

# **Country Risk: the good, the bad and the ugly**

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Everybody who has worked in a developing country has an *opinion* on the risks involved in making an investment in that country. A potential investor can also access a wealth of relevant *information* through the internet and other sources.

In this paper, I am going to first make some general observations on country risk and then present a template to assist you in *assessing opinions* and *organizing information* for country risk analysis. This approach will then be applied to two gold producing developing countries.

### ***The Need for Long-term Country Risk Assessment***

Mining companies tend to conduct formal Country Risk evaluations at three times:

- prior to *exploration*,
- prior to the *feasibility study* and
- prior to the *investment decision*.

Companies are generally willing to assume more risk during the exploration stage. However, *since* there may be a ten year period from the time a mining company first enters a country until it begins to realize a return on its investment, it must focus on *long-term risk*. Mining companies must look *beyond* the tenure of *current governments* and *current officials* and identify any factors in society which could lead to a change in direction, a shift in policy or a restructuring of the overall political system to the detriment of their investment.

### ***The Nature of Country Risk***

Country risk is in the eye of the beholder. Judgements about risk are necessarily subjective. Risk varies according to one's tolerance for uncertainty and potential loss. In fact, every risk is relative. The higher one's ability to manage an adverse situation, the less risky it is to you.

There are only three categories of risk that matter: negligible, manageable and intolerable. These are the *good*, the *bad* and the *ugly*.

### ***Responsibility for Country Risk Assessment & Management***

Executives at country and regional levels tend to develop insensitivity to day-to-day socio-political events in order to maintain the *confidence, drive and optimism* necessary to achieve their operational goals. This is the *Garden of Eden Syndrome*. Their high confidence in their ability to manage generally causes them to avoid considering any risk *intolerable*.

Country and regional management also tend to allocate the highest priority to issues or problems that they are most able to solve or manage. This can be called *Preferential Prioritising*. Issues which appear unmanageable tend to fall below the threshold for monitoring or are omitted altogether. Such issues fall into the category of “we will cross that bridge if we come to it.”

Relying on *in-country management* to assess risk provides only one side of the picture. Their views need to be complemented by *corporate management* as well as by outside consultants. For corporate management, risk is also *relative* to conditions in other countries. Risks look more daunting in a given country if they are worse than anything the company has faced in other countries. Historically, corporate management is more sensitive to country risk since it is more likely to have experienced severe losses from country risk than in-country management.

*Consultants* give a third perspective to risk, which often reflects neither the ability of in-country management nor the experience of corporate management. The views of consultants are interesting, but to be meaningful, their conclusions need to be integrated with country management’s capacity to manage risk and the corporation’s general risk tolerance. However, a consultant’s risk ratings can provide a useful benchmark to determine whether the company is off base in its assumptions and conclusions.

### ***What is Country Risk?***

Here are some examples of the different types of Country Risk.

- Expropriation
- Restrictions on capital repatriation & dividend remittances
- Interruptions from war or insurrection
- Taxation changes
- Regulatory changes
- Institutional deficiencies
- Corruption
- Social violence
- Inadequately trained local management & labour
- Prevalence of infectious diseases e.g. AIDS/malaria

### ***Political Risk***

With the exception of the last two items, the major component of Country Risk is in fact “Political Risk”. Political Risk can be defined as “political system stability and/or government policy stability”. A mining project will be adversely affected if the policies of the government change in a negative way or if the government itself breaks down or restructures in a way which adversely affects the project. Examining policy trends is

insufficient as governmental system failures may also occur (for example through corruption, military coups, etc.). Three types of factors affect Political Risk: social factors, political factors and economic factors.

### ***Social Factors***

- Regional conflicts and threats
- Secessionist movements
- Conflict between ethnic, linguistic or religious groups
- Significance of social groups outside the political system
- High social violence levels

### ***Political Factors***

- Polarization of the political spectrum
- Lack of strong leadership in government
- Corruption in government and the judicial system
- Popular feeling against International Monetary Fund conditions
- Restrictive or coercive measures to retain power
- Lack of accountability in government, police and military
- Human rights violations

### ***Economic Factors***

- Deterioration of standard of living
- Deteriorating levels of foreign investment
- Current account deficits and high external sovereign debts
- Disparity of income distribution among classes or regions
- GNP growth and inflation levels
- Unemployment and underemployment
- Institutional deficiencies with respect to the enforcement of contracts

Together these three factors can be used as a basic generic *country risk template*.

Let us now *apply* this country risk factor template to assess two specific countries, both of which are experiencing considerable change and are highly geologically attractive.

## INDONESIA

### *Background*

Indonesia is a multi-ethnic, multi-religious (although mostly Moslem), and a physically and politically fragmented society. Since decolonisation, Indonesia has been held together by a military under Javanese leadership. Rightly or wrongly, the country has been described as a Javanese empire. Now the country is in transition. The government is democratic. Some degree of decentralisation is occurring. But the future is very uncertain.

In 2004, for the first time, all political representatives will be elected directly and the first direct presidential election will occur.

Megawati Soekarnoputri, formerly the Vice-President, assumed the position of President in July 2001, following the impeachment of the previous incumbent. In the 1999 parliamentary elections, Megawati's party won the largest number of seats, but fell far short of winning a majority. Consequently, Megawati appointed a Cabinet that included members of all major political parties, technocrats and military representatives. Given her party's minority position, Megawati needs to demonstrate *strong leadership* to obtain the necessary legislative support to govern effectively.

### *Social Factors*

Returning to the generic country risk template outlined above, I will first outline how the *Social Factors* portion of that template can be filled in with respect to Indonesia.

Indonesia has several well known *secessionist movements*. East Timor's success in separating from Indonesia encouraged the separatist movement within the strongly Moslem *Aceh Province* on western Sumatra. While the Government reached an agreement with the Free Aceh Movement in early December of 2002, it is not clear that the agreement will hold.

In *Irian Jaya* (western New Guinea) and in *Kalimantan* (Borneo), the regional secessionist movements are intertwined with *ethnic conflict* as the indigenous inhabitants battle outsiders. The outsiders were moved in as a result of Indonesia's policy of "transmigration" designed to resettle people from overpopulated regions to those less populated. These significant secessionist groups *operate outside the political system* in Indonesia.

In the *Moluccas*, once called the Spice Islands, where the Christians were once a majority, the transmigration policy has resulted in a Moslem majority. *Religious conflict* has now arisen between Moslems and Christians resulting in *high levels of social violence*, including thousands of deaths.

### ***Political Factors***

I will now examine the *Political Factors* described earlier as they relate to Indonesia.

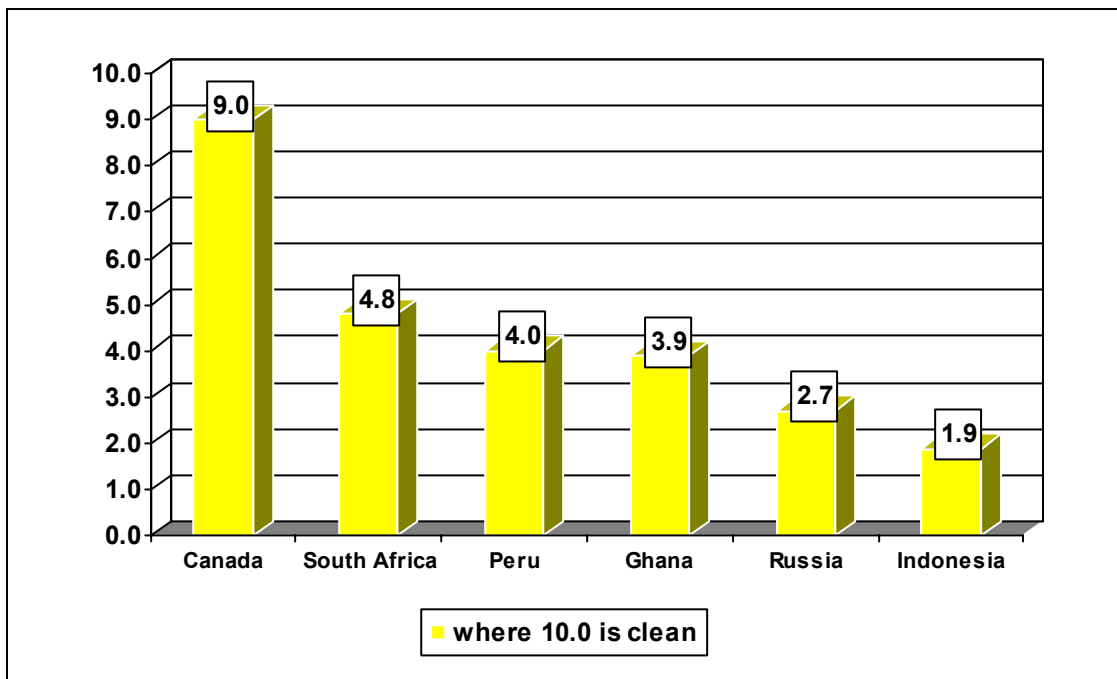
In Indonesia, the *polarization of the political spectrum* occurs primarily as a result of the *Military* still thinking of itself as being the *guardian of stability*. The temptation to carry out a coup to preserve the integrity of the nation could increase because of secessionist pressures, political infighting or urban unrest.

*Megawati's passive approach and aloof style* have raised concerns about her *lack of strong leadership*. In the week after the October bombings in Bali, she said and did little. She toured the bomb site and met victims in hospital, but afterwards remained silent and continued her normal schedule. She made no formal address to the nation and refused to speak to the media. Her apparent *indecisiveness* probably also reflects the political constraints under which she is operating.

Indonesia's continuing *corruption scandals* have led to the general public's growing disillusionment with established politicians.

*Figure 1*

### ***TRANSPARENCY INTERNATIONAL CORRUPTION PERCEPTIONS INDEX 2002***



In the 2002 *Transparency International Corruption Perceptions Index*, Indonesia scored 1.9 out of a clean score of 10 and ranked 96<sup>th</sup> out of 102 countries surveyed. Almost everyone perceives corruption to be rampant in countries with a score of less than 2. Many international investors would also use that description for a score of less than 3.

The *International Monetary Fund conditions* on privatisation and the ending of subsidies are not popular. In January of this year, the government rolled back the cancellation of some subsidies when faced with massive demonstrations.

There is *lack of accountability in the police and the Military*. In the two years since the police were separated from the Military, approximately 150 clashes between the police and the army were reported. There have been allegations that most of the clashes occur because of competition for control of illegal business ventures, including protection rackets, illegal mining and logging.

In an obviously related issue, there is a serious *shortfall in funding for the Military*. It is estimated that the government budget only covers 30-35% of Military expenditures. The shortfall is raised through private business activity. While there is talk of improving the transparency of military finances, as long as the Military retains independent sources of funding, full civilian control will not be possible.

The *dangers of illegal military business activity* were demonstrated in late October of 2002, when police announced that they suspected the military of involvement in the ambush and murder of staff within the security perimeter of the Freeport Indonesia gold and copper mine in Irian Jaya. There has been speculation that the attack was launched to justify a crackdown on separatists, but a more likely explanation is that it was an attempt to extort *protection money* for mine security from the managers of Freeport.

According to Amnesty International and others, the military has a long history of *human rights violations*, especially in secessionist areas. In Aceh and Irian Jaya, hundreds of cases of extrajudicial executions, “disappearances”, torture and unlawful arrests were reported. Elsewhere, there are numerous reports of deaths and injuries resulting from excessive force used by the military and police.

### ***Economic Factors***

Finally, I will review a few of the generic *Economic Factors* included in my country risk template and apply them to Indonesia.

- The *Real GNP Growth rate* was 3.7% for 2002, continuing the trend of modest economic growth since 1999. However, this is *far short* of the level required to substantially reduce *high unemployment* and restore the economy.
- *Inflation* was 10% at the end of 2002.
- Net flows of foreign investment are often used as a general market indicator of country risk. In 2001, Indonesia suffered a US\$3.3 billion *net outflow of foreign investment*, compared with a pre-economic crisis peak *inflow* of US \$2 billion in 1996. This was Indonesia’s fourth yearly loss in a row.

- Servicing the government's *combined foreign and domestic debt* of some US\$150 billion in 2002 is expected to total 40% of routine expenditure.
- Corruption and lack of judicial independence have made *contract enforcement uncertain* for foreign companies operating in Indonesia. With respect to mining companies, the situation has been rendered even more uncertain by the implementation of regional autonomy which has resulted in confusing and contradictory legislation. Mining companies have frequently been caught up in turf battles between local governments and the central government.

### ***Indonesia Country Forecast***

From now until after the elections of 2004, there is a very high probability of turmoil which could negatively affect foreign investments. Megawati will have to improve her performance if she wishes to complete her term as president and win re-election. She must perform a delicate *balancing act*. She must keep moderate Moslem support through not *overtly* appearing to bow to western demands on both anti-terrorist issues and economic policy. Simultaneously, she must fight corruption, diffuse threats of regional secession and implement the necessary legislation to improve the economy. If she fails to complete her term or win re-election and if secessionist forces gain strength, the possibility of military intervention remains.

## **SOUTH AFRICA**

### ***Background***

After nearly 50 years of Nationalist Party rule and apartheid, the African National Congress ('ANC') was elected in 1994 with Nelson Mandela as President. In December, 1997, he transferred the leadership of the ANC to *Thabo Mbeki* who went on to win the 1999 election with 266 seats out of 400 in the National Assembly. The next largest party has only 38 seats. The ANC also has a tripartite alliance with the South African Communist Party and the Congress of South African Trade Unions.

The key to understanding South African Government policies is to appreciate that 77% of the voters are *black* and that they are currently bearing the brunt of a staggeringly high 29.5% *unemployment rate*.

### ***Social Factors***

Turning to the generic list of *Social Factors*, I will now illustrate how this part of the country risk template can be filled in with respect to South Africa.



There is concern that *famine* may cause an influx of people from Zimbabwe and other neighbouring countries which will further tax the government's ability to cope with its social obligations.

Another *regional threat* is the *HIV/AIDS* issue. It is estimated that about 25% of the mineworkers currently employed in South African mines are infected with this virus. Projections to the general South African population suggest that as many as 10% were HIV positive at the end of 2001. This is expected to reduce economic growth due to the rising costs of health care and other effects of the epidemic. Its enormous impacts on labour and productivity are expected to contribute significantly to the cost of doing business in South Africa.

Currently there are *no secessionist movements* of any consequence.

There is still potential for *ethnic conflict*. The Zulus, represented by the Inkatha Freedom Party, have continuing grievances with the ANC (a multi-tribal grouping dominated by the Xhosa tribe) and the economic disparities between white and black could trigger racial unrest, if not addressed. To date, these potential conflicts have been adequately managed by the ANC.

With 80% of the population being Christian, *religious conflict* has not been an issue. The end of apartheid and the introduction of universal suffrage have meant that there are *no significant social groups outside the political system*.

There are however very *high levels of crime and violence*. Partly as a result, vigilante action and mob justice have occasionally occurred. The Independent Complaints Directorate is investigating numerous reports of deaths in police custody and as a result of police action, as well as complaints of torture, serious assault and attempted murder. High levels of unemployment have encouraged property theft and car-jacking, sometimes with associated violence. While the murder rate has declined by about a third since 1994, it still remains unacceptably high by international standards. In response, the government has established an exclusive crime fighting unit to deal with priority crime, including police corruption, and is hiring thousands of additional police.

### ***Political Factors***

The umbrella provided by the ANC's Tri-partite Alliance has discouraged *political polarization* in South Africa. The ANC government is expected to win the 2004 elections with a majority and Mbeki is expected to maintain his *strong leadership* position.

The continuing social and political pressure on the ANC to address the income and wealth disparities issue has spawned the *Black Economic Empowerment ("BEE")* philosophy behind much new legislation. An example of such legislation is the *Petroleum and Minerals Resources Development Act* which creates a new mineral regulatory regime. The system has changed from a 'fee simple' to a 'lease' basis. It has introduced the 'use it or lose it' philosophy that we are familiar with here in Canada. It also provides for the transfer of ownership of privately held (largely white controlled) mineral rights to

the State and for a five year transition period during which companies will have the exclusive right to receive a *mining lease* for their existing operations.

This legislation requires a BEE *Charter* to “set the framework, targets and time-table for the entry of historically disadvantaged South Africans into the mining industry.” *Consultations* with relevant stakeholders have resulted in a Charter requiring 26% ownership of mining industry assets to be in the hands of historically disadvantaged South Africans *within 10 years*. Industry has committed to “assisting” such persons to *finance* the first 15% of this *within five years*. But ‘ownership’ is only one of seven BEE requirements contained in the Charter. Others include: Human Resources Development; Employment Equity; Community Development; Living Conditions and Procurement. Accompanying legislation will also impose a State royalty tax on mining companies.

*Corruption* is a significant issue in South Africa. In the Transparency International Corruption Perceptions Index 2002, South Africa scored 4.8 out of a clean score of 10 and ranked 36<sup>th</sup> of 102 countries surveyed [see *Figure 1*, page 6]. However, the Government has taken measures to combat corruption in the civil service and passed ‘whistle blower legislation’. While there are many allegations of political and police corruption, the judicial system, certainly at the appeals level, is not perceived as corrupt.

### ***Economic Factors***

South Africa has a number of *positive economic features*:

- generating about 40% of Africa’s aggregate GNP, it has extensive mineral resources, a diversified industrial base and a booming service sector
- *inflation* at about 9% is levelling off and fiscal deficits are being reduced
- *net foreign investment* has increased in recent years
- its external financial commitments are manageable

South Africa also has a number of *economic weaknesses*:

- the economy has not been growing rapidly enough (about 2.8% in 2002) to allow the government to effectively reduce *unemployment* (at 29.5%) and poverty or redistribute wealth
- low levels of domestic savings and capital investment make it dependent on volatile foreign investment
- the *AIDS* epidemic will have a *negative* influence on economic *growth* in the future

Unlike many other countries, South Africa *is* taking steps to address its challenges. Nonetheless, it remains vulnerable to any deterioration in global investor confidence.

*Economic disparities* are considered a serious threat to the continued political and social stability of South Africa. It has been said that if *white South Africa* was a separate country, it would rank 24<sup>th</sup> on the UN’s Human Development Index. *Black South Africa* would rank 123<sup>rd</sup>.

### ***Country Forecast***

The period through 2008 is likely to remain politically stable as the ANC and President Mbeki remain in power. If Mbeki hopes to achieve his *economic objectives* of encouraging economic growth and reducing unemployment and poverty, he must ensure that his *political objectives* of reducing the huge disparities of income and wealth caused by apartheid are implemented without discouraging foreign investment.

South Africa is a country in transition. International perception of how Black Empowerment legislation is implemented in the next year will be significant. While outside observers may be sceptical, there is a quiet determination within South Africa to seize this window of opportunity and make it work.

### ***Relative Country Risk***

Let us now make some quick comparisons between Indonesia and South Africa.

Based on what I have presented today, my conclusion is that *Indonesia* is on a slippery slope towards possible *chaos*. The only way out appears to be a return to *military rule* which would make it a “pariah state”.

*South Africa*, while sitting on a *ticking time-bomb of poverty and unemployment*, is feeling its way forward and responding slowly but consistently to social pressures. More importantly, South Africa has developed a *consensus approach* to policy making. Country risk in South Africa, while between medium and high, is probably *manageable*.

There are country managers for mining companies operating in Indonesia who consider all risks there to be manageable. For many external observers however, Indonesia’s risk is beginning to seem *intolerable*.

### ***Benchmarking***

Commercial country risk services such as Business Monitor International provide useful *benchmarks* to test our conclusions. For example, both in the case of *Long-term Political Stability* and *Long-term Economic Outlook*, Business Monitor International ranks Indonesia significantly lower than South Africa [see Figures 2 and 3, page 12].

Figure 2

**BUSINESS MONITOR INTERNATIONAL'S LONG-TERM POLITICAL STABILITY RISK**

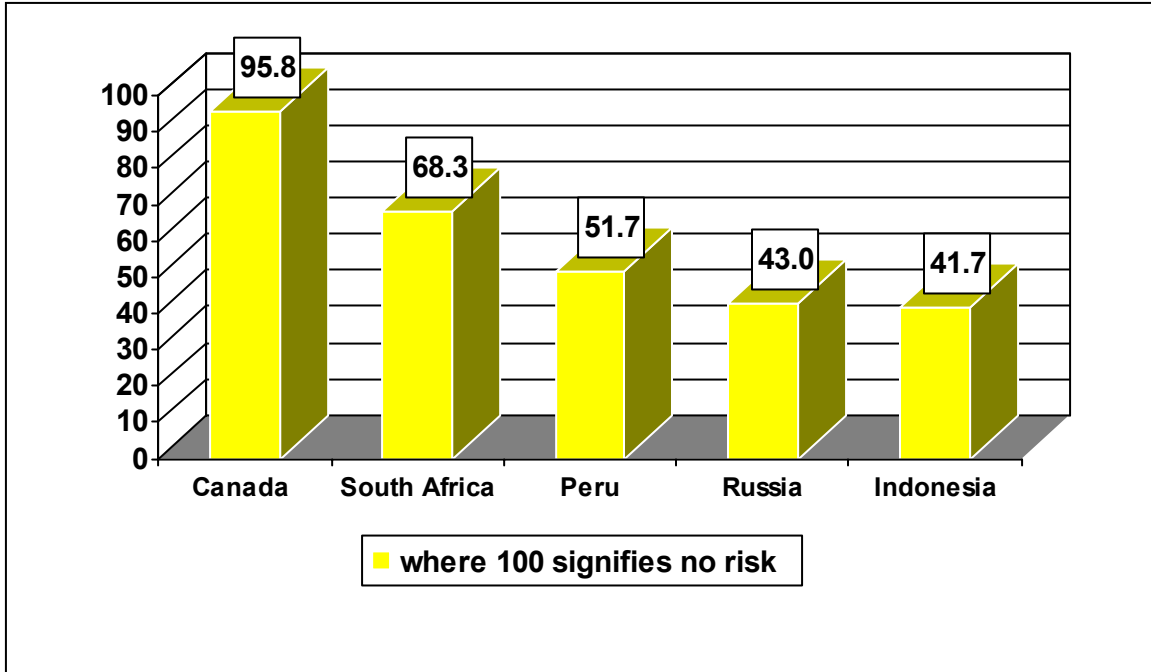
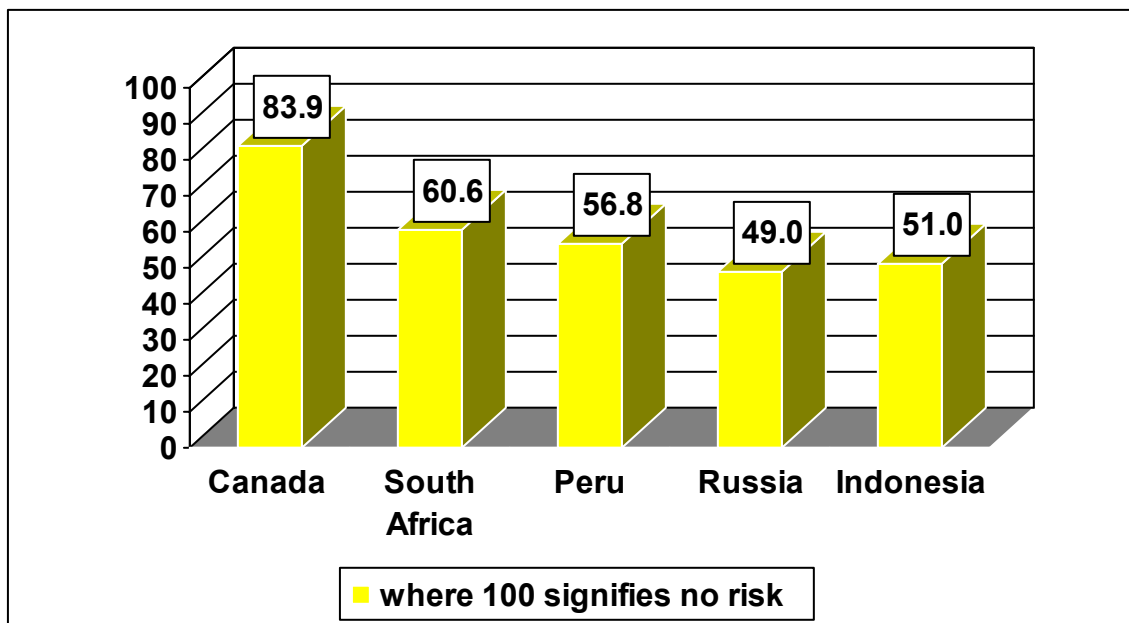


Figure 3

**BUSINESS MONITOR INTERNATIONAL'S LONG-TERM ECONOMIC OUTLOOK RISK**



Similarly, as a measure of the attractiveness of governments' mining policies (including political risk), the *Policy Potential Index of the Fraser Institute's 2002/2003 Annual Survey of Mining Companies* scores South Africa at 47 and Indonesia at 19 out of a possible score of 100.

### ***Useful Information Sources***

Finally, in order to assist you to research for yourselves which countries are *the good, the bad and the ugly*, I have listed below some *useful website information sources*.

- [www.businessmonitor.com](http://www.businessmonitor.com) – Business Monitor International.....(pay)
- [www.countrydata.com](http://www.countrydata.com) – CountryData.....(pay)
- [www.countrywatch.com](http://www.countrywatch.com) – CountryWatch.....(pay)
- [www.eiu.com](http://www.eiu.com) – Economist Intelligence Unit.....(pay)
- [www.prsgroup.com](http://www.prsgroup.com) – The PRS Group.....(pay)
- [www.amnesty.org](http://www.amnesty.org) – Amnesty International.....(free)
- [www.cia.gov](http://www.cia.gov) – U.S. Central Intelligence Agency, Factbook.....(free)
- [www.state.gov/r/pa/ei/bgn/](http://www.state.gov/r/pa/ei/bgn/) - U.S. Dept. of State.....(free)
- [www.state.gov/www/global/human\\_rights/](http://www.state.gov/www/global/human_rights/) - U.S. Dept. of State.....(free)
- [www.transparency.org/pressreleases\\_archive/2002/2002.08.28.cpi](http://www.transparency.org/pressreleases_archive/2002/2002.08.28.cpi)  
Transparency International Corruption Perceptions Index 2002.....(free)
- [www.fraserinstitute.ca](http://www.fraserinstitute.ca) – The Fraser Institute Annual Survey of Mining  
Companies.....(free)

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