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The new risks of globalisation **A new approach to country risk**

Analysis by the credit insurer Euler Hermes

Following a return to growth in 2010 driven by the emerging economies, 2011 will see a lower rate of growth for the global economy and, in particular, for the developed nations. In an economy that is highly globalised, financially unstable and exposed to major social and political risks at a local level, the interdependency of countries changes the nature of country risk and poses new problems for businesses.

“The global economy has undergone three major changes that profoundly alter the nature of country risk. Firstly, increasing interdependency generates a greater cyclical risk. Secondly, unequal distribution of the fruits of growth creates new socio-political risks in certain countries, and lastly, the persistent global financial instability creates further volatility in the mature economies. The difficulties faced by one country have now become a problem for all, particularly in a global economy that is experiencing a slow down in growth”, summarised Wilfried Verstraete, Chairman of the Euler Hermes Group Management Board.

A new country-risk map

Economic globalisation marks the end of a traditional approach to country risk, which is based on a purely structural analysis of the economic and political risks associated with transfers and convertibility. The process of globalisation has in fact seen both a frequent shifting of the borderlines between emerging and developed economies and a rise in economic and financial exchanges between these two categories of countries. This structural factor is itself accentuated by two additional factors: the economic and financial crisis and the heterogeneous nature of the recovery around the world, meaning that imbalances between economies are not being absorbed rapidly and are resulting in increasingly volatile risks.

“To be relevant, country risk analysis must now associate the traditional structural approach (assessment of the economic and political risk) with indicators of short-term vulnerability (financial and cyclical). This combination ultimately leads to the definition of four categories of country risk policy (weak, average, significant, and high)”, explains Karine Berger, Euler Hermes’ Head of Market Management and Strategic Marketing and Chief Economist.

Ever-closer interdependencies that heighten cyclical risk

The scarcity of basic resources (commodities, oil, etc.) and the rise in cross-border trade increases the interdependency of countries.

Cross-border trade is increasing as a result of three factors operating in parallel: rising demand (driven by economic factors linked to the recovery, and by structural factors such as demographic changes and the catch-up effect of developing economies), the liberalisation of borders, and the extension of global supply chains. In these conditions, economic conditions in emerging nations are increasingly becoming

engines of growth and of world trade, exposed to exogenous risks that are difficult to predict, as shown by the triple shock experienced by Japan.

Greater cyclical risk

The rise in interdependency has resulted in greater cyclical risk, as measured by the Cyclical Risk Indicator (CRI).

New social risk, with global consequences

As shown by the current socio-political events in the Middle East, many countries are exposed to higher risks as their populations increasingly become frustrated and more demanding.

In fact, although income per capita is rising around the world, there are variations between one country and another, and strong growth is not synonymous with high levels of job creation. The unequal distribution of growth associated with demographic and technical changes in countries with strong political regimes further increases the risk of social unrest, the consequences of which are not generally restricted to the local economy.

Financial instability that is now affecting the developed economies

Financial equilibriums remain precarious on a global scale. The volatility of capital is widespread but has a greater impact on the developed economies than on emerging nations, creating a further risk for monetary policies. The weight of sovereign debt is generating increasing requirements for external financing and the risk of a domino effect given the complex web of banking flows. Systemic financial risk is therefore a new factor to be taken into account in analysing country risk.

Greater volatility in risk aversion

The continuing financial instability on a global scale is a source of greater volatility in risk aversion, which can be measured using a Financial Flows Indicator (FFI) that reflects the vulnerability of a given country to an external shock and its ability to withstand or avoid a systemic shock, particularly in respect of its sensitivity to capital flows.

What are the threats to and challenges for the world economy?

In this context, global growth will be more moderate in 2011. Following growth of 4.1% in 2010, the world economy is expected to grow by 3.1% in 2011 and by 3.4% in 2012. A number of factors underlying the slowdown have already been identified for OECD countries (the ending of stimulus programmes, tax consolidation measures, and weak demand) and for the emerging economies (rebalancing measures, the normalisation of monetary policy, etc.).

Euler Hermes draws three conclusions for business transactions

1. Country risk is changing. It is simultaneously more complex, more volatile and more global, but remains strong.
 - Complex: both emerging and developed economies need to be monitored.
 - Volatile: country risk elements and factors are subject to greater volatility.
 - Global: the interdependency of economies creates the risk of a knock-on effect between one country and another, in the same way as surging commodity prices.
 - Strong: major natural, health and geopolitical risks are always present and could potentially affect a large number of countries.
2. Faced with this broad range of risks, businesses are now more vulnerable and must therefore exercise greater vigilance.

- Managing and monitoring these risks calls for greater attention, more resources and more time.
- The amplitude and consequences of risks are increasingly difficult to plan for and anticipate (such as the events in Japan), whether domestically or for a business sector or a supply chain.
- Businesses must therefore ensure they have the appropriate capabilities and technical resources.

3. In this context, Euler Hermes therefore advises businesses to strengthen the role of their Risk Managers.

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Euler Hermes has developed a credit intelligence network that enables it to analyse the financial stability of 40 million businesses across the globe. The Group insured worldwide business transactions totalling **€633 billion** exposure end of December 2010.

Euler Hermes, subsidiary of Allianz, is listed on Euronext Paris. The Group and its principal credit insurance subsidiaries are rated AA- by Standard & Poor's.

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