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REDUCING POLITICAL RISKS AND MORAL HAZARD IN EAST WEST FINANCIAL RELATIONS

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REDUCING POLITICAL RISKS AND MORAL HAZARD IN EAST WEST FINANCIAL RELATIONS

by Gunnar Eliasson

Abstract

Western business firms are subjected to significant political risks when engaged in investment in the formerly planned economies. First, most of these risks are of such a character that there will be no spontaneous creation of insurance products in the market. Second, the risks are so large that even very large firms would not dare to take them on as long-run commitments. It would only occur in very short-term investments. Hence, these risks cannot be eliminated without some Government involvement in the form of guarantees or some other kind of coverage.

It is in the interest of Western industrial nations to see viable growth economies emerging out of the formerly planned economies. There should, hence, be a strong interest in instituting an "insurance" system to reduce risks created by the absence of the political stability and the institutions necessary for the dynamic functions of a market economy. This insurance operation should furthermore be organized such that incentives are strong to develop these necessary institutions. Above all the insurance operation should be organized to be capable of bridging the social instabilities that might otherwise abort the reindustrialization process of the formerly planned economies.

One difficult problem is that reindustrialization will take a very long time. Another problem is the moral hazard problem both on the part of firms and of support receiving countries.

This brief paper sketches an insurance system that significally reduces the moral hazard problems and - even though based on a large Government equity contribution - takes decisions down to where the competence resides, in the market.

The Nature of Risks

There are three elements to consider when organizing such an insurance system:

(1) The *nature of risks* - the insurance principles

(2) an *incentive system reducing the moral hazard* propensity of *receiving* Eastern *nations*

(3) an *incentive system* boosting political support of *political risk reduction*

The guiding principle of the proposal to be expounded below is that the insurance system created to reduce political risks should not distort market incentives. In addition it should be designed to be effective in particular for supporting *foreign direct investment.*

It has to be recognized that any investment involves a long term committment. Rents from the investment, including the principal are recovered only after some time. The insurance we are talking about is the probability of not being able to capture these rents or recover the original investment because of risks beyond those technical and commercial risks a normal business should be expected to cover against its own equity. Those political risks are listed in Table 1. The time dimension is critical. The insurance coverage needs to be sustainable in time and up to large limits.

Furthermore such political risks cannot be described for each country by known or subjectively estimable distributions. They rather hit all investors or all foreign investors simultaneously.

Hence it is important that the insurance arrangement incorporates incentives not only to reduce moral hazard on the part of investors but also on the part of the national authorities, to keep the political risk level low.

Investments in any economy are subject to the five kinds of risks listed in Table 1. The three first kinds of risks are of such a nature that risk averse actors would consider them very large. Even large firms would potentially risk total failure. Many of these risks, furthermore, are such that no business firm would consider their assessment as part of their normal competence. Neither would this be the case for an insurance company, as I know them. Hence, any viable insurance arrangement would require some kind of Government guarantee.

The critical problem is to draw a clearly defined line between the risks that firms should cover as parts of their business and where extraordinary political risks are present, that make any investment project in a formerly planned economy look unfavourable to a corresponding investment in the West. This means *drawing the line between political and business risks* in Table 1. To draw that line I will use the contract defining the property right to future profits, the equity contract.

The equity contract specifies the holder's right to influence the management of his or her investment, to access the rents acruing from the same investment and the right to trade in the contract (the share). In the western market economies these rights are well defined and liberal. An important task of the investor is to assess the business risks associated with achieving his expected rate on return from the managing of (by himself or the person to which he has delegated the right to manage) his assets. The political risks in Table 1,

however, mix with the business risks. First and second order risks influence the earnings capacity of the firm or operate directly on limiting the defined property rights; that is the freedom to manage, access and to trade in the entitlement to future profits.

While the assessment of business risks defines the competence of firm management, this is not so for political risks, hence the prescence of expected political risks (1), (2) and (3) in Table 1 tends to result in a prohibitive risk premium or discount factor in the investment decision. The idea of the proposal to follow is to remove the assessment of such political risks from the business investment problem, either through instituting a specialist political insurance system or an insurance system, where such risks are covered by a third party. We are concerned with foreign direct investment in a formerly planned economy and we are considering western Governments that want to see these economies rapidly transferred into industrial economies and are willing to cover those risks, if an incentive system can be organized that minimizes opportunistic behavior on the part of the receiving countries.

The East West Insurance Corporation (EWIC)

This is the way it can be arranged. A group of western nations decides how large the political risk is in the East, and where in the East it would be willing to underwrite it on the part of its potential business investors. This becomes an equity stake in the "East-Western Insurance Corporation". The equity stake is apportioned on the different countries the western countries want to support. Each country is allotted an equity stake in the EWIC. It becomes a share owner responsible for the proper management of that stake such that it grows in value, as invested by a 100 percent commercial investor, according to market principles. This equity stake is not available or mortgable until the formerly planned economy has reached a certain minimum level of development and/or per capita income. The equity is there to protect the investments of western companies. The equity is reduced as western companies investing

in that country claim, and receive compensation for losses occurred due to well defined political risks in terms of Table 1.

The awarding of such compensation has to be entirely unpolitical according to a preset legal procedure.

The equity stake would then grow in pace with the management of these assets and the commercial success of the insurance business.

The character of the EW Insurance Corporation would - to the extent possible - prespecify the three risks covered. In case a firm contemplating investment in a covered country is uncertain about coverage of the particular political risks it envisions, it can enter negotiations with the EW Insurance Corporation to see whether coverage is accepted or obtainable at an extra charge.

The guiding principle of getting insurance premia would, however, be that the country in question declares a particular, low risk level under categories 1,2 and 3 to attract foreign investment. For a reasonable premium the foreign investment is covered against the equity for these risks.

Since the business firm is facing uninsurable risks (market failure, uncertainty) the implication is that the firm would always be willing to pay something for coverage, either in the form of an agreed upon voluntary eccess[1] or a charge.

Hence, the EW Insurance Corporation, to the extent it develops a professional political risk assessment capacity should also be able to earn an extra return on its equity.

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[1] The maximum amount the insured is willing to cover himself.

The receiving nation should also be very concerned, in view of its equity stake, to reduce the political risks, since otherwise claims on the same equity would increase. This is the moral hazard control in item (2) in the Table above.

Table 1 Risk Hierarchy

<u>Political</u>

1) Force Majeure - first order risk
   - military etc.
2) Force Majeure - second order risk
   - collapse of monetary system
3) Institutional Deficiencies controllable by political authorities
   - third order risk

<u>Business</u>

4) Rules monitoring and controlling opportunistic behavior on the part of business agents.

5) Business risks

A court of last resort

One important problem is how disputes between the EWIC and its client investors should be settled. Again, the appropriate legislation being enacted, this procedure could be defined such that the moral hazarad problem is further reduced.

Whenever a dispute arises referring to political risks, there should be a well defined procedure to run it through the local courts. But the risk taking foreign investors should always have the option to take it out of the local court and place it in front of an international court to judge according to a well defined foreign law and/or be treated in a non-discriminatory manner. The verdict so obtained will determine the adjudication of the EWIC.

Such a procedure would be a strong deterrent from arbitrary political rule changes in the receiving country. It would also provide a strong incentive to establish local conventions (and precedents) that are compatible with western market principles in order to avoid the embarrassing attention that would decrease the inflow of foreign capital. It is important to note that this insurance arrangement means that the inflow of capital is dependent on private, profit motivated decisions on the part of firms and banks, not on Government political decisions. This would also mean that those countries that move fast to establish orderly inhouse institutions will reduce political risks the most and both receive a proportionately larger volume of foreign investments and keep a larger part of the equity share in the EWIC.

The incentive scheme is very business like. The countries that manage their economy most successfully receive the most in the form of equity value in the end. The cost for this foreign aid to the donating country would be the same. The rules would be well defined and clear and involve a minimum of negotiations and bureaucratic procedure at the nation to nation level. Incentives would be high on the part of the receiving country to do its best to organize a viable growth economy.

The Moral Hazard problem

The idea with the insurance arrangement is to make (1) the country politicians concerned with getting their institutions in order (2) the firms happy about investing and (3) the insurance company management concerned about increasing the equity of the insurance operation. There are two types of moral hazard problems to consider in this context. First of all, a viable transition from a planned to a market economy subjects the citizens of the formerly planned economy to social adjustment pressure that they may resist under a Western type democracy that favours the currently voting population. This is, however, not in the long term public interest, i.e. in the interest of future generations. Hence, the optimal political regime during the transition may be some form of benevolent dictatorship, or authoritarian regime.

The *first* type of moral hazard occurs if there are incentives for the three parties above (the politicians, the insurance corporation and the foreign investors) to coalesce to support exactly such a political situation. In one sense this may *not* be a real problem. It may facilitate the transition, by suppressing short term interests. In another sense, if such an authoritarian regime is instituted, and also benefits the transition, it may be difficult to return to democracy later on.

The *second* type of moral hazard problem is more serious. Foreign investors and the insurance company can earn money in different ways. Many of these ways, will, however, not contribute to long term economic growth. The politicians of the receiving country may not understand which way is best for them in the long run, or be corrupt, rather pocketing some money than taking care of the future public interests of the country. The latter appears frequently to have been the case in the underdeveloped countries receiving foreign aid. The problem, hence, should be for the western countries to prevent the forming of coalitions between the three parties above that are not beneficial

to long run development of the economy. Such bad behavior on the part of political authorities also includes social concerns that are detrimental to long run growth. One should not assume, in forming this arrangement that the political regimes of the receiver country are informed and non-corrupt. If they are it is not in the interest of the West to support them. Neither should one expect foreign investors to take responsibility for the long run development of the receiving country. Hence the monitoring of bad coalition forming will have to be the task of the insurance corporation. This amounts to vesting the insurance corporation with the kind of political power that has been resisted by many developing nations.

On this score one could say that the Western offer will be on a *take it or leave it* basis, and that only countries willing to accomodate will receive support. Hence, by organizing competition among the Eastern planned economies for good long term behavior long term growth in the region will be maximized. This amounts to making management of the insurance corporation concerned about its long term equity development, and restrict its operations, such that it only engages in insurance activity that promotes its long term equity development, and is good for the country.