

***Country Risk and the Attractiveness for
Foreign Capital Flows in Emerging
Countries. Evidence from Africa***

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Motivations

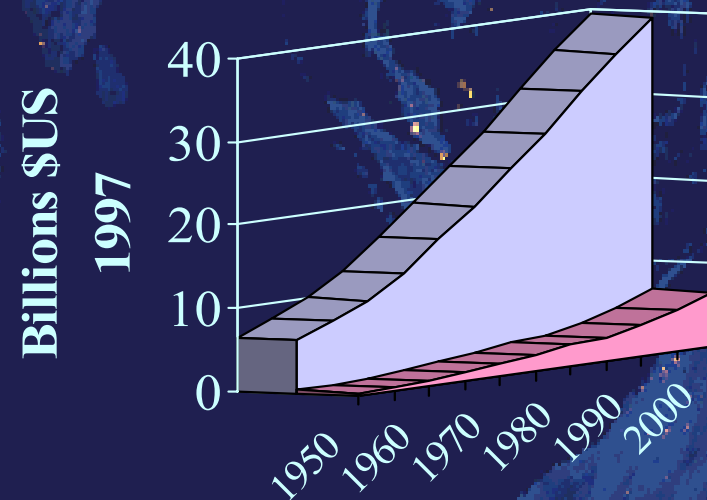
- Increase in world exchanges
- Increase in Foreign Capital
- Poverty, marginalisation
- A two-part world :
a new perspective North-South
- An always growing interdependence between economies
- High Indebted Poor Countries Initiative (HIPC)
- Global market
Unfair distribution of capital flows

International Trade

1950-2000

- World GDP x 6
- GDP Per Capita x 3
- Trade x 14
- % world trade in world GDP
 - 1950: 6%
 - 1998: 14%

■ world Trade ■ world GDP





Capital Flows (1)

Financial Markets

Portfolio Investment

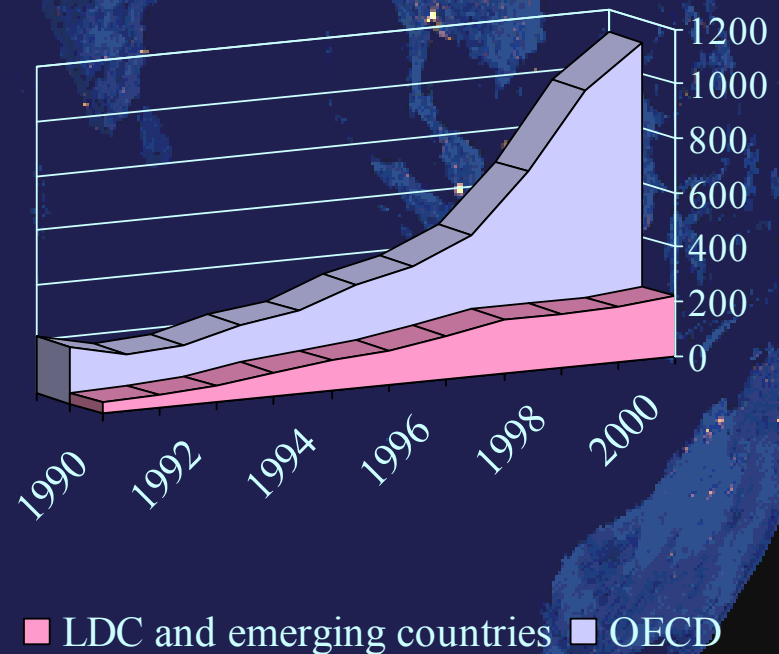
- :
 - 1970: \$ 10-20 billion per day
 - 2000: \$ 1500 billion per day
- High Volatility
 - Asian crisis
 - Pension Funds

Capital Flows(2)

Foreign Direct Investment (FDI)

- High growth
 - \$ 209 billion in 1990
 - \$ 1100 billion in 2000
- Destination
 - 17% LDC in 2000
 - 40% between 1993 and 1997
- Concentration LDC (2000):
 - 80% to 20 countries
 - 65% to 5 countries
 - 35% to China

Foreign Direct Investment

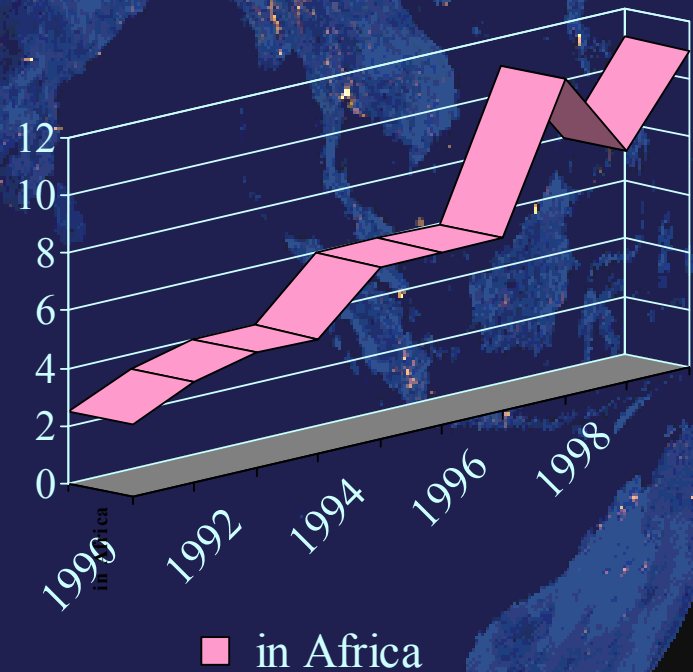


Capital Flows(3)

FDI in Africa

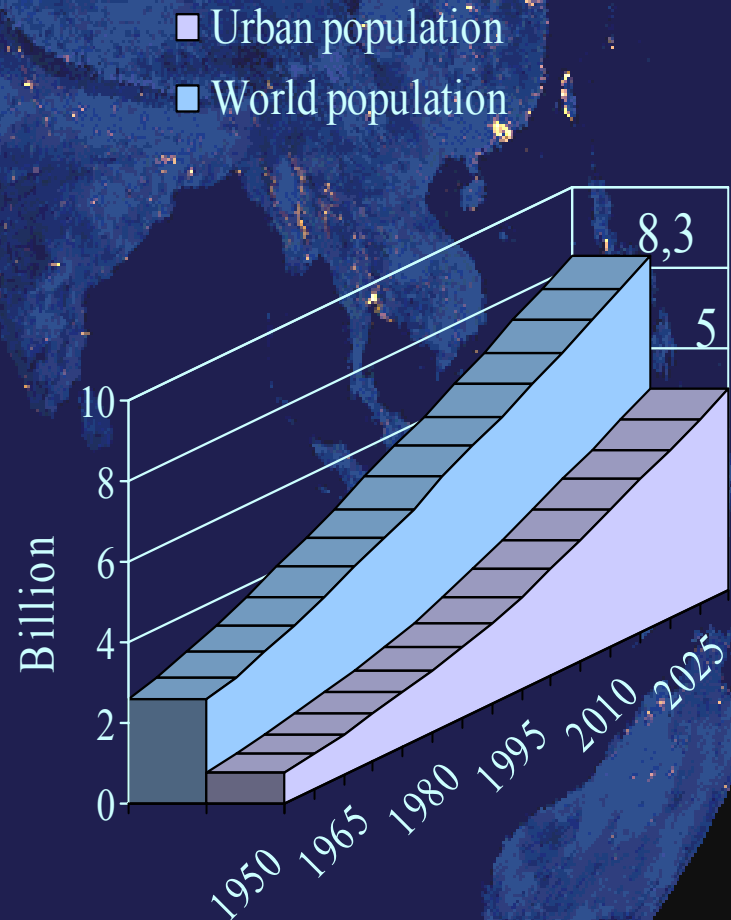
- Multiplied by 5 1990-1999:
 - From 2 to 10 billion
- 1,2% of the world FDI
- 5% of the LDC's FDI
- 70% in 5 countries:
 - Angola
 - South Africa
 - Egypt
 - Marocco
 - Nigeria

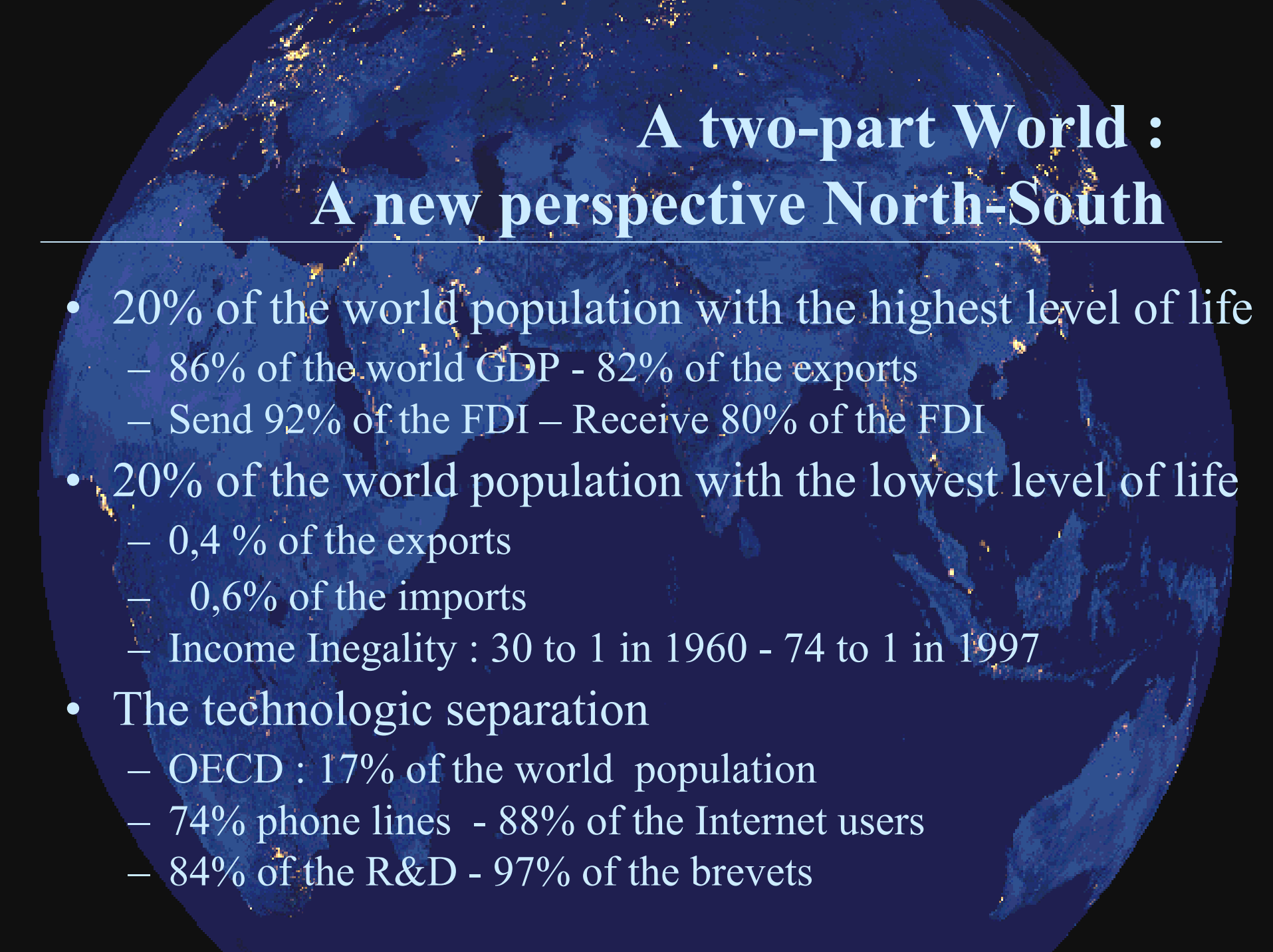
FDI in Arica



Increase in the demographic pressure

- **World population**
 - 8,3 billion in 2025
 - + 38% over 25 ans
 - + 80 million per year
- **Fast Urbanisation 90% of increase in urban zones**
- **5 billions people living in urban areas in 2025**
 - 60% people living in urban areas in 2025
- **Migration Flows**
 - 145 million migrants in the world
 - 19 million of refugees





A two-part World : A new perspective North-South

- 20% of the world population with the highest level of life
 - 86% of the world GDP - 82% of the exports
 - Send 92% of the FDI – Receive 80% of the FDI
- 20% of the world population with the lowest level of life
 - 0,4 % of the exports
 - 0,6% of the imports
 - Income Inequality : 30 to 1 in 1960 - 74 to 1 in 1997
- The technologic separation
 - OECD : 17% of the world population
 - 74% phone lines - 88% of the Internet users
 - 84% of the R&D - 97% of the brevets

1. The attractiveness of emerging countries (1)

- The emerging markets have some joint characteristics :
- *economic growth*
- *GDP value*
- *infant mortality and the life expectancy*
- *risk*
- *the need for reforms and liberalization of the economy*

1. The attractiveness of emerging countries(2)

- **Group 1:** controlled inflation, relative stable exchange rate, developed financial and banking system, access to international money markets, important volume of transactions with a reliable system of compensation.
- **Group 2:** low volumes of transactions , small market capitalization, technical deficiency on the level of operation , high rate of inflation , frequent devaluations, restricted access to international money markets
- **Group 3:** incipient stock exchange markets, many economic problems , no access to international money markets.

2. The risk to manage: the country risk

- Country risk: political risk, economic and financial risk or more generally in a form representing the materialisation of a disaster endangering the achievement of the aims fixed by the investors.
- The assessment of the country risk must be done by respecting the following triptych **Identification-Valuation-Treatment (I-V-T)**.
- *Identification*. By considering factors like political stability, budget deficit, balance of payments, debt burden, uncertainty on the rights of ownership and capital flight.
- *Valuation*. Ensured by notations, classifications, and indices.
- *Treatment*. Transfer, reduce or eliminate the risk by structuring projects (in order to limit the risks of conflicts of interests with the local authorities and to avoid vertical integration in the host country) *Coverage*

2.1 Identification of country risk

- Two components, the political risk and the economic risk.
- Political risk consists of acts and measurements taken by the authorities of a country or induced by a particular situation in the country.
- Economic risk covers the non-payments, the commercial risk and the monetary risk.
- The political risk is assessed under two levels:
 - the macro-economic level
 - the micro-economic level

2.1 Identification of country risk(2)

- **Macro-economic level:**
- 1) Expropriation is the most extreme demonstration and the most expressive of political risk.
 - Examples: Eastern Europe following the advent of Communism. Cuba . Iran .. Peru ..
- 2) Political risk caused by ethnic, religious or social conflicts appeared.
 - Examples: Afghanistan . Yugoslavia . The Kurdish problem. The balkanisation of ex-Zaire and the Rwandan genocide. The retrocession of Hong Kong to China.
- **Micro-economic level**
- 1) The consequences of the conflicts of interests between foreign investors and host country.
- 2) Corruption
 - Examples: Firestone in Kenya. Foreign investments accepted in Indonesia were partially controlled by the son of Suharto

2.2.. Valuation (Measure of country risk)(1)

- The valuation of the political risk is carried out by taking into account five families of significant factors:
 - 1) **Political stability** : the frequency of government changes, the level of violence in the country and the existence of conflicts with the other states.
 - 2) **The economic factors** : inflation, balance of payments, debt, debt service and GDP growth rate. These indicators help to determine the health of the economy.
 - 3) **The subjective factors**: the perception of the foreigners of the behaviour of the local authorities with regard to the private sector.
 - 4) **The risk on the rights of ownership** : the possibility that the government modifies these rights or carry out expropriations.
 - 5) **Capital flight** : the will of the citizens of a country to export their saving because they fear about the safety of their capital.

Valuation (The measuring instruments)

- 1. **The rating of Moody's or that of Standard and Poor's.**
- 2. **The notation of the BERI:**
 - political stability, balance of payments, bureaucracy, availability of long-term credit, and relations with foreigners obtains this notation,
- 3. **The index of Euromoney**
 - political risk, economic risk, debt service and the balance of payments, the capacity of refunding, market indicators
- 4. **Frost and Sullivan Political Risk Services (FSPRS)**
 - risk of non repatriation, tax policy, monetary policy and debt,
- 5. **The index of World Political Risk Forecast (WPRF)**
 - stresses the political conditions, which influence the activity of the businesses: change of political regime, change of government, expropriation and problems of repatriation of the revenues;
- 6. **The index of perception of corruption (IPC) of Transparency International**
- 7. **The index of the Economist Intelligence Links (EIU)**
 - risk on the level of the medium-term loans, political risk and commercial risk in the short run,
- 8. **The Profit Opportunity Recommendation (POR)**
 - the state of the economy, the social and political condition and the climate of businesses

2.3 Treatment

- The risk can be transferred entirely or not to specialized organizations of three types:
 - governmental agencies, international institutions and private companies.
- **Well-known governmental agencies:**
 - the OPIC (Overseas Private Investment Corporation) in the United States,
 - the COFACE (French Company of Insurance for the Foreign Trade) in France,
 - the SEE (Company for the Expansion of Exports) in Canada,
 - the ECGD (Export Credit Guarantee Department) in the United Kingdom.
- They help companies of their respective country to carry out investments abroad or to make exchanges with foreign countries (partial coverage on the credits and turnover).
- **International institutions** such as MIGA (Multilateral Investment Guarantee Agency), which makes possible the hedge of the risk of non-repatriation of the benefit, the risk of breach of contract, the risk of expropriation and the risk of social disturbances.
- **Private insurance companies** like The Lloyd's of London, which propose contracts of coverage against certain achievements of the country risk.

3. Lessons from economic theory(1)

- The factors that explain foreign capital flows are divided into two groups thanks to Calvo, Leiderman and Reinhart (1996): **push and pull factors**. The push factors explain why capital leaves a country in direction to another while the pull factors give the reasons for which a country attracts capital.
- **The principal push factor** are the level of interest rate and the need for diversification
 - "one does not put all his eggs in the same basket: diversification partially explains the presence of foreign capital in the countries of the South.
- **With regard to pull factors**, there are political stability, economic growth, high profitability, reliability of the stock exchange, good state of the infrastructures, quality of life, advantageous tax policies, labour quality as well as geographical location.

3. Lessons from economic theory(2)

- Mandelker and Tandon (1995): link between macro-economic variables and the stock market.
- Chunchinda and Jokung (2001): in the case of Thailand , portfolio investment is positively related to the Bangkok Stock Exchange capitalization and also to the quality of the Thai economy
- Chunchinda and Jokung (2001) : direct investment increases with economy growth rate and economy quality.
- Chuhan, Claessens and Maningi (1993) : portfolio flows are about equally sensitive to pull and push factors in Latin America and they are four times more important in East Asia during 1988-1992.
- De Santis (1994) and Harvey (1995) : the preoccupation of diversification of the risks pushes the foreign capital towards emerging countries.

3. Lessons from economic theory(3)

- Alesina and Perrotti (1996) and Mauro (1993) : an inverse relationship between political instability and economic growth or investment, political risk slows down investment.
- Jokung (1998) : the quality of the economy measured by the index of Gwartney, Lawson and Block and the growth rate of the GDP are positively related to direct investments flows in Malaysia and Singapore.
- Sianesi (1995) : three main location factors: demand conditions, cost factors, and political factors.
- Kravis and Lipsey (1982): host market size and openness are the major determinants for location decisions but labor costs are also taken into account.

4. Threats and Weaknesses of Africa

- **The foreign debt represents 46.7 % of the GDP in 2004 and accounts about 275 billion dollars. The share of the public expenses devoted to the debt servicing was between 30% and 50% in 2004. It amounts at 26.7 billion dollars in 2004.**
- **This servicing should decline thanks to the HIPC initiative (Heavily Indebted Poor Countries)**
- **Sub-Saharan Africa was located last year between 92nd row and 177th row in the classification given by the index of human development.**
- **In 2000, more than 50% of the population lived below the poverty line, the aim is to make this percentage fall to 25% in 2015.**
- **Several African countries take part in the HIPC initiative with the objective to help countries concerned to quickly profit from an important reduction of their foreign debt in order to support the fight against poverty.**
- **The goal clearly noted by HIPC initiative is to make free and available capital, which ensured the debt servicing in order to assign them to the fight against poverty.**

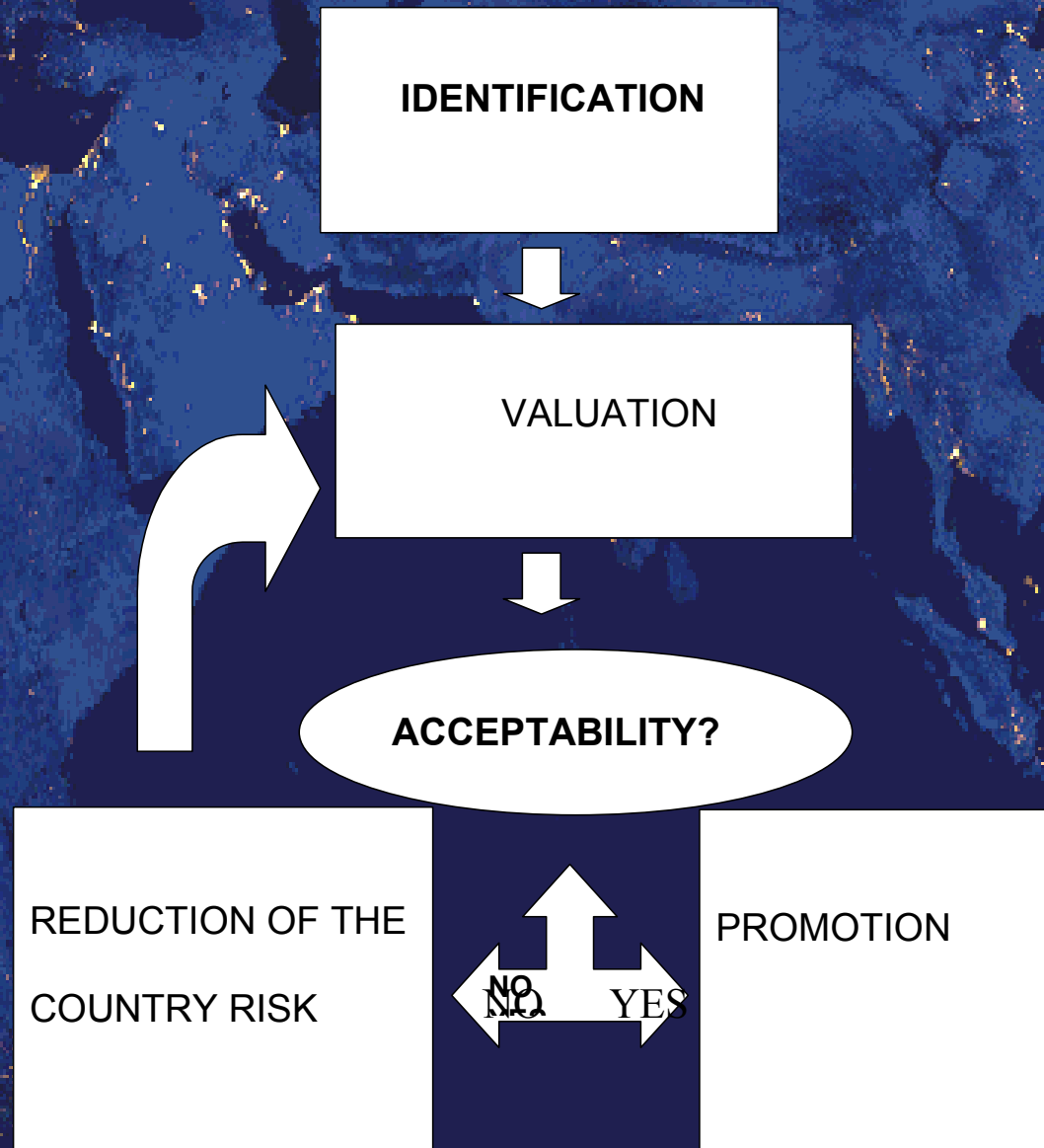
5. Attractive policies, good governance

- They fear however that investors choose other countries if they do not offer subsequent advantages and assistances to them. Thus the arsenal of seduction is impressive:
- 1) **tax support** : the reductions of rate, with the abatements preliminary to the calculation of the income tax, to the exemptions or the rebates on the customs duties, to the accelerated depreciation and the reductions on the social taking away.
- 2) **financial assistances**, loans with interest rate subsidy, guaranteed loans and subsidies with the formation, with the more or less free supply of grounds, water, and road.

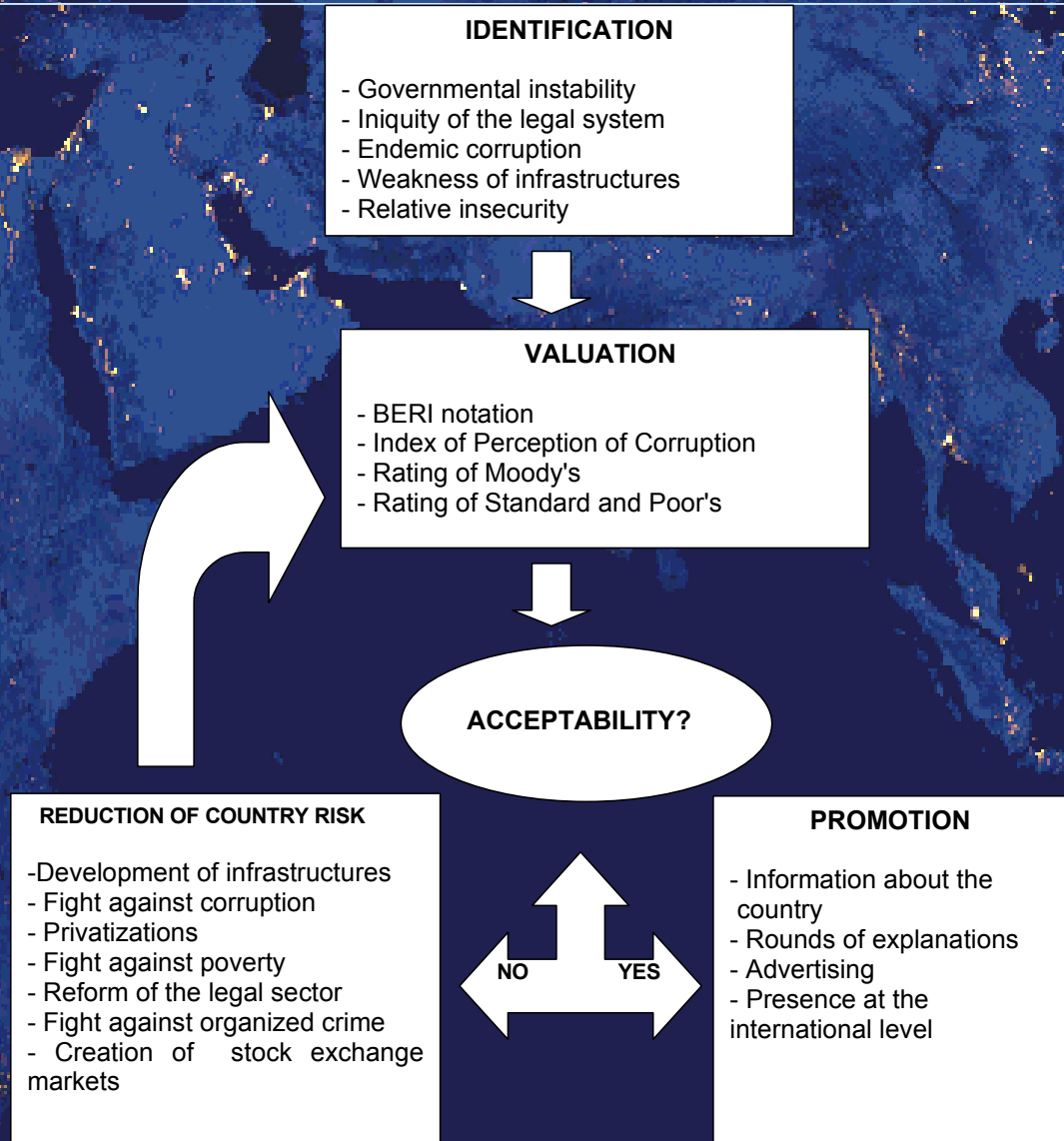
6. Risk management process(1)

- While referring to the lesson as well economic as factual in term of country risk and attractiveness of the foreign capital, the diagram that we propose to illustrate our risk-management process is the following: **Identification, Valuation, Acceptability, Reduction and Promotion**
- The continuous improvement registered in the objective of reduction of the country risk as presented in the diagram, will give a positive response to the acceptability of Africa in term of risk in a near future.

6. Risk management process (2)



6. Risk management process (3)



Conclusion

- In the concert of the emerging countries or in the process of development, the voice of Africa could be made hear. That would facilitate the attraction of the foreign capital in order to take part in the development of this continent .
- The need for sending clear and precise signals to the contributors of capital is essential today and the good governance with the attractive economic policies (governmental stability, weakness of inflation, sustainable high growth and creation of a stock markets) will play to a certain extent their driving role.
- It is necessary to attract capital but they will have then to be directed towards the most productive sectors and especially generators of repercussions on the population by technology transfers, gains of productivity and rises in real income.
- It will be necessary as a preliminary level to improve safety of goods and people, to reduce corruption, to reform the legal system while making it more reliable and to improve the infrastructures (roads, water, utilities) while applying judiciously economic lessons.

Africa has to manage country risk with processes like IYT