PRImed for change

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In its September 2000 issue, The Economist published a ranking of the countries it saw as the riskiest globally, based on a combination of political and economic stability, debt structure and regulatory policies. Three of the top five countries listed were in Asia, with Myanmar, Pakistan and Indonesia taking the first, third and fifth spots, respectively. Ahead of Pakistan and Indonesia were Zimbabwe and Russia. That three of the top five were in Asia speaks volumes about Asia's problem. What these countries all have in common is a high degree of perceived political risk. It does not matter whether there really is a high degree of political risk in a country ? the perception of the existence of political risk makes it a problem. In an interdependent, one market-oriented world, countries with high degrees of perceived political risk have a tough time attracting foreign investment and staying afloat economically.

Foreign direct investment link

The Association of Southeast Asian Nations' (ASEAN) statistics paint a grim picture. Between 1995 and 1999 ASEAN's share of global Foreign Direct Investment declined from 20% to just 11%. ASEAN's share of the pie was ironically declining even before the 1997 crisis hit, when there was not a perceived political risk problem. Why? -other areas of the world became equally or more attractive places to invest (specifically Latin America) because a more level playing field materialized for investors by the mid-1990s as a result of the global embrace of democracy and increased competition for investors' resources. In an increasingly competitive world, governments began to realize that investors don't necessarily knock on their door without inducement. Also, after the Asia Crisis, investors discovered they could invest in other parts of the world with fewer perceived risks, thus enhancing their anticipated returns.

Since 1997, with the exception of the purchase of distressed assets in places like Japan and South Korea, investors have by and large been hesitant to commit large sums of new capital to the region. Now that investors perceive Asia to be a problem, it has proven difficult to lure them back. The trend is likely to continue. In October 2000, the Asian Development Bank released a report stating that it believes inflows of portfolio investment in Asia are likely to decline by up to 75% in 2001, from $13.2 billion to $3.3 billion.

Stock markets and currencies

Asian economic health ? gauged by stock markets and currencies ? is lousy. Comparing end of year 2000 with end of year 1999 for ten of Asia's stock markets is sobering. All of the indices were down. Leading the pack was Seoul (down 46%), followed by Bangkok (down 43%), Jakarta (down 38%), and Manila (down 35%). Clearly, investors have been pulling a lot of money out of these markets.

A similar story can be told for Asia's currencies. Again, of the 10 countries in the sample, all were down over the past 12 months, led by Indonesia (down 25%), the Philippines (down 19%), New Zealand (down 19%) and Australia (down 17%). When the carnage is this deep and widely spread, it is evidence of a region-wide phenomenon, an indication that there is fundamental weakness in economies across the board.

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Much of this stems from a crisis of confidence. Traders and investors have lost confidence that Asia will find its footing any time soon. The reasons include a number of factors. First, commodity prices continue to be depressed. Some commodities, such as palm oil and coffee, are down nearly 60% from three years ago. With so many Asian economies dependent upon the export of commodities for their primary source of foreign exchange, the inability to earn sufficient hard currency from the sale of these raw materials puts significant pressure on their own currencies. Second, with oil prices at 10-year highs, most of Asia's economies are having to devote a larger percentage of their scarce foreign exchange to the importation of oil. Asia's oil consumption has increased nearly 60% since 1990, meaning more countries are importing more refined petroleum, including countries like Malaysia and Indonesia which are net oil exporters. It is even estimated that China, which currently imports only about 4% of its oil, will nearly triple its importation of oil by the year 2020, to approximately 11%. High oil prices can only have a negative impact on most of the region's economies.

All this is having a cumulatively negative impact on the people of the region. Unemployment and poverty are generally rising ? a stark reversal from decades of progress in places like Indonesia. These problems are also fuelling a rise in political extremism. There has been a dramatic increase in separatist movements, kidnappings, and religious extremism that not only threatens the well being of the people of the region, but impacts the investment climate. In short, the combination of depressed commodity prices, high oil prices and lagging social indicators is creating a regional investment environment that is unattractive to foreign investors.

The reform link

When it appeared that most of the region's economies looked like they were well on the road to recovery last year, the region's governments became somewhat complacent about the reform process. Many of these governments had done an inadequate job of addressing corporate and governmental reform to begin with. Few had made the hard decisions needed to break the bonds big business had with government and few had been bold enough to allow failing companies to fail. Instead, many injected more state cash into these companies, thereby prolonging the inevitable. Indeed, it now seems clear that many governments in the region declared their countries ?cured? prematurely. When what was needed was decisive, stern action, what was often delivered was political compromises that have deepened the structural malaise.

The result is that the ?Asia Crisis? is far from over. The region is unlikely to truly begin recovering until the region's governments embrace meaningful reform on a governmental and corporate level. The consequences of inaction will take their toll on the people of the region, and foreign traders and investors will likely continue to lack the confidence to return to the region in numbers sufficient to make a difference to regional economies.

Impact on PRI users and providers

The result of all this is that there appears to be a greater awareness on the part of traders and investors doing business in Asia about both the existence of PRI, and how it can be utilized as a risk management tool. The business community from Europe and North America has long sought out PRI when doing business in Asia, and there are now growing numbers of businesses inside Asia that are becoming accustomed to seeking PRI for their regional transactions. This has much to do with an increasing hesitancy to rely on a handshake or a government-to-government agreement (which was common before the crisis) to ensure the successful completion of cross border transactions in post-crisis Asia. The Reagan-era adage ?trust, but verify? seems to apply, after many regional businesses endured substantial pain from failed business ventures in the period immediately following the Crisis.

Since 1997 equity investors have in large part become hesitant to commit new funds to projects, and many of the region's banks ? having adopted conservative lending policies as a result of the Crisis ? are treading cautiously when considering the commitment of new funds to trade and investment transactions. Two trends have compounded the impact of the Crisis on banks. The first is the absence of a steady flow of transactions that banks can feel good about. In the early and mid-1990s, when times were good, many banks jumped on the infrastructure bandwagon, lending for

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dozens of toll roads, power and water projects. Many of these projects encountered problems servicing their debt, and the banks were left holding the bag. As a result, most banks have tightened their internal lending procedures.

Secondly, not only do they fund fewer long-term infrastructure projects than before, these projects must be of a particularly high quality to generate their interest. Although profit margins for infrastructure projects in Asia have actually increased for banks since 1997 (due to the reduction in funds available for lending), there is generally greater competition for the high quality projects among financial institutions. For other types of lending, profit margins have actually eroded. Whereas previously a bank may have commonly factored in profit margins of 150-to-250bp (or higher) when determining its lending rates for medium-term loans, it is now common for banks to work with margins of 100bp or less.

These new trends have narrowed the range of options that banks will consider when addressing risk management issues, in an effort to remain competitive. When considering whether or not to include PRI in a transaction, for instance, banks may be forced to choose between protection and profit. Many banks will therefore lend without coverage, taking their chances on the political risk question rather than cutting into the margin.

For political risk insurers, the fallout from the Crisis has also been pronounced. A number of significant claims arose as a consequence of having insured some of the same infrastructure transactions that got the banks into trouble. The most significant of these was a $290 million claim that impacted a number of carriers. For an industry with a small level of premiums generated in a given year (when compared with mainstream lines of insurance), these types of claims can have a considerable impact on this tiny industry.

Fortunately, however, even at the height of the crisis, only some of the pending claims materialized. Many of the investment disputes that arose were resolved through diligent effort on the part of project sponsors and insurers. Still, enough damage was done to cause underwriters to adopt an underwriting philosophy similar to that of the post-Crisis banks. Yet, although now more conservative in their approach, there are few countries in which underwriters will not consider reviewing trade and investment transactions at all. The issue is one of aggregation of exposure. Investors, traders and lenders seem to be focused on the same countries as sources of concern over political risk-related issues. This presents a challenge for underwriters, who naturally want to limit the amount of exposure in any one country.

The playing field for political risk insurers has become crowded, by the industry's standards. The arrival of new players since 1996 has made the PRI business more competitive than ever at a time when the insurance market is soft. PRI providers thus find themselves in the same boat as banks, dealing with smaller margins and chasing fewer desirable deals. This environment is favorable for buyers of PRI, but means that underwriters face the dual challenge of accepting business that makes sense while generating premiums that justify the risk assumed.

The bottom line is that Asia is not yet out of the woods. Banks will continue to search for transactions that make sense while yielding an adequate margin to justify participating in loan syndications; and political risk insurers will continue to provide coverage for transactions that fit their risk profile and include a sufficient risk-to-premium reward. The challenge for businesses seeking loans and insurance for their trade and investment transactions will be to obtain financing at an affordable level while adding a level of protection that makes moving forward sensible.

Asian governments will continue to face difficult choices concerning the completion and maintenance of the reform process. This may translate into unpopular decisions, but in consideration of the long-term well being of each country, its people, its businesses, and the region in general, these decisions must be made. Ultimately, it will yield the perception among the international business community that Asia is a safer place to do business.

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