2010

World Investment and Political Risk

World Investment Trends and Corporate Perspectives

Investment and Political Risk in Conflict-Affected and Fragile Economies

The Political Risk Insurance Industry

MIGA

World Bank Group
Multilateral Investment Guarantee Agency

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FOREWORD

The mission of the Multilateral Investment Guarantee Agency (MIGA) is to promote foreign direct investment (FDI) into developing countries to support economic growth, reduce poverty, and improve people's lives. As part of this mandate, the agency seeks to foster a better understanding of investors' perceptions of political risk as they relate to FDI, as well as the role of the political risk insurance (PRI) industry in mitigating these risks.

The global economy is emerging from a severe recession that slowed down growth and curtailed capital flows to developing countries. FDI was not spared. Having declined sharply in 2009, FDI flows to developing countries are expected to recover in 2010—but in an uneven fashion. Yet, developing countries are projected to grow nearly twice as fast as industrialized countries, enhancing their appeal to multinational enterprises that seek new markets. Corporate views on investment prospects presented in this report not only confirm this appeal, but also highlight persistent investor concerns about a spectrum of political risks.

FDI continues to be concentrated in a handful of countries. Faced with a vicious cycle of conflict and poverty, many of the world's poorest countries are not able to attract sizeable volumes of such investment, putting their prospects for stability and growth into an even more precarious position.

Conflict-affected and fragile economies suffer from cycles of political violence that are hard to break and from a high probability of relapse into conflict. Steady economic growth and rising incomes following conflict can lead to a substantial reduction in the risk of relapse. FDI is an important element in helping to break that vicious cycle by supporting economic growth and development through the transfer of tangible and intangible assets, such as capital, skills, technological innovation, and managerial expertise.

This report focuses on the role that political risk perceptions play in influencing cross-border investment decisions into conflict-affected and fragile economies. Specifically, the report examines (i) the overall trends in FDI and corporate perspectives regarding political risk in the aftermath of the global financial crisis; (ii) the influence that conflict and fragility have on investor political risk perceptions and investment decisions; and (iii) an overview of the PRI industry in the aftermath of the crisis, and how investment insurance providers, especially multilateral organizations, can act as catalysts to help drive FDI into this group of countries.

The global economy is still in flux, but the outlook for FDI is slowly improving. We hope that this report helps shed additional light on how investors perceive and mitigate political risks in conflict-affected and fragile economies, as well as the role that investment insurance providers, including MIGA, can play in fostering such investment.

Izumi Kobayashi
Executive Vice President

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SELECTED ABBREVIATIONS

ATI	African Trade Insurance Agency
BU	Berne Union
CAF	Conflict-affected and fragile
DAC	Development Assistance Committee
ECA	Export credit agency
EIU	Economist Intelligence Unit
FDI	Foreign direct investment
GDP	Gross domestic product
ICIEC	Islamic Corporation for Insurance of Investments and Export Credit
ICSID	International Centre for Settlement of Investment Disputes
IDA	International Development Association
IMF	International Monetary Fund
MIGA	Multilateral Investment Guarantee Agency
NGO	Nongovernmental organization
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PIF	Palestine Investment Corporation
PRI	Political risk insurance
UNCTAD	United Nations Conference on Trade and Development

Dollars are current U.S. dollars unless otherwise specified.

EXECUTIVE SUMMARY

Political risk remains the top preoccupation for foreign investors operating in developing countries over the next three years, in spite of persistent concerns over the global downturn in the short term. The global economic recession triggered by the financial crisis that has unfolded over the past two years has not spared the developing world. Yet, the fragile and modest recovery now under way is being led by developing countries, which are expected to remain attractive destinations for foreign direct investment (FDI). In light of overt political risk perceptions, the revival of FDI to these destinations calls for continued risk mitigation, including political risk insurance (PRI).

Only a few countries are expected to keep absorbing most FDI flows to the developing world. However, most conflict-affected and fragile (CAF) economies struggle to attract private capital. This is caused not only by the risk of political violence, but also by structural weaknesses. Yet, economic development is an essential component of stability. Together with other types of capital flows, FDI—by providing much-needed financial resources, technology transfer, managerial expertise, and connections to the global economy—can help generate sustained, private-sector-led economic growth, which is a necessary condition for economic development and poverty alleviation. Given the limited availability of skilled human resources in CAF countries, FDI may be one of the critical components supporting this development process, which, in turn, helps prevent a relapse into violent conflict.

Besides examining general FDI and risk perception trends in developing countries, this year's report focuses on CAF economies. It attempts to better understand political risk perceptions and how they influence investment decisions, as well as the role PRI can play in easing the constraints that foreign investors face and in shaping investment decisions.

Although political risk also affects industrialized countries, this report covers developing countries exclusively. Similarly, the focus is on FDI and PRI for long-term investment, rather than on trade insurance or other forms of risk mitigation. Finally, CAF countries were considered as a group. Even though they include heterogeneous economies affected by political violence to varying degrees, it was not always possible to refine the analysis to take these distinctions into account. This report is meant to shed partial light on a broad topic that requires further research.

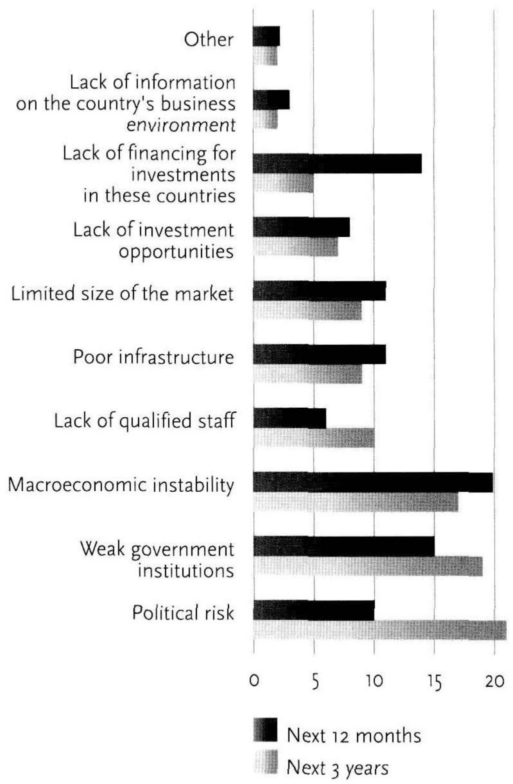
The main findings of the report can be summarized as follows:

Political risk remains a top obstacle to FDI in developing countries over the medium term.

In the short term, concerns over the fallout from the financial crisis appear to dominate investors' preoccupations. Yet, FDI projections and surveys conducted for this report suggest that investors are cautiously optimistic about prospects for a global economic recovery led by the developing world. As a result, FDI to developing countries is expected to recover over the medium term. Investors from the primary industries, as well as those based in developing countries, appear particularly bullish in their investment intentions. As concerns over the health of the global economy recede, political risk considerations will return to pre-eminence for investors from both developed and developing countries.

Ranking of the most important constraints for FDI in developing countries

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

In absolute terms, however, about half the investors surveyed for this report consider that political risk in the developing countries where they operate is not very high, even though a majority reports having suffered losses resulting from these risks.

When considering political perils, corporate decision makers remain most concerned about government interventions that adversely affect the financial viability of their investment, such as changes in regulation, breach of contract, expropriation, and restrictions in currency transfer. This concern confirms results from investor surveys conducted for last year's report.

Conflict and fragility appear to influence FDI through three main channels. As a result, both the composition and role of FDI in CAF economies differ from those observed in other developing countries.

The onset of conflict can affect investment through (i) the possible destruction of assets; (ii) the unavailability of inputs and adequate human resources resulting from the lack of infrastructure and weak institutional and regulatory frameworks; and (iii) abrupt declines in domestic demand, thus leading to lasting impoverishment that persists beyond the end of hostilities. Projects are, therefore, affected to varying degrees depending on sector characteristics, time horizons, and rates of return.

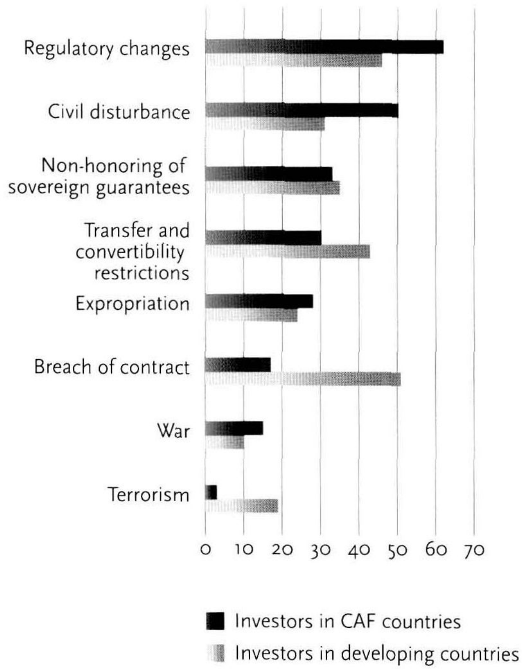
This analytical framework, confirmed in part by econometric analysis and investor surveys, helps explain how FDI flows to CAF economies differ from patterns observed in developing countries. Although the amount of FDI flowing into CAF countries is in line with their global economic weight, it dwarfs other sources of private capital flows such as debt and portfolio investment, which, unlike in other developing countries, are minimal in CAF economies. In addition, FDI flows to CAF countries are heavily dominated by extractive industries.

Investors are primarily concerned about adverse government intervention rather than political violence, even in CAF states.

Respondents operating in CAF and other developing countries alike are more concerned about changes in regulations, non-honoring of sovereign guarantees, currency restrictions, and expropriation than risks of political violence. Changes in regulations not only ranks first among investors' concerns in CAF countries, but also is most frequently responsible for losses in these investment destinations. The risk of civil disturbance, however, is more salient among investors' concerns and more often is responsible for losses in CAF economies than in developing countries in general. The risk of war and terrorism, however, ranks low for both groups.

Political risks of most concern to foreign investors

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010 and MIGA-EIU CAF Investors Survey.
Note: Percentages add up to more than 100 because of multiple selections.

Foreign investors involved in developing countries use a wide range of risk-mitigation techniques to manage political perils. Yet, PRI remains a niche product, in particular in CAF countries. The main reasons cited for not using insurance in these investment destinations are the limited level of risk and low levels of potential losses, suggesting that investors operating in CAF economies may have a higher tolerance for risk. But this finding may also reflect the PRI industry's shortcomings, because a significant minority of investors surveyed cite either that they are not familiar with this type of insurance, or that what is available is inadequate.

Overall, business opportunities in a predictable regulatory environment appear to override concerns over political peril, even in CAF economies. As a result, the availability of PRI does not appear to weigh significantly on investment decisions for most survey respondents involved in CAF countries. Yet, investors in industries such as financial services are more sensitive to whether they can obtain PRI than are those operating in the primary sector. This finding suggests that, although insurance may not result in much additional FDI to CAF countries, it could potentially help diversify the sector composition of these flows.

Multilateral PRI providers have a key role to play not only in directly covering FDI in CAF countries, but also in mobilizing additional insurance in the market.

Outstanding PRI cover in CAF countries is concentrated in a handful of countries that are well endowed in natural resources and has been underwritten by few insurers. Although a number of export credit agencies are restricted by risk ratings and foreign policy considerations, a few private PRI providers have been active in CAF destinations, but mainly in the extractive and energy sectors, partly reflecting the composition of FDI flows.

Because of their ownership structure and mandates, however, multilateral PRI providers are uniquely positioned to encourage investment in CAF countries, to offer some deterrence against adverse government intervention, and to mediate disputes before they turn into losses. They are, therefore, well placed to encourage coinsurance and reinsurance in investment destinations that other insurers may not have otherwise considered, as demonstrated through a number of initiatives targeting CAF countries.

CHAPTER ONE

WORLD INVESTMENT TRENDS AND CORPORATE PERSPECTIVES

Overview

The world economy is emerging from a severe economic downturn, which has taken its toll on private capital flows, including foreign direct investment (FDI).[1] Showing resilience during the initial phase of the global financial crisis, FDI flows to developing countries[2] then dropped by 40 percent in 2009 on average, although South Asia, the Middle East and North Africa, and sub-Saharan Africa were less affected than were other developing regions. This decline was similar to the trend observed in developed countries. Yet, FDI continues to be the largest source of international private capital in the developing world. A small number of countries absorb the bulk of such investment, however.

As the global economic outlook slowly improves, so do prospects for foreign investment. Developing economies, which are expected to grow twice as fast as the developed world, are expected to have a modest recovery in FDI flows. Investors surveyed for this report remain keen to expand in developing countries, particularly in the medium term. Those from the primary sector, in light of rising commodity prices, appear to be the most bullish, together with investors based in developing countries (South-based investors).

Developments in the global economy have only temporarily overshadowed concerns about political risk. Investors from both developed and developing countries rank political perils as the top constraint to investing in the developing world over the next three years. On the one hand, risks related to government intervention—particularly adverse regulatory changes and breach of contract—are considered the highest and are affecting investors' operations the most. On the other hand, the risk of political violence is perceived to be low relative to other perils and to have the smallest impact.

Even though a majority of surveyed investors report having suffered losses resulting from political risk, about half of respondents do not consider political perils very high in absolute terms in the developing countries where they operate. Only one in three investors currently uses contractual risk-mitigation tools—and only 21 percent turn to political risk insurance, opting instead for a range of informal techniques.

Global Recovery and Economic Prospects

Following an acute recession, the world economy has now entered a phase of recovery, albeit not without risks and with a great deal of turmoil and unevenness. Policy challenges have shifted from preventing a collapse of the private-sector financial system, to dealing with risks posed by fiscal positions of several high-income countries in Europe, and to taking difficult structural steps to ensure that the recovery is sustainable. The interventions that stabilized the international banking system and that softened the impact of the financial crisis on the real economy were achieved at great cost. Public-sector deficits and debt to gross domestic product (GDP) ratios among G7 countries have ballooned to levels that have not been seen since the 1950s. At the same time, the health of financial markets, while much improved, remains fragile. The process of reregulation of financial markets has barely begun, and significant additional consolidation and recapitalization, as well as a return of market confidence and credit demand, are required before banks in high-income countries can be expected to step up lending.

In spite of these challenges, the real economy is rebounding out of the 2009 recession. Global industrial production expanded by 9 percent (annualized rate) in the second quarter of 2010, while merchandise trade increased by 22 percent (annualized rate).[3] Global GDP is expected to grow by 3.3 percent in 2010 and 2011 and to rise to 3.5 percent in 2012 (table 1.1).

Developing economies, sustained by buoyant domestic demand, are expected to grow by at least 6 percent a year in 2010, 2011, and 2012—more than twice as fast as high-income countries. Developing countries are expected to generate close to half the annual increase in global demand between 2010 and 2012, and their rapidly rising imports will also account for more than 30 percent of the increase in global exports.[4] As a result, they are anticipated to be a major driver of global growth over the next few years. The combination of the steep decline in activity in 2009 and the relatively weak recovery projected in the high-income countries, however, means that developing economies are likely to be operating below capacity and that unemployment, although on the decline, will continue to be a serious problem.

Economic growth in China and India, which has been underpinning the recovery in the developing world, appears to be slowing as the impact of the domestic policy stimulus and inventory cycle is waning. Other middle-income developing economies, however, are picking up, thanks to accelerating domestic and global demand. Countries in East Asia and the Pacific benefited from close links to China, where a large government stimulus package boosted investment and growth. Similarly, government intervention to mitigate the impact of the global crisis in the Russian Federation has reverberated across Central and Eastern Europe, where stronger commodity prices and improved global financial stability have also contributed to an uneven recovery. The outlook for the Middle East and Africa will continue to rely on recovering commodity prices and stronger external demand. Latin America's recovery will largely be driven by private consumption as government spending is expected to wane. Overall, prospects for developing countries will increasingly be determined by domestic demand and private-sector activity, by the global trade environment and commodity prices, and by how they address fiscal and longer-term structural challenges.

Capital Flows in the Aftermath of the Crisis

The global crisis resulted in a continued decline in private capital flows and remittances to developing countries in 2009, while official lending and official development assistance (ODA) held up. Aggregate

Table 1.1 The global economic outlook, 2008–2012
Percentage change from previous year

	2008	2009[e]	2010[f]	2011[f]	2012[f]
World	1.7	-2.1	3.3	3.3	3.5
High-income countries	0.4	-3.3	2.3	2.4	2.7
Developing countries	5.7	1.7	6.2	6.0	6.0
East Asia and the Pacific	8.5	7.1	8.7	7.8	7.7
Europe and Central Asia	4.2	-5.3	4.1	4.2	4.5
Latin America and the Caribbean	4.1	-2.3	4.5	4.1	4.2
Middle East and North Africa	4.2	3.2	4.0	4.3	4.5
South Asia	4.9	7.1	7.5	8.0	7.7
Sub-Saharan Africa	5.0	1.6	4.5	5.1	5.4
Memorandum items					
Developing countries					
excluding transition countries	5.7	3.0	6.6	6.2	6.2
excluding China and India	4.3	-1.8	4.5	4.4	4.6

Source: World Bank, Global Economic Prospects 2010 and revised estimates.
Note: e=estimate; f=forecast.