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.

private and official financial flows fell sharply for a second year in a row in 2009, declining by 29 percent to $554 billion (3 percent of GDP), from $778 billion (4.5 percent of GDP) in 2008 (table 1.2). The slump was largely due to declining FDI and the collapse of private debt, which overshadowed recovering portfolio equity flows and a tripling in official lending.

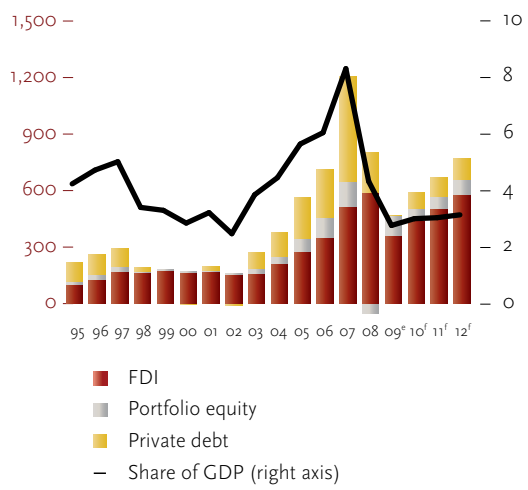
Financial flows to developing countries began strengthening toward the end of 2009, however, and are expected to slowly recover over the medium term, sustained by private capital. Net private flows (which include FDI and portfolio equity flows, as well as debt from private creditors) are projected to rebound in 2010 and 2011, but to remain substantially lower than their $1.2 trillion peak in 2007 (8.5 percent of GDP) (figure 1.1). Although bank lending collapsed, bond issuance and short-term, mostly trade-related debt flows began to rebound as early as 2009. Going forward, however, tighter financial regulations and competition for international funding from high-income countries (when the interest rate environment changes in those markets) are expected to weigh on private capital flows to developing economies.

Relatively immune to the effects of the financial crisis on major donor countries, ODA to developing countries was virtually unchanged in 2009 (figure 1.2). ODA in constant terms reached $123.1 billion in 2009, marginally above the $122.3 billion in 2008.

Bilateral ODA declined slightly from $87 billion in 2008 to $86 billion in 2009 in constant terms. However, the nature of ODA did shift, as bilateral concessional loans replaced bilateral grants in 2009, likely reflecting fiscal stress in donor countries.

Figure 1.1 Net private capital flows to developing countries

$ billion and percent



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

Table 1.2 Net international capital flows to developing countries

$ billion

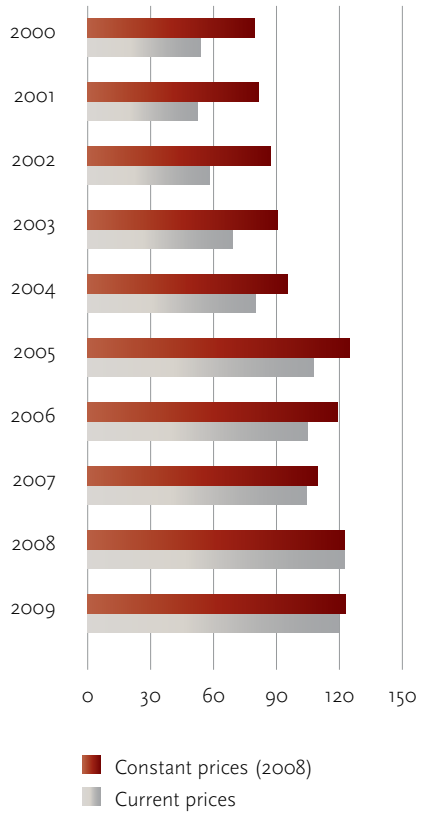
	2005	2006	2007	2008	2009^{e}	2010^{f}	2011^{f}	2012^{f}
Net private and official inflows	493	642	1,202	778	554	–	–	–
Net private inflows (equity + debt)	564	714	1,203	750	470	568	670	771
Net FDI inflows	274	343	508	587	354	416	501	575
Net portfolio equity inflows	67	108	135	-53	108	60	63	78
Net debt flows: official creditors	-71.5	-72.3	-0.9	28.1	83.4	–	–	–
Net debt flows: private creditors	223	263	560	216	8	92	106	118

Source: World Bank, Global Economic Prospects 2010 and revised estimates.
Note: e=estimate; f=forecast; – = not available.

Following a 6 percent decline to $316 billion in 2009, workers' remittances are expected to rebound by 6 percent in 2010 and 7 percent in 2011, supported by the modest recovery in high-income countries. However, continued high unemployment rates, tighter immigration controls, and exchange rate uncertainties will keep affecting remittances.

Figure 1.2 ODA into developing countries

$ billion



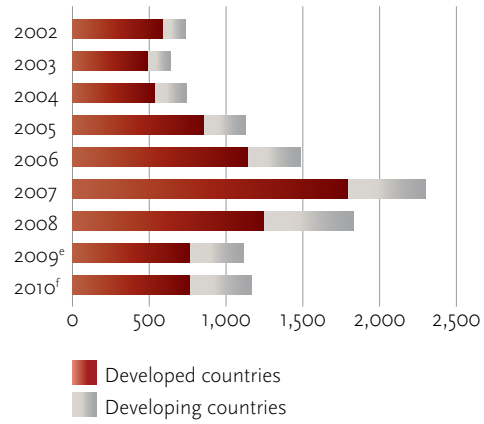
Source: World Bank, Global Economic Prospects 2010.

The Rebound of FDI Flows into Developing Countries

Although FDI flows worldwide are showing signs of recovery in 2010, the rebound was anemic in light of the severity of the recession, especially in the developed world (figure 1.3). Multinational enterprises (MNEs) were hit hard by the global economic recession and financial crisis of 2008. Slower global growth in 2008 and 2009 squeezed their profitability, while global economic uncertainty, weak global demand, and the credit crunch affected their willingness and ability to expand overseas. As a result, global FDI flows declined from $1.8 trillion in 2008 to an estimated $1.1 trillion in 2010—51 percent below the 2007 peak of $2.3 trillion.

Figure 1.3 FDI flows worldwide

$ billion



Source: World Bank estimates.
Note: e=estimate; f=forecast.

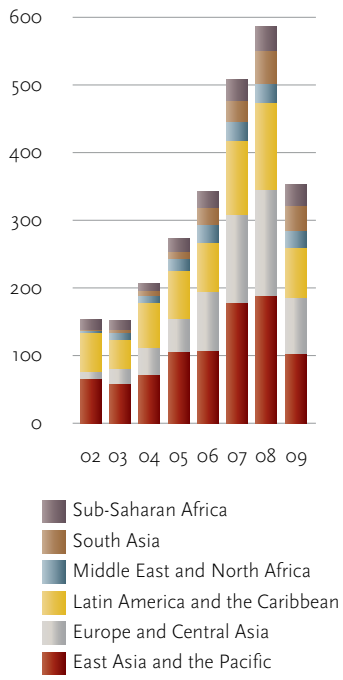
The developing world absorbed about 37 percent of global FDI flows in 2009—a proportion that has risen over the past decade and is expected to continue expanding, attesting to the growing significance of the flows in the world economy. After appearing resilient at the onset of the global crisis in 2008, FDI inflows to developing countries slumped by 40 percent in 2009—a decline similar to high-income countries'—to $354 billion (2.1 percent of GDP), compared to $587 billion (3.4 percent of GDP) in 2008.

All developing regions suffered, but the decline was uneven. East Asia and the Pacific, Europe and Central Asia, and Latin America and the Caribbean all experienced declines in FDI of more than 40 percent (figure 1.4); the decline in FDI flows to East Asia and the Pacific was steeper than the decline following

the Asian crisis of 1998–1999, and China recorded a record 47 percent drop to $78 billion. Less affected, however, were South Asia, sub-Saharan Africa, and the Middle East and North Africa, thanks in part to natural resource investments. Overall, FDI inflows to the developing world continue to be overwhelmingly concentrated in middle-income countries, with Brazil, the Russian Federation, India, and China (BRIC) alone absorbing about half. Although the share of FDI to low-income countries increased slightly in 2009, it remained below 3 percent of investment to all developing economies.

Figure 1.4 FDI flows by developing region

$ billion



Source: World Bank estimates.

FDI prospects appear brighter for developing countries in 2010 and beyond: their economic performance is expected to outpace that of high-income economies; domestic demand is buoyant, especially in East Asia; high-income countries, a major source of FDI to the developing world, are expected to maintain interest rates low in the short term; and the recovery of commodity prices could encourage higher levels of FDI in the primary sector. Conversely, the global economic recovery remains fragile and uncertain.

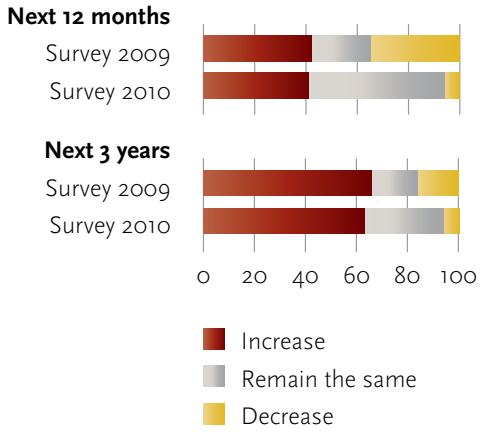
Overall, FDI inflows to developing countries are projected to increase by 17 percent to an estimated $416 billion in 2010. They should continue growing by a modest 20 percent and 13 percent a year in 2011 and 2012, respectively, as the global economic recovery strengthens.[5] By 2012, FDI flows to the developing world are expected to reach $575 billion—a figure still below the pre-crisis peak of 2008, thus highlighting the severe impact of the recent downturn.

A survey of 194 executives from MNEs worldwide commissioned by the Multilateral Investment Guarantee Agency (MIGA) in June 2010, the composition of which mirrored that of actual FDI flows by sector and region (the MIGA-EIU Political Risk Survey 2010, see appendix 2) confirms the expected recovery of FDI flows to developing countries in 2010 and beyond. Around 40 percent of those respondents who were surveyed in both 2009 and 2010 expect to increase their investments in developing countries over the next 12 months. That this proportion is not higher than in last year's survey (figure 1.5) suggests that investors remain cash-constrained or cautious, in light of improved but still uncertain prospects for world growth. Yet, investors' measured optimism and improved financial situation is apparent: only 6 percent of respondents in 2010 plan to reduce their investments over the coming year, compared to more than a third of firms surveyed in 2009.

Respondents in both the 2009 and 2010 surveys were more optimistic over the medium term: about two-thirds anticipate to increase their overseas investments, while the proportion of investors expecting to divest from developing countries has more than halved since last year (figure 1.5). This finding is in line with macroeconomic projections, thus suggesting continued FDI recovery over the next couple of years.

Figure 1.5 Changes in foreign investment plans

Percent of respondents

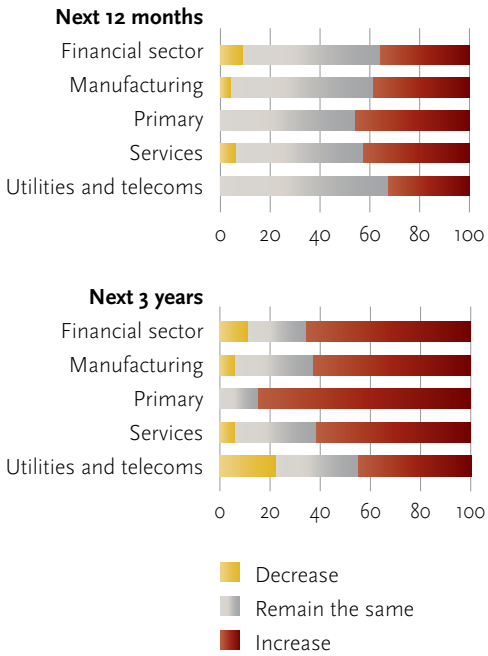


Source: MIGA-EIU Political Risk Survey 2009 and MIGA-EIU Political Risk Survey 2010.
Note: The findings presented here apply only to the group of investors who were surveyed both in 2009 and 2010. Appendix 2 presents the findings for all investors surveyed in 2010.

Unlike the 2009 survey, only a very small proportion of firms surveyed this year plan to decrease their investments in developing countries over the next 12 months, regardless of sectors (figure 1.6). A mixed picture emerges when it comes to increasing investment, however. Respondents from the primary sector appear the most bullish, particularly over the medium term, possibly reflecting the recovery of commodity prices. Firms in telecoms and utilities, conversely, trail other sectors both in the short and medium terms. In addition, only 36 percent of MNEs in the financial sector plan to increase their investment in developing countries in the next 12 months—possibly a reflection of the fallout from the global financial crisis; yet, the proportion almost doubles over the next three years, with two-thirds expecting to expand in developing countries, which suggests expectations of a significant improvement in the business and financial environment.

Figure 1.6 Changes in foreign investment plans by sector

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

FDI from Developing Countries

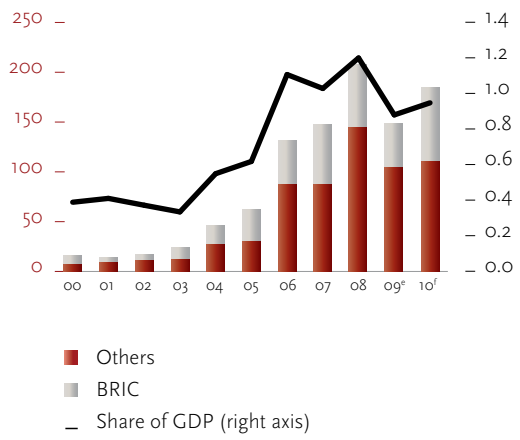
FDI flows originating from developing countries rebounded briskly to an estimated $185 billion in 2010 (figure 1.7). The economic crisis had dampened developing countries' outward investment in 2009, when FDI declined by 28 percent to $149 billion following a record $207 billion in 2008. Much of the slump was attributed to Brazil, where FDI outflows turned negative by $10 billion in 2009 from $20 billion in 2008, as struggling Brazilian companies relied on loans and amortization payments from their foreign affiliates. Despite its severity, that decline was significantly below the drop in FDI flows from developed countries. The relative resilience of developing countries as a source of FDI can be attributed to the growing desire of their MNEs to expand abroad as they seek to access new consumer

markets and natural resources. Many of these firms have developed significant brand recognition and a global presence beyond their region. With a limited reliance on international debt markets, the financing of their overseas expansions with cash and domestic debt has helped shield them from the credit crunch.

FDI outflows from the BRIC countries continue to lead. Together they have seen their share of FDI outflows from developing countries increase from 56 percent to 64 percent between the first and second half of the past decade. China and the Russian Federation have been the largest outward investors over the past few years, with $44 billion and $45 billion in FDI outflows in 2009, respectively. Non-BRIC developing countries—notably Chile with $8 billion; Mexico with $7.6 billion in 2009; and even Kazakhstan, whose outward FDI increased three-fold in 2009—are gradually moving up the ranks of outward investors as their MNEs globalize their operations.

Figure 1.7 FDI outflows from developing countries

$ billion and percent

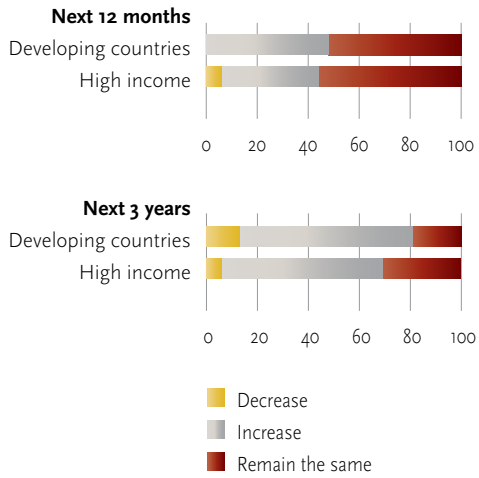


Source: World Bank estimates.
Note: e=estimate; f=forecast.

The MIGA-EIU Political Risk Survey 2010 suggested that the rebound in FDI outflows from developing countries is set to continue. In the short term, respondents based in developing countries are more bullish about investing in the developing world than firms based in high-income countries (figure 1.8). Over the next three years, however, this gap largely closes, with roughly two-thirds of investors from both industrialized and developing economies intending to increase their investments in developing countries. This finding underscores the growing weight of developing countries in the global economy,[6] not only as destinations but also as sources of FDI.

Figure 1.8 Changes in foreign investment plans by source

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

Corporate Perceptions of Political Risk in Developing Countries

Political (or noncommercial) risk facing foreign direct investors is the probability of disruption of MNEs' operations by political forces or events originating in either host countries or home countries, or resulting from changes in the international environment (box 1.1). In host countries, political risk typically refers not only to uncertainty over governments' and political institutions' actions that affect foreign direct investors, but also to dynamics that could result in civil disturbance, terrorism, civil wars, and cross-

border conflict. Because of its longer-term nature and assets on the ground, FDI is often more vulnerable to political risk than are other types of cross-border capital flows.

World Investment and Political Risk 2009 highlighted the persistence of investor concerns about political risk in developing countries. Although the link between FDI and political risk is not straightforward, investor surveys carried out in 2009 highlighted that political perils were perceived as a top constraint to cross-border investment by firms based in industrialized countries and developing countries alike. Risks related to government intervention, especially breach of contract, loomed large in investors' perceptions. Restrictions on transfer and convertibility, non-honoring of sovereign guarantees, and civil disturbance ranked high in the short term, but they were expected to recede in the medium term.

These concerns, which predated the recent financial crisis and global economic downturn, have persisted in its aftermath. The MIGA-EIU Political Risk Survey 2010 of MNE executives sought to assess (i) how political risks feature among the factors that constrain investment plans, and (ii) how these risks are being mitigated. How companies perceive, mitigate, and manage these risks needs to be better understood in order to better define the role that PRI can play in this context (chapter 3).

Political Risk: A Major Constraint to FDI in Developing Countries

Developing countries are usually regarded as carrying higher political risk than industrialized countries do, although that notion is increasingly challenged.[7] Although developing economies are still largely moving toward greater investment liberalization and an improvement of the business environment,[8] new limitations on foreign investment and tighter screening and approval processes have been on the rise in recent years. Out of 77 regulatory changes pertaining to FDI introduced by developing countries in 2009, 26 of them introduced restrictions on such investment, the highest share recorded in this decade.[9] Regulatory obstacles specific to FDI and foreign ownership restrictions are more prevalent in select sectors (e.g., media, transportation, and electricity).[10] In addition, the global economic crisis has further exacerbated the debate about the exact role of the state in market economies and state-owned enterprises in FDI[11] that predates the onset of the financial crisis. These developments are likely to weigh on political risk perceptions.

Contributing to investor perceptions of political risk is the increase in the number of treaty-based investment disputes between MNEs and host developing countries, which rose from 23 in 2000 to 206 in 2009. While the increase in the number of disputes is in line with the growth of FDI flows and the promulgation of bilateral investment treaties, defendants in these disputes fall disproportionately in Latin America, with just five countries in that region accounting for 28 percent of all investment treaty claims.[12] This increase is also confirmed by the number of arbitration cases registered with the International Centre for Settlement of Investment Disputes, for which South America alone accounts for 30 percent of all cases.[13]

In response to the recent economic crisis, several developed and developing countries introduced a variety of measures to boost their economies (e.g., economic stimulus packages, state aid, access to finance, or the temporary state acquisition of domestic companies under distress).[14] These measures often aim to protect specific sectors deemed strategic—such as finance or agribusiness—or "national champions." Although most of these measures are meant to be temporary, a revival of state intervention could influence political risk perceptions.

In addition, the global downturn and the measures taken to soften its impact on local economies have resulted in fiscal strains. Although developing countries enjoy stronger public finance and better public debt-to-GDP ratios relative to industrialized countries as they emerge from the crisis,[15] these fiscal pressures, if not managed properly, could undermine governments' ability to meet their financial obligations and local currencies. Although restrictions on the repatriation of profits by foreign investors have so far not materialized, risk perceptions remain high.

Conversely, unwinding rescue packages also carries risks of political instability and civil unrest in some investment destinations if the economic recovery fails to gather enough steam. Removing food subsidies to alleviate ballooning deficits, especially when combined with the recently rising food prices, has resulted in such unrest in a number of developing countries. Food security concerns have also led to large-scale investments involving land acquisitions or long-term land leases, which have sparked civil unrest in several developing countries.[16]

Contract renegotiations in the extractive industry and, in some cases, outright nationalization have contributed to the perceived resurgence of resource nationalism. The decline in the price of many commodities, including oil, from their pre-crisis highs, does not seem to have moderated this risk. A recent survey of mining companies highlights concerns over political instability and security threats.[17] In addition, expropriations and nationalizations in parts of Latin America have spread beyond the extractive industries, into services, public utilities, and manufacturing, thus feeding investors' concerns.

At the same time, some investors argue that new political risks—beyond the traditional concerns surrounding currency convertibility and transfer restriction, political violence, and expropriation—have emerged over the past few years.[18] The rise of local, regional, and nongovernmental interests, including local governments, cultural or religious interests, and nongovernmental organizations (NGOs), has given rise to new uncertainties. Transnational crime and corruption have emerged as political risks affecting foreign firms. In this context, government authorities use their regulatory powers to undermine investor interests. In the worst instances, it is even difficult to separate criminal elements from political interests, because the two are closely aligned. This is especially prevalent in countries with low-transparency, high-corruption indexes or in the so called "failed states."[19] And despite the absence of any major successful attack over the past year, terrorism continues to pose a threat.

In addition, a recent Lloyd's report[20] analyzes the specific political risks arising from the internationalization of production by MNEs, highlighting the interconnectedness of international production and its effect on accelerating the transmission of these risks. The report presents new risks facing globalized production networks, such as supply-chain disruptions caused by political events, with potentially severe impacts on output and the production process. It also underscores how the interconnectedness of production contributes to accelerating the transmission of risks across countries and industries. Finally, it discusses an array of political risks whose presence is not confined to developing countries, such as civil

Box 1.1 What Is Political Risk?

Broadly defined, political risk is the probability of disruption of the operations of multinational enterprises by political forces or events, whether they occur in host countries or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions not only of governments and political institutions, but also of minority groups such as separatist movements.

For the purposes of the investor surveys conducted for this report, political risk was more specifically defined as a breach of contract by governments; adverse regulatory changes by host countries; restrictions on currency transfer and convertibility; expropriation; political violence (war or civil disturbance such as revolution, insurrection, coup d'état, sabotage, and terrorism); and non-honoring of sovereign guarantees. This definition includes risks that are not currently insurable by the political risk insurance (PRI) industry.

The insurance industry uses a narrower definition of political risk, which usually includes (i) restrictions on currency convertibility and transfer, (ii) expropriation, (iii) political violence, (iv) breach of contract by a host government; and (v) the non-honoring of sovereign financial obligations. Changes in host countries' laws and regulations, however, are not covered. Although there is a general consensus over these broad categories within the PRI industry, exact definitions and labels vary among insurers.

Source: MIGA, *World Investment and Political Risk 2009*.

unrest or the risk of non-honoring of sovereign guarantees, which is closely linked to debt default. The latter is also identified as the second biggest concern in a recent survey of executives by the Economist Intelligence Unit (EIU), after the risk of a "double dip" recession.[21]

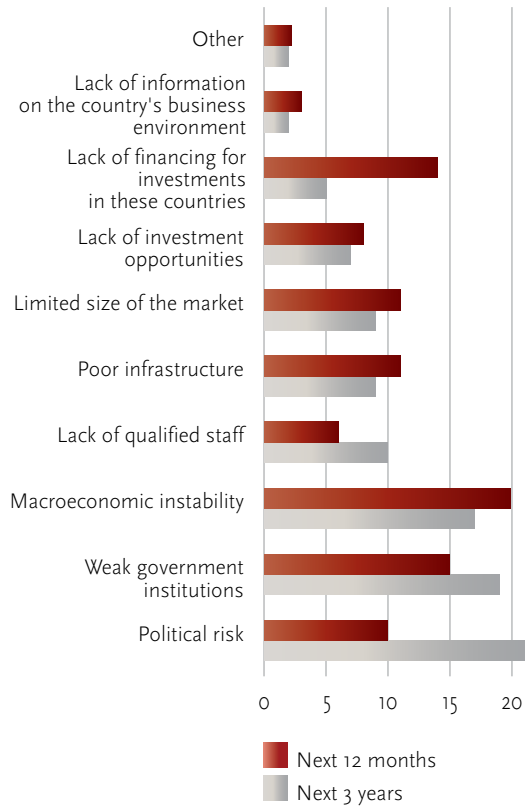
Political risk is the single most important constraint for investment into developing countries over the medium term, according to the MIGA-EIU Political Risk Survey 2010. Over the next three years, survey respondents expect to be more constrained by political risk than by macroeconomic instability, limited financing, poor infrastructure, or small market size (figure 1.9). Investors surveyed also rank weak government institutions (including red tape and corruption)—which have a direct bearing on political risk as defined in this report—as the second main constraint to investments into developing countries in the medium term. The growing salience of political risk relative to other concerns over the medium term confirms the findings of the MIGA-EIU Political Risk Survey 2009.[22]

In the short term, however, cross-border investment plans are most significantly hindered by the fallout from the recent financial crisis, the subsequent economic recession, and the persistence of recession-like conditions—even during recovery. Although developing economies rebounded strongly in the first half of 2010, the global recovery has been uneven and remains fraught with risks, as discussed earlier. As a result, macroeconomic instability and lack of financing are at the forefront of investors' concerns when it comes to planned overseas investments in the next 12 months (figure 1.9). Yet, all of these concerns become relatively less prominent over the medium term, suggesting that respondents expect the economic situation to improve.

Firms' expectations that political risk will become the most important constraint for FDI in developing countries in the medium term are consistent across the board. Investors based in developed countries and developing countries alike view political risk as an important constraint to FDI over the next three years. South-based investors view political risk as surpassing all other constraints over the next three years, while weak government institutions, also associated with higher political risk, is their main concern over the next 12 months. The notion that South-based investors might be more tolerant toward political risk because of their familiarity in operating in politically risky domestic environments is not supported by the findings of the MIGA-EIU Political Risk Survey 2010. This was also one of the key findings of the 2009 MIGA-Vale Columbia Center Political Risk Survey in the BRICs.[23] Similarly, there was no substantial difference in the ranking of political risk between small firms and medium or large firms. Both sets of investors viewed political risk as an important constraint in the medium term; medium-size or large firms viewed it slightly more so.

Figure 1.9 Ranking of the most important constraints for FDI in developing countries

Percent of respondents



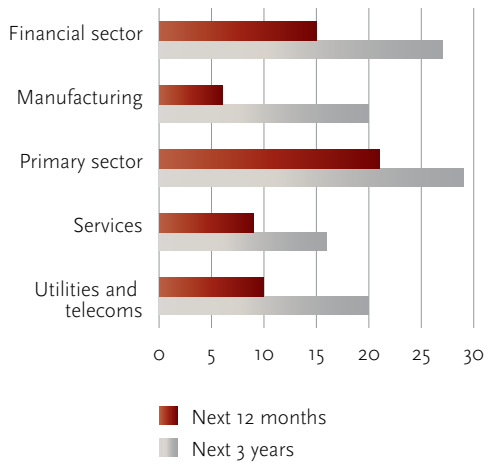
Source: MIGA-EIU Political Risk Survey 2010.

However, there are significant differences in perceptions across sectors. The proportion of firms in the primary sector that found political risk to be the main investment constraint was larger than in any other sector, both in the short and medium

terms (figure 1.10). This finding is likely a reflection that investors in that sector—mostly the extractive industries—often operate in difficult and risky environments, with significant sunk costs and long time horizons. Bound by the geography of mineral deposits, they are more constrained in selecting their investment destinations than are investors in other industries.

Figure 1.10 Proportion of firms that identify political risk as the top constraint of FDI in developing countries

Percent of respondents

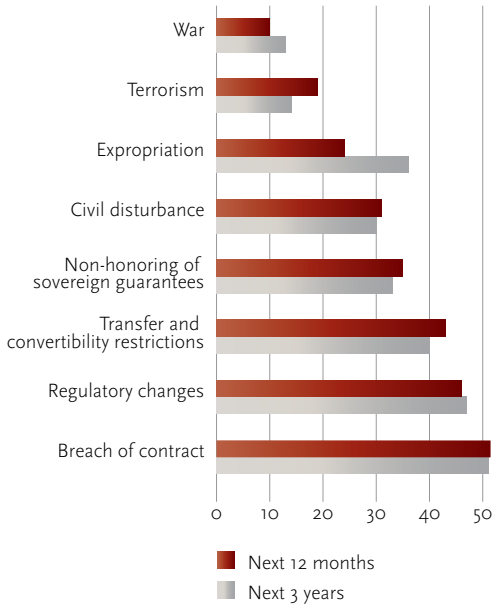


Source: MIGA-EIU Political Risk Survey 2010.

Among various political risks, more investors surveyed are concerned about adverse government interventions—expropriation, restrictions on currency transfer and convertibility, adverse regulatory changes and non-honoring of sovereign guarantees—than about political violence (figure 1.11). Past events influence perceptions of future risks: investors report that most of the losses they have suffered were due to some form of government intervention. In addition, the bulk of FDI to developing countries flows into a handful of developing countries perceived to be relatively stable and to carry a relatively low risk of political violence.

Figure 1.11 Types of political risk of most concern to investors when investing in developing countries

Percent of respondents



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

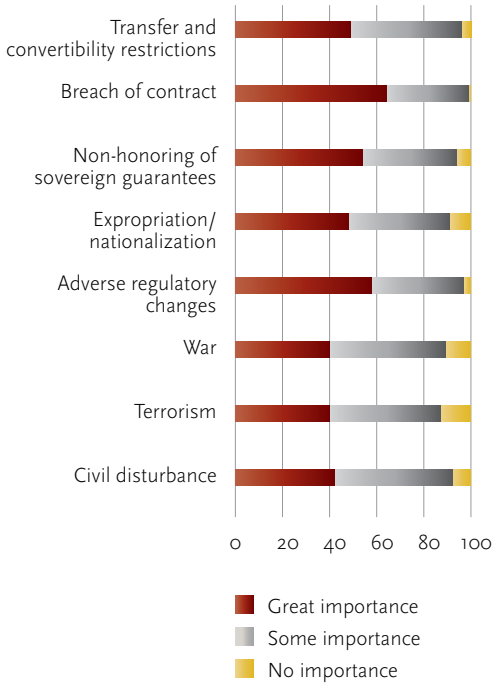
Among adverse government interventions, investors are most worried about breach of contract and adverse regulatory changes, both in the short term and over the next three years. There is no significant difference between North- and South-based investors concerning the importance of these two perils, and both had been identified as rising sources of concern by investors surveyed in the MIGA-EIU Political Risk Survey 2009. The risk of transfer and convertibility restrictions, however, is of far greater concern to North- than South-based firms. The latter also appear to be more concerned about civil disturbances. The ranking of perils appears relatively stable over time, with one exception: the proportion of investors citing expropriation rises significantly over the medium term.

Although, as mentioned earlier, the relationship between FDI and political risk is not straightforward,[24] different types of political risk have different bearings on respondents' investment location

decisions (figure 1.12). Risks arising from government intervention—in particular breach of contract and adverse regulatory changes—weigh more heavily on these decisions than on those associated with political violence. North-based investors attach greater significance not only to political violence risks than do South-based investors, but also to transfer and convertibility restrictions, with 33 percent of them considering the latter to be of great importance in their investment location decisions.

Figure 1.12 How much importance does your firm assign to each of the risks listed below when deciding on the location of its foreign projects?

Percent of respondents

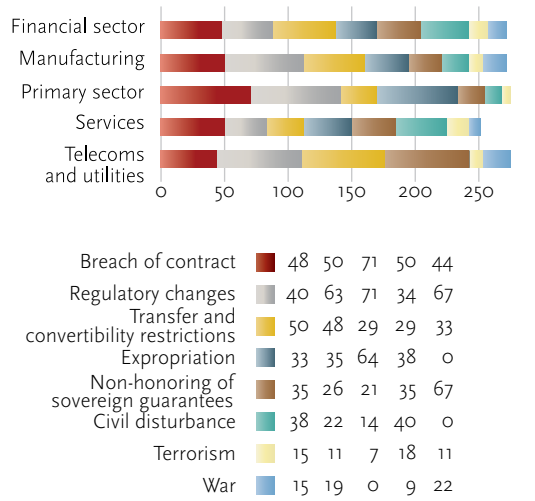


Source: MIGA-EIU Political Risk Survey 2010.

If one follows the rise of resource nationalism over the past few years, it is not surprising that the risk of outright expropriation is of great concern to firms operating in the primary sector (figure 1.13). Firms operating in the telecoms, utilities, and primary industries—whose operations often rely on host government licenses or contracts—are worried mainly about adverse regulatory changes. About twice as many firms in telecoms and utilities, which usually have offtake agreements or guarantees from host governments, are concerned about the willingness and ability of authorities to fulfill their financial obligations, compared to other services. The highest proportion of investors worried about currency transfer restrictions operates in financial services, which often relies on cross-border operations for financing. The risk of political violence—whether civil disturbance, terrorism, or war—is among the lowest across sectors. Mining operations, often isolated and geographically confined, are easier to secure than operations with multiple assets spread across country. At the same time, their sales are not affected by disruptions in local demand that can result from political violence, unlike investments in services targeted at the domestic market.

Figure 1.13 Political risk perceptions in developing countries by type of peril and sector

Percent of respondents



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

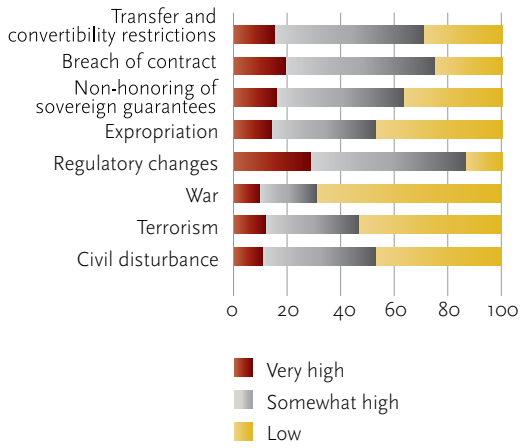
Perceptions of political risks relative to other investment constraints are reflected in investors' views of these risks in absolute terms. Almost half of the investors surveyed (49 percent) consider that the level of risk in one or more categories of political risk

in their host developing countries is currently very high (i.e., very likely to occur).

The probability of adverse regulatory changes and breach of contract occurring are perceived to be the highest in the developing countries where these firms are presently investing (figure 1.14). Political violence, conversely, is thought the least likely and to have the smallest impact on operations, reflecting the concentration of the investments in middle-income economies where conflict is largely absent.

Figure 1.14 In the developing countries where your firm invests presently, what is the perceived level for each of the following risks?

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

Investors' ranking of the different perils by likelihood of occurrence broadly mirrors their ranking by concern (figure 1.11), with the risk of various types of government intervention perceived to have a higher probability of occurrence than political violence. Yet, the likelihood of perils does not always match the severity of their impact on investment and, therefore, investors' concerns. For example, a perceived high level of risk arising from war and civil unrest implies a greater probability of occurrence of this type of risk, but its actual impact on investment may be small in terms of potential losses. It is both the probability of occurrence for each risk, and the potential losses that each type of risk generates that are likely to influence the choice of risk-mitigation tools.

The occurrence of losses itself appears to have a moderate impact on risk perception. Most respondents do not consider political risks to be very high in their host countries, although some three-quarters of them have experienced losses caused by political risks in one or more of their investment destinations over the past three years. These losses were mostly due to breach of contract and adverse regulatory changes (figure 1.15), both of which are at the top in the list of risks that investors consider high both in absolute terms and relative to other political risks (figure 1.11). Three times as many North-based firms experienced losses related to transfer and convertibility restrictions as did South-based investors. These losses were also more prevalent for medium-size and large firms, as were losses from adverse regulatory changes. Only a small proportion of firms experienced losses owing to political violence, which mirrors the low ranking of these risks in investor concerns.

Figure 1.15 Proportion of firms that have suffered losses caused by political risk over the past three years

Percent of respondents

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

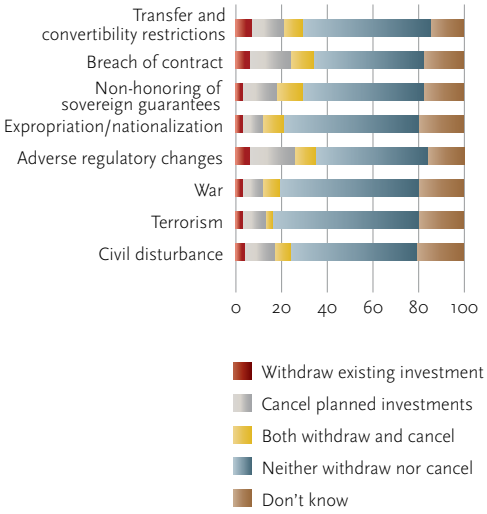
Concerns over expropriation (discussed earlier), however, appear out of line with the frequency of past incidents: although only 6 percent of respondents reported losses due to expropriation, twice as many consider the risk as high. This concern is likely to be related to the potential severity of losses caused by expropriation, which often results in a total loss of investment.

A majority of investors do not view political risk as a reason to cancel a planned investment or withdraw

an existing one (figure 1.16). Even political risks that most often caused financial losses and rank high in investors' concerns relative to other perils result only in a minority of respondents reconsidering their investment plans. Political violence, about which most investors appear little concerned, was certainly not perceived to be a reason to withdraw or cancel an existing investment for most respondents.

Figure 1.16 Have any of the following risks caused your company to withdraw an existing investment or cancel planned investments over the past 12 months?

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

Corporate Approaches to Political Risk Management

The growing salience of political risk relative to other constraints to foreign investment in developing countries, together with survey results suggesting that political risks have caused some losses to a majority of foreign firms involved in those countries, highlight the need to mitigate these risks.

Indeed, the overwhelming majority (95 percent) of investors surveyed for this report actively manage political risk. Risk management includes assessing the level of peril (through internal analysis and the use of consultants); noncontractual mitigation strategies (engagement with local governments, communities, and NGOs, as well as joint ventures with local enterprises and operational hedging); and contractual risk-mitigation tools (such as PRI and credit default swaps).

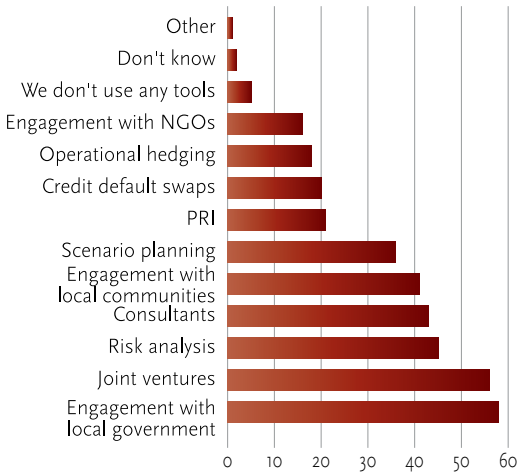
When it comes to mitigating these risks, the overwhelming majority of investors prefer noncontractual strategies (figure 1.17). Engagement with local governments—such as maintaining an open dialogue and good relationships—and joint ventures with local enterprises were seen as the most effective tools to mitigate the risks of adverse government interventions. Some 63 percent of respondents evaluate and monitor the level of political risk in their investment destinations through internal risk analysis or risk analysis performed by external consultants. South-based investors are slightly more likely to use informal risk-mitigation tools than are North-based investors. Small firms are more likely to engage with local communities and NGOs for risk mitigation than are medium-size and large firms. Investor preference for informal mitigation tools confirms the findings of the MIGA-EIU Political Risk Survey 2009.

Only one in three respondents (32 percent) currently uses contractual risk-mitigation tools, including PRI (21 percent). North-based investors are twice as likely to use PRI compared to South-based investors, despite the fact that both sets of investors are highly concerned about political risk. This limited use may be due to a lack of knowledge about the availability of different PRI products and how they can be used to mitigate risks. Medium-size and large firms are also more likely to use PRI than are smaller firms.

While the proportion of respondents that use PRI is low compared to noncontractual tools, it is significantly higher than the proportion of firms using PRI observed in the MIGA-EIU Political Risk Survey 2009 (14 percent). The increase in the popularity of insurance contrasts with the flat share of FDI to developing countries covered by insurance underwritten by members of the Berne Union in 2009 (see chapter 3).

Figure 1.17 Tools used to mitigate political risk in developing countries

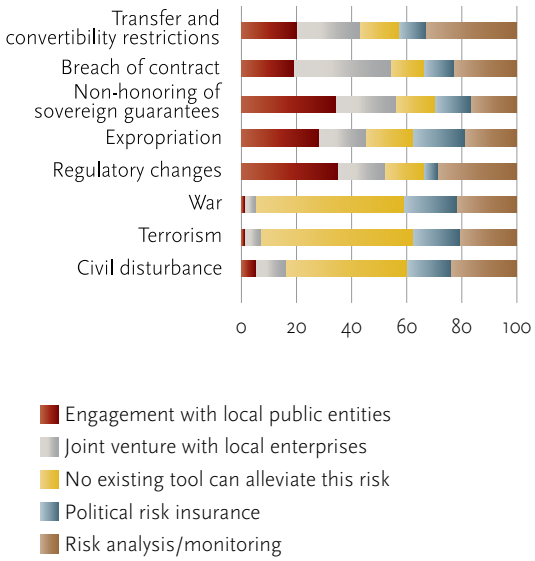
Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.
Note: Percentages add to more than 100 because of multiple responses.

Figure 1.18 Most effective tools used to mitigate political risk in developing countries by type of risk

Percent of respondents



Source: MIGA-EIU Political Risk Survey 2010.

Overall, PRI is regarded as the most effective risk-mitigation tool by 36 percent of investors surveyed.[25] Compared to other risks, PRI was considered relatively more effective for mitigating the risks of expropriation and political violence (figure 1.18). Yet, the proportion of investors who considered that there was no effective mitigation tool against political violence was also significantly higher than for any other risk. The fact that both expropriation and political violence currently rank lower than other perils among investor concerns, as discussed earlier, helps to explain the relatively small role PRI continues to play in risk management, even though it is regarded as being relatively more effective. Yet, it also raises questions about whether there is sufficient awareness among investors of the role PRI can play in mitigating the risks of most concern to investors: only 1 in 10 investors considers PRI as the most effective tool to mitigate breach of contract risk, which ranks highest among investors' concerns (figure 1.18); at the same time, 1 in 20 respondents considers PRI as the most effective way to mitigate the risk of adverse regulatory changes—a peril that is usually difficult to cover by insurance.

Despite concerns about risks and unevenness to economic recovery in the immediate future, investors continue to be optimistic regarding investment plans in developing countries in the medium term. North- and South-based investors remain concerned about political risks as constraints to their overseas investments, and they are more worried about adverse government interventions than political violence. In mitigating risks, most investors turn to informal and noncontractual instruments, with a minority using PRI.

The following chapter examines investment trends and political risk perceptions in conflict-affected and fragile economies.

Chapter One—Endnotes

1 Foreign direct investment is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy in an enterprise that is resident in an economy other than that of the foreign direct investor. It comprises equity investment, reinvested earnings, and intra-company loans.

2 Developing countries are those classified as low- and middle-income countries by the World Bank Group. Developed or industrialized countries are those classified as high income.

3 World Bank, 2010, *Global Economic Prospects 2010*, Washington, DC: World Bank.

4 Ibid.

5 Modest increases are also projected by the Institute of International Finance, 2010, *Capital Flows to Emerging Market Economies*, Washington, DC: IIF and A. T. Kearney, 2010, *Investing in a Rebound: The 2010 A. T. Kearney FDI Confidence Index*. Vienna, VA: A. T. Kearney.

6 OECD, 2010, *Perspectives on Global Development: Shifting Wealth*, Paris: OECD. According to this report, longer-term forecasts suggest that developing countries are likely to account for nearly 60 percent of world GDP by 2030.

7 See Peter Apps, "'Political risk everywhere' Here to Stay," Reuters, June 24, 2010, which also looks at political risk in industrialized countries.

8 World Bank, 2010, *Doing Business 2011: Making a Difference for Entrepreneurs,* Washington, DC: World Bank.

9 United Nations Conference on Trade and Development (UNCTAD), unpublished data. UNCTAD's definition of developing countries differs somewhat from the one used by the World Bank. See also Karl P. Sauvant, 2009, "Driving and Countervailing Forces: A Rebalancing of National FDI Policies," in Karl P. Sauvant, ed., *Yearbook on International Investment Law & Policy 2008–2009*, New York: Oxford University Press.

10 World Bank, 2010, *Investing Across Borders 2010*, Washington, DC: World Bank.

11 Ian Bremmer and Nouriel Roubini, 2010, "Paradise Lost: Why Fallen Markets Will Never Be the Same," *Institutional Investor*, September.

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19 Foreign Policy, *The Failed States Index 2010*. http://www.foreignpolicy.com/articles/2010/06/21/2010_failed_states_index_interactive_map_and_rankings.

20 Lloyd's 360 Risk Insight, 2010, *Globalisation and Risks for Business: Implications of an Increasingly Interconnected World*, London: Lloyd's.

21 EIU, "Double-Dip Recession Tops Executives' Concerns for Global Economic Outlook," press release of July 26, 2010.

22 MIGA, 2009, *World Investment and Political Risk 2009*, Washington, DC: World Bank.

23 See findings in ibid.

24 For a review of the literature on FDI and political risk, see MIGA, 2009, ibid., annex 5.

25 This is the proportion of investors that selected PRI as the most effective tool for one or more political risk categories.