



Heleen Rijkens

Dear Reader,
The Arab world took us all by surprise with the dawn of 2011 seeing a spate of uprisings challenging the often corrupt, nepotistic and long-reigning regimes across North Africa and the Middle East. Whilst

the revolutions in Tunisia and Egypt suggest the dawn of democracy and greater economic opportunities, the history of these countries has yet to be written – and this is particularly true for Bahrain, Libya and Yemen. In light of the rapid developments here, we have included only one article relating to the region – on the short- and medium-term prospects for Egypt. Our other debt-focused article concerns Venezuela, but we

also include five guest-written articles – providing analyses on the UK’s Bribery Act 2010, on 2011’s top risks, on the financial, economic and political situation in the five Central Asian “stans”, and on North Korea.

We would also like to draw your attention to the conference that we are sponsoring and organising for the fourth time, to be held in Amsterdam on Thursday 22 September 2011. The “Funding and Managing Dispute Resolution Conference” will focus on the theme of minimising costs and maximising results. Speakers will talk about litigation funding, damage calculations, intelligence and on all subjects that can affect the money you spend on litigation and the money you get out of it. We hope you enjoy this newsletter and look forward to welcoming you in Amsterdam in September.

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Funding & Managing Dispute Resolution Minimising Costs, Maximising Results

Funding & Managing Dispute Resolution Conference

Maximising Costs, Minimising Risks

Thursday 22 September 2011
Industrieele Groote Club
Amsterdam
The Netherlands

We are pleased to announce our hosting of the above conference, to be held at the Industrieele Groote Club in Amsterdam on Thursday 22 September 2011.

The conference will focus on how parties involved in legal proceedings or arbitration can benefit from funding, intelligence and insurance solutions, with the aim of transforming in-house law departments from cost centres into profit centres. Substantive areas to be covered will include both strategic options and practical solutions. Specific panel debates will examine how to forum shop to reduce costs and how to share your costs and risks, whilst one speech will outline the challenges and solutions in cooperation between funders and lawyers. A further panel debate will examine the latest developments in the legal and economic aspects of costs, damages and interest awards. One speech will examine where mediation can be successful and where more forceful and

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Funding & Managing Dispute Resolution

Minimising Costs, Maximising Results *(continued)*

FUNDING & MANAGING DISPUTE RESOLUTION CONFERENCE

Minimising Costs, Maximising Results

“The conference will focus on how funding, intelligence and insurance solutions can transform in-house law departments from cost centres into profit centres. This one day conference will gather together experts and people of interest to lawyers in private practice, in-house counsel, and professionals in export credit agencies and political risk insurers.”

innovative methods are required. The day will conclude with a panel discussion on how to overcome the legal and practical hurdles to ensure you actually get paid. Debt recovery matters, cartel damages claims or securities actions, arbitrations and class actions will all be considered – in both the developed and emerging markets.

This one day conference will gather together experts and people of interest to lawyers in private practice, inhouse counsel, and professionals in export credit agencies and political risk insurers. Confirmed speakers include partners of Herbert Smith, Norton Rose and Stephenson Harwood, and in house counsel from General Electric and Michelin. Further details will be circulated shortly, and we look forward to seeing you at what promises to be a fascinating conference.

22 September 2011

De Industriële Groote Club
Amsterdam, The Netherlands

Standard Rate per Delegate: €599.00 EUR



OMNI BRIDGEWAY



2011's TOP RISKS:

Some Bad Bets in the World's Emerging Markets

Ian Bremmer and David Gordon of Eurasia Group

A wave of money flooding into emerging markets has lifted many boats. But when the tide goes out, certain countries - and the investors betting on them - may be left high and dry.

There are very different risk profiles among emerging markets, and even beyond the increasingly turbulent Middle East, not all are going to perform well this year. The risks facing these countries include negative economic policies (fiscal imbalances in some, premature austerity in others) as well as more purely political risks (including contentious elections and political violence).

As these problems play out in 2011, they will contribute to poor investment outcomes, ranging from adverse regulatory changes to asset bubbles and weak stock market performance.

The most notable underperformers are Argentina, Hungary, Peru, South Africa, Sri Lanka, and Thailand. In Argentina, investors appear overly optimistic that policy will improve - either as a result of President Cristina Kirchner losing her re-election bid or a change in direction if she wins. In fact, she is likely to win, but policy is unlikely to change, leading to higher inflation and more populist economic policies.

In Hungary, markets have recently turned south, but still do not seem to be pricing in the scope of the potential impending crisis as the Fidesz government attacks asset holders across a range of classes. Hungary may once again have to turn to the IMF, but Prime Minister Viktor Orban has walked himself into a political corner with his vitriolic anti-IMF rhetoric.

Investors in Peru underestimate the potential for populist candidate Ollanta Humala to make a serious run at the presidency. He's a decided underdog to be sure, but it's too early to write him off. Even if the more market-friendly Alejandro Toledo wins, we're likely to see more resource nationalism - and mild capital controls if the Peruvian sol continues to appreciate.

Despite its aspirations, South Africa won't improve its investment climate in 2011. Growing political pressure on President Jacob Zuma ahead of municipal elections in April-May and the ruling party leadership contest in 2012 will

increase the risk of government inertia and erratic policy-making and reinforce the African National Congress's "single party rule" mentality."

Many people have become overconfident that the end of Sri Lanka's civil war will usher in a period of political stability. But President Mahinda Rajapakse, insecure in his position, is centralizing power while failing to address the country's structural challenges. That's a recipe for resurgent political and ethnic tension, and it will dampen growth prospects.

Finally, 2011 promises to be a year of political tension in Thailand, especially given the king's failing health. Allies of former Prime Minister Thaksin Shinawatra remain popular in much of the country, raising the risks of a violent, flawed election or a military intervention. There's real potential for serious and sustained unrest involving Thailand's incumbent elites and the pro-Thaksin "red-shirt" movement.

“...not all [emerging markets] are going to perform well this year...most notable underperformers are Argentina, Hungary, Peru, South Africa, Sri Lanka, and Thailand.”

Ian Bremmer is president of Eurasia Group, the world's leading political risk consultancy, and author of *The End of the Free Market: Who Wins the War Between States and Corporations?* David Gordon is the firm's head of research.





THE BUSINESS ENVIRONMENT IN CENTRAL ASIA

An overview of the political, financial and security risks facing Western investors

Anna Walker of Control Risks

Despite its rich natural resource endowment and underdeveloped manufacturing and services sectors, former Soviet Central Asia is a region that has not always featured prominently on investors' agenda.



This is partly because of the greater perceived rewards in larger emerging markets, but is also undoubtedly because of the risks associated with investing in what are still complex and to a large extent poorly-understood business environments. The five Central Asian republics of the Commonwealth of Independent States (CIS) – Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan – share a Soviet-era history that gives them a common legacy in many areas, including their political, cultural and economic ties with Russia. Together with factors specific to each country, these in turn have an impact on the business environment, which presents foreign companies with a diverse set of financial, political and security risks.

Financial risks

Financial risks in the region tend to be linked to the countries' natural resource endowment, the degree of dependence on external borrowing, be it private sector or multilateral, and the depth of integration

into global capital markets. Of the five countries, Kazakhstan has made the most progress over the past 20 years in developing its financial services sector, which in turn is the most integrated into global financial markets. Foreign borrowing by the commercial banking sector alone was equivalent to 50% of Kazakhstan's total external debt in mid-2008 and to 50% of GDP. As access to external borrowing seized up from mid-2008, so the sectors that were reliant on bank credit – principally real estate – went into rapid decline, creating a vicious circle in terms of bank solvency and the ability of the sector to meet its external debt repayments. Foreign creditors of several of the banks had to accept a drastic haircut, while the state asset holding company in effect nationalised two of Kazakhstan's largest four banks. Though non-performing loans across the banking system remain high at around 33% of total credit as of March 1st 2011, the crisis has forced the sector to reconsider its lending policies and to adopt a more cautious approach that

should mitigate risks to creditors in the future. At the other end of the scale, Turkmenistan and Uzbekistan, by contrast, are relatively isolated in global financial terms and hence emerged from the crisis comparatively unaffected by the crisis – an outcome that their leaders used to their benefit, by ascribing it to their successful economic policies. Their commodity endowment has also brought them foreign-exchange revenue, providing the governments with a financial cushion. Financial risks in these countries stem more from the cautious approach to economic and structural reform adopted by successive governments, which have retained a high degree of control over economic activity, such that commercial and market-based considerations tend to play a secondary role to political imperatives. The dependence of central banks on the government also distorts monetary policy. The resource-poor countries of Kyrgyzstan and Tajikistan present a different set of financial challenges. With minimal foreign direct investment, the two countries are heavily reliant on concessional financial assistance from both multilateral and bilateral sources. This, in turn, has been predicated on the adherence to a series of structural reform programmes drafted in conjunction with the international financial institutions. The progress of these reforms has been far from smooth. Tajikistan in particular has faced criticism in the past for what might be termed its 'creative accounting' to improve its creditworthiness, while the Kyrgyz authorities ousted in April 2010 have been accused of siphoning off credit extended to the country for their personal gain.

Political risks

One political risk that is common to the five countries is the uncertainty over the presidential succession. Each is ruled by a president who came to power through manifestly unfree and unfair

elections. Two of them – Nursultan Nazarbayev of Kazakhstan and Islam Karimov of Uzbekistan – have served as leader since before the collapse of the Soviet Union, while a third, Tajikistan’s Imomali Rahmon, has been in power nearly as long, acceding to the presidency in 1992. Following the death of his predecessor as Turkmen president, Saparmurad Niyazov, Gurbanguli Berdimuhamedov won the 2007 election – the first in post-Soviet Central Asia in which an incumbent was not standing.

Kyrgyzstan, where two leaders have been forced out of office in the past six years on the back of social unrest, and where the current administration under Roza Otunbayeva is attempting to move towards a parliamentary system of government, is something of an exception in the region. However, there is widespread resistance to abandoning the presidential model and no guarantee that the reforms currently underway will not be reversed under a successor government.

All five countries in theory have constitutions that set out procedures for the presidential succession, yet these constitutions are rarely abided by and – as repeatedly occurred across the region – can be amended at the whim of whoever is in power. With no country having an obvious successor to the current incumbent, and most of the incumbents seemingly intent on remaining in office for life, the transfer of power when it does eventually occur is likely to be anything but open and transparent.

This creates a number of political risks for companies. The top-down nature of decision-making, and the importance of personal relations with the president, has meant that the continuity provided by the personalised nature of the various regimes has on the surface provided a measure of stability for foreign investors. However, it masks a longer-term and potentially serious problem, in that once the current generation of leaders leaves the scene, it is by no means clear how the succession process will unfurl. In a worst-case scenario, power could pass to a different, formerly rival, political faction, with investors who have allied themselves to the wrong side of the political divide at risk of contractual changes or even expropriation. Two examples of this are the groups of investors that allied themselves with Rakhat Aliyev and Timur Kulibayev, the competing sons-in-law of President Nursultan Nazarbayev of Kazakhstan.

Institutional shortcomings – underdeveloped civil services, the absence of independent

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institutions (including the judiciary), and flawed legal and bureaucratic frameworks – exacerbate this political risk. Though two decades of administrative and structural reforms have made varying degrees of progress, foreign investors can still not expect to receive consistently transparent and fair treatment when dealing with bureaucracy. This contributes to concerns over the stability and sanctity of contracts, particularly given the questionable respect for avenues of recourse such as international arbitration. This can be seen by Kazakhstan’s behaviour as defendant in the recent *AIG, Biedermann, Telsim and Rumeli ICSID* arbitrations.

Aside from several high-profile examples in the natural resources sector in Uzbekistan, examples of outright expropriation across the region are relatively few and far between. This is partly because, apart from Kazakhstan, levels of foreign investment and foreign participation in these economies is limited. However, the governments do not necessarily need to resort to direct expropriation to carve out a more lucrative economic role for state entities. For example, revisions to the legislative and taxation regimes governing the natural resources sector in Kazakhstan in recent years have created uncertainty for foreign companies, which have also faced pressure to renegotiate their contracts to increase the share of the state in oil and gas projects. Talk of removing stable tax arrangements for foreign investors in the sector further complicates the operating environment in Kazakhstan.

The intertwining of political and business interests within these countries is another political risk faced by investors, particularly in the context of intensifying global anti-corruption efforts. Across the region, political figures at the highest levels – as well as their family members – have personal interests in lucrative economic sectors, but transparency as regards business ownership

tends to be minimal. Carrying out due diligence on prospective business partners so as to better establish these relationships is therefore a prerequisite.

Security risks

Foreign companies operating in Central Asia face a range of security risks, from petty crime to tension over the shared use of natural resources, particularly water and gas, for which there is no region-wide agreement. Government harassment at one end of the spectrum and repression at the other, including active use of Soviet-era national security committees, close monitoring of electronic and print media, and restrictions on basic freedoms of assembly and expression, has generally kept a lid on formal political opposition across the region. In addition, governments have promised their populations to a greater or lesser degree a form of social contract, whereby they have pledged to ensure a basic standard of living (for example through subsidies and minimum wage stipulations) but to restrict political opportunities until such time as they deem economic development to have progressed sufficiently. This policy has come under strain, however, and social problems such as high unemployment (and a related lack of employment opportunities, including barriers to private-sector business), and rising food and energy prices are fostering resentment that in the longer term could spill over into destabilising unrest. Security threats also stem from the region’s proximity to Afghanistan. Though the likelihood of a spillover of the conflict into Tajikistan, Turkmenistan and Uzbekistan (the countries that share a border with Afghanistan) is low, crossborder drug-smuggling continues to thrive. Several of the major trafficking routes from Afghanistan to Europe cross the region, where the threat is exacerbated by the weakness of border security structures, complicity in the illegal trade



by officials in the intermediary countries and a failure by the countries to improve their co-ordination of counternarcotics policy. Widespread corruption in the security and law-enforcement bodies is a further factor inhibiting a more effective anti-smuggling policy. The direct impact from drug-smuggling on companies operating in the region is probably limited, but there are indirect effects such as its role in sustaining organised crime and fuelling petty crime. The spread of religious extremism poses another potential threat to regional security, though the influence of and support for radical Islam across the region is difficult to gauge not only because of the secretiveness of the groups involved but also because the governments tend to ascribe extremist motives to all political dissent. The most high-profile regional group, the Islamic Movement of Uzbekistan – founded in the 1990s with the primary aim of ousting Uzbekistan’s president, Islam Karimov – was believed to have been largely destroyed in the wake of the US invasion of Afghanistan in 2001, where it had sought safe haven. However, reports suggest that the IMU has managed to regroup in the intervening decade, and several attacks in the past two years have been attributed to it or to splinter groups. The threat from terrorist groups such as the IMU varies across the region. Incidents of violent extremism in Turkmenistan and Kazakhstan, for example, are rare to non-existent, while in Uzbekistan the security forces have developed quite effective intelligence networks to penetrate such groups. Weak state capacity in Kyrgyzstan and Tajikistan increases the security threat in these countries, though the direct security threat to foreign companies from such groups is limited, with government and security forces being the primary targets.

Conclusion

The diverse set of risks outlined above could easily deter all but the most committed investor from Central Asia, yet there are also notable rewards on offer for companies prepared to expend the time and effort in exploring the substantial opportunities available. Risk management is one of the keys to this success. While the risks will inevitably vary by country and by sector, devising an appropriate risk assessment and risk mitigation strategy is a prerequisite for any company considering investing in the region.

Anna Walker is Senior Analyst on the Central Asia and South Caucasus desk of Control Risks.

BRIBERY ACT 2010: Implementation and Implications

Andrew Ottley of Ince & Co

The Bribery Act 2010 will finally come into force on 1 July 2011, following the publication of the Ministry of Justice’s Guidance on the Act on 31 March. Commercial organisations now have limited time in which to get ready.



The backdrop is the increasing international pressure for a concerted crackdown on bribery and corruption, exemplified by the OECD Convention on Combating Bribery of Foreign Public Officials, to which the UK signed up in 1998, and statements from UK judges such as that “there can be no doubt that corruption of foreign government officials or foreign government ministers is at the top end of serious corporate offending.” The Act is part of an effort to ensure a culture change, in which no UK business any longer regards the payment of bribes in certain jurisdictions as a regrettable fact of life, but would forego business rather than pay a bribe. Indeed, in a manner reminiscent of the money laundering legislation, it effectively compels businesses to become self-policing.

The Act’s major innovation is the introduction of the corporate offence of “failure of commercial

organisations to prevent bribery”. A commercial organisation will be criminally liable if a person “associated with” it bribes another intending to obtain or retain business, or an advantage in the conduct of business, for the commercial organisation, irrespective of whether the organisation itself has any knowledge of the bribe. A person is “associated with” a commercial organisation if he carries out services for it, or on its behalf. The obvious examples are employees and agents, but the definition is elastic and each case will turn on its own facts. The only defence – apart from contesting the facts – is for the organisation to show that it had in place “adequate procedures” designed to prevent associated persons committing bribery, thus incentivising businesses to adopt specific anti-bribery procedures. This begs the obvious question of what is ‘adequate’, as to

which the Act says nothing. Instead, the Act requires the Government to publish 'Guidance about procedures which relevant commercial organisations can put in place to prevent persons associated with them from bribing' before the Act could come into force. It is this guidance which has now been published, but, as can be deduced from this description, it is not prescriptive but rather high level and outcome-focussed. Nonetheless, the Guidance does seem to be intended, in part, to meet criticisms that the Act goes too far, placing companies at unnecessary risk of criminal liability, and tending to stifle business.

The Guidance includes a commentary on the corporate offence, explaining the policy behind it and how the Government expects the Act to apply in practice. It is something of a balancing act between reassuring businesses on the one hand and upholding the legislation on the other.

The starting point in understanding the issues is the Act's definition of a bribe: it is a financial or other advantage intended to induce or reward the "improper performance" of a person's function or activity where, very broadly, any personal benefit to the recipient could create a conflict between his own interests and the interests of those he is supposed to be serving. Improper performance is anything done in breach of the expectations of good faith and impartiality which a reasonable person in the UK would have of the recipient (and of course the mere receipt of the benefit may itself be enough). Anyone with a 'close connection' with the UK (e.g. a British citizen or a long term resident) can be prosecuted here wherever the alleged bribe took place and the Act expressly excludes any appeal to local custom or practice (in, for example, a country where backhanders are accepted as the norm) by way of defence.

Hospitality

Alarmists suggested that the definition was sufficient to criminalise the entire machinery of corporate hospitality. The Guidance emphasises this was never the Government's intention; it confirms (as various informed sources have been saying for some time) that "reasonable and proportionate" expenditure is unlikely to engage the SFO's or the DPP's attention. It actually instances the entertainment of foreign clients at a Six Nations Match at Twickenham as 'extremely unlikely' to be regarded as a bribe.

There is no such exemption – either for Six Nations Rugby specifically, or "reasonable and proportionate" expenditure in general – in

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the Act. The point is that where expenditure is reasonable and proportionate it is unlikely to be regarded as evidence of an intention to induce "improper performance", which is the critical ingredient of the main bribery offence. The underlying assumption appears to be that the representatives of customers or clients who receive reasonable and proportionate hospitality will still exercise their judgment properly in awarding contracts, and the providers of such hospitality do not intend anything else. Even so, the fact that a payment is reasonable and proportionate will not prevent a prosecution or conviction if there is positive evidence that the payer intended to induce improper performance, even if the benefit was modest, and commercial organisations will still need to set criteria for hospitality payments in their anti-bribery procedures.

Bribery of Foreign Public Officials

The Act's second key innovation is the introduction of the separate offence of bribing a Foreign Public Official. This offence is committed where a person offers or provides a financial or other advantage intending to influence the foreign public official in that capacity and to obtain or retain business, or an advantage in the conduct of business (unless the Foreign Public Official is permitted or required by the local written law to be influenced by the inducement).

What is distinctive about this new offence is that, in contrast to the general offence, the prosecution does not have to show any intention to induce any improper performance on the public official's part. The benefit, coupled with the intended advantage, is enough. This has been criticised as sweeping and draconian.

The Guidance explains the Government's position as follows:-

- the requirement of an intention of improper performance was excluded because, in countries where corruption is rife, it would be very difficult

for the prosecution to prove what a local official's functions actually were. It was preferable therefore to define the offence broadly rather than risk that justifiable prosecutions would be stymied because of evidential difficulties;

- nonetheless, the Act is only intended to bite where the mischief of actual or intended improper performance has arisen;

- and the prosecution would need to show a 'sufficient connection' between the payment and the intended business advantage.

The suggestion is that 'business advantage' will be interpreted quite narrowly. The provision of benefits which simply help to maintain a relationship are unlikely to be regarded as intended to generate business as such, or obtain a business advantage; there will need to be evidence that the benefit was intended to have 'a direct impact on decision making'.

The Guidance goes on to give as an example an expenses-paid trip by foreign government officials to a remote mining facility intended to demonstrate a company's safety standards as falling outside the intended scope of the offence, as would fringe benefits such as fine dining and sports matches on an overseas trip, if the trip can otherwise be justified. The Guidance thus seems to be intended to align bribery of Foreign Public Officials more closely with the criteria applicable to the main offence, but again businesses' procedures will have to address this area.

Facilitation Payments

Another effect of the formulation of this offence is that it catches facilitation payments – payments made to officials to ensure that they perform, or perform more quickly, steps which they are in fact under a duty to carry out in any event. The Guidance accepts that in many places small bribes to facilitate government action are a fact of life which cannot be eradicated without a culture shift. However, the Guidance makes no attempt



to limit the Act's application to facilitation payments. Rather the expectation is that businesses' procedures will provide for facilitation payments to be challenged and resisted: one of the Case Studies annexed to the Guidance proposes that companies should build into their delivery schedules an allowance for the time it will take to do so.

The Guidance acknowledges that facilitation payments are often obtained by extortion. Such circumstances are not excluded from the ambit of the Act, but as the Guidance points out, an individual who makes a facilitation payment under pressure may well have a defence of duress. Beyond that, it will be a matter of prosecutorial discretion, and the prosecutors (either the Serious Fraud Office or the Director of Public Prosecutions) are required to consider whether prosecution is in the public interest before proceedings are brought. Factors against prosecution include the existence of an anti-bribery policy that is normally adhered to, proactive reporting of the payment and an element of duress; factors in favour include large or repeated payments, and evidence that facilitation payments are accepted as a normal feature of business, or that anti-corruption policies are flouted. Again this approach is clearly designed to incentivise businesses to introduce or upgrade anti-bribery procedures.

Adequate Procedures

So what will adequate procedures look like? As indicated, the Guidance leaves the onus on individual businesses to work out what is required in their particular circumstances. What the Guidance does (as in the previous draft) is to offer six Principles which a business can adopt to shape its procedures.

Interestingly (as compared with the draft guidance) Principle 1 is entirely new, namely that a commercial organisation's procedures will be "proportionate" to the risks it faces and the nature, scale and complexity of its activities. This appears to be a response to the complaints of compliance overload but of course it places a premium on implementing the third Principle, which is that businesses should carry out a risk assessment in drawing up anti-bribery procedures. Without such

an assessment, it will be difficult for a commercial organisation to show that its procedures are proportionate and therefore adequate.

Otherwise the Principles remain as already trailed:

- top level involvement: the board and senior management will embrace the philosophy and promote the procedures;
- due diligence on business partners, including investigation of their track record and their own anti corruption standards;
- effective communication of the procedures, including training of staff; and
- ongoing monitoring and improvement.

There will be no substitute for a careful review of the Guidance itself and its application to the business in question. Helpfully, the Principles are illustrated by Case Studies supplementing the pointers in the Principles themselves as to how the Principles might apply in practice.

As mentioned, the Guidance stresses that it is not determinative and in the event of a prosecution it will be for the defendant company to satisfy the court that, in the particular circumstances of the case, its procedures were adequate. Compliance (or non-compliance) with the Guidance will not necessarily be determinative either way. Nonetheless the Guidance is bound to function as the primary yardstick, not only at trial, but equally if not more importantly, at the investigation stage, when the prosecutors are considering whether it is in the public interest to proceed.

As the Guidance is at pains to point out, the intention of the Act is not to criminalise ethically run organisations which face isolated instances of bribery. But the flip side is that such organisations will need to have adequate anti-corruption procedures in place, and the countdown has begun. Failure to take these steps will place businesses at serious risk, as the penalty for a corporate offence is an unlimited fine, and the indications are that the courts will be prepared to consider fining a guilty company into extinction if it is perceived to represent an ongoing corruption risk.

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Don't forget the North Koreans

Ian Bremmer of Eurasia Group



With all the upheaval in the energy-rich Middle East, it's easy to forget that North Korea remains the world's single biggest security threat. And as he's proven many times over the years, Kim Jong-Il doesn't like to be ignored.

After a quiet couple of months, North Korea appears to be preparing for the next round of trouble. Recent talks with the South broke down almost immediately. A row over refugees has begun, with North Korea demanding the return of 31 people who crossed into South Korean waters in a fishing boat and South Korea insisting that four of them have asked for asylum.

In addition, published reports suggest North Korea could be preparing a third nuclear test. Pyongyang is threatening missile strikes against the South Korean mainland if balloons carrying propaganda leaflets continue to cross the border. There's nothing new about threats from the north, but the sinking of a South Korean naval corvette and the shelling of a South Korean island last year provide an unusually hostile backdrop.

North Korea has plenty to feel vulnerable about. The toughest winter in decades has damaged this year's rice crop, and North Korean officials are reportedly asking for food aid even as they threaten to drown South Korea in a lake of fire. And the hastily-coordinated transition to Kim Jong Il's all-but-unknown 27-year-old third son continues. Don't forget the North Koreans. They have a way of reminding us they're still there.

Ian Bremmer is president of Eurasia Group, the world's leading political risk consultancy, and author of *The End of the Free Market: Who Wins the War Between States and Corporations?*

“...organizations will need to have adequate anti-corruption procedures in place...as the penalty for a corporate offence is an unlimited fine.”

Emerging Market De(bt)velopments

VENEZUELA Chávez's credit crisis?

Despite a recovering global economy and sharply rising oil prices, Venezuela's economy remains mired in recession – leading to new warnings over the country's debts.

Financial markets now view Venezuela as the next country most likely to default. At a time of rising oil prices, this is a dubious honour for the fifth-largest oil exporter and for President Hugo Chávez, who has neither defaulted on any debt nor even threatened to do so.

Nevertheless, credit default swaps jumped to indicate a 57.7% probability of Venezuela defaulting on its obligations in 2012 – even overtaking prices on Ukrainian debt. The jump was due to deteriorating political and economic situations, which have jeopardised Venezuela's solvency. What are these developments, and what are the implications for investors and traders?

Government accounting is somewhat opaque, but official figures show that Venezuela's total debt rose by 20% during 2010 to the current level of \$71.7bn, of which \$37bn is external debt. Researchers at Econométrica predict that total debt could spike to \$146.5bn during 2011, or 58% of GDP. This figure combines Ministry of Finance debt, loans from China, \$21.8bn in arbitral awards that Venezuela has yet to pay, and the liabilities of PDVSA, the state oil company.

Oil has become Venezuela's economy: petroleum now accounts for 92% of its dollar earnings. This already precarious dependence has been exacerbated by Chávez's running of PDVSA. The company has been starved of investment, and management and employee ranks have been crammed with Chávez loyalists. The result has been a fall in output from 3.3 million barrels per day in 1998 to 2.25 million today. However, the key issue regarding Venezuela's solvency is that Chávez uses the output to provide subsidised oil to allies overseas, from Cuba to the Greater London Authority. Only 1.25 million barrels per day are thus sold for full-price export. Expropriations are also crippling Venezuela's economy. Chávez's hostility to business has seen the nationalisation of hundreds of companies on fabricated charges and with little compensation, if any. Regulatory expropriations have also occurred.



“CDSs jumped to indicate a 57.7% probability of Venezuela defaulting...in 2012. Beyond that, Chavez's recent...moves suggest he might...simply refuse to pay outstanding debts.”

Western companies that have been hit include Ternium, Cemex, Helmerich & Payne and Owens-Illinois. As a result, much of Venezuela's private sector has fled, including the oil supermajors Chevron, Shell and Total, causing huge capital flight. For example, Venezuela experienced a 28% drop in private investment in 2009. Expropriations from external – often Western – parties are now also complemented by

expropriations from internal funds. For example, recent figures reveal that PDVSA withdrew – for unclear reasons – \$829m of the \$832m in Venezuela's Macroeconomic Stabilisation Fund, leaving just \$3m to help even out the effect of oil price fluctuations on the economy.

Capital flight and increased imports have exacerbated Venezuela's currency woes. The 2005 pegging of the Venezuelan bolívar to the dollar alongside parallel markets and complex currency control mechanisms made foreign exchange scarce. Moreover, on 30 December 2010, the bolívar was devalued for the second time that year, abolishing the lowest exchange rate.

The economic aim is to attract foreign funds, improve Venezuela's balance sheet and boost the competitiveness of the local economy. The political aim is to make Venezuela suffer the pain from the devaluation sooner rather than later – certainly in advance of the 2012 presidential election. However, with PDVSA still booking revenue at the elevated 4.3 bolívares per dollar, the boost to the economy from devaluation will be limited.

Venezuela is an outlier in Latin America for two reasons: it is failing to benefit fully from either the global economic recovery or the sharp increase in oil prices; and it suffers from high inflation too. The economy shrank by 3.3% in 2009 and by 1.9% in 2010 and is entering its third year of recession. In a region with traditionally high inflation, all countries bar Venezuela and Argentina now have single digit inflation. In Venezuela, inflation stands at more than 30%, rising to 40% for food.

Politically, Venezuela has become much more volatile. It is a country with a reasonably strong representative democracy, with a 66% turnout in the September 2010 elections, few claims of irregularities, and neither side challenging the results. However, recent developments cast doubt on how long this tradition will be allowed to continue. The September elections sent a clear message to Chávez's United Socialist Party of Venezuela and its allies, which lost the popular vote. Only by



“Expropriations from external – often Western – parties are now also complemented by expropriations from internal funds.”

gerrymandering and the abolition of proportional representation did Chávez retain a majority, albeit one now below the two-thirds threshold required to effect major changes.

Undeterred, Chávez used the last few days of his existing super-majority in parliament to obtain sweeping powers, effectively neutering the incoming legislature. Key among these was an enabling act, which allows Chávez to rule by decree for the next 18 months. Other measures include limits on parliamentary sessions and debate times, controls on broadcasts of parliamentary debates and bans on foreign funding of NGOs.

More ominously, perhaps, Chávez and his most senior general recently stated that the armed forces would not tolerate an opposition victory in the 2012 election. Increased political oppression and violence against the opposition suggest not only Chávez's desperation to win in 2012, but that he might do anything to cling to power. His support for Colonel Gaddafi's attempts to stay in power in Libya may be a sign of things to come.

Overall, the risk of default in the short-term is probably overdone. Venezuela's export income should comfortably cover its foreign exchange needs: \$100bn of imports, \$28bn of capital flight and \$11bn of debt service – especially if oil prices remain above \$100 per barrel. Furthermore, the central bank has \$22.5bn in cash and gold, and \$7bn in unspecified liquid assets, while another \$39bn has been funneled into an unaudited government fund.

If the worst happens, Caracas may have to ask Beijing for another loan in return for further subsidised oil: China has lent Venezuela \$12bn in this manner since 2008. In the short-term, Venezuela's continued solvency appears feasible until 2012. Beyond that, even if Venezuela does have the ability to pay, Chávez's recent political moves suggest he might take a leaf out of his Ecuadorian neighbour's book and simply refuse to pay outstanding debts. Investors and traders are therefore right to be very wary of Venezuela's medium-term prospects.

EGYPT

Egyptian eruptions

Just as the dust had settled and the debris had been cleared from Tahrir Square, the media's spotlight switched from Egypt to Libya.

Despite ongoing protests in Libya, Yemen and elsewhere, there is a growing sense that the Arab world's spring of 2011 might turn out like the Prague Spring of 1968 – that this might not be the Arab world's 1989 but rather another 1848. Nevertheless, having sat atop North Africa's largest economy for 30 years, the toppling of President Hosni Mubarak on 11 February was a seismic event that continues to cause shockwaves. Existing investors will be well aware of them, but what factors should prospective investors in Egypt consider? Trade disruption and its impact on economic and debt fundamentals will be considered, before an examination of the short-, medium- and long-term challenges.

In the short-term, trade has been impacted significantly. One immediate consequence of the riots which started on 25 January was the exodus of tourists. Companies like Thomas Cook lost £15mn from cancelled holidays and £5mn from repatriation costs – for Egypt and Tunisia combined, whilst the Egyptian economy itself lost \$30-40mn in tourism revenues each day during the revolution. Western governments have lifted travel warnings but the slow return of tourists will depend largely on continued stability.

More significant than the dearth of tourists has been the general disruption to labour and trade infrastructure. With arson, curfews, demonstrations and looting, security concerns prompted many businesses to close including, for example, subsidiaries of Nestlé and Unilever and several Indian multinationals like Wipro and Ranbaxy. Some of these Indian-owned subsidiaries, for example Tata Motors and Essar Global, acted as regional offices, so the impact on their business will be magnified. Although fears of deepening descent into lawlessness are proving overblown, petty crime is on the rise, as is unemployment – as businesses cut payrolls in response to reduced demand.

Whilst traffic through the Suez Canal – one of Egypt's key earners – has not been affected, cargo operations at Egypt's Alexandria, Damietta, Ein Sokhna and Port Said container ports came to a standstill and are only now beginning to deal with the backlog. For example, shipping giants AP Møller-Maersk suspended some operations, whilst

CMA CGM and Hanjin Shipping re-routed vessels, with ports like Malta benefitting temporarily. Some traders took another approach – ordering vessels to circle close to port until the turmoil passed in order to avoid non-payment risks. However, back on dry land, bank closures and communications outages confounded both the aforementioned approach as well as most efforts to import or export. Egypt's woes have increased counterparty risk far and wide: Egypt, for example, is the world's biggest wheat importer, and imports 74% of Lebanon's apple crop; Turkey too stands to lose in the short-term, as the biggest regional exporter to Egypt.

Also, many of Egypt's listed companies, like Ezz Steel and Palm Hills Development, were not only affected economically but also politically: with close ties to Mubarak's regime, ongoing corruption investigations are partly to blame for the delay in re-opening the Egyptian Exchange – affecting capital market fund-raising and trading alike. Counterparties involved with the estimated \$40-70bn of assets embezzled by Mubarak will also be affected, and international efforts to identify and freeze Mubarak's properties and cash are afoot. These short-term trade disruptions will also impact Egypt's macroeconomic outlook. Delaying the re-opening of banks may have averted bank runs and various measures, like higher daily minimum cash withdrawal limits and longer clearance periods for bank transfers, may have ensured minimal capital flight. Nevertheless, currency, current account, fiscal, growth and inflationary concerns remain. Political turmoil has both weakened the Egyptian pound and stemmed capital inflows, the latter of which is reinforcing the former. The Central Bank of Egypt (CBE) may have to sell foreign reserves to support its currency, but its likely imposition of controls on access to foreign exchange may also resuscitate a forex black market.

With a depreciating currency and increasing commodity prices, inflation is expected to accelerate. The CBE faces a significant challenge in balancing its fight against inflation and the government's desire for growth to not be stifled by excessive interest rate rises.

Growth, between 2005 and 2008, was driven by strong, investor-focused reforms and economic

liberalisation – in spite of their unpopularity with the population at large. However, the ministers responsible for such reforms have now been tarred with the brush of the last regime. The current and any incoming government are likely to focus on stabilisation initially and only return to the liberalisation agenda gradually, from perhaps 2013 onwards. Even then, widespread non-patronage-based privatisation is likely to remain a distant prospect.

The Economist Intelligence Unit expects the current account to remain in deficit until 2014 and the government's fiscal deficit – averaging 8% of GDP over the last decade – to deepen to 12.1% of GDP over the current fiscal year. This fiscal deficit will be exacerbated by increased spending on government wages, subsidies and public works projects, which will also push up public debt. External debt is estimated to stand at \$30.8bn, or 14% of GDP. Yields have increased sharply: at a CBE auction of Treasury bills on 27 February, average yield increased to 11.097% and 12.162% for three- and nine-month bills respectively. Recent studies suggest that the greater a sovereign's democratic credentials, the lower

its yield. Egypt's debt sustainability could thus depend in part upon how successfully the military administers the parliamentary and presidential elections. If the elections are held too early for opposition groups to mobilise, the existing, ancient regime-linked parties will benefit and voters will become dissatisfied. In light of this, Moody's cut Egypt's rating from Ba2 to Ba3, citing that continuing anxiety about the transition was having an adverse impact on Egypt's fiscal position and general economic performance.

Egypt's debt situation also in part depends on the charm of Samir Radwan. As the new finance minister, Radwan has asked the EU to write-off its loans and provide unconditional grants, and has asked others, such as Switzerland, to increase FDI in Egypt. The African Development Bank, the EBRD, the IMF and the US have all offered aid of varying levels of assistance and conditionality. Again, how strongly the military and incoming government affirm their democratic credentials will affect how much debt relief and aid are provided. For example, if the army failed to deliver on its promises, the US might consider suspending its annual \$1.3bn grant to Egypt for military sales, and

might even consider imposing an arms embargo. Such arms might actually be needed. Although future conflict with Israel remains unlikely, potential geopolitical tensions could arise in the short-term from the growing humanitarian crisis on Egyptian's border with Libya, and in the long-run from the incoming regional regime controlling use of the vital Nile.

After the uncertainty and history-making of the last two months, one would hope systems would get back online, backlogs would clear and Egypt would return to business as usual. Irrespective of whether the forthcoming elections pass smoothly, an Egyptian sovereign default is highly unlikely, as is a recurrence of the trade disruptions of the type just experienced. However, if the incoming government does not stabilise the economy swiftly and does not return – despite the population's wariness of economic pain – to a reform agenda, of improving labour market participation and removing rigid economic structures, that actually yields results – then the same social and economic demands that underscored the Tahrir Square protests may well be heard again.

DEBT PRICES: June 2011

COUNTRY / ISSUE	Low Price	High Price
Africa Hyper-Exotics		
Angola / Trade	50.000%	55.000%
Angola / Loans	55.000%	59.000%
Cameroon / Trade (non-HIPC)	14.000%	20.000%
Congo / Trade (non-HIPC)	22.000%	26.000%
DR Congo / Loans, Trade (non-HIPC)	16.000%	20.000%
Ghana / Trade (non-HIPC)	78.000%	82.000%
Kenya / Trade	39.000%	49.000%
Mozambique / Trade (non-HIPC)	20.000%	26.000%
Senegal / Loans, Trade (non-HIPC)	12.000%	16.000%
Sudan / Loans (non-HIPC)	11.000%	14.000%
Tanzania / Loans, Trade (non-HIPC)	10.000%	13.000%
Uganda / Trade (non-HIPC)	14.000%	16.000%
Zambia / Loans, Trade (non-HIPC)	13.000%	20.000%
Zimbabwe / Trade	1.000%	4.000%

COUNTRY / ISSUE	Low Price	High Price
Latin America & Caribbean Hyper-Exotics		
Cuba / Trade	2.000%	4.000%
Cuba / Loans	5.000%	10.000%
Suriname / Loans, Trade	14.000%	18.000%

COUNTRY / ISSUE	Low Price	High Price
Eastern Europe Hyper-Exotics		
Azerbaijan / Trade	18.000%	23.000%
Bosnia / Trade	36.000%	41.000%
Georgia / Trade	11.000%	15.000%
Serbia / Trade	44.000%	54.000%
Turkmenistan / Trade	23.000%	33.000%
Ukraine / Trade	18.000%	25.000%
Uzbekistan / Trade	20.000%	24.000%

COUNTRY / ISSUE	Low Price	High Price
Middle East Hyper-Exotics		
Egypt Trade	65.000%	75.000%
Iraq / Paris Club	84.000%	89.000%
Iraq / Bonds	91.000%	92.000%
Libya / Trade	25.000%	35.000%
Syria / Trade	6.000%	11.000%

COUNTRY / ISSUE	Low Price	High Price
Asia Hyper-Exotics		
Mongolia / Trade	22.000%	30.000%
North Korea / Loans, Certificates	9.000%	12.000%

Trade: Trade Debt Instruments
Loans: Loan Agreements
PDI: Past Due Interest

Prices are a percentage of principal only, however assuming inclusion of an average amount of PDI for the specific debt instrument and the specific debtor. Trade debts and their documentation differ from case to case and price ranges should therefore be considered as a benchmark only. Price ranges are based on a compilation of sources and analytics. Liquidity on most instruments is very limited and trading may not have taken place for some time. Omni Bridgeway is regularly requested to value distressed debt of countries not listed above, including distressed debt eligible under HIPC (Heavily Indebted Poor Countries) and/or Paris Club agreements. Such valuations are available on request. Omni Bridgeway does not provide its legal services for debt that qualifies for treatment under the HIPC Initiative. For such debt, Omni Bridgeway offers its clients the management and guidance through the HIPC reconciliation and restructuring process and related services.



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