FOCUS ON
Political Violence and Terrorism: Spring Showers or Imminent Storm?

Produced by the Economic Analysis and Research

EXECUTIVE SUMMARY

- *The recent events have drawn our attention back to the effects of violence and terrorism on the financial markets and the real economy. We have examined two scenarios: the first with a short-term deterioration and increased uncertainty affecting companies' strategies, the second with an escalation of the violence extended to potential areas of interest for exports and investments.*
- *Terrorism and political violence have an estimated global cost of USD 64 billion, equal to the GDP of Kenya. Nonetheless, their impact in financial terms is not significant: comparing the indices of the European and American stock exchanges after the main terrorist attacks from 11 September onward, the effect on the financial markets has been diminishing. In a scenario of non-escalation, the effects on the real economy would be relatively limited, but they might undermine public confidence and, with it, the ability to seize important business opportunities.*
- *In case of escalation, on the other hand, the picture might produce a "flash flood". The shortage of international reserves in some countries, the declining standard of personal safety, and the raising operational costs might significantly affect several traditional markets for Italian exports. A reduced flow of strong currency from tourism, for example, might create additional difficulties for Egypt, weakening its credit rating and making it difficult for local companies to secure loans.*
- *The Mediterranean rim is the area most exposed to events of political violence, starting with North Africa and the Middle East (with risk ratings of 71/100 and 54/100 respectively), followed by Sub-Saharan Africa (57/100). It will be even more important to have adequate coverage in these markets, from individual transactions to long-term investments.*

BASE SCENARIO: LIMITED FINANCIAL IMPACT BUT INCREASED UNCERTAINTY IN COMPANIES' STRATEGIES

Russia, Ukraine, Syria, Libya, and Iraq, without forgetting the lingering instability in Egypt and Tunisia and the evolution of sanctions against Iran: these are questions that drove analysts to speak of a return of political risk in 2015.

Is it truly a relapse or just another round in the long series that began in 2010 with the Arab Spring? We continue to lean toward this latter hypothesis, due in part to the attacks in Paris and the terrorism emergency they generated in Europe and beyond.

First of all, it is interesting to understand how these latest events differ from similar ones like the September 11 attacks, Madrid and London and the bomb at the Boston Marathon in 2013. Political violence is certainly closer, not so much in geographical terms as in cultural ones (for example, the terrorists and victims belong to the Mediterranean area and in some cases reside permanently in Europe).

Nevertheless, the financial markets seem to increasingly "ignore" these political shocks, even after Paris. The attacks may have an impact on stock prices, but this effect tends to be short-lived, as demonstrated by the pattern of the major market indices in the months following terrorist events (Chart 1). In just one month the New York Stock Exchange recovered all it had lost after 9/11. Likewise, the European stock indices, including France's, seem to assign less importance to this type of event (a week later, the Euronext index of Paris was holding at 8% above the levels of 13 November).

CHART 1. *Terrorist attacks and market indices, % change*

Source: Thomson Reuters, work-up by the SACE Economic Analysis and Research

This does not mean, however, that these episodes of political violence have no effect on the real economy. Political violence **increases uncertainty** and makes business decisions more difficult, influencing expectations and undermining confidence among companies and markets.

In a scenario of non-escalation - currently the most probable - the impact on the economy is expected to be temporary.

One important activity likely to be affected by the shock is tourism, with impact varying from country to country. Egypt is an emblematic case: the tourism sector contributes 15% to GDP, besides being a source of foreign currency. The aircraft that exploded in the skies over Sinai will cause a reduced flow of tourists to the country, with relevant effects on the economy. The country's international reserves are already low (€ 16 billion, three months' cover for the country's imports): in the past, this shortage has generated payment delays and defaults in foreign currency to the detriment of Italian exporters, as well as downgrading the creditworthiness of local importers.

Initial analyses of France, conversely, show a possible short-term decline for the country for late 2015 and early 2016, without prolonged repercussions. Specifically, there might be a drop in GDP in the fourth quarter with 2015 growth below expectations (+1%)[01] due to the effects on tourism-related activities, which contribute 9% to GDP directly and indirectly. Adding in transport, entertainment and related commercial activities, in fact, the estimated losses come to € 600 million a day in the emergency period. Just in November an average of 16 million tourists normally arrive, and some of them might have decided to cancel their trips.

IF THE SITUATION DETERIORATED? THE SCENARIO OF ESCALATION

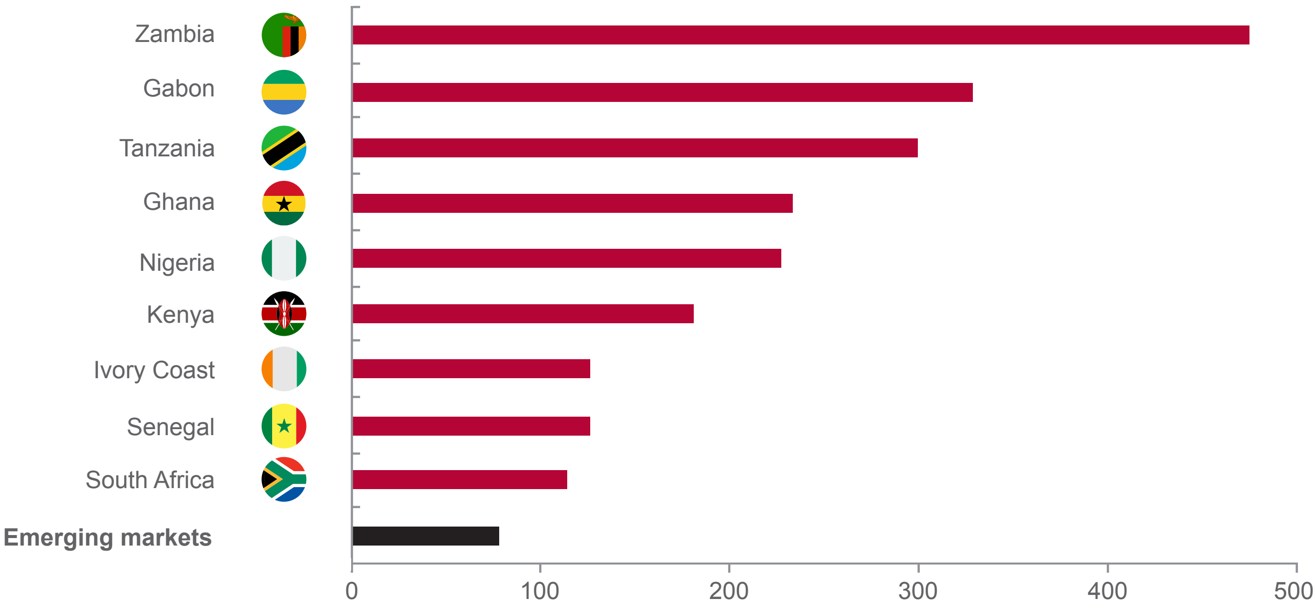
The scenario of escalation - currently the less probable - would be different, with Mali-type attacks in other countries of Sub-Saharan Africa (e.g. Nigeria, Somalia, Sudan), North Africa (Tunisia, Algeria, Egypt) and the Middle East, with spillover into countries with a Muslim majority such as Indonesia and Malaysia. In such a situation, dominated by frequent episodes that damage western economic interests, uncertainly might gain the upper hand, with permanent repercussions on business confidence and thus with significant long-term economic effects.

We might witness a sort of *Tequila effect*, the domino effect generated by the Mexican currency crisis in 1994, which triggered subsequent crises (Asian Tigers 1997-98, Brazil, Argentina in 2002).

[01] *See Roubini Global Economics, "The Paris Attacks and the French Economy", 23 November 2015.*

Global growth would be affected, and we might therefore witness a "flash flood" in which repetitive attacks would add to a series of deteriorating phenomena for the world economy: decreasing commodity prices, rising debt in the emerging countries (with a significant widening of the spread, as in the case of the African countries; Chart 2), the Chinese slowdown and, last but not least, the monetary policies of the Federal Reserve. It is impossible to make accurate estimates, but **even the American recovery and the (more fragile) European one would be greatly affected**.

CHART 2. *EMBIG spread, change in basis points from October 2014*



Source: IMF, World Bank, Bloomberg, Pew Research

FROM MACRO TO MICRO: DIRECT IMPACT FOR COMPANIES (A FEW SUGGESTIONS)

In 2014 the direct and indirect costs of terrorism globally totaled USD 64 billion[02]. Between 2008 and 2014, the "cost" of terrorism increased by one-fifth. At the aggregate level, these figures may seem relatively small, but they are not from the standpoint of a company that exports to or invests in foreign markets and finds itself dealing with losses that may affect expected cash flows and investment capital.

[02] *See Institute for Economics and Peace, "Global Peace Index 2015". The estimate of costs for terrorism includes deaths, injuries, ransom payments, and property damage generated by it.*

The SACE risk indicators is constantly updated to provide a timely situation on the various countries. **We have seen a one-point increase in the global index**, which with 43 points out of 100[03] still remains the lowest among the risks of a political nature: the risk of non-transfer in foreign currency is 44/100, while the SEN index (relative to seizure, expropriation and nationalization) remains in first place with 49/100, confirming how the specter of political risk is varied and interconnected.

The index of political violence is two points higher on the African continent: **North Africa has risen from 69 to 71/100 and remains the most dangerous area; the Sub-Saharan area has increased from 55 to 57**. Even Latin America has risen by one point, from 38 to 39, though with two-point increases for Brazil, Colombia and Mexico.

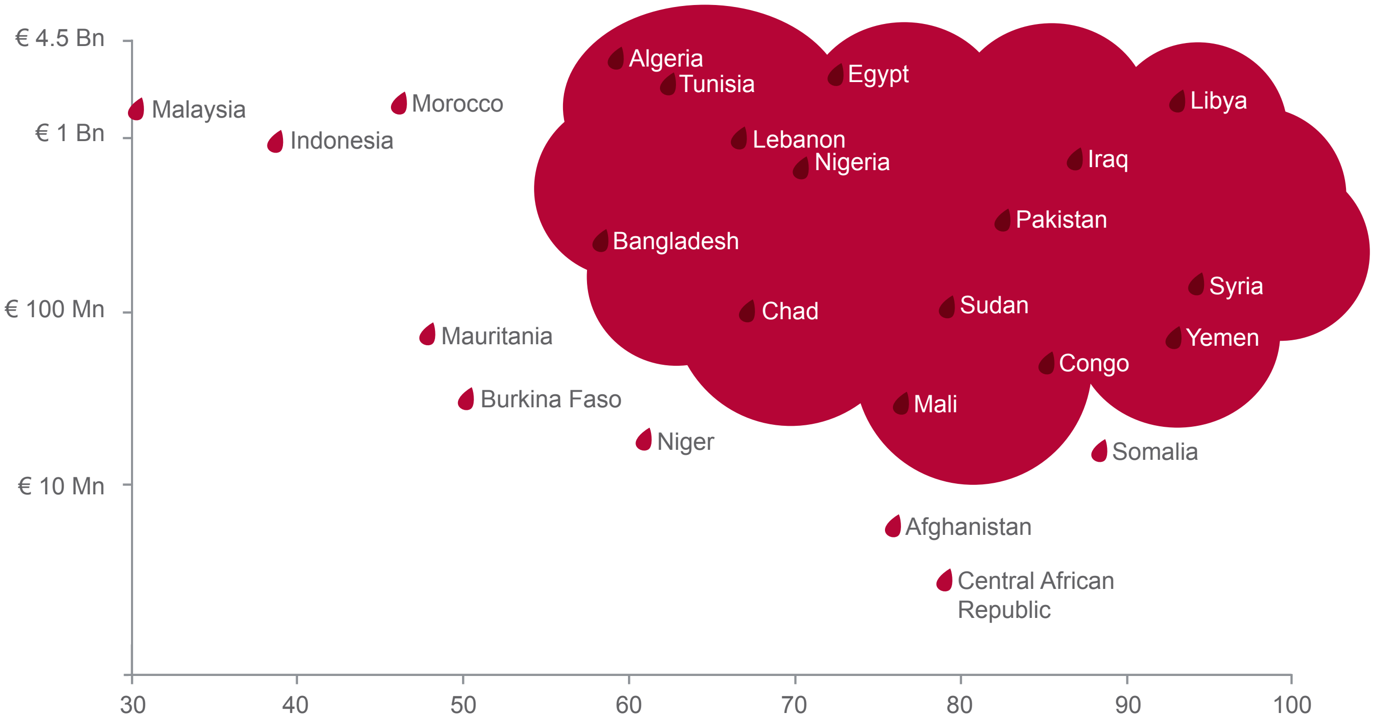
The Middle East remains at generally high levels (54 points), retaining its top ranking in intra-area variability, due to the sudden acceleration in violence (i.e. Syria, Turkey, Yemen) and the latent situations of conflict (Jordan, Iran, Iraq). The Arab Spring provided an important lesson for several Italian companies, large and small, traditionally less inclined to hedge against political risks.

If, for example, we take the countries with the greatest risk of terrorist attacks, we note that **Italian exports to those markets generally fall within a medium-high range of political violence** (between 65 and 95 points average out of a maximum of 100; Chart 3). Along with destinations currently more secure (Indonesia, Malaysia, Morocco), we can distinguish a group of countries (between 65 and 75 points) that represent a major portion of our exports, remaining at high levels of political violence but manageable with insurance coverage.

The political risks associated with terrorism may also represent a strong deterrent to direct investments in emerging or developing countries and may prove a problem for companies operating in those countries. In the scenario of escalation, **companies might generally take a more risk-averse approach**, suspending or cancelling their foreign investments and losing important opportunities for growth through market oversight.
There is a response to the unpredictability of these events, an insurance response known as Political Risk Insurance, which offers coverage for investments, both in equity and in bank financing, in case of political violence, non-transfer of profits, expropriation and breach of contract.

[03] *Zero for minimum risk, 100 for maximum risk.*

CHART 3. *Countries with the highest risk of terrorist attacks due to risk of political violence (horizontal axis: 0 minimum, 100 maximum) and value of 2014 Italian exports (vertical axis)*



Source: SACE

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