6.0 Political Risk Overview – In the neighbourhood: A regional look at politics and investment

We have observed that companies' discussion and framing of international political developments have tended to take place on two levels: global and national. Large-scale, multi-continental situations such as the Cold War, the debt and financial crises of the 1980s and 1990s and, more recently, the so-called Global War on Terror play a major role in shaping investors' risk appetites and judgments about which markets make good investment destinations and which do not. At the same time, many companies also pay close attention to political trends, regulatory environments and government attitudes toward business within individual countries. This national-level focus is understandable as it is local laws, regulations, institutions and personalities that effectively enable the establishment and continued operation of foreign-invested enterprises and with which oversees managers have the most contact. This two-level focus has been the general rule for at least a decade and a half.

However, in the past year or so many of our clients have raised concerns that imply another level of analysis: regional. We are being asked questions such as:

- Could terror attacks in one Middle-eastern country significantly destabilize the whole region?
- Can we expect contract renegotiations in Venezuela to be repeated in other Latin American markets? and
- Why are we losing out to Kremlin-connected Russian companies in Central Asia? With increasing frequency.

In addition, concepts such as correlation risk and policy contagion are entering the underwriting calculus of the political risk insurance industry.

The questions above imply a central premise: political developments in one county can affect the investment environments of neighbouring nations. In the emerging markets, the dynamics of intra-regional influence are often based upon circumstances particular to the region at hand and vary greatly in terms of their sustainability.

Political risk assessment at EDC has always had a heavy regional component and has led to the development of a solid understanding of the investment implications of regional power dynamics. In the following pages, we present our observations and conclusions on a number of regional situations about which Canadian investors have expressed concern.

Latin America

Much of the political discourse on Latin America revolves around the United States' *de facto* leadership position in regional affairs and its bilateral relationships with individual countries. Indeed, Washington's close involvement, combined with Latin American leaders' inability or unwillingness to exert influence beyond their borders, has been a hallmark of the region's history. However, in today's Latin America at least two countries – Venezuela and Brazil – are having a marked influence on investment and business conditions in other countries in the region.

Venezuela's leader, Hugo Chávez, is spearheading what he calls the "Bolivarian socialist revolution," combining old fashioned charismatic populism with an empowerment of Venezuela's poor and increased regional integration through financial or "in-kind" assistance. Domestically, the revolution is predicated upon channeling economic wealth into massive government spending and social programmes for the benefit of the poor. In Venezuela, a country that is highly dependent upon oil exports, social spending of this magnitude requires that the state get its hands on much of the money generated by the petroleum sector. One of the ways that Chávez has done this is by renegotiating contracts between the state and foreign investors to increase the state's ownership stake and degree of control over the sector. Firms that have not agreed to the state's new terms have been forced to leave the country.

POLITICAL RISK OVERVIEW

Venezuela's Bolivarian project has been enabled, to a great extent, by the tremendous increase in energy prices following Chávez' rise to power in 1998. Oil revenue windfalls have financed government spending, and the combination of high prices and Venezuela's plentiful reserves have kept foreign companies engaged in the market even as the government imposes less than favourable conditions upon them. So long as oil prices remain high, there will be enough money to keep many investors interested even as the government targets an ever larger share of the petroleum pie.

Proponents of the Bolivarian Revolution hold that the revolution's principles are applicable to other countries with characteristics similar to pre-Chávez Venezuela (i.e. wealth and power concentrated in the hands of a small elite alongside vast numbers of virtually disenfranchised poor). As such, there is a sense that the Bolivarian socialist ideology can and should be exported. The Chávez regime has approached these ideological exports in two ways. Firstly, the oil revenue bonanza has enabled Venezuela to attempt to buy political and ideological influence in Latin America and the Caribbean through financial grants or "in-kind" assistance such as discounted oil. Secondly, and more important to the issue of foreign investment, is that Chávez has produced a demonstration effect. His success in altering the business/operating/investment environment with respect to foreign investors has shown other leaders that it is possible to gain the upper hand and is directly or indirectly encouraging them to try to do the same.

For example, the governments of Bolivia and Ecuador have attempted to follow in Chávez' footsteps by pushing for greater state participation in their countries' respective energy sectors. However, their success to date has been limited. Bolivia had to temper its demands for gas price renegotiations with Brazil while Ecuador has found it difficult to attract foreign investors under its more stringent regulations. Since these countries lack Venezuela's enormous oil reserves and much of the capital and technology needed to extract what they do possess, Bolivia and Ecuador are simply not able to generate enough money and bargaining power to jump on the Bolivarian Revolution bandwagon. Furthermore, other populist leaders who might have been tempted to follow the Chávez example, Nestor Kirchner of Argentina comes to mind, have also realized that they simply don't have the level of natural resources required.

Brazil's impact on the rest of Latin America is deep, long term and structural. The country's vast natural resources, well-established manufacturing base particularly for automobiles, aerospace and capital equipment, and huge labour pool make it an attractive investment destination and trading partner. Covering approximately 50% of the continent, Brazil shares common borders with all but two other South American countries, and as such, has been pushed to develop tight networks of diplomatic and political relationships with a broad range of partners.

In addition, Brazil's leadership position in Latin America has been greatly enhanced by its relatively recent transition from an inward-looking military-ruled state to a democratically governed, emerging power. Abandoning the free spending habits of previous governments as well as the failed import substitution model prevalent in the 1980s in favour of fiscally responsible, investor friendly policies and regulations laid the groundwork for Brazil's emergence and established the governance and investment standards for other nations in Latin America, and in South America in particular. Furthermore, Brazil's policy shift does not appear to be transitory. Four consecutive administrations of differing political persuasions have endorsed and maintained the new course.

Brazil now actively exerts its influence through formal channels as evidenced through leadership of Mercosur, its role as regional leader in World Trade Organization (WTO) and G20 talks, or as a counterweight to the US in Free Trade Area of the Americas (FTAA) negotiations. Regional neighbours/partners that have not integrated with the Brazilian model have seen their investment flows or economic output suffer. One such example was the rapid and unceremonious diversion, earlier this decade, of auto-industry investment from Argentina to Brazil in the face of the Argentine peso crisis and worsening investment conditions there.

Many major, multinational investors have chosen to use a hub and spoke model for South America given Brazil's stability, policy evolution and geographic stature.

A confrontation between the Brazilian and Venezuelan propositions is currently playing out in Central America and the Caribbean on the subject of energy. Following the Brazil-US agreement on ethanol production and relying upon its technological lead in sugarcane-based ethanol, Brazil is proposing assistance to Central American and Caribbean countries to develop their own ethanol industry. Through PetroCaribe, Venezuela is providing cheap oil to 13 Caribbean countries in addition to making small investments in a number of the country's energy sectors. Chávez has also made numerous promises (pipelines, refineries, etc.) to Central American countries while providing them with cheap oil and electrical generators. In general, we expect to see many Central American and Caribbean countries align themselves with Venezuela to adopt more state-centred investment models in the short term.

In the longer term, Brazil's size and its more varied economy will enable it to have a more lasting influence in the hemisphere. The workability of the Bolivarian project appears to be dependent upon circumstances unique to Venezuela at this particular point in time. Therefore, despite Venezuela's stated aspirations toward regional leadership, its overall influence on the Latin American investment environment will be limited. In fact, a precipitous fall in oil prices would raise doubts about the sustainability of Chávez's agenda in Venezuela itself. Meanwhile, Brazil will be able to exert continuing regional influence through outward investment, technical cooperation with Latin American governments and provision of a market for neighbouring countries.

Middle East

Over the centuries, the Middle East has been a key playground of the world's great powers. Empires have overrun and been pushed off Middle Eastern soil for more than two millennia, and the current US troop presence in Iraq is proof that superpower interest in the region has not abated. Fluid intra-regional power dynamics have also been a key component of Middle Eastern history. In recent years, numerous states, including Iran, Iraq, Saudi Arabia, Egypt, Syria and Israel have, at various times and in various capacities, assumed the mantle of regional leadership and influence.

The US-led invasion of Iraq in 2003 triggered a dramatic shift in the balance of power in the Middle East, the effects of which grow stronger with time. Firstly, the removal of Saddam Hussein and the chaos that followed nullified the influence of one of the region's erstwhile key powers. Post-Saddam Iraq cannot govern itself nor secure its people, let alone exercise coherent influence over its neighbours. Secondly, Washington's difficulties in Iraq have taxed the US to the point where it is clear that it no longer has the capability or credibility to impose its will on the region.

Chaos in Iraq and the US quagmire have opened space for Iran. Iran has always been a major player in the region, but its position has been greatly enhanced since 2003. The country's nuclear programme has dominated world headlines, but more tangible and immediate evidence of its rising regional stock can be found in the new-found dominance of Shia groups in Iraq and the emboldened positions and recent military successes of Hizbollah in Lebanon and Hamas in the Palestinian Territories.

The Sunni Arab regimes of the Persian Gulf region (Saudi Arabia, Kuwait, Qatar, Bahrain, the United Arab Emirates (UAE) and Oman) are increasingly preoccupied by the ascendancy of Iran and deeply concerned that instability and militancy in the region will foster sectarian tensions and increased terrorism throughout the Gulf region. In particular, Sunni states with significant Shia populations, such as Saudi Arabia and Bahrain, are wary of the potential for Iran to stir up discontent among their own Shia minorities. The Arab Gulf states are also cognizant that any instability in the Gulf risks dampening investor enthusiasm with respect to a myriad of expanding economic and investment opportunities. These include a real estate boom, numerous industrial mega-projects and the proliferation of schemes aimed at transforming the smaller states into financial, commercial and tourism hubs.

Saudi Arabia's concern over regional developments has prompted it to undertake an increasingly proactive domestic security and foreign policy stance – a major shift away from its traditional role as a behind-the-scenes player under the US umbrella. The Saudi transition is correlated with the decline in US policy credibility in the Middle East but is principally motivated by its recognition that growing regional strife and the militancy it spawns pose direct threats to the Saudi regime's stability and the Royal Family's financial interests. In addition to greatly enhancing its domestic counter-terrorism capabilities, Riyadh is also actively involved in finding a resolution to the worsening Lebanese political crisis, brokered the now defunct Hamas-Fatah National Unity Government and has made efforts to dampen regional sectarian tensions. This is evidenced by Riyadh's hosting of a meeting of Iraqi clerics in late 2006 calling for an end to sectarian strife in Iraq.

Interestingly, although the Saudis perceive Iran as an enabler or provocateur of the very kind of instability they fear so greatly, Riyadh, unlike the United States, is not trying to isolate Tehran. Instead, it is pursuing a delicate balancing act, which includes the possibility of trade negotiations and joint dialogue on a number of political matters with regional implications. Neither side appears to be seeking any form of direct confrontation.

The smaller Arab Gulf states, which lack the political and economic clout of Saudi Arabia, have largely stayed on the sidelines of regional crises. However, they remain keen to retain the regional status quo and appear to be largely onside with Saudi efforts to check Iran on the one hand and engage with it on the other.

From the point of view of investors from most Western countries, Iran is currently off limits for all intents and purposes owing to sanctions and other restrictions related to its nuclear program and alleged sponsorship of terrorism. The investment climates of Saudi Arabia and the smaller Gulf states are highly dependent upon domestic and regional security considerations. Accordingly, the success or failure of Riyadh's current efforts to de-escalate regional tensions and control home-grown terrorism will have direct and far-reaching effects on economic developments on the Arabian Peninsula. At this stage, the situation is largely under control, but a sustained increase in regional instability could well bring the now robust Persian Gulf investment boom to a screeching halt.

Eastern Europe and Central Asia

In Eastern Europe and Central Asia, Russia remains the dominant regional power. One of the main factors behind this position is President Putin's efforts to reassert the Russian state, both in diplomacy and global business. This administrative strength was not always the case. Just a few short years ago, the Russian business model was one of young business tycoons functioning outside the governmental and political realm. In reality, they dabbled in both if needed, but there was no purposeful coordination between the state and business. In fact, they were often at odds. Much of this division stemmed from the speed and totality of the privatizations of the 1990s. State officials often suggested that the young tycoons had run away with what had been public assets and made their profits in a manner at odds with state aims. This, of course, took place in the context of a post-crisis environment in which state capacity had been constrained by economic events and lingering remnants of the post-Soviet bureaucratic culture. The new business people were capitalizing on a hamstrung state and worked at the pace of international business while the bureaucrats were left reeling from the fall of the Soviet Union.

This continued until the state takeover of Yukos, then Russia's largest oil company, in 2004. With this move the state returned to dominance in the strategically important energy sector. At the time, many Russia analysts felt the Yukos takeover and other state interventions into the private sector realm were discrete actions to fix specific problems left over from the chaos of the 1990s. However, the two and a half years since that event have shown that Yukos was only the beginning. There appears to be an even newer business model emerging; one premised upon a highly coordinated approach to business and the economy and in which the Kremlin's intentions and reach into the private sector extend beyond a few repairs. The line between business and

state has blurred and as such, commercial and political aims have become inextricably intertwined.

Companies and governments operating in the paradigm of mostly separate state and commercial realms are at a disadvantage when doing business, at home or abroad, with entities from today's Russia Inc. In the most negative of scenarios, non-Russian companies are neither able to compete nor hold good negotiating positions unless they are able to convince their governments to lend the same kind of direct and substantive support.

While this new business model has implications for anyone wanting to do business with Russian counterparts, it poses particular challenges for the governments of the countries on Russia's borders. This is particularly true if they are also courting investment from or political alignment with the West. Copying the Russian business model leads to Western accusations of corruption and state capture, purposely keeping a strong division between state and business, and puts one's own companies at a disadvantage vis-à-vis Russia The cases of the Central Asian countries and Ukraine are illustrative.

Throughout Central Asia this new business model has been tested, likely due to the nature of many foreign investments in the region: with oil, gas or mineral wealth, investment projects tend toward natural resource projects. The large Russian players in the oil, gas and mining sectors (e.g. Gazprom, Rosneft, Rusal, Norilsk Nickel) are globally competitive and proximate. Given that natural resource projects tend to be complicated and implicate many arms of government regardless of the business model being followed, the new Russian model is particularly apt for these projects as it allows government-to-government influencing.

With only five million people and an abundance of hydrocarbon resources, Turkmenistan is an investment destination of interest to many players. All foreign investors wanting to enter into Turkmenistan must be comfortable with working with the government since independent sources believe that the government accounts for three quarters of all economic activity. The government selectively chooses its investment partners in what is a poor investment climate suffering from a lack of established rule of law and arbitrary decision changes.

Uzbekistan has the largest population in Central Asia and significant mineral and gas resources. Granting incentives on a case-by-case basis, foreign investors need a strong negotiating position against the government, especially given the capricious regulatory environment. State-owned or government-affiliated businesses often receive unfairly advantageous treatment from the judiciary in business disputes. This lack of predictability can be a major impediment to foreign investors not wanting to dedicate time and resources to government relations activities.

On the other hand, investors have not been deterred from entering Kazakhstan, investing more than US$30 billion since independence, primarily in the huge oil and gas sector. The government is very involved in foreign investment oversight, including an early screening of investments, sometimes by very high-level officials. Major projects go through the president's office.

In these three countries as well as Tajikistan and Kyrgyzstan, the ability for the Russian state to influence the government is critical. In some cases, Russian firms are displacing Western companies, but for the most part, the Russian state influence is felt on a project-by-project basis. It is difficult to tell whether these countries adopted this model of business after seeing the Russian state's own success with it, or whether it is just that this model particularly fits with the style of doing business (interpersonal relations, tendency toward adversarial negotiations) of the CIS.

In Ukraine, which through its two major parties was struggling to decide between alignment with Russia or alignment with the European Union, the situation is more complex. The eastern part of the country, with its energy-intensive heavy industries, has traditionally been more pro-Russian than Kyiv. During the period after the Orange Revolution, when Kyiv was abuzz with pro-West Kyiv-based politicos energized by the defeat of presidential candidate Viktor Yanukovych and his backer, former president Leonid Kuchma, Eastern business people must have felt under pressure both from the new government and from Russian competitors. The ability to pair with their

government officials was limited, right at the time when Gazprom-Ukraine negotiations over gas supply.

At present, investors' interest in Ukraine appears to be on hold. The ever-changing political dynamic in the country has left foreign investors unable to comfortably predict policy direction. Russian firms are still interested, and the Russian state has a strong interest in the outcome of the current political wrangling. Should the political instability continue, government-to-government negotiations on behalf of investment projects are likely to continue.

Asia

Asia is unique among the world's developing regions in having two countries with legitimate aspirations as global powers. Both India and the People's Republic of China (PRC) have populations in excess of one billion and are home to extremely fast-growing economies. By 2050 the two countries are expected to account for more than of 30% of global GDP (up from about 8% in 2006). Furthermore, India and China possess considerable military strength and are in the process of modernizing their capacities – particularly their navies – to further extend their reach. Both countries are becoming intent on carving out diplomatic influence and representation in international institutions commensurate with their demographic, economic and military power.

That the presence of two dynamic giants in their midst affects their smaller neighbours is obvious. Their sheer size alone is enough to create a powerful gravitational pull. However, despite the fact that they are often mentioned in the same breath when global developments are discussed they do not carry the same weight in a global or regional context.

Following centuries of focusing inward, China began to open its economy to international trade and investment in the early 1980s. The rapid economic growth and connections to the global economy that ensued meant that the PRC once again had vital interests beyond its borders and, as importantly, the means to pursue them. Through a combination of economic incentive, deft diplomatic maneuvering and implicit military threat, China has been largely successful in shaping the continent in a way broadly aligned with its interests.

Examples of Chinese success are many. The PRC has effectively isolated Taiwan – an island that the PRC perceives to be a breakaway province but whose government was recognized by many countries as the legitimate authority over all of China until well into the 1970s. Now, Taiwan has few diplomatic allies, and it is fair to say that no one anywhere in the world makes policy or commercial decisions about Taiwan without first taking stock of the PRC's likely reaction.

On its western flank, where the PRC's interests are shaped by its desire for domestic stability, territorial integrity and energy security, the PRC has taken a proactive stance in its relations with the Central Asian states. The security focus of the Shanghai Cooperation Organization (SCO) and substantial Chinese investment in Central Asian energy projects are evidence of this. Furthermore, the PRC combined its interest in being a global actor and its influence vis-à-vis long-time ally North Korea, to play an integral role in facilitating the 2007 agreement on the dismantling of Pyongyang's nuclear program.

The source of Chinese regional power, however, is the degree to which the economies of most East Asian countries are now linked with that of the PRC. As has often been noted, the PRC has become a crucial hub for the global supply chains of most multinational enterprises (MNEs). "Made in China" labels – indicating that products have undergone final assembly in the PRC – have become ubiquitous. However, many of the components used in Chinese-assembled products are made elsewhere – particularly in developing East Asia. MNEs invest in intermediate facilities there for the express purpose of feeding into their Chinese assembly operations. As such, much of the region's trade takes the form of exports to China, and much of its inward investment is predicated upon complementary investment in China. Therefore, East Asian governments have found themselves in a position in which their vital interests depend upon the continued success of Chinese businesses and, by implication, on the political stability in the PRC.

In comparison, India has experienced difficulty in taking its position among the global powerhouses and has struggled to match China's reach. Its diplomatic purview has been largely confined to South Asia, it has consistently underperformed as an investment destination and it has not succeeded in creating the kind of economic linkages that would give other governments a direct stake in the country's stability or prosperity.

There are several hypotheses as to why this is the case. Firstly, India has very few neighbors (four) compared to China which borders 14 states. As such, China is required to engage with almost four times the number of countries on matters of territorial integrity and domestic stability. It is possible that the PRC's need to deal with such a broad range of next-door neighbours has pressured the country into developing more nuanced and multi-faceted diplomatic capabilities.

A second key consideration is the Indo-Pakistani relationship. Ongoing tensions and the potential for open conflict between the two counties tie down attention, resources and political capital that India could otherwise use to project its influence throughout Asia and beyond. China does not face any threats of similar magnitude. Interestingly, the PRC, through its long-term support of Islamabad, has contributed to India's hamstrung position.

A third factor that could help to explain China's current regional standing relative to India is the differing nature of internal politics within the two countries. The PRC is a one-party state in which the government/party is directly involved in the majority of political, economic and social matters and in which decision making is ostensibly centralized in Beijing. Conversely, the Indian model is one of a multi-party democratic federal state characterized by political and economic decentralization and numerous ideologies. Whereas, in general, the Chinese Communist Party (CCP) leadership can decide upon a course of action and follow through with it, India's government often finds itself with limited options and difficult implementation processes owing to internal wranglings or resistance from opposition political groups and other levels of government. In addition to these structural constraints, a host of domestic security issues including militants in the northeastern and central states and sectarian tensions throughout the nation require New Delhi to focus its attention inwardly rather than on building the country's regional and global standing.

While China's position in the region is now paramount, it may not always remain so. Recent reform in India has opened the country's economy to a greater degree than ever before and, for the first time since independence in 1947, there appears to be workable agreement in society as to the best way forward. At the same time, the Chinese development model is pushing against some limitations. While centralized, directive government may work well in conjunction with low-level manufacturing activities, it is a hindrance to the higher-value elements of the value chain that China must master if its economy is to continue to grow fast enough to meet the expectations of the population. Similarly, the broad, nebulous scope of global diplomacy requires much more agility than relatively well-defined 'neighborhood' issues. Micromanagement is anathema to complex economic and political activity; yet micromanagement has, to now, been the hallmark of the PRC government. Adjustment may well prove difficult for government and populace alike.

Paradoxically, India's historical problems may well turn out to be its greatest assets. Indian officials have spent decades, if not centuries, navigating myriad complexities and uncertainties without recourse to a consistent central authority. It is quite possible that the skills developed in that regard will help enable Indian business and government to excel at high-value, complex activities more readily than their Chinese rivals.

For investors, the Asia story illustrates the need for long-term thinking and a balanced approach. The immediate competitiveness gains that can be generated by assembling product in China are clear. This will continue to be true for the foreseeable future. At the same time, India is already becoming a global hub for services and advanced technologies and socio-political conditions suggest that this will continue. Furthermore, if, as is entirely possible, India gains momentum on China in the Asian power game some of the current China-East Asia alignment would likely shift toward India. A prudent regional strategy would therefore include due consideration of Asian

giants and creation of East Asian assets that can contribute to either India or China-focused supply chains.

Sub-Saharan Africa

Regional influence can emanate from many sources. Often, we look toward geographic or demographic influence, military might or economic prowess to analyze the reasons behind regional power dynamics, but ideas and the ability to adopt different policies can be equally influential. Countries, by devising novel approaches to their own situations can act as examples to neighbours facing similar issues. Such "demonstration effects" are currently having a significant impact on the investment environment in Sub-Saharan Africa.

Across the region it is apparent that many governments no longer buy in to the liberal economic doctrine that dominated the 1990s and early 2000s. Indeed, the belief that the sole path to economic development was through foreign private investment – largely from Western sources – is fast becoming a thing of the past. Today, African governments are looking for alternative economic policy and investment strategies to grow their economies and capitalize on resource wealth, though virtually all still recognize the importance of, and continue to seek access to, foreign capital. This gradual change in outlook is being fueled by a few coinciding factors: the continued high levels of poverty and underdevelopment throughout Africa despite increased liberalization, the current boom in commodity prices, and the increased attention the continent has received from "non-traditional" investors, most significantly from China.

It is in this particular context that the very different experiences of two important countries, Angola and South Africa, are acting as examples that other African countries are increasingly looking to as models for how to advance their own economies. Angola has become the most notable example of the "alternative investor" strategy through its partnership with China, an approach that has seen Angola benefit from billions of dollars of Chinese financing and investment. On the other hand, South Africa has become the example of the "local empowerment" strategy through the advancement of its black economic empowerment (BEE) strategy. Through BEE, the South African government aims to redress historic economic inequities within the country and ensure long-term sustainable economic growth through the equal integration of the black population into the domestic business environment. For a variety of economic, political, and even geographic factors, several African countries are following in the footsteps of Angola or South Africa, though these two strategies should not be viewed as mutually exclusive.

Sudan, Zimbabwe, Guinea, Chad, Nigeria, Equatorial Guinea, and most recently the Democratic Republic of Congo, appear to be taking a page out of Angola's book. Each of these countries' engagement with non-Western investors is on the rise and each is increasingly looking to countries such as China, and to a lesser extent India, Russia, and various Latin American and Middle Eastern countries to invest in natural resource and infrastructure projects and to also provide critical financial assistance. The key advantage for these African countries is that partnering with China (or others) gives them economic and political leverage over and the opportunity to bypass private investors and the multilateral financial institutions. Financial support from these alternative sources does not come with the high price tag of economic and political reform that the IMF and World Bank would impose as conditions for financial assistance.

Falling into the South Africa "empowerment" camp are several other Southern African countries that are considering their own versions of affirmative action policies to try to increase the local economic benefit from investment in their countries. Zambia passed its Citizens' Economic Empowerment (CEE) Act in September 2006 and Namibia is anticipated to have its own BEE legislative framework in place by the spring of 2008. Botswana has had empowerment legislation designed to boost local entrepreneurs in place since 2001, and there is currently active debate in policy circles about whether the country should adopt broader citizen empowerment laws. The major challenge for governments pursuing empowerment strategies is to find ways to implement legislation that generally imposes a range of local employment, ownership, training and management requirements on companies without deterring investment. If the implementation is

not well managed, empowerment policies can result in a more cumbersome investment environment as companies encounter additional bureaucratic and regulatory requirements.

Both the "alternative investor" and "local empowerment" strategies result in a stronger role for the government vis-à-vis business – albeit in different ways. Countries such as South Africa and Namibia are using legal and regulatory mechanisms to bring about economic redistribution and transformation – an approach that is likely to eventually result in greater transparency and clarity, though investors will continue to face short to medium-term uncertainties regarding exactly how these policies will be implemented. Conversely, the approach being taken by Angola, Sudan, Chad and Guinea produces a more politicized business environment where investment patterns are largely determined by high-level political interests and personal connections. As is the case already in Angola, the adoption of this alternative investor strategy has a significant impact on the environment for Western investors.

Engagement with China has had a clear effect on the way in which the Angolan government now prefers to do business. As such, companies face an environment where there is weak and/or unclear separation between the state and business, poor transparency, and arbitrary and inconsistent regulation. Investors bidding on government tenders often have to include possible financing arrangements in order for their proposals to be considered, and for large projects the Angolan government prefers bids to come with some form of political support from the investor's home country government.

In summary, the expanded number of foreign investors and public financiers throughout Africa, and the disillusionment with foreign direct investment as a catalyst of economic development are influencing policy dynamics in many African countries. The more politicized nature of the alternative investor approach produces an investment environment that is more arbitrary and less transparent for investors, while the empowerment approach presents risks related to government expectations about local participation in foreign-owned projects and companies. Essentially, what these developments point to is the ever-growing importance of companies assessing and understanding the local context of their investment destinations and adapting their market choices and business strategies accordingly.

Conclusion

As has been illustrated above, one country's ability to influence the investment environment of others can emanate from several sources – some structural and long term, others more circumstantial and transitory in nature. What's more, evolving power dynamics within regions mean that some of the key dilemmas facing investors today are likely to be less important in the coming years.

- In Latin America, we believe that the reach and depth of Venezuela's regional influence is limited as its Bolivarian Revolution is enabled by circumstances unique to the country and, in the case of high oil prices, of potentially limited duration. Brazil's lead as an increasingly outward-looking, market-based regional powerhouse is much more likely to carry the day. As such, overall investment conditions for Western firms in Latin America should improve in the coming years.
- In the Middle East, the chaos of Iraq is giving rise to a pronounced rivalry between Saudi Arabia and Iran. From foreign investors' point of view, Iran is a destabilizing force in the region while Saudi Arabia, despite having its own problems with Islamic extremism and a somewhat ambivalent attitude toward foreign investment, has emerged as a *de facto* guarantor of the investment boom that is currently transforming the smaller Persian Gulf states. Investors' fortunes will rise or fall based on Riyadh's success or failure in preserving regional stability.
- Russia has adopted a new business model characterized by the intertwining of state and commercial interests and, as the dominant power in Eastern Europe and Central Asia, is exporting the model to its neighbours. The neighbours have bought in to varying degrees.

Western investors interested in these neighbouring countries need to realize what they are up against and prepare appropriately.

- In the current environment, China is clearly Asia's dominant player. The country's economic boom and subsequent assertion of political and diplomatic power has impacted the whole continent, and the structure of the East Asian economy has been profoundly changed by China's rise. India, also a rapidly growing giant, has yet to attain China's regional and global reach, but this balance could change as both countries strive to attain places at the high end of the value chain. Investors need to be aware of this dynamic and plan their pan-Asian strategies accordingly.
- In Sub-Saharan Africa, new ideologies are emerging as governments, frustrated by the unmet expectations of liberal economic policies, develop new approaches toward foreign investment. Some are courting non-Western investors and making concurrent political deals with the firms' home governments. Others are working to codify the participation of nationals and the host-country benefits. The latter group of countries, led by South Africa, should eventually produce more amenable environments for Western investors – even though the process of creating "empowerment" rules is likely to be fraught with hiccups.

"Know thy markets" remains political risk assessment mantra. Adding a regional layer to the well-established global and national layers can help international investors make their market knowledge more complete and improve the prospects of a healthy return.