

CIFE Centre international de formation européenne
BOULOGNE BRUXELLES STRASBOURG

GLOBAL RISK MANAGEMENT


HOW TACKLING **FAILED STATES** AND **INSTITUTIONAL WEAKNESS?**

CIFE SEMINAR NICE MAY 8, 2020
MICHEL-HENRY BOUCHET

1

Key Takeaways?!

1. **WHAT ARE WEAK STATES, FAILED STATES AND ROGUE STATES?**
2. **WHY DO STATES FAIL?**
3. **WHICH COUNTRIES MOST EXEMPLIFY THE FEATURES OF INSTITUTIONAL WEAKNESSES?**
4. **WHAT ABOUT EARLY-WARNING SIGNALS OF STATE FAILURE?**



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2

1. What is a « weak » State?

A “WEAK STATE » IS UNABLE OR UNWILLING TO PROVIDE COMMON GOODS TO MAINTAIN SOCIAL COHESION THROUGHOUT THE PROCESS OF DEVELOPMENT

INSTITUTIONAL WEAKNESSES GENERATE A CRISIS OF SOCIAL MEDIATIONS

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3

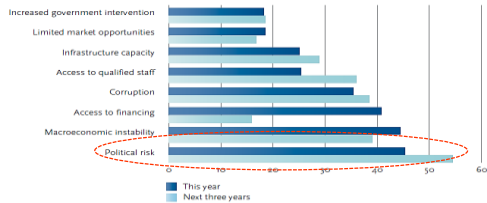
Threat materialization

► Wealth gap, political upheaval, sanitary crisis, capital controls, heavy bureaucracy, sham contracts and bribery, corruption, blocked funds, ideological shift, contract repudiation, expropriation, coup d'état, martial law, revolution, civil strife damage, war damage, kidnapping, crimes, terrorism

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4

MIGA: THE KEY CHALLENGE OF POLITICAL RISK

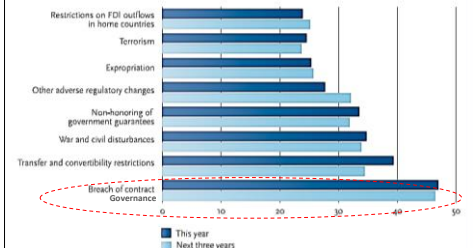
MAJOR CONSTRAINTS ON FOREIGN INVESTMENT IN EMERGING MARKETS
Percent of respondents

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?

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MIGA: TYPES OF POLITICAL RISK OF HIGHER CONCERN TO MNCs IN EMCS

Percent of respondents



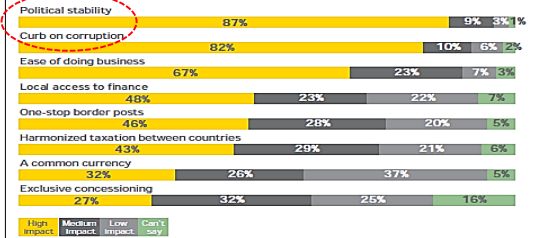
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RANKING OF TOP RISKS REPORTED BY FTSE 100 FIRMS
(FT JULY 2017)

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BOOSTING FDI IN AFRICA?

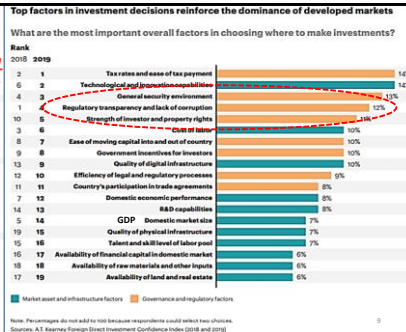
What impact would the following changes have on Africa attractiveness?



E&Y Africa Attractiveness

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GOVERNANCE &
TRANSPARENCY
MATTER IN FDI
STRATEGY!



WHERE DOES STATE FAILURE COME FROM?

State failure stems from the state's **incapacity or unwillingness**:

- to deliver **public goods**, e.g., security, social welfare, economic growth, social peace, good governance
- to claim the monopoly of the **legitimate** use of force
- to manage an **efficient** state bureaucracy
- to interact as a **fully functioning** member of the international community
- to respond **effectively** to challenges and crises
- to generate sustainable **development** prospects based on good governance!

(Sources: Timo Alexander Graf, Brookings, Fund for Peace, et alii)

2. WHAT IS GOVERNANCE?

Governance consists of the **quality of institutions** by which authority is exercised

- Accountability
- Political Stability & Social Peace
- Government Effectiveness
- Transparency and Regulatory Quality
 - Rule of Law
 - Control of Corruption

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11

WHAT IS « GOOD GOVERNANCE »?

XIVth century Sienna: **Good Government Allegory** =
Balance between
Wisdom, Justice, Strength, Prudence, and Peace



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12

LEVIATHAN (1651) THOMAS HOBBES

Why are some countries less corrupt and better governed than others?

Peace is attained through a **social contract**, whereby men consent to being ruled by **one supreme sovereign authority**

Absolute monarchy is the best form of central authority that can guarantee peace



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WHEN HOW MUCH (POWER) GETS TOO MUCH?



1. **Weak** states cause bad outcomes
2. Weak states are characterized by **conflict over control** of the political and economic spheres
3. **Excessive** centralized authority leads to tensions and repression
4. Political and economic power **concentration** go hand in hand with bad governance and corruption
5. Strong and adaptive **institutions** provide a social contract, hence **social mediations** that channel demands for change
6. A legitimate, hence respected, central authority can guarantee social stability and provide a basket of **key political goods** (human security, dispute resolution, political participation, and physical infrastructure)

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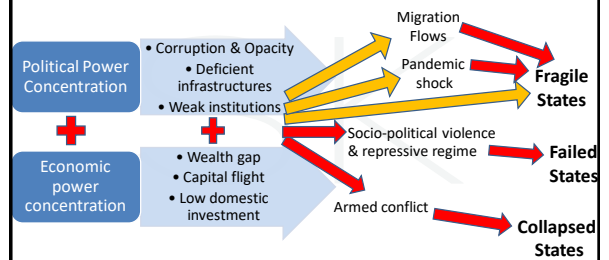
3. THE KEY INGREDIENTS OF STATE FAILURE

1. Weakness of institutions
2. Bad governance & corruption
3. Income & wealth gaps
4. Limited socio-economic freedom
5. Loose sustainable development policies

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15

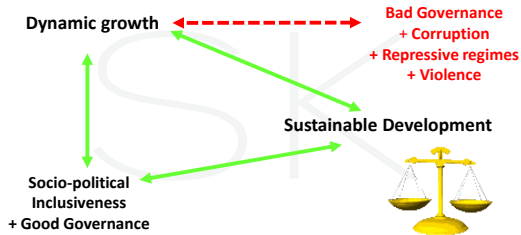
THE UNFOLDING OF STATE FAILURE



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16

TRILEMMA OF GROWTH AND DEVELOPMENT?



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17

HOW MOVING FROM GROWTH TO SUSTAINABLE AND INCLUSIVE DEVELOPMENT?

Assumption n°1

- Primacy of human capital for both growth and democratization: Growth in income and human capital causes institutional improvement with better political institutions even with pro-market dictators:
- Economic growth and human capital accumulation cause institutional improvement, rather than the other way around

Assumption n°2

- Democracy and other checks on government are the key mechanisms for securing property rights and boosting growth
- Good and stable institutions will enhance the pace and quality of economic growth
- Robust institutions and good governance matter!

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18

A FEW FACTS REGARDING DEMOCRACY AND DEVELOPMENT



1. Political regimes have little impact on GDP growth rate
2. Growth is influenced less by the type of regime than by regime instability
3. Economic growth provides legitimacy to dictatorships (while increasing demand for political change)
4. But GDP per capita growth does breed democracy
5. Per capita income grows faster under democracy (due to human capital and because population rises less fast than under dictatorships)
6. Democracy provides a stable political and institutional environment, hence a positive impact on sustainable growth!

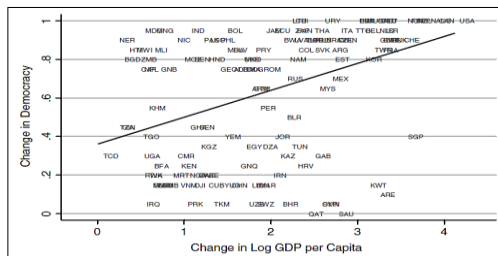
Since 1980, of the 124 EMCs that have managed to sustain a 5% growth rate for a full decade, 52 % were democracies. What matters is the implementation of key reforms for growth and development.

Feng, Y. Cambridge, 1997- Przeworski, A/ NYU- Ruchir Sharma 09/2012

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19

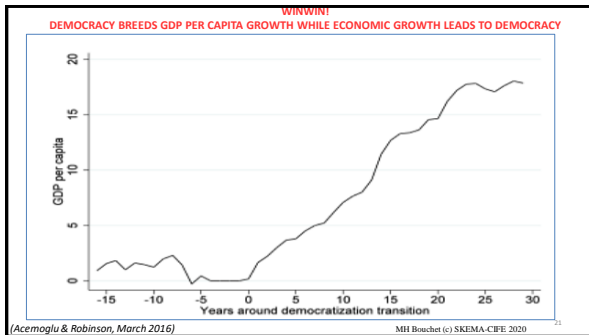
DEMOCRATIZATION AND INCOME GROWTH 1500-1995 INCOME PER CAPITA AND DEMOCRACY ARE CORRELATED = INSTITUTIONS TRANSFORM GROWTH INTO SUSTAINABLE DEVELOPMENT



J. Robinson, 2006

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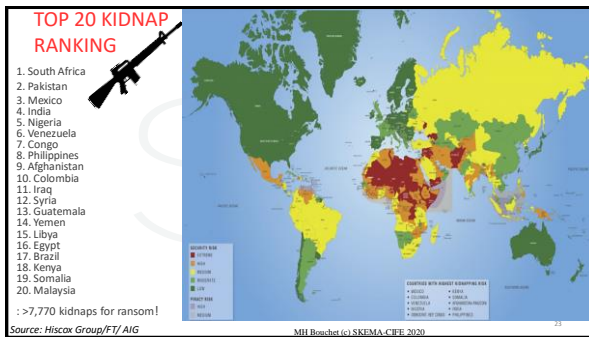
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4. MEASURING STATE FRAGILITY

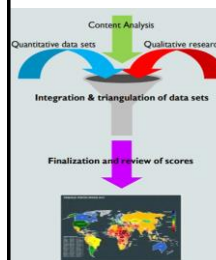
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22



THE FUND FOR PEACE : FRAGILE STATES INDEX'S METHODOLOGY

The Fragile States Index = critical tool in highlighting the pressures that can outweigh a states' capacity to manage those pressures.



Annual ranking for 178 countries

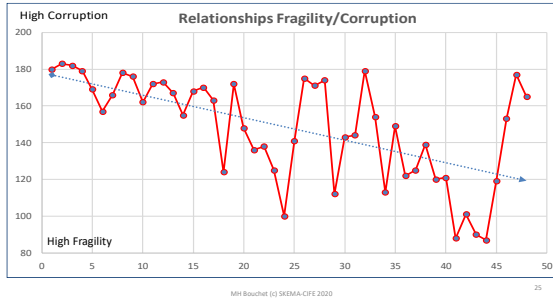
12 political, economic and social indicators
 >100 sub-indicators, coupled with qualitative analysis and expert validation:

Economic decline, uneven development, brain drain, state legitimacy, public services, corruption, human rights, demographic pressures, refugees, external intervention, rule of law...

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24

STATE FRAGILITY IS STRONGLY LINKED TO CORRUPTION



GLOBAL PEACE AND SECURITY INDEX (INSTITUTE FOR ECONOMICS AND PEACE)

RANK	COUNTRY	SCORE	CHANGE	RANK	COUNTRY	SCORE	CHANGE	RANK	COUNTRY	SCORE	CHANGE
85	Bolivia	2.044	+4	113	El Salvador	2.262	+2	143	India	2.605	+4
86	Kosovo	2.048	+5	114	Guatemala	2.264	+4	142	Pakistan	2.605	+2
87	Haiti	2.052	+4	115	Turkmenistan	2.265	+4	143	Colombia	2.661	+2
88	Paraguay	2.055	+12	116	Brazil	2.278	+10	144	Venezuela	2.671	+2
89	Cambodia	2.066	+8	116	Thailand	2.278	+3	145	Mali	2.710	+2
90	Morocco	2.070	+13	116	Armenia	2.284	+3	146	Nepal	2.735	+1
91	Cuba	2.073	+7	119	Kazakhstan	2.300	+1	147	Laos	2.800	+26
92	Guayana	2.075	+9	120	Nicaragua	2.312	+54	148	Nigeria	2.898	+4
93	Trinidad and Tobago	2.084	+7	121	King of the Congo	2.323	+1	149	North Korea	2.901	+1
94	Mozambique	2.099	+9	122	South Africa	2.333	+5	150	Ukraine	2.905	+2
95	Kyrgyz Republic	2.105	+13	123	Honduras	2.341	+7	151	Sudan	2.995	+3
96	Ghana	2.112	+1	124	Bahrain	2.357	+5	152	Turkey	3.015	+3
97	Bahrain	2.115	+4	125	Myanmar	2.353	+2	153	Pakistan	3.072	+2
98	Papua New Guinea	2.118	+2	126	Niger	2.364	+6	154	Russia	3.093	+2
99	Georgia	2.122	+3	127	South Africa	2.399	+2	155	Dem. Rep. of the Congo	3.118	+4
100	Guinea	2.125	+4	128	Vietnam	2.401	+4	156	Libya	3.188	+1
101	Bangladesh	2.128	+9	129	Saudi Arabia	2.409	+1	157	Central African Rep.	3.296	+1
102	Uzbekistan	2.168	+7	130	Azerbaijan	2.425	+3	158	Somalia	3.300	+1
103	Lesotho	2.167	+1	131	Ethiopia	2.434	+4	159	Iran	3.369	+1
104	Burkina Faso	2.176	+35	132	Zimbabwe	2.453	+6	160	Yemen	3.412	+2
105	Tajikistan	2.194	+12	133	Eritrea	2.504	+6	161	South Sudan	3.526	+4
106	Uganda	2.195	+2	134	Philippines	2.516	+4	162	Syria	3.566	+1
107	Cote d'Ivoire	2.203	+4	135	Burundi	2.520	+1	163	Afghanistan	3.574	+2
108	Togo	2.205	+5	136	Egypt	2.521	+7				
109	Djibouti	2.207	+2	137	Chad	2.522	+2				
110	China	2.217	+2	138	Cameroon	2.538	+4				
111	Algeria	2.219	+2	139	Iran	2.542	+9				
112	Guinea Bissau	2.237	+6	140	Kenya	2.600	+1				

http://www.visionofhumanity.org/sites/default/files/Global%20Peace%20Index%20Report%202016_0.pdf

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BROOKINGS INSTITUTE: INDEX OF STATE WEAKNESS IN THE DEVELOPING WORLD

4 "baskets" of key indicators: economic, political, security, social welfare

20 sub-indicators: 141 countries

- Economic: GNI per capita, GDP growth, Income Inequality, Inflation, Regulatory Quality
- Political: Government Effectiveness, Rule of Law, Accountability, Corruption
- Security: Conflict Intensity, Political Stability and Violence, Incidence of Coups, Gross Human Rights Abuses
- Social welfare: Child Mortality, Primary School Completion, Undernourishment, Water Source & Sanitation Facilities, Life Expectancy

Rank	Country	Overall Score	Economic	Political	Security	Social Welfare	GNI Per Capita
1	Somalia	0.52	0.58	0.03	1.27	0.70	225
2	Afghanistan	1.65	4.51	2.08	0.00	0.00	271
3	Congo, Dem. Rep.	1.67	4.08	1.80	0.28	0.52	130
4	Iraq	3.11	2.87	1.67	1.63	6.27	1134
5	Burundi	3.21	5.01	3.46	2.95	1.43	100
6	Sudan	3.29	5.05	2.06	1.46	4.59	810
7	Central African Rep.	3.33	4.11	2.90	5.66	1.25	392
8	Zimbabwe	3.44	1.56	1.56	6.81	3.84	350
9	Liberia	3.64	3.39	3.91	6.01	1.25	140
10	Cote D'Ivoire	3.66	5.23	2.12	3.71	3.46	870
11	Angola	3.72	5.42	2.67	5.52	1.45	1080
12	Mali	3.76	3.66	3.63	6.34	3.34	280

GEORGE MASON
UNIVERSITY
SCHOOL OF
PUBLIC POLICY
CENTER FOR
SYSTEMIC PEACE

STATE
FRAGILITY
INDEX

Frangility Index	Effectiveness Score	Legitimacy Score	Security Legitimacy	Armed Conflict Indicator	Political Effectiveness	Regime Type	Economic Effectiveness	Economic Legitimacy	Net Oil Production or Consumption	Social Effectiveness	Social Legitimacy	Regional Effects
Dem. Rep. of Congo	24	13	11	War	dem	War	dem	na	na	na	na	Afr
Central African Rep.	23	12	11	War	DEM	War	DEM	na	na	na	na	Afr
South Sudan	22	12	10	War	SF	War	SF	na	na	na	na	Afr
Sudan (North)	22	11	11	War	aut	War	aut	na	na	na	na	Mus

The State Fragility Matrix scores 167 countries since 2007

2 Criteria: Effectiveness and Legitimacy

4 performance dimensions: Security, Political (Regime/Governance Stability), Economic (GDP...), and Social (Human capital...)

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30 CANDIDATES FOR FAILED STATES CATEGORY?

Developing countries

- Tajikistan
- Eritrea
- Mozambique
- Madagascar
- Haiti
- Afghanistan
- Equatorial Guinea
- Guinea Bissau
- North Korea
- Yemen
- South Sudan
- Syria
- Somalia
- Burundi
- CAR

Developing countries

- ✓ Iraq
- ✓ Gabon
- ✓ Cameroun
- ✓ Venezuela
- ✓ Libya
- ✓ Uzbekistan
- ✓ Zimbabwe
- ✓ Cambodia
- ✓ DR Congo
- ✓ Turkmenistan
- ✓ Angola
- ✓ Chad
- ✓ Congo
- ✓ Sudan



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29

20 CANDIDATES FOR « WEAK » STATES CATEGORY?

Developed countries?

- Argentina
- Serbia
- Bosnia and Herzegovina
- Croatia
- Romania
- Hungary?
- Greece?
- Montenegro
- Tunisia?
- Paraguay

Developed countries?

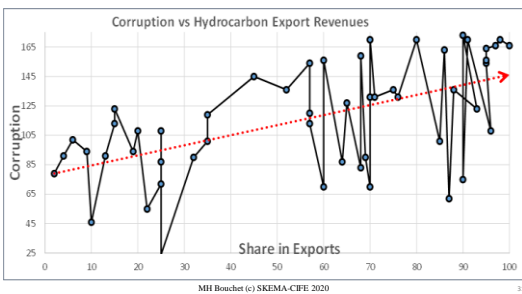
- ✓ Brazil
- ✓ Kazakhstan
- ✓ Algeria
- ✓ Kuwait
- ✓ Indonesia
- ✓ Saudi Arabia
- ✓ Belarus
- ✓ South Africa
- ✓ Egypt



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30

OIL-BASED GROWTH LEADS TO POWER AND WEALTH CONCENTRATION, AND CORRUPTION



31

DEVELOPMENT = ECONOMIC GROWTH + KEY CONDITIONS THAT MAKE IT SUSTAINABLE!

	CHILE	COSTA RICA	TURKMENISTAN	GABON
GDP/per capita	\$15,000	\$11,000	\$15,000	\$14,000
Life Expectancy	80	81	68	65
HDI Rank	42	68	108	115

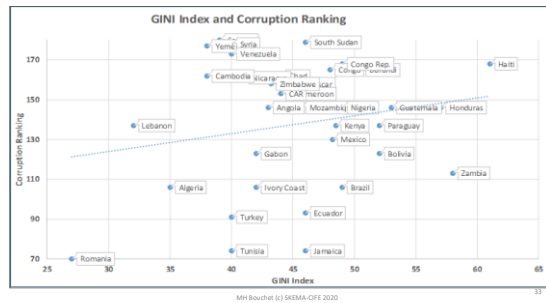
	ARMENIA	SRI LANKA	NIGERIA	ANGOLA
GDP/per capita	\$5000	\$5000	\$5000	\$5500
Life expectancy	75	77	54	60
HDI Rank	81	97	158	1489



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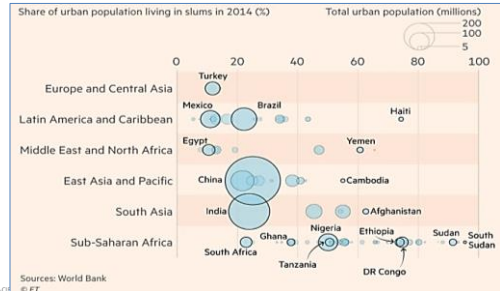
32

CORRUPTION IS STRONGLY RELATED TO LARGE INCOME AND WEALTH GAPS

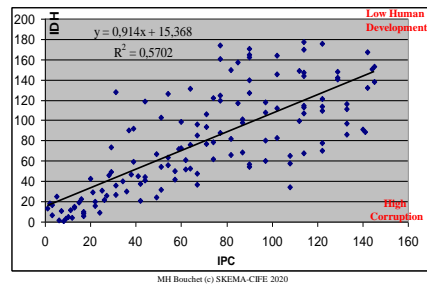


COUNTRIES WITH THE LARGEST SLUM POPULATIONS

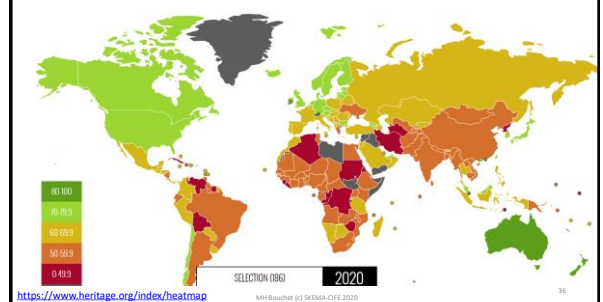
(SHARE LIVING IN SLUMS/TOWNSHIPS %)

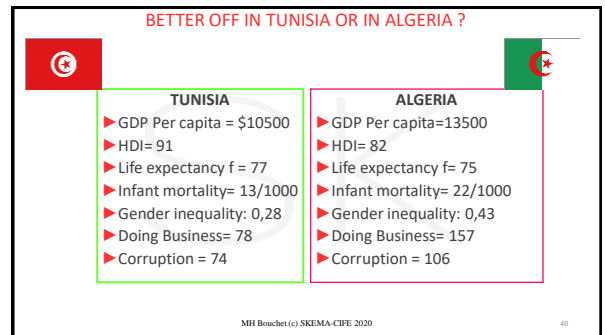
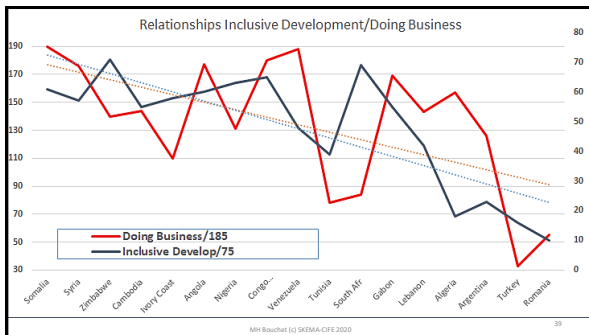
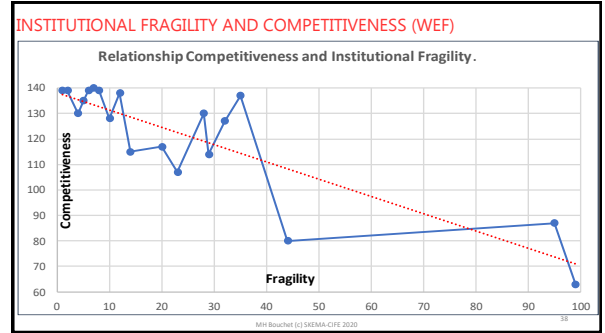
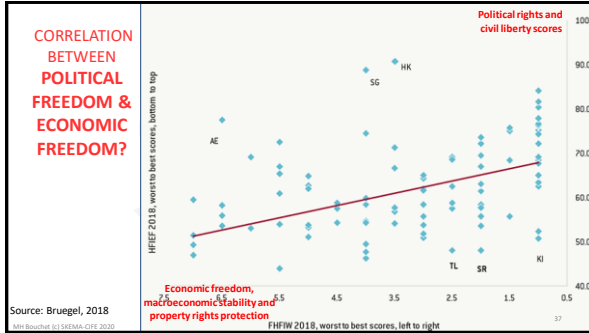


LARGE CORRUPTION IS STRONGLY RELATED TO LOW DEVELOPMENT SCORE! CORRELATION HUMAN DEVELOPMENT /CORRUPTION



RELATION BETWEEN STATE FAILURE AND SOCIO-ECONOMIC FREEDOM?





5. WHERE DOES POLITICAL RISK & INSTITUTIONAL WEAKNESSES COME FROM?

- ▶ **Origins?** Political risk stems from the overall **uncertainty** related to the exercise of power by a government and its ramifications
- ▶ **Impact?** Arbitrary political decisions, conditions, and events will affect the business climate in such a way that investors, exporters, creditors, as well as domestic residents will confront risks and losses.

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41

AMBASSADOR PAUL BREMER

(US STATE DEPARTMENT) HARVARD BUSINESS SCHOOL REVIEW, 2002

Political risk analysis is both an art and a science but many types of risk are amenable to rigorous analysis:

1. How **resilient** is the political system?
2. Is there a tradition of **peaceful transitions** of power?
3. How robust are the **social shock absorbers** that provide buffers between individual citizens and governments?

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42

WHERE DOES POLITICAL RISK COME FROM?

- Terrorism
- Wealth gap
- Ethnic/linguistic fragmentation
- Bad governance + Corruption
- Cultural fragmentation (urbanization, migrations, social frustration, religions)
- Internal violence and power struggle (martial law, coup d'état, guerrilla warfare...)
- Regional contamination

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43

WHERE DOES POLITICAL TURMOIL COME FROM?

Managing the stress of modernization?

▶ **violence and instability stem from:**

1. rapid social change
2. centralized decision-making system
3. mobilization of new groups into politics
4. slow development of political institutions



- ▶ As societies modernize, they become more complex and disordered. If the process of **socio-economic** modernization is not matched by a process of **political and institutional** modernization with political institutions capable of result is violence.

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44

POLITICAL DIS/ORDER IN RAPIDLY CHANGING SOCIETIES

Process of socio-economic change

EMCs

OECD (?)

Deficit of strong institution-building capacity
Economic liberalization without social reforms and
institutional strengthening

Process of political institutionalization



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45

A DEFICIT IN INSTITUTION-BUILDING ALWAYS LEADS TO SOCIAL UPHEAVAL



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46

ECONOMIC GROWTH + POLITICAL MODERNIZATION IN CHINA?

- « Political reform is a necessary companion to economic modernization: without the safeguard of reforms, the fruits of economic reform would be lost »

(August 2010 Shenzhen PM Wen Jiabao)



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INSTITUTIONAL STRENGTHENING, ECONOMIC DEVELOPMENT AND POLITICAL STABILITY: CHALLENGING TRIANGLE!

Chile's President Bachelet = democratic strengthening + economic growth + social protection

- « In Latin America, there are countries where people are uneasy about the process of economic liberalization, because structural economic reforms were not accompanied by the social policies that were necessary to fight poverty and social injustice »



Interview by McKinsey Quarterly, 2007

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6. MEASURING CROSS-COUNTRY GOVERNANCE ACROSS TIME?

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49

ICRG CROSS-COUNTRY CORRUPTION RISK INDEX



- 140 countries
- Composite risk rating
- Monthly rating since 1980
- 22 variables
- 3 categories:
 1. Socio-political (100)
 2. Financial (50)
 3. Economic (50)

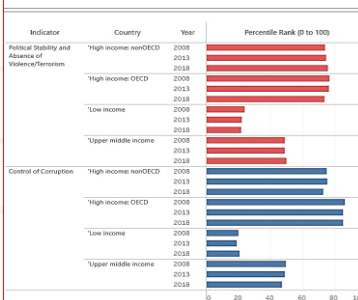
► Political Risk Rating = 12 weighted variables (100)

1. Government Stability 12
2. Socioeconomic Conditions 12
3. Investment Profile 12
4. Internal Conflict 12
5. External Conflict 12
6. **Corruption** 6
7. Military in Politics 6
8. Religious Tensions 6
9. Law and Order 6
10. Ethnic Tensions 6
11. Democratic Accountability 6
12. Bureaucracy Quality 4

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MEASURING GOVERNANCE AND CORRUPTION (WORLD BANK)

Worldwide Governance Indicators

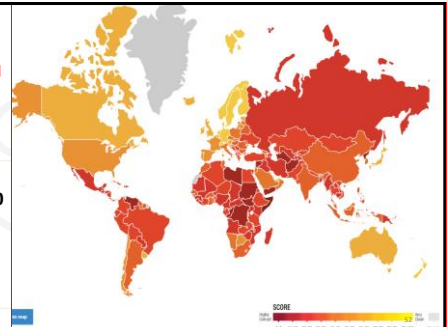


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TI WORLD MAP OF CORRUPTION

BRICS

South Africa= 70
 India = 80
 China = 80
 Brazil = 106
 Russia = 137



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7. TOWARD EARLY WARNING SIGNALS OF STATE FAILURE?

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53

WHY DOES CAPITAL FLIGHT DESERVE MORE ATTENTION?



- Macroeconomic consequences: increase in S/I gap
- Symptom of institutional weakness (banking system, savings mobilization)
- Push & Pull forces
- Recycling of external debt and development aid?
- **Reflection of bad governance and corruption?**

New research and policy focus of IFIs (Lessard/Williamson, Dooley, Cuddington, Bouchet/Gros Lambert, Collier, Cerra, Boyce/Ndikumana, Bouchet/Seto, & Bouchet/Kharraz)

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54

COVID-19 CRISIS AND WEAK STATES? = CAPITAL FLIGHT, INSOLVENCY AND DEFAULT

- Sanitary and economic disaster in fragile states = political and social disorder
- Q1 2020 = net **\$100 billion** has left 12 leading EMCs, including Brazil, Argentina, Turkey, Mexico, Peru, and South Africa (stark contrast to inflows of \$79 billion in 2019)

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55

HOW MEASURING CAPITAL FLIGHT?




5 approaches:

1. All gross capital outflows
2. Short-term private capital outflows (*hot money*)
3. Errors & Omissions in the BOP
4. Residual BOP calculation= (net FDI inflows + debt increase) – (current account deficit + reserve accumulation)
5. « **expatriated savings** »: **ExR-adjusted private deposits in international banks**

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56

IN SEARCH OF CAPITAL FLIGHT DATA?



BANK FOR INTERNATIONAL SETTLEMENTS

Table A6.1

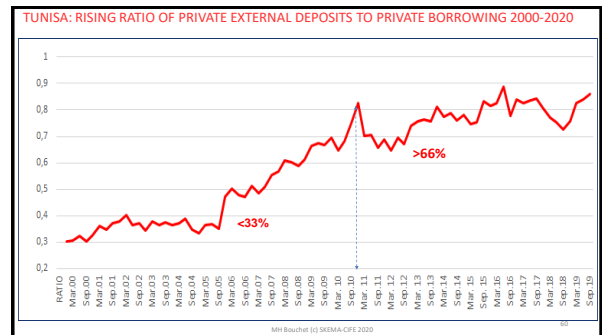
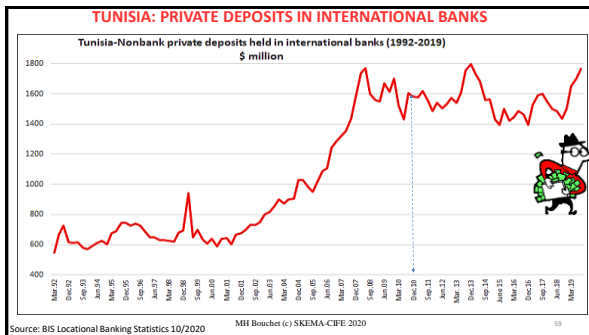
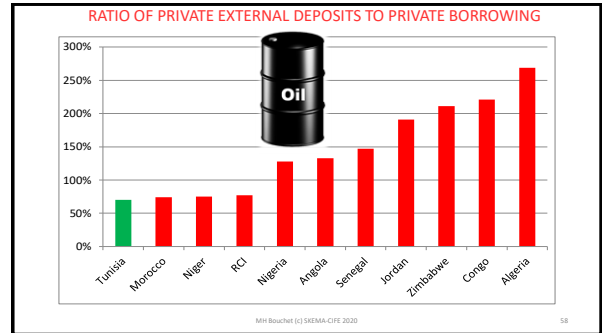
Banks' cross-border positions on residents of Tunisia

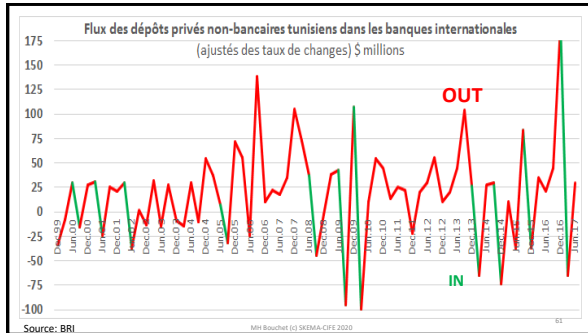
Outstanding at end-September 2019, in millions of US dollars

Tunisia	All sectors		Bank sector		Non-bank financial		Total	Non-financial sector								
	Claims Q3 19	Liabilities Q3 19	Claims Q3 19	Liabilities Q3 19	Claims Q3 19	Liabilities Q3 19		Non-financial corporations Claims Q3 19	Liabilities Q3 19	Households Claims Q3 19	Liabilities Q3 19	General government Claims Q3 19	Liabilities Q3 19	Unallocated/ non-financial Claims Q3 19	Liabilities Q3 19	
Cross-border positions	3,886	7,462	1,172	6,330	1	71	2,864	1,766	837	258	188	1,206	1,047	11	62	286
By instrument																
Loans and deposits	3,140	7,130	737	5,312	1	71	2,853	1,443	692	247	188	895	1,047	11	61	286
Debt securities	354	1	254	—	—	—	1	0	—	—	—	0	—	—	—	—
Other instruments	480	16	231	15	—	—	0	0	0	0	0	—	—	—	—	—
Unallocated	1	324	0	2	—	—	-4	322	—	11	—	311	—	—	—	—
By currency																
All instruments																
US dollar	805	2,751	261	1,683	—	58	242	719	170	31	6	415	9	1	56	272
Euro	2,379	4,309	540	3,348	1	12	1,791	942	667	214	87	709	1,036	10	1	10

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5/7





ECONOMETRIC ANALYSIS

Flow of Expatriated Savings =
f(capital inflow variables, institutional factors, and macroeconomic variables)

Macroeconomic variables:
(Δ r1%, CPI, Trade Op, Budget Deficit/GDP, M2/GDP, CA/BOP)

CAPITAL INFLOW VARIABLES:
(Δ Debt , ODA)

Institutional variables (Governance, corruption, civil liberties)

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62

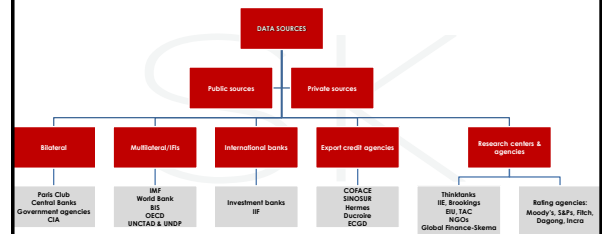
KEY ROLE OF GOVERNANCE & INSTITUTIONAL VARIABLES

- ✓ a 1% increase in **Governance** (quality of government) will reduce by 1.45% the flow of expatriated savings to GDP, on 99% level of confidence
- ✓ a 1 % increase in **Civil Liberty** is associated with 0.9% decrease in capital flight
- ✓ A 1% increase in **External debt** (capital inflows) leads to a 2,1% rise in capital flight (revolving door & recycling syndrome)
- ✓ A 1% increase in conditional **development aid** leads to a 0,2% reduction in capital flight

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63

MAJOR SOURCES OF COUNTRY RISK INTELLIGENCE



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64