POLITICAL RISK INSURANCE: A SOLUTION TO CAPITAL FLIGHT?

by

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by

FERNANDO PAIZ

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in partial fulfillment of the requirements for the
Degree of Master of Science in Management

ABSTRACT

The purpose of this thesis is to determine if political risk insurance will provide incentive enough to stem capital flight from developing nations in Latin America. The study is based on a review of the literature on capital flight and country risk assessment and on interviews with:

Latin American investors holding portions of their assets abroad, in an effort to study the rationale followed by the perpetrators of capital flight;

Officers of U.S. banks holding Latin American debt, to assess their support to a project of this sort;

Private and government-controlled insurance companies providing forms of political risk coverage in the region, to understand actuarial country risk assessment;

Officers at multilateral organizations providing financing to LDCs, to understand their developmental policies;

U.S. Government officials at the Departments of Commerce, State and Treasury, to comprehend the policies implemented to deal with the problem of capital flight.

The study concludes that political risk insurance is not incentive enough to reverse capital flight. Structural, economic and political causes influence investor's decisions to continue seeking the security of foreign diversification.

Thesis Supervisor: Dr. Donald R. Lessard
Title: Professor of International Management
Introduction

The absence of growth in the economies of Latin American nations is due in great part to the lack of capital investment. Capital flees the region when faced with the prospect of confronting risks such as chronic currency devaluations, nationalizations, exchange controls, and general political or economic instability.

If such risks could be insured by a carrier with long-term commitments and adequate financial backing, Latin savings abroad could be lured back to the region. The consequences of drawing massive sustained investment into Latin America would bring about increased per capita income, growth of GNP, increased exports and foreign currency reserves, eventually allowing for stable economies, providing the basis for widespread prosperity in the region.

The purpose of this thesis is to determine if providing protection in the form of political risk insurance to local investors of developing nations would
create the adequate incentives to stem or reverse capital flight. Given the importance of the region as a trading partner of the United States, special emphasis will be given in the analysis to Latin American less developed countries (LDCs).

The first chapter studies the causes, magnitude and consequences of capital flight. The second attempts to establish the feasibility of providing political risk protection, what type of entity could do it, and what premiums are needed to cover country risks. The third chapter studies the Latin American investors' rationale and decision process when effecting capital investment diversification abroad, and his demand for political risk insurance. The last chapter provides some conclusions.

The main sources of information for this research project were personal interviews. These included Latin American investors, and in the United States, private banking and insurance executives, officers of the government and international and multilateral organizations.
dealing with Latin America.' These sources were supplemented with literature on the subject of capital flight, country risk assessment and economic development of the LDCs.

\[\text{I have identified only their country of origin.}\]

\[\text{For a detailed list of sources please refer to the appendix. Latin American investor's names were kept confidential as per our agreement. I have identified only their country of origin.}\]
Commerce and manufacturers can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.

Adam Smith (1776)

Chapter 1

Capital Flight

Definition of Terms

Discussing the issue of capital flight arouses strong emotions. With headings like "Poor Man’s Debt, Rich Man’s Loot" news media editorials subjectively confuse the facts, making it probably one of the areas where Latin Americans are most misunderstood.

Some view it as a symptom of a sick society, as a cause of Latin America’s failure to recover from the debt problem and a rational reason for lenders to be leery of increasing their exposure. Others regard the term as a pejorative description of natural, economically rational responses to portfolio choices that have confronted wealthy

2 The Washington Post, Jan ’89 article by James S Henry
residents of some debtor countries in some recent years. Both views are correct.³

When law-abiding citizens fleeing exposure to political risks queue up at financial institutions abroad, they join tax evaders skimming unreported profits, drug dealers transporting their collections, and politicians hiding their loot. It is such company that gives flight capital such a bad rap.

When Latins think of capital flight, they perceive themselves as people suffering high risk exposures, simply reacting as rational citizens to protect their rightfully-owned assets from undue risks. It must be noted that country risk affects locals more than foreign investors. Locals are overexposed because naturally, they tend to have substantially higher proportions of their own assets invested in their home countries. Their desire to protect their economic status through international diversification is in direct conflict with national

loyalties. Yet, in looking for this diversification, these investors are acting rationally and "normally" as their counterparts would in developed nations.

In order to understand capital outflows, the terms have to be defined. The same action say, by an investor in Japan that purchases a property in Hawaii or opens a saving account in California, is considered a normal diversification effort. But, when a Latin investor does the same in Florida it counts as flight capital. What is the difference? Lessard and Williamsen (1987) justify the different classification arguing that the underlying rationale in both cases is the same but the motivation is not. In the second case; moneys are running away from a country for variety of fears and suspicions, and not necessarily acting on purely economical reasoning or motivation.

Latin American movements of capital are defined as capital flight because local investors are trying to escape the high risk exposure in their home countries. In our example, the Japanese investor would be merely
responding to opportunities abroad and fulfilling personal goals of risk diversification in his investment portfolio.

In support of this fact, note that most Latin investor's foreign holdings are in passive investments yielding lower real rates of return than the ones obtained in the normal course of their businesses in their own countries. The fact these returns are in a hard currency with lower risks of devaluation justifies it.

Capital outflows are not always considered negative, nor is it necessarily illegal to perform them in most countries. As late as 1981, Venezuela encouraged capital outflows on the grounds it reduced inflation. Yet, I would still classify these outflows as "capital flight," together with moneys transferred illegally against the intended policy of the host government. The issue of the legality of the currency conversion and transfer, or the agreement with the policies of the host government,

have nothing to do with the fact those moneys are converted and held abroad because the investors consider themselves at risk in their own country. History has taught them not to trust the stability of their country’s fiscal and monetary policies. In the case of Venezuela, the ones who exchanged Bolivars for U.S. Dollars were only very timely in getting rid of a fictitiously overvalued currency. There is a value judgement implied in the common definition of capital flight, as it suggests "capital flight" differs from "undesirable capital outflows." In fact, *Capital Flight: Policy and Responses* states there is such thing as "good" capital flight, citing as an example the flows involving the German Jews in the 1930s.

This leaves the connotation that persecuted German Jews were "justified" in taking their moneys out of Germany because of logically perceived high risks to their persons and their assets. Implicitly, we come to accept the existence of a difference with those flows coming out of Latin America, where individuals feel their governments’s actions are confiscatory in nature, threatening their well being. I will discuss at length this issue when describing
the nature of the risks capital gets exposed to in the LDCs.

Thus for this work, the term capital flight will encompass only the abnormal movements of domestic capital caused as a reaction to specific regional threats and that go beyond normal portfolio diversification. The question of the legality of the flows, or if they are or not desirable for the domestic economy, will play no role in the definition of this concept.
Magnitude of the Problem

In the early 80s the world was running an annual balance of payments deficit with itself on the vicinity of $100 billion. In other words, the balance of payments deficit equaled 10% of the total value of world market trade. The International Monetary Fund had a useless explanation for such a statistical hole; it explained it was "caused by "asymmetries." The fact is this figure comprised the tip of the iceberg for growing hidden capital flows from a world underground economy. Capital flight per se, is an important part of these flows.

Measuring capital flight with any degree of accuracy is a problem. One of the most often used and accepted procedure is that of equating it with the "errors and omissions" figure in the Balance of Payments accounts. But this procedure is plagued with flaws in both the assumptions used (specifically regarding by which means

capital outflows take place), and the serious difficulty in obtaining reliable information. Let's look at the schematic balance of payments accounts in Table 1 and go through its application to understand the argument I am trying to make.
Table 1

Balance of Payments Accounts

<table>
<thead>
<tr>
<th>Description</th>
<th>Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of Goods and Non Factor Services</td>
<td>+(A)</td>
</tr>
<tr>
<td>Imports of Goods and Non Factor Services</td>
<td>-(B)</td>
</tr>
<tr>
<td>Investment Income</td>
<td>+(C)</td>
</tr>
<tr>
<td>Foreign Debt Service Payments</td>
<td>-(D)</td>
</tr>
<tr>
<td>Remittances from Abroad</td>
<td>+(E)</td>
</tr>
<tr>
<td>Transfers and Outflows</td>
<td>-(F)</td>
</tr>
<tr>
<td>Total Current Account Balance</td>
<td>+(G)</td>
</tr>
<tr>
<td>Direct Investment from Abroad</td>
<td>+(H)</td>
</tr>
<tr>
<td>New Foreign Loans</td>
<td>+(I)</td>
</tr>
<tr>
<td>Amortization of Foreign Debt</td>
<td>-(J)</td>
</tr>
<tr>
<td>Increase in Foreign Assets of Domestic Banking System</td>
<td>-(K)</td>
</tr>
<tr>
<td>Resident Capital Outflow into Long-Term Assets</td>
<td>-(L)</td>
</tr>
<tr>
<td>Resident Capital Outflow into Short-Term Assets</td>
<td>-(M)</td>
</tr>
<tr>
<td>Total Capital Account Balance</td>
<td>+(N)</td>
</tr>
<tr>
<td>Errors and Omissions</td>
<td>+(O)</td>
</tr>
<tr>
<td>Increase in Foreign Currency Reserves</td>
<td>+(P)</td>
</tr>
</tbody>
</table>

Source: modified by the author from *Capital Flight: Policy and Responses*
To begin with, most analysts have assumed (L), Resident Capital Outflows converted to long term assets, represent "normal" portfolio diversification, whereas (M), Resident Capital Outflows converted to short term assets, are more likely to represent flight of capital. This distinction can be misleading. It is true, the first step of capital flight is usually short term assets (money market accounts, time deposits)*. As the account holder matures and becomes a sophisticated foreign investor, it will convert some of those same assets into long term fixed ones. The point is that the change in no way has anything to do with the underlying rationale prompting the investor to keep those assets outside of his own country, thus, not meriting classification under a separate category.

Both (L) and (M) are very difficult to measure. If an investor is fleeing from abnormal risks at home, the last thing it wants to do is attract the attention of the local authorities. Thus, it is highly unlikely any reports

* Without exception, Latin American investors interviewed indicated that the opening of foreign currency checking accounts and short term certificates of deposit was their first step to secure capital outflows.
will get filed with the government. In many instances, even if it is totally legal and foreign currency is readily available at the local bank, outflows are hidden from local authorities and government statisticians. This is achieved in many ways, particularly depositing the moneys under shell corporations domiciled in so called "tax haven" countries. Most of the flows are impossible to trace, occurring hidden as part of under-invoiced (A) Exports of Goods; over invoiced (B) Imports of Goods; or "black market" purchases of foreign currency originating from (E) Remittances from Abroad.

Underground transactions, though usually more expensive to the investor, occur mainly in countries that impose strict exchange controls, or in those that introduce distorting externalities, (such as subsidized exchange rates for certain imports.) Local businessmen feel it is their right to take full advantage of these distorting factors, and most tend to abuse them. Let me share an example of how one of these processes worked in a case I'm familiar with:
In 1986 Eximbank extended a line of credit to the Central Bank of Guatemala for the exclusive purpose of financing the purchase of raw materials from the United States. The credit line was made available to Guatemalan manufacturers at an arbitrary preferential exchange rate of 1.6 Quetzales per dollar. At the time, the prevailing exchange rate in the open market was 3.2 Quetzales per dollar.

Importers scrambled to meet the many bureaucratic requirements for these loans, as they represented a 50% savings to purchase U.S dollars. (The government of Guatemala required the savings be transferred to the public, thus easing the inflationary pressure of the recently devalued Quetzal.) All seems ok up to here. The problem is that the importer has no problem in getting his supplier or freight forwarder to over-invoice the goods and beat the system for a substantial profit.

Eximbank is an independent U.S. Government agency that helps to finance and facilitate the export of American Goods and services.
So, for example, raw materials worth one million dollars will be invoiced for $1.5 million through a letter of credit guaranteed and eventually paid by Eximbank. After shipping, the exporter collects his due and proceeds to deposit the over-invoiced $500,000 in a local U.S. account (in the name of the importer). Note here the double windfall for the importer. It obtains foreign currency to import his goods at 50% lower cost than the market and gains fictitiously eight hundred thousand Quetzales as a tax deductible increment in raw materials cost. By this process capital outflows become a tax deductible expense keeping the books properly balanced and beyond suspicion! These types of distortions create a great temptation, are too easy to hide, and in reality serve as an incentive for capital flight of the most damaging form.

So if the deposit is made into a U.S. bank account in the name of a shell corporation domiciled in any accommodating "tax-haven" country, the Balance of Payments accounts would have never been able to pick the transaction up on its (0) Errors and Omissions account. Although both
tend to cancel each other, the same would happen with under-invoiced exports and "black market" purchases of remittances.

I have used quotation marks when referring to the black market of currency because its existence is not necessarily illegal, as the name implies. For example, in Guatemala the tax code allows businesses to deduct as a legal expense the cost of purchasing currency in the open or black market, even when banking laws state that only the Central Bank has the authority to buy and sell foreign currency in the country. Inconsistencies in the law remain in a somewhat intentional manner, as the condition allows the government to apply the law of their choice when they need to.

Freeing the currency market relieves the pressure from the Central Bank which cannot provide dollars at the "official" rate to satisfy the needs of importers. The system allows the Central Bank to operate with two or three rates of exchange that match the intended economic policies of the government, without needing officially to devaluate.
the currency. Notice that without official devaluation, government owned companies holding U.S. dollar denominated liabilities, maintain fictitiously low debt equity ratios. They conveniently convert debt in their books at the official rate.

Presuming (O) Errors and Omissions are in fact caused by capital outflows, it would be appropriate to include them as a part of (M) Short Term Capital Outflows. Though this approach falls short because of the arguments expressed above, it has been used in the pioneering studies in this area.*

The Institute for International Economics' conference on capital flight concluded that none of the existing measures of resident capital outflows was satisfactory. Even if its measurement accuracy cannot be ascertained, the relevant point for this thesis is that the estimated resident capital stock held abroad by Latin Americans is of a magnitude similar to all the region's

foreign debt. Any project achieving the return of these funds would have a tremendous relevance to the economies of the region.

Table 2
Deposits of Non Banks Held Domestically and Abroad,
in Billions of U.S. Dollars, at year end.

<table>
<thead>
<tr>
<th>year</th>
<th>Argentina</th>
<th>In Domestic Banking System*</th>
<th>In Banks Abroad</th>
<th>Deposits Abroad% Domestc Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>81</td>
<td>24.3</td>
<td>6.7</td>
<td>28</td>
<td></td>
</tr>
<tr>
<td>82</td>
<td>8.2</td>
<td>7.1</td>
<td>87</td>
<td></td>
</tr>
<tr>
<td>83</td>
<td>8.4</td>
<td>7.9</td>
<td>94</td>
<td></td>
</tr>
<tr>
<td>84</td>
<td>7.7</td>
<td>7.6</td>
<td>99</td>
<td></td>
</tr>
<tr>
<td>85**</td>
<td>7.1</td>
<td>8.2</td>
<td>115</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>year</th>
<th>Brazil</th>
<th>In Domestic Banking System*</th>
<th>In Banks Abroad</th>
<th>Deposits Abroad% Domestc Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>81</td>
<td>47.7</td>
<td>3.7</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>82</td>
<td>49.6</td>
<td>3.1</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>83</td>
<td>35.1</td>
<td>8.1</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>84</td>
<td>38.4</td>
<td>8.2</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>85**</td>
<td>38.7</td>
<td>8.5</td>
<td>22</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>year</th>
<th>Mexico</th>
<th>In Domestic Banking System*</th>
<th>In Banks Abroad</th>
<th>Deposits Abroad% Domestc Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>81</td>
<td>70.5</td>
<td>9.4</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>82</td>
<td>32.2</td>
<td>10.4</td>
<td>32</td>
<td></td>
</tr>
<tr>
<td>83</td>
<td>36.8</td>
<td>12.7</td>
<td>34</td>
<td></td>
</tr>
<tr>
<td>84</td>
<td>45.4</td>
<td>14.3</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>85**</td>
<td>35.8</td>
<td>15.3</td>
<td>43</td>
<td></td>
</tr>
</tbody>
</table>


* Deposits (Sight, Savings and Time) in local currency converted at end of period exchange rates.
** September figures.
Table 2 details the balances held by individuals and corporations (non-banks), both domestically and abroad for Brazil, Argentina and Mexico for the years 1981 to 1985. Note from these figures the magnitude of the estimated deposits abroad. When expressed as a ratio of domestic deposits, reached 115% for Argentina in September of 1985.

The fact citizens of developing nations are willing to keep a larger share of their savings stock abroad rather than at home, and the relative importance such funds have for the local economies, should be reason enough to make every effort to identify the causes for this phenomena. Understanding the causes, a critical first step in identifying possible solutions is the central motivation for this thesis.
Causes For Capital Flight

The fact that discernible peaks of capital outflows occurring in major Latin American countries have not coincided, leads one to believe that the major causes for capital flight lie in a country’s particular circumstances. As opposed to external factors such as high interest rates or lack of interest income taxation in the United States. These source country causes, when analyzed, can be grouped as structural, political and economical. Let's look at each in detail, particularly as perceived by the Latin investors themselves and by the banking community.

Structural Causes

It is sometimes very difficult to determine if the conditions cited are causes or consequences of capital flight. For example, analyzing an obvious motivator of capital outflows, such as interest rate differentials between the domestic system and any foreign bank, poses the
problem of establishing what comes first. Real rates are influenced by currency devaluations, and exchange rates in turn are affected by capital outflows. An obvious circular form of reasoning takes place, forcing us to face a typical "chicken and egg" problem.

Albeit, in reality it is possible to identify the structural and economic roots of the problem in the government's intervention. Notwithstanding this fact, an argument will always be made that the flight of investment capital is also a cause of the structural deficiencies and economic upturns in the LDCs.

Capital flight does not occur only as a reaction to political risks. On many instances, the investor will choose to place his assets abroad because it perceives that investment opportunities in his country are deficient, either because the country remains underdeveloped in commercial and banking laws or lacks a functioning capital market. Infrastructures incapable of handling large scale operations and the small capacity of absorption of the
market are often included among the reasons investors seek to diversify their investments abroad.

These deficiencies are termed structural because the local economies will only attract a certain amount of local or foreign investment due to the institutional structures of the government, its legal systems and commercial codes. Following is an analysis of each:

**Financial Markets**

Financial markets in Latin America are not doing their key developmental role of eliciting higher savings efficiently. And they are not geared up to attract significant reflow of residents' assets now held abroad.

The problem lies in government policies. Until public sectors in Latin America are cut back in both scope and borrowing requirements, available savings will continue to finance inefficient bureaucracies and money-losing state companies instead of capital formation with a high rate of return. . . . . . Government financing practices must evolve away from compulsory, non-market mechanisms toward voluntary, market-determined vehicles that price capital appropriately for both public- and private-sector users. Warranted also are the dismantling of credit allocation rules and the phasing out of interest-rate subsidies, which ration capital resources to established, often inefficient companies at the expense of emerging industries.
State-owned financial institutions should not enjoy preferential treatment and should base their lending on sound economic and financial considerations. Finally, the structure of interest rates in most countries should be freed to encourage greater financial savings -- at home rather than abroad.'

The reform of financial markets cannot be carried out in isolation from supporting macroeconomic policies. This is the lesson of successful reforms elsewhere. Among other reforms to improve growth prospects, debtor countries must raise investment and increase productivity, eliminate subsidies and protection of money-losing government owned enterprises. This, in turn, requires expansion of domestic savings, the reversal of capital flight and efficient allocation of resources. If financial market reforms and structural changes, as the ones discussed here, are carried out to remedy existing deficiencies, then the inflows of foreign capital can make and enduring and positive contribution to Latin American economic growth. Latin investors faced with developmental problems in their home countries and with the option to participate in fully

' World Financial Markets April/May 1986, page 10
developed international capital markets confront the tough choice: national loyalty versus rational self interest.

**Capital Markets**

Except for the larger Latin American nations, most LDCs do not even have an organized market where stocks or commercial paper can be traded. The lack of developed capital markets does not allow for the masses or institutions to invest in assets that could show capital appreciation. This factor, coupled with the shortage of available long-term credit, limits most enterprises to be individual investments or limited partnerships. Though statistics might show a high proportion of public corporations registered to operate in the LDCs, in effect they are very closely-held family corporations. Few have their stock publicly traded.

**Legal Systems**

The poor design or inconsistent application of the law is also considered one of the structural causes for
lack of additional capital investment in the region. For example, few LDCs have commercial codes that permit a supplier to force a creditor into bankruptcy proceedings, and have the courts liquidate its assets in order to collect a chronic past due account. Poor legal support creates substantial abuse that discourages commercial credit and the normal operation of businesses as conceived in the United States.

On the other hand, the civil court system is generally slow, cumbersome and easily corrupted. This condition is very threatening to investors who fear not knowing what protection or threat to expect from the courts.

Infrastructure

Last, but also a critical factor, is the pervasive lack of adequate infrastructure caused by incompetent government operated public services and utilities. Poorly planned and outdated phone systems and postal services, highway and port installations, etcetera,
are all reasons why many industries choose not to establish in the region. This is an obstacle for investment, as the inefficiencies it creates are enough to offset comparative advantages such as low labor costs, availability of raw materials or geographic location. These limitations, coupled with the issues of political risk, are enough incentive to drive away the capital from the most loyal and nationalist citizens.
Political Causes for Capital Flight

The well publicized, often caricatured images of Latin American military rulers that get continually toppled, replaced by other military "juntas" or dictators, causes a level of unrest that constitutes the top of the iceberg regarding the types of politically caused risks to which investors are exposed in the LDC. Beyond commercial risks caused by political unrest lie a series of capricious government actions that can be destructive for business.

To bring this point across, let me share the experiences of extreme cases as related during two interviews with Nicaraguan and Peruvian entrepreneurs, both living today in Miami, Florida. The Nicaraguan investor assured he was not exaggerating when he stated that his businesses had suffered every one of the instances described below.
Confiscation

The outright takeover of the company, with no compensation being paid to the owners constitutes a confiscation. This condition will happen only in a state of anarchy, where the government wants to "punish" a scapegoat for the economic problems affecting the poor, or a large mass of voters.

Invasion

The takeover of company facilities by mobs, on occasions led by and condoned by government officials, constitutes the most typical type of invasion of property. The civil police forces look the other way and the court system offers no help or has no authority to enforce any actions by the owners.

Nationalization or Expropriation

One of the most extreme forms of political risks; an expropriation is carried out by the government through
its court systems, for the well being of the community, or to serve national interests. Owners expect to be reimbursed for the fair market value of their property.

However, in Nicaragua, nationalizations took place perceived as revenges, punishing political loyalties of the stockholders. The values of the properties were understated by government appraisers, and to aggravate matters, payment was made in the form of government bonds payable in local currency several years into the future.

In a real example, a property appraised for U.S. $3.0 million was nationalized in 1979 by the government and paid for with bonds for 30.0 million Cordobas due in 10 years, bearing a 12% interest per annum paid at maturity. (The prevailing rate of exchange in 1978 was +/- 10 Cordobas per Dollar.) This year the owner will collect his 93.2 million Cordobas which convert to U.S.$ 1,553.33. This is not a typing mistake. After repeated devaluations, today the exchange rate is +/- 60,000 Cordobas per Dollar!
These bonds could have been sold at varying levels of discount in the years before maturity, and their market value would have been higher. Yet, the point remains, the loss of one person would have been split into the loss of several. The numbers still hold to make the point of the magnitude of the risks to which investors are exposed in the region. This case is reminiscent of the way the German government deflated its restitutions debt after the war. In effect it is one way of legalized robbery, from which locals are justified in seeking protection.

According to Victor Meneses, senior corporate officer for Latin America and Africa at Citicorp, nationalization fears have greatly receded, as there has not been a pattern of them during the last eight years or so. Nonetheless, the past nationalizations of banks in El Salvador, Mexico and Nicaragua have sent tremors throughout the region. As of today, these fears are probably more localized in Central America, due to the threat posed by the communist government in Nicaragua, than in any other South American country. Table 3 shows a comparison of the frequency of expropriations by region, in the world between
1960 and 1976. One can see that Latin America leads developing regions in total number of expropriations; even though they have affected, as compared with the rest of the world, a low percentage of U.S. owned corporations operating in the region. These data say a lot about the political clout of the U.S. government with Latin nations and justifies the perceived level of risk to which domestic investors feel they are exposed to.

Table 3
Expropriations by Region, 1960 -1976

<table>
<thead>
<tr>
<th>Region</th>
<th>Total Number of Expropriations</th>
<th>As % of U.S companies in the Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>144</td>
<td>2.6</td>
</tr>
<tr>
<td>Arab States</td>
<td>78</td>
<td>20.4</td>
</tr>
<tr>
<td>Black Africa</td>
<td>39</td>
<td>8.1</td>
</tr>
<tr>
<td>Asia</td>
<td>31</td>
<td>2.2</td>
</tr>
</tbody>
</table>

**Intervention**

Intervention by the government can take many forms; from subtle controls exercised by government organized unions, to the outright appointment of government officials to administrative or board of directors' positions. This type of actions inhibit the normal operation of business to such a degree, they may eventually destroy it.

**Special Taxes**

Special taxes are taxes levied on a particular industry, as opposed to applying equally to all enterprises. In Nicaragua, the investor held these actions were taken with the intention of causing harm to a particular business in order to control it eventually.

**Removal of Protection**

Some companies are able to exist in developing countries only because special barriers for entry were
imposed on foreign competitors, they had been exempt of certain taxes or granted access to subsidized financing. These special treatments are offered industry wide, and for a predetermined numbers of years. A surprise lifting of this protection before the originally offered time period expires, practically eliminates the companies' ability to operate.

**Price Controls**

A venture can easily be destroyed if it is forced to sell some of its products at a given price level, regardless of its costs. The obvious option, simply to stop selling price-controlled, money-losing items is not necessarily feasible. A company manufacturing pharmaceutical products will expose itself to immediate nationalization if it refuses to sell inventories of products the government considers "basic necessities" for the masses. Laws against "hoarding and speculation" capriciously created and liberally applied, bring court orders to sell inventories, fines to the firm and jail terms for its managers. The true goal is to distract
public attention and to shift the blame to the private sector for ill designed public policies.

It is easy to imagine why price controls are one of the first factors that force otherwise law abiding managers to operate their companies outside of the law in order to survive. Customers needing supplies and understanding the irrationality of the system, will accept an invoice for the official price, and pay the balance (to cover the true mutually agreed price of the product) in cash. The corporation uses this cash to purchase other price controlled supplies or keeps it as unreported profits. This is usually the beginning of an underground economy, securely rooted in these types of government actions.

A Peruvian investor related a case where these price controls almost forced the closing of a cereal manufacturer. The government, in an effort to help local growers of grain, prohibited imports and imposed minimum

¹⁰ The type of industry has been disguised in order to hide the identity of the subject.
prices that were higher than world market ones. The price of the finished product was set at a level that was well below its costs using domestic raw materials. Facing huge losses, the producer requested permission to import its raw materials at the lower world prices. Even after offering to use its own sources to secure the foreign currency needed, the request was denied. Facing bankruptcy, the government eventually revised the price structure, allowing the company to continue to operate. Resilient management and entrepreneurial ownership are tested to their limits in these instances.

**Employment and Wage Controls**

A company can be forced to pay fictitiously high minimum wages, or to maintain a larger work force than needed. Sometimes unions are granted the authority to decide who is hired or who can be fired, and when. Surprising as it may sound, companies can also be prevented from paying higher wages when needed, thus promoting the desertion of qualified personnel. This last case particularly applies to managerial positions, justified by
the myopic view that management serves no "productive" function. Managers' high salaries are perceived as taking away income from those in the general labor force.

**Calling In of Loans**

Corporations suffer chaos when the government takes control of the banking system and proceeds to call in existing loans, or with the same effect, refuses to provide additional lending. Often this step is done to permit the government's "legal" intervention of a business in a way that is sure not to create the international repercussions nationalizations do.

**Intimidation**

Officers or executives of a company can be intimidated by government officials or by a government organized union. Damage is caused by promoting the desertion of qualified personnel and by disrupting the normal operations of the company when threatened executives feel forced to leave the country.
One of the most damaging types of intimidation occurs in the form of kidnapping. This is a risk that has been dealt with very efficiently in developed countries due to the integrity and efficiency of the security forces. But in many countries of Latin America, kidnapping of executives and family members of stockholders occur constantly and without apparent control of the authorities.

Businesses are forced to invest substantial amounts of capital protecting both executives and facilities. These expenditures are totally unproductive and contribute to decrease the level of productivity of the firm.

Devaluation

Without getting into any analysis of the causes for this complex phenomenon, it is important to mention it, as it threatens particularly those companies that do not export, and those that have liabilities in foreign currencies and their assets are not necessarily
convertible. Intentionally, currency devaluation is being listed among other political risks. This is based on the conviction devaluations are mainly the direct result of incompetent government actions and not purely of exogenous economic conditions.

**Exchange Controls**

The government through currency exchange controls can inhibit the payment of foreign private debts, making the local operator lose its international credit ratings. This happens when an importer is required to deposit, in local currency with the central bank, all remittances owed to foreign suppliers. The Central Bank in turn will emit, against its deposit accounts abroad, a cashier's check in the name of the supplier which the company forwards. The problem originates when hard currencies are scarce. A backlog "dam" builds up at the central bank, manifesting itself first in the form of processing delays of 3 to six months. Eventually the Central Bank is confronted with the option of "paying" with debentures, in lieu of cash.
This action brings about the immediate downgrading of the credit rating of the country. So even if the firm managed to keep its commitments by using its own private reserves of foreign currency, it will no longer be able to secure open account terms from any supplier in the world! The firm might not lose its credit rating, but suppliers discounting their portfolios of accounts receivables with their banks will soon find those accounts domiciled in that country are no longer considered eligible; or just as bad, credit will be refused because of the supplier's own exposure with other past due customers in that particular country. The loss of commercial credit from suppliers, usually not requiring specific collateral from the firm, can be devastating to cyclical operations such as agriculture and commerce, creating huge pressure for additional capitalization. In the case of my family's business, a retail chain of supermarkets and variety stores in Guatemala, this aspect alone motivated the opening of a subsidiary buying office in the United States; an entity that would be free of this country credit stigma.
Physical Destruction

In this point I want to identify the risk of the destruction of property caused by non insurable events, such as revolutions, civil turmoil, malicious acts and terrorism. Applying the war exemption clause of insurance policies, some times riots and mob actions are refused coverage by normal hazard insurance policies, as these events are linked to larger national disturbances.

To deal with such elements of political risk, as mentioned above, huge amounts of top management's time and corporate resources are needed. This waste is one fact often ignored, that contributes to make LDC enterprises uncompetitive with the rest of the world.
Economic Causes for Capital Flight

One of the major causes of capital flight has been the erratic returns obtained from the financial markets in most of the LDCs. In Argentina, Mexico and Brazil, the masses that participated in the banking financial markets with their savings deposits, have lost fortunes through devaluations and inflation. Adjusted for inflation, depositors have received, in effect, negative rates of return. The ones that waited, in a few years basically lost their assets.

Figure 1 presents graphically the real rates of return obtained by saving accounts deposit holders in those three countries between 1981 and 1986. In the graph, nominal saving rates of return were deflated by the consumers' price inflation index of each country. Notice that using this method of computation, during this period Mexico did not ever yield a positive rate of return on a savings account. Argentina's CD rate, on the other hand, erratically ranged its yields from -60 percent in one
quarter, to as high as +108 percent in another. Brazil has allowed the market (or has succeeded in following it), to set the pricing of savings return rates, with the result of achieving, in this aspect at least, more stability.

These rates of return correlate well with the patterns of capital flight in each of these countries. From these data alone, it is not surprising that Brazil has had the least problem of capital outflows of the three major Latin American LDCs. An investor, in any of these countries, would be almost irrational not to protect its hard earned savings by removing them from the system entirely. Or at least, exchange them in to hard convertible assets that might prove to be more inflation proof.
Real Interest Rates for Saving Accounts 
Three Major Latin American Countries 
1981 - 1985

**Argentina 30 day CD rate regulated until March '85, free rate thereafter.**

published by Morgan Guarantee Trust Co., New York
Figure 2 presents a graphic comparison of the trends in domestic savings formation in the same three
major Latin countries, and compares it with that of the United States. The effect of the erratic returns in the market, in the rate of savings formation and accumulation, is obvious.

This point is even better made when we compare the rate of return differential between a U.S. dollar denominated deposit with one of equivalent amount in a LDC. The differential is calculated by depositing an amount in the United States in a regular savings account, and the equivalent exchange in a LDC. Ninety days later, the returns of each, capital plus interest, are converted back to U.S. dollars at the exchange rate of the day. The percentage difference between the two amounts is plotted in Figure 3 for Argentina, and Figure 4 for Mexico.

An investor would have made on average 39% less per year in Argentina, and 5.3% less per year in Mexico, if compared the returns of a low-yielding savings account in the U.S. From the data analyzed before, one can see investors had very good reasons to take their moneys out of Latin America. And that is what they did, as suggested by
Figures 3 and 4 that also depict capital outflows in those countries during the same period. From these graphs it is possible to see the direct correlation the movements of capital have with the returns on deposits.

![Argentina Rate of Return Differential and Capital Flight](image)

*Realized rate of return differential between domestic CDs in the U.S. and Argentina

Source: *World Financial Markets*, April/May 1986
Kyung-Mo Hu, senior economist at the Exchange and Trade Relations Department of the International Monetary Fund (IMF), expressed that the creation of a futures market
for currency exchange would help create the right environment for the repatriation of flight capital. A futures market would enable local investors to protect themselves from the risks discussed in this section. Hedging currency devaluations is impossible with monetary instruments in most Latin American countries. This deficiency should be included among the structural deficiencies of most developing economies. In fact, the IMF links capital flight directly with restrictions to the conversion of currency and the inability to protect oneself from devaluation.

Note that averages of return differentials can be very misleading. A difference of 5% over several years might not seem as too big, but one single quarter with 50 or 60 percent differential is certainly an overwhelming motivator to take one's money out the local currency, and even better, deposit it out of the country. To bring those deposits back, the incentive must be even greater because of the investor's perception that the same risk may occur again at any unpredicted moment.
Also, it is important to remember, that devaluations in Latin America are usually measured in terms of the U.S. dollar. If the investor reasonably computes returns in terms of the Deutsche Mark or the Yen, in certain periods it could increase the differential substantially. In risk adjusted terms, the return differential between a deposit in any LDC and a conservative investment in a developed country, makes capital flight an economic imperative for the rational investor.

A few export industries with substantial local value added activities manage to maintain themselves ahead of inflation always under grave danger of losing terrain. Even these companies, investing their local currencies in fixed capital assets are not protected from the side effects of inflation. The premise that an asset is simply worth more units of local currency after devaluations, is not necessarily true. Fixed assets do not provide protection enough because of huge time lags in the adjustment of prices. These lags are mainly caused by the companies' inability to obtain financing in the market. As
deposits flee into hard currencies, the banks are left with no funds to support their lending activities. (Refer again to Figure 2 in page 42, for the cumulative dollar value of domestic deposits in three major Latin American LDCs.) This factor, coupled with the lack of demand for capital goods in a recession, depresses market prices to levels well below their replacement values.

Most companies find it impossible to carry the burden of interest rates that attempt to predict future inflation rates and protect the bank from this risk. Thus are unable to finance inventories, plant and equipment, eventually going bankrupt. This point is difficult to imagine for someone that has not operated a business in a country exposed to such hyperinflation. The experiences of Peruvian investors interviewed brings this point forward dramatically.

In the recent past, the official" interest-rate in Peru was of 120% per annum. But to protect itself from

"In Peru, just as in many LDC economies interest rates are imposed and regulated by the government.
unpredictable and escalating devaluations, the nominal rate charged by the banks ended up being equal to 520% per annum. To go around the rate controls imposed by the government, the borrower is asked to sign a note for a higher amount than the one received, and the bank proceeds to take its interest charge up front. Just imagine the cost of financing imported inventories of raw materials, given the government's requirement that the importer deposit 50% of the value of its imports at the time the import licence is requested. The approval normally took months and thus with great delay one could expect to give start to the long process of the importation.

Local investors in LDCs don't yet feel comfortable enough in terms of the macroeconomic swings in the region. In the United States, as in all industrialized nations, investors have sought to limit their risks and exposure in a particular industry through different forms of diversification. One of these processes, the precursor of the multinational corporation in a stable environment, is known as conglomeration. Through conglomeration a
corporation diversifies into unrelated fields within its own territory.

As businesses in individual markets become riskier, investors naturally seek to limit the losses they would suffer in any one line of business by diversifying their interests. The management of assets at risk is one of the things to which Neo-classical Economics is well suited; this school of economics convincingly argues that in certain circumstances, diversification (meaning across industries in one market) would contribute to economic efficiency and growth.¹²

In a country where investors fear economic instability will eventually endanger all areas of the economy, the option of conglomeration is not a solution.

Neo-classical theory shows that when investors in a decentralized economy cannot balance possible losses in one line of business against possible gains in others, they prefer to hold safe but low-yielding assets.¹³

So capital flight takes place as a response to economic instability and the difficulty to diversify risks.


¹³ ibid
domestically, drawing productive resources out of the country, eventually causing a slowdown of the economy.

Another aspect of the great relevance economic conditions have in motivating capital outflows is the element of long term expectations. In the U.S., the historical propensity to accumulate retained earnings is a reflection of the long-term expectation of stockholders that their investment will continue to produce higher returns in the hands of corporations than in their own. This propensity is strengthened by the tax code. In Latin America, on the contrary, companies usually return, in the form of dividends, reserves to their stockholders, which in turn use the cash to diversify their own portfolios. Individuals, having much more flexibility than corporations, find it easier to secure their assets usually abroad.

The ever visible hand of Government intervention in the market pricing of factors of production causes additional incentives for capital outflows. For example, the Guatemalan government that has historically controlled
the interest rate structure banks may charge, in 1978 fixed loan rates to a maximum of 11% per annum. At the time, long term, high grade commercial paper in the U.S. was yielding returns of up to 20%, and bank insured certificates of deposit 17%. An investor could exploit this arbitrage by borrowing to his capacity in Guatemala, converting the proceeds of his loan in local currency into dollars and finally depositing it abroad. Then, offering as collateral his U.S. deposits, take out a new loan in Guatemala to repeat the process. The same advantage was taken by local subsidiaries of multinational corporations, which borrowed in excess of their needs in order to transfer the low cost of funds to affiliates abroad.

Such distortions in the market precipitated the devaluation of the Guatemalan Quetzal, as it was impossible to hold the official rate of exchange against such pressure. This phenomenon created unusual demands on the banking system, pushing all institutions to their legal lending limits and, obviously, drying up available resources critically needed to finance working capital of local enterprises. In a financial system free to react to
market forces, such demand would have caused interest rate
increases. Thus, eliminating the arbitrage opportunities
and with it the element of fictitious demand.

With this we complete the section that attempts
to narrow down the causes of capital flight, and turn to an
analysis of its consequences and implications for different
stakeholders. The purpose is to identify who benefits from
reversing capital outflows, and eventually who would be
willing to support an insurance scheme to achieve it.
Consequences and Implications of Capital Flight

For Less Developed Countries

The first and immediate consequence of capital flight is the deterioration of the balance payments accounts of the nation. Foreign exchange reserves are reduced to levels that are insufficient in most cases to absorb more than a limited proportion of the initial impact of any crisis. In most LDCs, reserves have been reduced below levels that would provide even the barest minimum of operational flexibility for short-term economic management. This has forced most developing nations to carry out austerity programs, reducing imports of all kinds.

Countries differ considerably in the extent to which they can compress imports without suffering adverse effects. "Much depends on the degree and promptness with which a country can shift resources from domestic consumption to exports and provide domestic substitutes for
imports. This type of flexibility is in turn a function of the stage and development of the industrial sector."

The lack of capital investment in developing nations of Latin America is one of the fundamental causes for the backward conditions of the region. In this point there is agreement even among the extremes of different political system ideologies. Elyanov, a communist economist states in this regard:

Capital investment in developing nations is highly important for several reasons. First because technical modernization of the economy has to be accomplished in a very short time, bypassing the intermediary stages that Western Europe went through during the industrial revolution. Second, modern technology being introduced is much more expensive than that used when the now developed nations went through that stage. Thirdly, modern technology requires skilled labor forces and consequently, considerable investment in general and special education, health services, etc. Fourth, industrialization in developing nations requires the accelerated development of transport, trade, services and other elements of the productive infrastructure. Finally, the question of providing jobs and means of subsistence to the

rapidly expanding population is acute in these countries as never before."

Without capital investment there is never enough competition for the factors of production; be it human resources, technology, raw materials, physical plant, etc. This keeps salaries from raising, consumption from growing and causes a continuous stagnation of GNP growth. Stagnation causes another problem about which little has been written; talent flight from the LDCs. Sergio Garcia-Granados, Senior Vice President and Financial Consultant at Shearson Lehman Hutton, commented that even though for the middle and high classes, Latin America provides many comforts that would be very costly in industrialized nations, the lack of opportunities force many educated individuals to seek better fortunes abroad. This symptom can be easily measured at American Consulates by the perennial visa requests for permanent immigration to the U.S.. Additional capital investment from the private

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15 Elyanov, A.Y. (1977) Economic Growth and the Market in the Developing Countries Progress Publishers, Moscow
sector would quickly reverse this trend, Garcia-Granados added.

Population growth causes that when GNP is measured on a per capita basis, most LDCs show negative rates of growth. Negative per capita GNP growth assures that the distribution of wealth continues to polarize. This is caused by the fact that the more productive segments of the population, usually the more educated/high income groups are better prepared to deal with inflation and the likes, and tend to hold or improve their conditions. So when the averages decline, the poor usually get poorer. This is one of the most damaging results of lack of investment; impossible to revert by government policies oriented to the redistribution of wealth, and not to the creation of it.

The economic impact of this polarization on national savings is not trivial because the rich in developing nations tend to have low saving rates, and the poor are not able to save at all. Cline states one form of this argument in that upper income groups in developing
countries have relatively low incomes when compared with those of their counterpart classes in Europe and the U.S., whose consumption patterns they nevertheless imitate. The relevance of Cline's study for this thesis is that this aspect contributes to aggravate the impact of capital flight. The already low per capita savings of developing nations is stored outside of the country.

But back to the point, among the first repercussions of the disinvestment caused by capital outflows is the slow rates of real GNP growth. According to Thirlwall evidence exists there is a strong correlation between the rate of growth of income (adjusted for population growth) and the investment ratio in a given economy. In developed countries there is a stronger association between the growth of total income and the investment ratio, than between growth of per capita income and the investment ratio. As shown by from Table 4, there


is a high correlation between the rate of domestic savings formation, and gross investment, both expressed as a percent of GNP.

Table 4
Savings and Investment as a % of GNP, Average 1960 - 67

<table>
<thead>
<tr>
<th></th>
<th>Domestic Savings (S/Y)</th>
<th>Gross Investment (I/Y)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>16.3</td>
<td>17.7</td>
</tr>
<tr>
<td>Africa</td>
<td>13.1</td>
<td>16.7</td>
</tr>
<tr>
<td>South Asia</td>
<td>11.3</td>
<td>13.9</td>
</tr>
<tr>
<td>East Asia</td>
<td>11.0</td>
<td>15.6</td>
</tr>
<tr>
<td>South Europe</td>
<td>21.5</td>
<td>24.9</td>
</tr>
<tr>
<td>Middle East</td>
<td>14.8</td>
<td>19.8</td>
</tr>
<tr>
<td>Average for LDCs</td>
<td>15.0</td>
<td>17.8</td>
</tr>
<tr>
<td>&quot; Developed Countries</td>
<td>21.7</td>
<td>21.2</td>
</tr>
</tbody>
</table>


I perceive the problem as a self fueling spiral; a form of vicious circle as depicted in Figure 5. Investment, is a precondition for economic growth, which is usually necessary for a country to sustain political
stability (as the voting population will have every reason to support the status quo). A politically stable country is considered to post a lower risk to investors. So when evaluating investments in risk adjusted terms, this becomes an incentive motivating normal domestic savings ratios. High levels of savings provide the capital base for financial institutions to fuel and lubricate capital investment, which again allows for economic growth, starting the circle again.

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Figure 5
The Investment Spiral

Political Stability

Insurance

Economic Growth

Confidence

Investment

Savings
In this spiral, the "Confidence" link is the only one insurance can reinforce. Confidence alone will not be sufficient to sustain flow in the spiral. Other structural factors, as discussed before, must be addressed if minimal political stability and order is to be achieved.

The impact of reversed capital flight may be of tremendous proportions for developing nations. A priori, as discussed above, resource inflows are expected to influence positively the domestic savings formation, apart from supplementing it. Given that the savings rate -- average and marginal -- is regarded as a key economic indicator, reversed capital flight could improve the credit worthiness of developing nations. I have not been concerned for any negative impacts of large capital inflows into developing nations. Nonetheless, the 70s have seen a growing debate on this issue, arguing that such flows can have inflationary effects and that "external resources have little effect on growth because they tend to work as a substitute for indigenous savings; the rate of return on
inflow-financed projects is low, and the cost of capital soon becomes a burden on the recipient economy."

This would not be the case necessarily with reversed domestic capital inflows, as they would simply go to form part of the stock of foreign currency reserves of each country, foreign currency exchanging for the local currency of importers, without the need to increase the money supply. In fact, in the United States, foreign deposits are already counted as part of the money supply, and as such, turn over against exports and imports, i.e., goods and services, and are used in making and unmaking domestic investments by foreigners." The rest of the argument, I consider total nonsense for the following reasons:

Statistical analysis point out that if any single factor is to be associated with underdevelopment, it should

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indisputably be scarce capital. Certainly, it would be an over simplification to regard economic growth as a matter of capital accumulation alone, as other factors, as mentioned before, are also needed in conjunction. But economic growth is not possible without some increase in the stock of capital.

An empirical study showed that compared with the U.S. and Northwestern Europe, capital investment has been a more important source of growth for the LDCs of today. For great many of the LDCs, the inner mechanics of take-off involve a problem of capital formation, for which there are materially two ways: domestic savings and inflow of foreign resources . . . . The fact that the inflow of foreign resources can catalyze economic growth cannot be over-emphasized.20

When a country faces binding foreign exchange constraints -- and more often than not that is the case for LDCs -- external resource inflows can have a discernible impact on growth. It matters little if the transfer is of a small fraction of the domestically available resources. For example, Manne found that the optimal use of a relatively small ($75.0 million) increase in foreign resources . . . .

20 Das, Dilip K. (1986)
exchange availability to Mexico would step up annual growth of the industrial sector from 5.5% to 8.0%. Manne has been criticized for overly optimistic interpretation of his results, but nonetheless, the importance of external resources is clearly made by his research.

Zysman agrees with this position, stating that fast growing countries have higher rates of savings and gross investments. Differences in investment, productivity and growth finally will reflect themselves in the patterns of each country's development of international trade: fast growth countries will see their share expand, while slow growth countries will see it contract. As stated before, this is probably the most devastating consequence of flight capital, as it also occurs in parts of the world that have some of the highest rates of population growth. Fast growing populations and slow growing economies are the main ingredients in a recipe that guarantees turmoil is in store for the future of a nation.

21 Das, Dilip K. (1986)

22 Zysman, John (1983), Governments, Markets and Growth, Cornell University Press,
Consequences and Implications of Capital Flight

For The U.S. Banking System

Any return of capital or even the stemming of capital outflows will have a substantial effect in strengthening the asset positions of Western bankers in Latin America. As it stands today, Cline believes the high exposure of Western bankers in developing nations mean that, even more than before, the success of export expansion in those countries will affect not only their own development, but also the stability of the international financial system.\(^3\)

In Mexico alone, at the end of 1982 exposure in relation to capital exceeded 40% in nine of the twelve largest U.S. banks. Taking Latin America’s five biggest borrowers together (which listed in order of debt size are: Brazil, Mexico, Argentina, Venezuela and Chile), the

exposure of the same dozen banks ranged from a low 82.5% of capital (for Security Pacific Bank) to a high of 262.8% (for Manufacturers Hanover Bank), with most banks falling in a range of 140 - 180 percent. The banking system was, and still is quite vulnerable.

Though continued increases in loan loss reserves will cushion the effects of a potential series of loan defaults from Latin America, the banking system would suffer deeply if they would ever happen. Please refer to Table 5 for data on the outstanding foreign debt balances of the major Latin debtors.

Table 5

Foreign Debt of Major Latin Debtor Countries
at years-end 1988, in billions of dollars

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>$120.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>107.4</td>
</tr>
<tr>
<td>Argentina</td>
<td>59.6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>35.0</td>
</tr>
<tr>
<td>Chile</td>
<td>$20.8</td>
</tr>
<tr>
<td>Peru</td>
<td>19.0</td>
</tr>
<tr>
<td>Colombia</td>
<td>17.2</td>
</tr>
<tr>
<td>Bolivia</td>
<td>5.7</td>
</tr>
</tbody>
</table>

On the other hand, bankers have the dual role of being the recipients of flight capital, and for years have enjoyed substantial profits deriving from syndicating loans to Latin America. So by reducing deposits abroad, a scheme to reverse capital flight poses a potential dilemma for the banking industry. The importance of flight capital as a potential source of deposits to big banks is evident. It has obvious advantages over other sources of deposits. The Swiss experience suggests it is possible to facilitate flight capital and keep its whereabouts secret in exchange for below-market interest rates on the deposits they receive.

Flight capital . . . was often different in practical terms than it appeared to be in accounting terms. If its origins were sufficiently dubious, the need for secrecy might well make it behave less like a "deposit" and more like the long-term capital resources of the financial institutions. This is an attribute of flight capital the Swiss and Hong Kong banks had long appreciated.24

But U.S. and Western Banks, are more vulnerable in the area of the quality of their assets (loan portfolios), than in any reduction of deposits. The liquidity existing in the market is of such magnitude that any reduction of deposits stemming from reversed capital flows to Latin America would not make any significant difference. If the Japanese or the Arabs removed their deposits from the U.S., that would make a real difference to the industry.25

This line of reasoning creates a series of topics worth pursuing. In the past, the United States has acted as a banker to the rest of the World, and in particular to Latin America. The deposits of successful private banks rise year after year, as they did in the United States. Other countries and foreign individuals were like firms banking in the U.S. In my view, the nation historically pursued policies to attract foreign capital, such as supportive legislation, income tax exemption on interest

25 Gonzalo de las Heras
income, federal deposit insurance programs, and allowing for certain privacy of information.

Opposing this view, in early 1966 a draft memo on flight capital was circulated among economist at Chase Manhattan Bank. The memo held that U.S. banks were at a disadvantage in competing for flight money with the Swiss and other international money centers, mainly due to the following aspects\(^2\):

a.) ability for the C.I.A., F.B.I., U.S. Treasury and the Justice Department to subpoena clients records.

b.) U.S. restrictive investment and brokerage regulations which limit the secrecy of investment activity.

c.) U.S. estate and withholding tax on foreign investment.

\(^2\) Naylor (1987), page 33.
d.) role of the U.S. in the Cold War, exposing deposits or assets to a freeze as a result of it.

e.) the generally held view by sophisticated foreign depositors that U.S. investment managers are naive and inexperienced in the manipulation of foreign funds, especially in foreign markets.

Chase Manhattan's Bank concerns were unfounded. As a banking center the U.S. has broad appeal; the dollar is the world's leading reserve currency, the country has unmatched stability, negligible probability of revolution or confiscation, and a negligible probability of inconvertibility. Those are powerful arguments for individuals seeking refuge from political risks. As such, the industry has enjoyed handling the recycling of loan moneys and being the banker of first choice of wealthy Latin Americans, (much in the same way it handled the recycling of the Arab petro-dollars).

I believe this unique function performed by U.S. banks influenced their behavior, as evidenced by their loan
allocation, country risk exposure and pricing decisions in Latin America. This behavior has been less in response to the actual economic performance analysis of a given country, than to factors such as the overall lending environment and each bank's characteristics.

Few Banks, for example review the accuracy of their initial forecasts against the country's actual economic performance, and thus do not assess the reliability of their methods of credit country risk analysis.

Since the eruption of the debt crisis and widespread rescheduling exercises, the banks' herd instinct has prompted a 180-degree switch to a strong lending bias against developing countries. . . . The changes in the international environment have been paralleled by improvements in the quality and use of country risk analysis by all segments of the international community.27

Hopefully then, reversing the flows of capital flight would reinforce the individual economies in the region, and that coupled with improved country risk analysis and the strengthening of the asset positions of

the banks, would again open the doors for badly needed lines of credit for the region.

The failure to achieve these goals expose the banking industry to be pressed to accept de facto actions by the federal government, that concerned with the political and economical stability of the LDCs is pressing for the outright forgiveness of the loans. At stake are an estimated $400 billion in outstanding debt to the banking industry, which needs to be drawn out of the "uncollectible accounts" into performing loans in order to minimize the damage of the write-downs on the bank's balance sheets.

As proposed now, only those countries that meet the stringent criteria of the federal government will be eligible for debt reduction plans. Countries which impose strong IMF-approved economic reforms and can show they are recapturing their citizens' private capital from abroad,

*As published in the Wall Street Journal, the Bush administration announced in March 1989 that it was supporting a proposal to cut debt principal and interest payments by 20% to 39 debtor countries.*
will be entitled to use the special measures to cut their debt burden presently being proposed by Washington.\textsuperscript{29} Assuming the details of these new proposals from the Bush administration get ironed-out, any program that entices the return of private capital would be a valuable tool to help a country obtain such concessions.

Restoring private financial flows from nationals to the region would have major positive effects for the banking industry. Helping to achieve it, is where the idea of investment insurance for locals may play an important role. If the region regains its credit worthiness and returns to the marketplace, new loans and foreign capital inflows are more likely to happen. As a corollary to the improvement of the banks holdings of LDC debt, the market will reward the banks with substantial price increases of their stock.\textsuperscript{30} Even though the proposed plans of debt


reduction would imply the banks would lose some money, in exchange, through World Bank and IMF guarantees, they would acquire more credit-worthy debt and thus make future losses less likely. Significantly, most losses would be absorbed by the loan-loss reserve provisions already existing in the bank’s books.

One element of this plan, the Banks must watch for is the proposal to identify, and possibly tax on behalf of Latin governments, foreign deposits in U.S. banks. Although this idea is aimed at making U.S. deposits less attractive for Latin depositors and thus contribute to stem capital flight, and thereby contributing to retain capital for the repayment of debt, it can trigger exactly the opposite reaction.

Taxing only citizens of developing nations poses innumerable problems. Among the most obvious ones lies the fact that such policy goes contrary to the spirit of the U.S. constitution and as such, could not be applied only to citizens of arbitrarily selected countries. (And applying it across the board would cause devastating effects to the
liquidity of the financial markets.) Second, the intended
effect would be eliminated if the same policies are not
consistently followed by Switzerland and other major
European banking centers. Latin investors and money
managers at the U.S. brokerage houses are not stupid, and
they would simply shift their customer's deposits to
friendlier pastures. Third, it can be practically
impossible to enforce because of the difficulty to identify
the true nationality of accounts. Deposits in the name of
corporations domiciled in "tax-haven" nations guarantee the
secrecy of whom the real owners are, and legally such
accounts bear the nationality of that host country. It is
not by coincidence that those so called tax-haven nations
do not have capital flight problems.

Clearly making the point of the difficulty of
tracing accounts, William Mulroand, CEO of The Bank of
Montreal claimed in the autumn of 1985 when queried on the
efficacy of the bank regulatory apparatus stated: "I can
hide money in the twinkling of an eye from all the
bloodhounds that can be put on the case, and I would be so
far ahead of them there would never be a hope of unraveling
the trail. I am not kidding you. Technology today means that this sort of thing can be done through electronic means.31"
Consequences and Implications of Capital Flight

For The United States

There is serious concern in the U.S. for the stability of Latin America.

Why the [U.S.] government has taken such an active role in the crisis is not difficult to discern. On broad foreign policy grounds, Latin America has always been regarded as a region important to U.S. national interests. From the moment Mexico's difficulties began, there was never any doubt among policy makers that the security of the United States, rather than just Mexico's, was at stake -- that the United States too would be threatened by serious economic or political instability south of the border. Nor was there any doubt that the contagion of disorder could spread to other Latin American nations as well. [The U.S.] simply could not ignore the potential for chaos in its own backyard, which might be sparked by financial default.32

Without doubt, U.S. trade has been hurt ever since the debt-crisis erupted seven years ago. The administration fears that without easing the staggering

debt burden, fragile Latin democracies -- which have receded or achieved little or no economic growth since 1982 -- might fall, sparking takeovers by the radical left or the military right. Also a growing number of economists think a reduction of Latin debt, the return of private capital that has fled and the restoration of private financial flows in Latin America is key for continued U.S. economic growth.

By The Wall Street Journal’s estimates, U.S. businesses have lost $75 billion in exports since the debt crisis forced Latin nations to devote ever more of their foreign exchange earnings to service loans. Yet, this figure can be quite conservative if one considers that by 1982 the region had surpassed all but Western Europe as a market for U.S. goods and that Mexico alone, became the third largest customer of the United States. Once the crisis broke out, additional to loosing export business, commerce and real estate in the American south was seriously damaged.

Government officials never tired of stressing how many exports, hence how many jobs, would be lost if something were not done for troubled debtor nations. Washington's efforts to support these countries' financial stability could yield significant foreign policy dividends and domestic political gains. The motives were summarized by Paul Volker:

The effort to manage the international debt problem goes beyond the vague and generalized concerns about political and economic stability of borrowing countries . . .. The effort encompasses also the protection of our own financial stability and the markets for what we produce best.31

The natural markets for what the U.S. produced best were hurting. With South America alone, the U.S. trade balance shifted from a $1.1 billion surplus in 1981 to a $11.7 billion deficit in 1985 as a result of a 9.1% fall in exports combined with a 35% surge in imports. This turnaround largely reflects the LDC debt crisis.

These figures do not yet give us the whole picture of how much the Latin American debt crisis affected U.S. trade. Consider the following reasoning, and deduct from the tally of the balance of trade all imports of mineral fuels and lubricants. The presumption is that the U.S. will import oil if it needs it, so to include it in the balance of trade with Latin America distorts the picture of a true loss of competitive advantage or of the economic problems suffered by either part.

So if oil is taken out of the computations, in 1981 the U.S. enjoyed a trade surplus with South America of $8.1 billion, $2.2 billion with the Caribbean basin and $10.8 billion with Mexico, for a whooping total of $21.1 billion in one year alone. This surplus deteriorated to a net deficit of $1.2 billion in 1987, caused by a decline in exports to the region and a surge in imports. Note that these figures are not adjusted for inflation; so, had the region not suffered the drastic strains of the debt crisis, its purchases should have maintained a similar pace with U.S. imports from the region.
Table 6

U.S. Balance of Trade By Regions, 1981, in millions,
(Imports Exclude Trade of Mineral Fuels and Lubricants)

<table>
<thead>
<tr>
<th>Region</th>
<th>Imports</th>
<th>Exports</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>2508</td>
<td>7594</td>
<td>5086</td>
</tr>
<tr>
<td>South Africa</td>
<td>2508</td>
<td>2910</td>
<td>402</td>
</tr>
<tr>
<td>Planned Economies</td>
<td>3181</td>
<td>7872</td>
<td>4691</td>
</tr>
<tr>
<td>Middle East</td>
<td>1468</td>
<td>13934</td>
<td>12466</td>
</tr>
<tr>
<td>Other Asia</td>
<td>7948</td>
<td>8030</td>
<td>82</td>
</tr>
<tr>
<td>East Asian NICs</td>
<td>21914</td>
<td>14781</td>
<td>-7133</td>
</tr>
<tr>
<td>Non E.C. Europe</td>
<td>8717</td>
<td>12795</td>
<td>4078</td>
</tr>
<tr>
<td>European Community</td>
<td>37324</td>
<td>51672</td>
<td>14348</td>
</tr>
<tr>
<td>Japan</td>
<td>39678</td>
<td>21640</td>
<td>-18238</td>
</tr>
<tr>
<td>Australia</td>
<td>2641</td>
<td>5179</td>
<td>2538</td>
</tr>
<tr>
<td>New Zealand</td>
<td>819</td>
<td>920</td>
<td>101</td>
</tr>
<tr>
<td><strong>Sub-Total</strong></td>
<td>128906</td>
<td>147327</td>
<td>18421</td>
</tr>
</tbody>
</table>

| Canada                  | 37133   | 39399   | 2266    |
| Mexico                  | 7007    | 17780   | 10773   |
| Caribbean Basin         | 4414    | 6590    | 2176    |
| South America           | 9539    | 17675   | 8136    |
| **Sub-Total**           | 58093   | 81444   | 23351   |

| Total                   | 186999  | 228771  | 41772   |

Table 7

U.S. Balance of Trade By Regions, 1987, in millions

(Imports Exclude Trade of Mineral Fuels and Lubricants)

<table>
<thead>
<tr>
<th>Region</th>
<th>Imports</th>
<th>Exports</th>
<th>Balance</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>2229</td>
<td>4209</td>
<td>1980</td>
<td>38.93%</td>
</tr>
<tr>
<td>South Africa</td>
<td>2048</td>
<td>1281</td>
<td>-767</td>
<td>-190.80%</td>
</tr>
<tr>
<td>Planned Economies</td>
<td>7984</td>
<td>5713</td>
<td>-2271</td>
<td>-48.41%</td>
</tr>
<tr>
<td>Middle East</td>
<td>3260</td>
<td>7970</td>
<td>4710</td>
<td>37.78%</td>
</tr>
<tr>
<td>Other Asia</td>
<td>13958</td>
<td>8273</td>
<td>-5685</td>
<td>-6932.93%</td>
</tr>
<tr>
<td>East Asian NICs</td>
<td>61028</td>
<td>22856</td>
<td>-38172</td>
<td>535.15%</td>
</tr>
<tr>
<td>Non E.C. Europe</td>
<td>14386</td>
<td>8872</td>
<td>-5514</td>
<td>-135.21%</td>
</tr>
<tr>
<td>European Comm</td>
<td>80540</td>
<td>59731</td>
<td>-20809</td>
<td>-145.03%</td>
</tr>
<tr>
<td>Japan</td>
<td>87982</td>
<td>27808</td>
<td>-60174</td>
<td>329.94%</td>
</tr>
<tr>
<td>Australia</td>
<td>2877</td>
<td>5467</td>
<td>2590</td>
<td>102.05%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1180</td>
<td>814</td>
<td>-366</td>
<td>-362.38%</td>
</tr>
</tbody>
</table>

Sub-Total       | 277472  | 152994  | -124478 | -675.74% |

Total           | 378049  | 246971  | -131078 | -313.79% |

Note: % Change column compares the Balance of Trade of 1981 with that of 1987.

The region is decidedly one of the best trading partners for the United States. The geographical comparative advantage of the U.S. is evident when noted that during the same period, the balance of trade with other key trading partners deteriorated at a much faster pace. For example, Japan went from a deficit of $18.2 billion in 1981 to a deficit of $60.2 billion in 1987. Europe went from a surplus of $8.0 billion to a deficit of $20.8 billion!

So, the point made from these chapters is that both the U.S. as a whole, and the banking industry in particular, have a lot to gain if local entrepreneurs return their assets to their countries in Latin America. In attempting to confirm if an insurance solution can realistically be proposed, the next chapter will establish if coverage is feasible by studying actuarial country risk analysis, what type of entity could provide coverage and at what cost.
Chapter 2

An Insurance Solution to Capital Flight?

At the beginning of my research I placed an emphasis in establishing the feasibility of providing political risk insurance to local investors in their own countries. The feasibility has to be determined for several players: the host government involved, the institution providing coverage and the investor's purchasing insurance. The host government must accept the thesis that some citizens require an advantage or special protection in order to maintain retained earnings locally. The institution launching the program must find political risk insurance profitable or congruent with its overall scope. The investor must accept the program and find it attractive.

This emphasis directed me first into establishing the potentiality of accurately measuring country risks, as this was the key to set premium rates. The second step was
to analyze the likelihood that such coverage be provided by different types of institutions. Private insurance companies, the U.S. government, private banks and multilateral institutions were considered. The third and last step was to establish the investor's attitude towards this program. Following is the development of each of these steps:

**Country Risk Assessment**

Determining country risk is a crucial area for any entity providing political risk insurance. For many reasons its measurement is totally impossible in an exact quantified manner. The main reason is that political risks are both a consequence and a cause of financial and economic problems. This interdependent relationship, linked to the inherent subjective evaluations needed to be done when one measures elements as "political leadership, or quality of the bureaucracy"\(^{35}\) of one country, make for this evaluation a most difficult one. Private and public

\(^{35}\) As measured by the International Country Risk Guide
entities have developed different means of measuring all assumed relevant factors, giving these evaluations numerical values and plugging them into mathematical models that produce ranking indices usable as a comparable measuring stick.
**Statistical Modes of Sovereign Risk analysis**

In academic literature, the analysis of sovereign risk consists of the employment of statistical models to estimate the probability of default by debtor nations. Treating the latter as the dependent variable, researchers have applied statistical procedures to the problem of identifying the significant independent or explanatory variables influencing the probability of default. Put simply, the problem is to estimate:

\[
\text{Probability of Default} = f(\text{economic variables})
\]

If researchers could identify economic variables that influence probability of default on sovereign lending, analysts would be able to track that variable over time with the purpose of identifying the countries most at risk of default.
Heffernan identifies the following representative list of explanatory variables that have been tested for statistical significance in predicting default:

**Current Account Variables**

Debt Service Ratio (DSR): ratio of external debt service payments to the value of exports of goods and services.

Ratio of External Debt to the Value of Exports of Goods and Services (D/Ex): the denominator is the same as that for the DSR and the numerator consists of total external sovereign debt.

Ratio of Imports to GNP (IM/GNP): this ratio attempts to capture a measure of flexibility when it comes to cutting back on the import bill. It also provides an indication of the degree to which national income growth

---

will be affected should a country have to reduce its import bill in response to debt servicing difficulties.

Ratio of International Reserves to the Imports of Goods and Services (RES/IM): this ratio is an indicator of short term liquidity problems. Some researchers express it in terms of months.

Growth Rate of Exports (GEX): one can expect a negative correlation between this variable and the probability of rescheduling foreign debt.

Variance in Export Earnings (VAREX): stable export earnings reduce the probability of defaults, thus the higher the variance, the higher the probability of defaults.

Ratio of Current Account Deficit to the Export of Goods and Services (CAX): this ratio is meant to provide an indication of the country's new borrowing requirements in a given year.
**Capital Account Variables**

**Ratio of Capital Inflows to Debt Service (K/DS):**
capital inflows contribute to the country's foreign exchange receipts, which in turn ease the servicing of external debt. There is a negative relationship between this variable and sovereign risk.

**Ratio of Amortization to External Debt (A/D):**
this is probably the most controversial of all explanatory variables employed in statistical models. The inverse of this ratio is supposed to represent the average maturity of a country's external debt.

**Commitment per Capita (C/POP):** this is the ratio of new debt contracted during a given year to population.

**Other Variables**

**Ratio of International Reserves to External Debt (RES/D):** expressed as a percentage of total outstanding
external debt, as this ratio rises, the probability of default declines.

Per Capita Income (Y/GNP): this is an indicator of a country's living standards; the higher they are, the greater the consumption of non-essential goods, making for greater flexibility in the adjustment of consumer patterns.

Share of Investment in National Income (I/GNP): this indicator signals the importance placed on investment by the country: one should look for a steady increase of this ratio as a good indicator of a reduction in risk.

Ratio of External Debt to GNP (D/GNP): gives an indication of foreign claims on a debtor's country production.

Ratio of Reserves to GNP (RES/GNP): like the ratio of reserves to imports, this is an indicator of liquidity.
Monetary Indicators: these indicators try to identify countries with strict money supply growth targets, which makes them less likely to suffer problems of domestic inflation, which in turn makes them less competitive in world markets and hence prone to balance of payments problems.

World Credit Liquidity (L): attempts to capture a supply side variable: the degree of credit abundance in the world economy.

Ratio of Domestic Savings to GNP (S): a country with a high savings ratio will be less dependent on forms of external financing in the future.

Per Capita Rate of Economic Growth (G): this is an indicator of how quickly per capita incomes are rising, thus providing a measure of the general health of the economy.
A Practical Application

Let us look at one concrete example of how these concepts are applied in practice at The Foreign Credit Insurance Association. FCIA is a division of Eximbank that provides credit risk insurance to U.S. exporters to any country in the world. (Eximbank is the independent U.S. Government agency that helps to finance and facilitate the export of American goods and services.)

FCIA has developed a system which allows it to rank countries according to the political or economic risk of operating, investing or lending to a citizen of that country. But in a U.S. government entity, given the political implications of a poor ranking being given to a friendly nation, the same must be kept confidential, and great efforts are made to have FCIA’s independently obtained rankings match those of Eximbank.

This is difficult because FCIA has a different perspective from that of Eximbank, and probably different from many commercial banks, mainly because the term of
their exposures are not the same. FCIA insures mainly receivables that are short term (one to twelve months), so their concern is the likelihood of this country, and naturally, the buyer, to be able to service its debt within the course of twelve months.

This system of ranking countries is based on a series of indices that are calculated and compounded internally. Among them are:

- balance of payments,
- foreign currency reserves,
- the ability to raise capital in the international capital markets,
- dependence on one commodity to generate foreign exchange,
- priorities to provide foreign exchange for certain imports versus others,
- political stability, and many others.\(^3\)

\(^3\) As per interview with Byron M. Shoulton, Economist at FCIA.
Not one variable or measurement index has necessarily a major weight than the others.

With this information each country is ranked by FCIA's staff on a scale from one to ten every quarter. One being the least credit worthy, ten being the most. Then each country is put into market groupings simply identified as A, B, C, D and E. Each grouping is then actuarially assigned a different premium for insurance coverage.

"A", the highest ranking, would group countries without balance-of-payment or balance-of-trade problems. This would include countries not dependent on one commodity or industry. Germany, Japan or the U.K. would fall in this category.

The "B" category is identified as satisfactory in all areas, except having one or two problems, for example, a weak financial sector one might be concerned about. In this category would fall countries like Taiwan or Singapore.
A "C" market is seen by FCIA as a country in transition. For example Saudi Arabia could fall here if oil prices are low and they are confronting balance of payment problems. (Sometimes specific sectors of the economy would be given this ranking, and the government itself a higher one.)

"D" markets are countries with serious problems servicing exterior debt and facing structural problems in its economy forcing it to borrow heavily. Most developing nations fall under this category.

In an "E" market no coverage would be offered at all. Nicaragua or Peru would fall in this category at this date.

In order to support its internal rankings FCIA relies also on third parties, that prepare independent evaluations. One of them, published by the International Country Risk Guide (ICRG), a publication of International Reports, Inc., provides a detailed country-by-country breakdown of the comparative risks of operating in,
investing in, or lending to particular countries using a three-dimensional evaluation system. This system attempts to weigh the composite risk, and express the disaggregated political, financial and economic risks by an indicator.

The main risk ratings it provides are broken in three. The first one, measuring Political Risks, is broken down into thirteen political indicators for each country, then assigning each factor a weighted point value. A detail of these indicators is presented in Table 8.

Table 8

Political Risk Indicators

<table>
<thead>
<tr>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>economic planning failures</td>
</tr>
<tr>
<td>economic expectations versus reality</td>
</tr>
<tr>
<td>political leadership</td>
</tr>
<tr>
<td>external conflict risk</td>
</tr>
<tr>
<td>corruption in government</td>
</tr>
<tr>
<td>military in politics</td>
</tr>
<tr>
<td>organized religion in politics</td>
</tr>
<tr>
<td>law and order tradition</td>
</tr>
<tr>
<td>racial and nationality tensions</td>
</tr>
<tr>
<td>political terrorism</td>
</tr>
<tr>
<td>civil war risks</td>
</tr>
<tr>
<td>political party development</td>
</tr>
<tr>
<td>quality of the bureaucracy</td>
</tr>
</tbody>
</table>

100
The second rating, **Financial Risk**, is broken into five indicators of financial performance with weighted values assigned to risk factors identified for each country. A detail of these factors is presented below in Table 9.

<table>
<thead>
<tr>
<th>Financial Risk Indicators</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>- loan default or unfavorable loan restructuring</td>
<td>10</td>
</tr>
<tr>
<td>- delayed payment of suppliers' credit</td>
<td>10</td>
</tr>
<tr>
<td>- repudiation of contracts by governments</td>
<td>10</td>
</tr>
<tr>
<td>- losses from exchange controls</td>
<td>10</td>
</tr>
<tr>
<td>- expropriation of private investments</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>50</td>
</tr>
</tbody>
</table>

The last rating, **Economic Risks**, encompasses six economic indicators that have also been identified for each country. Table 10 lists these indicators in detail.
Table 10

Economic Risk Indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>inflation</td>
<td>10</td>
</tr>
<tr>
<td>debt service as a percent of exports</td>
<td>10</td>
</tr>
<tr>
<td>international liquidity</td>
<td>5</td>
</tr>
<tr>
<td>collection experience</td>
<td>5</td>
</tr>
<tr>
<td>current account deficit as a % of exports</td>
<td>15</td>
</tr>
<tr>
<td>foreign exchange (parallel market indicators)</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>50</td>
</tr>
</tbody>
</table>

In calculating the aggregate political, financial and economic risk, the following formula is used:

\[
\text{CPFER (country X)} = 0.5 \times (\text{PR} + \text{FP} + \text{ER}),
\]

where CPERF = Composite Political, Financial and Economic Risk rating; and

\[
\begin{align*}
\text{PR} & = \text{Total Political Risk indicators} \\
\text{FR} & = \text{Total Financial Risk indicators} \\
\text{ER} & = \text{Total Economic Risk indicators}
\end{align*}
\]
The highest overall rating (theoretically 100) indicates the lowest risk, and the lowest score (theoretically 0) indicates the highest risk.

For more general purposes, the individual risk value of particular countries can be estimated using the following fairly broad categories:

<table>
<thead>
<tr>
<th>Risk Level</th>
<th>Score Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low risk</td>
<td>85.0 to 100</td>
</tr>
<tr>
<td>Low risk</td>
<td>70.0 to 84.5</td>
</tr>
<tr>
<td>Moderate risk</td>
<td>60.0 to 69.5</td>
</tr>
<tr>
<td>Moderately high risk</td>
<td>50.0 to 59.5</td>
</tr>
<tr>
<td>Very high risk</td>
<td>00.0 to 49.5</td>
</tr>
</tbody>
</table>

Even with these measuring systems, the past experience of entities like FCIA in this area of country risk assessment has been mixed. To understand the magnitude of the losses that can be caused when one country's economic and political systems are in distress, let's look at the case of Mexico in the 1982/83 years.
For FCIA, Mexico alone caused for over $380 million in losses during that year. So even after 24 years of profitability, the size of these claims convinced several of the underwriters and re-insurers of FCIA to pull out, forcing Eximbank to pick up the risk coverage in the political area. The underwriters agreed to continue carrying the coverage of commercial risks.

FCIA is, as its name suggests, an association of the 16 largest insurance companies in the U.S., and even for them, sharing any part of the political risk has been unattractive. To hedge this exposure, FCIA requires from its customers that they spread their risks in several countries. They also impose sub limits per customer, but to date, have never imposed on themselves a limit of country exposure. The establishment of a country limit is the basis for limiting the total risks of cross border transactions\(^{*}\). Such a limit could be expressed as a percent of paid-in capital and reserves to assure that in

the event of a catastrophic loss in one country, major claims could not carry the organization into insolvency.
Entities That Could Insure Political Risk

Private Insurance Companies

In the market exist already many private and government-controlled entities that provide some form of political or sovereign risk insurance. The reason to address the question at all is that the program, as conceived in this thesis, poses a new type of risk from any being commercially covered today. It is uncertain if private insurers, banks, governments or multilateral institutions will be able to take such big risks in any sizable volume, even though all have a real stake in the outcome and success of revitalizing the economies of developing nations.

Entities like OPIC from the public sector, and Lloyds of London, American Insurance Group (AIG) or Citicorp International Trade Indemnity Corporation (CITI) from the private one, have been providing different forms of sovereign and political risk insurance for many years. Their programs are available and designed to cover foreign
assets of domestic companies. None of them though, have an existing "off-the-shelf" product to offer to a Latin citizen wishing to insure his exposure in his own country. Although private insurers do not rule out the possibility that given a concrete request they would consider quoting coverage on a case by case basis, CITI's officers explained that this coverage entailed a completely different risk than that posted by insuring foreign investment in a country. For details of the risks covered, please refer to a sample copy of the policies offered by Citicorp International Trade Indemnity Corporation included in Appendix 3.

Richard Stern, Vice President and General Counsel for Citicorp Insurance explained that the difference lies on the issue of leverage on negotiations of claims and the seeking of compensation from a government. For example the nationalization of a domestically owned bank or farm in El Salvador would not disturb good economic relations with any foreign government. Acting under the legal system of that country, repayment (if there is one), can be in the form of
worthless" long term government bonds issued in local currency. The insured party would find it has no leverage to influence the local authorities to provide fair compensation, much less expect to receive it in U.S. Dollars. It cannot expect to be supported by any real pressure from foreign governments and there will be no outcry in the international media because the affected party is a subject of the laws of the country effecting the expropriation. Thus, insuring citizens in their own countries constituted for the insurance industry a "new" type of political risk for which little or no actuarial experience exists.

Byron Shoulton, economist at the Foreign Credit Insurance Association, confirmed that in the case of a claim, the insurance company would pay the insured and it would have a recourse against the host country by taking

" Depending on the issuing government, market conditions, terms, and the currency of issue, the market resale value of these debentures has dropped to as low as 3 cents on the Dollar.

" Byron M. Shoulton, economist at the Foreign Credit Insurance Association
possession of whichever compensation might have been offered. If the insurance company believes it has not been adequately compensated, it can go to the world courts to file a suit. But the problem here is that this court has no authority to enforce its verdicts. Other than effecting political pressures and the governments' concern over their public or international images, more often than not, governments tend to ignore these verdicts.

On the other hand, if the entity being nationalized happened to be owned by an European national, the process of ensuing claims against the host government would be supported by all sorts of political pressure through multilateral organizations and all diplomatic channels available to them. The pressure seeking to obtain fair compensation in a hard currency wouldn't be questioned as the investment probably was recorded by the central bank as coming in to the country in the same currency in the first place. It is easy to imagine that there is little probability of obtaining compensation in hard currency in the first example, of the investor from El Salvador, mentioned above.
As compared with other entities, private insurers felt they did not enjoy any special leverages to secure favorable negotiations of claims. Other than removing a country from the list of nations where coverage is provided, they held no means of exerting pressure. The expected result of such a measure was considered to be inconsequent in influencing a government's decision to carry out a nationalization policy or to provide adequate compensation afterwards.

As one way to alleviate this concern, insurance companies would like to subscribe agreements with the host governments of the nations before they are to provide coverage. The idea is to agree ahead of time on matters like how to establish exchange rates; arbitration courts accepted to both; mechanisms for appraisal of market value of properties and, if possible, the seniority of their debt as compared to all previously acquired commitments by the country. (Please refer to Appendix 4 for a copy of one such agreement subscribed between the Governments of the United States of America and Costa Rica relating to the
Regarding the issue of Latin American governments granting a different seniority to insurance company claims, de las Heras stated that it is not at all possible to grant any special privileges to insurers. All countries that have been forced to renegotiate their debt in exchange of rescheduling payments -- and this is almost all of them -- have committed to several points. One of which binds them not to grant any superior seniority or guarantees to a new lender without offering the same benefit to existing ones. This condition is known as the "negative pledge clause."

When asked if it would be possible to obtain senior claims on a country's assets abroad as compensation for an insurance claim, Meneses explained that no one has

\[41\] Gonzalo de las Heras, Senior Vice President at Morgan Guarantee Trust Company, responsible for foreign lending.

\[42\] Victor Meneses, Senior Corporate officer for Latin America and Africa at Citibank, a subsidiary of Citicorp.
a claim on any country's assets abroad. Not even World Bank or the International Monetary Fund have a claim on a country's assets abroad. Countries are very sensitive about hypothecation of assets and in many countries doing so would be against the constitution. Additionally to this, there is no official seniority either. Theoretically all debtors are "pari passu," though in practice they are not treated as such, legally they are all equal.

Countries do tend to pay the IMF or the World Bank before they pay private banks, but this is not because they have an obligation to do so. For example, as of June 30, 1988 at The World Bank only 2.3% of the $127.9 billion in loans outstanding to developing nations were in a non-accrual basis. (In fact this figure includes principal outstanding not yet overdue. Past due principal plus non accrued interest represents one half of one percent of the whole portfolio of loans outstanding. Included among past due nations from Latin America were Peru, Nicaragua and

Panama.) This outstanding record reflects the fact the World Bank is practically the only institution still extending new loans and refinancing in the region, and that as a matter of policy will not disburse new financing if all previous loans are not up to date. So countries simply stop paying everyone else, but manage to stay current with The World Bank.

The issue of leverage of claims on the host government is a complicated one. Many countries, Mexico and Brazil for example, have even fought and resisted programs like the ones offered by OPIC, even though they come at no cost and no possible adverse effect to them. The source of the problem stems from traditional U.S./Latin American mistrust. Mexico, for example, will not allow the U.S. government to enter the Mexican courts, Brazilians think they should not be required to sign an OPIC treaty to get U.S. investment there. So there is a political undercurrent which makes even something like OPIC difficult to sell.
The reality is that investment flows have been kept separate from the debt problem. So during the time Latin countries have struggled restructuring their debt, investments have been coming in and out of the region without any restrictions. So in a peculiar pragmatic sense (for Latin American governments) equity is superior in seniority to debt. But again, this is "de facto" and not law. For example, dividends keep coming out of Argentina, but not interest or principal on private and official debt to private banks. Again, like in the case of World Bank, this is happening in order not to discourage foreign investment. U.S. banks could go to court on this issue, but have chosen not to do so.

So, it is highly unlikely and politically suicidal that a country's government, in an effort to attract a program of investment insurance such as the one considered in this thesis, will offer an insurer, and in fact anybody, any superior claims on its assets. On the other hand, no support should be expected from the U.S. government regarding official sequestering of accounts if a foreign government is not performing on its agreements with
an American insurance company. Meneses suggests that has been the case, even when OPIC (a U.S. government owned entity) has lost money due to the nationalization of assets. The well known exemption of Iran, that took place a few years ago was an extreme case where the government acted on presidential orders. In that case, it was a reaction to the hostages issue and it does not constitute a precedent to be taken into account for political insurance risk assessment purposes.

According to de las Heras, the problem for insurance companies providing this type of coverage starts when they look at Latin American countries who seemingly cannot pay their debts to anyone -- be it private banks or foreign governments. Why should they offer insurance to their nationals if they cannot expect to collect on recourse claims? Recourse claims against a government, would lie for all practical purposes, in third place, behind the Paris Club agreements and the already existing private and public debt to banks and multilateral entities. And, as mentioned before, most developing countries are not paying even them!
The expectation of being able to convince a private insurer to underwrite comprehensive coverage for political risks in Latin America, and particularly if it is to include local investors, seems highly unlikely. Shoulton suggested that the private sector would not be willing to bear these risks alone, and would look towards the government for a joint venture, a subsidy or a certain type of guarantee. If this was so, it would have to be a government outside the region in order to have any credibility in the market.

Another reason for private insurers to seek out the help of the government before attempting to provide comprehensive coverage for political risks, stems from one of the most important barriers preventing their entry into the business. That is the existence of OPIC and other government-operated insurance schemes, that by offering subsidized insurance, make private insurance unprofitable.

As in other instances of market distortion, it is in the best interest of insurance buyers to buy insurance when it is priced below the market rate. Since OPIC's rate is uniform across countries
(e.g., 0.6% for manufacturing operations), it clearly pays to insure in risky nations (mostly LDCs) and not insure in low-risk nations. Thus government plans are faced with the problem of adverse selection."

Right now, governments in the region provide outside investors with assurances that they can freely take out their dividends over time, and if they so desire can repatriate their original investments at any moment. Governments provide these assurances because they are the prerequisite investors require in the first place before coming in. Even with these government guarantees, insurance is needed because of the high risk that officials will change their minds or that the countries entirely change the ideologies and policies of their governments.

Private Banks

At first thought, the natural institution that comes to mind to provide this insurance is the banks themselves. Not only do they have most to gain from increased investment in the region, but they are the only ones to hold any leverage to enforce a claim against them.

The comparative advantage of banks in enforcing contracts with LDC borrowers is further strengthened by the role of the IMF and, to a lesser degree, the World Bank. Both institutions have leverage because they represent a continuing source of finance and because they play a special role in signaling to other financial institutions whether to stop lending to a particular country.  

I am presuming this leverage stems from the fact lending to a country can be stopped if a government is not honoring its international agreements. Banks have the experience, they have the clout and they have the financial

interest in the region. Banks can make or break a country. As it will be seen in the next section, one of the measuring factors to establish the level of country risk, and one deciding criterion for potential investors is the ability of a country to access funds in the world financial markets. Such markets simply dry up if a country gets "black balled" by the financial community.

The problem for another type of organization to offer private insurance coverage in the LDCs stems from the fact private holders of debt or other type of investments, as insurance contracts would be, do not obtain similar help in the enforcement of their claims. Further making the case for private banks offering this insurance coverage is the previous experience of the U.S. government and that of other countries that have attempted to impose sanctions in the case of expropriations. Usually, the sanctions or mechanisms designed to react to these events have failed because of the difficulty of establishing damages and
assigning fault, and hence, obtaining the collective response required to make the penalties effective."

There was a consensus among interviewed bankers that they would like to see capital flight slowed down or reversed. In as much as this insurance scheme achieves that goal, it would enjoy the full support of the banking industry. The question if that support would translate into taking direct exposure by providing the coverage is completely another matter. As a senior corporate officer for Latin America and Africa at Citibank, Meneses' view was that U.S. banks as such would not consider carrying any of the risk directly. Being the holders of a fair amount of the country risk already, their underwriting capacity was very limited. From the banks' point of view, making an investment (on an equity basis) to support this project would be well worth it, assuming it gets a reflow of private capital, improving the quality of those economies as well as the quality of the bank's debt. "Furthermore, private banks may well fund such a project as long as it is

" Lessard, Donald (1985)
promoted by a third party not directly associated with the banks, and can be kept at arms length,” stated Meneses during interview.

Serious legal limitations, coupled with the existing exposure of the industry as a group, lead me to believe banks are not a realistic alternative to undertake this project independently. The magnitude of potential expropriation losses may bankrupt an underwriter, unless that loss is only a small percentage of its total operations. With the existing levels of exposure already held by this industry, far exceeding healthy levels, it is doubtful the market will let them bear additional risks. If a third party gets a program started, banks will probably provide their support, albeit on a limited basis.
The U.S. Government

When interviewing officers of the U.S. government's branches that are involved in promoting the development of Latin America, they enthusiastically considered the idea of an insurance solution to the problem of capital flight as feasible one. Walter Bastian, Director of the Caribbean Basin Program at the Department of Commerce, even considered it possible for such a program to be provided by some branch of the U.S. government. Bastian deemed it would be politically acceptable to obtain support from Congress for an insurance program, even though he recognized funds for his own program were being tightened due to the budget deficit.

Any program that has a cost to the taxpayer, or is perceived as having one, would be politically very difficult to sell in the context of Congress' fight against the dual budget deficits. It is not difficult to imagine the reaction of the media and that of local stakeholders if the government advises domestic farmers that their
subsidies will be curtailed, military bases have to be closed, municipal governments are receiving reduced amounts of Federal funds and now presents a program to guarantee investments of the rich in Latin America. It would be political suicide, no matter how much sense it made to strengthen U.S.'s trading partners to the south, and the possible long term benefits of this program to the nation.

This argument leads me to believe that it would not be politically feasible to support a program of direct insurance by the U.S. government. Not even one providing guarantees to an entity underwriting coverage. Even though guarantees are not accounted for as a budget item until needed, the potential benefits to the country are too far removed from the voter's perspective. The rest of the world, and in particular the small nations of the Caribbean basin, look to the U.S. for leadership. But now the country is looking inwardly to find the solutions to its own multitude of problems.
Multilateral Organizations

An international multilateral agency, providing insurance without the specific intent of protecting the citizens of one particular country is the last alternative considered that may be politically and economically viable for all the parties involved. Presuming insurance is the solution for capital flight, the World Bank opted to provide this service directly. The World Bank approved in April of 1988 the creation of the Multilateral Investment Guarantee Agency (MIGA), recognizing that international cooperation is needed to achieve economic development and to attract foreign investment in developing nations (and in the process manage to keep local one there). Miga's purpose is to encourage investment in developing countries by alleviating investor's concern about non-commercial risks. Miga intends to carry out these goals by investment guarantee operations, provisions of advise and technical assistance to governments of LDCs. It will also provide mediation and consultation on investment policies and
programs among member governments, and between them and the international business community.

Only World Bank or a multilateral entity like it could be the logical underwriter of such a guarantee program. Previously discussed evidence indicates that the technical problems surrounding private insurers, private banker's, or even worse, the U.S. government's direct intervention make it unrealistic for these entities to provide such coverage. When this research was started, MIGA was not in operation, and this conclusion was derived without knowing of their plans. The fact World Bank has opted to create MIGA, eliminates any further reason to continue speculation as to who could, or should, provide insurance to local investors in Latin America. The relevant point should be to understand the goals and motivations of MIGA, in order to speculate on its possible effectiveness in achieving its intended goals.
Chapter 3

The Multilateral Investment Guarantee Agency

World Bank is in the process of obtaining ratification from its member countries, to the convention establishing MIGA. As of January 1989, the convention has been signed by 73 nations totaling 74% of the agency's authorized capital of U.S.$ 1,082,000,000. As expressed by Christophe S. Bellinger, guarantee officer at MIGA, the agency's board had just approved the underwriting of insurance coverage, though none had been sold yet. It was Mr. Bellinger's function to seek eligible projects in order to start operations.

Scope of Guarantee Program'

The scope of MIGA's guarantee program is determined by "eligibility requirements" -- tests which

"'Taken from MIGA's Investment Guarantee Program general information booklet published by MIGA itself.
must be met if and investment is to qualify in principle for coverage by MIGA. These tests relate to the investor, the country in which the investment is to be located, the time and type of investment, and the type of risk against which coverage is sought.

**Eligible Investors**

To qualify for coverage by MIGA, investors must be nationals of a member country other than the one in which the proposed investment is made (host country). For the purpose of this test, a corporation is considered a national of a member country if either of the following conditions are met. First, it is incorporated and has its principal place of business in a member country, or second, the majority of its capital stock is owned by nationals of member countries.

As a result of this alternative test MIGA coverage is available to foreign-owned corporations domiciled in a member country (other than the host country), as well as to companies established in a non-
member country but majority owned by nationals of member countries. Eligible investors include both private individuals and corporations. Publicly-owned corporations qualify for coverage if they operate on a commercial basis.

Also, on application by the prospective host-government, eligibility can also be extended nationals of the host country who plan to transfer investment assets from abroad. The extension of MIGA's guarantee protection to host country nationals is designed to encourage the repatriation of flight capital. For this purpose, Miga may also provide coverage to offshore investment funds through which host country nationals recycle flight capital into their own countries. Note that MIGA's broad delineation of qualified investors should enable it to afford uniform guarantee protection to those investors from different countries who jointly finance a project in a developing country.
Eligible Investments

Eligible investments MIGA can insure include only new investments between member countries where the investment project is located in a developing country. New contributions used for the expansion, modernization or financial restructuring of an existing enterprise are also eligible. Investments in any freely usable currency qualify for coverage. Investments also can be made in kind; for example, in the form of machinery, patents, technical services, managerial know-how, trademarks and marketing services. Applicants must provide a credible valuation of non-monetary assets in the currency for which the guarantee is issued.

By insuring only new investments, MIGA falls short of providing comprehensive coverage to existing investment in the area, and I contend, this fact alone will prevent this project from stemming capital flight originating from individuals overly exposed with existing operations. In addition to this, requiring the application from a host country's government in order to provide
coverage to nationals who plan to return assets from abroad, will cause an inordinate roadblock for Latin investor. Here MIGA has misunderstood the inherently secretive nature of investors that have spent their lives covertly purchasing dollars in the black market, in order to create their own financial security abroad. It would be surprising if any investor in fact goes to his government and requests it to apply for the political risk insurance it requires for the return of $10 million he has stashed away through the years.

On the other hand, the fact any new investment coming from a member country into a developing one can be insured, opens one major door for the return of previously flown capital. One that does not require the intervention of the host government and that also allows for certain privacy of information; I am referring to the fact any Latin investor holding liquid assets in the United States can use those funds to capitalize, say a Florida corporation. That new entity would qualify under the terms of this agreement to seek insurance coverage, as it would
be treated as an American corporation investing in a developing nation.

**Covered Risks**

Like most investment guarantee agencies, MIGA offers coverage of three broadly defined types of non-commercial risk, namely:

- **Transfer and convertibility restrictions** (such as restrictions on the repatriations of dividends and other investment proceeds in freely usable currency). This coverage embraces both active blockage, which implies the explicit denial of the conversion and/or transfer of local funds by the host government through laws, decrees, regulations, or administrative acts; and passive blockage, where administrative or bureaucratic delays hold up the transfer and/or conversion for more than 90 days (or as many days as agreed by the contract) of the investor's application for such transfer. Coverage also includes exchange rate discrimination, i.e., the inability to convert local currency except at an exchange less favorable
than a reference rate of exchange specified in the guarantee contract.

- **Expropriation and similar measures.** This coverage is designed to broadly encompass direct, indirect and creeping expropriation. The pertinent language of the MIGA Convention includes "any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment." MIGA's General Conditions of Guarantee explicitly extend coverage to "creeping expropriation," which implies, a series of host government measures which when combined are expropriatory, even though each individual measure taken alone might be considered a proper exercise of the host government's regulatory powers.

- **War/revolution/civil disturbance.** This coverage usually embraces the removal, destruction or physical damage of tangible assets of an investment project and the substantial interference in the enterprise's
business operations as a result of acts of war, revolution or other organized political violence designed to overthrow the host government. In accordance with common practice, business interruption is normally confined to major interferences in the projects enterprise's operations persisting for at least one year.

In addition to these conventionally offered coverage, MIGA also offer special breach of contract protection. It encompasses losses resulting from any repudiation or breach by an entity of the host government of a contract with the insured party. In order to avoid MIGA's involvement in the substance of investment disputes, coverage is confined to three types of cases. The first is where the guarantee holder cannot take its complaint to a competent court or arbitral tribunal which is independent from the executive branch, adheres to minimum standards of due process and is empowered to make binding decisions on the complaint. The second is where such decision is not rendered within a reasonable period of time as is specified in the insurance contract (to be not less than two years); or the third case, where the guarantee holder cannot
enforce an award in his favor within 90 days from initiation of enforcement action or such other period as may be specified in the individual guarantee contract. Any of these three cases of denial of justice may entitle guarantee holders to compensation, so that the guarantee in fact covers both adequate recourse to obtain a final decision in due course and the enforceability of such decision.

The breach of contract coverage tends to be of particular importance to investors under production- and profit-sharing agreements or in "build, operate and transfer" contracts. The latter are in essence variants of turnkey contracts where a construction syndicate delivers a plant (e.g., a power plant), retains ownership or it and operates it for a specified period of time, after which it transfers ownership to an agency of the host government. In this example, the construction syndicate recoups its investment from the sale of electricity under a specified rate formula according to a sales contract, usually with a state-owned utility company. Depending on the specifics of
the arrangement, MIGA may cover the construction syndicate’s rights under the sales contract.

**Premiums and Fees**

MIGA is required to operate on a self-sustaining basis. It must therefore charge premiums and fees which adequately cover its administrative expenditures and reasonably projected underwriting losses. It charges small application fees, standby premiums for committed but inactivated coverage, premiums for actual coverage, and fees for special services rendered in conjunction with a guarantee.

Unlike most national agencies and private insurers, MIGA offers investors a choice between individually priced coverage of particular types of risks and coverage of risk packages comprising all types of covered risks. As it is now devised, and subject to review in light of actual experience, the premium rates for any type of coverage (e.g., currency transfer, expropriation, etc.) varies between 0.3 and 1.5 percent of the amount of
guarantee per annum. Within this range, MIGA in each case determines the actual premium rate in accordance with the results of its risk assessment; it may also take into account the impact of the proposed guarantee on its overall risk portfolio and the premium rates of a potential coinsurer and reinsurer.

Variable premium rates are the corollary to a flexible underwriting concept. As noted before, MIGA determines its premium rates between broad ranges on the basis of the risk profile of each guarantee proposal and other relevant factors. To ensure the objectivity and consistency of premium rating, (a source of conflict in such a politically heterogenous organization) MIGA's president institutes administrative procedures that provide for appraisals and recommendations by MIGA's underwriting staff, review by senior management of staff recommendations, and final decision by the President.

To determine the rates for risk packages, MIGA first sets a rate within the above range for each type of risk comprising the package and may then apply, at its
option, a discount of up to 50 percent of the sum of the individual rates. Although rates should be determined solely by the project's and the host country risk assessment, the inherent nature of the entity as a developmental agency prompts this unique approach.

MIGA focuses its primary attention on the particulars of each individual project (so called "project underwriting"). This approach is designed to reflect fairly the risk characteristics of the individual project rather than those of the host country, and it may make it possible for MIGA to cover good projects in economically troubled countries, such as export-oriented or import substitution projects in highly indebted countries.

MIGA, of course, also takes into account investment conditions in the host country to the extent that they may affect the vulnerability of a particular investment to the specific risks against which coverage is sought. The existence of a bilateral investment protection treaty between the investor's country and the host country is normally accepted as evidence of adequate legal
protection. Another important factor is the host country's foreign exchange regime and reserves.

Future Expansion of the Insurance Program

According to MIGA's broad parameters set by the Convention for its articles of incorporation, the initial guarantee program can be further developed and expanded by the Board of Directors. For example, cover could be extended to additional forms of direct investment and long- and medium-term loans to a project enterprise made by a financial institution. By the same token, coverage might be extended to additional types of non-commercial risk such as terrorism or sabotage.

Companies planning an investment which does not precisely fall within the ambit of MIGA's existing program as is outlined here are encouraged to consult with MIGA before assuming coverage is not available. It is key to remember that MIGA is an investment incentive agency and not a for-profit insurance corporation, and as such will,
when and where appropriate, decide to extend or modify its programs to cover an exceptional investment or risk.

With this we have analyzed potential suppliers of political risk insurance, and covered in depth one program offered by a natural candidate, a branch of the wealthy and powerful multilateral agency: The World Bank. The fact that to date this entity has not sold any coverage due to the recent announcement of its programs make it too soon to establish if such coverage, as proposed will be enough incentive to bring Latin investors to repatriate their assets. The key to answer of this question lies in understanding the rationale and particular idiosyncrasies of the Latin entrepreneur. It is my contention that the decision process and criteria observed by Latin investors following a strategy of country risk diversification is grossly misunderstood by American policy makers. The next chapter attempts to shed some light on this particular subject drawing mainly from personal experience and interviews with Latin American individuals in the positions of corporate CEO or heads of families holding substantial investment assets in the United States.
Chapter 4

Latin American Investment Abroad

Regarding Latin American investment abroad, the key issues that this chapter attempts to understand are the following:

- Which are the risks investors perceive to face in their own countries, as compared to ones faced abroad.

- How was the investment strategy devised and how often was it revised. And as corollary to this issue, what has been the actual experience (returns) with investment abroad, specially as compared to the returns the investors were accustomed to at home.

- Would these investors be in the market to purchase political risk insurance if it was available?
- Once insured, would investors bring flight capital back? If not, why not?

As part of the process, all but one of the interviews were recorded with the approval of the subjects. In order to improve access to delicate information, I personally committed to maintain the anonymity of my subjects and to insure the confidentiality of the information provided. Respecting that commitment, all subjects are only identified by country of origin, and in some cases I have chosen to disguise their industry, as not doing so would have compromised this effort. Most of the data from the interviews served also as supporting material for the previous chapters.

**Rationale**

During the meetings with investors from El Salvador I was informed of the existence of a specific insurance program in El Salvador that was created under the auspices of the U.S. Agency for International Development. The program provides protection to the investments of the
private sector in certain strategic sectors of the Salvadoran economy through insurance against damages due to civil turmoil, malicious acts and terrorism.

The Investment Promotion Insurance System (PROINVER being its Spanish acronym), had its difficult beginnings based on a fund provided as collateral by the U.S. AID; it used as a marketing arm a consortium of local insurance companies and eventually sought Lloyds of London to purchase reinsurance. I say difficult beginnings because when the program was proposed, local insurers were skeptical a large enough market existed and considered the sale of this product a "hard" sell. This hard sell issue pertains to the fact insurance protection costs doubled expense levels maintained for regular hazard policies. Irrelevant of the protection provided, this is a huge cost hike for entities operating marginally in a region affected by internal warfare.

Studying the results of this program in El Salvador is relevant for this thesis, as it is the only existing program providing comprehensive insurance for
managing the risk of terrorist and guerrilla caused work stoppages and destruction of assets. Conclusions may be drawn from the loss experience in El Salvador, and an estimation can be made of the demand that exist for this type of protection, and most importantly, establish if the insurance is incentive enough for investors to stop drawing their funds out of the country.

The PROINVER program has barely completed one year of experience. The first year losses have been moderate and FOINVER (AID's fund) has not suffered a significant outflow. In fact, when interest income is included, the loss of capital is minimal, while the impact of the program on the psychology of the productive sector and the ability of damaged industries to rebuild has been, and continues to be quite important. The policy goals of providing the productive sectors protection against terrorist attacks has proven to be valuable and worth pursuing. Nonetheless, the ultimate goal being studied by

this work, that of stemming capital flight has not been achieved.

As indicated by local investors, the overriding factor in the decision is stability, both in an economical and a commercial sense. It is not enough to protect an enterprise from the risks of nationalizations, terrorist acts, etc. What the investor needs is the expectation, with a high level of certainty, that his business plans can be achieved. The entrepreneur must assume the economy it is participating in is not going to be subjected to huge macro-economic swings that may change his comparative advantage overnight. These events, loosely labeled commercial risks, cause the investor to demand higher returns on investment in order to adjust for the higher levels of risk. If the economy can not sustain realistically those higher levels of expected profits, the investor will simply move some assets to safer grounds.

This point must not be misunderstood to imply there was no demand for the political risk insurance of PROINVER. In fact, the program quickly oversold its
underwriting capacity, even though, insurance coverage has been limited to 50% of the value covered under the fire policy, and the government made it available mainly to export oriented industries. (The exception was a small sub program insuring the Salvadoran bus fleet).

At present, PROINVER's fund can be leveraged only by the 15% deductible and the 10% retained by the local Consorcio, giving the program a total capacity of 144 Colones (approximately U.S.$24 million). This is undoubtedly a very small amount in the context of the Salvadoran economy. It is likely that such severe rationing will produce anti-selection; that is, the most exposed industries will be insured first. This being the case, losses could be quite high if the terrorist again begin to attack the private industrial structure of the country.

Thus, there is a market and there is a need. And certainly, it is too soon to measure the impact on capital investment this program will have in El Salvador. But my guess is that, if any, it will only slow the rate of
capital flight. The peruvian investor expressed this view succinctly by saying "the day I have to leave my country [due to political unrest], I want to know that when deplaning in Miami we don't have to go and deal with an insurance company. Our money will be safe in the bank."

This position was found to differ among investors mainly when they reached another stage in their investment diversification process. For example, the Panamanian investor had just recently started creating a nest egg outside of Panama. As he put it, his family had not yet reached a critical mass of liquid assets abroad to sustain the family in case they had to leave the country. This investor, irrelevant of the purchase of insurance protection, will continue to pull moneys out of Panama until his own "insurance" is formed at a bank account. Such an individual could not afford the contingent liability of not being able to collect on his insurance due to some small print technicality.

Note that until the recent events surrounding the Noriega administration, Panamanian investors generally not
participated in capital flight. This fact confirms the premises that capital outflows occur mainly in countries imposing severe exchange and transfer controls. Since Panama uses the U.S. dollar as the only printed currency, such controls are not practical. The U.S. presence in the Canal Zone, which has historically insured the absence of the most common political problems suffered by the rest of Latin America, has given local and foreign investors a sense of security. All these factors, coupled with the strength of the financial community and the low taxation structure, have contributed to make Panama an exception in the region. Capital had nothing to "flee" from until now that political risks have become a real threat to the community.

On the other hand, both investors from El Salvador had started this process over 25 years ago, and had accomplished substantial success and financial security in the United States. These investors had entered a different stage of the game, participating in land banking, stocks and bonds and other non passive forms of investment. In their words, the most successful process followed had
been, first to "park" funds abroad while they became "acclimatized" with the investment environment. Second, start joint ventures with local people having good track records in their fields. Then, as this process developed and the significance of the foreign portfolio increased, they moved key family members abroad to get involved with the direct management of these ventures.

For most, the process started by going into the same businesses they owned at home. When doing so, the prevailing result was that returns on investment in the U.S. were lower than those obtained in their home operations. In this regard, comparing on an industry to industry basis, the case for investment insurance could be made very well. The return differential would justify the premium costs, the investor would secure higher returns at home and political risk exposure would be protected by the policy.

But, this was not the case for the most sophisticated and experienced investors as their return on investment in their foreign operations was greater than the
one achieved in their host countries. Note this is not comparing on an industry to industry basis, but over all.

For example, if the specific group operated a manufacturing operation at home, the returns it provided were much lower than the average return on investment in the U.S.. Returns at home were not higher than what was being obtained through joint ventures in land speculation and real estate development in the U.S. As one can imagine, once that stage is reached, no amount of insurance will ever entice the return of capital investment to Latin America. The opportunity cost would not justify it. The sheer size of the U.S. market would provide unlimited development potential, impossible to match in developing economies.

As a matter of fact, most investors stated in one way or another, their concern over the saturation of their local markets in a particular industry. This is a natural limitation of small developing countries, so even with limited competition, investment perspectives are constrained. Local projects are expected to survive on their own creation of wealth and the ability to secure financing locally. When this fails, in a somewhat
contradictory manner, capital has been repatriated. The main cause being the lack of liquidity in the local system.

Crossed repatriation of capital has also been effected by these sophisticated investors. In an effort to diversify their country risk, and take advantage of know-how in a particular industry and region, many have invested in neighboring developing nations. In most cases, also participating in local joint ventures as described before.

One common factor to all interviewed investors was their need for secrecy and privacy. Categorically they would not seek to purchase insurance if one requirement is that their government be privy to their holdings abroad. Even recognizing that real opportunities are being lost in areas where the investors had personal expertise, the risk of future repercussions would stop them from sharing any information with the government. This attitude should indicate to World Bank's MIGA that a change in its insurance program will be required to make it successful.
Investors required that the existence of the policy be totally secret. In the same way as it happens with kidnapping insurance provided by Lloyds, making public the existence of the policy simply increases the risk of an abduction. Investors feel they would increase their own exposure in areas not insured, by exposing their private financial information to their government. It must be noted that without exception none of these investors paid income taxes in their countries for income generated abroad. (They did pay income tax, where applicable, in the host countries where these investments were kept). This situation creates a delicate legal issue, as an investor should be assessed retroactive taxes because local legislation, the same as in the U.S., requires that taxes be paid on the individual's world income.
Conclusion

Political risk insurance as such, is not the solution to alleviate investor's concerns causing capital flight. Acquiring protection to eliminate that one risk does not change the main sources of concern. These are mainly the serious commercial risks caused by the major macro economic swings suffered by the local economies. The lack of adequate infrastructures which, coupled with many forms of direct or indirect government intervention, threaten the security of the investment and hurt the profitability for the entrepreneur.

Insurance would contribute to alleviate some of these concerns, bringing some capital investment back, and cause a decrease in the volume of the outflows. But to be achieve its intended results and be attractive to all potential buyers, this insurance must be made available to every type of industry and with no strings attached. The
carrier must commit to long term coverage, and not require the special previous approval of the host government. The government itself should not know which entities are insured and which are not, forcing an unbiased equal treatment of all players.

Only capital investment will create the wealth to improve the living conditions of the population. If capital flight is to be reversed to attract it, the only solution is that the countries create an environment that truly welcomes investment, and allows it to flourish. Paying lip service to this principle is not enough. The investor must know that it can trust the stability of the government and the honesty of its bureaucrats. That when something fails, the system will have the adequate checks and balances to adopt the needed solutions. Failure to achieve this places the LDCs at a major disadvantage in attracting capital vis a vis the developed nations.

Insurance should be considered only as protection for uncontrollable fortuitus events. Just as regular hazard insurance protects a family from catastrophic events
but is never a substitute for a safety program, in the same way, selling protection should not replace attacking the roots of the problem. Programs like the one presented by MIGA must be developed in conjunction with the consistent advise to the governments of the LDCs to implement the proper policies to attract and retain foreign and local capital.
Appendix 1

List of Interviewed Subjects

1.- Richard Stern
Vice President & General Counsel
Citicorp International Trade Indemnity, Inc.
New Jersey

2.- Victor Meneses
Senior Corporate Officer
Latin America and Africa
Citibank, N.A.
New York

3.- Gonzalo de las Heras
Senior Vice President
Morgan Guaranty Trust Company
New York

4.- Byron M. Shoulton
Economist
Foreign credit Insurance Association
New York

5.- John H.B. Harriman
Senior Vice President
First Interstate Trading
Miami

6.- Harry Hood Bassett, Jr.
President and Chief Executive Officer
Bank Espirito Santo
Miami

7.- Walter Bastian
Director Caribbean Basin Division
U.S. Department of Commerce
Washington, D.C.
8.- James Todd  
Economic Advisor  
U.S. Mission  
Organization of American States  
U.S. Department of State  
Washington, D.C.

9.- James C. Suma  
U.S. Agency for International Development  
U.S. Department of State  
Washington, D.C.

10.- Charles A. Leik  
Deputy Vice President  
Export-Import Bank of the United States  
Washington, D.C.

11.- Jose Alberto Oribe  
Counselor  
Embassy of Guatemala  
Washington, D.C.

12.- Rodolfo Rohrmosser  
Ambassador  
Embassy of Guatemala  
Washington, D.C.

13.- Donna M. DiPaolo  
Office of Regional Economic Policy  
for Latin America  
U.S. Department of State  
Washington, D.C.

14.- Faustino A. Perera  
International Economics Division  
Office of Trade and Investment Analysis  
U.S. Department of Commerce  
Washington, D.C.
15.- John W. Gurr  
Senior Insurance Officer, Latin America  
Overseas Private Investment Corporation  
Washington, D.C.

16.- Luisa D. Cerar  
Director  
Commonwealth of Puerto Rico  
Economic Development Administration  
Washington, D.C.

17.- Felix Pena  
Sub Gerente de Integracion  
Departamento de Desarrollo Economico y Social  
Inter-American Development Bank  
Washington, D.C.

18.- Mark Le G. Allen  
Division Chief  
International Capital Markets  
International Monetary Fund  
Washington, D.C.

19.- Kyung-Mo Huh  
Senior Economist  
Exchange and Trade Relations Department  
International Monetary Fund  
Washington, D.C.

20.- Gunther H. Muller  
Gerente General  
Corporacion Interamericana de Inversiones  
Washington, D.C.

21.- Christophe S. Bellinger  
Guarantee Officer  
Multilateral Investment Guarantee Agency  
The World Bank  
Washington, D.C.
22.- Miguel Urrutia  
Interamerican Development Bank  
Washington, D.C.

23.- Roger Lacayo  
Nicaraguan Entrepreneur  
Refugee in Miami

24.- Sergio Garcia-Granados  
Senior Vice President & Financial Consultant  
Shearson Lehman Hutton  
New York

25.- Carlos Escobar  
Vice President & Financial Consultant  
Merryl Lynch  
Miami

26.- Investor  
Peru  
30.-  
Investor  
Honduras

27.- Investor  
Ecuador  
31.-  
Investor  
Chile

28.- Investor 1  
El Salvador  
32.-  
Investor  
Panama

29.- Investor 2  
El Salvador  
33.-  
Investor  
Guatemala
Appendix 2

Questionnaires Used

A verbal explanation was given to each subject of an interview, regarding the concept of providing political risk insurance to Latin American investors in their own countries. For the ones that requested it, the following text accompanied their questionnaire:

INVESTMENT INSURANCE FOR POLITICAL RISKS IN LATIN AMERICA

The absence of growth in the economies of Latin American nations is due in great part to the lack of capital investment. Capital flies out of the region when faced with the perspective of confronting unbearable risks as chronic currency devaluations, nationalizations, exchange controls, and general political instability.
If these risks could be insured by a carrier with long term commitments and adequate financial backing, Latin savings abroad could be lured back to the region. The impact of drawing massive sustained investment into Latin America would bring about increased per capita income, growth of GNP, increased exports and foreign currency reserves, and eventually stable economies providing the basis for widespread prosperity in the region.

The purpose of this thesis is to establish the feasibility and long term benefits of providing such insurance to any interested party. Special emphasis will be given in the analysis to the Caribbean and Central American countries, as a program such as this one could be an extension to the Caribbean Basin Initiative.

OPIC's through its foreign investment insurance programs has many restrictions to provide insurance coverage in Latin America. The fact only U.S. citizens (or U.S. corporations owned by U.S. nationals) are eligible for coverage, coupled investor's lack of knowledge of these
programs and their lack of "know home" has kept them away from the region.

If such insurance program was available to any interested party willing to pay for its coverage, it would probably receive the attention of Latin Americans with "nest egg" savings outside their own countries.

Sources of information for this research project would include direct interviews with officers of the following entities:

- Foreign Commerce Insurance Association
- Overseas Private Investment Corporation
- U.S. Agency for International Development
- International Monetary Fund
- Private Bankers in Florida
- Caribbean Basin Initiative’s office
- Ministers of Economy and Finance of Latin Countries
- Private Export Funding Corporation
- Eximbank
- Individual Latin investors with deposits abroad
Following, please find samples of the questionnaires:

Questions for U.S. Bankers:

1.) Do you think it would be feasible to offer political risk insurance to Latin American investors in their own countries?

2.) Do you think such coverage would have any adverse effects on the size of Latin American deposits in the U.S.A.?

    a.) Would you lose any business because of it?

    b.) Would offering this insurance coverage have any adverse effects on the U.S. economy as a whole?

3.) Would increased capital investment in Latin America have any effect in those countries' ability to pay their foreign debt?
a.) If so, would you support such a scheme if proposed by the U.S. Government?

b.) In case of claims, the insuring entity would have ultimate recourse with the government of the country in question. What type of institution do you think would have a comparative advantage (leverage) to effect such a claim to the host government?

4.) In order to make insurance viable, the insurer might require senior claims on the country's assets. This would imply banks would have to become subordinated creditors. Would U.S. Banks accept to subordinate their debt?

5.) Given bank's asymmetry in power (and their deep involvement with the region), as compared with insurance companies, would they be interested in providing country risk insurance? Can you legally do so?
Questions for Insurance Company Executives

1.) Would you consider such insurance desirable?

2.) Describe any potential conflicts of interest for bankers, in as much such scheme would repatriate Latin American deposits now in the U.S.?

3.) If political risk insurance were offered, would that factor by itself be enough to cause a shift of Latin American deposits from U.S. Banks (or dollar denominated investments) back to their home countries?

   a.) Can you estimate demand?

4.) Do you think such insurance would be economically feasible for private enterprise? If not, who do you think could provide coverage?

5.) As an insurance company, are you willing to accept any country risk?
6.) In case of claims, the insurance carrier would have ultimate recourse with the government of the country in question. What type of institution would have a comparative advantage (leverage) to effect such a claim to the host government?

7.) Would you (as an insurer and/or a U.S. Taxpayer) be against such coverage be offered by:

a.) Private entities

b.) The U.S. Government
Questions for Latin American Investors:

Latin American entrepreneurial able groups are not investing in their home countries as much as their businesses demand due to the high political and economic risks involved. This questionnaire seeks to understand the rationale and decision process faced by these individuals. There has been very little research performed in this area, and it is the contention of the writer, that the process is grossly misunderstood abroad.

Political risk insurance, by alleviating one major area of investor's concern, has been considered as one of the solutions to attract capital flows back into the region. This questionnaire also seeks to understand your reactions as an investor in the region, to these statements.

O.) Describe the nature of the risks you face in your country of origin? (Please define risks separating pure sovereign risks from commercial ones.)
a.) Could you identify unusual political or economical risks that are unique to your investment environment?

1.) Would you be interested in such coverage? Can you imagine or estimate demand?

   a.) If such insurance was offered, would it bring additional investment (new capital) to the region?

   b.) Would it change the type of your investments? (I.E., From short range to long range, from capital intensive to labor intensive).

   c.) Who would take advantage of this type of coverage? (Foreigners or locals, and why?)

2.) How much would you be willing to pay for coverage? Expressed as a % of the insured portfolio, for you, what would a reasonable rate be?
a.) Since investments, specially in capital intensive industries, have medium or long term pay-back periods, what commitments would you require regarding the duration of your coverage, in order to returning any investment capital?

b.) What deductible would you consider acceptable?

3.) What entity would you expect be willing to give such a coverage? What level of skepticism would you have to these parties honoring such coverage agreements

a.) International insurance companies
b.) Foreign banks
c.) U.S. Govt. Or similar international entity
d.) Multilateral organizations such as World Bank, Interamerican Development Bank, etc.

4.) Given the availability of this type of coverage, would you be willing to shift back any of your deposits or U.S.$ Denominated assets, to your home country? Why?
a.) Is there any difference between the return on investment you are obtaining, from your investment portfolio abroad with the one in your home country? What is the return on equity on each of the major types of investments you own?

b.) What percent of your assets are held abroad? Do you have a specific target? (The purpose here is to identify how over-exposed are local investors to country risks.)

c.) Is there a fixed percentage of profits that are moved out of the country every year to diversify investment portfolio, or is there a certain amount kept out regardless? How do you set these goals?

d.) Please explain the rationale for your group OR family's investment policy. What is the strategy? Who decides? How do you choose the investment instruments? How did you choose the country where you maintain your assets?
e.) The media views your investments abroad as capital flight and not as portfolio diversification, as would be the case for an American investing abroad. What are your views on this matter?

5.) Referring to your country of origin, please answer the following:

a.) Is there a problem of lack of capital investment? Is there a need for additional investment?

b.) What would be the effects of channeling additional investment into your country? What amounts would be needed to make a difference?

c.) How do you expect your home country's government to view this proposal? If it counts with official support, do you think it is possible to secure guarantees to be offered to the entity providing insurance to entice them to provide such a service?
d.) Can you create an insurance solution to the lack of investment in Latin America?

6.) How often do you revise your investment strategy?

7.) How sensitive is your investment allocation process or decision criteria to local:

   a.) Political events
   b.) Economic conditions (ie. depressions, inflation)
   c.) Interest rate differentials

8.) In the future do you see any changes regarding the way you have made investment decisions. The question is attempting to establish if given previous investment experience and results; have you considered different strategies for the future?

9.) If your company went through a crisis in your home country, would you return any portion or all of your $ denominated assets in order to resolve it?
10.) When borrowing abroad or in your country, have you or would you consider in the future offering crossed guarantees, pledging domestic or foreign assets as collateral?

11.) Do you think Latin America faces also a flight of talent due to lack of challenging local opportunities?
Appendix 3

Sample Insurance Policies
EXPROPRIATION INSURANCE
between
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
("CITI")

and

__________________________________________

__________________________________________

(the "Insured")

DECLARATIONS

For purposes of this policy, the terms below are defined as follows:

1. Policy Period: __________________________
2. Host Country: __________________________
3. Enterprise: __________________________
4. Investment: __________________________
5. Policy Currency: _________________________
6. Insured Percentage: _____________________
7. Premium: ______________________________
8. Maximum Liability: ______________________
9. Endorsements: __________________________

By acceptance of this policy the Insured agrees that all statements contained in the Application and the above Declarations and all written statements submitted by the Insured or its agents are the Insured's representations and agreements and that this policy, which includes any endorsements, constitutes the entire agreement between the parties concerning the subject matter and supersedes any prior agreement or understanding.

Agreed and Accepted By CITI

Title: __________________________
Date: __________________________
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.

EXPROPRIATION INSURANCE

I. Peril Insured

In consideration of the Premium paid by the Insured and subject to the terms and conditions set forth below, CITI hereby agrees to compensate the Insured for the Insured Percentage of loss occurring during the Policy Period resulting solely and directly from Expropriation. "Expropriation" means any act or series of acts constituting expropriation, confiscation, nationalization or requisition by the Host Government which for a period of nine months substantially and directly:

1. Deprivation of Rights of Investor
   Deprives the investor of rights in all or a specific portion of the insured investment which rights are necessary to substantially realize the benefits of the insured investment; or

2. Taking of Enterprise Assets
   Deprives the Enterprise of all or a portion of its assets; or

3. Cessation of Operations
   Deprives the Enterprise of fundamental rights, thereby ultimately necessitating the cessation of operations.

"Host Government" means the central governmental authority of the Host Country, or portion of the Host Country in which the Enterprise is located, exercising effective legislative, executive and judicial control, whether de jure or de facto.

II. Exclusions

CITI shall not be liable for any loss caused by or arising from:

1. War
   Destruction or physical damage directly or indirectly occasioned by, happening through or in consequence of war, invasion, acts of foreign enemies, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power.

2. Commercial Failure or Insolvency
   The Insured's or the Enterprise's commercial failure, insolvency or default on any financial obligation.

3. Malfeasance by Insured
   Wrongful, dishonest or criminal acts or omissions by the Insured or the Enterprise or agents of either.
4. **Non-Compliance with Host Country Laws**
Failure of the Insured or the Enterprise to comply with all legal requirements of the Host Country and any other governing authority, including failure to obtain necessary licenses and permits.

5. **Nontransfer of Currency**
Exchange control measures or delays in currency conversion or transfer.

6. **Breach of Policy**
Material breach of any representation, condition, warranty or covenant of the Insured contained in this policy.

III. **Compensation**

1. **Total Loss**
In the case of total loss, the compensation payable shall be the Insured Percentage times
   
   (a) the principal and accrued interest of any debt Investment covered, plus
   (b) the net book value of the equity Investment covered, translated into Policy Currency,

   as of the date the expropriatory effect commences. The net book value shall be computed in accordance with principles of accounting generally accepted in the domicile country of the Insured and used by the Insured. Adjustments shall be made to account for the Enterprise as an independent entity, and to reflect the standard of arm's-length dealing between related parties and reductions in realizable values.

2. **Partial Loss**
In the case of a partial loss, the compensation payable shall be the Insured Percentage times the net book value of
   (1) the portion of the Insured's Investment taken or (2) its pro rata equity interest in the assets taken. In no case shall the compensation payable for any loss computed under this section 2 exceed the compensation which would be payable for a total loss under section 1 on the date the expropriatory effect commences.

3. **Date of Loss Computation**
Compensation shall be computed as of the date the expropriatory effect commences. Where the Expropriation consists of a series of acts, the loss date is the date when the cumulative effect of the acts constitutes Expropriation, thereby commencing the Waiting Period. Compensation shall be increased, however, to take into account reductions in net book value directly caused by such expropriatory acts occurring prior to the loss date, but not to exceed the Maximum Liability.
4. **Insolvency**
   If Enterprise liabilities exceed assets as of the date the Expropriation occurs, compensation shall not exceed the Insured Percentage times the amount the Insured would have been entitled to receive had the Enterprise been liquidated at book value.

5. **Salvage**
   Compensation shall be reduced by the Insured Percentage of any other compensation, offset or salvage realized by the Insured outside the Host Country with respect to the Expropriation. Any amounts of salvage realized by CITI with respect to a compensated Expropriation shall be applied first to reimburse CITI for its out-of-pocket expenses in pursuing salvage and shall then be divided between the parties according to the Insured Percentage ratio. However, to the extent CITI's net recovery exceeds the amount CITI paid plus its out-of-pocket expenses, the Insured shall be paid a portion of the excess determined by dividing the time period between the date of the loss event and the date of claim payment by the time period between the date of the loss event and the date the excess is recovered.

6. **Maximum Liability**
   Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations.

7. **De Minimis Claims**
   CITI shall not be liable for any Expropriation if the amount of compensation payable would be less than United States $20,000.

IV. **Conditions**

1. **Notice of Potential Claim**
   The Insured shall notify CITI promptly, and in no event in more than 30 days, of any occurrence which could give rise to a claim.

2. **Cooperation**
   The Insured shall take all reasonable steps to avoid or minimize loss. The Insured shall cooperate fully and cause any person or entity within its power to cooperate fully with CITI in the investigation of any claim, the resolution of any potential claim situation and the pursuit of any claim salvage. Such cooperation shall include disclosure of records and documents and the making available of witnesses. Prior to any claim payment, the Insured shall pursue and cause the Enterprise to pursue all reasonable legal, administrative, judicial and informal means of avoiding or remedying any Expropriation which would be compensable under this policy. Neither the Insured nor the
Enterprise shall enter into any agreement concerning a loss or potential loss without CITI's prior written consent.

3. **Burden of Proof**
The Insured shall have the burden of proof in establishing its right to any compensations under this policy. Any claim for compensation shall be submitted within 6 months of the expiration of the Waiting Period following the event of loss and if withdrawn may not be resubmitted.

4. **Assignment and Subrogation**
As a condition to any claim payment, the Insured shall assign to CITI all of the Insured's right, title and interest in the Investment and assets taken and all related claims against third parties. Should CITI so request, the Insured shall retain legal title to any interests or claims to which CITI is entitled. CITI shall have no obligation to pursue salvage with respect to any claim. Any salvage received by the Insured shall be considered held in trust for CITI and transferred to CITI for apportionment in accordance with Article III, section 5.

V. **Warranties**
The Insured warrants and agrees that:

1. **Accuracy of Representations**
All written statements submitted to CITI to obtain this policy are true and correct and no material information has been withheld. Should there be any material inaccuracy in the Insured's representations, CITI may void this policy, retain the premium paid and refuse to compensate the Insured for loss occurring prior to the discovery of the material misrepresentation.

2. **Preservation of Remedies**
The Insured will preserve and cause the Enterprise to preserve all legal, judicial and administrative remedies applicable to any Expropriation and furnish reasonable assistance in maintaining any rights or property transferred to CITI.

3. **Confidentiality**
The Insured will not disclose the existence of this policy to any third party without CITI's prior consent except in confidence to the Insured's broker and banker.

4. **Self-Insured Retention**
The Insured will remain at risk for any loss resulting from the peril insured by this policy to the extent of at least 100 percent less the Insured Percentage times the net book value of its equity and debt interest in the Enterprise.
VI. General Provisions

1. Declarations
The Declarations and the Application are an integral part of this policy. For purposes of this policy, the terms defined in the Declarations shall have the meanings set forth therein.

2. Cancellation
This policy may not be cancelled by either party, except that CITI may cancel for nonpayment of premium upon ten days written notice to the Insured. In such case, this policy shall be void \textit{ab initio} and no claim shall be compensable, whether arising before or after the due date of the Premium.

3. Non-Assignment
The Insured shall not assign or transfer this policy or the benefits or obligations thereof to any other party or person, except with CITI’s prior consent. The Insured may, with CITI’s prior agreement, require any payments hereunder to be made to a named loss payee, all the Insured’s obligations under this policy remaining unaffected.

4. Other Insurance
The insurance provided under this policy shall be excess over any other insurance or indemnity covering the same event of loss.

5. Notice and Modification
All notices under this policy shall be in writing and delivered to responsible officers of the parties at the addresses indicated in the Declarations. This policy may be modified only by written, mutual consent of the parties.

6. Governing Law
This policy shall be governed by the laws of New York.

7. Arbitration
Any controversy relating to this policy shall be settled by arbitration in New York, New York according to the then prevailing Commercial Arbitration Rules of the American Arbitration Association. Unless the Insured initiates arbitration, CITI’s liability with respect to any claim matter shall expire one year after CITI notifies the insured of CITI’s determination concerning an application for compensation. A decision by an arbitrator or arbitral panel shall be final and binding, subject to the Maximum Liability limit.
CURRENCY NONTRANSFER
INSURANCE FOR INVESTORS
between
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675
("CITI")
and

__________________________________________

(the "Insured")

DECLARATIONS

For purposes of this policy, the terms below are defined as follows:

1. Policy Period:
2. Host Country:
3. Enterprise:
4. Investment:
5. Policy Currency:
6. Insured Percentage:
7. Premium:
8. Maximum Liability:
9. Waiting Period:
10. Endorsements:

By acceptance of this policy the Insured agrees that all statements contained in the Application and the above Declarations and all written statements submitted by the Insured or its agents are the Insured's representations and agreements and that this policy, which includes any endorsements, constitutes the entire agreement between the parties concerning the subject matter and supersedes any prior agreement or understanding.

Agreed and Accepted By CITI

Title: ________________________________
Date: SPECIMEN
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675

CURRENCY NONTRANSFER
INSURANCE FOR INVESTORS

I. Peril Insured

In consideration of the Premium paid by the Insured and subject to the terms and conditions set forth below, CITI hereby agrees to compensate the Insured for the Insured Percentage of any loss occurring during the Policy Period resulting solely and directly from a condition of Nontransfer remaining in effect continuously for the Waiting Period. “Nontransfer” shall mean inability of the Enterprise and/or Insured, after all reasonable efforts, to convert and transfer outside the Host Country available funds through any normal currency exchange channel to remit in Policy Currency a distribution of earnings from or repatriation of the insured investment.

The loss shall be deemed to occur and the Waiting Period commence with the first attempt by the Enterprise and/or Insured to transfer the funds in question.

II. Exclusions

CITI shall not be liable for any loss caused by or arising from:

1. Pre-existing Restrictions
   Pre-existing restrictions on transfer such that the Enterprise and/or Insured would have been unable to transfer legally a similar distribution in comparable circumstances as of the commencement of the Policy Period or as of the date of any subsequent extension or renewal.

2. Internal Freezes
   Restrictions on usage of the funds within the Host Country.

3. Nonperformance by Insured
   Material failure by the Insured and/or Enterprise to perform any reasonable legal requirement necessary to convert and transfer the funds or to make all reasonable efforts to effect transfer through all direct and indirect legal means.

4. Malfeasance by Insured
   Wrongful, dishonest or criminal acts or omissions by the Insured or its agents.

5. Insolvency or Financial Default
   Insolvency, bankruptcy or financial default of any party except the official exchange control authority of the Host Country.
6. **Currency Fluctuation**
Currency fluctuation or devaluation.

7. **Delays by Insured**
Failure by the Insured to attempt the transfer, or take reasonable steps to cause the Enterprise to effect the transfer, of the funds from the Host Country within thirty days of the earliest date that the funds were available for transfer.

8. **Breach of Policy**
Material breach of any representation, condition, warranty or covenant of the Insured contained in this policy.

9. **War**
Declared or undeclared war (whether before or after the outbreak of hostilities) between any of China, France, Great Britain, the Union of Soviet Socialist Republics and the United States of America or between the Host Country and the Insured's Country.

III. **Compensation**

1. **Basis of Compensation**
Compensation shall be the Insured Percentage times the Policy Currency equivalent of the currency of the Host Country sought to be transferred as of the end of the Waiting Period. The equivalent value shall be determined by applying the net exchange rate prevailing in the normal exchange market or channel through which Policy Currency is generally available for the type of transaction involved.

2. **Other Compensation**
With respect to any event of loss, compensation shall be reduced by the Insured Percentage of the amount of any other compensation or monetary benefit realized by the Insured by reason of the event.

3. **Currency of Payment**
All compensation shall be computed and paid in Policy Currency.

4. **Salvage**
Any amounts of salvage realized by CITI with respect to a compensated claim shall be applied first to reimburse CITI for its out-of-pocket expenses in pursuing salvage and shall then be divided between the parties according to the Insured Percentage ratio. However, to the extent CITI's net recovery exceeds the amount CITI paid plus its out-of-pocket expenses, the Insured shall be paid a portion of the excess determined by dividing the time period between the date of the loss event and the date of claim payment by the time period between the date of the loss event and the date the excess is recovered.
5. **Maximum Liability Limits**

Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations. In the event that CITI has issued an expropriation policy covering the insured investment, under no circumstances shall CITI be liable in the aggregate under both policies combined for an amount in excess of the higher of the two Maximum Liabilities set forth in Declarations of the policies.

IV. **Conditions**

1. **Notice of Potential Claim**

The Insured shall notify CITI promptly, and in no event in more than 30 days, of any occurrence which could give rise to a claim. Notwithstanding any other provision of this policy, if an event of loss occurs, CITI may terminate the Waiting Period and demand a claim filing and an assignment and subrogation, in accordance with section 4 of this Article, within ten working days as a pre-condition to any claim payment.

2. **Cooperation**

The Insured shall take all reasonable steps to avoid or minimize loss. Should a claim or potential claim situation arise, such steps shall include taking all reasonable steps to effect transfer of the funds through any legal means. The Insured shall cooperate fully and cause any person or entity within its power to cooperate fully with CITI in the investigation of any claim, the resolution of any potential claim situation and the pursuit of any claim salvage. Such cooperation shall include disclosure of records and documents and the making available of witnesses. Prior to any claim payment, the Insured will pursue all reasonable legal, administrative, judicial and informal means of avoiding or remedying any event of loss which would be compensable under this policy. The Insured shall not enter into any agreement concerning a loss or potential loss without CITI's prior written consent.

3. **Burden of Proof**

The Insured shall have the burden of proof in establishing its right to any compensation under this policy. Any claim for compensation shall be submitted within three months of the expiration of the Waiting Period following the event of loss and if withdrawn may not be resubmitted.

4. **Assignment and Subrogation**

As a condition to any claim payment, the Insured shall assign to CITI all of the Insured's right, title and interest in the currency which is the subject of the claim and all related claims against third parties and, unless illegal, deliver the funds to CITI in the Host Country. Should CITI so request, the Insured
shall retain legal title to any interests or claims to which CITI is entitled. Any salvage received by the insured shall be considered held in trust for CITI and transferred to CITI for apportionment in accordance with Article III, section 4.

V. Warranties

The Insured warrants and agrees that:

1. **Accuracy of Representations**
   All written statements submitted to CITI to obtain this policy are true and correct and no material information has been withheld. Should there be any material inaccuracy in the Insured's representations, CITI may void this policy, retain the premium paid and refuse to compensate the Insured for loss occurring prior to the discovery of the material misrepresentation.

2. **Current Exchange Control Regime**
   As of the commencement of the Policy Period and as of the date of any subsequent extension or renewal, the Insured is not aware of and has no reason to be aware of any significant delays in the types of currency transfers which are the subject of this policy or any restriction imposed under the laws, regulations, orders or decrees of the Host Country or under any voluntary agreement which would impair or significantly delay such transfers except as specifically disclosed in the Application.

3. **Preservation of Remedies**
   The Insured will preserve all legal, judicial and administrative remedies applicable to any claim and furnish reasonable assistance in maintaining any rights or property transferred to CITI.

4. **Confidentiality**
   The Insured will not disclose the existence of this policy to any third party without CITI's prior consent except in confidence to the Insured's broker and banker.

5. **Self-Insured Retention**
   The Insured will remain at risk for any loss resulting from the perils covered to the extent not insured by this policy.

VI. General Provisions

1. **Declarations**
   The Declarations and the Application are an integral part of this policy. For purposes of this policy, the terms defined in the Declarations shall have the meanings set forth therein.
2. Exchange Rates
Any computation of currency equivalents required by this policy
shall utilize the method set forth in Article III, section 1.

3. Cancellation
This policy may not be cancelled by either party, except that
CITI may cancel for nonpayment of Premium upon twenty days
written notice to the Insured. In such case, this policy shall
be void ab initio and no claim shall be compensable, whether
arising before or after the due date of the Premium.

4. Non-Assigment
The insured shall not assign or transfer this policy or the
benefits or obligations thereof to any other party or person,
except with CITI's prior consent. The insured may, with CITI's
prior agreement, require any payments hereunder to be made to a
named loss payee, all the insured's obligations under this policy
remaining unaffected.

5. Other Insurance
The insurance provided under this policy shall be excess over any
other insurance or indemnity covering the same event of loss.

6. Notice and Modification
All notices under this policy shall be in writing and delivered
to responsible officers of the parties at the addresses indicated
in the Declarations. This policy may be modified only by
written, mutual consent of the parties.

7. Governing Law
This policy shall be governed by the laws of New York state.

8. Arbitration
Any dispute relating to this policy shall be settled by
arbitration in New York, New York according to the then
prevailing Commercial Arbitration Rules of the American
Arbitration Association. Unless the insured initiates
arbitration, CITI's liability with respect to any claim matter
shall expire one year after CITI notifies the insured of CITI's
determination concerning an application for compensation. A
decision by an arbitrator or arbitral panel shall be final and
binding, subject to the Maximum Liability limit.

______________________________

*
CONTRACT FRUSTRATION INSURANCE
FOR EXPORTERS OF GOODS AND SERVICES
between
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675
("CIT")
and

______________________________

(the "Insured")

DECLARATIONS
For purposes of this policy, the terms below are defined as follows:

1. Policy Period:

2. Buyer:

   The Buyer is a _________ Buyer.

3. Guarantor:

   which has guaranteed the obligations of the Buyer.

4. Buyer's Country:

5. Insured's Country:

6. Contract:

7. Policy Currency:

8. Insured Percentage:

9. Maximum Liability:

   subject to any Per Period Liability limits added by endorsement.

10. Coverages Elected:

11. Waiting Period:

   Perils covered in Art 1.1 & 5: _______ days
   Perils covered in Art 1.2,3 & 4: _______ days

12. Premium:

13. Endorsements:

By acceptance of this policy the Insured agrees that all statements contained in the Application and the above Declarations and all written statements submitted by the Insured or its agents are the Insured's representations and agreements and that this policy, which includes any endorsements, constitutes the entire agreement between the parties concerning the subject matter and supersedes any prior agreement or understanding.

Agreed and Accepted By CITI

Title: ___________________________
Date: ___________________________
Perils Insured

In consideration of the Premium paid by the Insured and subject to the terms and conditions set forth below, CITI hereby agrees to compensate the Insured for the Insured Percentage of loss occurring during the Policy Period resulting solely and directly from any of the following perils remaining in effect continuously for the Waiting Period:

1. **Public Buyer Repudiation or Non-Payment**
   The unjustified repudiation of the Contract or failure to make any payment due under the Contract by the Public Buyer and any Guarantor or the material failure by the Public Buyer and any Guarantor to perform any obligation under the Contract where such failure renders it commercially impractical or impossible for the Insured to perform its obligations under the Contract. Failure to perform includes failure by the Public Buyer and any Guarantor to honor a judgment or arbitral award based upon a repudiation or failure to perform under the Contract during the Policy Period; such event of loss shall be considered to occur during the Policy Period.

2. **Buyer's Country Frustration/License Cancellation**
   The application of any law, order, decree or regulation having the force of law in the Buyer's Country, including cancellation of a valid import license, which directly prevents further performance of the Contract and is outside the control of the Insured.

3. **Insured's Country Frustration/License Cancellation**
   The application of any law, order, decree or regulation having the force of law in the Insured's Country, including cancellation of a valid export license, which directly prevents further performance of the Contract and is outside the control of the Insured.

4. **War**
   A state of war, civil war, insurrection, rebellion or revolution in the Buyer's Country which directly prevents performance of the Contract for at least six months, thereby causing termination of the Contract.
5. **Nontransfer of Currency**

Inability of the Buyer and/or Insured, after all reasonable efforts, to effect the transfer of funds outside the Buyer’s Country through any normal currency exchange channel, if such transfer is necessary

a. for the Buyer to satisfy a Policy Currency obligation to the Insured under the Contract, or

b. for the Insured to repatriate the proceeds of the sale of equipment or materials in the Buyer’s Country which the Insured is legally entitled to convert and repatriate under the terms of the Contract and local law.

Only after delivery to CITI of the nontransferable currency shall any compensation be payable.

**Exclusions**

CITI shall not be liable for any loss caused by or arising from:

1. **Nonperformance by Insured**

   Material failure by the Insured to perform any obligation under the Contract or to comply with the terms of any export or import license or other legal requirement.

2. **Malfeasance by Insured**

   Wrongful, dishonest or criminal acts or omissions by the Insured or its agents.

3. **Insolvency or Financial Default**

   Insolvency, bankruptcy or financial default of any party except a Public Buyer or the official exchange control authority of the Buyer’s Country.

4. **Currency Fluctuation**

   Currency fluctuation or devaluation.

5. **Delays by Insured**

   Failure by the Insured to attempt the transfer, or take reasonable steps to cause the Buyer to effect the transfer, of any funds from the Buyer’s Country within thirty days of the earliest date that the funds were available for transfer.

6. **Disputes**

   Any material dispute under the Contract which has not been finally adjudicated or settled except to the extent that the Buyer’s position is demonstrably without merit or any final award or judgment in favor of the Buyer is demonstrably unjust.
7. **Breach of Policy**
Material breach of any representation, condition, warranty or covenant of the Insured contained in this policy.

8. **War**
Declared or undeclared war (whether before or after the outbreak of hostilities) between any of China, France, Great Britain, the Union of Soviet Socialist Republics and the United States of America or between the Buyer's Country and the Insured's Country.

9. **Physical Damage**
Physical damage, including ionizing radiation or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel or the radioactive toxic, explosive or hazardous properties of any nuclear assembly or nuclear component thereof.

**Compensation**

1. **Basis of Compensation**

   a. **Repudiation, Non-Payment, Frustration, War**
   For loss by reason of a peril specified in sections 1, 2, 3 or 4 of Article I, compensation shall be the Insured Percentage times the amount of

   (i) **Post Delivery**
   legally enforceable debt due the Insured under the Contract for services performed and goods delivered and

   (ii) **Pre-Delivery**
   necessary costs and expenses incurred by the Insured directly related to performance of the Contract which have not been paid for by the Buyer or compensated under (i), plus a deemed profit factor of ten percent of such costs and expenses,

   as of the occurrence of the event of loss, less

   (x) any valid credit, off-set or counter-claim available to the Insured and

   (y) any costs or expenses saved by the Insured by reason of premature termination or suspension of its performance under the Contract.

   b. **Nontransfer of Currency**
   For loss by reason of the peril specified in section 5 of Article I, compensation shall be the Insured Percentage times the Policy Currency equivalent of the
currency of the Buyer's Country sought to be transferred as of the later of (1) the due date of the obligation or (2) the date the currency of the Buyer's Country is deposited for transfer. The equivalent value shall be determined by applying the net exchange rate prevailing in the normal exchange market or channel through which Policy Currency is generally available for the type of transaction involved.

2. **Fines and Penalties**
   In no event shall compensation include any amount for governmental fines, duties or taxes or Contract penalties, including penalties for delay or nonperformance.

3. **Other Compensation**
   With respect to any event of loss, compensation shall be reduced by the Insured Percentage of the amount of any other compensation or monetary benefit realized by the Insured by reason of the event.

4. **Currency of Payment**
   All compensation shall be computed and paid in Policy Currency.

5. **Salvage**
   Any amounts of salvage realized by CITI with respect to a compensated claim shall be applied first to reimburse CITI for its out-of-pocket expenses in pursuing salvage and shall then be divided between the parties according to the Insured Percentage ratio. However, to the extent CITI's net recovery exceeds the amount CITI paid plus its out-of-pocket expenses, the Insured shall be paid a portion of the excess determined by dividing the time period between the date of the loss event and the date of claim payment by the time period between the date of the loss event and the date the excess is recovered.

6. **Maximum Liability Limits**
   Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations. Under no circumstances shall CITI be liable in the aggregate under this policy for events of loss in any one time period for more than the amount of any Per Period Liability limit prescribed for that period by an endorsement.

**Conditions**

1. **Notice of Potential Claim**
   The Insured shall notify CITI promptly, and in no event in more than 30 days, of any occurrence which could give rise to a claim.
2. **Cooperation**

The Insured shall take all reasonable steps to avoid or minimize loss. Should a claim or potential claim situation arise, such steps shall include (1) where prudent, ceasing further performance on the Contract and refraining from new transactions with the Buyer and (2) taking reasonable steps to find alternative buyers for the goods or services which are the subject of the Contract. The Insured shall cooperate fully and cause any person or entity within its power to cooperate fully with CITI in the investigation of any claim, the resolution of any potential claim situation and the pursuit of any claim salvage. Such cooperation shall include disclosure of records and documents and the making available of witnesses. Prior to any claim payment, the Insured will pursue all reasonable legal, administrative, judicial and informal means of avoiding or remediing any event of loss which would be compensable under this policy. The Insured shall not enter into any agreement concerning a loss or potential loss without CITI's prior written consent.

3. **Burden of Proof**

The Insured shall have the burden of proof in establishing its right to any compensation under this policy. Any claim for compensation shall be submitted within three months of the expiration of the Waiting Period following the event of loss and if withdrawn may not be resubmitted.

4. **Assignment and Subrogation**

As a condition to any claim payment, the Insured shall assign to CITI all of the Insured's right, title and interest in the Contract, goods, equipment, materials and currency which are the subject of the claim and all related claims against third parties. Should CITI so request, the Insured shall retain legal title to any interests or claims to which CITI is entitled. Any salvage received by the Insured shall be considered held in trust for CITI and transferred to CITI for apportionment in accordance with Article III, section 5.

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**Warranties**

The Insured warrants and agrees that:

1. **Accuracy of Representations**

All written statements submitted to CITI to obtain this policy are true and correct and no material information has been withheld. Should there be any material inaccuracy in the Insured's representations, CITI may void this policy, retain the premium paid and refuse to compensate the Insured for loss occurring prior to the discovery of the material misrepresentation.
2. **Validity of Contract and Authorizations**
The copies of all documents submitted with the Application are true copies of those documents; the Contract is valid and fully enforceable in the Buyer's Country; all licenses and authorizations obtained in connection with the Contract are valid.

3. **Preservation of Remedies**
The Insured will preserve all legal, judicial and administrative remedies applicable to any claim and furnish reasonable assistance in maintaining any rights or property transferred to CITI.

4. **Confidentiality**
The Insured will not disclose the existence of this policy to any third party without CITI's prior consent except in confidence to the Insured's broker and banker.

5. **Self-Insured Retention**
The Insured will remain at risk for any loss resulting from the perils covered to the extent not insured by this policy.

6. **Modification of Contract**
The Insured will not materially modify or amend the Contract without the prior written consent of CITI.

**General Provisions**

1. **Declarations**
The Declarations and the Application are an integral part of this policy. For purposes of this policy, the terms defined in the Declarations shall have the meanings set forth therein.

2. **Exchange Rates**
Any computation of currency equivalents required by this policy shall utilize the method set forth in Article III, section 1. b.

3. **Cancellation**
This policy may not be cancelled by either party, except that CITI may cancel for nonpayment of Premium upon twenty days written notice to the Insured. In such case, this policy shall be void ab initio and no claim shall be compensable, whether arising before or after the due date of the Premium.

4. **Non-Assignment**
The Insured shall not assign or transfer this policy or the benefits or obligations thereof to any other party or person, except with CITI's prior consent. The Insured may, with CITI's prior agreement, require any payments hereunder to be made to a named loss payee, all the Insured's obligations under this policy remaining unaffected.
5. Other Insurance
The insurance provided under this policy shall be excess over any other insurance or indemnity covering the same event of loss.

6. Notice and Modification
All notices under this policy shall be in writing and delivered to responsible officers of the parties at the addresses indicated in the Declarations. This policy may be modified only by written, mutual consent of the parties.

7. Governing Law
This policy shall be governed by the laws of New York state.

8. Arbitration
Any dispute relating to this policy shall be settled by arbitration in New York, New York according to the then prevailing Commercial Arbitration Rules of the American Arbitration Association. Unless the insured initiates arbitration, CITI's liability with respect to any claim matter shall expire one year after CITI notifies the insured of CITI's determination concerning an application for compensation. A decision by an arbitrator or arbitral panel shall be final and binding, subject to the Maximum Liability limit.
CONTRACT FRUSTRATION INSURANCE
FOR IMPORTERS OF GOODS

between
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675
("CITI")

and

_____________________________________

(the "Insured")

DECLARATIONS

For purposes of this policy, the terms below are defined as follows:

1. Policy Period:
2. Seller:_____________________________________________
The Seller is a _______ Seller.
3. Guarantor:_________________________________________

which has guaranteed obligations of the Seller.
4. Seller's Country:____________________________________
5. Insured's Country:__________________________________
6. Contract:__________________________________________
7. Policy Currency:____________________________________
8. Insured Percentage:_______________________________
9. Maximum Liability:__________________________________

subject to any Per Period Liability limits added by endorsement.
10. Coverages Elected:__________________________________
11. Waiting Period:____________________________________

Perils covered in Article 1.1 & 5: _______ days
Perils covered in Article 1.2, 3, 4 & 6: _______ days
12. Premium:_________________________________________
13. Endorsements:_____________________________________

By acceptance of this policy the Insured agrees that all statements contained in the Application and the above Declarations and all written statements submitted by the Insured or its agents are the Insured's representations and agreements and that this policy, which includes any endorsements, constitutes the entire agreement between the parties concerning the subject matter and supersedes any prior agreement or understanding.

Agreed and Accepted by CITI

Title:___________________________________________
Date:__________________________________________
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675

CONTRACT FRUSTRATION INSURANCE
FOR IMPORTERS OF GOODS

1. Perils Insured

In consideration of the Premium paid by the Insured and subject to the terms and conditions set forth below, CITI hereby agrees to compensate the Insured for the Insured Percentage of loss occurring during the Policy Period resulting solely and directly from any of the following perils remaining in effect continuously for the Waiting Period:

1. **Public Seller's Failure to Perform**
   The unjustified repudiation of the Contract or material failure to perform by the Public Seller and any Guarantor under the Contract, including a failure to deliver goods, due to any cause beyond the Insured's control and in circumstances where the Insured is not in material default under the Contract, to the extent any advance payment of the Insured is not reimbursed by the Public Seller or any Guarantor as required by the Contract. Failure to perform also includes failure by the Public Seller and any Guarantor to honor a judgment or arbitral award based upon a repudiation or failure to perform under the Contract during the Policy Period; such event of loss shall be considered to occur during the Policy Period.

2. **Seller's Country Frustration/License Cancellation**
   The application of any law, order, decree or regulation having the force of law in the Seller's Country, including cancellation of a valid export license, which directly prevents further performance of the Contract and is outside the control of the Insured.

3. **Insured's Country Frustration/License Cancellation**
   The application of any law, order, decree or regulation having the force of law in the Insured's Country, including cancellation of a valid import license, which directly prevents further performance of the Contract and is outside the control of the Insured.

4. **War**
   A state of war, civil war, insurrection, rebellion or revolution in the Seller's Country which directly prevents performance of the Contract for at least six months, thereby causing termination of the Contract.
5. **Nontransfer of Currency**
Inability of the Seller and/or the Insured, after all reasonable efforts, to transfer funds outside the Seller's Country through any normal currency exchange channel, if such transfer is necessary for the reimbursement of any advance payment due the Insured in Policy Currency under the Contract.

6. **Deprivation of Insured's Goods**
The application of any law, order, decree or regulation in the Seller's Country which deprives the Insured of the right to export from the Seller's Country goods acquired under the Contract for which title and risk of loss have passed to the Insured.

II. **Exclusions**

CITI shall not be liable for any loss caused by or arising from:

1. **Nonperformance by Insured**
Material failure by the Insured to perform any obligation under the Contract or to comply with the terms of any export or import license or other legal requirement.

2. **Malfeasance by Insured**
Wrongful, dishonest or criminal acts or omissions by the Insured or its agents.

3. **Insolvency or Financial Default**
Insolvency, bankruptcy or financial default of any party except a Public Seller or the official exchange control authority of the Seller's Country.

4. **Currency Fluctuation**
Currency fluctuation or devaluation.

5. **Disputes**
Any material dispute under the Contract which has not been finally adjudicated or settled except to the extent that the Seller's position is demonstrably without merit or any final award or judgment in favor the Seller is demonstrably unjust.

6. **Breach of Policy**
Material breach of any representation, condition, warranty or covenant of the Insured contained in this policy.

7. **War**
Declared or undeclared war (whether before or after the outbreak of hostilities) between any of China, France, Great Britain, the Union of Soviet Socialist Republics and the United States of America or between the Seller's Country and the Insured's Country.
8. Physical Damage
Physical damage, including ionizing radiation or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel or the radioactive toxic, explosive or hazardous properties of any nuclear assembly or nuclear component thereof.

Compensation
1. Basis of Compensation
   a. Failure to Perform, Frustration, War
      For loss by reason of a peril specified in sections 1, 2, 3 or 4 of Article I, compensation shall be the Insured Percentage times the amount of advance payments reimbursable to the Insured under the Contract for which goods are not delivered, less
      (i) any valid credit, off-set or counter-claim available to the insured and
      (ii) any costs or expenses saved by the Insured by reason of the Seller's non-performance under the Contract with respect to amounts advanced by the Insured.

   b. Nontransfer of Currency
      For loss by reason of the peril specified in section 5 of Article I, compensation shall be the Insured Percentage times the Policy Currency equivalent of the currency of the Seller's Country sought to be transferred as of the later of (1) the due date of the obligation or (2) the date the currency of the Seller's Country is deposited for transfer. The equivalent value shall be determined by applying the net exchange rate prevailing in the normal exchange market or channel through which Policy Currency is generally available for the type of transaction involved.

   c. Deprivation of Insured's Goods
      For loss by reason of the peril specified in section 6 of Article I, compensation shall be the Insured Percentage times the price paid for the goods of which the Insured is deprived.

2. Fines and Penalties
   In no event shall compensation include any amount for governmental fines, duties or taxes or Contract penalties, including penalties for delay or nonperformance.

3. Other Compensation
   With respect to any event of loss, compensation shall be reduced by the Insured Percentage of the amount of any other compensation or monetary benefit realized by the Insured by reason of the event.
4. **Currency of Payment**
   All compensation shall be computed and paid in Policy Currency.

5. **Salvage**
   Any amounts of salvage realized by CITI with respect to a compensated claim shall be applied first to reimburse CITI for its out-of-pocket expenses in pursuing salvage and shall then be divided between the parties according to the Insured Percentage ratio. However, to the extent CITI’s net recovery exceeds the amount CITI paid plus its out-of-pocket expenses, the Insured shall be paid a portion of the excess determined by dividing the time period between the date of the loss event and the date of claim payment by the time period between the date of the loss event and the date the excess is recovered.

6. **Maximum Liability Limits**
   Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations. Under no circumstances shall CITI be liable in the aggregate under this policy for events of loss in any one time period for more than the amount of any Per-Period Liability limit prescribed for that period by an endorsement.

IV. **Conditions**

1. **Notice of Potential Claim**
   The Insured shall notify CITI promptly, and in no event in more than 30 days, of any occurrence which could give rise to a claim.

2. **Cooperation**
   The Insured shall take all reasonable steps to avoid or minimize loss. Should a claim or potential claim situation arise, such steps shall include, where prudent, ceasing further advances or other performance on the Contract and refraining from new transactions with the Seller. The Insured shall cooperate fully and cause any person or entity within its power to cooperate fully with CITI in the investigation of any claim, the resolution of any potential claim situation and the pursuit of any claim salvage. Such cooperation shall include disclosure of records and documents and the making available of witnesses. Prior to any claim payment, the Insured will pursue all reasonable legal, administrative, judicial and informal means of avoiding or remedying any event of loss which would be compensable under this policy. The Insured shall not enter into any agreement concerning a loss or potential loss without CITI’s prior written consent.
3. **Burden of Proof**
The insured shall have the burden of proof in establishing its right to any compensation under this policy. Any claim for compensation shall be submitted within three months of the expiration of the Waiting Period following the event of loss and if withdrawn may not be resubmitted.

4. **Assignment and Subrogation**
As a condition to any claim payment, the insured shall assign to CITI all of the insured's right, title and interest in the Contract and assets which are the subject of the claim and all related claims against third parties. Should CITI so request, the insured shall retain legal title to any interests or claims to which CITI is entitled. Any salvage received by the insured shall be considered held in trust for CITI and transferred to CITI for apportionment in accordance with Article III, section 5.

**Warranties**
The insured warrants and agrees that:

1. **Accuracy of Representations**
   All written statements submitted to CITI to obtain this policy are true and correct and no material information has been withheld. Should there be any material inaccuracy in the insured's representations, CITI may void this policy, retain the premium paid and refuse to compensate the insured for loss occurring prior to the discovery of the material misrepresentation.

2. **Validity of Contract and Authorizations**
The copies of all documents submitted with the Application are true copies of those documents; the Contract is valid and fully enforceable in the Seller's Country; all licenses and authorizations obtained in connection with the Contract are valid.

3. **Preservation of Remedies**
The insured will preserve all legal, judicial and administrative remedies applicable to any claim and furnish reasonable assistance in maintaining any rights or property transferred to CITI.

4. **Confidentiality**
The insured will not disclose the existence of this policy to any third party without CITI's prior consent except in confidence to the insured's broker and banker.

5. **Self-Insured Retention**
The insured will remain at risk for any loss resulting from the perils covered to the extent not insured by this policy.

6. **Modification of Contract**
The insured will not materially modify or amend the Contract without the prior written consent of CITI.
VI. General Provisions

1. Declarations
   The Declarations and the Application are an integral part of this policy. For purposes of this policy, the terms defined in the Declarations shall have the meanings set forth therein.

2. Exchange Rates
   Any computation of currency equivalents required by this policy shall utilize the method set forth in Article III, section 1.b.

3. Cancellation
   This policy may not be cancelled by either party, except that CITI may cancel for nonpayment of Premium upon twenty days written notice to the insured. In such case, this policy shall be void ab initio and no claim shall be compensable, whether arising before or after the due date of the Premium.

4. Non-Assignment
   The Insured shall not assign or transfer this policy or the benefits or obligations thereof to any other party or person, except with CITI's prior consent. The Insured may, with CITI's prior agreement, require any payments hereunder to be made to a named loss payee, all the Insured's obligations under this policy remaining unaffected.

5. Other Insurance
   The insurance provided under this policy shall be excess over any other insurance or indemnity covering the same event of loss.

6. Notice and Modification
   All notices under this policy shall be in writing and delivered to responsible officers of the parties at the addresses indicated in the Declarations. This policy may be modified only by written, mutual consent of the parties.

7. Governing Law
   This policy shall be governed by the laws of New York state.

8. Arbitration
   Any dispute relating to this policy shall be settled by arbitration in New York, New York according to the then prevailing Commercial Arbitration Rules of the American Arbitration Association. Unless the Insured initiates arbitration, CITI's liability with respect to any claim matter shall expire one year after CITI notifies the Insured of CITI's determination concerning an application for compensation. A decision by an arbitrator or arbitral panel shall be final and binding, subject to the Maximum Liability limit.
INSURANCE FOR
CALLING OF ON-DEMAND GUARANTEE
between
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675
("CITI")
and

____________________________________________________________

(the "Insured")

DECLARATIONS

For purposes of this policy, the terms below are defined as follows:

1. Policy Period: 
2. Buyer: The Buyer is a _____________________ Buyer.
3. Buyer's Country: 
4. Insured's Country: 
5. Contract: 
6. Guarantee: 
7. Bank: 
8. Counter-Indemnity: 
9. Policy Currency: 
10. Insured Percentage: 
11. Maximum Liability: subject to any Per Period Liability limits added by endorsement.
12. Waiting Period: ____________________________ days
13. Premium: 
14. Endorsements: 

By acceptance of this policy the insured agrees that all statements contained in the Application and the above Declarations and all written statements submitted by the insured or its agents are the insured's representations and agreements and that this policy, which includes any endorsements, constitutes the entire agreement between the parties concerning the subject matter and supersedes any prior agreement or understanding.

Agreed and Accepted By CITI

Title: ______________________________
Date: ______________________________
CITICORP INTERNATIONAL TRADE INDEMNITY, INC.
50 Tice Boulevard
Woodcliff Lake, New Jersey 07675

INSURANCE
FOR CALLING OF
ON-DEMAND GUARANTEE

I. Perils Insured

In consideration for the premium paid by the Insured and subject to the terms and conditions set forth below, CITI hereby agrees to compensate the Insured for the Insured Percentage of loss occurring during the Policy Period resulting solely and directly from any of the following perils remaining in effect for the Waiting Period:

1. Public Buyer Wrongful Calling
   A wrongful calling of the Guarantee by the Public Buyer to the extent that the amount drawn is in excess of the amount due the Public Buyer under the Contract.

2. Calling Permitted under the Contract
   A calling of the Guarantee by the Buyer based upon failure of the Insured to deliver goods or services as required by the Agreement where such failure is solely and directly caused by
   a. Buyer's Country Frustration/License Cancellation
      The application of any law, order, decree or regulation having the force of law in the Buyer's Country, including cancellation of a valid import license, which directly prevents further performance of the Contract and is outside the control of the Insured.
   b. Insured's Country Frustration/License Cancellation
      The application of any law, order, decree, or regulation having the force of law in the Insured's Country, including cancellation of a valid export license, which directly prevents further performance of the Contract and is outside the control of the Insured.
   c. War
      A state of war, civil war, insurrection, rebellion or revolution continuing in the Buyer's Country for at least six months, which directly prevents further performance of the Contract.

3. Failure of Public Buyer to Honor Award
   A failure of the Public Buyer to honor an arbitral award or judgment directing the Public Buyer to pay the Insured any amount which the Public Buyer has drawn under the Guarantee.
II. Definitions

1. **Contract**
The contract specified in the Declarations between the Insured and the Buyer.

2. **Guarantee**
The undertaking specified in the Declarations given by a local bank to the Buyer, in accordance with the Contract.

3. **Bank**
The bank specified in the Declarations which the Insured has caused to give a counter-guarantee to the local bank in respect of the Guarantee.

4. **Counter-Indemnity**
The undertaking specified in the Declarations given by the Insured to the Bank to indemnify the Bank for its payments to the local bank under the Guarantee.

III. Exclusions

CITI shall not be liable for any loss caused by or arising from:

1. **Nonperformance by Insured**
Material failure by the Insured to perform any obligation under the Contract or to comply with the terms of any export or import license or other legal requirement.

2. **Malfeasance by Insured**
Wrongful, dishonest or criminal acts or omissions by the Insured or its agents.

3. **Insolvency or Financial Default**
Insolvency, bankruptcy or financial default of any party except a Public Buyer or the official exchange control authority of the Buyer's Country.

4. **Currency Fluctuation**
Currency fluctuation or devaluation.

5. **Disputes**
Any material dispute under the Contract which has not been finally adjudicated or settled except to the extent that the Buyer's position is demonstrably without merit or any final award or judgment in favor of the Buyer is demonstrably unjust.

6. **Breach of Policy**
Material breach of any representation, condition, warranty or covenant of the Insured contained in this policy.
7. War
Declared or undeclared war (whether before or after the outbreak of hostilities) between any of China, France, Great Britain, the Union of Soviet Socialist Republics and the United States of America or between the Buyer's Country and the Insured's Country.

8. Physical Damage
Physical damage, including ionizing radiation or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel or the radioactive toxic, explosive or hazardous properties of any nuclear assembly or nuclear component thereof.

IV. Compensation

1. Basis of Compensation
For loss by reason of a peril specified in section 1 or 2 of Article I, compensation shall be the Insured Percentage times the amount which the Insured is required to pay the Bank as a consequence of the event of loss, exclusive of any interest payable from the calling of the Guarantee. For loss by reason of the peril specified in section 3 of Article I, compensation shall be the Insured Percentage times the amount of the award or judgment the Buyer has failed to honor. Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations.

2. Fines and Penalties
In no event shall compensation include any amount for governmental fines, duties or taxes or Contract penalties, including penalties for delay or nonperformance.

3. Other Compensation
With respect to any event of loss, compensation shall be reduced by the Insured Percentage of the amount of any other compensation or monetary benefit realized by the Insured by reason of the event.

4. Currency of Payment
All compensation shall be computed and paid in Policy currency.

5. Salvage
Any amounts of salvage realized by CITI with respect to a compensated claim shall be applied first to reimburse CITI for its out-of-pocket expenses in pursuing salvage and shall then be divided between the parties according to the Insured Percentage ratio. However, to the extent CITI's net recovery exceeds the amount CITI paid plus its out-of-pocket expenses, the Insured shall be paid a portion of the excess determined by dividing the time period between the date of
the payment under the Counter-Indemnity and the date of claim payment by the time period between the date of the payment under the Counter-Indemnity and the date the excess is recovered.

6. **Maximum Liability Limits**
Under no circumstances shall CITI be liable in the aggregate under this policy for more than the amount of Maximum Liability set forth in the Declarations. Under no circumstances shall CITI be liable in the aggregate under this policy for events of loss in any one time period for more than the amount of any Per Period Liability limit prescribed for that period by an endorsement.

V. **Conditions**

1. **Notice of Potential Claim**
The Insured shall notify CITI promptly, and in no event in more than 30 days, of any occurrence which could give rise to a claim.

2. **Cooperation**
The Insured shall take all reasonable steps to avoid or minimize loss, including, where prudent, ceasing further performance on the contract and refraining from new transactions with the account party. The Insured shall cooperate fully and cause any person or entity within its power to cooperate fully with CITI in the investigation of any claim, the resolution of any potential claim situation and the pursuit of any claim salvage. Such cooperation shall include disclosure of records and documents and the making available of witnesses. Prior to any claim payment, the Insured will pursue all reasonable legal, administrative, judicial and informal means of avoiding or remedying any event of loss which would be compensable under this policy. The Insured shall not enter into any agreement concerning a loss or potential loss without CITI's prior written consent.

3. **Burden of Proof**
The Insured shall have the burden of proof in establishing its right to any compensation under this policy. Any claim for compensation shall be submitted within three months of the expiration of the Waiting Period following the event of loss and if withdrawn may not be resubmitted.

4. **Assignment and Subrogation**
As a condition to any claim payment, the Insured shall assign to CITI all of the Insured's rights against third parties related to the loss and any other interests which are an offset to the loss. Should CITI so request, the Insured shall retain legal title to any interests or claims to which CITI is entitled. Any salvage received by the
Insured shall be considered held in trust for CITI and transferred to CITI for apportionment in accordance with Article IV, section 5.

VI. Warranties.

The Insured warrants and agrees that:

1. Accuracy of Representations
All written statements submitted to CITI to obtain this policy are true and correct and no material information has been withheld. Should there be any material inaccuracy in the Insured's representations, CITI may void this policy, retain the premium paid and refuse to compensate the Insured for loss occurring prior to the discovery of the material misrepresentation.

2. Validity of Contract and Authorizations
The copies of all documents submitted with the Application are true copies of those documents; the Contract is valid and fully enforceable in the Buyer's Country; all licenses and authorizations obtained in connection with the Contract are valid.

3. Preservation of Remedies
The Insured will preserve all legal, judicial and administrative remedies applicable to any claim and furnish reasonable assistance in maintaining any rights or property transferred to CITI.

4. Confidentiality
The Insured will not disclose the existence of this policy to any third party without CITI's prior consent except in confidence to the Insured's broker and banker.

5. Self-insured Retention
The Insured will remain at risk for any loss resulting from the perils covered to the extent not insured by this policy.

6. Modification of Contract
The Insured will not materially modify or amend the Contract, the Guarantee or the Counter-Indemnity without the prior written consent of CITI.

VII. General Provisions.

1. Declarations
The Declarations and the Application are an integral part of this policy. For purposes of this policy, the terms defined in the Declarations shall have the meanings set forth therein.
2. Extension of Policy Period
If it appears prudent to extend the Guarantee and Counter-Indemnity, the Insured may extend the Policy Period for up to six months by (1) notifying CITI of the extension prior to expiration of the original Policy Period and (2) paying CITI, within fifteen days of commencement of the extension, an additional pro rata premium.

3. Cancellation
This policy may not be cancelled by either party, except that CITI may cancel for nonpayment of Premium upon twenty days written notice to the Insured. In such case, this policy shall be void ab initio and no claim shall be compensable, whether arising before or after the due date of the Premium.

4. Non-Assignment
The Insured shall not assign or transfer this policy or the benefits or obligations thereof to any other party or person, except with CITI's prior consent. The Insured may, with CITI's prior agreement, require any payments hereunder to be made to a named loss payee, all the Insured's obligations under this policy remaining unaffected.

5. Other Insurance
The insurance provided under this policy shall be excess over any other insurance or indemnity covering the same event of loss.

6. Notice and Modification
All notices under this policy shall be in writing and delivered to responsible officers of the parties at the addresses indicated in the Declarations. This policy may be modified only by written, mutual consent of the parties.

7. Governing Law
This policy shall be governed by the laws of New York state.

8. Arbitration
Any dispute relating to this policy shall be settled by arbitration in New York, New York according to the then prevailing Commercial Arbitration Rules of the American Arbitration Association. Unless the Insured initiates arbitration, CITI's liability with respect to any claim matter shall expire one year after CITI notifies the Insured of CITI's determination concerning an application for compensation. A decision by an arbitrator or arbitral panel shall be final and binding, subject to the Maximum Liability limit.
Appendix 4

Sample Agreement Between an Insurer and Host Government

COSTA RICA

INVESTMENT GUARANTIES

Agreement signed at San Jose November 22, 1968;
Entered into force October 24, 1969

Agreement between the Governments of the United States of America and Costa Rica relating to investment guaranties of the Government of the United States.

The Government of the United States of America and the Government of Costa Rica, desiring to strengthen the friendly relations which unite the two countries, and recognizing that investments in Costa Rica of private capital originating in the United States of America can further the development of Costa Rica's economic resources
and productive capacity, bringing about a rise in its production and an increase in trade between the United States and Costa Rica, have agreed as follows:

1. The Government of the United States of America and the Government of Costa Rica shall, upon the request of either one, consult concerning investments in Costa Rica which the Government of the United States may guaranty.

2. The Government of the United States of America will not guarantee an investment in Costa Rica unless the Government of Costa Rica approves the activity to which the investment relates.

3. If, in accordance with the Constitution and the laws of Costa Rica, and pursuant to an investment guaranty, an investor transfers to the Government of the United States of America (a) legal currency of Costa Rica, including credits in such currency; (b) any claims or rights which the investor has or may have, resulting from his business activities in Costa Rica or from events entitling the investor to payments under the investment
guaranty; or (c) all or part of the interest of an investor in any property (real or personal, tangible or intangible) situated in Costa Rica. The Government of Costa Rica will recognize such transfer as valid and operative. Nothing in the subrogation envisaged herein shall give the Government of the United States greater rights against the assets of the enterprise for which the investment guaranty was granted than the rights of the subrogating investor.

4. Sums in legal currency of Costa Rica, including credits in such currency, acquired by the Government of the United States of America by virtue of a transfer of currency or from sales of property, rights, or claims transferred under an investment guaranty shall be accorded treatment by the Government of Costa Rica with respect to exchange, repatriation, or use thereof, no less favorable than the treatment accorded to funds of citizens of the United States of America derived from activities comparable to those carried out by the investor, and such sums may be used freely by the Government of the United States of America for any of its expenditures in Costa Rica.
5. Any dispute between the Government regarding the interpretation or application of the provisions of this Agreement or arising from events causing payment under an investment guaranty shall, at the request of either of the Governments, be the subject of negotiations between the two Governments and in so far as possible shall be settled in those negotiations. Within the period of three months after a request for negotiation, the two Governments are unable to agree on a settlement of such dispute or claim, the matter shall be referred, upon the initiative of either Government, to a sole arbitrator selected by mutual agreement for final and binding settlement according to the applicable principles of international law. If the two Governments are unable to agree on the selection of an arbitrator within the period of three months after either Government has indicated its desire to submit the question to arbitration, the President of the International Court of Justice shall, at the request of either of the two Governments, designate the arbitrator.

6. Recognition of the subrogations mentioned in Clause 3 of this Agreement shall be subject to the following conditions:
a. None of the provisions of this Agreement shall give the Government of the United States of America other rights than those held by the investor with respect to any petitions, claims, or rights to which the Government of the United States has been subrogated.

b. When the constitution and laws of Costa Rica do not permit the acquisition by the Government of the United States of America of any right, title or participation that an investor may have in any property within Costa Rican territory, the transfer of such right, title, or participation to the Government of the United States of America shall not be valid; but the transfer to that Government of any claim to which the investor may be entitled under the laws of Costa Rica be valid for obtaining and receiving from the State of Costa Rica, through the appropriate legal channels, compensation for any right, title, or participation in such property. It is understood that when the investor's right, title, or participation refers to lands within Costa Rica, the Government of the United States will not seek to acquire
title, dominion, or possession, tenancy, or occupancy of such lands, or in any way to acquire title of ownership to any part of such national territory.

c. Pursuant to its Constitution, its laws, and the Agreement, the Government of Costa Rica will permit investors to make the necessary arrangements to dispose of properties still belonging to them after receiving compensation from the Government of the United States, transferring them in the most expeditious form, consistent with obtaining their fair value pursuant to the provisions of the laws of Costa Rica, to persons qualified to acquire them in accordance with such laws.

7. This agreement shall enter into force on the date of the note whereby the Government of Costa Rica informs the Government of the United States of America that it has been approved in conformity with the constitutional procedures of Costa Rica." When this Agreement enters into force, it shall replace and terminate the Agreement on

" October, 24, 1969
investment guaranties effected by an exchange of notes dated February 23 and 25, 1955, with the related note of February 26, 1955, and from that date forward the provisions of this agreement shall apply to investment guaranties issued in conformity with this Agreement but prior to its effective date, and to those issued in conformity with this Agreement after its effective date.

In witness whereof, the respective representatives, duly authorized for the purpose, sign this Agreement in San Jose, capital of the Republic of Costa Rica.

Done in duplicate, in the English and Spanish languages, both equally authentic, on this twenty second day of November, 1968.

(SIGNED) For the Government of the United States of America, Clarence A. Boonstra, Ambassador.

(SIGNED) For the Government of the Republic of Costa Rica, Fernando Lara, Minister of Foreign Relations.

*TIAS 3201; 6 UST 665*