GUIDE TO COUNTRY RISK

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How to identify, manage and mitigate the risks of doing business across borders

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THE ECONOMIST IN ASSOCIATION WITH
PROFILE BOOKS LTD

Published by Profile Books Ltd
3a Exmouth House
Pine Street
London EC1R 0JH
www.profilebooks.com

A CIP catalogue record for this book is available from the British Library

e-book ISBN: 978 1 78283 057 3

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Acknowledgements

THE IDEA FOR THIS BOOK was hatched following a lecture I gave on country risk at Manchester Business School in 2011, at the height of the euro-zone sovereign debt crisis. I would like to thank Ismail Erturk, director of the MSc Executive Management programme on banking and financial services, who noted that there was not much written on the topic. I took up this suggestion when I left Standard Bank in 2013, having been head of the country risk team for international operations since 2001. The enthusiasm of colleagues and friends then propelled me along. From Standard Bank, I am grateful to Nina Triantis, global head of telecoms, John O'Mulloy, managing director, Jiri Choteborsky, director telecoms and media, and Sophie Papasavva, now a founding member of EFMC Loan Syndicates LLP, for their support and input to the Roshan and Wataniya case studies. I would like especially to thank Laura Rattner, my long-term colleague now heading the western hemisphere country risk team at Macquarie Group, Deborah Bekker at Standard Bank, Alistair Newton, managing director at Nomura International, and Helena Huang at Chatham House for their contributions to excellent case studies on Argentina, Nigeria, North Korea and China respectively.

I began working on country risk early in my professional career as editorial director of the Economist Intelligence Unit's Country Risk Service in the late 1980s. But I would not have been in a position to write a book on this topic without the rich experience gained through working for a unique emerging-markets bank, Standard Bank, which was expanding its reach globally in the remarkable decade of the 2000s. It would not be possible to list everyone, but people who made my work more enjoyable include Neil Holden, a mathematical

wizard, and Arnold Gain, with whom we set up the overall framework for country risk, and Santiago Assalini and Annerie Cornelissen, who provided the steely nerves and support during the challenging days of the 2008–09 crisis.

I am also grateful to Daniel Franklin, executive director at *The Economist*, for introducing me to Profile Books where Paul Lewis encouraged me to take up "big themes" and Penny Williams tidied up the material so nicely. The big themes idea led me to the discovery of a wonderful book, *Against the Gods*, by Peter Bernstein, which matched my own thinking on risk: yes, there are many risks out there in this complex world, but humanity has the ability to manage most of them. This is what this book is about. This is the message I would like to give my daughter, Ozan, as well as thanking her for telling me to "stop procrastinating" when my attention was flagging. And last but not least, I want to thank my partner, Bernhard Blauel, for the long years of support that allowed me to focus on my work.

Mina Toksöz
August 2014

1 Introduction: a brief history of country risk

What is country risk?

Country risk – what can go wrong when business is conducted across borders – can affect any company, any time, anywhere. Its importance must be understood not just by bankers, insurers and other corporate risk managers but by anyone with commercial interests abroad. Whether you are running a factory, investing in a pension fund, or just importing or exporting, it can be perilous to ignore what is going on in overseas markets. As the Arab spring political events in 2011 and the global financial crisis in 2008–09 demonstrated, upheaval in one country can send powerful shock waves far beyond its borders.

Major payments crises occur with alarming regularity. A decade before the banking and sovereign (or public) debt crisis of the southern euro-zone economies, there was a debt default in Argentina in 2001; Turkey had a banking and payments crisis in 2000; Russia defaulted in 1998, a year after the Asian financial crisis, which itself followed a series of defaults in Latin America and Africa in the early 1980s. Further back, there were big defaults in the inter-war years and during the first era of globalisation in the 19th century.

There are always economic and political shocks happening somewhere in the world with the potential to spread. In 2013, the focus of concern was emerging markets and how they would fare if the US Federal Reserve tightened monetary policy. In 2014, it seemed that the Fed was not going to tighten much for some time and the focus moved to a potential bubble brewing in the US corporate bond market. In the past few years, risk managers could fret about the consequences of Cyprus's banking collapse, Syria's civil war,

the wobbles in the Chinese financial sector, the Ukraine crisis and the global or regional impact of possible international sanctions on Russia. The impact of such faraway events is easily transmitted through financial, banking and trade flows to all corners of the world economy. There are also upside risks to factor in, such as the lessening of sovereign default risks in the euro zone over 2013, which also need managing.

Given this frequency of crises and our vulnerability, why is country risk so difficult to forecast and manage? In part, this is because the nature of risk constantly changes, and because so much depends on the particular perspective of each business and industry. Each wave of defaults seems unique because of the different global economic context of the time, and the varied histories and economic circumstances of the countries where they occur. This is especially true, for instance, when comparing a payments crisis in an emerging market with the banking and sovereign debt crises afflicting developed economies. A lot also depends on the types of investment instruments that are involved: bonds, commercial loans, long-term project finance, resource-based lending, foreign direct investment and trade finance are affected by economic shocks in their own special way.

Thus it seems that every payments crisis is a new crisis, and each one triggers its own wave of academic research that looks to history to explain its causes, and predict and prevent the next one. But, of course, the next crisis is likely to be caused by a different set of factors, triggering yet another wave of retrospection. Some may argue that because today's world is so complex and interrelated, and as we have more information than we can use, the old risk models no longer apply. New methods are being explored using chaos theory and focusing on unmeasurable uncertainty. But to understand better what lies ahead, we need to consider the history and development of our thinking about risk more generally.

Thinking about risk came with the Enlightenment

Country risk is a post-colonial concept, one that has become ever more important in today's global economy. Today we have the

analytical tools and the information to analyse and manage the risks facing international business. We also have a philosophical and international framework in which to do so. The ancient Arab and Chinese traders who traversed the Indian Ocean and the English and Dutch colonists shuttling between the Moluccas and Europe faced massive risks at their destinations – that they might not come back alive, for one. But all they had was a few gunboats to deal with local troubles.

There were not the political conditions, the analytical tools or the country data available to think about future uncertainty and risk. Data did not go beyond patchy rudimentary shipping and demographic records.[1] Clay tablets in ancient Mesopotamia show diligent recording of lending activity and some empires such the Roman and Chinese dependent on tax revenues conducted regular censuses. But it was in the city-states in Renaissance Italy that the recording of trade and financial activities reached a new level, including the introduction of double-entry book-keeping.

More analytical interest in foreign lands and thinking about the future came during the Enlightenment when the mathematical tools to measure probabilities of uncertain events were developed. Two Central Asian mathematicians, Al-Khwarizmi and Al-Khayyami (also known as Omar Khayyam), had invented algebra (*al-Jabr*) several hundred years earlier. But even though the underlying mathematics had been discovered, the prevailing political ideas at the time of the Arab and Seljuk empires were not amenable to developing these tools further into risk analysis. As Peter Bernstein puts it in his book *Against the Gods: The Remarkable Story of Risk*: "The idea of risk management emerges only when people believe that they are to some degree free agents."

What Bernstein calls the first step in making measurement the key factor in the taming of risk was taken by an Italian, Leonardo Pisano, who became acquainted with the Hindu–Arabic numbering system. He then wrote *Liber Abaci* in 1202, which contained the numerical sequences that came to be known as the Fibonacci series – still a favourite of financial whizz-kids today. The next breakthrough came in Italy in the 15th and 16th centuries where men such as Luca Paccioli and Girolamo Cardano began attaching probabilities to measure

risk. Then came the great men of mathematics – Thomas Bayes, Jacob Bernoulli, Abraham de Moivre, Pierre-Simon Laplace and Carl Friedrich Gauss – who inched towards the discovery of the bell curve, the normal distribution and the law of large numbers. Eccentrics such as Francis Galton (a cousin of Charles Darwin) put forward the radical idea of regression to the mean, which remains a key notion for investing in stockmarkets.

While the French, the Italians and the Germans developed the mathematics of probability, the British and the Dutch put them into practice and created new institutions. John Graunt and William Petty, working on birth and death records in 17th-century England, introduced statistical sampling and key concepts such as averages. This enabled calculations for life insurance policies, which the Dutch and British governments used to raise public funds. Around this time, with the expansion of international trade, Lloyds of London was established in the famous coffee house in the City of London frequented by traders, ships' captains and marine underwriters to exchange information on remote areas of the world. The ideas of the northern Enlightenment influenced two Scottish clergymen in 18th-century Edinburgh, Robert Wallace and Alexander Webster, to calculate average life expectancy and create the first pension fund in the world. Thus in Britain, risk mitigation with life insurance, pension funds and marine insurance policies had become so widespread that, according to Niall Ferguson in his book *The Ascent of Money*: "By the middle of the 19th century being insured was as much a badge of respectability as going to Church on a Sunday."

From science of probability theory to management of risk

By the end of the 19th century there was a more critical view of science and an emphasis on the limits of human reason. And after the cataclysmic events of the two world wars in the 20th century, Bernstein says:

> *[T]he dream vanished that human beings would know everything … and that certainty would replace uncertainty. Instead, the explosion of knowledge has served to make life more uncertain.*

These concerns switched the focus from the laws of probability to the management of uncertainty with the work of Frank Knight and John Maynard Keynes. But even before these thinkers, two late 19th-century mathematicians, Jules Henri Poincaré and Laplace had already recognised that there were situations where there was too little information to apply the laws of probability since mathematical probabilities can only be derived from large numbers of independent (and homogeneous) events, such as the rolling of dice. Knight made the crucial distinction between risk and uncertainty – that risk was measurable uncertainty – in his 1921 book, *Risk, Uncertainty and Profit*.

Knight also highlighted the difficulty of the forecasting process and considered the reliance on the frequency of past occurrences to be extremely hazardous. Working at about the same time, Keynes (whom Knight disliked) agreed. In *A Treatise on Probability*, Keynes emphasised the importance of intuition as opposed to the science of probability theory. These sentiments paved the way for game theory, invented by John von Neumann, who first busied himself discovering quantum mechanics and was a leading member of the team that made the atom bomb. The modern critique of the mathematical, "scientific" treatment of risk was shaped by Kenneth Arrow and Frank Hahn. They focused on the lack of information faced by economic decision-makers and on unmeasurable uncertainty as opposed to measurable risk. This was followed by chaos theory, which tried to make sense of the increasing complexities of a globalised world, and, in the aftermath of the 2008–09 global crisis, focused on tail risks and unmeasurable uncertainty.

The evolution of country risk roughly followed these trends in broader risk analysis. The small number of observations of country defaults, their interrelatedness and lack of homogeneity, and the unreliability of history to forecast future crises were all issues that framed the development of analysis. But despite these problems, efforts to quantify country risk have continued. In this book a country risk-rating model is proposed (see Chapter 8) in the tradition of Robert Solow, an economist, who once characterised economic model builders as "the overeducated in pursuit of the unknowable. But it sure beats the alternatives". However, bearing in mind the

limits of this approach, the rating model should be used as only one component of the overall country risk management process.

The rise of international portfolio flows

Thinking about country risk became more systematic in the late 19th century and the early years of the 20th century when a global capital market emerged with international capital flows larger in scale than anything seen before (that is, relative to the global GDP of the time). Its centre was the City of London with UK overseas investment amounting to 150% of UK GDP in 1913. The bulk of this investment – around 80% – was portfolio capital in the form of stocks and bonds, mostly issued in the City of London; foreign direct investment (FDI) was not that significant. Most of the lending was for infrastructure investment with railways alone accounting for about 41% of the total.

British overseas investment was mostly in the colonies. A major risk mitigant for the buyers of these colonial securities was the explicit guarantees by the British government decreed by the Colonial Loans Act of 1899 and the Colonial Stock Act of 1900.[2] Crédit Lyonnais set up a research department called Service d'Etudes Financières in 1871 to monitor overseas risks and Moody's issued its first sovereign credit rating in 1919, though these activities were wound down after the Great Depression in the 1930s.

The 19th-century era of globalisation was one of reckless lending and, not surprisingly, major waves of defaults, including several US states, Austria, the Netherlands, Spain, Greece, Portugal, Australia, Canada, the Ottoman empire, Egypt and almost every country that had recently gained independence in Latin America.[3] However, these series of defaults did not generate the pre-emptive risk management activity that was to come after the second world war and become systematised following the 1980s series of defaults.

This was still the era when colonial powers did as they pleased, as seen in 1840, when the Qing emperor, Daoguang, ruled that British subjects were subject to Chinese law as he confiscated and destroyed the opium shipped to Canton (today's Guangzhou) by two British traders, William Jardine and James Matheson. In response, the British prime minister, Lord Palmerston, sent in gunboats, taking Hong Kong

and establishing the principle of extraterritoriality in the treaty (of Nanking) ports. When the Ottomans defaulted in 1875, European creditors established themselves in the heart of Istanbul, overlooking Topkapi Palace, set up the Ottoman debt office – the Duyunu Umumiye – and took over all tax revenues and money printing from the Ottoman authorities. When Spain defaulted in 1847, some MPs in the House of Commons suggested that the UK should take over the Spanish territories of Cuba and Puerto Rico to repay the British bondholders. But there were limits to how much support the UK government was prepared to provide. This time Palmerston demurred; he prophetically warned about moral hazard and that creditors would become reckless if they always expected the government to step in.

The principle of national sovereignty

Just as it took the Enlightenment ideas to deal with risk in the broad sense, it needed the establishment of national sovereignty as the international norm before international business began to take responsibility for their dealings and systematise the management and mitigation of country risk. The shift towards sovereignty in international law began in the aftermath of the first world war and Woodrow Wilson's declaration of "the right of nations to self-determination" in 1918 (though this was mostly meant for European states). This was followed by the Atlantic Charter of 1941, signed between Franklin D. Roosevelt and Winston Churchill, with unclear implications for colonial territories. (Historians trace the first emergence of the concept of the sovereign state to the Treaty of Westphalia in 1648.) Finally, UN Resolution No. 1514, "Declaration on the granting of independence to colonial peoples", passed by the UN General Assembly in 1960, provided the political and legal link between self-determination and decolonisation and enshrined national sovereignty in international law.

The risks for international business in the inter-war years and during the two world wars, and the process of decolonisation that began in the 1920s, were mostly discussed in terms of political risk.[4] International investors faced nationalisation and expropriation of their assets, with resulting losses depending on how smooth or disruptive

the process of decolonisation had been.[5] These risks escalated during the two world wars (when German firms operating in the US and almost anywhere else in the Americas were expropriated) and following the second world war as radical regimes in the colonies came to power, gaining independence and pursuing policies of nationalisation of industry and land reforms in agriculture.[6]

The reaction from Europe and the United States to such expropriations was still political. The British response to the nationalisation of the Anglo-Persian Oil Company (precursor of BP) in Iran by Mohammed Mosaddegh, the prime minister, was to engineer a coup in 1953 to bring down the democratically elected government and restore the monarchic rule of Reza Shah. Similarly, gunboats were sent in response to the nationalisation of the Suez Canal in 1956 by Gamal Abdel Nasser, and Egypt paid compensation to the mainly British and French shareholders of Universal Suez Ship Canal Company until 1962. The US government's approach to what was then called the third world remained fixed in cold war terms – as seen in Cuba in 1959.

But public opinion was becoming more critical of political interventions. As far back as the 1920s, following the occupation of the Ruhr by French and Belgian forces in 1923 to obtain reparation payments from Germany, British and American financiers had concluded that force would be of little use in collecting the debt. The corporate landscape was also changing. Multinational firms not associated with colonial rule were approaching risks in international business with new measures. Swiss firms such as Nestlé, Brown Bovery and Sandoz devised strategies to deal with political risks, relying on Switzerland's neutrality to keep their international businesses going, even during the war. These included long-term strategies to sit through the political problems, multiple headquarters, appointing politically influential local figures on their boards and the "cloaking" of the firm to appear local.[7]

Institutions that brought a more pre-emptive approach to manage the risks facing international business were playing a bigger role:

- In 1919 the Export Credits Guarantee Department (ECGD) was established in the UK, the first in the world to provide exporters with credit insurance.
- In 1934 the Berne Union, an association of public and private export insurance firms from the UK, France, Italy and Spain, was founded.
- In 1944 multilateral institutions were founded at the Bretton Woods Conference with the aim of averting the devastating problems of international trade and finance that had emerged in the inter-war years. These included the International Monetary Fund (IMF) and the World Bank.
- In 1947 the General Agreement on Tariffs and Trade (GATT), a multilateral agreement to regulate international trade and promote reduction of tariffs and trade barriers in a mutually beneficial way, was signed.
- Not all were for pre-emptive risk management. In 1956 the Paris Club of official creditors to work out defaulted debts was formed.

Multinationals, expropriation and loan risk

The rapid global expansion of US multinational companies following the second world war generated more analysis of the identification and management of overseas risks. (The book value of direct investments by US firms abroad rose from $7.2 billion in 1946 to $70.8 billion in 1969, with $21.6 billion located in Europe.) The Cuban revolution of 1959 and the expropriations that followed further increased the focus on the political risk facing US multinationals. The Multilateral Investment Guarantee Agency (MIGA), the political risk insurance arm of the World Bank, estimated in 2011 that the number of expropriation acts during 1960–79 stood at 560 and that about 15–20% of all US FDI abroad measured in volume terms was nationalised. Hence political risks – expropriation, licence cancellation, nationalisation, currency devaluations and capital controls – were identified as key risks that needed to be managed. One of the earliest risk services, Business Environment Risk Intelligence (BERI), was founded in 1966