Managing Country Risk

A Practitioner's Guide to Effective Cross-Border Risk Analysis

Daniel Wagner

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"This book is a marvelous exploration of a mind trained to integrate all information on all subjects into a coherent viewpoint that produces a business decision. After a long career practicing this kind of thinking in both the public and private sectors, Wagner's approach, and this book, are a treasure."

Dr. Paul Armington, President, World Institute for Leadership and Management in Africa

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I dedicate this book to my spouse, family, and friends, who have all been an incredible source of love and support over the years. Thank you for being there throughout the ongoing journey.

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Preface

Almost any event can increase a trader's, investor's, or lender's cross-border risk. An unexpected resignation, a terrorist act, or a currency collapse can completely transform the political and economic landscape of a country, a region, or the world. Since the advent of globalization, politics and economics have been forever entwined, sometimes resulting in calamitous outcomes. There have been several sobering examples over the past two decades, including the collapse of the Thai baht in 1997. The sudden and dramatic collapse of the Thai currency set off a chain of events that ultimately led to the economic meltdown of many of Asia's economies, resulted in the overthrow of the Indonesian government, and sent gyrations across the rest of the world.

One of the disadvantages of globalization and instant communications is that the impact of such change is felt instantaneously. Today there is less time to react before someone else does; we may be sleeping while others are reacting. Perhaps the impact of localized economic and political events would not be so dramatic if the international marketplace were not so interconnected—if currency and stock trading did not occur and information were not broadcast 24 hours per day. The trend toward seamless international financial transactions has continued at an even more breathtaking pace over the past decade.

One action or event that may be forecast to have a certain outcome at a certain point in time may end up having a completely different or unanticipated outcome years later. For example, when former US President Carter granted ownership of the Panama Canal to Panama in 1978, who would have imagined that, in 1999, when ownership was actually transferred, a Hong Kong company (Hutchison Whampoa) would spread enough money around the power brokers in Panama City to buy control over the ports at both ends of the canal? As a result, some would argue that China instantly gained the potential ability to influence the flow of global trade. On the flip side, by granting the concession to operate the ports to Hutchison, Panama, which has no national army, virtually guaranteed that US military influence would be present in the country for decades to come. This, in turn, will impact how future US military budgets are allocated and how US tax dollars are spent.

Consider also the impact that Turkey's possible accession to the European Union may have on Europe and beyond. Turkey has tried to join the EU for more than a decade, but strenuous objections from Greece and other members kept it from succeeding. Yet today, Turkey looks like the bastion of stability and conservatism compared to the economic "basket case" that Greece has become. Turkey and its political model—a pragmatic blend of civilian and military influence—have enormous political influence throughout the Arab world. What impact might the EU have in the Arab world today if Turkey had been admitted to the EU a decade ago? Today, Turkey is less interested in joining.

The impact of political change on businesses is as significant as it is on individuals—perhaps even more so. At stake are trillions of dollars of revenues derived from trading and investing abroad. For a business, the risks associated with political change are multifaceted. In general, an international investor often faces the risk of expropriation of assets when a new government takes power or an existing government adopts a negative orientation toward foreign investment. The risk of not being able to convert local currency into hard currency or to transfer hard currency out of a country because of a shortfall in the national foreign exchange supply or a change in law is ever present. And depending on where an investment is located within a country, the risk of damage to a facility or an interruption of business operations because of political violence can arise without warning.

For international traders, political risks are every bit as real. Imagine exporting goods to a government buyer only to discover after the fact that it has not been paying its bills, the United Nations has just imposed an embargo on the country, or your own government has just rescinded your export license. Cross-border partnerships can be unexpectedly tested as unanticipated events may unravel promising business prospects. These types of events happen all the time—even in times of peace. Political change only accentuates the political risks inherent in trading or investing abroad.

This book is about how to identify and manage the plethora of risks associated with conducting business abroad and how to think outside the box to be able to anticipate the impact of change on business operations. By reading this book, you will come to know more about country risk management than virtually all of your peers. You will also be able to add value to the risk management processes in your organization, even if you are not formally part of a risk management unit. If doing so helps your organization become smarter about how it does business abroad and enhances its ability to make a profit, all the better, because in the process it will be contributing to development, job creation, and improving the lives of people around the world.

Daniel Wagner
Norwalk, Connecticut

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Over the course of the past quarter-century I have worked with a lot of really talented people, a number of whom were particularly influential in helping me better understand the nature and practice of country risk management. In the realm of political risk insurance underwriting, Christophe Bellinger of the Asian Development Bank, John Hegeman of Chartis, and Christina Westholm-Schroder of Sovereign Risk Insurance provided unique working-level insight based on their own in-depth experience and perspective. Luis Dodero, formerly general counsel of the Multilateral Investment Guarantee Agency (MIGA), and Srilal Perera, formerly chief counsel of MIGA, enabled me to better appreciate the impact of legal and regulatory risk on cross-border investment. It was a privilege to work with each of them. I also want to thank the many individuals I worked with along the way who helped me learn so much about managing country risk while I lived and worked in Asia, Europe, and North America. Doing so enabled me to amass the knowledge I am now sharing in this book.

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The Author

Daniel Wagner is the founder and CEO of Country Risk Solutions (CRS), a cross-border risk consultancy based in Connecticut, and Director of Global Strategy with Political Risk Services. Prior to founding CRS, Daniel was senior vice president of Country Risk at GE Energy Financial Services, where he was part of a team investing billions of dollars annually into global energy projects. Daniel was responsible for advising senior management on a variety of country risk-related issues, strategic planning, and portfolio management. He created a Center of Excellence for country risk analysis in GE and led a team that produced a comprehensive automated country risk rating methodology.

He began his career underwriting political risk insurance (PRI) at American International Group (AIG) in New York and subsequently spent 5 years as guarantee officer for the Asia region at the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) in Washington, DC. During that time, he was responsible for underwriting PRI for projects in a dozen Asian countries. After serving as regional manager for political risks for Southeast Asia and greater China for AIG in Singapore, Daniel moved to Manila, Philippines, where he was guarantee and risk management advisor, political risk guarantee specialist, and senior guarantees and syndications specialist for the Asian Development Bank's Office of Cofinancing Operations. Over the course of his career, Daniel has also held senior positions in the PRI brokerage business in London, Dallas, and Houston.

Daniel has published hundreds of articles on risk management and current affairs, is a nonresident scholar at the Institute for Near East and Gulf Military Analysis in Dubai, and a regular contributor to foreignpolicyjournal.com, *The Huffington Post,* and the International Risk Management Institute (IRMI). His editorials have been published in such notable newspapers as the *International Herald Tribune* and the *Wall Street Journal*. His first book, *Political Risk Insurance Guide,* was published by IRMI.

Daniel holds master's degrees in international relations from the University of Chicago and in international management from the American Graduate School of International Management (Thunderbird) in Phoenix. Daniel received his bachelor's degree in political science from Richmond College in London. He can be reached at daniel.wagner@countryrisksolutions.com or through www.countryrisksolutions.com.

Abbreviations

ADB	Asian Development Bank
AID	Agency for International Development (of the United States)
AIG	American International Group
ASEAN	Association of Southeast Asian Nations
BCA	Brazil Cooperation Agency
BI	Business Interruption
BIS	Bank for International Settlements
BMI	Business Monitor International
BRIC	Brazil, Russia, India, China
BRICS	Brazil, Russia, India, China, South Africa
CCP	Chinese Communist Party
CDB	China Development Bank
CEND	Confiscation, expropriation, nationalization, deprivation
CF	Contract frustration
CI	Currency inconvertibility/nontransfer
CIRC	China Insurance Regulatory Commission
CNOOC	China National Offshore Corporation
CNPC	China National Petroleum Corporation
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agency
ECGD	Export Credit Guarantee Department (of the United Kingdom)

ECI	Export credit insurance
EIU	Economist Intelligence Unit
EU	European Union
EXIM	Export–import
FARC	Revolutionary Armed Forces of Colombia
FDI	Foreign direct investment
FSA	Fuel supply agreement
FTA	Free trade agreement
G20	Group of 20 (finance ministers and central bank governors)
GDP	Gross domestic product
GOI	Government of Indonesia
HDI	Human Development Index
HIPC	Highly indebted poor country
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development (World Bank)
ICSID	International Center for the Settlement of Investment Disputes
IDR	Indonesian rupiah
IFC	International Finance Corporation
IIF	Institute for International Finance
IMF	International Monetary Fund
IPP	International power project
LC	Letter of credit
LEU	Low-enriched uranium
LNG	Liquefied natural gas
M&A	Mergers and acquisitions
MBPD	Million barrels per day (of oil)
MDBs	Multilateral Development Bank
MENA	Middle East and North Africa
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational enterprise
MOF	Ministry of Finance
MW	Megawatt
NATO	North Atlantic Treaty Organization
NEXI	Nippon Export and Investment Insurance (of Japan)
NKW	NKW Holdings
ODA	Overseas development assistance
OECD	Organization of Economic Cooperation and Development
OFDI	Outward foreign direct investment
OPIC	Overseas Private Investment Corporation (of the United States)
PDVSA	Petroleos de Venezuela
PLN	Perusahaan Listrik Negara (of Indonesia)
PNG	Papua New Guinea

PPA	Power purchase agreement
PRC	People's Republic of China
PRI	Political risk insurance
PRS	Political risk services
PSU	Pennsylvania State University
PV	Political violence
REM	Rare earth mineral
RMB	Chinese renminbi (yuan)
SOE	State-owned enterprise
TDI	Trade disruption insurance
UK	United Kingdom
UNCITRAL	UN Conference on International Trade Law
UNCLOS	UN Convention on the Law of the Seas
UNCTAD	UN Conference on Trade and Development
US	United States
USD	US dollar
USPA	US power authority
WTO	World Trade Organization

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Chapter 1
Country Risk in Perspective

> When you consider what a mystery the East Side of New York is to the West Side, the business of arranging the world to the satisfaction of the people in it may be seen in something like its true proportions.
>
> Walter Lippmann, 1915[1]

Introduction

It became fashionable for political and economic pundits to declare in 2011 that as a result of the arrival of the Arab Spring, the world had become a more dangerous place, and that the risks associated with conducting cross-border business had risen. One could perhaps legitimately make such an argument in the countries directly affected by the Spring, but was cross-border risk in 2011 really more generally perilous than it was in, say, 1988 or 2001, when global shock waves resulted from the collapse of the Soviet Union and the beginning of the War on Terror? Not in my view—yet the chorus of analysts' voices made it sound as if the Arab Spring had an equally profound impact on global trade and investment.

If, as noted by Lippmann, the world was considered mysterious in 1915, the Arab Spring was indicative of how political change in the second decade of the twenty-first century could be characterized as evolutionary and in a seemingly constant state of metamorphosis. It is no longer so easy to define one's allegiance or to identify with a single country or strain of political thought. Globalization, interconnectedness, social media, and the age of instant communication have greatly changed the political and economic landscape, as well as the nature of structural change in countries throughout the world.

In 1988 and even as recently as 2001, trade and investment decisions were by definition based on less available information and less sophisticated means of assessing and managing risk. Today, cross-border traders and investors benefit from a more level playing field with respect to access to information, more open markets, and a more competitive landscape. More countries want to attract foreign direct investment (FDI), enhance international trade, and be members of the global "club" than ever before. To do so, they must maintain a competitive footing and constantly reinforce their comparative attractiveness as trade and investment destinations. That makes the global trade and investment climate *less* risky than in recent history, but it also makes the need to understand the true nature of cross-border risk more acute than ever before.

Insight into the Foundation of the Arab Spring[2]

Understanding why the Arab Spring erupted is important not only because so many dynamics were at play, but also because no one accurately predicted how or when such upheaval would occur, and its impact was dramatic. Businesses have naturally become more risk averse as a result of the changes that have taken place throughout the Middle East and North Africa (MENA) since Muhammad Bouazizi, a food cart vendor, lit himself on fire in Sidi Bouzid, Tunisia, in January 2011. He did so out of utter frustration and hopelessness, and his story resonated throughout the country and region. But the aspirations of the region's people as manifest by what came to be known as the Arab Spring must be considered in the context of an underlying unease about the scope and impact of political and economic change. While the region's businesses quickly adapted to the many changes that resulted from the onset of the Arab Spring, many of them also came to recognize that the likely result would be an extended period of uncertainty and some degree of doubt about whether all the change would in the end result in meaningful long-term benefits.

Let us examine why the Tunisian spark ignited a wildfire that spread throughout the Middle East, as it will provide insight into how politics are inextricably linked with economics and how some political change that is decades in the making can occur in an instant. A corollary to one of the best known theories of human development—basic needs theory—is that as long as governments deliver the basic services their citizens require, there is little inherent incentive for them to rise up in opposition. Even if there were an incentive for them to do so, it is reasonable to ask whether they are willing to risk what they have for the hope of achieving something better in the long term.

It can certainly be argued that citizenries that have only known one-party or one-person rule, as is so common in MENA, will be hesitant to embrace change. Even if they were given an opportunity to participate in a genuinely democratic vote, the fact that it would be for the first time in many countries in MENA raises doubt about whether voters would truly vote their consciences. As the recent democratic experiment in Iraq has demonstrated, the process can be highly politicized, and remnants of long-established political forces can clash with new political forces for many years before the dust settles and the benefits of change become apparent. Political change implies uncertainty and the average person is less likely to risk stability for an uncertain future.

The Middle East's remaining governments have considered what they must do to prolong their time in power. Their ability to be perceived to be providing meaningful basic services may in large part determine how long they can remain in power; this was certainly the case with Saudi Arabia in the months following Ben Ali's overthrow in Tunisia. Given that oil production costs in the region are generally below $15 per barrel, hefty short- and medium-term revenues gave the governments of oil-producing nations options they may not otherwise have had to help ensure that basic needs were met (see Figure 1).

If the Tunisian example is any guide, they have a lot of work to do. Ben Ali was ultimately driven out of power by a chain of events originating in Sidi Bouzid, in the country's western center. According to the World Bank, this part of Tunisia consistently had the highest rate of poverty in the country between 1980 and 2000—more than twice the national average in 2000. The people in Sidi Bouzid had little to lose by promoting political change once an opportunity was created. But the reason that the suicide of food cart vendor Muhammad Bouazizi triggered the riots and Ben Ali's subsequent departure is that opposition groups, trade unions, and much wealthier parts of the country became galvanized: They were collectively tired of being oppressed, too many of them were unemployed, and Ben Ali's family had enriched itself too grotesquely for too long.

Tunisia had been neither the worst nor the best at providing basic services to its people. As noted in the charts that follow, the country was either at or above average for lower middle-income countries in the region with respect to total spending on education between 1980 and 1995. But its spending on education actually declined or remained stagnant during the 1980s and 1990s. Tunisia was again an average performer in terms of health expenditures as a percent of gross domestic product (GDP) and one of the better regional performers in terms of health expenditures per capita. The

Tunisian government provided free or subsidized health care to its lowest income groups, but the percentage of GDP the government devoted to food subsidies declined by more than half between 1989 and 1999, in the first decade of Ben Ali's reign (see Figures 2 and 3 and Table 1).

So, Tunisia had done neither particularly well nor particularly badly in looking after the basic needs of its people in recent history. Tunisia's GDP per capita has risen notably over the past 50 years, reaching US$3,800 by 2009—at the top of the World Bank's classification for lower middle-income countries, albeit well below the global average. That the country is well integrated with Europe both from a business and tourism perspective has meant that the financial crisis hit Tunisia harder than other, less well integrated countries in the region. This undoubtedly raised the level of common dissatisfaction with the Ben Ali regime (see Figures 4 and 5 and Table 2).

Had the Tunisian masses been given greater freedoms and had the state not held such a vise-like grip on power, the spark that occurred in Sidi Bouzid may not have turned into a bonfire. Tunisia under Ben Ali had been

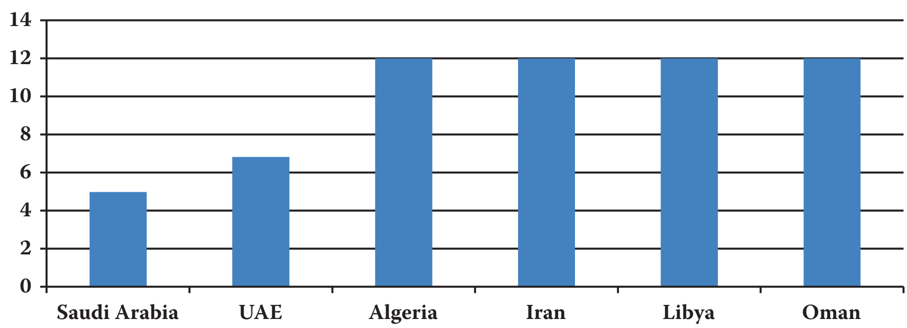

FIGURE 1 Estimated break-even oil production costs for selected MENA countries (US$). (From: http://www.reuters.com/article/2009/07/28/oil-cost-factbox-idUSLS12407420090728)

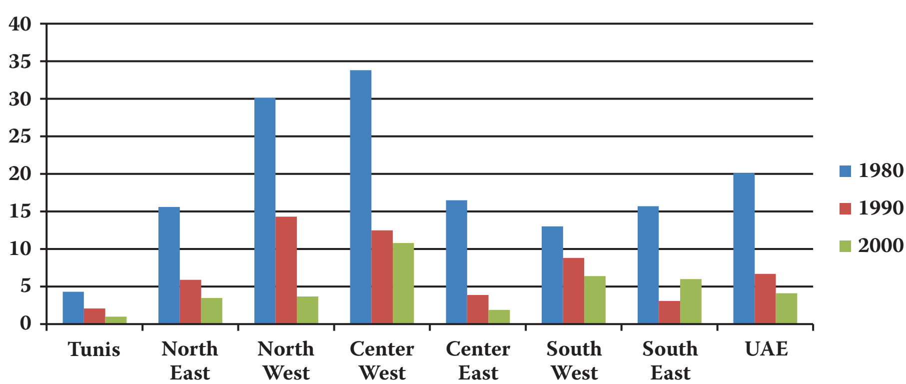

FIGURE 2 Percentage of population living in poverty in Tunisia by region (1980, 1990, and 2000). (From: http://siteresources.worldbank.org/INTPGI/Resources/342674-1115051237044/oppgtunisia11.pdf)

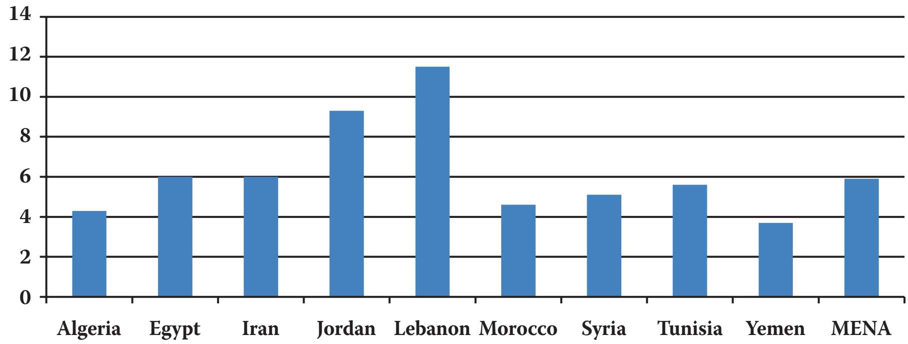

FIGURE 3 Health expenditures in 2002 as a percentage of GDP. (From World Bank, World Development Indicators, 2003.)

TABLE 1 Percentage of Total Government Spending on Education[a]

Country	1980	1985	1990	1995
Egypt	—	—	31.09	32.6
Iran	6.23	9.47	11.21	19.01
Jordan	15.22	24.28	24.83	24.44
Morocco	14.79	13.54	14.74	—
Syria	26.29	27.98	21.34	—
Tunisia	17.91	16.41	16.21	16.36
Lower middle-income average	14.55	16.42	15.85	16.34

Source: www.worldbank.org/education/edstats.
Note: "—" means not available.
[a] Selected countries in MENA (1980–1995).

a police state virtually since he assumed power in 1987; its security apparatus came to be larger than that of France, which has six times its population. With unacceptably high unemployment rates throughout the Middle East and millions of young people yearning for a greater voice, the potential for a similar backlash certainly exists in a variety of other countries, such as Algeria and Saudi Arabia.

While many of the region's governments made a more visible effort to appeal to the common citizen through enhanced public services, food and gas subsidies, and more funding for education, none of them released their own vise-like grips on power. They attempted to walk a fine line between enhanced reforms and an enhanced security apparatus, or they simply restricted freedoms even further. What would have been much smarter is for these governments to release their grip on power gradually while making genuine overtures to demonstrate that they were open to changing their tune. If the masses saw the door open a crack, their temptation to force it open may have been reduced. But the fact that this did not happen implies

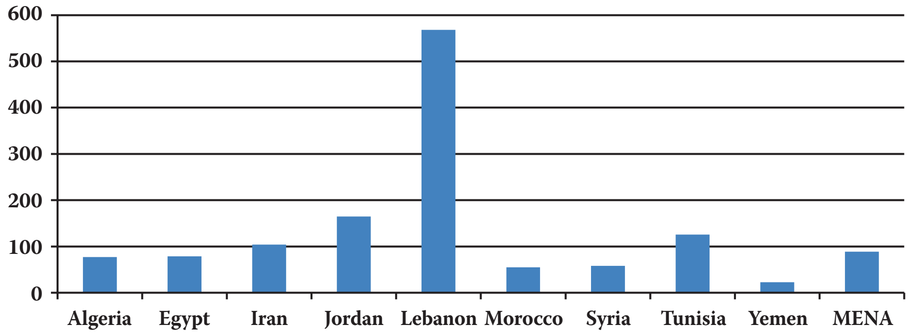

FIGURE 4 Health expenditures in 2002 per capita (USD). (From World Bank, World Development Indicators, 2003.)

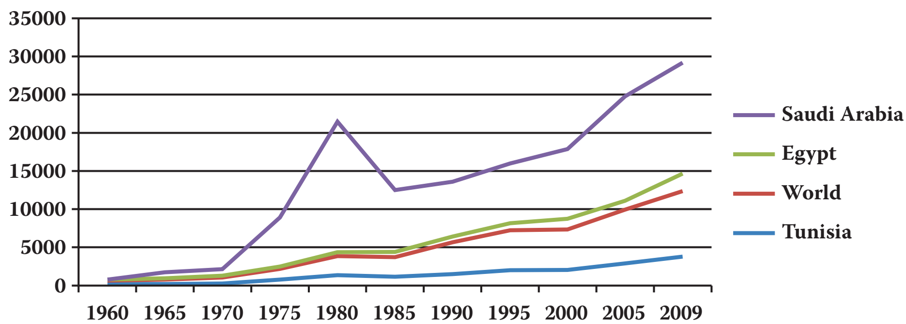

FIGURE 5 Tunisia versus selected countries and the world: GDP per capita at current prices (not adjusted for inflation; converted to USD at market exchange rates). (From World Bank, World Development Indicators, 2010.)

TABLE 2 Food Subsidies as a Percent of GDP (1989–1999)

Country	1989	1992	1995	1999
Algeria	2.9	3.3	0.9	0
Egypt	3.7	5.1	1.3	1.7
Iran	—	1.5	2.9	2.7
Jordan	3.1	1.5	2.9	2.7
Morocco	—	1.3	1.7	1.7
Tunisia	2.8	1.9	2.1	1.2
Yemen	—	3.7	2.6	0.3

Source: World Bank, World Bank Development Indicators, 2002.
Note: "—" means not available.

that entrenched governments throughout the world may be inclined to remain in power at any cost, which certainly has important implications for companies considering trading, investing, and lending abroad, as well as for the analysts trying to determine the true nature of the risks involved in doing so.

When the process of political change began in MENA in January 2011, there was much hope among its people and concern among its governments about the manner in which this change would evolve. For most of its people, there was tremendous hope that the decades of enduring repression under authoritarian governments would soon come to an end. For many of its governments, there was hope that the introduction of incremental reform would placate public sentiment and enable continuation of the status quo. The aspirations of neither have come true.

While citizens in Egypt and Tunisia had initial cause for celebration when Presidents Ben Ali and Mubarak were forced to abdicate their presidencies, it quickly became clear that their jubilation was premature. While the figurehead of the only government many of them had ever known was indeed removed, the infrastructure of the government and virtually all of its other members remained in place.

Historic Change, But Not "Revolutionary"

The reason why the political upheaval in MENA was historic is precisely because it involved establishing a new kind of relationship between governments and the people they govern: a fundamental overhaul of Arab state/society relations that have remained relatively unchanged for more than half a century. According to a study by Freedom House[3], in 67 countries where dictatorships have fallen since 1972, non-violent civic resistance was a strong influence more than 70% of the time. Change was made through civil society organizations that utilized non-violent action or other forms of civil resistance. It would be nice to believe that Egyptians, Libyans, and Tunisians have reasonable grounds to hope that the fruit of their labor will ultimately be democratically elected and functioning governments, yet the average citizen in these countries is unlikely to find that the governments they thought would replace the ancien regimes will be everything they had hoped for.

There will inevitably be immense pressure on whatever form of government ultimately succeeds the current regimes in all these countries. They must be seen to be bringing about meaningful change quickly, but this will be far more difficult to achieve than would ordinarily be the case and is likely to result in one of two scenarios. The first is that, frustrated by the slow pace of democratic change—something the populations of these countries are not familiar with—and frustrated at the lack of visible and rapid improvements in the economy, protestors are likely to continue to return to the streets, prolonging the economic chaos and adding pressure to the recovery process while at the same time increasing instability and insecurity. Secondly, wary of falling prey to the type of mass protests the new governments helped to foment, and falling into the trap of trying to be all things to all of their people, the new governments will rush through popular measures such as rises in the minimum wage and public sector wages—measures that they are not able to afford—sowing the seeds of even longer-term economic distress and postponing much needed genuine reform until some point in the future.

In no case can the political change that has occurred in Egypt and Tunisia be seen as 'revolutionary.' While the titular heads of government have been removed from power, the institutional underpinning of these governments, and many of the individuals responsible for implementing policies of repression for decades, remain in place. In their first year, the agents of change actually achieved very little. The majority of their original aspirations—greater democracy, an end to living in fear, and an easier life for the majority of the people—were, in fact, not met, and may not be met in the medium or even long-term. Rather, the introduction of instability and uncertainty into the average person's daily life has only increased frustration levels and decreased expectations for achieving their objectives, which in turn creates greater levels of frustration and sets the stage for ongoing uncertainty and instability.

In the first post-Spring polling of Egyptian opinion[4], there was great fear among moderates over the possible rise of Islamists and the possibility of greater sectarian violence. Egypt is a conservative country but evidence has mounted that the majority of people do not want the kind of Islamic rule prevalent in Iran, let alone in Saudi Arabia, but the Muslim Brotherhood was the best known and organized political force in the country and did well in elections. There is very little genuine confidence among policy makers or ordinary citizens that the transition to the Egyptian version of democracy will go smoothly, or proceed as originally envisioned. Economic hardship resulting from Mubarak's ouster has contributed to a climate of fear and uncertainty, and the military junta that took Mubarak's place has proven to be increasingly intolerant, having delayed the election until late 2012, and has not given any indication that it intends to abdicate power from behind the scenes.

Egypt's female activists expected the revolution to yield greater liberty, equality, and social justice for women. However, leading activists expressed their disappointment at the way women were being sidelined[5] by the military government in Egypt. Some fear an even worse outcome—that of a rise in Islamist political parties will force women back into a subservient role. Debate is flourishing in Egypt and no one can predict what sort of consensus or conclusions will emerge.

One consequence of the uprising and subsequent departure of Mubarak was a rise[6] in sectarian conflict, with several deadly clashes between Muslims and Coptic Christians erupting in Cairo in 2011. Supporters of the Mubarak regime point to this as evidence of the stabilizing role the Mubarak regime played in Egypt, where such clashes were rare. However, human rights groups[7] have blamed the Mubarak regime for long-standing failures in the protection of Egypt's Christian minority (approximately 10% of the population), impunity for perpetrators of religious-based violence, and its inability or unwillingness to promote religious freedom and tolerance among different groups.

In Tunisia, as elsewhere across the Arab world, Islamist movements were ruthlessly suppressed during the pre-Spring reign of the autocrats. Despite this, political repression went hand in hand with modernity in Tunisia and it boasts one of the most liberal societies in the Arab world, allowing divorce, scantily clad westerners on its beaches, alcohol, and women's rights. Fears[8] of an Islamist government have arisen in Tunisia as the previously banned Ennahda Party, many of whose leaders returned from exile, established themselves as one of the strongest[9] political movements in the country.

In Libya, Islamists quickly gained control of the post-Gaddafi government. The new Tripoli Municipal Governing Council was led by a member of the Muslim Brotherhood, the country's most influential politician was an Islamic scholar, and the country's most powerful military leader was the former leader of a group believed to be aligned with Al Qaeda. The democratic forces within Libya were quickly sidelined and crushed. The Muslim Brotherhood members of the interim government, who dominated the Governing Council immediately following Gaddafi's ouster, quickly declared their intention to impose fatwas, ban theater, prevent women from driving, and eliminate art that takes a human form. Article one of the "new" Libya's draft Constitution stated: "Islam is the Religion of the State, and the principal source of legislation is Islamic Jurisprudence (Sharia)." In other words, the law of Islam was the intended law of the "new" Libya. So there is every reason for democrats, liberals, and moderates throughout the region to be concerned.

The Rise of Unemployment and Poverty

In spite of these problems, polling[10] revealed that Egypt's citizens remained cautiously hopeful in the months following Mubarak's removal from power. Egyptians expressed high support for democracy and civil liberties, but were more concerned[11] with the immediate struggles of finding jobs, improving security and feeding their families. Unemployment predictably rose across the region as the unrest persisted, and has remained high. The problem of unemployment also disproportionately affects certain sectors as well as the young. In Yemen for example, one million workers[12] in the construction sector are thought to have lost their jobs since the uprising began.

The incidence of poverty in the region is also unlikely to change in anything but the medium-to-long term as cash-strapped transitional governments and embattled regimes suffer from rapidly deteriorating public finances. According to the UN Human Development Report 2009, approximately 19% of Egypt's population and 47% of Yemen's population lived on less than $2 per day.

Some inadvertent effects of the revolution hit the poorest the hardest. In Egypt for example, food prices quickly doubled[13] since the outbreak of unrest, and youth unemployment hovers around 30%. As intractable a problem in the Middle East as in many other regions of the world, poverty is likely to be a key factor in determining the agenda of newly elected governments in Egypt and Tunisia. Secular-minded parties are likely to be all too aware of this given the tendency toward Salafist extremism, particularly in Egypt, which tends to come more from impoverished rural areas. Indeed, the salafists did well in Egypt's first past-mubarak elections.

The Muslim Brotherhood also finds the majority of its support in the more rural, poor, and conservative towns and villages than in the major cities of Egypt, where the state security apparatus has a far greater presence. This is going to increase the risk of populist social spending should a secular party take control of the Egyptian government. However, given the strength and organization of the Muslim Brotherhood, it is more likely that some kind of fractious coalition government will emerge in Egypt and may well involve Islamists and secularists working side by side. Indeed, this scenario may actually work out to be worse for poor Egyptians because it is highly likely to delay decision making, and may make it more difficult for reform and change to take place as the different parties squabble over the means to an end.

The Impact on US Credibility in the Arab World

As is the case in other parts of the world, the US was waiting to see what type of regimes will emerge in post-Spring MENA. In the short term, US policy is likely to be a combination of hesitant, cautious, and outspoken, as on one hand it does not want to be seen as bullying or dictating, nor does it want potentially friendly new governments to be labelled as American stooges. However, America's influence in the region has clearly been weakened as a result of the Spring, having been criticized for cradling repressive, anti-democratic regimes for decades while spouting democratic rhetoric that many in the Arab street view as meaningless. America's inability or unwillingness to make a real difference in Syria and Yemen have similarly damaged its position as "the decider."

Egypt's military-led government has shown signs of independence from US foreign policy by acting as a mediator between Hamas and Fatah, resulting in the new cooperation agreement between the two Palestinian factions. The government also quickly re-opened the border crossing with the Gaza strip. Polling suggests that an independent foreign policy is popular among a broad swath of Egyptians.

All this has created particular unease for Israel, which finds itself once again surrounded by potentially hostile neighbors. Soon after the Spring erupted, President Obama told Israel's Netanyahu that it was in Israel's best interest to find a solution to the perennial Israel/Palestine issue as soon as possible for Israel's own sake. He rightly pointed out that if this issue continues to linger, Israel will find itself overwhelmed with the plethora of challenges it faces in the near term. What was left unsaid was that the US no longer has either the influence or stamina to be the driving force behind such a solution.

Paradoxically it may well suit the US to stand back from the regional tumult as it continues to unfold and evolve. US foreign policy appears to be of less interest to an American public that has become preoccupied with its own variety of home-grown concerns. Persistently high unemployment, a double dip in the housing crisis, political divisiveness, and the absence of a meaningful deficit-reduction strategy has caused the American government and public to turn increasingly inward. As has been the case with the foreign policy of other major nations, US policy in the Middle East has had to adapt to rapidly changing circumstances and will no doubt require further adaptation based on what occurs next in the region.

The average citizen in Tunisia, Egypt, Syria, and Yemen may well have been better off without the Spring, for they wouldn't have suffered the violent repression that ensued, economic chaos, and a less physically secure environment in which to live. The primary concerns of average citizens prior to the Spring have resurfaced and are now foremost in the minds of the majority of Arab citizens. There is little reason to believe these concerns will be addressed in any meaningful fashion in the near or medium term by governments that are finding their own footing and determining the right mix between reform and repression.

The sad fact is that every one of the MENA states that experienced dramatic political change in 2011 continues to stare at the edge of an abyss today. Their future is entirely unclear. No one really knows if what will ultimately replace the current governments will in fact be preferable to what they had to begin with. It is a huge leap of faith to presume that to be the case. Now that numerous forces from across the political spectrum have been introduced into the political process in Egypt and Tunisia, it is just as possible that what will emerge after the dust has settled are governments that are incapable of governing because of their attempt to placate and include all the various elements of the political process or that are radicalized by the participation of extreme forces in the process, ending up with the polar opposite of what existed before.

While it appears more likely that what will evolve in the end in most of these states is a Turkish approach to democracy, wherein the most important players in the political process have a seat at the table and the military has an important role to play under a veneer of democracy, it is certainly possible and even probable, perhaps, that in some states Muslim Brotherhood-esque political movements will gather steam and prevail. It is too soon to say which states may end up this way, but it would not be entirely surprising if extreme religious parties do well in the polls in Egypt, for example, where the Brotherhood won 20% of the votes in the presidential 2005 election before being banned.

What all this implies is that political change in MENA will continue to be a messy, imprecise, and painful affair wherein much blood will be spilled in the future and the aspirations of millions who simply wanted a better life for their children will probably find their dreams quashed by the power grab that has ensued. One would have hoped that in today's world of instant communication and high aspirations, the end game would look more promising.

How Political Change in MENA Is Impacting Country Risk Analysis[14]

Political change in MENA has had a profound impact on many countries in the region and beyond, pummeling some of the most established governments in the world. One of the unintended consequences of this change has been to prompt some country risk analysts to reevaluate how they analyze risk. In the rarified atmosphere of country risk analysis, this is a useful exercise, but for individuals and organizations that already think about the world in an esoteric fashion, the challenges are unique.

Country risk analysis probably sounds to a layperson as if it is the domain of number crunchers, political scientists, and intelligence agencies. In fact, it is, but how numbers and theories are used to arrive at a meaningful conclusion varies widely, depending on the individual or organization doing the analysis. For example, many banks tend to be skewed heavily toward plugging numbers into algorithms or spread sheets, political scientists often apply political theory to the behavior of nation-states, and intelligence officers use information to draw conclusions about the likely behavior of leaders, political parties, the military, and other state and nonstate actors.

The job of a country risk analyst can be overwhelming, given the amounts of information that must be absorbed and synthesized into easily digestible text. When one considers that country risk analysis is not only about politics, but also about economics, sociocultural dynamics, and history, there is a lot for an analyst to contemplate in drawing conclusions. This must, of course, all be applied to each country at a given point in time. Due consideration must be given to scenarios, unexpected events, and short- and long-term trends.

Given this, there are numerous risk management lessons a country risk analyst may learn from the recent upheaval in MENA. First, even though political change may be expected in any country at some point in time as a result of fundamental socioeconomic disparities, high levels of corruption, rumblings in the military, or the actions of a neighboring government, the ability to anticipate when and how such change may occur presents a daunting task. In the case of Tunisia, the fact that so many people were disenfranchised within society and that President Ben Ali had been in power and abusing that power for so long prompted large segments of society to coalesce to promote rapid political change. In the absence of the poor, middle class, business community, and elements of the military coalescing at the same time, the spark would in all likelihood not have created a flame. So one lesson here is that social, political, and economic disenfranchisement can reach a boiling point in an instant, given the right circumstances.

Second, although an analyst may expect that political change is likely to erupt from a larger, more important country in a given region, the fact that a country is larger and more important may prevent it from embracing political change. Very few would have predicted that Tunisia was to become the venue for the spark that turned into the flame in North Africa. Egypt was a likelier candidate, but Egypt's geopolitical importance, its prominence with respect to US foreign policy and military aid, and the size and strength of its military made it a less likely candidate for radical political change. The regional implications for radical political change in Egypt made it harder to achieve as a catalyst, but once change had begun elsewhere in the region, it was certainly ripe to participate.

Third, what may appear to be fundamental change is not really change at all, or change for the worse. In reality, not much changed in 2011 in either Tunisia or Egypt. Rather, figureheads were merely removed and the fundamental elements and people in charge of the governing system that was in place prior to the change remained in place. In addition, the aspirations of the Egyptian and Tunisian people were thwarted, even though some among them may want to believe something had really changed. Quite the contrary: Frustration levels were higher toward the end of 2011 than they were before Ben Ali and Mubarak departed the scene because so little had changed and so little appeared likely to change in the near term. In the case of Egypt, that frustration level quickly reached a boiling point as many citizens appeared to realize that what may have resulted from their efforts was either a military-led government protecting the status quo or a radical government represented by the Muslim Brotherhood or other political force—not an end game most people had anticipated or wanted.

Fourth, in today's linked-in, globalized world, political change that may have been limited in regional impact has great potential to explode in scope. This is not to say that profound political change cannot happen in remote corners of the world that are less linked in or globalized—of course, it can and does—but what might have been limited to the departure of former President Ben Ali became a tour de force for the entire region. A corollary here is that it will become more difficult for country risk analysts to predict accurately what happens next in the short and long term. While few analysts would have believed that one dictator after another would fall in succession in MENA, few also would have imagined that a military stalemate would have persisted for months in Libya. We are in uncharted territory, and the truth is that no one can really know with any certainty what will come next.

The job of country risk analysts has therefore just become more complicated. Many previously accepted assumptions about the way the world works have been shattered as a result of what has happened thus far in MENA. In the years to come, many unexpected events will no doubt continue to occur, impacting the foreign policies of most of the world's major governments. In order for country risk analysts to stay ahead of the game, they must excel in being able to use the past and present to try to predict the future. In that regard, their job is really no different than it was before—just a bit more complicated.

Perception versus Reality of Risk: Does Terrorism Negatively Impact Foreign Direct Investment?[15]

Risk perception is, of course, important and helps shape foreign investors' behavior. Such behavior is difficult to predict and depends on a number of factors, including conventional wisdom, prior experience, perception and tolerance of economic and political risk, and long-term objectives. For example, logic leads many foreign investors to believe that acts of terrorism have a negative impact on FDI flows. Yet, common sense dictates that the loss of foreign investor confidence following acts of terrorism would prompt large outflows of capital in affected countries and that, once a country is branded a terrorist target, it will attract reduced levels of FDI. Some academic studies have demonstrated that sometimes this is, in fact, the case; however, foreign investor sentiment is often not dictated by common sense. The lure of profit and desire to establish trade partnerships is often a stronger motivational force than perceived political risk is a disincentive to invest.

Although the growth of global terrorism is indeed on the minds of some corporate decision makers when contemplating whether or not to invest abroad, it did not prevent many of them from deciding to invest in the post-9/11 developing world. According to the United Nations Conference on Trade and Development (UNCTAD),[16] FDI flows to the developing world *surged* 200% between 2000 and 2004, up from 18% to 36% of global FDI. During the same period, FDI flows to developed countries *plunged* 27%, from 81% to 59% of global FDI. In every category of *developed* countries cited, the inward FDI trend was *down* significantly, while in every *developing* country category, the inward FDI trend was *sharply higher.* Although the vast majority of terrorist attacks take place in developing countries,[17] the FDI trend is clear.

Further to this point, the UN compiled a ranking of inward FDI immediately following 9/11—from 2001 to 2003[18]—that measured the amount of

FDI countries receive relative to their economic size (calculated as the ratio of a country's share of global FDI inflows to its share of global GDP), with some surprising results. Third, fifth, and seventh on the list were Azerbaijan, Angola, and The Gambia, respectively. Investment in oil and gas exploration and development accounted for much of the investor interest in these countries for the period. Interestingly, of the top 20 performers, only 3 were developed countries. Germany was ranked 102, the United States 112, and Japan 132, out of 140 total.

Does this mean that perceived terrorism risk negatively affects FDI decision making? That undoubtedly depends on where one intends to invest. Clearly, a company considering investing in Iraq would have far greater concerns about terrorism than one investing in Canada. Interviews and surveys of executives in multinational corporations in the 1960s and 1970s[19] found political events to be one of the most important factors influencing foreign investment decisions. This was no doubt due in large part to the Cold War and the perception that regime change could have stark implications for foreign operations.

Times have changed, however. Consulting firm A. T. Kearney produces an annual publication, *The FDI Confidence Index,* in which it polls top decision makers in the world's largest 1,000 companies and asks their opinions on a range of FDI-related issues. The conclusions are surprising. In 2003, just 2 years after 9/11, corporate leaders' top pick for global event most likely to influence their investment decision was recovery of the US economy. Terrorism and security concerns were tied with the Middle East conflict for number 7 on the list of 11 concerns.[20]

In 2004, with the US economy on the rebound, its recovery was still the top pick, but down from 84% to 60% of respondents' concerns. The list of decision-maker concerns had grown from 11 to 15, with terrorism and security staying stationary at number 7, this time tied with concerns about rising interest rates.[21] Although the A. T. Kearney studies do not focus on specific countries, it is worth noting that in each instance, economic concerns outweighed political concerns by a large margin. In addition to recovery of the US economy, the other top concerns in 2004 were the impact of global or regional trade initiatives, the threat of global deflation, and the depreciation of the US dollar. On this basis, it does not appear that terrorism per se had a heavy influence on FDI decision making.

Empirical Studies Can Yield Contradictory Results

Empirical studies examining the link between perceived political risk, terrorism, and FDI flows have yielded contradictory results. Some have found linkages, while others have not. The former have tended to be older studies; some of the newer studies challenge the previous results.

Some empirical studies have tended to put more emphasis on macroeconomic variables as explanatory factors in FDI flows, while others stress the importance of political variables. In practice and in theory, it appears difficult to make a clear-cut distinction between political and economic variables as definitive sources of influence, and it is reasonable to conclude that FDI decisions in developing countries are determined by both political and economic factors.[22]

A Harvard study[23] states that higher levels of terrorism risk are associated with lower levels of net FDI. In an integrated world economy, where investors are able to diversify their investments, terrorism may induce large movements of capital across countries. Another academic study[24] takes this a step further and examines the impact of terrorist attacks on capital markets. The authors researched the US capital markets' response to 14 terrorist/military attacks from 1915 to 2001 and concluded that they recover faster from such events now than they did a century ago. This is largely attributed to a stable banking/financial sector that provides adequate liquidity in times of crisis and thereby promotes market stability.

In their largest decline, the US markets dropped 21% over an 11-day period when Germany invaded France in 1940 and took 795 days to recover to their pre-event level. After 9/11, the markets dropped just 8% over an 11-day period and took just 40 days to recover. Other financial markets were not as resilient. For example, over the 11-day period following 9/11, Norway's stock market dropped 25% and took 107 days to recover. One possible reason for the favorable US performance is that the Federal Reserve took steps to provide liquidity throughout the banking and financial sector. This serves to emphasize that, to a limited degree, post-event investor perceptions can be managed by effective government response.

In a study done at Pennsylvania State University[25] (PSU), the effect of economic globalization on transnational terrorist incidents was examined statistically using a sample of 112 countries during the period 1975–1997. The strong results showed that FDI, trade, and portfolio investment have no directly positive effect on the number of transnational terrorist incidents among countries, and that the economic development of a given country and its trading partners reduces the number of terrorist incidents in a given country. To the extent that FDI and trade promote economic development, they have an indirectly negative effect on transnational terrorism. Perhaps the decision makers polled in the A. T. Kearney studies knew intuitively what the PSU study proved statistically: that economic development is a deterrent to terrorism.

A related study done at PSU[26] tested whether democratic forms of government reduce the number of terrorist attacks. In this case, 119 countries were examined between 1975 and 1997. Contrary to some earlier academic studies on this subject, which promoted the idea that terrorist groups are more often found in countries with democratic forms of government than authoritarian forms of government, the author found that some aspects of democracy—such as higher electoral participation, which produces a high degree of satisfaction among a general population—tend to reduce the number of transnational terrorist incidents, while other aspects of democracy—such as a system of strong checks and balances and the ability to restrict press freedoms—often serve to increase the number of such incidents.

The conclusions reached in both PSU studies make sense and are backed up by statistics, yet they do not address the fact that many countries with vastly different histories and forms of government have experienced long-term terrorism[27] on their soil (for example, Colombia, Israel, Turkey, Nepal, India, Pakistan, the Philippines, Spain, the United Kingdom, Saudi Arabia, and Algeria). The same is true of countries with "new" terrorism problems (such as the United States and Thailand). More often than not, it appears that countries with significant terrorist acts tend to have democratic forms of government. Terrorism does not appear to occur with great frequency in countries with authoritarian or communist forms of government, which lends credence to the earlier academic studies. In the complicated world of terrorism, undoubtedly, both arguments are true and neither is true.

The same PSU author produced another compelling study examining the impact of political violence (PV) on FDI.[28] The study posits that terrorist incidents do not produce any statistically significant effect on the likelihood that a country will be chosen as an investment destination or on the amount of FDI it receives. Further, it states that unanticipated acts of terrorism do not generate any changes in investor behavior in terms of investment location choice or the amount of investment.

However, a study done on the impact of terrorism and FDI in Spain and Greece[29] arrived at a completely different conclusion: that acts of terrorism had a significant and persistent negative impact on net FDI. The study's authors concluded that 1 year's worth of terrorism discouraged net FDI by 13.5% annually in Spain and 11.9% annually in Greece. On this basis, it was concluded that smaller countries that face a persistent threat of terrorism may incur economic costs in the form of reduced investment and economic growth.

Related to this, the same coauthors of the previously cited Harvard study produced a case study on the economic costs of the Basque conflict[30] and concluded that there is evidence of negative economic impact associated with terrorism in the Basque portion of Spain. On average, the conflict resulted in a 10% gap between per-capita GDP of a comparable region without terrorism over a two-decade period. Moreover, changes in per-capita GDP were shown to be associated with the level of terrorist activity. The coauthors also demonstrated that once a cease-fire came into effect in 1998–1999, Basque stocks outperformed non-Basque stocks. When the cease-fire ended, non-Basque stocks outperformed Basque stocks.

An interesting corollary is the research done by the Asian Development Bank (ADB) when it created a terrorism insurance facility for investors in Pakistan. ADB learned that in nearly every instance, acts of terrorism in Pakistan were directed at government and/or military targets; commercial loss (if any) was nearly always the result of collateral damage. A survey of local insurance companies in Pakistan revealed that the incidence of commercial loss due to acts of terrorism was almost zero. This is in sharp contrast to the image of Pakistan that prevails in the global media, where it is portrayed as a poor place to invest because of perceived terrorism risk. *Yet, 9/11 produced more than $50 billion in commercial losses in the United States, which remains one of the top FDI destinations.* This demonstrates just how flawed common perceptions of risk can be.

The Impact of Perception on Investment Decisions

Perceptions of terrorism risk have a great deal of influence on some investment decisions, but very little on others. Among the factors that influence decision makers are:

- Economic health of the investment destination
- Difficulty associated with doing business in a given country
- Existence of rule of law and good corporate governance
- Existence of corporate and government connections
- Level of public discord
- Media attention
- Cost of production

Investors may also distinguish between "perceptions" of the existence of a terrorism threat in a given FDI destination and "acts" of terrorism, or between "domestic" acts of terrorism and "international" acts of terrorism. However, one factor often not considered when contemplating making a cross-border investment is consumer behavior and its linkage to the political process. Perceptions are important here, as well. Predicting consumer behavior correctly can be as important in determining the success of an investment as predicting whether terrorism will have an impact on operational capability.

For example, one would think that the rise in hostility toward the US by a variety of Europeans in response to the Iraq War would result in fewer European sales of goods by American companies. Interestingly, one of the first detailed empirical studies on consumer behavior after 2003[31] noted that although up to 20% of European consumers did consciously avoid purchasing American-made products, sales by American companies in 2000–2001 and 2003–2004 grew at least as quickly as those of their European rivals in

Europe. In the case of Coca-Cola, McDonald's, and Nike, European sales grew 85%, 40%, and 53%, respectively, for the period. Apparently, Europeans make a distinction between the actions of the US government and the products of American companies.

Short-term corporate costs directly or indirectly linked to acts of terrorism can be substantial, but the potential long-term costs of terrorist threats to national economies can be devastating. A study by Australia's Department of Foreign Affairs and Trade[32] found that developing countries stood to lose the most because of their dependence on FDI and export-led growth. The developing economies of East and Southeast Asia were deemed to be the most vulnerable. The study estimated that economic growth in the region could decline by 3% after 5 years of ongoing terror threats and by 6% over 10 years.[33] The attacks of 9/11 were estimated to have cost the US some $660 billion through 2005 and significantly reduced global investment levels.[34] The International Monetary Fund (IMF) estimated at the time that the loss of US output from terrorism-related costs could be as high as 0.75% of GDP, or $75 billion per year in the future.[35]

So does perceived terrorism risk negatively affect FDI decisions? There is no single answer to this question because it is dependent on numerous variables. The empirical evidence answers the question in both the affirmative and the negative, and persuasive arguments have been made on both sides. Similarly, some theorists maintain that democratic political systems are a breeding ground for terrorism, while others claim just the opposite. And some earlier studies concluded that corporate executives consider political and terrorism risks to be among the most important factors influencing the decision-making process, while later studies minimize their importance.

It can probably be said with some certainty that all of the studies are correct and all of them are incorrect because it does not make much sense to generalize about what motivates foreign investment decisions. Existing theories and arguments fail to explain the rationale behind what motivates many foreign investment decisions. One is left to speculate about such motivations, although the A. T. Kearney surveys lead one to conclude that economic motivations are stronger than political deterrents in influencing foreign investment decisions. Perhaps, in the future, a brave academic will tackle this question.

Also yet to be addressed in the literature is the question of whether certain sectors or industries of an economy are more sensitive to the negative effects of terrorist attacks than others. Or why do some countries experience protracted terrorism over time, and what is its impact on FDI decision making? A lengthy history of terrorism has not prevented foreign oil companies from making, and continuing to make, long-term investments in Colombia or Algeria. Angola continued to receive huge foreign investments in its energy industry at the height of its civil conflict. Of course, investment in all these countries would presumably have been much higher in the absence of recurring terrorism or civil conflict. The US continues to be one of the world's top foreign investment destinations, even though it remains Al Qaeda's number one target. Although the level of FDI is down significantly in the US after 9/11, it is hard to say for certain whether this is due primarily to a changed perception of the US as a "safe haven" destination or whether the prevalence of low interest rates in the US prompted capital investors to seek more lucrative alternatives.

Risk Management versus Profit Maximization

Some companies are concerned primarily with profit maximization, while others are more concerned with risk management and loss minimization. The impact of government-to-government relations on the FDI equation can be an important factor motivating FDI flows, as can the desire to establish and maintain international trade links. Experienced foreign investors may discount terrorism risk automatically because they will have had good experience or strong corporate and government relationships locally. Inexperienced foreign investors may never pursue cross-border investment opportunities because of the absence of prior experience or meaningful corporate and governmental relationships.

The question of what would happen in the event of a truly catastrophic terrorist event must also be considered. Would new construction-related investment flow in, as is the case when natural disasters occur? Would the explosion of a dirty bomb make a city so dangerous that the replacement of damaged buildings would not be possible? It is questions like these that serve to reemphasize the limited value of generalizing about terrorism's impact on FDI. Theorists can speculate all they want about what "may" happen if such an event were to occur, but theories and complicated forecasting models have been proven wrong many times in the past.

Depending on the investment destination, terrorism either already is or has the potential to become a primary consideration in formulating investment decisions. Much will depend on the motivations, experience, and resources of a given foreign investor. As the Pakistan example noted earlier demonstrates, it is vitally important not to rely solely on widely held perceptions about the nature of terrorism risk in a particular country. A wise foreign investor will separate fact from fiction to arrive at an investment decision based on reality on the ground that is consistent with investment objectives.

Be Wary of Statistics

Many of us were taught the importance of utilizing numbers in order to measure and understand the nature of cross-border risk. Clearly, quantitative risk analysis is quite useful in that regard, but a common mistake that is made by practitioners is to over-rely on statistics and numbers, at the expense of qualitative means of assessing risk. Take, for example, the idea of measuring the likelihood that business operations may be interrupted by frequent strikes. Would one be more likely to imagine that strikes would occur with greater frequency in developed or developing countries, in democratic countries or those run by military dictatorships, in established democracies, or newly established democracies? According to Figure 6, strikes are actually more common in developed democracies.

In this case, labor strikes are generally undertaken to fight for higher wages or better working conditions. Given that all of the top 10 countries listed are democracies, the frequency of the strikes is higher than they may be expected to be under a military dictatorship, but what is their impact? Do they often shut the country down? Do they last for days or weeks? More than likely, they last for a single day and, depending on the industry in which they occur, they may not occur at all. For example, it may be deemed illegal for air traffic controllers or policemen to strike in a country where the rule of law prevails.

Contrast this with the possible length and impact of a strike in a country undergoing dramatic political change. When demonstrators were putting pressure on former Egyptian President Mubarak to step down, it emboldened workers to press for long-standing demands that they felt unable to pursue while he remained at the height of his powers. The strikes went on for weeks and impacted numerous types of public and private sector businesses, such as power generation, railways, bus transport, telecommunications, and food production. The country was virtually shut down while protests gathered momentum. Would this have happened in Denmark? Even in strike-prone France, has there ever been a time when workers from throughout society struck repeatedly at the same time? No. If one were to have relied solely on the statistics in Figure 6, one would believe that strikes are mostly a problem in well-developed democracies, where people have a voice and the rule of law is strong.

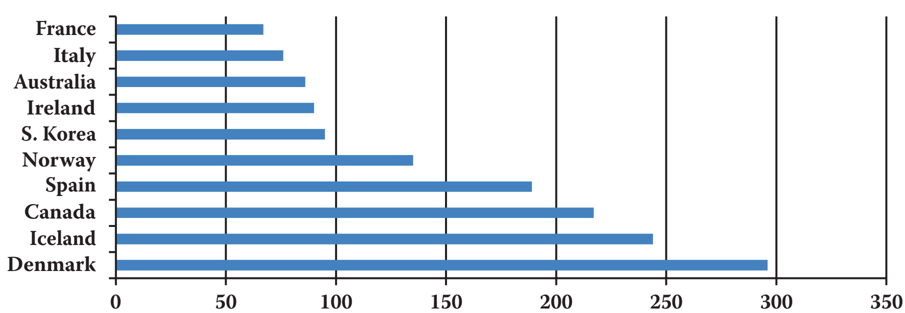

FIGURE 6 Number of strikes by country (top 10 countries: 1996–2000). (From www.nationmaster.com/graph/lab_str-labor-strikes)

Consider the widely accepted belief that infant mortality rates say something fundamental about the relative development of an economy or society. People generally believe that developed countries have lower rates of infant mortality and developing countries have higher rates. Based on the data in Figure 7, that may or may not be the case.

According to these data, Cuba—a very poor country—has a lower infant mortality rate than wealthy Canada. The rate for China—a BRIC (Brazil, Russia, India, China) country and soon to be the world's largest economy—is only slightly lower than that of desperately poor Nicaragua. Iraq—even with all its problems—is lower than the world average. That of India—also a BRIC country, with one of the world's highest rates of economic growth—is the highest of them all. Clearly, a single indicator cannot tell a country's story.

In Figure 8, it is evident that Indonesia under Suharto (in blue) had a much stronger sustained economic growth rate than staunchly democratic Italy. Only during one year (1977) in this 25-year example did their growth rates intersect. Otherwise, Indonesia exhibited a much stronger performance for the period.

Table 3 notes that Indonesia had only one recorded strike, no recorded assassinations, and no changes of government between 1970 and 1995; however, Italy had a multitude of each. Yet, Indonesia's 32 years of stability under Suharto did not prevent the dramatic change of government and end of Suharto rule in 1998.

Italy did much better in terms of attracting FDI, however. Although the two countries were not far apart until 1995, FDI in Italy has dramatically increased since then, while FDI in Indonesia has proved to be sensitive to global economic trends, experiencing wide swings during the Asia Crisis

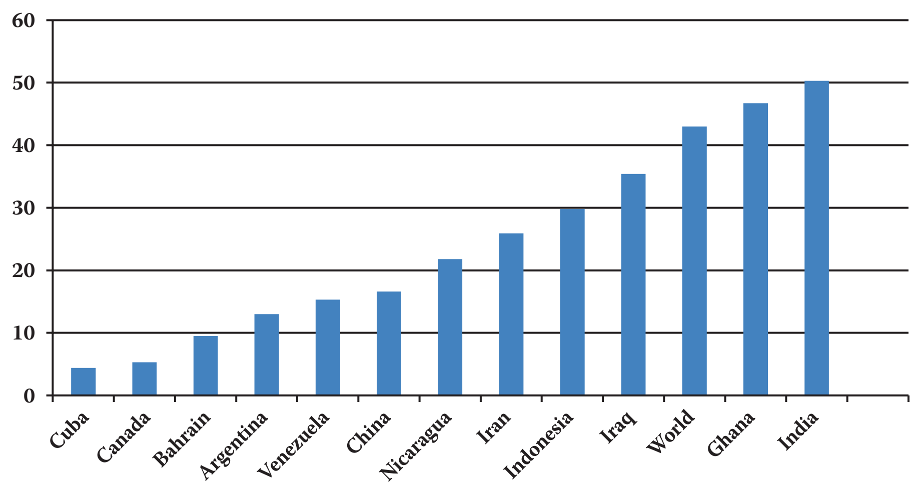

FIGURE 7 Infant mortality rates for selected countries (2009: rates of death per 1,000 people). (From www.google.com/publicdata)

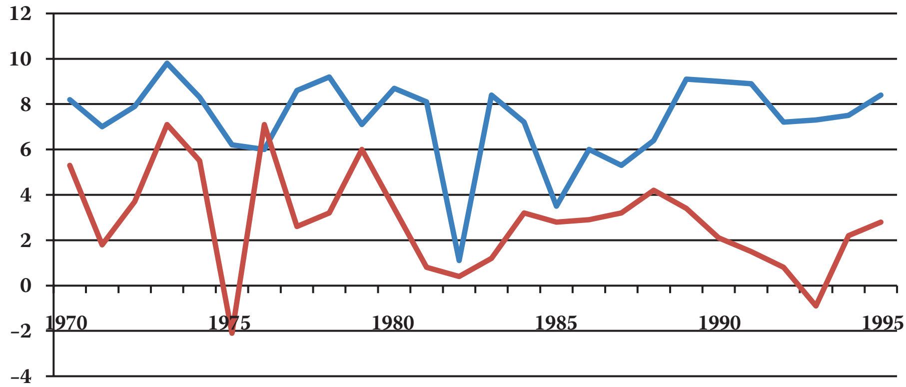

FIGURE 8 GDP growth rates: 1970–1995, Indonesia versus Italy (percent change from the previous year, adjusted for inflation). (From World Bank, World Bank Development Indicators, 2010.)

TABLE 3 Incidences of Political Instability (1970–1995)

	Indonesia	Italy
Strikes	1	26
Assassinations	0	41
Number of governments	0	29

Source: www.cosmopolis.ch/english/cosmo6/italy.htm; Sam Wilkin.

and the Great Recession. Based on this, Italy's tendency toward political instability mattered less with time vis-à-vis FDI, while Indonesia's post-1998 political instability proved to matter more (see Figure 9).

One of the cardinal rules of country risk management, therefore, is to consider statistical information in the context of the history of a country, how its existing political structure influences its economic performance, and how a given country influences and may be influenced by the region and world around it.

What Statistics Say about the Global Recovery since 2009[36]

Statistics compiled by the World Bank[26] show that net FDI flows contracted by approximately 40% in 2009—at the height of the Great Recession—representing the sharpest decline in 20 years, but this was much less than the net decline in private bank lending, which plummeted 134% that year. FDI began to improve in the second quarter of 2009 among both developed and developing countries. As noted later, FDI into developed countries fell further than into developing countries from 2008 through 2009, but proportionately, developing countries made up more ground after Q1 2009

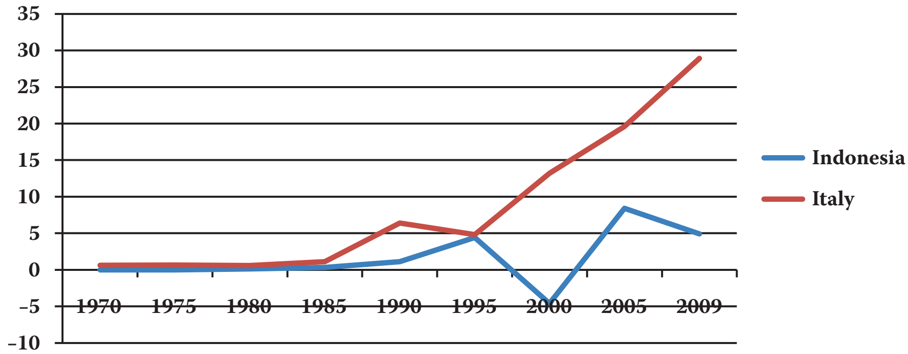

FIGURE 9 FDI growth rates: 1970–2009, Indonesia versus Italy (net inflows of investment, billions of USD). (From World Bank, World Bank Development Indicators, 2010.)

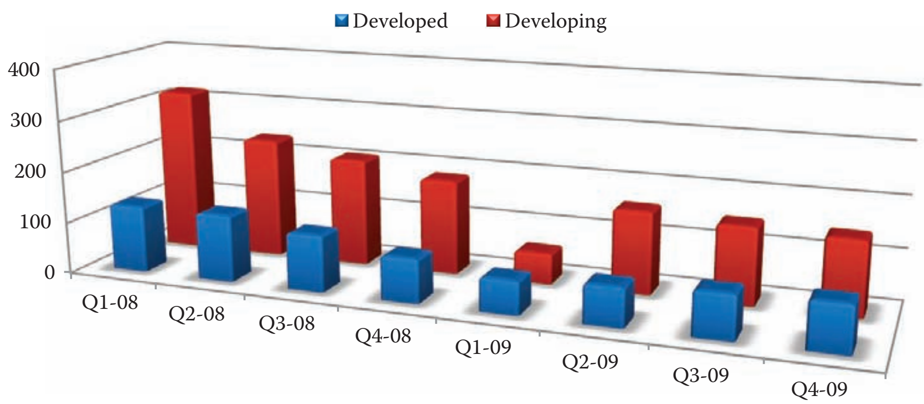

FIGURE 10 Global net FDI flows: 2008–2009, billions of US dollars. (From World Bank and country statistics.)

than did developed countries. If the collective view of foreign investors was that country risk was rising during the period, the FDI statistics would not have demonstrated such strength following the peak of the crisis among either developed or developing countries (see Figure 10).

According to the World Trade Organization (WTO) and World Bank,[37] unlike during the Great Depression, overt acts of trade protectionism were largely absent from the global trade arena during the Great Recession, but the number of restrictive trade actions taken on the part of governments exceeded those of liberalized trade actions by 10 to 1. This is not surprising, as countries naturally seek to protect domestic industries in times of crisis. As noted later, the top five countries restricting trade transactions were (in order) India, Argentina, China, the United States (see Figure 11).

In spite of this, global trade volumes rose by 21% year-on-year in January 2010, in terms of both volume and value. Interestingly, during the period October 2008 to February 2010, the number of antidumping investigations

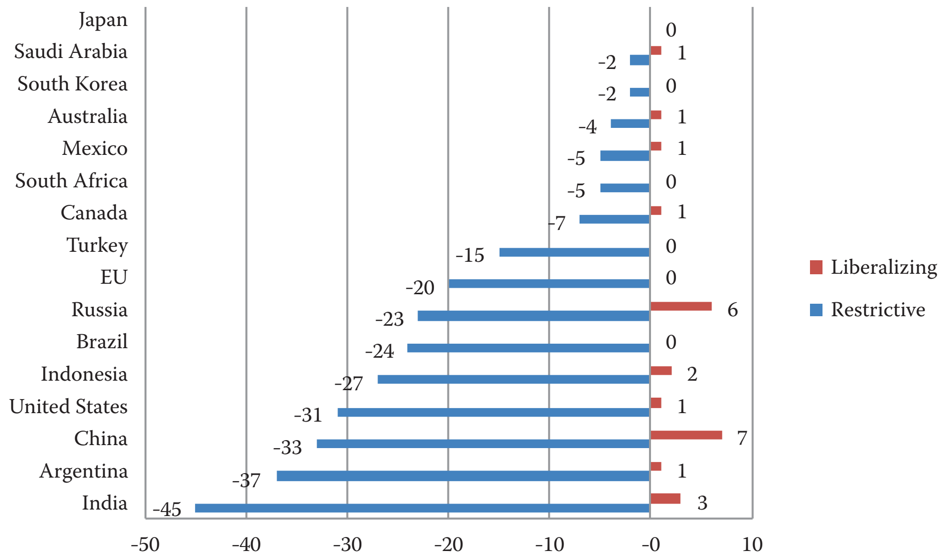

FIGURE 11 Trade measures taken by the G20: October 2008–February 2010. (From World Bank and WTO Secretariat.)

initiated by G20 governments fell by 21%. Given the number of restrictive actions taken by governments during the period, new antidumping investigations should have risen considerably, but did not. So, does this point to rising country risk? Again, the answer appears to be no. Having avoided tit-for-tat protectionist measures among the world's major economies, and having seen an impressive rebound in trade during the height of the crisis, country risk remained stable.

What all this means is that our perceptions of risk must change. Simple categorization of countries into good or bad, rich or poor, and risky or not risky no longer captures the scope of risk companies face when trading or investing in today's evolving mosaic of trade and investment climates. Greece was clearly perceived as riskier than India in 2011, but that was not the case in 2008. Rather than saying the world is a riskier place, it is more accurate to say that depending on where a company invests and in what sector, a developed country can easily be riskier than a developing country. For example, the country that was the boldest in taxing mining company profits in 2010 was not a corrupt, poor, developing country, but Australia. As a result of the Australian government's actions, other mineral-rich countries in the developed and developing world were likelier to follow suit.

Gone are the days when the West called the shots and the rest of the world snapped to attention. Gone also is the time when so many of the good ideas, best risk management practices, and acceptable standards of behavior were automatically derived from the developed world. Countries such as Brazil, China, and India are showing dramatic progress in establishing improved governance, business practices, and advances in technological prowess. If the global economy is akin to a business cycle, then the developed countries are mature markets in the process of gradual decline, while the most dynamic economies of the emerging world have yet to hit their prime.

Country risk management is a function of where one invests, in what sectors, and in what manner. Country risk may indeed be rising at a given point in time, but in the developed world—as the Great Recession of 2008/2009 has taught us—the price paid for years of living on credit and lax regulatory oversight finally exacted a price. Country risk is largely perceived to be falling in many parts of the emerging world, where opportunity abounds, governments continue to liberalize foreign investment regimes, and trade and investment volumes continue to outpace those of the developed world.

Managing Country Risk in the "New Normal"[38]

Since the global economy stabilized, trade and investment flows are returning to more conventional patterns, which means that cross-border transactions are set to continue to rise in the current decade. Among the many challenges facing risk managers now that the economic convulsions have stopped is to manage cross-border risk effectively. This is more important today than in recent memory for a simple reason: The rules of engagement for conducting international business have changed—the risks associated with cross-border transactions are high, risk aversion is high, but the margin for errors is low.

It is only natural after recovering from global economic trauma that international businesses would think more carefully about assuming and managing cross-border risk, but doing so has become more difficult. One of the things that has changed since 2008 is that the "new normal" includes a paradigm shift. Just as the rule book changed after the collapse of the Soviet Union, it has changed again as a result of a combination of a decade of globalization and a decoupling in growth patterns between the developed and developing worlds, which implies a change in risk profile between the two.

There was plenty of debate when the financial crisis began about whether industrialized and emerging countries would move in tandem downward. Indeed, they did, by and large, but what has become clear over the past several years is that many developing countries are galloping ahead of the developed countries. They are projected to have sustained average growth rates between 6% and 8% per year in the medium to long-term, while North America and Europe may experience growth rates of 1% to 3% for the foreseeable future. The temptation among many international companies will be to trade and invest in developing countries as a result of the disparity in growth rates without, perhaps, fully considering the implications of doing so from a political risk perspective. The need to do so has always been present, but the way many businesses traded or invested internationally before the Great Recession did not require the same degree of due diligence that is required today.

You have heard the story before. It all sounds good on paper: Country X is growing rapidly, it has a democratic government, demand for your product there is high, and the country or buyer appears to have the money to pay for it. But in an era when economic volatility is high and many financial professionals have little more than a quarterly orientation to the future, it is important to consider what may happen 5 or 10 years from now, after your long-term investment has been made, the government changes, and the country can no longer pay its bills. What tools, if any, does your company have to assess and manage such risks?

To the extent that international companies devote any resources at all to understanding cross-border trade and investment climates (in my experience, most do not), they tend to over-rely on internal sources of information or on externally generated country risk analyses, which are more often than not produced generically and are not necessarily appropriate for specific transactions. This is perhaps the most common mistake risk managers make. They believe that because they have information about the general political and economic profile of a country, they have a true handle on the nature of the risks associated with doing business there.

What about gauging legal and regulatory risk, the country's friendliness toward foreign trade and investment, and other companies' experience there? Too often, companies get caught in an "investment trap": They commit long-term resources to a country only to find that the bill of goods they were sold—or thought they understood—turned out to be something completely different. There are plenty of stories about companies whose investments turned into disaster because the regulatory environment changed, a legal issue arose, international sanctions impacted their ability to operate, or they selected the wrong joint venture partner. After the investment has been made, it is often too late to pull out without incurring large losses and experiencing reputational risk once the story hits the press.

Another common issue is that the lines of communication between risk management personnel, risk management and decision makers, or decision makers is bypassed, convoluted, or just plain wrong. I have seen instances where

- Risk management is given only cursory participation in the transaction approval process.

- Sales teams bypass risk management entirely or ignore risk management's recommendation because they fear a transaction will be canceled as a result of unacceptably high levels of risk.
- A CEO delivers a presentation to a board of directors that is false, but he believes it to be true because the risk manager's staff said it was.
- A board of directors has no idea what questions they should be asking of corporate decision makers.

A risk manager may have the right information, based on a short-term assessment of the risks. The long-term view may be completely different, but in the absence of knowing what questions to ask and having clear lines of communication, the right information may not be taken into consideration.

The simple way to limit the possibility that unforeseen adverse events will occur is to establish clear reporting lines and do your homework—I mean really do your homework—and hire one or more individuals in your company to focus full time on managing these risks and/or hire an external firm to create a customized risk profile for each and every investment your company plans to make. The expense involved pays for itself many times over when a problem is uncovered and avoided, yet many companies are happy to invest millions of dollars to make cross-border investments without doing their homework.

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... Daniel Wagner has brought the world the go-to book on country risk analysis. **Managing Country Risk** *provides a broad, deep, and accurately detailed analysis of country risk analysis tools and techniques in a volume unlike any I have read before. It is both timely and likely to enjoy a long shelf life.*
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... an excellent, thought provoking, and well-crafted book that speaks directly to the needs of financial professionals tasked with navigating the complex world of cross-border risk analysis. Investment managers, commercial lenders, risk managers, and members of senior management will all benefit from the insights in this book... .
—Peter Went, Vice President, Global Association of Risk Professionals Research Center

Wagner carefully sorts through the fundamental principles of country risk management, adding context with examples from his quarter century as a political risk insurance underwriter, country risk manager, and advisor. The chapter on political risk insurance is the best comprehensive description of the product that I have seen. ... an invaluable tool for the scholar and practitioner alike in understanding country risk ... .
—Frederick E. Jenney, Partner, Project Finance & Development Group, Morrison & Foerster

I found great value in Daniel Wagner's approach of combining 101 subject matter with graduate-level country risk concepts, and was fascinated with the practical examples he used to drive the points home. ... this book would be of great value to a widely varied audience, including CEOs, CFOs, risk managers, directors of multinational boards, insurance underwriters and brokers, academics, and public sector practitioners.
—Rod Morris, Vice President of Insurance, Overseas Private Investment Corporation

... The first book that combines easily understood text, insightful analysis, and effective strategies to minimize the risks inherent in cross-border business transactions. ... a must read for anyone charged with managing country risk.
—Mark T. Williams, Executive-in-Residence/Master Lecturer, Boston University School of Management

... a marvelous exploration of a mind trained to integrate all information on all subjects into a coherent viewpoint that produces a business decision. After a long career practicing this kind of thinking in both the public and private sectors, Wagner's approach, and this book, are a treasure.
—Dr. Paul Armington, President, World Institute for Leadership and Management in Africa

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