The World Bank is committed to re-activating existing production facilities in its client countries by allowing those facilities to obtain the necessary inputs and financing for production. To this end, the World Bank has developed the Political Risk Guarantee Facility (PGF), which provides access to foreign capital, in particular for projects involving existing local enterprises. A PGF is currently operating successfully in Bosnia and Herzegovina, and similar projects are expected to begin in Albania and Ukraine in the coming weeks. This newsletter describes how PGFs operate and how they could be used elsewhere.

Addressing a Barrier to Growth

Local enterprises in transition countries often have the know-how and human resources to engage in productive activity but cannot obtain financing to purchase raw materials, machinery, and other input goods because of the perception of high political risk. This perception prevents foreign financiers from providing capital to fund viable commercial transactions; the resulting shortage of capital constrains economic activity and limits growth. Foreign input suppliers and their banks may be willing to do business with local enterprises if certain political risks could be eliminated. The PGF was designed to do just that (see figures 1 and 2).

For entrepreneurship to grow in countries previously dominated by state-owned enterprises, there has to be an acceptance and clarity regarding the different risks and responsibilities of each “player” in the system. The PGF is based on this principle of unbundling risk. The private sector should be exposed to and should manage commercial risks, while the Government should take responsibility for political risks, which it can control and mitigate. The role of the PGF, therefore, is to enable the private sector to operate without worry about government interference or political risk, as the perception of these risks has a strong negative impact on productive activity.

Guarantee Mechanism

Once the World Bank and the Government have come to an agreement regarding a PGF, a Guarantee Agency is established by the Government to administer it. The Guarantee Agency processes applications for guarantees from the private sector and supports the private sector’s interests. It operates according to a detailed Operations Manual that defines important principles such as which types of transactions are eligible, the policy of first-come, first-served (i.e., guarantees issued in the order that applications are received), and the independence of the Agency’s day-to-day operations.

The Framework Guarantee Contract (FGC) defines the terms and conditions of the political risk cover. Each Guarantee
Contract issued by the Guarantee Agency is based on the FGC. The FGC clearly defines the covered risks for a particular country. For example in Ukraine, the covered risks are:

- war and civil disturbance
- expropriation
- inconvertibility or inability to transfer currency
- cancellation of licenses
- seizure of goods or prevention of their sale
- imposition of new or increased import or export taxes
- government interference with logistical services
- government interference with the repossession of leased goods

Furthermore, the risks covered by a PGF are tailored to fit the particular situation in the host country. For example, the PGF that was set up in Bosnia and Herzegovina provides cover against losses resulting from the imposition of a U.N. Embargo against Bosnia and Herzegovina.

The FGC also spells out the procedures to follow in case a claim arises; it provides for a Cure period, which allows the Government to resolve a situation arising from the occurrence of a covered risk rather than pay a claim. The FGC contains a dispute resolution mechanism in case a claim is not admitted by the Guarantee Agency. This mechanism is based on independent international arbitration according to UNCITRAL rules and is governed by the laws of a “neutral” country.

The World Bank, through a foreign commercial bank, the “Agent Bank,” provides financial credibility to guarantees issued by the Guarantee Agency by standing behind the Guarantee Agency’s commitment to compensate guarantee holders’ loss resulting from a covered risk. The World Bank’s support comes either in the form of an IDA
credit or an IBRD guarantee (see figures 1 and 2). The claims payment mechanism is in place so that the guarantee holder is assured that if the Government refuses to pay (once a claim has been admitted either by the Guarantee Agency or by an independent arbitrator), the Agent Bank will pay with World Bank funds.

### Practical Experience

The PGF has been applied in two countries, Moldova and Bosnia and Herzegovina, and is currently being launched in Ukraine and Albania. The important lessons learned from implementing these projects is that an up-front and in-depth assessment of demand is crucial in the early stages of project preparation. This assessment must clearly demonstrate that political risk is a significant barrier to accessing capital for commercially viable transactions. It is also essential that the Government in the host country be committed to allowing the private sector to do business without government interference. The Government must refrain from making full government guarantees available—in particular for transactions involving state-owned enterprises—because this creates unfair competition for the private sector.

### Additional Features of a PGF

The PGF is a flexible mechanism that can support a wide array of transactions: from simple barter transactions to financial leases to commercial banks confirming letters of credit (see box). PGFs can be cross-sectoral, or sector-specific (i.e., transactions in agriculture and agro-processing, the coal sector, etc.). PGFs have thus far been used for small to medium scale projects but can also be designed to support larger projects. For example, eligible transactions in Albania can be as small as $25,000 but a PGF could potentially cover transactions of $100 million or more. The types and size of eligible transactions depend on the environment in the host country and the sector being covered by the PGF.

The amount of business activity that a PGF supports over the life of the project is a multiple of the size of the facility. This is because funds backing up the guarantees revolve throughout the life of the project such that when a guarantee runs out, the funds can be used to backstop subsequent guarantees. For example, if the average life of guarantees is one year, and a $100 million facility is in place for five years, the total business supported by the facility could reach $500 million.

Furthermore, other donors can contribute to existing PGFs, thereby increasing the size of the facility. The PGF in Bosnia has
doubled in size thanks to contributions from bilateral donors. The World Bank is also looking to find ways of leveraging PGFs by involving private political risk insurers and Export Credit Agencies. The benefits of a leveraging mechanism would be twofold: (i) more business would be generated, and (ii) market players would be brought in to the host country that could eventually take over the role of the PGF.

**Long-Term Host Country Benefits**

The PGF allows the host country to benefit from increased economic activity without having to provide full government guarantees to attract foreign capital. In addition, PGFs can play a key role during a country’s transition period while domestic capital markets are still developing. In the early stages of implementation, the projects supported by PGFs provide essential support to the local banks by allowing them to finance cross-border transactions. Furthermore, PGFs help the host country build its reputation with private sector financiers by establishing a track record of sound commercial business transactions without government interference. The commercial links between foreign and local companies enabled by a guarantee facility can last far beyond the life of the project itself. Finally, the Guarantee Agency is encouraged to expand its services and possibly evolve into a full-fledged export credit agency providing the host country’s enterprises with services similar to those in the OECD countries, when this is justified by the development of the local economy.