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Assessing Country Risk in Africa and the Middle East

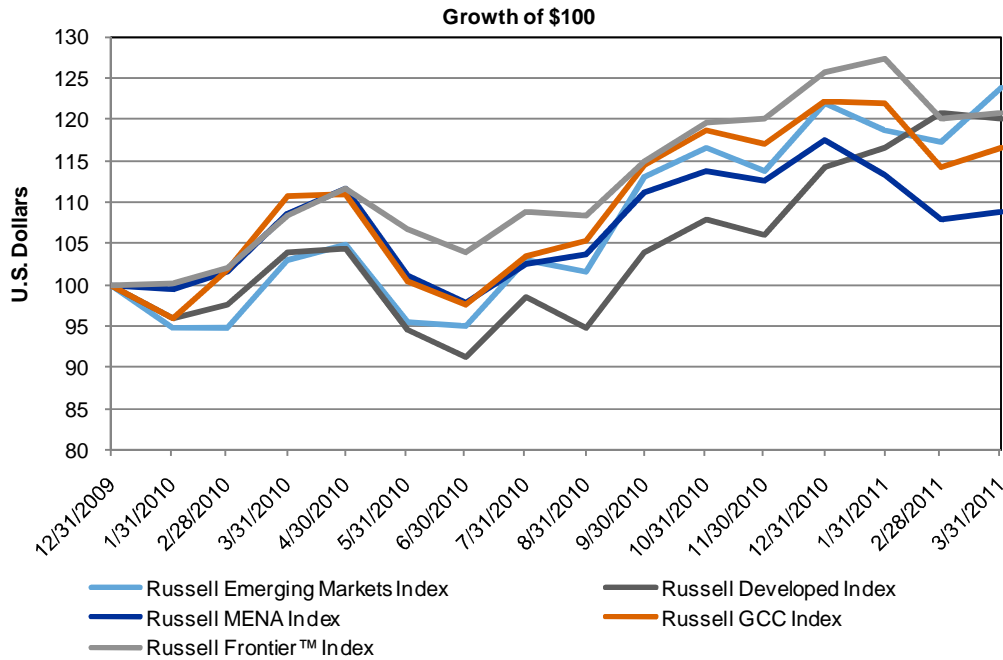
A number of countries in Africa and the Middle East are in the midst of popular uprisings that are altering the political, social and economic landscapes of their regions. On January 14, 2011, Ben Ali, the longtime ruler of Tunisia, fled to Saudi Arabia in the face of nationwide demands for democratic elections. Following the Tunisian protests, the people of Egypt successfully ousted their own dictator of 30 years, Hosni Mubarak.² These events were the first in an ongoing wave of political unrest that has forced investors to closely evaluate their portfolio allocations to these countries and regions.

As can be seen in Figure 1, after a year of outperformance relative to the Russell Developed Index, the affected non-developed regional indexes have begun to lag. The regional upheavals have led Russell Indexes, as a global index provider, to conduct a review of some widely used economic and stability indicators – specifically, their ability to predict country risk. Our analysis and findings are presented in this paper.

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² Tunisia is a member of the Russell Frontier Index with a weight of 1.26% as of 3/31/2011. Egypt is a well-established emerging market, with a weight in the Russell Emerging Markets Index of 0.47% as of 3/31/2011.

Figure 1 / Cumulative Monthly Returns of Regional Indexes, January 2010 – March 2011



Note – The Russell MENA Index covers the Middle East and North Africa Region.

There are several composite scoring systems available in the marketplace that attempt to measure a country’s general level of stability. In this paper, we examine three in particular: the EIU’s Country Risk Score, the World Bank’s Governance Indicators and the Heritage Foundation’s Freedom Index.

The EIU risk score is a composite score incorporating sovereign risk, banking sector risk and currency risk factors, with a lower overall score expected to correspond to lower risk. The World Bank’s Governance Indicators evaluate a country on six factors aggregated to a composite stability score, with a higher score expected to reflect better governance outcomes. The Heritage Foundation’s Freedom Index assesses a country on 10 measures of economic freedom to produce a composite score, with a higher score indicating relatively greater economic freedoms.

As can be seen in Table 1, below, the EIU and Heritage Foundation composites were generally reliable predictors of the recent instability in Africa and the Middle East. No single composite offered a completely accurate picture of the potential for problems, however, which suggests the difficulties inherent in attempting to quantify country risk. For example, The Heritage Foundation ranked Bahrain the 10th most “free” nation in the world, yet its government has recently enacted emergency laws to stem political protests. The countries highlighted in Table 1 – most of which have a combination of an above-median regional EIU score and a below-median Freedom Index score – have all faced major political challenges recently.

Table 1 / Country Risk and Stability Indicators

Country	Russell Classification	EIU Risk Score	WBGI Composite Score	Heritage Foundation Freedom Index Score
Kenya	Frontier	61	153	57.4
Nigeria	Frontier	58	88	56.7
Tunisia	Frontier	55	303	58.5
Jordan	Frontier	54	313	68.9
Tanzania	Frontier	51	248	57.0
Ghana	Frontier	50	334	59.4
Senegal	Frontier	47	245	55.7
Egypt	Emerging	47	228	59.1
Morocco	Emerging	47	262	59.6
Gabon	Frontier	46	178	56.7
Mauritius	Frontier	45	442	76.2
45 = EIU median, 302.6 = WBGI median, 62.7 = Heritage Foundation Freedom Index median				
Zambia	Frontier	44	244	59.7
Namibia	Frontier	40	371	62.7
United Arab Emirates	Emerging	40	396	67.8
Saudi Arabia	NA	38	266	66.2
Bahrain	Frontier	38	339	77.7
South Africa	Emerging	37	359	62.7
Kuwait	Frontier	32	252	64.9
Botswana	Frontier	31	421	68.8
Oman	Frontier	28	376	69.8
Qatar	Frontier	24	439	70.5
United States	Developed	23	500	77.8

Sources: Economist Intelligence Unit, January 2011; World Bank, 2010; Heritage Foundation, 2011.

We also analyzed specific country-level variables to determine whether they offered greater insights into country risk in the African and Middle East regions included in Russell's Emerging Markets and Frontier Markets Indexes.³ Many of the countries reviewed exhibit disparate economic characteristics that do not offer a clear mix of stability indicators. Factors such as median age of the population, levels of unemployment, poverty and GDP per capita, as seen in Table 2, do not, by themselves, offer an explanation of why certain countries are experiencing sometimes violent uprisings while others remain relatively stable. Two factors, however, appear to offer the strongest indications of potential problems: the length of time the current leader of a country has remained in power, and recent food price inflation.

Table 2 / Economic Characteristics

Country	Median Age of Population	Unemployment Rate	% of Population Below Poverty Line	GDP per Capita (\$USD)	*Year Current Political Leader Took Power	Agriculture as a % of GDP
Oman	24.1	15%	NA	\$25,800	1970	1.40%
Egypt	24.3	9.70%	20%	\$6,200	1981	13.50%
Tunisia	30	14%	3.80%	\$9,500	1987	10.60%
Qatar	30.8	0.50%	NA	\$145,300	1995	0.10%
Bahrain	30.9	15%	NA	\$40,400	1999	0.50%
Jordan	22.1	13.40%	14.2%	\$5,300	1999	3.40%
Morocco	26.9	9.80%	15%	\$4,900	1999	17.10%
Senegal	18	48%	54%	\$1,900	2000	14.90%
Kenya	18.9	40%	50%	\$1,600	2002	22%
Mauritius	32.7	7.50%	8%	\$13,500	2003	4.80%
UAE	30.2	2.40%	19.5%	\$40,200	2004	0.90%
Since 2004 = median years leader in power; 5% = median percentage of GDP from agriculture						
Saudi Arabia	25.3	10.80%	NA	\$24,200	2005	2.70%
Namibia	21.7	51.20%	55.80%	\$6,900	2005	9%
Tanzania	18.5	NA	36%	\$1,500	2005	41.60%
Kuwait	28.5	2.20%	NA	\$51,700	2006	0.30%
Botswana	22.3	7.50%	30.30%	\$13,100	2008	2.30%
Zambia	16.5	50%	86%	\$1,500	2008	19.70%
South Africa	25	23.30%	50%	\$10,700	2009	3%
Gabon	18.6	21%	NA	\$14,600	2009	4.50%
Ghana	21.4	11%	28.50%	\$1,600	2009	33.70%
Nigeria	19.2	4.90%	70%	\$2,400	2010	31.90%
United States	36.9	9.70%	12%	\$47,400	2008	1.20%

Sources: CIA World Factbook 2011 and Bloomberg.

* Transitional governments are now forming in Egypt and Tunisia. Nigeria's elections have historically been marked by political violence and corruption - the April elections may represent a significant period of country risk.

³ No country from either region has reached developed-market status.

The intersection of these two characteristics – how long a regime has been in power, and the pressure of rising food prices –helps to explain why many populations have been moved to call for change now. The World Bank estimates that as many as 44 million people in low- and middle-income countries have been pushed into extreme poverty since June 2010 due to rising food prices, which are nearing a return to their 2008 peak. The countries most affected have been those which rely significantly on imports of wheat, rice or corn, and which lack domestic crop substitutes.⁴ These factors appear to be a recipe for political instability in many of the countries evaluated.

None of the three country risk reporting agencies we reviewed, and none of the specific country-level variables we examined, has, on its own, fully predicted the unrest in the Africa and Middle East regions. The EIU and Heritage Foundation scores showed real strengths as composite-level predictors of instability – and yet some of the “least risky” and most economically “free” countries may see their governments deposed. More granular economic characteristics, such as high per capita GDP, may serve as buffers against unrest in one country but not in another. Given the complexities associated with identifying country risk, we believe that a multifactor approach incorporating a wide range of inputs, both quantitative and qualitative, will be most advantageous.⁵

⁴ World Bank: Food Price Watch, 2011.

⁵ Russell Indexes uses the Economist Intelligence Unit (EIU) country risk score as part of a multi-factor market classification model.

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