The Outlook for Foreign Direct Investment and Political Risk

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Keynote Address by
Graeme Wheeler, Managing Director, The World Bank

In Les Miserables, Victor Hugo describes the actions of a little black cat, "We all know the habits of cats of hesitating in an open doorway – hovering uncertainly at the risk of being crushed by the closing of the door."

Today, most investors are equally hesitant.

International capital flows increasingly dominate our cycles of industrial production, and we have seen how these can create global instability and cause the Basel 2 pillars to fail in a G7 economy.

Every asset across the globe has been revalued and large portfolio adjustments are taking place in household, corporate, and government balance sheets. Governments have become guarantors and investors of last resort, and acquired ownership interests outside their traditional investor habitat and risk tolerance. Fiscal, monetary, financial and debt management policies have become blurred, further exchange rate adjustment is needed to help correct global payment imbalances, public sector debt is on an explosive path in many countries, and governments worry about when to return to more orthodox policy settings.

We have seen several asset bubbles since the Asia crisis – in high tech, public and private equity, real estate, structured financial products, commodities and emerging market fixed income. Risk capital moves rapidly from one asset class to another as each cycle plays out. Currently, another bubble may be forming – this time in emerging market fixed income and equities – funded in part through highly leveraged carry trades out of dollars. In parts of East Asia, property prices are rising rapidly.

What is the outlook for foreign direct investment in developing countries?

Over the past decade, 30% of global FDI went to the developing world. Annual net FDI inflows to developing countries peaked at $580 billion in 2008, and have been more resilient than other private capital inflows during the crisis. About half of the inflows went to the BRICs – 2/3rds of it in the services sector and mainly in financial services. Flows to low income countries tend to be commodity based.

Developing countries, in turn, are increasingly becoming a source of FDI flows. In 2008, they accounted for 13% of global FDI outflows. BRICs originated 70% of these - mainly through investments in their region.

MIGA's survey indicates that FDI flows are expected to increase over the next three years with many investors – particularly those from the U.S. and U.K. – redirecting investment to developing countries. This is likely to be a long term trend.

World Bank projections suggest that in two decades time, the G7 share of global GDP will decline from around 60% currently to a little over 40% by 2030. In three decades time, China and India could be the largest and third largest economies respectively – although the latter will depend upon India's success in transferring the dynamism of its services sector to manufacturing.

The opportunities and demand for FDI are enormous. Climate change is the defining issue of our time and offers huge scope for FDI. Developing countries are expecting large financial transfers since the concentration of greenhouse gases largely originated in the developed world, and developing countries are likely to experience 80% of the costs of the damage from climate change. By 2030, annual mitigation costs in developing countries could be $140 billion - $175 billion; annual adaptation costs an additional $10 billion - $90 billion. These investments are so large that they can only be mobilized through innovative approaches to public-private partnerships.

Substantial FDI will also be needed to enhance food security and water resource management. Staple food production needs to increase by 50% over the next 40 years. To put this challenge into perspective, the average yield increase in Africa in the past 45 years was under 30% and population more than trebled over the same period.

Currently, 2 ½ billion people live without access to sanitation - one billion people lack access to safe water. Annual global investment in water management is currently around $75 billion – the annual investment needed is 2 ½ times this.

Some researchers suggest that the world's middle income population could swell by up to 2 billion by 2030. This massive market growth will provide opportunities for partnering with frontier firms in developed countries to leap-frog on new biotech, wireless, mobile, and digital technologies.

Realizing these opportunities will require ongoing reform and careful risk management. The scale of FDI flows will depend on the progress made in delivering sound economic policies, good governance, social stability, and adequate infrastructure. The rule of law, enforceable property rights and measures to fight corruption and illicit payments will also be important. Some researchers estimate that annual illicit flows from developing countries are in the range of $800 billion to $1 trillion.

Regulatory frameworks also matter. Although the private sector creates around 90% of new jobs, in many developing countries there is so much regulation that many jobs occur in the informal sector where workers have little protection. In India, for example, the 30 million working in the formal sector, comprise less than 10% of total employment.

Fortunately, there has been good progress on the reform agenda. Macro policy settings improved following the contagion created by the Asian financial crisis in the late 90s, and over the past 6 years, 80% of the Doing Business reforms monitored by the World Bank focused on easing business start-up and transacting.

Regional economic integration will also be an important determinant of FDI flows. We saw this in Turkey. The opening of EU accession negotiations in 2005 led annual FDI flows to surge from $3 billion in 2004 to $22 billion three years later. Considerable opportunities for economic integration exist elsewhere. South Asia is the least integrated region in the world - countries that have opened up trade with the rest of the world remain closed to each other. In Latin America, the proposal almost two decades ago to join 34 countries into a free trade zone proved to be a step too far, but should remain a longer term objective.

Demographics will also affect the climate for FDI. By 2030, Western Europe’s and Japan’s working age population will be declining. In Japan, Italy, and Spain, more people will be in their 70s than in their 20s, and Russia and Eastern Europe’s population is projected to decline rapidly. On the other hand, India’s median age is currently 25 years; in China it is 35. Firms will need to access labor from labor surplus countries and shift their production capacity to those developing countries where labor is more plentiful and markets are expanding.

This suggests that the rising level and proportion of FDI to developing countries is likely to continue over the next two decades. But this judgment is predicated on no major global discontinuities or shocks. Several global shocks have occurred over the past two decades – the collapse of the Soviet Union in the late 1980s, the Asian Crisis of 1998, and the food, fuel, and financial crises of the past 2 years. None, however, have permanently reversed the transfer of skill enhancing technologies or the catalysts of trade, investment and capital flows that underpin the globalization process. What is the outlook for the future?

This takes us into the area of political risk.

Projections about political risk are inherently difficult. They are usually stylized, based on recent trends, and assume that current global power relationships continue. For example, the world would be very different if the Soviet Union had not collapsed, or if post-crisis fiscal and unemployment challenges in the developed economies prove more deep-rooted than expected.

Looking ahead, the biggest challenges are likely to come from issues around nuclear proliferation, terrorism, and political tensions associated with climate change, food security, water management, demographic aging, the degree of poverty alleviation, and the distribution of income.

FDI is driven by the catalysts that support globalization. But, globalization will only be sustainable if its benefits are widely shared. There are troubling signs on this front. The number of people living in extreme poverty – already more than twice the population of Europe – is increasing. At the global level, none of the 7 millennium development goals are expected to be fully met, and the 1.4 billion extreme poor are increasingly politically, economically, and socially disconnected from global society.

Fragile states face the starkest situation. Poverty rates in the 37 fragile states average 54% compared to 22% in other low income countries. 22 of these fragile states are in Sub-Saharan Africa.

Demographics will dramatically increase the challenge. Almost all of the 3 billion increase in global population projected by 2050 will occur in developing countries – two thirds of it in regions currently experiencing low economic growth. Hardest hit will be Sub-Saharan Africa. 54% of its population is aged under 20 (compared to 24% in OECD countries), and this region is likely to have tens of millions of youth unemployed for decades to come.

Globalization that is sustainable will require all countries to share in its benefits, and a fair and equitable resolution to global collective challenges such as climate change and the management of the international trading system. If this cannot be achieved, we are likely to see an unraveling of global integration.

For the foreseeable future, the outlook for political risk insurance looks promising. Although over the past decade, only about 10% of FDI flows to emerging markets have carried political insurance, this is likely to change as emerging market countries expand their share of FDI outflows, and as investment in primary production shifts to more risky destinations.

How do the Multilateral Development Banks (MDBs) support FDI?

The MDBs promote sustainable development in developing countries by providing financial resources, sharing knowledge, building capacity, and forging partnerships in the public and private sectors.

In the last financial year, the World Bank Group provided $60 billion of grants, loans, and investments to low and middle income countries. Since its inception, the IFC, the Group's private sector arm, has invested in over 500 companies with foreign investors. The Bank provides data on FDI flows (including source and destination) to developing countries and analyzes the links between FDI and domestic investment and growth. Its Doing Business Report monitors investment climate reforms in over 180 countries. The Foreign Investment Advisory Service (FIAS), a joint effort of the IFC, MIGA, and the World Bank, has undertaken investment climate surveys in over 100 countries.

MIGA provides valuable political risk insurance to investors and lenders, and has written over $20 billion in guarantees for 600 projects in 100 developing countries. Outstanding guarantees currently exceed $7 billion.

MIGA also provides important knowledge services and technical assistance to governments wishing to promote FDI. One such example is its excellent report on World Investment and Political Risk, and today's global political risk summit in partnership with the Financial Times.