

- (ii) The expected loss must be definite, known in time, place and cause. Specific PR events can be the result of long disputes (creeping expropriation), often needing arbitration (breach of contract), resulting in hard to estimate losses (what's the value of the expropriated asset?), or a consequence of unpredictable events (civil unrest);
- (iii) The loss must be accidental. In a PR the insured interacts with the source of the risk-generating event (often a foreign government/buyer) and can influence the final outcome¹³;
- (iv) The loss must be calculable. PRI events cannot be expressed in terms of probability of loss or by applying actuarial methods.

For any investor, estimating the risk of a single long-term project is impossible.

Quoting from J. M. Keynes: “*Our basis for knowledge for estimating the yield 10 years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the city of London amounts to little and sometimes nothing*”. Investors (and their insurers) are facing major uncertainties, and political risk is one of them. Many laymen will use risk and uncertainty interchangeably and even professionals might disagree on the differences¹⁴.

Uncertainty cannot be gauged by past occurrences, it is not statistically measurable by a normal distribution, and it reflects a number (often very large or even infinite) of possible different states of the world, of alternative scenarios.

If a probability is assigned to those scenarios, it is the result of a subjective view rather than being based on statistical evidence. “*Although both actuarial and micro-*

¹³ In their article “The Hidden Risks in Emerging Markets”, W. Henisz and B. Zellner quote an insurer as saying: “...if you back the right assured, you can usually keep problems from occurring in the first place – and if they happen, you have an excellent chance of mitigating your loss”.

¹⁴ Frank Knight (1921) made an important distinction between risk and uncertainty, where situations with risk are those when outcomes are unknown but the ex-ante probability distribution is known; when that distribution is unknown – when there is uncertainty – the situation may be very different.

forecasting models rely on historical data, the analogy between actuarial models of life, property and casualty insurance and insurance of complex derivatives (credit risk, liquidity risk, market risk, legal risk, catastrophic risk, regulatory risk, compliance risk, reputational risk) is false. Insurers relying on a false analogy are spreading into a world beyond actuarial risk”¹⁵.

In uncertainty, social behaviour is part of the deliberation; interdependence of humanity is a major factor. This reality cannot be entirely accounted for by simply assuming that events are “non-linear”, such as for the Chaos Theory, an approach that rejects the symmetry of the “Bell Curve” as a description of reality, and assumes that results are not proportional to such a curve. Forecasting based on non-linear models is subject to the same hurdles that stand in the way of conventional probability theory: the raw material of the model is the data of the past.

Past data from real life constitute a series of events rather than a set of interdependent observations, which is what the laws of probability requires. What history provides is only one sample of the economy and the capital markets, not thousands of separate and randomly distributed events. Even though many economic and financial variables fall into a distribution that resembles a “Bell Curve”, the picture is never perfect. Once again resemblance to truth is not the same as truth.

Why do entrepreneurs undertake new investments if they have no clue on the likely return from them? Keynes provides the answer by calling upon the “animal spirits”. Animal spirits do not imply irrational behaviour, they rather reflect the fact that entrepreneurs have the ideas that spur the investment, the drive to realize it and the ability to take advantage of upside risk and mitigating downside risk as events may require. In other words, entrepreneurs have creativity. According to Albert Hirschman: *“Each project comes into the world accompanied by two sets of*

¹⁵ Skidelsky (2009).

partially or wholly offsetting potential developments: i) a set of possible and unsuspected threats to its profitability and existence; and ii) a set of remedial actions that can be taken should a threat become real. (...) Creativity always comes as surprise to us; therefore we can never count on it and dare not believe in it until it has happened. In other words, we would not consciously engage upon tasks whose success clearly requires that creativity be forthcoming”¹⁶.

¹⁶ Hirschman (1967).

5. Pricing political risk: a statistical approach or “an art”?

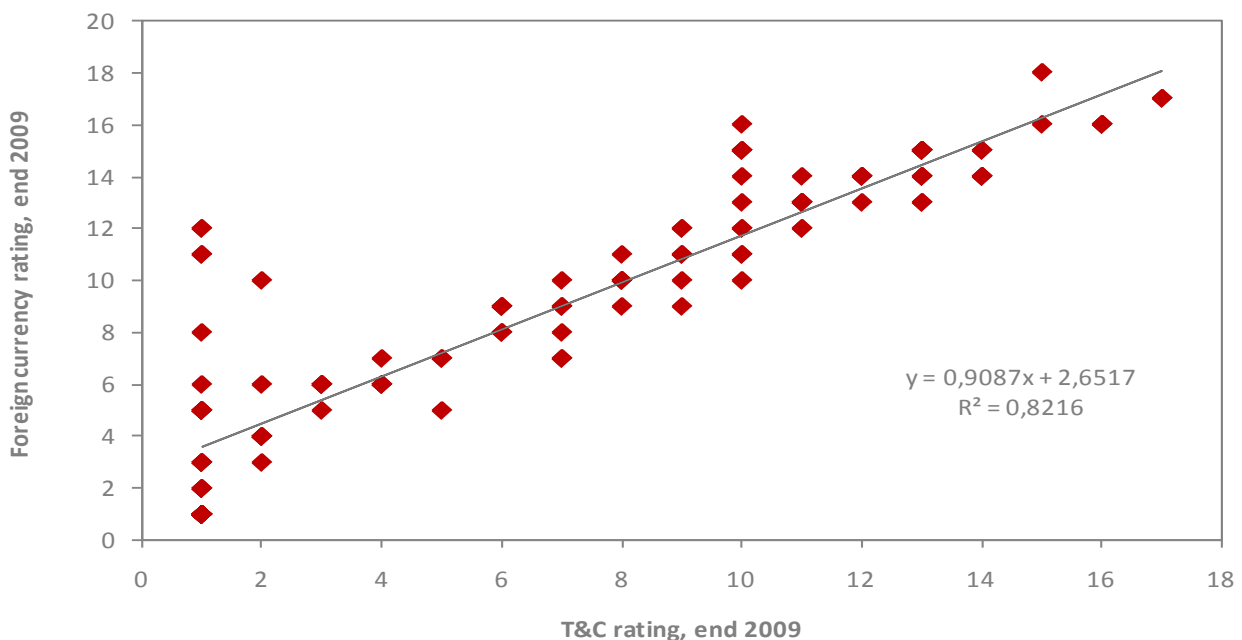
Despite all the above, PRI is available on the market even if its economics and pricing remain arcane. At least, two pricing approaches can be identified on the market:

- (i) **One method uses market available indicators and adjusts them to reflect “basis” differences on risks.** Available indicators are CDS, yields and spreads for sovereign risk, ratings. As they reflect credit risk more than political risk, their correlation can be rather limited. It is stronger for PR events of economic nature; it might be negligible for others. The risk of convertibility and transferability of foreign exchange risk can have the highest correlation as it depends on a country’s macroeconomic and financial situation (above all, its balance of payments situation; Fig. 4). However, if and when a crisis erupts, it can evolve along different trajectories: a banking crisis, a sovereign default, a large devaluation or the introduction of forex restrictions. If the balance of payments is untenable, the situation might play out differently depending on the foreign exchange rate system in place: a country with a flexible foreign exchange rate would be less likely to introduce controls compared with a country with a hard peg. Other PR events (expropriation, nationalization, civil unrest, etc.) are little linked to the credit risk available indicators. Measuring PR using credit risk information is like trying to answer the question whether a train is faster or a chocolate sweeter. Even if you adjust for basis difference (is it coal-fired train or milk chocolate), you still end up with implausible outcomes.

- (ii) **The second method is by trial and error.** Starting from the recognition that pricing PR is almost impossible, the chosen approach would be more of “an art”. Of course, there are sound and hard analyses behind the assessment of a

risk: PR insurers do not go blindly into selling policies, they do analyze all pertinent matters (economic, social, political; historical, perspective; macro policies and micro behaviour) and come up with reasonable scoring systems (Fig. 5, 6 and 7). These findings can help compare different countries and events by allowing them to be ranked (there can be at least an “ordinal” measure, but not a “cardinal” one); checklists make sure all variables are taken into account; tree-decision making helps work out plausible relations. Yet, there is no actuarial number that can be used to quantify the final risk; there is not a probability distribution. The price thus arrived at has to be often checked with other market players, by seeking their participation in a reinsurance program.

Fig. 4 Transfer and convertibility risk ratings: high correlation to foreign currency ratings*

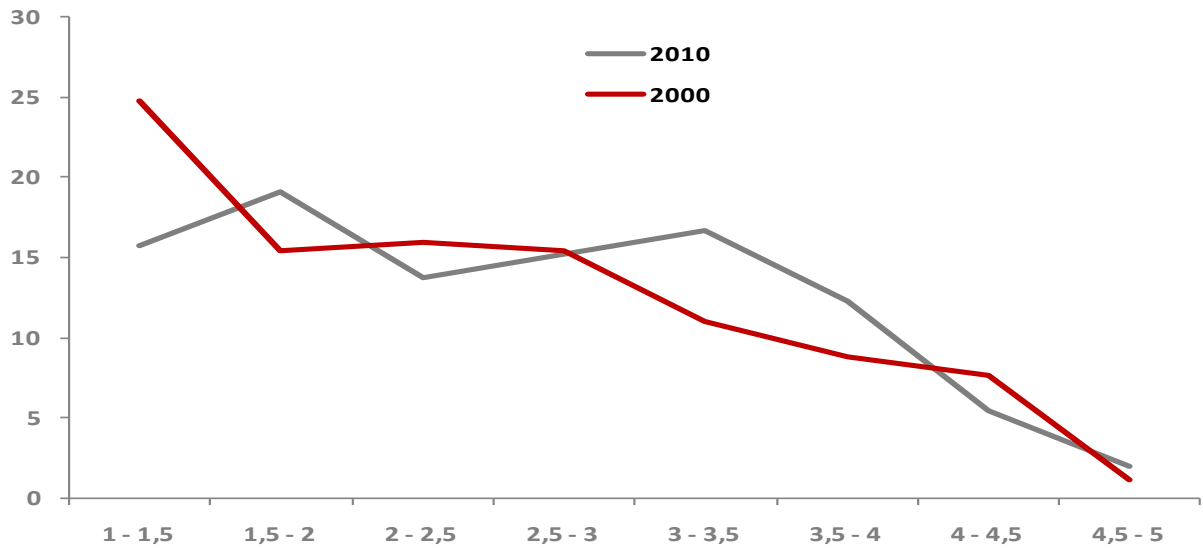


*1= AAA; 2=AA+;.....18=CCC.
Source: SACE calculations on S&P’s data.

The world is still a risky place. Figure 5 shows that over the last decade the distribution of countries by level of security risk has not changed much, with a further deterioration in the group of countries which were considered as “medium risk”.

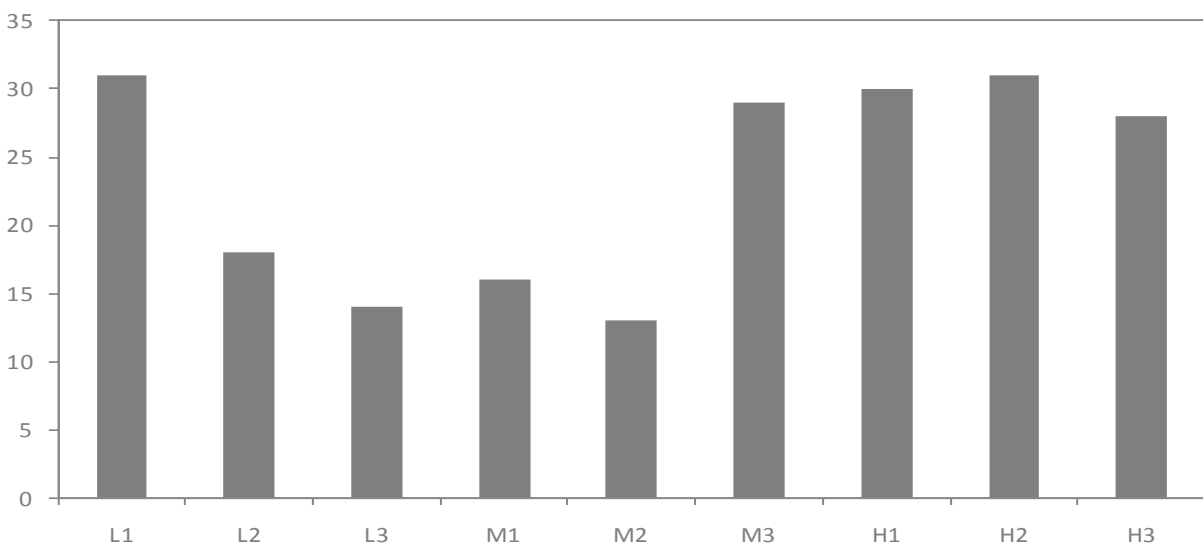
Figure 6 shows that out of a group of over 180 countries, risk of expropriation is medium-high in more than half the countries. The assessment is different for political violence risk where there is a higher number of countries with low scores and quite a relevant number in the medium-high range (Fig. 7).

Fig. 5 Security risk scores*: country distribution by score classes (in % of total number of countries)



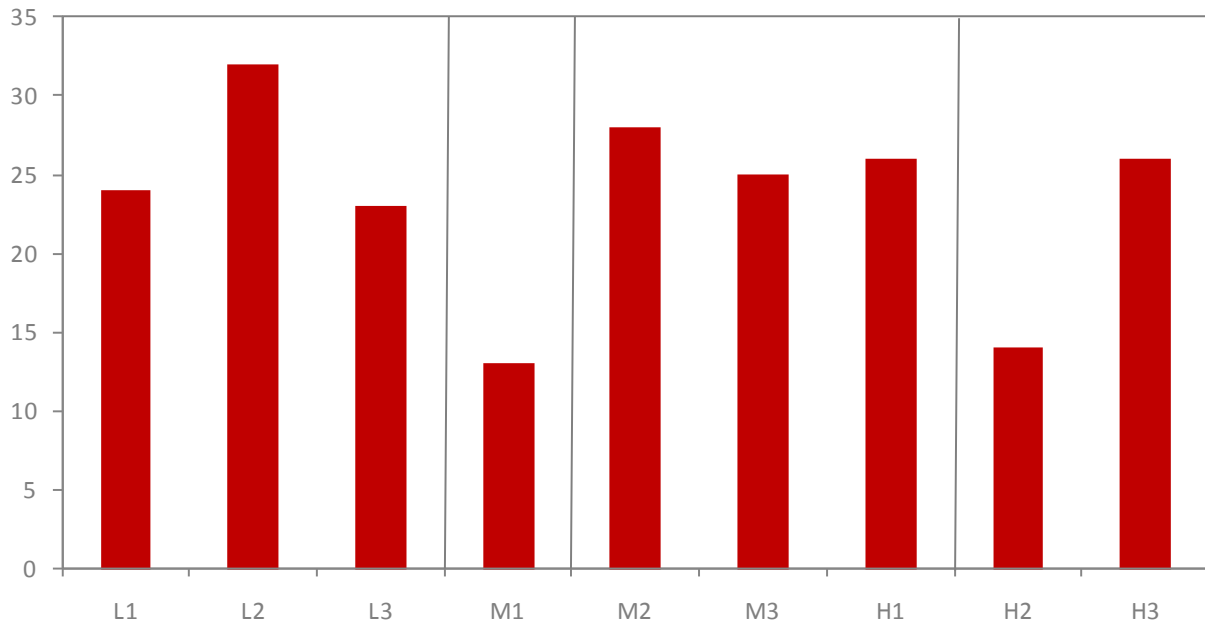
*1 minimum risk, 5 maximum risk. Security risks include: civil unrest; crime; terrorism; external security threats. Source: SACE calculations on Global Insight data.

Fig. 6 Expropriation risk score* (an ECA's view): country distribution by score (number of countries, 2009)



*L1 minimum risk, H3 maximum risk. Expropriation risk includes: rule of law; property rights; government intervention; control of corruption. Source: SACE.

Fig. 7 Political violence risk score* (an ECA's view): country distribution by score (number of countries, 2009)



*L1 minimum risk, H3 maximum risk. Political violence risk includes: rule of law; voice and accountability; political stability and lack of violence, crime and terrorism.
Source: SACE.

A risk matrix for pricing should estimate the impact of several factors. The probability of default would depend upon the country's situation, for the various risk events, global and location-specific; its track record and likely evolution; the nature of the sector; the size, visibility and strategic importance of the investment; the experience of the investors in managing conflicts, amongst others. The recovery rate would be a function of the wording of the policy (often insurers use "positive" and "negative list" to define insured events); legal recourse or arbitration for a default event; risk mitigants; collaterals; risk-sharing; formulas. This entails more a checklist than a precise statistical approach.

6. Why buy political risk cover?

The second question is what's the motivation to buy PRI? The golden rule of risk management is that each risk should be managed by the party most effective at doing so. In principle, manufacturing firms should focus on producing and marketing, leaving the management of other risks to specialized insurers. Banks, as intermediaries that can match different sides on a transaction, should offer market risk (currency and interest rates) protection. Insurance companies should focus on other sources of risks, such as credit risk. As we shall see shortly, political risk, besides private insurers, seems to be better managed by government-linked entities or multilaterals.

Agents tend to associate PR with the risk of conducting cross-border business (i.e. transactions that take place in a different political and economic environment) without a clear differentiation across risk events. The perception and sensitivity to PR is obviously extreme in countries with weakest economic fundamentals, fragile institutional structures and unstable governments. The preoccupations of conducting cross-border risk include:

- i) counterparty risk (sovereign, sub-sovereign, banks, corporate);
- ii) foreign exchange risk (devaluation);
- iii) foreign exchange controls (convertibility and transferability of currency);
- iv) government interference in the business conduct (various forms of expropriation);
- v) breach of contract or wrongful acts on specific transactions;
- vi) other changes in policies (be they discriminatory or non-discriminatory);
- vii) instability (terrorism, acts of war); etc.

PR is present in both emerging and industrialized countries. Covering counterparty risk in industrialized countries, for example, is done through credit insurance. Foreign exchange risk protection can be cheaper for most traded currencies of major economies. But it would be rather unusual to seek protection for government interference in advanced countries, even if this can not be ruled out.

In the past decades markets have developed many new risk products; much of the innovation has come from the banking industry or insurers that have promoted financial guarantee products. Among the new product lines, CDS have shown the most rapid increase becoming a key credit risk management tool. They have been offered not only by banks but also insurers such as AIG. CDS has been used to cover some dimensions of political risk (credit risk related to the issuance of bonds by sovereign and sub-sovereign borrowers as well as by major banks and corporates in emerging markets). Another rapidly growing line of business has been the protection offered by mono-liner insurers, offering credit enhancement on certain securities (municipal bonds) or portfolios of securities. The offer of more traditional PRI has also increased but never experienced the growth of other credit tools.

The offer of new products has grown increasingly detached from underlying asset, because of the pooling and re-pooling of the asset and the speculative/arbitraging use of the protection. The recourse to risk management tools to protect and manage the underlying transaction has become a minority component in the overall market as other uses have become paramount. The volume of derivatives has become much larger than the underlying asset; the volatility of the protection has enormously increased; the counterparty risk of the insurers has been put to serious stress, as in the case of AIG. The crisis of 2008 and 2009 has caused the collapse of this house of cards and raised serious doubts on past risk strategies and above all the ability of risk protection to cover their positions.

Who is buying PR protection? A foreign direct investor, especially if involved in capital intensive ventures, with large initial sunk costs, is one of the most likely buyers of PRI in its stricter definition (CEN). Foreign investors are likely to cover their positions in a selective way, to limit peak exposure or to mitigate frequency losses. The largest multinationals, as in the case of the Oil Majors, tend to manage political risk internally, able as they are to raise the stakes at the highest levels with government counterparts, often with the explicit support of their own governments. Occasionally they might seek PRI to cover certain risk: peak ones or in especially intractable countries. Manufacturers tend to see PR as an operational risk for which they rarely seek cover, unless the operation is a very difficult country environment or on a project whose size might put at risk their own survival. However, it is generally recognized trend that PRI for corporations (mostly in the form of CEN) is not a growing business.

When corporations seek protection, they have two major goals: financial indemnification in case of an adverse event and “enhanced bargaining power”. PRI protects the economic interests of a corporation in case of losses but the presence of the insurer is often seen as a deterrent to certain acts by the State in a third country. Avoiding disputes, litigations, or outright expropriation ex-ante is far more valuable than having an indemnification ex-post. This is achieved when the insurer is a strong player with political clout as in the case of ECAs and IFIs: being the instruments of government, they can raise the dispute to a level of equals. Quoting from a former MIGA Executive VP: *Historically, MIGA’s leverage on the ground has enabled it to resolve a number of disputes between host governments and investors. Helping clients and hosts to solve problems encountered in Venezuela, Russia, Argentina, Nicaragua, Bolivia, Kyrgyzstan, and Nigeria, among others, has allowed, worldwide, productive projects to continue*¹⁷.

¹⁷ Yukiko Omura quoted in Foreign Direct Investment Magazine: “Take cover to reduce risk”, January 5 2005.

It follows from this that the key providers of PRI must be insurers that have the backing of the State or owned by States such as ECAs and IFIs. A company, especially if small, can hardly take up a government committing a violation. ECAs and IFIs can exercise moral suasion on the host-government to prevent it from taking arbitrary actions. States are the signatories of Foreign Direct Investment Protection and other Treaties, and are best suited to solve cross-boarder disputes. Some ECAs, for example, price their cover only on the basis of an existing bilateral Treaty with the country receiving the investment.

Obviously enhanced bargain can be achieved also through other means, for example by joining a local partner with a better understanding of the local environment or simply better connections and lobbying capacity. **However, if the “enhanced bargaining power” is a motivation for buying PRI, how should this reflect in the price for available cover?**

Banks that finance FDI or other cross-border transactions are also a likely buyer of PRI: in the current market, they have represented the major source of demand for PRI to cover their own loans (short term trade-related or more long term investment-related) or as a protection for their collateral (often a lending requirement). This demand for cover would mirror the motivations seen for the corporate.

When the cover is broader than a single transaction, it may respond to a “portfolio management” motivation: the reduced risk in the portfolio creates headroom for new commitments or for taking-up new exposure without necessarily keeping it on the books, thus satisfying the clients and making an intermediation margin without breaching country limits. Portfolio investors are less interested in some forms of PRI, as they keep their position extremely liquid (hot money). They usually hedge credit or market risks but not political events.

As banks have the largest and most sophisticated risk management structures, they use available cover to optimize capital allocation. Within their strategy, cross-border risk management is an important component. Banks have often a choice between allocating marginal capital to a new transaction and buying an insurance policy: this creates the “arbitrage” opportunity. If the cost of the policy is more than compensated by the return on the freed capital, banks will have an incentive to do so. Of course, in a perfect market such an arbitrage would not be possible, but we live in markets that are very far from being perfect. And the arbitrage could be even larger if the definition of mitigant is not clear: Central monetary authorities require certain capital allocation against country risks. This requirement can be waived buying some cover. But what cover? Core political risk insurance (CEN) and comprehensive cover are not the same thing; CEN offers no protection vis-à-vis the credit risk of the counterpart, be it private or sovereign. Yet it seems to allow banks to eliminate their country risk capital coefficient, while remaining exposed to a non payment due to the counterparty default. This is the “arbitrage” motivation behind the purchase of PRI.

Exporters are preoccupied with events causing a default on the payment due. The causes could be a credit or a political event. Dealing with unknown counterparts in an unknown environment raises both the counterparty and country risks. Without a proper track record new counterparts are difficult to assess, especially if they are non-sovereign; furthermore, risk events can be independent from the quality of the counterpart, stemming from uncertainties in the rules of the game, and particularly ownership and exchange rights, the enforceability of contracts or licenses, the wrongful calling of bonds, etc. Finally, the least developed the country, the more likely that other forms of risk will be higher including civil unrest, civil war, terrorism, etc.

In assessing and taking decisions about managing risks, companies should follow a logical set of questions along the lines of this checklist:

- i) What risks are better managed internally and what risk can be better covered through market instruments? As we have discussed, some risks (market risk, political risk, credit risk, etc) find adequate offer on the market. By covering them, companies can focus on their strategic tasks (i.e. production and marketing);
- ii) What size of the risks is proportionate to the balance sheet? The protection might not need to be complete, and the company might want to retain some risks on its balance sheet, to benefit from a potential upside or to optimize the cost of cover.
- iii) What is the nature of the risk (peak, frequency) and how does it play on the company liquidity and solvency? As a corollary to the point above, a company might wish to protect itself from peak, excess of loss and other forms of extreme risks. To reduce the cost of protection, it might be willing to take a first loss or by protection on a portfolio of positions rather than single ones;
- iv) What is the exact nature of the risks? Are they commercial/credit risks or are they political? Companies have to understand better the nature of the risk events in order to buy a protection that is effective and leaves little “basis risk”. Unfortunately, many agents are still confused about the nature of credit events and the appropriate cover required to provide protection from them;
- v) How will events play out to generate the risk? This is especially important for PRI cover as the events often must be defined ex-ante: terrorist vs. war cover; legitimate policies vs. discriminatory government measures; multiple events such as devaluation and breach of contract on tariff adjustment.

7.The outlook for Political Risk Insurance

Understanding the outlook for PRI entails agreeing on what the political risk is. Political risk, in reality is different things to different people. Let us start with sovereign credit risk. The nineties saw a major reduction of sovereign risk in emerging markets, with a tightening of spreads and early repayment of outstanding debt. The current crisis is affecting some groups of leveraged emerging markets (e.g. CIS and Eastern Europe), some specific debtors in Middle East (Dubai), and is making the situation in many other developing and emerging markets harder. The major effect though however is being experienced in industrialized countries: for some the risk of insolvency has become tangible, Ireland and Greece; for others, the risk of a downgrade is a distinct possibility (USA; UK). In general, in the coming months many industrialized countries will have to place on the markets an increasing amount of public debt, and are likely to pay higher spreads. The sovereign risk has increased mostly in industrialized countries, even if this will not mean for them necessarily a default risk.

Among emerging markets, particularly telling is the case of Dubai which highlights several issues that have so far remained behind the scene: the difference between an explicit sovereign guarantee and the implicit support of the State; the value of the guarantee or support if the debtor represent much of the Sovereign debt (i.e. the default of one part triggers the default of the whole); the exposure with other counterparties in the same country in presence of cross-default and cross-acceleration clauses. It will be much clearer in the future that “implicit support” may not be quite a proxy for Sovereign risks; what will define specific case will be the precedent not so much the rule.

The events of September and October 2008 have led the business community into a more realistic assessment of narrower political risk. In the 1990s businesses

adopted a benign view of the world. The collapse of the Berlin Wall seemed to promise a new era of peace and stability and a new world order based on the rule of law (the “End of History”). It has been abundantly clear for some time to PRI market professionals that this vision of the 1990s was not being realised. Global terrorism; resource nationalism; global warming; and now the economic crisis: all point to a new era of instability and disorder. Indeed we may well now have “more history” in front of us than behind us. However, insuring those risks will not be easy. As they often have a catastrophic nature, much will depend on how financial markets will recover and whether “good” financial innovation will not be chased out by “bad” financial innovation.

Despite progress in several emerging countries, many of the least developed countries remain highly risky. If the situation in Iraq has somewhat improved, Afghanistan and North Korea have probably worsened; so has the situation in Pakistan and Iran. Failed States are still in large numbers; many countries in the African continent continue in their trajectory of short successful periods followed by a reverse to instability and chaos. In Latin America populism is still deeply rooted in several countries. National policies vis-à-vis natural resources remain highly volatile in many countries, with periods of open foreign investment policies followed by periods of resource nationalization, breach of signed agreements and contracts.

Many emerging markets have now introduced open foreign exchange systems, with floating rates reducing the need to introduce controls. However the risk has not completely disappeared, as witnessed by number of instances in eastern Europe, the CIS and elsewhere.

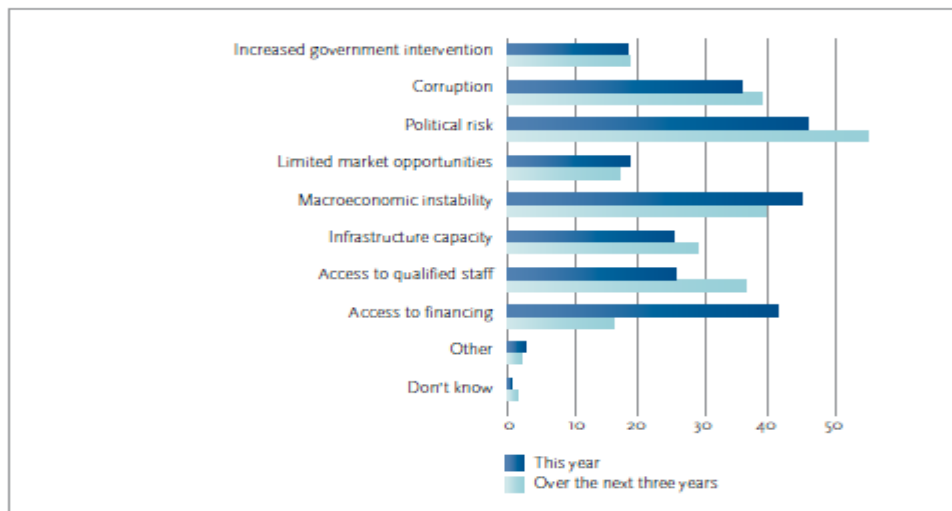
The new realism towards globalization is causing many companies to look again at what the PRI market has to offer. The PRI market has been through a significant phase of product development in the last few years, broadening the offer of risk

mitigants of sort, on top of the bubble in the CDS offer. War risk policies are now available for loss or damage due to a wider spectrum of events. Cover for expropriation goes well beyond the standard concept of direct expropriation of assets and it is mainly related to the creeping expropriation (i.e. Kashagan and Sakhalin projects). Transfer risk remains very tangible as a consequence of the deterioration of economic conditions even in countries such as Latvia and other CIS countries.

PR is not subsiding for the simple reason that in a global world the sources of instability are increasing and so is the number of players that can be affected by them. Political risks are being perceived as one of the greatest constraint on investment (Fig. 8), although survey results do not converge on this (Fig. 9); within them breach of contract and currency restriction are perceived as of most concern (Fig. 10). Those risks are hard if not impossible to predict; certainly we have no statistical instrument to foresee them. The tools to protect from the risks are increasingly sophisticated and this is positive. At the same time, their complexity creates uncertainty on the effectiveness of the cover: was the event a flood or a hurricane? Was it an act of terrorism or a war? Was the discriminatory act of a Sovereign or was it non-discriminatory? Is there a basis risk in the cover? Was it included in the policy wording? The presence of a multitude of providers of risk mitigants also raises the issue of the counterparty risk: will they be creditworthy when called upon?

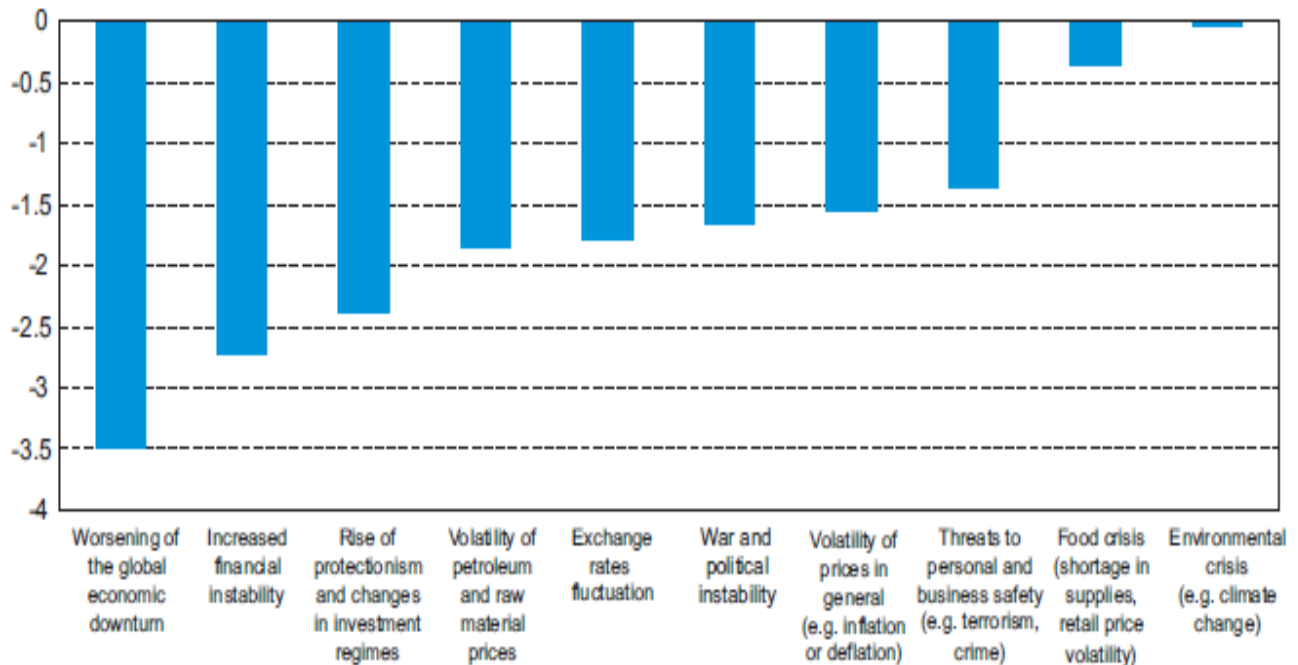
Fig. 8 Political risks as major constraints to FDI*: results from a survey

5. IN YOUR OPINION, WHICH OF THE FOLLOWING FACTORS WILL POSE THE GREATEST CONSTRAINT ON INVESTMENTS BY YOUR COMPANY IN EMERGING MARKETS THIS YEAR AND OVER THE NEXT THREE YEARS? (SELECT UP TO THREE)
Percent of respondents



*Survey on 351 executives of Multinational companies around the world in June 2009.
Source: MIGA-EIU.

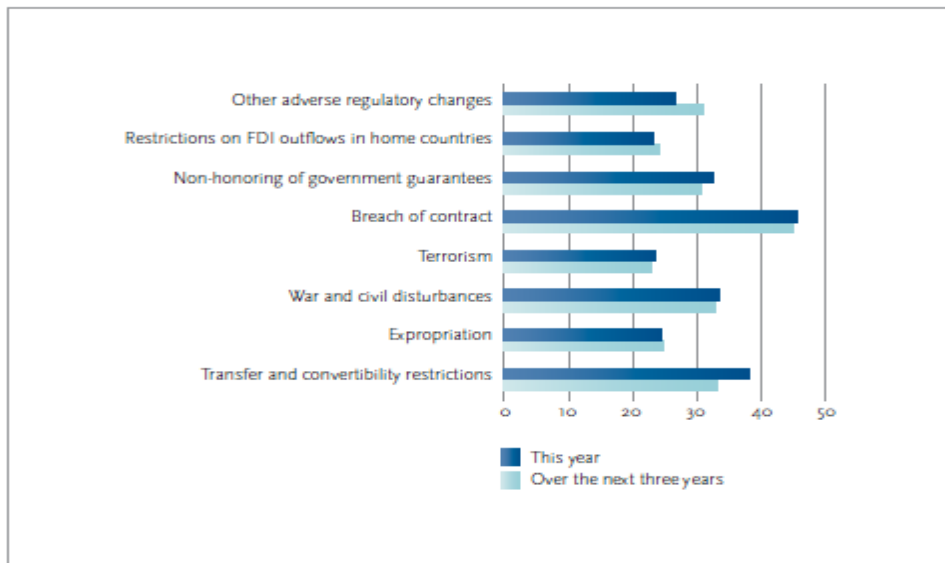
Fig. 9 Risk factors for FDI in 2009-2011*: results from another survey



*Survey on 241 company executives selected among the largest non-financial transnational corporations. Average values of responses: -4 large negative impact very probable; 0 negligible impact very probable.
Source: Unctad.

Fig. 10 Political Risks of most concern

8. IN YOUR OPINION, WHICH TYPES OF POLITICAL RISK ARE OF MOST CONCERN TO YOUR COMPANY WHEN INVESTING IN EMERGING MARKETS AT PRESENT AND IN THREE YEARS?
Percent of respondents



*Survey on 351 executives of Multinational companies around the world in June 2009.
Source: MIGA-EIU.

As the risks are increasing, investors do not try to cover all of them nor do they find on the market all the cover they need. The demand for core PRI, which can be identified with CEN events, is not increasing and the offer still rest mostly with public ECAs. Private insurers that are active in the PRI market mostly cover events that are not strictly PR, ranging from credit risk (non-honouring by the Sovereign and trade-related) to breach of contract and bonding. The PR is high in industrialized markets, although it is not perceived as such and it is not covered by neither private or public insurers.

A great confusion still reigns in the field of PR: it is a small market, with many small product lines; without a consistent methodological apparatus. We talk a lot about it, but we seem to have very little understanding of it. **The only conclusion, at this point, is that the Political Risk Insurance is not an industry.** It is a set of products that cuts across many possible events, mostly cross-border and with a strong focus on emerging markets. As industrialised countries get riskier and many emerging markets get stronger; how will this “non-industry” develop?

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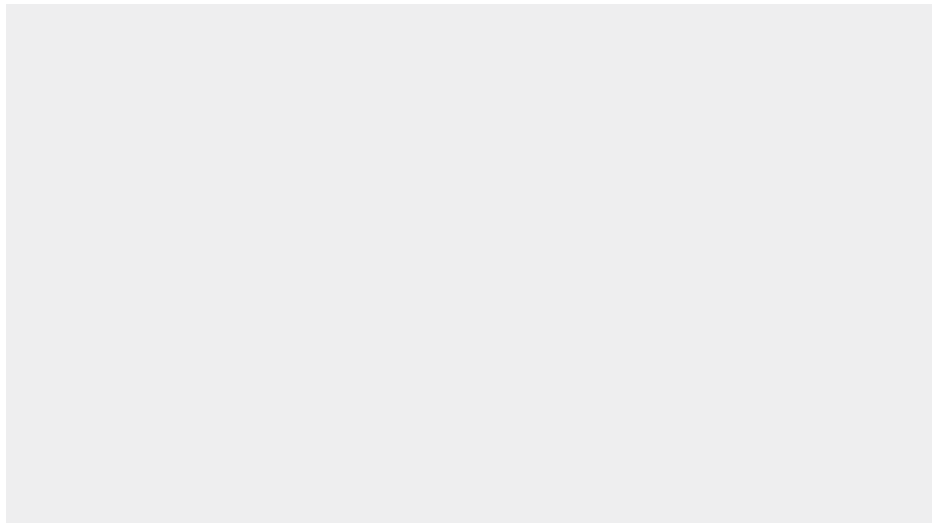
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