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.

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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:

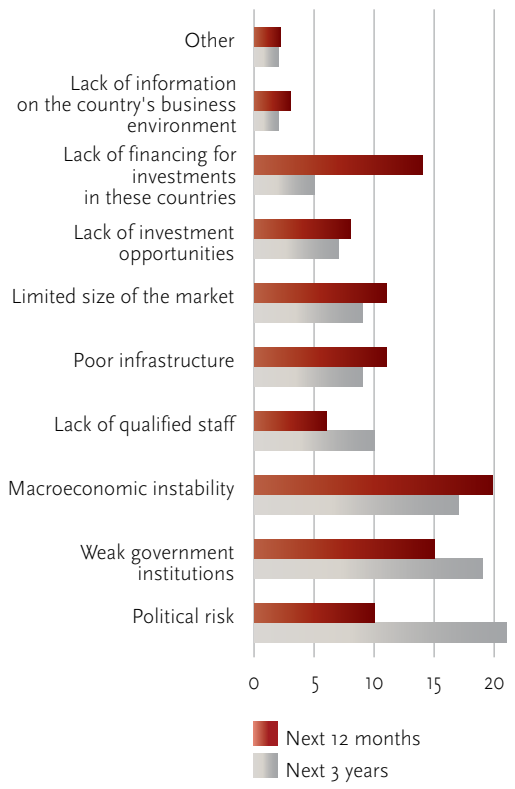
Political risk remains a top obstacle to FDI in developing countries over the medium term.

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.

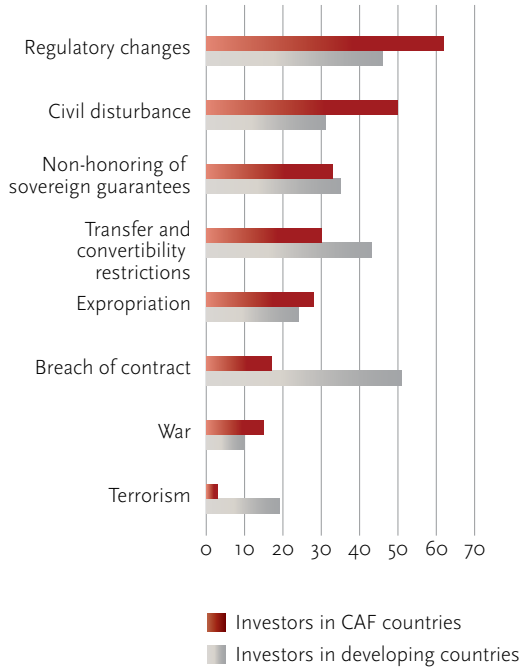
This analytical framework, confirmed in part by econometric analysis and investor surveys, helps explain how FDI flows to CAF economies differ from patterns observed in developing countries. Although the amount of FDI flowing into CAF countries is in line with their global economic weight, it dwarfs 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.