

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 INVESTOR 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 economic and financial crisis has severely curtailed economic growth and international private capital flows, prompting unprecedented government interventions. Although developing countries have not been spared, past economic and policy reforms, growing domestic markets and emergency financial assistance have helped them weather the storm.

In the current context of high uncertainty and relative retreat of the private sector, this report seeks to examine the evolution of political risk perceptions. Understanding how investors perceive and deal with these perils will contribute to mapping out the role of political risk insurance in the emerging post-crisis investment landscape, and how it can contribute to a revival of FDI. With scarcer private capital and only a handful of countries absorbing the majority of investment flows to emerging markets, encouraging private capital to the world's poorest economies remains a critical focus for the World Bank Group.

The report focuses on how the current global financial crisis has impacted the outlook of the investment community and the insurance industry regarding investments in developing countries. For this purpose, MIGA commissioned independent agencies to conduct several corporate surveys. More specifically, the report examines: (i) overall trends in FDI and political risk perceptions; (ii) corporate views on foreign investment and the political risk environment in emerging markets; and (iii) the ability of the PRI industry to respond to an emerging post-crisis investment landscape. Given the changing shape of the world economy and MIGA's mandate, the report pays particular attention to the growing role of South-based investors and PRI providers in promoting global cross-border investment flows.

Izumi Kobayashi
Executive Vice President

ACKNOWLEDGEMENTS

This report was prepared by a team led by Stephan Dreyhaupt, and including Emanuel Salinas, Persephone Economou, Moina Varkie-Toft and Thomas Tichar. Inputs were also received from Roxanna Faily, Alpona Banerji, and Caroline Lambert, who also edited the report. Suzanne Pelland was in charge of graphic design. Melissa Johnson provided administrative support.

This report would not have been possible without the vision and support of James Bond, MIGA's Chief Operating Officer. The team also wishes to thank the other members of the editorial committee, including Frank Lysy, Edith Quintrell, Marcus Williams, Daniel Villar, Marc Roex, Mallory Saleson, Mansoor Dailami, and Jonathan Halpern, for providing invaluable guidance and comments. Throughout the various stages of the report, the team was fortunate to have the cooperation of the World Bank's Development Prospects Group (DECPG) under the guidance of Mansoor Dailami. We would also like to thank MIGA colleagues, in particular Srilal Perera and Ivan Illescas.

The World Bank's Development Economics Vice Presidency (DEC) provided most of the macroeconomic data used in chapter 1, as well as comments on the analysis. UNCTAD contributed information on trends in international investment agreements. The investor surveys covered in chapters 1 and 2 were conducted on behalf of MIGA by the Economist Intelligence Unit (global survey) and the Vale Columbia Center on Sustainable International Investment (BRIC survey). Additional perspectives of Singapore-based investors were obtained with

the help of International Enterprise (IE) Singapore. The BRIC survey also relied on contributions from Sociedade Brasileira de Estudos de Empresas Transnacionais e da Globalização Econômica (SOBEET) in Brazil; Qi Guoqiang, President, International Cooperation Journal, Ministry of Commerce, in China; Premila Nazareth, an independent consultant in India; and Andrei Panibratov at the Graduate School of Management, St. Petersburg State University in Russia. Chapter 3 benefited from invaluable co-operation from Kimberly Wiehl and Lennart Skarp of the Berne Union. In addition, inputs were received from the African Trade Insurance Agency, Charles Berry of BPL Global and Toby Heppel of FirstCity Partnership Ltd.

Peer reviews were provided by Carlos Alberto Primo Braga (Director, Economic Policy and Debt in the Poverty Reduction and Economic Management Network, World Bank), Pierre Guislain (Director, Investment Climate Department, World Bank), Henry Russell (Manager, Finance and Guarantees Group, World Bank), Hans Timmer (Director, Development Prospects Group, World Bank), Karl P. Sauvart (Executive Director, Vale Columbia Center on Sustainable International Investment), James Zhan (Director, Division on Investment and Enterprise, UNCTAD) and Michael Gestrin (Senior Economist and GFI Programme Manager, Investment Division, OECD). Additional comments were received from David Neckar (Willis), Kevin Godier (Global Trade Review), Joerg Weber (Chief, Programme International Arrangements Section, UNCTAD), Jan Muller, Thomas Meyer (Hannover Re), Daniel Hui (Swiss Re), Christina Deischl and Petra Hansen (Munich Re).

SELECTED ABBREVIATIONS

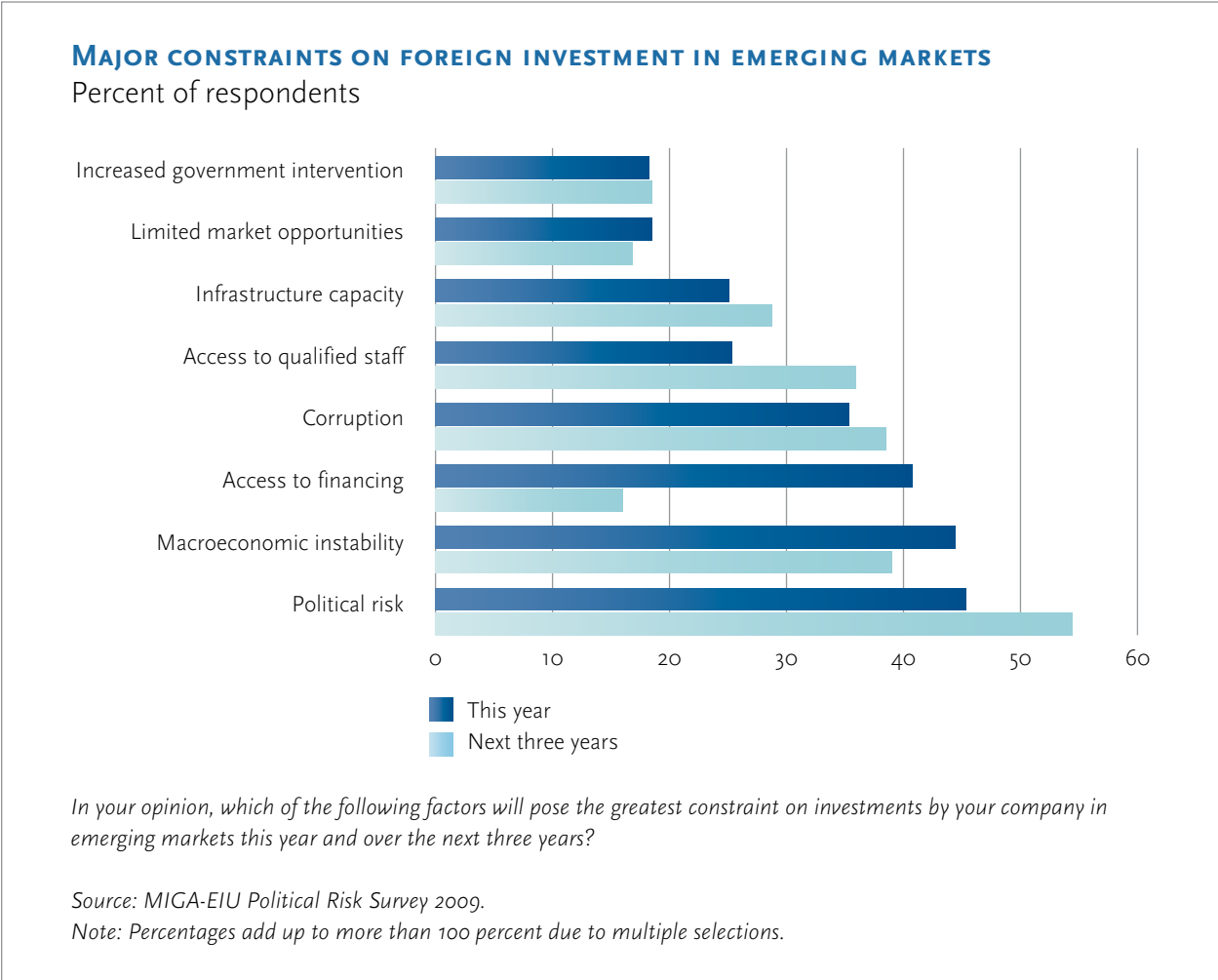
ATI	African Trade Insurance Agency
BIT	Bilateral investment treaty
BRIC	Brazil, the Russian Federation, India and China
BU	Berne Union
CDS	Credit default swaps
CIS	Commonwealth of Independent States
ECA	Export credit agency
ECGC	Export Credit Guarantee Corporation
EIU	Economist Intelligence Unit
FDI	Foreign direct investment
GDP	Gross domestic product
ICIEC	Islamic Corporation for the Insurance of Investment and Export Credit
ICSID	International Centre for Settlement of Investment Disputes
IMF	International Monetary Fund
M&As	Mergers and acquisitions
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PRI	Political risk insurance
T&C	Currency transfer and convertibility
VCC	Vale Columbia Center on Sustainable International Investment

EXECUTIVE SUMMARY

Political risk is a top concern for corporate foreign investors—from industrialized but also developing countries—when venturing into emerging markets. At the same time, these investors maintain a positive outlook on economic and business prospects in the developing world, which is expected to attract a growing share of global foreign direct investment (FDI) as the world economy slowly recovers. Positive business sentiment over emerging markets amid concerns over political perils point to a sustained need to

mitigate these perils. This, added to the rise of South-based investors, offers opportunities and challenges for the political risk insurance (PRI) industry. In the current context of high uncertainty, understanding how investors perceive and deal with political risks helps to map out the role of PRI in the emerging post-crisis investment landscape.

This report focuses on FDI and PRI for long-term investment, and only covers political risk in developing



countries. Although political risk also affects other forms of private capital flows, these are beyond the scope of this publication.

The main findings of the report are summarized as follows:

While political risks top foreign investors' concerns, the global economic and financial crisis has not fundamentally altered FDI prospects for emerging markets.

Political risk remains one of the main obstacles to foreign investment in emerging markets and is likely to continue being so over the medium term. Corporate investors surveyed for this report rank political risk amongst their top three concerns when investing in developing countries more often than any other consideration, including macroeconomic stability and access to financing. The survey suggests that the prominence of political risk relative to other concerns will increase over the next three years, as constraints related to the global financial and economic crisis gradually ease.

Booming economies, abundant liquidity, shrinking financial spreads, flattening risk premiums and a hunt for higher returns encouraged a relatively high tolerance for risk over the past few years. Yet some political risks were already deteriorating before the economic crisis hit. Contract renegotiations in extractive industries and a resurgence of “resource nationalism” in some places heightened concerns over expropriation and breach of contract, even though the nature of expropriation risk has evolved from the outright nationalizations prevalent in the 1970s to regulatory takings. Decentralization has introduced sub-sovereign entities as a source of risk, in particular for infrastructure projects whose viability relies on these entities being able to meet their contractual and financial obligations. Controls on access to foreign exchange have receded and financial markets have been liberalized over the past two decades, but some concerns over the ability to convert and transfer currency in times of crisis, such as the current one, persist, particularly in fixed exchange regimes. High-profile terrorist attacks around the world, as well as piracy and separatist, ethnic or religious tensions in some countries, have highlighted that the risk of political violence is still prevalent. At the same time, the shift of global FDI towards emerging markets, perceived to be riskier than industrialized ones, may have contributed to the salience of political risks, with investors expanding their investment horizons to unfamiliar business destinations.

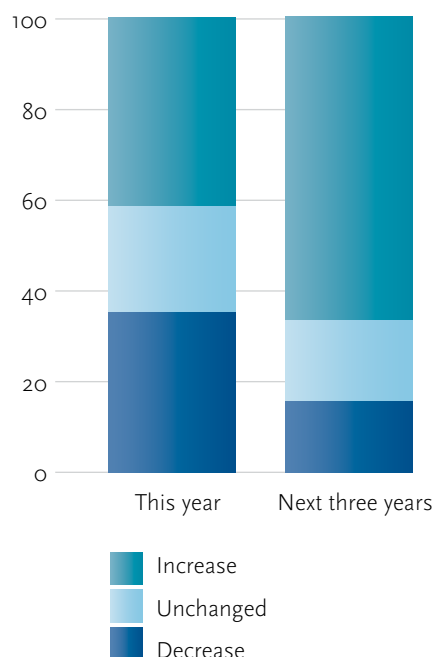
These trends are likely to persist over the medium term. As the world economy recovers, some form of resource nationalism may endure in certain countries. Opportunities for private investment in infrastructure and the extractive industries, with their long term horizons, large scale, and reliance on central or local government licenses or guarantees will continue to carry concerns

over breach of contract, expropriation and related political risks. Some forms of political violence, such as terrorism and civil unrest, are not expected to ease in the short or medium term. And the continued globalization of capital flows still carries the potential to destabilize exchange rates regimes and local financial markets, providing temptations for some governments to restrict these flows in times of crisis.

The recent economic and financial turbulence does not appear to have altered political risk perceptions across the board, but rather exacerbated concerns over specific perils and destinations for a minority of investors. A majority of the investors surveyed for this report do not believe the downturn itself resulted in higher political risks in their main investment destinations; 35 percent, however, thought otherwise. Specific political risks directly related to the fallout of the crisis have emerged in the most vulnerable destinations. Concerns that governments may be tempted to impose transfer and convertibility restrictions have emerged in countries where the financial

INVESTORS' VIEWS ON FOREIGN INVESTMENT PLANS

Percent of respondents



Do you expect your planned investments abroad to change this year compared with last year, and over the next three years compared with the previous three years?

Source: MIGA-EIU Political Risk Survey 2009.

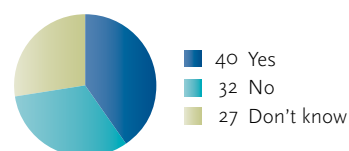
crisis has severely undermined liquidity and put pressure on the local currency. With unemployment on the rise, declining remittances and pressure on social programs due to shrinking government revenues, the risk of civil unrest is more pronounced in some countries. Budgetary pressures have also raised concerns about the ability of governments and state-owned entities to fulfill their contractual obligations and honor sovereign guarantees. Better policy regulatory environments, stimulus packages, and international assistance, however, have somewhat cushioned the impact of the downturn, and these risks have so far either not materialized, or have had a limited impact. In addition, they are expected ease as the economy slowly recovers.

Although the global financial crisis and economic downturn have severely curtailed economic growth and FDI, global foreign investment flows are expected to start recovering in 2010. Longer-term trends that sustained the rise of FDI to record levels until 2008—including the corporate search of new markets, resources and assets, intensified competition, the development of global supply chains, liberalized investment regimes and lucrative investment opportunities—are expected to sustain foreign investment once the global economy recovers from the recent shock. The investor survey conducted for this report confirms that, despite the severity of the global crisis, foreign investment intentions are robust over the medium term; if signs of economic recovery were to stall or reverse, however, or constraints on project finance to persist, these FDI intentions may struggle to materialize in full.

The developing world remains an attractive destination for FDI. Although emerging markets have not been spared from the effects of the crisis, they have on average fared better than the industrialized world in terms of both economic growth and FDI inflows. Whereas the economies of industrialized countries are projected to contract by 3.2 percent in 2009, developing countries' GDP is expected to still grow by 1.2 percent. Emerging markets are expected to keep capturing and generating an increasing share of global FDI going forward, a trend that predates the crisis. The surveys conducted for this report confirm that investors' outlook on emerging markets remains bullish; investment intentions that emerge from these surveys, however, remain heavily focused on the handful of countries—particularly Brazil, the Russian Federation, India and China (BRICs)—that have absorbed the bulk of FDI into developing economies over the past few years. Added to the continued rise of investors based in emerging markets, this underscores an economic shift towards the emerging world, whose weight in the global economy is expected to continue growing.

INTEREST IN PRI

Percent of respondents



Moving forward, do you expect your company to consider political risk insurance for its investments abroad?

Source: MIGA-EIU Political Risk Survey 2009.

Concerns over political risks, combined with sustained FDI into emerging markets over the medium term, suggest a growing need for political risk mitigation and opportunities for the PRI industry.

The continued prominence of political risk concerns and the growing interest in emerging markets as investment destinations underpin interest in risk mitigation going forward. Historically, political risk insurance has covered only a small share of FDI, as most investments into emerging markets have been uninsured. Yet only 6 percent of investors surveyed for this report said they did not mitigate political risks at all; but those who did manage these risks appear to rely primarily on their own risk management capacity—even though a sizable minority judges that capacity as poor—and on informal mitigation mechanisms, such as engaging with local governments or local partners. Insurance, on the other hand, appears to be a niche product: 14 percent of surveyed investors contracted PRI, but almost twice as many did so when venturing into markets considered the riskiest. However, 40 percent of the respondents also indicated they would consider using insurance for future investments.

This places the PRI industry in a position to expand its reach and support the expected rebound of FDI to the developing world. The industry has grown from a minimal presence 20 years ago to a well-established market today, generating annual premiums of about \$1 billion. The sector is now mature and resilient, shaped by numerous shocks, such as the Argentine peso crisis and the September 11 attacks, in the past two decades. Its exposure is diversified across a number of well-capitalized and informed carriers, underwriting standards and processes have been strengthened, and reinsurance has grown exponentially.

So far, the PRI industry has weathered the global downturn relatively well: most private and public members of the Berne Union have reported robust financial results, in spite of a decline in new business in the first half of 2009; the downturn has so far not resulted in the expected level of claims; and overall market capacity for political risk cover appears to have held steady.

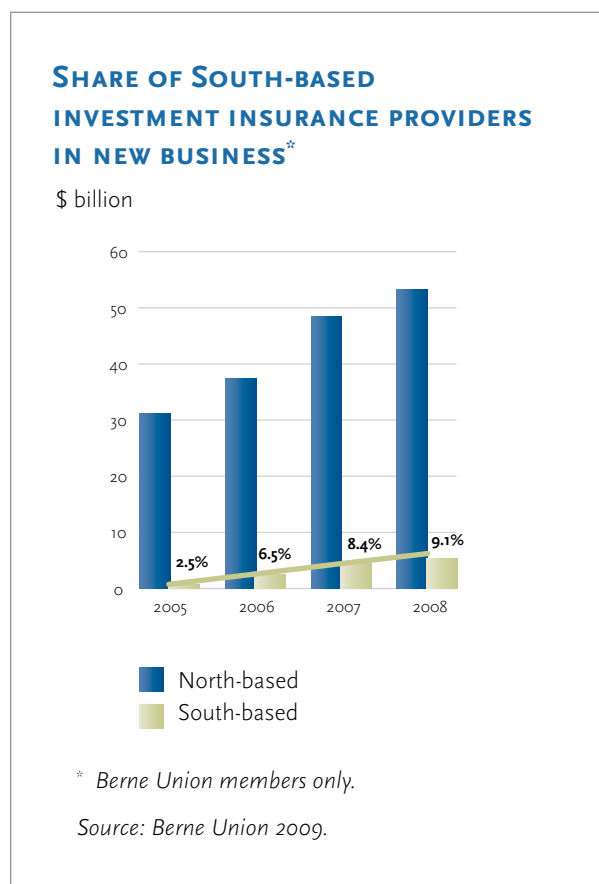
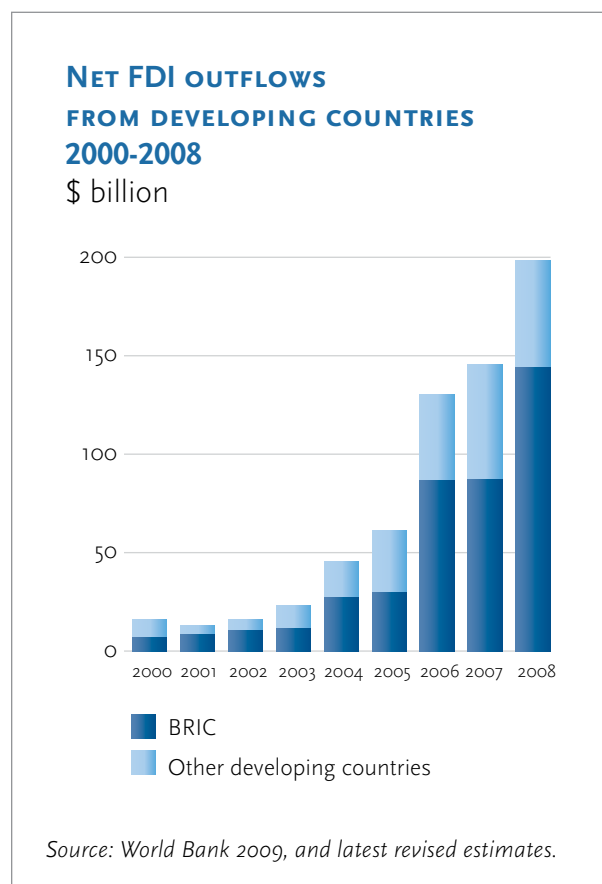
The financial crisis has resulted in higher selectivity and stricter underwriting conditions in some segments of the private insurance market though, and capacity has been reduced for some countries. The multilateral and national insurers, however, are better able to maintain capacity, prices and tenors in times of crisis, and are therefore well placed to fill potential gaps that may arise in the private market. This highlights public insurers' role in stabilizing the PRI market in uncertain times. Continued co-operation between public and private insurers—through coinsurance, reinsurance and information sharing—will be important to support the expected recovery in FDI. The industry as a whole is well able to respond to an increase in demand for risk mitigation that may arise from investors deciding to insure existing projects, as well as from the revival in new investments expected from 2010 onwards.

Although prospects for FDI are optimistic, banks are likely to remain cautious, at least in the near term, potentially constraining investments relying on project finance. This could affect demand for PRI in conflicting ways when it comes to these types of projects: a lower volume of operations on the one hand, but a higher willingness to obtain PRI for projects that do go ahead.

The emergence of South-based investors is increasingly shaping the global FDI environment and presents regional growth opportunities, but also challenges, for the PRI industry.

South-based investors, particularly from the BRICs, have been a growing source of investment to emerging markets, and this trend is expected to continue over the medium term. Between 2003 and 2008, FDI outflows from developing countries increased more than eight fold, reaching an estimated \$198 billion in 2008, 73 percent of which came from BRIC countries. With their economies having so far weathered the crisis better than industrialized ones, the South-based investors surveyed for this report appeared bullish in their investment plans.

These emerging investors are also concerned about political risks: the surveys conducted for this report show



that, as with North-based investors, political risk is ranked first amongst concerns when investing in emerging markets, both today and over the medium term. As they venture from familiar regions, South-based investors appear to be increasingly more preoccupied with political perils relative to other concerns.

Most South-based respondents use some form of risk mitigation but, when they do, favor informal methods such as engaging with local governments and setting up joint ventures, rather than PRI. Yet over half the survey respondents—in particular those from China and India—indicated they would consider political risk insurance for future investments.

The growing weight of South-based investors in global FDI offers opportunities and challenges for the PRI industry. Insurers are reaching out to this fast-growing market segment. The private PRI market has been developing a growing presence outside of London, New York and Bermuda to capture the rising demand for investment insurance from South-based investors; Singapore, for example, is emerging as a regional insurance hub. The changing landscape of global FDI is also shaping the industry, as some PRI providers originating from emerging markets are fast expanding their investment cover. South-based export-credit agencies such as Sinosure have increased their investment insurance portfolios manifold, and relatively new regional insurers such as the African Trade Insurance Agency (ATI) have also experienced tremendous growth in the

past few years. New products specifically tailored to local needs—such as Shariah-compliant insurance, have been developed. The share of South-based insurers in Berne Union members' new business expanded from 2.5 percent in 2005 to over 9.1 percent in 2008. But the market still needs to improve investor awareness of PRI and become more proactive in promoting its services and adapting its offerings to the needs of South-based investors.

FDI recovery, the growing interest in emerging markets as investment destinations and concerns over political risks are expected to support a further expansion of the PRI industry. But while it will most likely continue growing in absolute terms, PRI is likely to remain a niche product providing cover for a small share of FDI and project finance debt to emerging markets, in part because insurable risks are a subset of the total spectrum of political risks which concern investors. History suggests that PRI is of particular interest in the immediate aftermath of financial and economic crises, and following high-profile claims, when certain political risks are exposed.

Although PRI is not a key determinant of FDI flows to developing countries, it can nonetheless play a key role in supporting the changing dynamics of global investment, in facilitating large and complex projects in sectors that have high development impact and are government priorities, and in promoting investments into underserved markets, such as poorer countries and conflict-afflicted environments.