ONE

The Softness and Hardness of Political Risk

"I have two people working on political risk, and that is probably one too many."

Thus spoke the senior executive of an oil supermajor, a company with global operations in the sensitive business of extracting resources from the sovereign territory of other countries, in 1977. The wave of oil nationalizations had just peaked, and the turmoil of the Iranian revolution lay ahead. But in this seasoned leader's view, understanding politics merited the efforts of perhaps one of tens of thousands of employees.[1]

This view would be outrageous today. It was not then. A generation ago, few companies thought about world politics, even those that should have been doing so. They did the things companies have always done: bought, produced, and sold; invested and innovated; competed for markets. But they paid little attention to understanding, and even less to influencing, the ways other countries and societies worked.

They were not indifferent to politics. Businesses have never been innocents at home, but have always followed and sought to influence political decisions and the processes that produce them. Even in the most stable, law-governed systems, business is a key element of the informal constitution of power. But a generation ago, few companies took an interest in politics abroad. Those most likely to do so were a small number of large western companies investing in less-developed countries where state institutions were too strong and unpredictable or too weak and unreliable. But even among these, some made a virtue of saying: "We're not political. We focus on business."[2]

Today, the situation is fundamentally different. PwC's 2018 global survey of chief executive officers (CEOs) found that five of the top eight risks that CEOs are "extremely concerned" about are political. It concluded that

> CEOs across the world are increasingly anxious about broader societal threats—such as geopolitical uncertainty, terrorism, and climate change—rather than direct business risks such as changing consumer behaviour or new market entrants.[3]

But while the significance of global politics for markets is escalating, the capacity to manage its impact is declining. As a consequence, even though all aspects of business have grown in complexity, the challenges that politics create have risen more than any other traditional source of risk.[4] This chapter explores three questions:

1. How has political risk evolved?
2. Why has political risk proved so difficult to understand and engage?
3. How can political risk be better understood and engaged?

The Evolution of Political Risk

All of life carries risk, and economic activity is a part of life. Where market actors face risks that are infrequent, low impact, or manageable, they can create value through production and exchange. But frequent, severe, or unmanageable risks will hinder value creation. Production and exchange themselves always carry risks, including process integrity, safety, and changes in price and demand. Such risks are *intrinsic*: it is impossible to imagine production and exchange taking place without them. They can be better managed or mitigated over time—many have fallen significantly—but never eliminated entirely.[5] Production and exchange face *extrinsic* risks. too, ones that arise from outside these activities themselves. Extrinsic risks take three forms: nature, criminality, and politics.

Natural forces—storms, floods, droughts, volcanoes, earthquakes, disease, and others—can destroy assets and goods, and hinder trade and transport. In the long sweep of premodern history, when technology and markets changed slowly at best, nature was the major determinant of annual success or failure through its effects on harvests. Nature still has a major impact today. Total losses from disasters now run at around $200 billion a year, with over 80 percent of these caused by natural (rather than manmade) events.[6]

A second source of extrinsic risk is crime, primarily the illicit transfer of economic value through theft and fraud. Crime destroys assets and goods, raises costs, hinders trade, and deters investment. There is no clear estimate of the global costs of all crime specifically for business, but cybercrime alone now costs $600 billion a year.[7]

The third source of extrinsic risk is politics. We all have an intuitive sense of what "politics" means, but may find it harder to define the term precisely. Modern political science offers a clear and helpful concept: politics is collective choice that is binding on a community. To see this, draw a contrast between politics as the domain of collective choice and economics as the domain of individual choice. Economic choices—for example, what to consume or produce, or what kind of employment to engage in—are individual and voluntary. Such choices will be constrained—we may not be able to buy everything we want, or choose the exact job we want—but they are not coerced. We make these choices, and no one else forces us to do so. Furthermore, these choices affect only the person who makes them and other, similarly consenting individuals who freely enter into voluntary, contractual relationships (for example, of sale or employment). By contrast, political choices are collective and binding. They may be a consequence of individual decisions (in a dictatorship, the choice of a single leader; in a democracy, the choices of a majority of citizens), but everyone in the community is obliged to accept these decisions whether or not they support them.[8]

Economic choices, then, are individual, consenting, and voluntary. Political choices are collective, compulsory, and coercive. Chapter 2 will show that the interaction of these two forms of choice lies at the heart of any political economy. Political decisions are enforced in two ways. The first and more familiar way is by sovereign power exerted from above. The second, newer, and increasingly significant way is the informal enforcement of norms and values through social pressure from below. Political risk arises when market production and exchange are hindered by attempts to enforce collective outcomes in either way, whether from above by states or from below by civil society.

Because nature, crime, and politics do not arise from the performance of production and exchange, but are extrinsic to them, it is possible to imagine a hypothetical world in which any or all of these sources of risk are absent—where nature is benign, where there is no crime, and where politics never encroaches on markets. Such a world will never, of course, exist in practice. But the frequency and impact of each form of risk has varied widely across regions and over time. What trends do they exhibit, and how are these changing?

Some natural risks, such as earthquakes and volcanoes, are trendless fluctuations, although there is now a scientific consensus that human impact has caused extreme weather and other climate-related risks to increase. By contrast, most crime has seen a striking decline over the past two centuries, particularly in the most developed countries—though the rapid rise in cybercrime is an exception to this trend. Natural risks can be mitigated by building resilience to them. Criminal risks can also be mitigated, as well as prevented and deterred. Humanity has become more resilient to disasters in recent decades: despite huge population growth, average deaths from natural disasters have fallen fourteen-fold in less than a century. In the past three decades, the *incidence* of natural disasters has risen by 81 percent, but the average *cost* of a disaster has fallen by around 20 percent.[9] Risk-sharing through insurance can also help manage both natural and criminal risks. Indeed, it was shippers' needs to protect against losses from nature (storms) and crime (pirates) that led brokers to found the modern insurance industry at Edward Lloyd's London coffeehouse in 1688.

Political risk is different from these other extrinsic risks. Many forms of it are rising in all sectors and most countries. For some companies, and not only those we might assume, it is becoming the most important risk of all. And it is becoming harder, not easier, to mitigate. Six trends are driving this. The first four show how, in recent decades, exposure of economic activity to global political risks has risen. The fifth shows how political risks themselves are now rising, and the sixth shows how political risks are becoming harder to mitigate.

Economic activity has become more exposed to global political risk in four ways:

1. The *scale* of economic activity exposed to political risk has grown as the relative significance of cross-border flows has risen. From 1970 to 2017, trade rose from 27 percent to 56 percent of global gross domestic product (GDP), and from 1988 to 2017 the total stock of foreign direct investment (FDI) rose from 8 percent to 40 percent of global GDP.[10] *The density of international flows has risen.*

2. The *composition* of international flows has widened as globalization has touched every commercial activity. These flows have expanded from loans, trade in goods, and primary production to global manufacturing supply chains, equity investment, data, and trade in services. For example, from 1982 to 2008, FDI by multinationals rose from 5 percent to 27 percent of global GDP. Though some worry that deglobalization has begun to set in, the evidence is mixed, and ratios of cross-border flows to total activity continue to be high by historical standards. All economic sectors are now significantly exposed to global political risk. *The diversity of international flows has risen.*

3. The *geography* of flows has widened. Until the 1980s, most international flows were intra-western ones among the United States, western Europe, and Japan—stable, low-risk countries that enjoyed strong relations with one another within strong international organizations. Since then, globalization has become far more genuinely global. From 2000 to 2014, flows of FDI into developing countries rose from 20 percent to 55 percent of global FDI. This has brought more countries—with more dissimilar systems, societies, and cultures—into closer contact, multiplying the potential for misunderstanding, confusion, and failure. *The "difference" per unit of international flow has risen.*

4. The *complexity* of flows has risen as old patterns of risk production and consumption are disrupted. Political risk is no longer produced only by "difficult" developing countries and consumed by western ones. From 2000 to 2013, FDI flows *from* developing countries rose from 10 percent to over 30 percent of global FDI. Chinese bank lending abroad, negligible at the beginning of this century, is now over $1 trillion. The international expansion of companies from the global east and south—in particular, but not only, from BRICS (Brazil, Russia, India, China, and South Africa)—is exposing them to political risk both in other developing countries and in western ones.[11]

   Increasingly, non-western investors must navigate cultures, systems, and societies very different from those of their home states. In particular, western host nations, with their impartial institutions, unregulated politics, and unruly civil society, may prove "difficult" for non-western companies. But neither the "west" nor "rest" is homogeneous: non-western companies often fail to understand political risk in other non-western countries. *The range of actors exposed to political risk has widened.*

These four trends, logically distinct but intertwined, have spread exposure to political risk. Political costs and barriers to international trade and investment have fallen, making it easier, cheaper, and safer to conduct transactions across national borders. From the 1980s, three developments in particular enabled markets to expand into new areas: in the First World, the neoconservative revolution of privatization and deregulation; in the Second World, the lifting of the Bamboo Curtain and the fall of the Iron Curtain; in the Third World, structural reform and export-led industrialization. As a result, more market actors from more countries found it more feasible to transact across more borders. Political risk exposure spread because absolute levels of risk fell. This continues a longer historical pattern. Since the rise of market capitalism, political risk has been a major factor in determining the scope of markets. Even as new transport and communications technologies create the potential to expand markets, variations in political costs and constraints shaped the incentives to innovate and apply them.

5. But things are changing. A wider range of actors and transactions, more exposed to political risks than ever before, now faces a more rapid

growth in these risks than at any time since 1945. Three key alignments of markets, states, and societies, which have underpinned the advance of global market capitalism, are under strain: the alignment of global institutions with the distribution of power that underpins international security, the alignment of domestic economic interests with international openness that underpins the global economy, and the alignment of corporate behavior with social values that underpins the legitimacy of markets. As these alignments come under pressure, the political risks of major inter-state conflict, a closing global economic system, and declining trust in business all risk. Chapters 3 and 4 explore in detail the causes and consequences of these eroding alignments.

6. Even as political risks rise, they are becoming harder to mitigate. The old ways of dealing with them—force, money, and trust—are losing legitimacy and effectiveness. In the age of empire, force was routinely used to acquire assets, open up markets, enforce agreements, and suppress local resistance.[12] The East India Company was even licensed to wield force directly in its own interests. With European imperial expansion, a growing proportion of trade and investment came to be imposed within borders rather than negotiated across them. "Informal empire" achieved the same results without incurring the costs of rule. Until President Franklin D. Roosevelt introduced his "Good Neighbor" policy in 1933, the United States repeatedly intervened in Central America to protect railways, sugar exports, debt payments, and other commercial interests. Even then, interference in other states' affairs—including the ouster of democratically elected leaders—for commercial goals did not cease entirely. [13] But force was usually a last resort. More routine was the use of corporate funds to remove impediments by bribing and buying off local interests. Force and money were also deployed in combination to co-opt local elites and suppress popular unrest.

But today, force and money are being delegitimized as tools for managing political risks. They are not necessarily unusable, but their use is now publicly unacceptable. Norms of sovereignty and nonviolence have rendered the unilateral use of force, even for traditional security reasons, domestically controversial. Its use in the service of economic interests, while not impossible, is now nearly unthinkable for most major states, especially western ones. Even though bribery and corruption remain globally widespread, their legality and morality are also under sustained attack. National legislation with extraterritorial reach, international conventions, and global civil society are making corruption more costly and less acceptable. These efforts remain uneven and highly imperfect, but the direction of ethical travel is toward more stringent expectations of probity and transparency. No one now openly admits to corruption: it is always disguised as something else and called by another name. As markets spread through societies and between states, political influence has become the one commodity that is less permissible to trade.

A third source of corporate power, the soft power of trust, is also eroding. Like all forms of authority, companies are becoming subject to greater critical scrutiny. The assumption that they are intrinsically benign holds less and less sway in civil society. Corporate media statements are now more likely to provoke reflexive skepticism. Ironically, the more that markets have come to dominate collective outcomes, the less that companies are trusted. This is most true in the west, where the marketization of social life is most fully advanced. Trust in large businesses has fallen further than in almost any institution. CEOs, company boards, and media spokespeople are now the *least* trusted sources of information about corporate affairs. Globally, only 18 percent of the population trust business leaders to "do the right thing."[14]

Companies, then, can no longer wield force, or have it wielded on their behalf, to resolve political problems. They can no longer directly pay off others to settle them. And they can no longer rely on the soft power of goodwill to prevent them from arising. When publicly exposed, dubious methods of influence can now sink even the biggest companies.[15] As political risks escalate, the familiar ways of dealing with them are failing. No other kind of risk faces these two mutually reinforcing problems.

In sum, the six trends outlined above are transforming the scale, scope, and significance of political risk. Political risk is no longer only a concern of big western companies. It no longer arises only in developing countries. It is no longer caused only by states. It is no longer synonymous with "sovereign risk" or "emerging market risk." And it can no longer be dealt with in the old ways. At the same time political risk is becoming more varied and complex in its sources, in the demands it makes, and in the forms of power it wields. Most companies now potentially face some form of political risk, yet few are well prepared to meet it.

To illustrate the novelty of this state of affairs, consider the impact of politics on the digital economy. Political risk has traditionally been a function of distance and difference. The further a company's activities are from its home state, the more likely it is to face political problems. By contrast, a company active in a neighboring or culturally similar state will find it easier to navigate the political and social territory. Political risk is also traditionally an *inverse* function of mobility. Highly mobile forms of capital, such as portfolio investment, can exit at light speed from assets or entire countries literally at the press of a button. By contrast, an extractive asset, like an oil field or mine, is immobile. Once investors have committed significant capital investment, they become vulnerable to sovereign intervention, and can only take the drastic step of exit at great cost. Hence the classic "obsolescing bargain," in which the terms of the investor-state relationship shift in favor of the latter as a project matures.[16] Trade relations—which are not trapped, but may be costly to adjust—lie between these two extremes.

The virtual economy might therefore be assumed to face little political risk. It is highly mobile, creates value from moving and using intangible data, and owns almost no physical assets. Yet many of its leading companies have found, to their costly surprise, that political risks are among the biggest they face—not only in "different and difficult" countries like China, but familiar democratic western ones. To many observers, Google sounds most like a traditional (rather than disruptive) company when it speaks about government relations. It is not clear what a "googly" way to conduct these might look like. A best-selling insider account by two senior Google executives devotes barely two pages to government relations. These set out how governments should engage with disruptive companies (key message: don't get in the way), but not how such companies should engage with governments.[17] Facebook, Uber, and other key players in the digital economy have struggled with similar challenges. Paradoxically, the dynamic, visionary, cosmopolitan culture of Silicon Valley has been remarkably parochial in its failure to anticipate, understand, and manage adverse responses from governments and civil societies. Chapter 4 will show why.

The growing salience of political risk and declining legitimacy of traditional solutions have created a demand for ways to understand and address it. An industry has sprung up in response: the political risk industry. What does the industry look like, and how well is it supplying this demand?

The Problematic Practice of Political Risk

Few now deprecate political risk as the oil executive quoted at the start of this chapter did forty years ago. Entire corporate roles and functions have been created to manage it, supported by an ecosystem of consultancies. But few would say that political risk is understood and managed well. Surveys by McKinsey show that most CEOs now rank external affairs as one of their highest priorities, but have little confidence in their ability to influence them—and that this confidence is declining further. A major study by Forbes found that "most companies neither measure nor manage political risk."[18] As the Introduction observed, failures to understand and mistakes in addressing political risk are endemic. Why is this? Three issues stand out.

Legitimacy and Numbers

Although awareness of political risk is rising, the activity of managing it still struggles for legitimacy across business. Even now, it is rarely integrated into corporate culture, strategy, and decision-making. It can be unclear to those responsible for it, and even more to their colleagues, what they do, why it matters, and how it is related to the rest of the business. Even the name for this work lacks consistency: it is variously described as "external affairs," "policy and corporate affairs," "stakeholder relations," "government relations," and so on. No other business function has such a variable title.

Why this confusion? Because politics is extrinsic to the core work of production and exchange that lie at the heart of corporate thinking. CEOs and senior executives rise to their positions by virtue of technical or market, not political, expertise. Most of a company, by definition devoted to core activities, typically regards understanding politics not as something which requires a distinctive skill set or experience, but rather as a "soft" function, even one that "anyone can do," As a cost center, it is easily targeted when budgets must be cut. Few business school curricula address political risk in any detail.

The political risk industry and its practitioners have sought legitimacy by mimicking the methods of established core functions. One such approach is to develop its own set of technical tools, such as stakeholder grids and maps, to help ensure that political and social issues and situations are analyzed in systematic and consistent ways. But they can feel formulaic—more like a compliance exercise, conducted and then forgotten, than an organic part of the corporate mind or a living guide to action. When conceived as mere compliance, political engagement lives in the shadow of a company's legal department and may be conducted largely by legal means. This can lead to the compression of external relationships—subtle, sensitive, variegated—into a narrow, careful bandwidth of standardized procedures. And if a company then sounds like a lawyer when it engages with its stakeholders, its authenticity and effectiveness will suffer.

Political risk practitioners may also use the corporate language of numbers to monitor the political world and define measurable outcomes. Such metrics include the imputed probabilities of various political events, the commercial value at stake, and the "return on investment" in political risk management.[19] By making political risks directly comparable with nonpolitical ones such as safety, commercial, and technical risks, these efforts speak to the wider business and make it more likely that political risks will be integrated into decision-making.[20] Specific, identifiable cases of risk for individual companies—an asset expropriation, forced closure of a project, or a tariff or tax increase—can be calculated. This may be the best (and often the only) way to gain the attention of senior leaders.[21]

Nowhere has more thought been given to quantifying the impact of politics on economic life than the insurance industry. Measurement of risk in all its forms lies at the heart of this business, and demand for political risk insurance is growing rapidly. According to the Berne Union, the international association of investment insurers and export credit agencies, political risk insurance has more than tripled since 2005. It now accounts for nearly half of all medium- and long-term export credit insurance claims, and over 80 percent of recoveries. Political risk is rising fastest in advanced economies.[22] Yet the insurance industry is the first to admit that political risk is harder to assess—"more subjective, less quantifiable" as senior professionals report—than nearly all other risks.[23]

Even experts in quantifying risk find it difficult to measure international politics. Conversely, experts in international politics struggle to find use for quantification. Foreign ministries rightly expect their missions and diplomats to show evidence of their achievements, and in conscious imitation of corporate method, they may even enjoin their staff to put numbers on their activities. Most diplomats play the bureaucratic game, but some have voiced their doubts. In 2006, the departing British ambassador to Rome, getting matters off his chest, protested that "diplomacy cannot properly be measured" and that "[w]e manage or contain disputes; very rarely do we deliver a quantifiable solution." He was moved to quote Maxim Litvinov, Soviet commissariat for foreign affairs, advising Josef Stalin in 1929 of the difficulty of formulating a Five-Year Plan for his department: "we have to deal with a number of factors that are scarcely subject to calculation, with a number of elements outside our control."

This begs several questions. Are international relations, even for diplomats (let alone for companies), merely about containing disputes? Under what conditions *can* quantifiable solutions be delivered? Are today's disrupted, shifting markets really so different from Litvinov's depiction of a complex world "scarcely subject to calculation . . . outside our control"?[24] A recent report on the future of the British Foreign and Commonwealth Office (FCO) stepped up the case for quantification. Numbers, it argued, are widely used in the corporate world, and should be used in diplomacy as well:

> Business has woken up to the transformational potential of big data. The FCO has not. The FCO is not yet in a position to "mine" even its own internal data for insight, which means we miss important patterns and trends.[25]

But this raises further questions. Yes, business is using big data, but is it doing so to understand and manage political risk? Or does it find that politics is sufficiently different from core production and exchange activities—where big data *is* transformational—that its value there is more elusive? If business itself struggles to deploy big data for corporate diplomacy, then big data's potential for government diplomacy may itself be limited.

The debates will continue. There is no doubt that, both for companies and states, big data poses questions about quantifying political events, and engagement with them, more sharply than ever. There is nothing wrong with seeking greater precision in assessing the impact of activity. But few would disagree that the political world is intrinsically more qualitative, and harder to measure, than the core business activities of production and exchange. There is a looser, more contingent relationship in political life between countable effects and underlying purposes, between outputs and outcomes. In his anthropological study of diplomacy, Iver Neumann quotes an evidently weary secretary general of the Norwegian Foreign Service, who has carefully counted his outputs:

> According to my meticulous records, last year I attended 67 suppers, 40 luncheons and 73 receptions. I have to deliver speeches at most of the suppers. I have to give a welcoming speech at most of the lunches. On top of it all, I hosted 184 lunch and dinner guests at my own table. The returns on all this socializing are limited.[26]

Yet official socializing remains an important way of managing diplomatic relations to produce desired outcomes. Neither in Norway nor elsewhere has appetite for it diminished. The underlying outcomes may be hard to measure, even if they are of fundamental importance. Inputs, in the form of resource costs, can be counted, but the outcomes they produce often need to be judged more qualitatively. Such judgment should be rigorous, but it must not be quantified if it makes no sense to do so. There is no safety in numbers alone.

In politics, not everything that counts can be counted. Indeed, counting the wrong things can be disastrous and undermine the goals it is designed to serve. America's greatest military failure, the Vietnam War, occurred partly because of a concerted effort to apply the methods of a successful multinational business—targets, metrics, measurable outcomes—to the conduct of a profoundly political enterprise. This not only generated a host of perverse and self-defeating behaviors, as well as organizational corruption, but blinded decision-makers to the essence of war as a clash of unmeasurable, qualitative forces: interests, wills, and commitments. The biggest western military failures in our own time stem from conceptual failure, not inadequate measurement—failure to think through the *nature* of a conflict rather than to apply sufficient data to it.[27] War, properly understood, is always an instrument of political ends. As the political context of warfare becomes more complex and varied, narrowly military metrics of success (like the ill-fated "body count" in the Vietnam War) distort strategic judgment.

For similar reasons, the complex political context of market life imposes limits on the value of measurable metrics. Jeff Bezos, CEO of Amazon, one of the biggest and most data-driven companies in the world, has noted that "when the anecdotes and the data disagree, the anecdotes are usually right."[28] He was referring to customer feedback: how much truer must this be of the far more ambiguous world of political behavior? False precision that only appears impressive lays snares and creates delusions. As Cecilia Sottilotta observes in her comprehensive study:

> the recent proliferation of political risk indexes and maps . . . is not matched by a serious methodological reflection on the way they are constructed, the causal relationships they posit, and . . . their predictive power.[29]

Relevance and Prediction

The issue of relevance compounds that of legitimacy. Much political risk activity is unbalanced, producing a great deal of analysis and prediction but much less guidance on what to do. Two problems arise from this.

First, the record of political prediction is undistinguished and seems to be getting worse, especially on the biggest calls. Even democratic elections—repeated, data-rich events that should be highly amenable to refined statistical analysis—regularly confound political scientists. The 2016 Brexit referendum, 2016 U.S. presidential election, and 2017 British parliamentary elections are among the most recent, emphatic cases. Much political prediction is really a form of entertainment, a parlor (and parlous) game played by garrulous pundits. Perverse incentives select on judgment. Studies show that the more prolific a commentator, the poorer his or her predictive record. But such "hedgehogs" (who "know one thing" and paint the world in primary colors) crowd out the "foxes" (who "know many things" and use *pointillist* precision). Bold but erroneous certitude makes for more compelling viewing than cautious, nuanced precision.

Debates rage about the possibilities and limits of prediction in politics. On one side are those who argue that reliable excellence (though not infallibility) is possible. Philip Tetlock's "superforecasters" are quintessential foxes, ordinary people who predict extraordinarily well by cultivating open, curious, self-critical habits of enquiry. Bruce Bueno de Mesquita's "predictioneers" claim similar success by a different route (in their case, a 90 percent rate of prediction accuracy), by applying refined models built from the rigorous logic of "expected utility" to decisions that produce political outcomes.[30] On the other side are skeptics who doubt the possibility, even in principle, of reliable political prediction. The obstacles are not merely technical ones that might be overcome with enough data or computing power, but are inherent in the complex nature of political systems: dynamic, nonlinear, chaotic, and highly sensitive to tiny changes in initial conditions.[31] A solar eclipse can be calculated centuries in advance to the minute, but the weather cannot be predicted more than a few days ahead, and then only imperfectly. Earthquakes cannot be predicted at all. Politics, argue the skeptics, is more meteorology than astronomy.[32]

The loudest skeptic is Nassim Nicholas Taleb. Deriding the "Soviet-Harvard delusion" that political events have prior discernible causes, he insists that true understanding comes from practice, not from theory or research. Prediction is not merely useless but can be harmful. The most significant events are high-impact, low-probability "black swans" that cannot even be imagined before they happen, let alone predicted. His "apophatic" knowledge—won by practice, but not easily communicated—echoes a tradition that sees understanding as tacit, implicit, and rooted in experience, and can be traced back to the ancient concept of *praxis*, the unity of theory and practice.[33] It is a spiky counterpoint to a confident rationalism that outside observers with the right tools can frame a better understanding of a complex situation—and engineer a better outcome—than decision-makers immersed in it.

Arguments about the inseparability of knowledge and practice in the political world raise a second issue. Even if political predictions were more accurate and useful, what would their practical implications be? Senior business leaders may hear from political risk experts, and pay well to do so, but in private after the meeting they often ask: "what do I do with this?" Detached from practice, external political commentary and analysis can seem brittle and scholastic. By analogy, would a company accept advice from an engineering consultant who had studied but never practiced engineering?

Both theory and practice are needed: practice tests concepts and keeps them honest and grounded, and theory can make experience systematic and useful to others in different circumstances. We cannot avoid making predictions: every deliberate action embodies assumptions about how the world works. It is better to make these assumptions explicit and subject them to improving scrutiny than to leave them implicit, unexamined, and likely to be wanting. Understanding political risk demands a judicious blend of theory and practice, abstraction and experience, first- and third-person perspectives—ways of seeing and doing. Chapter 5 will explore the practice of political risk and the mind-set it demands.

Politics and the Risk Perspective

Politics, then, is inherently qualitative, hard to measure, and difficult to predict. This hinders the integration of a political perspective into a modern corporate culture of metrics, precision, and performance indicators. The third issue, which compounds the first two, is the nature of the risk perspective itself.

Understanding and managing risk of all kinds is now an explicit focus of business strategy and planning. But this is still new, evolving, and unevenly practiced: an international standard (ISO 31000) for it was adopted only in 2009. Organizations are still learning how to integrate risk thinking into their governance. Risk officers can often be seen as curmudgeons or Cassandras whose warnings get in the way of otherwise attractive opportunities. As the chief systems engineer at NASA's Jet Propulsion Laboratory put it: "Risk mitigation is painful, not a natural act for humans to perform." It requires people to challenge their assumptions and imagine what could go wrong, including with their own plans, policies, and convictions. It naturally meets resistance.[34]

The banking industry epitomizes both the acceptance in principle and the ambiguous practice of risk. Before the 2008 global financial crisis, this sector developed the most precise, quantified, and comprehensive approach to risk management of any sector. Regulators bought into its confident view that financial risk was now better understood and managed than ever before. But as we now know, its major players made some of the least accurate predictions of any kind. The height of the crisis saw repeated occurrences of "25-sigma events"—events with a probability so low that a special program must be written to calculate it. This is roughly the likelihood of winning the UK National Lottery twenty-one times in a row.

One reason was a failure of the risk models themselves, which embodied complacent, ahistorical assumptions about property price movements and risk correlation. But more importantly, as Michael Mazarr has shown in detail, senior executives pursuing lucrative opportunities repeatedly ignored internal warnings and froze out or fired the risk officers who issued them.[35] If it is easy to ignore specific, quantifiable risks caused by core business activity, it is even easier to ignore less familiar or measurable risks that intrude in hard-to-predict ways from the external political and social environment. If politics is regarded only in terms of risks, it will be neglected. One must think systematically about political forces and their relationship to economic life. Politics is much more than the risks it creates.

These three issues—legitimacy, relevance, and the limitations of a risk perspective—contribute to the neglect and misunderstanding of political risk. Because politics is extrinsic to market life, companies are not naturally familiar with how to think about it. But because politics is increasingly pervasive, this failure has consequences: it will be more damaging for more businesses in more relationships in more parts of the world.

A systematic approach to politics and its relationship to value creation is needed. This approach must show how a political way of seeing and doing is irreducibly different in nature from the core business activities of production and commerciality (which in turn are different from one another), and also show how these are related. Production, commerciality, and politics are the three cogs that drive the intricate, evolving mechanism of value creation. To succeed and endure, business must recognize the role that each cog plays and ensure that they mesh, not clash.

This cog must be understood in its own terms. The political world has its unique grammar, actors, and forces. It is governed by more variables, fewer laws, and greater uncertainty. A wide variety of sources is needed to understand it. Its very nature can evolve—indeed, is evolving—in ways that have no counterpart in the physical or market worlds with their surer laws and more stable regularities. For all these reasons, engaging with political risk may demand special forms of anticipation and creativity. Politics is differently *tactile*. Whereas the technical world of production is law-like and mechanical, and the commercial market world is transactional, the political world is organic, human, and *soft*. It is inescapably less predictable and countable, more contingent and ambiguous, more reflexive. This does not mean politics cannot be understood rigorously, or that better tools and numbers are not useful. But we must recognize and tolerate the intrinsic softness of politics and the special challenges this creates. The fact that political risk is less amenable to fixed method does not mean that it is less important, but that it is more difficult. Political risks are harder because they are softer.[36]

Conclusions

The questions posed at the beginning of this chapter can now be answered:

1. How has political risk evolved?
2. Why has political risk proved so difficult to understand and engage?
3. How can political risk be better understood and engaged?

For half a century after 1945, global political risks (with a few, mostly temporary exceptions) fell. This trend emboldened more companies to venture further overseas than ever before. A senior oil executive might, as illustrated at the start of this chapter, feel the need for just one expert to advise him. But political risks are now resurging dramatically, exposing an unprecedented range of actors, sectors, countries, and relationships to these risks. Chapters 3 and 4 will explore why this has happened.

But even as understanding and managing political risk have become more urgent, doing so is now more difficult as the old methods of force, money, and trust have been delegitimized. Practice has not responded to the scale of the challenge and remains uneven. Three reasons for this reinforce one another. First, since politics is extrinsic to production and exchange, managing it is undervalued as an activity with its own mind-set and skill set. Second, too much attention is paid to prediction, with its frequent disappointments, and too little to engagement. Third, seeing politics only through the prism of risk narrows perspective and neglects the underlying forces driving risk. Chapter 5 considers how to cultivate and integrate a political mind-set in a business context.

More important than better techniques or more data, useful though these are, is a clear concept of how politics is related to processes of value creation. This will yield a new understanding of a world in which, paradoxically, market and political forces are simultaneously spreading. The next chapter begins this work.