TURUN KAUPPAKORKEAKOULUN JULKAISUJA
PUBLICATIONS OF THE TURKU SCHOOL
OF ECONOMICS AND BUSINESS ADMINISTRATION

Antti Loikas

A Government Analysis of Political Risk: Exploring Equilibrium, Instability, and Pluralism at the Local, National, and Supranational Level in Europe

Sarja / Series Ae-4:2003 (pdf) A-4:2003 (nid.)
ISBN: 951-564-153-5 (pdf) 951-564-140-3 (nid.)
ISSN: 1459-4870 (pdf) 0357-4652 (nid.)

A Government Analysis of Political Risk

Exploring Equilibrium, Instability, and Pluralism at the Local, National, and Supranational Level in Europe

Locus rebit actum – The act is governed by the Law of the Place where it is done.

Cinus de Pistorio, 1270–1336

The paradigm of political risk has its focus on the relationship between economic actors and political environments. Political risk analysis concerns the assessment and management of the political variables, which negatively affect companies in their international trade and investment environment.

The study of the government analysis of political risk focuses on the transformation of the European Union's political environment and the shifting boundaries between economic actors and political authorities. Political risks are located at different levels of nation-states, the European Union, and international institutions.

It has been argued, regarding the state-centered paradigm of political risks, that the risk level is lower in liberal democracies. The nation-state has been defined in traditional analysis as a pluralist unit.

In transforming international relations, the state's role as a sovereign, political authority is obsolescing and the principles of the market economy are spreading due to the integration and globalization processes. In this new sphere, plurilateralism denotes the regime of the pluralist liberal democracies. Over and above nation-states, the plurilateral regime is an agreement of continuous co-operation between economic and political milieus, organized in order to stabilize the non-zero-sum game between economic actors and political authorities, by harmonizing the rules of the game inside the regime. In this research, the impacts of transformation on the government-instigated political risk theory are explored.

It could be argued that the political risk level is lower in the plurilateral regime due to the stabilized and legitimate institutionalized market-based rules of the game and the continuing co-operation agreements between political and economic actors. From this starting point, it is possible to widen the analysis to the internal markets of the European Union over and above nation-states by framing the way the risk level is lowered by political governance and new risk instruments, and extending the analysis from internal markets to the structures of governing external environments of the European Union as a new level of political authority in political risk analysis.

Key words: Investments, Foreign - Political Aspects; International business enterprises – Political Aspects, Organization; Management; Political Risk.

Acknowledgements

A dissertation requires the advise and assistance of many people. I wish to express my sincere appreciation to Docent, Dr. Arto Suominen for his encouragement and advise of risk management and to Professor Satu Lähteenmäki at the Turku School of Economics and Business Administration. I am greatly indebted to the lecturers of the Turku School of Economics and Business Administration who deepened my knowledge into the companies' risk management processes in the course of all the stages of my studies.

The thesis pre-examiners were Professor Llewellyn D. Howell, Thunderbird, The American Graduate School of International Management, Glendale, Arizona and Professor Tauno Tiusanen, Lappeenranta University of Technology. I would like to express my profound appreciation to them for the reading and commenting of the manuscript.

I also wish to express my appreciation to Graduate School of Cultural Research and Integration, the University of Turku, Professor Esko Antola, the Institute for European Studies and the Jean Monnet Centre, Professor Harto Hakovirta the University of Turku, and Professor Raimo Väyrynen. I owe my gratitude to Leena Siitonen, Ph.D., who improved my English in the process of writing. Moreover, I extend my gratitude to the staff of the departments.

This research has benefited from funding by the Foundation of Economic Education, and the Turku School of Economics and Business Administration and its foundations, which are all gratefully acknowledged.

Finally, I would express my appreciation to my family for the encouragement throughout the various phases of this undertaking.

Content

Figures

Acronyms

APEC	Asia-Pacific Economic Community
ASEM	Asia-Europe Economic Meeting
ASEAN	Association of Southeast Asian Nations
BERI	Business Environmental Risk Information
BI	Business International
CAS	Country Assessment Service
CIS	Commonwealth of Independent States
CMEA	the Council for Mutual Economic Assistance
CSECI	The Commercial Sector of Export Credit Insurance (OECD)
EBRD	European Bank for Reconstruction and Development
EC	European Community (earlier European Economic Community EEC)
ECB	European Central Bank
EC Treaty	Treaty of Rome
ECSC	European Coal and Steel Community
EEA	European Economic Area agreement
EEC	European Economic Community
EFTA	European Free Trade Area
EIB	European Investment Bank
EIU	Economist Intelligence Unit
EMU	The European Economic and Monetary Union
EU	European Union
EURATOM	European Atomic Energy Community
FDI	Foreign Direct Investment
FGB	Finnish Guarantee Board
GATT	General Agreement on Tariffs and Trade, established in 1948
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IFDI	International Foreign Direct Investment
IFC	International Finance Corporation
IGC	the Intergovernmental Conference
IMF	International Monetary Fund
IRR	the Internal Rate of Return
MAI	Multilateral Agreement of Investment
MIGA	Multilateral Guarantee Agency
NATO	North Atlantic Treaty Organization
NAFTA	North American Free Trade Area
NIC	Newly Industrialized Country
NPV	Net Present Value
OECD	Organization for Economic Cooperation and Development. Established in 1948. The successor of the Organization for European Economic Co-operation, which was formed to administer the American and Canadian aid for reconstruction of Europe after the Second World War. Now its focus is on enhancing market economy and pluralism. The 30 member countries consist of the USA and Canada, the EU Member States, Australia, Japan, New Zealand, Turkey and Switzerland, which totals 24 states. Advanced transition countries have joined to OECD in 1990's;

	Mexico 1994, Czech Republic in 1995, Hungary, Poland and South Korea in 1996 and Slovak Republic in 2000.
OPIC	Overseas Private Investment Corporation
PCA	Partnership and Co-operation Agreement (EU and Russia)
PRS	Political Risk Services
SDR	Special Drawing Rights
SEA	Single European Act
TREP	Transatlantic Economic Partnership
UN	United Nations
World Bank	Group: International Bank for Reconstruction and Development IBRD, the International Development Association IDA, International Finance Corporation IFC, and Multilateral Guarantee Agency MIGA.
WPRS	World Political Risk Services
WTO	World Trade Organization, established in 1995. The successor to the GATT. WTO embraces within the same structure the trade negotiations on products (GATT), services (GATS), and intellectual property (TRIPS).

The Treaties Establishing the European Communities and the European Union

The founding Treaties of the European Communities are the **Treaty of the European Coal and Steel Community ECSC**, signed in Paris 1951, the **Treaty of European Economic Community EEC**, signed in 1957 in Rome and **the Treaty of the European Atomic Energy Community, Euratom**, signed in Rome 1957. All three Treaties are legal entities. In 1967, the EEC Treaty was merged with the Treaty of Euratom.

The Treaty on European Union (EU) was signed in Maastricht in 1992. It created a decision-making procedure structure based on three pillars. The first pillar with the Community decision-making power is the Treaty of EEC that was renamed **the Treaty of EC**. The Treaty of ECSC expired on 2002 and the Treaty of EC regulates now the coal and steel sector. The second and the third pillars are under intergovernmental decision-making procedures. These pillars are the implementation of a common foreign and security policy CFSP and the matters of judicial and home affairs JHA. The European Union can only act through its component parts, the Communities and the Member States.

In this study, the European Union, EU, refers to the Treaty on European Union, signed in Maastricht in 1992. It includes all three pillars of community and intergovernmental decision-making. The Treaty of EC refers to the first pillar of the Community decision-making. For example, in external commercial relations, the European Community has trade agreements with almost every country in the world. In the study of political risk, however, several risk levels cross the borders of political and economic decision-making procedures. The Security level is one such level. For example the matters relating to international organized crime, terrorism, or drug trafficking are among those matters being managed in the environment of companies by the decision-making procedures belonging to the first, second and third pillars. Moreover, it should be noted that the establishment of a single European currency was an objective in the Treaty on European Union.

The Treaties have been amended by institutional and responsibility changes by the Merger Treaty in 1967, the Single European Act in 1987 (Internal Markets), the Treaty of Amsterdam in 1997 (amended and renumbered the EC and EU Treaties), The Treaty of Nice in 2003 (merged the EC and EU Treaties into a consolidated version). The Treaties have also been amended by the new member countries joining the European Community; 1973 (Denmark, Ireland, and the United Kingdom), 1981 (Greece), 1986 (Portugal and Spain). 1995 Austria, Finland, and Sweden. The Treaty of Accession of the 10 new Member States in 2004 was signed in 2003.

1. Introduction

What constitutes the political risk in the environment of international trade and investments? Why does it matter? Why should it be explored? These questions have not been high on either the agenda of political science or economic life in Finland, although this field of study focuses on one of the most significant areas in international relations: the intersection between markets and politics. Political risks are embedded in every level of the present political transformation in Europe, which is why they are worth exploring.

This research will illustrate that, despite its strong links with the present political transformation, political risk research has its origin in a decades old tradition. The paradigm of political risk is originally Anglo-American both at the theoretical and conceptual levels and as a research tradition, literature, and school of thought. Due to its interdisciplinary nature, it bridges various methodologies and approaches. Instead of focusing on differences between them, it forms the main link between all the studies and, traditionally, focuses on how political environments of economic action differ from one another between societies, and how those differences can be managed by states and companies.

The paradigm of political risk has emerged, **first, due to practical needs, second, due to theoretical models, and third, as a response to political events in the international arena.** In addition, the development has given birth to international organizations specializing in risk management and also to specific publishers of political risk analysis with a weighty role in the world economy.

The development of the paradigm of political risk will be illustrated, in the following parts, in the abovementioned order. **Firstly,** the paradigm of political risk was developed in the USA mainly after the Second World War. Practically speaking, there was a need for information from new independent states: including Europe's business environments. Since the War, Western states have been harmonizing their systems of managing risk in foreign trade and investments.[1]

---

[1] Brummersted.1983, Stapenhurst.1992.

Secondly, at the theoretical level, the early attempts to model political risks in the less-developed countries relied on the concept of bilateral monopoly: Host countries controlled the conditions of market-entry, foreign investors controlled other factors of production, for example, capital, management, or technology. Raymond Vernon's model of *Sovereignty –at Bay* captured the relationship between the two monopolists: a state authority and a foreign company. The shift of bargaining power from a company to a state authority was at the core of this model[2]. This model became the classical base for later models and has prevailed ever since.

A later model, presented by Ting in 1988, applied Vernon's model by introducing the obsolescing demand factor, in which the main cause of political risk was the aggressive industrial policy of the host country. In order to attract foreign companies" entry into a country to help the country's move toward industrialization, there emerged a demand for foreign investments that also brought in technology and training and developed exports. After a positive input to the country, foreign investments were gradually replaced by national investments. The demand of foreign investments gradually obsolesced and this process was accelerated by political regulation. The obsolescing demand model pointed to the political risk that companies faced in rapidly-growing Asian and South American environments.[3]

It could be asked how the environments in former socialist states and the new Europe are being managed? What are the theoretical models suitable for the management of political environments of economic action there? This study suggests harmonizing the rules of the game in a plurilateral regime with bilateral, multilateral, and plurilateral agreements, and multilevel governance that will be targeted at specific borderline cases defining the shifting boundaries between companies and political authorities.

The classical approach to political risk appears to be too narrow in the era of globalization and integration. In order to deepen the assessment, there is a demand for a new theoretical approach to political risk. There has been a need for further development of the analysis by Thomas Brewer on the dimensions of political risk in in-

[2] Vernon.1971.
[3] Ting.1988.

ternational politics[4]. The starting point is that the present transformation in international relations is giving birth to new actors in the international arena. Besides the United States there is, for example, the European Union with its multi-level political authority structure. Because the political risk governance will also get an increasingly European perspective, a methodology for the analysis should be found. Therefore, this study is divided into the instrumental and political governance analyses.

At a definition level, the paradigm of political risk was developed by dividing risks into micro- and macrolevels depending on whether they affected a specific company or all the companies in a host country. Furthermore, there was a debate on whether to use stability and instability or policy approaches and whether the analysis should be done using a quantitative or qualitative method. These debates are reviewed in Part Three.

Thirdly, political risk research has been developed hand in hand with specific political events that have created a demand for risk analysis. One of these early events was the revolution in Iran in 1979, with its hostile acts against international companies that increased the demand for refocusing the approaches to political environments by the U.S. companies. Regardless of the political transformation in the former socialist states, the economies-under-transformation in Eastern Europe, and emerging trade blocs in Europe and Asia, the basic arguments since the days of Vernon's theory that relied on the state regime have not altered. So there is a demand for a new model. This development will be explored further in this study.

On the supply side of political risk analysis, commercial publishers of political risks were founded. Their models will be explored in Part Three. The published rating lists relied on the fact that the paradigm of political risk is part of comparative politics and is estimated using comparative country risk ratings. The risk indicators related to the types of governance feature the significant changes in different countries" risk profiles.

Along with these private organizations, governments have founded multinational risk guarantee institutions. An example of these is the Multilateral Investment Guarantee

[4] Brewer.1985.

Agency founded as part of the World Bank Group in 1988. The World Bank Group may be considered an institution for managing political risks in the international economy as its one purpose is to maintain the international financial regime as part of the international financial architecture[5]. In that context, monetary regimes are initiated by political authorities and thus considered political constructs. On the other hand, the markets are allowed to work inside the regime and follow the market principles. This is one of the borderlines that are made in the intersection between markets and political authorities. It depends on the perspective whether an issue is political or economic. This is the reason for analyzing equilibrium in order to trace whether the environment is stable, and shifting boundaries to trace whether the environment is predictable while analyzing the political transformation and the intersection between markets and political authorities.

In the political environment of European companies, the political transformation has been robust. However, managing the risk factors in a new environment is not quite feasible. The study should be started by analyzing the basic arguments of political risk analysis. In general, the basic questions that have not changed concern the political factors affecting the financing of trade and securing foreign investments abroad.

1.1 Political Environment and Economic Actors

In this study, the central aim is to develop a framework of political risk in international relations and emphasize the European perspective. We will explore the tasks included in the framing of new political risk management institutions and instruments, when political authority structures are transformed in Europe.

The paradigm of political risk has its focus on the relationship between economic actors and the political environment. Emphasis is on the phenomenon that political power relations determine the boundaries for economic action. According to Hans J. Morgenthau, when we speak of power, we mean man's control over the minds and actions of other men. By political power we refer to the mutual relations of control among the holders of public authority and between the latter and the people at large.[6]

---

[5] Kennen.2001:131.
[6] Vasques.1996:24.

Does an equilibrium exist between "economic" and "political" milieus? What are the prospects of change? Are the risks in this relationship manageable? What kind of political environment is characterized by a low risk level? Why?

In order to illustrate the government analysis of political risk, the study focuses on the transformation of the European Union's political environment and the shifting boundaries between economic actors and political authorities. The European business environment represents a central part of the Western political and economic milieu. It is the basis for analyzing political risks from a wider than national perspective and, in that way, ascertaining the phenomenon of political risk at several authority levels. Theoretically, the rules of the game[7] and borderline cases[8] in political transformation are defined in political processes that are located at different levels of nation-states, the European Union, and international organizations.

Political risk variables, in the operational milieu of companies in Europe, are defined as the result of circumstances created by the European integration, of the implementation of rules and regulations at the state level, and of those changes and reflections integration has brought to the external economic relations of the internal markets. Risk analysis concentrates on the relationship between a company enterprise and a political authority in Europe, when integration moves from the phase of creating an internal market into the phase of directing and regulating a market and into a political union with a common foreign and security policy. A consequence of this regulating integration is that, in the European Union, authority and power structures are transformed both in its internal market and in external relations. Development of the Union's political dimension is, in turn, reflected in external commercial relations.

The European-wide operation of organizations, internationalization of interest groups and non-governmental organizations, together with improved information technology, are creating an environment, where it is difficult to indicate, who pushes who around in Europe, who is making political decisions, and who exerts political authority in a specific region in Europe. Economic actors have to work in an environment

[7] North.1990:3. "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction…'They structure incentives in human exchange, whether political, social, or economic.' This definition will be deepened in Part Four of this study.

[8] Borderline cases are marginal factors, demonstrating the transformation of a political system, or the

where national and international norms are crossing and opposing each other. It is not clear, in whose hands is the legitimate power to set the rules of the game. In addition, it is not clear whether the center of political decision-making is located at the nation-state level, the European Union level, or the local level.

Political risk management in international exchange has been the task of national political authorities. However, no consensus seems to exist concerning the criteria for assessing political risk at the European Union level, even though the future of its internal markets depends on such things as how different Member States will harmonize risk management instruments and institutions. Currently, political risk management is dispersed to nation-states and several European institutions. The European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), Member States, and the European Commission are all managing political risks. At the global level, there are risk management instruments in the World Trade Organization (WTO) and the Organization for Economic Cooperation and Development (OECD).

1.2 The Research Problem

Traditionally, political risk is defined as uncertainty of the changes in the political, social, or economic environment; the development of relationships between political authorities and economic actors. Political risk is a likelihood that the political powers will cause changes in the economic life, and that these changes will affect the company's mode of action negatively. In this study, political risk is defined as the unpredictable transaction costs at the company level, caused by uncertainty.

What is the cause of uncertainty and unpredictability? The research problem is located in the relationship between an economic actor and a political authority in an environment where both actors have individual and non-compensated roles. The relationship between a political authority and an economic actor can be understood as mutually equilibrating. A borderline case of this relationship is public services and public utilities and their supply and demand. In a stable action environment, the state authority maintains those principles of pluralism; liberalism and democracy by which

---

shifting boundaries between the functions of political authorities and market forces.

the public services are justified. The more stable the equilibrium, the more predictable it is.

In the international business environment, the political risk management concerning the principle of public services has appeared as political risk guarantees supplied by the state authority. These guarantees have been based on national strategic interests. This arrangement has determined the borderlines of the economic and political actors and set the rules of the game for exchange in international business activities.

When seen from the perspective of the political risk research tradition, the political transformation currently occurring in Europe amounts to the redefinition of the equilibrium that determines the identity of actors and the rules of the game of the exchange, from the level of state authority to the equilibrium of multilevel political authority and multilevel markets. Public services, as an example of the instruments of political risk governance, are determined by this new context.

The starting points in the analysis are the separate roles of the political authorities and economic actors. Political governance means, among other things, the management of unstable relationships between the actors in society. Instability can be eliminated by self-imposed and self-enforcing agreements between actors. Sustainability, continuity, and the realization of equality presuppose the repetition of imposing agreements. Because single solutions are seldom optimal for each actor, continuity serves to guarantee the possibility of stabilizing an actor's position in the future. The task of politics is to maintain continuity of imposing agreements and, thus, sustain stability. Therefore, trust and legitimacy are closely related concepts in political governance. In international relations beyond the nation state, trust and legitimacy are maintained differently from the nation-state environment.

An environment with a low political risk level has been characterized by pluralism because its functions are predictable compared to any other political environments. When comparing state authorities, it has been argued in the research tradition that the more democratic the society the more accountable it is; and the more accountable the society the less susceptible it is to sudden or explosive political shocks. This argument emphasizes certain characteristics of society where the opposition has a legalized role. This is a pluralist society, as opposed to a monist, uniform political regime. Liberalism and democracy are considered to sustain pluralism because it is, in terms of political risk, a form of optimal political authority.

Optimal political authority may be characterized by the concept of externalities. According to Coleman, in order to understand externalities, we should start the analysis of political power that both limits and enables the actors in society. The political authority provides for the rules of the game in societies by creating externalities in the exchange of resources in non-self-sustaining social relations. These relations depend on a third party for their continuation. Incentives to one or both of the two parties to continue the relation are not intrinsic to the relation but must be supplied from outside. This is the kind of relationship on which formal organizations are built.[9] At the levels of security policy, state, and society, the rules of the game and shifting boundaries are placed asymmetrically in different locations and, therefore, limit in different ways pluralism; liberalism and democracy. As a consequence there is not just one optimum, in the analysis of rules of the game and borderline cases, but every level has its own balance. Pluralism emphasizes neither pure liberalism nor pure democracy as the optimal precondition for stability in every situation. The optimum must be an equilibrium of differences in the points of view, characterized by the dynamism of repetition of interaction.

What are the characteristics of a company in the equilibrium? As an economic actor, a company transforms through its organization the inputs of capital, labor, and natural resources in its production function into outputs of commodities[10]. This production process is technical and amenable to quantification by means of costs, which can be defined as transformation costs. These costs do not, however, represent the total costs of a company. External to the technological production process, the political environment creates transaction costs for the company. These costs are in general not easily predictable, because they emanate from the state of political stability and the action of the political authority. The company is an economic actor, whose function is to utilize effectively the production process through its organization. Its function is not to sustain pluralism, a task that belongs to the political authority. The enterprise

[9] Coleman.1994:41, 43.
[10] Henderson, Quandt. 1980:64–65.

takes transaction costs as given and, according to the research tradition of political risk analysis, prefers a state where pluralistic stability prevails.

1.3 Organization of the Study

The traditional institutional approach to political risk compares risk-indicators, which measure the level of pluralism in a state regime. In this study, the central aim is, in accordance with conceptualizing a framework of political risk, to develop a theory for political risk assessment and governance instruments. This is done by using the neo-institutionalist theory of Douglass C. North.

In the equilibrium of international relations, conducted between pluralist states, the determining factor of stability was continuity. What is the factor that at present determines the equilibrium and the boundaries between political authorities and economic actors? This new equilibrium has been the subject of research, which has used a hermeneutical method. It means that the totality of political risk has been formed from individual observations, which after several rounds of investigation have become parts of the whole.

> *The paradigm of modern hermeneutics is thoroughly explained in* Wahrheit und Methode *(1960) by Hans-Georg Gadamer. The goal of hermeneutics is to get a deeper understanding of your object. The principal method is to inspect the object from alternating perspectives. The starting point in the inspections is the first grasp, or the preliminary cognizance you have when you start the study (it is always there, even if it may be unclear or quite wrong). During the process, you then alternate the perspective, or examine the object from various angles. Each new examination improves your understanding of the object. Likewise, when you return to an angle that you have already used, you will often be able to find new insights, because in the meantime, the other views have improved your sensitivity in finding new aspects to the already previously well-known facts and interpretations. Alternation of the viewing points is called the hermeneutical circle (or the hermeneutical spiral, if you wish to imply that you are getting somewhere with the method). You continue with it until shifting to a new angle no longer produces any interesting findings. The most usual pair of*

viewpoints to be alternated is a global view of the object, alternated with a detailed view of the components of the object. [11]

To apply and conceptualize the European framework to fit in the paradigm of political risk is a task requiring reanalyzing the political risk literature. One of the reasons for using the hermeneutical method is that the term “political risk” has not been generally standardized in the research on international relations. Therefore, one of the most difficult tasks in the beginning of this research was to decide what to include in the analysis in the investigation of this problem area. In any case it has become clear that the existing studies of political risks have not sufficiently explained the risks originating from transforming the European political environment, neither their analysis nor their control.

Each empirical field of study can be described by the cases, or “units”, analyzed, the characteristics of cases, or “variables,” being considered, and the number of times each unit is observed, or “observations”. Thus, both the selections of cases and variables must be guided by theory.[12] From this starting point this study intends to conceptualize the shifting boundaries between economic actors and political authorities, leading then to a theory of political risk. The units and variables are being selected for further empirical studies concerning political risks for observation from a European perspective.

The theoretical framework for the immediate analysis is neo-institutionalist. According to David E. Apter, neo-institutionalism combines traditional institutionalist concerns with developmentalism. Traditional institutionalism emphasized the uniquely Western character of democracy and proclaimed its universality. Democracy is defined as differentiated civil government, legislatures and courts, executive powers, and local government and municipalities. Neo-institutionalism can be said to have evolved out of a general concern for pluralist democracy and concerned with transitions to democracy. This is one reason, why neo-institutionalism might be an appropriate base for political risk analysis. Neo-institutionalism uses a broad comparison based on historical cases, and utilizes class and state formation within what might be

[11] Routio.1997:22.
[12] Jackson.1996: 751–762.

called a post-Weberian framework. It can also be studied by using the rational-choice theory, which is applied to the investigation of democracy in terms of the so-called double market, the intersection between the economic marketplace and the political economy. Neo-institutionalism emphasizes the importance of legal structures and the significance of their presence or absence. It is connected with social and political theory.[13]

The precondition for the political risk research emphasizes the optimal pluralist political regime as low political risk level. In Part Two the focus is on the meaning of this precondition. What kind of equilibrium can exist in a pluralist liberal democracy? A key question is how does the traditional approach to political risk change with the transforming political environment?

In Part Three, the paradigms of political risk are analyzed. Studies are categorized in terms of whether they explore political risk instruments or whether they analyze the political risk governance regime. The focus is placed on how the political risk can be standardized. “Governance regime” refers to the continuing international cooperation agreements between governmental authorities.

In Part Four, the political risk variables are analyzed beyond the traditional variables used in comparative analysis. To standardize the phenomenon of political risk, a new framework and new indicators for political risk analysis are presented. Traditionally risks were managed by the institutional arrangements of states. Specific instruments of state activity have included export credit guarantees and bilateral and multilateral trade and investment agreements. In general, the political authority creates the rules of the game in societies, which stabilize the political environment of economic actors. The equilibrium between the economy and politics depends on the national ideologies at the state level and, globally, on world-order ideologies, and those are reflected in the economy. Two dimensions of political risk can be distinguished: on the one hand, the question is of the characteristics of risk at the company level; on the other, it is about the characteristics of the political environment itself. The characteristics of the company risk are analyzed in Part Five and the characteristics of the political environment in Part Six.

---

[13] Apter.1996:375–389.

In Part Five, the analysis deals with the fact that political risks are managed by the trade and investment instruments offered by the political authority and the private sector. Risks faced in the environment of economic actors can be differentiated into marketable and non-marketable risks by the mode of their management. Political authorities transform non-marketable risks into marketable ones by the governance of political environments. Many of the political risks, which were non-marketable in a state regime, are saleable and transferable within a plurilateral regime.

Part Six focuses on the governance of political risk. Thus, with few exceptions, political risk has been an area for the government and public sector rather than for the private sector insurers. This fact will be scrutinized from the international relations perspective. It explores what kind of a task is the framing of new political risk management institutions and instruments.

The object of the research is the theoretical literature of political risk. The results of the analysis will be applied to the European Union’s internal and external trade and investment environment. The central focus is the framing of the multiple political authority levels and the risks related to them. The case concerning the European Union’s Internal Market in the Part six was written in 1997 before the Treaty of Amsterdam was signed. The Treaty of Amsterdam amended and renumbered the EC and EU Treaties in 1997. The renumbering is shown in brackets, for example Article 113 (Article 133 since 1997). It has not been updated because the focus is on its connections to political risk theory rather than the Treaty itself. The analysis of political risks in the Russian investment environment will have a special emphasis, because of the importance of the positive development of commercial relations between Finland and Russia.

2. Pluralism and Equilibrium in Societies

2.1 Equilibrium

The analysis of political risks has been done at the nation-state level. Political risks have been estimated by using the comparative country risk ratings. In the comparative analysis, political risk categories are based on the premise that the more democratic the society, the more accountable it is; and the more accountable the society, the less susceptible it is to sudden or explosive political shocks. Part Two focuses on this basic argument.

The premise refers to pluralist societies, where a predictable political equilibrium prevails. According to James S. Coleman, in a rational analysis, the social equilibrium results from exchanges of control resources among actors. Actors are connected to resources only through two relationships: their control over resources and their interest in resources. Under certain circumstances, control can be unilaterally transferred from one actor to another. In the social system of exchange, an actor is interested in a certain resource, but he does not necessarily have control over it. The action principle for each actor in the system is one that leads him to gain control over the resources that interest him. The actor gives up a resource he has and exchanges it with another actor who has control over a second resource and is willing to exchange it for the first. Under certain conditions in society, with many actors and interests, an equilibrium point is in outcomes that are in some sense optimal. After an exchange, each actor is in control of those resources that most interest him, subject to the power of his initial resources, and, since he will exercise that control to achieve the outcome he prefers, there is no way to achieve any greater satisfaction given the initial distribution of control and interests. In this sense, the outcome is optimal and social equilibrium prevails. In the market exchange, there is a price system; in the pluralist political milieu, there is a whole set of equilibrium points that constitutes legalized exchange of political control among actors. Under certain conditions, there will be exchanges each of which would be better for both actors than the initial point, but none of which would be better for both actors than any other point in the set. The equilibrium point that is achieved in such a small system of exchanges can be described as a property of the system, that is a macrolevel property, just like price in the market exchange.[14] In a pluralist environment, the exchange of controlling resources is arguably predictable, because actors are committed to a continuous contracting game.

However, there are two equilibria of political regimes that can be traced in the international environment of economic actors: the pluralist state regime equilibrium and the plurilateral regime equilibrium that will be defined later. In addition, there is a transformation from the former equilibrium to the latter, due to the integration and globalization processes. The elements of this transformation are explored in this Part.

On the other hand, equilibrium may defined as a dynamic balance – an optimum which is a not a maximum between different political forces in pluralist environments. Equilibrium prevails in a system when various elements of this system are in balance, for example, balance of power or balance between economic actors and political authorities. There is a demand for a stable and predictable environment for economic action characterized by equilibrium between political units. For example, when a state, or a group of states, upsets the balance of power, other states respond in opposition, restoring the equilibrium in the international system. The same logic is found between economic and political actors[15].

In the political risk analysis, the political environment is considered external to the market, and it defines the limits of action for the state, companies, and individuals.[16] Political power relationships are definitive for the existing international rules of the game in society. The power to act is in the first place political, not juridical or economic. Through power relations it is possible to create and stabilize the rules of the game[17].

[14] Coleman.1994:38–42.
[15] Viotti, Kauppi. 1993: 231
[16] Kobrin, Stephen J: *Managing Political Risk Assessment: Strategic Response to Environmental Change*, University of California Press, Berkeley 1982, Ting Wenlee: *Multinational Risk Assessment and Management.* Greenwood Press, Connecticut 1988 and Stapenhurst, Frederick: *Political Risk Analysis Around the North Atlantic*, St Martin's Press 1992.
[17] North, Douglass C: *Institutions, Institutional Change and Economic Performance*. Cambridge University Press, 1990:3, *Definition of Power: Machiavelli, Niccolo: Prince*, (Huhtala, Aarre 1969), WSOY, Juva 1984.

Significant changes in different countries" risk profiles are related to globalization and integration. The development of integration rests, at its root, on an initial influence of politics and the economy.[18] The main integration risk components are related to both the development of the internal markets and external relations of the European Union. At the global level, the political risks are related to an increasing number of liberal democracies.[19] When there is a regime of pluralist liberal democracies, a so-called plurilateral regime, the political risk level is lower than in any other environment. Within the plurilateral regime, the-rules of the game are constantly harmonized in order to lower the political risk further. The consolidating effect of this process reaches to the economic environments outside the core of the plurilateral regime.

The OECD countries provide the core of developed post-industrialized states in the plurilateral regime in which the European Union is in the center. The environments outside the core may be categorized in two types of balance between the economic and political factors: In heavily industrialized countries such as Russia, China, and India the role of the political authority is more significant than within the core of a plurilateral regime. In the pre-industrialized world, where industry is still at the first stage of development, economic relations are strongly built on direct regulation maintained by political authorities. In the core plurilateral regime, the rules of the game are so well established that the role of the political authority becomes narrower[20].

[18] Haas, Ernst B: *The Uniting of Europe: Political, Social and Economic Forces*, Stanford University Press 1968, Nugent Neill: *The Government and Politics of the European Community.* Macmillan Press, second ed. 1992, Nugent Neill: *European Business Environment*. Macmillan Press 1994.

[19] Fukuyama. 1992: 70.

[20] Majone. 1997:9. Majone is illustrating the regulation and regulatory institutions in the European Union: "The growing significance of the agency model is the indication of the transition from the interventionist state of the past to the regulatory state of the future.'

2.1.1 Balance and Shifting Boundaries between the Economic Actor and Political Authorities

Political risk analysis concerns political variables, which negatively affect companies" international trade and investment environment. These negative affects are political risks, and they will be defined as an unpredictable transaction cost later in this research. As Robert O. Keohane has pointed out, there is both a supply and demand of international regimes. He emphasizes the role of regimes in reducing transaction costs and coping with uncertainty in international economic action[21].

The fundamental questions concern the shifting boundaries between the political and economic factors, which determine the values of the risk variables. The market economy must, in crisis situations, grapple with the question of replacing the-rules of the game of the market by a political hierarchy. Only after a balance has been stabilized, will it be possible to return to a market-directed society. Replacing the market with a political hierarchy is expensive.[22] However, in a global environment, this is the way to control risks. Adam Smith and Karl Marx represent an example of extremes in formulating the balance between economic and political actors. Whereas liberals stress the mutual benefits of international commerce, Marxists regard these relations as basically conflictual.[23]

Liberalism, protectionism, demand stimulus, and mercantilism were concrete, in market economies, at the level of pluralist nation-states, whereas socialization and planning have lost their importance in a plurilateral regime. At present, discussion is more concerned about the visions between the classical and the managed liberalism. Liberalism is a solution for finding a balance in the pluralistic political environments. Liberal thinking has particularly stressed the positive role that the international institutional rules of the game can play in promoting co-operation in the world political economy. Democracy is an instrument for maintaining co-operation among interest groups, companies, and individuals. Interest group liberalism is connected with political decision-making in a case where individual subjectivism and pluralism are

[21] Keohane.1989: 102.
[22] Williamson.1996:115, 355.

separated. According to subjectivity, an individual looks after his own interest; in a pluralist system, political influence takes place in interest groups. Robert A. Dahl proposes that the interest group liberalism is a system where all active and legitimized population groups can get their opinion heard in decision-making[24]. Pluralism is a legalized competition between interest groups and at the international level between nations. An illustration of the negotiating power of decision makers in companies and politics can be defined by the framework of political risks in this competition[25].

2.1.2 The Borderline Cases Demonstrating Transformation and Shifting Boundaries

Political risk can be analyzed by focusing on borderline cases in international political transformation and in the relationship between economic and political actors. The rules of the game and boundary lines of the market economy change within an institutionalized path. The investigation of balance concerns instability and borderline cases that divergent actors face in their environment. In this case, control means minimizing instability[26]. In the modern world, international competition among nations requires an efficient interaction between economic and political actors to ensure the equality of individuals.

2.2 Pluralism: A Dynamic Equilibrium

Pluralism is a metaphor used for theories in international relations, where there is an equilibrium in continuous agreements among political and economic actors, which must co-operate. In an environment of low political risk, pluralist structures lead to co-operative transformation instead of non-co-operative change. Instead of individual agreements, an equilibrium of a variety of agreements resides in a pluralist environment. Thus, in the long run non-zero-sum situations can be avoided. The institution-

---

[23] Gilpin. 1987:12,27,34.
[24] Dahl, 1963:137.
[25] The bargaining positions of political authorities and economic actors has been analyzed from the point of view of political risks in: Lax, Howard: *Political Risk in International Oil and Gas Industry.* Greenwood Press, New York 1983, Lax, Howard: *States and Companies,* Greenwood Press, New York 1988.
[26] Haas,1991.

alized rules between a political and an economic game are based on competition and feedback. An equilibrium between formal and informal rules of the game exists as well.

Pluralism in a state system is reflected also at an international level. According to Jan-Magnus Jansson, it is possible to observe the same pluralist extensions in the international system that can be observed in pluralist societies at the state level. Pluralism has maintained that the interaction between groups comes from different cultural backgrounds and divergent political endeavors.[27]

Pluralism refers to an image of international relations, which assumes that non-state actors are important entities in international relations. The state is not necessarily a rational and unitary actor, but is composed of a multitude of competing bureaucracies, individuals, and groups. The agenda of world politics is extensive and goes well beyond security concerns. Much of the work on decision-making and transnationalism falls within the pluralist image as a result of focusing on a multiplicity of factors and actors.[28] Theories on liberalism, democratization, and integration, and the interdependence theory are all pluralist theories.

Prior to the integration process, there were no international political authorities that would have had direct legitimacy over a single citizen of a nation-state. Citizens" Europe has transformed the legitimacy of the European Union as an authority higher than Member States and increased pluralism in Europe[29].

The theories of political economy focus on the relationship between economic and political actors. These theories are pluralist when based on four key assumptions. [30]

Firstly, in addition to the nation-states, there are independent international organizations using their own rights. States may have pooled their sovereignty in international organizations in order to achieve common goals.

[27] Jansson.1993: 175.
[28] Viotti &Kauppi.1993: 590.
[29] Antola & Rosas: 1995.
[30] Viotti, Kauppi. 1993:228–229.

Besides the formal international economy, there is also an informal international shadow economy with actors of its own.[31] Neither multinational corporations nor terrorist groups can be dismissed as international actors. This leads to the differentiation of formal and informal rules of the game in an international system.

Secondly, the state is not a unitary actor, but composed of individual bureaucracies, interest groups, and individuals. Competition, coalition building, conflict, and compromise among international actors are the core issues in politics. Interest groups and companies have an impact on public opinion and embody cultural differences.[32]

Thirdly, the state is not a rational actor. A shortage of information and compromises in policymaking are limiting decisions that can be made and implemented. Even when there is an objective goal, it cannot be achieved by technical means because of the existing irrationality. For example, in the parliamentary system, the representatives represent their own groups regardless of whether a representative is the best possible person, when it comes to his or her knowledge or when the benefit of the group is in conflict with society's benefit. The knowledge revolution caused by information technology will reduce the shortage of information, and, at the same time, the political authorities" monopoly position will disappear. Control of information will be increasingly difficult for any political authority.

Fourthly, the agenda of international politics is extensive. Although the security issues are of importance, other matters also affect international politics. Economic, social, and ecological factors increase interdependency between actors. Occasionally, trade and investment arrangements or energy questions can be high on a political decision makers" agenda. Cultural differences can also be the reason for a political conflict. Socio-economic factors are, in certain situations, just as important as security factors. In plurilateral structures, states are inching towards peaceful political relations because of their interdependence in economic relations[33].

Because of the pluralist metaphor of international relations theories, the variables affecting the relationship between political and economic actors are numerous.

[31] Strange.1996:110–122.
[32] Zysman. 1994.

Therefore, the framing of the relationship between economic actors" risks and political authorities" functions is based on a fuzzy model.

Also, because of the numerous variables, co-operation agreements are of primary importance on the agenda of a stable and predictable environment. These agreements concentrate on the questions on borderline cases of co-operation. Pluralism emphasizes the equilibrium as a product of negotiating processes between economic and political actors. Property and action rights are legitimized by political agreements.

Pluralism is realized in an exposition, where "market failure" and "state and government failure" are opposite each other. Where the equilibrium resides, depends on the stability between different ideologies of the political economy, the degree of democracy, and the level of economic integration. Douglass C. North has argued that ideology is a variable that determines the expense of transaction in a political environment. Ideology, which consists of the subjective "models" individuals have for explaining and evaluating the world around them, not only plays an essential role in political choices, but also is a key to such choices that affect economic performance.

Individual perceptions about fairness and justice of the rules of the game obviously affect performance[34]. The first step is an analysis of different ideological beliefs about fundamental issues in political economy. This ideological examination of international relations is presented, for example, in Robert Gilpin[35] and Peter Gourevitch's works[36].

2.2.1 Liberalism and the Shifting Boundaries

Pluralism is a characteristic in the theory of liberalism. It is the opposite of the realist metaphor, where the state is the unitary actor and the most important issues are na-

---

[33] Keohane & Nye.1989: 247–248.
[34] North.1997.
[35] Gilpin. 1987. *The Political Economy of International Relations* captured the characteristics of the equilibrium between the state level authorities and national and international markets.
[36] Gourevitch. 1986. *Politics in Hard Times. Comparative Responses to International Economic Crises*, focused on the policy options for dealing with economic disorder in a state regime.

tional security issues[37]. The liberal theories bring the economy to the same level as security policy.[38]

In liberalism, an individual is the central actor and the holder of political rights. Interest groups are formed by individuals who pursue their own advantage. The state has a very limited task in the society and, accordingly, its purpose is to ensure political, social, and economic stability at the extreme ends. These ends are tasks related to maintaining law and order and internal and external security in society. From the companies" point of view, it is worth realizing that a political authority is allowed to regulate even long-range economic functions, if social stability so demands[39].

The international environment of economic activity is a continuation of the domestic environment. In an international environment, the negotiation processes differ from the domestic ones. The feasibility of the pluralistic metaphor is supported by decision-making seen as a series of negotiations. In those negotiations, the behavior of actors is directed also by such independent state variables as family relationships, values, culture, institutions as a whole, communication systems, and understanding other cultures.

In the paradigm of political risk there is a strong path favoring the liberalist tradition of political thought. In liberalism the shifting balance between economic and political action is related to the ideologies of political economy.

However, there exists a wide range of assumptions related to liberalism. In order to trace the shifting boundaries that are set in balance between political authorities and economic actors, the following assumptions and characteristics should be noted.

Liberalism is a tradition of political thought composed of a set of practical goals and ideas. It emphasizes individual levels of analysis and the minimal role of the state and the political authority in societies. The role of political authority is an arbiter, a regulator in disputes between individuals, which maintains stability in a political environment. Liberalism is based on assumptions of commercial liberalism, which

[37] Spegee.1996: 102–126.
[38] Keohane & Nye, 1989:247, Viotti & Kauppi. 1993: 10.

argue that the expansion of the international economy made wars more costly for states. This assumption is strengthened by the notion of the theory of comparative advantage in international economy and free trade. Democratic liberalism argues that the spread of democratic political systems will decrease confrontations and outbreaks of hostilities. Regulatory liberalism argues that the benefits of international law, accepted rules of the game, and international organizations would enhance global cooperation.[40]

According to Ernst B. Haas, in world-order ideologies the differences in purpose and form of collaboration can be traced between classical and managed liberalism. The purpose of collaboration, in classical liberalism, is to create global rules of the game that permit market forces to work freely, and to reduce international transaction costs for all state and private activities, including the maintenance of peace. The form of collaboration is based on as many organizations as seem to be needed for specific tasks, with limited powers, and with emphasis on the rule of law. There is no central coordination.[41]

In managed liberalism, the purpose of collaboration is to create global rules to protect valued national institutions and practices, as far as a recognized international interdependence requires them to flourish for national practices. The form of collaboration is to create such organizations, as seem to be required by specific tasks, willing to delegate power as suggested by the extension of recognized interdependence. Central coordination is accepted as needed.

The significance of these ideologies, as shown by Haas, will have a role in the development of the internal market of the European Union. The role of a political authority as regulator of the economy is based on the discourse concerning classical and managed liberalism.

In the classical liberalism of Adam Smith, the greatest efficiency comes from private calculations, and the task of a political authority is to leave the markets alone[42]. As-

---

[39] Aggarvall, 1987:3–38.
[40] Viotti &Kauppi.1993:231.
[41] Haas.1990:66.
[42] Goddard, Passé-Smith & Conklin.1996:37–53.

sumptions about the nature of international economic relations are a non-zero-sum game, where harmony follows from comparative advantage. The state is an outcome of a pluralist struggle, where the economy determines politics. To achieve the liberalist goals and objectives, there is a demand for free trade, division of labor, and free flow of investment. As an outcome, the nation-state disappears, politics gives way to economics, and equilibrium, based on competition, becomes dynamic.[43]

In managed liberalism, the political authority provides at least some services that are necessary for the market to function properly, but are in no one's private interest to supply. Defense, security, education, and infrastructure can be claimed necessary for the market, but those who use, by and large, the language of Adam Smith, seek instead to curtail the role of a political authority's action. In good times and bad, the neoclassical solution to international distress is to allow the markets to reallocate resources. While the market destroys, it also creates. It destroys the inefficient but rewards the competitive actor. The concept of comparative advantage can be used as a theoretical standard for all countries: developed and developing, agrarian and industrial: first-generation industrial and third-, fourth-, or n-generation; large and small. The classical school has a policy prescription for depression, and it is deflation that helps the market push down factory prices. Deflation is also a standard used for all situations and seasons. According to this model of political economy, the classical answer is to let the market do its work in the bad times. In commercial policy, there is no chance of protectionism.[44]

Unlike the policy options of classical and managed liberalism, mercantilism, emphasizing national interests, can intervene at the specific level of companies. Relationship between economics and politics is such that politics determines economics. The means of achieving goals and objectives include the use of restrictions by the state and the control of facets of interaction. Sooner or later, there will be a breakdown in relationships, an international conflict, or regional blocs[45].

When analyzing political risks, it should be noted that despite criticism mercantilism has never disappeared. The governments" policies toward the condition of specific

[43] Aggarwal. 1991.
[44] Gourevitch.1986: 36–68.

industries have come, increasingly, to call for an industrial policy or a competition policy. Mercantilism requires very complex institutional mechanisms. The explanation of economic ideology stresses the role of perceptions, models, and values. In international explanations, it stresses the impact of war, security issues, military procurement, and other elements of the national interests of the state system in shaping an economic policy.[46]

Robert O. Keohane and Joseph S. Nye with their neo-liberal institutionalism, represent the neo-liberal political thought. In the neo-liberal theory, the core actors are pluralistic states. The actors" behavior is not determined by the structure. The system does not dominate and the core metaphor is “market failure”. Cost/benefit regime is one of the core concepts in political economy. Neo-liberalism emphasizes not only stability, but also change.[47]

Susan Strange has defined shifting boundaries between economic actors and political authority in a way that highlights their diversified roles. She has identified ten responsibilities attributed to the state that have been transformed, but have not entirely disappeared.[48] First was the right to sacrifice the lives of individual citizens related to the states" responsibility to defend national territory against foreign invasion. Second, the responsibility to maintain the value of the currency. Third, choosing the appropriate form of capitalist development, that is, how far the state intervenes in the market economy. The fourth responsibility that of correcting the cyclical booms belonged to the state, as well as the fifth responsibility of providing a safety net. The sixth responsibility, taxation, is also an attribute of the state. The seventh responsibility is an overall development strategy that is not maintained by the markets. This covers, for example, control over foreign trade. According to Strange, in this policy area there is a particularly substantial gap between the claims of the states and the actual outcomes of trade. Eighth, the state's power is exercised within its territorial borders: The states offer public goods, economic infrastructure from ports to roads, and education. Therefore, a significant borderline case between the economy and politics is public services. Ninth, governments have to maintain competitiveness in

---

[45] Aggarwal. 1991
[46] Gourevitch.1986: 42–68
[47] Haas.1991, Loikas.1992. Appendix 2.
[48] Strange, 1996, 73–82.

the national markets. Tenth, the state authority has a monopoly in the legitimate use of violence against the citizen or any group of citizens.

In the analysis of the shifting boundaries in environments that are characterized by the liberalist theories, the responsibilities of the state must be redefined. Political risk governance has its main focus on all these responsibilities.

The debates over whether the government or the market should produce certain goods or services may have to be conducted in terms that assume an overly simplified understanding of property. The concept of property rights does not refer simply to possession or ownership, but to a broader range of relationships. Privatization of public utilities and other public services involves a redistribution of property rights, but the move to contracting and internal trading organizations and agencies also involves changes in the structure of property rights.[49]

The core metaphor in neo-liberalism is “market failure”[50]. This failure is based on the structure between the economy and politics and on the absence of institutionalized rules of the game. The theory of government failure is less formally developed than the theories of market failure, though it appears to be of the same form, and it argues that the inherent characteristics of supply and demand for government services will lead to inefficiency. All political systems are a mixture of market principles and organized, authority-based planning, but the mix can vary enormously.[51]

In the international relations theory, Robert O. Keohane was able to show how the failures of states and governments led to international agreements on co-operation between nation-states and to the formation of regimes.[52] In the transaction cost approach of the international relations theory, the design of political institutions affects how far transaction costs allow or prevent the achievement of gains from international exchange.[53] Williamson has addressed the general issue of the relative efficiency of using market mechanisms as opposed to bureaucratic forms of organization. The basis of his argument is that the most advantageous institutional form will

[49] Walsh.1995: 39.
[50] Haas.1991.
[51] Walsh.1995:15–37.
[52] Keohane. 1989.

depend on the level of transaction costs. Transaction costs may be high when the process of exchange is difficult or complicated. In these circumstances, hierarchical organization may be more efficient than the market processes. Institutional patterns will tend to evolve in a way that will minimize the costs of transactions, with organization being more appropriate in some cases and markets in others. Williamson argues that the growth of markets or hierarchies is more efficient depending on a number of factors: uncertainty and bounded rationality, complexity, opportunism, and asset specificity.[54]

2.2.2 Democracy: Predictability of the Shifting Boundaries

In the paradigm of political risk, the essential features of accountable democracy have been described as having the following characteristics: First, a government and its executive have not served more than two successive terms. Second, the constitution stipulates free and fair elections for the legislature and executive. Third, there is more than one political party and a viable opposition, and, fourth, evidence of checks and balances exists between the executive, legislature, and judiciary[55].

Beyond these characteristics, it depends on stability and predictable boundary lines between political authority and the economic actor. In this chapter, the reason for democratic stability is depicted as a macrolevel characteristic. Clearly defined and predictable boundary lines, for their part, are illustrated at the microlevel.

2.2.2.1 Borderline Cases at the Macrolevel

At the macrolevel, the two theoretical models for political regimes in a state are a pluralist regime and a monist regime. In the context of Western liberal democratic tradition, the concept of democracy as an institutional arrangement refers to the existence of a distinct democratic form for organizing political life, its ultimate task being to successfully channel and reflect the wishes of the majority in both policy formation and policy execution stages. Accordingly, the genius of democracy lies in its capacity to articulate the interests of the "many" (the majority) as opposed to those

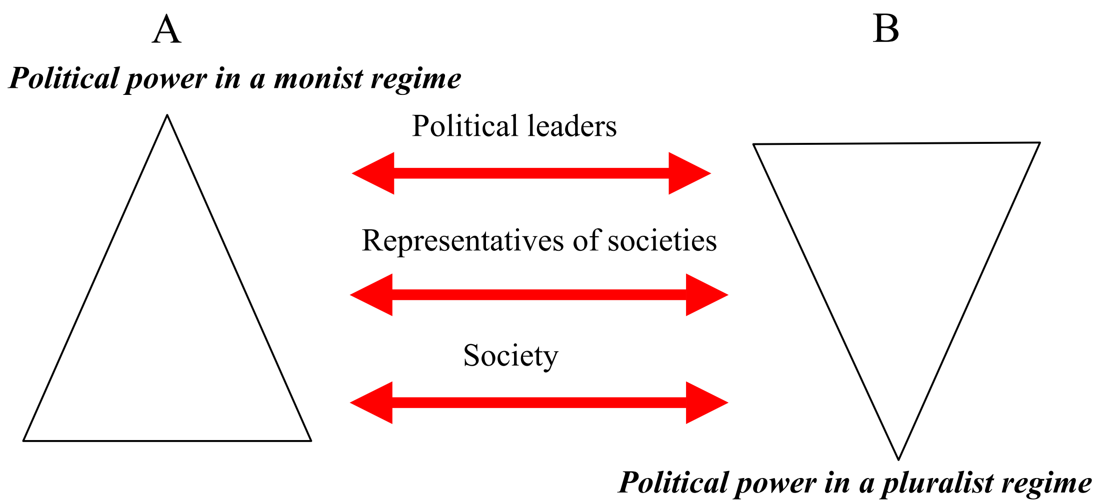
[53] Alt & Alessina. 1996: 648–649.
[54] Williamson.1996:10.
[55] Howell. 1998:190.

expressed by "the few" (the minority) by allowing "*demos*" (the people) to participate, directly or indirectly, in the political process.[56]

It can be argued that, in pluralist liberal democracies, institutionalized mechanisms exist for managing change and resolving conflicts. If a citizen or a group of citizens is not pleased with the state of affairs, they have legitimate channels for political actions to change things. In the pluralist regimes, political leaders are elected and dismissed by the citizens. In monist regimes, in turn, there are no legitimate channels for changing political leaders. In terms of the political risk, the main notion is that when changing political leaders in monist societies, all the rules of the game are changed at the same time. In the monist environments, a power struggle breaks the sharp division of formal and informal rules of the game.

In pluralist regimes, the institutional rules of the game are not so closely related to an individual political leader or political regime. Any transformation of the rules of the game is more predictable. For example, the death or murder of a political leader in pluralist societies will not automatically change the rules of the game in society or shift the equilibrium between political authorities and economic actors.

Figure 1 Political Power in Pluralist and Monist Political Regimes



[56] Chyryssochou. 1998:48.

The political authority structures can be illustrated by using a pyramid as a metaphor (See Figure 1). The institutional rules of the game are stabilized differently in pluralist and monist political regimes. In monist or totalitarian regimes, the rules of the game may change more rapidly than in pluralist liberal democracies, because the political power has a weak linkage to the society. A change of political leaders means the change of the institutionalized rules of the game in the economy as well (B).

In pluralist liberal democracies, transformation of the rules of the game prevails instead of change. Neither a new political leader nor an interest group is capable of changing the rules of the game instantly. Society is constructed of opposing interest groups (A). Stability and predictability are derived from this dynamic equilibrium based on competition between divergent actors.

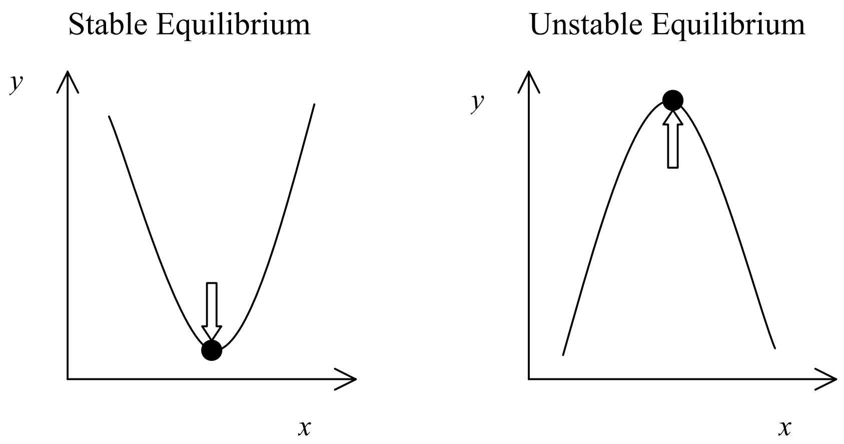
According to Ilya Prigogine, chaos is the normal situation in nature. He has shown the dangers of dominating attractors, which create an illusion of stability. The presence of a single strong attractor indicates a future catastrophic risk, as the situation will inevitably go topsy-turvy when this attractor disappears or is displaced by an even stronger one. Politicians hope that the chances are very small that this will happen in their turn in office.[57] However, in pluralist societies, political power has been dispersed and there is no single attractor compared to the monist political regime. Therefore, it is a stable system. In Prigogine's example, the stable dynamical systems are those in which slight changes in the initial conditions produce correspondingly slight effects. Chaotic systems are an extreme example of unstable motion because trajectories identified by distinct initial conditions, no matter how close, diverge exponentially over time.[58] Democracy and market mechanisms are stable dynamical systems because they produce correspondingly slight effects (elections and economy trends).

---

[57] Stahel.2002:268.
[58] Prigogine.1997:30.

Prigogine uses an example of a pendulum, where the potential energy is minimum. If a small disturbance is followed by a return to equilibrium, the system is stable and in contrast in the unstable system, the smallest disturbance will cause it to fall.[59]

Figure 2 Stable and Unstable Equilibrium [60]



Robert A. Dahl has questioned the universality of pluralism in order to work by the ideal models:

> *Moral and political relativists may contend that if the people of a country choose to be governed by a non-democratic regime, their choice of a political system is as valid as any other choice. But this is paradoxical and ultimately nonsensical. For people cannot truly choose how they are to be governed unless they have the opportunities, rights, privileges, and institutions provided by democracy. People in a democracy can choose to be governed by authoritarian rulers, although in fact they rarely do. But once they have made that choice, they can no longer easily reverse it. That is the reason for a conclusion that "Western" democracy is culturally unsuitable for the people of some particular country. It is one thing to say that for people who have lived under authoritarian regimes for generations it may be difficult, even impossible in the*

[59] Ibid.
[60] Ibid.

> *short term, to develop a democratic culture strong enough to sustain democracy.*[61]

The indicators of democracy can be defined in different regimes. Dahl has introduced the term “polyarchy“ to denote democracy as an ideal system and the institutional arrangements that have come to be regarded as a kind of imperfect approximation of an ideal. The term “polyarchy” was originally coined by Dahl and Lindblom (1953) and developed more fully by Dahl (1971). Polyarchy is defined as the set of institutional arrangements that permits public opposition and establishes the right to participate in politics. As formulated in polyarchy, the minimum requirements for political democracy were: 1. Freedom to form and join organizations; 2. Freedom of expression; 3. The right to vote; 4. Eligibility for public office; 5. The right of political leaders to compete for support; 6. Alternative sources of information; 7. Free and fair elections; and 8. Institutions for making government policies depend on votes and other expressions of preference.[62]

Aaron Wildavsky quoted Joseph Schumpeter and Giovanni Sartori in his article on democracy and balance. It illustrates the transparency of the democratic regime that the political risk analysis has gone after. Schumpeter has defined democracy as a procedure. The democratic method is an institutional arrangement for arriving at political decisions in which individuals acquire the decision power by means of a competitive struggle for the people's vote. The purpose of a stratified democracy is to preserve existing institutions. Hence, it sets out deliberately to duplicate itself in churches, schools, families, and all sorts of associations it co-opts by teaching its own sense of who is fit to rule – people of traditional (hierarchic) sensibilities; people who keep the well-known, but not publicly advertised, secret that institutions and their leaders are far from perfect. Sartori objects to the notion that “democracy seemingly demands transparency, that the house of power be a house of glass”.[63]

This draft division between democratic and monist societies focuses on the notion in the paradigm of political risk that an investor is an “outsider” in the foreign business environment. If democracy is in balance and transparent, the rules of the game ar-

---

[61] Dahl.1995:43.
[62] Coppedge & Reinicke.1990:51.

guably are stable and predictable between a political authority and an economic actor also from the viewpoint of a foreign investor.

2.2.2.2 Borderline Cases at the Microlevel

At the macrolevel, the democratic regimes are argued to be stable and predictable business environments. Where, then, are the boundary lines between an economic actor and a political authority at the microlevel of a company?

Contrary to the belief that markets are dominating both the economic and the political environment, there are separate and non-replaceable tasks for both the political authority and the economic actors. These diversified tasks set the boundary lines between the actors. Defining the boundaries between political authority and the economic actor is the equivalent of defining the responsibilities of the state. Political risk assessment requires the assessment of democratic structures in an environment. It can also be argued that political risk can be low, if the economy and politics are clearly defined as separate issues at the microlevel. This can be found by analyzing the legitimacy of the rules of the game.

One of the borderline cases is democratic decision-making. The basic assumption, in Robert Dahl's theory, is that the assumptions justifying the democratic process in the government of a state do not apply to economic companies[64]. Dahl suggests that in an efficient environment the tasks of different actors must remain separate. Maintaining democracy in an environment is the task of a political authority only. Economic activity is a task for a company, not for a political authority. We may ask: Where are the boundary lines between democratic decision-making and decision-making in enterprises?

Although the markets command production structures and credits, the political authorities have tasks, which markets do not have the ability to handle. Companies as private economic actors demand political authority for security issues in military and in society – in foreign relations, taxation, and, generally, in a wide variety of issues that are not economically profitable, but form part of the necessary infrastructure and

[63] Wildavsky.1994:3.

require a power shift from private sector to political sector. They can be defined as public goods and services, which are supplied by the political authority.

At the highest level, the political authority supplies security guarantees. Without these guarantees, the long-term economic action is non-existent. This cannot be questioned, not even in the most neo-liberal theories. In security issues, the political authority has the power over markets. This can be illustrated by comparing the sanctions that are available from markets and the political authorities, which maintain stability. The political authority has a legitimate right to use violence as a sanction, while the markets have the right to make decisions concerning labor, credits, and production. A company does not make such binding decisions, as does the political authority. Laws made by the government of a state, if need be, can be enforced by physical and material coercion. At the company level, the ultimate sanction is dismissal. The workers being the objects of decision-making in companies obey the managerial decisions voluntarily. Unlike the political authority, a company does not make binding decisions.[65]

According to Dahl, the effort to inaugurate the democratic process within companies is essentially a waste of time because it violates the superior right to property. There are two dimensions in property rights: First, in the fundamental moral sense, if democracy is justified in governing companies, it would diminish the capacity of citizens to exercise property rights. Second, it would shift ownership from stockholders to employers. In addition to property rights, oligarchy, hierarchy, and power are interlinked in companies in a way that prevents democratic decision-making. Efficient economic action cannot be based on bureaucracy and the slow decision-making of centralized systems.[66] Derived from Dahl's foundations, there is a boundary line in democratic decision-making between a political authority and a company. Furthermore, the main problem stems from the definition of property rights.

In a pluralist environment, boundary lines are based on continuous co-operation agreements in conjunction with dynamic bargaining processes among political and economic actors. Political authority has a central role in consolidating stability in an

---

[64] Dahl.1985:134.
[65] Dahl.1985: 113–116.

environment. Public service principles and infrastructures, for example, a monetary regime, are constructed through political power. Markets have been, and will be, dependent on monetary regimes. After the Second World War, an intergovernmental conference, with the United States in the lead, established the Bretton Woods regime in order to stabilize the international monetary order that was destroyed by the War. Now the European Union is building up a monetary order and that way creating a New World Order together with other emerging economic blocs.

Great and small powers, hegemonies, and objectives of power have constructed international regimes with different capabilities in regard to the rules of the game.[67] Consequently, it can be argued according to the classical assumption that a riskless international business environment without political factors does not exist, because the tasks remaining for the political authority are many and varied.

Obviously an environment without political authority is turbulent, and long-term investment projects are impossible without stable rules of the game. Even in the most liberal societies, there are distinct roles for both the markets and the political authority, because there is always a demand for stable and official rules of the game both in markets and societies. In an environment where the rules of the game are unofficial, a foreign company is in every situation an “outsider” and the environment is governed by the “insiders”. As in the studies of Charles Kindleberger and Douglass C. North, which are analyzed later in this research, the management of foreign markets requires an existing political governance that enables foreign economic action. However, in the theoretical base for political risk analysis, an environment of non-existing political authority can be assumed, but it has nothing to do with the ontology of prevailing economic environments.

The lowest political risk level was assumed to exist in pluralist liberal democracies, when compared to other political regimes, as the basis of higher stability and predictability. Decentralized political powers in both markets and political systems are able to create those conditions. Interest group liberalism has an important role in a decentralized regime.

---

[66] Dahl. 1985: 111–113.
[67] Bromley.1991.

To manage pluralist organizations in the pluralist environment requires a pluralist manager. According to Morgan, the hallmark of the pluralist manager is that he or she accepts the inevitability of organizational politics, recognizing that because individuals have different interests, aims, and objectives, employees are likely to use their membership in the organization for their own ends. Management is thus focused on balancing and coordinating the interest of organizational members so that they can work together within the constraints set by the organization's formal goals. The pluralist manager is not politically neutral, but an active player in the politics of organization and uses the roles of organizational power broker and conflict manager to maximum effect. [68]

2.2.3 Integration and Extensive Boundaries

According to Ernst B. Haas, the theories that explain integration are pluralist and form part of the global integration theory. The core actors are the people organized in diverse ways. The behavior of actors is not determined by a specific structure. It is not clear whether the integration system dominates the actors. Evolution and cybernetics are among the core metaphors, and the core concepts are related to survival and making life better. A substantive focus is the system as a whole, and change is emphasized.[69]

According to the pluralist metaphor of international relations, the agenda of international politics is extensive. States can pool their sovereignty by shifting the political power beyond the national level towards international decision-making. The pluralist metaphor characterizes the theories of integration, which minimize the nationalist interests that produce zero-sum situations among the actors. The integration process in Europe has been a process of peace aiming at preventing wars by submitting energy and steel production to transnational control in Germany and France. The gradual enlargement process from the first Member States has aimed at stabilizing the

[68] Morgan.1997:204.
[69] Haas.1991, Loikas 1992, Appendix 2.

pluralist liberal democracy and minimizing the security threats faced by the new member states in Europe.[70]

It should be noted, in the strategies of companies, that pluralist processes are affecting the emerging business environment in Europe. The process of integration is characterized by an emerging plurilateral regime for harmonizing the rules of the game at the levels wider than a nation-state: the security system, the European Union, and the society and individual levels.

In Europe, the source of political risk for a company exists in adjusting the institutional rules of the game, developed by the decision-making process of the Union, into the functional goals of a company. For example, in the telecommunications sector, the barrier for free trade is that the sector is linked, at national levels, to security issues, state monopolies, and in part to other sectoral policies in the policy design.[71]

In its multifold activities, the European Union is asserting a powerful set of liberal economic and political values: The EU is a legal organization, through which political values – human rights, democracy, economic liberalism based on the centrality of market – are asserted.[72]

In the operational milieu of companies in Europe, political risks are the result of circumstances created by integration, implementation of rules and regulations at the state level, and of those changes and reflections integration has brought into the internal markets" external economic relations. The European integration is changing the substance of political risk and its management and transforming the identities of European economic actors.

---

[70] The history of integration has been analyzed in: Dedman,Martin J. 1996. *The Origins and Development of European Union,1945–95*. London: Routledge, Laffan Brigit. 1992. *Integration and Cooperation in Europe*. London: The Routledge/University Association for Contemporary European Studies Series, Jordan, Robert S. & Feld, Werner J. 1986.*Europe in Balance.* London: Faber & Faber, Trausch, Gilbert (ed).1993. *Die Europäische Integration vom Schuman-Plan bis zu den Verträgen von Rom : Pläne und Initiativen, Enttäuschungen und Misserfolge*. Baden-Baden: Nomos. Archer, Clive. 1994. *Organizing Europe. The Institutions of Integration*. NewYork: Edward Arnold.

[71] ETLA.1995. Kansallinen kilpailukyky ja teollinen tulevaisuus. Michael Porter's theory on industry clusters is being applied in this research in Finland. Porter's definition of 'national champions' was studied keenly in the early 1990s across Europe. David Jacobson (1994) compared the dependency of national telecommunication sectors on security issues in Europe.

Risk analysis concentrates on the relationship between companies and political authorities in Europe, when integration moves into the phase of regulating a market. It should be noted that the regulation is different from regulation in a nation state. This is analyzed and defined in Part Six as a borderline case. Thus, a consequence of this regulating integration is that, in the European Union, authority and power structures are transformed both in the internal market and external relations.

Thus, far from economic integration, the next phase is a move towards political integration. This is a totally new base for the rules of the game and boundaries between political authority and market forces. Public services represent the significant borderline case in this equilibrium.

Total economic integration includes no tariffs or quotas; common external tariffs; free flow of factors of production; harmonization of economic policies; and unification of policies and political institutions.[73] How widely these targets will be maintained depends on the bargaining processes between the Member States. The balance between economic actors and political authorities is defined by the political processes in Europe. These processes are divergent in different industrial sectors. Wallace & Wallace have used the metaphor of a pendulum for characterizing the European governance in different policy processes. A pendulum oscillates between two magnetic fields, one being based on the nation-state, while the other is transnational.[74] In political risk governance, this metaphor can be used for characterizing the harmonization of the rules of the game between member states, in order to transform non-marketable political risks into marketable ones. It means that the better the economic environment functions, the easier it is to transfer the risks outside the company. Furthermore, the lower the general risk level in an environment is, the more complex political risks political authority is capable of managing. The amount of risk capital is higher in stable environments. Currently, however, there are a multitude of formal and informal rules of the game, and this is the reason for the high transaction cost level for companies in Europe.

---

[72] McGoldrick. 1997:212.
[73] Viotti & Kauppi. 1993: 390.
[74] Wallace & Wallace, 1996:12–35.

While depending on competition between national and transnational ideas, interests, and institutions, the bargaining process stabilizes the emerging rules of the game between economic actors and political authorities. Equilibrium in different spheres depends on time and the issues concerned. Liberalism in the European Union is linked to free trade and an internal market without frontiers within the Union.[75] At the nation-state level, it may be a question of national interests, at the global level the market-based rules of the game are emphasized. At the global level, the emerging European trade bloc has set boundaries of its own between international politics and international markets.

Protectionism, nationalism, and a closed economy are considered the causes of wars.[76]The liberalist path of political thought has stressed the positive effect of economic integration. Stability can be found in the balance between commercial liberalism, democratic liberalism, and regulatory liberalism. In commercial liberalism, it has been argued, the expansion of the international economy has made wars costlier for states. As economic interdependence increases, there will be a disinclination to cut profitable economic ties. Democratic liberalism has argued that the spread of democratic political systems meant that questions of war and peace were no longer confined to a small group of political and military elites as in the past. Leaders have to be concerned with domestic public opinion that could act as a brake on any move towards international confrontation. The regulatory liberalism has emphasized that the benefits of the accepted rules of the game and the international organizations would contribute to the peaceful settlement of disputes among states and, thus, enhance global co-operation.[77]

Political risk management has been the traditional task of a nation-state. The pluralistic state system has changed to a plurilateral regime, which will take on a stronger role in political risk management. An authority regime is an instrument for achieving stability in a turbulent political environment. In the context of political risk, it is a process of the transformation of the governance and management instrument of the political risk from nation-state authority towards the European Union's authority.

---

[75] Action Plan for the Single Market. CSE (97)1 final, 4 June 1997.
[76] Wallace & Wallace.1996:1–30.

2.3 Transforming Equilibrium: From Pluralism to Plurilateralism

Integration theories explain, in principle, the co-operation between nation-states. However, the process between nation-states has produced an institutional regime that contains both fragmenting and unifying elements.

Regarding the state-centered paradigm of political risks, the risk level is lower in liberal democracies. Nation-state has been defined as a pluralist unit. In transforming international relations, the state level as political authority is obsolescing, and the principles of the market economy are spreading due to the integration and globalization processes.

Plurilateralism denotes a regime of pluralist liberal democracies. It can be argued that the political risk level is lower in a plurilateral regime, due to the stabilized and legitimate institutionalized market-based rules of the game, and through continuing co-operation agreements between political and economic actors. It is possible to widen the analysis to internal markets, by framing the way the risk level is lowered, and from there to the external environments of the European Union. Unlike the global uncontrolled market, a plurilateral regime is an agreement of continuous co-operation between the economic and political milieus with the goal of stabilizing the non-zero-sum game between economic actors and political authorities. The greater the differentiation and fragmentation of plurilateral structures and levels, and the greater the overlapping memberships, the greater will be the stability of the overall structure[78]. The plurilateral regime gives structure to the phenomenon of political risk in the operational environment of European companies.

The concept of interdependence consists of a dynamic balance, in the pluralist state system, between economic actors and political authorities. Managing interdependent international environments involves the construction of sets of rules, procedures, and associated institutions for governing interactions in areas related to the boundary

[77] Viotti & Kauppi.1993:231.
[78] Cerny.1993:46.

lines between economic actors and political authorities.[79] With the governance, the international regimes were established.

The transformation, which occurred in the state-centered international environment, has led to the replacement of pluralistic state system, in the OECD countries, with a plurilateral regime. Bilateral and multilateral agreements were made earlier by state authorities, but now, within the plurilateral regime, the agreements are made by actors which affect the society from the security system level to society level, both above and below the former state authority.

The purpose of this investigation is to develop a theory of transformation, based on integration by the means of a metaphor of plurilateralism, to describe the harmonization of the-rules of the game in the OECD countries. Also, the diffusion of the plurilateral regime to the economies outside the core of the regime is illustrated.

A plurilateral regime emphasizes the positive role of economic and cultural relations between the liberal democracies. Increased interdependence harmonizes, by the means of developing integration, both the official and unofficial rules of the game.

At a global level, the political risk assessment and management should be shifted from nation-state oriented analysis to the analysis of the relationships of economic and political actors in larger categories than nation-states. The OECD countries have been identified as representing the core of the plurilateral regime of post-industrialized countries. At the core, economic relations have been characterized by international market-based and stabilized rules of the game and, therefore, the presence of political authority in business actions is not evident.

The economic relations, with the visible role of political authority, are characterized by economic relationships of industrialized confines, for example, in Russia, China, India, and other states, where the economy is based on heavy industry. Furthermore, in pre-industrialized confines, the highly visible political authority, whose role is to maintain stability and predictability, has characterized the economic relations.

---

[79] Viotti & Kauppi.1993:243,244.

Thus, does there exist a balance between “economic” and “political” in the fragmented plurilateral milieu? Are the risks in these relationships manageable? Are the frontiers between the different categories stable in terms of the predictable rules of the game? Do answers to these questions exist?

By developing the prevailing paradigm of political risk, this study has redefined the term “political". The political risk, a dependent variable in analysis, is “political.” Thus, “political” is related to risk management and governance. Traditionally, a political risk has been managed by the nation-state authority's governance. A political risk is managed by political rules of the game. The neo-institutional research tradition sees them as the institutional rules of the game. The concept of trust will be significant in political risk assessment in a plurilateral regime.

Plurilateral equilibrium can be located between the market failure and the state and government failure. Political risk indicates the instability of the equilibrium. When seen as a pendulum, as described above, a plurilateral regime makes the categories of the different business environments fuzzy or non-existent. This means that risk management and governance are likely to be something other than a pure market-based or politically based arrangement, and now, increasingly, reside at the European Union level. In Part Five the Overseas Private Investment Corporation (OPIC) and the European Bank of Reconstruction (EBRD) will be evaluated as examples of hybrid instruments.

By definition, plurilateral is contingent on bilateral and multilateral agreements in international relations. However, compared to the multilateral agreements that are binding on all members in a similar way, the plurilateral agreements have distinct characteristics. For example, the market-based rules of the game may combine participants, but some fragmenting rules of the game remain.

The European Economic and Monetary Union (EMU) is one example of such a regime. Firstly, there are Member States of the European Union that belong to it; secondly, there are Member States of the European Union outside the EMU, and, thirdly, other European states continue to play by the rules of the game of the EMU. Within these frames the non-state actors also began to play by its rules. The most important issue is that after a while it will become complex to draw boundary lines between the independent rules in various economic environments.

Another example is the World Trade Organization with agreements that represent the frameworks for the rules of the game between different participants, but as a result, there are no unitary rules but fragmented rules in a single framework. This phenomenon will be illustrated more closely in Part Six, concerning economic environments in the European Union, the United States, Latin America, and Russia.[80]

A third example of a plurilateral regime is the process of the Multilateral Investment Agreement (MAI). Instead of harmonizing unitary rules for international investment, the political bargaining process falsified it. The requirements of the Agreement were not accepted. However, certain principles remain in the international economic environment. As a result, in a plurilateral regime, there are institutionalized channels for co-operation. The denser the regime, the wider the channels for lobbying one's interests.

2.3.1 Borderline Cases in a Plurilateral Regime

The most important point is that, in a genuinely plurilateral world, no single state or group of states can any longer play a hegemonistic role. Power has been transferred elsewhere in the system.[81] Also in the Europe of the future, political factors will determine rules and boundaries to be faced in the market. Contrary to the popular thinking of the 1990s, even the most liberal thoughts concerning the relationship between economic actors and political authorities have noticed the separate tasks of the actors. The tasks have not been interchangeable.

Thus, what is changing in the European political economy is the transformation from pluralist state regime to plurilateral regime. A plurilateral regime is based on four

---

[80] Hoekman & Kostecki. 1992: 38. *The Political Economy of the World Trade System,* Pelkmans, Jaques. 1998: *Atlantic Economic Cooperation. The Limits of Plurilateralism*., Petersman, Ernst-Ulrich.1996. *International Competition Rules for Governments and for Private Business*, Charnovitz, Steve.1995. *Regional Trade Agreements and the Environment*. Charnovitz is analyzing the methods of linking trade and the environment in plurilateral agreements by the Asia-Pacific Economic Co-operation Forum and Free Trade Area of the Americas.

[81] Cerny.1993: 35.

assumptions derived from the transforming pluralist international environment of companies in Europe.

The first assumption concerns the fact that political authority has been dispersed to several authority levels in Europe. There is a transformation toward multi-level political authority and multiple markets. Equilibrium between state authority and economic actor is shifting from the pluralist state level towards a regime of pluralist liberal democracies. Frontiers between different authority levels remain fuzzy. Market-based rules of the game are united at different authority levels. Dependency on historical rules of the game has such an effect that, instead of change, there is a dynamic transformation process in international relations. In order to capture the transformation process, in Part Four of this study, Douglass C. North's neo-institutionalist theory on institutionalized rules of the game is applied to the political risk problem.

According to the second assumption, the differentiated tasks between economic actors and political authorities will also be maintained in Europe in the future. The economic actors and political authorities will have differentiated roles. Equilibrium prevails between these roles where the opposite ends are the market failure and the state and government failure. **Public services are the borderline case in this equilibrium.**

It is possible to analyze the transforming frontiers of the political economy in Europe by analyzing the development of the internal market process. Until the Treaty of Amsterdam, public services were excluded from the integration process. Now the principles concerning them are set in a European-wide bargaining process. The differences between Member States will continue fragmenting the emerging rules of the game on this highly politicized agenda. Equilibrium between classical and managed liberalism, as well as transnational democracy, are setting the limits for actors, according to Susan Strange and Robert Dahl's fundamental research.

Transformation towards plurilateral equilibrium is fragmented depending on the industrial sectors. The public services and informal rules of the game fragment business environments in the Member States of the European Union.

The third assumption is based on the fact that a diversified political authority works differently than a state authority. In the European Union, authority and power structures are transformed both in the internal market and in the external relations and set the frontiers of regimes. Political authority is being transformed into an economic regulator. A political authority in a plurilateral regime has no budget, compared with a state authority, but it maintains stability by harmonizing the rules of the game and boundary lines. This means that market-baseness in societies is on the increase.

As a result, the rules of the game remain diversified in internal markets and external economic relations. Fuzzy frontiers are placed between Europe and the USA, Russia, Asia, Africa, and Latin America, what comes to the rules of the game set by the nation-states. At this point, the World Trade Organization (WTO) represents a global forum for harmonizing the rules of the game. International co-operation emerges between different areas through international agreements. Part Four will focus on the role of international organizations, and the supply and demand of co-operation regimes, as shown by Robert O. Keohane.

The fourth assumption points out that the political powers define the mode of equilibrium at a global level. The boundaries set by liberalism, democracy, and integration are defined in the future plurilateral regime. The emerging trade blocs determine the way the political risk governance and risk instruments will be set in the wider system of multilevel governance. Internal markets and monetary regimes define the boundaries between the economic and political blocs.

Philip G. Cerny quotes Charles Lindblom's term “polyarchic world” when he characterizes the plurilateral world as a world of neither anarchic nor hierarchical character. That world is not necessarily either a peaceful world or a good society. The interaction of each systemic level and each transnational structure may contain conflicts in general rather than reinforce or exacerbate them[82]. However, fuzzy frontiers between different political economic environments are described by this definition. New international monetary regimes, internal and external markets, and, in general, a wide web of contracts are characteristic of the emerging regions of institutionalized rules of the game beyond a nation-state's regime.

[82] Cerny. 1993: 50–51.

3. The Paradigm of Political Risk

Part Three focuses on the paradigm of political risk. The objective is to frame a new approach emphasizing the European perspective. The reason for a new approach is the integration process that has shifted the equilibrium between economic actors and political authorities.

The traditional method for analyzing political risks is the comparative method. This method is used in research for the analysis of the political risk indicators at the company level, in this Part and Part Four, and the analysis of institutional management in Parts Five and Six.

Political risk indicators can be divided into independent, intervening, and dependent variables. The dependent variables are the actual risks a company faces in its political environment, for example, unfair regulation targeted towards its operation. Risk management at the company level is the management of dependent variables by "political risk instruments" offered earlier by nation-states, and increasingly nowadays by markets and multi-level political authorities, for example, by the European Union and international organizations such as the European Bank of Reconstruction and Development, EBRD. At the political authority level, it is a question of institutional risk assessment and management, in other words the management of independent and intervening variables. "Institutional rules of the game at the formal and informal level'. Different approaches are based on divergent causes of political risks.

The paradigm of political risk was developed, together with the modern comparative political method in the United States after the Second World War. Risk variables in comparative analysis included state institutions, the degree of liberalism, democracy, and a free market economy in the environment of companies.

Early attempts to model political risks in the less-developed countries relied on the concept of bilateral monopoly; host countries controlled the conditions of market-entry, foreign investors controlled the capital, management, and technology. Raymond Vernon's model of *Sovereignty at Bay* captured the dynamic relationship between these two monopolists. The shift of the bargaining power from a company towards state authority was the essence of the model[83]. This model was the classical base for later models and has prevailed ever since.

However, the classical approach to political risk appears to be too narrow in the era of globalization and integration. In order to deepen the assessment, there is a demand for a new theoretical approach to political risk.

According to the paradigm, it was argued that the lowest political risk level exists in liberal democracies.[84] Pluralism was a metaphor for the theories in international relations that were emphasizing democracy, liberalism, and integration. These theories were linked to Western values and concretely stabilized in the OECD countries. These approaches still prevail in the comparative method of political risk. Changes in the economies-under-transformation in Eastern Europe and emerging trade blocs have not altered the argument.[85]

Generally, it is difficult to predict the political risks at the microlevel of an individual company that are derived from the rules of –the game at the macrolevel in the political environment. Therefore, political risks are being managed by the governance regime instead of a single instrument. However, the governance structure has changed together with integration. In order to analyze political risks, a new model for political economy to indicate the risk level in different environments is needed. The model would illustrate the regulation policy in the OECD countries and its spread the rest of the world.

The modern economic environments were characterized by the state companies and state interventions. Privatization and the path to the free market economy and a marketable risk environment have transformed the role of political authority. Improved access to capital markets has lessened the requirements for state guarantees in the single market of the European Union. The external relations of the European Union characterize the extension of a plurilateral regime. In Wolfgang Streek's words:

[83] Vernon.1971
[84] Kobrin.1982.

> *[the] European integration has over more than four decades come to be firmly defined as a process of economic liberalization by international means: of the opening up of national economies through internationally negotiated expansion of markets beyond national borders. Associated with this was the evolution of a now well-established pattern of selective supranational centralization and institution building, which dedicates supranational institutions primarily to purposes of market making.* [86]

Prior to privatization and the free market economy, political risk indexes were used to measure the state's share as guarantor, owner, and operator in the economy. These political risk indexes measured the direct and indirect role of state guarantees. Indirectly, states were giving guarantees to banks and insurance companies and subsidizing companies. International trade and the investments of private companies were promoted by guarantees in order to maintain competitiveness. For international trading partners, it was enough to know that the state authority secured the foreign business associates, for example, in the case of non-payment.

The integration process has caused the transformation of the political risk milieu. Political transformation implies that there is need for developing a new political risk management system. In this research, the new political risk variables are derived from the theory of Douglass C. North, concerning the formal and informal rules of the game in societies. However, the new system is linked to the past. It is necessary, therefore, to go beyond old risk variables and proceed to the new logic of political risk. Generally, it is possible to delineate the problem area, but it seems that definition, recognition, measurement, and management of risk remain complex. It is difficult to move from one level of analysis to another without changing the meanings of the selected risk indicators.

However, the main problem in the paradigm of political risk is quantification, because it often destroys the identities of the political risk variables and causes problems in research methodology: unique events have no probability. Therefore, the

---

[85] Moran.1998.
[86] Streek, Wolfgang.1998.

comparative method can be divided into the qualitative method that preserves the identity of variables, and the quantitative method that conceals the identity of variables. Political risk assessment is based on subjective perceptions. Therefore, there is reason to be skeptical regarding the quantitative risk ratings offered by commercial publishers of political risk analysis. Furthermore, even if information and data are available, it is difficult to connect them to the decision-making procedure.

One of the risk analysis methods is the Delphi method, where the assessment of the risk level in a certain environment is based on a subjective comprehension of political risk. In the rating lists based on the Delphi method, the risk indicators were quantified by using the assessment made by economic actors themselves. With the development of the Delphi method, the Commercial Publishers of Political Risk ratings were founded to publish country-rating lists. These lists reflected the existing conditions for trade and investment in business environments.

3.1 Defining Political Risk

No single, universal model for assessing political risk has emerged because it is not feasible. This view is shared by most of the international affairs research community. In this context, the particular concerns and responsibilities of individual organizations determine what constitutes a risk and which technique for assessment is the most appropriate.[87]

Political risk is defined as the uncertain changes in a political, social, or economic environment, in other words, the uncertain development of the relationship between political and economic milieus in societies. Political risk is a likelihood that political powers will cause changes in economic life, and that these changes will negatively affect the way a company acts.[88]

When assessing and managing the political risks at the international level, it is assumed that the political factors are closely connected to economic activity. According to Thomas Brewer, the connection is the result of three factors, in particular: Firstly, economic resources are commonly used to achieve political targets both as

[87] Brummersted. 1988:78.

sanctions and rewards. Secondly, political competition is mostly a competition for scarce economic resources. Thirdly, the economic objectives are commonly achieved by collective political decisions.[89]

The concept of “political risk” is controversial because its identity crosses the boundaries of specific social sciences: political science, economics, law, and sociology.[90] Therefore, it is difficult to harmonize the different perspectives. Even the term “political” combines both the character and originator of risk. The complexity depends on how broadly the political risk is defined.

According to certain extreme interpretations, political risks are considered to be only those caused by the actions of public political power, whereas at the other extreme, all the dimensions between “economic” and “political” are included in the definition.

Generally, the originators of political risk are considered public power, political parties, interest groups, or the uncertainty caused by the groups” activity in the environment of a company. Above all, the definition emphasizes that it is a question of the power outside the market factors and that the main cause of emerging risks is the dynamic character of a political environment. Behind the transforming rules of the game in a political environment is a political power shift.

Furthermore, this research provides an additional definition regarding the management of risk: In the definition of political risk, “political” refers not only to its cause, but also to the means of managing it. In the case of non-marketable political risks, management is possible only by a political authority. Risk management instruments are derived from the rules of the game of an institutional regime, which are maintained by the political authority.

The concepts of **political risk and country risk**[91] are closely related especially in the banking and financial world. Country risk assessment involves the analysis of the economic characteristics affecting a country's ability to support its current and ex-

---

[88] Loikas.1992.
[89] Brewer. 1985.
[90] Simon. 1984:124.
[91] Shapiro, 1996: 806.

pected level of external debt. Because the economic analysis is based mainly on the indicators based on gross domestic product, country risk is a macro-risk affecting all companies in the same manner.

The study of country risk deals with the quantitative data and leads to more established, better articulated, and better quantified results in terms of its conceptual and methodological formulations than those of political risk that are based on a subjective analysis.[92]

It can be difficult to differentiate between the political and economic origin of risk due to the interrelationship of “political” and “economic.” Thus, according to Alan C. Shapiro, the political risk level is lower if the operations of the economic actor are beneficial to political authority and if a certain company's position is difficult to replace with that of another company. In regard to country risk level, the better a nation's economic performance, the lower the likelihood that its government will take actions that adversely affect the value of companies operating there.[93]

Due to the macro-political characteristics mentioned, the weakness of the country risk analysis is in its asymmetric connection to an individual company's risk level. Furthermore, political transformation does not necessarily follow the market logic. The zero-sum situations among political and economic actors cannot always be avoided. Revolutions and wars are examples of such situations. The political risk analysis examines economic factors, but more important than the liquidity of a country is the willingness to remit the foreign debt. Furthermore, in political risk analysis the sources of the data are critically examined.

Moody's methodology on country risk illustrates the differences between the country risk and the political risk. From Moody's perspective, the assessment of sovereign risk is intended to be no more than an evaluation of that country's foreign currency credit risk. These country risk assessments should not be regarded as evaluations of the virtues of that nation's specific political ideology or leadership, except when such factors relate to the question of creditworthiness. For example, a country with a

[92] Ting. 1988: 60.
[93] Shapiro.1996: 612.

highly-centralized or totalitarian government could warrant a high credit assessment provided that the government is stable, that there is reason to believe it will maintain its legitimacy, and that other positive factors are in place, such as strong export markets and an efficient economic structure for resource exploitation. By contrast, a country with a strong commitment to democracy and the free market economy could from the narrow perspective of credit assessment be regarded as a high credit risk state.[94]

A weakness in country risk analyses is that these models have been used only in assessing economic factors and exclude social and political factors that can impact on the debt repayment capability. Another weakness concerns structural shifts of the independent variables over time. In reality, the economies of various countries and the international environment are undergoing a rapid transformation process.

Figure 3 Closely Related Risk Concepts

COUNTRY RISK	**POLITICAL RISK**	**POLITICAL THREAT**
INDICATORS BASED ON GROSS DOMESTIC PRODUCT	INSTITUTIONALISED RULES OF THE GAME -predictability	ABSENCE OF A STABLE SECURITY BALANCE
LIQUIDITY: FOREIGN EXCHANGE EARNINGS AND DEBT BURDEN[95]	SECURITY POLICY LEVEL STATE LEVEL COMMUNITY LEVEL SOCIETY LEVEL	SECURITY POLICY: MANAGING CHAOS, ANARCHY, AND TURBULENCE

There is a definitional difference between the concepts of **risk and uncertainty**. “Uncertainty” means that the information in the decision-making process is false or lacking. “Risk” is the realization of the likelihood of an unexpected, causal event. The realization of risk causes a negative difference in the expected and the realized income. In the key position is the amount of information, which enables the uncertainty to be changed into risk. Risk – at least in theory – is measurable, can be assessed, and avoided.

[94] Coplin & O’Leary. 1994: 147.

One of the properties of uncertainty is that the determination of risk premiums in economic activities is not possible. The problems would be non-existent; if there were accurately defined risk premiums. It is a question of subjective likelihood, which is analyzed in Part Five and Part Six. Transforming uncontrolled uncertainty into risk is one of the basic functions of political authority. In political risk management, the political authority creates the equilibrium between "political " and "economic" by institutionalizing the rules of the game.

The concept of **political threat** belongs to the security policy level in risk analysis. Generally, the security threats frame the economic environment at the highest macrolevel. Specifically, at the microlevel, a certain company may become an object of threat when political power is exercised. Where the security threats prevail, stability can be maintained by compensating the market powers with the political hierarchy.[96]

According to Martti Siisiäinen, the future is always a threat for the actors. However, risk does not mean whatever threatens. In a risk situation, it is possible to select from different options. The future's risk is a consequence of decision-making and, thus, caused optionally. Natural calamities come without freedom of choice. In premodern communities, threat was the same as danger, in modern communities threat is the same as risk. The more rational the decision-making and management machinery becomes, the more risks can be faced in the future. The more rational the calculations and the more complex the calculations, the more future risks will be confronted.[97]

What kind of political risks characterize the plurilateral core? In classical liberalism, political hierarchy compensates the markets for security threats. This argument refers to a notion that was based earlier on the fact that political transformation does not necessarily follow the market logic. Maintaining order in society is the task of a political authority even according to the most liberal theories. When applied to the political risks paradigm, a threat can be the crisis situation in which a community drifts into chaos. When managing threat through a plurilateral regime, the institutionalized rules of the game will compensate the political authority. Harmonization of the rules

---

[95] *Institutional Investor*. 1994.
[96] Williamson. 1996.

of the game is based on the reputation effect [98] and continuous agreements[99], which are introduced in Part Four.

According to Pekka Visuri, there is a basic comprehension of threat in security analysis, which can be similar to vulnerability. During the Cold War, the threats were concrete and quantifiable. In the prevailing international environment, risks derive from the continuation of peaceful development[100]. In the political risk paradigm, for example, it may be a question of efforts to diminish economic vulnerability or economic competition between nations, which may lead to an unfair regulation affecting international companies.

3.1.2 Comparative Political Risk Analysis

The rules of the game between political authority and economic actors, and risk related to that relationship, could be analyzed by using a comparative method.[101] The institutionalized rules of the game and inclusive risks are expediently compared in different operational environments by taking as a reference the best-known operational environment for the company. Values of the risk variables are determined by factors in political, economic, and social environments inside and outside the borders of political authority.[102] The authority levels are local, regional, national, European, and global.

The variables in political risk analysis can be identified at different authority levels. Values depend on the prospects for the decision-makers” actions or factors originating from society, which affect a company's activity. For example, a conflict exists in harmonizing the energy and telecommunications policies in the European Union, where there are aims, on the one hand, at further liberalization and, on the other, at the prevailing interest structures in nation-states that resist the change.

---

[97] Siisiäinen. 1994.
[98] Williamson. 1996.
[99] Keohane. 1998.
[100] Visuri.1997:222–236.
[101] O’Donnell 1994:48.
[102] Brummersted.1988.

The typology of the risk variables can be derived from the typology presented earlier by David A. Brummersted[103]. **Independent variables** in the risk analysis are *psychological, political, societal, interstate, and state community* structures created by integration processes and *global variables*.

Psychological variables connect the personal characteristics, beliefs, attitudes, old experiences, and the factors of the social background to political decision-making. The decisions are formed by the decision-maker's personality. There is a correlation between leadership style and political decisions.[104] *Political variables* are associated with the permanent political structures of the states, for example, with the agency establishment, legislation, party, institution, interest groups, bureaucracy, and formulation of public opinion. *Societal variables* include economic factors such as economic growth, balance of payments, and inflation. Internal stability in the political risk analysis concerns variables in this group. *Interstate variables* are alliances such as economic and military alliances. A new independent variable, the *state community variable*, is needed for such organizations as the EU, NAFTA, and Mercosur, which regulate economic actors according to different degrees of validity. *Global variables* include the geopolitical status of states and regimes in international relations.

Identification of differences between states along certain major dimensions can be completed by using **intervening variables**, which are in between the independent and dependent variables. They include the legitimacy of political authority and the technical structures of government and economy in the area, which is the most determining level in the company's political environment. According to Ernst B. Haas, stability in the political environment is a question of authority and its legitimate power.[105]

Furthermore, according to Vanhanen, the intervening variables have to be systematized in a comparative analysis.[106] Yet, systematizing is not without problems, because during a transformation process the authority levels are fuzzy. How would one

[103] Brummersted.1988.
[104] Tversky & Kahneman.1992:297–323.
[105] Haas.1991.
[106] Vanhanen.1994.

capture “governance without government"[107], when analyzing political risk? Should the absence of political authority or multi-level governance be interpreted as a sign of instability or a new market-based regulation policy in the environment of a company, where the role of political authority is obsolescing? Uncertainty is a feature in the market economy, but this type of uncertainty must be separated from chaos. As analyzed in Parts Four and Five, the rules of the game in market economies (harmonization and co-operation at all levels of analysis) represent stability in the plurilateral core. Liberalism prevails in presenting the political ideology of the plurilateral regime. The alternative regime is a pluralist state-centered regime.

The intervening variable is the legitimacy of the authority structure, for example, in the European Union's commercial policy and external relations in the new frame of international commerce and investment. Decision-making procedures are independent variables, but the intervening variables are the legitimacy of these structures .

Together the independent and intervening variables represent the institutional rules of the game in the political environment of a company. These variables are taken as given at a company level. Furthermore, the institutional rules of the game can be divided into formal and informal rules of the game. The reason for this will be analyzed closely in Part Four in this study. Briefly, the political risk level may be analyzed by exploring whether there are more formal rules of the game in the environment than informal ones. The more informal rules of the game the higher the political risk level for a foreign trader and investor in an environment.

In general, both the independent and intervening variables must be standardized before it is possible to analyze the political risk level. Framing the independent and intervening variables is the main target in political risk assessment in Europe. According to the plurilateral approach, it can be argued that the rules of the game are currently being harmonized in pluralist liberal democracies.

When considering the management of political risks, the institutional management aims at harmonizing the independent and intervening variables of the rules of the

[107] Rosenau.1997.

game between societies. The management instruments are used for managing the dependent variables.

Dependent variables have a direct impact on the companies" activities. Usually the values of these variables cannot affect the environment, but must be taken as given at the company level. Therefore, political authorities have offered political risk guarantees for companies. At the company level, lobbying is more about affecting intervening variables, the political authority structures, and policy making than dependent risk variables.

However, political risks are commonly considered to belong to the management of dependent variables, but this point of view is limited to the technical level only when considering the technical instruments in a company's production function, because the political environment is taken as given.

Dependent variables are important, when decision-making is limited to the "to-go /not-to-go" dimension in investment decisions. Also, there are alternative environments in which to invest or trade. Decision-making becomes more complex when the "to-go" decision has been made or when there is no alternative environment. In the European Union, the decision-making strategy of "to-go /not-to-go" will be important regardless of the internal markets and harmonization processes, due to the differing informal rules of the game at the implementation and society levels. This will be focused on further in the study.

Beyond the risk variables, there are four evaluative criteria in comparative risk analysis[108]: According to the comprehensiveness criterion, an analysis is used for processing clearly at all those levels, which have been selected for research. When describing, explaining, and predicting the political environment, the risk variables are extracted from six levels of analysis: 1. Individual; 2. Group; 3. State ; 4. Interstate; 5. State community; and 6. Global.

The criterion of comparability means the risk spectrum must be differentiated according to the type of political authority. In dealing with structure and legitimacy in the function of a political authority, the new knowledge must be produced through an approach that assumes political authority differs from one level of analysis to another. The requirement of comparison allows for the construction of typologies of political risk.

The criterion of operability requires that the concept of metaphor has no empirical meaning until one defines rules or procedures for identifying it in the real world. A metaphor might be operationally defined as an analyst's set of attitudes about a foreign country or a state community measured in terms of a set of questions asked by analysts.[109]

The criterion of policy relevance requires analysts to consider the needs of a decision maker and how these needs might be satisfied; is the research helping the decision makers to resolve authority structures and identify the variables, which affect marginal rules and institutional rules of the game?

According to Stephen Nairne, while no widely accepted methodology for assessing political risks has emerged, any approach should fulfill at least six basic requirements[110]: First, identify social, political, and economic factors that may adversely affect a country's business environment. Second, identify social, political, and economic factors that may adversely affect a sector or a project's viability within this environment. Third, measure social and economic factors whenever possible. Measuring political risk is analyzed in Part Five. Fourth, systematize risk estimates allowing for comparisons across countries, sectors, and projects. Fifth, while imposing discipline on the selection, weighting, and analysis of variables, the model must be flexible and predictable. Sixth, identify viable business opportunities in an environment.

Figure 4 presents the variables of political risk analysis. Independent and intervening variables are the institutionalized rules of the game in societies. The values of the variables are taken as given at the company level. The dependent variables are politi-

[108] Brummersted.1988
[109] Delphi method, Chapter 3.3.
[110] Nairne, Stephen, 1997:29.

cal risks that companies are trying to manage by transferring the risks outside the company.

The two types of dependent variables of political risks are the risks caused by political authority and those caused by society both at the microlevel and macrolevel. These levels are divided into internal and external risks depending on whether the risks are caused by an internal phenomenon in the political environment or whether they are caused by an external factor that appears in an environment. The significance of assessing the different types of political risks will be shown in risk management. The management depends on the causes of the risks.

Figure 4 Political Risk Variables

INDEPENDENT VARIABLES (GIVEN AT A COMPANY LEVEL)

PSYCHO-LOGICAL	POLITICAL	SOCIETAL	INTERSTATE	STATE COMMUNITY	GLOBAL
• Personality • Beliefs • Perceptions	• Bureaucracy • Interest Groups • Domestic Pressures • Structural Differentiation	• National Culture • Domestic Conflict • Social Structure • Economic Factors	• Alliances • Bloc Membership • Interstate Organization • Trade/ Currency Agreements • Policy Inputs	• System: the EU, Federal states, etc. • Structure • Operation • Sub-systemic Phenomena	• Systemic Attributes • Status Rank

INTERVENING VARIABLES (GIVEN AT THE COMPANY LEVEL)

TYPOLOGIES OF POLITICAL AUTHORITY: LEGITIMACY OF THE RULES OF THE GAME IN SOCIETIES: STATE, THE EU, TRADE BLOCS, ECONOMIES-IN-TRANSITION, RUSSIA, NATO

DEPENDENT VARIABLES, KEY RISK VARIABLES
(RISK MANAGEMENT AT THE COMPANY LEVEL)

	MACROLEVEL All companies		**MICROLEVEL Selected companies**	
	SOCIETY	**POLITICAL AUTHORITY**	**SOCIETY**	**POLITICAL AUTHORITY**
INTERNAL	REVOLUTION COUP D'ETAT CIVIL WAR GUERILLA WARFARE DOMESTIC VIOLENCE	EXPROPRIATION NATIONALISATION REPATRIATION RESTRICTIONS HIGH INFLATION BUREAUCRATIC POLITICS LEADERSHIP STRUGGLE	*SELECTIVE* TERRORISM *SELECTIVE* STRIKES *SELECTIVE* PROTESTS NATIONAL BOYCOTT OF COMPANY	*SELECTIVE* EXPROPRIATION BREACH OF CONTRACT PRICE CONTROLS JOINT VENTURE PRESSURE DISCRIMINATORY TAXES LOCAL CONTENT LAWS
EXTERNAL	CROSS-NATIONAL GUERILLA WAR INTERNATIONAL TERRORISM DISINVESTMENT PRESSURE WORLD PUBLIC OPINION	WAR BORDER CONFLICTS ALLIANCE SHIFTS INTERNATIONAL BOYCOTTS/ EMBARGOES	INTERNATIONAL ACTIVIST GROUPS *SELECTIVE* TERRORISM FOREIGN MNC COMPETITION INTERNATIONAL BOYCOTT OF COMPANY	BILATERAL TRADE AGREEMENTS MULTILATERAL TRADE AGREEMENTS EXPORT/IMPORT RESTRICTIONS DIPLOMATIC STRESS FOREIGN GOVERNMENT INTERFERENCE

Generally defined political risks are present in an environment, when there are political changes and it is difficult to adapt those changes at the company level.

According to Susan Strange, because of the obsolescing role of state authority and transformation of authority levels, there is a need for a broader and more comprehensive approach to the study of political economy, broader than it is in the prevailing comparative politics and economics. The comparative methodology of political risk would be part of this new comparative political economics. Strange demonstrates three approaches: The first methodological way would be to organize the material on the basis of markets or sectors, the balance between political authority and market forces. The second would be to analyze the institutions interfering in the market operations, and the third method would be to analyze the functions of authority in a political economy.[111]

The first method of approaching political risks is by organizing the material on the basis of markets and industry sectors and by seeking a balance between the political and economic. At the company's level, the risk level is derived from the equilibrium in specific sectors and markets. As noted in Part Two, equilibrium depends on the ideologies in political economy.

For example, security issues vary meaningfully between industry sectors and markets and define the risk level of a company. However, international markets are not controlled by small states and their political authorities. Financial markets, energy markets, telecommunications markets, and textile markets differ appreciably from one another in terms of the equilibrium between “economic” and “political.”

Strange points out two problems arising from the sectoral method: First is consideration of the holistic entity: How many markets have to be analyzed before retrieving a comprehensive picture of the mix of values, and who-gets-what in the system as a whole? Second, consideration is given in the subdivision of each market into diverse parts, for example, in the energy sector the division into markets based on hydro, oil, or nuclear power. According to Strange, the service market is becoming ever more complex. However, in political risk analysis, the service market is the most important market because it defines the limits between "political" and "economic" in public services, as will be analyzed in Part Six.

The second method is currently under development by institutional economists. It analyzes the kinds of roles of intervention a number of institutions from national governments and international organizations to private foundations and business associations have exerted.

But describing these institutions can be tedious. Furthermore, any statistical description lacks the dynamics of the real world, and technical developments rapidly alter the relationships between political authority and markets. Assessing the relative importance of various institutional sources of authority on divergent issues and at different times is not easy, so the authority-market relationships are hard to capture with a method that attests to a rather static vision.

The institutional risk management is analyzed in Part Five. According to Strange, the biggest changes occurring in the international political economy are the shifts away from states and towards markets. Arguably, analyzing institutions and organizations has not lost its meaning, but institutions must be defined using broader pluralist definitions, as is done in Part Four. Institutions and their risk management instruments are the products of bargaining between different interest groups that can be revealed, and an available instrument is the result of existing co-operation.

The idea that, in co-operation with the political power, stability can be sustained by increasing the formal rules of the game in the environment is a background for international business. Political authority has created conditions for large investments by giving guarantees, dividing risks, organizing infrastructure building, and maintaining public services. New institutions will be based on market logic instead of state institutions.

When the risk-taking capacity is marginal, management of the environment is possible only through a political authority's institutions. A political authority's power is different from the power of companies because it can make decisions that are binding

[111] Strange, 1996:40–43.

on citizens, and the laws made by the government of a state can be enforced by physical coercion.[112] Therefore, the first analysis was on the equilibrium between "economic" and "political" in the study of political risk.

In the third method, the functions of authority in a political economy are analyzed: who or what is exercising those functions and with what effect on the outcomes. The method is flexible and can be applied to all forms of authority. It starts with questions about who is exercising authority and why, by what means, and with what consequences. The hypothesis presented by Strange is that on many issues most states have lost control over some of the functions of authority and share them either with other states or with non-state authorities[113].

In a plurilateral regime, control can be achieved by harmonizing the rules of the game between economic actors and political authorities. Stability is derived from the rules of the game in the market economy and the continuous agreement in which the zero-sum game situations can be avoided.

In the approach that will be presented in Part Four, the analysis of the institutional rules of the game is a variation of the first, second, and third methods of Strange. This alternative suggestion for a comparative method for studying political risk is derived from the theoretical foundations of Douglass C. North.

3.1.3 Types of Dependent Risk Variables

In the framework of risk variables, the concern is about dependent variables at the company level. However, the complexity in the types of political risk is reflected in its universal definition.

Political risks are not undifferentiated occurrences. The risks may vary between countries, industrial sectors of the economy, companies involved, and the particulars of each project. The types of risk to which a company is exposed vary accordingly.[114]

---

[112] Dahl. 1985:113.
[113] Strange.1996:40–43.

Stefan Robock[115] dichotomized risks as micro and macrorisks depending on whether the risks were targeted towards particular or all foreign economic activities in a country. Macrorisks are considered to be such factors as revolution, internal war, or war between nations, general strike, or nationalization of a company. Risks at the microlevel are, for example, selective strikes and regulation exercised by political authority.

Jeffrey D. Simon[116] followed the logic of Robock and in addition categorized the political risks according to their origin: risks caused by societal factors and risks caused by political authority factors. Beyond this dichotomy there are internal and external factors.[117] They represent factors originating inside and outside the prevailing political regime.

In addition, the dependent political risk variables vary at the levels of national political regimes, the European Union regime, and global political regimes. Varying degrees of legitimacy concerning the formal rules of the game explain that complexity.

3.2 Existing Approaches in the Political Risk Paradigm

Political risks are caused by instability, regulation policy, exchange rate fluctuations, a company's internal strategic planning to maximize profits, and unpredictable events, such as natural disasters.[118] There are two approaches in the paradigm of political risk: instability and policy approaches.[119] The common factor in both approaches is that the rules of the game between economic and political actors in society are analyzed, while the environment is given at the company level. Instability confuses the rules of the game, and political decisions can unpredictably cut a company's profitability. In the policy approach, however, the political actors can be identified.

[114] Lax.1983:10.
[115] Robock.1971.
[116] Simon.1984:123–143.
[117] Simon. 1982:66.
[118] Ting. 1988:2.
[119] Lax. 1988.

Stability prevails when there are several institutionalized constraints in a company's political environment. For example, the laws regulating the buying and selling of property. Changing the framework on institutionalized constraints requires changing the laws, but additional informal norms have to be changed in the political environment, before a foreign investor can be sure that these business transactions also follow the new law in practice.

Even if there are inefficient institutions in an environment, norms can be changed only by those actors who have bargaining power.[120] Generally it is assumed, in the paradigm of political risk, that a company has no control over its political environment.

A policy approach has been developed from the model of bilateral monopoly, where an antagonist relationship exists between a state authority and a company. However, the institutionalized rules of the game present a new approach for assessing political risk in European internal markets and external relations. It covers both the instability and policy approaches.

Before proceeding to discuss the different approaches and a suggested new approach to the assessment of political risk, some remarks should be made on the theoretical evolution of the paradigm of political risk.

In the model called “obsolescing bargain,” developed by Raymond Vernon in 1971, two political actors, a nation-state and a foreign company, were pitted against one another for control of economic and political dominance. Vernon's book, *Sovereignty at Bay: The Multinational Spread of U.S. Enterprises*, is a classic study in political risk analysis. However, the equilibrium of bilateral monopoly has since been transformed and changed between political authorities and economic actors to an equilibrium between multi-level political authority and multi-markets in the international arena.

Vernon researched instability from the perspective of the bargaining positions between U.S. companies in their international political environment. At first, there is a co-operative relationship in bargaining, but as time goes on a power shift emerges in the bargaining positions. Co-operation takes place in administrative and technological systems. The investment's life cycle shortens as the technological and management skills spread into the environment of the host states. The negotiating power shifts away from the company, which exposes the company to political risks.[121] The current risk models are largely applications of the obsolescing bargain model.

The typology of political risk evolved, when Stefan H. Robock (1971) developed more advanced concepts and argued that risks were caused by the non- continuous trends in the environment. Instability was the most important factor that had an effect on emerging risks. Robock emphasized instability risk and divided risks into a macrolevel and a microlevel. On the macrolevel instability affects all companies in a country, whereas microlevel risks become focused on individual companies. According to Robock, it is possible to define a vulnerability degree for a company. Oil, metal, and finance sectors are the most vulnerable. Technology and the raw material production sectors are less vulnerable, because they bring skills and new technologies to host countries. Robock has suggested that injection of new technology is the best way to prevent political risks, because the activity has become irreplaceable. However, the life cycle of technological products was longer then than now.[122]

In 1982, Jeffrey D. Simon specified Robock's risk types. He added the sublevels of society and government risks to the micro and the macrolevel risks. In addition, the political risks were divided on the basis of their cause – whether community factors or the government's internal or external factors.[123]

In the conceptual model developed by Thomas L. Brewer in 1981, the relationship between the economic and political milieu was defined in a broader context than before. Risks are caused by political processes and belong to the area of regulation policy exercised by a state authority. The relationship between the state and the company is characterized by bilateral monopoly. There is a competition between the economic and political actors. Firstly, security issues direct state behavior according to

---

[120] North. 1990:68.
[121] Vernon.1971.
[122] Robock.1971.
[123] Simon. 1982:62 – 71.

the assumptions of realism in international relations. If the company's activity is threatening state security, the activities of the company will be limited. Secondly, according to a pluralist paradigm, the state is not a unitary actor but reflects the bargaining processes between different interest groups. The power elite defines the rules of the game in a political environment and political risk depends on the changes in the power elite's interests. Thirdly, according to the model of bureaucratic and organizational behavior, it can be argued that government policy is a product of organizational and bureaucratic institutions. Fourthly, the environment under the control of a national authority is affected by a transnational, global paradigm. Power shifts in international relations affect government policies.[124]

Brewer's model provided a basis for new concepts and a new approach, as Raymond Vernon's model had done ten years earlier. Its most interesting aspect was the use of the concepts of politology. It combined many models of the political risk for understanding the problem. It was state-centered but, because of the global dimension, it could be applied on different levels of analysis.

Howard Lax developed models for sectoral political risk, in 1983 and 1988, and investigated the oil sector. In his theoretical foundation, a regulation shift causes the risks. Risk types in a bargaining situation are a transfer risk set by political authority and an operational risk which means increasing political control. Administration risks are changes of the rules of the game and property risks are directed at property rights. Agreement risks include unfair requirements [125].

In 1988, Wenlee Ting combined an industry policy and Vernon's model and developed a bargaining model for political authority and economic actors. Political risks are embedded in the industry policy. Empirical evidence includes the Newly Industrialized Countries (NICs) in Asia and concentrates on sectoral policy.[126]

The requirement of quantifiability created a demand for specific indexes. In 1975, Dan Haendel, Gerald West, and Robert G. Meadow developed the Political Risk Stability Index (PSSI-index). It is based on empirical data and quantification of the

---

[124] Brewer.1981:5 – 12.
[125] Lax.1983 & 1988.

prospect of diminishing returns at a company level. It was derived from the instability in the political environment using quantitative methods.[127]

The research of political risk has evolved, from the perception of the problem and the concepts and models, to a formulation of risk management regimes. Measurement indexes have been developed, as well as management instruments, at the company level. Organizational aspects have been analyzed at international, government, and company levels. Finally, risk management is a task belonging to a political authority and, therefore, all these dimensions are combined within a wider context.

The examples of the indexes include one developed by R.J. Rummel and David A. Heenan in 1978 for measuring risks. The analysis was descriptive and quantitative. Risk variables included internal instabilities, conflicts, and economic ratios, as well as political extremism[128]. However, it could not be used to solve the problem of objectivity, because the identity of political risk variables was lost in the quantification process. The use of methods that produce indexes creates an illusion of objectivity.

The revolution in Iran, in 1979, represents a political event that has become a watershed for the paradigm of political risk. In 1980s, several commercial risk rating services were established in the United States: Business Environmental Risk Information (BERI), Frost and Sullivan's World Political Risk Services (WPRS), Business International "s Country Assessment Service (CAS), Euromoney Country Assessment reports, and International Country Risk Guide. The methodologies quantified empirical data using expert methods based on variations of the Delphi method. Many of these methods have been developed and are still used and, because of mergers between companies, they are now used by new companies globally.

In 1979, William D. Coplin and Michael O'Leary developed a model for using analyst predictions and a modified Delphi technique to frame political risk. This method provided probabilities of political risk for host countries. Originally World Political Risk Forecasts (WPRF), it was later named Political Risk Services. It provides projections of most likely regime, level of turmoil, currency convertibility, investment

---

[126] Ting.1988.
[127] Haendel, *et al.*1975, 1979.

risk, and export risk. In 1994, William D. Coplin and Michael K. O'Leary and 1998, Llewellyn D. Howell published handbooks on the prevailing risk rating methodologies giving an overview of the methods of commercial suppliers of political risk analysis.[129] WPRF emphasizes the pluralist point of view in political processes where the interventions of political authorities are causing political risks for companies.

In 1982, Steven J Kobrin studied organizational aspects of political risk at a company level. In his empirical research, he compared the ways political risk analysis had been organized in U.S. companies. In Finland, Jarmo Salonen did related research on the organizational structures in European companies in 1987[130].

Kobrin's organizational study was part of a wider set of surveys on political risk. Earlier, he had studied the expropriations in developing countries from 1960 to 1979. Seventy-nine developing countries were compared concerning the expropriation of the affiliates of multinational corporations. According to Kobrin, political risks are basically more hazards than perils. It means that political risks are characteristics of a political environment, not political dependent variables or political processes. A political risk should be analyzed from the perspectives of organization theory, economics, politics, and international relations.[131]

Political risk management has been the task of political authority. In international relations, institutional rules of the game have been harmonized among nation-states, which created a regime of political risk management with identical procedures. This development will be shown in Parts Five and Six. Even though the concept of international regime is proclaimed an old-fashioned, static concept replaced by a dynamic concept of governance without government,[132] it can be argued that nothing has radically changed in market economies, and that this is the reason for using the concept of regime in this study. Markets have always represented a dynamic dimension in international relations, whether the existence is characterized by regime theory or governance approach. Political risk can be divided into marketable and non-

[128] Rummel & Heenan.1978:67 – 76.
[129] Coplin & O'Leary.1994, Howell.1998.
[130] Salonen.1987.
[131] Kobrin.1976:29 – 42, 1978:113 – 122, 1979:67–80, 1980:32–47. 1980:65–88, 1982, 1984:329–348.
[132] Young. 1997:28.

marketable risks[133], and the more there are of the latter the more dynamic governance without political authority there is. In the most market-dominated environment, the political authority is a regulator instead of an owner or economic actor.

The political risk management regime was developed after the Second World War. In 1983, Alan C. Brennglass studied the development of the U.S. national guarantee board, Overseas Private Investment Corporation (OPIC). OPIC has been a model for management institutions and organizations in other industrial countries in terms of risk guarantees. However, OPIC is a market-based institution and its funding is gathered from the capital markets in the United States, even though a political authority is coordinating and setting the guarantee policy in order to safeguard national strategic interests that can vary from the development policy to the foreign policy. [134] In addition to OPIC's programs that cover such political risk perils as nationalization, war, and revolution, OPIC supplies direct loans, loan guarantees, and equity investments in order to fund projects in host countries.

In small industrial states, most of the guarantees are based on budget funding. However, the internal market in the European Union is changing the capability of small Member States to fund political risk guarantees using a market-based system. The European Union’s internal market rules will represent the new regime of political risk guarantees in the future. When the market-based system in risk management is strengthened, it is possible to define the new governance system where the role of political authority is that of a regulator instead of an economic actor.

Alan C. Brennglass analyzed risk management systems in the United States in 1983. In 1992, Frederic Stapenhurst compared the systems around the Northern Atlantic: in Europe, Canada, and the USA. Stapenhurst's overview of political risk analysis, looking in particular at the function in three different home country contexts as it evolved and is carried out in American, Canadian, and Western European companies. Despite the small differences in risk coverage, the systems are largely the same.[135] Widening the perspective to the World Bank group, and the Multilateral Investment

---

[133] Concepts refers to political risk transfer as a management strategy, which will be analyzed in Part Five of this study.
[134] Brennglass.1983.
[135] Stapenhurst.1992.

Guarantee Agency (MIGA), it is possible to define this analysis as a regime analysis in industrialized countries. When the tendency is towards a market-based system, as in the United States, a regime can compensate as a governance structure without government. In addition, when the access to international capital markets increases in all the other states, the static regime, where small states were covering their guarantees from the budget, transform into dynamic governance without government. In a dynamic regime, the political authorities aim at harmonizing the rules of the game between economic actors and political actors and the risk management instruments through markets.

In a static regime, the agreements were bilateral and multilateral agreements between states. The dynamic governance, where the political authority is a multilevel authority and agreements are being made at every level from the security system level to society level in order to harmonize the rules of the game and increase the market-based system, can now be defined as a plurilateral regime or plurilateral governance. The European Union is a new level in this plurilateral system where the European economic and monetary system, internal markets, and common external trade policy are transforming the political space in international relations.

In addition to models, definitions, indexes, organizational aspects, and regimes, the paradigm of political risk covers the context in the field of study. In the 1980s and 1990s, Jerry Rogers edited several publications on political risk. Rogers has, thus, followed the evolution of the political risk paradigm in the United States. [136]However, due to the perspective of a company and the lack of a holistic analysis of the problem of political risk management as a function of political authority, the results have remained fuzzy. Stephen Nairne's proposal for the need to differentiate between private and public sector risks, and among a selection of project and sectoral risks, strongly supports the development of methodologies incorporating transaction-specific variables, in addition to country-specific variables, to guide risk management decisions[137]. This goes hand in hand with the suggestions of Strange for the methods in political economy. The transaction-specific approach is in the neo-institutionalist approach analyzed in Part Four. By analyzing the political risk at the

[136] Rogers, Jerry, (ed).1983, 1986,1988,1997.
[137] Nairne.1997:30.

transaction-specific level, it is possible to trade in such areas, whose political and economic functioning of the environment is highly doubtful.

In 1998, Theodore H Moran returned to the development of Raymond Vernon's "obsolescing bargain model" of the bilateral monopoly model and to framing the political paradigm through the articles written by the strategists of multinational companies and financial institutions in his analysis[138]. However, what was weighted was the perspective of the corporation and risk management instruments, not the shifting boundaries in relationship between economic actors and political authorities at different levels of analysis. This limits the understanding of prevailing political transformation in international relations related to integration and globalization processes. What had been necessary was a further development of the analysis by Thomas Brewer on the dimensions of international politics, as already represented in his article in 1985. The transformation in international relations caused by the integration process needs an analysis that goes further than Raymond Vernon's model.

3.2.1 Instability Approach

As an approach to the dilemma of political risk, political instability is defined as a dramatic change in political environment, for example, war, revolution, or political violence. Political instability changes the existing power system. If the two main approaches, instability and policy approach, are characterized, sudden political change is a characteristic of instability, and gradual political transformation is a characteristic of policy approach.

Traditionally, instability has been one of the main causes of political risk. If the precondition is that the rules governing the relationship between "economic" and "political" are a parameter at the time when an investment is made, risks are future conditions that may transform the rules. In the case of instability, rules are non-existent or may become non-existent in the future. Tension and pressures, which lead to political instability, are continuations of such a cause-and-effect network comprised of cultural, ideological, religious, and economic factors. Political instability increases crime and the shifting of economic activity from the formal economy to the shadow economy.

In pluralistic liberal democracies, the rules are under constant transformation. The political regimes, where stability prevails, have been categorized by a model developed by H. C. Johnson (see Figure 5)[139].

Figure 5 National Political Regimes and the Economy

POLITICAL REGIME

		UNSTABLE	STABLE
ECONOMY	WEAK	INDUSTRIALIZING, RAPIDLY CHANGING STATES	TRADITIONAL AGRICULTURAL STATES
	STRONG	CONFLICT BETWEEN ECONOMIC AND TECHNOLOGICAL DEVELOPMENT AND POLITICAL POWER RELATIONS	INDUSTRIALIZED COUNTIRIES WITH STABLE POLITICAL ENVIRONMENT

Power relations and developments in a state can be estimated from five different perspectives: political, social, and technical development, natural resources, and prevailing peaceful order. H. C. Johnson categorizes states and regions by political system and economy in four classes depending on how they are placed within the unstable-stable, weak-strong dimensions. In the model, a great likelihood of political risks is found in the states in which the political system is unstable and the economic circumstances are weak or strong. In such states, it can be expected that political leaders have no power to implement rules of the game in a company's environment. The lowest likelihood for political risks will be in the states, in which the political system is stable but economic conditions vary. These categories include the industrialized states and traditional agricultural states.

---

[138] Moran.1998, 1973:273–287.

There are channels for political activity in democratic societies, but in non-democratic societies political activity is more likely to be expressed violently.[140] According to Samuel Huntington, revolutions are more likely in societies where the economy is strong but where no channels for political action exist.[141] In pluralist liberal democracies, channels for political action exist for individuals and interest groups. Political risks are related to changes in property rights. Douglass C. North defines property rights as the rights individuals have to appropriate their own labor and the goods and services they possess. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behavior – they constitute the institutional framework.[142]

Instability in the institutional framework has value as a macro-political variable. In the case of instabilities, it is denied that risks are related to a specific company or industry. In the same vein, the dependent variable is only vaguely related to the independent variables. Political risk is a by-product of modernization and a common condition among developing states. There is a tendency, on the part of Europeans and Americans, to judge other states by Western standards. Events that are unusual by Western norms are often characterized as signs of disorder and political instability even if those events are common to the political culture and traditions of the country.[143]

For studies on instability, methods are based on understanding the macro-political frames rather than the relationships between risk variables. In Part Four how the management of instability is developed by harmonizing the rules of the game between different political environments of economic actions will be analyzed.

Scenarios for Managing Instability

Risk is a measure of the unpredictable probability of changing conditions in the future. Nevertheless, the future is inherently far from certain. It is the future that holds

---

[139] Johnson.1981:31–48.
[140] Simon.1984:130.
[141] Huntington.1970: 266.
[142] North. 1990: 33.

both the promise of profitability and the risk of changes that might reduce corporate returns or otherwise interfere with corporate interests. The temporal difference between current and future political conditions is the dilemma: political risks are not inherent in the current investment environment, although the roots of the future risks may be. [144]

In the Prince method, developed by Coplin and O'Leary, pluralist political processes cause risks. For this purpose, optional political regimes are evaluated using the Delphi method. This leads to a specific evaluation of policies under different political regimes in a company environment in the future.[145] The scenarios about the future political risk level are mainly concerned with the shifting boundaries of regulation.

However, the scenarios of political risks in a plurilateral regime will be impossible to capture before the analytical framework is examined, as elaborated in this study.

3.2.2 Policy Approach

Policy approach has at its core a tendency to see political risk as being embodied in policy decisions regulating the economic actions made by political authority. Traditionally, in pluralist nation-states policy decisions are made by state authorities.

Political instability has been defined as a dramatic change in the political environment. The policy-oriented approach is characterized by gradual transformation of the institutional framework of rules of the game in societies. Traditionally, transformation can be direct or indirect depending on what the formal rules are and how they are implemented.

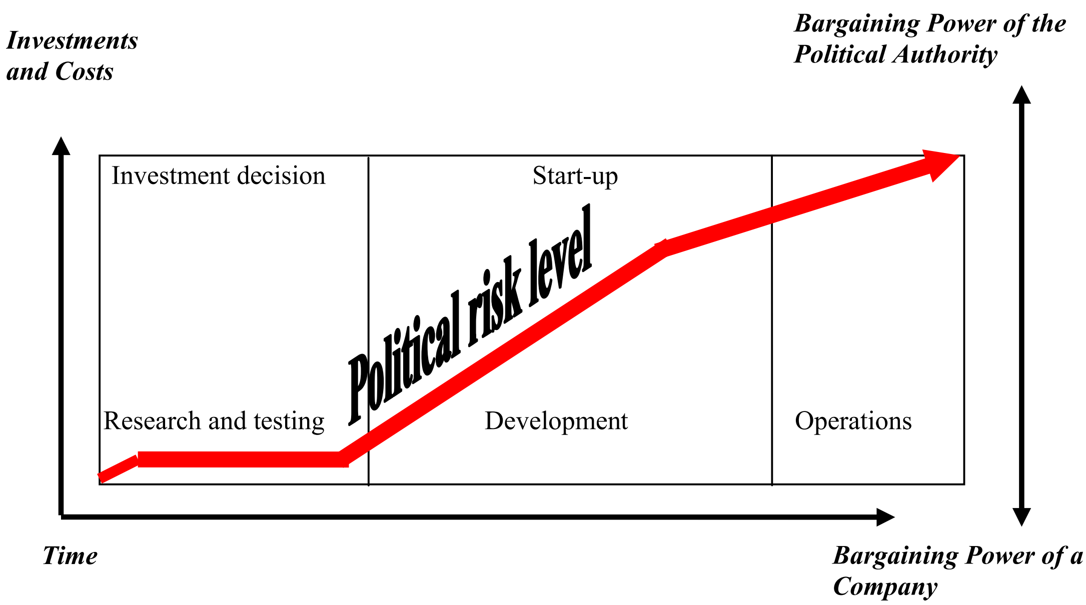
The policy approach is framed by using the model of obsolescing bargain by Raymond Vernon (1971). Wenlee Ting (1988) has developed the model further by adding to it an aggressive industry policy. Coplin and O'Leary have developed the Prince method for analyzing the risks and captured the pluralist perspective in determining the alternative options of the political authorities. Raymond Vernon's obsolescing

---

[143] Lax.1988: 41–55
[144] Lax.1983:13

bargain model was a policy-oriented approach to the problem of political risk. Figure 6 shows the phase of bilateral monopoly where the political risk level of a company rises, when the bargaining power shifts from a company to political authority[146].

Figure 6 Bargaining Power in a Bilateral Monopoly between Political Authority and an Economic Actor



Investment agreements are determined by the dynamics of the relationship between the host government and the company. Vernon's scenario *Sovereignty at Bay* describes an era in the 1960s and 1970s in which the hostile political and economic actors were pitted against one another for the control of economic resources and political dominance.[147]

Each agreement between political authority and company is but one of an ongoing series of agreements that must change to reflect the respective bargaining strengths of the actors involved. A strong degree of interdependence can prevail but, over time, the bargaining power shifts to favor the political authority instead of the company.

---

[145] Coplin & O'Leary. 1998.
[146] Derived from Lax: 1988:143.
[147] Ting. 1988: 39.

Because of the pluralist character of the political power structure, there are various elites – governments, business, scientific leaders – who are affected by the economic actors, and a company may bolster some elite and threaten another. The prevailing ideology, as expressed by the elite, has an important impact on how political authorities deal with the economic actors. A regime is partially defined by its underlying political values and principles, which constrain and channel the purposes for which the state's resources are spent.[148]

However, the obsolescing bargain refers to the vulnerability of companies with large fixed investments and that the terms of their operating agreements have been changed or renegotiated. These companies have suffered a "hostage effect." It means that they could not credibly threaten to withdraw. Projects with large fixed investments, stable technology, and undifferentiated products – in particular, natural resource and private infrastructure projects – are faced with inherent "structural vulnerability".[149] This "structural vulnerability" increases the bargaining power of political authorities, and that means political risks at a company level according to the model of obsolescing bargaining.

The declining bargaining power can appear as a result of an industry policy. Wenlee Ting defined "the host country dynamics" as an entire set of political forces that accompany a country's industrialization and economic development. States have adopted formal industrial policies and consciously and deliberately set up entry-control and management systems to deal with foreign investment and trade.[150]

When analyzing policy options, risk assessment aims to understand the rational and organized risk framework that is comprised of industry, trade, and investment policies. In market economies it is a question of market-based regulation policy.

The host country dynamics is a complex set of rules and regulations that are simultaneously attracting investments by offering services and benefits to the companies and limiting the access of those companies' actions, which do not support the objectives of the investment policy targets. Host country dynamics creates the entry manage-

[148] Lax.1988: 138–147.
[149] Moran.1998: 9–10.

ment system that changes from country to country. Risks appear as a set of bureaucracy towards the company. Bureaucracy consists of licenses and documents needed for business. Political control is exercised on the basis of the documentation rules. Investments, which are not desired by a state, will confront requirements and increased bureaucracy that will limit business operations in a later phase when the investment is made. [151]

International business crosses the boundaries of old political regimes between the environments in the plurilateral core and environments farther away from it. Risk management is intended for understanding the dynamic interactions of policies for companies on the frontiers of different categories of environments. The farthest type of environment consists of developing countries with an under-developed economy and society structure. The control of foreign companies is unorganized and stays closer to protectionist policy than specific industrial policy. Between the plurilateral core and developing countries is the type of environment, which includes newly industrialized states like South Korea, Singapore, Taiwan, and Brazil. According to Ting, these states, which have aggressive industrialization goals, a clearly conceived industrial policy, and high-technology aspirations, tend to have specialized and formalized entry management systems.[152]

In the core, there are the developed and industrialized states, the OECD countries. These states are promoting high-technology companies and harmonizing the rules of the game in societies through the integration process in order to create predictable internal markets. This integration process creates a plurilateral regime between these countries. As pluralist liberal democracies, these states were earlier harmonizing the rules of the game by bilateral and multilateral international agreements. The political transformation can be defined as plurilateral, because the agreements are now being made between actors at the levels of a security system, the European Union, nation-states, and society. Both the agreements and actors are multiple. Political authorities become more and more regulators than economic actors. However, the rules are followed up by a political authority and at different levels, for example, at a security

---

[150] Ting. 1988: 39–63.
[151] Ting.1988:21–28.
[152] Ting.1988:67. South Korea joined the OECD in 1996. In 1988 when Ting's research was made, there were 24 states belonging to the OECD. Now there are 30 member states in the OECD indicating

system level, the frontiers between "political" and "economic" vary. Electronic cash is one example of a plurilateral regime. Inside the regime it is possible to buy and sell in cyberspace and cross the frontiers of political authorities. Marketable rules of the game spreading inside the regime are denser than those outside the regime. Internal markets and the entry management system of the European Union represent the ins and outs in a plurilateral core. International organizations, such as the World Trade Organization (WTO), are embodiments of this regime at the global level. This regime places more weight on stability than growth. The modern state has been characterized by high growth rates.

The fourth category is the economies-in-transition in Eastern Europe, where the states are harmonizing the rules of the game of a plurilateral regime. The equilibrium process between economy and politics includes simultaneous transformation and change.

Two distinct views exist on how the former communist states can rebuild their economies and reintegrate themselves into the international economy. The first view proclaims that piecemeal market reforms cannot succeed and new foundations must be built across all dimensions simultaneously. The second view asserts that for both economic and political reasons effective and competitive markets cannot be created quickly. Incremental reforms can provide entrepreneurs with essential information that simply is not available in the more rapid approach. Furthermore, the shock therapy will produce such large economic dislocations that newly entranced citizens will reject the proposed market reform.[153]

These four categories characterize the frontiers of political environments of companies. Policy choices can be evaluated within different contexts. Because the equilibrium between "political" and "economic" is likely to exist somewhere other than in the pure market-based economy and, on the other hand, somewhere other than in the centrally planned economies, the Prince method developed by Coplin and O'Leary, that is analyzed in the following part, is suitable for risk evaluation, due to its pluralist perspective on the policy made by political authorities. The method was based on

---

the spread of market economy.
[153] Frieden & Lake.1995(1997):419–420.

state-centered pluralism instead of plurilateralism, and, therefore, a paradigm change in political risk analysis is needed.

3.2.3 Paradigm Shift

Approaches for assessing and managing political risk have varied between instability- and policy-oriented approaches. The main objective has been the relationship between "political" and "economic" and, specifically, the relationship between economic actors and political authorities.

However, equilibrium and transformation, which have occurred in international relations, have led to a condition, where state authority has been made obsolete and displaced by multi-level political authority. In market economies, the equilibrium between political and economic is being transformed in a new direction. In pluralist liberal democracies, it concerns the market-based regulation in a plurilateral regime caused by integration process.

Transformation reflects the assessment and management of political risk. Instead of the nation-state approach, inside the regime there are different regions where the rules of the game differ from each other in international environments. The neo-institutionalist approach analyses the rules of the game as institutions representing the paradigm shift.

This suggestion is based on the reasoning that European integration creates an internal markets and external economic relations milieu, where the bilateral and multilateral agreements appear too limited for a frame explaining the relationship between the economic actors and political authorities. Douglass C. North (1990) and Charles Kindleberger have explained the globalization of institutional market-based rules of the game in societies in order to manage the risks in international trade and investment. This historical base can be regarded as an elementary frame derived for risk assessment and management in this new international milieu applicable in Europe.

A new approach requires new definitions, models, methods, and indexes, and it will definitely lead to a new risk management regime that will create a new European perspective on the issue. In this new approach, instability can be defined as the absence of rules of the game that enable investments and trade in the long run. Instability can be argued to be higher in the frontier environments of plurilateral regime. Policy is not defined through a pluralist nation-state but by harmonizing the policies of multilevel political authority inside the plurilateral regime.

Multi-level political authority is governing the rules of the game by market-based regulation policy, which differs by industry sectors and by markets. Political risk analysis, assessment, and management are different whether there is a question of company risk or risk level characterized by the political environment itself. The risk management instrument, the institutional rules of the game, are provided by a pluralist nation-state. In a plurilateral regime, instruments are increasingly market-based. However, the institutional structure can only be maintained by a political authority.

Thomas Brewer analyzed institutional structures in the early 1980s, as noted earlier in this part of the study[154]. He identified the theories between "economic" and "political" using realist, pluralist, organizationalist, and transnationalist metaphors. The new institutional approach is a path away from this development, but emphasizes the integration process as a cause that will lead to a plurilateral environment of economic actors. At the instrumental level, that is closer to an individual company, internal market regulation, economic and monetary union, and developing external economic relations will create new instruments of their own.

From the perspective of the European companies, the paradigm of political risk requires them to develop a new instrument: There is a need for an analysis of variables – a new institutional comparative analysis for internal markets and external economic relations of the European Union.

This analysis is presented at a definitional level in Part Four, instruments are analyzed in Part Five and institutional transformation in Part Six, where the factors maintaining stability are identified. It is argued that a method for analyzing risks empirically, the Delphi method, is valid. However, new variables have to be identified:

---

[154] Brewer.1981

the transaction costs at the instrumental level and the rules of the game at the institutional level.

3.3 Methodologies for Political Risk Analysis

Institutions have provided the basic structure by which people throughout history have created order and attempted to reduce uncertainty in exchange.[155] Identification of political risk is part of the assessment and management process of institutional transformation in international relations.

One cause for political risks at the company level is that the political environment is unfamiliar. Another cause for the risk level is that the environment is not properly analyzed.

In the Grand Tours method, the risk analysis is based on the observations, which are made when visiting a country. In the Old Hands method, the "old business hands" are brought in to consult on political risk. Together with the Grand Tours method, the Old Hand thod offer an impressionistic view of the political environment.[156]

The most systematic though subjective is the Delphi method, where every risk variable is weighted by a panel of experts. Risk variables include political and economic regime factors, political turmoil, and international relationships of political authority.[157]

The use of panels of country experts was in response to the demand for measurability. The Delphi method is a general framework for applying a political diversification in any region, county, or community that is concerned with the companies' operations, and is intended to systematically identify and describe regional comparative advantages and opportunities for economic development and diversification, as well as disadvantages or barriers.

---

[155] North, 1990:118.
[156] Slater. 1987: 151.

In the 1950s, the Rand Corporation developed this technique, termed the "Delphi" method, for forecasting and problem solving involving highly complex issues. Some of the earliest applications of the method concerned strategic military problems.

A number of variations of the original Delphi method have been developed. Political risk analysis is one of these variations. In its most general form, though, a panel of experts who respond to an iterative series of written questionnaires characterizes the method. Each set of questions and the responses returned by the panelists is termed a "round". Following each round, the responses to the questionnaires are analyzed by a panel moderator and the results are summarized and reported back to the panel members. The moderator is also responsible for developing subsequent questionnaires based on these responses, with the intention of further clarifying and refining the responses with each new round.

The Delphi method presents a very useful approach to the analysis of complex, multidimensional problems. A comprehensive panel of experts, responding to feedback in this way, can bring a very broad range of ideas and perspectives to bear on problem solving. The Delphi method may also be particularly useful in situations where strictly objective data are scarce or the development of a mathematical computer model would be prohibitively difficult or expensive. The first, and arguably most important, stage in an effective Delphi study is the assembly of a comprehensive and representative panel of experts who are in a position to offer sound observations about regional attributes.

A Delphi study cannot be considered a rigorous procedure. A Delphi-type process may provide the best available alternative in situations where data are scarce and resources for large-scale model building are not available. Measurability can be increased by preparing an index on the values of risk variables. For example, available international political risk indexes are the BERI (Business Environmental Risk Index) [158], and Prince model (Political Risk Forecasts) [159]. [160]

[157] Rummel & Heenan.1978:67–76.
[158] http://www.beri.com/22 Sept.2002.
[159] http://www.prsgroup.com.22 Sept.2002.
[160] Gibson & Miller:1990:34.

3.3.1 Commercial Publishers of Political Risk Analysis

Three of the earliest examples of quantitative-type political risk models were Fredirick T Haner's (1975) Business Environmental Risk Index (BERI), the Business International (BI) Country Assessment Service (Business International, 1981), and Coplin and O'Leary's (1976,1978) World Political Risk Forecast (WPRF). All attempted to assess the general investment climate in a number of countries using the Delphi method to poll a panel of experts.[161]

The commercial publishers for political risk analysis forecast the future political conditions in countries or wider regions. An index on country and political risk, based on variables that are evaluated in procedures that are close to the Delphi method, is produced.

The analysis of BERI and Political Risk Services are the most suitable for political risk analysis, as well as the analysis produced by IHS Energy Group Political Risk Ratings and Ranking Index and the analysis of the Control Risk Group. Other publishers analysis are closer to the country risk analysis.

Figure 7 compares the methodologies of commercial publishers of political risk analysis. It is updated using the handbooks edited by William D. Coplin & Michael O'Leary (1994) and Llewellyn D. Howell (1998, 2001).

[161] Stapenhurst. 1992: 62.

Figure 7 Commercial Publishers of Political Risk

Organization	Political risk	Method / Data	Key variables and index
BERI	Sociopolitical changes that are negatively affecting foreign companies	Delphi method, data is produced by expert panels	-Political Risk Index PRI -Operations Risk Index ORI
Control Risks Group	Emphasizing security risks in newly emerging econo-mies	Data is supplied by the experts on life, work, and study in the regions of interest	Qualitative analysis on security variables
EIU	Country (liquidity) risks to investors Macroeconomic and finan-cial standpoint	Country risk analysis Statistics of IMF	Political stability and politi-cal effectiveness. Credit ratings
Euromoney	Country risk	Quantitative: 25% economy 25% politics 10% debt	Political risk is reported along with country risk index
Institutional Investor	Non-payment	Banks" statistics	Creditworthiness in 100 point index
Moody's	Non-payment (state)	Long term assessment of credit risk based on histori-cal projections	Country's foreign currency credit risk index
PRS Political Risk Services IBC USA Inc.	Future of political regimes negatively affecting foreign companies	Frost and Sullivan's Prince method	Letter grade in financial transfer, direct investment, and export market
S&P Standard & Poor's	Likelihood of default	Expert panels	Debt ratings: long term debt, commercial paper, preferred stock, certificates of deposit, money market funds, mutual bonds fund, insurance com-panies" claims-paying ability
IHS Energy Group Political Risk Ratings and Ranking Index	Political risk to international oil companies	Subjective or qualitative assessments; particular variable	Non-technical factors that affect a particular country's petroleum climate

The political risk index, BERI, measures environments by indexes. The political risk index, PRI, measures socio-political changes. The Operations Risk Index, ORI, measures the degree to which complex operating conditions affect production and profits earned in the local currency by a foreign company. The third index is the R factor that measures the risk affecting access to foreign exchange and remittances of profits and repatriation of capital in a convertible currency. These three indexes are integrated into an overall assessment, the Profit Opportunity Recommendation (POR). [162]

The objective of BERI is to measure the business climate in 45 countries. There are two variables being measured: the business climate including the political environment and the degree to which nationals are given preferential treatment. The index assumes a perfect business environment for a company is equal to 100. A panel of about 105 experts rate 15 criteria that make up a cross-section of the country's business environment from zero (unacceptable conditions) to 4 (superior conditions). The criteria are weighted to place emphasis on critical success factors, and this expands the 15 to a weighted total of 25. A rating of 4 on each criterion gives a perfect environment of 100. Political, operations, financial, and nationalism sub-indexes refine the interpretation of the overall rating. Through reuse of the ratings and application of different weightings for selected criteria, the data are recast to construct the four sub-indexes. BERI is a version of the Delphi method. The purpose of the BERI ratings is to provide a perspective of future conditions in the countries. The political sub-index (weighting of 25) composites the variables of political stability, attitude toward the foreign investor and profits, nationalization, monetary inflation, balance of payments and bureaucratic delays. The nationalism sub-index (weighting 25) composites the variables of attitude toward the foreign investor and profits, nationalization, currency convertibility, and bureaucracy. [163]

According to Stephen J Kobrin, BERI is fairly systematic. Although experts' ratings are intuitive, the method is detailed and explicit. It is not structured, because the index, except for weighting of the factors, is not based on an explicit model of either the political-economic environment or its potential impact on the firm. One of BERI's advantages is that it can serve as an 'early warning' function. Kobrin lists three limits of the index. First, the BERI scores are defined at the macro level and do not take industry and firm specific factors into account. Second, the panelists' rankings are highly subjective and third, most of the panelists are associated with the private sector and, thus, view the environment from that vantage point. [164]

[162] Howell.1994:37.
[163] Haner.1980:197-201.
[164] Kobrin.1982:203-204.

In 1997, Frederic T Haner stated, that the global operating environment for business has changed radically in the 1990's. Managers must adjust strategies to reflect these fundamental changes. He saw new business potential due the disintegration of the Socialist World, the evolution of the European Union, the adoption of free-market policies and privatization as well as telecommunications.[165]

Since the 1980's, BERI's methodology has evolved and providing micro level measures, especially in the petroleum sector among the other industry sectors. Political risks are analyzed through the PRI Index, which focuses on sociopolitical conditions in a country. Now, it uses experts with diplomatic careers and training in political science. The six internal causes of Political Risk that are analyzed are: First, fractionalization of the political spectrum and the power of these factions; second, fractionalization by language, ethic and/or religious groups; third, restrictive measures required to retain power; fourth, mentality, including xenophobia, nationalism, corruption, nepotism and willingness to compromise; fifth, social conditions; sixth, organization and strength of forces for a radical government. There are two external causes of political risks. First, dependency on and/or importance to a major hostile power and second, negative influences of regional political forces. The PRI Index composites two symptoms of political risk. First, societal conflict and second, instability as perceived by nonconstitutional changes. [166]

Frost and Sullivan's Prince method is based on the Delphi method[167]. It is published by PRS (Political Risk Services), and was developed by William D. Coplin and Michael K. O'Leary in 1969. Both the instability variables and policy variables are analyzed in this model.[168]

Based on the Prince method, PRS Group publishes two evaluations of political risk. PRS is a political regime stability index . The International Country Risk Guide

[165] Haner.1997:1-23. in Rogers (ed).1997.

[166] Howell.2001:103-109.

[167] Raddock.1987:166.
[168] Raddock.1987, Howell.1997:187.

ICRG is a descriptive evaluation that is a composite of political, financial and economic sub-evaluations. [169]

The Prince is a comprehensive method, which systematizes the risk variables and includes scenarios for future conditions in a political environment at the micro level. With this method it is possible to produce measurements for specific political outcomes. In addition, the positions of the major individuals, groups, and institutions that could affect international business in a country can be analyzed systematically. The model can be customized for an individual firm or project by weighting the risk variables.

As a result there is a chart categorizing the political risks for the most likely regime, turmoil, and restrictions. There are four risk categories: A, B, C, and D. Category A represents the lowest political risk level and D the highest. The investment areas include finance, direct investment, and export sectors.

The following variables are estimated: Background variables have an impact on the way the political system works. These variables include geographic factors, international, such as relationship with neighbors and the international system, social problems, and economic variables. These variables indicate how the changes might affect the prevailing political regime.

Political turmoil variables forecast the types and magnitude of politically motivated violence. These include riots, terrorism, etc. Based on this, scenarios of turmoil in the second and third most likely political regimes are developed.

Restrictions on international business variables forecast the likelihood that the government will change restrictions on the operations of international business through ownership, management, and labor politics, local operations, and the repatriation of profit or capital. The scenarios are made for the second and third most likely regimes.

[169] Howell.2001: 303-355.

Trade policy variables forecast the likelihood that the government will significantly change policies restricting imports. The variables include tariffs and non-tariff barriers, economic policies, labor policies, and policies toward international finance. The scenarios are made for the second and third most likely regimes.

According to Stephen J Kobrin, vulnerability to political risk appears to depend as much on project characteristics as it does on political events.[170] The methodologies of the publishers of political risk forecasting have evolved in a direction emphasized by Stephen Nairne to systematize risk estimates allowing for comparisons across countries, sectors, and projects.

Gerald T West emphasized that one of the challenges is the problem of assessing and managing very different political risks. When managing the project political risk, the exposure to a political event is usually defined as the maximum amount an investor would lose if the given event occurred. At the project level, risk is a property associated with an individual investor and prospective investment. Moreover, long-term debt investors face different political risks than short-term debt investors; the risks faced by contractors, suppliers, and equity investors will also vary. [171]

The IHS Energy Group's Political Risk Ratings and Rating Index focuses micro level assessment further. It advises how to modify the model to fit a specific firm within the petroleum industry. Its first advantage is that the variables affecting the petroleum industry are counted.[172] The second advantage is that it stresses the variables at the society level. The Index is a composite of political risk (60%), socioeconomic risk (20%), and commercial petroleum risk (20%). The composition of variables includes war and external threats, civil and labor unrest, internal violence, regime instability, environmental activism, ethno-linguistic factionalism, constrains on foreign oil company investment, restrictions on repatriation, and threat of adverse changes in contracts.

---

[170] Kobrin.1982:xi

[171] West:2001:47-58.

[172] Hallmark & Whited.2001:367.

Hallmark and Whited state that the Political Risk Ratings and Ranking Index can only be used as a tool for comparing countries as the most superficial level. It can only serve as a first step. The political risk assessment process must eventually move toward some effort to understand the exact nature of the risks present in a given country, and to ascertain the manner and extent to which the risks adversely affect a foreign oil company investment.[173] However, the society level variables are incorporated in Political Risk Ratings and Ranking Index. They use the term 'subnational ratings'. Although it focuses on nation-states instead of regimes over and above nation-states, its methodology is functional when applied to the questions rising from managing political risks in the business environments apart from nation-states. The basic thought is that the political risk may be confined to a certain geographic area in a country.

Llewellyn D. Howell examined the role of individual variables in respect of three political risk models in the period 1986-1997: BERI, PRS's International Country Risk Guide ICRG, and the Economist BI. A conclusion was that in the period 1992-1997, each of the three models indicates a stronger role of democratic institutions in shaping the investment environment than they did in 1986-1992. However, other variables in each of the models surpassed the democracy variable in importance. For the Economist model the important variable was the pace of urbanization; for the BERI, the social conditions and mentality; for the ICRG the most important variable was corruption and civil war risk. [174] This may be a conclusion at the level of individual variables. Thus, we may ask whether all these variables are better scored in democratic societies because they are variables measuring the level of democracy in environments. Even if the variables are better scored in static authoritarian societies and political risk may be managed in the short term, how are the variables scored in the long term?

In the former socialist countries, the state companies were responsible for maintaining and financing public services from infrastructure and education to health care. Without possibility to contract-out these functions the companies are unable to compete and a real market economy does not exists in the countries of transition. One

[173] Hallmark & Whited.2001:372

[174] Howell.2001:86-109

demand for democracy in those countries is the possibility to externalize the public service function without causing instability in the environment. One result of neglecting the democratic processes is capital flight – there is no trust in the predictable rules of the game. There are only bazaars and kiosks and large companies of the oligarchs but no market for the small and medium size companies that are more dependent on the public services supplied by the political authority. The theoretical base for this logic was presented by the model of Ilya Prigogine. We may also ask whether insurance is a functional instrument above single business transactions. Reinsurance, however, requires a stable institutional environment.

In addition to general stability the democratic institutions are shaping in the environment of the companies, only a stable political regime is able to provide public services in the environment of the companies and maintain the predictability rules related to them. The institutional approach in Part Four focuses on the formal and informal rules of the game in the political environment. It studies the borderline cases, which indicate the location of the political risks in societies. Theodore H. Moran has posed a topical question concerning the internal markets and the external commercial relations of the European Union: ‘to what extent can the expansion of private sector financing replace any need for public sector financing in petroleum, mining, pipeline, and other infrastructure projects – in particular, those most vulnerable to the dynamics of the obsolescing bargain such as natural resource and private infrastructure investors[175].

Therefore, even if the causes of the political risks are located at the society level, maintaining stability in a political environment is the responsibility of the political authority, that stabilize the rules of the game in the environment of economic actors. In pluralist regimes, the rules of the game are predictable and as stated a company takes the rules of the game as given. Referring to Susan Strange, stability and on the highest level security, is a task of political authority. As Robert O. Keohane argued and tested, the political risks that originate from the zero sum game can be avoided in a pluralist political environment characterized by a continuous game and repetition among actors.

Using indexes is easy and cheap, but they do not help to understand the institutional rules of the game or the hierarchical structures at different authority levels in societies. How to deal with political risk in the European Union? Transforming the international system alters the prevailing country specific analysis further. In the European Union, the political risks have to be identified at different political authority levels from security to society levels. Therefore, the old, country specific indexes are inappropriate. Internal markets, strategies, instability, and multilevel authorities policies have to be taken into consideration when analyzing the prevailing political environments of companies.

3.4 Summary

In this Part we have investigated the following: research on political risk both on the theoretical and definitional levels, research tradition, literature, schools of thought, and companies dealing with risk evaluation. Typical of political risk research in the United States is that it is detached from political values and does not observe, for example, security policies nor the point of view of a small state.

The present research tradition, specifically within the U.S. framework, is limited. Therefore, it became useful to study the political science metatheory on pluralism prior to the methodological research of political risk. One of the weaknesses of analytical models is that they may break easily into a great number of small details and, thus, remain scattered drafts. The main reason for such reaction is the lack of the abovementioned political metatheory.

Political events and phenomena have their basis in ideological influences of individuals and groups. Without a political theory, it is problematic to investigate those risks, which have a strong impact on an individual company or on society, as parts of one entity. The pluralistic liberal democratic model of society is closest to that ideal society in which the political risks in the company's operational environment are the least. However, such a political departure is not presented here nor is it the goal of the methodological study, because risk and opportunity have not been separated. This means that the greatest chances for profit are often located in the envi-

---

[175] Moran. 1998:81.

ronments with high political risks, whereas in stable pluralistic operational environments, the negotiating power of actors in relation to one another is so formidable that the profit margin will be narrowed although it will increase in the long term.

Alan C. Shapiro defined a stable market economy, where the political authority's interference in companies is minimal as a more riskless environment. (Shapiro, 1994). The deficiencies of this neo-liberal definition become explicit in those problems companies face in the economies-in-transition in Europe. When a political authority becomes involved in business, there exists another side to it, which remains unemphasized outside the definition. A political authority maintains rights to action and ownership and is liable for law and order. A price for stability is also those limits on entrepreneurial activity by which rights to own and act are maintained as set by political authorities. Another case is whether regulations to limit action are created in an environment of great instability, or whether previously a strongly-regulated environment will further comply with the new rules. The liberal theory, as shown in the beginning of this study, has taken a stand on regularization.

The research tradition in the U.S. has focused on methodology. The lack of political values in the analysis using political risk instruments renders it generally invalid, although the intentions were the opposite. Universal political risk instruments are rare. When planning for direct investment, there is a remarkable difference in whether it is done in a centralized totalitarian regime or in a different type of regime.

Hence, it has been useful to study liberalism and, then, to proceed from the research tradition to the institutionalized rules of the game in society and to the explanatory theories of the evolvement of co-operation. Thus, a holistic vision of political factors in a company's environment can be achieved. The definitions of the comparative politological method are similar to those used while moving from the investigation of dependent variables to that of the independent and intervening variables and to the paradigm shift of the political risk. In Part Four the new risk variables in a new politological context will be defined.

In this Part the paradigm of political risk at a conceptual level in regard to literature, models, approaches, methods, indexes, and commercial publishers of political risk has been analyzed.

The Delphi method is a strategic method derived from military use and applied to economic and political intelligence. While weighting the technical analysis, the variables in political environment lose their identity. That is a severe problem. It is typical of the American tradition that the political aspects are not identified properly and the issue hierarchies are not clarified. Risk is too technical and close to the marketable risks.

In recent years, the research of political risks has been developed through case studies. Project finance as an instrument has been used in the environment of political turbulence. The term “project finance” refers to a wide range of financial arrangements with one common denominator: lenders look to the cash flow and earnings of the economic entity being financed as the source of funds from which a loan is to be repaid, and to the assets of that economic entity as collateral for the loan, not to the earnings or assets of the parent investor. Project finance allows the parent investor to avoid providing lenders with recourse to its own earnings or assets in case problems occur.[176] As a result, both the insurers and lenders would like the shares of the project be pledged to them in the event of political turmoil.[177]

However, thoughts about the institutional governance of political risks have also emerged when the multilateral development banks, as central actors in managing political risks, are defining their role in transforming international finance architecture. When the transition in the emerging economies in Central and Eastern Europe advances the demand for both the institutional political risk governance, as well as the risk management instruments, is changing. The balance between the public and private sector at the global level and the financing of international public goods will be on the agenda.[178]

[176] Moran.1998:71.

[177] Moran.2001:5.

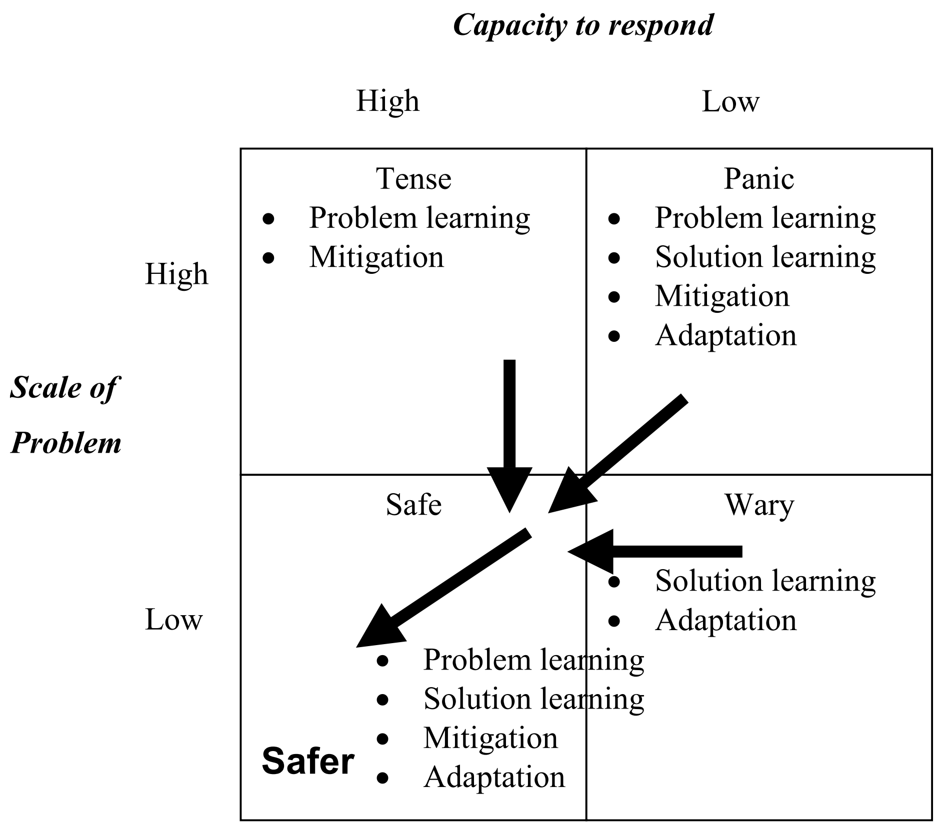
[178] Buiter, Fries.2002:25.

The political risk research has been developed hand in hand with specific political events, such as dramatic revolutions and regime changes, which have created a demand for risk analysis. The transition economies that emerged after the collapse of the planned economy regime mainly occurred peacefully in Europe and instead of causing risks created viable business opportunities there.

Walter R. Stahel emphasizes cultural issues as causes of current political risks. A milestone is 11 September 2001, the date of “Attack on America”. However, he lists several threats from bio-terrorism to the operation of the shadow economy, which demonstrate the technological shortages in risk management, as well as the inability to manage cultural issues. In other words, there is a sense that it is people who are the biggest risk factor.[179] Stahel explains the strategies to a safer world using a figure where the scale of the problem (risk) and the capacity to respond (management) are cross-tabulated.

[179] Stahel.2002:269.

Strategies for a safer world[180]



The Figure demonstrates the emphasis on a safer world, but at the same time it rises the question of the border lines of pluralism from the society level to the security level which are defining the limits of political risk management: democracy and the move towards a police state and monist regimes, citizens' liberties, and security threats that have lead to the first nationalization of an industry in U.S. history – the screening of airplane passengers was taken over by federal authorities from private companies.[181]

Culture defines the borderlines of pluralism, but it should be noted that a company as an organization is itself a cultural phenomenon that varies according to a society's stage of development.[182] When observing a culture, we are observing an evolved form of social practice that has been influenced by many complex interactions be-

[180] Stahel. 2002:270
[181] ibid.272.
[182] Morgan.1997:120.

tween people, events, situations, actions, and general circumstances.[183] Defining political risks by using the neo-institutional approach in Part Four further focuses these issues.

Assessing political risks in the transforming European environment requires a paradigm shift in political risk analysis. It should start with institutional rules of the game in the relationship between "economic" and "political". Assessment, models, frames, definitions, indexes, management, and regimes should be identified. The starting point is a pluralist liberal democracy. Through the regimes, the prevailing international system is being transformed into a plurilateral regime or plurilateral governance in risk management.

---

[183] *Ibid*.515.

4. Paradigm Shift: Institutions and Neo-institutionalism

The pluralist state regime has changed into a plurilateral regime and challenged the traditional assessment and management of political risks. Above traditional comparative risk variables, there are political variables that determine the prospects of political governance in various environments. A reason for analyzing political governance instead of single instruments is because the study of political risk can be divided into management of risk at the company level and the political risk governance at the level of political authority. In the business environment, the governance of risk variables is primary, and management instruments depend on stable governance.

The paradigm of political risk should answer the question how the transforming rules of the game and transforming political authority are defined in the prevailing environment of companies. On the one hand, a political risk is the risk that political authority will unexpectedly change the rules of the game by which the economic actors operate or, on the other, there is generally uncertainty about the rules of the game, which can be considered a political risk.

According to North, the starting point for the assessment and management of change is to define dependent risk variables as institutional rules of the game. North's definition fulfills the four requirements set by the pluralist metaphor on international relations theories, which made the following assumptions: 1. Non-state actors are important entities in international relations. 2. The state is not a unitary actor. 3. The state is not a rational actor. 4. The agenda of international politics is extensive. Plurilateralism is related to the extensive agenda of international politics in accordance with transforming political authority from the pluralist and unitary nation-state level into a multilevel political authority. The new frame of reference is composed of institutional 1. rules of the game, 2. change, and 3. the formal recognition and legitimization of the new rules of the game.

North's neo-institutionalist theory explains the paradigm shift in political risk analysis. Institutions are defined more broadly than in the traditional institutionalist theory[184]. Institutions are the formal and informal rules of the game, not organizations. Institutions both stabilize and regulate the political environment of companies. The institutional rules of the game are the independent and intervening variables in the risk analysis. The political risk, and the dependent variable, is the unpredictable change of the rules of the game in the company's environment.

We cannot see, feel, touch, or even measure these broadly defined institutions; they are constructs of the human mind. Do institutions matter? Do tariffs, regulations, and rules matter? Does government make a difference? [185] Institutions provide the basic structure by which people throughout history have created order and attempted to reduce uncertainty in exchange. Together with the technology employed, institutionalized rules of the game determine transaction and transformation costs and, hence, the profitability and feasibility of engaging in economic activity.[186]

4.1 The Rules of the Game in Societies

Political circumstances prevalent in a business environment and their risks can be studied from the point of view of political instability and policy exercised by political authority.[187] The research tradition of political risk has focused on these issues. However, these angles are not holistic enough and do not offer grounds for a deeper analysis of the political change, which is important for companies.

A more profound means of analysis is to analyze the institutional rules of the game, which are well established in European societies. This analysis determines the limiting conditions for individuals, political decision-makers, and companies" functioning and measures the current instability.

[184] The "old institutionalism" characterized political science until the early 1950s. It is divided into historical and behavioral institutionalism emphasizing the dynamics of politics and policy-making. The comprehension of governance is based on the details of structure. The "new institutionalism" explain institutions as variables shaping policy and administrative behavior. It concerns what benefits and burdens governments actually produce for their citizens. There are several strands of thinking contained within it. For example, normative institutionalism, rational choice approaches historical, structural, and social institutionalism. Douglass C. North's neo-institutionalist theory emphasizing the role of the variables in economic history. Peters, Guy. B.1996: 205–209. *Handbook of Political Science*.

[185] North. 1990:107.

[186] North.1990:118.

The transformation in Europe is amenable to the creation of new rules of the game. The rules of the game have their initiation in political ideas and become legitimized in the process of stabilization. The understanding of the new rules of the game prevalent both in the European Union and Eastern Europe assists in eliminating that uncertainty in the business environment, which prevents entrepreneurial activity.

Institutions are defined as limitations, brought into existence by political authorities, which direct all actors in society.[188] Institutions are influential in political, economic, and social action, and their change is integral to societal change, Institutions explain the differences between entrepreneurial environments in different societies and are created to govern uncertainty.[189]

North has paid attention to the fact that the neo-classical economics has not taken into full consideration the limiting conditions of economic actors and, therefore, he has developed a frame of reference on institutional impact. The common denominator for the business and political environment is the frame of reference of institutions, which determines the limiting conditions for individual and organizational activity.

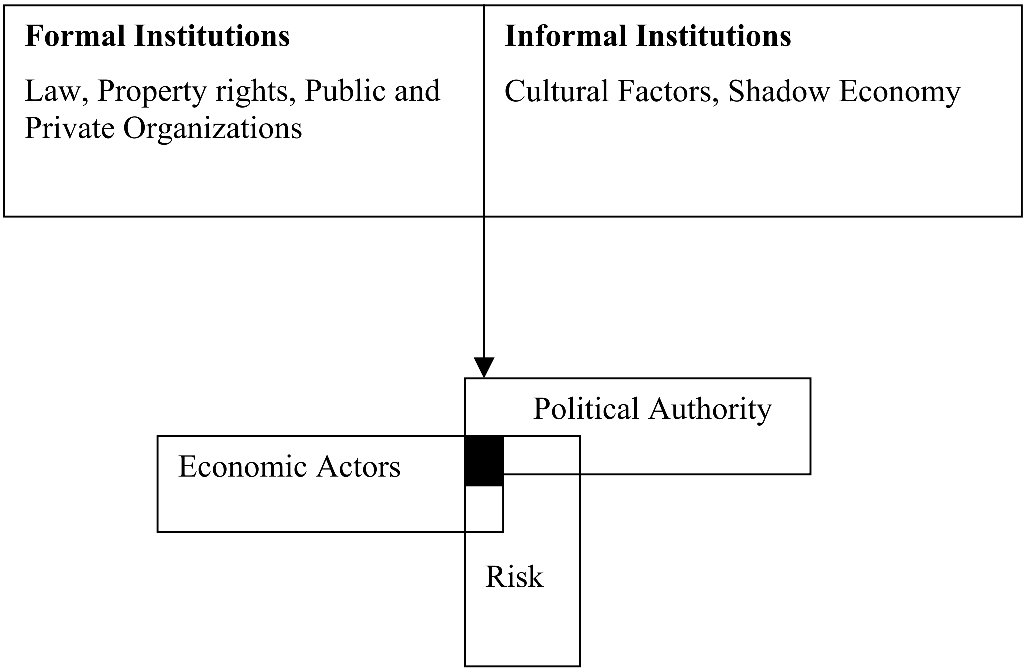
The societal institutional rules of the game eliminate uncertainty by introducing a structure for everyday activity. Thus, we know how to manage different situations when doing domestic business: how to act with clients, personnel, deliveries, competing companies, formal, and numerous interest groups. The behavior of the interest groups is predictable, when the background for their activity is known. In another state, the business activity is based on different institutions than in the home state, where the entrepreneurial environment remains static and unchanging.

Currently, we live in a time when new European institutions are being formed. In the formation stage, it is possible to compare stable and unstable institutions. Institutional rules of the game are born and stabilized, when individuals strive to change an uncertain environment into a governable environment.

---

[187] Ting, 1988:2.
[188] North.1990:3.

Figure 8 Formal and Informal Rules of the Game



Political risk denotes an intersection in the equilibrium between political authority and economic actors as seen in Figure 8. Risk can emerge, for example, in a situation, when the legitimacy of prevailing authority is under transformation. The societal rules of the game can be divided into formal institutions, such as regulations and laws, and informal institutions, such as norms that control behavior. Institutions can be deliberately created or they can stabilize on their own as a result of an individual action.

In terms of political risks, institutional limitations on the business environment depend on cultural differences and ethnic factors. Culture can be defined as the transfer of knowledge, skills, values, and other factors from one generation to the next by the means of learning and imitation.[190] By analyzing cultural factors, it is possible to understand the expectations of the political actors in foreign business environments.

---

[189] Lesourne.1993.

[190] North.1990:37. In his study North uses definitions: formal rules of the game and informal constraints of human behavior. Informal constraints derive from culture. Formal rules derive from political and economic rules and contracts. P.47. Stability derives from formal rules and informal constraints that are called norms.p.83. However, in the study of political risks, I have made a rougher division into formal and informal rules of the game in the business environment, because if both rules of the game are predictable, political risks are non-existent. According to the political risk point of

Related to the question of how national culture influences the management practice – structure, strategy, and human resource systems, Takeo Fujisava, cofounder of Honda Motor Company said, "Japanese and American management practices are 95 percent the same, and differ in all important respects".[191] When analyzing the European Single Market comprising the fifteen Member States, as well the external business environment in Russia, a striking quotation by Confucius is appropriate, "All people are the same. It's only their habits that are so different".[192]

Another example of informal institutions is the shadow economy in the business environment. A political authority sets the limiting frames for informal institutions. Political authority sets laws concerning what is legal and illegal in society. However, even if the formal rules of the two market economies are identical, the structures of the shadow economy may vary. The bulk of the shadow economy keeps changing state by state and impacts the business environment differently in each of them. Identical laws in two different countries may be followed differently in practice. Because of the point of view of a foreign company, informal institutions are not easily managed.

> *Transparency International: "Corruption Perception Index Ranks Finland As the Least Corrupt Country".*[193]

Formal institutional limits are political and economic rules and constraints and the hierarchical relationship among them. Institutional change at a high hierarchical level

---

view, the number of informal rules of the game is the principal point in analysis. In pluralist societies, the rules of the game are transparent.

[191] Scneider, Barsoux.1997: 73.

[192] *Ibid*.1.

[193] The Corruption Perceptions Index 2002, compiled by Transparency International, a non-profit organization fighting corruption worldwide, ranked 102 countries, the highest number ever, on the basis of perceptions of the degree of corruption as seen by business people, academics, and risk analysts. Finland is in the top place as the least corrupt nation in the world, followed by Denmark, New Zealand, Iceland, Singapore and Sweden. Overall, corruption is perceived to be rampant in some of the world's poorest countries, but it is also prevalent in some developed countries whose companies invest in developing nations. TI raises awareness of the damaging effects of corruption, advocates policy reform, works towards the implementation of multilateral conventions, and, subsequently, monitors compliance by governments, corporations, and banks. At the national level, chapters work to increase levels of accountability and transparency, monitoring the performance of key institutions and pressing for necessary reforms in a non-party political manner. http://www.transparency.org/ 22 Sept.2002.

is more expansive and rarer than institutional change at a lower level. An example is a constitution change, which transforms the rules of market economy or the status of private companies . The functioning of institutions enables political and economic exchange. In principle, political rules lead to economic rules, although causality acts in both directions.[194]

Institutions determine what the actors are or are not allowed to do in different situations. North compares institutions to the rules of the game, which determine the process of the game. The game has both written and unwritten rules. To win the game it is often necessary to test the rules; thus, action is dependent on the type of game and the implementation of the rules of the game.

Institutions at large determine the opportunities one can strive for in society. Organizations as part of the institutional structure are built to utilize these opportunities. Organizations together with institutions determine the opportunities for actors in mutual impacting relationships.

Organizations can be political, economic, social, and educational. They are groups formed by individuals who together strive for a particular goal. Institutions influence the birth and activity of organizations and impact on the way the institutional frames of reference change over time. The theory of liberalism in international relations emphasizes the activity of interest groups in the process of stabilizing the rules of the game. [195].

In the business environment, a political authority acts as an organization, which sets the laws and changes the rules of the game, or exercises political economy. Hence, economic action is formed by using the protection a political authority can offer to a company, which is functioning in the authority's region. Organizations, which belong into the shadow economy, such as criminal organizations, have an impact on the business environment of a company, but it is impossible to measure their impact in advance.

[194] North.1990:47–50.
[195] Viotti & Kauppi. 1991:196–198.

Uncertainty in the business environment decreases the co-operation and reciprocity among actors. Robert Axelrod has indicated this by means of the game theory. His research supports the hypothesis that expectations regarding the future, in particular, determine the co-operative relations between political authority and economic actor.[196]

Information that limits uncertainty is of primary importance for international business. The problems arise from the premise that there are very many factors. However, in neo-institutional economics, the factors of uncertainty have been evaluated through analyzing property rights[197], methods of game theory[198], and transaction cost analysis.[199].[200] According to Douglass C. North, emphasizing the rational choice and perfect market has lead to a situation, where the implications of incomplete information and the complexity of environments and subjective perceptions have been excluded from the analysis.[201].

However, the difficulties that are faced in analyzing the equilibrium between economic and political actors in an environment of multitude variables can be suppressed by the theory of co-operation. The study by Robert Axelrod concerns the evolution of co-operation and covers the requirements for co-operation in antagonist relations that can be derived from a situation of obsolete bargaining power between a company and political authority. Co-operation is a way of decreasing instability in the environment because trust and risk are regarded as subclasses as will be described in the section concerning legitimacy.

Institutional rules of the game are the common denominator for all the social sciences, including economics and politology. In the decision-making at the level of a company, institutional rules of the game have an impact by determining the transaction costs, which can be seen as costs of economic actions on markets.[202] Transformation and production costs are determined by the technology used in the transfor-

---

[196] Axelrod.1981:25, 306–318.
[197] Coase.1984.
[198] Schoter.1981, Solow.1990.
[199] Williamson,.1993.
[200] Pasinetti.1994:37.
[201] North, 1990:111.
[202] North.1990:61–73.

mation process. Total costs are divided into transformation and transaction costs. The political environment determines the transaction costs by defining the action and property rights. These vary by state, region, and civilizations.[203] By analyzing the institutional rules of the game, it is possible to link the political environment to the strategic decision-making at the level of a company.

The starting point in the analysis is the static equilibrium and comparison between the different business environments. However, the analysis can proceed through the institutional rules of the game to the institutional transformation and change. Transformation is the central definition for pluralist theories. Strengthened interdependence is transforming the authority of a nation-state. Political risk in this context is related to transforming authority levels. The emerging authorities have new rules of the game. For example, the new rules of the game, in the European internal markets and external commercial relations, seem to be closer to market-based rules in the equilibrium between economic actors and political authorities. In pluralist liberal democracies, this political transformation is peaceful integration process. [204] According to Wayne Sandholtz and John Zysman, institutional rules of the game at the community level in Europe are transforming with the transnational coalitions of elites and new institutions that will be structured for the coalitions.[205] This notion of gradual transformation supports the neofunctionalist theory of Ernst B. Haas.

4.1.1 Institutional Change

Institutional change transforms the boundary lines between economic actors and political authorities. In societies, in which the political regime can be characterized by the concept of pluralism, there is a gradual institutional transformation instead of instant change. For example, the EU membership of Finland was a gradual transformation of the rules of the game through EFTA membership and the EEA agreement. This gave time for informal institutional rules of the game to adapt and stability has prevailed.

---

[203] Shapiro.1994:474 – 504.
[204] Viotti & Kauppi. 1991:212–213.
[205] Sandholtz & Zysman. 1992.

The rules of the game in a political environment are defined by the prevailing institutional starting point and throughout the change to new institutional rules of the game and boundary lines. This is faced at the level of a company with instability and new regulation policies. In pluralist environments, change is institutionalized and, as referred to in the pyramid metaphor presented in Part Two, it can be argued that the change is more manageable and the transactions costs more predictable.

Thus, with the institutional transformation all the old rules of the game similarly would not shift under a new political authority. In the political risk context, it would mean that political risk guarantees, offered earlier by a nation-state, would now be offered by the European Union. With the transformation the logic of risk guarantees will change. At the Union level, the new logic is market-based and more closely follows the model prevailing in the United States. Instead of nation-state guarantee boards, national and Union level authorities are now regulating the political risk guarantees in the market-based system. The market-based logic will now be operating by a new governance of regulations. In the governance without government model, the market logic will replace the nation-state. This is possible because there is more risk capital available in the European internal markets than was the case in the state regime.

Political rules lead to economic ones. This argument made by Douglass C North is based on the assumption that property rights and contracts are enforced by political decision–making. In equilibrium, a given structure of property rights will be consistent with a particular set of political rules. Political rules are the central factor when assessing institutional change in societies. The political authority defines the property rights and assigns prices on the stability it will create by taxing the economic actors. According to these factors, a company can define its bargaining positions.[206]

In the European transformation, the logic of market-based rules of the game in the political environment of companies remains the same, but instead of a nation-state authority, there is a multilevel authority that means multilevel governance. In order to maintain its power, the authority is required to maintain stability and, thus, keep

[206] North, 1990:49.

the transaction costs predictable.[207] Otherwise the stability is replaced by a risk environment. Although the transaction costs related to property and action rights are difficult to evaluate in advance at the company level in a political environment, the level and operation of the prevailing bureaucracy will be a sign of transaction costs. An unpredictable transaction cost level means a high political risk level.[208]

The impact of institutionalized rules of the game on risk analysis at the company level can be summarized according to the following four dimensions.[209] First, the political and economic models are specific to a particular constellation of institutional constraints both through time and cross-sectionally in different environments. The models are not generally valid. This is notably true when comparing business environments in a plurilateral regime. Secondly, the behavioral models that are based on perfect information and rationality have concealed the multitude of formal and informal rules of the game. Thirdly, ideologies and subjective points –of view guide the choices made by individuals. Fourthly, politics and economics are strongly interlinked. Their cause-relationships may be difficult to make.

In the international relations theory, realists emphasize the simplicity of the theories and models. Otherwise, it is not possible to see the objectives in their holistic framework. By describing the objective more specifically and by adding more facts, the holistic frame becomes increasingly fuzzy. That is why they emphasize theories that conceptualize the objectives and distance themselves from them. Thus, it is possible to investigate the problems and weight them correctly.[210] The change related to the rules of the game in Europe is not an independent issue. It is part of a path-dependent process of historical transformation in European societies.[211]

---

[207] Sandholtz.1994:81.

[208] Williamsson, 1993: **Institutional environment**: the rules of the game that define the context within which economic activity takes place. The political, social, and legal ground rules establish the basis for production, exchange, and distribution. **Institutional arrangement:** the contractual relation or governance structure between economic entities that defines the way in which they co-operate and or compete.

[209] North.1990:110–112.

[210] Viotti & Kauppi. 1987: 214

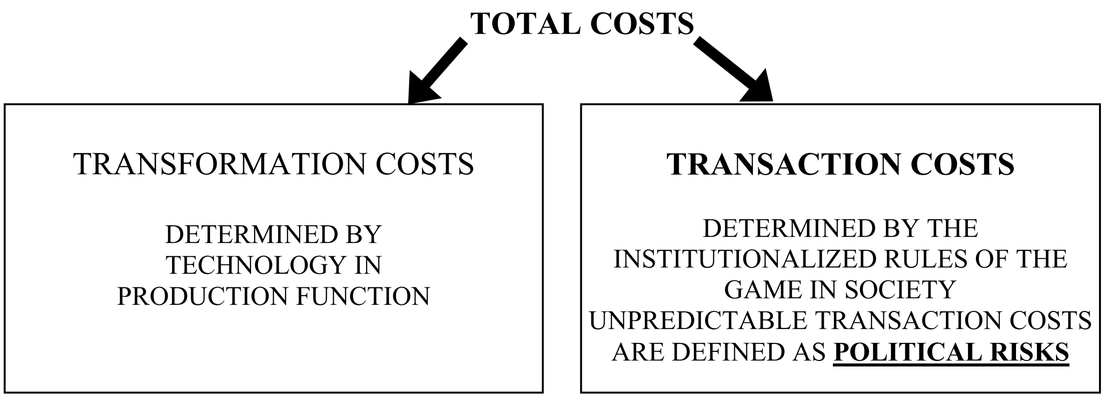
[211] Williamson, 1996:240–243. Path Dependency is a notion that history matters and explains the differential strengths and weaknesses of alternative forms of governance. The fundamental transformation is a specific manifestation of the proposition that history matters.

The environments of political and economic actors are much the same. However, the assumption of the rationality of individuals has affected the way in which motivations are widely excluded from the economic models. Ernst B. Haas has captured this problem in his neofunctionalist theory. According to the theory, the integration processes will proceed if they are linked to the interest of the power elites in member states. The operations of the business environment cannot be explained using only the economic definitions, because there are no independent fractions, for example, political or economic ones, in society. The interventions of political authority in the economy cannot be explained without noticing the political rules that make the action and property rights legal. In politology, this is a question of the legitimacy of the political power structure.

4.1.2 Institutional Rules of the Game and the Concept of Unpredictable Transaction Costs

The total costs of an company are determined by transformation[212] and transaction costs.[213] The political institutions determine the transaction costs in societies.[214] Political risk is defined as an unpredictable transaction cost. At the final stage, a high transaction cost level renders the economic action unprofitable.

Figure 9 Total Costs of a Company



Production costs are determined by the technology used in production. It is assumed that the production costs are the same despite the political environment where the production function is located. The traditional neoclassical paradigm with perfect information assumes zero transaction costs[215]. Social costs, as well as political risks, are excluded. For example, the labor, capital, and land costs are considered technology costs, and their allocation a technological issue.

---

[212] The concept of transformation is used in two different senses in this research. Transformation costs refers to a concept of the factors of production in economics and political transformation to a concept of political authority levels in politology. A reason for this unavoidable conceptual differentiation is that the international political economy has been fragmented into international politics and international economics.
[213] North.1990:61–73. "Transaction and transformation costs".
[214] Williamsson, 1993: **Transaction:** the microanalytic unit of analysis in transaction-cost economics. A transaction occurs when goods or a service is transferred across a technologically separable interface. Transactions are mediated by governance structures (markets, hybrids, hierarchies). **Transaction costs**: the *ex ante* costs of drafting, negotiating, and safeguarding an agreement that arise when contract execution is misaligned as a result of gaps, errors, omissions, and unanticipated disturbances; the costs of running the economic system.
[215] North. 1990:62.

However, production costs are just one part of the total cost of a company. Differences beyond technical issues between environments are faced when comparing the transaction costs. These costs are determined by defining, protecting, and enforcing the property rights to goods (the right to use, the right to derive income from the use thereof, the right to exclude, and the right to exchange[216]. These attributes are determined by the institutionalized rules of the game in the political environment.

Assessing the political risk means the assessment of the rules of the game determining the transaction costs. Management and governance of these risk variables aims at minimizing and predicting costs. If the governance and management are impossible by diversifying and bargaining, political risks can be avoided by leaving the project.

A major political risk is that the invested capital will be totally lost because of restrictions made by the political authority. Risks can be avoided in advance by not investing, or trading (instead of investing), if the reputation of the political authority is unknown. Trade based on payment in advance is appropriate, if the social and legal structure of the environment is incapable of ensuring the property and action rights. Political risk governance is a public service rendered by political authority. Although there is a strong tendency towards market-based systems, it can be assumed that the outcome of the transformation will settle in an equilibrium of marketable and non-marketable functions, where both systems exist. The reason for this is the non-quantifiable characteristics of political risk. Therefore, the economic decisions under risk have to be made with subjective knowledge compared to the production costs which are quantifiable.

By analyzing the regulative rules of the game in the environment of companies, the instability can be moved closer to the definition of risk. Traditionally, before the political transformation in Europe, business environments were divided into home and host[217] states. In its home state, a company is an insider, the informal rules of the game are known and, therefore, the risks are low. Thus, in host states, foreign companies are outsiders and have to rely on the formal rules of the game.

---

[216] North.1990: 28.
[217] Lax.1983.

Institutions provide the basic structure by which people throughout history have created order and attempted to reduce uncertainty in exchange.[218] The evolution of the management of uncertainty in long-distance trade was advanced by technical and organizational inventions. These inventions lowered the transaction cost level in three ways: the mobility of capital increased, information costs were lowered, and finally, the risks could be spread. The mobility of capital becomes possible by the development of laws. Fairs were transformed and institutionalized as banks and, finally, as financing houses. Harmonizing the measures and introducing new technology lowered information costs. Finally, it was discovered how to manage and govern the uncertainty by stabilizing the rules of the game through establishing joint stock companies and increasingly advanced risk-sharing organizations.[219]

Despite the similarities in market economies, the formal and informal rules of the game differ in different environments. This phenomenon derives from the differences in culture, shadow economies, and existing networks between individuals, which are reflected in the ways by which economies work.

Stability derives from the prevailing constraints in a choice situation as, for example, in the rules for foreign exchange. Transformation and change of the framework for exchange affects both the formal and informal constraints. Even if the prevailing rules of the game were inefficient, they provided models of operation. In addition, only the individuals with extensive bargaining power are able to change the rules of the game. [220] Thus, the political risk has not disappeared. The historical path has lowered the political risk level but, nevertheless, not created a neo-classical environment of zero transacting cost.

Hence, according to the neo-institutionalist paradigm, the assumption is that the transaction costs are higher than zero. However, the management of political risks is not based on probabilistic calculations because of the unpredictable transaction costs. Theoretically, a zero-transaction-cost environment could be hypothesized in order to analyze the environment.[221] However, public services are a characteristic of the phe-

[218] North.1990:118.
[219] North.1990:125–127.
[220] North.1990:68.
[221] North, 1990:118.

nomenon where zero-transaction-cost level is not achieved. That entails a feasible presence of political authority in the equilibrium between the political and economic environment. Otherwise, we can characterize the environment as a risky environment. In that kind of environment such public utilities as energy and transportation infrastructure cannot exist due to high transaction costs.

Despite the fact that the measurement of transaction costs in advance is not possible in every situation, it is possible to compare the efficiency of the equilibrium between different business environments: sectors, states, and regions. In this study, the comparison is placed at the level of different categories of the plurilateral regime. Public services represent the borderline case between those economic and political situations in international relations where it is beneficial to replace anarchy with hierarchy.

4.1.3 Co-operation between an Economic Actor and Political Authority

In Part Two, the study by Robert A. Dahl on a preface to economic democracy shows the boundary lines between political authority and economic actors. Dahl's study illustrates that there exists supply and demand for both actors with separate functions. A company is not a democratic actor that must give security and social guarantees to society. It creates inefficiency, if political matters necessary for stability are shifted to companies[222]. Economic actors must remain economic actors, not political ones, even if their operations have political consequences. Consequently, political authority must remain a political actor, not an economic one. In this framework, at different ends of equilibrium, the political authority is a regulator with political power, not an actor or an owner of economic units. Stability in order to maintain a low political risk level prevails only when the boundary lines between economic and political authorities and operational rules of the game are clearly defined.

Before proceeding to the transformation of the state – market relationship of the new regulation, the factor behind the stable and predictable equilibrium is the continuous co-operation among actors – the manner in which the co-operation was achieved earlier and will be achieved in the future among the two separate actors. In the traditional nation-state -centered context of political risk, the companies manage and the political authorities govern the phenomenon of political risk. Political risk governance can be characterized as a public service rendered by political authority. Is this political transformation concerning political risk governance shift in balance in Europe? The question is how co-operation will be stabilized in the future in the new conditions of multi-markets and multilevel governance in Europe.

Robert Axelrod has developed theories of the evolution of co-operation between two actors. The paradigm he used was the two-person iterated Prisoner's Dilemma. He started it at an individual level in 1984 and has proceeded into multivariate structures in 1997. His latest study focuses on a series of studies that go beyond the basic paradigm of the Prisoner's Dilemma: towards co-operation among nations, competition among companies, contests among organizations for wealth and membership, and competing pulls of social influence for cultural change[223]. The purpose of the study of political risk is to combine the neo-institutionalist theory with Axelrod's theory on the evolution of co-operation in order to analyze the positions of economic actor and political authority in the obsolescing bargain model: How to maintain bargaining positions and how are the rules of the game legitimized?

The limits of co-operation are constraints that create stability. Despite the informal rules of the game, Axelrod emphasizes the universality of determinants in co-operation. His theory supports the theory of Douglass C. North on the reasons why the rules of the game are institutionalized. Both the theories of Robert A. Dahl, on principles of economic democracy, and Robert Axelrod, on the evolution of co-operation, are sufficient for also describing the borderline cases in a transformed Europe because of their universality. Assumptions made on co-operation are separate from transformation. An economic actor must remain an economic one and a political authority a political one despite the shift from nation-state authority to multi-level authority and from national market to multi-markets. In the obsolescing bargain model, the investor's bargaining power decreases from the point when the company controls technological and management knowledge. However, the agreements that were made at the start may need to be renegotiated, and this increases the risk level.

---

[222] This notion refers from the dilemma of state/market failures in the following chapters
[223] Axelrod.1997.

The bilateral monopoly position has turned towards plurilateral positions together with a multilevel political authority. The Member States of the European Union have pooled their sovereign negotiating powers in international economic relations.

In the traditional model of the obsolescing bargain factor, Raymond Vernon (1971), Howard Lax (1988), and Wenlee Ting (1988) have analyzed risk prospects in different environments. Through co-operation, the shift in bargaining power can be eliminated by both sides. The utility derived from co-operation is mutual gain from an increased economic action. However, while liberalism emphasizes the dynamic variable-sum game between actors, this can be regarded as a non-zero-sum game.

The measurement problems of political risk are investigated in Part Five. In this context the differences between the characteristics of risks should be noted. The management and governance of political risks are based on particular types of risks. Static risks are pareto-optimal and characteristic of the obsolete bargaining setting where one actor's gain is the other's loss (zero-sum game). In an environment, where risks are static, stability prevails but co-operation is non-existent. Without dynamism, the economy weakens.[224] Dynamic risks are characteristic of environments with technological and socio-economic transformation. These risks are present in a variable-sum game where there is a base for mutual gain and foundations for co-operation among political authorities and economic actors.

A strategy is a specification of what to do in any situation that may arise[225]. What is the best strategy? Axelrod's suggestion for the strategy is “Tit-for-Tat”.[226]

Axelrod questioned, under what conditions would co-operation emerge in a world of egoists without central authority? The answer shows how the co-operation prevails in social, political, and economic relations.[227] He tested his argument in the two players Prisoner’s Dilemma-game, where players get points if they co-operate during the

---

[224] Ref. to traditional agricultural states in Johnson’s model in Part three.
[225] Axelrod. 1984:14.
[226] Axelrod. 1984.
[227] Axelrod’s methodology can be defined as individual methodology. Hannu Nurmi defines methodological individualism as an approach, in which the entire phenomenon can be derived from the thoughts and acts of individuals. Nurmi, 1978:179.

game.[228]. The winning strategy was tit-for-tat, where a player at first co-operates but will later reply to co-operation by co-operation and to cheating by cheating. Co-operation emerges as the game continues.[229]

Axelrod showed that his theoretical strategies could be applied generally in social relations.[230] Co-operation can be achieved by using five distinct strategies[231]: First the shadow of the future has to be enlarged. It means that the possible threats and advantages of co-operation are affected in the future. Without continuity there will be no co-operation. Second, incentives must be clear and, if there is a Prisoner's Dilemma situation, the payoffs have to be changed. Third, individual utilities have to be interlinked in some way for people to care about each other. Fourth, co-operation is of utmost importance. Fifth, the environment must be framed in order to identify the other player in a continuous game.

Axelrod's theory was a game-theoretic test of co-operation, and it verified that co-operation is possible without any authority higher than the actors. But instead of authority, in the realist theory the maintenance of co-operation is deterrence, and according to the liberals it is the cost-benefit ratio. In the realist way of thinking, absence of authority in international relations leads to competition in armaments, and according to the liberals the absence of authority has lead to the integration of economies, because the market-based rules of the game are the common denominator for cost-benefit calculation. A political regime is a consequence of this calculation. In the part on international organizations managing political risk, the factors of supply and demand of international regimes will be presented.

Game theories are criticized for their requirement of rational choice assumptions, whereas the theories of political economy do not emphasize the actors' rationality.[232] Pluralist theories question the rationality of political authorities, because interest groups and a shortage of information influence decision-making procedures. According to John Zysman, game theories are not appropriate for explaining the evolution of the European integration process, but there are institutional theories and theories

[228] Axelrod.1984:55–69.
[229] Axelrod.1984:27–54.
[230] Axelrod.1984:88–105.
[231] Axelrod.1984:126–139.

which explain how the coalitions of elites maximize their interests.[233] Axelrod's theory, however, does not explain the co-operation based only on rational decision-making.

E.B. Haas maintains, when observing the metatheory of international relations, that an individual's assumption of rationality is not an important factor in political economy[234]. In international politics, there are always new players ready to try discontinued strategies. Haas noted that structures exist only in human thinking; when people change, structures will also change. An example from the Staghunt game illustrates this phenomenon: In this game, some Stone Age hunters had to be satisfied with small game while working alone but through co-operation and by dividing the work they were able to hunt for bigger game, for example, when some of them chased a stag for others to spear. The hunter who abandoned co-operation always returned to the group. According to Haas, such co-operation is not achievable due to the myriad players and because in international relations there is no learning at the individual level.

However, the market-based rules of the game are universal when compared, for example, to political and cultural ones. There are elements of co-operation that are not dependent on informal rules of the game. Liberalism is based on assumptions about such a variable-sum game. Axelrod's theory of the evolution of co-operation is also based on similar assumptions. Co-operation can prevail without a rational choice. The assumption that is made is a requirement for the continuous game. Economic relations often fulfill that requirement.

Axelrod's study presented the boundary lines in co-operation between two antagonistic actors. However, this bipolar world has been replaced by a plurilateral environment in which multimarket and multilevel political authority exist.

---

[232] Haas.1991.
[233] Sandholtz, 1992:85.

4.2 The Levels of Institutional Rules of the Game

When considering the studies of Douglass C. North and Robert Axelrod, we can ask: Where should the level of political risk analysis be focused? Whether to deal with an individual decision-maker in a company or an internal political regime in a state, or formal and informal interest groups engaged in political processes? Or are the political regimes, on a macrolevel in international relations, more important factors in terms of the political risks a company faces in its environment?

The levels of analysis, from an ontological point of view, are the assumptions about the ontology of a paradigm on how the world is constituted and the assumptions about the standards on how the world should be investigated. [235] For a company, the political risks as dependent variables must be confronted at the microlevel, for example, as confiscation or nationalization, or restrictive regulation. Consequently, political risks could be managed at the company level. However, the management and governance has much to do with the macrolevel governance. The specific management instruments are a by-product of political governance even in market economies.

Globally, there are multi-markets and multilevel political authorities. Political risks are divided into risks arising from the instability or risks emerging from the policy decisions in the surrounding environment. Thus, globally, international economic action crosses the frontiers in a plurilateral regime. Since political risk governance is a public service offered by a political authority, these frontiers remain. Instead of a pluralist state system, the plurilateral regime is part of the liberal system of governance and in accordance with the rules of the game set between economic actors and political authorities. How would we trace a plurilateral regime?

According to Vinod Aggarval, there are reasons for regime formation. In this case, it is a need to establish equilibrium between economic actors and political authorities in the business environment. The political regime can account for the strength, nature, and scope of actors.[236] "Strength" refers to the stringency with which rules of the game regulate the behavior of political authorities and economic actors. "Nature"

---

[234] Haas.1991.
[235] Laudan.1990: 73.

refers to the objects promoted by the regime's rules and procedures. “Scope” refers to the range of economy sectors regulated by the regime for sectors of finance, competition, harmonization, energy, telecommunication, and transport.

Kenneth Waltz has identified distinct levels of analysis and attempted to specify relationships among different levels of analysis in international relations. Could the cause of war be found in the nature of an individual? Or in the nature of states and societies? Or in the nature of the international system of states? Each question suggested reflects different levels of analysis – individual, state, and society, or international. Waltz concluded that the permissive cause of war is the condition of anarchy in the international political system of states, whereas the actual causes of any given war can as well be found in the other levels of analysis. Whether or not one agrees with his conclusion, the important point is that his analysis of the problem of war included different levels. David Singer developed this analysis of different levels further. He argued that one's choice of a particular level of analysis determines what one will or will not find. Different levels tend to emphasize different actors and processes. The easy answer to the question, concerning which level of analysis should be emphasized, is that all levels of analysis should be considered. Such a response is not particularly useful, because it suggests that we have to study everything.[237]

Different levels of analysis can be traced in the political risk analysis. The traditional state-centered analysis compared state institutions at an organizational level. Raymond Vernon's classical model of bilateral monopoly between the state authority and a foreign company showed the obsolescing bargain factor in power positions. In a neo-institutional framework formal and informal rules of the game appear at hierarchical levels. In international relationships, the highest stakes are security issues defining the rules of the game.

4.2.1 Security System Level

Security issues define the rules of the game between “economic” and “political” at the highest stakes. Stability within and without the political regime is maintained

---

[236] Aggarwal. 1986:20–21
[237] Waltz.1959.

through the governance of security issues. When placed in the obsolescing bargaining model, the bargaining power of political authority is based on its role of supplier of security through military power.

Coercive, relational power is direct and visible. Indirect, structural power is invisible. They both exist in an environment of economic actors. Thus, anything as messy as power cannot be included in an economic equation or a purely economic analysis. It is hard to include power in economic actions, which are simply asymmetries of power. Real life is full of such uses of power, which by strictly economic logic are irrational[238]

Kenneth Waltz pointed out two considerations on war:

> *Positively, to necessitate the arming of peacefully inclined countries, some countries must be ready and willing to use force to make their will prevail. Negatively, there must be lacking the authority that can prevent the unilateral use of such force. If both the positive and negative conditions are present, then the peaceful logically must look to the state of their armaments not because they wish to gain something from war but because they wish both to prevent its occurring and to protect themselves should it occur ...Among states and among men there is no automatic adjustment of interests. In the absence of supreme authority, there is then constant possibility that conflicts will be settled by force.*[239]

Although the realism emphasizes the power as high politics, all images in the international relations theory are linked to the security high on agendas.[240] Security issues are reflected in the stability of societies. Whatever their form of government, states act in their national interests. Realists argue that states have a little choice in defining their national interests, because the international system is based on the balance of power. For liberalists, national interests are wider and include economic issues like economic welfare, and they emphasize international trade. According to liberalists, the international system is not purely anarchic. If institutions and channels of com-

[238] Strange.1996:19–21.
[239] Waltz. 1959: 188–189.
[240] Viotti & Kauppi.1993:1–23.

munication provide for stable expectations of continuing peace, the Prisoner's Dilemma may be avoided.[241]

National interests can be divided into competition and strategic issues that are linked to the economy. Competition policy is being harmonized in the European Union. Steven Weber and John Zysman have analyzed why the changed relationship between security and the economy would alter the character of the European Union. For two generations, a complementary and symbiotic relationship between strategies for growth and security underpinned political bargains, on which the European Community was built. Those bargains were often entangled with, and framed and shaped by, the terms of the national politics of the member states.[242] National interest explains why the political risk governance and management issues are not being harmonized, even though there have been many efforts since the 1950s, as will be shown in Part Five.

However, the state level in security issues has been transformed towards larger security regimes with the widening issues in security. According to Buzan, Waever &, de Jaap, the security is defined by a security complex containing military security, political security, economic security, societal security, and environmental security.[243] From a mercantilist perspective, economic security is part of a wider priority of national interests, and economic success tends to be seen as zero sum. Liberalists value the economic efficiency as a positive sum game and emphasize the problems on how to maintain economic and political stability. Hegemonies, regimes, and institutions offer three ways by which stability is maintained.[244]

When considering the wide spectrum of security issues on different sectors, it can be seen that maintaining stability requires deeper international co-operation in security issues than purely military co-operation. In addition, when considering the equilibrium between political authority and economic actor, the balance can be found by locating different points in the sector in question. For balancing market and state failure, the political authority's interventions are different depending on whether the

[241] Nye, Joseph, S.Jr.1993:40–41.
[242] Weber & Zysman. 1997.
[243] Buzan, Waever & de Jaap.1998:8.
[244] Ibid.95–97.

question is about social, environmental, or military stability. Also the equilibrium between political authority and economic actor remains closer to the political authority although the market logic would predict otherwise. For example, the energy sector and telecommunication sector would have a different balance. The energy sector is closely linked to national interests, whereas the telecommunication sector requires a liberal economic regime. This situation is described in Part Six. Multiple security dimensions lead to a situation where international co-operation becomes close to plurilateral co-operation in that it takes place at several levels of environment. Security communities develop along plurilateral paths[245].

> *Security is an impure public good. International relations resemble the business world in that the provision of security can require replacing anarchy with hierarchical governance structure, at least among a subset of states. Whereas, in the economic realm, a transaction consist of the trade of goods or services between parties to organize production, in the military realm, states trade goods or services to enhance their security and to assure their survival. A transaction might entail the provision of certain types of raw materials, specialized equipment, skilled labor, or dispatch of specially trained troops to aid allies in organizing their defense. However, it is important to stress that the substitution of hierarchy for anarchy is costly, so that hierarchical governance structures emerge not only because they promise greater security but also because they can reduce transaction cost. That is, just as economic agents – to minimize transactions cost – tend to arrange themselves hierarchically, threatened states weakened by the enormous cost involved in gathering and evaluating information, in preparing for, negotiating, and concluding agreements, etc., seek allies. Given that coordinated efforts are oftentimes more efficient than individual efforts, countries facing high transaction cost could benefit from joining political entities with well developed, cooperative organizational structures. Clearly, the level of transaction cost is important in determining, which security arrangement countries choose. If transaction costs are negligible, the organization of military activities for efficiency reason seems to be ir-*

[245] Adler & Barnett.1998:30.

> *relevant. When the level of transaction cost increases, the likelihood of a state preferring a confederation over an alliance will also increase.*[246]

The economy is a strategic resource for security policy. International co-operation in security issues is reflected in the economy [247]. Transaction cost analysis shows that states may pool sovereignty in order to maintain stability. The security complex can be governed by making co-operation simple. For example, the GATT-agreement was made by the states belonging to NATO.[248]

Edward M. Graham and Paul R. Krugman have identified risk-indicators related to foreign direct investment at the security system level[249]. Among them is a military conflict between the investing and receiving states, or foreign business activity, which starts to threaten the nation's security. In 1993, of the investments in the U.S., 89 per cent originated in its allies, that is, NATO countries and Japan as the biggest ally. The level of threat determines the contents of security policy. A risk variable will then be the relationship of the political authority, in an operational environment, with two regimes of security policy.

All that the international relations theory itself can tell us is that threat leads to alliances, since alliances are viewed as political structures militarily capable of dealing with a security problem. It cannot definitely tell us how binding a relationship countries will enter into. In the military realm, the level of threat is instrumental in determining the nature and degree of states' commitment. That is, if the level of external threat states are facing is low, there is no need for a strong commitment, and, therefore, if countries choose to co-operate, an alliance might be chosen over a confederation. On the other hand, if the level of external threat is high, states are likely to prefer an arrangement that gives them greater assurance.[250]

Thus, the political risks have been assigned to two categories: Category A consists of political risks derived from instabilities of security issues. These risks are, for example, those faced in the investment environment in "risky states." In this case, a

---

[246] Weber.1997:329.
[247] Visuri.1997:124–143.
[248] Sandholtz, 1992:167–197.
[249] Graham & Krugman 1995

company may be operating within two different security environments. Another dimension is that political authorities are unable to offer stable rules –of the game for companies. Category B consists of political risks caused by the market instabilities that are seen, for example, in France in the telecommunications sector when the sector's liberalization caused questions on national security. Generally, these risks can be seen in the European Union and within the plurilateral regime. When considering the risks in Category B, there are suitable risk management instruments available on the market. The risks in Category A can be managed only by the political authority's governance.

At the global level, the states in Category A can be classified according to the following criteria: Those states and actors, which do not abide by the conventional and core norms of the international community, except in an isolated incident, are perceived as conducting volatile or uncertain policies. They have situated themselves in a dangerous strategic context such as rivalry or in a conflict-prone region, and have the propensity to employ force internally or internationally. These indicators of risky states have three facets. First, these political entities may have the propensity to pursue goals most other states would condemn morally. Secondly, risky states are generally rational in the sense that they react to incentive structures. Risky states may select strategies that do not seem optimal, from the perspective of a Bayesian agent, to create uncertainty about the sanity of their actions. Thirdly, the risky states incorporate state-level explanations. Instead of speculating on their motives, the correlation of arms expenditure of one state with that of another state might be an indicator on how risky a state or dyad is. [251]

4.2.2 International Organization Level

In the context of political risk, international organizations are the arena for the nation-state authorities to co-operate in order to lower the transaction costs in economic exchange. Co-operation takes place in the international regime of nations-states.

---

[250] Weber, Katja, 1998:325.
[251] Schneider & Weitsman.1997.

The regimes between pluralist nation-states are social institutions that influence the behavior of nation-states and their subjects. These regimes consist of formal and informal rules of the game: principles and norms, specific rules, as well as procedures and programs. This comprehensive presentation on international regimes has been made by Levy, Young & Zürn.[252] Raymond Vernon has examined, from the point of view of political risk analysis, the cultural and institutional roots of behavioral differences among states participating in the process of regime formation.[253]

Robert O. Keohane has analyzed the international supply and demand of regimes from the point of view of transaction costs.[254] He has made some important notions on the formation of regimes, which are used in this study, and it is important to present here his basic definitions. According to Keohane, there exist supply and demand of co-operation in international relations. When placed in the obsolescing bargaining model, the bargaining power of a political authority is limited by international organizations.

International organizations have re-emerged as effective economic regulators in the co-operation of nation-states. Thus, we now have an emerging division of economic actors in governance between international, national and regional political authorities. A nation-state can no longer assert a monopoly over deciding who will govern and how. A nation-state is, undoubtedly, a specific part of a complex governance system. On international arena, the organizations higher than a nation-state provide essential elements of governance by producing the institutional rules of the game.

> *Institutions create the capability for states to cooperate in mutually beneficial ways by reducing the costs of making and enforcing agreements, what economist refer to as "transaction costs"…Even powerful states have an interest, most of the time, in following the rules of well-established international institutions, since general conformity to rules of well-established international institutions, since general conformity to rules makes the behavior of other states more predictable … The scholarship drew heavily on the twin concepts of uncertainty and credibility….*

[252] Levy, Young & Zürn.1995.
[253] *Ibid*.:281.

International institutions can reduce this uncertainty by promoting negotiations in which transparency is encouraged; by dealing with a series of issues over many years and under similar rules, thus encouraging honesty in order to preserve future reputation and by systematically monitoring the compliance of governments with their commitments. [255]

Keohane's main concepts in regime formation are the supply and demand of the regime[256]. Regimes are formed because both of them exist. There supply and demand of security at the state level, state community level and society level. Regimes lower transaction costs. They can be characterized as continuous multilevel agreements.[257] This feature fulfills Axelrod's requirement for evolution of co-operation.[258] Regimes can be researched by analyzing their consistency.[259] This is doneIt is by showing how many agreements are linked in a regime. For example, a regime can cover energy issues, but wider complexes can be involved like the United Nations or international investment agreements, such as the MAI agreement between the OECD countries.[260] Thus, the regimes take on the characteristics of nation-state agreements.

The transformation of a pluralist state regime into a plurilateral regime can be demonstrated, because there are myriads of new international interactions, which happen above and beyond a nation-state. The causes for plurilateral transformation are in the globalization and integration procedures. Integration is pooling the state sovereignty, and globalization is emerging also at the level of society networks. For example, electronic cash and the Internet are creating connections outside the control of a nation-state.

Governance without government is a characteristic of a plurilateral regime. Beyond the plurilateral transformation are the market-based rules of the game. These rules are the common denominator. Political and economic actors are governed by market-

---

[254] Keohane.1989.
[255] Keohane.1998:110:82.
[256] Keohane. 1989:101
[257] *Ibid*:102.
[258] *Ibid*:165.
[259] *Ibid*:111–113.
[260] Keohane. 1989.

based rules. The European Economic and Monetary Union is one example of governance in which the balance is closer to markets than politics.

The concept of a plurilateral regime connects the present political transformation with the earlier metatheory of political risk. A plurilateral regime is a path-dependent characteristic of pluralism. It is derived from bilateral and multilateral agreements in international relations pertaining to nation-states and the trade and financial agreements made between them.[261] Bilateral and multilateral agreements are made between nation-states, referred to as “binding all participants who sign the agreement”. These agreements are binding on all participants in the same way.[262] The European Union was created by multilateral agreements between nation-states that are binding on all who participate in the agreements.

"Plurilateral agreement” refers to agreements that are not binding on all participants in the same way. “Pluri” is defined with reference to “several” derived from an adjective which means “existing apart, separate, distinct”.[263] An example of a plurilateral regime is the co-operation agreements between the European Union and Russia. The contractual pact is related to the agreement of the World Trade Organization (WTO) with certain characteristics. A plurilateral agreement binds only those parties that have specifically become signatories to any one of them. There are parts in the agreements, which fragment the general rules of the game. These can be illustrated by analyzing borderline cases in agreements. Some of these agreements are included in Annex 4 and include, for example, the Agreement on Government Procurement.[264]

However, “plurilateral” can also be used for characterizing informal rules of the game. “Plurilateral” refers to different types of actors, including the non-state ones. Individuals and groups can make such agreements over nation-state borders; for example, the use of electronic cash via the Internet is possible within a plurilateral regime. However, inside the regimes formal and informal rules of the game vary. Some security agreements may also be regarded as “plurilateral”.

---

[261] Oxford English Dictionary. second edition.1999.
[262] Oxford English Dictionary. second edition.1999
[263] *Ibid.*
[264] Hoekman & Kostecki.1995:122–124.

Market-based rules of the game amalgamate the agreements on co-operation at every level of the environment. However, there are separate hierarchies within the agreements, but these are not maintained by the political power of a nation-state. There is no hegemony as it were in a nation-state regime. The European Union is a customs union with pooled sovereignty. The North American Free Trade Area, NAFTA, is a typical free trade area without pooled sovereignty, and agreements made in this regime are closer to a framework than a legitimate agreement.

Why would the new agreements be defined as “a regime” and not, for example, as “a governance"? Logically, this is done, because a plurilateral regime lowers transaction costs compared to a nation- state regime. As Keohane has argued, there is supply and demand for a plurilateral regime: Transaction costs are lowered by this regime because of the commonly accepted formal and informal rules of the game.

A plurilateral regime covers all the levels of analysis and all types of actors in the global arena, from the security system level to society level. However, it is obvious that the unitary rules of the game cannot be obeyed worldwide. This is not the end of history, as was argued by Francis Fukuyama in his study, *The End of the History and the Last Man*. Fukuyama argued that Western civilization and the liberalist revolution would conquer the world after the socialist world had collapsed.[265] Regardless, rules are still obeyed at different levels of adherence depending on whether we are acting in an environment that belongs to a plurilateral core or in an environment outside of it. Additionally, inside the borders, the rules of the game become fragmented. An example demonstrated in this study concerns public services in the European Union’s internal market. Political risk governance is a public service of a nation-state in order to create a stable economic environment. When this has been changed, the market-based rules of the game maintain stability in a plurilateral regime where both the markets and the political authority function at several levels.

International organizations are still an arena for co-operation but only a limited one. “Plurilateralism” refers to those loose interregional forms of co-operation, which are

[265] Fukuyama.1992: 70.

driven by political leaders, but are not characterized by formal structures or binding treaties [266].

4.2.3 State Level

A nation-state is a sovereign state whose citizens are united by such ties as language, common descent, etc., which constitute a nation.[267] A nation-state governs the political risks of companies by creating stability and predictability of the rules of the game. In theory, state laws are a means by which people can be equally compelled to perform their covenants.[268] Within this role, the state causes risks when exercising its political power. When placed in the obsolescing bargaining model, the bargaining power of a state authority is based on the abovementioned governance and regulation policy.

The role of a state is determined in the balance of the market and state failure. Public services are a borderline case. When the markets are incapable of, or unwilling to, supplying public services, there appears a demand for state authority.

The theory of government failure is developed less formally than the theories of market failure, but they both argue that the inherent characteristics of supply and demand for government services will lead to inefficiency. There are many reasons for the growth of government: the market failure, benefits of political institutions' diminishing transaction costs, the structure of political rewards, and the comparison of burdens and benefits of societal actors. Each of these reasons tends to lead to an oversupply of publicly produced goods. It is difficult to define and measure output, both in principle and in practice, and there are particular problems in the evaluation of quality. The supply of public sector goods is in the hands of a monopoly, which has the backing of law and, thus, the market is not contestable. Much of the public sector is concerned with the production of services for which there are inherent problems in the definition and control of technologies. It can be argued that there is no bottom-line in the public sector and no mechanism for the termination of unsuccess-

---

[266] Pelkman.1998.
[267] Oxford English Dictionary, second edition. 1999.
[268] Williamson. 1996:32.

ful public policies. These characteristics of the supply and demand of goods and services in the public sector will lead to systematic non-market failures.[269]

In the traditional approach to political risk, the state is a pluralist unit. Due to its role in maintaining a stable business environment, the state co-operates in the international arena. Growing interdependence has lead to the transformation of the role of the nation-state. When the market-based rules of the game stabilize, the state's role changes from an owner of economic units and an economic actor to a regulator and promoter. Political risk governance will be transformed into a market-based governance. In a new context, the state will set the boundary lines for the economy by law instead of giving risk guarantees directly to companies. This change transforms the political risk management instruments of companies. In a new environment, companies will face the political risks directly without a state buffer.

Above is a general notion of political transformation. Notwithstanding its transformed role, the state is the most important unit for assessing political risks in an environment [270]. Despite the existence of general rules of the game, some of them still vary by state, although the trade policy has been shifted, for example, to the European Union. The economy is only one dimension in this political space: parts of geopolitical, social, cultural, and security issues still continue to be located at the state level, and these fragmenting issues are reflected in companies' operations as political risks.

Thus, in the environment of companies, a wrong solution would be that eroding frontiers meant the end of the nation-state: politics, nationalism, and national identity in the internal market would still vary. The political environment in Member States will be shaped by culture, history, and objective, which define the identity. Languages and dialects still remain despite the operation of a single market. Even if a growing number of Europeans were connected to electronic networks, the majority would identify themselves according to their nation-state. As will be presented in Part Six,

[269] Walsh, Kieron.1995: 23–25.
[270] This argument is based on where the institutional rules of the game are located that are causing the political risk for a company. For example. the implementation of European trade policy in member states. From the point of view of political risk, a state is an actor that has a nationalistic and protectionist trade policy that is causing the risks. Strange (1996) argues that the most important level of analysis is a nation-state despite its pooled authority in economic issues.

the public service market is one of the borderline cases that are fragmenting the single market. Globally, no market operates without a structure that is maintained by political authority.

It has already been noted that the state authority will be diversified into a multi-level authority. According to the logic of transformation, the state authority will be transformed into a regulator and promoter, not an owner or economic actor, with the nation-state as an implementation level. Regarding the new role of the nation-state, the most important problem will be how to deal with the welfare state within the new market-based regulation policy. Among the industrialized countries, the contents of a welfare state and its definitions vary. Consequently, it would be difficult to understand that a model would be adapted that would neglect the human infrastructure, that is, health and education in a long term. In the economy, the concept of state failure would lead to the lessening role of the state, but maintaining public services at a basic level would not be an impossible task, even at the European level, when it appears that these services remain under the states' authority and the rules of the game will be harmonized.

Furthermore, competition reveals the institutional differences between societies. The competition of industrial sectors varies between nation-states. Economic history explains the transformation of institutional rules of the game that is connected to competition between nation-states. In a market economy, the competition explains the harmonization of the rules of the game at the state level. Successful structures are being copied and applied in different environments. Market processes developed in states with different institutional structures. Zysman has classified four structures. [271] His approach is evolutionary and emphasizes the historical transformation. First, neo-institutional structures define the economic environment. These structures have a historical background and reflect the individual level and cover, for example, cultural factors separated from political institutions at a conceptual level. Preceding Zysman, North has argued that the neoclassical paradigm has blinded us to the implications of historical transformation. The assumption of rational choice remains unchanged.[272] Secondly, institutional structures that define the operation of specific organizations

---

[271] Zysman.1994.

[272] North, 1990:111.

lead to market economies in nation-states operating differently. This has an impact on capital and labor markets. For example, the skill and knowledge levels in the labor force vary. International rules of the game are enforced differently.

Thirdly, market logic is initially located inside the state institutions as political ideologies and from there it is reflected onto the strategies and production decisions of companies. The co-logic of market and political rules of the game define how the companies' strategies in an international environment are realized. Fourthly, competitive positions are defined by institutional differences. Differences between company strategies, market access, and technology create international competition. Therefore, it is impossible to determine, in advance, which former socialist states will be successful in applying the market-based rules of the game to their societies.

Institutional transformation within a state is a gradual process, and is affected by feedback from society and the market. O'Donnell has described how the two free trade groups, the European Community and EFTA have integrated themselves with trade agreements into a single European economic zone covering both the formal and informal institutional rules of the game[273]. Finland has experienced a similar early transformation.[274] The transformation in Europe involves management and governance of formal and informal rules of the game in different regional economic environments.

Institutional rules of the game define the transaction costs. Douglass C North asks, why is it costly to transact?[275] Market and trade can be divided into three types of exchange in order to trace different price levels. At the local level actors know each other well. Trust and continuity prevail. Transaction costs are low. The second level of exchange is the impersonal exchange where parties are constrained by kinship ties, such as, for example, merchant codes. North explains that, at the impersonal level, the role of the state was strengthened, in medieval Europe, because the state protected merchant codes and maintained rituals, which were institutionalized as the rules of the game. Simultaneously, the state's role also increased the transaction cost, because fiscal activities increased. The state was a source of insecurity, when it

---

[273] O'Donell. 1994:57.
[274] Koivisto.1997:195–250.

strengthened its power by regulating the economic actors. There were costs involved in the protection and enforcement of property rights. At the international level, an exchange is an extension of a third party enforcement. The returns on opportunism and cheating rise with complexity. There are problems with achieving third party enforcement of an agreement via an effective, applicable, judicial system.[276]. The European Union is a hybrid of the different levels of state and international exchange. When analyzed from the point of view of political risk, it is easy the trace the profitability of the integration process in the development of exchange.

The more international a business environment, the more there are variables affecting the company, and the more a third party enforcement is needed. Therefore, activities are narrowed down to a few sectors. O'Donnell analyzed trade statistics in Europe and discovered that companies specialize more by commodities and sectors than by countries.[277] Stapenhurst compared national and international trade and showed that basic factors are the same at both levels. The international environment is an extension of national circumstances in market economies. Differences are reflected in currencies, interest rates, fiscal systems, regulation policies, languages, and cultures.[278] Before the integration process, the nation-state represented the frontier of an institutional unit of different rules of the game. However, the logic of exchange has been similar in market economies.

As result of the development in the integration process, the equilibrium between economic actors and state authority has been transformed into an equilibrium between multimarket and political authorities. However, the European Union has no fiscal rights. Instead it regulates and harmonizes the rules of the game by means of an internal market policy and a competition policy. In this context, the state is being transformed into a market-based regulator. Thus, an internal market for commodities has emerged, but it is still incomplete for services. Public services are a borderline case in the transformation process of a nation-state. Until recently, public services have remained under the nation-state's authority.

---

[275] North, 1990:28.
[276] North.1990:34–35.
[277] O’Donell, 1994:61
[278] Stapenhurst, 1992:15

From the point of view of political risk, nation-states have harmonized the rules of the game of economic exchange. In this way, the state has transferred the political risk to the international community. This move was based on the fact that continuity maintains co-operation, as demonstrated by Robert Axelrod. With co-operation, it is possible to lessen the instability. The international market is a buffer in order to stabilize economic cycles in nation-states. The negative impacts of the international market have been emphasized too much. International markets enable the pooling of risks. Just as a state protected merchants in early modern Europe; the co-operation of nation-states is a way to further develop impersonal exchange, for example, through co-operation in the World Trade Organization and OECD. In this process, the international regimes emerged. By the transformation through liberalization and pluralism at state level, the new developing networks have lead to a plurilateral regime with global market-based rules of the game. However, the political authority cannot protect economic actors until it has assumed the power to enforce the rules of the game.

Earlier, in the mixed economies, the risk governance was a state monopoly. The state gave guarantees to banks, insurance companies, and bilateral international trade. Even when a multilateral agreement was made, the state was the sovereign level the rules of the game were enforced. This type of governance has changed, and there now exists a multitude of co-operation networks. The rules of the game are stabilized under a pooled sovereignty in a plurilateral regime based more and more on markets.

The borderline case is public services. A risk management instrument rendered by the nation-state, as offered to its companies, can be characterized as a public service because it is located in the equilibrium of “economic” and “political,” in the intersection of the market and states’ failure.

4.2.4 European Community Level

The European Community represents a key level in the political risk analysis. The European Union is distinguished from international organizations by its claim to sovereign powers. The Member States combine their power and authorize the EU to act for them in order to exchange the influence of all of them. This is referred to as “pooling of sovereignty”. With the pooled sovereignty of the Member States, the EU focuses on a unique equilibrium between economic and political milieus. Political risks, in the operational milieu of companies, are the result of circumstances created by integration, of implementation of rules and regulations at the state level, and of those changes and reflections integration has brought into the internal markets' external economic relations.

The Single Market Act and European Monetary Union are changing the substance of political risk and its management, and transforming the identities of national economic actors into European ones. Risk analysis concentrates on the relationship between company and political authority in the European Union; when integration moves from the phase of creating an internal market into the phase of directing and regulating a market. As a result of this regulatory integration , authority and power structures in the European Union are transformed in both the internal market and external relations. Development of the Union's political dimension is, in turn, reflected in external commercial relations. Economic actors have to work in an environment where national and international norms are intersecting and opposing each other. It is not clear, in whose hands the legitimate power is to set the rules of the game. In addition, it is not clear whether the center of political decision-making is located at the nation-state level, European Union level, or local level.

The internal markets are in an environment of low political risk level because of the consistent rules of the game and boundary lines. Thus, because of the abundance of unofficial rules of the game, harmonization will come to a halt at different institutional levels in different Member States, as will be shown in Section 6.2.3. on public services. These new political risks in the internal market appear at the community, implementation, and society levels.

In the early stages of integration, a single market was realized for commodities. Now, in the Treaty of Amsterdam, the single market is approaching one of the most significant borderline cases in the balance between the economic and political milieus – the public services. Political risk governance is a public service, because it is based on safeguarding the national interests.

The external powers of the European Community are stated in Articles 100 to 116 of the Treaty of Rome. Diplomatic instruments in external issues are set in Article 113 and the sanctions available in Article 228a. Thus, its role as a power bloc is stabilized with the functioning of the European Economic and Monetary Union.

Integration means the making up or composition of a whole by adding together or combining the separate parts or elements; combination into an integral whole – making something whole or entire.[279] Therefore, the plurilateral regime characterizes well the European Union in the analysis of the political risks. Political governance in Europe is the continuous co-operation between Member States, as has been theorized by Douglass C. North, Robert Axelrod, and Robert Keohane. Formal and informal rules of the game in equilibrium are set and legitimized in a plurilateral process, which is different in each Member State. However, at the global level the plurilateral regime combines the rules of the game and boundaries of a market-based system. This explains why integration should be a characteristic of a plurilateral regime. It is an unfinished, path-dependent process, and the transformation is continuous. Moreover, the agreements of co-operation between Member States are under constant transformation. When placed in Vernon's obsolescing bargain model, power shifts take place at every level from security level to society level. Those that are continuous are the pluralist, market-based rules.

An analysis at the state level showed the nation-state to be at an advanced level in the development of impersonal exchange. In order to protect and enforce property rights, the state regulated society and the economy. In mixed economies, the state was an owner and an economic actor. The European Union presents a more advanced level in development of impersonal exchange.

In theory, the integration process is based on a pluralist, liberalist, and democratic path, and it is assumed that there is no information shortage and that transaction costs are predictable in internal markets, as it would be in a nation-state regime. However, the neo-institutionalist paradigm of political risk has argued that a riskless environment does not exist. Because of the presence of both political and economic logic, the boundary line between them will be set, in the future, at the European Union level. What kind of regulation will be needed in the European Union? How it will be traced in impersonal exchange with the European Union enforcement? Firstly, it will regulate the internal market and, secondly, it will represent the Member States in external economic relations.

Whether Europe is locked into a system of nation-states in the future, or whether the rudiments of a European society exist, depends on the integration process of the service markets. The European Monetary Union represents the "economic," marketable transformation compared to the emerging European governance of public services that represent the "political," non-marketable transformation in the equilibrium. This study is focused on the "political" dimension.

However, the EMU is an instrument in the political governance structure. After the Second World War, the U.S. created a regime for political risk management with its hegemonic power; an international monetary regime manifested in the International Financial Architecture in the Bretton Woods organization. It remains to be seen whether the European Union will be able to stabilize the business environment with the monetary regime it is forming. Political risk instruments for external economic relations have not been market-based in the European Union, because there has not been a market-based monetary regime. Such regimes are based on an agreement between Member States.

A political regime has been developed, with its own rules of the game, which distinctly separate the discussion from nation-state politics. How has this transformation been reflected in the risk management and governance? By offering the risk management instruments and governing the political risks? In a plurilateral regime, which consists of actors from different informal rules of the game, the common denominator is the market-based rules of the game. However, because an interrelationship between "economic" and "political" is and has been in the equilibrium, the new boundary line is at the level of the politically weighted governance.

The security level of analysis, at the highest stakes, determines stability in Europe. At the earliest stages, the EEC did not need to pay an enduring economic price to

---

[279] Oxford English Dictionary, second ed. 1999.

achieve its security goals – particularly as it rested relatively comfortably under an American nuclear umbrella and within a stable dollar-based, American-guaranteed monetary order. Integration was overall a positive- sum-game, because, while one goal was being pursued, security helped achieve the other, an economic growth, and conversely the new objectives and institutions of the economy were instruments for the security policy. Certainly, there are economic arguments that favor the EMU. A single currency may give a more solid foundation for long-term non-inflationary growth to a unified European market and investment space. It may do so by reducing transaction costs and other uncertainties connected to currency fluctuations. To some extent this debate – while helpful in clarifying the costs and benefits of the EMU – misses the point. The anchoring of Germany in Europe is clearly only one part of the new security story. The dissolution of the Soviet Union left a set of countries on the eastern flank of Western Europe that presents a new set of problems.[280] The establishment of single European currency was an objective in the Treaty on European Union in Maastricht in 1992.

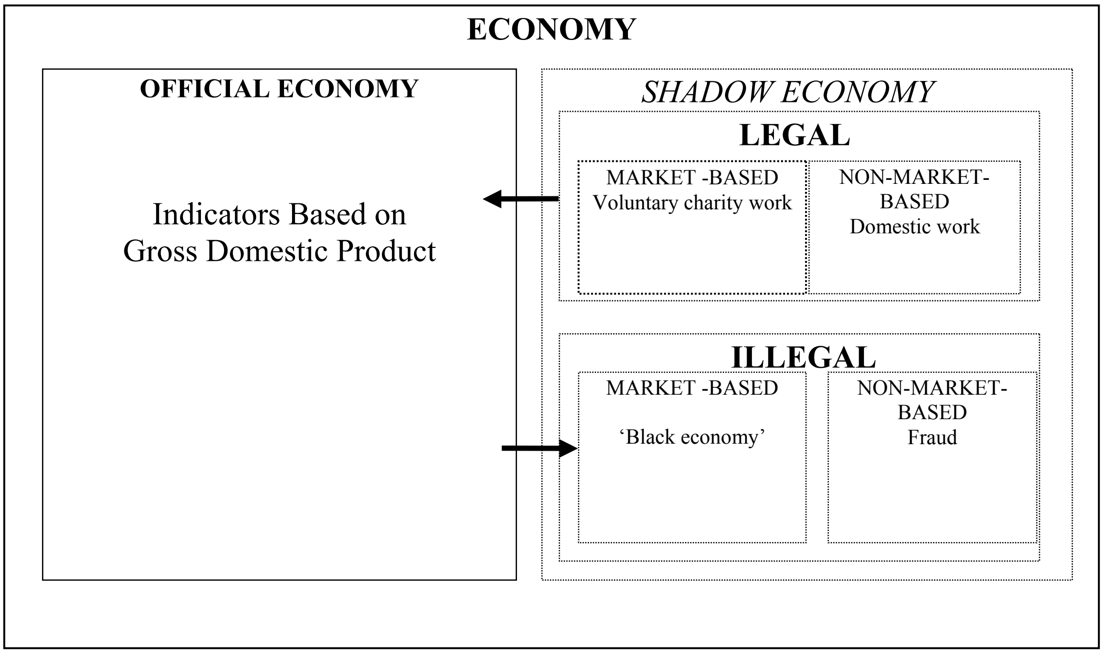
4.2.5 Society Level

Informal rules of the game were part of the heritage that is called culture. [281] Traditionally, in a state regime, a foreign company was an "outsider," when its position in a sovereign state was analyzed. The law sets formal boundaries for actors in a certain environment. But societies are more complex and pluralist by nature than the formal rules of the game can illustrate.

This is also true when considering the equilibrium between economic actors and political authorities. At an informal level, the society actors set the rules of the game that can differ enormously between regions and states. This is illustrated in the following Figures[282]. (See Figure 10 and Figure 11).

[280] Zysman.1996.
[281] North.1990.37.
[282] Loikas.1994.

Figure 10 Shadow Economy



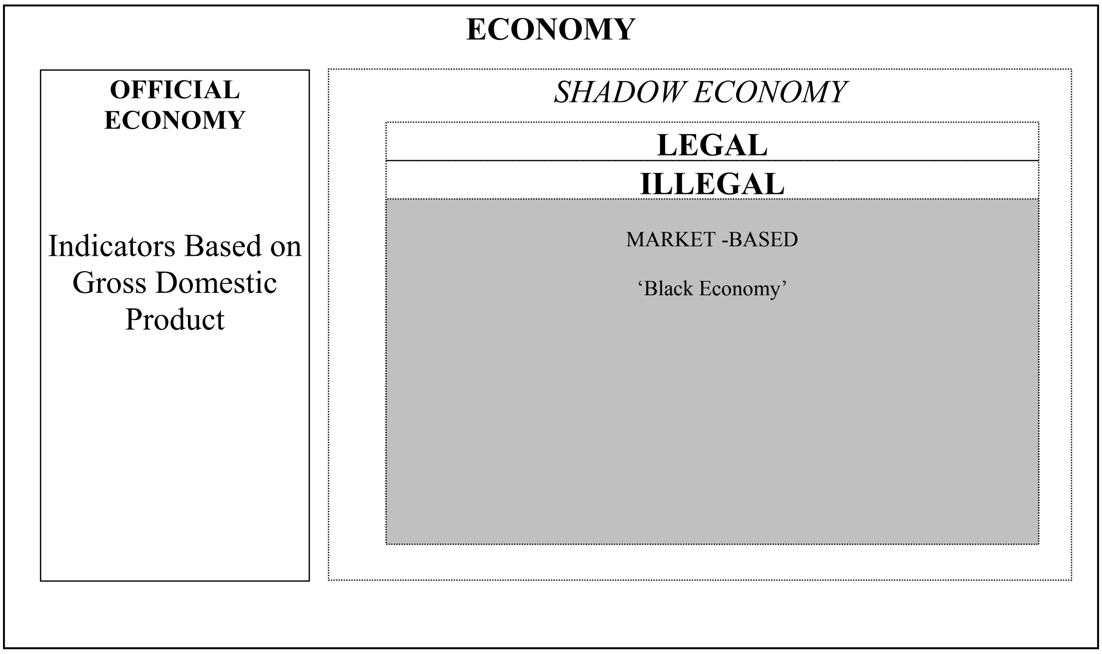
Derived from the study of Stephen J. Smith, the economy in a state can be divided into "official economy" and "shadow economy". "Official" denotes the indicators based on Gross Domestic Product. Alongside an official economy is a shadow economy, which is not formally confirmed. The shadow economy can be divided into legal and illegal sectors, and these can be divided further into market-based and non-market-based sectors.[283]

The purpose of the division is to illustrate the formal and informal economic rules of the game at the society level and to connect them with the rules of the game in a political environment. As in the economy, the informal rules of the game in a political environment are a buffer against turbulence. For example, if the political decisions concerning the economy are wrong, the economic activity will shift to the shadow economy. In a case where the official rules are inefficient, the informal rules prevail. This change has taken place in states, which have experienced a turbulent change of political regime. If the political regime is insufficient to offer the trustworthy rules of the game, individuals must live in a shadow society.

283 Smith.1987.

As shown above, it is feasible to compare different environments and analyze, whether the formal or informal rules in the prevailing environment give preference to "insiders" or "outsiders". The Multilateral Agreement of Investment was targeted to lessen the division between "insiders" and "outsiders" globally. Figure 11 presents a theoretical example of an environment where the black market defines the rules of the game.

Figure 11 Turbulence in Formal Rules of the Game



In an environment where informal rules of the game are present in a society, the role of an international agreement made by political authorities is obsolete. The legitimacy of "political" is low, and this situation is reflected in the property rights of foreign companies. At the highest level, where there is a lack of legitimacy at the security level in the society, no base for co-operation or risk sharing exists.

In a traditional analysis of political risk, a low political risk environment was characterized by pluralism at the society level. As a pluralist theory, liberalism denotes individualism and interest group liberalism in decision-making and market-based rules-of–the game in society. When the society factors are placed in the obsolescing bargaining model, the bargaining power of a state authority is based on the abovementioned pluralist issues. In theory the society level and state level, in a pluralist liberal democracy, were the same. In practice this was not the case, because, for example, the EC Member States were not pure pluralist liberal democracies. The equilibrium of economic actors and political authorities was not determined by the free market economy principles. In every corner of Europe, transformation has caused a change from nation-state society to international society within the European Union.

Generally, the more pluralist the environment, the more important are the market-based rules of the game. This can be argued because the cultural differences fragment the business environments. Information technology has created a new international business environment. Yet, cultural differences fragment the markets in the plurilateral regime. Because of the fragmentation, commodities can be divided into neutral commodities, which lack cultural content, strategic commodities that are governed by political authorities, and ethnically sensitive commodities with high cultural content.

Within the companies' risk management function, the society risk is a matter of the political authority's capability to implement the existing rules. When authority structures are transformed into regulation structures, the choices the consumers make may be different from the earlier ones, because individuals themselves are now responsible. The individual's identity as a political and economic actor is defined by ideologies and subjective models no longer unitary in a certain nation-state.

At the macrolevel the levels of pluralism, liberalism, and democracy can be analyzed at the society level. When he defined the boundary lines between company and democracy at the microlevel, Robert A. Dahl focused on the fact that in the equilibrium there are differentiated roles between political and economic actors. In a turbulent environment, some of the actors have no bargaining power. In pluralist societies, power relations are balanced.

4.3 Legitimization of the Transformation at the Different Levels of Analysis

According to Max Weber, legitimacy is the center of political science. It refers to the attitudes of people towards political power and authority.[284] In the political risk analysis, the question is about the shifting boundaries between formal and informal rules of the game and how legitimate the equilibrium is between economic actors and political authorities at different levels of analysis.

Authority differs from legitimacy. At the level of international organizations, states may meet the organization's expectations without appreciating and valuing them. An organization's authority consists of the ability of the organization to have its decisions implemented irrespective of the will of the members concerned.[285] Therefore, a political authority, together with legitimate power to set and implement the rules –of the game and boundary lines in the business environment, is necessary for maintaining stability. The existence of this combination has two dimensions. The positive dimension, from the point of view of companies, is the growing stability. Economic action without the stability of institutionalized rules remains short term. The negative dimension is that the bargaining power will shift to political authority when it regulates markets by setting the rules.

Defining political risk as an unpredictable transaction cost emphasizes the positive dimension. If the rules of the game are legitimate from the security system level to society level, it is possible to manage the negative dimension of political authority and its legitimacy in a co-operative game.

Pentti Sadeniemi has defined the role of legitimacy in international relations. He questioned the legitimacy on the one hand and the uneven development of power among the units of an international system on the other. Legitimacy, because of its effectiveness, is a matter of concern to regimes and individual political leaders. Threats to legitimacy originate inside the political unit and beyond its borders and, therefore, considerations of legitimacy must be expected to influence the foreign, as well as the domestic, behavior of regimes. Throughout history, various communities

[284] Jansson.1993:122–123.
[285] Haas.1990:87–88.

of states have had an evolving notion of what can and cannot be considered an internationally legitimate participant in that community. According to Sadeniemi, currently, while democracy is by definition an internal way of legitimating power, democratically legitimated states have shown a growing, if varying and not always consistent, tendency to restrict some forms of international discourse and co-operation within their own circle.[286]

When applying these notions to the study of Douglass C. North, it becomes obvious that the risk management and governance is based on the legitimate rules of the game in the regime of pluralist liberal democracies where the boundaries between markets and political authorities are set in a similar procedure despite informal rules of the game.

According to North, one variable of legitimacy is the enforcement of regulations. In a world of perfect enforcement, there would be, ideally, a third party impartially (and with no costs) evaluating disputes and awarding compensation to the injured party when contracts are violated. In such a world of opportunism, shirking and cheating would never pay. But this kind of world does not exist. Indeed, the problem of creating a relatively impartial judicial system that enforces agreements has been a critical stumbling block in the path of economic development. In the Western world, the evolution of courts, legal systems, and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over time and space – an essential requirement for a world of specialization. [287]

According to Kieron Walsh, the institutional theories point to very many problems that will have to be solved, if a new institutional framework of risk management is to operate effectively. [288] First, the governance structure has to enable the development of market-based risk management instruments.

The key issues arising are related to information, incentives, trust, quality, and risk. The development of markets and contract systems has the effect of creating the par-

[286] Sadeniemi: 1995:220–232.
[287] North.1997.

ties for an exchange. Contracts may be written in a way that they leave all or most of the risks to one party or the other, and the distribution of risks tends to have financial implications. The contractor who takes on greater risks will generally want to receive a higher price, and providing guarantees against risk will involve costs. The client is ultimately likely to bear the cost of risks, either directly, for example, through the purchase of insurance, or indirectly through the costs passed on by the contractor. The tendency is to minimize the maximum loss and to maximize the minimum gain rather than to make decisions on the basis of objective probabilities.[289]

Different levels of the density of legitimacy rules in an environment characterize the frontiers of global business environments among the three categories. In the case of the OECD countries, they characterize a certain legitimate environment, but plurilateral agreements make the frontiers fuzzy. This is the reason for using marketable rules of the game as an indicator of legitimacy. Legitimacy sets the borderlines between formal and informal rules of the game. In the industrialized world, the market-based rules of the game have prevailed in society despite the eras of nationalization of certain industry sectors. However, environments that lack the history of legitimate market-based rules of the game characteristically have a higher political risk level.

In the political risk approach, it can be argued that the structure of market-based rules of the game is in fact governance without government. Rosenau points out that governance without government refers to the role that social institutions or governance systems, in contrast to organizations or material entities, play in solving those collective-action problems that pervade social relations under conditions of interdependence[290].

Why do the rules of the game last? In international business, trust is the legitimator of co-operative rules of the game. The paradigm of political risk has emphasized stability in a state-centered regime. In a plurilateral regime with numerous actors, the concept of trust must be weighted. According to James S. Coleman, the expansion of trust leads to increased potential for social action on the part of those who are trusted, and the contradiction of trust has the opposite effect. The expansion of trust tends to

---

[288] Walsh.1995:54
[289] Walsh.1995: 54.

bring further expansion, whereas contradiction leads to further contradiction. Among large communities of mutual trust, all the actors are engaged in an activity that produces an outcome in which all have a similar interest. [291] In a plurilateral regime, political risks are located in situations of the contradiction of trust with conflicting interests. Furthermore, these environments are no longer connected to nation-state borders.

For Williamson, trust and risk are regarded as subclasses. A situation of trust is a situation of risk where the risk one takes depends on the performance of the other actor. Trust is linked with reputation, and reputation has to be acquired. In the game theory, the treatments of economic organization refer to trust, usually in the context of parties engaged in sequential, repeated games.[292] Trust itself is nearly non-calculative; however, economic transactions are always governed with reference to the institutional context of which they are part.[293].

The rules of the game concern the trust of predictable property rights and the action rights of individuals in an environment. Credible guarantees additionally require the support of a political and economic system that is respectful of property rights.[294] Having trust in the formal and informal rules of the game in political processes, investors will not fear political risks.

Williamson argued that trust is non-calculative. However, it is possible to compare the densities of the predictable rules of the game. According to Robert O. Keohane, the supply and demand of international co-operation intersect in the point of common interest[295]. In the political risk context, this can be a trustworthy and predictable rules of the game regime. Hence, how to measure regime density? Keohane suggested using the rational choice theory.[296]

---

[290] Rosenau.1997:147
[291] Coleman.1994:188–196.
[292] Williamson. 1996:257–259.
[293] *ibid:* 275.
[294] Williamson. 1993:24–25.
[295] Keohane. 1989: 101.
[296] *ibid*. 101.

However, if the non-calculative characteristics presented by Williamson, concerning the trust are accepted, it is possible to compare the trust density between different political regimes. The comparison can be made by analyzing the density of the regime in strength, nature, and scope defining the rules of the game between economic actors and political authorities[297]. “Strength” refers to the stringency with which rules regulate the behavior of economic actors. “Nature” refers to the objectives of the regime rules and procedures, for example, openness and “scope” is the range of issues that are regulated by a regime. In the political risk context, risk is the absence of governing rules in an environment that restrains the use of risk management instruments. In that situation, the transaction costs of a company become unpredictable.

Because the principles of legitimacy are assumed to be close to trust in international relations, the comparison of environments is divided into five levels according to their relationship with the international community globally and regionally. The division is presented in Figure 12. In Robert Axelrod's terms, co-operation is based on beliefs in a continuous game. In a plurilateral environment, a co-operative strategy between economic actors and political authorities is based on strategies that evolve automatically rather than by human invention and in co-operation with more than two players.[298].

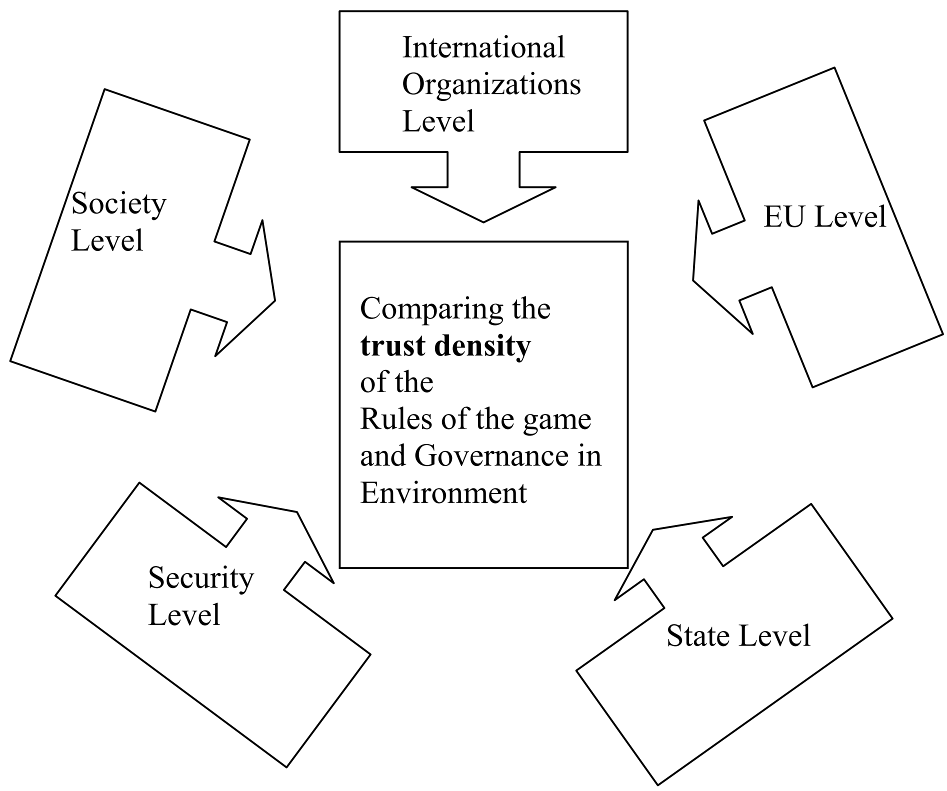
Before proceeding to examine the typology, a question should be asked about the sanctions if the rules of the game are not followed in a certain environment. The international market functions by market-based rules. Therefore, the lack of legitimacy, that is, mistrust will lead to a situation in which the economic actors cannot invest and, for example, trade is based on payments in advance because of the lack of risk management instruments. The sanctions need not be specific but they are consequential to mistrust.

If the starting point of the risk comparison is a WTO agreement or in OECD countries, it is obvious that the requirements of the global rules of the game cannot be fulfilled universally and identically. Therefore, the plurilateral regime is the one that binds and creates obligations only in those environments which have specially re-

[297] Aggarwal. 1985:21.
[298] Axelrod.1997.

garded any one of them. Plurilateral regimes cover, for example, the EU – U.S. Atlantic economic co-operation, the EU – Russia co-operation, and the trade blocs in Latin America and Asia.[299]

Figure 12 Comparative Frame for Political Risk Levels: Comparing Business Environments Relationships with the Rules of the International Community



When comparing risk levels, these five levels should be estimated in a certain environment, for example: whether the security level is in equilibrium; does the political authority in the environment belong to category A or B as illustrated in Section 4.2.1.; or, whether it can be identified as a "risky state". At the highest stage, the legitimate power of political authority is based on those security guarantees it can supply. It should be noted that Security Level is incompatible with the other categories. However, I argue that in political risk analysis it should be considered a category of its own, because of the abovementioned high-ranking status. It is the highest legitimator of the power of political authority. Even the neoliberalist theories do not ques-

[299] Pelkmans.1998.

tion the political authority's role in keeping up the structures of internal and external order and security in political and economic environments. Furthermore, I argue for the relevance of separating Security Level to a category of its own, because the political transformation that is obsolescing the weight of the State Level in political risk analysis and shifting it toward European Union Level does not diminish the significance of a stable and trustworthy security balance as an establishment for a stable business environment.

The stability of governance structure should be estimated against whether it enables the use of political risk management instruments or whether the marketable rules prevailing in the political risk analysis can be excluded.

Whether the causes of political risk are in located at a state level or at some other level of analysis, its assessment depends on trust. According to Partha Dasgupta, trust is central to all transactions and yet economists rarely discuss the notion. It is treated rather as a background issue. Therefore, he illustrates the impact of trust in economic transactions[300]. These notions may apply in political risk analysis: First, there must be incentives before people enter into transactions with one another. This supports North's notion on the spread of rules of the game in an international exchange. Second, the enforcement agencies have to be trustworthy, just as Robert Axelrod's notion on the emergence of co-operation and Robert Keohane's concept of the continuous co-operation agreements. Third, trusts among agencies are interconnected. At the security level the threats are often invisible. Political risks are much the same; there are no obvious units in which trust can be measured. Thus, trust is connected to expectations about the actions of other people and agencies. In the case of political risk, trust is connected to expectations about rules –of the game in a political environment.

In international relations, trust is the property of collective units, not isolated individuals. "Trust implies certain shared values"; "Trust involves the notion of motivational relevance, as well as the notion of predictability".[301] In political risk analysis, plurilateralism characterizes the trust density. Relationships with the international

[300] Dasgupta:1988:49–52.
[301] Kegley & Raymond.1990:248–249.

community separate different business environments in the name of predictable rules –of the game.

In this context, the European Union level, state level, and society level are the most legitimate levels of analysis. Political risks, in the operational milieu of companies in nation-states, are the result of circumstances created by integration, of implementation of rules and regulations at the state level, and of those changes and reflections integration has brought into the internal markets' external economic relations. The legitimacy of community authority at the Society Level is changing the substance of political risk and its management and transforming the identities of European economic actors. When member states are represented in international organizations by the European Union in economic issues, these three levels of analysis are strengthened.

The theories of co-operation and integration in international relations have been established in a regime of nation-states. Therefore, the transformation of the economic environments from pluralist nation-state regime to plurilateral regime of trade blocs emphasizes analyzing the rules of the game. In economic action, it is not necessary for the rules of the game to be legitimate as long as they are trustworthy.

In political risk analysis at the European Union level, the problem arises about whether the economic action takes place in internal markets or whether it crosses the borders of external economic relations; whether the governance structure is a stable one – trustworthy or legitimate to enable the use of political risk management, or whether the marketable rules prevail so that the political risk analysis can be excluded.

At the state level, are there fragmenting issues between the state and other political authorities? Are the rules of the game official in order to enable the operation of "outsiders", or are informal rules of the game those which prevail? Do the principles of pluralism, liberalism, and democracy ensure a stable transformation, instead of a change, in societies? Are the rules of the game more formal than informal? These relationships show the boundaries between "insiders" and "outsiders", and whether the outsiders would be able to operate in the existing environment.

The assumption made in political risk analysis is that the political environment is a given at the company level. Thus, it is not a task of a company to govern the risks, but only to manage them in a politically governed environment. Stability in accordance with a low risk level is based on the trust in legitimate rules of the game at different levels of analysis.[302]

[302] Braithwaite & Levi.1998:1–74.

5. Risk Management Instruments

5.1 Marketable and Non-marketable Risks

Political risks can be divided into categories by the mode of their management. Traditionally, the political risk instruments were foreign direct investment guarantees and export credit guarantees.

Pure marketable risks can be managed through market mechanisms at the company level. Marketable risks are quantifiable. There are clear risk variables and a statistical likelihood that enables the pooling of risks.

Pure non-marketable risks require governance by a political authority. Governance refers to the process of institutionalizing the rules of the game in society. The non-marketable risks characterize the level of stability in a business environment. An example of non-marketable risks is found at the security system level in the case of a war, threat, or violence, which will have an impact on a foreign company in the host country. Instead of a statistical likelihood of managing a political risk stemming from security shifts, governance is based on emphasizing the externalities supplied by political authority: the benefits of co-operation among actors. Political authority transforms non-marketable risks into marketable ones by creating ground for co-operation. Formerly this was done at a nation-state level, now at a plurilateral regime level.

Figure 13 Marketable and Non-marketable risks

<table>
<tr>
<td rowspan="2">Marketable risks
Market-based Instruments
Quantifiable

Transformation and transaction costs are measurable. Increasing the legitimacy of the rules of the game increases the marketable base of an internal market and external economic relations.</td>
<td colspan="2">Non-marketable risks
The Governance Regime
of Political Authority

Unpredictable Transaction Costs</td>
</tr>
<tr>
<td>a)
Risk Management
Instruments</td>
<td>b)
Harmonizing the
Institutional Rules
of the game</td>
</tr>
</table>

In this Part, the political risk management regime that is maintained by political authority is investigated. It is defined as a regime of institutionalized rules of the game. The analysis emphasizes the transformation occurring in risk management instruments and their political base.

In the event the market fails to institutionalize stable rules of the game, which enable market-based instruments, the political authority sets boundaries between the economy and politics in societies by providing public services and public goods in market economies.[303] At the company level, these instruments are market-based. (See Figure 13, Part (a)). In order to stabilize the institutional rules of the game, the political authority creates a regime, where the boundary lines towards the market are clearly defined. (See Figure 13, Part (b)). It is analyzed in Part Six.

The typology of political risk variables and the management instruments of risk are separate, because political risks cannot be quantified in advance, as will be shown in this chapter. The study of political risk has to start from the description of risk structures and proceed to the analysis of instruments. An instrument is a tool for simplifying a complex bulk of risk variables. It is difficult or uneconomic for a company to evaluate all the political variables in an environment or an individual transaction.

This realization strengthens the role of political authority while it governs the qualitative political structures. Karl Deutsch has shown that there are qualitative and quantitative steps in the analysis.[304] This is a fact in political risk analysis as well. Risk instruments are a by-product of political governance.

In transaction cost analysis, one of the standard claims is that if transaction costs are high the market is no longer the most efficient governance structure.[305] Political authority lowers the risk level in the environment of companies by political risk guarantees for investments and foreign trade.

---

[303] Williamson.1996: Market Failure. Keohane.1989: State and Government Failure.
[304] Deutsch.1969.
[305] Weber.1997:328.

On the one hand, outside of the markets, the analysis of political risks can be seen as starting from the discussion on the theories of Karl Marx and Adam Smith, because the stabilization of the rules of the game in societies is defined by political ideologies[306]. The balance and the boundaries between the economy and politics differ depending on the ideological point of view. On the other hand, at the global level, when the business environment is analyzed, questions on world order will rise. The USA has been a hegemony in the OECD regime by setting the rules of the game in political risk management instruments. In the USA, the political risk management instruments are closer to market-based instruments, if compared to the European ones. The USA has coordinated the private risk capital into trade and investment projects in turbulent environments. Other Western states have tried to adapt the way in which the USA has succeeded. Mixed economies have adapted the frameworks with budget funding.[307] However, market-based risk management is possible now through the evolution of the internal market of the European Union.

5.2 Management Strategies [308]

'You can hedge currency and interest rate risk, but you can't hedge the risk of rioters burning down your store, the government seizing your assets, or consumers thinking you want to poison them" [309]

In the neo-institutionalist theory of Douglass C. North, the lack of formal and informal rules of the game in an environment is realized as high and unpredictable transaction costs. Price level is determined by these costs in the market, as analyzed in Part Four. The central issue is that the transaction costs can be measured – although the majority of them only afterwards. From a company's point of view, the political environment would not work linearly within any significant span of time. Making forecasts will not be successful.

[306] North. 1990:11,132, North. 1997.
[307] Brenglass.1983, Stapenhurst,1992.
[308] Political risk – Political refers to the cause of risk, as well as its management and governance. Because political risk factors cannot be measured quantitatively, as will be proved later, the concept of "political" gets a new definition. "Non-marketable risks" are manageable only by political authority. The political risk management instruments can be defined as public services that are located in the equilibrium between "political" and "economic" milieu.
[309] Levinsohn.2002:40.

The costs of information, licenses, payments, and taxes, which the political authority may have set later in the unpredictable business environment, can only be known afterwards. For example, it is difficult to predict how the crime rate in an environment will impact a company. Those expenses that are difficult to anticipate, can be estimated by comparing the efficiency of formal and informal institutions. In capital markets, the interest rate level tells quantitatively the efficiency of institutions, yet, these key ratios are not comparable in every state.

The reliability and comparability of statistics vary. In a situation where statistics are untrustworthy, one may evaluate the legitimacy of police force and customs institutions, functionality of telecommunications and energy networks, labor, and the efficiency of bureaucracy. The level of corruption is one factor measuring the efficiency of bureaucracy. These institutions either increase or weaken the efficiency in the business environment[310]. The number of strikes indicates the amount of institutional inefficiency. If the only efficient institution is the army, it is a long way to a pluralist environment, where a dynamic equilibrium between the political and economic milieus may exist. In industrialized states, the differences in the efficiency of institutions are realized as varying competitiveness positions.

At the company level, the focus on political risk depends on the type of business dealings the company practices. Risk becomes focused on the capital and cash flow. Defensive management can be used before the investment is actually made. At this early stage, it is possible to decide, whether to invest or not in a certain environment. At a later stage, political risks are managed with integrative strategies. This is a set of strategies available in order to minimize the political risks during the business operations. Political risk management strategies are shown in Figure 14.

[310] North.1990:69.

Figure 14 Political Risk Management Strategies of Companies

DEFENSIVE MANAGEMENT	INTEGRATIVE MANAGEMENT
1. Political Risk Avoidance 2. Political Risk Insurance 3. Diversification in order to minimize the impact of political threat.	4. Control of Political Risks 5. Loss Prevention 6. Risk Transfer outside the company

1. Political Risk Avoidance[311] is the most commonly practiced risk-management strategy. It involves a decision to avoid exposure to personal, property, and liability risks by not entering into a certain economic activity where there are political risks. Decision-making is based on an analysis at the macrolevel. When a decision not to invest in a certain environment has been made, the company can reallocate its investment resources.

When there are high profit prospects in an environment of high political risk, the company has to use another management strategy in order to maintain the prospect for a profitable economic action. A certain level of risk is always present in business operations. It is possible to reserve funds in a project of high risk. However, one must evaluate whether the company is able to cope with the realized risk threat.

Political environments can be described in terms of the density of plurilateralism. The deeper the issue density, the lower the risk level and the reasons for political risk avoidance. Connections with the international community are of great importance.

2. Political Risk Insurance. Political risk insurance for companies with overseas investments provides protection against financial loss caused by unexpected, discriminatory, or arbitrary acts of foreign governments. These include: confiscation, expropriation, or nationalization of assets, contract termination, license termination and embargo, currency inconvertibility, or non-transfer of payments.[312]

---

311 Shapiro.1996:621,Ting.1988:193.
312 Fitzgerald.1996:66.

Before political risk can be managed by insurance, there has to be a possibility of risk pooling. Theoretically, if sufficiently large numbers of exposed units with common risks are grouped together, the certainty of loss can be more accurately predicted and known and, hence, provides a basis for distributing the cost of loss.[313] Political risk insurance presupposes a clearly defined political risk. However, it may be difficult to determine the exact cause for losses in a dynamic political environment. One of the major problems is that the political risks are not manageable by market instruments.

Political risk insurance is based on the government decisions to give guarantees in order to maintain its national interests. National interests may include the availability of raw material or energy. Pooling risks characterizes the co-operation between states under the same political and economic regimes. For example, West Germany was rebuilt with the multilateral guarantees of the Allies after the Second World War[314]. In a plurilateral regime, co-operation agreements are made at all the levels of analysis in order to maintain trust. Insurance companies inside the dense regime are able to pool the risks because of the continuous co-operation agreements.

According to Theodore H Moran, foreign Investment in natural resource and infrastructure projects has long been among the most sensitive of all international company activities. The deterrence feature, whereby changes in the terms and conditions of operating in a particular project will damage the interest of powerful actors who might then bring to bear their influence upon those who are responsible for those changes, has become one of the principal strategic objectives of parent investors and senior lenders in putting together the international project finance structure.[315]

Gerald T West emphasizes that there are two risk mitigation features in political risk insurance: deterrence and leverage. Political risk insurance from national and multilateral agencies, can act as an effective deterrent against host government interference with insured private investment. In addition, it is believed that the investor

---

[313] Ting. 1988:195.
[314] Brennglass, 1983: Overseas Private Investment Corporation OPIC was founded in conjunction with the process of financing the reconstruction of Europe after the Second World War.
[315] Moran. 1998:71.

stands a better change of successfully resolving the matter if a national or multilateral agency is involved as an insurer. The second benefit of investment insurance is leverage. At the project level, risk insurance improves the overall risk/return profile of the project and allows lenders, for example, to extend the terms of their loans. [316]

3. Diversification of Political Risk. Diversification of political risk is a portfolio management strategy, where the risks are distributed by investing in a diverse range of assets instead of a limited variety. Diversification may lead to investing in a broad mix of markets, states, and products, as is done in a classic portfolio diversification: investments in stocks, bonds, and financial assets whose price changes are determined to be independent and not correlated with one another The political transformation aims at harmonizing the rules of the game in the European internal market and at long run diversification in these markets also becoming easier for highly specialized companies.

4. Loss Control and 5. Loss prevention[317]. Loss control and loss prevention require an efficient early warning system of political risk. Companies should react rapidly, when there are signs of political turbulence, but there are problems analyzing risk whether the signals are coming from the micro level or macrolevel of the environment. How could one predict the reflections of political turbulence at the macrolevel towards an individual company at the microlevel? For example, one should consider, whether the increased amount of non-paid receivables is a reflection of political turmoil in the environment as an increased transaction cost, or whether the changes in cash flow are a sign of increased transformation costs.

6. Risk Transfer. In the strategy for the transfer of political risk, the risk is shifted outside the company. Traditionally, companies have transferred the political risks to nation-states, which have covered the realized risks from the state budgets, whereas nation-states have governed the "political" by international co-operation. Nation-states have co-operated in order to maintain structures, which enable hedging at the company level. In this strategy, a company transfers some of the price fluctuation risk further to another transacting party. Above a nation-state, the political power

---

[316] West.2001:145-147. In Howell.2001.

relations define the use of this kind of strategy. Inside an international regime, the continuous co-operation agreements maintain trust on the common rules of the game. Political risk transfers can be achieved through "unbundled" forms of entry arrangements, such as equity and contractual joint venture, licensing, franchising, management contracts, and certain forms of countertrade.[318]

Transformation from the nation-state level to the European Union level is a path dependent process of impersonal exchange. Because risk transfer has been closely linked to political authority governance, the "governance without government" requires that the nation-state level be compensated with market-based rules of the game. This requires stabilization of political rules of the game from the security level to society level and their strengthened linkage to the market-based rules of the game in the equilibrium between the economic and the political milieus.

At the company level, political risk management strategies depend on the overall nature and orientation of the risk facing the company, the transformation function strategies, the objectives, and the risk/return orientation. Companies based on manufacturing are exposed to the most comprehensive spectrum of political risks. This situation reflects on management strategies. In the manufacturing companies, all the required instruments are under consideration in contrast to international banks and exporters, and traders, who can manage only a specific number of political risks. The ultimate political risk is nationalization of a company without compensation. In addition, there is an option that the company is taking a risk that it is capable of covering in the case of materialized risk.[319].

In import and export, risks are related to cash flow and exposure to movable assets. Risks can be transferred differently depending on whether this is done inside or outside the regime of the OECD countries. In the OECD countries, one can trade on an open account due to the stabilized rules of the game. Financing companies buy the receivables. Risks are often insurable, which is the reason for low transaction costs.

---

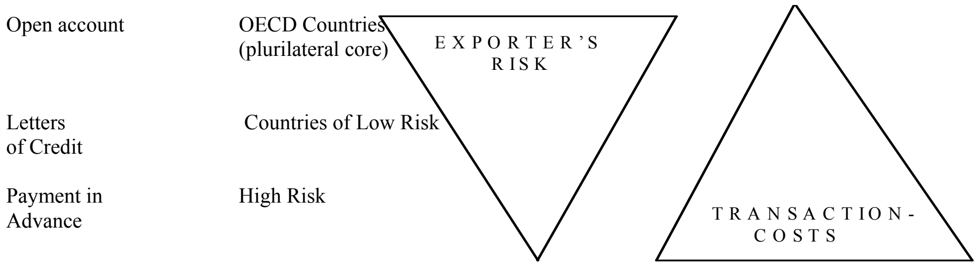
317 Ting. 1988:195.
318 Ting.1988:198.
319 Suominen. 1993:49, 57–64.

A company may take bigger risks on its own, because there is a more dense trust in legal rights.

The less stable the environment, the higher are the transaction costs of a company. A company has to “buy” the-rules of the game from their home country or from international markets, because the political environment in the host country does not offer them. This process is managed by buying letters of credit. In that process, risk is transferred outside the company to a third party, for example, to an international finance institution. In the environments of high risk, the management instrument used is payment in advance. This is presented in Figure 15.

Figure 15 Risk Management Instruments in Trade

Payment Instrument Export Country Risk and costs



Pure marketable risks are quantifiable, and they can be pooled in order to make them insurable. In the following chapter the borderline cases in political risk transfer will be analyzed.

5.2.1 Transferring Political Risk

Political risk affects the value of companies through changes in the future cash flow and in the investors' acquired return. In investment decisions, political risks can be analyzed in capital budgeting procedures at the company level. The methods available are the net present value technique (NPV) and the internal rate of return (IRR) technique, cost-benefit technique, and profitability index technique. These procedures were not originally designed for political risk analysis, but at the company level they are valuable methods for incorporating risk analysis in decision-making processes.[320] Through presenting a dyad of these methods, the problems related to political risk analysis become visible. One of the problems is related to quantifying the numerous political risk variables. Although different risk variables have different contents, the technique of the capital budgeting procedure is the same.

The difference between a company's internal and international political environment is, basically, formed by the institutionalized rules of the game in societies, as discussed in Part Four. The formal rules of the game are easily learned by a foreign company, but the discrepancy appears in the informal rules of the game. A foreign investor is an outsider, when it comes to managing the informal environment. Therefore, the risk variables are more numerous in an international environment.

In a pluralist political environment, the formal rules of the game are only one limited condition. The transformation or the change of environment depends on the philosophy behind the equilibrium between political and economic rules.

In a foreign environment, instability arises from the likelihood of wars, violence, nationalization, or revolutions and from an unexpected regulation of economic actors. Human rights and the level of democracy are variables to be considered when analyzing certain conditions of property rights that are analogical to a set of political rules.

Political risk variables can be evaluated with the net present value method by adding a political risk premium to the capital cost by adding percentage points to the discount rate r. The discount rate can be adjusted using a shorter payback or investment period or assigning probabilistic values to the project's estimated cash flow. Wenlee Ting (1988) maintained that a major shortcoming of the cash flow approach is the high cost and obtaining accurate and reliable risk information to perform an acceptable adjustment on the cash flow. It can be argued that it is impossible to give one composed estimate of political variables.

[320] Ting. 1988:107–131.

Determining the Risk-Adjusted Net Present Value, NPV:[321]

$$NPV = -I + \sum_{i=1}^{n} \frac{R(t) - C(t)}{(1 + r)^{i}}$$

I = investment expenditure at time 0
R(t) = project's estimated revenues at time t
C(t) = project's estimated costs at time t
r = discount rate

According to the NPV procedure, if the unadjusted discount rate r is 10, it can be raised to 15 percent to reflect a political risk level. The 5 percent represents a risk premium. It should be emphasized, for the process of analyzing political risk, that the adjusted premium is based on a subjective analysis. Might it be possible to estimate the emerging market regulation system in the internal market of the European Union, using this method at the company level? Rather than estimating the non-marketable transaction costs, these risk premiums are suitable for estimating marketable transformation costs that result from the use of technology in the production function.[322]

In technical terms, when the net present value is more than zero, the project is profitable. The decision to be made is to accept a project, if its NPV is greater than zero. The net present value method for analyzing political risk is suitable in conditions where we do not have to raise the risk premium due to political variables. In other words, under this condition of political risk level, the transaction cost level is predictable. In pluralist liberal democracies, the predictability is higher than in other political environments due to the constant transformation of the rules of the game and the dynamic equilibrium of political power. In the argument on lower political risk level, instead of transformation there is a change of the rules of the game in the static equilibrium of political power in other political environments.

The global rules of the game between economy and politics, in international relations, will be combined in international agreements between political and economic actors. In such cases, the political risk variable is the political regime's relationship

[321] Ting.1988:108.

with the international community in the company's environment. The rules of the game of the market economy are considered stabilized due the path dependent equilibrium in the OECD countries.

If the relationship to the international community is plurilateral, as it is among the OECD countries, the political risk can be defined by using the following linear risk formula:

Risk Certainty x Risk Severity = Expected Loss [323]

In statistics, risk is expressed in quantifiable terms. Risk may be characterized by the zero-sum game where there is a probability of losing or winning. The risk level varies between zero and one. [324]Existing international agreements and interdependent relations between political authorities are a guarantee of a low risk level. The WTO agreement is such an example. Although these agreements are not legitimate like a sovereign law, they form a base for harmonized and continuous rules of the game in the future. In a game beneficial to all the participants, it is possible to calculate the compensation prospects, if the political risk will be realized. It should be noted again, that the quantification would focus on cash flow, not on political variables. The method of the break-even probability considers the expected compensation, if the "political" will be realized. Alan C. Shapiro has shown, that the risk of expropriation and the compensation can be combined by the following formula. If the P* is greater than the probability of expropriation, the project will have a positive net present value.[325]

This formula, however, does not offer an answer to the problem of the probability of expropriations. Even if we could define the probability of expropriation in one environment, the quantitative values are bound to specific situations. Generally, non-marketable risks are non-quantifiable. These methods can be used only in market-based regimes with continuous agreement of co-operation.

---

[322] North. 1990.
[323] Nairne, Stephen.1997:38–39.
[324] Suominen.1999:10.
[325] Ting. 1988: 113, Shapiro.1996:558–560.

In the following section, the problem of quantifying political risks in capital budgeting at the company level will be considered. The results have shown that political risk management is a governance function of the political authority.

5.2.2 Quantification of Political Risk

The methods analyzed in the previous section would be ideal in managing political risks, but they require that the political risk variables could be estimated in advance. In strategic decision-making, the risks could be estimated and transferred outside the company. Then, what are the problems that hinder the estimation of political risk variables in capital budgeting procedures? The theory of decision under certainty assumes that the decision maker has (i) perfect information, (ii) consistent goals, and (iii) well-behaved opportunity sets[326]. The methods analyzed in the previous chapter would be ideal in managing political risks, but they require that political risk variables could be estimated in advance. In strategic decision-making, the risks could be estimated and transferred outside the company.

Objective and Subjective Risks. Objective risk refers to risk with a statistical outcome. There are risk indicators, and the different variations in the result can be estimated. The objective risk requires a distinct definition. A subjective risk refers to the perceptions of an objective risk. The formation of subjective risk is a function of both the personality and the risk-taking behavior of individuals.

Political risks, like other business risks, can be managed with traditional tools of business risk management: avoidance, transfer, diversification, loss prevention, insurance, and retention. In order to be able to manage these risks, there are some characteristics, which must to be carefully considered.

One of the problems we face in conducting research on political risk is that the concept of probability differs from the concept of risk. Probability refers to the long-term change or relative frequency of occurrence of some events, whereas risk is a concept of relative variation. When the probability of a loss becomes certain, risk

---

[326] Elster, Jon. 1990: 186.

becomes zero. Accurate prediction of the probability of some specified events is made possible through the law of averages which states that the greater the number of observations, the closer the actual probability will approach the expected probability. In reality, large amounts of data are available for many political factors due to the unique nature of the political environment.

There are three major characteristics of political risk:

(1) Political risk is subjective risk. Objective or statistical risk is defined as the normative variation of an actual outcome of an event from some expected outcome. The key focus is to distinguish one outcome from another, normally a benchmark measure indicated by the expected average. Subjective risk refers to the perceptions of objective risk. Unlike objective risk, which concerns the actual or empirical outcome of a risk event, subjective risk is essentially a mental or psychological state regarding uncertainty. This uncertainty is concerned with the state of political environment and, hence, it is a mental state involving conscious awareness of risks. For instance, the role of personality, age, education, and other socio-economic factors can shape the perceptions of uncertainty and risk and the nature of an individual's risk-taking behavior. Political risks arising from adverse governmental actions are not easily amenable to statistical measurement. Most indicators of political risk are formed from subjective perceptions of the state of political uncertainty in a given business environment.

(2) Political risk is static risk. Static risk refers to a risk stemming from an unchanging and stable society or a socio-political system in equilibrium. Political risks, which originate from unpredictable government actions such as expropriations, are essentially static risks. They are usually perceived of as leading to an unfavorable outcome or losses for the company concerned. Such risks result from a zero-sum type game situation, in which the lack of economic or technological growth frequently leads to adverse actions to be taken by the government at the expense of foreign economic actors.

(3) Political risk is speculative risk. The probability of a positive outcome or opportunity for gain is normally not associated with the pure risk phenomenon. Political

risks, such as damages sustained by investors during a political turmoil, normally lead to losses only. Political risks will not be considered pure risks because of the nature of the interactions between the company and the business environment. Policy risks emanating from the political actor in a business environment tend to be more speculative. Both the political and economic actors are speculating for benefits they may gain when co-operating, despite the fact that one's gain may be another's loss.

All the abovementioned qualities of political risk will restrict the use of pure risk management methods. In order to manage political risks, the political authority has offered instruments for assessing the risk premiums in the financing of investments.

At present, a multilevel political authority is a characteristic of the plurilateral regime, where the governance of political risk is transformed to marketable logic. In order to increase trust in the formal rules of the game in societies, the marketable management of risks is presented. This is the path Douglass C. North has emphasized in his neo-institutionalist theory.

Political risk guarantees are harmonized by the continuous co-operation agreements of a plurilateral regime. The denser the regime's connections the more marketable are the risk management instruments.

Political risk analysis is an art – not a laboratory science that lends itself to precise predictions. Corporate planners look for a basis for comparison, particularly, if they have to make a choice between proposed sites. Numerical expressions of the likelihood of future political events are bound to be problematic due to the number of variants involved. Analysts offer considered judgments, not measurements. Numerical ratings are of a minimal value unless they are amended with written, qualitative assessments, which explain how the analyst came to a particular conclusion.[327]

Even though the characteristics of political risk indicate the limits of quantifying them, quantitative indicators are useful tools when their limits are recognized. William T. Irwin uses **the sensitivity analysis** in order to identify all risk variables that are probabilistic in nature. The software starts with the expected values, next it takes one variable and runs the model with both the high- and low-end values. The resulting high and low economic parameters are then extracted and repeated for each variable nominated. The graphically displayed results demonstrate which variables are most sensitive. The most sensitive variables are the ones a project developer should focus on by attempting to minimize downsize and catalyze upside potential. Secondly, by using **a decision tree** it is possible to organize a chronological display of decisions and uncertainties in a project. Sensitivity and distributed probability studies remain valuable in assisting project execution planning when **the go/no-go investment decision**s are being made. These analyzes do not eliminate risks or provide a mode of risk management. However, they help to minimize investment in countries that are unfamiliar[328]. Referring to Nairne's conclusions concerning the development and refining of analytical tools that provide structured comparisons of risk and opportunity across projects, sectors, and countries,[329] these analytical tools are available before the investment is made. In the obsolescing bargain factor model (Figure 6) "a hostage effect" is demonstrated after the actual investment. After the investment is made it is necessary to analyze the regulatory risks of multiple levels of political authority, as well as on the level of multilateral lending institutions.

Lensik, Hermes, and Murinde have demonstrated that political risk leads to increased **capital flight**. The risky investment climate in a country leads to a situation where the residents decide to invest their wealth abroad due the adverse domestic investment climate or a too high-risk level. This signal by the domestic actors will have an impact on foreign investors' investment decisions. It has been asked what is the abnormal amount of capital outflows? The first method, **residual method**, measures capital outflow from balance of payments statistics by comparing net increases in external debt and the net inflow of foreign investment. The second, **hot money method**, measures the unrecorded capital flight by adding up net errors and omissions and non-bank private short-term capital outflows. The third, **Dooley method**, measures abnormal and illegal capital outflows.[330] The measurement of capital flight is a substantial quantitative indicator of political risks because it is measuring both the formal and informal rules of the game in a political environment of economic

---

327 Howell.1998:60.
328 Irwin, William T, 1998: 57–69.
329 Nairne, Stephen. 1998:41.
330 Lensik, Hermes, Murinde.2002:73–92.

activity. It measures the effectiveness of the political authority to set the rules that favor economic growth, as well as society's trust in the economy in the environment.

5.2.3 Multilateral Instruments

Part Three focused on how the political risk management instruments have harmonized under international political economy regime. Alan C. Brennglass studied the early days of OPIC in the USA and Frederic Stapenhurst the connections of guarantees between Western industrialized states. Kindleberger argued that merchants pressured their governments to lift restrictions on international trade and finance so they could pursue overseas business opportunities.[331] North emphasized, that risk management was based on harmonization of the rules of the game in impersonal exchange. This concluded that there was a supply and demand for an international political risk management regime.

After World War II, the World Bank Group and the International Monetary Fund globally coordinated the economic co-operation between nation-states. This multilateral governance was the base for multilateral political risk instruments. International development banks stabilized the economic environments at the macrolevel to enable the functions of markets nationally and internationally. International monetary regimes could be seen as instruments of risk management. Very many political risks between OECD countries were abolished by the co-operation of the monetary regimes[332]. The rules of the game were stabilized, first with the Bretton Woods agreement and, later on, with floating exchange rates. However, in a nation-state regime, national interests characterized the reasons for political risk guarantees.

In Western industrialized states, the political risk levels were lowered mainly because of integration processes and the establishment of plurilateral regimes. There were questions raised about political risks in developing countries. The Multilateral Investment Guarantee Agency (MIGA) was established in 1988. MIGA is part of the

[331] Kindleberger.1997.
[332] OECD co-operation also covers the rules of the game in export credits. In 1992, they were composed into a Helsinki package. Thus, these rules are applied to only 3.2 percent of the world trade in

World Bank Group. It was created to fill the gaps noticeable in political risk coverage for long-term investments. It mainly encourages the flow of investments to developing countries and economies in transition. [333] For a market-based activity to be promoted, it must work with other underwriters, both public and private.

MIGA has an Internet-based information service, for companies seeking to invest in privatized companies in the world's emerging economies, at http://www.ipanet.net. The service provides online access to business profiles of state-owned companies and assets currently for sale, along with details of the relevant laws, regulations, and procedures governing investments and transactions.

MIGA offers a political risk management instrument for the global level. Along with maintaining the Internet-based information service, the rules of the game are harmonized in terms of the competition in foreign investment. However, the projects thus covered are massive and, therefore, distant from a company level.

The latest design of multilateral political risk instruments was linked to the collapse of the socialist world, which led to the establishment of the European Bank for Reconstruction and Development (EBRD) in 1989.[334] At that time, the G7 heads of state agreed, that reconstruction of the former socialist states was primarily a European responsibility. The European Community (EC) was designated as the co-ordinator of Western aid and credit. The EBRD was set up with a strategy favoring the private sector and the bank controlled feasible projects.[335]

There was a vision, in 1990 and 1991, that the EC, newly revived by the Single European Act (SEA) and the dramatic yet peaceful end of the post-World War II division, would now move forward to extend its achievements in a straightforward manner to Eastern Europe. The U.S. made it clear that Europe should take the primary responsibility for this task. The European Commission negotiated the terms of the EBRD in order to manage the stabilization of the rules of the game in the former

industrial products. Ray. 1995: 7.
[333] Wagner. 1994.
[334] Weber.1994.
[335] Strange 1996:26–27.

socialist states. The EBRD was established to supply the political risk management instruments.[336]

The EBRD was created as one of the newer international development banks. Its president Jacques de Larosière highlighted its differences compared with institutional organizations, thus:

> *The IMF is essentially concerned with maintaining appropriate macroeconomic conditions and focuses on macrostabilization issues, and thus has rather limited overlap with the EBRD. The World Bank is related to public sector financing. EBRD does both public and private sector financing. It takes equity shares in the private investments, and lends to public institutions and to private institutions, and take equity shares in public and in private entities.*[337]

Although risk management instruments may seem quantifiable at the company level, they are not directly derived from the risk indicators. The political authorities and international co-operation organizations offer them in order to achieve an environment for stable economic transactions. It can be concluded at the company level that the availability of political risk management instruments offered by political authorities is not a firm sign of low political risk in certain environments. Therefore, the availability of market-based risk transfer instruments indicates a low political risk level as an equilibrium between the economy and the political and predictable rules of the game and transaction costs.

5.2.4 Private Instruments

Companies can protect themselves against uncertainty by means of insurance. Political risk insurance for investment and trade transactions is available in international markets outside the political authority's guarantees. These private instruments are based on risk pooling on international security markets. However, they are often

[336] Weber & Zysman,1997.
[337] Europe. March 1994. Issue 334:15.

short-term and expensive when compared to those of a political authority.[338] Thus, they can be considered marketable instruments. With a few exceptions, political risks have been an area for the government and the public sector rather than for insurers in the private sector.[339]

Despite the fact that there are non-marketable risks in economic environments, there is a strong tendency towards market-based rules of the game in political risk instruments.

Stephens points out the reasons that prevent the use of private insurance instruments in political risk management[340]. The private instruments can be available, if there is trust among actors, as defined by Williamson[341]. International co-operation exists to harmonize the rules of the game for maintaining trust. Keohane pointed out that co-operation lowers transaction costs by increasing information about the other actor's behavior. We can ask, are there some instances other than political authorities that would be able to supply trust in the international environment of economic actors.

Multinational accountancy firm have turned out to be organizations which offer trust and that way have turned into actors with political power in international relations as have the political risk rating companies whose methodologies were analyzed in Part Three of the study. By maintaining credit ratings on companies, multinational accountancy firms are pooling information beyond sovereign states and beyond trade blocs. In a pluralist state regime, a nation-state offered trust by guaranteeing the operation of the state-owned companies. The information on state ownership was sufficient for risk management.

In a plurilateral regime, the trust is maintained by accountancy firms" ratings. Trustworthy partners in business are those companies that have a rating score. This trading score divides the actors into insiders and outsiders in the international market. Credit ratings are global and cross political borders. They can be characterized as continu-

338 Wagner. 1994: 30–38.

339 Stephens.1998:149. Stephens is the Secretary General, Berne International Union of Credit and Investment Insurers.

340 *Ibid*.

ous co-operation agreements. Without a rating score a company is unable to enter international markets. The privatization process increases the political power of accountants.

Susan Strange explained that the multinational accountancy firms play an important and influential role in world economy. She asked, what is the nature of their authority in the running of the world economy, and why do states allow them have such authority? The fact is that the leading financial services firms are now setting up operations across the globe while traditional national centers are coming home to foreign companies with global operations.[342] What is the equilibrium between these authorities and the markets in the world system? According to Strange, accountants have been instrumental in economic considerations as brokers in big mergers and takeover deals involving international companies. They are involved in corporate financing to the effect that they operate almost like banks, and certainly play a key role in the world's financial structure.[343] Thus, accountants are important actors in plurilateral regime based on market-based rules of the game.

In a pluralist state regime, the role of accountants was defined by each national government and most operated within the boundaries of national economies. With the transforming international system, multinational accountants became the brokers between market economies and their role strengthened with the liberalization of national economies. Accountancy firms followed multinational corporations because of the path dependent transformation since the days of *Sovereignty at Bay*, when British and US multinationals dominated the world economy; Anglo-American accountants followed their firms. The world monetary regime based on the World Bank Institutions in Washington and financial centers supported their strengthening role in London, New York, Singapore, and Hong Kong. Strange pointed out that reputation was the key element on their way to an influential position in the world economy. These accountants were able to supply trust that was earlier supplied by the national governments.[344]

---

[341] Williamson. 1997:250–279.
[342] Sassen, Saskia. 1999.
[343] Strange. 1996:135–148.
[344] Strange.1996:136.

According to Williamson, the reputation effect, that is linked to trust, is a significant rule of the game in trade and investment. Parties to a transaction to which reputation effects apply can consult not only their own experience or analysis, but they can also benefit from the experience of others.[345] The multinational auditors base their analysis on economic indicators. The trust and reputation effects increase their political power for the management of political risks. The global operations of these companies indicate continuous agreements between economic actors.

5.2.5 National Instruments

Traditionally, a political authority of a nation-state supplied national guarantees for national companies operating abroad. Guarantees were based on budget finance and given in order to maintain national interests. Competitiveness and security levels were issues regarded as strategic for national interests.

Economic relations are emphasized by the strategic fact that the linkage between politics and international business is obvious on the macrolevel, in three different ways.[346] Firstly, the political system shapes the economic system because the structure and operations of the international political system determine, to a great extent, the structure and operation of the international economic system. The international political system has shaped the post-war international economic system. For political reasons, the East and West were isolated into two separate economic systems in Europe. The collapse of the Soviet Union, the rise of Russia and the new European states, the decline of US power, and the increased pluralism in the West, as well as new political pressures, completely transformed the international economic and political business environment.

Secondly, political concerns often shape economic policy, because economic policies are frequently dictated by overriding political interests. For instance, economic policy is frequently either shaped by political concerns or becomes an explicit tool of strategic and diplomatic policy. Trade policy is often consciously linked with political goals. Trade policy measures have been used for military policy purposes.

---

[345] Williamson.1996: 115–116.

Third, international economic relations may also be considered political relations, because international economic interaction is a process by which state and non-state authorities manage, or fail to manage, their conflicts and by which they co-operate, or fail to co-operate, in order to achieve common goals. Most international interactions contain elements of both conflict and co-operation. Even in situations of extreme conflict, there often is an element of co-operation and vice versa. That is the reason for analyzing equilibrium between economic actors and political authorities instead of optimizing maxims; for example, studying public services as a borderline case in a relationship instead of neo-liberalism as an optimum of a riskless business environment.

In the Western market economies, and in mixed economies that had organized their economy to resemble a market-based structure, the national risk guarantee organizations were created to coordinate the risk coverage.

Hence, the study of political risk could be divided by its objectives: whether it concentrated on risk guarantee regimes, like the studies by Alan C. Brennglass (1984) and Frederick Stapenhurst (1992), or on comparative analysis of risk variables, like the study by David Brummersted (1988). These approaches were already studied in Part Three, but in this connection of instrumental management they are worth repeating. The variable-oriented approach studies the management of political risk at a company level. In variable analysis the results have remained fuzzy, because of the perspective of a company and the lack of holistic analysis of the problem of political risk governance as a function of political authority. Regime-oriented research studies the governance of political risk at political authority levels.

The governance of political risks has led to the development of governance regimes. The United States, as the leader in the international economy, has also set the rules of the game in risk management in industrialized countries. The Overseas Private Investment Corporation (OPIC), in the United States, was a model for other industrialized countries. The grounds for federal state guarantees were in the financing of the reconstruction of Europe after the Second World War with Marshall aid. OPIC was

[346] Spero.1990: 3–15.

the model for governance. The political risk management regime was developed after the Second World War. In 1983, Alan C. Brennglass studied the development of the U.S. national guarantee board, OPIC.

OPIC has been a model for management institutions and organizations in other industrial countries for risk guarantees. It is a market-based institution that governs the risk guarantees. Funds are gathered from the capital markets in the United States, although a political authority governs the guarantee policy in order to achieve national strategic goals that can vary from the development policy to the foreign policy. The functions of OPIC have been wider than in other similar agencies in small states. In addition to OPIC's programs, which cover political risk perils such as nationalization, war, and revolution, OPIC offers direct loans, loan guarantees, and equity techniques for funding projects in host countries[347].

In 1992, Frederick Stapenhurst compared the risk guarantee organizations around the northern Atlantic. In Europe, Canada, and the USA, Stapenhurst's overview of political risk analysis looked, in particular, at the functions in three different home country contexts, as they evolved and were carried out in the American, Canadian, and Western European corporations. Despite small differences in risk coverage, the systems are in general the same. When the perspective was widened into a World Bank's institution, the Multilateral Investment Guarantee Agency (MIGA), it was possible to define this analysis as a regime analysis in industrial countries. When the tendency is towards a market-based system, as in the United States, a regime can compensate as the governance structure.

How has the political risk management reflected on mixed economies? There were heavy state guarantees, and the state was an economic actor and owner of economic entities. Indirectly, the banking and insurance sectors, as well as the state companies, had states guarantees. Risks were covered from the state budget. At the national level, the offering of risk guarantees was a competitive advantage for ensuring the strategic targets, for example, an availability of energy and raw materials.

[347] OPIC. Annual report. 1994.

The static regime, where small states were covering their guarantees from budgets is transforming. It is transforming towards dynamic market-based governance: political authorities are harmonizing the rules of the game and financing the risk management instruments through the markets. It follows that potential access to international capital markets increases in small states. The denser the relationship with the plurilateral regime, the wider is the access to capital markets.

Pooling of sovereignty was developed for facing the threats of instability in the global market. The supply and demand of international organizations, as Keohane has emphasized, strengthened co-operation between nation-states. In the pluralist state regime, in Europe, the co-operation takes place, for example, in the Berne International Union of Credit and Investment Insurers and the OECD's Trade Committee's Group on Export Credits and Guarantees[348].

The internal market in the European Union increases the capability of small Member States to fund political risk guarantees by a market-based system. This system will represent the new regime of political risk guarantees in the future. When the market-based system in risk management is strengthened, it becomes possible to define the new system as a governance system instead of a regime, where the political authority acts functions as a regulator, not as an economic actor.

[348] Finnish Guarantee Board (FGB) represented Finland at the meetings of the OECD Trade Committee's Group on Export Credits and Guarantees and at the meetings of the countries party to the OECD Arrangement on Guidelines for Officially Supported Export Credits, the Consensus. The OECD seeks to even out the competition conducted on export credit terms. OECD countries apply the Arrangement terms when granting or guaranteeing officially supported export credits, mixed credits, and tied aid.
A major breakthrough was achieved in 1997, when premiums were, for the first time, made subject to overall regulation: in June, the countries party to the Consensus approved an agreement prepared at expert level on guiding principles of premium. The OECD countries agreed on minimum risk-based premium levels, which each export credit agency must start to apply by April 1, 1999 at the latest.
The working group of premium experts, which is subordinate to the Consensus, continued its meetings to discuss practical application of the premium agreement. Their work has also focused on developing methods to measure whether the premium levels now agreed on are sufficient to cover operating costs and losses of guarantee activities in the long term.
Discussions continued on the need to change the consensus terms required by project financing, and tangible proposals on amending the export credit consensus terms were prepared. http://www.takuukeskus.fi/fin/1997/main1.htm. 24 Nov.1998.

5.3 Negotiating the Environment

Risk management instruments in trade and investment have belonged to the main strategy for managing political instability in an environment at the company level. These instruments are passive, and a political environment has been taken as a given. Are there any active instruments? In the obsolescing bargain model, the bargaining power is maintained by applying a regulation policy set out by the political authority.

Alan Shapiro has shown that some companies try to gain understanding with the host government before investment and to define rights and responsibilities of both parties. These methods have lost their meaning. In addition to Shapiro's study, there are also other similar notions.[349]

In the internal market of the European Union companies can lobby[350] but, generally at the company level, risk management is concentrated on transaction exposures, and the political environment is taken as a given. In addition to stability and predictability that is supplied in the internal market, a foreign company may design certain after-care programs for utilizing the development policies of European Union.[351] In the distribution of the market-based rules of the game, the plurilateral regime is fragmented by the specific rules of the game, but the basic ones are the same[352]. Interest group liberalism emphasizes lobbying. However, based on Robert A Dahl’s finding on economic democracy in Part Two, it can be argued that maintaining stability and predictability in the political environment is a function of political authority. Only within a stable political regime is it worth analyzing the negotiating procedures.

5.4 Summary

At the company level, the management of unpredictable transaction costs is based on a governance framework maintained by the political authority. Earlier, the manage-

---

349 McCarthy & Simmonds. 1993.
350 Brewer & Young.1995:33.
351 Young & Hood.1994.
352 Brewer, Thomas, Young, Stephen. 1995. This article presents a multilateral frame for rules of the game. Thus, a plurilateral regime emphasizes the results of these scenarios: Fragmentation of the rules remains despite efforts to harmonize them.

ment was based on the nation-state's guarantees, now, more and more on the market-based rules of the game in an integrated and globalized world.

The new framework can be defined as a plurilateral regime. Several strategic issues fragment the harmonization of political risk management instruments, but, all in all, co-operation is emphasized because political risks have to be managed through political governance. The result of these analyses shows that there is no single, universal instrument for resolving the dilemma of equilibrium between the economic and political milieus. It follows that the political risk instruments at the European Union level have to be analyzed as an issue of political governance of harmonizing the rules of the game of the national risk instruments in Part Six.

6. Institutional Risk Governance

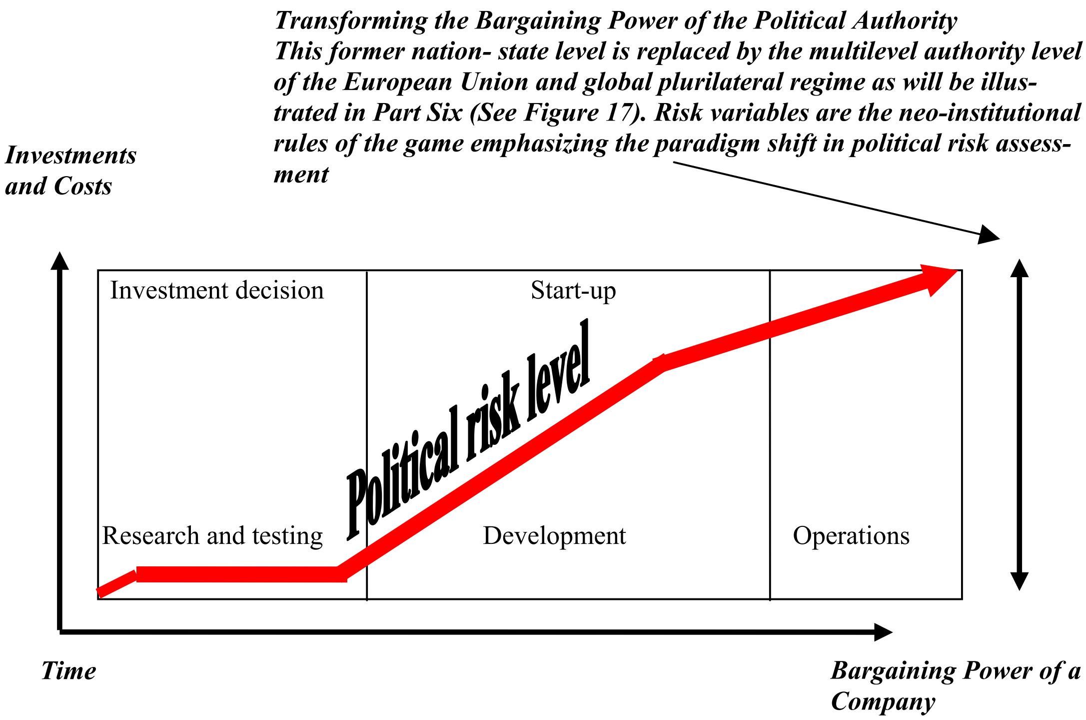
Part Six focuses on the rules of the game and the shifting boundaries between economic actors and political authorities in a plurilateral regime. It is framing the traditional paradigm of political risk, the transforming environment of political economy in Europe, the new risk variables, and the risk management governance and instruments. Institutional governance frames the parts of the whole in the study of political risk using the hermeneutical method.

Figure 6 in Part Three illustrated the traditional political risk model of bilateral monopoly between political authority and an economic actor in the international exchange. It was originally developed by Raymond Vernon. Traditionally, a political risk was not only caused, but also managed, by the nation- state authority's political governance. On the one hand, the political authority created stability but, on the other, it could use its authority monopoly to cause risks to international companies by restricting, among other things, their action and property rights. In this Part, Vernon's obsolescing bargain model is used to characterize the bargaining power shifts from the national authority level to multiple political authority levels.

The bargaining power of the political authority was conceptualized traditionally as the bargaining power of the nation-state. Now, the nation-state authority is replaced by the European Union and Member States, which are defined as the multilevel political authorities in Europe.

The new authority levels set the rules of the game and boundaries in an international political economy and define the equilibrium between economic actors and political authorities in a plurilateral regime. It could be questioned, how the multilevel political authorities govern the policy and instability oriented approaches of the causes of political risks? In addition, are there new approaches that have to be taken into consideration in the European political economic milieu when the political risks are being managed? This political transformation is further illustrated in Figure 17 and Figure 18 that concern the transforming state level in the obsolescing bargain model at the European Union and global level.

Figure 16 Transforming the State Authority Level in the Obsolescing Bargain Model



The risk indicators in comparative analysis were replaced by neo-institutional risk-indicators, the formal and informal rules of the game, derived from the theory of Douglass C. North. Political risk was defined as an unpredictable transaction cost emphasizing the policy oriented and instability oriented approach of the causes of political risks in Part Four in this study. According to the definition, the political risk of a company rises due to instability and unpredictable policy decisions. On the one hand, the transaction cost level may be unpredictable because of the political transformation from national level governance to the European Union governance. On the other, it is focused on whether the transformation might produce a new kind of predictability into trade and investment in the external relations of the European Union?

Part Five focused on the fact that political governance is primary and risk instruments are a by-product of the political governance, when the political risks are being managed in an international environment. Several issue areas are analyzed in this respect. First, the European Union governance in the internal market sets the rules of the game and boundary lines in the equilibrium between the economic actor and political authority. Second, the rules are reflected in the external relations of the European Union, which is harmonizing the national policies and thus creating a new political economy milieu at the global level.

6.1 Plurilateralism: Harmonizing the Rules of the Game[353]

As applied from the study of Douglass C North, the political risk governance maintained by political authorities is defined as the structure of institutionalized rules of the game and its path dependent transformation of them. If the markets fail to institutionalize the stable rules of the game, the market is replaced by a hierarchy set by political authority. Political authority sets externalities, the boundaries between the economy and politics with public service and public goods principles. In market economies, the driving force is the harmonization of the rules of the game emphasizing the benefits of co-operation[354]; (a) by internal market legislation using regulation policy and (b) by a plurilateral regime of the rules of the game on external economic relations.

Governance creates stability; the equilibrium between economic actors and political authorities. When it involves a market-based governance, it can be defined as governance without government in a turbulent environment. Common rules of the game lessen the requirements of political governance in single exchange acts in Europe.

Stability is depicted through many specific constraints that affect a particular choice. Significant changes in this institutional framework involve a host of changes in a variety of constraints – not only legal constraints, but also norms of behavior. Although the institutional constraints may not be ideal or efficient for one set of individuals involved in a particular exchange and, therefore, those parties would like to

[353]. With the harmonizing policy, the rules of the game in pluralist market economies govern a wider context than the nation-state level. Political power related to external economic relations is shifting from nation-states to the European Union, which is becoming a new political authority. However, its policy is regulative and market-based. Governance is based on agencies that control the economic actors. In political risk governance management, Finnvera is a new agency, combining the regulative and market-based logic. Like OPIC, it is a hybrid, with the functions at the equilibrium between economic actors and political authorities.

[354] Williamson: market failure. Cf. state and government failure.

restructure the institutions, the same set of institutions for other sets of choices may still be as efficient a bargain as possible. Moreover, it is the bargaining strength of the individuals and organizations that counts. Hence, only when it is in the interest of those with sufficient bargaining strength to alter the formal rules will there be major changes in the formal institutional framework. The complex of formal and informal constraints enables continual incremental changes at particular margins. These small changes, both in formal rules and informal constraints, will gradually alter the institutional framework, so that it evolves into a different set of choices than it began with.[355]

The complex set of risk variables is simplified through institutionalizing the rules of the game. When the instability is governed at the macrolevel, it is possible to design the risk management instruments at the microlevel, that is, the company level.

In the contexts of neo-institutional theory, the market-baseness means designing and legitimizing the rules in a way that allows markets to act. The analysis of the risk management instruments, in Part Five, shows how difficult and nearly impossible it is to manage the multitude of political risk variables at the company level. Management of instability without political hierarchy is difficult.

As analyzed in the study of Robert A. Dahl, the laws made by a legitimate political authority can be enforced by physical coercion at the highest stakes. The physical coercion is a borderline case between economic actors and political authorities. It is an instrument that is unavailable in the market. Institutional risk governance stabilizes the environment of trade and investment. The political risk governance is a public service offered by a political authority. The governance of political risk is a borderline case located in the equilibrium between "economic" and "political." An internal market for commodities exists in the European Union, while an internal market for services is still emerging.

Plurilateral harmonization, however, represents the transformation of governance at the global level. In this respect, the business environments can be divided into the core of low political risk and other with fuzzy boundaries farther from it. Therefore,

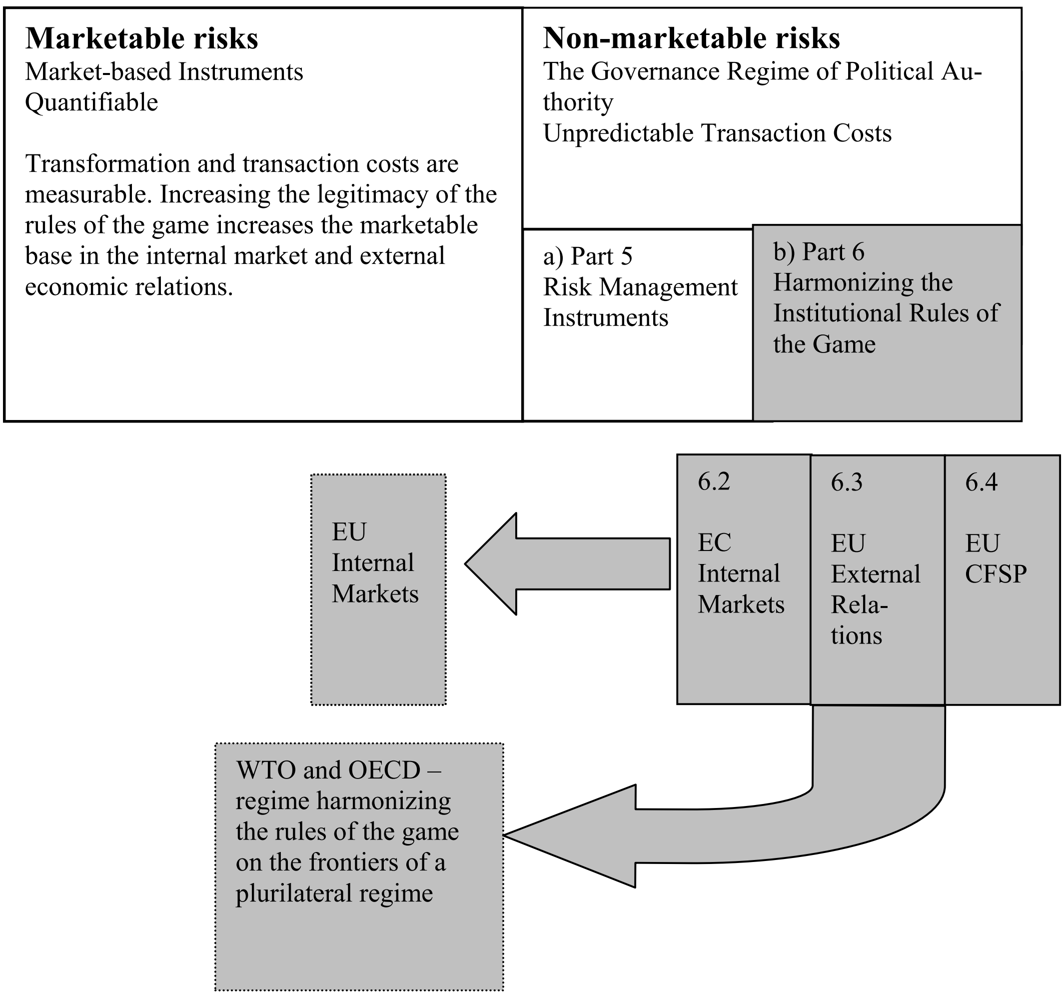
---

[355] North. 1990:68.

the perspective of a single risk management instrument is far too narrow to provide for an understanding of the phenomenon of political risk in a business environment. Plurilateralism denotes governance of political risk and requires the presence of political authorities.

Figure 17 frames the institutional governance of marketable and non-marketable risks in the European Union and at the global level. Co-operation within the WTO and OECD represents global governance while the European Union rules are divided between European community rules (the Treaty of Rome 1956) and European Union rules (the Treaty of Rome 1956 and the Treaty of Maastricht 1993).

Figure 17 Institutional Risk Governance



6.1.1 Neoliberalism and the Dependency Theory: A Borderline Case

In the international relations theory, the world system school of thought disagrees with the peaceful transformation of international regimes and assumes that the relationship between the different categories is one of conflict and exploitation. Immanuel Wallerstein uses a three-tiered hierarchical formation of countries in his globalist approach. His categories consist of a core of the capitalist world system, a semiperiphery and a periphery. The rich, industrialized, and militarily stronger states constitute the core. The poorest, often agrarian, states belong to the periphery, and between them lies the semiperiphery, characterized by an economic base that combines core industrialization and peripheral agriculture. The Third World countries are not "underdeveloped" nations, but peripheral "capitalist" nations. Peripheral capitalist economies operate by economic laws and growth factors clearly different from those of the economies one might call the model of "classic capitalism." This is only so, because our model of "classic capitalism" is wrong, since both in the sixteenth century and today the core and the periphery of the world-economy were not two separate "economies" with two separate "laws" but one capitalist economies system with different sectors performing different functions. The industry sectors, which are characterized by unequal exchange, are located on the periphery. [356]

Instead of pointing to an unequal exchange by industry sectors, Douglass C. North's neo-institutionalist thought emphasizes institutional rules of the game at the formal and informal levels as the borderline cases separating the function of international business environments. According to his viewpoint, there is space for flexible frontiers between the tiers, which enables international co-operation instead of conflict and exploitation.

Furthermore, Robert O. Keohane emphasizes co-operative characteristics of international regimes and the-rules of the game, with their neo-liberal institutionalism, represent the neoliberal political thought. According to Keohane, the supply and demand of international co-operation intersect in the point of common interest[357]. International regimes are designed to mitigate the effects on individual states of uncertainty

[356] Wallerstein.Immanuel.1979:66–92.
[357] Keohane. 1989: 101.

deriving from rapid and often unpredictable changes in world politics. Thus, regimes create a question of trust. It is uncertain whether other actors will keep their commitments.[358]

A plurilateral regime, however, is characterized by fuzzy borders. Among multilevel political authorities, there are non-state actors in co-operation establishing the universal rules of the game in the political economy. Increased interdependence increases trust when questioned whether other actors play fair. In a plurilateral regime, integration is a process of harmonization of the rules in the relationship between economic actors and political authorities. Without the ideas of North, Keohane and Plurilateralism, the frontiers would remain sharp-edged and the international environment would be enforcing the exploitative ideas of Immanuel Wallerstein.

Political governance of the co-operative relationships between the political authorities and economic actors at the global level is based on the agreements made in international organizations, such as the World Trade Organization and the Organization of Economic Co-operation and Development OECD. With the transformation of political authority from the national level into the union level, the European Union is strengthening its mandate to represent the Member States in international organizations. In addition to the question how legitimate is the European Union as a representative actor in international organizations, it can be asked how trustworthy are the rules of the game these organizations are able to set? Or how trustworthy the prevalent rules of the game are in separate environments in terms of political risks?

---

[358] Keohane.1989:111–124

6.2 European Union: The Rules of the Game in Internal Markets

The diffusion of generally known rules of the game enhances global business activity. In the European Union internal markets, there are community risks, implementation risks, and society risks hindering the harmonization of joint rules. These risks are illustrated by focusing the process of defining the concept of public services in the internal markets. The concept of public services defined the limits between economic actors and political authorities in a state regime. This is also true of a plurilateral regime. Thus, the assumption regarding plurilateral regimes emphasizing that there remain fragmented rules in Europe which characterize the separate economic spheres in the future and can be considered political risks.[359]

Because of increased market-baseness in Europe, the roles of political authorities are transforming into those of regulators instead of owners of economic units. Charles P. Kindleberger contends that free trade in Western Europe arose, in many instances, as individual entrepreneurs pressured their governments to lift restrictions on international trade and finance, so that they could pursue overseas business opportunities. Kindleberger points out that political activity by entrepreneurs cannot be used to explain the rapid expansion of free trade in Europe after 1850. The wave of free trade may have been motivated by ideology rather than by economic or political interest during the nineteenth century.[360]

Thus, political risk has been one of the central hindrances in international economic activity. As derived from the theory of Douglass C. North, harmonization of the rules of the game between economic actors and political authorities lowers the level of political risk confronted as unpredictable transaction costs at the company level. One step in the evolution of governing the political risk is the emerging internal market in Europe. It has been argued in this study that the internal market is an environment for a low political risk level, based on consistent rules of the game and predictability of shifting boundaries between political authorities and economic actors. Thus, because of multitudes of informal rules of the game, harmonization will stop at different insti-

[359] According to Stephen J. Kobrin, the global world economy is blurring the distinction between the public and private spheres. The idea of public property or public goods is underdeveloped. According to his view, the distinction between the public and private is becoming diffuse. Kobrin 1998(a).

tutional levels in different Member States and economy sectors, as will be shown in Section 6.2.3. on public services.

The political Euro-risks are realized as fragmentation of the rules of the game in the internal market and as incapability of the Union's political authority to institutionalize global economic relations. Community risks can be identified by analyzing the framework of treaties of the European Union. Decision-making procedures define the authority structure between the Union and the Member States. We can assume that harmonization of the rules will decrease transaction costs and institutionalize the external economic relations by increasing market-based rules. These risk types are embedded into a general political risk level that the companies must confront in the European internal market and the EU's external relations.

6.2.1 Embedded Political Risks

6.2.1.1 Community Risks

The Community Risk arises from the transforming regulation and new governance dimensions, for example, common foreign and security policy and its reflections on external economic relations. These decisions concerning the future of the European Union were on the agenda of the Intergovernmental Conference (IGC), which resolutions were incorporated in the Treaty of Amsterdam in 1997.

In the short term, the community risks are included in the creation and operation of internal markets, not in the future of the European Union. The new internal market program was to be realized, at the latest in early 1999, however, all the hindrances have not been removed yet. Above all, the types of national politics and legislation, which are fragmenting the rules of the game, still exist. Douglass C. North has demonstrated, that the fragmentation results from the historical experiences of the Member States, from their culture and traditions – the informal rules of the game in societies. These informal rules could be changed formally by community legislation, but they do not automatically unify informal structures neither can they be extended to relationships between individuals.

---

[360] Kindleberger.1997.

The establishment of a single market was started with the Treaty of Rome. The harmonization by liberalization of national legislation and standards and market management was a governance instrument for achieving a single market. At its establishment, and later when the Single European Act was created, harmonization measures were drafted by the Commission in co-operation with working groups from industrial sectors, composed of experts nominated by Member States" governments. Therefore, the establishment processes can be characterized as pluralist ones.[361]

The European Economic and Monetary Union, EMU, set out the political development of European integration by emphasizing the "economic" and "instrumental" dimension in the Treaty of Maastricht in 1993. However, the "political" dimension concerning public services was set out in the Treaty of Amsterdam, in 1997, in Article 7d(16).

The Treaty on European Union, the Treaty of Maastricht, was ratified in the Member States 1 November 1993, and Austria, Finland, and Sweden became members of the European Union on 1 January 1995 by adopting the rules of the game of the European integration process. The Treaty of Maastricht opened a new era of political economy for the member states. The new phase indicated that several sectors of political governance were incorporated into the integration process. From the point of view of the states, the integration process diffused the more sensitive policy areas, such as taxation. The Treaty of Amsterdam in 1997 transformed the decision-making and power structures in the Union. It combines the Treaty of Rome and the Treaty of Maastricht into one agreement, which covers all dimensions of integration.

The paradigm shift in the governance of internal market is related to the role of political authority in Europe. The boundaries are set out differently in regard to the relationships between markets and the community's authority – whether it develops, in a long term, according to the federalist (Jean Monnet, Walter Hallstein, Altiero Spinelli), transnationalist (Karl Deutsch), functionalist (David Mitrany), neo-

[361] Wallace & Wallace.1996: 125–156.

functionalist (Ernst B. Haas), or realist (Hans J. Morgenthau, Stanley Hoffman) approaches.[362]

According to Ernst Haas, the European Union's institutional development is located in integration process. It refers to the enlargement of the European Union's authoritative and legitimate international role. In addition, the integration process is conceptualized by causality. The integration process is a "spillover" from one economy sector to another. The political economy hypothesis as a second view argues that the integration process is a reflection of the competition positions of companies and economies in the world political economy. Moreover, the convergence hypothesis focuses on the institutional transformation and change from the point of view of centrally organized decision-making procedures. Robert O Keohane and Stanley Hoffmann end their analysis with three hypotheses on regime analysis.[363] Thus, even if the regime theories can be questioned using the "governance without government" arguments made by James N. Rosenau[364], from the perspective of political risk, regimes can be argued to explain the transformation of the political risk governance and management instruments in Europe.

Currently, the agreements concerning the functions of internal markets are made by a multilevel political authority, which can be characterized as a plurilateral regime, especially when considering political risks at the company level.

6.2.1.2 Implementation Risks

The Second Euro-risk is the implementation risk, caused by fragmentation in the process of implementing the Single Market rules at a nation-state level. Multi-speed indicates that the Member States are aiming at implementing the same regulations but, for either economic or political reasons, the regulations are not harmonized at the same time or through the same path. The existing regulations, however, are legitimate both at the community level and state level.

---

[362] Cram, Laura.1996:40–58.
[363] Keohane &Hoffman.1991:18–26.
[364] Rosenau.1997.

The integration process is based on the liberalist tradition, when setting the rules of the game in the industry sectors. Despite the fact that pluralism is emphasized, one risk is that integration increases conflicts within the member states and among them. Political disagreements are related to the direction of integration and they might grow. In addition, integration may be politicized in the member states essentially more than at present.

One result of the implementation risk may be a legitimacy crisis. The legitimacy crises of nation-state political authority were based on the fact that, as already stated in the introduction, Europe-wide operations and the internationalization of interest groups and non-governmental organizations in general, in conjunction with improved information technology, have caused a situation where it is difficult to indicate, who pushes who around in Europe, who is making political decisions, and who exerts political authority in a specific region. Economic actors have to work in a plurilateral environment, where national and international norms are crossing and opposing each other. It is not clear in whose hands is the legitimate power to set the rules of the game. In addition, it is not obvious, whether the center of political decision-making is located at the nation-state level, the European Union level, or the local level.

6.2.1.3 Society Risks

The third type of Euro-risk is the society risk, which is caused by the informal rules of the game in societies. These risks differ from the risks caused by the formal rules at the implementation level. On one hand, there is the development of European societies at the Member State level, which makes the environment unpredictable; on the other, those risks are indicators of the emerging European civil society that may work differently from the civil society in the nation-states.

The informal rules of the game are related to the identities of the economic and political actors. However, the market-based rules of the game are a common denominator for individuals coming from different cultures. When creating the European identity, it should be noted, that the Euro-currency strengthens both the internal and external identities of the citizens of the European Union. Neoclassical economics emphasizes the rules of the game, where the political governance as a factor of production or the civil society when informal rules of the game have been excluded. Yet, neoclassical models are sufficient only in environments, where institutional market-based governance prevails, political hierarchy maintains stability and informal rules have no role.

Informal rules of the game are so numerous in the Member States, that it is impossible to govern their differences by a centralized governance of the European Community. This is one of the reasons for emphasizing market-based regulation in Europe. Even then the central problem is how to create a consensus on the Community's added value at the local level. From the point of view of a company, it may remain unclear, how the European economic environments are operating at the nation-state level. The risks are linked to the problem of harmonizing the European Community's rules at the local level in the way that the informal rules affecting business are also being harmonized or made predictable.

Once again, the society level can be analyzed from the point of view of the history of political economy. When studying the informal rules of the game and the development of democracy in pluralist societies, today and tomorrow's choices are shaped by the past. In market economies, the rules between economic actors and political authorities have been harmonized for centuries, which has created the supply and demand of international regime for trade and investment emphasizing the non-zero-sum game between actors. When gains from internal markets were reflected at the society level, political risks decreased. The 1970s became a period of "eurosclerosis ", when international economic depression prevented the acceptance of community governance at the nation-state level, and the integration process halted.

The society risks are a consequence of the community development but they are also related to the development of societies, which are interlinked. This is a matter of a self-strengthening cause-and-effect relationship.

On the other hand, stronger civil societies have been the cause of certain political risks. In a plurilateral environment, integration weakens the relationship between the state authority and civil societies. An example is the operation of interest and pressure groups. These groups pressure the community directly and avoid using state-level institutional organizations. The power of civil societies has increased, because individuals are more knowledgeable than before. Personal computers and Internet connections are strengthening the plurilateral society. Individuals are able to analyze the information they have received.

The logic of the internal markets also strengthens the role of civil societies. The logic is weighting the market-based decision-making and currently the control is increasingly being left to individuals, not to a political authority. Consumers control the quality, and influence the prices, of commodities by their consumer decisions.

In addition, the importance of the central role national elites play in the integration process has been emphasized. These elites have re-evaluated their interests from purely national to regional orientation, and this has led to the transformation of traditional, nationally centered belief systems.[365]

The integration process weakens the state's sovereignty and connections to the civic society. There are, though, differences between the civic societies when compared regarding different categories inside the plurilateral regime. In the core of the plurilateral regime, the borders of nation-states are at the low, and political risks at an even lower, level. Trustworthy electronic cash and Internet shopping are an example of differentiated frontiers between environments. The closer to the core, the trustworthier is the economic exchange without externalities set by a political authority.

6.2.2 The Case of the European Economic and Monetary Union

The European Economic and Monetary Union (EMU) will stabilize a new global regime for political risk governance, as the earlier monetary regimes have done at the global level. The establishment of the single European currency was an objective in the Treaty on European Union, which was signed in Maastricht in 1992. A single monetary policy is entrusted to the system of Central Banks of the Member States and the European Central Bank, ECB. The euro will convert the international monetary regime that has been dominated by the U.S. dollar since the Second World War, into a more polarized regime of the world economy. Although the European Central

Bank could emphasize the monetarist character of the euro as free from political meddling, it needs a learning period for interpreting the euro-wide aggregates, managing the monetary instruments, and experiencing the possibly asymmetric effects in the Member States. In addition, companies, banks, and states outside of the Euro regime will use the euro as a transaction, portfolio, reserve, and intervention currency.[366]

The political economy hypothesis emphasized the fact that European companies can compete on an international scale, if their home markets became united instead of fragmented[367]. The EMU can be defined as an instrument of the internal markets for harmonizing the European rules of the game internally and externally. The harmonization effects of the EMU cover both the formal and informal rules of the game, both the implementation and society level, in Europe.

When moving from the **community level** to the macrolevel, the political risks place themselves in a bargaining situation between two different options: should there be established a political governance or a monetarist rules of the game? This discussion should define the kind of equilibrium between political and economic in internal markets, which would prevail in the future. At the **implementation level,** the convergence criteria were manipulated in internal markets during the transition period. This fact may reflect on the future functions of the EMU. At the **society level,** the earlier monetary regimes have transformed the identity of political and economic actors. The emerging plurilateral regime, within its fuzzy borders, will also transform the identities. However, the identities of the companies and citizens are not bound as closely to nation-states as earlier.

The European Monetary Union is a technical construct dependent on a wider political governance process between economic actors and political authorities. The concept of public services defines the political borders of monetary instruments in internal markets, as well as in the European Union's policy towards industry sectors. Public service principles, which are included in the Treaty of Amsterdam, define the political content of the monetary policy in Europe.

---

[365] Gram, Laura. 1996: 45
[366] Wegner.1998.:451–457.

All in all, the use of a new currency is a technical problem, and the risks it may cause are quantifiable and predictable. In technical terms, the monetary system lowers transaction costs in an economic activity. When analyzed using the new institutional theory, the balance between formal and informal rules of the game in different regions in Europe may prevent achieving the technical targets.

The political risks related to currency have, traditionally, been translation and transaction exposures of foreign exchange risk. The accounting measures of this exposure focus on the effects of currency changes on the previous decisions of the company, as reflected in the book of values of assets acquired and liabilities incurred in the past. Thus, book values represent historical costs and market values reflecting future cash flows of assets typically differ. Therefore, the retrospective accounting techniques, no matter how redefined, cannot truly deal with the economic effects of a devaluation or revaluation on the value of a company, because these effects are, primarily, prospective in nature.[368] The political dimension is part of the operations of the Economic and Monetary Union and its capability to create stability for both the internal and external markets of the European Union. The stability of the internal market can be observed through fragmented rules of the game in different parts of the European Community. Economic actors are depending on the political currency and, when the national governance is eliminated, first by convergence criteria and second by limiting the power of national banks, the rules of the game will be transformed to market-based ones.

The traditional approach to political risk has separated exchange rate risks into country risk analyses, on the basis of economic factors. In Europe, the threat of fragmentation is eliminated through a convergence criteria set by the political process. Political governance has been of primary importance in achieving the market-based monetary system in the existing economic environment. This process has shown, also, how the development has proceeded through political bargaining.

---

[367] Keohane & Hoffmann.1991:22.
[368] Shapiro.1996:247.

6.2.3 A Case of Market-Based Regulation

EU economy hit by lack of single market in services. Brussels to warn of national barriers to its plan for competitive supremacy. The European Union's economy, businesses and consumers are suffering huge losses because the EU has failed to build a single market for services a damning report by the European Commission will say today. The Brussels authorities believe the findings will act as a wake-up call to governments in 15 Member States, which are accused of not doing enough to help companies to do business across the EU.[369]

Political governance of the equilibrium between economic actors and political authorities requires a clear definition of the roles of the actors. Until the Treaty of Amsterdam, the public services principle was excluded from the policies of the European Union. In the post-Amsterdam era, the regulation policy covers these principles in telecommunications, energy, finance, and transportation sectors. The political risks, which were governed as a public service at the nation-state level, are part of the new governance structure in Europe.

The new regulation policy is a result of political bargaining at the community level, the implementation level, and the society level. According to the policy oriented approach to political risks, there is a tendency towards a market-based system at the Union level, because it is the only way to arrange public services without budget finance.[370]

Brussels to review the opening up of services. Pressure by France to rethink policy could be an obstacle to single market. ...France, the EU country most concerned about opening up former state monopolies, has warned that full liberalization of the electricity and postal markets could endanger essential services.[371]

---

[369] Guerrera, Francesco.2002.
[370] The EU budget is 1.3 percent of the total GDP of the member states. (Wegner. 1998:452).
[371] *Financial Times*. 9 Aug 2002.

The bargaining process of regulations in the European Community may be seen as an equilibrium where, on the demand side, is the benefit from adapting a single European currency. This unique currency, replacing twelve different currencies, speaks with a single voice to the rest of the world. In terms of the political risk, unitary and predictable transaction costs would be preferred in place of those, which are fragmented and difficult to predict. On the supply side of regulation, there are the institutions of the European Union: the European Commission is the central institute to supply market-based regulation.[372]

In this part, plurilateralism will be studied by showing the governance's transformation from state authority into the Union's authority. Firstly, the political transformation of governance of the main industrial sectors will be analyzed. The Union's policy has been implemented through different strategies depending on their political characteristics. Secondly, public services in between the political and economic milieus will be analyzed. Thirdly, the transforming ideology of regulation policy will be framed. The new frame will be described as the transformation from a pluralist nation-state regime towards a plurilateral regime.

6.2.3.1 The European Union's Governance of Industry Sectors

A definition of the concept of public services will set boundary lines between the political authority and economic actors in Europe. The EU's policy towards industry sectors, energy[373], telecommunications,[374] and traffic[375], has become a widely researched topic.[376] Beyond a specific industry policy, the rules of the game have been harmonized by a liberal economic policy, enhancing competition, the single market[377], and the Economic and Monetary Union[378]. A countervailing weight against the European Union's harmonizing policy has been the national interests of the Member States, which have set limits for supranational governance[379].

---

372 Radaelli.1998.
373 Matlary. 1997.
374 Sandholtz & Sweet..1998: 134.
375 Cowie, Harry. 1996.
376 Wallace & Wallace.1996.
377 Wallace & Young. 1996.
378 Tsoukalis. 1996.

In the management of political risk in the business environment, a political risk variable is the regulation of the market by political authority. Stability is maintained by political governance in the environment. Political governance of the economy is changing toward a market-based regulation policy in Europe[380]. Therefore, in this context, a common denominator and a highly politicized concept of public services will point to the balance in the near future in the post-Amsterdam era between economic actors and political authorities in Europe.

6.2.3.2 The Treaty of Amsterdam and the Shifting Balance between Economic Actors and Political Authorities

The public services are related to political risk management in two ways: First, the process in which public service principles are set at the European internal market demonstrates the political authority shift from the nation-state level to the European level. It is an empirical borderline case of political transformation from a pluralist state regime to a plurilateral regime. Second, it demonstrates how the shifting boundaries between economic actors and political authorities are being stabilized in the plurilateral core via harmonizing the rules of the game. In the plurilateral core, this process further demonstrates that political regulation of markets, a potential political risk, is also a gradual and predictable process compared with similar processes farther away from the core.

In her research on political economy, Susan Strange suggested that the methodological way would be to organize the material on the basis of markets or sectors, when studying the balance between political authority and market forces. The neo-institutional method uses this suggestion. Since the levels of analysis are pluralist rules of the game, instead of traditional organizational institutions, it is possible to consider the impact of community risks, implementation risks, and society risks in the analysis of public services.

---

[379] Loikas. 1995 (b): 91–129.
[380] Majone. 1996.

Services of general economic interest[381] are commercial services with a general economic utility, which are, accordingly, subjected by the public authorities to specific public services obligations (Article 90 of the Treaty establishing the European Community, Article 86 of the Treaty of Amsterdam). It is the task of a Member State to set out the obligations of public services on energy, telecommunications, finance, and transport sectors[382].

In the Treaty of Amsterdam, Article 7d, (16) defines public services in the Union's policy. With the entry into force of the Treaty of Amsterdam, a new Article 7d will be written into the Treaty establishing the European Community, acknowledging the place occupied by services of general economic interest in the shared values of the Union. The concept of public service is two-fold: It embraces both the bodies providing services and the general-interest services they provide. Public-service obligations may be imposed by the public authorities on the body providing a service (airlines, road or rail carriers, energy producers, and so on), either nationally or regionally. According to the public service policy, the political authority of a nation-state is transformed from an owner and economic actor to a regulator. The idea behind a public service charter[383] is that there should be an instrument setting out the basic rights and principles governing the provision of services to users. Such principles would include continuity of service; quality; security of supply; equal access; affordable prices, and social, cultural, and environmental acceptability.

As a result the identities of economic and political actors are being transformed – the rules of the game are harmonized. This transformation of the European Union has been linked to the transformation of the regime of the OECD countries. With the European Union membership, the Finnish actors are inside this transformation and the identities of actors are moving towards a market-based system from the mixed economy, where the political issues were weighted more intensely than in the present plurilateral regime of post-industrialized countries.

---

381 Reuters. 1997i.
382 The European Policy Centre. 1997.
383 The European Federation of Public Service Trade Unions. 1996. EPSC 5th General Assembly. Emergy resolution "Intergovermental Conference and Public services'. Vienna: 23–24 May 1996

From the equilibrium point of view, liberalizing the rules of the game in economies has been the main issue in the governance at the European Union level and global level. How far will it be possible to liberalize the markets in Europe?

The principle of public services will set boundaries on markets depending on who is offering these services, on what conditions, who is controlling the quality of the services, how the responsibilities are shared between economic and political actors, and how these principles are being harmonized in internal markets.

These questions will also frame the economic policies in the Union in the future[384]. In the telecommunications sector, it is a question of governance concerning universal services. In the energy sector, it is a question of opening up the electrical and gas networks, and in the transportation sector, it is a question of common infrastructure projects between the public and private sectors. In these four sectors the common denominator is **the services of general economic interest**.

The telecommunication sector is becoming liberalized and globalized, and cross-national mergers are under way. A problem arising from this development is whether it is possible to ensure equal access to information networks for every citizen by the provision of free competition. How will citizens be guaranteed the basic services regardless of economic resources and geographical location? **Universal service** is a concept developed by the Community institutions. It refers to the set of general interest demands to which services such as telecommunications and the mail should be subject throughout the Community. The aim is to ensure that all users have access to quality services at an affordable price.[385]

In the energy sector, the obligation of arranging for public services is quite different. It means privatization of state monopolies. The energy sector is monopolized, because it is a strategic characteristic of a nation-state. The contents of public services are related, for example, to the national security and competition issues. The equilib-

---

[384] *Common Market Law Review.* Editorial Comments. 1996. 33:213–222.
[385] Reuters. 1997c, 1997j, COM (96) 73, COM (96) 608.

rium between “economic” and “political” is, in this case, closer to “political” than in the telecommunications and energy sectors.

In the transportation sector, the public services co-operate in projects concerning networks in Europe. In the **Public-Private Partnership model** (PPP-model), private risks are shared with political authority in order to finance massive infrastructure projects. In the finance sector, the resolutions, concerning the status quo of public banks in the Member States, are defined according to public service principles.

The European Union's policy aims at separating the governance of political authority and the ownership in economic actions. Political authority remains a regulator, and private companies are responsible for economic actions. Public service principles cover horizontally all the key sectors of economy. Frames are set by the Single Market Policy, Competition Policy and decision-making procedures. According to the Treaty of Amsterdam, public services obligations remain the authority of the member state. The subsidiarity principle is intended to ensure that decisions are made as closely as possible to the citizen and that constant checks are made as to whether action at the Community level is justified in light of the options available at national, regional, or local implementation level.

At the implementation level, the public service governance has remained under a Member State's authority, mainly due to the resistance of France in the negotiating process. Although the issues that concern public services are bound with the first-pillar activities of internal market matters, the competition policy and the internal market policy limit the authority of the Member States.

There is a demand for predictable rules of the game concerning the equilibrium between economic actors and political authorities, in order to stabilize the environment of companies. The base for formal rules of the game, regarding the limits at the European Union level, was set in the Intergovernmental Conference (IGC) that led to the Treaty of Amsterdam in 1997[386]. Article 7d (16) concerning public services is the central part of that base.

The Treaty of Amsterdam was a compromise on smaller issues to achieve further goals in the integration process. One of these goals was the Economy and Monetary Union (EMU) and the other goal was the selection of new Member States in the enlarging process of European integration. These are the goals, which will define the lines for future developments in the European integration. In order to ensure the achievement of these goals, the reformulation of the European Commission, the Union's institutions, and the common security policy were left open.

The formulation of the Union's policy and authority hierarchy for public services will set the shifting boundaries in the internal market[387]. Later, the transforming of rules of the game in business environment will be stabilized with the new internal market program.[388] The Single Market Act of 1985 created the common market for commodities, but the common market for services remained imperfect. A real internal market requires the internal market for both the commodities and public services. Public services" harmonization is the most politicized part of the common market, because it is the core stage where to set the balance between "economic" and "political."

When analyzing the transformation in the business environment from the Finnish point of view, the main observable change is the marketable characteristics of the rules of the game in the common market concerning public services. As the common commodities market, the service market will be created by the liberalization of the economy. One reason for this is the absence of the possibility to finance the public services through the budget of the European Union. The role of political authority at the Union level concerning the public services is that of a regulator instead of an owner of the public service institutions or a provider of the services. These tasks are left to the private sector, in reality, the members states are responsible for maintaining public services and harmonizing the differences among Member States.

A nation-state is the traditional supplier of public services, which mostly have non-marketable characteristics. The European Union has to replace the nation-state, without budget, if the internal market of public services is created. This is one dilemma.

[386] Treaty of Amsterdam. 1997.
[387] Reuters. 1997g.

When the Single Market Act was formulated, its realization was supported by the theory of comparative advantage in international economy. According to the basics of comparative advantage, removing trade barriers would result in increased welfare. When it comes to the services and, specifically, the public services, there is no commonly accepted theory. A state authority maintains public services because the markets were insufficient to provide such services. We can argue, that the service market will be the factor that will fragment the internal market among member states in the future. The negotiations that led to the Treaty of Amsterdam were one indication of that finding.

As presented by Cinus de Pistorio, "an act is governed by the law of the place where the act is done."[389] This will be the shifting balance, also in the internal market in the future. However, there are new definitions for a place; there are places inside and outside of the plurilateral regime.

The role of the European Union as a regulator in a plurilateral regime is being harmonized, but it does not mean removing the fragmentation of the market regulation between member states. The new principles are a result of the plurilateral bargaining process. The question is how the multilevel political authority and multi-markets are inter-linked in a business environment. The principles should be accurate for the reduction of transaction costs and for increasing predictability in the internal market.

The research of the World Trade Organization (WTO) on the trade policy of the European Union illustrated the prevailing status of the service market in the internal market [390] The service market is the most significant individual part in the economy, which creates competitiveness. In the European Union, the service sector represents more than sixty percent of the value of economic activity, and the labor force. The services supporting energy, communications, traffic, finance, and business are the most significant inputs in the economy. For example, the telecommunications services represent eight per cent of the total costs of the finance sector, and energy was one of the largest inputs in steel and aluminum and the automotive industry. Reduc-

---

[388] CES (97) 1 final.
[389] *Encyclopedia Britannica*. 1996. "Economics – the history'.
[390] WTO report by Secretariat 1997. Trade Policy review European Union WT/TPR/S/30

tion of these costs is essential for competitiveness. Liberalizing these services is required for reduction of these costs.

Since the beginning of the European Union and, later, since the beginning of the internal market, the barriers in the commodity market are being removed. Thus, according to the abovementioned research of the WTO, the barriers in the service sector have been slowly lowered. The Action Plan for the Single Market aims to remove the remaining barriers in the internal market[391]. However, the rules of the game in the service market are fragmented by Member States. The strategy to confront this fragmentation is liberalization and harmonizing the rules of the game between Member States, ensuring open competition and free access to the telecommunications, traffic, and energy networks.

In the European Union, a benchmarking strategy is adopted in order to compare the competitiveness positions of economic actors [392] This procedure consists of the definition of indicators, measuring, and following-up the positions of competitors globally and between the Member States. Global competitors include U.S. and Japanese companies. According to the European Commission, European inefficiencies are in the productivity of companies and their ability to create workplaces. High input costs are maintained by high charges on energy, telecommunications, and transport services.

Liberalization by harmonization is a rule of the game in the internal market of the European Union. Where are the frontiers of liberalization? Where are the boundaries between political authority and economic actors? These limits are situated differently in different industrial sectors. The Treaty of Amsterdam includes the public service principle. The Union sets minimum rules for services and, thus, Member States themselves set the conditions for service obligations. The prevailing political ideology of the European Union and the Union's legislation on economy sectors set bounds. There is a "strictly necessary" principle, which defines the circumstances where a state authority can intervene in the operation of the market. For example, in the energy sector the principle has already been applied by defining electricity as a

[391] CES (97) 1 final, 4 June 1997.
[392] COM (96) 463. 09.10.1996.

commodity, not as a service. The principle of "strictly necessary" is both a judicial and political principle.

The telecommunications sector is liberalized and globalized by the markets themselves and by the political decisions that enable the development. Questions keep rising because of the demand for democratic values in free competition in information society: How to guarantee the basic services and basic infrastructure for all citizens regardless of the economic resources and geographical locations of the users? The liberalization of the telecommunications sector has maintained the development of the information society. Due to this development, the traditional voice telephone connections have increased, the price level of the services has been lowered, and bases have been created for extensive availability of telecommunication services and further on for increased democracy both inside the plurilateral regime and globally. In the telecommunications sector and finance sector, the harmonization of the rules of the game has followed the frames defined in the World Trade Organization (WTO) agreements.

In the energy sector, the public services have different content, which is related to strategic issues. The problems are related to the privatizing of state monopolies. There are non-marketable factors in the energy sector that prevent its liberalization. For example, nuclear waste is one of the problems, and another is the characteristics of long-term and capital requirements for investment in the energy sector. Furthermore, the spillover of environmental problems requires that, in the energy sector, the market be replaced by political regulation more completely than in the telecommunications sector.

The rules of the game in the energy sector depend on the energy networks in the internal market and the dependency on foreign energy sources. In addition, there is enough private capital for large-scale infrastructure investment. How should the relationship between the plurilateral regime and external regions develop?

Energy policy is coordinated by co-operation in OECD countries. The European Union is an observer in the International Energy Agency. The Treaty of Amsterdam did not change this situation, because the authority of the Union in external economic relations, Article 113 (133[393]), was not significantly increased.

One instrument for maintaining public services in the traffic sector is the Public-Private Partnership model (PPP-model). The functionality of an infrastructure is maintained in the internal market by common acquisitions of public and private sectors, in which the political risks included in long-term investment projects are transferred to the public sector. The financing of the Channel Tunnel built from Great Britain to France is an example of this model.

6.2.3.3 Plurilateral Equilibrium

The emerging market-based regulation in the European Union aims at harmonizing the rules of the game between economic actors and political authorities, but it seems that the results remain fragmented[394]. In the case of public services at the community level, it should be noted that the conceptions of Article 90 do not apply to non-economic activities such as compulsory education and social security or security, justice, diplomacy, or the registration of citizens. This is a notion in a plurilateral regime with separate rules of the game in the common framework of the Member States.

Article 7d(16) on public services, incorporated in the Treaty of Amsterdam awaited ratification by the national parliaments in early 1997 when this research began. Earlier, the principles on public services were consolidated in the formal documents of the European Union, for example, in the directives on electricity and telecommunications networks.

The changes made in the decision-making process concerning the key industry sectors indicate, how this regulation process is expected to harmonize the rules of the game in an internal market. Concepts of public service obligations differ between the industry sectors: in the telecommunications sector it is a question of universal ser-

[393] The Treaty of Amsterdam amended and renumbered the EC and EU Treaties in 1997. The renumbering is shown in brackets, for example Article 113 (Article 133 since 1997).
[394] The European Federation of Public Service Trade Unions. 1996. EPSC 5th General Assembly. Energy resolution "Intergovernmental Conference and Public Services'. Vienna: 23–24 May 1996

vices; in the energy sector the concept is public services; and in traffic sector the concept is public utilities.

The public services will also be defined as a part of the enlargement process of the European Union. The new Member States are being integrated into the European Union at a time, when the principles of public services are harmonized in the current Member States. From the Finnish point of view, if the new Member States can adopt the new rules of the game concerning public services sooner than in Finland, this development will affect the Finnish companies" competitive position in Europe.

The European Parliament's economy committee has urged the European Commission to start the process for incorporating public services in the Union's policy. A schedule was requested by the Commission, in which the objectives of public services were to be realized according to the Treaty of Amsterdam. The process incorporating public services as a rules of the game in the internal market has started.

The process, which sets the rules of the game, is testing the plurilateral regime assumption, which is argued to be the prevailing theoretical foundation characterizing the transformation in the political environment of economic actors. In a pluralistic state system, the concept of public services was defined at the state level. In a plurilateral regime, the political authority is transformed into plurilateral political authority at the Union level, state level, and society level. The non-governmental organizations and labor market organizations at the European level are participating into the formulation of the public service policy that is set in the European Union's institutions. Additionally, implementation of the Union's policy is fragmented, "plurilaterilized," at society levels in the member states. Agreements that are made between labor organizations and companies in certain industry sectors may differ among the European regions that are different from the areas of the nation-states.

The rules of the game and shifting boundaries between economic actors and political authorities vary between industrial sectors. The boundary lines are not located identically in energy and telecommunications sectors. The scope and nature, as identified through the public services context, can also indicate the frontiers between a plurilateral regime and external regions. The consequences of the new regulation policy will change the governance organizations" structures in the Member States.

6.3 European Union: The Rules of the Game in External Commercial Relations

How to frame the transforming environment of political economy in the **external relations of the European Union**? In this section, a synthesis is created concerning the rules of the game and the borderlines between economic actors and political authorities in the core of a plurilateral regime and the environments farther away from it.

The rules of the game in the European Union's external relations are studied in the frontiers of post-industrialized, industrialized, and pre-industrialized environments that represent the global political economy spheres[395]. A plurilateral regime links these spheres together by joint marketable rules of the game. Thus, certain fragmented rules remain, which are interpreted through the analysis of borderline cases.

When analyzing political risk assessment in the European Union's external relations, the trade relations between the European Union and the United States are characterizing the governance of policy oriented risk in **the core of the plurilateral regime**. Safeguards and the concept of liberal protectionism are the borderline cases in the analysis. Market baseness characterizes the rules of the game in the environment. Therefore, the political hierarchy is generally an exception in this business environment.

The governance of political instability in the business environment is illustrated by focusing on the governance of economic relations between the European Union and Russia in **the second category of plurilateral regime**. Political governance through specific commercial contracts characterizes an attempt to create stability and predictability in international exchange. Once again, in a plurilateral regime, market base-

[395] Stephen J. Kobrin uses the metaphor of neomedieval Europe to characterize a movement of the political progression in political economy. A look at medieval Europe, the "immediate" past, can help us imagine the global future. Neomedieval Europe allows us to overcome the inertia imposed by our immersion in the present and think about other possible modes of political and economic organization. He points out, how the beginning of the 16th century is widely identified as the watershed between the medieval and modern eras. "If we are again at a similar watershed, on the cusp of a transition to an era, what might it look like? If the post-Westphalian era is coming to an end, can we discern the shape and structure of the emerging, global international po1itical economy?" Kobrin characterizes this environment as a digital world economy, where the national frontiers created in Westphalia are obsolescing. Kobrin S.J. 1998(a).

ness is emphasized. Thus, the rules of the game remain so distant from the ones at the core that political risk management instruments are required. However, specific commercial contracts, which depend on wider, general commercial contracts, characterize the plurilateral regime in the international political economy.

The requirement for political governance increases in the international exchange with **the third category of plurilateral regime** if compared to the core and the second category of environments. Political risk instruments are demanded because of the instability and unpredictability of the rules of the game. In those environments, political authority is a principal economic actor and owner of companies.

However, when political authorities in the plurilateral core supply political risk-instruments in order to maintain exchange, there are political conditions to be made before guarantees are given. One of these requirements has been that human rights are being respected in the environment. This conditional requirement characterizes one borderline case in the European Union governance. Political authority is often the principal actor in securing both a stable economic environment and human rights in society by means of political hierarchy in the environments of the third category. Markets and market-baseness have a secondary role.

The commercial policy of the European Union was established in order to set the institutional rules of the game in the political environment. These institutional arrangements can be considered institutional political risk governance in order to manage instability and unpredictable regulation according to the obsolete bargain factor model that was derived from Raymond Vernon as illustrated in the beginning in this Part. Figure 18 is replacing the nation-state level in the model as a frame of the rules of the game, which are determining the boundary lines in the balance between economic actors and political authorities.

Figure 18 Framework for the Rules of the Game at Global Level

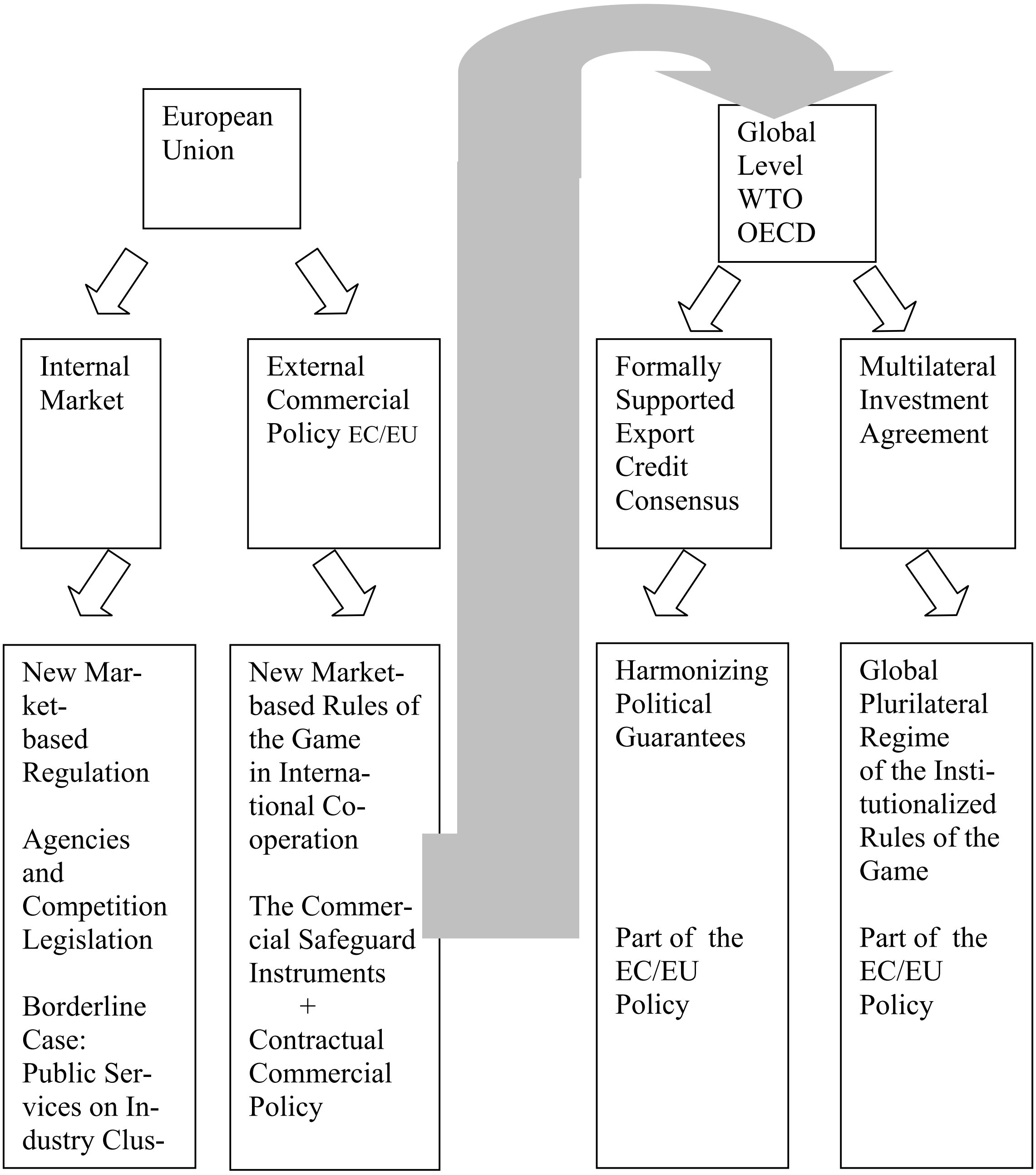


Figure 18 illustrates the frame for harmonizing the rules of the game by co-operative arrangements among political authorities at a global level. It replaces the state level in the obsolescing bargain model. The rules of the game are constraints set by the international community. They are initiated by governmental and non-governmental actors in a plurilateral regime and represent a political framework in order to maintain the functioning of markets. In the context of this study, the institutional management aims at transforming the transaction cost level to become more predictable in the external trade and investment relations. The multilateral trading system, as embodied by GATT and WTO regime, will be an arena, where regional trading blocs are negotiating in order to institutionalize trade liberalization and stable global rules of the game. Institutions in the Multilateral Trading Regime are divided into multilateral and plurilateral categories. According to the WTO agreement, membership in multilateral agreements is obligatory for Member States, but there are no obligations on WTO countries to become members of the plurilateral agreements.

Plurilateral agreements also refer to loose interregional forms of co-operation, which are driven by political authorities, but are not necessarily characterized by formal structures or binding treaties, and do not seek preferential arrangements. Asia-Europe Economic Meeting (ASEM), Asia-Pacific Economic Community (APEC), and TREP (Transatlantic Economic Partnership) are qualified in these arrangements. [396] Generally, plurilateral rules of the game are formal and informal rules with a varying level of legitimacy. However, in a plurilateral context, trusting the prevailing rules of the game is sometimes more important than legitimacy.

The question is, how these rules of the game will be legitimized in political environments and how their contents will be changed in the bargaining process. It should be noted, that the European Union will represent the Member States when the rules of the games will be defined in international organizations[397]. The Treaty of Amsterdam deals with the changes in the authority structure, and Article 113 (133) concerns the representation in the WTO and, specifically, the intellectual property rights.

Commercial policy is one of the most integrated EC policy arenas. The apparent coherence of the EC's external trade relations was not an insignificant factor in the proposals realized in part in the Treaty of European Union for the development of a Common Foreign and Security Policy. [398] The common Commercial Policy gives rise to large numbers of trade agreements and interventions, controlling access to the Single Market, establishing trade relations, dealing with dumping or unfair subsidies,

[396] Pelkmans.1998.
[397] Instead of the European Union, in the external relations, the European Community has trade agreements with about every country in the world. (Nugent.1994:385) EC refers to the first pillar of the European Union with community decision-making. The second and third pillars are under intergovenmental decision-making procedures.
[398] Church. 1994:186.

and providing credits. These can refer to the EC market, partners, and third markets, where Community companies compete with others from competitor states. [399]

The treaty provisions governing the Common Commercial Policy (legal basis) are set out in Articles 110 to 115 EC. Article 113 is the most frequently used Treaty provision in the exercise of the European Community's powers in the field of external relations.[400] The Member States of the European Community have established a customs union with harmonized rules of the game for imports from external countries. The Community's common commercial policy is based on a common external tariff similarly applied in each Member State. When the EEC Treaty was signed, the Community's economy and external trade were geared mainly to producing and trading in industrial commodities. This situation no longer applies, because the service sector is now the main source of jobs within the European Union and accounts for a substantial proportion of its international trade, as was analyzed in the previous section concerning public services. This trend is explained by the very brisk competition from the new industrialized countries in traditional sectors and also the economic changes brought about by the new information and communication technology.

Following the Uruguay Round negotiations under GATT, the setting-up of the World Trade Organization (WTO) clearly reflected this trend. In order to cope with the changing nature of trade, the WTO embraces within the same structure trade negotiations on products (GATT), services (GATS), and intellectual property (TRIPS). In the face of the new pattern of international trade, the European Union must be able to develop its trade mechanisms rapidly, if it wishes to maintain a key role in world trade relations. The scope of Article 113 is still rather vague and unless it can be made to provide for the globalization of trade negotiations, the EU will continue to create difficulties for itself vis-à-vis its trading partners. The Treaty of Amsterdam is intended to clarify the situation by providing the Union with the means of extending the common commercial policy, where applicable, to services and intellectual property rights.

[399] Church. 1994:343.
[400] Macleod, Hendry & Hyett. 1996:266.

With the enforcement of the Treaty of Amsterdam, a new paragraph will be added to Article 113 (which will become Article 133 following renumbering). Under this new paragraph, the Council, after consulting Parliament, may extend the scope of Article 113 to international negotiations and agreements on services and intellectual property rights, insofar as they are not already covered by common commercial policy.

The addition of this paragraph would enable the Union to avoid discussions involving amendment of the Treaty (this being possible only following an intergovernmental conference and ratification by each Member State), if it was decided to extend the scope of the traditional trade negotiation procedure. Following the entry into force of the Treaty of Amsterdam, a decision to extend the Community's powers in trade matters will have to be taken unanimously by the members of the Council.[401]

The legal basis for external economic relations is in Articles 113, 228, 235, and 238 of the Treaty on European Union. In legislative procedures important international trade agreements are adopted by the Council and require the assent of the European Parliament. Moreover, the association agreements need the assent of the Parliament before they can be implemented. The European Commission has a mandate approved by the Council and it negotiates multilateral external commercial agreements in the World Trade Organization, as well as bilateral arrangements, applies EU trade legislation, and proposes new legislation. Directorates-General I, IA, and IB share responsibilities for external relations, Directorate-General III deals with some industrial cooperation matters and Directorate-General VIII with the Lomé Convention and some specific development programs.

There is a confusing terminological problem related to the European Community and the European Union regarding external relations. Dominic McGoldrick has clarified this problem. The EC has an international legal personality, but the EU does not have it. International agreements are concluded in the name of the EC rather than that of the EU. Politically, however, relations with third states are now presented as if being with the EU rather than with the EC.[402] EC refers to community authority (only the first authority pillar of the EC Treaty) and EU refers to community authority and

[401] http://europa.eu.int/comm/sg/scadplus/leg/en/lvb/a20000.htm#a20003. 20 Jan.1999.
[402] McGoldrick. 1997:3.

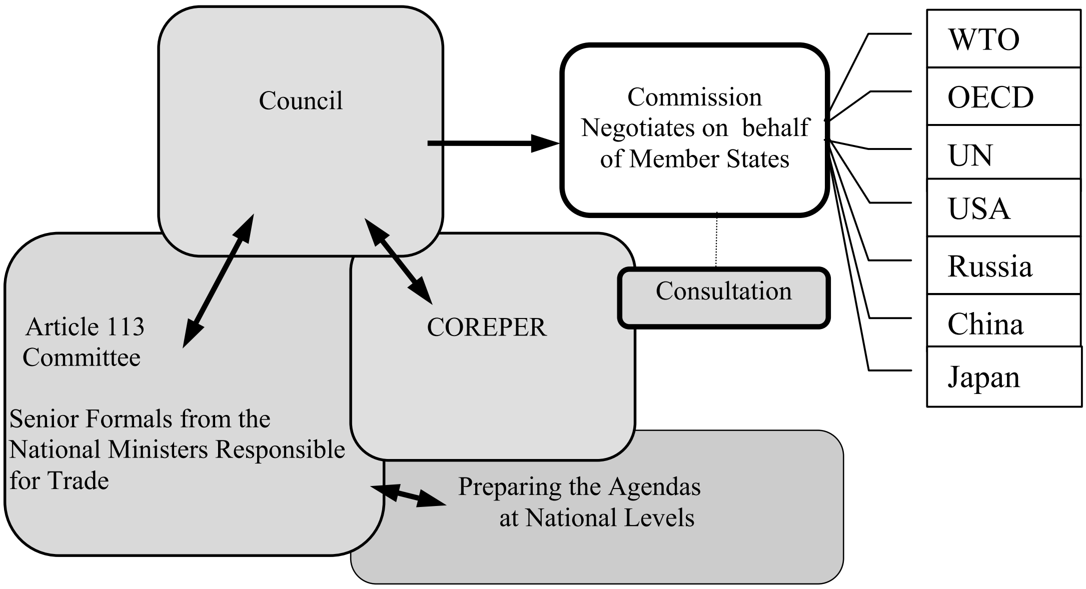
intergovernmental authority (including the first pillar of the EC, the second of Common Foreign and Security Policy and the third of Justice and Home Affairs authority pillars). Thus, Article 113 belongs to the first pillar of the EC.

The European Community can use a customs union, tariffs, import quotas, and export subsidies in agriculture products, antidumping sanctions, and the possibility to react on the subsidies from third states as strategic tools. Article 113 allows a Member State to apply a national commercial policy, if the common commercial policy leads into economic difficulties. GATT and WTO agreements limit the commercial policy of the European Community[403].

Trade agreements, which are made on the basis of Article 113 of the Treaty of Rome, are the responsibility of the Commission and the Council.[404] There were no broad changes in this in the Treaty of Amsterdam. The Commission makes the recommendations to the Council (foreign ministers of the Member States) to conclude a trade agreement with an external state or organization. The Committee of Permanent representatives (COREPER) discusses the recommendation and places it on the agenda of the Council. In Council meetings the agendas are categorized in A and B categories. Category B includes issues of a high political interest for Member States and these require a wider discussion than issues in Category A. The Commission negotiates on behalf of the EU states. DGI (External Economic Relations) takes the lead role on behalf of the Commission. The Commission is in touch with the Article 113 Committee. This Council Committee consists of the senior formals from the national ministers responsible for trade.[405] Compared to the decision-making of trade representatives of the United States, the different national interests of the European Union members may create inefficiency in decision-making. In this sense, the European Union is a pluralist decision-making body in international trade. In addition, European wide interest groups have political power in decision-making procedures as supplier of information on governance, implementation and control of rules of the game in Europe[406].

[403] O'Donnell, 1994.
[404] Nugent.1994:388.
[405] *Ibid.*390.
[406] Rhodes.1994.

Figure 19 Policy Processes in the Decision-making of External Trade



It follows, that instead of nation-states as the actors in the international political economy, the regional economic blocs are emerging in the global arena. According to John Zysman, the emerging regional trade blocs will characterize the economic environment in the future.[407] This has an impact on political risk management and governance. The world trading system is divided into three competing blocs – the U.S., the EU, and Asia – which cover most of the international trade and investment flow, although most of it is within the blocs.[408]. External economic activity between the blocs crosses the frontiers of the business environments of different categories in the world. A plurilateral regime is a fuzzy set of agreements with those frontiers.

Developing new political risk instruments, due to the political transformation in political economy, reflects the way in which the relationships between political authorities and economic actors are governed. What kinds of risks have to be managed between the emerging trade blocs or between the frontiers of different spheres?

[407] Zysman, John. 1996.
[408] Cohen.1991.

6.3.1 Governing Political Risks in External Environments

6.3.1.1 Balance in a Plurilateral World.

In the plurilateral core, market-baseness is also a rule of the game in political economy. Political risks are governed by harmonization policies. Although the political governance of stable rules of the game in societies is primary, political hierarchy in exchange is, generally, an exception. Political risk instruments are not demanded by the market actors. An example of the borderline cases, a concept of liberal protectionism in the USA is analyzed in this section.

In the European Union, the commercial safeguarding instruments are among the commercial measures the European Community can take in respect of imports and exports. The objective of these instruments is to protect the Community market from imports, either because of sudden disruptions caused by such imports ("safeguard measures") or because the imports are unfairly traded (anti-dumping and countervailing duty measures).

Measures can also be used against trade barriers established by third countries or to assert the Community's international rights not only to protect the domestic market, but also to defend the Community's exporting interests. Safeguard measures are part of the framework of the basic regulations, mentioned above for establishing the Community's import regime.

Safeguard measures are dealt with in the framework of the basic regulations mentioned above for establishing the Community's import regime. Member states may take safeguard measures against imports in certain cases.[409] Member states are required to inform the Commission of the action they intend to take or have taken. The current Community Regulation on countervailing measures closely follows the WTO Agreement. There is the field of anti-dumping measures and the basis is in EC regulation. Also, material injury subsidies are given to “sunset provision,” but in GATT

[409] Article 113 of the Treaty of Rome defines the measures Member Statea Member StateMember State has.

the subsidies policy has followed the commercial policy definitions.[410] In the European Community, tariff classification has a predominant role in the implementation of a whole set of trade rules, including trade defensive mechanisms such as anti-dumping or safeguard measures. The WTO agreement has the central status in the framework of rules.[411]

Compared to the European Community's regime, the U.S. regulation of foreign trade and investment is better institutionalized and legitimized. USA has a longer path-dependent history of governing foreign trade and investment due to the formal and informal rules of the game of the market-based political economy. When analyzing the European Union's instruments, the United States with its relationships with international markets is a more comparative unit than are the single Member States of the European Union.

6.3.1.1.1 Liberal Protectionism as a Borderline Case of the Liberal World Order

'Brussels plans sanctions on US. The European Commission yesterday proposed slapping wide-ranking trade sanctions on politically sensitive US products – including fruit, T-shirts, and even billiard tables – in retaliation for US-imposed steel tariffs.'[412]

US decisions to steel tariffs would harm Finnish industry indirectly due sharp competition elsewhere.[413]

According to Jonathan Chrystal, there is a demand side of the political market in the United States, where domestic producers demand political instruments for the Incoming Foreign Direct Investment (IFDI) policy. The political market appears as import barriers to formal restrictions on IFDI. [414] Another research concludes that the opposite is true based on an empirical study. According to Hathaway, the continued openness of the U.S. economy during the 1970s and 1980s poses a puzzle for many theories of political economy.

[410] Macleod, Hendry & Hyett. 1996:279.
[411] Vander Schueren.1997: 255–275.
[412] Mann, Michael.2002.
[413] *Kauppalehti.*4 Sept.2001.

> *Despite the world economic recessions of this period, the influx of cheap goods from Asia, and the increased competitiveness of European Firms, demand for protection was much lower than many scholars, particularly interest-group theorists, had predicted. In fact, many U.S. industries that were hurt by these trends actually became less protectionist. Although the use of non-tariff barriers increased during the 1970s and 1980s, these trade barriers proved to be less effective in reducing trade than the tariffs they replaced. Unilateral reductions in U.S. tariffs continued unabated, regional trade agreements blossomed, and the global movement toward multilateral trade liberalization marched steadily forward.*[415]

Therefore, as a borderline case, it is possible to consider "liberal protectionism" as a cause of political risk in the United States and apply it as a cause of political risks in the plurilateral core generally. Vinod K. Aggarwal used the concept of liberal protectionism in his study that focuses on the reasons for emerging protectionist sanctions that were faced by foreign companies in the U.S. markets. Restrictive policies that are targeted towards foreign companies are emerging from the complaints about unfair foreign competition by U.S. companies.[416] Liberal protectionism focuses on the political reasons for setting the barriers of trade. At the same time, it captures the boundaries of liberal trading order in the plurilateral core.

The policy-oriented approach in the paradigm of political risk illustrated risks in a stable economic environment. According to this approach, it can be asked, what are the rules of the game and borderline cases in liberal market-based world order. The political environment for economic action in the European Union reflects the rules of the game in the U.S. political markets. One reason is the competition positions of these regions, as well as the development towards harmonization of the rules. A general frame for the liberal order is set in the WTO agreement.[417]

---

[414] Crystal, Jonathan.1998.513.
[415] Hathaway.1998:575–613.
[416] Aggarwal.1985 & 1991.
[417] WTO report by Secretariat 1997. Trade Policy review European Union WT/TPR/S/30.

In United States, the power of managing international economic policy and trade policy is concentrated in the President and presidential units of political governance. The power circle includes the National Security Council and the Agency for International Development. At the implementation level, the Office of the United States Trade Representative, whose responsibility covers the trade negotiation in General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), and Organization for Economic Co-operation and Development (OECD). Congress, Interests groups, and the press set pluralist limitations for economic policy.[418] Economic relations are highlighted in relationships between the European Union, Russia, Japan, and China.[419]

Risks that are faced by foreign companies in the United States are protectionist ones. Aggarwal, Keohane & Yoffie characterized this protectionism as a negotiated regime. The barriers towards foreign economic activity were set by institutionalized, temporary and sporadic protectionism depending on the patterns of the barriers. Barriers to entry were set by industrial sectors. The threat experienced by the domestic industry, was reflected in negotiated barriers in the 1970s and 1980s.[420] From the point of view of the political risk analysis, the negotiations refer to predictability.

In addition to the complaints of unfair foreign competition, security issues may turn into a cause of political risks. According to Krugman, the foreign trade statistics indicated that among the foreign direct investment in the United States, 86 per cent originated from the allies of the United States. In 1994, the investments from Eastern Europe and Russia were minimal, from the Middle East one percent and 14 percent from the other non-allied states.[421]

As a response to liberal protectionism, the European Union has instruments of its own, which are based on Article 113 of the Treaty of Rome and in Common Foreign and Security Policy based on intergovernmental decision-making.

The EU and the United States form a global partnership, covering not only trade, but

---

418 Kegley & Wittkopf, 1991:279–322, 355–453
419 Graham &Krugman, 1995:144–146, Spero.1990:203–235
420 Aggarwal, Keohane & Yoffie.1987.
421 Graham, Krugman, 1995:97.

also co-operation on a whole range of foreign policy issues and global challenges. In December 1995, the EU-US Summit adopted the New Transatlantic Agenda together with a Joint EU-US Action Plan. Thus, these agreements are manifold, and the regulations are based on multi-level governance in a way that the relations can be characterized as a plurilateral regime.

The set of institutions and rules of the game adopted by trade blocs affects the demands for protection of trade authorities by companies. The design of protective institutions in trade blocs plays an important role in determining the commercial policy. In the absence of a strong political commitment, there is a danger that protectionist forces will capture the design of new institutions. The trade blocs should adopt a simple and transparent trade policy decision-making process emphasizing the welfare effects of trade policies on the general interest in the market-based system.[422]

6.3.1.2 Governing the Borderline Case of Instability

In an environment belonging to **the second category of plurilateral regime**, the role of political governance and political authority is increased in comparison with the business environment in the core. The instability approach concerning the rules of the game illustrates the political governance in order to create predictable economic conditions in the environment. Specific contractual agreements are an example of these borderline cases. Thus, their relevancy is more related to the concept of trust than legitimacy.

In the case of the United States, the frame for political risk illustrated the policy approach in the paradigm of political risk in a plurilateral core. In regard to Russia, the frame concerns the instability approach. The framework concerning trade and investment relations between the EU and Russia can be seen as a specific part of contractual commercial policy. The contractual commercial policy comprises agreements concluded between the European Community and the third states and the European Community's participation in multilateral agreements. At the end of the transitional period, the Community acquired exclusive competence to conclude such trade agreements.

Compared to the United States, the rules of the game between the European Union and Russia are based on contracts made on a macrolevel and political governance more closely than in transatlantic relations, where companies at the microlevel have more market-based risk management instruments available.

During the transitional period, a number of measures were taken to facilitate for the common commercial policy of Member States' bilateral treaties with Community treaties. These measures comprise a progressive replacement of existing Member-State bilateral agreements in the field of commercial policy by Community agreements, strengthening EC's competence in this field, although Member States maintain agreements dealing with the deeper economic co-operation.

Foreign Direct Investment in Russia and Political Risks

The following quotations represent points of view of Finnish business life in assessing Russian markets, investment environment, and prevailing risks. Estimates for Russian environments vary widely, ranging from environment of high risks where the immediate no-go decision is the only decision, to estimates of high prospects. All in all, quotations taken from the leading Finnish and international business newspapers stress political factors causing risks to companies. These seemingly irreconcilable differences vary as unpredictably as the Russian business environment itself. The unchanging characteristic is that only a few question the need for investments in the Russian environment.

Apart from the microlevel quotations, ETLA has carried two wide empirical surveys on industry cluster investments in Northwest Russia. The first, published in 1999, stated that Finnish companies have pursued a cautious investment strategy in Russia[423]. The most recent one, published in October 2002, reveals that Finnish industry is investing in Russia again. Even though investments are modest, a certain confidence has been indicated concerning the Russian market.[424]

---

422 Sanoussi. 1998.
423 Hirvensalo.1999.
424 ETLA. Industry Clusters Analysis in North West Russia. 2002.

Financial sector

Despite development there, we have to bear in mind that the Russian market is considered uncertain and volatile. Even if the three biggest credit ratings agencies [international] have upgraded Russian scores, from the point of view of exchange markets, Russia is still considered a less developed country. Kauppalehti 16 Nov. 2001.[425]

Finnvera [export credit] *is giving export credit guarantees to Russia again. However, Russia is rated with a score of 7/7, which is the lowest score. Guarantees are supplied only to the best export companies for up to three years time. In practice, these companies are operating in the sectors of energy and raw materials.* Kauppalehti. 23 April2000[426]

The Finnish banks learnt their lesson from the crisis of the early 1990s when almost all the banks had heavy liabilities in the Soviet Union. Kauppalehti 15 Oct. 1998.

Exchange-listed companies

None of the Finnish exchange-listed companies have taken high risks in the Russian market with the exception of Hartwall [brewery]. Kauppalehti. 24 March 2000.[427]

Most of the Finnish exchange-rated companies have taken risks in Russia. It would be surprising if the Russian crisis would not have had an effect on the Finnish companies. Kauppalehti 10 Sept 1998[428]. [Russian economic crisis started in August 1998.]

---

[425] Hyvästä kehityksestä huolimatta täytyy muistaa, että Venäjän markkinoita pidetään edelleen epävarmoina ja volatiileina. Ja vaikka kolmen suurimman luottoluokittajan Venäjä-reittaukset ovat nousseet, voidaan Venäjää pitää osakemarkkinamielessä edelleen kehitysmaana.' *Kauppalehti* 16 Nov.2001.

[426] Finnvera avaa taas takuitaan Venäjälle. Venäjän jää kuitenkin matalimpaan 7/7 ryhmään. Vientitakuita yritysriskille Finnvera myöntää ainoastaan parhaille vientiyrityksille kolmeen vuoteen saakka. Käytännössä nämä yritykset toimivat usein miten energia- ja raaka-ainesektorilla. *Kauppalehti.* 23 April.2000.

[427] Yhdelläkään suomalaisella pörssiyhtiöllä ei ole suuria riskejä Venäjän markkinoilla, ehkä Hartwallia lukuun ottamatta. *Kauppalehti.* 24. March.2000.

[428] Venäjä-riski on useilla listatuilla yhtiöillä. Olisihan se yllättävää, jos Venäjän tilanne ei vaikuttaisi suomalaisyrityksiin.' *Kauppalehti* 10 Sept.1998

Food industry sector

Valio [dairy] *is avoiding the Russian risk. Henceforth, our strategic market will be the European single market that is characterized by non-volatile demand'.* Kauppalehti 12 April 2002[429]

Energy sector

Fortum [Oil] holds the best prospects for market growth in Russia. It owns gasoline stations in St Peterburg and Viipuri, oil exploration and upstream licenses in the Timan-Petchora area, and a share in planning the giant Stokmanovskoje oilfield, as well as a 25 percent share of Gasum, a company planning to supply natural gas from Russia to Central Europe via the Baltic Sea. Kauppalehti 24 March 2000.[430]

Telecommunication sector

A company with prospects for growth is Sonera [telecommunication operator], which is putting on the market an international optical fiber cable network in Moscow. Kauppalehti 24 March 2000.[431]

Forestry sector

Exchange-listed companies have pilot investments [in Russia]*: UPM-Kymmene* [Forestry] *owns a furniture factory, Stora Enso* [Forestry] *owns a package factory and it is makingn a sawmill investment, Metsä Serla* [Forestry] *has package factories in St.Petersburg and Krasnodar.* Kauppalehti 24 March 2002.[432]

---

[429] Valio aikoo vähentää Venäjän riskiään. Aiomme vahvista asemiamme nimenomaan EU:n sisällä, koska näillä markkinoilla kysyntä on vakiintunut eikä heilu suhdanteiden mukana. *Kauppalehti* 12 April.2002

[430] Parhaat kasvumahdollisuudet ovat varmaankin Fortumilla, jolla on hultoasemaketju Pietarissa ja Viipurissa, osallisuus öljynetsintä- ja porauslisensseihin Timan-Petsoran alueella, osuus Stokmanovskojen jättimäisen kaasukentän suunnitteluun sekä neljännes Gasumista, jonka on määrä ryhtyä toimittamann kaasua Venäjältä Itämerta pitkin Keski-Eurooppaan. *Kauppalehti* 24 March2000.

[431] Kasvuyritys Venäjällä lienee myös Sonera, joka on saamassa lanseerausvaiheeseen kansainväliseen kantaverkoon liittyvän valokaapeliyhteyden Moskovaan. *Kauppalehti* 24 March2000.

[432] Monella pörssiyhtiöllä on pilotti-investointeja, UPM-Kymmenellä on huonekalutehdas, Stora-

Finnish companies have pursued a cautious investment strategy in Russia. Particularly large enterprises have made only small investments in relation to their resources. Small and medium-sized enterprises have made larger investments compared to their resources, but also in their case investments have been mostly in the form of used machinery and equipment. The cautious investment strategy has proved wise particularly in light of the Russian economic crisis, which has tightened the financial situation of all Russian subsidiaries.[433]

In 1997, the investments totaled only 4% of Finnish exports to Russia. In comparison, investments were 48% of Finnish total exports. The Russian economic environment is considered highly problematic.[434] Russian legislation and regulations and the functioning of Russian authorities topped the list of the Finnish managers" worries. The Customs was experienced as the foremost problem area, while legislation, bureaucracy, authorities, and taxation also figured high.[435]

As a whole, the gross foreign investment in Russia was USD 10, 958 billion in 2000, of which Foreign Direct Investment accounted for 40.4%. Compared to 1999, FDI increased by 3.97%. FDI sectors were food and catering, food industry, transport, and communications, where almost half of the investments were made in 2000. The USA, Germany, Cyprus, and the Netherlands were the biggest investor countries accounting for over 50% of all investments. The USA had made the biggest cumulative FDI as of the end of 2000, totaling 34%. Cyprus is the second biggest investor, totaling a cumulative FDI of 19.9% [436]

FDI to Russia totaled USD 2 billion in 1995, USD 2.4 billion in 1996, USD 5.3 billion in 1997, 3.4 billion in 1998, USD 4.3 billion in 1999, USD 4.4 billion in 2000, and USD 4.0 billion in 2001.[437] Why is the number of long-term Foreign Direct In-

---

Ensolla pakkaustehdas ja suunnitelma sahaustoiminnasta, Metsä-Serlalla on toimivat pakkaustehtaat Pietarissa ja Krasnodarissa. *Kauppalehti* 24 March.2002.

[433] Hirvensalo.1999:1.

[434] Rautava. 1999:10.

[435] Azeem.2002:4.

[436] Tiusanen, Vinni, Jumpponen.2002:36–37.

[437] Central Statistical Office of Finland. http://www.stat.fi/tk/tt/ibs/ibslahialuetietokanta.html. 27. Aug 2002.

vestments (FDI) low in Russia?[438] According to Moran, foreign investment in natural resource and infrastructure projects has long been among the most sensitive of all international corporate activities.[439] Does this sensitivity matter? Why do foreign investors choose the no-go alternative concerning the Russian market? Is there really a demand for Foreign Direct Investment in Russia? How do the obsolescing bargain factor model with multiple political authority levels and neo-institutional variables, and the formal and informal rules –of the game explain the political risk in the no-go investment decisions?

Capital Flight

Capital flight is a quantitative indicator of political risk in a business environment. It measures both the formal and informal rules of the game. Lensik, Hermes, and Murinde demonstrated in their empirical analysis that political risk leads to increased capital flight[440].

Economist Intelligence Unit (EIU) reported that foreign investments are staying away from Russia. Capital flight from Russia was USD 18 billion in 2001, compared to USD 28 billion in 2000. The first quarter of 2002 indicated that capital flight was falling and net private capital inflows were increasing. The EIU reported that the reason for falling capital flight is that Russian businesses have increased their domestic investments. Nevertheless, the net foreign direct investment (FDI) was negative, amounting to USD 2.5 billion in 2001, equivalent of 0.8% of GDP, compared to other transition economies in Central and Eastern Europe, where the ratio is 5–10%. A significant portion of Russian FDI was repatriated flight capital (30% of the total FDI) [441], that is a positive sign because it shows, among other things, that the rules of the games are becoming more predictable from the point of view of Russians concerning the Russian business environment. One interesting FDI was made by British Petroleum when it raised its stake in the Russian oil company Sidanko in 2001. That investment totaled USD 375 million, (7.2% of the FDIs in 2001). BP's decision was a sign of new confidence as will be shown when analyzing the case of bankruptcy as

---

[438] Long-term investment refers to investment in physical assets.
[439] Moran.1998:70.
[440] Lensik, Hermes, Murinde.2002, ref. Chapter 5.2.2.
[441] Economist Intelligence Unit Limited, Country Report Russia, 11 June 2002.

a variable of political risk causing the no-go investment decisions of foreign investors.

According to the EIU, during the first quarter of 2002, one of the biggest foreign investors in Russia was British Petroleum investing in energy sector. Despite this investment, the food and retail sector was the main target of the Foreign Direct Investments totaling 32.3 percent of the total FDI. Foreign investors are cautions about informal rules of the game. The informal rules of the game; corruption, the reliability of the Russian partners, the behavior of local competitors, and the extent to which the law is an effective means of protecting investors' rights were mentioned as the causes of risks that were preventing investment decisions in Russia. Transactions cost are, therefore, unpredictable.

Bankruptcy

The abovementioned informal rules of the game are causing unpredictability, especially when political authority is not maintaining predictable rules in the investment environment. Predictable rules mean that laws are implemented in a way that a foreign investor can rely on the rules of the game in the long term. Political risk may occur when bankruptcy legislation is implemented in a way that the political rules intermingle with the economic rules and the formal rules intermingle with the informal ones as is the case with corruption. When comparing investment environments in Russia, the USA, and the European Union, a borderline case is bankruptcy[442] that both divides and combines these environments.

When analyzing bankruptcy using the obsolescing bargain model, it can be seen that it is an important variable that now prevents FDIs (no-go decisions) and causes capital flight. In the obsolescing bargain factor model, political risks are caused by a company's diminished bargaining position in the operational environment. The bar-

---

[442] Refers to the *Financial Times* investigation into the USD 3.3 billion fortune made by executives and directors from the 25 largest US public companies to go bankrupt since January 2001. *Financial Times*. 31 July 2002. Matthew Josephson published *The Robber Baron* in 1934, when the USA was in the middle of a backlash against the financiers and industrialists who many believed had led the country into the crash of 1929 and the ensuing Depression. The book struck a chord with a disillusioned public because it offered a history-repeats-itself view of capitalism's dark side. … In the late 19th century, regulation was almost non-existent. Courts swept away such restrictions on business practice as did exist. The barons were unscrupulous and opportunistic as they built up empires in railways, finance, oil, and steel in the USA.

gaining power is diminished by instability or by the policy of the host country's political authority. In the case of instability, political authority fails to maintain or implement predictable rules in the environment.

After my December TV inter-active show, I got half a million messages. Of these 75 percent were complaints about the interference and illegal actions of state officials and institutions. President Putins's State of the Nation Address. 18 April 2002.

Exploitation of bankruptcy legislation in the underdeveloped markets is a method used by oligarchs in pursuit of economic power in Russia. The *Financial Times* has drawn attention to bankruptcy offences in Russia. Medium-sized companies, especially those operating in the steel industry, are run into bankruptcy as members of the oligarchy are "centralizing production".

According to the *Financial Times*: "One large Russian oil company explained that after the August 1998 economic crisis, many otherwise profitable firms experienced temporary liquidity problems, which their competitors used to bankrupt them. 'The bankruptcy process does adequately take into account the legal rights of shareholders,,' said the company. In the case of Sidanko, a large west Siberian oil company, shareholders, including BP/Amoco, the international oil giant, have stood by helpless as some of its most profitable subsidiaries have been cherry-picked by rivals through bankruptcy." [443]

It has been previously noted that plutocracy was created in Russia by the oligarchs. An article published in *Foreign Affairs* described the method by which the oligarchs established their status in the energy sector by using the guarantee instrument; the state was made to mortgage, for example, parts of its energy resources and production. As financial difficulties occurred , proprietary rights were transferred to banks owned by oligarchs. It is no longer possible nor even necessary to mortgage state property, when the economic sectors are controlled by oligarchs. [444]

[443] Clover, Charles. 2000.
[444] Wolosky, Lee. 2002.

Now the same method seems to be used in the corporate sector. When a company incurs debts and is unable to pay the credit installments, (the oligarchs') banks and creditor companies demand that the indebted company go bankrupt. In Russia, new companies do not yet necessarily operate relying only on cash flow financing which is why, for example, foreign companies have the following two possibilities: 1. to inject (forever) more money into their subsidiaries, which does not pay, since cash flow financing is not yet expected 2. to let the subsidiary company go bankrupt – which is the only alternative in that kind of situation. Consequently, a company that is in full working order is stranded under the control of these creditors. This applies to both foreign and Russian medium-sized companies with debt capital. After this the oligarchs establish a large company, into which the medium-sized companies have been merged, and produce for example steel for foreign markets below transformation costs. On the international markets, the current market price is charged and the income thus obtained remains abroad; that is, the proceeds are not used for such activities as investments to develop the sector in Russia.

In any case, the Russian law cannot, in practice, prevent bankruptcy offences. From the point of view of foreign companies, this presents a barrier to investments and hinders business activities, because other partner companies cannot be credited on account of lack of confidence, and there is no justice for the party that has suffered. The bankruptcies of BP Amoco's subsidiaries serve as examples of this.

A wave of bankruptcies would be an obvious consequence in case the present economic boom turns into a recession, since information about the methods that have been used spreads rapidly. Legitimacy missing, the "rich" subsidiaries owned by foreign companies present an excellent target for bankruptcy offenders. From the point of view of the oligarchs' activities, an economic slump would be a good opportunity to spot the profit-making companies that may have been set up in Russia. Neither foreign nor domestic companies have data protection in respect of, for example, cash flows in Russia. Viewed from this perspective, confidence in continuing economic growth is very fragile. Cash transactions are still the only safe form of economic co-operation. Companies should devote intensive attention to the development of trade with Russia, because it appears that it will not be possible to find a remedy to the problem of bankruptcies in the near future. One solution would be guarantees by the Russian Federation to certain key companies which would impede this kind of development on a case-by-case basis, but after that it would no longer be a market economy.

Market regulation has developed in the Western industrialized countries over the centuries, but has no path dependent history in Russia even if the importance of market-based regulation has been recognized in recent years. It is true that going bankrupt is an acceptable reaction in the market economy in case business activities fail, but this takes place only in a strictly regulated environment whilst ensuring that the legal interests of the shareholders and other interest groups are secured.

Considered from the point of view of political risk management, this involves a specific qualification. We are dealing with a risk arising from the political operational environment – a political risk, a factor rendering the transaction costs unpredictable in the obsolescing bargain factor model. In spite of this, it cannot be regarded as a political risk against a company for which the Multilateral Investment Guarantee Agency MIGA, for example, could provide guarantees. It is compounded with the market risk because, in the end, the company has run into liquidity problems. It is impossible, in practice, to identify the origin of the risk involved. In addition it should be borne in mind that limited companies were created in order to manage complexity in operational environment which is taken as given. If there is a risk that the environment is not manageable by the foreign investor by the formal rules of the game, a no-go decision is inevitable. Therefore, bankruptcy offences should be recognized as an indicator in political risk analysis concerning acquisitions and merger value creation decisions.

When comparing stable and predictable merger and acquisition environments, first the business environment in the European Union should be called predictable as a starting point. The European Union governance in the internal market sets the rules of the game and boundary lines in the equilibrium between the economic actor and political authority and legitimacy prevails. Second, the stabilized rules of the games are reflected in the external relations of the European Union. The European Union is harmonizing the national policies and thus creating a new political economy milieu where acquisitions and mergers become possible. Market rules are fully legitimized.

This does not mean, that there were none of the unpredictable rules of the game in the internal markets. On the contrary, there are unpredictable rules because of the existing national fragmented rules. However, there is a continuous game and the shadow of the future is enlarged, as Robert Axelrod defined (4.1.3). Without continuity there will be no co-operation. Bankruptcies have also been in the spotlight in the USA. According to the *Financial Times* "Top executives and directors of the biggest US business collapses amassed billions in salary and share sales while the stock markets was still booming. In three years, they crossed about USD 3.3 billion before their companies went bust having wiped out hundreds of billions of dollars of shareholders value and nearly 100 000 jobs.*"* In addition a *Financial Times* survey looked at the history of bankruptcies in the US since the days of early –20th century corporate America, when the balance of risks and rewards were questioned in the railways, oil, finance, and steel sectors.[445] Regarding the situation in Russia, why is bankruptcy a political risk variable when it is not in the US and the European internal market. According to Axelrod's requirement of continuous game, there are predictable ways of dealing with that risk variable in the long term. Bankruptcy in the US and European Union markets is an exception and its consequences are manageable. In Russia, there is lack of continuous rules of the game in the political environment. Instabilities make foreign companies wary of the risks in Russia. In the case of liberal protectionism in the US, the mechanisms of the political markets are predictable even though risks occur. Co-operation in the OECD and WTO process is a warranty of the continuous game.

However, even though informal rules are hindering investment in Russia, it is not the case when it comes to Russian companies operating abroad where predictable rules prevail. The *Financial Times* stated that a growing number of Russian managers are aiming for acquisitions in the West. There were several examples. The Greek government decided to sell 23% of Hellenic Petroleum. The Russian Yukos and Lucoil companies were among three frontrunners in the competition. In addition, Russian Gasprom acquired a 10 per cent share in the German group Wintershall. Earlier Gasprom had acquired Hungarian and Romanian companies, as well as expanding control over refineries and pipelines in the Baltic States, Slovakia, Kazakhstan, and North America (Getty Oil). Because of the growing domestic economy of Russia, the

[445] Hill, Andrew. 2002.

managers can react when high-quality Western assets are available cheaply.[446] In Finland, over 1,500 joint-stock companies with Russian management participation were registered by the beginning of 2001 and the cumulative Russian FDI was USD 260 million[447].

Therefore, managing international mergers and acquisitions is a reality when their logic is characterized by the legitimized rules of a market economy. Where mergers and acquisitions are performed geographically, they depend on the level of stability of the legitimate rules in a business environment. In addition, because of different organizational cultures between European and Russian companies, there is value capture available only in the short term. The integration process of the totally different company cultures between acquiring and acquired companies may risk the value creation in the long term. However, because investments are possible for Russian companies in the US and Europe, it should also be reciprocal.

> **Russia business finds bankruptcy route to expansion**
> *Financial Times*, By Charles Clover
> Published: July 24 2000 17:19GMT | Last Updated: July 24 2000 17:31GMT
>
> *Aleksander Abramov did not have to buy any shares to acquire Russia's huge Kemerovo steel plant this spring. He bought the plant's debts, gathered a few signatures, and sued for bankruptcy. Now he runs Euroasholding, the 10th largest steel producing company in the world, producing 12 million tons per year from three huge Siberian mills, two of which (including Kemerovo) he acquired through bankruptcy. He is the latest in a series of Russian businessmen to use the country's controversial bankruptcy law to amass a business empire of enterprises.*
>
> *Mr Abramov, for instance, has not laid anyone off at the bankrupt steel plants. In fact, he has actually increased the workforce since his company took over as the plant's external manager, and has nearly doubled production. He is finally starting to buy the shares. "I can say confidently that the plant is no longer in crisis," he said. "That is the point of bankruptcy: promoting effective property ownership." But bankruptcy in Russia is controversial, mainly because it is so uncommon. Bad debts in the Russian economy equal between one-quarter and one-third of the country's GDP, according to the World Bank. But only a fraction of the enterprises actually get bankrupted. Enterprises that have most often filed for bankruptcy include steel plants, aluminium smelters and oil companies, which are among the most profitable industries in the country. In fact some analysts contend that bankruptcy is just a tool to change control of lucrative chunks of the Russian economy. "Bankruptcy has become the favourite means for reapportioning property," said Yulia Latynina, a respected economic journalist in Moscow.*
>
> *Last winter, RAO-UES, Russia's electricity utility, sued or threatened to sue two of the country's largest aluminium smelters for electricity debts, forcing shareholders of the Trans-World Group and Mikom, two Russian aluminium-trading companies, to sell out. The shares have wound up in the hands of the gigantic Russian Aluminium, run by Oleg Deripaska, who enjoys a close relationship with Anatoly Chubais, head of RAO-UES. Mr Deripaska said that it was not his fault that his competitors were not paying their bills, "aluminium is the third most prof-*

[446].Financial Times 2 Feb 2002.
[447] Liuhto, Jumpponen. 2002:7.

itable business in Russia, after oil and chocolate. If you can't pay your bills, it means you are making too much of the money offshore."

Mr Abramov also defends the practice, saying that many enterprises that look bankrupt are not in reality, but make their profits in offshore zones using complicated transfer-pricing schemes. Bankruptcy, he says, forces companies to stop the practice: "It's a fact that in Russia, the process of bankruptcy has been used as a tool for market expansion. But let me underline that it is a market mechanism. If you don't want to get bankrupted, you just have to pay the debt." According to the targets of bankruptcy, a main problem is that the courts can order enterprises to pay huge sums within very short grace periods – typically 100 days.

One large Russian oil company explained that after the August 1998 economic crisis, many otherwise profitable firms experienced temporary liquidity problems, which their competitors used to bankrupt them. "The bankruptcy process does adequately take into account the legal rights of shareholders," said the company. In the case of Sidanko, a large west Siberian oil company, shareholders, including BP/Amoco, the international oil giant, have stood by helpless as some of its most profitable subsidiaries have been cherry-picked by rivals through bankruptcy.

In other cases, local prosecutors have filed criminal charges against companies, freezing their bank accounts, and then rivals have taken them to bankruptcy court. The bankruptcy process has put an unprecedented amount of economic power in the hands of Russia's 89 regional governors, who control the local court systems in which the bankruptcy suits take place, and in practice often get to name the external management. Recently, the Kremlin has started to tame the governors with legislation designed to shrink their powers. But the governors are so firmly entrenched that it will be a tough fight.

Bankruptcy also means that Russia's biggest creditors, natural gas monopoly Gazprom, RAO-UES, and the railways, now have gained a huge degree of control over the distribution of property. Just as RAO-UES toppled the established order in the aluminium industry, Gazprom has been doing it with steel – it was debt to Gazprom that Mr Abramov used to acquire Kemerovo steel plant. Mr Abramov said the flaws in the bankruptcy process are mostly a product of legal inexperience in Russia's fledgling market system. "We need a few years to accumulate juridical expertise, and then everything will be fine," he said.

The Levels of Political Risk Analysis

Is there really demand for Foreign Direct Investment in Russia? The political risks are located at the same levels in Russian investment environment as they are in the European Union and the United States. The risk levels are the security level, the Federation level, the Area level (State), and the Society level. It is hard to identify the present economic system in Russia[448]. However, the political environment apart from society and economy determine the economic system, as well as the environment for FDIs. According to Antti Karppinen, four political identities can be identified covering the risk levels in Russia. He emphasizes that the cultural factors are numerous at the society level. With these identities, the old Soviet nomenclature has divided into two subgroups and those groups now form the economic actors of Russia.[449]

[448] Sutela, Rautava.2000:300.
[449] Karppinen. 2000, 2002.

The political identities consist of the facts that, first, as a superpower, Russia's identity is based on its role of a major nuclear power state. Russia is able to use that power if needed. The North Atlantic Treaty Organization has expanded "out-of-area" and is considered a threat.

Second, Russia is a Euro-Asian superpower. The Far East dimension is connected to ASEAN relations and Transatlantic and European relations are connected to the US. and European Union relations.

The third identity is based on the empire of the former Soviet Union. This identity defines the relations with the Baltic States and the Commonwealth of Independent States, CIS. According to this third identity, there is a conflict concerning the process of the World Trade Organization. If the economy is liberalized, the present economic activity, where the oligarchs are using power and the borderline between public and private rules is fuzzy, is being threatened by the more transparent rules of the game.

The fourth Russian identity is the establishment of the Russian Federation. It defines the relations "borderlines" with the states formerly belonging to the Soviet Union's empire. The relations with the CIS are based on bilateral relations. Energy is the main sector of economic co-operation. The United Nations forms a significant forum in international relations.

In addition to the formal political authority levels, there are contradictories in adopting an attitude toward the present political and economic transition at the society level. Around the Baltic sea, attitudes towards Hanseatic trade vary. Also, there is contradiction between the old Russian and Soviet virtues of community and the Protestant virtue emphasizing entrepreneurs and private property. Besides, there are 140 peoples in Russia causing fragmentation of the informal rules of the game.

After the collapse of the Soviet Union, the former Soviet nomenclature is divided into two groups; the propagandists and the management. The ideological propagandists are active in politics, or in religious matters. The management, however, has gained its position through the privatization process and it forms the group of owners of the industry sectors or alternatively, the ownership is materialized through the ownership of the finance sector.

The group of managers is divided further into two subgroups. One of those who have lost their prospects in business and one those of “the natural monopolists”. The natural monopolists have met with their success in the privatization process of the electricity, oil, gas, transportation sectors, and the railway sector in the near future. The group of the natural monopolists is divided into the neo-capitalists who are determined to build an empire, and the aspirants of the maximum disposal, who are responsible for the capital flight.

The neo-capitalists, as the determined builders of the Russian empire, are operating and developing their business in Russia. There is a demand for spare parts and infrastructure investment in order to foster the economic development further. The neo-capitalists are operating in the aluminum, mineral, and forestry sectors. The group is also supporting the financial sector reform under the government control. From the point of political risk, Levinsohn has suggested that an instrument of managing political risk by the foreign investor is to borrow money from the local bank. He concludes that by engaging locals in profit-making the level of political risk will be lowered.[450] However, because the financial sector reform is still under way, this may not yet be a way of managing risks in Russia.

There are political contradictions in the economic environment that are causing instability for domestic and foreign investments. In the Soviet Union, 75 per cent of the economy was linked to the war industry. The Gosplan diversified the strategic production to the Council for Mutual Economic Assistance countries (CMEA). In any given state, the diversified production consisted of partial components. During the new political economy, the CIS countries have not been able to build up a stronger geo-strategic community than that of the Soviet Union. The infrastructure is breaking down throughout the CIS. The level of infrastructure is even lower than in the former Soviet Union.

[450] Levinsohn.2002.

More over, the development of the telecommunication sector collides with the old political culture and is strengthening the civil society as it does in the European Union and the United States. Controlling the telecommunication sector is difficult. From the point of view of the old political culture in Russia, this sector will bring "too many strangers" into the game. There is a challenge that relates to the development of the Arrow of Time. By strengthening the civil society, the middle class as entrepreneurs are making the control of civil society and the restoration of the authoritarian regime more difficult. Despite efforts to limit these forces, the use of information technology will strengthen them.

Russian identity is linked to its role as a major nuclear superpower. It follows that "it is expensive to live in Russia". The assets of the mobilization –economy are used in withstanding the siege and maintaining defense. In this respect, the Russian dialog with the USA is a determinant variable defining how much assets the war industry demands. How much can an economy, comparable to that of Belgium, use in the war industry sector knowing the wide unviable area of Siberia. In addition the Baltic Sea, Pacific Ocean, Arctic Ocean, and Black Sea require the presence of the Russian superpower.

The natural resources being utilized by the technology of former Soviet Union are waning. The resources in the Russian Far East will have more and more strategic weight. In addition, there are prospects for further uncertainty at the society level. First, there are 100, 000 unemployed, formerly highly- respected military personnel with no chance of an income from the private sector. Second, 40 % of the citizens live below the minimum subsistence level. Third, the infrastructure is breaking down. Fourth, public services (health, education, social security) are impossible to maintain.

Russian Co-operation with the International Community

When analyzing the Russian Business Environment and its relationships with the rules of the international community, the international development banks role, as well as the WTO process, form the framework for analysis.

As the end of May 2002, Russia had received a total of SDR 21.5 billion in International Monetary Fund assistance. The Fund has not made any disbursements to the Russian Federation since mid 1999.[451]

The commitment of the International Bank for Reconstruction and Development totals USD 12 billion for 52 projects. (May 2002). Its strategy, in co-operation with the Russian Government, focuses on three issues: First improving the business environment and enhancing competition. Second, strengthening public sector management and third, mitigating social and environmental risks. IBRD finances mainly public sector infrastructure projects, whereas the International Finance Corporation IFC finances the private sector. IFC's portfolio totaled USD 248 million in spring 2002. It is operating in financial services, banking, manufacturing, communications technology, and agribusiness. Multilateral Investment Agency MIGA had an outstanding portfolio in Russia of ten guarantees with a total of USD 264 million. There have been no claims against Russian projects.[452]

The European Bank for Reconstruction and Development EBRD will target its operations at fostering regional investments and promoting the restructuring of the infrastructure. It is also emphasizing the private investment flows to Russia, as well as SME sector investment and financial sector reform. In spring 2002 EBRD approved EUR 4.3 billion for investments in Russia.[453]

The international development banks are financing the Russian transition. Comparing the results, as well as the difficulties, that are faced there will serve as an indicator for political risks assessment and management. The plurilateral regime with market-based rules of the game is taking shape in the WTO membership process of Russia. Negotiations on Russia's accession to the WTO have continued since July 1995. The most critical pieces of outstanding legislation with the respect to Russia's WTO accession are the Customs code, a law on technical regulations, and laws on intellectual property. [454]

---

[451] www.imf.org [in respect 10. Sept 2002].
[452] www.worlbank.org. [in respect 10.Sept 2002].
[453] www.ebrd.com [in respect 10.Sept 2002].
[454] Anttonen, Matti. 2002: 4.

6.3.1.2.1 General Contractual Commercial Policy

Political governance through specific commercial contracts characterizes an attempt to create stability and predictability in the international exchange. Once again, in a plurilateral regime, market baseness is emphasized. Thus, the rules of the game remain so distant from the core of the regime, that political risk management instruments are required.

Concerning political risk, contractual commercial policy has become a more significant area, because the relationship between the economic environment and international agreements is strengthened. An objective is that a state authority would no longer guarantee business risks from the budget and privatization would remove the state ownership. The rules of the game will be formed at global level in the context of multitude contracts. The Member States' previous multilateral contracts are changing to bilateral contracts between the European Union and Russia. Thus, these agreements are not enough for a stable business environment, but a frame for continuous co-operation agreements for a plurilateral regime with a low political risk level.

> *The General Agreement on Tariffs and Trade (GATT) established a common code of conduct for international trade and provided machinery for reducing and binding tariffs and a forum for regular consultations on international trade. The functions of the World Trade Organization WTO are to facilitate the implementation, administration, and operation, and to further objectives, of the WTO Agreement and the Multilateral Trade Agreements, and to provide a framework for the implementation, administration, and operation of the Plurilateral Trade Agreements.*

> *The Council decision approving membership on behalf of the European Community was based on Articles 43,54,57,66,75,84(2), 99,100, 100a, 113, 235 in conjuction with the second subparagraph of Article 228(3) EC. As a member of the WTO, the Community has the right to vote and speak at the ministerial conference and the general council when the Community exercises its right to vote, it has a*

number of votes equal to the number of Member States, which are members of the WTO. The number of votes of the Community and Member States may in no case exceed the number of the member states, which are members of the WTO. No comparable arrangements exist for the matters, but in practice co-ordination takes place within the Article 113 Committee.[455]

OECD

The European Community is not a member of the OECD Convention but its participation in the Organization is defined in an Additional Protocol to the Convention. The Community has no right to vote and as a general rule cannot participate in decisions of the Organization. Many aspects of the work of the OECD are outside the scope of Article 113. The Court of Justice decided that both the Community and the member states had competence and that the Community's competence was not based on Article 113 alone.[456]

The Community is a participant in the OECD Arrangement on Guidelines for Officially Supported Export Credits (the "Consensus"), which is a non-binding arrangement establishing rules governing the grant of export credits and tied aid. The Consensus was first given effect in the Community by a Council Decision of 4 April 1978, which was based on Article 113.[457]

At the level of harmonization of the rules of the game in pluralist liberal democracies, the OECD and WTO are ideologically linked to promote multilateral rules for trade and investment. "An agreement such as the WTO is essentially an exercise of national sovereignty rather than a surrender of it"[458].

6.3.1.2.2 Specific Contractual Commercial Policy

The general framework for the rules of the game of economic relations between the European Union and Russia are based on the WTO Agreement. Thus, the Russian

[455] Macleod, Hendry & Hyett.1996:179.
[456] Macleod, Hendry & Hyett.1996:292.
[457] OJ L44/1 1993
[458] http://www.oecd.org/ech/special.htm 22 Sept..2002

economic environment is a transforming one and, therefore, specific contracts have been made. Market-baseness and pluralism have been the leading political ideologies in specific contracts derived from the general agreements.

What is the purpose of these contracts at the political authority levels that seems to be far too distant when seen from the microlevel of an individual company? In terms of political risk management, political governance is primary in order to stabilize the environment of economic action. Political risk management instruments are by-products of the political governance. There are reasons for this occurring, and, among others, political authorities are able to set the rules of the game for continuous co-operation in the long run. If there is temporary but drastic turbulence or instability, political relations are more durable than private economic actions. Political structures are more permanent than economic ones. This argument can be supported by the limits of political authority, as illustrated by Suzan Strange in Part Two. The halo effect in the market means that economic actors are acting and making decisions by scanning the general opinions in the environment without knowing the facts. Decisions have to be made instantly in uncertainty. Political authority may resist longer the halo-effects on the indicators of the turbulence. Actually, political authority structures have their reason for existence in managing the turbulence and halo-effects.

Political governance has instruments that can be divided into framework contracts and risk management instruments that are offered to companies. Hence, it can be argued that the more instruments available for risk management supplied by political authority, the higher the risk level is in an environment. If the economic environment is stable and predictable, the general contracts are sufficient for creating trust that enables the market-based rules of the game. Political environment's relations with the international community are, therefore, important indicators. It characterizes the trust level in political governance that reflects the stability in relationships between economic actors at the microlevel.

As an example of a political governance regime, in order to govern political economic relations with Russia, the European Community has created a contractual pact, which is related to the WTO agreement at the global level. The WTO represents globally market-based rules of the game in economic relations and, also, a framework for economic relations with postindustrial states.

In Russia, the political risks are related to the development of a pluralist market economy regime and its connections to the global economy. The European Union's co-operation agreements with Russia are based on that fact. At the state level, risks are related to just these co-operation agreements. At the society level, there is a political risk that the informal rules of the game are stronger than the formal ones and agreements become a dead letter from the point of view of a company at the microlevel. However, political risk governance is the primary framework. A stable business environment requires pluralism, that is emphasized by transformation instead of change, and clearly defined legitimate rules of the game.

It is not reasonable to create co-operation agreements, which parties cannot fulfill, and this is one of the reasons for specific contracts, even though it has been criticized. According to Yavlinsky, the vital question for Russia is whether it will become a quasi-democratic oligarchy with corporatism or take the road to becoming a normal, Western-style democracy with a market economy. Currently, the prevailing political regime is neither democratic nor communist, neither conservative nor liberal, but closer to oligarchy that was already largely in place under the Soviet system. Thus, from the point of view of democratic equilibrium that characterizes a low political risk level, Yavlinsky points out that, recently, elections have become an accepted part of Russian life. With minor exceptions, voting and ballot counting have been peaceful and relatively free, while voter turnout has been higher than that of the United States. For the future, the West should hold those in power in Russia accountable for undemocratic deeds in much the same way, as it is willing to criticize its allies. Western leaders should apply to Russia the same criteria for evaluating the health of its democracy and the strength of its market economy as they apply to themselves.[459]

In this context, it should be noted, that the WTO organization which was developed from the General Agreement of Tariffs and Trade (GATT), represents the way in which the Western states have harmonized the rules of the game in their internal and external political economic relations. Therefore, the general and specific contracts are an appropriate frame for governing commercial relations with Russia.

Until 1996, the specific contracts between the European Union and Russia were based on development of the agreement on trade and co-operation between the European Community and the Union of Soviet Socialist Republics on trade and commercial and economic co-operation signed on 18 December 1989.

In 1994, the Partnership and Co-operation Agreement (PCA), was signed as a basic co-operation agreement on economic relations between the European Community and Russia.[460] The PCA covers trade in goods and the establishment of a cross-border provision of services, intellectual property protection, industrial and commercial co-operation, as well as co-operation in the harmonization of legislative provisions, cultural co-operation, and provisions on financial assistance. A Co-operation Council, Co-operation Commission, and Joint Parliamentary Committee are set up under each of the Agreements. The Agreements are designed to open the way for possible free trade areas. The Agreement is based on Articles 113 and 235. The PCA agreement establishes a political dialog and regulates the trade and investment projects. When the Russian and EU national parliaments have ratified it, political and economic relations will be governed by a partnership and co-operation agreement.

In order to achieve the goals set in a PCA agreement, an Interim Agreement on Trade and Trade Related Matters was signed in 1995.[461] By a declaration, signed in 1993, a political dialog between the European Community and Russia is maintained on political and economic issues of mutual interest.

In addition, industrial co-operation based on the Tacis program covers the co-operation in practical problems faced by the participants in Russia and the European Union in creating and modernizing economic structures. The Tacis program is designed to help the transition from a centrally planned economy to a market economy. Tacis projects include help in the restructuring of state companies and private sector development, reform of public administration, raising agricultural efficiency, and

---

[459] Yavlinsky.1998.
[460] COM (94) 257 final 15 June.1994
[461] OJC L 247. 13 Oct.1995

supporting improvements in the safety of nuclear power plants. Between 1991 and 1995, Tacis made available more than ECU 790 million to Russia, and nearly 500 projects were completed or under way[462].

In 1995, the European Community made a specific strategy for future EU – Russia relations. In Annex 8 of the strategy, it was emphasized that the EU is committed to establishing a substantial partnership with Russia in order to promote the democratic and economic reform process, to enhance the respect for human rights, to consolidate peace, stability, and security in order to avoid new dividing lines in Europe, and to achieve the full integration of Russia into the community of free and democratic nations. The PCA provides a firm basis on which to build such relations with Russia. The European Union continues to support the further development of democracy, the rule of law and pluralism in Russia, by promoting a solid and independent judicial system and reinforcement of the freedom of media, as well as an early membership in the Council of Europe for Russia. The EU's assistance in achieving these goals could be provided through measures such as regular consultation and technical assistance in certain areas, active promotion of people-to-people contacts and exchanges at all levels, support for regional co-operation in a wide range of sectors, monitoring of the Russian parliamentary and presidential elections, and support for Russian accession to the Council of Europe. In this strategy, the European Union referred to the OECD, WTO and G7 agreements and loan guarantees of the International Monetary Fund (IMF).

The contractual frame between the European Union and Russia reveals the political environment and political risks that companies have faced in the Russian economic environment. The equilibrium between political authorities and economic actors was neither transparent nor predictable because, in the Russian internal political governance regime, legal functions, although based on this law, are not practiced as yet in Russia, neither have the laws on entrepreneurial activity developed into an operational rules of the game for a market economy[463]. This situation prevails in the Rus-

[462] http://europa.eu.int/pol/ext/info_en.htm#c04. 9 March.1999
[463] Orlov.1996:329.

sian business environment, as has been found by research published in Finland during the last few years[464].

According to North, insecure property rights, poorly enforced laws, barriers to entry, and monopolistic restrictions will tend to shorten the time frame and lead to economic activity on a small scale. The most profitable business may be in trade, redistribution activities, or the black market. In an unstable environment, large companies with substantial fixed capital exist, only under the umbrella of government protection.[465]

In international trade and investments, international institutions and hierarchical political structures are important, but not always successful and powerful enough to set the-rules of the game. Thus, the case of Russia shows how the contractual political governance works toward a market-based environment. A foreign investor or trader is always an outsider in regard to the informal rules of the game in society. Formality, defined by North as a quality of the institutional rules of the game, creates transparency and accountability regarding the changes in environment. A wide range of informal institutional rules of the game creates inefficiency.

According to Robert O. Keohane, ineffective institutions, such as the United Nations Industrial Development Organization, exist alongside effective ones, such as the European Union. What makes some institutions more capable than others? How do such institutions promote co-operation among states and trade blocs? What mechanics of bargaining do these political authorities use? When comparing the United Nations and the European Union, it is evident that the EU has more economic incentives for co-operation[466]. As the world moves toward new forms of global regulation and governance, the increasing impact of international institutions raises new questions about how these institutions will themselves be governed.[467] However, it should be noted that commercial relations between the European Union and Russia, at this point, are still more politically governed than market-based.

---

[464] Cf. In references: Handbooks concerning Trade and Investment in Russia: Honkanen, Matti. 1994 & 1995, Lehto, Juha. 1994 & 1995.
[465] North.1990:67.
[466] The EU is Russia's largest trading partner by far, accounting for close on 40% of the latter's foreign trade. http://europa.eu.int/en/eupol/pcag.html#nat. 14 Sept.1998.
[467] Keohane 1998.

6.3.1.3 Governing External Environments from Security System Level to Society Level

The requirement for political governance is greater in the environments belonging to **the third category of plurilateral regime** in international exchange. Political risk instruments are needed because of the instability and unpredictability of the rules of the game. In these environments, political authority is the principal maker of the economic rules. However, when political authorities closer to the core supply political risk-instruments to maintain exchange with external environments, there are specific conditions to be established, before guarantees can be given. One of these requirements has been that human rights must be respected in the environment. This conditional requirement is the essence of the borderline case in the European Union’s governance that is reflected in the security and society level issues to the international exchange. In order to maintain a trustworthy environment in the exchange process, the rules of the game, as risk variables, cover all the political levels from the security level to the society level where a political hierarchy is needed.

In the environments of the third category, generally, the political authority is a principal actor in securing both a stable economic environment and human rights in society by means of a political hierarchy. Markets and market-baseness have a secondary role. What has been transformed in the political economy is that, instead of the authorities in separate European states, these states face the European Union as a single political authority that emphasizes pluralism in its policy.

The European Community's political risk governance and management instruments regime stresses the market-based rules of the game in commercial relations. The external commercial relations belong to the first pillar of the Community's authority. With the development of a political union, there will be reflections from a common security policy and, generally, from the second and third pillar of the Union's intergovernmental authority to commercial relations as well.

The European Community can use economic sanctions under Article 228a following a common position or joint action related to the Common Foreign and Security Policy.[468]

> *Article 228a stipulates that where the Community's Foreign and Security position or joint action provides for an action by the Community to interrupt or reduce, in part or completely, economic relations with one or more third countries, the Council shall take the necessary urgent measures. This procedure has been used several times, in particular in response to United Nations Security Council Resolutions. Article 73g of the EC Treaty provides for a specific legal basis for such action in relation to capital movements and payments.*[469]

Article J.1 (2) of the Treaty on European Union introduced the development and consolidation of democracy, the rule of law, and respect for human rights and fundamental freedoms as an objective of the common foreign and security policy.[470] Human rights represent an issue area that has its reflections from the Common Foreign and Security Policy to commercial relations. The political risk research stresses the pluralist structures in indicating that a low political risk level and human rights are a central part of liberal and democratic structures in a political environment.

According to Angela Ward, separate political regimes can be traced in the emerging frameworks of co-operation between the European Union and the external states. The European Union's relations with the states, party to the Lomé convention 28, and its dealings with the southern Mediterranean, Israel, Latin America, and the states of Central Europe and the ex-Soviet Union, have all been cast against a firm commitment to human rights and democratic principles.[471] The European Union is able to set conditions for economic relations with these states only if those states have respect for human rights.

On relations between the East Asian states, as well as between the United States and Canada and Australia, the principles of pluralism are embedded in their relations on a

[468] McGoldrick.1997:31.
[469] Macleod, Hendry & Hyett. 1996: 416.
[470] Ward.1997:507.
[471] Ward.1998.

sector-by-sector basis, but on separate causes. Europe views the United States as a partner in the global struggle to ensure human rights and foster democracy.[472]

This structure can be characterized by a plurilateral regime with separate rules of the game with a common denominator, in this case, human rights that affect the commercial relations.

This section is focused on the commercial relations under the Community's (EC) authority. In external economic relations, however, the reflections from intergovernmental pillars, as notified by Ward, are a remarkable issue of setting the balance between economic actors and political authorities.

6.4 Political Governance for Harmonizing Risk Instruments in the European Community

What kind of a task is the framing of a new political risk instrument at the multilevel political authority in Europe? According to the European Union policies, the rules of the game are created through the harmonization policy and increasing market baseness in them. In external relations, these rules of the game and boundary lines are changing the political risk instruments that are supplied by national and the European Union's political authorities by their harmonization policy in the frontiers of different categories of business environments.

Member states in the European Union are pluralist liberal democracies and a central part of the plurilateral regime. The European Union has committed itself to the principles of democracy, rule of law, and respect for human rights. Therefore, harmonization inside the plurilateral core defines the rules of the game and boundaries in the governance of political risk management in these states, and the aforementioned principles are reflected onto their relationships with the external world of other categories in the regime.

[472] Ward. 1998.

Political risk management governance is traditionally weighted with strategic dimensions in nation-states. Only the pure, quantifiable risks are managed through markets. The risks, that were faced in international environments, were divided into pure risks and risks with quantifiable characteristics. Pure political risks, however, were non-quantifiable, and political governance is the only way to manage political risk by increasing the predictability of the rules of the game in societies and increasing their formality order to allow for foreign economic activity. These facts have not been changed with the transforming political authority from nation-state level into multi-level governance. What has changed is that, under the conditions of the predictable rules of the game, private instruments replace the political instruments.

Is there still a need for political risk instruments or is the market-baseness of the rules of the game from the core penetrating also the other two categories of a plurilateral regime and creating a situation where there is no longer a demand for political risk instruments?

Figure 18 illustrated how the multilevel political authority replaces state authorities as the only authorities that set the rules of the game in a political economy. The harmonization policies create new political environments for economic action, both in internal markets and external commercial relations of the European Union and in the frontiers of a global plurilateral regime. How are they are reflected in political risk instruments?

As analyzed in Part Five, companies manage risks by assessing risk premiums and, therefore, demand political risk management instruments supplied by public or private sectors. In Russia risk management instruments are provided, for example, through the European Union's coordination and by the European Bank for Reconstruction and Development (EBRD), which shares the political risk by making equity investments in transition countries. In order to stabilize market economy structures, the political authorities have pushed companies to invest in the former communist states. The political risk management instrument regime sets preference on market rules and private risk sharing instead of political hierarchy.

In the pluralist state regime, conditionality in the terms of risk instruments was set politically. In the plurilateral risk management regime, instruments are increasingly based on market terms. In USA, the Overseas Investment Corporation (OPIC) represents a model for this hybrid organization in which the market-baseness is combined with political governance. The risk capital is lent from private capital markets. In this regime, multinational accountants have a heavier role than earlier when evaluating the financial status of economic actors.

Henceforth, the European risk management instruments regime will create a logic of its own. Its working will be stabilized as the result of a harmonization policy that has been established between Member States in the European Union. In a plurilateral regime, in the case of regulatory political authority, risk coverage from state budgets as a permanent arrangement is not a trend of the future. According to the theoretical findings of Robert A Dahl, in Part Two, political authorities and economic actors have separate functions in pluralist liberal democracies. Political authorities" budgets are targeted towards public services and public goods; to maintaining basic infrastructures; social security, education, stability, and general security in the equilibrium between economic actors and political authorities. Political hierarchy in an economy is an exception.

In the European Union, the political risk management instruments are objects of its harmonization policy. The reason for this is that the instruments are a part of the public sector rather than that of the competitive market. They are linked to national interest issues and, therefore, the harmonization process has been longstanding. The political risk instruments include a sectoral policy under the external relations and a competition policy. The area of political risk instruments is partly governed by the provisions of a treaty relating to external trade: Articles 112 and 113 provide for the harmonization of export aid. Progress in controlling this aid has been achieved under the treaty's trade provisions, and in the OECD and WTO.

The Commission submitted, in June 1997, the council's directive on harmonization of the main provisions concerning export credit insurance for transactions with medium- and long-term cover, and in connection with various negotiations in the OECD framework. According to a proposal, credit insurance is an instrument extensively used by governments to promote exports. By providing cover for their exporters against the risk of default by the foreign debtor, whether on commercial or political grounds, the governments encourage them to do business in a market presenting an element of risk the companies are unwilling or unable to bear. Each year, the Member States" credit insurance agencies cover ECU 25–30 billion of new contracts with a credit period in excess of one year. From 1980 to 1995, the cost to the national budgets was particularly high (for example, nearly ECU 5 billion a year between 1988 and 1994 for the Community as a whole), due to the claims arising from political contingencies, including the debt crisis, the Gulf War, and the collapse of the Soviet Union. More than tools for managing instability in external environments, export credit guarantees are considered a competitive instrument of Member States in foreign trade and investments. This development has emphasized the role of export credit guarantees as a tool of public services for promoting national interests.[473]

Although each Member State has its own export credit insurance system with different guarantee conditions, premium rates, and cover policies, they function by the rules of the former political risk regime, as was shown in Stapenhurst's study.[474] Fragmented systems have led to a situation in which the Community's exporters do not have an identical competition position.

> *Concerned about the effects of government interference in markets at the taxpayers' expense, OECD countries have bound them to disciplines restricting official support with regard to credit terms. Negotiations are currently under way, in the OECD, to introduce guidelines, which would result in convergence of premium rates applying to the different systems of export credit insurance.*
>
> *In the Community itself it was apparent from the outset that the Member States' systems for granting aid for exports to third countries needed to be harmonized, and indeed this objective is explicitly set out in Articles 112 and 113 of the Treaty establishing the European Community.*
>
> *The Council set up a Policy Coordination Group for Credit Insurance, Credit Guarantees and Financial credits in 1960. Its brief was to frame proposals for harmonizing Member States' credit insurance arrangements.*

---

[473] COM (97) 264 final.
OJC L 69, 11 March.1997.
OJC L 216, 8 Aug 1997.
[474] Stapenhurst. 1992.

The established Coordination Group has been involved in issues of consultation and co-operation between credit insurers, in connection with negotiations in the OECD framework.

On the harmonization front, a technical committee was given a mandate, in the late 1960s, to draft common credit insurance policies for all credit insurers in the Community. Such terms were enacted in a Council Directive, adopted on 27 October 1970, which, however, remained a dead letter. None of the initiatives mooted since then has born fruit, including the establishment of a European credit insurance system and, more recently, the creation of a credit insurance pool for Eastern Europe.

Similarly, on 13 July 1994, the Commission adopted a proposal for a directive based to a large extent on two reports submitted to the Council by an expert working party charged with looking at ways of harmonizing medium-term and long-term export credit insurance. Once again, the Council declined to approve the proposal, objecting both to the procedural aspects and the lack of flexibility, particularly in its approach to competition from outside of the EC.

The Member States have been reluctant to cede their freedom to maneuver on officially supported export credits, partly on political grounds, since they regard export policy to some extent as a foreign policy tool, and partly for financial reasons, since the cost of claims to the public purse is considerable. The proposal of the Commission constitutes a in the direction of harmonizing of the export credit insurance systems, and it aims at introducing a measure of transparency in this field also.

The proposal lays down certain common principles applicable to the main constituents of cover; however, it allows for considerable flexibility in the way of application. Derogation is allowed on the condition that any alteration in the quality of cover be reflected in the premium charged and notified to the Commission and the other credit insurers.

The common principles on premium represent a framework designed to bring greater transparency to the current practice and to allow for incorporation of guidelines emerging from the ongoing OECD negotiations. The proposal does not prejudge the outcome of these negotiations, which cover the following areas:

- *country risk model and country classification procedure;*
- *premium benchmarks and premium feedback tools;*
- *related conditions;*
- *permitted exceptions; and*
- *special attention to the specific position of small exports credit agencies.*

The Directive is designed to be complemented by future OECD rules. The common principles on cover policy establish a format necessary for the exchange of information between credit insurers.[475]

[475] COM(97) 264 final. Member states will be required to transpose its provisions into national law by 1 April 1999.

Political risks in the obsolescing bargain model are related to medium-term and long-term trade and investment. The development of the internal market, the payment in advance instruments, and global operation of accountancy firms, have made the role of short-term export credit guarantees obsolete. Political risks related to the stability of the-rules of the game in different environments are managed with these instruments. Meanwhile, the states compete and subsidize their companies with short-term guarantees. The Union's policy is targeted to these proceedings, which may cause a certain policy-oriented political risk for companies. Of the total aid given by the Member States to their manufacturing industry over the period from 1992 to 1994, 7 per cent went to support exports, largely in the form of favorable terms for export credits and export credit insurance.[476]

In Finland, the national guarantee board is the Finnish Guarantee Board (FGB, Takuukeskus), which 1 January 1999 became part of Finnvera Finance Corporation. Transformation of guarantee boards reflects the new policy of the European Union.[477].

---

[476] OJ C 281, 17 Sept.1997. Communication of the Commission to the Member States pursuant to Article 93 (1) of the EC Treaty applying Articles 92 and 93 of the Treaty to short-term export credit insurance.

[477] The European Mutual Guarantee Association (AECM) is made up of guarantee agencies operating in Europe. It currently has 10 members. The Finnish Guarantee Board (FGB) became an associate member in June 1997. AECM seeks to develop work between guarantee agencies with a view to securing the financing of SMEs and improving risk financing in Europe.

An FGB representative participates in the monthly meetings of the EU Council Working Group on Export Credits. The group makes proposals on harmonizing export credit operations and discusses both individual projects and country risks. The group prepares joint EU Opinions for OECD cooperation, as EU states are represented at OECD export credit Consensus meetings by the European Commission, and individual member states have no voice.

The Directive aims to ensure that the same export credit guarantee terms apply to all users of export credit guarantees throughout the EU, who thus have equal opportunities to compete with the merits of a product, not with the financing terms attached to it. The proposal requires some amendments to FGB's definitions of risk and its claims practice and also calls for more transparency, but the principles of guarantee operations remain unchanged.

The Communication based on EU Competition Rules referring to short-term export credit guarantees, in preparation since 1993, came into effect in September 1997. The starting point of the Communication is that the operations of public export credit agencies receive government support, and that competition is thus distorted in their favor in the guaranteeing of marketable risks, that is, in an area in which private insurance companies also operate.

Marketable risks are currently defined as short-term commercial risks in industrialized countries. From the date on which the Communication comes into effect, EU member states have one year in which to amend their export guarantee schemes and ensure that public export credit agencies cease to provide coverage for marketable risks. http://www.takuukeskus.fi/fin/1997/main1.htm.24 Nov.1998.

New rules have been proposed on non-marketable risk in the field of export credit insurance. The rules are designed to ensure that EU exporters have the same coverage available throughout the EU at the same cost. They are also aimed at eliminating state-sponsored guarantees for short-term risks. The proposed directive will harmonize the methods by which EU states assess the pure and political risk of exporting to a particular country.

What kind of a task is the framing of a new political risk instrument at the multilevel political authority in Europe? According to the European Union's policies, the rules of the game are created through the harmonization policy and the increasing market-baseness. In external relations, the rules of the game are reflected in the political risk instruments that are supplied by national and the European Union's political authorities by their harmonization policy.

Member states in the European Union are pluralist liberal democracies and a central part of a plurilateral regime. Also, the European Union is committed to the principles of democracy, the rule of law, and a respect for human rights. Therefore, harmonization inside the plurilateral world defines the-rules of the game and borderline cases in the governance of political risk management in the states involved, and these principles are reflected in their relationships between the external worlds of modern and pre-modern. A borderline case in harmonizing the political risk instruments is the endeavor towards market-baseness.

Ultimately, however, it is a question of political governance at the European Union level. What kind of rules of the game will be faced after the harmonization has been completed, and what will be the consequences on external trade and investment acts? Will there still be a need for political risk instruments, or will the market-baseness of the rules of the game from the plurilateral core also penetrate into the business environments outside the core and create a situation where the demand for political risk instruments no longer exists?

7. Conclusions

The central aim of this study is to conceptualize a framework for a government analysis of political risk. It has become clear that framing the new political risk management institutions and instruments is not a technical but a political task. The reason for this phenomenon is that, instead of measuring probabilities of political turbulence in different environments and creating quantifiable risk premiums for certain political threats towards trade and investments, pluralist societies are in the process of creating an equilibrium, where political risks are lessened. There prevails, among pluralist societies, a rules-of-the- game regime – a plurilateral regime – related to liberalism, democracy, and integration that has led into a functional environment for companies to act without political risks.

Fundamentally, this study has focused on a plurilateral regime which will create such rules of the game which will also make it possible to extend the stability required by companies to regions outside of the European Union, which itself is located within the plurilateral regime.

When considering the historical background of managing political risk in international relations, two optional paths for lowering the risk level can be identified for political risk assessment at governance level.

First, a state authority maintains trustworthy rules of the game and sets boundary lines towards markets in an environment that in such a way creates predictability in the international economic action. One strategy to lower the risk level is to create a pluralist state regime, where co-operative relations exist among political authorities. Each authority in this regime defines the rules of the game in its territory. When crossing the state borders, the rules of the game among a political authority and an economic actor change. The more pluralist the society the more transparent are the prevailing rules. Pluralism indicates a low political risk level.

Henceforth, when there are several political authorities, in addition to the state authority, in an international system, the rules of the game vary, not according to the state borders, but to the rules of the game and borderline cases that define the equilibrium between political authorities and economic actors in the existing environment. What constitutes the regime is the market-baseness of the rules. This implies that, when analyzing political risk, we should consider whether we are dealing with the former pluralist environment of the state level or the latter plurilateral environment with fuzzy borders. These different paths are significant when analyzing political risks in the European Union, in the formerly closed and mixed economies, and in the socialist states, which now are under political transformation.

The reason for the views presented in the analysis of political risk is that both the political and economic actors demand stable and predictable rules of the game, if their goal is to sustain economic growth. One way to collaborate is to harmonize the rules among economic actors and political authorities globally.

There are both formal and informal rules. The more formal the rules, the more predictable is the political environment of economic exchange at an international level. Moreover, in international relations the concept of trust is more important than legitimacy that often is non-existent. The diverse actors must sustain trust in order to co-operate.

The starting point for this investigation was the fact that companies are technical units, in which production functions are located. Companies have their particular role in transforming inputs of work, capital, and natural resources into outputs subject to the technical rules in production. The production function is an objective, quantifiable, and manageable by a company's organization. Companies demand a stable and predictable political environment. In a globalized world this requirement is strengthening not weakening. Beyond the production function and the company's organization, there is the political environment with its subjective characteristics, factors of stability, and opposing forces of utility and power relations. These are focused on as political risk factors, which are taken as given by companies.

Only a political authority is capable of supplying stability and predictability. At the international level, national authorities demand co-operation with other states in order to achieve stability and predictability globally.

A nation-state has maintained rules of the game in the economic environment and, if the rules have been missing, has given political risk guarantees directly and indirectly to economic actors in order to maintain international exchange. Inside its political regime, there have been legitimate and trustworthy rules. The Nation-state has been the political authority, which has defined the identity of economic actors. At the international level, the frontiers of a nation-state have been the frontiers of the economic actors' identities. Due to integration and globalization processes, the identities of national economic actors are under transformation.

In broad terms, integration refers to a process inside the Western world and its global penetration. Thus, the Western states are the core of the plurilateral regime. It is a regime of market-based rules of the game, but it should be noted that there are fragmented parts inside the regime. Because of the informal rules of the game, fragmentation will remain there. The fragmented frontiers are the frontiers of political risk assessment and governance.

From the point of view of the rules of the game in a plurilateral regime, the monetary regimes are instruments of political governance, where the shifting boundaries are set as close to the market arrangements as possible in order to maintain stability and efficiency. Currently, the monetary regime, whose core was founded just after the Second World War, is expected to transform itself into a new one. Political risks from the company's point of view have to be analyzed against this transformation. This political construction is creating a political risk instrument of its own. At this stage, there are more political risk instruments available than before. Political authorities are transforming the former non-marketable risks into marketable ones. In a pluralist state regime, the International Monetary Fund and the World Bank Group have developed frames for co-operation of economic actors and political authorities at the global level. The integration process in Europe will transform this equilibrium. Therefore, there are path-dependent rules of the game, which link together these institutional transformations. Their rules have a common denominator, which is market-baseness. Moreover, these facts are a common denominator in the emerging plurilateral regime of pluralistic liberal democracies.

In the equilibrium of pluralistic governance, an international co-operation was realized in the international economic and monetary system. Transformation of Europe, with its own economic and monetary order, disperses the existing equilibrium. Regardless of this dispersal, the old and the new system function by the same historical plurilateral rules of the game. They are characterized by certain common rules of exchange, although combinations of the rules of the game separated from each other exist within the system.

In terms of political risk, preference should be given to a plurilateral regime which is based on a market economy; this regime would maintain continuous co-operation in the exchange process, although the rules of the game for exchange would to some extent be different in different operational environments in the EU, the U.S., Russia, Latin American, and African states. A marked change has started to occur already in the internal market of Europe, when the authority responsible for public services has been moved to the Union level. A plurilateral regime is indicated by the definition of marginal conditions for economic and political equilibrium both at the Union level, the state level, and at the international level, where the Union represents the Member States. Also, the functional logic at the society level has changed, when the mutual interaction in the plurilateral regime is direct and passes the state level and political authorities. The role of the political authority has changed and become that of a regulative maker of the rules.

The concept of "pluralism" characterizes the theories of liberalism, democracy, and integration. A pluralistic metaphor is a counterweight for the realistic metaphor, according to which the theories of international relations emphasize the primary importance of security policy and state-centered system of governance. Thus, although a security policy is not emphasized in pluralistic theories as the sole core, it does have a central role. This central role of political authority includes guaranteeing security – a task, which does not belong to the market, which is unable to provide for it. There cannot exist any balance or stability without security provided by the political authority. The role of a guarantor of security as belonging to the political authority is not called into question by either pluralistic or the most liberal theories of international relations. In principle, this is a question of the location of marginal rules or the location of equilibrium.

In addition, security issues are becoming plurilateral along with the political and economic issues. Regimes with fuzzy borders are being formed. In the paradigm of political risk, security issues have been consequential in the equilibrium of economic and political actors. The highest stakes are set in terms of the security system. In the plurilateral regime these terms are defined by the North Atlantic Treaty Organization. Members of pluralistic security communities expect a peaceful transformation, because as strong civil societies they share pluralistic values.

The plurilateral regime assumption denotes that the rules of the game cannot be harmonized at once, but that there are continuous processes of harmonizing them inside the regime gradually. The denser the regime, the more unitary are the rules among economic actors and political authorities. The frontiers of plurilateral regime are located between the European Union and Russia, Asian, Latin American, and African states, and also among the WTO countries, NATO countries, and OECD countries. When the economic activity crosses these frontiers, a political risk analysis should be performed. These frontiers represent also different political decision-making processes and, importantly, different degrees of democracy and human rights.

Frontiers of plurilateral regimes are characterized by separate and fragmented boundaries between economic actors and political authorities. In the environment of European companies, politics have been based on a model employing a liberal order. However, there are tasks of political authority that cannot be shifted to markets alone. Public services represent a case of a fragmenting issue among the Member States. In the European Union, a new regulation policy emphasizes the role of political authority as a market-based regulator – not as the owner of economic units, public service institutions, or a provider of services. This transformation will reflect onto the political risk assessment and management in such a way that, with the market-baseness, the companies themselves are going to bear the risks instead of moving them to the political authority. This process is expected to increase efficiency. Thus, it is clear that the rules of the game will remain fragmented.

***

A political risk paradigm should analyze the plurilateral regime as an optimal environment of low political risk level instead of a pluralist state, because of the political transformation that has occurred in international relations. In general, international politics resides in the equilibrium of "political" and "economic," specifically in the equilibrium between an economic actor and a political authority. What are the origins of their relations? What are the variables and prospects of changing them? These dilemmas will be faced in the integration processes in the common markets. At the global level, it has been a question of the shift from relations between nation-states to the density of the relationships between multilevel political authorities in a plurilateral regime.

The OECD countries have been identified as representing a core of a plurilateral regime of industrialized countries. Economic relations are characterized by international market-based and stabilized rules of the game. The presence of political authority is not evident in business actions. Economic relationships with the second category of plurilateral regime in Russia, China, India, and other countries, where the economy is based on heavy industry, are characterized by the economic relations with the visible role of a political authority. In the third category of plurilateral regime, mainly in developing countries, the economic relations are characterized by the highly visible political authority, whose role it is to maintain stability and predictability. Transformation from the national to international level requires shifts in the equilibrium.

Hence, the purpose of this investigation was to develop a theory of transformation based on integration by means of a metaphor of plurilateralism to describe the harmonization of the rules of the game in the OECD countries. Also, the global diffusion of a plurilateral regime with the economic and political spheres was illustrated. Liberalism leads to harmonization of the rules of the game in societies. Integration theories are linked to liberalism, which can be defined as a metaphor for plurilateralism. A plurilateral regime is a characteristic of the environment. In the OECD countries, pluralism is defined by the state system and as the basis for "plurilateral regime" when framing the political risks in Europe.

Analysis of equilibrium led to a definition of the replacement of a pluralistic state system, in the OECD countries, with a plurilateral regime. A plurilateral regime emphasizes the positive role of economic and cultural relations between liberal democracies. Increased interdependence harmonizes, by means of developing integration, both the official and unofficial rules of the game. Political authorities and national markets will become replaced by a multilevel political authority and multi-markets.

***

The traditional method for analyzing political risks was the comparative method in a state-centered paradigm. Risk indicators were divided into independent, intervening, and dependent variables, and risk management at the company level was the management of dependent variables, such as confiscation or nationalization. Different approaches were based on divergent causes of political risks, which were dependent and intervening variables, like the stability of a political regime.

A paradigm for political risk was developed in conjunction with the comparative political method in the United States after the Second World War. Information was gathered from the new independent states and their business environments. In the comparative analysis, variables included the state institutions and the degree of liberalism, democracy, and economic openness.

Then, the Commercial Publishers of Political Risk Ratings were founded. They published rating lists of sovereign countries. These rating lists, based on the Delphi method, reflected commercial relations and the existing conditions for trade and investment. In that method, assessing the risk level in a certain environment is based on a subjective comprehension of political risk. Subjectivity limits the use of international political risk ranking lists based on quantitative and qualitative values. Countries could be easily divided into socialist, market, and mixed economies. The rating lists, where risk indicators were quantified by using assessments by economic actors themselves, offered a foundation for continued agreements between economic actors in foreign and domestic environments. It was argued that the lowest political risk level existed in liberal democracies. These theories were linked with Western values and, concretely, with the OECD countries.

The paradigm of political risk was divided, for the purposes of this investigation, into two categories. Political risk governance emphasizes the management of political risk by international regimes. Furthermore, this research made an additional definition regarding management of risk: In the definition of political risk, "political" refers not only to its cause, but also to the means used for managing it. In the case of non-marketable political risks, management is feasible only by a political authority. Risk management instruments were derived from those rules of the game of the institutional regime, which were maintained by the political authority. Another category of studies analyzed single instruments without paying attention to political governance. These studies remained inside the regime and often failed to predict political transformation.

The state companies and state interventions were, in a modern environment, characteristic of the status quo. Privatization and the path to openness and to marketable environment have made the role of political authority obsolete. Improved access to capital markets has lessened requirements for state guarantees in the single market of the European Union. The external relations of the European Union characterize an extension of the plurilateral with marketability and a market-based logic. The integration process has caused transformation in the political risk milieu in the Member States. For example, in Finland, it is a question of transformation, not change, because in its mixed economy Finland had institutionalized the formal rules of the game of a market economy. However, the formal frames and informal rules of the game were different compared to those of the Western economies.

Transformation from a pluralist to a plurilateral environment implied, that it was necessary to develop a new political risk management system. However, there was no detectable certainty whether the new instrument was a path from the past. Therefore, it was necessary to go beyond the old risk variables and proceed to a new logic of political risk.

The new political risk variables, namely the ones concerning the formal and informal rules of the game in societies, were derived from the theory of Douglass C. North. It is at the same time a regulatory model for market-based rules of the game. The equilibrium between economic actors and political authorities is based on stable and predictable rules of the game at the formal and informal levels. Together with the shifting boundaries between economic actors and political authorities, these levels were conceptualized as new political risk indicators.

When framing the political risk in the European Union and economies-in-transition, a specific definition of political risk was needed to replace the general definition given above. Specifically, then, political risk was defined as unpredictable transaction costs.

The traditional neo-classical paradigm of political economy with perfect information assumes zero transaction costs. Political environment is, thus, excluded. In neo-classical terms, there are no differences between different political environments of market-based societies.

According to Douglass C. North, however, institutions and the way they evolve shape economic performance. Institutions affect economic performance by determining, together with the technology employed, the cost of transacting and producing. They are composed of formal rules, informal constraints, and their enforcement characteristics; while formal rules can be changed overnight by the polity, informal constraints change very slowly. Both are ultimately shaped by the subjective perceptions people possess to explain the world around them, which in turn determine their explicit choices of formal rules and evolving informal constraints. Institutions differ from organizations. Institutions contain the rules of the game in a society and, as a consequence, have structured in either political, social, or economic incentives. A set of political and economic institutions, that provide predictable transaction and credible commitment, provide for efficient factor and product markets underlying economic growth. In an unstable environment, formal institutions are non-existent. Institutions contain both the formal and informal rules of the game in society. This fundamental thought, derived from Douglass C. North's theory, emphasizes the unofficial rules of the game as much as the official ones. North's neo-institutional foundations of defining the institutions more widely than before in international relations theory form the basis for political risk assessment and management in a plurilateral regime. In the political risk analysis, institutional rules of the game are risk variables. There are two types of variables: formal and informal rules of the game.

The political risks in international business have been, traditionally, managed by institutionalizing transaction procedures. The nation-state has been the primary actor in transferring political risk to society in order to enable economic exchange. The nation-state has given guarantees, both directly and indirectly, to economic actors. It has built infrastructures and, thus, lowered the political risk level and shifted the transaction costs to itself. Small countries depend on international markets and the international economy. Therefore, governments provide political risk guarantees for companies. Availability of raw materials and energy as well as food supply, market access, have led to an interdependent environment. Technological development has created pressures for national programs in maintaining their competitive positions. A plurilateral regime, however, provides for greater stability. Now it is of utmost importance that political authorities create, through stable rules of the game and harmonized marginal rules, governance of political risk for economic actors. When this system is reliable, the regime stays outside political risks.

Theoretically, we have defined the above arrangements as institutional rules of the game of society. The nation-state has set bounds between the economy and politics. In future, the role of the European Union will be strengthened as a legitimate creator of boundary lines and rules of the game. Based on these theoretical findings, it is possible to frame and compare risk prospects in different societies.

The borderline cases and the rules of the game determining transaction costs are the new institutional variables in risk analysis. Institutions have a dominant role in comparative politics and political risk analysis. Institutionalized rules of the game can be applied to different levels of hierarchy created by the political authority that has the political power to set the rules of the game in an environment where the economic actors are effective. The hierarchy levels, from security system level to society level, were analyzed separately. Moreover, the concept of trust is often a more important denominator than legitimacy in international relations.

Political risk management instruments were analyzed in Part Five. There a political risk governance regime, which is now under a transformation process was illustrated. Transformation from state level to the European Union level was emphasized. New risk instruments were defined as plurilateral instruments. Emerging new instruments are market-based and less politically guaranteed.

Risk instruments were also analyzed from the perspective of an individual company. The analysis revealed that the political government is embedded whenever a single company uses a political risk management instrument. The political authority remains a background actor maintaining predictable rules of the game in the environment.

Political risk management instruments are under transition. Within the plurilateral regime, the process is not one of change but of transition. Different rules of the game are being harmonized. Nevertheless, the role of political authority still exists.

***

First, the common market, second, the development of common commercial policy and third, the economic monetary union, most directly, will create pressures for developing new political risk management instruments**.**

This aim is accomplished by harmonizing the rules of the game and boundaries on existing national instruments and by shifting them towards a marketable logic. The Commercial Sector of Export Credit Insurance (CSECI) relates the short-term export credit risks on trade termed “marketable.” The definition currently comprises only so-called commercial risks as opposed to political risks in trade within the European Community and in most of the OECD countries. Insurance of medium-term and long-term export credit risks is largely non-marketable. Efforts are being made, in the European Union, to harmonize the terms of export credit insurance; premiums and country cover policy. Non-marketable risks are still under Member States’ control, while these controls are harmonized. External commercial relations are governed by the provisions of the EC Treaty relating to external trade, Articles 112 and 113. Article 112 provides for harmonization of export subsidizing instruments. In addition, not only competition within the Community is affected by subsidizing instruments for Community Exports, but also the competitiveness of the Community's exporters, with the exception of those of the Community's trading partners which have similar instruments available. Controlling and harmonizing the instruments has been achieved under the Treaty's trade provisions, in the OECD consensus and the World Trade Organization's (WTO) agreement.

The European common market is argued to lower the transaction costs at company level by harmonizing the rules of the game between member states. At a global level and among the OECD countries, the European Economic and Monetary Union is a unique institutional arrangement, when considered from the political risk perspective. The Single Market has lowered transaction costs and political risk level between the European Union Member States by making the rules of the game more predictable. The European Economic and Monetary Union will lower political risk level even more by creating new instruments for risk management, just as the World Bank created instruments after the Second World War. However, there are political risks that cannot be managed through markets. The management of these non-marketable risks always has been a function of the political authority. In the Treaty of Amsterdam, Article 16 on public services sets bounds between politics and free market economy. Even if a paradigm shift in the European Union's policy occurred, for Finnish companies it would be a question of marketable rules of the game in accordance with the OECD regime. The role of political authorities as regulators will strengthen.

In the external commercial relations of the European Union, a political authority is needed as a setter of boundary lines and a creator of rules of the game. For instance, energy dependency will lead to arrangements, which can be sustained in the long run only by a political authority. Relations with “risky states” need risk management procedures of the public sector, because they are too costly and unpredictable for the private sector.

In addition, interaction between economic and political factors on common markets reflects on the external economic relations. Risks are also being transformed into marketable risks in external relations. Institutionalization of the external economic relations of the European Union will be framed based on markets and the rules of the game of harmonization in the global context of relations with Russia and the United States. The main concepts are the general and specific commercial agreements and a trustworthy international co-operation.

The central question is: How will policymaking in the European Union, the United States, and Russia direct the global co-operation in harmonizing the rules of the game in an equilibrium between economic and political factors? At the global level, the main instrument is the WTO agreement where the rules of the game between the European Union, the United States, and Russia are formulated. Moreover, in terms of political risk assessment, it should be emphasized that the WTO is an instrument for harmonizing the rules. This co-operation has prospects in a plurilateral regime among industrialized states. It is not an instrument for political conditioning, but for making transactions costs predictable in a market-based exchange.

***

Framing the new risk management institutions and instruments is not a technical but a political task. It is a by-product of political risk governance and a projection of the expectations regarding international collaboration. Ideologies on world order, in the minds of national policy makers and their delegates in international organizations, are reflected onto the merging equilibrium among political and economic actors.

It has been argued that, in the state-centered paradigm of political risks, the risk levels in liberal democracies were low. The nation-state has been defined as a pluralist unit. Comparative analysis of political risk has emphasized indicators related to quantifiable democracy as a sign of a low risk level. Thus, the relationships of political risk instruments to risk variables were secondary. The primary condition is that the instruments are set now by multilevel political authorities, in order to pursue stability and predictability in economic environments. When the rules of the game are predictable, markets may replace political hierarchy. As a matter of fact, it is a sign of the times that the more political risk instruments are available, the more there are political risks. Among the OECD countries, the political risk level is low. The trustworthy rules of the game prevail.

Henceforth, analysis should be concentrated on the density of the plurilateral regime emphasizing low political risk level in this regime, due to the stabilized and trustworthy institutionalized market-based rules of the game and the continuing co-operation agreements between political and economic actors. Instead of concentrating on the illusion of political risk instruments as being derived from the political risk variables, further analysis should be targeted at world order institutions as a by-product of political bargaining processes, which are creating the political risk instruments of the future.

Political risk is dependent on the prevailing ideologies about the world order. Therefore, its characteristics are determined by the emerging equilibrium of international political and monetary regimes as their instruments. This equilibrium should be studied in a far more profound manner. Political management is rather more related to the world order in the context of security, integration, and globalization than at the level of risk variables' evolving illusion of a single risk instrument.

Bibliography

Adler, Emanuel & Barnett, Michael (1998) *Security Communities*. Cambridge: Cambridge University Press.

Aggarwal, Vinod K. (1985) *Liberal Protectionism*. Berkeley: University of California Press.

Aggarwal, Vinod K. (1987) *International Debt Threat*. Berkeley: Institute of International Studies.

Aggarwal, Vinod K., Keohane Robert O. & Yoffie, David B. (1987) The Dynamics of Negotiated Protectionism. *American Political Science Review*, Vol.81, No 2.

Aggarwal, Vinod K. (1991) International Political Economy. *Political Science 126A*. Berkeley: University of California.

Alt, James, E & Alessina, Alberto (1996) Political Economy: an Overview. In Goodin, Robert E. & Kindleman, Hans-Dieter. (1996) *The Handbook of Political Science*. New York: Oxford University Press, pp. 648–649.

Amsterdamin sopimus Euroopan unionista tehdyn sopimuksen, Euroopan yhteisöjen perustamissopimusten ja niihin liittyvien tiettyjen asiakirjojen muuttamisesta. [Treaty of Amsterdam] CONF 4005/97 Bryssel 23.09.1997

Annet, Anthony (2001) Social Fractionalization, Political Instability, and the Size of Government. International Monetary Fund. *IMF Staff papers*. Vol 48, No 3.

Antola, Esko – Rosas, Allan (eds.) (1995) *A Citizens' Europe. In Search of a New Order*. London: Sage.

Antola, Esko, Ojanperä Virva & Loikas, Antti (1998) *Amsterdamin sopimuksen vaikutus Suomen talouden avainsektoreille*. [The Treaty of Amsterdam and Its Reflections on the Key Industry Sectors in Finland] Jean Monnet Unit. Turku: University of Turku.

Antola, Esko, Ojanperä Virva & Mörttinen, Matti (1996) *Mitä EU:sta*. Juva: WSOY.

Anttonen, Matti (2002) A Turning Point in Russia's WTO negotiations? *Russian Economy. The Month in Revie*w. 4/2002. Helsinki: Bank of Finland. Institute for Economies in Transition.

Apter, David (1996) Comparative Politics. In Goodin, Robert E. & Kindleman, Hans-Pieter. (1996) *The Handbook of Political Science.* New York: Oxford University Press, pp.372–400.

Attali, Jaques (1997) The Crash of Western Civilization: The Limits of the Market and Democracy. *Foreign Policy*. 1997. No. 107, Summer.

Axelrod, Robert (1981) The Emergence of Cooperation Among Egoist.

American Political Science Review, Vol. 25, pp. 306–318.

Axelrod, Robert (1984) *The Evolution of Cooperation*. New York: Basic Books.

Axelrod, Robert. (1997) The Dissemination of Culture. A Model with Local Convergence and Global Polarization. *Journal of Conflict Resolution*. Vol. 41 Issue 2, p. 203.

Azeem, Mirja (2002) Finnish firms see more business in Russia – and reform needs. *Russian Economy. The Month Review*. 5/2002. Helsinki: Bank of Finland. Institute for Economies in Transition.

Bank of Finland. *Russian Economy. The Month Review*. 7–8/2002. Helsinki: Bank of Finland. Institute for Economies in Transition.

Bank of Finland. *Russian Economy. The Month Review*. 14/2001. Helsinki: Bank of Finland. Institute for Economies in Transition.

Bakker, A F P. (1996) *International Financial Institutions*. Heerlen: Netherlands Open University.

Bilal, Sanoussi (1998) Political Economy Considerations on the Supply of Trade Protection in Regional Integration Agreements. *Journal of Common Market Studies*. Vol 36, No. 1. March, pp. 1.

Boyle, John, Prosser, Tony (1995) Universal Service in a Liberalized Europe. *European Public Law.* Vol. 1, Issue 4, December, pp.541–548.

Braithwaite Valerie, Levi, Margaret. (1998) *Trust. The Basis for Trusting the State and Its Agents*. New York: Russell Sage Foundation.

Brennglass, Alan C. (1983) *The Overseas Private Investment Corporation. A Study in Political Risk*. New York: Praeger.

Brewer, Thomas L. (1988) MIGA: A New Organization to Promote and Protect Private Direct Investment in Developing Countries. In Rogers, Jerry. 1988. *Global Risk Assessments: Investments, Concepts & Applications.* Book III. Riverside, California: Global Risk Assessment, pp. 75–97.

Brewer, Thomas L. (1992) An Issue-Area Approach to the Analysis of MNE-Government Relations. *Journal of International Business Studies*. Vol. 23, Issue 2, p. 295.

Brewer, Thomas L. (1993) Government Policies, Market Imperfections and Foreign Direct Investment. *Journal of International Business Studies*. Vol. 24, Issue 1. p.101.

Brewer, Thomas, Young Stephen (1995) European Union Policies and the Problems of Multinational Enterprises. *Journal of World Trade*, No.29, p.33.

Brewer, Thomas, Young Stephen (1995) Towards a Multilateral Framework for Foreign Direct Investment: Issues and Scenarios. *Transnational Corporations*, Vol. 4, no 1, April.

Brewer, Thomas (1981) Political Risk Assessment for Foreign Direct Investment Decisions: Better Methods for Better Results. *The Columbia Journal of World Business*, Vol. XVI, pp. 5–11.

Brewer, Thomas (1985) Political Risk in International Business: New Directions for Research. *Management and Public Policy*. pp. 157.

Bromley, Simon (1991) *American Hegemony and World Oil*. Cambridge: Polity Press.

Brummerstedt, David A. (1988) Host Country Behavior: Issues and Concepts in Comparative Political Risk Analysis. *Global Risk Assessments: Issues, Concepts and Applications*. Book III. Riverside, California: Global Risk Assessment. pp. 75–97.

Buiter, Willem, Fries, Steven (2002) What should the Multilateral Development Banks do? *Working Paper No 74. London: European Bank for Reconstruction and Development.*

Business Insurance (1994) Political Risk Market Booms as Trading Barriers Drops. No 48. November. p.3.

Buzan, Barry, Waever, Ole & de Wilde, Jaap (1998) *Security. A New Framework for Analysis*. London: Lynne Reinner.

Cerny, P.G. (1993) Plurilateralism: Structural Differentiation and Functional Conflict in the Post-Cold War Order. *Millenium*, Vol. 22, No.1, pp. 27–51.

Chryssochoou, Dimitris, N. (1998) *Democracy in the European Union*. London: Tauris Academic Studies.

Church, Clive H. (1994) European Union and European Community. *A Handbook and Commentary on the Post-Maastricht Treaties*. Aldershot, Hertfordshire: Simon & Schuster International Group.

Chen, Ien (2002) Barons of Bankruptcy. *Financial Times*. 31 July 2002.

Clover, Charles (2000). Russia business finds bankruptcy route to expansion. *Financial Times*. 24 July.2000.

Cohen, Stephen S. (1991) *Geo-Economics: Lessons from America's Mistakes*. Berkeley: Berkeley Roundtable of International Economics.

Coleman James S. 1990 (1994) *Foundations of Social Theory*. Cambridge, Massachusetts: Belknap Harward.

Collard, David (1995) The Mainspring of Institutional Change. *International Journal of the Economics and Business*. Vol. 1995, Issue 3, p. 497.

Commission of European Communities (1995) An Energy Policy for the European union. White Paper of the European Commission. COM (95) 682 final. Brussels 13.12.1995.

Commission of European Communities (1996a) *Universal Service for Telecommunications in the Perspective of a Fully Liberalised Environment.* COM (96) 73. Brussels 6.12.1996.

Commission of European Communities (1996b) *Euroopan parlamentin ja Neuvoston direktiiviehdotus avoimen verkon tarjoamisen (OPN) soveltamisesta puhelintoimintaan ja teleyleispalvelusta kilpailuympäristössä.* KOM (96) 419. Bryssel 11.09.1996.

Commission of European Communities (1996c*) Yleishyödylliset palvelut Euroopassa.* KOM (96) 443 lopull. Bryssel 11.09.1996

Commission of European Communities (1996d) *Benchmarking the Competitiveness of European Industry*. COM (96) 463. Brussels 09.10.1996.

Commission of European Communities (1996e) *Commissions Communication on Assessment Criteria for National Schemes for the Costing and Financing of Universal Service in Telecommunications and Guidelines for the Member States on Operation of Such Schemes.* COM (96) 608. Brussels 27.11.1996.

Commission of European Communities (1997a) *Action Plan for the Single Market*. CSE (97) 1 final. 4.6.1997.

Commission of European Communities (1997b) *Euroopan laajuisten energiaverkkojen ulkoinen ulottuvuus*. KOM (97) 125. Bryssel 26.03.1997

Commission of European Communities (1997c) *Kokonaiskatsaus energiapolitiikkaan ja energia-alan toimiin*. KOM (97) 167. Bryssel 23.04.1997

Commission of European Communities (1997d) *Agenda 2000 for a Stronger and Wider Union*. COM (97) 2000 final. Brussels 15.07.1997.

Commission of European Communities (1997f) *Proposal for Council Directive on harmonization of the main provisions concerning export credit insurance for transactions with medium- and long-term cover*. COM(97) 264 final Brussels 12.8.1997.

Common Market Law Review (1996) Editorial Comments. Public Service Obligations: A Blessing or Liability? No. 33, pp. 213–222.

Coplin, William D., O'Leary, Michael K. (1994) *The Handbook of Country and Political Risk Analysis*. New York: East Syracuse.

Coppedge, Michael; Reinicke, Wolfgang H. (1990) Measuring Polyarchy. *Studies in Comparative International Development*, Vol. 25 Issue 1, Spring, pp.51.

Cowie, Harry (1996) *Private Partnerships and Public Networks in Europe*. London: Federal Trust.

Cram, Laura (1996) Integration Theory and the Study of the European Policy Process. In Richardson, Jeremy J. (ed). 1996. *European Union: Power and Policy-Making*. London: Routledge.

Crystal, Jonathan (1998) A New Kind of Competition: How American Producers Respond to Incoming Foreign Direct Investment. *International Studies Quarterly*, Vol. 42, Issue 3, September, p. 513.

Dahl, Robert A. (1971) *Polyarchy: Participation and Opposition*. New Haven: Yale University Press.

Dahl, Robert A. (1985) *A Preface to Economic Democracy*. Cambridge: Polity Press.

Dahl, Robert A.(1995) Justifying Democracy. *Society*. March/April, Vol. 32, Issue 3, pp.43.

Dasgupta, Partha (1988) In Gambetta, Diego (ed.) (1988) *Trust: Making and Breaking Cooperative Relations*. Oxford, New York: Blackwell, pp. 49–52.

Dedman, Martin J. (1996) *The Origins and Development of the European Union, 1945–95: A History of European Integration*. London: Routledge.

Delorme, Robert, Dopher, Kurt (eds.). (1994) *The Political Economy of Diversity. Evolutionary Perspectives on Economic Order and Disorder*. Cheltenham: E. Elgar.

De Mortagnes, Charles Pahud, Allers, Vivian (1996) Political Risk Assessment: Theory and the Experience of Dutch Firms. *International Business Review*. Vol.5, No.3, pp.303–318.

Deutsch, Karl W. (1969) Towards an Inventory of Basic Trends and Patterns in Comparative International Politics. *International Politics and Foreign Policy*, Rosenau, James N. (ed.) Rev. ed. New York: Free Press, pp.498–512.

Economist Intelligence Unit Limited (2002) *Country Report Russia*, 11 June 2002.

Elster, Jon (1990) *Explaining Technical Change: Studies in Rationality and Social Change*. New York: Cambridge University Press.

European Centre of Enterprises with Public Participation (1994). *European Competition and Public Service*. Brussels: Author.

European Report (1997a) *Energy: European Parliament Report on Framework Programme*. 2249.Sep.10. Brussels: Eric Daimiens.

European Report (1997b) *Transport: Commissions Communication on Financing Networks.* 2249.Sep. 10. Brussels: Eric Daimiens.

European Report (1997c) *Telecommunications/Audiovisual: Bangemann calls for New World Order*. 2249.Sept.10. Brussels: Eric Daimiens.

European Report (1997d) *Gas: Deadlock on Internal Market Directiv*e. 2249.Sept.10. Brussels: Eric Daimiens.

European Report (1997e) *Transport Networks: Commission Espouses Public/Private Partnership Concept*.2250.Sep.13. Brussels: Eric Daimiens.

European Report (1997f) *Transport: Citizens" Network Green Paper follow-up*. 2250.Sept. 13. Brussels: Eric Daimiens.

European Report (1997g) *Amsterdam Treaty: October 2 Signing Ceremony*.

2255.Oct.1. Brussels: Eric Daimiens.
European Report (1997h) *Amsterdam Treaty: Ratification Process Launched*. 2256. Oct. 4. Brussels: Eric Daimiens.
European Report (1997i) *Public Services: Framework for Services for General Interest.* 2256.Oct.4. Brussels: Eric Daimiens.
European Report (1997j) *Telecommunications: Amended Interconnection Directive*.2256.Oct.4. Brussels: Eric Daimiens.
European Report (1997k) *EU enlargement: Council and Parliament Review Commissions Proposals*.2256.Oct.4. Brussels: Eric Daimiens.
European Report (1997l) *Agenda 2000: Council Confirms Initial Analysis*. 2257. Oct.8. Brussels: Eric Daimiens.
European Report (1997m) *Amsterdam Treaty: Call for Early Implementation*. 2257.Oct.8. Brussels: Eric Daimiens.
European Report (1997n) *Telecommunications: Progress towards Deregulation.* 2258.Oct.11. Brussels: Eric Daimiens.
European Report (1997o) *Energy: Hearing on Gas Market Liberalisation.* 2258. Brussels: Eric Daimiens.
Etla (2002) *Luoteis-Venäjän yritysklusterit*. Helsinki: Etla

Financial Times (2002a) Russia's New Capitalists Eye Western Growth. 2 February 2002.
Financial Times (2002b) The Oligarchs are Different Now. 9 August 2002.
Fitzgerald, Thomas M., Jr. (1996) Protecting against Credit and Political Risk. *Journal of Accountancy*. Vol. 181, Issue 1, January, pp. 66.
Frieden, Jeffery A, Lake, David A. (ed.). (1995) *International Political Economy. Perspectives on Global Power and Wealth*. New York: St. Martin's Press.
Fukujama, Francis (1992) *Historian loppu ja viimeinen ihminen*. [End of History and the Last Man] Juva: WSOY.

Gibson, Lay James; Miller, Mark M. (1990) A Delphi Model for Planning "Preemptive" Regional Economic Diversification. *Economic Development Review*. Vol. 8, Issue 2, Spring, pp. 34.
Gilpin, Robert (1987) *The Political Economy of International Relations*. Princeton, New Jersey: Princeton University Press.
Goddard, Roe C., Passé-Smith, John T. & Conklin, John G. (1996) *International Political Economy*. Boulder, Colorado: Lynne Reinner Publishers.
Goodin, Robert E., Klingemann, Hans-Dieter (1996) *A New Handbook of Political Science*. New York: Oxford University Press.
Gourevitch, Peter (1988) *Politics in Hard Times: Comparative Responses to International Economic Crises*. New York: Cornell University Press.

Graham Edward M., Krugman, Paul R. (1995) *Foreign Direct Investment in the United States*. Washington DC: Institute for International Economics.

Guererra, Francesco (2002) EU Economy hit by lack of single market in services. *Financial Times*. 31 July 2002.p1.

Haas, Ernst B. (1990) *When Knowledge Is Power: Three Models of Change in International Organizations*. Berkeley: University of California Press.

Haas, Ernst B. (1991) *Theory of International Relations*. XB220A Berkeley: University of California.

Haendel, Dan, et al. (1975) *Overseas Investment and Political Ri*sk. Lexington, Massachusetts: Lexington Books.

Haendel, Dan (1979) *Foreign Investments and the Management of Political Risk*. Boulder, Colorado: Westview Press.

Hallmark, Terry, Whited, Kevin (2001) The IHS Energy Group's Political Risk Ratings and Ranking Index. In Howell, Llewellyn D. (2001) *The Handbook of Country and Political Risk Analysis*. New York: The PRS Group.

Haner, Frederick Theodore (1980) *Global Business Strategy for the 1980s*. New York: Praeger Publishers.

Henderson, James M, Quandt, Richard E. (1980) *Microeconomic Theory*. A Mathematical Approach. Singapore: McGraw-Hill Book Company.

Hernesniemi, Hannu, Lammi, Markku & Ylä-Anttila, Pekka (1995) *Kansallinen kilpailukyky ja teollinen tulevaisuus*. Helsinki: ETLA.

Hill, Andrew (2002) Rethinking Rockefeller and the Rest. *Financial Times*, 31 July 2002,p7.

Hirvensalo, Inkeri (1999) *Sijoitukset Venäjälle. Kokemuksia Venäjälle tehtyjen sijoitusten rahoituksesta*. Helsinki; ETLA.

Hoekman, Bernard M., Kostecki, Michel M. (1995) *The Political Economy of the World Trading System*. Oxford: Oxford University Press.

Honkanen, Matti (1994) *Ulkomainen yritys Venäjällä ja Ukrainassa*. Helsinki: Lakimiesliiton kustannus.

Honkanen, Matti (1995) *Venäjän kaupan opas*. Helsinki: Hakapaino Oy.

Howell, Llewellyn D. (ed.) (1998) *The Handbook of Country and Political Risk Ana*lysis. New York: IBC USA.

Howell, Llewellyn D. (ed.) (2001) *Political Risk Assessment: Concept, Method, and Management*. New York: PRS Group, Inc.

Howell, Llewellyn D. (ed.) (2001) *The Handbook of Country and Political Risk Analys*is. New York: PRS Group,Inc.

Howell, Llewellyn D., Chaddick, Brad (1994) Models of Political Risk for Foreign Investment and Trade. *Colombia Journal of World Business*. Vol. 29, Issue 3, Fall, p. 70.

http://europa.eu.int/ [in respect 22 September 2002].

http://europa.eu.int/information_society/index_en.htm. [in respect 22 September 2002].

http://mkaccdb.eu.int/ The Market Access Database. [in respect 22 September 2002].

http://www.beri.com/ Business Environment Risk Intelligence. [in respect 22 September 2002].

http://www.prsgroup.com. The Political Risks Service Group. [in respect 22 September 2002].

http://www.transparency.org/. [in respect 22 September 2002].

http://www.stat.fi/tk/tt/ibs/ibslahialuetietokanta.html. Central Statistical Office of Finland. [in respect 27 August 2002.]

http://www.imf.org [in respect 10 September 2002].

http://www.worlbank.org. [in respect 10 September 2002].

http://www.ebrd.com [in respect 10 September 2002].

Huntington, Samuel P. (1996) *The Clash of Civilizations and the Remaking of World Order*. New York: Simon & Schuster.

Irwin, William T, (1998) In Moran, Theodore H. (ed). (1998) *Managing International Political Risk*. Oxford: Blackwell Publishers Ltd, pp. 57–69.

Jackson, John E. (1996) Political Methodology. In *the Handbook of Political Science*. 1996. New York: Oxford University Press, pp. 751–762.

Jacobson, David (1994) The Technological and Infrastructural Environment. In Nugent, Neill. 1994. *European Business Environment*. Basingstoke: Macmillan Press.

Jansson, Jan-Magnus 1969. (1993). *Politiikan teoria*. Juva: WSOY.

Johnson, Howard. C. (1981) Assessing Country Risk. London: *Euromoney* Publications, p. 31–48.

Kauppalehti (1998) Venäjä-riskejä useilla listatuilla yhtiöillä. 10.9.1998.

Kauppalehti (1998b) Kriisi opetti pankit varovaisiksi. 15.10.1998.

Kauppalehti (2000) Mäkinen, Tapani. Venäjä ei pörssiyhtiöitä heilauta. Kauppalehti. 23.4.2000.

Kauppalehti (2000b) Mäkinen, Tapani. 2000. Finnvera avaa taas takuitaan Venäjälle. Kauppalehti. 11.07.2000.

Kauppalehti. (2000c) Valio aikoo vähentää Venäjän riskiään. 12.04.2001.

Kauppalehti (2001) Pesonen, Eeva-Stina. Venäjä-sijoitus vaatii pitkää pinnaa. Kauppalehti. 16.11.2001.

Karppinen, Antti. Ambassador. Ministry for Foreign Affairs of Finland. Helsinki. Interviews. August 2000, April 2002.

Kegley Charles W. Jr., Wittkopf, Eugene R. (1991) *American Foreign Policy*. 5th ed. New York: St. Martin's Press.

Kennen, Peter B. (2001) *The International Financial Architecture*. Washington, DC: Institute for International Economics.

Keohane, Robert O., Hoffmann, Stanley (Eds.). (1991) *The New European Community, Decisionmaking and Institutional Change*. Boulder, Colorado: Westview Press.

Keohane, Robert O. (1989) *International Institutions and State Power. Essays in International Relations Theory*. San Francisco & Boulder, Colorado: Westview Press.

Keohane, Robert O. (1998) International Institutions: Can Interdependence Work? *Foreign Policy*. Issue 110, Spring, p. 82.

Keohane, Robert O., Nye, Joseph S. (1989) *Power and Interdependence*. Second ed. Boston: Scott, Foresman and Company.

Kindleberger, Charles E. (1996) *Centralization versus Pluralism. A Historical Examination of Political-Economic Struggles and Swings within Some Leading Nations.* Copenhagen: Copenhagen Business School Press.

Kindleberger, Charles P. (1997) The Rise of Free Trade in Europe. In Freiden, Jeffrey A., Lake, David. A. (1997) *International Political Economy*. New York: Routledge, pp. 73–90.

Kobrin, Stephen J. (1976) The Environmental Determinants of Foreign Direct Manufacturing Investment. An Ex Post Empirical Analysis. *Journal of International Business Studies*. Fall-Winter, pp.29–42.

Kobrin, Stephen J. (1978) When Does Political Instability Result in Increased Investment Risk? Columbia *Journal of World Business*. Fall, pp.113–122.

Kobrin, Stephen J. (1979) Political Risk: A Review and Reconsideration. *Journal of International Business Studies*, Vol. IX, pp. 67–80.

Kobrin, Stephen J. (1980) Foreign Enterprise and Forced Divestment in LDCS. *International Organization.* Winter. Vol.34, pp. 65–88.

Kobrin, Stephen J. et al. (1980b). The Assessment and Evaluation of Noneconomic Environments by American Firms: A Preliminary Report. *Journal of International Business Studies*. Spring-Summer. pp. 32–48.

Kobrin, Stephen J. (1982) *Managing Political Risk Assessment: Strategic Response to Environmental Change*. Berkeley, California: University of California Press.

Kobrin, Stephen J. (1984) Expropriation as an Attempt to Control Foreign Firms in LDCS: Trends from 1960 to 1979. *International Studies Quarterly*, VOL 28. pp.329–348.

Kobrin, Stephen J. (1997) Electronic Cash and the End of National Markets. 1997. *Foreign Policy*, No.107. Summer, pp.65–78.

Kobrin, Stephen J. (1998a). Back to the Future: Neomedievalism and the

Postmodern Digital Economy. *Journal of International Affairs*, Spring, Vol,51, Issue 2, p361–387.

Kobrin, Stephen J. (1998b). The MAI and the Clash of Globalizations. *Foreign Policy*. Fall, Issue 112, pp.97–110.

Kuusela, Hannu, Ollikainen Reijo (1998) *Riskit ja riskienhallinta*. Vammala: Tampere University Press.

Lax, Howard (1983) *Political Risk in Oil and Gas Industry.* New York: Greenwood Press.

Lax, Howard (1988) *States and Companies: Political Risk in International Oil and Gas Industry.* New York: Greenwood Press.

Lehto, Juha (1994) *Venäjän kaupan opas*. Jyväskylä: Gummerus.

Lehto, Juha (1995) *Liiketoiminta ja Kauppa Venäjällä*. Jyväskylä: Gummerus

Lensik, Robert, Hermes, Niels, Murinde, Victor (2000) Capital flight and political risk. *Journal of International Money and Finance*. No 19. Pp.73–92.

Levinsohn, Alan (2002) New Geopolitics Spotlights. Political Risk management. *Strategic Finance*. January 2002.

Levy, Mark A, Young, Oran R. & Zürn, Michael (1995) The Study of International Regimes. *European Journal of International Relations*, Vol. 1 (3), pp. 267–330.

Liuhto, Kari, Jumpponen, Jari (2002) *The Internationalization Boom of Russian Corporations*. Studies of Russian Banks, Energy and Metal Companies. 2002 N:o 135. Lappeenranta: Lappeenranta University of Technology.

Loikas, Antti (1992) Poliittiset riskit: Menetelmät ja metodologinen ja teoreettinen tutkimus.[Political Risk: Methods and Methodological and Theoretical Research] MA Thesis. Department of Political Science. University of Turku.

Loikas, Antti (1994) Shadow Economy in Great Britain. London: Ministry of Foreign Affairs. Unpublished.

Loikas, Antti. (1995a) Yritysten riskit globaalissa toimintaympäristössä. [Political Risks in a Global Environment]. Institute for European Studies. Turku School of Economics and Business Administration. Unpublished.

Loikas, Antti: (1995b). Euroopan muutos ja suomalaisten yritysten poliittiset riskit: Telekommunikaatio ja energiasektorit [Political Transformation in Europe and Political Risks: A Case from Telecommunications and Energy sectors] Institute for European Studies. Turku School of Economics and Business Administration. Unpublished.

Loikas, Antti. (1996a) Poliittiset riskit Venäjällä. [Political Risks in Russia.] Unpublished.

Loikas, Antti. (1996b) Suomalaisten yritysten poliittiset riskit. [Political Risks of the Finnish Companies] University of Turku. Unpublished.

Macleod, I., Hendry, I.D. & Hyett, Stephen. (1996) *Foreign Policy in European Community*. Oxford: Clarendon.

Majone, Giandomenico (1998) Understanding Regulatory Growth in the European Community. In Hine, David (1998) *Beyond the Market: the EU and National Social Policy*. London: Routledge.

Majone, Giandomenico (1997) The Agency Model: The Growth of Regulation and Regulatory Institutions in the European Union. European Institute of Public Administration. No. 3.

Majone, Giandomenico (ed). (1990) *Deregulation or Re-regulation?: Regulatory Reform in Europe and the United States.* London:Pinter.

Mann, Michael (2002) Brussels plans sanctions on US. *Financial Times*. April 20/21April. 2002, p.1.

Marray, Michael (1994) OPIC profile. *Euromoney*. December.

Matlary, Janne Haaland (1997) *Energy Policy in European Union*. New York: St. Martin's Press.

McCarthy, Daniel, J. Puffer, Sheila, M. & Simmonds, Peteer J. (1993) Riding Russian Roller Coaster: U.S. Firms" Recent Experience and Future Plans in the Former USSR. *California Management Review*. Vol. 36 (1), Fall, pp. 100–115.

McGoldrick, Dominic (1997) *International Relations Law of the EU*. New York: Addison Wesley Longman, Inc.

Moody's Investors Service (1994) In Coplin, William, D. & O'Leary, Michael. *The Handbook of Country and Political Risk Analysis*, pp. 145–172.

Moran, Theodore H. (ed). (1998) *Managing International Political Risk*. Oxford: Blackwell Publishers Ltd.

Moran, Theodore H. (2001) *International Political Risk Management. Exploring New Frontiers*. Washington: The International Bank for Reconstruction and Development.

Morgan, Gareth (1997) *Images of Organization*. London: SAGE Publications, Inc.

Nairne, Stephen. (1997) Political Risk on Shifting Sands: An Export Credit Agency's View. In Rogers, Jerry. 1997. *Global Risk Assessment: Issues, Concepts & Applications, Book IV*. Riverside, California: Global Risk Assessments, Inc, p. 29.

North, Douglass C. 1990 (1994). *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

North, Douglass C. (1997) *The Contribution of the New Institutional Economics to an Understanding of the Transition Problem*. Helsinki: UNU/WIDER.

Nugent, Neill (1991) *The Government and Politics of the European Union*. Basingstoke: Macmillan.

Nugent, Neill. (1992) The Deepening and Widening of the EC: Recent Evolution, Maastricht and Beyond. *Journal of Common Market Studies*, Vol. 30, no. 3.

Nugent, Neill (1994) *The Government and Politics of the European Union*. 3rd ed. Durham, North Carolina: Duke University Press.

Nugent, Neill (1994) *European Business Environment*. Basingstoke: Macmillan.

Nye, Joseph S. (1974) Multinational Corporations in World Politics. *Foreign Affairs*, Vol.53, pp.153–175.

Nye, Joseph S. Jr. (1993) *Understanding International Conflicts: An Introduction to Theory and History*. New York: Harper Collins.

O'Donell, Rory (1994) The economic environment. In Nugent, Neill. 1994. *European Business Environment*. Basingstoke: Macmillan. pp.47–91.

Official Journal of European Communities (1990) OJ L 257, 21.09.1990. Council Regulation (EEC) No 2698/90 of 17 September 1990 amending Regulation (EEC) No 3906/89 in order to extend economic aid to other countries of Central and Eastern Europe.

Official Journal of European Communities (1996) OJ C 281, 26.09.1996. Services of General Interest in Europe.

Official Journal of European Communities (1997a) OJ L 127, 30.01.1997. Directive 96/92/EC of the European Parliament and of the Council of 19. December concerning common rules for the internal market in electricity.

Official Journal of European Communities (1997b) OJ C 281, 17.09.1997. Communication of the Commission to the Member States pursuant to Article 93 (1) of the EC Treaty applying Articles 92 and 93 of the Treaty to short-term export credit insurance.

Official Journal of European Communities (1998) OJC L 148. 19.05.1998. Council Directive 98/29/EC of 7. May 1998 on harmonisation of the main provisions concerning export credit insurance for transactions with medium and long-term cover.

Overseas Private Investment Corporation. Annual Report 1995.

Oxford English Dictionary. Second Edition.1999. Oxford: Clarendon.

Pelkmans, Jacques (1998) Atlantic Economic Co-operation. The Limits of Plurilateralism. *Centre for European Policy Studies.(CEPS) Working Document*. No 122.

Prigogine, Ilya (1997) *The End of Certainty. Time, Chaos, and the New Laws* *of Nature*. New York: The Free Press.

Radaelli, Claudio M. (1998) Governing European Regulation: The Challenges Ahead. *European University Institute, RSC Paper* No 98/3. http://www.iue.it/ERPA/Mainfiles/.../.../RCS/WP-Text/radaelli.html.

Rautava, Jouko (1999) *Suorat sijoitukset Suomesta Venäjälle ja Baltian maihin vuonna 1997*. Helsinki: Bank of Finland. Institute for Economies in Transition.

Rautava, Jouko, Sutela, Pekka (2000) *Venäläinen markkinatalous*. Helsinki: WSOY.

Ray, John E. (1995) *Managing Official Export Credits*. Washington, DC: Institute for International Economics.

Reuters. European Union Briefing:

Advertising/Marketing/Media Broadcast (1997) EU Backs Public Service. 27.Jun.1997.

Agence Europe (1996a) EU: Several years of discussion and polemics have not brought any closer the positions of the fifteen on the union's policy over Public Services – Consensus on some major principles cannot conceal the differences over implementation measures – A fundamental debate for the European Model of Society. 16.Oct.

Agence Europe (1997a) EU/Telecommunications – World Conference. Commission emphasizes that EU has to speak as one at World Conference on Radiocommunications. 21.Jun.

Agence Europe (1997b) EU/IGC/MEDIA – Public Broadcasting and Amsterdam. 9.Jul.

Agence Europe (1997c) EU: EP/FINANCING – Resources ceiling political error: Mr. Colom Naval states the choice of the Commission not to propose a higher resources ceiling a "political error" that the EP should put right. Activities of European Parliament. 6. Sept.

Agence Europe (1997d) European Parliament / Internal Market – Directive on telecommunication sector. 20.Sept.

Agence Europe (1997e) EU: European Parliament / Internal Market /Council Agreement on cautious and limited liberation of postal services. Common position approved for most part plenary session of the European Parliament. 17.Sep.

Chamber World Network International Ltd. (1997) Germany: Bonn and Paris anxious to cooperate despite political differences. 1997 Transport Europe. 25.Sep.

Constancy Europe Associates Ltd. (1997) Opinion of the Committee of the Regions. COR opinion on role of regional government in Public Services.

(January 1997 Session). 01.Sept.

European Report. (1997a) France: Analysts still see privatisation of Credit Lyonnais. 11.Jun.

European Report (1997b) EU: Competition – Commissions counters German call for public bank exceptions. 11.Jun.

European Report (1997c) EU: European Council – A closer look at the new Amsterdam Treaty. Majority voting. 21.Jun.

European Report (1997d) EU: EU: European Council – A closer look at the new Amsterdam Treaty. Financing public broadcasters. 21.Jun.

European Report (1997e) EU: European Council – A closer look at the new Amsterdam Treaty. The Landesbanken issue fudged? 21.Jun.

European Report (1997f) EFTA: State Aid – EFTA surveillance authority smiles on Husbanken's Public Service role. 16.Jul.

European Report (1997g) EU: Transport – Pan-European proposals at Helsinki. 29.Jul.

European Report (1997h) Luxembourg: Gas: – Luxembourg compromise on Internal Market. 6.Sep.

European Report (1997i) EU: Competition – Commission probes special status of public banking institutions. 17.Sep.

European Report (1997j) EU: Postal Services – Commission will reject Parliament's amendments to directive. 17.Sep.

European Report. (1997k) EU: Background – Debate continues over Natural Gas Market Liberalisation Draft. 24.Sep.

European Report (1997l) EU: Public banks – Commission to launch probe into state transfers to Westlb. 27.Sep.

PARTNER, McKENNA & CO. 1997. EU: The EU directive on the internal market in electricity – where are the difficulties? 31.Mar.

Reuters (1997a) EU: Papoutis speech on electricity. 20. May.

Reuters (1997b) Germany: Funding Public, private banks greet EU resolution. 18.Jun.

Reuters (1997c) EU: EP Transport & Tourism committee vote on postal services draft. (COM(95) 227 final). 16.Sep.

Reuters (1997d) France: EU Assembly approves postal service liberalisation. Sep.16.

Reuters (1997e) EU: Presidency compromise fails to break deadlock regarding gas proposal. 17.Sep.

Reuters (1997f) Belgium: EU Telecoms Market transforming as deadline nears. 22.Sep.

Reuters (1997g) Outcome of CESI seminar on Public Services in Europe. European Confederation of Independent Trade Unions. Seminar Public Ser-

vice in Europe – 13th October till 15th October 1997. 17.Oct.
Reuters (1997h) EU: EP Committee backs report on General Interest Services. 07.Nov.

Robock, Stefan (1971) Political Risk: Identification and Assessment. *The Columbia Journal of World Business*. July-August, pp. 6–20.

Rogers, Jerry (1983) *Global Risk Assessment Issues, Concepts & Applications. Book I*. Riverside, California: Global Risk Assessment.

Rogers, Jerry (1986) *Global Risk Assessment Issues, Concepts & Applications. Book II*. Riverside, California: Global Risk Assessment.

Rogers, Jerry (1988) *Global Risk Assessment Issues, Concepts & Applications. Book III*. Riverside, California: Global Risk Assessment.

Rogers, Jerry (1997) *Global Risk Assessment Issues, Concepts & Applications. Book IV*. Riverside, California: Global Risk Assessment.

Root, Franklin (1972) *Analyzing Political Risk in International Business*. Washington DC, Philadelphia & London: Taylor & Francis.

Rosamond, Ben (1997) Debate: Economic and Monetary Union in Europe. *New Political Economy*. Vol. 2, Issue 3, p. 475.

Rosenau, James N. (1990) *Turbulence in World Politics. A Theory of Change and Continuity*. New York: Princeton University Press.

Rosenau, James N. (1997) *Along the Domestic – Foreign Frontier: Exploring Governance in a Turbulent World*. Cambridge: Cambridge University Press.

Routio, Pentti (1997) *Tuote ja tieto: tuotteiden tutkimuksen ja kehittämisen metodiopas*. Helsinki: Taideteollinen korkeakoulu.

Rummel, R.J., Heenan, David, A. (1978) How Multinationals Are Analyzing Political Risk. *Harvard Business Review*, January-February, pp. 67–76.

Salonen, Jarmo (1987) *Poliittisen toimintaympäristön havainnointi ja muutoksiin varautuminen – käytäntö eurooppalaisissa yrityksissä*. Turku: Turun kauppakorkeakoulu.

Sandholtz, Wayne, Borrus, Michael, Zysman, John, Conca, Ken, Stowsky, Jay, Vogel, Steven & Weber, Steve (1992) *The Highest Stakes. The Economic Foundations of the Next Security System*. Berkeley Roundtable of International Economics. New York: Oxford University Press.

Sandholtz, Wayne, Sweet, Alec Stone (1998) *European Integration and Supranational Governance*. New York: Oxford University Press.

Sandholtz, Wayne (1992) ESPRIT and the Politics of International Action. *Journal of Common Market Studies.* Vol. XXX.

Sassen, Saskia (1999) *Foreign Affairs*, Jan/Feb99, Vol. 78 Issue 1, p75.

Schneider, Gerald, Weitsman, Patricia A. (1997) Eliciting Collaboration From Risky States: The Limits of Conventional Multilateralism in Security Affairs. *Global Society*. Vol 11, No 1, pp.93–109.

Scneider, Susan C., Barsoux, Jean-Louis(1997) *Managing Across Cultures*. Hertfordshire, London: Prentice Hall.

Schoter, Andrew (1981) *The Economic Theory of Social Institutions*. Cambridge: Cambridge University Press.

Schroeder, Paul W. (1977) Quantitative Studies in the Balance of Power. *Journal of Conflict Resolution*, pp. 3–21.

Shapiro, Alan C. (1996) *Foundations of Multinational Financial Management*. Lexington, Massachusetts: Paramount Publishing.

Siedentopf, Heinrich, Ziller, Jacques (eds.). (1988) Making European Policies Work. The Implementation of Community Legislation in the Member States. Vol. 1 *Comparative Synthesis*. London: Sage Publications.

Siisiäinen, Martti (1994) *Yhteiskunnalliset liikkeet ja muutos*. Rovaniemi: Lapin yliopisto.

Simon, Jeffrey D. (1982) Political Risk Assessment: Past Trends and Future Prospects. *Columbia Journal of World Business*. Fall, pp. 62–71.

Simon, Jeffrey D. (1984) A Theoretical Perspective on Political Risk. *Journal of International Business Studies*. Winter 1984, pp. 123–143.

Simon, Jeffrey D. (1985) Political Risk Forecasting. *Futures*, Vol. 17, pp. 132–143.

Singer, David J. (1969) The Level of Analysis Problem in International Relations. *International Politics and Foreign Policy,* pp. 20–29.

Smith, Stephen (1987) *The Shadow Economy in Britain and Germany*. London: Institute for Fiscal Studies.

Spegele, Roger D. (1996) *Political Realism in International Theory*. Cambridge: Cambridge University Press, pp. 102–126.

Spero, Joan Edelman (1990) *The Politics of International Economic Relations*. New York: St. Martin's Press.

Stahel, Walter R. (2002) Insurance, Risk Management and Culture. *The Geneva Papers on Risk and Insurance*. April Vol 27 No 27, pp.268–274.

Stapenhurst, Frederick (1992) *Political Risk Analysis Around the North Atlantic*. New York: St. Martin's Press.

Stephens, Malcom (1998) A Perspective on Political Risk insurance. In Moran, Theodore H. 1998. *Managing International Political Risk*. Oxford: Blackwell Publishers Ltd, pp. 148–168.

Stobaugh, Robert B. (1969) How to Analyze Foreign Investment Climate, *Harvard Business Review*, September-October, pp.100–107.

Strange, Susan. (1988) *States and Markets. An Introduction to International Political Economy*. London: Pinter.

Strange, Susan (1991) *Rival States, Rival Firms, Competition for World Market Shares*. Cambridge: Cambridge University Press.

Strange, Susan (1996) *The Retreat of the State. The Diffusion of Power in the World Economy*. Cambridge: Cambridge University Press.

Suominen, Arto (1994) *Yritysten riskienhanllintakäyttäytyminen ja vakuutus-politiikka liikkeenjohdon toiminnan osana.* Series A–5:1994. Turku: Turku School of Economics and Business Administration.

Suominen Arto. (1999) *Riskienhallinta*. Vantaa: WSOY.

The European Policy Centre (1997) *Making Sense of Amsterdam Treaty*. Brussels: Author.

Ting, Wenlee (1988) *Multinational Risk Assessment and Management – Strategies for Investment and Marketing Decisions*. Westport, Connecticut: Greenwood Press.

Tiusanen, Tauno, Vinni, Sirpa, Jumpponen Jari (2002) *The Investment Climate in Russia. Part II. Case Studies*. 2002. No 19. Lappeenranta: Lappeenranta University of Technology.

Tversky,A. & Kahneman, D. (1992) Advances in Prospect Theory: Cumulative Representation of Uncertainty. *Journal of Risk and Uncertainty* No.5, pp.297–323.

Valtiontakuukeskus. 1994. Vuosikertomus 1994. Helsinki: Kauppa- ja teollisuusministeriö.

Vanhanen, Tatu. (1994) Demokratisoituminen 1990-luvun maailmassa. *Politiikka* Vol. 35, p. 2.

Vasques, John A. (1996) *Classics of International Relations*. Princeton, New Jersey: Simon & Schuster.

Vernon, Raymond. (1971) Sovereignty at Bay: *The Multinational Spread of U.S. Enterprises*. New York: Basic Books.

Vernon, Raymond (1995) Seeds of Conflict. The Global Spread of Corporate Enterprise. *Harvard International Review*. Vol. 17, Issue 3. p. 26.

Viotti, Paul, Kauppi, Mark (1987) *International Relations Theory*. New York: Macmillan.

Viotti, Paul, Kauppi, Mark (1993) *International Relations Theory*. (2nd ed.). New York: Macmillan.

Viscusi, Kip V., Zeckhauser, Richard J. (1996) *The Risk Management Dilemma*. London: Sage Periodicals Press.

Visuri, Pekka (1997) *Turvallisuuspolitiikka ja strategia*. Juva: WSOY.

Wagner, Daniel (1994) A New World For Political Risk Investment Insurance. *Risk Management*, October.

Wallace, Helen & Wallace, William (1996) *Policy Making in the European Union*. Oxford: Oxford University Press.

Wallerstein, Immanuel (1979) *The Capitalist World Economy: Essays by Immanuel Wallerstein*. New York: Cambridge University Press.

Walsh, Kieron (1995) Public Services and Market Mechanisms: Competition, Contracting and the *New Public Management*. London: Macmillan.

Waltz, Kenneth N. (1959) Man, the State and War – *A Theoretical Analysis*. New York: Columbia University Press.

Ward, Angela (1998) Framework for Cooperation between the European Union and Third States: a Viable matrix for Uniform Human Rights Standards? *European Foreign Affairs Review*. Vol. 33, pp. 505–536.

Weber, Katja (1997) Hierarchy Amidst Anarchy: A Transaction Costs Approach to International Security Cooperation. *International Studies Quarte*rly. No.41

Weber, Steven (1994) Origins of the EBRD. *International Organizations*. Winter. Vol 48, pp.1–38.

Weber, Steven & Zysman, John. (1997) Why the Changed Relation between Security and Economy will Alter the Character of the Europe Union. *BRIE Working Paper* 99. April.

West, Gerald T. (2001) Managing Project Political Risk. In Howell, Llewellyn D.2001.*Political Risk Assessment: Concept, Method, and Management*. New York:The PRS Group.

West, Gerald T. (2001) The resurgence of Political Risk Insurance. In Howell, Llewellyn D. (2001) *Political Risk Assessment: Concept, Method, and Management*. New York: The PRS Group.

Williamson, Oliver E. (1975) *Markets and Hiera*rchies. New York: Free Press.

Williamson, Oliver E. (1993) The Economic Analysis of Institutions and Organisations – In General and with Respect to Country Studies. *University of California, Berkeley, Economic Department Working Papers* No. 133. Paris: OECD.

Williamson, Oliver E. (1996) *The Mechanisms of Governance*. New York: Oxford University Press.

Williamson, Oliver E. (1998) The Institutions of Governance. *The American Economic Review*. May, pp. 75–80.

Wolosky, Lee. (2000) Putin’s Plutocrat Problem. *Foreign Affairs*. vol.79, no 2. March/April 2000.

World Trade Organization Report by Secretariat (1997) Trade Policy Review European Union. WT/TPR/S/30, 20.Oct.

Yavlinsky, Grigory (1998) Russia's Phony Capitalism. *Foreign Policy*. May/June, p. 67–80.

Young, Oran, R. (ed.) (1997) *Global Governance: Drawing Insights from the Environmental Experience*. Cambridge, Massachusetts: Massachusetts Institute of Technology.

Young, Stephen, Hood, Neil (1994) Designing Developmental After-Care Programmes for Foreign Direct Investors in the European Union. *Transnational Corporations*, Vol. 3, no. 2, August, pp. 45.

Zeckhauser, Richard J, Viscusi, Kip W. (1996) The Risk Management Dilemma. *The Annals of the American Academy of Political and Social Science*. Vol. 545. May, pp. 144.

Zysman, John. (1994a) Dynamic Diversity: Institutions and Economic Development in Advanced Countries. In Delorme, Robert & Dopfer, Kurt (eds.) *The Political Economy of Diversity*. Cheltenham: E. Elgar.

Zysman, John. (1994b) *From Failure to Fortune? European Electronics in the Changing World Economy*. Berkeley, California: Berkeley Roundtable of International Economy.

Zysman, John. (1994c) *Technology and Trade*. Berkeley, California: Berkeley Roundtable of International Economy.

Zysman, John. (1996) The Myth of a "Global" Economy: Enduring National Foundations and Emerging Regional Realities. *New Political Economy*. Vol. 1. Issue 2, July, pp. 157.