Country Risk & Governance: strange bedfellows?

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Abstract

This working paper investigates whether governance and corruption issues are incorporated in country risk assessment by private and official creditors. Today there is a wide ranging consensus to consider that economic growth is a necessary but not sufficient condition to pave the way for sustainable development and favourable business environment. Investors and creditors are looking for an optimal combination of robust fundamentals, socio-political stability and government efficiency. Governance quality captures the essence of this search for squaring the circle. However, when looking at actual risk exposure by private capital markets and official institutions, one cannot find much evidence of a relationship between corruption and lending flows. At best, corruption is not a driving element of lending decisions, at worst one can identify categories of creditors who seem to back corrupt governments up. Much remains to be done thus to reconcile governance, country risk assessment and lending strategy decision.

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1. Introduction: Governance and Country risk assessment

The concept of governance has emerged as a challenger of environment, innovation, and sustainable development in academic circles and international policy debates. Reducing poverty, alleviating debt burdens, promoting sound environment policies and enhancing the role of women in development have little lasting impact in the absence of strong institutional foundations and a policy process that is both open and participatory.

In business, Enron, Worldcom, Vivendi and Parmalat, among too many other examples, cast light on lack of transparency and accountability, namely, bad corporate governance. On the international sphere, likewise, Cameroon, Turkmenistan, Argentina, Nigeria or Burma all constitute examples of dreadful sovereign governance. The combination of public awareness and better information has placed the issue of governance and government efficiency on the center stage of political risk assessment. Country risk cannot be captured any longer by scrutinizing liquidity and solvency indicators or by over-refining sensitivity analysis in balance of payments projections. Although governance emerged as a research issue in the academic community in the mid-1960s, it moved on the front burner of the policymaking debates only some twenty years later. Corruption was brought into the picture when scholars started to question the quality of the economic decision-making process and the allocation of the growth benefits. Issues of capital flight and economic inefficiencies were raised to assess the scope of “Dutch disease” in countries where too much and too fast wealth is managed unwisely[1].

2. What is governance? What is corruption?

The issue of governance is relatively new in international finance. It emerged only in the early 1990s when the role of official institutions was put under the scrutiny of OECD countries' parliaments and NGOs. The latter challenged the IFIs as throwing taxpayer money at corrupt regimes and as bailing out incompetent governments in emerging market countries. They raised the issue of "governance" as a necessary criteria for determining eligibility access to public aid money.

Governance refers to sound public administration and service quality. It includes those issues as transparency, government accountability for the use of public funds, the rule of law, and social inclusion, according to former US Treasury Secretary Larry Summers (in IMF/World Bank Development Committee (2000)). According to the World Bank in 1989, "by governance is meant the exercise of political power to manage a nation's affairs[2]". The World Bank refined and expanded its definition of governance in mid-2000 to stress the role of institutions: "Governance includes traditions and institutions…"[3] Efficient public sector institutions thus are at the heart of good governance.

Corruption, (from the Latin *corruptio* = decay), is one of the key criteria to assess the quality of governance. The World Bank has a short and straightforward definition of corruption: *it is the abuse of public power for private benefit* (Tanzi (1998)). This definition is widely used by scholars in the academic community.[4] It refers to the exchange and delivery of services for payments, privileges and undue compensations. In a way, something public (license, contract, tax break, subsidies, market share, bidding rights…) is exchanged or sold for private gains (speculation, insider information, cash payment, monopoly position…). At the root of corruption is an arbitrary decision that translates into unfair comparative advantage. In the course of this paper, we define corruption as *rent-exacting power by public agency officials with a view of exchanging discretionary public preferences for private gains*. It involves a patron-client relationship.

3. Where does corruption come from?

There is no consensus between economists and risk analysts regarding the root causes and consequences of corruption. A first school of thought considers corruption as an inescapable, though temporary, fate in emerging market countries. It is simply a "normal" consequence of fast change in backward societies. Scholars such as Leff (1964), Lui (1985), Beck and Maher (1986), Lien (1986), Huntington (1968), Gamer (1976), Harberger (1988), and Charap and Harm (1999) argue in different ways that corruption is a by-product of modernizing societies along the route towards the Rostowian "take-off" stage of economic development. Corruption stems from weak institutions but it can also result from the expansion of governmental regulation aimed at strengthening economic development. Harberger considers that bureaucrats cannot avoid pressures that stem from ties of family, religion, school, club, and ethnicity. These ties constitute pervasive networks between government leaders, their appointees, and the clientele over which their authority is exercised. As Huntington summarizes: "A traditional society may find a certain amount of corruption a welcome lubricant easing the path to modernization[5]". Corruption performs a useful role to "grease the wheels" of rigid social and institutional structures. It can even play a role of

income redistribution in poor countries with rigid institutional fabrics. Corruption itself may be a substitute for reform. It serves to reduce social demands and group pressures for policy changes. As such, corrupt bureaucracies are an efficient form of rent-extraction for the ruling elite. Corruption buys time and creates adhesion. A similar stance, albeit with diametrically opposed conclusions, is found with Marxist scholars who analyze the role of the state in Third World countries in relation with the "international division of labor". Frank (1980), for instance, argues that corruption of elites has clear economic purposes to offer favorable conditions to international capital[6].

The debate regarding corruption is polarized, indeed. A second approach looks at corruption as a sub-optimal allocation of resources with negative impact on growth. It devotes attention to bad governance, including reckless government spending, nepotism, and crony capitalism, all leading to hidden subsidies, capital flight and ruthless speculation, resulting in conditions that precipitate crises. Corruption has adverse effects not just on state efficiency but also on savings, investment and growth. Nye (1967), Rose-Ackerman (1975, 1978) as well as Shleifer and Vishny (1993) tackle corruption from a cost-benefit analysis angle, concluding that corruption is probably economically wasteful, politically destabilizing, and destructive of governmental capacity. Wei (1997), like Mauro (1995) and Tanzi (1998), points out that corruption boils down to an arbitrary tax that distorts markets and incentives, and it is likely to lower private investment, and reduce economic efficiency and growth. Leite and Weidmann (1999) observe that countries which heavily rely on natural resource exploration are more likely to feed corruption, as high rent activity tends to foster rent-seeking behavior.

A third approach to corruption focuses on the consequences of bad governance on economic growth and financial crisis. In the mid-1990s, Krugman (1994) popularized the controversial view (also presented by Alwyn Young in 1995) that "crony capitalism" undermines economic efficiency and creates fertile ground for financial crises. In the aftermath of the Asian debacle, Krugman (1998a, 1998b, 1999) stressed the role of moral hazard and bad governance related to implicit government guarantees on unregulated banks. Likewise, Roubini (1998), and Radelet and Sachs (1998) have focused on the role of speculative short-term capital flows as crisis triggers, emphasizing the role of financial systems without adequate supervision. Johnson (1999) also examines to what extent corruption is associated with the onset and/or the depth of financial crises[7] Wei (2000) finds evidence that corrupt countries tend to depend on large inflows of foreign capital, with much larger share of bank loans than FDI, hence a marked vulnerability to financial crisis.[8] Bad governance has also been called upon to analyze Argentina's protracted difficulties in the eve of the 2002 crisis, with regard to the lack of independent judiciaries and widespread corruption. As Miguel Kiguel puts it: "Argentina's biggest problem is institutional and political – not economic. Hence the priority should be restoring stability with public-sector and institutional reform to deal with a complete vacuum of law"[9]. And Michalet (1999) concludes that corruption discourages foreign direct investment while precipitating capital flight. He notes: "One key aspect of investment climate is the assessment of political stability as well as transparency and efficiency of the legal and judiciary system"[10].

4. Corruption and IFIs' lending policy

Until the mid-1990s, governance was not at the center stage of the IFIs' policy discussion agenda. Environment protection as well as the role of women and the conditions for promoting sustainable development were then on the front burner. In a major 1989 report entitled "Sustainable Growth with Equity: A long-term perspective for Sub-Saharan Africa", the World Bank recognizes that a crisis of governance underlies the litany of Africa's development problems, while giving modest attention to combating corruption[11]. Times have changed. At the 1996 Annual Meeting, World Bank President Jim Wolfensohn spoke about "the cancer of corruption" and its devastating effect on development [12]. At his first Washington press conference, IMF Managing Director, Horst Köhler stressed the IMF's priority to pay the utmost attention to "the promotion of transparency and accountability" (IMF Survey (2000b)).

The mounting interest in corruption stems from a combination of better information, greater public awareness, and pressure from NGOs, bilateral donors and tax payers to enhance scrutiny of the use of public funds. In the US, Capitol Hill challenged the IFIs as throwing taxpayer money at corrupt regimes and as bailing out incompetent governments. Eradicating corruption had to become a necessary criterion for determining eligibility access to public aid money. OECD country governments, who are also major shareholders in the IFIs, have recognized that corruption is a transnational phenomenon that requires global coalition building. As early as in 1994, the Organization of American States drew up the "Inter-American convention against corruption", which requires countries to make it a criminal offense to both solicit and accept bribes[13]. As the Center for Strategic and International Studies notes: "Since the end of the Cold War, corruption has emerged on the international agenda as one of the most significant transnational issues of our time"[14].

In short, the IFIs stress the importance of corruption as one of the biggest obstacles to a country's long-term development. They insist on the need for a credible legal system, transparency in spending public funds, and a stable regulatory framework. These issues constitute the core of the so-called "second-generation policy reforms" aimed at constituting a set of rules and guidelines conducive to private sector development based on sound institutions. This new emphasis recognizes that development means economic growth plus those conditions that make it sustainable. These conditions include efficient markets, robust institutions, transparency and good governance. Investigating this issue, Gupta and al. (1998) established a strong relationship between corruption on the one hand, income inequality and poverty in the other hand. Furthermore, they showed that the causality was from corruption to income inequality and poverty.

Klitgaard (1998), Gray and Kaufmann (1998), and Mauro (1998) highlight that the World Bank has pioneered the efforts towards combating corruption in member countries in the mid-1990s. The Bank Institute initiated a Governance Program to build national integrity systems to fight corruption in 1994. The Bank strengthened its anticorruption measures contained in its procurement guideless[15] in 1997. The Bank's Executive Directors adopted new strategies and guidelines to enhance the Bank's efforts to promote good governance and combat corruption[16] in 1998. In addition, the Bank itself cleaned up inside its own yard. In December of 2000, the Bank fired staffers for allegedly taking bribes from private companies in exchange for awarding them contracts.[17] The Bank set up an "Anticorruption Knowledge Center" as well as a Development Forum discussion on anti-corruption strategies. The Center

focuses on a number of emerging market countries in Africa, Latin America, Asia and Eastern Europe. All in all, 48 countries are involved in specific anti-corruption and governance measures under the Bank's auspices with Africa at the center of the Bank's efforts.

The IMF, not to be left behind, took several measures to promote good governance policies in member countries since the second half of the 1990s. Beyond morality considerations, the IMF gradually admitted that, in the long-term, corruption is not "efficient" from the standpoint of sustainable growth requirements. Corruption goes with a mal-functioning government, and this can harm economic performance severely. A few weeks before retiring from the Fund, Michel Camdessus, former IMF Managing Director, summarized the Fund's position by these words: "Satisfactory development is not possible when corruption is rampant"[18]. At the September 1996 Interim Committee Meeting, the IMF stressed the importance of sound governance, including transparency, rule of law, public sector efficiency and anti-corruption measures[19]. In mid- 1997, the IMF enacted a number of "good public management" principles that constitute the base of the Fund's surveillance mandate. In addition, the IMF made strides in improving its own governance, particularly through increased openness and transparency[1]. The underlying assumption is that market-based economic policy, coupled with privatization and deregulation, reduces the incentive for bribery since state intervention produces loopholes and client-patron relationships. Hence a renewed emphasis on private-sector led growth, so as to minimize state interference with market-forces. All in all, poor governance comes with excessive and arbitrary government intervention, discretionary decision-making, lack of transparency, poor management, and an ill-defined regulatory framework.

5. Corruption and country risk assessment

It is one thing claiming that corruption is a risk factor along with inflation, deficits and over-indebtedness. Measuring corruption in order to rank countries and incorporating governance criteria in credit decisions are a more formidable challenge. By definition, it is difficult to use quantitative measurements for illicit practices. Most techniques attempt to capture the degree of corruption in a country through the perception of investors, creditors, and local economic agents. Polls and panel interviews constitute the main approach, along with the Delphi technique based on the survey of country specialists' opinions. The measure of corruption thus is highly subjective.

One can distinguish four main sources of corruption evaluation, namely, risk rating agencies, NGOs and academic institutes, specialized private organizations, and the World Bank. Official lenders as well as private investors and creditors thus can use a wide range of corruption measurement sources. There is no deficit of information regarding corruption and governance for country risk analysts and decision makers. The following tables capture the salient features of the fifteen most useful sources.

[1] IMF Survey, 2000.

Business Environment Risk Intelligence (BERI) provides a Political Risk Index assessing the social and political environment of a country. It is built on the opinion and scores provided by a hundred experts with a diplomatic or political science background. Governance quality is included into political risk analysis along with government effectiveness and social indicators. http://www.beri.com	**Political Risk Service's** risk analyses cover a hundred countries and are updated on a quarterly basis. International Country Risk Guide measures and tracks corruption perception in government, law and order, expropriation risk, as well as the quality of bureaucracy. These measures stem from the subjective assessment of experts around the world. http://www.prsgroup.com	Given its unique policy dialogue with more than 180 countries, **the World Bank** has developed a comprehensive database of composite governance indicators, measuring perceptions of voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and corruption. www.worldbank.org/wbi/governance/
The London-based **Economist Intelligence Unit** (EIU) provides a comprehensive 5-year forecasting country risk analysis on some 100 EMCs., on a quarterly basis. The EIU's method flows from expert's answers to a series of 77 predetermined qualitative and quantitative questions. http://www.eiu.com	To look upon governance and corruption, **Moody's** takes into consideration the structures of social interaction, social and political dynamics, as well as the economic fundamentals. Moody's relies on the judgment of a group of credit risk professionals to weigh the various risk factors as well as the impact of each of these factors upon business prospects. http://www.moodys.com	**Standard & Poor's** rating approach is both quantitative and qualitative. It is based on a checklist of 10 categories, including governance and political risk. Political risk factors gauge the impact of politics on economic conditions, as well as the quality of governance and the degree of government support in the population. S&P assigns short term and long-term ratings. http://www.standardandpoors.com
Euromoney publishes ratings of some 180 countries since 1982 on a semi-annual basis. The methodology is built from a blend of quantitative criteria and qualitative factors coming from surveys with about 40 political analysts and economists. Political risk receives a 25% weighting, as much as economic performance. Countries are graded on scale from 0 (worst) to 100 (best). www.euromoney.com	**Institutional Investor**'s ratings are published twice a year since 1979 to assess the creditworthiness of about 150 countries, based on a survey of some 100 international bankers' perception of creditworthiness, including economic, financial and socio-political stability criteria. The resulting score scales from zero (very high chance of default) to 100 (least chance of default). www.institutionalinvestor.com	**Transparency International**, a non-profit non-governmental organization in Berlin, provides an annual survey of corruption practices in nearly 90 countries since 1995. The Corruption Perception Index is based on a wide network of information sources with local NGOs, domestic and foreign corporations, investors, and business contacts. www.transparency.org

Heritage Foundation established since 1985, in partnership with the WSJ, provides an economic freedom index for some 160 countries, both industrialized and developing. The ranking is based on ten socio-political and economic criteria, including political stability, state interference, investment codes, regulatory framework, institutional strength, and corruption scope. www.heritage.org	PricewaterhouseCoopers's **Opacity Index** measures the lack of clear, accurate, formal and widely accepted practices in a country's business environment. As such, it focuses on the relative state of corrupt business practices, the transparence of the legal system and the quality of the regulatory framework. It measures the resulting extra risk premium that stems from additional business and economic costs. www.opacityindex.com/	The Institute for Management Development's **World Competitiveness Report** analyses 49 industrialized and emerging economies around the world based on a far-reaching survey since 1989. Its analysis of the institutional framework addresses issues such as state efficiency, transparency of government policy, public service's independence from political interference, bureaucracy as well as bribery and corruption. www.imd.ch
Freedom House since 1972 monitors the progress and decline of political rights and civil liberties in 192 countries. FH publishes an annual survey of the Progress of Freedom in the world. The ranking is based on a wide survey of regional experts, consultants, and human rights specialists. Political stability and civil liberties are ranked on a scale of 1 (best) to 7 (worst). www.freedomhouse.org/ratings/index.htm	**The Political and Economic Stability** Index of Lehman Brothers and Eurasia measures relative stability in around 20 EMCs by integrating political science theories with financial markets developments. The monthly evaluation uses both quantitative and qualitative criteria, including institutional efficiency, political legitimacy, economic performance, and government effectiveness. www.legsi.com	**Political and Economic Risk Consultancy** (PERC) specializes in strategic business information and analysis in East and Southeast Asia, with emphasis on corruption and business costs. Annual risk reports survey over 1,000 senior expatriates living in to obtain their perceptions of corruption, labor quality, intellectual property rights risks and other systemic shortcomings. www.asiarisk.com

6. Corruption, governance and capital flows

There are two ways to measure the relationship between governance and creditors' strategy. One is to use the stock of external indebtedness by creditors, while the other is to rely on capital flows broken down by creditors. The former is of little use as the evolution of debt stocks is distorted by exchange rate variation. In addition, creditors' strategy is also influenced by the "backlog" of the accumulation of previous loans and its impact on portfolio strategy. We thus use capital flows from four categories of investors, namely, official multilateral agencies, official bilateral creditors, banks and bondholders, and private investors, including FDI and portfolio equity flows.

As a measure of corruption, we use the corruption index released by ICRG, with the exception of the corruption perception indices of Germany-based NGO Transparency International[20] in tables 1 & 2. As a measure of governance, we use the index of political rights and civil liberties of Freedom House. The secondary market discounts come from Bloomberg's database and FP Consult database (now part of Fortis Investment Management[21]). Economic data come from the IMF's International Financial Statistics and the World Bank's Global Development Finance database. The sample pools a cross-section of 103 countries, with four sub-periods over the years 1984-2001.

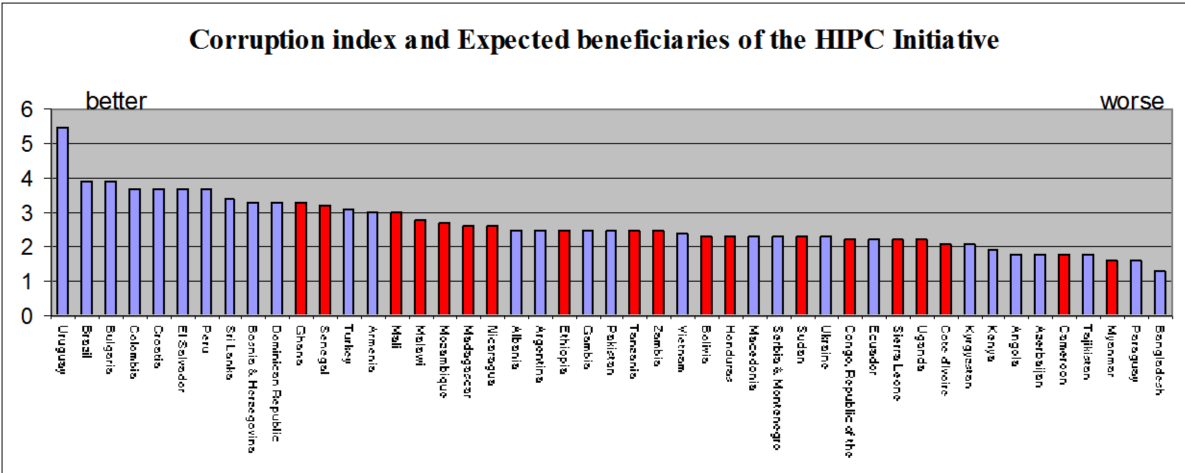
In view of the IFIs impressive statements against corruption, the quality of governance should be at the forefront of the IFIs' criteria to allocate official funds, including for debt reduction. And if so, governance performance should further improve following access to debt relief operations if the latter are predicated on *ex ante* conditions of transparency improvement, and on *ex post* allocation of debt relief proceeds to priority social needs. This remains to be confirmed.

A. A static observation of corruption and debt relief eligibility

A precondition for *ex ante* eligibility to official debt reduction is robust macroeconomic adjustment and strong governance. As former US Treasury Secretary Larry Summers summarizes: “The debt reduction initiative is a special effort aimed at promoting mutually reinforcing objectives –-poverty reduction, sustainable development, and good governance--, while strengthening the incentives for reform and growth.”[22] The HIPC batch should all be members of an “excellence class”. One should expect, thus, that only "deserving" countries get access to donor funds for debt reduction. Many of the debtor countries eligible to the HIPC Initiative, however, exemplify both poor macro-economic performance and bad governance at the time of their access to officially-sponsored debt reduction operations. Actually, official aid for debt relief is widely criticized on two grounds. First, there is not enough aid for pulling developing countries out of the poverty trap. Cohen (2000) criticized the Debt Initiative as lacking a market perspective, thereby not reflecting the actual "market value" of the debt which should take account of the risk of non-payment. Second, the Initiative has been under the US Congress’ fire for doing too much, i.e., using taxpayer money for subsidizing developing countries' inefficient public management.

The following chart is a snapshot that illustrates the relationship between country access to official debt reduction and corruption. It shows that beneficiaries of the HIPC Initiative are smoothly distributed along the corruption index. Notoriously corrupted countries (on the right portion of the graph) get similar access to debt reduction schemes as countries with better corruption records. The latter is measured by the Transparency’s corruption perception index as of 2003. The Initiative seems lacking a "pro-governance bias".

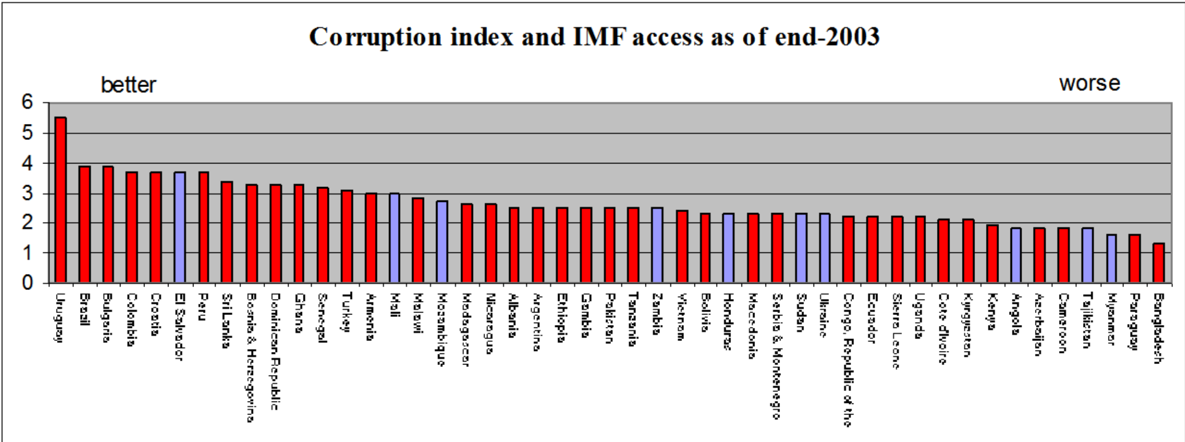
Table 1: Eligible countries to debt relief programs (in black) and corruption level as of end-2003



B. <u>A static observation of corruption and access to IMF lending</u>

Where does IMF lending go to? As of end-2003, 55 countries had lending arrangements with the Fund, amounting to some US$83 billion of agreed available resources. What is the relationship between access to IMF lending and corruption? The following table is a "snapshot" that illustrates this relationship between low corruption and access to IMF resources at end of 2003. It clearly shows that IMF resources are equally distributed whatever the corruption level. Countries as notoriously corrupt as Cameroon, Côte d'Ivoire and Bangladesh get access to twice as much resources as countries like Bulgaria, Croatia, Bosnia, Armenia and Senegal which exemplify robust governance efforts. Given quotas constitute the leverage for access to IMF resources, the analysis gets refined in a subsequent part of this paper to take account of the size of the economy in the relationship between corruption and IMF lending flows over a 16-year period.

Table 2: Countries with access to IMF lending and corruption level as of end-2003



C. A dynamic approach to corruption, governance and capital flows

On the face value of the new IFI's credo, one could expect that: *Other things being equal, low corruption is associated with high official fund allocation*. On the base of mounting attention devoted to corruption by risk rating agencies, one could also expect that: (i) *Other things being equal, high corruption is associated with low secondary market debt price*, and (ii) *High corruption is associated with low private fund allocation.*

To test the hypothesis “lower corruption/larger capital flows”, we use a number of variables include aggregate net resources combining all capital flows, both private and official, before breaking down the sources between three categories of creditors:

- Official creditors (bilateral and multilateral)
- Private creditors (international banks and bondholders), and
- Private investors (FDI and portfolio equity flows)

The various regressions between corruption and capital flows include two other controlling variables, namely, GDP per capita and nominal GNP. The former is a proxy representing the level of economic development, and can possibly have an influence on the amount of capital inflows. Nominal GNP is used to take into account the size of the economy and the quota-based access to IMF resources. As expected, the size of the economy represented by GNP gets a significant positive coefficient. We regress both on panel data over the time period 1984-2001 and on a cross-section basis, with four sub-periods: 1984 to 2001, 1984 to 1989, 1990 to 1995, and 1996 to 2001. This choice is not arbitrary: 1984-1989 corresponds to the end of the Soviet Union era and the beginning of the official treatment of the debt crisis, 1990-1995 corresponds to the emancipation of the Soviet satellites and the EMCs’ return to the capital markets; and 1996-2001 coincides with the new IFIs’ stance against corruption in a context of acute emerging market crises (Mexico 1994-95, Asia 1997, Russia 1998, Argentina 2001).

The following table summarizes the main results.

Table 3. Regression results between corruption, governance and external capital flows

Type of Investor	**Corruption**	**Freedom & Democracy**
Net aggregate resource flows	Lower corruption/larger net resources	More freedom /larger capital flows only since 1996
Official Flows	Lower corruption/larger net resources	No relationship
Banks and bondholders	At best no relationship; at worst (1996-2001 period) higher corruption/larger capital flows	Less freedom / larger capital flows
Secondary market discount of London club debt	Higher corruption/lower debt prices	N/A
Portfolio equity investors	Lower corruption/larger equity flows	No relationship
FDI	No relationship	More freedom / larger capital flows

These results cast light on the direction of capital flows according to different categories of creditors but also on the relative weight of corruption and governance criteria in risk-taking decision-making.

Regarding aggregate net resources flows, one finds a negative correlation between corruption and capital flows, namely, countries with better control upon corruption managed to attract larger external resources, whatever the capital origins.

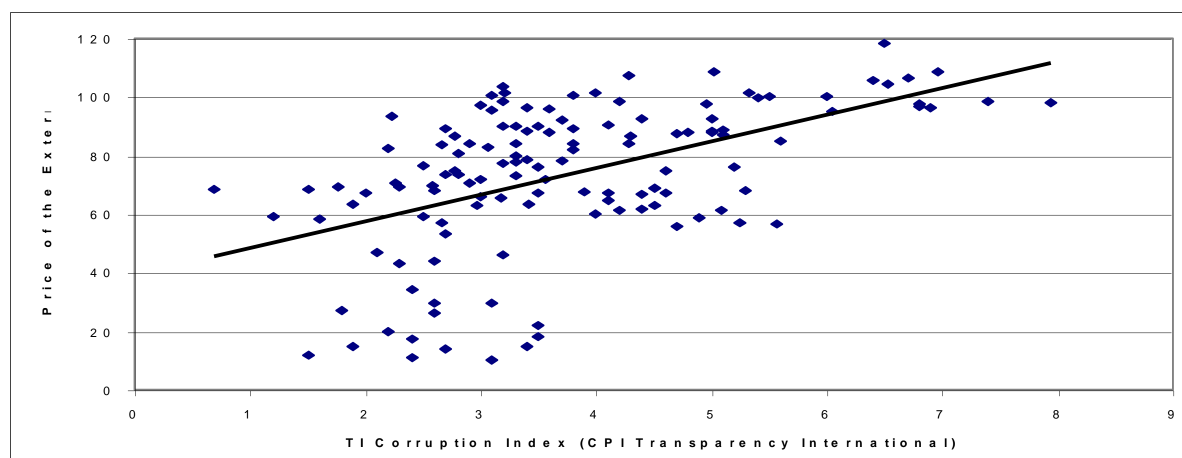
Official flows tend to be associated altogether with lower corruption and better governance

Regarding FDI flows, clearly, corruption is not a driving variable for investment decision discrimination. Two explanations can be provided. One, corruption tends to "grease the wheels" as Huntington suggested. Two, as emerging markets have become all the rage, investors allocate their capital gradually to worse governance countries, a shortsighted strategy that might lead to signs of an investment bubble should market conditions tighten. As the head of emerging markets at Pictet, the Swiss private bank, concludes regarding Russia and China: "We are seeing massive oversubscriptions for new listings and valuations that make very little sense. People are buying into the concept of emerging markets without looking too carefully at the details"[2]. Both China and Russia suffer from the worst Opacity Indices of PWCs, measuring corruption and legal opacity, while enjoying A2 and Baa3 sovereign ratings from Moody's Investors Service, respectively.

Regarding private bank lending, we first observe the correlation between corruption and the secondary market price of London Club debt. Market trading volumes, which had grown rapidly in the 1990's, peaked at U.S$6 trillion in 1997 and then fell off sharply after the Russian default in mid-1998, as investors re-evaluated the volatility and returns on Emerging Markets investments. In 2003 market trading turnover reached about US$3 trillion and liquidity remains high. The discount on debt paper, which is the inverse of the price, reflects both overall market conditions and country risk assessment. We find a strong correlation between corruption and discount that can be explained by the adverse impact of corruption on the quality of public administration, including debt management, hence lower creditworthiness and higher discount. The following table illustrates this positive relation.

[2] Portfolio: "Pictet takes a long-term look at emerging markets", Financial Times, Fund Management, February 2004, page 5.

Table 4. Corruption and secondary market discount



The analysis of the relation between private creditors and corruption in emerging market countries is further enhanced by looking at the direction of bank lending and bond investment. Whereas the secondary market discount applied to the stock of London Club exposure, the correlation now explores capital flows from both banks and bondholders, and finds a positive relation between corruption and risk exposure. This is well illustrated by Venezuela. The country's corruption is ranked 104 by Transparency International, worse than Kazakhstan, Moldova and Uzbekistan, while it successfully reopened market access with a US$1.5 billion seven-year bond deal in mid-2003. The bond enjoyed the "Deal of the year" prize of LatinFinance, because "it raised money cheaply for the government, retired Brady bonds, soaked up surging local currency liquidity and provided access to dollars legally for banks and businesses.[3]"

Why such a creditor myopia? A first explanation stems from competition among private lenders and declining spreads, encouraging developing country borrowers to turn to capital markets. Spreads were historically low in the mid-1990s, just before the Asian crisis, and they fell again in 2003, due to high liquidity and few attractive alternatives. Latin American borrowers, thus, were able to raise close to US$39 billion from international investors in 2003, mostly with low-cost, dollar-denominated debt. Brazil's US$1 billion global bond in April of 2003 was a roaring success, according to LatinFinance. In addition, even though private creditors might incorporate corruption and governance factors in their assessment of country creditworthiness, this does not necessarily translate into declining risk exposure given the huge backlog resulting from the loans made in the previous decades. Today's size of loan and bond portfolios is the consequence of yesterday's exposure policy. Indeed, the 1980s and most of the early 1990s have been marked by concerted and "defensive" lending operations, initially under the Baker refinancing plan, and later under debt exchange offers coupled with the retirement of Brady bonds.

[3] LatinFinance, February 2004, n°154, page 33.

7. Conclusion

This paper tackles the issue of governance and corruption from the standpoint of two categories of foreign creditors, namely, official institutions and private capital markets. Corruption is the symptom of deeply-rooted institutional weaknesses in a country's economy. At the root of corruption, a kleptocratic state manages to parasite the country's economy. Nepotism, in turn, increases distortions in resource allocation and it exacerbates income inequalities. At minimum, corruption discourages domestic savings and investment due to its tax effect. At worst, it triggers capital flight and brain drain..

Whereas the political economy literature considers corruption as a fatality or a sort of "natural disaster" that stems from the very process of institutional modernization, the economics literature analyses it as rent-seeking behavior. All this is of little comfort for creditors and investors. The paper examines how much governance is incorporated in lending decisions by official institutions and by private lenders. The paper shows that, whatever the bells and whistles, IFIs tend to allocate public money, particularly for debt reduction programs, without drastic discrimination with respect to corrupt regimes. Their lending record, however, suggest that IFis lend more to less corrupt and more democratic countries. This is in echo, with important nuances, of Alesina and Weder (1999) who showed that there is no evidence that bilateral or multilateral aid goes disproportionately to less corrupt governments. In fact, if anything, they find the opposite: “more corrupt governments receive more foreign aid than less corrupt ones”[23]. Our paper finds, however, a marked correlation between government loans and corrupt regimes. Bilateral creditors, clearly, tend to allocate more funds to more corrupt and less democratic countries. Regarding private investors, including banks, bondholders and equity investors, corruption and governance are not driving criteria for risk exposure strategy decisions. There is thus a wide gap between better information regarding corruption and governance for country risk assessment, and incorporating these criteria into decision making.

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