Eclairages

Department of Economic Research

Monthly - No. 115
October 2007

Political Risk and Country Risk: Approaches to Measurement

For decades, "political risk" in international finance was considered to involve only major crises; it materialized when war prevented the production of goods and services, or when a revolution undermined earlier commitments. Such episodes have not disappeared, even if the situation appears to have improved since the end of the cold war.[1] But investors' concerns in the area of "political risk" have broadened far beyond the exceptional circumstances of war and revolution.

Despite the comparative stabilization of the international situation, the *political dimension* remains the most crucial factor regarding a country's fragility (or solidity). But what is political is apprehended less in terms of major shocks and "great events" than through a series of small touches. Tensions between communities, corruption, governance, the quality of government and the rule of law are thus realities perceived by investors and lenders. Political risk, insofar as it can push a country into crisis, is constantly present in the analysis, even if the observation instruments used for observation have evolved: foresee ability remains a key component of any country assessment.

Quantifying or rating political risk is now essential for international operations in the financial and economic spheres. **The first part examines the definition of what must be quantified, that is, tensions and not only crises. Next, a brief review of the economics literature highlights the reemergence of institutional issues in economic thought.** The functioning of institutions is now being quantified via governance indicators. But governance is only one aspect of political risk, with which it is all too often conflated. The confusion arises when "other factors" of political tension are overlooked, if only because they are less readily quantifiable. **The third part examines examples of quantitative approaches to ethnic issues, showing that the literature shows new directions for enhanced country-risk analysis.**

From anticipation of "crises" to the analysis of "tensions"

Let's begin by defining the terms: country risk identifies the incremental risk incurred when trade, finance or investment is undertaken outside the nation's borders. This involves determining the risk relating to each country affecting an operation. **In this framework, political risk is a component of country risk; it represents the possibility that a political event could call the project into question.** Under the traditional view, political risk relates to the risk of a severe crisis—as is also the traditional view of country risk. With the move to quantification, it is thus essential to extend risk analysis to "tensions" as well as crises.

The risk of political crisis

Investing abroad means entering a foreign sovereign territory with different laws and different in-

1. Human Security Center report published in 2005. Since the 51 conflicts identified in 1991—the peak since 1945—the trend has been downward. Coups d'état are also less prevalent.

stitutions that operate at a different pace. For half a century, international investment was channeled from politically stable, developed countries. Investing abroad meant, in the extreme case, taking on exposure to a sudden upheaval in the institutional environment and, in particular, running the risk of seeing the foreign government change existing contracts and rules.

Country-risk analysis as a discipline originates in the political crises of the past. Historically, the concern arose with the first wave of globalization in the late 19th century. For the financial sector, without even considering the international consequences of the Russian revolution in 1917, the USSR continued to matter even after it ceased to exist as a political entity.[2] With post-World War Two decolonization, country risk returned to the news. Nationalization of the Suez Canal marked the first step on a path that has included oil shocks and the South's awareness of its geopolitical power.[3] In their different ways, the Iranian revolution and the fall of the Berlin Wall with the transition of the Eastern European countries towards the market economy were critical events that radically changed countries' political positions relative to the rest of the world. Political risk materialized, at worse, by isolating a troubled country, i.e., in suspending its participation in international affairs. Most often, it translated into cases of "*force majeure*" and repudiation of existing contracts. For investors, this sometimes meant a sudden, unilateral and comprehensive decision to stop payments, either in full or in part.

For decades, these events were the principal manifestation of political risk and explicitly recognized as such in the insurance process. Typical clauses mention "extraordinary government action," political or quasi-political events ("war, revolution, annexation, civil unrest" or "arbitration award, breach of contract, selective discrimination, boycott by a government entity"). **Political risk is then seen as an sudden dramatic change in the institutional context, and the two concepts tend to be intertwined.**

Country risk, crisis and tension

This dramatic view of political risk is the extension of the long-standing standard of country risk, namely "crisis". Crisis, because of its cathartic function and the fascination it arouses, the scope of the destruction it entails; and its visible damages, continues to be the apogee of country risk. **But from the practitioner's viewpoint, there is no reason for the two concepts to overlap: risk is not reducible to the "probability of crisis".**

The economist must begin by recognizing **that there is no single definition of "crisis".**[4] More specifically, there are as many definitions as there are authors. Even limiting the scope to the field of finance, there is no "absolute crisis," but rather events capable of affecting market segments: currency, stocks, debt, banks, real estate, and so on. There is no standard measure for the threshold beyond which events are considered a "crisis." Further, crises can break out in different markets, but the problem could also be limited to a single segment. A sharp drop in equity prices could affect exchange rates and spread to one or more other countries—or it could fail to have any such effects. There is no such thing as a crisis that arises simultaneously across all sectors; what occur are rather linkages and sequences.[5]

Not only is the definition of "crisis" hazy, but "crisis" is also context-dependent. A political crisis does not have the same meaning in a working democracy as in a country with fragile institutions. This is not simply a matter of vocabulary, as 2005 saw what were referred to as a crisis for the European Union, with the rejection of the Constitutional Treaty by France and The Netherlands, and the crisis in Ukraine that played out following the Orange Revolution. "Crisis" has been defined as "*an unstable or crucial time or state of affairs in which a decisive change is impending*" or "*a situation that has reached a critical phase*" (Merriam Webster online dictionary); the crisis depends on the "state of affairs" or "situation" in question. The more unstable the initial situation, the more dramatic the change can be.

Last and most importantly, a "crisis" is probably not the biggest danger a country faces, and certainly not the most common one. The economics literature, in particular, may have dwelled too much on describing and classifying crises, especially in recent years.[6] **The approach tends to overlook the tensions that economies experience—tensions that can derail a project just as surely as a sudden dramatic change.** Now, while crises do exist, they occur rarely. Tensions, on the other hand, are a permanent fixture, though they differ in intensity. And tensions are what ultimately interest the country-risk analyst and the investor, whether or not they degenerate into a crisis. In other words, while crises have doubtless become rarer in recent years, the reason is perhaps because the decisions taken to avoid them have been more effective than in the past. But we can doubt that the underlying tensions have disappeared, or that new forms of tensions—arising from those very decisions—have not emerged.

2. The solution to the Russian crisis in 1998 involved temporarily reviving the USSR and stating that it was in default, although Russia, during negotiations in 1992-97, had agreed to assume all Soviet Union assets and liabilities.

3. G.Corm, 1956-*2006, Le Proche Orient éclaté*, Gallimard, 2006 (1989 edition in English: *Fragmentation of the Middle East: The Last Thirty Years*)

4. Without even mentioning the concept of "probability," which is often used improperly in a world of uncertainty.

5. See especially Boyer, Dehove and Plihon [2004] Les crises financières, Rapport du CAE no. 50, and the publications by C.Borio at the BIS.

6. Work published by Olivier Jeanne, for instance.

The difference can be illustrated by the change in the perception of Brazilian risk. The market perception is evidenced in the spread (the difference between the yield on the country's debt and the risk-free rate, here the US Treasury security with the same maturity). The greater the market's worries over a country, the higher the spread over the Treasury in the secondary market, as lenders fear they will not receive timely payment. **During the 2002 Brazilian presidential election, yields shot up, reflecting uncertainty perceived by the markets.** The spread culminated at 2500 basis points in late September, just days before the elections. **There was no political crisis, but the risk measured by the market exceeded the worst times in the country's economic history**, e.g., the devaluation of the real in 1999, or when Russia and Asia plunged into crisis.
Thus, in addition to "critical situations," there are multiple political tensions that the country-risk analyst must bring to light. **Now that quantification has been mandated by the regulatory authorities, in the Basel 2 prudential principles, the job facing analysts has become a matter of measuring those tensions.**

Measuring the political dimension: institutions and governance

Is the political dimension quantifiable? In the 1980s, the question worked its way into economic analysis via a focus on institutions, originating in work on development and growth. Today, it can be affirmed that the political dimension is measurable: governance can be measured and provides an approximation of institutional matters. The governance indicators are thus increasingly used by the players in international finance and considerable literature is devoted to them.

Institutions re-enter the spotlight

In 2006, Luxembourg reported GDP per capita (in PPP terms) of USD 80,500, or 120 higher than Burundi's USD 680. Wealth differentials, and their changes over time, led to renewed interest in the 1990s in the question: **why are some countries richer than others?**

For quite some time, economics addressed the question by focusing on the accumulation of production factors and total factor productivity. It treated a country's social and political system as an exogenous factor. The two leading models of economic growth, the neoclassical model (Solow, 1956) and the Keynesian model (Harrod-Domar, 1948) both emphasize the importance of the saving rate. The introduction of endogenous technical progress and then human capital by Romer (1986) and Lucas (1988) marked the first attempt to incorporate factors whose definition and measurement are more subjective into a growth model. Yet, to quote North and Thomas, ***"The factors we have listed (innovation, economies of scale, education, capital accumulation, etc.) are not causes of growth; they are growth".***[7] For North and Thomson, institutional differences are the basic explanation of disparities in development. **North defines institutions as "*the rules of the game of a society or more formally are the humanly-devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both*".**[8]

To explain Kaldor's[9] sixth "stylized fact" of economic growth (the difference in the growth paths of economies over time, and the persistence of those differences), North takes the example of England and Spain.[10] In the early 16th century, both states had to meet rising the costs of war, and therefore had to increase revenues. England had a Parliament with the right to make laws, inquire into abuses and share in the conduct of national policy, while Spain was a monarchy with a centralized bureaucracy. England's responses to the need for greater resources included the founding of the Bank of England, the development of a private capital market and greater security for property rights. By contrast, Spain saw the generalization of confiscation by the crown and tax increases that resulted in insecurity regarding

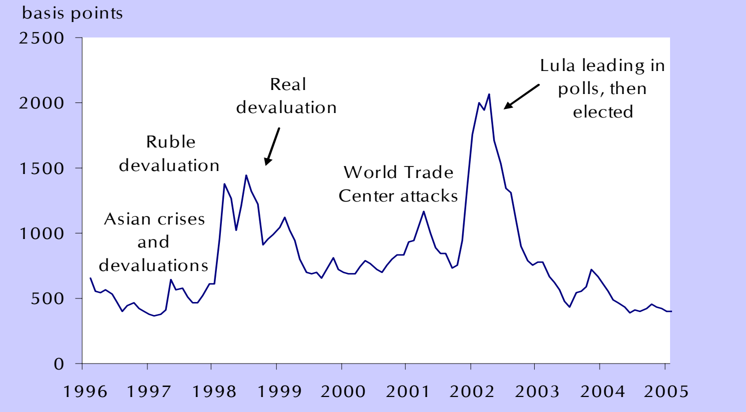
7. D.North and R.Thomas, *The Rise Of Western World, A New Economic History*, 1973.

8. D.North, *Institutions Matter*, 1994.

9. N.Kaldor, *Capital Accumulation and Economic Growth*, 1961.

10. D.North, *Institutions, Institutional Change and Economic Performance*, 1990.

Chart 1



Sources : JPMorgan, Datastream, Crédit Agricole S.A.

property rights. The same line of reasoning explains differences in the level of development between North America and Latin America, tracing patterns back to their respective colonizers. According to the argument, **the United States and Canada were endowed with institutions that encourage productive activity, whereas in Latin America, gainful activity was restricted to the Church, administration, and the army.**[11]

Where do institutions come from? The argument for colonial influence

The analysis above may seem too historical, but is confirmed by work in "new comparative economics,"[12] which emphasizes the influence of the colonization process in explaining both institutional patterns and current economic performance. A distinction can be made, for instance, between countries colonized by England (including New Zealand, Australia, the United States, Canada, Hong Kong and Singapore) that inherited the common law system, on the one hand, and on the other hand countries colonized by France, Spain and Portugal (including Latin America and West Africa) that inherited the "civil law" system.[13] The argument runs that the common law system, combined with Protestant influence, provides both better protection of property rights, and an efficient, modestly sized State. On the other hand, the "civil law" system, combined with a high proportion of Catholics or Muslims and high ethnolinguistic heterogeneity, is considered to favor a less-efficient, more-interventionist State.

The findings of other authors assign less importance to which European power colonized a given area:[14] the United States and Ghana were both colonized by the English. **Here, a distinction is made between two different patterns of colonization: settlement and exploitation.** Based primarily on an examination of the mortality rates of Europeans stationed in the colonies (soldiers, bishops and sailors) in 17th, 18th and 19th century records, and population densities before Europeans arrived,[15] Acemoglu, Johnson and Robinson identify regions more or less amenable to European settlement. Where settlement was difficult for Europeans (high mortality rate and high population density), they put in place institutions that facilitated rent extraction and private-property systems unfavorable to capital accumulation. **The settler mortality rates recorded over 100 years ago explain over 25% of the differences in the standard of institutions observed today.**

Institutions or governance?

Since North, a consensus seems to have formed regarding the importance of institutions in understanding and investigating income differentials across the world. Still, while North specifically defined the term *institutions*, insisting on *constraints*, the term remains inherently imprecise. Further, North did not provide a clearly defined statistical approach to econometric measurement of the influence of institutions on growth. How to measure the institutional standard of a country remains a matter of debate.

For example, Glaeser et al note that the three most widespread institutional measures (the *International Country Risk Guide* institutional surveys,[16] the KKZ indicator of government effectiveness, and the data supplied by the Polity IV base[17]) fail to reflect either the constraints on governments, or the permanent (or at least sustained) characteristics of the political environment.[18] They reflect a broader, more normative notion, namely governance, defined as ***"the traditions and institutions that determine how authority is exercised in a particular country. This includes (1) the process by which governments are selected, held accountable, monitored, and replaced; (2) the capacity of governments to manage resources efficiently and formulate, implement, and enforce sound policies and regulations; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them".***[19]

The two Koreas illustrate the conceptual differences between institutions and governance. When Korea was partitioned in 1948, the North and South both had the same GDP per capita.[20] But in 2006, GDP per capita (PPP) came to USD 1,800 in North Korea, and USD 24,500 in the South. Both countries have the same climate, the same natural resources, and the same ethnic and cultural homogeneity. Some authors claim that **"their very different institutions led to divergent economic outcomes".**[21] Still, when insisting on the rule of law, private property rights and contract enforcement, what is at issue is not a matter of institutions but rather one of governance. In both cases, the choice of the institutional framework and the development model was originally made autocratically, with communism on the one hand and capitalism on the other. If institutions (in Douglass North's sense) evolved differently, the difference arose mainly as a matter of governance.

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11. For information on the theories of D.North, see J.Arrous, *Les théories de la croissance* (in French), 1999.

12. For information on this area, see S.Djankov, E.Glaeser, R.La Porta, F.Lopez-de-Silanes and A.Shleifer, New Comparative Economics, 2003.

13. R.La Porta, F.Lopez-de-Silanes, A.Shleifer and R.Vishny, *The Quality of Government*, 1998.

14. D.Acemoglu, S.Johnson and J.Robinson, *The Colonial Origins of Comparative Development: An Empirical Investigation*, 2001.

15. The data on mortality rates derive mainly from P.Curtin (*Disease and Empire: The Health of European Troops in the Conquest of Africa*, 1998), and the data on population densities from C.McEvedy and R.Jones (*Atlas of World Population History*, 1978).

16. Surveys of specialists conducted by PRS Group (Political Risk Services). For information, see http://www.prsgroup.com/ICRG.aspx

17. For more information, see http://www.cidcm.umd.edu/polity/

18. E.Glaeser, R.La Porta, F.Lopez-de-Silanes and A.Shleifer, *Do Institutions Cause Growth?*, 2004.

19. D.Kaufmann, Z.Kraay and P.Zoído-Lobatón, *Governance Matters*, 1996.

20. A.Maddison, The World Economy: A Millennium Perspective, 2001.

21. D.Acemoglu, S.Johnson and J.Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, 2004.

Institutions, governance and growth

In practice, governance is more amenable to quantitative investigation than institutions (see Box 1). The relationship between governance and income has been documented. **The KKZ index, that is, the average of the six KKZ indicators, is thus highly correlated with GDP per capita, and also, albeit to a lesser degree, with long-run economic growth and the stability of that growth.**[22]

It is also interesting to note that countries with a single leading export (with a high value in the UNCTAD export concentration[23] index) appear to also have weak governance; in other words, governance is correlated with export diversity.

The items discussed above do not, however, allow us to draw any real conclusions regarding the direction of causality. **Does economic growth contribute to improved governance, or does governance allow stronger, more stable economic growth?** The answers are important for theory and practice—and also for country-risk specialists. A good grasp of the issue should help government policy makers to establish priorities, and give analysts a handle on anticipating a country's evolutions.

Does improved governance contribute to growth?

The sudden emergence of governance in economics stems primarily from the idea that causality runs from governance to growth, because it seemed an established fact that good governance is one of the keys—if not *the* key—to increased economic performance.[24] **North (1990) argued that "*the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World*".** Another example is the explanation of global income disparities by differences in the rates of investment in physical and human capital, and in productivity levels, across countries. And those differences are themselves explained by the institutional standard of a country, depending on whether it facilitates or impedes investment, knowledge creation and transfer, and the production of goods and services.[25]
Weak institutions, as approximated by measures of governance, also exposes a country to greater volatility in its growth path.[26] Distortionary macroeconomic policies—seen, ever since the Washington Consensus, as the main explanation behind both growth volatility and the greater number of crises observed in the emerging countries—are thus envisaged as symptoms of institu-

22. M.MacFarlane, H.Edison and N.Spatafora, *Growth and Institutions* (third chapter of *World Economic Outlook*), 2003.

23. UNCTAD index.

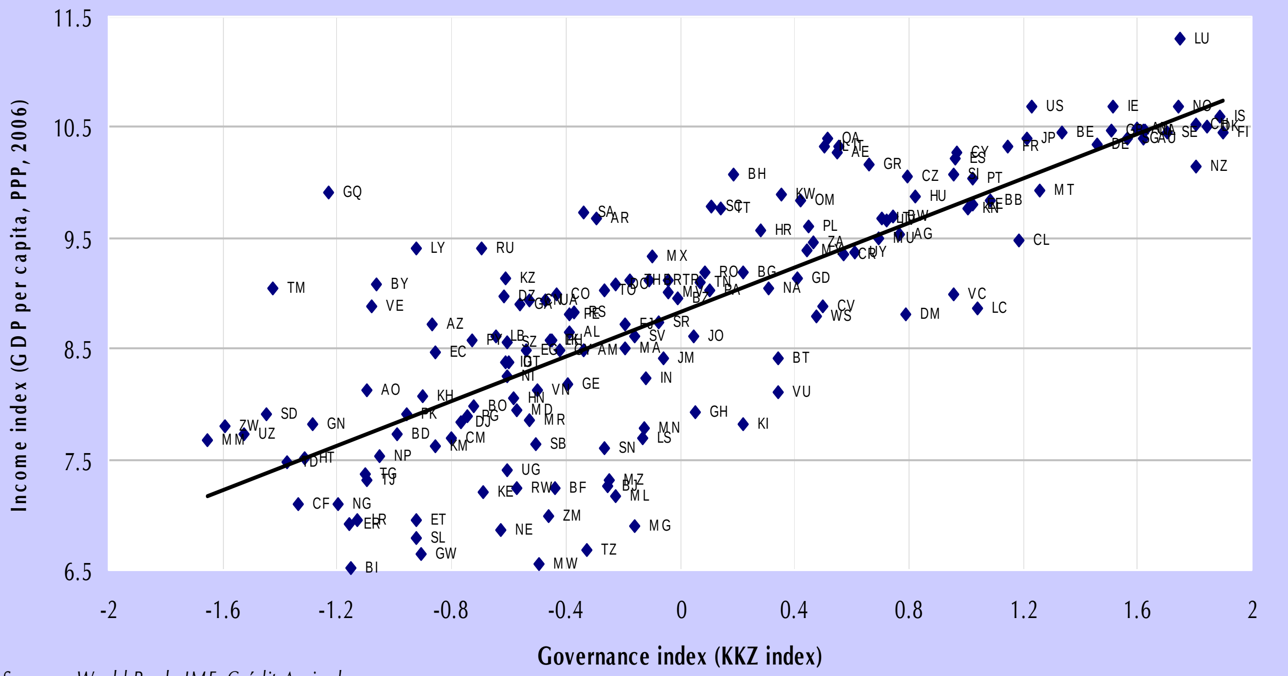
24. M.Olson, *The Rise and Decline of Nations*, 1982 and B.Weingast, *The Political Foundations of Democracy and the Rule of Law*, 1993.

25. R.Hall and C.Jones, *Why do some countries produce much more output per worker than others?*, 1999.

26. D.Acemoglu, S.Johnson, J.Robinson and Y.Thaicharoen, *Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth*, 2002.

Chart 2

Governance and national income are undeniably linked



Sources: World Bank, IMF, Crédit Agricole

See ISO country codes, page 16

Box 1

Measuring governance: the example of the six KKZ indicators[1]

Kaufmann, Kraay and Zoído-Lobatón identified three components of governance, each of which is measured by two indicators.

The process by which those in authority are selected and replaced, approximated by:

1. **Voice and accountability, the extent to which a country's citizens** are able to participate in selecting their government, as well as freedom of expression, freedom of association, and free media.
2. **Political stability and absence of violence**, perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism.

The ability of the government to formulate and implement sound policies, approximated by:

3. **Government effectiveness**, the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
4. **Regulatory quality**, the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

The respect of citizens and the state for the institutions that govern their interactions, approximated by:

5. **Rule of law**, the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as welche as the likelihood of crime and violence.
6. **Control of corruption**, the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

These six indicators are composites of hundreds of preexisting qualitative indexes. Those indexes (which measure the perception of governance), in the last study (September 2006), come from 31 different data sources supplied by 25 organizations.[2] The KKZ indicators are accordingly based both on international surveys (of firms and individuals) and the opinions of specialists (working in rating agencies, NGOs, and national or international organizations). For each country, the model aggregates the sources to compute six scores with a reduced centered distribution (for each indicator, the mean is zero and the standard deviation is 1). The scores are used to rank the countries for each indicator.

Subjectivity versus objectivity

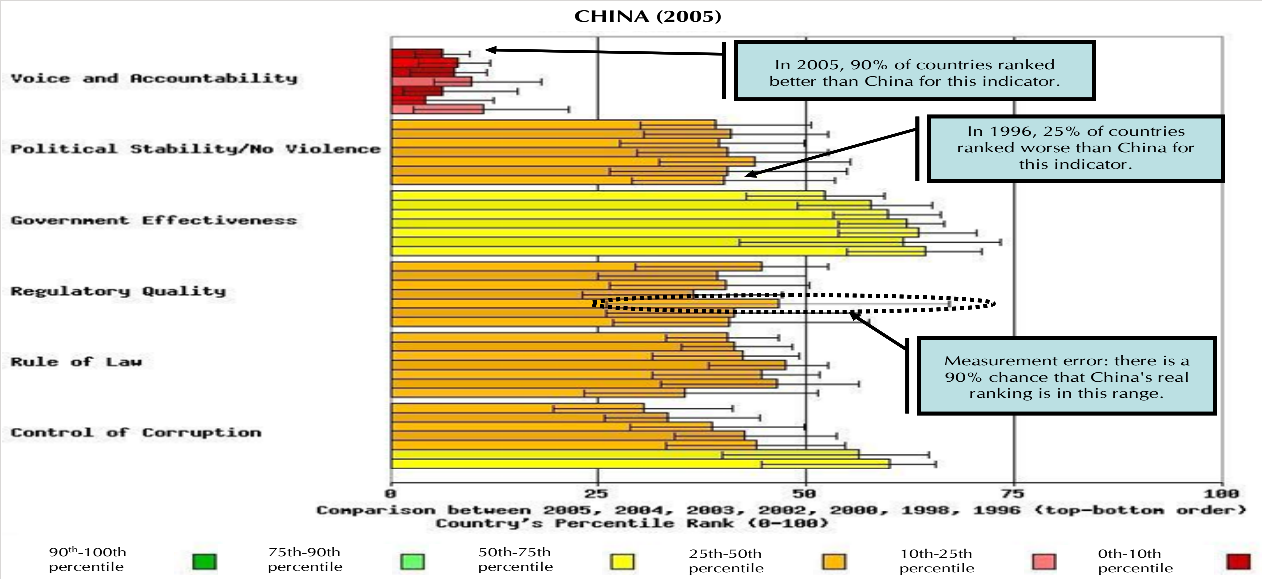
The KKZ indicators are subjective. Since the themes of institutions and governance (re)emerged in the foreground of the economic scene in the early 1990s, numerous indicators have been built. Some are objective. The International Telecommunication Union (ITU) gives waiting times for the installation of a telephone line, which can be seen as a measure of government efficiency. T. Beck et al[3] have also compiled a base including 106 objective items concerning political institutions (e.g., the number of years the current head of the executive has been in office and the number of legislative seats held by the three leading political parties). For Knack and Kugler,[4] export-related revenues as a portion of total budget revenues, and the their volatility, can proxy government effectiveness. An objective indicator may seem preferable to a subjective indicator at first, but Kaufmann et al[5] point out two objections. First, quantitative indicators are not immune to sometimes large measurement errors, and not only in the poorest countries: for the fourth quarter of 2001, which was admittedly a difficult period, the US Bureau of Economic Analysis supplied in mid-2002 three estimates of GDP growth, with a range from 0.2% to 1.7%[6]. Second, the objective measures of governance supply too little information. For instance, the number of days required to set up a company may fail to sufficiently take into account the complexity of procedures in other areas, and therefore overall regulatory quality.

In other words, objective indicators may be less capable of measuring a concept as abstract and broad as governance. Still, it must be borne in mind that the KKZ indicators do not reflect a country's actual performance, but rather the perceptions of local respondents or specialists abroad.

Limits to the KKZ indicators

The KKZ indicators are recognized by most researchers to be the best-built governance indicators, but they are not immune to criticism. Arndt and Oman examine four failings.

The main failing arises from a working assumption used in building the KKZ indicators: the noncorrelation of errors in the sources. In other words, among the sources used, those that are highly correlated with other sources are supposed to be more informative and more accurate, and thus are assigned greater weight. But that assumption is unrealistic: there are likely to be hysteresis effects across the multiple sources, if only because most sources base their analysis on those of other sources. And there is nothing to say that this herd behavior reflects the true level of governance in a country. Thompson and Shah[7] show that two respected indicators (published by the NOG Transparency International and by the private ICRG) indicated a decline in corruption before the 1997 Asian financial crisis, followed by an increase, whereas recent studies show that corruption had not



Source: World Bank, OECD, Crédit Agricole

Measuring governance: the example of the six KKZ indicators

changed during that period. Finally, this option necessarily makes the KKZ indicators mainstream indicators, as the multiple sources necessarily confirm what is measured, and therefore understood, by the largest number. The second failing has to do with the difficulty of comparing levels of governance over time. Because of the sometimes large margins of error, the authors of the indicator themselves admit that real change can only be said to occur if the confidence indicators do not overlap. Applying this rule of thumb to the six indicators in 1996 and 2004, Arndt and Oman find that only 56 out of nearly 200 countries have had a real change in their level of governance; this number appears to be low. The third failing arises from the lack of diversity in the sources. Galtung[8] quotes one of the founders of Transparency International, the NGO, who states that most of the sources represent a private sector, western, male and financially affluent viewpoint. Finally, due to the assumption of noncorrelation of source errors, local sources, which are supposed to represent the "emerging" viewpoint, are underweighted because in the minority.

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1. For an in-depth study of governance indicators, see Arndt and Oman, 2006, Uses and Abuses of Governance Indicators, OECD Development Centre.
2. D.Kaufmann, A.Kraay, and M.Mastruzzi, Governance Matters V: Aggregate and Individual Governance Indicators for 1996-2005, 2006.
3. T.Beck, G.Clarke, A.Groff, P.Keefer, and P.Walsh, New Tools in Comparative Political Economy: The Database of Political Institutions, 2001.
4. S.Knack and M.Kugler, Constructing an Index of Objective Indicators of Good Governance, 2002.
5. D.Kaufmann, A.Kraay and M.Mastruzzi, Governance Matters III: Governance Indicators for 1996-2002, 2003.
6. R.Wirtz, Gross Domestic Product: Understanding News from Noise, 2002.
7. T.Thompson and A.Shah, Transparency International's Corruption Perceptions Index: Whose Perceptions are they Anyway? 2004.
8. F.Galtung, Measuring the Immeasurable: Boundaries and Functions of (Macro) Corruption Indexes, 2005.

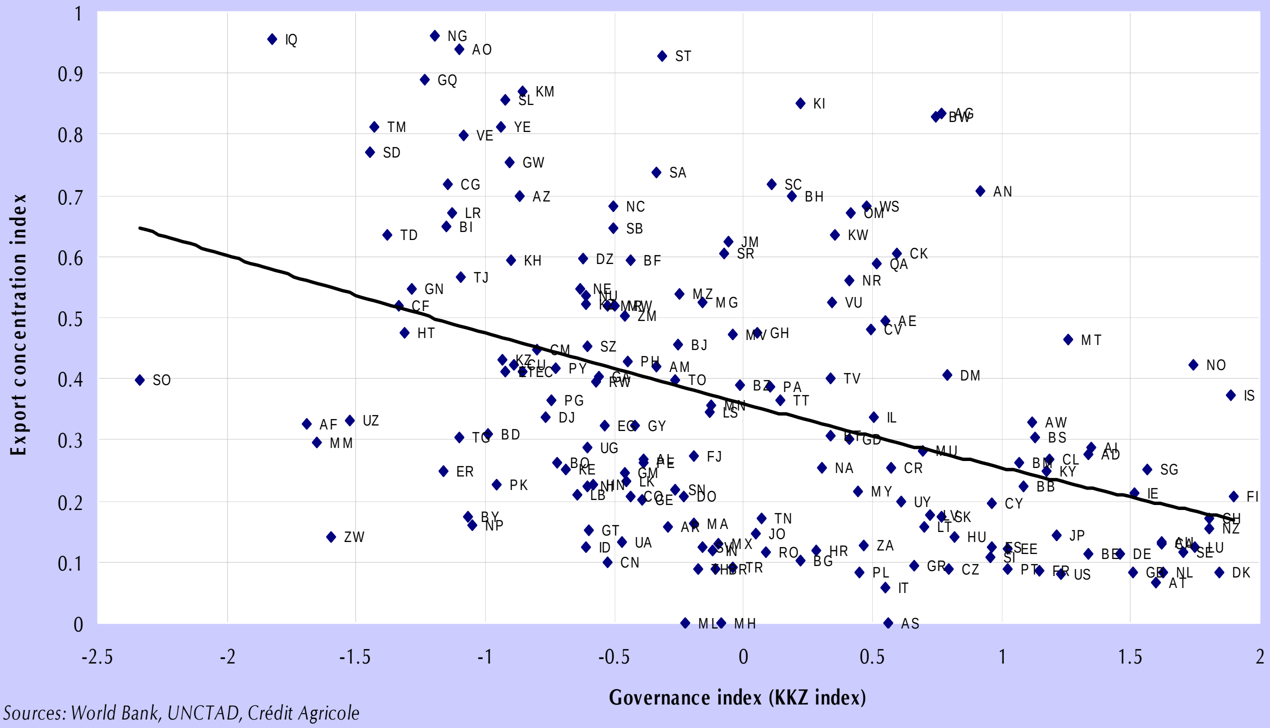
tional problems. Two forces are at work. First, if a society imposes weak institutional constraints on its leaders, new leaders coming into power find it easier to redistribute income to their own benefit, thereby creating economic turbulence. Second, the lack of constraints on leaders also means that taking political control yields greater rewards (and that losing political control yields greater losses), making for a greater frequency in political fighting. As a consequence, leaders may seek to pursue short-term policies better suited to preserving their hold on power and satisfying special interests. More generally, "with weak institutions, economic cooperation may have to rely on 'trust' or, more explicitly, on cooperation supported by repeated games strategies." This system is sensitive to the least shock; entrepreneurs opt for sectors of the economy from which they can quickly withdraw their capital, thus contributing to greater economic instability.

More generally, institutions appear to be the decisive medium through which other factors conventionally adduced to explain differences in economic performance play their role, e.g., geographical determinants, macroeconomic policies, and trade openness.[27]

27. W.Easterly and R.Levine, Tropics, Germs, and Crops: How Endowments Influence Economic Development, 2002 ou D.Rodrik, A.Subramanian and F.Trebbi, Institutions Rule: The Primacy of Institutions over Integration and Geography in Economic Development, 2002.

Chart 3

Single-export countries appear to have lower governance rankings



Sources: World Bank, UNCTAD, Crédit Agricole

Box 2

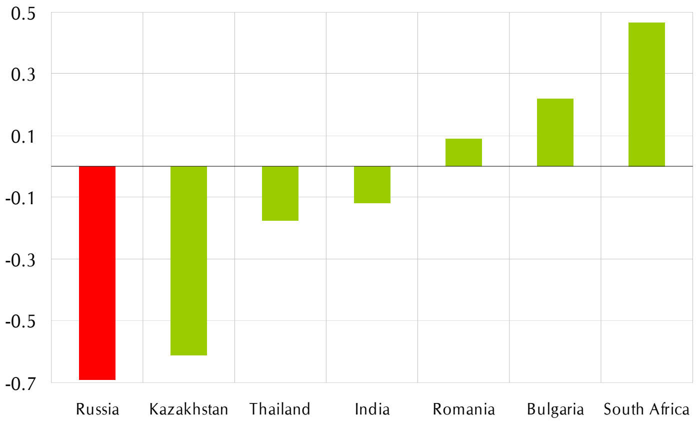
Russia: governance and political risk

The forced liquidation of Yukos and the jailing of its chairman, the oligarch Mikhail Khodorkovsky, the gas crisis between Russia and Ukraine, the assassination of journalist Anna Politkovskaia, the pressure exerted on Royal Dutch Shell in the framework of the Sakhalin-2 oil and gas project, the fatal polonium poisoning of Alexandre Litvinenko, the former FSB agent in exile in the UK, and the resulting worsening in diplomatic relations between London and Moscow: these affairs are symptomatic of Russia's deteriorating political environment in the past three to four years. As the list shows, the change is far from being neutral for private investors, whether foreign or domestic, and for Russia's trading and diplomatic partners. Here it is less a matter of heightened risk of a severe crisis (a coup d'état, popular uprising, or armed conflict) than of "instability" or "tension" in most of the areas affecting governance, as defined by the World Bank. After improvements during President Putin's first term, governance on the whole has deteriorated since 2003-2004. Further, governance continues to be less satisfactory than in other countries with the same risk rating, as assigned by the main agencies.

More State

Kremlin policy began to change direction around the start of 2004, with less opening, more state interference, and "more Russia." Less economic, political and institutional reform: despite the international development of some industrial groups and their listing on western stock exchanges, Russia's production sector continues to operate outside international standards, in terms of organization and control. More state intervention, primarily to enable the State and approved groups to preserve or recapture control of strategic sectors including hydrocarbons, electricity, nuclear power, mining, arms, and aerospace: this is an area in which allegations of tax evasion or violations of the law have become routine instruments for expropriations benefiting the State; this raises questions regarding the instability and arbitrary nature of the legal framework. "More Russia" means a return to the foreground in international diplomacy, and particularly the more or less implicit use of energy as a weapon in trade and diplomatic relations with the "Far Abroad" and notably western Europe (Russia supplied 15% of EU oil and 30% of EU natural gas in 2005), and the explicit use of energy in that way with the "Near Abroad" (the CIS countries).

Average of six governance indicators, 2006: Russia ranks low

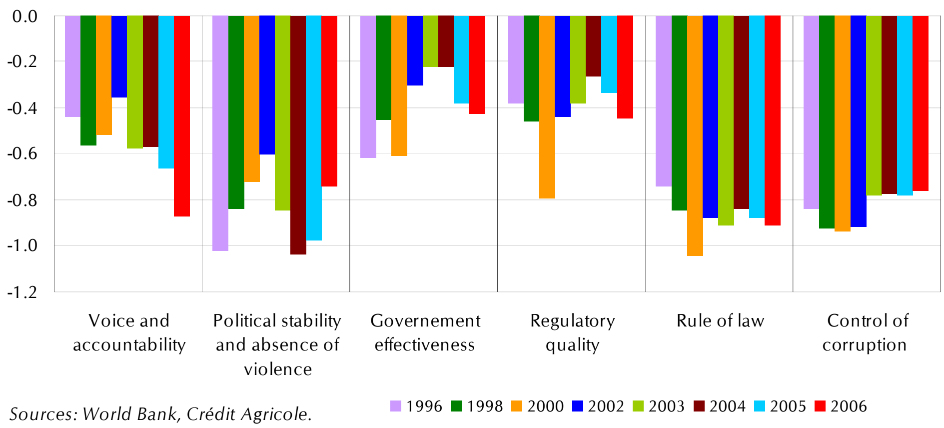


Sources: World Bank, Crédit Agricole.

Stability but not much cause for comfort

Today's major question is what can be expected from the presidential elections in March 2008. Many observers consider that the poll will be a nonevent, as whichever candidate is supported by Putin is overwhelmingly favored to win. In that event, Kremlin policy should be one of continuity, with a touch of "reform" in the case of Dmitry Medvedev, or a "conservative" touch in the case of Viktor Ivanov, the two identified potential successors. But one should look towards the *siloviki*, one of the most powerful lobbies in the Kremlin, which claims Viktor Ivanov as a member. The term *siloviki* refers to the military, the police, the judiciary and the intelligence services. Literally, a *silovik* is a servant or former servant of one of those institutions. In this case, the Viktor Ivanov clan also includes personalities who are not or were not members of these state structures. Infiltrated throughout the state apparatus (including the civil service, ministries and state-owned companies), they should continue to exert considerable weight in setting Kremlin policy, and the policy itself should show continuity. Accordingly, unless a post-election power struggle comes to dominate events, stability can be expected. This could be cause for satisfaction, because all projects, especially investment projects, require stability. But this would mean stability in a framework of mediocre governance and largely uninviting business climate. In other words, the *siloviki* could be expected to pursue the policies that bind them together: a State that is highly centralized, secured and protected, where order and stability dominate over the development of civil society; and economic "nationalism," protection of Russian firms against international competition and an unwelcoming attitude towards foreign investors; and a great, powerful Russia in the international arena. This would have implications for neighboring countries, as political risk is capable of being exported. Ukraine, Belarus, relations with Europe (Kosovo) and the international community (the Iran question) are recent illustrations of how important Russian domestic politics can be for other countries.

Governance indicators show no real improvement



Sources: World Bank, Crédit Agricole.

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Does economic growth lead to better governance?

While a consensus appears to exist regarding the positive influence of good institutions on economic performance, it is far harder to determine any causality running in the opposite direction and the literature reports far fewer studies. The limited work available today, however, cautions against oversimplification.

First, an increase in per capita income has no significant effect on governance improvement.[28] **Despite the finding that "higher income produces better institutions," the influence is relatively slight:** income explains only 10% of the variations observed in institutional quality.[29] Intuitively, it makes sense that an increase in wealth does not automatically produce an improvement in the governance criteria. Russia provides the example of a country where the hydrocarbon rent has increased income per capita, without preventing continued uncertainty or possible deterioration of the institutional situation (see Box 2).

Institutions and political risk

As seen above, the theoretical relationship between institutions and growth is fairly well documented. How this can be employed by country-risk analysts is less clear. A country that is well-ranked by these criteria is not necessarily free of political tensions. Taiwan ranks 48th on the 2006 KKZ index, but may raise more political questions than 88th ranked Bulgaria.

The task assigned to country-risk analysts—measuring the factors that could cause negative surprises—cannot be fulfilled by looking at this form of governance alone. The governance criteria overlook a broad range of factors, including international relations (e.g. dependence/domination, and the regional environment), economic and social tensions (e.g., distribution of wealth and power among different groups, the population's perception of economic results, demography, and urbanization), and socio-cultural aspects (disparities across communities or generations, separatism, and the ability of the national culture to absorb outside stimuli).

Experience in measuring governance confirms that the political sphere is quantifiable. Other political areas should also be incorporated in country-risk analysis, provided the appropriate quantification work is done beforehand. **The quantitative literature available today may be patchy, with work in a variety of areas, but on the whole has not yet yielded indicators that are as sophisticated or widely recognized as the governance indicators. One illustration is found in work on ethnic issues.**

Ethnic tensions[30]

Since the late 1980s, ethnic conflicts have come to outnumber other forms of intra-national conflicts.[31] But even if they fail to reach "conflict" or "crisis" proportions, tensions among different population groups can fuel tensions of varying intensity, as seen, for instance, in the linguistic communities of Belgium today. **To assess political tensions in a given country, one must determine the homogeneity (or heterogeneity) of the population.** The economics literature is beginning to investigate this topic, which cannot be ignored in country-risk analysis.

Measuring ethnic heterogeneity

The first difficulty is counting the number of ethnic groups, bearing in mind that "there are important regional variations in the conceptualization of ethnic identity beyond linguistic differentiation".[32] Initially, the first global bases listing ethnic groups were framed mainly in terms of linguistic distinctions, derived primarily from the *Atlas Narodov Mira* (compiled in the Soviet Union in 1964).[33] Paradoxically, however, the work on ethnic fractionalization in the United States does not examine languages spoken; "*if they did, blacks and whites would be classified in the same group*".[34]

Ethnic differentiation can also recognize criteria such as phenotype characteristics (e.g., racial origin and skin color) or religion. In Latin America, for instance, most countries are homogeneous in terms of language spoken (often the former colonizer's language), but more heterogeneous in terms of origin (European, Afro-Latinos, people of indigenous or Mestizo background, etc.). In the largely homogeneous Middle East, the relevant ethnic cleavage seems primarily a function of religion, e.g., in the divide between Shi'a and Sunni.

The second difficulty is that ethnic classifications are not definitive. Alesina et al cite the example of the division between Tutsis and Hutus in Burundi, which was considerably heightened during the colonial period. **Ethnic fractionalization can even be endogenous, because the delimitation of ethnic groups evolves over time.** Referring to Hammersley and Atkinson, Alesina et al write: "According to the reflexive theory of

28. D.Kaufmann and A.Kraay, *Growth without Governance*, 2002.

29. D.Rodrik and R.Rigobon, *Rule Of Law, Democracy, Openness, and Income: Estimating the Interrelationships*, 2004.

30. Definitions of "ethnic group" vary. The Encyclopædia Britannica (2006 Ultimate Reference Suite DVD) defines ethnic group as "a social group or category of the population that, in a larger society, is set apart and bound together by common ties of race, language, nationality, or culture," whereas the French Robert dictionary defines "ethnie" as follows: "(from Greek ethnos, 'a people or nation'), the set of individuals having in common a number of civilization-related characteristics, notably shared language and culture (whereas race depends on anatomical characterization)".

31. Works by the Center for Systemic Peace. For discussions on the topic, S.Huntington, The Clash of Civilizations?, 1993. R.Kaplan, The Coming Anarchy, 1994. P.Wallenstein and M.Sollenberg, After the Cold War: Emerging patterns of armed conflict 1989-94, 1995.

32. T.Okediji, *The Dynamics of Ethnic Fragmentation: a Proposal for an Expanded Measurement Index*, 2005.

33. C.Taylor and M.Hudson, *World Handbook of Political and Social Indicators*, 1972.

34. A.Alesina, A.Devleeschauwer, W.Easterly, S.Kurlat and R.Wacziarg, Fractionalization, 2003.

Box 3

Ethnic conflicts and positive discrimination

The term "positive discrimination" (or "affirmative action") initially referred to a policy of priority integration adopted in the context of a transition from a system of institutional oppression, along with the proclamation of the principle of equal rights and equal opportunity. India freed from British domination, the United States in the 1960s, or South Africa in the 1990s sought to remedy imbalances in society deeply divided by decades or even centuries of systematic inequality.

India

In the 1950s, India implemented a program of positive discrimination for members of underprivileged castes and tribes. This involved reserving a quota of jobs in the civil service and public enterprises for members of the untouchable castes and tribes, which had been constant victims of discrimination in the Hindu caste system (Hindus account for some 80% of the population). The policy was subsequently extended to the intermediate castes and to the upper portion of the lower castes, grouped together under the term Other Backward Castes (OBC). Initially intended to move India towards an egalitarian society, positive discrimination has had unintended effects that could threaten the social pact.

The latest event was the June 2007 revolt by members of the Gujjar caste in the State of Rajasthan, which resulted in numerous fatalities. The previous situation worsened in 1999 when the Jat farming caste, which accounts for 10% of the population of Rajasthan, was included in the OBC as a matter of political clientelism. The problem is that the new entrant upset the fragile equilibrium that existed previously: the sum of the quotas must not exceed half the positions available, and in Rajasthan, the tribes have a 12.5% quota, the untouchables 14%, and the OBC 23.5%. The Gujjars, who account for a significantly smaller share of the population (6%), suddenly feel squeezed in the OBC segment, after a portion of their privileges was reassigned to the Jats.

The Gujjars are also anxiously observing the rising power of the Meenas, a tribal group ranked lower in the social hierarchy, with which they had previously lived under similar conditions. In Rajasthan, the Meenas, who account for 13% of the population, are the majority in their "tribal" category and as such have received generous quotas that are contributing to their accelerated upward social mobility. Because the comparison is unfavorable to them, the Gujjars are demanding the same benefits as the Meenas. In other words, the Gujjars are revolting in order to be classified lower in the symbolic caste hierarchy. This is unprecedented since Independence and shows how much the social pact is in danger. The Meenas do not want to share their advantages. Animosity between the two groups is fueling a form of insidious caste warfare. In some districts, armed clashes have involved villages of both communities. In light of this example, it is legitimate to ask if India's positive discrimination policy has not been pushed to the limits.

Malaysia

The principal ethnic groups in Malaysia are the Malays (58%), Chinese (27%) and Indians (9%). The other numerically significant groups are indigenous ethnic groups and aborigines. Malays benefit from a policy of positive discrimination; the Chinese community has historically dominated the economy; this is recognized as the reason the Malay community is poorer on the whole. Violent clashes broke out between ethnic Chinese and Malays in May 1969, and two hundred ethnic Chinese were killed. In response, the authorities decided to set up a policy of positive discrimination in favor of the Malays, or Bumiputras, involving a range of target measures including financial aid, priority for Bumiputra capital in public enterprises, and quotas in universities. The authorities were counting on rapid economic growth to soften resentment by both Malays and Chinese. The idea was that Chinese enterprise in industry, trade and finance would compensate for restrictions in the political, educational and cultural spheres.

From one viewpoint, positive discrimination can be considered to have reached its objectives, as the Bumiputras now possesses the essential part of political power, while the Chinese and (to a lesser degree) the Indians are more present in the country's principal economic areas: the institutional imbalance establishes a social balance by correcting the economic imbalance. But the Chinese minority is increasingly challenging the government's racial policy, pointing to the danger of the Malay community drifting towards dependence on government assistance. Here again, ethnic tensions, although more subdued than in the case of India, and the new imbalances arising from positive discrimination policies intended to remedy existing imbalances, are a key component of political risk.

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ethnicity and nationality,[35] the boundaries of ethnic groups are changing because the individual's self-identification to groups can change as a result of political, economic or social forces (...)." They go on to cite work by Mozzafar and Scarrit: Somalia "prior to the 1991 civil war (...) appeared relatively homogeneous (85% Somalis), but during and after the civil war 'clans' became the dominant dimension of ethnic cleavage"[36] (see Box 3).

Despite the inherent lack of precision in the data, ethnicity can be quantified, starting with an indicator of ethnic fractionalization.

Ethnic fractionalization and growth

Ethnic fractionalization is defined as the probability that two individuals taken at random in a given population will belong to two different ethnic groups (Herfindahl index). At the theoretical maximum value of 1, each individual belongs to a different ethnic group.

Recent work (Alesina et al) proposes an indicator incorporating several differentiations. One index computes linguistic fragmentation (1,055 principal languages). An index of ethnic fractionalization is built next, adding other criteria (e.g., phenotype) to the linguistic criteria. For example,

35. For more information, see M.Hammersley and P.Atkinson, *Ethnography: Principles in Practice*, 1995.

36. S.Mozzafar and J.Scarrit, *The Specification of Ethnic Cleavage and Ethnopolitical Groups for the Analysis of Democratic Competition in Contemporary Africa*, 1999.

Bolivia's ethnic fractionalization is the following: *Blancos* (10.13% of the total population), *Aymara* (30.38%), *Quechua* (30.38%), *Mestizos* (25.32%) and other groups (3.8%). The linguistic fragmentation differs considerably: *Aymara* (3.24%), *Guarani* (0.12%), *Quechua* (8.15%), *Spanish* (87.65%), and other (0.84%). In some European countries, on the other hand, including Belgium and Switzerland, ethnic fractionalization reflects languages. Accordingly, the "ethnic groups" recorded in Switzerland are the following: German (65%), French (18%), Italian (10%), other Swiss (6%) and Romanche (1%). More generally, there is a 70% correlation between the ethnic and linguistic indexes. The data in Alesina et al cover approximately 650 ethnic groups in 190 countries.

The three least fragmented countries in the world are South Korea, Japan and North Korea. Twenty of the 21 countries with the greatest ethnic fractionalization are in Sub-Saharan Africa. Anticipating questions regarding endogeneity and demographic change, Alesina et al make the assumption that their ethnic base is stable over a 20-to-30 year horizon.

What are the links to growth? Easterly and Levine[37] note that while a 1963[38] World Bank report estimated they had far greater growth potential than South-East Asia, GDP per capita in most African countries actually declined between 1960 and 1990. The authors show that high fiscal deficits, political instability, underdeveloped financial markets, a sizeable parallel economy, low school attendance and inadequate infrastructures are the main reason for the lag (40% of the growth gap). They also claim that high ethnolinguistic fragmentation is highly correlated with the last four factors. **High ethnic heterogeneity thus has an indirect impact on long-term growth, notably by encouraging rent-seeking and by reducing the possibility of consensus in the choice of public goods.**
Ethnic fractionalization also influences the quality of economic and social policy (measured by the literacy rate, infantile mortality, etc.) and the quality of institutions (measured by the extent of corruption, the degree of political freedom, etc.)[39] **Ethnic fractionalization is sometimes considered one of the principal determinants of government efficiency.** In fragmented societies, it appears harder for a State to perform its function of redistributing to the poorest. Finally, in the case of high ethnic fractionalization, it is more likely to be in the interest of a group to impose restrictions on public freedoms to better control other groups: ethnic fractionalization indexes and democracy indexes are therefore inversely correlated.[40]

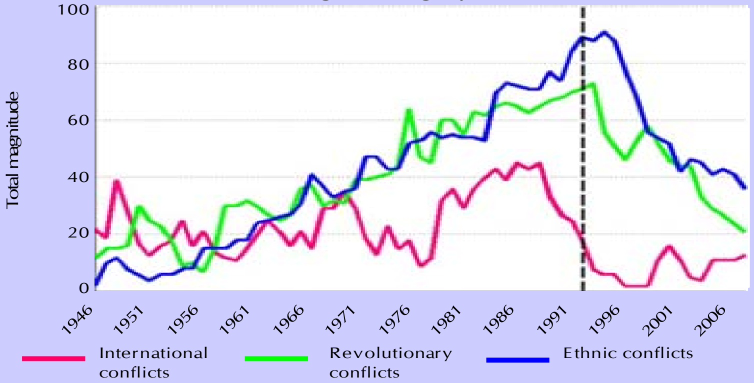
Alesina et al also compute an index of religious fragmentation, based on *Encyclopædia Britannica* data that lists 294 religions in 215 countries. The authors observe that this kind of fragmentation does not appear to be correlated with any macroeconomic variable. The principal reason advanced is that religious affiliation is more endogenous than linguistic or ethnic affiliation. A religion, the argument runs, can be prohibited, and it may be relatively easy for an individual to conceal his religious affiliation in order to avoid repression. Similarly, it is easier to change religion than to change phenotype or language. In actuality, greater religious fragmentation most often reflects a democratic society. South Africa, the United States and Australia are the three most fragmented countries in terms of religion, while Yemen, Somalia, Morocco, Turkey and Algeria have the least diversity. These findings do not conflict with those of Barro and McLeary,[41] whose paper concludes that growth responds positively to stronger religious beliefs—and particularly belief in heaven—but negatively to increased church attendance.

Polarization and conflicts

While the relationships between ethnic fractionalization and various macroeconomic, social and political variables have been widely documented, the linkages between fragmentation, ethnic conflicts and civil wars appear far more uncertain, or even nonsignificant. **Assessing future political stability requires an examination of the concept of ethnic polarization.**
The facts show that a large number of ethnic groups does not necessarily increase the prob-

Chart 4

Conflicts classified as ethnic in origin form the largest category



Source: Center for Systemic Peace, Crédit Agricole.

37. W.Easterly and R.Levine, *Africa's Growth Tragedy: Policies and Ethnic Divisions*, 1997.

38. S.Enke, *Population and development, a general model*, 1963.

39. R.La Porta, F.Lopez-de-Silanes, A.Shleifer and R.Vishny, *The Quality of Government*, 1998.

40. P.Aghion, A.Alesina and F.Trebbi, *Endogenous Political Institutions*, 2002.

41. R.Barro and R.McLeary, *Religion and Political Economy in an International Panel*, 2002.

Box 4

A slow convergence process with many obstacles

After the totalitarian regimes collapsed throughout central and eastern Europe, they were replaced by more democratic forms of government. The pace of political liberalization reflected not only the desire of the citizens of the region to move away from authoritarian systems, but also the pressure from Western governments, international financial institutions, (IFIs) as well as the European Union which made democracy an explicit precondition for membership negotiations. Once the issue of national security, including new international borders in some cases, was settled through NATO membership for the countries in central Europe (Poland, Hungary, Czech Republic, Slovakia) plus Slovenia and the Baltic States (Lithuania, Latvia, Estonia), European integration became the overriding objective for the accession candidates. For all of these countries, the prospect of EU accession has been a powerful spur to reform and indeed, a catalyst for a systemic change.

From a political economy toward sound economic policymaking?

Moreover, these countries generally implemented political and economic reforms simultaneously insisting on far-reaching democratization already at the outset of transition, before the resumption of growth. As the second decade of transition draws to a close, democracy and rapidly improving living conditions have become the norm among the above early reformers. Bulgaria and Romania followed the same process somewhat later and joined the EU last January; this in turn explains their delay in implementation of legal and institutional reforms. The EU recently also warned Sofia and Bucharest about the need for further efforts but without resorting to sanctions.

The post-communist period has been generally characterized by alternating governments, although the traditional left vs. right division of the political spectrum has become increasingly blurred. However, in Hungary the current socialist government was re-elected in 2006 only to be confronted with the urgent task of redressing major economic imbalances from its previous term which in turn contributed to its present unpopularity. While external political stabilization has been achieved at the outset of transition, the same cannot be said about domestic politics. The typical pattern throughout the region is a weak coalition government with a major party in the leading role and multiple junior partners from fringe formations. The fragile, opportunistically driven, coalitions have triggered early elections on numerous occasions. Fledgling democracies handicapped by unstable institutional arrangements have become in turn vulnerable to populist and nationalist temptations. This fragmentation of the political landscape reflects the maturing of young, occasionally limping, democracies in central and eastern Europe.

The need to maintain the reform momentum

The interesting feature of the transition process is the ever greater decoupling of the economy and financial markets from the politico-electoral cycle. For instance, Poland's economy has thrived in recent years despite chronic political infighting. At the same time, governments facing elections may pursue measures aimed at increasing political support rather than implementing sound economic policies. Furthermore, a reform fatigue, both on the side of the governments and the electorate, can be observed in a number of the new member states (NMS). This makes pursuit of reforms, especially in the sector of public finances, particularly difficult. The delayed entry into the eurozone by the Baltic republics has created a certain amount of political backlash.

The reform-minded government in Slovakia lost the election last year, but the major liberalization measures have not been reversed so far. In particular, its successor has reaffirmed the commitment to adopting the euro in 2009. Distracted by strong macroeconomic performance, governments in some countries have been focusing on measures aimed at “sharing the fruits of growth” instead of on policies promoting long-term economic growth and sustaining reform momentum. Finally, the incentive to pursue the reforms has weakened in certain NMS following their EU accession. This is of particular concern in countries where the development of a functioning legal framework and corporate governance of firms are still work in progress.

In the final analysis, the political leaders in the NMS are faced with the challenge of managing the expectations level of their citizens who have become accustomed to rapidly rising personal incomes. Most voters are unlikely to feel that they have accomplished the transition until the income gap with the more advanced market economies is narrowed significantly. To be sure, the process of real convergence is well underway but certain NMS still have a long way to go.

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ability of conflict; the relationship between ethnic diversity and civil wars is not monotonic.[42] Conflicts are found to be more common when a large ethnic minority faces a small ethnic majority, and less common in cases of high homogeneity or high heterogeneity. In a civil war, for instance, a rebel army must deal with substantial problems of troop cohesion and motivation. The stronger and clearer the social ties in the organization, the easier it is to set up an effective military force. Ethnic diversity makes recruiting and motivating troops harder for rebels, raising the question: "Why does ethnic diversity makes a society safer, and not more dangerous?"[43]

Ethnic affiliation has been shown by polarization analysis to have a statistical relation to the probability of conflict. The polarization concept was initially introduced as a measure of income polarization[44] (as distinct from the level of inequality in society, measured by the Gini index), and was later applied to ethnic groups.[45] Assuming zero distances between ethnic groups, the ethnic polarization index indicates the extent to which the distribution of ethnic groups in a society differs from a bipolar distribution (in which two groups each represent 50% of the population (in which case the polarization index is equal to 1).

42. D.Horowitz, *Ethnic Groups in Conflict*, 1985.

43. P.Collier, *Economic Causes of Civil Conflict and Their Implications for Policy*, 2000.

44. J.Esteban and D.Ray, *On the Measurement of Polarization*, 1994.

45. J.Montalvo and M.Reynal-Querol, *Ethnic Polarization, Potential Conflict and Civil Wars*, 2004.

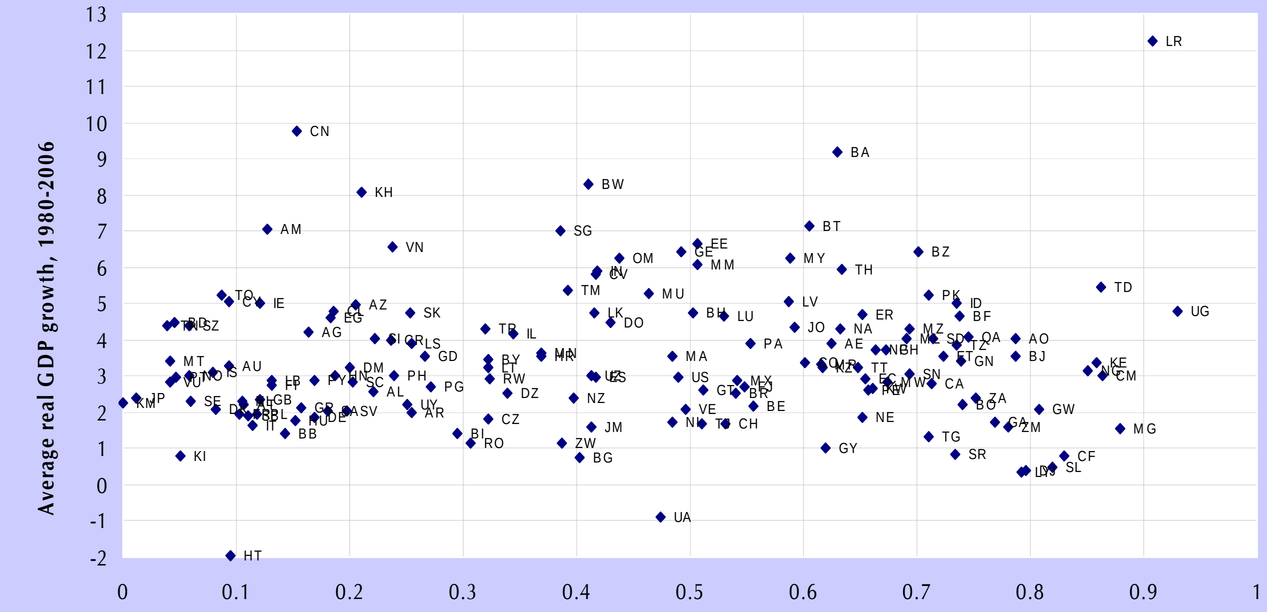
$$Polarization = 1 - \sum_{i=1}^{N} \left(\frac{1/2 - \pi_i}{1/2} \right)^2 \pi_i$$

Where π_i = percentage of the total population belonging to the i^{th} ethnic group,
N = number of ethnic groups.

The correlation between fragmentation indexes and polarization indexes is close to 70%. Guatemala illustrates the differences between polarization and fragmentation. The ethnic composition ethnic of the population is: *Ladino (Mestizos)* 55%, *Mayas* 42% and other groups coming to 3% of the total population. Ethnic fractionaliza-

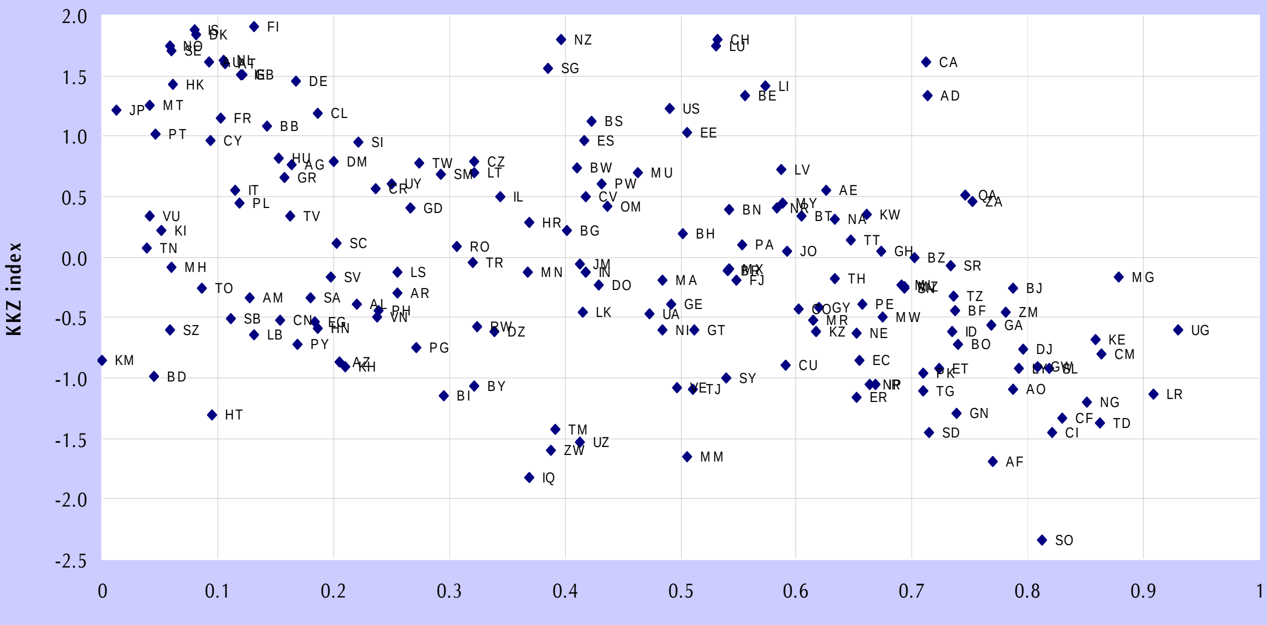
Charts 5 & 6

Linkages between ethnic fractionalization and growth are unclear



Sources: Alesina et al., IMF, Crédit Agricole

Ethnic tensions and institutional tensions: two different realities



Sources: Alesina et al., World Bank, Crédit Agricole tion is relatively low (0.52), while polarization is high (0.96).

Over the 1960-1995 period, nine of the ten most polarized countries had civil wars, versus "only" four of the ten countries with the highest Fragmentation indexes. Doyle and Sambanis,[46] using their definition of "civil conflict," indicate that unlike fragmentation, ethnic polarization is a determinant of civil conflict. Accordingly, a highly polarized country like Nigeria (0.95) is twice as likely to experience civil conflict than a country with global average (0.51).

The need for stabilizers

As seen above, there is an abundant literature pointing to the linkages between ethnic fractionalization and macroeconomic variables, and between ethnic polarization and the probability of civil conflicts. But this does no more than indicate the possibility of quantifying the relationships. Limiting ourselves to this ethnic aspect, how do these two findings fit into the attempt to measure political risk? The probability of civil war in a given country is obviously of direct interest to national or foreign firms trading with that country, and is actually central to identifying the political component of country risk. But usable results cannot be directly inferred from these indicators alone. For example, Switzerland has an ethnic fractionalization index of 0.53 and Rwanda 0.32. Similarly, Lebanon has an ethnic polarization index of 0.26 and Belgium 0.87. In both cases, differences in living standards are surely factors that can control the purely ethnic factors.

Before being used in a political-risk rating exercise, the indicators must therefore be combined with stabilizers to allow greater precision in identifying countries' potential "ethnic" weaknesses. Several potential areas should be examined. Alesina and La Ferrara,[47] in investigating in greater detail the consequences of fragmentation, identify four main types of "controls" for data on ethnic fractionalization: a country's mean level of technology, democracy, institutional and economic development. Along the same lines, in the area of ethnic polarization, Collier identifies some items that can reduce the probability of civil war: a country's level of development, its average level of inequality, as well as the percentage of primary products in total exports (conflict is more likely in the presence of expropriable resources[48]). These or similar "controls" could potentially be identified as stabilizing or destabilizing factors in quantitative risk analysis.

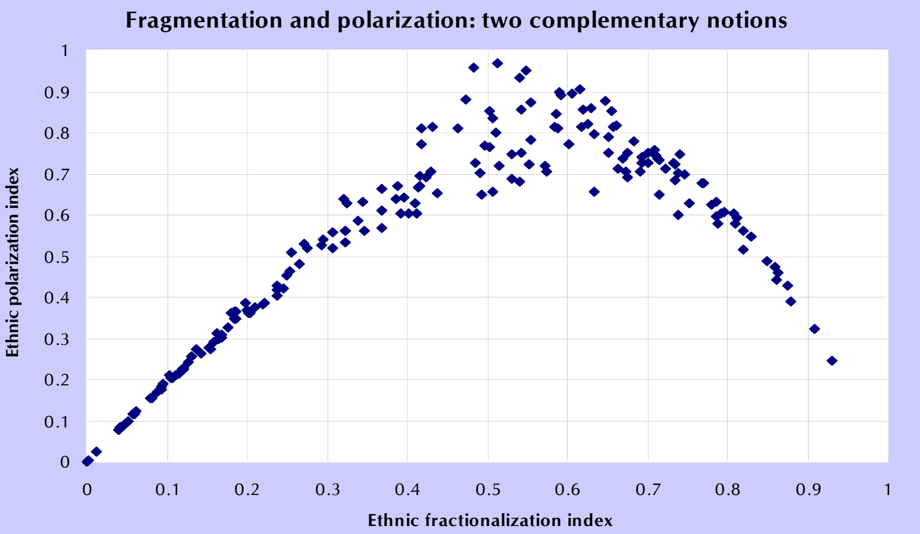
This digression into ethno-linguistic issues shows that **the political dimension is a measurable field.** This also applies to socio-economic tensions, measures of which could use development indicators (including the Human Development Index), income distribution data (the Gini index), or nominal illusion and memory effects regarding the current economic situation, for instance. The same goes for international-related tensions, whether domestic factors (e.g., dependence on exports or imports at world market prices) or external factors (e.g., fragile countries in the neighborhood, or a relation of subservience or domination with turbulent countries).

46. M.Doyle and N.Sambanis, *International Peacebuilding: A Theoretical and Quantitative Analysis*, 2000.

47. A.Alesina and E.La Ferrara, *Ethnic Diversity and Economic Performance*, 2004.

48. F.Caselli and W.J.Coleman, *On The Theory of Ethnic Conflict*, 2006.

Chart 7



Sources: Alesina et al., Montalvo et al., Crédit Agricole

The danger does not lie in risk itself, but in failure to anticipate risk. Because country risk must take political risk into account, and because economics can now undertake to quantify areas that were long considered qualitative only, **the country-risk analyst's task must develop in this direction, and take possession of areas that were previously subject to ad-hoc judgments.**

This consideration extends beyond conventional country-risk analysis. In the area of international aid, governments and multilateral organizations are beginning to take political issues into

Box 5

Africa and political risk

Africa's strong macroeconomic performance in recent years has tended to push the issue of political risk into the background. But political risk remains, as illustrated by oil-related incidents in Nigeria, with hostage-taking around petroleum production sites, especially in the Niger delta area. From another viewpoint, domestic political challenges are often the focus of conflict, as in Côte d'Ivoire. Increasingly, challenges are fueled by the prospect of oil discoveries and the promise future riches.

The oil manna...

The recent discovery of oil fields in Africa, combined with China's growing international influence and its need for raw materials, has made the continent a new El Dorado. The change was unexpected, including by Africans themselves.

Possession of sought-after commodities has focused attention on some previously neglected countries, which are now benefiting from substantial investment, including in infrastructure. That said, however, the newfound manna does not obviate the need for the traditional fiscal efforts demanded by the IMF, to which countries respond in varying manners depending on whether or not elections are on the horizon.

Further, there can be no doubt that the strategic possession of raw materials, and particularly oil, is a major impediment to the peaceful resolution of some conflicts, as seen in Sudan, as the increased supply of oil to China has shielded it from international sanctions for its action in Darfur.

And despite undertakings by many countries to take action to reduce poverty or improve education, the absence of truly coercive measures in the event of failure to act means that programs often exist only on paper.

... but continuing dependence on international aid for quite some time

The possession of sought-after raw materials is certainly a matter of good fortune for the continent, which until recently was considered poorly endowed and incapable of managing on its own. Africa as a whole will continue to depend on international aid for quite some time, but it is also clear that the situation now looks different. Having resources that are now highly valued is undeniably positive, but the resources are unevenly distributed across countries. Some are almost totally lacking in exportable resources and therefore largely fail to share in the new wealth achieved by other countries. Senegal is a fairly typical example: the country is relatively democratic, lacking in resources, and is increasingly subject to the impact of the strong euro (through the CFA Franc mechanism), and therefore cannot adjust its currency to try to preserve its exports.

Risk remains distinctly present

Angola has become one of Africa's leading oil producers, with daily output approaching 2 million barrels a day, ranking it 12th among OPEC members. But the considerable manna generated by oil remains largely at the discretion of the ruling MPLA party, so the situation could quickly degenerate.

Access to greater wealth due to high commodity prices does not benefit the population uniformly. Governance is often criticized by international organizations. As a result, it cannot be said that the improved overall economic performance has eliminated or even attenuated political risk in Africa. Quite simply, the perception of political risk is now shifting, and seems to coalesce in a single question: does the country have oil, or at least other marketable commodities?

Political risk is and will continue to be present in Africa. First, because the political and social fabric remains fragile. Second, because most countries are not prepared for the arrival of the new oil bonanza. And finally, because political instability all too often continues to be the rule.

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account to determine their interventions. National public policies will increasingly be indexed to indicators of this kind, which go beyond the standard economic targets. **With the political field now open for analysis, economic practitioners today can sharpen their tools for observation and modeling, bearing in mind the need for a practical, pedagogical state of mind, and the knowledge that the conceptual work is only now beginning.** ■

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ISO country codes

Pays (dénomination ISO)	Code ISO	Pays (dénomination ISO)	Code ISO	Pays (dénomination ISO)	Code ISO	Pays (dénomination ISO)	Code ISO
Afghanistan	AF	Dominique	DM	Libyenne, Jamahiriya Arabe	LY	Afrique du Sud	ZA
Albanie	AL	Dominicaine, République	DO	Liechtenstein	LI	Arabie saoudite	SA
Algérie	DZ	Équateur	EC	Lituanie	LT	Swaziland	SZ
Samoa Américaines	AS	Égypte	EG	Luxembourg	LU	Serbie	RS
Andorre	AD	El Salvador	SV	Macao	MO	Seychelles	SC
Angola	AO	Gambie	GM	Macédoine, l'ex-République yougoslave de	MK	Tanzanie, République-Unie de	TZ
Anguilla	AI	Ghana	GH	Mozambique	MZ	Singapour	SG
Antigua-Et-Barbuda	AG	Estonie	EE	Namibie	NA	Slovaquie	SK
Argentine	AR	Guinée	GN	Malaisie	MY	Slovénie	SI
Arménie	AM	Fidji	FJ	Maldives	MV	Salomon, Îles	SB
Aruba	AW	Finlande	FI	Niger	NE	Togo	TG
Australie	AU	France	FR	Malte	MT	Ouganda	UG
Autriche	AT	Guyane française	GF	Marshall, Îles	MH	Espagne	ES
Azerbaïdjan	AZ	Polynésie française	PF	Martinique	MQ	Sri Lanka	LK
Bahamas	BS	Guinée-Bissau	GW	Mauritanie	MR	Saint-Kitts-Et-Nevis	KN
Bahreïn	BH	Kenya	KE	Nigéria	NG	Sainte-Lucie	LC
Bangladesh	BD	Géorgie	GE	Mexique	MX	Saint-Vincent-Et-Les Grenadines	VC
Barbade	BB	Allemagne	DE	Micronésie, États fédérés de	FM	Soudan	SD
Bélarus	BY	Lesotho	LS	Moldova, République de	MD	Suriname	SR
Belgique	BE	Grèce	GR	Monaco	MC	Zambie	ZM
Belize	BZ	Groenland	GL	Mongolie	MN	Suède	SE
Botswana	BW	Grenade	GD	Monténégro	ME	Suisse	CH
Bermudes	BM	Guadeloupe	GP	Maroc	MA	Syrienne, République arabe	SY
Bhoutan	BT	Guam	GU	Réunion	RE	Taïwan, Province de Chine	TW
Bolivie	BO	Guatemala	GT	Myanmar	MM	Tadjikistan	TJ
Bosnie-Herzégovine	BA	Libéria	LR	Rwanda	RW	Zimbabwe	ZW
Burundi	BI	Madagascar	MG	Nauru	NR	Thaïlande	TH
Brésil	BR	Guyana	GY	Népal	NP	Timor-Leste	TL
Océan Indien, Territoire britannique de l'	IO	Haïti	HT	Pays-Bas	NL	Bénin	BJ
Brunéi Darussalam	BN	Honduras	HN	Antilles Néerlandaises	AN	Tonga	TO
Bulgarie	BG	Hong-Kong	HK	Nouvelle-Calédonie	NC	Trinité-Et-Tobago	TT
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Canada	CA	Iran, République Islamique d'	IR	Niué	NU	Tuvalu	TV
Comores	KM	Iraq	IQ	Norvège	NO	Burkina Faso	BF
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Tchèque, République	CZ	Liban	LB	Somalie	SO		
Danemark	DK	Mali	ML	Samoa	WS		
Gabon	GA	Maurice	MU	Saint-Marin	SM		

Publication Manager: Jean-Paul Betbèze
Chief editor: Jean-Paul Betbèze, Nicolas Meunier — Sub-editor: V. Champion-Faure

Crédit Agricole S.A.– Department of Economic Research
75710 PARIS cedex 15 — Fax : +33 1 43 23 24 68
Copyright Crédit Agricole S.A. — ISSN 1248 - 2188
Subscription : publication.eco@credit-agricole-sa.fr
Internet: http://kiosque-eco.credit-agricole.fr/site/page.php?pag_id=3

Copy deadline September 14, 2007