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Analysis: Emerging market investors face year mined with political risks

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By [Mike Dolan](#)

LONDON (Reuters) - As the tidal wave of global central bank liquidity recedes in 2014, emerging market investors are growing more anxious about local political risks - and how to spot them early on.

Developing economies have had a rough ride since the Federal Reserve first mooted a wind-down of its money printing last year. The looming withdrawal of easy cash worldwide pushed the dollar and Treasury yields up and drove Western investors home, jarring countries most dependent on foreign capital.

Emerging market bonds posted only their third year in the red since 1998 last year, while emerging equities ended 2013 in the red for the second year in three.

And as the global investment tide sweeps out, it may reveal a beach strewn with political detritus.

As competition for funds heats up while their economies rapidly lose steam, political risks have been amplified in the so-called 'Fragile Five' of Turkey, South Africa, India, Indonesia and Brazil, the emerging economies with the biggest overseas financing needs.

All five face elections this year, adding to brewing local concerns over a deepening corruption probe in Turkey or the waning popularity of South Africa's and Brazil's leaders.

South Africa and India hold parliamentary elections in 2014, while Brazil and Turkey have presidential elections. Indonesia has both. In fact, 12 of the major emerging markets go to the polls in some format this year.

"2014 will be a year in which the return impact from idiosyncratic political events in emerging markets could increase substantially," asset manager M&G Investments told clients this week.

"The prospect of these elections could potentially reduce the net capital flows into these economies on a temporary basis," it added, citing the threat of local capital flight, delayed foreign direct investment or portfolio flows as well as increased demand for currency and bond hedging.

Navigating the scheduled elections may be the easy bit, however. Some of the biggest political disruptions of the past four years were rather more sudden, such as the Arab Spring upheavals across the Middle East and North Africa or the more recent street protests in Ukraine.

For funds seeking to assess political risk well in advance, some form of advance warning system or scorecard is critical.

'WILLINGNESS TO PAY'

The world's biggest asset manager Blackrock, for example, publishes a Sovereign Risk Index every quarter that now ranks 50 countries in terms of governments' overall creditworthiness.

The index covers areas such as external finance needs, fiscal policies and banking stability, but also captures the essence of pure political risk under a heading 'Willingness to Pay'.

The introduction of Ukraine and Nigeria to the list this week saw the two countries come in at 45th and 39th respectively on overall ratings.

Their scores for 'Willingness to Pay', however, are far below the average of their emerging market peers. Only Venezuela has a worse rating than Nigeria, for example.

What's more, Blackrock highlighted the growing political element in its risk ratings, citing the recent unrest in Thailand and Ukraine in particular, and it said it had added an additional source in compiling its 'willingness to pay' gauge to strengthen monitoring.

All of the 'Fragile Five' flashed red on this category when Blackrock last updated this index in October.



Portfolio investors, therefore, may have their radars up in order to exit quickly, but does this work for companies with bricks and mortar investment on the ground?

Political risks to so-called foreign direct investments go well beyond tax hikes or payment risks and extend to outright expropriation of assets, threats to staff or plant and inventory damage from conflict or social unrest.

Traditionally these risks to foreign direct investment have had to be judged by deep local knowledge, or assessed by government insurance bodies or bespoke political risk agencies.

But a study published by the U.S.-based National Bureau of Economic Research this week showed that early-warning political risk gauges can be constructed from bond market prices and provide just as valuable a guide for business overseas.

The paper, by four U.S. economists from Columbia and Duke Universities and Universities of Washington and North Carolina, showed political risk gauges do provide a good warning of events defined both by claims recorded by the U.S. government's political risk insurance arm and major adverse news events.

What's more, the authors - Geert Bekaert, Campbell Harvey, Christian Lundblad and Stephen Siegel - reckon they can construct a real-time accurate gauge using a subset of sovereign bond spreads stripping out non-political factors like market liquidity, economic trends or the global market climate.

By and large, they argue, sovereign spreads in emerging markets overstate pure political risks by 3.1 percentage points.

But - in a warning as much to national policymakers as investors - their striking conclusion is that a 1 percentage point rise in the political risk spread leads to a drop in FDI of almost 12 percent, or some \$305 million on average, for the 30 emerging countries in major debt indices.

(Editing by Hugh Lawson)

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