledge, however, that “these two creditworthiness measures are established differently” (p. 136).

Euromoney combines the markets’ perception of risk with some objective factors. It is a weighted average of three indicators: 40% market indicators (access to bond markets, sell down performance, and access to trade financing); 20% credit indicators (e.g., payment record and rescheduling difficulties); and 40% analytical indicators (political risk, economic indicators, and economic performance forecasts).

Institutional Investor’s ratings, on the other hand, seem to be purely subjective; they are based on bankers’ opinions. Bankers from 75 to 100 leading international banks grade each country on a scale of zero to 100 (the lower the grade, the higher the risk

the country will default on its debt). The results are then adjusted by some unpublished formula that gives more weight to responses from banks with the most worldwide exposure and “the most sophisticated country analysis systems” (p. 136).

In this latter part of the assessment, a seemingly objective mathematical model is used that weighs the responses and calculates a country’s risk based on it. However, it is unclear how one measures “sophistication.”

The unpublished formula for determining how to weigh the countries’ responses therefore seem to be at least in part subjective, and there is no ready indication that it will yield accurate results. Furthermore, even if this unpublished weighting formula is entirely accurate, the first part of the equation, i.e., the individual banker’s input, is purely subjective. The inherent problem with such a model is, as the aphorism goes, “GIGO” (Garbage In, Garbage Out); if the inputs are flawed, so too will be the results.

Interestingly, although the magazines’ ratings were obtained in different ways and both included subjective elements, there was a high correlation between their country risk ratings, viz., “*Euro money* and *Institutional Investor*’s ratings strongly agree on the creditworthiness of the assessed countries” (p. 139). Some of the findings of this study were, in both magazines’ measurements, that the level of per capita income and the propensity to invest affect a country’s ratings positively and that a country less indebted to foreign countries will have a higher rating than one that is heavily indebted.

Even so, though the correlation between these two ratings systems may have been high, that still tells the investor very little about the accuracy or predictive value of these results. Even if some of the factors highlighted in these analyses are useful, others are yet missing from the model. In the “Handbook of Country and Political Risk”, Llewellyn D. Howell explains the problem of partial information: “Even if an optimal model is employed, the information that is incorporated as the basis of the assessment and forecast is inevitably incomplete and sometimes inaccurate.

Variations in the data introduce some margin of error in the projection. This is unavoidable in the social science analysis” (p. 6). The complexity of social phenomena, according to Howell, prevents one from making perfect predictions because there are always variables that are not or cannot be considered even in the best models.

Institutional Investor’s subjectivity was also noted by Thomas Brewer and Pietra Rivoli (1990) when they wrote “*Institutional Investor* scores are survey responses of individual bankers and thus represent to some extent personalized assessments of the countries’ creditworthiness” (p. 361). Brewer and Rivoli measured the effects of three political factors -- governmental regime change, political legitimacy, and armed conflict -- on a country’s perceived creditworthiness.

They found that proximate country instability, as measured by governmental regime change, was a significant factor in shaping lenders' risk perceptions, with the other two factors not being significant economic factors. Determining what shapes lenders' risk perceptions is important because they "affect both the supply and cost of capital flows to developing countries" (pp. 365-366). Even though credit risk ratings are affected by short-term political instability (and, to a lesser extent, by the level of long-term political stability), at the end of the day, these ratings are based on the subjective assessment of individuals or panels of "experts."

Using a panel of experts is a common practice among those who wish to assess and forecast political risk. For example, D.W. Bunn and M.M. Mustafaoglu (1978), when they forecast some of the political risks an oil company faces from investment in a developing country overseas, used such a panel. Bunn and Mustafaoglu identified ten "political risk events" they deemed important: sudden expropriation; creeping expropriation; adverse tax changes; civil disorder; war; production restrictions; repatriation limitations; domestic price controls; devaluation risk; and export restrictions (p. 1558).

Political risk factors for these events would then be determined and probabilities drawn up. In their example, they tested their method of forecasting political risk in a developing country in Africa using eight political risk events. A panel of four experts with "disparate backgrounds and interests from banking, commerce, university, and the oil industry" (p. 1560) was then employed to convey its members' assessments of the probability distribution of the political risk events. Despite the technical formulas and distribution tables that these authors used to reach their conclusions, the bottom line is that these assessments are inherently subjective.

As we saw with the *Institutional Investor* magazine's method of rating countries, banks are quite significant in this determination. Briance Mascarenhas and Ole Christian Sand (1985), in their study of the Country Risk Assessment methods of 50 U.S. commercial banks, note the importance of banks in the field of political risk assessment. Since multinational companies often rely on banks as their main source of external information about the foreign environment, they decided to find out how these banks assessed country risk. They classified the banks into four types, depending on the sophistication of their Country Risk Assessment system.

Type 1 banks have little international exposure and experience. In this type of bank, country managers, who "typically have neither a framework of analysis nor any specialized professional training for evaluating political and economic risks," and who therefore rely on "an intuitive, subjective, gut-feeling approach" make recommendations to a country loan limit committee (p. 23).

The country managers involved in the assessment lack the requisite knowledge of fields that are not strictly financial, such as economics, anthropology, sociology, and

politics, and so their subjective assessments will likely be inaccurate. The loan limit committee, lacking previous experience with a particular country and with non-domestic business in general, might therefore be unable to make an accurate measurement of the country's risk factors.

Type 2 banks are slightly more structured, using a staff coordinator and a "coordinating unit" which serves to request, standardize, collect, organize, and edit country risk studies and then make recommendations to the country manager. In this way, several country managers can give input and a fuller picture might be obtained. However, the biases of the country managers themselves still exist.

A third type of bank in the Country Risk Assessment system institutes checks and balances to counter the problems plaguing the first two types. In this system, in addition to the country managers' input, an independent staff unit is created to perform an assessment of its own. This serves the function of giving top management alternate perceptions of a country's risk, which can be extremely useful in getting a clearer picture of it.

A country manager might tend to take a "gut-feeling, businessman's approach, whereas the staff unit's report tends to be more academic and technical" (p. 25). Furthermore, knowing that their reports could be challenged might prevent the country managers from distorting information.

A type 4 bank is "characterized by increased specialization and differentiation." A separate coordination unit is used in addition to the assessment group, and political and economic assessments may also be separated and performed by specialists. The rationale behind this system is that experts in one field are not likely to be experts in another. As the article itself quotes a top executive as saying, "It is difficult to teach overnight the banking business to a political scientist" (p. 27).

This study concluded that the more sophisticated the organizational structure, the higher it was rated by the top managers in areas such as better quality of information and less distortion of information. The checks and balances of the type 4 system apparently help reduce biases and blind spots.

However, even this conclusion is suspect on the grounds alluded to earlier, as the authors readily acknowledge: "The results of this section should be viewed with caution since they are based on pooling the *subjective* perceptions of different individuals where comparison may not be valid" (p. 31) (emphasis added). Though the findings may intuitively make sense, even this assessment is flawed by a subjective ratings system.

Suk Hun Lee (1993) tested the relative importance of political instability and economic variables in *Euromoney* and *Institutional Investor's* credit rating systems and found that banks weighed economic factors more heavily than recent political

situations when assessing the creditworthiness of a lesser developed country. Though frequency of regime changes and armed conflict affected perceived risk, economic factors, which Lee assumed reflected longer term political stability, were stronger determinants.

Even if we accept the numerous estimates Lee was forced to make in his regression analyses, the utility of his findings is still questionable because, as noted above, these credit ratings systems are themselves subjective and perceived risk may not be useful for forecasting or predicting political risks.

Stephen J. Kobrin, perhaps the seminal voice on the issue of political risk definition and assessment, emphasizes the flaw of subjectivity in his 1979 article "Political Risk: A Review and Reconsideration" in the *Journal of International Business Studies*. He writes, "One of the conclusions of this paper is that most managers' understanding of the concept of political risk, their assessment and evaluation of politics, and the manner in which they integrate political information into decision making are all rather general, subjective, and superficial" (p. 68).

Kobrin makes the point that managers usually try to reduce and cope with uncertainty in business operations and would never "even consider basing a major new product introduction on a generalized feel for the market. Rather, they typically utilize a battery of relatively sophisticated research techniques to aid in reaching a judgment about both the product's potential and how to market it. Yet, judgments about the impact of politics upon operations appear ... to be rather superficial and typically based almost entirely on subjective perceptions" (p. 77).

In his 1984 article "Multinational Corporations and Political Risk in the Persian Gulf," Charles R. Kennedy, Jr. examines the methods used in assessing political risk, which he defines as "the probability that a given political event will result in financial losses for any particular firm" (p. 391). Though he points out that political risk can assume many different forms, in this article he focuses on the extralegal risks, i.e., those that come from outside existing authority, such as terrorism, military coups, and revolutions.

In the 1970s, Iran was considered by most (including the U.S. government) to be extremely stable. When the Shah was overthrown, this perception changed drastically, causing U.S. businesses with investments in Iran to incur significant losses. Kennedy looks at the various country risk assessment methods in use at the time of the Iranian Revolution, noting their flaws along the way.

According to Kennedy, there were three approaches to assessing political risk. The first one he calls "expert-generated opinion," which is "dependent on the accuracy of the subjective opinions generated from various sources -- primarily academic, government intelligence, affiliated banking institutions, and internal management -- whose criteria of evaluation often differ" (p. 392).

This is precisely the problem of subjectivity noted earlier and it is Kennedy's chief gripe against this approach. He notes several examples of expert-generated opinion approaches, including the Business Environmental Risk Index (BERI) and the Business International (BI) system, which he then dismisses as "all highly subjective and non-theoretical in nature" (p. 392). The ratings given using these methods are inherently flawed because they are based on subjective opinions.

The second type of approach that Kennedy examines also suffers from this flaw. In such a method, "attempts at objective measurement are then made, although a degree of objective-subjective interaction is always required." In the example he cites, the Political System Stability Index (PSSI), weighted indices are used for socioeconomic factors, societal conflict, and governmental process. "A subjective confidence score from 1 to 5 is given for each of the three indices," Kennedy notes, and he further argues that the assumption that three indices are equally important causes of instability has not been empirically tested (p. 394).

A third type of approach exists, according to Kennedy, which is not subjective; he calls it an "empirical-formal observational data model." Only data that can be empirically and statistically tested are used in this approach. Kennedy examines the two such models that were in existence prior to the 1979 Iranian Revolution and concludes that only one of them would have predicted the actual political turmoil that was to ensue.

The ineffective model was formulated by Harald Knudson and measured the frustration level in a society by comparing its level of aspiration to welfare and expectation levels. The actual analysis was done as follows:

Several operational variables for aspiration were used: literacy rate; daily newspaper circulation per 1,000 population; radios per 1,000 population; relative urbanization; and labor unionization. Welfare/expectation levels were operationalized by eight variables: infant mortality ratio; per capita calorie consumption; number of doctors per 10,000 population; number of hospital beds per 1,000 population; piped water supply per capita; GNP per capita; percent change in per capita GNP; and gross investment rates as a percent of GNP.

The relative importance (factor scores) of each variable in determining a society's level of aspiration and welfare/expectation was found through factor analysis of empirical data. (p. 394).

According to this model, political instability was likely when the frustration level was high or when the aspirations significantly exceeded welfare/expectations. However, as noted above, this model failed miserably in its task of predicting the political instabilities that occurred in Iran in 1979.

Kennedy points out several deficiencies in the model to explain this. For example, he points out that “the most important welfare/expectation variables, the GNP per capita level and rate of change ... continued to climb throughout the 1970s” (p. 397).

The model was not able to account for country-specific factors in its analysis. Also, “the model ignores the possibility that higher and constant rates of modernization as reflected in GNP growth or in the expectation variable might in fact precipitate instability within certain political-social structures” (p. 397).

The second model, known as the Hibbs model, has strength in the fact that, as opposed to the Knudson model, “it assumed no validity for any previous theory” (p. 398), thereby avoiding many value biases. Furthermore, it incorporated many important variables that are “currently considered to be key ingredients for understanding revolutionary change” (p. 398) and their empirically tested interactive relationship into the causal model.

Some of these variables include the type of political system, the degree of ethnolinguistic factionalism, group discrimination, the presence of political separatist or revolutionary groups, and major upheavals or internal wars in the recent past.

But even the Hibbs model is flawed, despite its relative effectiveness in predicting political risk to American corporations operating overseas. “The most obvious [flaws are] hard data constraints which preclude either the testing and incorporation of certain variables in the causal model or having high confidence in the reliability of the model’s predictions given frequent data errors in most Third World countries.

Current hard and reliable data do not exist for most countries on nearly all the variables within the Hibbs model” (p. 399). In other words, the model might work, given all the necessary data, but this data is simply lacking and thus the model is flawed. One must therefore “incorporate subjectively generated data into the statistical model” or alter the model in some other way to apply it to real situations (p. 400). Once again, we are left with the problem of subjectivity.

Lennart Sjoberg’s (2002) article in the *Journal of Science, Technology and Human Values* entitled “The Allegedly Simple Structure of Experts” Risk Perception: An Urban Legend in Risk Research” does an excellent job of highlighting the potential problems with a subjective assessment of risk. While trying to discover the underlying reasons for differences in risk perception between so-called “experts” and the general public, Sjoberg provides a list of possible explanations.

One such explanation is realism, i.e., the public is misinformed while the expert may be making accurate and realistic assessments. The author rejects this explanation by pointing out that “Realism cannot be the whole story, since experts vary. They

cannot all be right. ... risk assessment is not only a question of factual judgment; values enter necessarily” (2002, p. 447).

The difference in risk perception may also be a factor of differing political ideologies, socialization of values, and risk perception in professional training and work (i.e., conformity pressures and vested economic and career interests may affect one’s assessments), and perceived control and familiarity (i.e., an expert in a certain area may feel he has more control over the risks in that specific area) (p. 447). All these potential explanations illustrate the subjective nature of risk assessment even when the assessment is being executed by a so-called “expert.”

Indeed, Sjoberg (2002) attacks the very concept of experts, pointing out a basic flaw in the common use of the term. He notes that “the issue of expertise is a complex one, and ... experts are treated as a homogeneous [group for which] research has barely scratched the surface” (p. 448). The distinctions that are overlooked could be critical to the final product of the risk assessment.

For example, “topical experts” who have “a qualified education and experience in a given area of expertise ... may not have been risk managers, communicators, or assessors. ... On the other hand, there are also experts of method, people who do risk analysis in various fields, and are not fully qualified topical experts in more than a few of the fields” (p. 448). Since their knowledge, experience, and types of employment are probably vastly different, these two types of experts may have vastly different perceptions of risk.

Last but not least, the issue of business planning is inextricably linked to political risk when it comes to international business. Sorg (2024) argues that “financialization has strongly influenced how contemporary economic planning works”. We could define financialization (Mader *et al.*, 2020) as “an increasing role of finance for profit-making vis-à-vis trade and commodity production” (Krippner, 2011).

When the financial system is the core of the finance-led growth regime (Boyer, 2000), then, business planning and the associated political risk of international investments follow, first, the monetary policy applied by technocrats of (independent by politics) central banks, and second, elected democratically governments’ policy makers, but who are obliged to discipline the markets that finance their debts.

There is no room for democratic governance of our western societies, which ironically founded on the capitalism of the “free markets”. It turns that the political risk in international investments is ultimately determined by independent central banks and fund managers in the global capital market (both private technocrats).

Thus, the democratization of finance could provide a framework for sustainable levels of both low political risk and business planning (Sorg, 2024).

A selective summary of the above key ideas is presented to Table 1.

Table 1. Key ideas on political risk

Author(s), Year, Journal	Classified as	Key Ideas
Sorg (2024)	2. Measurement	<i>... financialization has thus reduced the democratic accountability of public planning, centered corporate planning on the short-term interests of managers and shareholders, depressed economic performance, and entailed economic volatility... The question is whether and how planning can be conducted in a more democratic form and directed at social and ecological needs instead of solely at shareholder value ... the financialization literature that has suggested more social and sustainable alternatives towards a "democratization of finance" ...</i>
Butler & Joaquin, (1998)	1. Conceptualization	<i>... risk of adverse consequences arising from political events.</i>
Butler & Joaquin, (1998)	4. Effects	<i>... the effects of political risks depend heavily on the government involved and the correlation between political shocks and market returns</i>
Butler & Joaquin, (1998)	2. Measurement	<i>... If political risk is diversifiable, then it will not affect investors' required returns or the firm's capital costs even though it may affect project cash flows.</i>
Cosset & Suret (1995)	1. Conceptualization	<i>In addition to assessing economic and social developments, there is a need for assessing political conditions and risks.</i>
Cosset and Suret (1995)	4. Effects	<i>... lower portfolio risk arising from low correlations across countries and higher returns arising from faster-growing economies.</i>
Cosset and Suret (1995)	2. Measurement	<i>... Political Risk Services (henceforth PRS), formerly Frost & Sullivan, is one of the world's leading agencies providing assessments of political risk... country specialists forecast the three political regimes most likely to hold power and their probabilities for the eighteen-month and five-year horizons... based on this subjective information, they devise a ratings system for countries on a scale of A+ (for the least risky countries) to D-...</i>
Howell (1994)	1. Conceptualization	<i>During the Cold War, for example, nationalization and expropriation of assets by socialist or communist governments were of major concern to investors in the developing world</i>
Yannaras (1989)	1. Conceptualization	<i>... the reality's perception isn't a matter of science, ideology or ethics; it's primarily the result of the hierarchy of human needs, i.e., the civilization, that determines the "worldview", and thus the economic</i>

		<i>perception, of managers.</i>
Errunza and Losq (1987)	3. Functioning	<i>... they contend that investors should not avoid the politically unstable regions of the world because investments in these markets might provide returns that outweigh the risks...</i>
Fitzpatrick (1983)	1. Conceptualization	<i>... the definition and assessment of political risk has been uncoordinated, due to the absence of a consensus regarding the conceptual framework on which to develop”.</i>
Brewer (1983)	2. Measurement	<i>“... the measurement of political risk needs to be more precise ...”.</i>
Bollen and Jones (1982)	2. Measurement	<i>... there may be a significant difference between perceived and actual political risk.</i>
Euromoney	2. Measurement	<i>... 40% market indicators (access to bond markets, sell down performance, and access to trade financing); 20% credit indicators (e.g., payment record and rescheduling difficulties); and 40% analytical indicators (political risk, economic indicators, and economic performance forecasts).</i>
Institutional Investor's ratings	2. Measurement	<i>... seem to be purely subjective; they are based on bankers' opinions. Bankers from 75 to 100 leading international banks grade each country on a scale of zero to 100 (the lower the grade, the higher the risk the country will default on its debt) ...</i>

Source: Authors' selection and classification.

4. Concluding Remarks

Political risk is a very difficult concept to define and is even more difficult to measure. Various systems and models have been invented to measure and assess this type of risk over the past few decades since the level of interest in overseas investments by multinational firms began to rise.

However, several seemingly unavoidable flaws afflict all these models. First, data from developing countries is often insufficient, making it impossible to accurately predict political risk even with the best of models. Second, measures of political risk are subjective because political science is one of the social sciences and, by its very nature, is not easily quantifiable and measured. Many of the models discussed above attempt to minimize and eliminate biases and give the most objective measures of political risk possible, and at times they are successful. However, a perfect system for measuring political risk does not exist and may never exist, given these two major flaws.

Still, major financial losses to multinational investors due to political events abroad remain an issue of concern. Hence, the limitation of the paper on quantitative answers. Some political sources of risk may be avoidable while others may be

diversified away in a global portfolio. Though assessments in the realm of the social sciences are inherently subjective, it is crucial that multinational businesses have a functional, albeit imperfect, method of assessing the risks to their investments before they invest. As Sjoberg (2002) notes, “There is room for much improvement in models of risk perception” (p. 457).

Finally, given that political risk belongs to business planning and the financialization dominates globally only the democratization of finance could reduce or even eliminate political risk within the business one for free markets. Further research should be directed on the resurgent debate on economic planning in the age of digitalization and climate crisis.

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