Political risk in the natural resources sector

2021

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Foreword

By Graham Knight

**Head of Global Natural Resources,
Willis Towers Watson**

It is my pleasure to welcome you to a new report that focuses on political risk in the natural resources sector, produced in partnership with Oxford Analytica and underpinned by a panel of external affairs and risk management professionals at five of the world's largest natural resources firms.

In these unprecedented times, companies in the oil, gas, power and mining sectors find themselves beset by challenges from all sides, as COVID-19 continues its stranglehold on every corner of the world. We are seeing green shoots of optimism with a series of vaccines on the horizon, yet they will take time to roll out and aftershocks will continue for some time – many of them political in nature, none of them simple.

COVID-19 has stressed an already tough market with a dramatic contraction in demand; in the global commodities markets, the impact has been acute. If risk levels remain elevated, companies will fall under increasing pressure from shareholders for greater levels of transparency around the losses incurred in the markets they operate in.

Companies will need the ability to monitor, quantify and manage these risks, as well as develop strategies to mitigate them; the first step towards this is building awareness of the changes. At a time of increasing uncertainty, it is important to take deeper dives into the issues we've highlighted in our Market and Risk Reviews over the last year; political undercurrents have run throughout these Reviews and deserve a deeper focus.

Reports such as this one, that outline the political risks facing the natural resources sector, have an important role to play in supporting executives seeking to make sense of the shifting landscape. Appropriately, the report opens with the views of our peers: a set of panel interviews with natural resources executives, ranking the top risks facing the industry.

Foreword cont.

Key risks

- **Sustainable recovery:** this encompasses a range of concerns: the ability of governments to manage the pandemic while trying to reopen their economies; aligning Environmental Social Governance (ESG) issues with a sustainable recovery; and building on the lessons the pandemic has taught us.
- **Geopolitical tensions with a rising China:** whether intentional sanctions or accidental conflict, the panel interviews highlighted the vast array of political knock-ons that could impact businesses.
- **Middle East conflict:** a contracting US military presence in the region; Iranian ambitions for a nuclear program; and a peace deal between Israel and the UAE offer risks and opportunities across the region.
- **Strategic competition between Chinese and western companies:** resource competition and the global reach of Chinese companies makes it nearly impossible to avoid such tensions, leaving many with hopes for good economic relations between East and West. Defining your risk appetite is essential, and six different scenarios have been presented that set out potential futures of what could go wrong – and how to aid your decision-making process.
- **Aggressive tax and royalty schemes:** the threat of being targeted for revenue-raising to pay back debts taken out as countries sought to manage the impacts of the pandemic is already on the minds of executives.

Under the radar

As well as these key concerns, the risk radar for 2020 also looked at what might be flying underneath it. The theme of state stability in resource exporting countries caught the eye. Might institutionally-weak countries be vulnerable to the current commodity price collapse?

Views from political risk experts

Two of the top risks (as seen on the left) are explored further by geopolitical analysts to shine a light on these issues and increase understanding around their interrelated nature. Essays on “Strategic competition between Chinese and Western companies” and “Natural resource fiscal policy after COVID-19” have been authored with the assistance of Oxford Analytica, a Willis Research Network partner. Oxford Analytica have tapped their top experts to bring you the latest thinking from the research community.

Final thoughts

We hope you will find that the political risk issues that we discuss in the pages that follow are the ones that concern you most, and that these insights will help you test your existing thinking and spark new ideas; we will seek to support you if you wish to follow up on any of the issues discussed in the study. The coming 12 months are going to require a holistic view of risk in an already charged landscape which has highlighted the need for organizations to create stronger links between their C-suites and operational managers to produce the required integrated and rehearsed responses.

Please read on and I’d be delighted to discuss any of your issues arising out of this publication with you at any time.

Section 1: Introduction

By Christophe Meurier

CEO, Financial Solutions
Willis Towers Watson

Those companies in the oil and gas and mining sectors that have thrived over the long term have inevitably become adept at managing through cycles. This year's cycle, however, has been crueler than most.

To put some figures behind that assertion: during the last global recession, in 2008, more than 80% of the world's economies recorded positive economic growth.[1] While North America and Europe struggled with the aftermath of the global financial crisis, many emerging market countries shrugged off the downturn. Some of these countries, such as India, were relatively insulated from international economic shocks; others, such as China, implemented aggressive economic recovery packages.

In 2020, by contrast, of the 192 countries for which the IMF produces economic forecasts, only 13% are expected to avoid economic contraction[1]. The economic shock wrought by the pandemic has proved to be "global" in an unprecedented way, and in global commodities markets, the impact has been acute.

And yet, even as natural resources companies struggle to manage a dramatic contraction in demand for their products, there have been a few green shoots. Some commodities, such as gold, have surged as a store of value.[2] Other mining commodities have shown signs of strengthening on the back of economic recovery in Asia.[3]

We asked Oxford Analytica to conduct research into the political risks facing oil and gas and mining companies during these unprecedented times. Oxford Analytica convened a panel of external affairs and risk management professionals at five of the world's largest natural resource firms. Oxford Analytica then conducted in-depth interviews with these professionals, to produce the risk radar that appears in the next section, and commissioned scholars in its global expert network to produce peer-reviewed essays on two of the top risks the executives identified: "strategic competition between Chinese and Western companies;" and "natural resource fiscal policy after COVID-19."

As you will see, China proved to be top of mind for the panelists, accounting for two of the top five risks on our list. Perhaps China's dominance is unsurprising. In a sense, 2020 was China's year. The Year of the Rat began in tragedy, as the pandemic exploded in Wuhan and threatened to overwhelm the city's medical system. And yet, by the end of 2020, China appeared to have gained control of the virus and restarted its economy – even as many Western countries continued to struggle. Indeed, despite much talk of "reshoring," and an acrimonious trade dispute with the United States, during the first half of 2020 China's share of world exports actually rose.[4] Say this for China's government: it can manage adversity.

What risks will natural resource companies face as Chinese and Western firms engage in strategic competition? What risks might arise from geopolitical tensions between China in the West? What political risk perils might be lurking "under the radar?" We hope you will find Oxford Analytica's findings on these subjects, which appear on the pages that follow, to be useful.

We sincerely thank the Oxford Analytica contributors who authored the following essays, but most of all we thank the expert panel of natural resource executives who guided the research for their time and insights.

[1] https://www.imf.org/en/Publications/WEO/weo-database/2020/October

[2] https://www.nbcnews.com/business/business-news/gold-prices-surge-record-high-amid-coronavirus-worries-u-s-n1234958#:~:text=The%20price%20of%20gold%20has,price%20set%20in%20September%202011; https://markets.businessinsider.com/commodities/gold-price

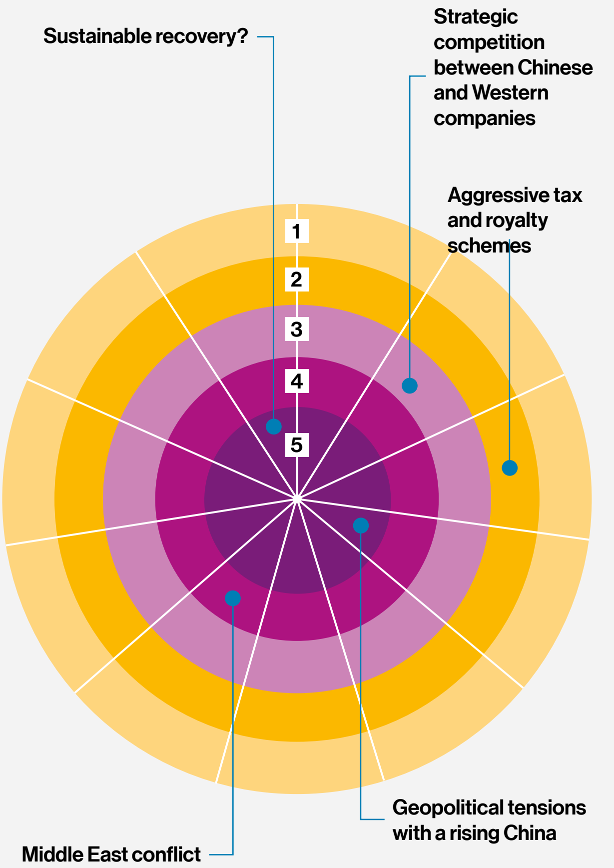
[3] https://investingnews.com/daily/resource-investing/base-metals-investing/copper-investing/copper-price-update/

[4] https://www.nytimes.com/2020/08/31/business/trumps-tariffs-coronavirus-china-exports.html

Section 2: The political risk radar

Political risk radar for the natural resources sector (ranked by number of mentions)

Fig 1 – Risk Radar 2021



Source: Oxford Analytica interviews with the executive panel. "Mentions" count the number of panelists who mentioned each risk topic.

Under the radar: State stability in resource exporters

To identify the top political risks facing the natural resources sector in 2021, Oxford Analytica convened a panel of external affairs and risk management professionals at five of the world's largest natural resources companies. Firms headquartered in the Americas, Europe and Asia-Pacific were selected. Oxford Analytica then conducted in-depth interviews with this panel of executives, to produce the risk radar that appears at left. Below, for each risk on the radar, Oxford Analytica summarizes some of the interview highlights. The views expressed do not necessarily reflect those of Willis Towers Watson.

Sustainable recovery?

One member of our executive panel, from the oil and gas sector, threw down the gauntlet: "simply trying to get back to where we were pre-pandemic is not enough – it would condemn us to go through the same thing again relatively soon. We need a sustainable recovery." This comment encapsulated a number of the panel's most frequently-mentioned concerns. There were worries that recovery would be unsustainable because governments would reopen economies before the capacity to control the spread of the virus had been sufficiently developed; worries that environmental and other objectives would be abandoned in a race to rebuild economically; and worries that much of what was learned in the world's response to the pandemic would be forgotten. We elected to gather these concerns under the heading "sustainable recovery," which takes the top place on this year's radar.

Our oil and gas panelists were most focused on the need for a sustainable economic rebound. "The number one, overriding issue is recovery from the pandemic," one executive contended. "This will not be easy, as even those countries that have done best so far have shown." The issue is particularly acute for the oil and gas sector because, as another panelist put it, "supply was going up just as demand fell off a cliff." More countries, for instance in Africa, are ready to bring new supplies into the market. Shale production techniques pioneered in the US are now going global, adding further to potential supply (for instance, in Argentina). A stop-start recovery, coupled with new sources of supply coming online, could make weakness in the oil price a risk for some time to come.

Other panelists were more worried about sustainability over the long term. “We have to get the first step in the transition to a post-COVID world right,” said an oil and gas panelist, who argued that the objective of climate policy should no longer be net zero, but “net negative” (removing carbon). “We are simply not doing enough,” he said, “and to be successful, the recovery has to change this – a sustainable recovery is the highest challenge we face.”

Panelists in the mining sector were also concerned about sustainability, particularly in regard to ESG (environmental, social and governance) policies. One panelist complained about a “lack of alignment with industry ESG efforts and lack of clarity on ‘what next’.” Others expressed concerns about the policies of particular countries, such as: the possible imposition of carbon tariffs in Europe; carbon pricing policy in Canada; and the “great unknown” of US climate policy under the next administration. A panelist from a mining company headquartered in the emerging world worried that weaknesses in the environmental policy of his own government could impact the company’s image and drive investors away.

Geopolitical tensions with a rising China

Tied with a sustainable recovery at the top of this year’s risk list is our next political risk challenge for the sector: geopolitical tensions with a rising China. Following the tumultuous events of 2020, it is unsurprising that the most-frequently mentioned relationship of concern was that between China and the US – although tensions between China and Europe and China and India were also noted.

Perhaps more surprisingly, panelists expressed most concern about the US side of the equation. Partly, that was because of the US government’s recent tendency to rely on sanctions and tariffs as a tool in international disputes. “The Americans are the problem,” one mining sector panelist said. “Can you continue to export to a given country? Work with a given supplier? Employ foreign individuals in the US? No idea.”

Other panelists were more concerned about the possibility of an “accidental conflict,” with the most frequently mentioned flashpoint being the South China Sea. Even here, though, the panelists had their eye on North America. “It [war between the US and China] would need a significant misestimation, and China is much less likely to do it,” an oil and gas panelist contended.

Although most of the panel interviews were conducted in October 2020, just ahead of the US presidential election, the executives were quick to point out that geopolitical tensions would persist, even under a new administration. “US-China strategic rivalry is more than a threat,” said an oil and gas executive. “It is a schism with an impact that reaches everywhere; the trade aspect is just the surface of a much deeper, fundamental battle.”

Middle East conflict

We asked our panel to focus on identifying global risks to their sector. There were, nonetheless, two geographic regions that panelists felt were of such significance that they might contribute to risk on a global scale. The first, of course, was China – discussed above and below. The second was the Middle East. “The Middle East is the most worrying region over the next two years,” as one executive put it.

Many of the panel’s concerns had to do with well-known issues, such as tensions between the US and Iran. Panelists from both oil and gas and mining companies worried about Iran’s quest for nuclear weapons, and US efforts to arrest such moves. A military conflict between the US and Iran could lead to oil price shocks, as well as disruptions of global shipping. Another oft-expressed concern was regional rivalries. The diminishing US presence in the region has arguably unleashed a struggle for regional dominance, most notably between Saudi Arabia and Iran, but also at times Turkey. “One thing all sides are realizing is Washington will be less active in the region going forward,” an oil and gas panelist claimed.

Saudi Arabia's position was seen to be particularly difficult. The country's leadership is aware that oil, which is central to the nation's economy, has a limited lifespan. But even as Saudi Arabia struggles to find a more sustainable economic footing, tensions with Iran and Israeli diplomatic efforts threaten to undermine the country's strategic position. The Saudis are on "the tightest of tightropes," as one panelist put it.

That said, the news for the Middle East has not all been bad – following the 2020 peace deal between Israel and the UAE, one mining panelist was intrigued by the opportunities in those countries and the Gulf states.

Strategic competition between Chinese and Western companies

In the main, our panelists hoped for good economic relations with China. (As one emerging markets miner noted: "it's our main market.") Yet there was also concern about resource competition. Chinese companies now have a global reach, and Western companies must decide whether to avoid them, bid against them, or perhaps join them. (The potential risks in this area are explored further in the essay section, below.)

As one panelist pointed out, global economic conditions could tilt the playing field to China's advantage over the next year. China's economy appears to be recovering even as many resource-rich countries are struggling. "In countries where there are high levels of indebtedness or civil unrest, China could be a beneficiary in a geo-strategic sense by contributing to the public goods that help those countries to get back on their feet," as one panelist put it. Another panelist said: "Chinese influence in Africa should be watched closely."

At the same time, the growth of Chinese resource investment could benefit some Western firms, because of opportunities for collaboration. "It is a known risk," a mining sector panelist commented. "If you work with the Chinese, then you either isolate sensitive information or you share. It is a question of risk appetite."

Aggressive tax and royalty schemes

The final risk on our 2020 radar is yet another aftershock of the pandemic. During the global downturn of 2020, many emerging markets drew on international bailouts or borrowed heavily – both domestically and internationally. Presumably, some of this debt will need to be paid back.

In countries with few alternatives – and even in the advanced economies of North America and Western Europe – natural resource companies have been a traditional target for revenue-raising.

Mining companies were most concerned. "These [emerging market] countries lack alternatives," said one panelist. "They have poor industrial and manufacturing bases, and tourism has been wiped out." While outright expropriation was seen to be unlikely (although one panelist did note concerns about Indonesia), changes to tax and royalty policies were forecast as countries "look to repair the fiscal damage of COVID."

This risk is discussed in more detail in the essays section below.

Under the radar

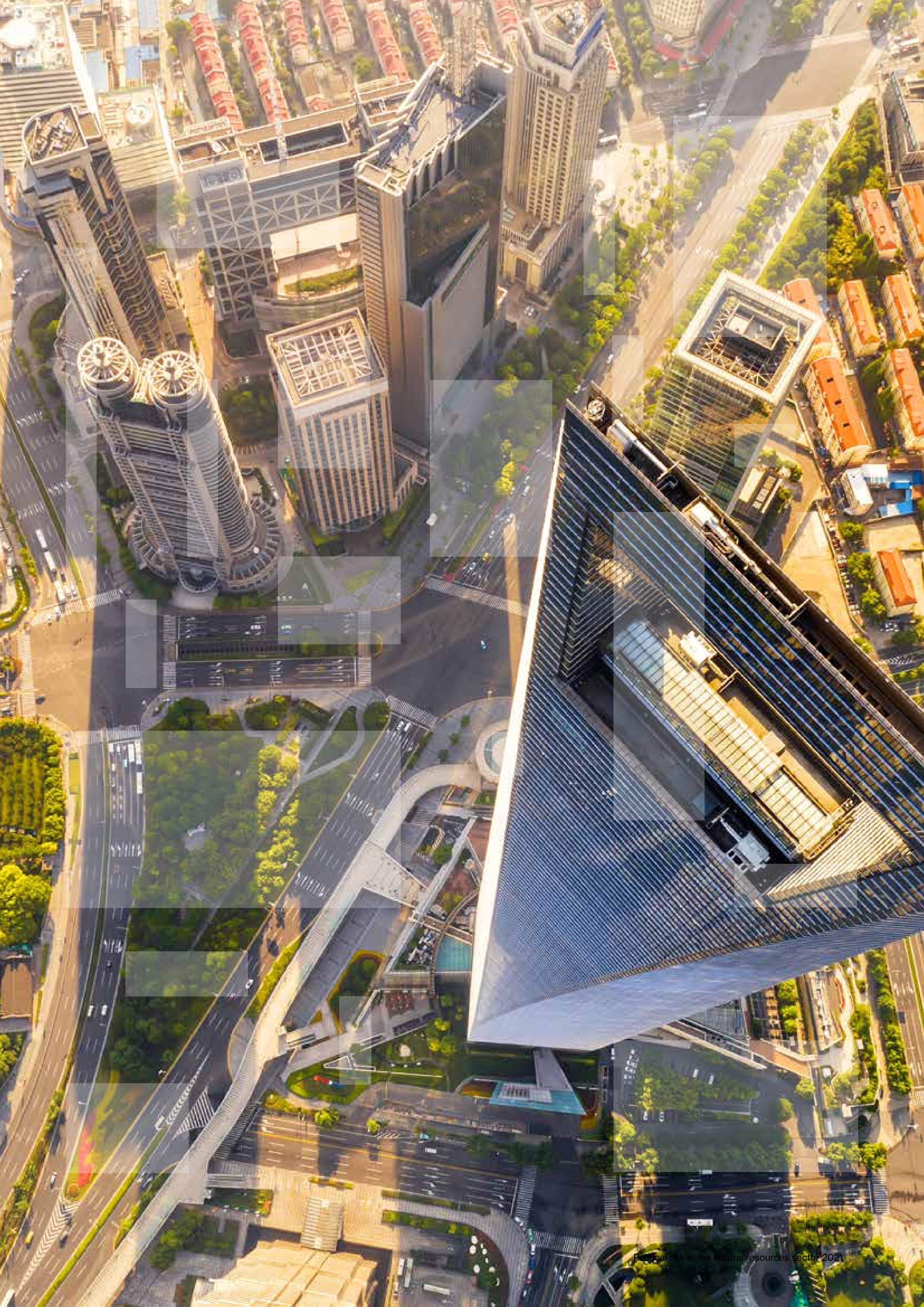
We conclude our risk radar for 2020 by looking at what might be flying below the radar – the risks that might become top concerns tomorrow.

There were a number of intriguing – or perhaps alarming – nominees in this category. Examples included the collapse of global institutions, if the US continued to withdraw its leadership, and possible debt crises in advanced economies.

In the end, however, we chose "state stability in resource exporting countries" as our pick for tomorrow's top concern. The oil price shock of the 1970s led to many risks for global companies in the natural resource sector – most notably a wave of postcolonial expropriations as control of natural resources became increasingly valuable. There were also, however, risks on the way down. The fall in oil prices helped to unleash the emerging markets debt crisis of the 1980s. Arguably, falling oil prices and concomitant fiscal collapse also played a role in triggering mass unrest, and eventually revolution, in Iran.

Might institutionally-weak countries be vulnerable to the current commodity price collapse? Some of our panelists thought so, noting "countries of concern include Angola, South Africa and some in West Africa." Another panelist was most concerned about Russia, noting that the country's highly-educated population might choose to hold their government to account for its perceived failures in pandemic management. "Here is the thing about dictators," the executive commented, "they are good until they are not."

Let us now look at two of the risks on the radar in more detail: "strategic competition between Chinese and Western companies" and "natural resources fiscal policy after COVID-19."



Section 3: Strategic competition between Chinese and Western companies: what could go wrong?

In some cases, Chinese companies and Western companies will be partners in developing promising resource deposits. In others, however, Chinese and Western companies will be brought into competition. In this essay, scholars from Oxford Analytica's expert network develop some hypothetical scenarios about the political risks that could arise for Chinese and Western natural resource companies as a result of this competition. These scenarios are inventions of the experts and not intended to refer to any specific company or companies. The views expressed do not necessarily reflect those of Willis Towers Watson.

Scenario background: capital matters

Although the emerging market bond markets have reopened since seizing up in March 2020, several defaults – including in Argentina, Ecuador and Lebanon – have occurred since then and, in the longer term, market financing remains dependent on global dollar liquidity conditions and risk appetite. By contrast, government financing offered by China may play a counter-cyclical role in the difficult year ahead, with surplus capital available through China's state-owned banking system, with China Development Bank or China Ex-Im Bank the most visible actors. These inflows could represent a financing alternative for developing world governments that typically rely on sovereign bond markets or programs sponsored by the IMF and World Bank.

Falling commodity prices have led to a deteriorating budgetary position for resource exporting nations and a need for such alternative sources of financing, which could include dollar-denominated credits from mainland China secured against the recipient's natural resources. Countries in dire fiscal straits may be willing to attract capital with incentives that are not available to Western-invested, legacy operators.

Over the longer term, it is worth monitoring the future of the non-dollar payment space, especially if China's move towards a central bank digital currency (CBDC) advances more quickly than expected. Belt and Road Initiative (BRI) countries may be increasingly depend on CBDC payment flows, with highly unpredictable outcomes for commodity pricing and the revenues of natural resource companies operating in the space.

Scenario 1:
Guatemala (Precious Metals)

Trigger

Despite US pressures, the country switches recognition from Taiwan to mainland China.

Immediate fallout

Emergence of infrastructure and logistics companies from mainland-China, offering credit-light infrastructure upgrades.

Mining company impact 1

A Western-invested mining company seeks permits to expand its tailings dam. However, it is informed by the authorities that only contractors from mainland China can be selected to undertake the construction. The switch threatens the existing service agreements with local companies, leading to deterioration in relations with the local community. Operations are frequently disrupted by sabotage, impacting both Chinese and Western miners in the area.

Mining company impact 2

In areas of brownfields exploration potential for the Western company, new players appear with government permission and approval to operate despite environmental concerns previously voiced by the government agencies.

WTW Comment: Political risk insurance can cover property damage and business interruption due to acts of politically-motivated sabotage.

Scenario 2:
Argentina – Juju Province (Lithium)

Trigger

Election of a new local Governor.

Immediate fallout

Permitting suspended over water supply concerns. The Governor organizes a local referendum to determine the longer-term future for the Western-invested facilities.

Mining company impact 1

The company scales back maintenance capital, and downgrades the production profile. Large scale community relations efforts fail to bring the expected results and the outcome of the referendum is uncertain. The Governor states that their administration will support the company in the referendum if the local royalty level can be ratcheted up, in contravention to the original agreements.

Mining company impact 2

As the company seeks federal support and considers its options, one of the federal agencies brings up the recently concocted industrial policy to promote downstream sectors and 'encourage' beneficiation of raw materials within Argentina. The Western company's downstream operations are managed by offtake partners in China. Negotiations begin to attract Chinese capital to build facilities in Argentina, even as the threat of the referendum, which has been delayed, continues.

WTW Comment: Whilst legitimate changes in government policy are not deemed insurable political risks, withdrawal of a permit that is discriminatory against a particular investor, however, is insurable.

Scenario 3:

Papua New Guinea – The Highlands (Gold/Copper)

Trigger

Increase in illegal mining activity.

Immediate fallout

Pit invasions make the operations increasingly risky from a health and safety standpoint. The company, during resettlement negotiations with local landowners, turns to the central government for security guarantees.

Mining company impact 1

The company decides to fortify the site – a significant capital expenditure. It invests in fencing, CCTV and drones with night vision. However, the relationship with the communities gradually worsens and the government proposes deploying an army unit (at the company's cost), a measure previously employed to protect Chinese logging companies operating elsewhere in the province.

Mining company impact 2

The security situation requires constant monitoring and adds significant cost. Power lines, which extend far behind the company's concession are interrupted by unknown actors. The company has an insufficient power back-up capacity and needs to invest in a much larger diesel-powered generation capacity. At the same time, access to greenfield exploration ground is becoming too dangerous for geologists and the company is unable to replace depleted resources. To offset its deployment costs, the government demands that the company opens a sizable head office in the capital. A list of prospective local employees is presented to the company.

WTW Comment: The relevant risk here relates to the actions the government may take if the company refuses to open the new office as requested. Retaliatory measures, including cancellation or revocation of concessions, mining licenses and/or export permits, could have a significant impact on the viability of the project.

Scenario 4:

Tanzania (Copper/Gold Concentrate)

Trigger

As a member of the BRI, Tanzania adopts CBDC.

Immediate fallout

CBDC, a blockchain-based digital payment system, allows China to internationalize its currency without fully liberalizing the Yuan (CNY). Dar es Salaam is issued digital CNY accounts by the People's Bank of China. The Tanzanian government agrees that prices of certain goods and services exported by Tanzania to China will be denominated in the units of this currency.

Mining company impact 1

As a foreign exporter of commodities out of Tanzania, the Western-invested company must obey the new ruling. As a recipient of generous credits from China, Tanzania has accumulated significant CNY-denominated liabilities, which are now redenominated in CBDC. The company attempts to negotiate an exemption with the Ministry of Mines for copper concentrate, but Dar es Salaam is keen to accumulate CBDC-denominated assets to offset its non-dollar denominated balance of payments deficit. The government insists that even if Western intermediaries are involved, the invoicing must be made in CBDC.

Mining company impact 2

Given the fluctuations in the exchange rate between the US dollar and the CBDC, the mining company is unable to price its cash flows accurately. The board debates whether to re-denominate operating and sustainable capital costs in CBDC, instead of the basket of dollars or euros. The company looks at selling the product directly into LME's inventories at a discount, rather than to the market.

WTW Comment: Political risk insurance can cover the inability to transfer currency out of a country. A political risk policy can also be structured to cover financial losses arising from forced conversion of currency ("Pesification"). Losses due to exchange rate fluctuations, however, cannot be covered except under very specific circumstances (for instance, a sovereign default that occurs due to a currency crisis).

Scenario 5:
Burkina Faso (Gold)

Trigger
Changes to the Mining Code.

Immediate fallout
A Western company's operating license is coming up for renewal. The company is told that parts of the concession must be relinquished due to insufficient exploration spending in the preceding period.

Mining company impact 1
The areas are highly prospective, and the government's demand is not aligned with the Mining Code, under which the agreement was originally signed with the government. The company is told that the changes to the Mining Code apply retroactively and the original agreement cannot be evergreened.

Mining company impact 2
China-invested competitors enter the country through direct negotiation with the government, outside the scope of the Mining Code. This means that surface rights, subsurface rights and forestry permits are all commingled for the new entrants, which is not the case for the legacy operators, who operate in accordance with the Code. In order to have its operating license renewed, the Western company relinquishes the prospective exploration ground, which is snapped up by the Chinese competitors.

WTW Comment: As noted above, discriminatory government actions can be addressed using expropriation cover. As soon as the company suspects something is amiss, it should contact its broker to be guided through the claims process.

Scenario 6:
Zambia (Copper)

Trigger
A Western-invested mining company decides to sell one of its two assets in Zambia to another operator which is confident of its turnaround plan for the operation. The government blocks the transaction.

Immediate fallout
The operation has been cash flow negative for several quarters. In theory, the current operator has the right to sell the asset, but the government is imposing additional conditions.

Mining company impact 1
The operators' other (and profitable) mine suddenly encounters problems with customs clearance and exports procedures on the way to Richards Bay in South Africa, from where the product is shipped. The renewal process for water discharge permits has also been suspended.

Mining company impact 2
The government demands a fee to permit the asset transfer to the new owner. The prospective buyer announces it is weighing the costs of paying a break fee to withdraw from the transaction. The seller continues to hemorrhage cash on the unprofitable operation. It plans to put it on care and maintenance. The government withdraws the export license. The company's only remaining option is to arrange for a swap arrangement with a Chinese mining company that operates freely in the country and does not encounter any export restrictions.

WTW Comment: The government actions covered by expropriation insurance can include inability to export, forced divestiture, and many other perils. The policy can also be extended to offer non-honoring of an arbitration agreement – in case the relationship with the host country breaks down to such an extent that an arbitration is required, and the government fails to pay an award made against it.

What risks will natural resource companies face following the pandemic?

By Stuart Ashworth

Global Director of Political Risk for Corporates, Financial Solutions Willis Towers Watson

Financial Solutions

The global pandemic has led to dramatic changes in political and economic circumstance. Resource rich nations, which are dependent on strong and stable global demand for commodities and international trade, are particularly exposed.

It is not uncommon (or for that matter illegal) for governments under stress to unilaterally amend contracts, but it is essential that foreign companies are given adequate channels for complaint and given fair compensation for a breach. In the event that there is a breach of contract with no compensation paid, financial losses (be that through restrictions in capital mobility, or business losses arising from overt political action) are all but inevitable. A political risk insurance policy may well provide some certainty in an increasingly uncertain world.

I will review some of the possible responses to the pandemic by host governments, and the coverages that can address the relevant risks.

Resource nationalism

Given how resources have been unevenly distributed around the world, resource nationalism has always been a feature of this sector. In the recent past, governments with limited budgetary resources have embarked on a process of privatization to boost their treasury coffers.

Political responses are more difficult to predict this time. The global financial crisis exposed inequality, and a growing fear of foreign competition coupled with a feeling of social injustice has arguably driven populism. This populist phenomenon is now, in some countries, being accelerated by COVID-19. Unfortunately, resource nationalism is frequently the rallying banner of a populist or autocratic regime.

In this moment of crisis, people are looking to their own governments for strong decisive action. Pandemics can lead to xenophobia. Anti-foreign sentiment can be fertile ground for the seizure of assets and the redistribution of wealth (be that repurposing of assets or the full nationalization of assets). Populist governments may sometimes become autocratic governments who use COVID-19 as an excuse to crack down on civil liberties and quell political opposition. With few economic levers to pull, emerging market governments will want to ensure they maximise returns from their depleting natural resource reserves.

Economic distress

We are now standing on the cusp of an emerging market sovereign debt crisis, as emerging markets have become economically vulnerable, and turned to global lenders for bailouts. We have seen defaults or restructuring in Lebanon, Ecuador, Argentina, Belize, Suriname and now Zambia. Even in those countries not at immediate risk of default, tourism revenue will drop, tax revenue will reduce, and medical expenditure will need to increase. This will further strain already stressed economies.

In some cases it may as a result be difficult to transfer funds from host countries, or those host countries may look to renege on, or renegotiate contracts.

In a market where cash is king, currency inconvertibility and exchange transfer cover will ensure monies are not captured or trapped onshore. Contract frustration cover can also help to ensure companies recoup financial losses sustained by contractual defaults.

Political unrest

We have also seen a steady rise in politically motivated conflict, from violent street protests to the threat of civil war or the occurrence of actual war. Even if a country avoids large scale conflicts, social division, protests and/or labour disputes can easily escalate, and the financial consequences which arise, either through physical damage or the interruption in activity, can be severe.

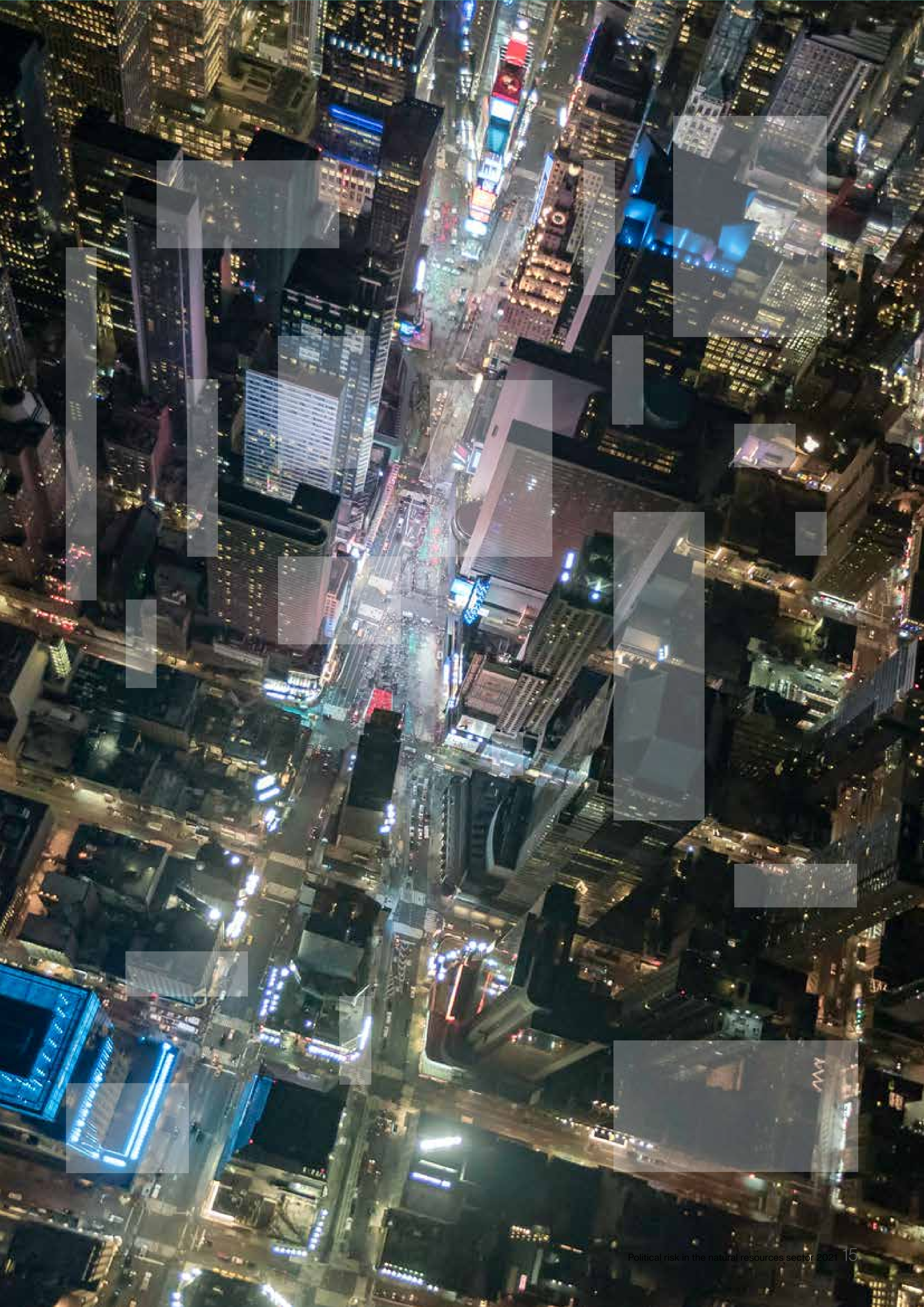
Conclusion

Political Risk Insurance was born out of the 1970's which saw a spike in political risks and nationalisations. Globalisation and the removal of trade barriers meant that some types of political risks had been in steady decline ever since.... until recently.

Populism, COVID-19 and the rise of extreme politics has led to a tear in the worlds' social fabric. We have seen the outbreak of violent social division (often fuelled by social media); and we are experiencing political and economic dislocation leading to a debt and currency crisis.

With much of the world distracted by fires on the home front, there is noticeably less scrutiny being given to actions of foreign Governments, and at the moment the rewards on offer appear to far outweigh the risks.

There has never been a more important time to measure these risks, to manage the risks which can be managed and to mitigate those that can't.



Section 4: Natural resource fiscal policy after COVID-19

In this essay, scholars from Oxford Analytica's expert network assess the risks and opportunities for natural resource firms arising from the fiscal shock to resource-rich host countries associated with COVID-19. The views expressed do not necessarily reflect those of Willis Towers Watson.

An unprecedented shock

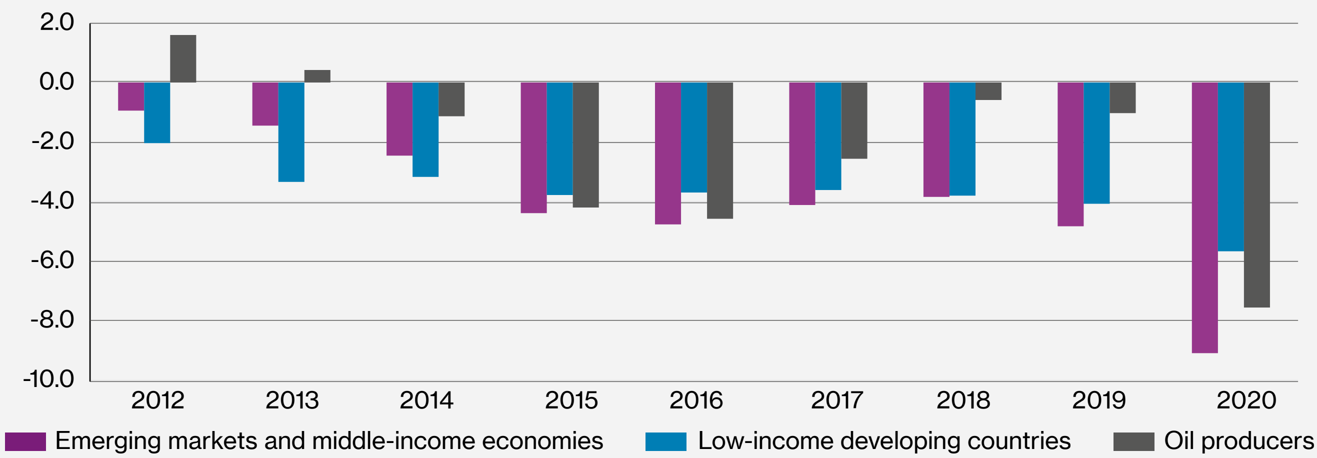
Historically, global recessions have tended to do less damage to emerging markets and developing countries (EMDCs). Many EMDCs have been less exposed through financial or trade channels to affected countries, and previous EMDC crises have tended to be in a particular country or region with, in most cases, only limited contagion.

By contrast, the economic impact of COVID-19 is truly global. The economic shock has been particularly acute in EMDCs because remittances, tourism and commodity exports – all of which have suffered as a result of the pandemic – tend to be larger drivers of growth. While remittances and prices of commodity exports have improved since April, they are unlikely to return to pre-pandemic levels in 2021.

Historically, EMDCs have been unable to expand fiscal policy as aggressively as developed economies because they lack deep capital markets to absorb debt issuance. Many people in EMDCs save in foreign currency bank accounts and capital flight is a risk if investors and savers deem their government policies irresponsible.

Perhaps partly as result of the unprecedented pressures of the pandemic, however, EMDCs have dramatically increased spending relative to historic trends. The IMF sees the average fiscal deficit in EMDCs doubling to around 10% of GDP during 2020, pushing public debt towards two-thirds of GDP, from 53% in 2019.

Fig 2 – IMF Fiscal Monitor, latest government budget, % of GDP, 2012-20 (projections for 2020)



Source: IMF Fiscal Monitor, https://www.imf.org/en/Publications/FM/Issues/2020/09/30/october-2020-fiscal-monitor

Some good fortune

Why has this fiscal expansion by EMDCs been possible? In part, because of some good fortune, along with international generosity.

The good news is that interest rates are ultra-low globally, and EMDC sovereign spreads have recovered since March/April. Traditionally when facing an economic crisis, EMDCs tend to raise interest rates to curb capital outflows and inflation. This time, many EMDCs have been able to simultaneously cut rates and raise debt internationally. The response of the major central banks in Japan, Europe and North America has underpinned global liquidity and provided a market for the record 124 billion dollars of EMDC sovereign bond issuance in January-June 2020. Dollar weakness is also protecting EMDC currencies, and dollar indebted EMDCs, from higher debt payments.

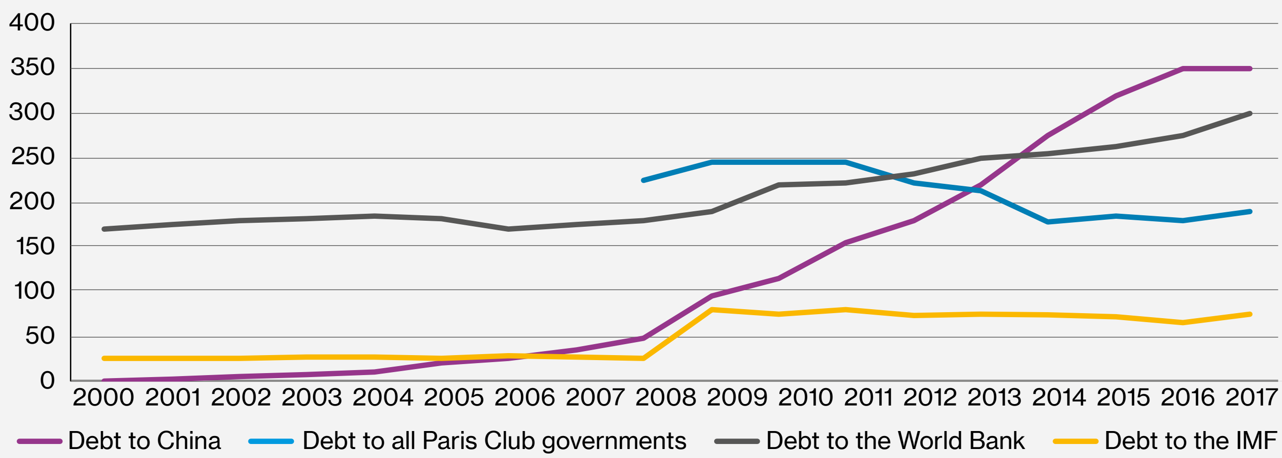
International assistance has also played a role in enabling EMDCs to respond to the crisis without suffering payment defaults. More than 100 countries have asked the IMF for support. The Fund has a lending capacity of 1 trillion dollars and still has close to 800 billion dollars to-hand, with only 250 billion dollars currently deployed. A 500 billion to 1-trillion-dollar SDR allocation under consideration, but US opposition makes it unlikely.

Other international institutions and development banks have pledged support for EMDCs, including 160 billion dollars from the World Bank. Sums promised by the regional development banks are smaller.

Another move that might help EMDC through the current crisis would be for credit rating agencies to consider a moratorium on ratings to minimize the stigma of debt restructuring and ease government fears that a downgrade would increase the cost of accessing global markets, or even prevent it altogether. However, the problem with pausing the issuance of rating is that restarting them could destabilize the recovery, making this option unlikely.

Seventy-six low-income countries are eligible for a G20-sponsored debt services suspension initiative (DSSI). These countries owe about 500 billion dollars in long-term public external debt, and half are already struggling to service their debts. The DSSI only offers relief from 2020 payments and extending it to provide a multi-year respite that countries could use to restructure their debts will require difficult negotiations between a diverse group of lenders that includes not only the main multilateral institutions, but also Paris and non-Paris Club countries (notably China) and the private sector.

Fig 3 – Aggregate external public debt owed by developing countries to various creditors, billions of dollars



Source: IMF Fiscal Monitor, https://www.imf.org/en/Publications/FM/Issues/2020/09/30/october-2020-fiscal-monitor

Spare a thought for the (relatively) rich

G20-sponsored debt relief does not include middle-income countries, such as Brazil, Turkey or Thailand. As banks and corporations find it more difficult to service and roll over external debts, more of these countries may need to seek global support – especially from the IMF.

For now, many of these countries have found some relief by adopting unconventional monetary policy. Colombia, Chile, Indonesia, Philippines, Thailand, South Africa, Turkey, Hungary, Poland and Romania have already initiated quantitative easing (QE), and more countries may follow.

To be sure, EMDC central banks have no experience of QE and will have to be careful to maintain credibility with investors. Acknowledging this need for credibility, Indonesia has announced the size of its program, around 2.5% of GDP, to reassure markets, and the Philippines has announced that its scheme will last no more than six months.

Another concern is that EMDCs have less developed savings systems, so local banks are largely buying the extra bonds, which risks crowding out private lending. QE will bolster financial stability and raise funds, but banks will be cautious of the risk of investor nervousness and outflows.

Opportunities for the natural resource sector

Over time, some of the conditions that have assisted EMDCs in weathering the shock from COVID-19 will reverse. At that point, some countries will come under severe fiscal pressure and may look to natural resource fiscal policy to make ends meet.

In some respects, these fiscal policy risks may be highest in advanced economies. Advanced economies (and China) have benefited from introducing more than 9 trillion dollars in fiscal stimulus and over 5 trillion dollars of liquidity, with many major economies spending more than 10% of GDP. In resource-exporting countries such as Canada and Australia, post-crisis fiscal consolidation efforts may involve aggressive changes to tax and royalty regimes for oil and gas or mining.

In emerging economies, early signs suggest the opposite approach: efforts to attract foreign capital are resulting in more attractive fiscal regimes for natural resources. For instance, South Africa's mining industry contributed 8% of South Africa's GDP last year, down from 20% three decades ago, and the government is seeking to rejuvenate its mining industry to help counter the economic devastation wrought by the pandemic. The government aims to halve the time it currently takes to secure all mining, prospecting and environmental licenses and is taking steps to incentivise exploration.

Seeking to diversify from its dependence on oil, Nigeria wants to see mining grow tenfold to account for 3% of the economy within five years. The government aims to accelerate the development of 50 mines, slated to be in operational by 2023, thus making up for the time lost due to COVID-19.

In the DRC, the government is restarting the disbursement of VAT refunds owed to mining companies, a point of friction between the two sides. Although Kinshasa faces many calls for public sector spending at present and the refunds potentially total hundreds of millions of dollars, it sees this a positive move in terms of the new investment it will open for a crucial sector.

Other initiatives include cuts or deferrals in payroll taxes, which contribute a significant proportion of total government payments (e.g., 14.6% of Zambia's total government revenue); although this has not yet been transformed into formal policy drafts.

Risks for the natural resource sector

That said, there are also significant risks for the resource sector. The economic shock associated with the pandemic has reduced foreign reserves in many EMDCs. Another bout of capital flight might see some middle-income countries 3-6 months away from considering capital controls. Few countries have been willing to impose such controls in recent decades, but discussion of their possible use is gathering pace in EMDCs.

Fitch ratings downgraded a record 33 sovereign ratings in the first half of 2020 and placed another 40 on negative outlook. Recession and rising public debt could put many EMDCs economies at risk of edging close to, or into, debt distress, beyond those already in restructuring or crisis. Thailand, India, Turkey, Indonesia and Malaysia each must repay more than 50 billion dollars by end-2022. If either global liquidity conditions or dollar weakness reverse, these sovereigns may face significant difficulty.

Paying the unprecedented bill of this crisis will require unconventional policies but authorities will be nervous of introducing policies that could be perceived as irresponsible internationally. This bind could result in rating downgrades and less market access.

Moreover, the new borrowing will increase interest payments, crowding out spending on social services, education, research and infrastructure – especially over the longer term, as global liquidity conditions become less favorable and higher interest rates, or a stronger dollar, make debt servicing more expensive. Academic research has indicated strong correlations between fiscal tightening and political instability, including riots, strikes, political assassinations, and violent overthrows of governments. When the unprecedented increase in fiscal stimulus by EMDCs is reversed, there may be severe political consequences.

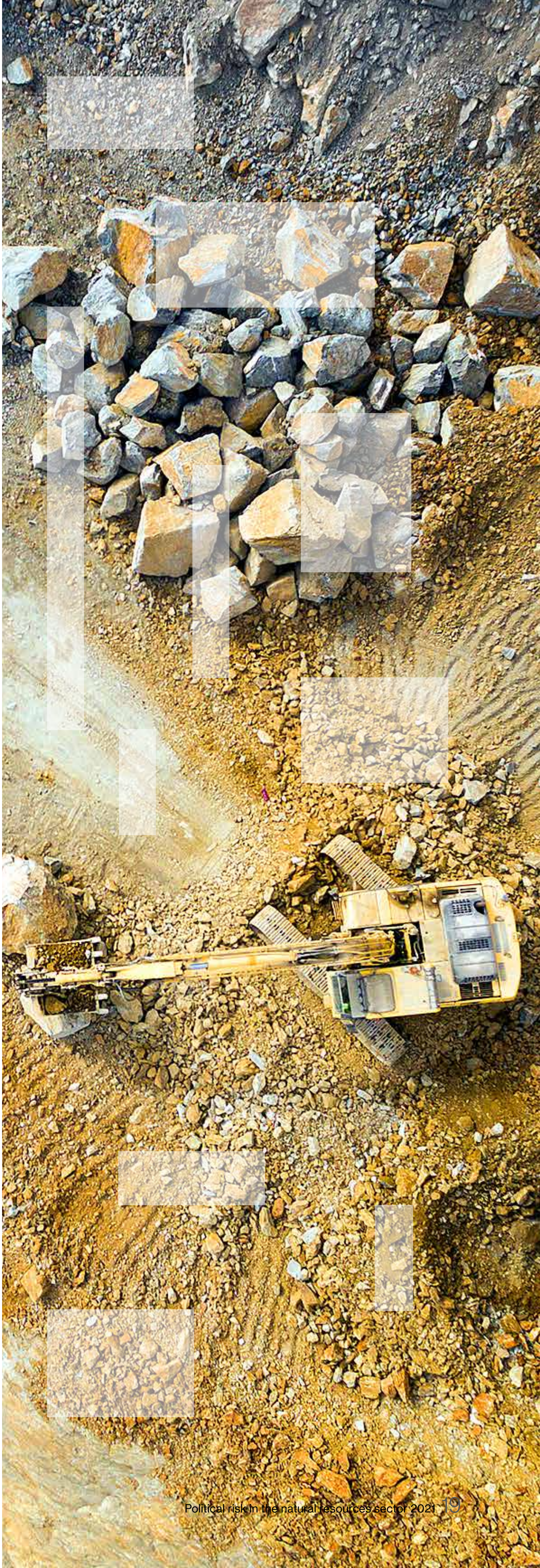
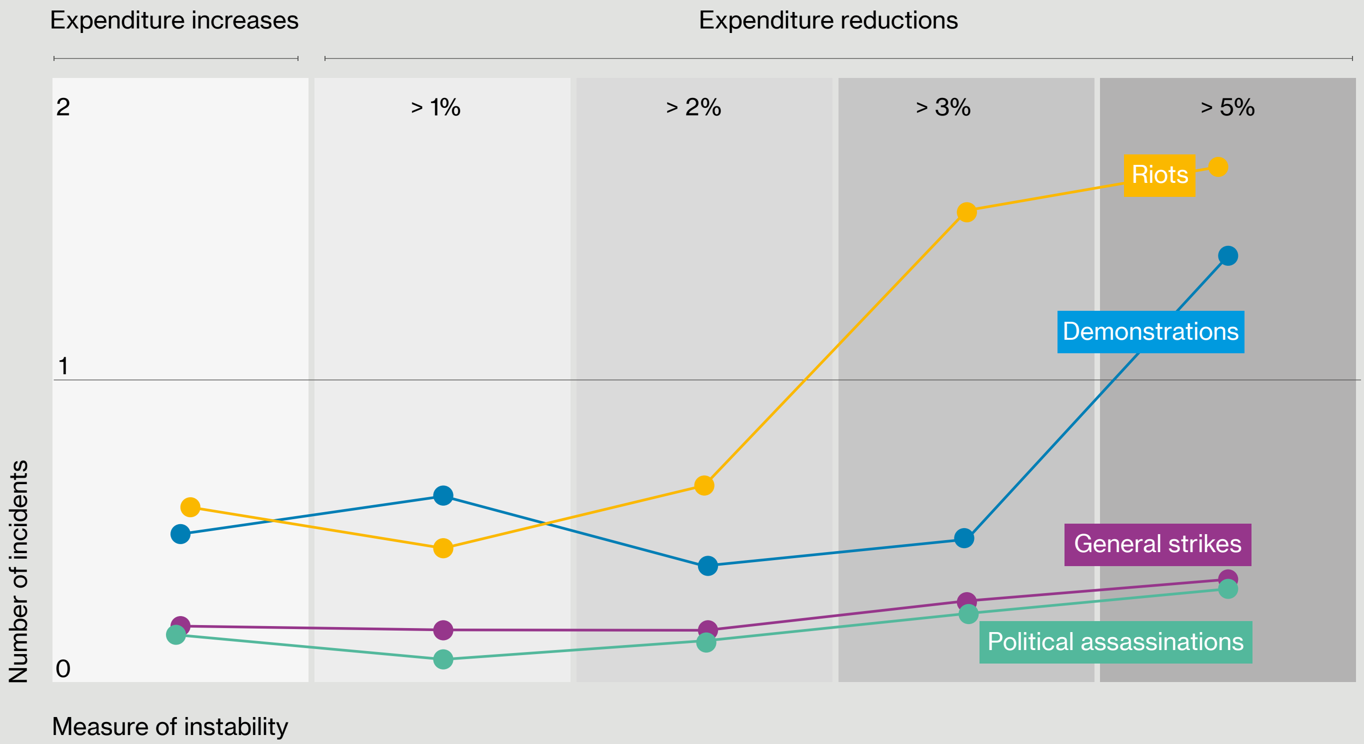


Fig 4 – Correlation between fiscal tightening and political instability



Sources: Oxford Analytica based on "Tightening Tensions: Fiscal Policy and Civil Unrest in Eleven South American Countries, 1937-1995 (2012)" by Hans-Joachim Voth; and "Austerity and Anarchy: Budget Cuts and Social Unrest in Europe, 1919-2009," by Jacopo Ponticelli and Hans-Joachim Voth (2011)

Tighter budgets after the pandemic could create a difficult political landscape in which budgetary priorities require a degree of austerity that triggers a rise in social unrest. Many countries could also face the risk of a public-debt crisis – particularly if key international assistance programs are not renewed in 2021.

Vulnerable countries include those:

- Where political instability is already evident.
- Institutions are weak.
- Debts are high, or large repayments are due in the near-term.
- Tourism, remittances or commodity exports are a key engine of GDP growth.

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