Risk & Reward

After 1989, Austrian companies were among the first to invest in Europe's "Wild East." But in assessing political risk, they have to up their game

by **Marcus How**

The strategy had seemed foolproof. When Austrian capital flooded the former Eastern Bloc after 1989, one of the main products offered by the banks were loans denominated in foreign currency – namely, euros or Swiss francs. In exchange for hedging against currency fluctuation, banks were able to reward borrowers with lower interest rates. The assumption was that these countries would eventually join the euro; these FX loans would pave the way.

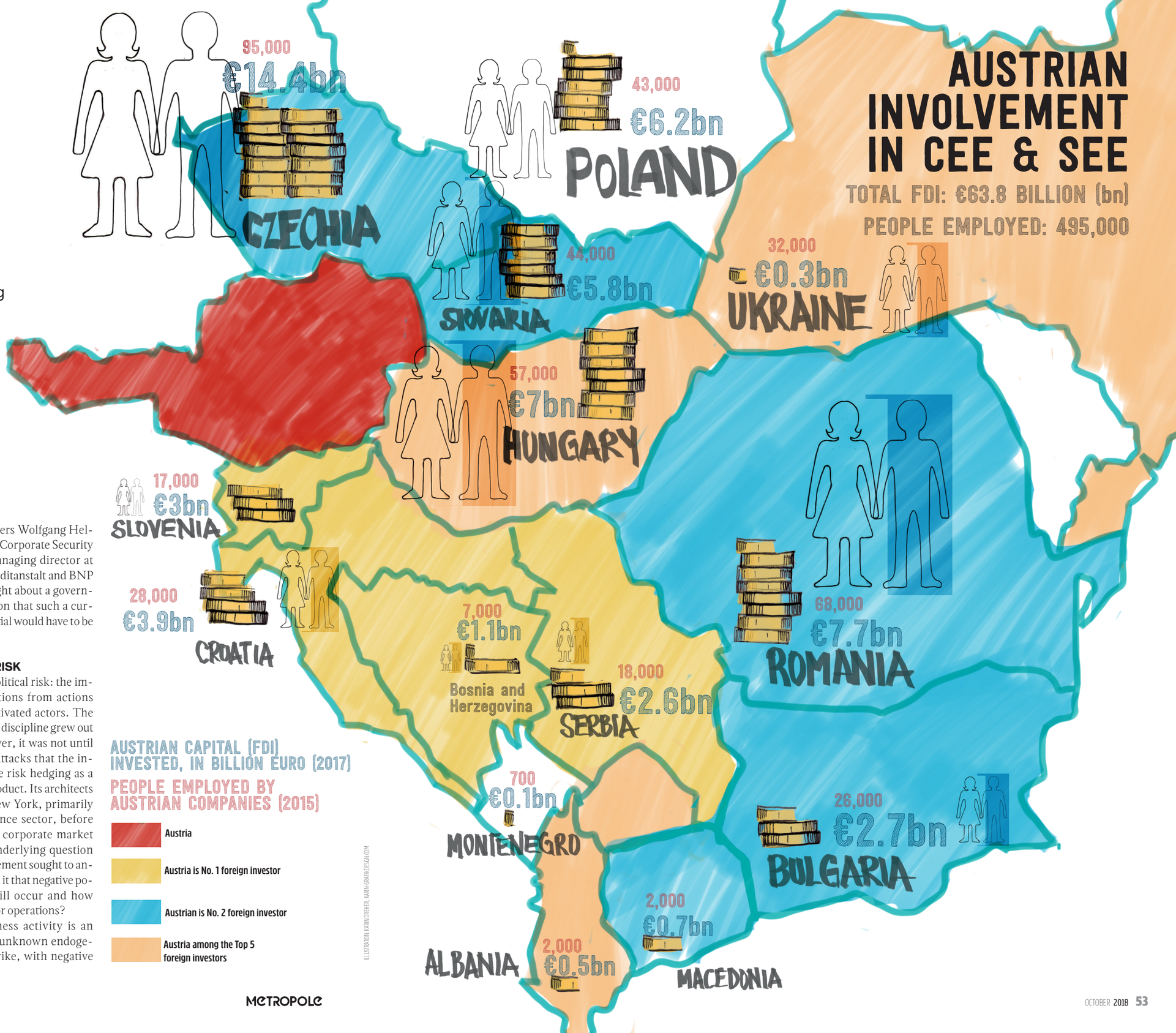
Then came 2008, when the financial crisis caused local currencies – the forint, the zloty, the leu, the kuna – to plunge relative to the euro and the mighty Swiss franc. Borrowers were simply unable to service their loans. In Hungary, the share of FX-denominated loans was particularly large, amounting to 28% of GDP. Back in government in 2010, Viktor Orbán's Fidesz party moved fast, enacting measures to convert hundreds of thousands of FX-denominated contracts into forints at a predetermined rate.

The measures cost the banking sector some €2-3 billion, with much of the burden falling on Austrian banks. This was an outcome no one had predicted: Analysis had been "primarily from a macroeconomic point of view," remembers Wolfgang Helpa, managing partner at Corporate Security Alliance and former managing director at (then) Bank Austria/Creditanstalt and BNP Paribas. "Nobody thought about a government imposing legislation that such a currency exchange differential would have to be picked up by the banks."

DEATH, TAXES AND RISK

It was a classic case of political risk: the impact on investor operations from actions taken by politically motivated actors. The study of political risk as a discipline grew out of the Cold War. However, it was not until after the 9/11 terrorist attacks that the industry began to package risk hedging as a cohesive commercial product. Its architects were in London and New York, primarily serving the (re-)insurance sector, before expanding to serve the corporate market more generally. The underlying question that political risk management sought to answer was, how "likely" is it that negative political developments will occur and how could these affect investor operations?

Central to any business activity is an acknowledgement that unknown endogenous variables could strike, with negative



Austrian companies eagerly invested in Central, Eastern and Southeastern Europe, building many successful businesses like Erste Group's Česká spořitelna. But they underestimated political risk. Risk analysis benefitted from the theories of Austrian-born economists such as Friedrich von Hayek, above, or Ludwig von Mises.

consequences. Historically the consideration of "risk" is a deep societal and economic phenomenon. Strategies were developed as early as ancient Mesopotamia, when lending activities were recorded on clay tablets to monitor the risk of nonpayment.

During the Renaissance and the Enlightenment, most scientists believed that it was theoretically possible to acquire absolute knowledge. But this paradigm was shattered by the dramatic tumble from the Belle Époque into the 20th century, demonstrating that progress doesn't necessarily follow an upward trajectory, that chaos and uncertainty pulse beneath the veneer of prosperity. With Gustav LeBon's analyses of crowd behavior, Sigmund Freud's theories of the unconscious as well as John Maynard Keynes' and Frank Knight's pioneering work on risk, people were now understood to be innately irrational, and the Enlightenment ideal of "certainty" seemed like a mythical pot of gold at the end of the rainbow.

It is in this light that risk, including its political variant, is understood today. Still, this understanding of risk – and its management – is deeply rooted in classical liberalism. "The idea of risk management emerges only when people believe that they are to some degree free agents," writes American economist Peter L. Bernstein. Risk may be unavoidable, but the outcome is not.

IGNORANCE IS TEMPORARY BLISS

As a free-marketeer, Bernstein partly drew from the Austrian School of Economics, from the ideas of Ludwig von Mises, Friedrich Hayek, Joseph Schumpeter, Karl Popper, and Peter Drucker. But like many Austrian intellectual exports, such thinking was and is not deeply embedded in postwar Austria itself. "These general concepts are not broadly known to executives," says Helpa, who currently instructs board members in professional risk management at the Donau-Universität Krems.

Richard Grieveson of the Vienna Institute for International Economic Studies (wiiw), sees this as part of a pattern: "Austria has [tended] to stick rigidly to individual disciplines, not… willing to think in an interdisciplinary way. So people in finance would not be willing to think about the linkages with the real economy or politics."

It's an odd blind spot given that, over the past century, political risk has materialized here in such dramatic ways. The dismemberment of the Austro-Hungarian Empire hit the imperial business giants hard: Erstwhile clients disappeared behind newly erected national borders; supply chains were shattered; assets were nationalized and expropriated; national currencies supplanted a single currency; imperial citizens suddenly found themselves stateless, prompting waves of migration – with the looming specter of totalitarianism just down the road.

This trauma was blocked out by a collective amnesia. Indeed, when the Iron Curtain fell in 1989, Austria – by then a prosperous, stable frontier state – was presented with a fresh opportunity. Its banks and corporations flooded into CEE, their capital fueling the development of aspirant capitalist states. The immediate risk may have been high, but it was thought this would decrease as these states converged with Western Europe.

As the Hungarian case showed, this was wishful thinking.

A decade later – with foreign currency loans unilaterally restructured by several CEE countries, with Austrian banks and corporations exposed to the crossfire of the Russian invasion of Ukraine and the sanctions that followed, and Turkey tanking into chaos – there are surely lessons to be learned.

As the Austrian National Bank (OENB) governor Ewald Nowotny said in 2009, "One of the main reasons we are in the mess has been a general misperception of risk."

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A MORE COMPLEX PICTURE

However, the image of Austria venturing complacently into CEE is as inaccurate as it is unfair. Austrian investors were able to become a systemic presence in CEE precisely because they knew how to navigate the various risks and hedge against them. In the case of the corporate sector, political risks are even often cost-free, with the Austrian Control Bank (ÖKB) underwriting some 95% of exports.

The ÖKB is not a child of the post-communist era; founded in 1946, it was already underwriting risks when Austrian exporters were trading with the Eastern Bloc. Nor is it the only component in Austria's (admittedly piecemeal) risk management infrastructure: The Ministry of Foreign Affairs continues to publish risk ratings and cooperates with the ÖKB, while the wiiw itself was established in 1973 to track economic developments in CEE.

The expertise gained during the Cold War era, when Austria was a neutral country on the edge of the Iron Curtain, afforded Austrian businesses and investors after 1989 an early movers' advantage. The geographical position, institutional expertise and long-standing networks were huge competitive advantages. According to wiiw data from 2016, Austrian capital is long since part of the system: The country is the third largest investor in the CEE countries that are part of the EU, amounting for 9.2% of its foreign direct investment (FDI), and with 11%, the second largest in the western Balkans. "Many years before the Iron Curtain fell," said Helpa recently, "a very dense network of business relationships was formed. We knew the people and the standards, so we felt at ease."

Helpa recalled a trip to Budapest in the 1990s: "I had a standard meeting with the Hungarian Central Bank and with an American CEO for a joint venture. Friendly, cooperative, it was fine; I went out very satisfied. But the CEO was shocked: Were they really the sort of people with whom we would want to do business? – and I said yes, because there's no one else around! And that's why you only see Austrian, and to a lesser extent, French and Italian, banks [in CEE]. No German, no British, no Americans, no Swiss."

This was not because Austrian investors were more happy-go-lucky; rather, knowledge of the markets and a sense of the mentalities at work, reduced the biggest risk: that of ignorance. Corruption, political instability, weak rule of law – these were political risks Austrian investors were prepared to swallow.

"Is it sufficient?" Helpa wondered. "On a standalone basis, no." Johannes Leitner of the Competence Centre for the Black Sea Region (CCBSR), a political risk platform, agreed. "So far, a systematic implementation of political risk management tools has been rather sporadic," Leitner said. They are now preparing a large quantitative survey to shed light on this exact issue.

A MODEL MADE IN AUSTRIA

Leitner and his business partner, Hannes Meissner, are tireless pioneers of political risk management in Austria, with a model organically developed as an Austrian-flavored version of the Anglo-Saxon variant.

In developing their product, Leitner and Meissner have used their academic backgrounds for theoretical and logistical support. Their methodology is unique, digging into issues like "systemic nepotism," "systemic corruption" and "institutional ambiguity" – that is, understanding those power networks and stakeholders that can capture a state or an economic sector in ways not immediately visible to outsiders. There is a qualitative aspect to this that cannot be captured by quantitative international benchmarks or overstretched analysts sitting in London, Paris or New York, upon whom many international investors rely.

Georgia is a classic example, a country that rose quickly through the international rankings of quality governance as Mikheil Saakashvili's government enacted a raft of legislative reforms in the wake of the 2003 Rose Revolution. Less visible was how Saakashvili's associated business interests consolidated on the state level and in certain sectors.

Despite the unique methodology, Leitner notes the challenge in persuading investors, not just Austrians, that "a strategic and proactive political risk management could help prevent negative scenarios." Dealing with crises as they arise is not sufficient, and rarely leads to competitive advantage.

Grieveson underlines the necessity of risk management, particularly in CEE: "The tectonic plates have definitely moved in the last 10 years," he says. "I think that, so far, many people have failed to understand what has happened. Why in Poland, for example, which on various economic metrics is the great post-communist success story, are so many people unhappy, and why do they have the government they have? Why do people in most of CEE think so differently about refugees to those in Western Europe? Why does only a quarter of Czechs want to join the euro? These issues matter a lot."

With thanks to George Santayana, those who do not study risk will be putty in its hands. Ⓜ

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