

CHAPTER TWO

THE CHALLENGE OF POLITICAL RISK

OVERVIEW

As signs of economic recovery in the aftermath of the most severe crisis in the post war era emerge (chapter 1), concerns over political risk continue to loom large. While the link between FDI and political risk is not straightforward, investors repeatedly rank political perils amongst their main concerns when venturing abroad. Understanding investors' current outlook on both risks and opportunities in developing countries is essential to shed some light on how the PRI industry can help mitigate concerns over political risks.⁷

The global economic downturn, by straining government budgets, putting pressure on exchange rates and bringing political and social tensions to the fore, has exacerbated specific political risks in the most vulnerable investment destinations, but does not appear to have led to a reassessment of political risk in all emerging markets. For example, concerns that government may be tempted to impose transfer and convertibility restrictions have emerged in highly leveraged countries where the financial crisis has severely undermined liquidity and led to high spreads. With unemployment on the rise, declining remittances and pressure on social programs due to shrinking government revenues, the risk of civil unrest has become more pronounced in some countries. Budgetary pressures and stimulus packages have also raised concerns about the ability of some governments and state-owned entities to fulfill their contractual obligations and honor their sovereign guaranties. These risks, however, have so far not materialized on a large

scale, and are less likely to do so as the effects of the crisis abate.

While corporate investors appear sanguine about investment prospects, in particular in emerging markets (chapter 1), political risk remains a major concern in the medium term, according to surveys of MNEs conducted for this report. Concerns over some longer-term political risks are likely to persist, even if some of the perils directly related to the fallout of the crisis recede as the global economy gradually recovers. The growing salience of political risk concerns, a trend that predates the onset of the global crisis, can partly be attributed to the increasing weight of developing countries—typically regarded as riskier destinations than industrialized ones—as foreign investment recipients. Over the past few years, the revival of resource nationalism in some countries, as well as contract renegotiations, have also weighed on political risk perceptions in extractive industries. Terrorist attacks have highlighted the emergence of new threats. And while political risk was thought to be a preoccupation primarily for investors from industrialized countries, it now appears to be a top concern for investors from the main emerging markets as well, as they venture further away from familiar business destinations.

Robust appetite for investment into emerging markets, combined with the persisting salience of political risks going forward, suggest a sustained need to manage and mitigate these risks. Yet most investors, both South- and North-based, appear to rely primarily on their own risk management capacity (even though a sizable minority

judges that capacity as poor) and on informal mitigation mechanisms, such as engaging host governments and local communities, to evaluate and manage political risk. The proportion of respondents using contractual political risk management products such as PRI when investing in emerging markets is relatively small, which insurance industry statistics confirm (chapter 3). This suggests that most investors regard political risk in their main investment destinations as manageable. However, a much larger proportion of investors seek PRI when venturing into markets considered the riskiest, suggesting that PRI has a significant role to play protecting investors in transactions that are beyond their internal risk management capacity. The surveys also suggest investors' interest in PRI, with 40 percent of respondents in the global survey saying they will consider it going forward.

POLITICAL RISK, FOREIGN DIRECT INVESTMENT AND CORPORATE PERCEPTIONS

What is Political Risk?

Broadly defined, political risk is the probability of disruption of the operations of MNEs by political forces or events,² whether they occur in host countries, home country, or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also of minority groups, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment.

For the purposes of the investor surveys conducted for this report, political risk was more specifically defined as breach of contract by governments, restrictions on currency transfer and convertibility, expropriation, political violence (war, civil disturbance and terrorism), non-honoring of government guarantees, adverse regulatory changes, and restrictions on FDI outflows in home countries. This definition includes risks that are not currently insurable by the PRI industry.

The insurance industry uses a narrower definition of political risk that focuses on actions that take place within host countries only. According to this definition, political risk is divided into (i) currency convertibility and transfer, (ii) expropriation, (iii) political violence, (iv) breach of contract by a host government, and (v) the non-honoring of sovereign financial obligations (box 3.2). Although there is a general consensus over these categories within the PRI industry, exact definitions vary among insurers.

Evolution of Political Risks

Although surveys suggest that investors are concerned about political risk when venturing abroad, the link between political risk and FDI is not straightforward (annex 5). More research is needed to determine the weight of political risk when compared to other factors that influence investment decisions, and clarify how the level of perceived risk influences FDI flows. The nature of political risk makes it difficult to predict and quantify, and concerns are primarily based on perceptions. These perceptions are influenced by broad geopolitical and economic trends, as well as local conditions.

The nature and perceptions of political risk have evolved over the past 30 years. The risk of expropriation was prominent in the 1970s, when MNEs found themselves at the core of public scrutiny, with their operations nationalized or controlled tightly. Especially in the area of natural resources and other industries deemed strategic by host country governments, MNEs found their autonomy waning.³ Over that period, expropriation losses resulted primarily from outright confiscation of foreign assets. The number of foreign expropriations declined drastically in the 1980s,⁴ however: while there were 423 cases of expropriation of foreign assets in the 1970s, that number dropped to 17 during 1980-1987 and to zero between 1987 and 1992.⁵

Over the same period, most emerging markets allocated foreign exchange via permits, and current and capital accounts controls were prevalent. This controlled foreign investors' ability to access and repatriate foreign exchange during balance of payments crises. As a result, a large number of transfer restriction claims occurred during the 1980s, triggered by the Latin American debt crisis and the subsequent fallout on the Philippines.

Transfer and expropriation risks appeared to ease significantly throughout the 1990s, as many countries began to liberalize their economies. Financial liberalization resulted in floating exchange rate regimes and the allocation of foreign exchange via market mechanisms through the banking sector, while capital controls were relaxed. These reforms eased the insurable risk of convertibility and transfer restrictions, but increased the uninsured risk of depreciation.

In the 1990s, the regulatory framework for FDI was characterized by increasing openness and a retreat of government intervention, as the benefits of foreign investment were deemed to exceed any adverse effects. Out of 1,097 changes in national FDI laws alone adopted between 1992 and 2000, 94 percent created a more favorable climate.⁶ Many countries went beyond establishing an open environment for FDI by proactively seeking to attract such investment via incentives, targeted investment promotion programs and pro-active

marketing. This has been complemented by greater efforts by many developing countries to reduce barriers to doing business.⁷ In addition, the multiplication of bilateral investment treaties (BITs)⁸ for the protection and promotion of FDI supported the trend towards greater openness and increasing FDI flows—globally and to developing countries. Investment also emerged as a focus of international agreements related to trade in goods and services, intellectual property rights and regional integration schemes.⁹

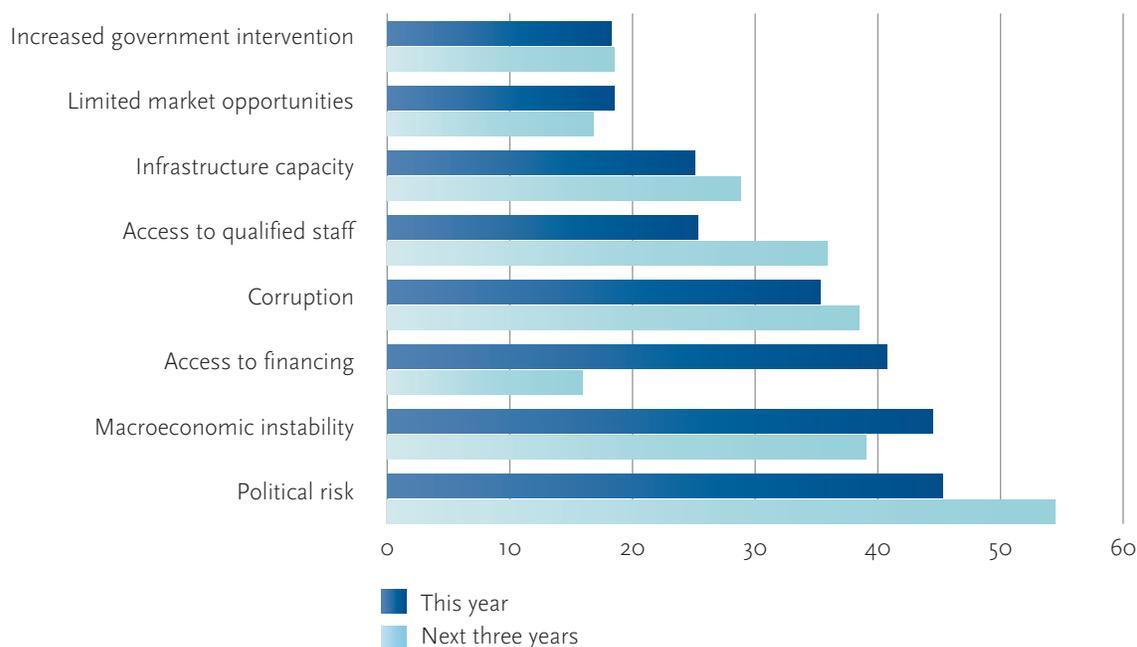
Although the trend toward reform and greater investment openness that gained force in the 1990s largely continues to-date,¹⁰ concerns over political risk persist, as documented in a number of surveys (annex 5). In the global survey (annex 3), MNEs investing in developing countries rank political risk amongst their top three concerns more often than any other preoccupation, including macroeconomic stability and access to finance. A higher proportion of respondents expect political risk to be among

their main investment constraints over the next three years (figure 2.1).

Ironically, the apparent resurgence of some political risks concerns over the past few years could be the result of greater openness to FDI, as the gradual dissolution of traditional barriers to investment may have amplified the relative salience of political risk among investor preoccupations. In addition, greater openness has contributed not only to an increase in global FDI, but also to a growing share flowing into developing countries (chapter 1). That emerging markets are perceived to be riskier destinations than industrialized countries is compounded by the number of investors expanding their business horizons by venturing into regions or countries for the first time.

In addition, MNEs based in developing countries have been investing growing amounts abroad (chapter 1). Some of that investment is in natural resources in countries beyond their regions of origin (e.g.

FIGURE 2.1 MAJOR CONSTRAINTS ON FOREIGN INVESTMENT IN EMERGING MARKETS
Percent of respondents



In your opinion, which of the following factors will pose the greatest constraint on investments by your company in emerging markets this year and over the next three years?

Source: MIGA-EIU Political Risk Survey 2009.

Note: Percentages add up to more than 100 percent due to multiple selections.

Brazil in Africa). Attention to political risk tends to be high during the first few years of operating in a new market, before sufficient familiarity and coping mechanisms are developed. As these enterprises spread their operations into new destinations in developing countries, they become more aware of political risk. This has contributed to the increase in demand for PRI from South-based investors (chapter 3).

Besides these general trends, the recent evolution of specific perils also contributed to a revival of political risk concerns that predates the global economic downturn.

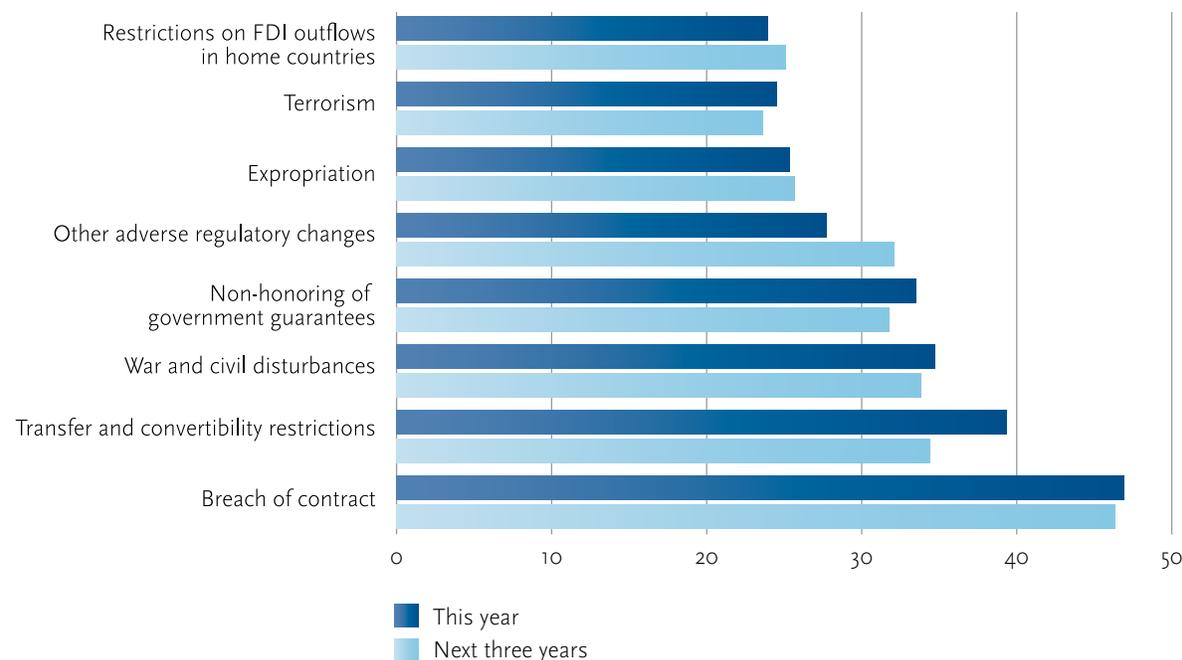
Expropriation, breach of contract and non-honoring of government guarantees. Concerns over expropriation have reemerged over the past few years. The nature of expropriation, however, has evolved compared to the 1970s and 1980s. Outright nationalizations have become the exception rather than the norm. Changes in regulations or contractual agreements that undermine

the financial viability of investments—as in Indonesia or Argentina in the late 1990s and early 2000s (chapter 3)—now dominate expropriation risks. Although the vast majority of changes in foreign investment regulations still go toward more openness, there are signs that FDI has been subjected to increasing scrutiny over the past few years.¹¹ The global survey confirms that more investors are concerned about breach of contract, non-honoring of government guarantees and adverse regulatory changes—which can result in investment loss—than outright expropriation. Breach of contract is the political risk of most concern to respondents, both this year and over the medium term. An increasing proportion of respondents are concerned about the risk of adverse regulatory changes going forward, with a third of them regarding it as a top concern in the next three years (figure 2.2).

Extractive industries are still particularly vulnerable to expropriation and breach of contract. The strategic nature of natural resources in host countries' economies, long

FIGURE 2.2 TYPES OF POLITICAL RISKS OF MOST CONCERN TO INVESTORS IN EMERGING MARKETS

Percent of respondents



In your opinion, which types of political risk are of most concern to your company when investing in emerging markets?

Source: MIGA-EIU Political Risk Survey 2009.

Note: Percentages add up to more than 100 percent due to multiple selections.

investment horizons, scale and capital intensity also make these projects prone to uncertainty and possible government intervention. In a global environment of rising commodity prices, as was the case prior to the financial crisis, some governments renegotiated concession and royalty agreements struck with foreign investors a decade ago, when commodity markets were depressed.¹² Other governments motivated by nationalist political agendas have sought to reclaim ownership of the mining sector by nationalizing foreign owned assets. This apparent resurgence of “resource nationalism” has heightened perceptions of expropriation and associated risks in recent years.¹³

Indeed, the global survey confirms that investors operating in the primary sector—mostly in the extractive industries—are more concerned about political risks in general than in other sectors: 57 percent cite political risk as a major concern this year, compared with an average of 45 percent for all sectors. Of particular concern to investors are breach of contract and expropriation. Investors in the primary sectors worried more about the risk of breach of contract than in any other sector, with 54 percent citing it as a top risk. Similarly, over 45 percent of respondents from the primary sector also considered expropriation a top risk, compared to an average of 25 percent among all respondents.

Sub-sovereign authorities have also become an increasing source of risk for foreign investors—especially expropriation, breach of contract and non-honoring of guarantees—over the past few years. As emerging economies embrace decentralization, local authorities, such as provincial or municipal governments, are expected to take on increasing responsibilities in providing infrastructure services. In recent years, disputes have arisen in the power sector in countries where the sub-sovereign has not been able to fulfill its commitments, and central governments have been hesitant to take over these obligations.

Transfer and Convertibility. In spite of liberalization of exchange regimes and more prudent monetary policies, transfer and convertibility risks have not disappeared. In the last 10 years, several countries have restricted current or capital account transactions, or frozen foreign currency bank deposits to limit foreign exchange outflows. But foreign exchange restrictions now tend to be imposed for shorter durations, and scaled back as the economy re-balances. Nevertheless this risk is still prevalent, especially when financial crises strike. In the global survey, 39 percent of respondents cited it as one of their three main political risk concerns (figure 2.2).

Political Violence. Fresh worries over political violence have emerged in the past decade. The September 11 attacks highlighted the risk of terrorism. As terrorist attacks around the world continue to make headlines, risk

perceptions are undiminished.¹⁴ Threats stemming from separatist and extremist movements, civil unrest, as well as piracy and hijacking that threaten to disrupt supply chains, have also weighed on political risk perceptions. Respondents in the global survey ranked political violence (combining war, civil disturbance and terrorism) as their second main concern after breach of contract¹⁵ (figure 2.2).

The preoccupations over political risk mentioned above are expected to outlive the current global downturn and persist over the medium term. In addition, the financial and economic turmoil itself has generated new concerns over political perils.

THE IMPACT OF THE FINANCIAL CRISIS ON POLITICAL RISK PERCEPTIONS

The onset of the recent global financial crisis has intensified concerns over specific political risks in the most vulnerable countries. A comparison between the political risk ratings for the 126 emerging markets covered by the Economist Intelligence Unit's Risk Briefing between pre-crisis June 2008 and the ratings for June 2009 show a degradation of perceptions: the political risk score had increased for 52 countries (41 percent of the total number of emerging markets in Risk Briefing), remained unchanged for 49 countries (39 percent), and decreased for 25 countries (20 percent) over this period.¹⁶

The most significant deterioration of political risk perceptions between June 2008 and June 2009 was over Eastern Europe, followed by Latin America, developing Asia, Sub-Saharan Africa and Middle East and North Africa. This is also roughly the order of the comparative severity with which the global economic crisis has affected emerging market regions. Social unrest showed the highest increase among the various types of political risk in the Risk Briefing, followed by the related risk of violent demonstrations, and the imposition of capital account controls, all of which are closely related to the global financial and economic crisis.

With unemployment on the rise, declining remittances,¹⁷ and fewer resources available to social programs due to shrinking government revenues,¹⁸ many developing countries are exposed to a risk of social unrest. To date, however, the crisis has amplified—rather than created—unrest in countries where social relations were already fragile.¹⁹ The risk of social unrest and political violence directly related to the current crisis is expected to ease gradually as economies recover.

In addition to possible social or political unrest, the global economic downturn has also exacerbated political risks arising from balance of payments shortfalls and revived

the risk of transfer restrictions (box 2.1). The crisis has had an adverse impact on some countries' current account balances through shrinking international trade and the decline in commodity prices. The accumulation of foreign reserves has suffered from the impact as countries are drawing upon them to lessen the impact of the financial crisis.²⁰ Private sources of capital are also drying up, and developing countries are expected to face greatly curtailed access to external financing (chapter 1). The World Bank estimates the external financing gap for developing countries to be \$352 billion in 2009 for a base case scenario.²¹ International assistance, however, is helping cushion the impact of the crisis. Several developing countries have received financial support from multilateral institutions to help alleviate balance-of-payments difficulties.²²

Investors surveyed for this report expect the risk of convertibility and transfer to recede over the next three years, with around a third citing it as concern in three years, compared to 39 percent this year. This could reflect optimism that the financial crisis will ease over this period. Concerns over this risk were concentrated in Eastern Europe and Central Asia for this year, where many markets relied heavily on foreign financing, and some have pegged foreign exchange regimes.

Budgetary pressures, due to slower economic growth, and priority on stimulus packages, could also weaken the ability of some governments and state-owned entities in developing countries to fulfill their contractual obligations and honor their sovereign guaranties. These pressures are particularly acute in countries where fiscal deficits are high compared to GDP. Between 2008 and 2009, Europe and Central Asia is expected to have the largest increase in fiscal deficit in relation to its economic size, followed by Sub-Saharan Africa.²³ Deteriorating fiscal positions raise the risk of payment defaults by sovereign (or sub-sovereign) and state-owned entities. Respondents in the global survey expect the risk of host governments failing to honor their guarantees to remain roughly the same over the medium term: 34 percent of respondents consider it as a main risk today, compared to 32 percent in three years (figure 2.2).

The financial crisis also gave rise to concerns that governments in both developed and developing countries may adopt policies to alleviate the effects of the crisis that might restrict outward FDI or discriminate against foreign investors.²⁴ Yet several reports tracking regulatory changes in investment since the onset of the crisis have found no general trend in that direction so far.²⁵

Yet, the risks directly related to the fallout from global crisis have so far not materialized on a large scale, and they are likely to ease as economic recovery slowly takes hold. The global survey suggests that the global crisis has not led to a fundamental reassessment of political risks

in the top FDI recipients in emerging markets: a majority of investors stated that the downturn itself had not affected their risk perceptions in their main investment destinations (35 percent considered the risk to be worse, however). As the BRICs dominate investment destinations (figure 1.7), this could reflect investor confidence in these countries' ability to weather a global crisis.

The global survey suggests that host countries' recent track records of political stability, rule of law and investor protection—rather than economic difficulties—are the main features influencing investors' perception of overall political risk. The investors surveyed were asked to provide their perceptions of political risk for the 40 largest emerging markets ranked according to the size of population. The ten countries most frequently identified by investors as the markets with the highest political risk included a number of countries that are at war or emerging from conflict, as well as others that have recently experienced acts of civil disturbance or where government decisions adversely affected foreign investors (annex 3).

CORPORATE PERCEPTIONS OF POLITICAL RISK MANAGEMENT

A majority of survey respondents expected to ramp up their investments in emerging markets over the next three years, as highlighted in chapter 1. Combined with an increasing proportion of investors citing political risks as the top investment constraint over the medium term, this suggests a growing need to properly manage these risks.

Yet most respondents have so far relied on internal risk assessments and informal mitigation tools—such as engagement with host country governments or joint ventures with local companies—or have not mitigated political risks at all. Political risk insurance features as a niche product primarily used for projects and destinations considered the riskiest. Yet 40 percent of respondents in the global survey expect they will consider PRI going forward.

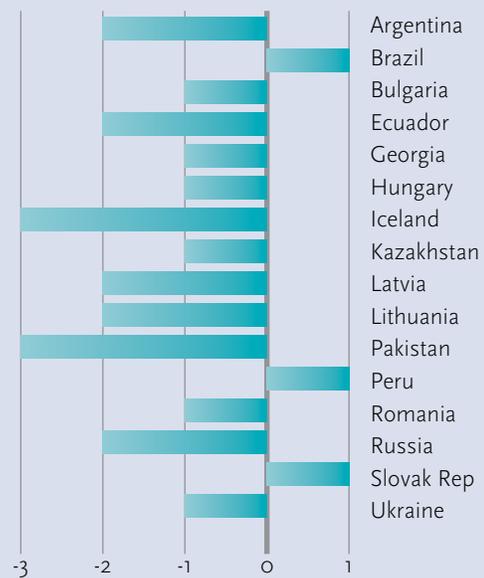
A majority of investors surveyed for this report were confident in their ability to appraise and manage political risks. But a significant minority was not: 24 percent of investors considered their ability to anticipate new political risks to be weak or non-existent (figure 2.3). Similarly, 29 percent of respondents regarded their ability to evaluate political risk mitigation strategies as weak or non-existent, and 23 percent admitted that their capabilities to implement those strategies were also poor. These findings suggest a sizable portion of investors may need assistance with assessing and managing political risks.

Box 2.1 TRANSFER AND CONVERTIBILITY RISK

Standard & Poor's (S&P), the rating agency, assigns transfer and convertibility (T&C) ratings that address the probability of such government interventions. During 2008, Standard & Poor's downgraded its T&C ratings on 13 countries, 12 of which are in the developing world (box figure). With the exception of countries affected by specific conflicts, these downgrades stem directly from the impact of the global financial crisis and imply an increased probability that host governments might intervene in their markets in ways that would be detrimental to the interests of foreign investors. According to rating agencies, the likelihood of such interventions appears to depend not only on macroeconomic factors, but also on political stability and governments' institutional strength. Indeed, all other things equal, a government committed to sustainable economic policies and with the authority to pursue them, would be in a better position to respond to the challenges posed by the financial crisis.

Most of the recent downgrades in T&C ratings are concentrated in Europe and Central Asia (ECA), where ratings on two out of three assessed countries were cut in the last year (box figure). According to S&P, the vulnerability of many countries in the ECA region stems from the characteristics of their financing structure, including large current account deficits, significant external public and/or private debt, and short-term maturities. Comparatively, many emerging economies in Latin America and Asia have manageable levels of external debt, and have successfully developed sizeable domestic capital markets, largely funded by private pension funds, which so far have provided relatively stable funding to local corporate borrowers.

CHANGES IN T&C RATINGS DURING 2008



Source: Standard & Poor's
 Note: Bars represent the change in number of notches in S&P's rating scale.

Most investors claimed that they manage political risks utilizing a wide range of mechanisms, and in many instances using more than one mitigation tool (figure 2.4). Most respondents relied on risk or scenario analysis to assess perils. A majority of respondents used informal tools, such as engagement with host country governments, as a way to mitigate political risks. Around a third of respondents managed risks through joint ventures with local partners, while a similar proportion engaged risk consultants.

A small proportion of respondents, on the other hand, used contractual risk mitigation such as credit default swaps (17 percent), or PRI (14 percent). This is broadly in line with PRI industry data indicating that new political risk insurance policies underwritten in 2008 by members of the largest insurance association covered around 10 percent of FDI flows to emerging markets (chapter 3).

The global crisis had a limited impact on desire to use risk-mitigating tools: the majority of investors (57 percent) reported that the crisis had not changed the attractiveness of these instruments one way or the other. A significant minority of respondents, however, found mitigation tools more attractive due to the downturn (19 percent).

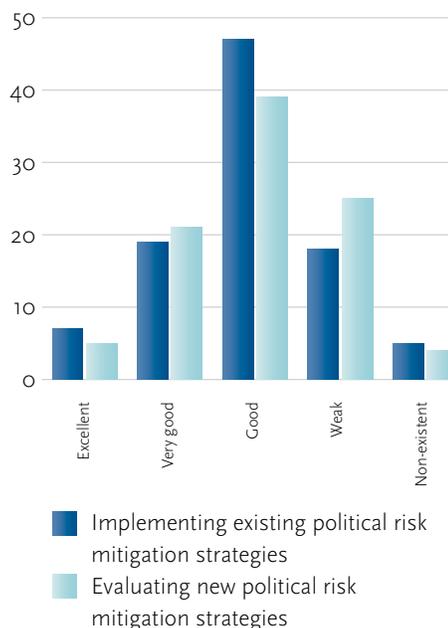
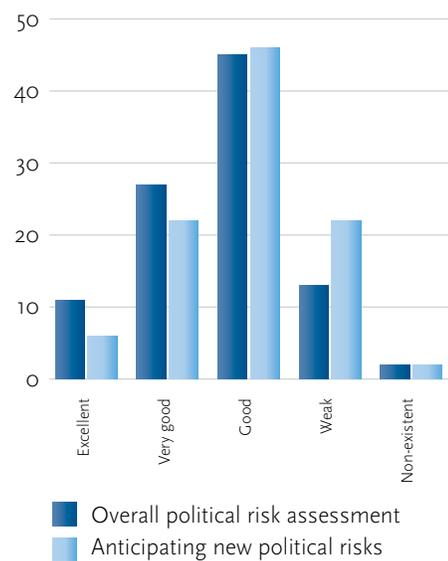
About 6 percent of the investors reported that they do not mitigate political risk at all (figure 2.4). The most common reason cited by investors was that the level of political risk in destination countries was not high enough (less frequently cited reasons included the cost of mitigation and inadequacy of products). Yet many of these respondents had investments in countries with a relatively high degree of risk, which indicates a wide variance in risk perceptions and tolerance—or in investors' ability to assess political risk adequately.

While a similar proportion of investors across all sectors undertake risk analysis and engage with host country governments, the use of other mitigation techniques varied across industries (table 2.1). About half of the respondents operating in the primary sector, utilities, transport and communications mitigated risks through joint ventures with local partners, while only one third of respondents did so in the financial sector, manufacturing and services. Financial sector investors, however, were much more frequent users of formal risk mitigation mechanisms, such as credit default swaps and PRI.

Several factors influence investors' decisions to contract political risk insurance (box 2.2). The global investor survey confirms that the level of risk in host countries is a major determinant. Although only 14 percent of investors in the global survey reported using political risk insurance on average, 22 percent of companies investing in what they perceived to be high-risk countries turned to PRI. This suggests that investors are confident they can manage risks effectively in most destinations, and

FIGURE 2.3 INVESTORS' CAPABILITIES IN ASSESSING AND MITIGATING POLITICAL RISKS

Percent of respondents

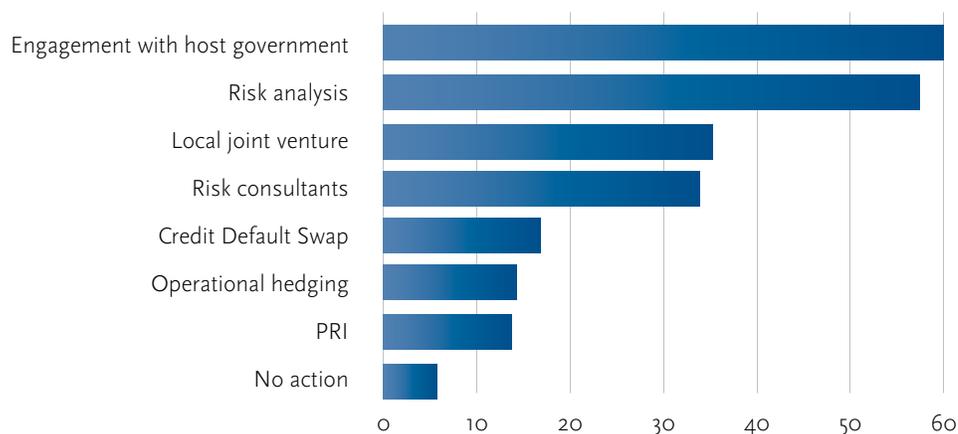


How would you rate your company's capabilities in the following areas?

Source: MIGA-EIU Political Risk Survey 2009.

FIGURE 2.4 TOOLS USED TO MITIGATE POLITICAL RISK IN EMERGING MARKETS

Percent of respondents



Which of the following does your company use as a tool for political risk mitigation? Select all that apply.

Source: MIGA-EIU Political Risk Survey 2009.

Note: Percentages add up to more than 100 percent due to multiple selections.

TABLE 2.1. TOOLS FOR MITIGATING POLITICAL RISK IN EMERGING MARKETS BY SECTOR

Percent of respondents

Sector	Local engagement	Risk analysis	Local joint venture	Risk consultants	CDS*	Operational hedging	PRI
Financial	54	58	31	33	32	14	21
Manufacturing	64	59	33	38	17	16	11
Services	63	54	33	29	11	17	13
Utilities and communications	55	59	48	35	8	6	14
Primary	57	61	48	35	2	12	6

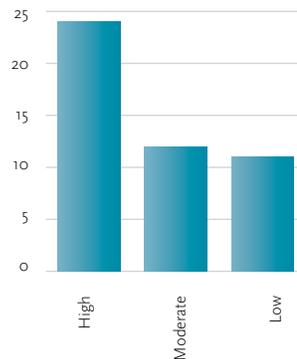
* Credit default swap.

Source: MIGA-EIU Political Risk Survey 2009.

Note: Percentages add up to more than 100 percent due to multiple selections.

FIGURE 2.5 PRI USAGE BY PERCEIVED RISKINESS OF INVESTMENT DESTINATION

Percent of respondents

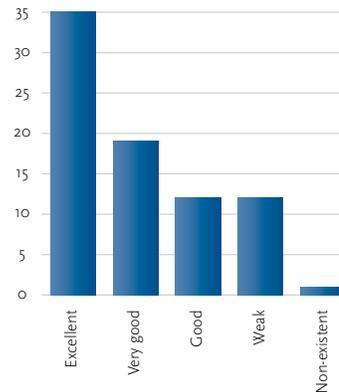


Proportion of respondents that use political risk insurance segmented by the perceived riskiness of their investment destinations.

Source: MIGA-EIU Political Risk Survey 2009.

FIGURE 2.6 PRI USAGE BY ABILITY TO IMPLEMENT EXISTING POLITICAL RISK MITIGATION STRATEGY

Percent of respondents



Proportion of respondents using PRI segmented by their ability to implement existing political risk mitigation strategies.

Source: MIGA-EIU Political Risk Survey 2009.

insurance is a specialized product reserved for investment environments they perceived to be the riskiest (figure 2.5).

The views of investors also confirmed that there is a link between respondents' ability to implement risk mitigation strategies and their decision to contract political risk insurance (figure 2.6). Investors best able to implement existing risk mitigation strategies reportedly used political risk insurance three times more frequently than investors with limited ability. Accordingly, only 1 percent of investors who reported having "non-existent" ability to implement risk mitigation strategies used political risk insurance. Furthermore, investors' ability to implement existing risk management strategies did not appear to be related to the level of risk of the investment destinations.²⁶ The latter finding lends support to the importance of creating awareness of political risk and risk mitigation mechanisms among investors.

Limited overall usage of political risk insurance as a risk mitigation tool at present, however, does not imply a lack of interest. When asked if they expected their company to consider political risk insurance for their investments abroad in the future, 40 percent of investors answered in the affirmative.²⁷ Among investors who rated their political risk assessment capabilities as excellent, the proportion

was even higher: 54 percent expected their company to consider political risk insurance going forward.

INVESTORS FROM EMERGING MARKETS: POLITICAL RISK PERCEPTIONS AND MITIGATION

Growing flows of FDI from emerging markets (chapter 1) raise questions about perceptions of political risks by MNEs headquartered in these countries, and about how these perceptions shape their investment decisions. The survey of companies from Brazil, the Russian Federation, India and China conducted for this report highlights that concerns over political risks parallel their bullish investment intentions: political risk ranked first among concerns when investing in developing countries, both this year and over the next three years (figure 2.7). The financial crisis itself, however, did not alter the political risk perceptions of 61 percent of respondents when it comes to their main investment destinations; but another 27 percent of respondents perceived political risk to have worsened.

Box 2.2 SELECTED FACTORS IMPACTING INVESTOR DEMAND FOR POLITICAL RISK INSURANCE

A study conducted in 2007 for MIGA by PricewaterhouseCoopers found that the use of PRI by investors depended on a number of factors:

Country conditions and ratings

Evidence of heightened political risks (e.g. protectionism, resource nationalization, suspension of global trade agreements, change in country ratings) in the host country increases the demand for PRI.

Internal guidelines

Corporate guidelines and internal standards may require the purchase of PRI for certain projects and country destinations.

Investor/lender risk appetite

The project's sector and investment horizon, as well as knowledge and previous experience in the destination country, influence the risk appetite of investors and lenders and their demand for PRI. More extensive knowledge, however, may either lead to a more informed PRI purchase or placement through other means (e.g. self-insurance).

Dispute resolution mechanism

Investors' comfort level with the destination country's dispute resolution mechanism affects the demand for PRI. Some form of dispute resolution should be in place for PRI to be contracted.

Unavailability of comprehensive insurance

Investors prefer to bundle insurance coverage if possible, and lack of this alternative can lead to the purchase of PRI as a stand-alone product.

Cost of PRI

Investor demand for PRI is affected by premiums.

Availability of discretionary insurance following traditional insurance programs already in place

Investors may increase existing PRI coverage in soft pricing markets, and reduce PRI coverage in hard pricing markets.

Prior PRI claims experience

Any prior claims experience (favorable or unfavorable) can impact the decision to purchase PRI. Evidence of claim payments and process transparency favorably influence demand for PRI.

Competitiveness of debt markets

As competition to fund various projects increases, some lenders' requirement for investors to acquire PRI may diminish.

Source: PricewaterhouseCoopers, 2007.

Political risk was the leading concern this year for Russian and Brazilian investors, as well as for Indian investors (jointly with macroeconomic instability) and the second most significant concern for Chinese investors. Except for the Russian Federation, political risk remained the foremost concern over the medium term, as the expected recovery of the world economy diminished the relative importance of concerns related to the crisis and recession. The prominence of economic concerns for Russian investors may suggest that they anticipate the effects of the financial crisis to linger on.

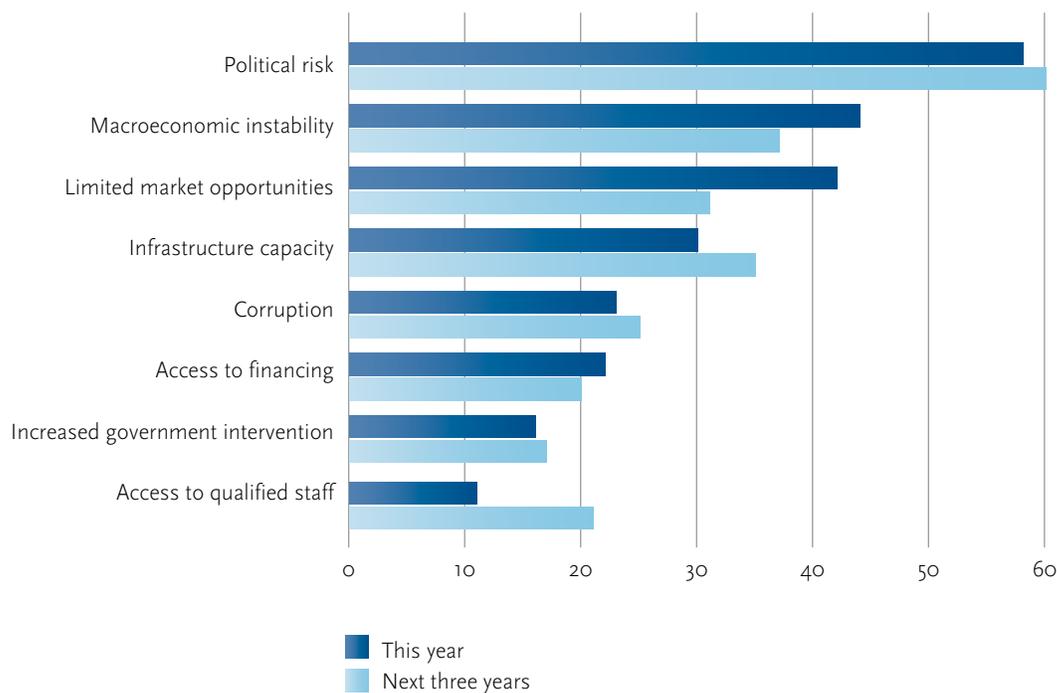
While investors from emerging markets view political risk as a significant constraint on investment plans, they differ over the type of political risk that is of greatest concern. Overall, most investors from the BRICs considered

breach of contract as the principal political risk this year and over the next three years (on par with transfer and convertibility restrictions for the latter). This was followed closely by transfer and convertibility restrictions and non-honoring of sovereign guarantees. The aggregate findings, however, mask important differences among the four countries regarding what each considers being the most worrisome political risk (figure 2.8). Political violence offers the sharpest contrast in relative weight of political risks for BRICs investors: it was considered the most significant risk for Chinese investors over the next three years, but it was of least concern for investors from Brazil and the Russian Federation.

Yet MNEs from the BRICs invest in developing countries they consider risky. Investors from Brazil, the Russian

FIGURE 2.7 MAIN FOREIGN INVESTMENT CONSTRAINTS FOR INVESTORS FROM THE BRICs

Percent of respondents



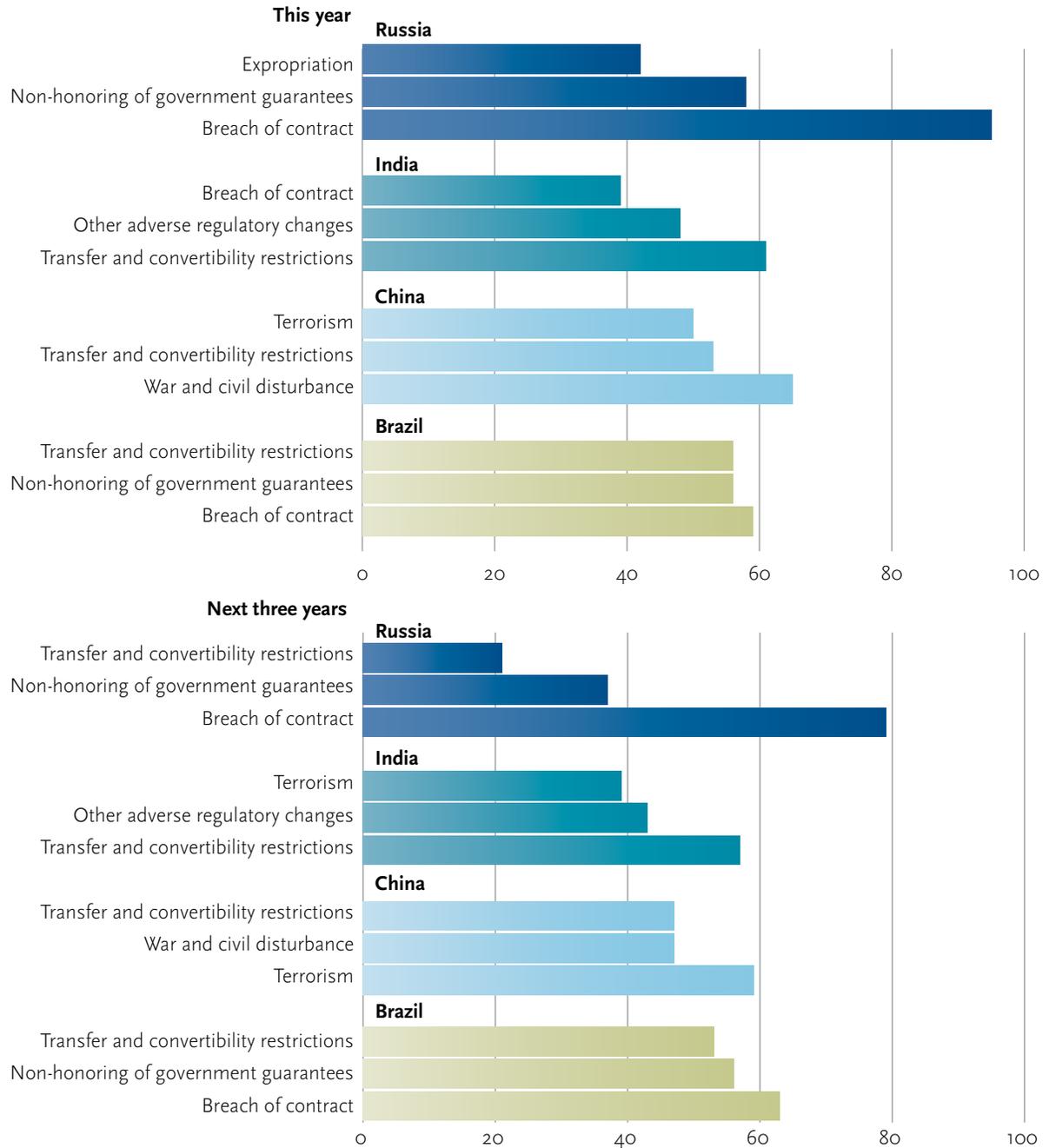
In your opinion, which of the following factors will pose the greatest constraint on investment by your company in emerging markets this year and over the next three years?

Source: MIGA-VCC Political Risk Survey in the BRICs 2009.

Note: Percentages add up to more than 100 percent due to multiple selections.

FIGURE 2.8 TOP POLITICAL RISKS FOR INVESTORS FROM THE BRICS

Percent of respondents



In your opinion, which types of political risk are of most concern to your company when investing in emerging markets?

Source: MIGA-VCC Political Risk Survey in the BRICs 2009.

Note: Top three responses. Percentages add up to more than 100 percent due to multiple selections.

Federation, India and China all cited as a top investment destination this year and over the next three years at least one country that also appeared in the list of their perceived riskiest countries. Argentina and Venezuela (R.B. de), for example, were among the largest five recipients of Brazilian FDI this year, and were also perceived by Brazilian investors as having very high or high political risk. Likewise Russian MNEs perceived their largest investment destinations (the members of the Commonwealth of Independent States) as highly risky. Some respondents argued that business strategy and profitable opportunities took precedence over political risk—except in cases of political violence—in determining where to invest.

Yet 11 percent of BRIC respondents said they did not mitigate political risks at all—compared to 6 percent in the global survey. The principal reason given by investors from the BRICs for not mitigating political risks was the lack of appropriate tools and products. This was the main objection for investors from Brazil, China and the Russian Federation and the second most important for Indian

companies (figure 2.9). Over a third of BRIC respondents also felt that the level of risk in their destination countries did not warrant mitigating political risk. A substantial minority (28 percent) said they were unaware of specific products and tools available; about a third of Indian MNEs cited their lack of knowledge in that area, despite the long existence of ECGC, the country’s public provider of investment insurance.

To the extent that they do mitigate political risk, MNEs from the BRICs use primarily informal and internal means to do so; they do not differ from respondents in the global survey on that account. Some respondents mentioned that an additional benefit of such indirect or informal risk mitigation techniques was their low cost, compared to more formal instruments. The most popular tools are producing political risk analysis and assessments, engaging with host country governments and engaging in joint ventures and alliances with host country firms (figure 2.10). Most MNEs from the Russian Federation, for example, viewed engaging with host country governments as the most effective means of shielding themselves against political risk. Political risk analysis and concluding joint ventures with local firms—the favorite choices of Chinese, Indian and Brazilian respondents—were also ranked as the preferred mitigation method by investors from the countries in the global survey.

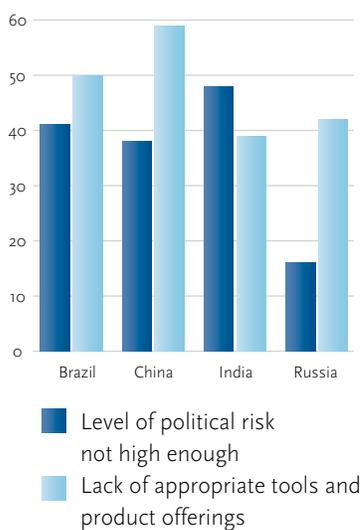
The financial crisis enhanced the attractiveness of risk mitigation tools for one in three BRICs respondents (mostly Chinese companies).

At present, PRI ranks low amongst risk mitigation tools used by BRICs investors. This may suggest that much needs to be done by the political risk insurance industry to reach out to these emerging investors (chapter 3). Russian MNEs are an exception, however, in that political risk insurance was the second most popular tool, after engagement with host country governments. The most common cover sought by the BRICs investors that used PRI was for breach of contract (mostly Russian companies), followed by transfer and convertibility restrictions, and expropriation.

Although political risk insurance ranked low as a current risk mitigation tool, more than half of BRICs respondents said they would consider PRI going forward (figure 2.11; see also chapter 3 on political risk insurance products available to MNEs from emerging markets). Chinese and Indian investors were the most enthusiastic. Russian companies—already significant users of political risk insurance—were more skeptical.

Amongst respondents using insurance, some MNEs from India mentioned they used PRI partly in response to requirements from banks financing their investments. Others from China and India mentioned that they used PRI because indirect or informal risk mitigation methods

FIGURE 2.9 REASONS CITED FOR NOT MITIGATING POLITICAL RISKS BY MNEs FROM THE BRICs
Percent of respondents

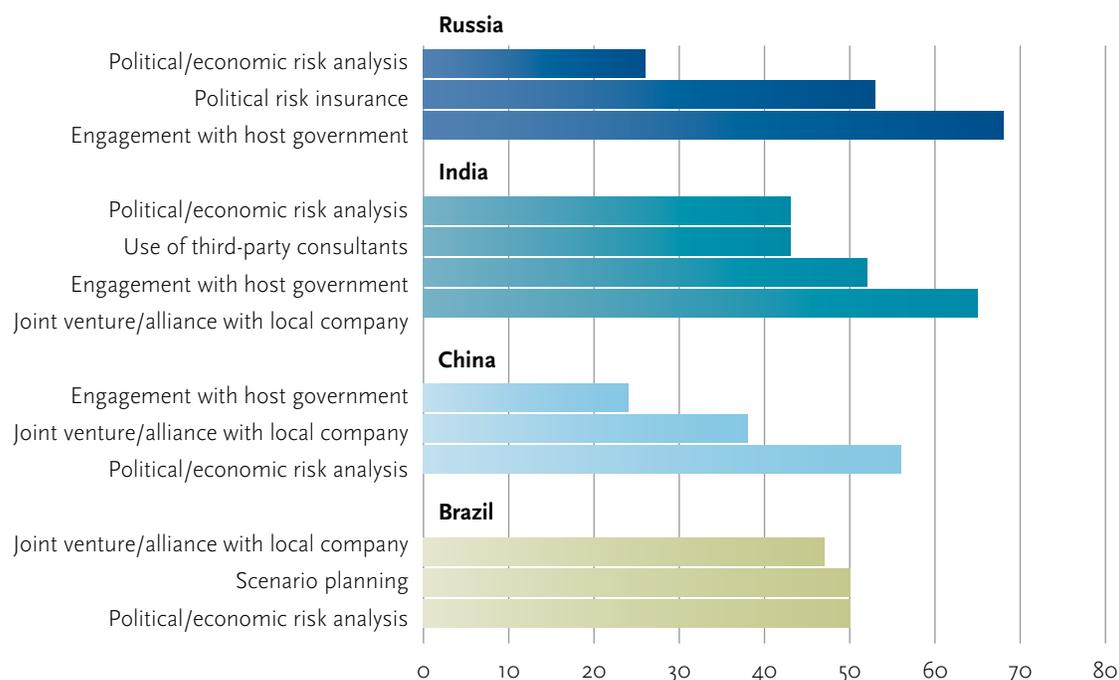


What are the primary reasons your company does not use tools or products to mitigate political risks?

Source: MIGA-VCC Political Risk Survey in the BRICs 2009.
Note: Top two responses. Percentages add up to more than 100 percent due to multiple selections.

FIGURE 2.10 POLITICAL RISK MITIGATION TOOLS USED BY MNEs FROM THE BRICS

Percent of respondents



Which of the following does your company use as a tool for political risk mitigation?

Source: MIGA-VCC Political Risk Survey in the BRICS 2009.

Note: Top three responses. Percentages add up to more than 100 percent due to multiple selections.

were not appropriate for covering risks of war, civil disturbance or terrorism. Some respondents felt that political risk insurance provides more effective coverage against political violence—although this was not reflected in the types of political risk coverage most frequently purchased.

Some respondents, on the other hand, felt that PRI defines political risks too narrowly, which reduces their appeal. Supply chain disruptions were cited as an example of loss that respondents thought as not covered by the formal mitigation products. Cost, cumbersome contracting process and confusing offering were also cited as factors inhibiting mitigation through insurance. Some respondents argued that the size of their investments was too small to justify contracting PRI.

When asked to self-evaluate their risk assessment capabilities, investors from the BRICS thought well of their

own abilities to assess political risk, but they were much less confident in their abilities to anticipate new risks. Most respondents viewed their abilities to implement risk mitigation strategies as good (the midpoint between their five options), but felt less able to implement new mitigation strategies. Chinese MNEs felt particularly ill equipped to evaluate risk mitigation strategies, and Indian MNEs felt weak in their ability to assign roles and responsibilities for political risk management.

The findings of the BRIC survey mirror sentiments of executives from other major emerging-market FDI sources, such as Singapore (box 2.6).

Box 2.3 POLITICAL RISK PERCEPTIONS OF SINGAPOREAN ENTERPRISES

With FDI outflows averaging \$16 billion annually during 2005-2008, Singapore is an important hub for regional and international investment. Asia is the top destination of Singapore's FDI, with 46 percent of its outward stock located there (as of 2007): China, Malaysia, Indonesia, Hong Kong SAR, China and Thailand are major destinations. More than half of its outward investment is concentrated in financial services and just over a fifth is in manufacturing.

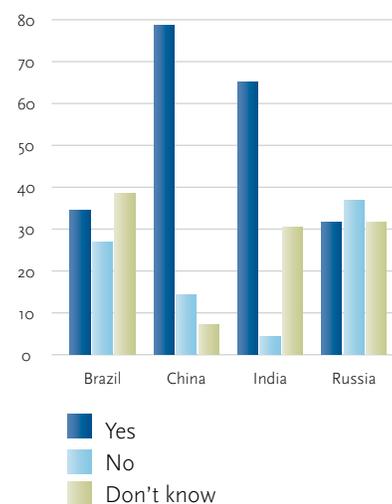
Singapore has weathered the financial crisis well, with investors becoming more optimistic about opportunities in the region. International Enterprise Singapore, an agency of the Ministry of Trade and Industry, collaborated with MIGA in July and August 2009 to gather perspectives from executives of Singapore-headquartered companies on investment and political risk. Singaporean companies were well placed to discuss issues relating to overseas expansion as some two thirds of them are planning to increase investment this year and nearly all plan to expand abroad in the aftermath of the crisis.

At the same time Singaporean companies are becoming more aware of political risk. Executives, mostly from enterprises in the manufacturing and services sectors, expressed political risk to be one of their top two constraints on investment this year and their top concern going forward. And although for the majority of these executives the financial crisis did not change their perceptions of political risks in their target markets, nor did it affect their interest in managing these risks, almost two thirds expected their companies to consider political risk insurance going forward.

Approximately half of the Singaporean executives assessed their own capacity for implementing, evaluating and managing risk mitigations strategies as weak or non-existent. However, they considered their ability to evaluate risks to be better, and identified the most pressing political risks facing their operations to be transfer and convertibility, breach of contract and regulatory changes, both now and going forward. The risk of expropriation was the fastest growing concern.

Source: *International Enterprise Singapore, and Singapore Department of Statistics, 2009*

FIGURE 2.11 INTEREST IN PRI FROM BRICs INVESTORS
Percent of respondents



Moving forward, do you expect your company to consider political risk insurance for its investments abroad?

Source: *MIGA-VCC Political Risk Survey in the BRICs 2009.*

The BRIC and global surveys suggest that the attitude of investors from emerging markets toward political risk may overall not be very different than those from industrialized countries. Respondents from both surveys ranked political risk as a top concern when investing in developing countries in the short and medium term—which challenges the view that investors from emerging markets are comfortable with political perils.

That the salience of political risk relative to other concerns does not translate into high usage of political risk insurance suggests that investors are confident they can manage most risks effectively without resorting to formal mitigation products. Indeed, they use a wide range of methods to do so. This could reflect confidence in the stability of the handful of investment destinations that absorb most FDI to developing countries, or sufficient familiarity with these destinations and the risks involved. PRI is more often used for destinations considered the riskiest, although a number of other factors also influence whether investors turn to insurance.

Yet, the surveys also highlight the need for the PRI industry to further reach out to investors, in particular those from emerging markets.

CHAPTER TWO —ENDNOTES

- ¹ This report covers political perils in developing countries only, and focuses on FDI. The impact of political risk on other forms of private capital flows is beyond the scope of this report.
- ² Luo (2008).
- ³ For a discussion of the history of the relationship between host country governments and multinational enterprises, see Vernon (1971).
- ⁴ Minor (1994).
- ⁵ Wiener (1996).
- ⁶ UNCTAD (2006), table I.11.
- ⁷ The World Bank's *Doing Business 2010* recorded 287 such reforms in 131 economies between June 2008 and May 2009, 20 percent more than in the year before.
- ⁸ Between 1991 and 2000, approximately 1,600 BITs were signed, compared to 386 signed in the 1980s and 166 in the 1970s. By end 2008, over 2,600 BITs were in place. Data provided by UNCTAD (2009a).
- ⁹ By end 2008, over 270 free trade agreements with extensive investment provisions existed. UNCTAD (2009a).
- ¹⁰ World Bank (2009), UNCTAD (2009).
- ¹¹ Sauvart (2009).
- ¹² See "Addressing Political Risk in the Extractive Sector", internet feature at (<http://www.pri-center.com/feature/index.cfm?fid=13>).
- ¹³ For a discussion of political risk in the energy sector, see Sachs (2007).
- ¹⁴ *Control Risks* (2007) and *Lloyd's and Control Risks* (2009).
- ¹⁵ Around 35 percent of respondents highlighted war and civil disturbance as major area of concern, while close to 25 percent of them mentioned terrorism. In aggregate, the proportion of respondents concerned about political violence is 43 percent.
- ¹⁶ From the underlying indicators rated in EIU's *Risk Briefing*, an aggregate measure of political risk was constructed that corresponded closely to the definition of political risk used for this report. It was based on the ratings of the risk of armed conflict, terrorism, violent demonstrations, social unrest, various measures of governmental instability, external tensions, enforceability of contracts, expropriation, and the risk of the imposition of current and capital account controls.
- ¹⁷ Remittance flows to developing countries are projected by the World Bank to decline by 6.1 percent in 2009 from \$338 billion in 2008. See Ratha et al. (2009).
- ¹⁸ World Bank (2009).
- ¹⁹ *Lloyd's and Control Risks* (2009), Eurasia Group (2009).
- ²⁰ World Bank (2009).
- ²¹ World Bank (2009), table 3.2.
- ²² For a full list of the countries that have received assistance to address short-term balance of payments problems from the IMF, see IMF (2009).
- ²³ World Bank (2009).
- ²⁴ For a discussion and a list of government policies that might discriminate against FDI and trade, see Thomsen (2009).
- ²⁵ OECD (2009), UNCTAD (2009b), and OECD, UNCTAD, and WTO (2009).
- ²⁶ Respondents with self-reported "excellent" and "non-existent" ability to implement existing risk mitigation strategies invest in countries with a similar risk profile. The level of risk in investment destinations of respondents with "excellent" abilities averages 2.14 (on a scale of 1 to 3, where 1 is low and 3 is high) and 2.19 for respondents with non-existent abilities. As compared to this, investment destinations of respondents with "good" abilities averaged 2.11 in the same scale.
- ²⁷ Respondents from the primary sector were the least likely to consider political risk insurance in the future: only 31 percent said they would, compared to 37 percent in manufacturing, 40 percent in utilities, transport, storage and communications, 44 percent in services and 44 percent in the financial sector.