**World Economic Forum**
**Global Agenda Council on Fragile States and Conflict Prevention 2013-2014**
**Discussion Paper**

# The Role of the Private sector in Fragile States: Catalyzing Investment for Security and Development

## Introduction

1. Some 1.5 billion people in an estimated 40 countries live in contexts marked by persistent vulnerability and fragility. Variously referred to as "fragile and conflict affected countries", “fragile situations”, and "frontier states" for their economic and development potential, these are environments where the social compact between states and society has been broken. They are countries confronted by a myriad of simultaneous and often overwhelming challenges, including those posed by armed conflict or political violence; serious and persistent human rights violations and impunity; and threats from organized crime and terrorist networks. They tend to have weak systems of governance including large scale and often systemic corruption and are challenged to uphold the rule of law. They also have significant human capacity constraints. These factors render them extremely vulnerable to internal and external shocks such as those posed by natural hazards, global economic crises or food commodity price fluctuations[1].

2. This paper looks at the role that the private sector can play in alleviating some of the concerns of such states. Firstly, it looks at the issues and concerns facing fragile states, offering an overview of the topic, and reviewing some of the current initiatives that exist today to address the problems facing such states. The paper then looks at the role that the private sector and investment in success of fragile states might play in helping. In particular, it focuses on a number of sectoral considerations, as well as both the economic and political dimensions of the private sector role. A number of key areas where the private sector role can be facilitated and its effectiveness improved will form the key policy recommendations of the paper. These will include considerations such as the role that can be played by Political Risk Insurance (PRI), possible “best practice” approaches to maximize impact, sectoral transparency initiatives and more “blue sky” alternatives. Private investment is by no means a “silver bullet” that can solve all the problems which beset fragile states, and this paper does not pretend to offer universal solutions to these

[1] OECD/DAC (2012) “Think global, act global: Confronting Global Factors that influence conflict and fragility”, Consultation paper September 2012.

often intractable problems. However, the aim is to promote discussion and to suggest useful, practical ways the private sector lens can be applied to these difficult areas. This is an important discussion to have.

**Section 1: Fragility**

***Fragile states today***

1. This discussion adopts as a working definition the concept of fragile state that is comprehensively explored in the *World Development Report 2011: Conflict, Security and Development* and that encompasses the various features outlined above.

2. At present, one of the great challenges confronting the international community is the real and persistent fragile Sahel region in Africa. Insecurity—with the rise of radical Islamism and transnational criminal activities—is a serious concern in the region, particularly in northern Mali, but affecting all the countries across the Sahel band, and down even into the Great Lakes region. Weak governance practices, enduring socio-economic challenges, combined with sporadic drought and flooding also continue to fuel a recurring humanitarian crisis. This has so far resulted in 18.7 million people facing food and nutrition insecurity, and over one million children under the age of five being at risk of severe acute malnutrition. . The multifaceted crises in the Sahel-Sahara and Great Lakes regions remain high on the agenda of the international community and various strategies are being developed to address such complex regional fragility. In northern Mali, fighting in 2012 caused around 320,000 people to flee their homes, seeking refuge both inside Mali and across Malian borders in Mauritania, Niger, Burkina Faso and Algeria. The ongoing conflict in Central African Republic has seen an estimated 400,000 people internally displaced, many of them fleeing across borders to the neighboring countries. Other fragile situations in countries such as Sudan, Afghanistan and Pakistan have created situations which bear heavily on local populations, as well as expanding to more geopolitical security concerns.

3. Fragile states are least likely to meet the Millennium Development Goals, according to the World Bank[2], resulting in hundreds of millions of people being trapped in a cycle of poverty and insecurity. Unless the causes of fragility are given greater priority by their partners and the countries themselves, fragile states are unlikely to make much progress in meeting MDGs or substantially reducing poverty and insecurity. Reducing fragility not only requires investment in human capacity, infrastructure and job-creating business, but also for these countries to create the institutions that provide security and justice, enable markets to work and to create a new social contract.

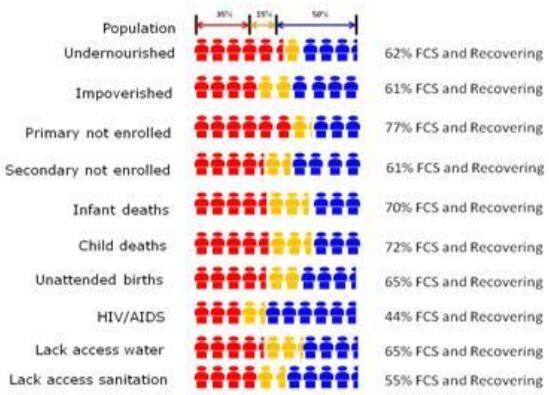
4. Failure to effectively prevent and respond to these situations results not only in a significant loss of human potential for those living in these states, but has serious consequences for global and regional security and stability, particularly where ceded political space is filled by criminal and terrorist elements. For example, global cocaine and heroin production and trafficking can be a risk for the stability of fragile states, and

[2] World Bank (2011) "World Development Report 2011: Conflict, Security and Development".

provides organized crime with some $153 billion in annual revenues (compared to $133 billion provided annually in Official Development Assistance to all developing countries worldwide[3]). Maritime piracy is also estimated to have direct economic costs of $5.7 to $11.2 billion including ransoms, insurance and re-routing. Low-intensity conflicts are increasingly becoming a strategic issue in a globalized world in which we cannot afford to ignore ungoverned spaces (drugs, but also pandemics). States have historically been the first responders of the world; if they fail to perform that role, problems can become much more difficult to solve.)

**Fragile and Conflict Affected States and the Millennium Development Goals:**

This diagram shows the total global MDG deficit (excluding Brazil, Russia, India and China). The figures in red and yellow show the proportion that relates to people living in countries affected by or recovering from violence.




5. Failure to respond effectively to fragile states also significantly impacts global economic growth. The World Bank has indicated that the impact on neighboring country GDP from fragile states is approximately $237 billion a year, and that trade levels after major episodes of violence can take 20 years to recover[4]. Four weeks after the uprising in Libya began in 2011, global oil prices increased by 15%.

6. The underlying characteristics of fragile states, such as ineffective institutions, poverty, high unemployment (particularly for youth), dependency on natural resources, impunity and lack of justice and ethnic (or religious) dominance by a single group, all contribute to make the states prone to conflict. There is also a much higher risk of conflict recurrence in fragile states, with a 39 per cent chance that peace will collapse within the first five years, compared with 14 percent for a typical low income country, and a 32 percent chance that it will collapse in the subsequent five years[5].

7. Looked at through a different lens, however, today's fragile states are potentially tomorrow's emerging markets. More than three quarters of states classified as "fragile" possess extensive mineral and energy resources.[6] Moreover, many of these states are either candidates for the proper implementation of the Extractive Industry Transparency Initiative

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3 OECD/DAC (2012): https://www.oecd.org/dac/aidstatistics/developmentaidtodevelopingcountriesfallsbecauseofglobalrecession.htm

4 World Bank, WDR 2011

5 Collier, Paul and Hoeffler, Anke (2004) "Conflicts" in B. Lomborg (ed.) *Global Crises, Global Solutions*, Cambridge University Press, Cambridge.

6 World Economic Forum~~Council~~, Network of Global Agenda Councils Reports 2011-2012 "New Models for Engagement in Fragile States", May 2012. http://reports.weforum.org/global-agenda-council-2012/#view/global-agenda-council-2012/councils/fragile-states

(EITI) or EITI compliant[7]. For instance, the IMF has estimated growth for GDP in Sierra Leone[8] in at 15-16% the last two years, with a further 13.9% estimated this year, and the country has attracted important investments such as the London Mining iron ore project at Marampa, a USD1.5bn investment, and the Addax biodiesel project at Makeni, a USD366m investment. Other noteworthy anticipated growth rates for 2014 include DRC (8.7%), Cote d'Ivoire (8.2%), Timor Leste (9.0%), Mongolia (12.9%), and Turkmenistan (10.7%). These compare to projected growth of 2.2% in advanced economies, and an even lower 1.2% in the Euro area.[9]

8. However, ensuring these countries and their populations positively capitalize on this potential will only be possible if new *and equitable* models can be found to carefully and substantially (re)establish state-society relations. This will include building context relevant development models that enable responsive, accountable and transparent governance, proper protection of human rights, provision of basic services and security, and the transformation of economies based on clear rules of engagement for government, the market and civil society actors. If we can do this, then we may be in a position to qualitatively build national resilience to fragility and vulnerability.

***Current initiatives on fragile states***

9. Our current knowledge of what determines state fragility and how to help countries transition to resilience has grown during the past decade. The international community has learned from the experiences of Afghanistan, Iraq, Palestine and the civil conflicts in central and West Africa and the Western Pacific. More recently, the Arab Spring is a reminder that countries which appear stable and not particularly poor are also prone to violent upheaval and armed conflict, transforming them into fragile states.

10. A rich academic literature on fragility and conflict has emerged from these experiences and has been incorporated into major policy reports by the Development Co-operation Directorate of the Organization for Economic Co-operation and Development (OECD) and the World Bank and the policies of OECD member states engaged in supporting security, development and legitimate authority in countries that have been affected by armed conflict.[10] Governments of fragile states too have formed their own group – the g7+ - to share knowledge and to deal collectively with the international community. Some of the essential points from these documents are summarized in Appendix 1.

11. Failure in one of the policy areas of institutional development, security and justice, and development can jeopardize results in the others. Experience in Afghanistan, Iraq, Pakistan and Palestine, for example, shows that it is not possible to buy peace through

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7 In 2013 these include: Afghanistan, Chad, DRC, the Re~~u~~public of Congo, Guinea, Liberia, Sierra Leone, Solomon Islands, Timor Leste, Togo, Yemen and Iraq.

8 IMF World Economic Outlook, April 2014.

9 IMF World Economic Outlook April 2014.

10 For an overview of the academic studies on fragility see Acemoglu & Robinson (2012), Collier (2009), Fukuyama (2011), Lindemann (2008), North et al (2009) and Stewart (2010). Documents which bridge theory and policy include OECD (2011), World Bank (2012), Call & Wyeth (2008) and Ghani & Lockhart (2008).

development assistance alone, as well as the limits of approaches based primarily on coercive force. Several partner countries, including Australia, Canada and the United Kingdom have set up central units in their governments to better coordinate their assistance to countries emerging from conflict based on lessons learned over the past two decades. They have also participated in a larger partnership of countries and agencies seeking to improve performance in fragile states called the International Network on Conflict and Fragility (INCAF), the International Dialogue on Statebuilding and Peacebuilding, and other associated communities of practice[11]. This has resulted, inter alia, in the development of new operational and policy tools, including the OCED/DAC 10 Guiding Principles for Good International Engagement in Fragile States[12]. At the country level, this coordination is usually the responsibility of UN Special Missions which are often under-resourced and lack authority over member states, UN agencies and international organizations.

12. The New Deal on Effective Engagement in Fragile States, which was agreed at an OCED sponsored meeting in Busan in 2011 between governments that have experienced armed conflict (also known as the g7+) on the one hand and states and agencies that seek to support them on the other. This sets out principles for guiding the partnership between them. Key features of this agreement are summarized in Appendix 2.

13. The New Deal explicitly recognizes the centrality of country ownership and the role of the country to manage its own transition towards resilience and development. Governments in fragile states typically have more capacity than usually credited and this capacity can grow quickly if the state can take charge of its transition from fragility to development. In some cases this can be difficult when government capacity is very weak, or it is unwilling to exercise its authority, and where international support is uncoordinated and driven by conflicting national and international agendas. This may also be time sensitive, with states often being especially vulnerable during the periods of transitional governments, for example with large private sector contracts being struck and the transitional leadership being potentially as motivated by short term gain as by the longer term welfare of the country.

14. Previous meetings of the Global Agenda Council on Fragile States assessed options for addressing these problems through "dual key" arrangements for shared decision making, including over natural resources revenues, between a country and a representative of its international partners. The Global Agenda Council on Fragile States has also previously recommended that business councils of investors and corporations active in fragile states in key sectors should play a central role in supporting good governance, growth and job creation. The Busan New Deal also calls for special measures to mitigate risks and for attention to be given to Peace-building and State-building goals of inclusive politics, security, justice, economic foundations for employment and improved livelihoods, and generating public revenues and delivering services.

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11 See INCAF, IDSP, International Stabilization and Peacebuilding Initiative (ISPI) https://www.civcap.info/home/international-stabilization-and-peacebuilding-initiative-ispi.html

12 http://www.oecd.org/dac/conflictandfragility/effectiveengagementinfragilestates.htm

***The current multilateral system***

15. The current multi-lateral system engages with Fragile States through a variety of mechanisms, ranging from the embassies of country governments; to the offices and representatives of the International Financial Institutions (International Monetary Fund, World Bank, regional development banks); to the UN, often through a specifically mandated UN mission and representative or its multiple specialized agencies, funds and programs; and a variety of non-governmental organizations often funded by the above entities.

16. Criticisms of the multiplicity of bodies engaged with fragile states have resulted in some efforts to streamline engagement processes, including as noted earlier in this briefing the introduction of the INCAF principles, the development of a dedicated Conflict hub in the World Bank to sharpen the operational response to fragility, and the New Deal, and new bodies, such as the Peace Building Commission, Fund and Support Office at the UN. There remains an active debate as to how best to organize both internal and external actors – and the interface between them – in fragile state contexts across the challenges of peace-building, post-conflict or disaster rebuilding, humanitarian response, governance and reconciliation tasks. At the country level, the answers will likely be context specific, and there is a growing body of lessons to be learned ( for example, the importance of quick and agile responses to conflict/fragility situations, as well as the building of partnerships both locally and internationally in response to them), as well as the approaches to be avoided .

17. The next few years will see further reforms brought to the international system, including to address perceived inequities related to emerging powers. A key question will be whether rising new powers will collaborate and contribute within or outside this system, the extent to which they will buy into the lessons identified on fragile states to date, and the role of regional actors.

18. As the framework for any successor to the Millennium Development Goals is debated, a question is justly raised as to how the MDGs can and should apply to Fragile States. Some propose that there is a need for a new MDG focused explicitly on Fragile States; others, pointing out that no Fragile States will meet a single MDG, that there should be a separate set of Peace and State Building Goals for Fragile States that take account of the need for intermediate goals and both objectives and processes that take into account the considerations of security and peace-building that will be absent in contexts where security is a given. Whichever approach is taken, it is clear that any successor framework needs to take into account that a different paradigm for peace-building, state-building and development is required for fragile states than that usually applied in any “normal” developing context.

19. Beyond the question of the MDGs, there are clearly some gaps in the architecture and processes of the multi-lateral system in responding to fragile states. Those that stand out include:
    - More attention should be given to the importance of functioning and thriving

economies in the transition from fragility to development. Too often, economic development is overshadowed by other critical areas, including security sector reform, building low priority government institutions and addressing grievances. These are undeniably important. Nevertheless, greater attention is needed to ***job creation, market-building and economic growth*** in fragile states. Whereas the UNDP, World Bank and even the ILO each play a role in this space, often this issue is marginalized or left to a later phase with regrettable consequences[13]. UN peace-keeping or political missions can be asked as part of their mandate to encourage such issues, but its doctrine dictates the mission itself focuses on creating only a secure environment for economic growth rather than playing a more direct role for this element, a prioritization that perhaps needs revisiting. It may well be a mission should not deliver such effects, but it can play a role in overall coordination and planning to ensure that these critical issues will be tackled substantively in an integrated way in parallel to security and political functions.

- The central importance of rule of **law, justice and a trusted police** force to overcoming fragility and conflict is often recognized, yet efforts in this area remain problematic[14]. Better outcomes are urgently needed yet consensus on 'what' and 'how' remain elusive.
- ~~Anti-~~Reducing those forms of corruption that corrode public confidence in institutions and retard economic development has become a chorus yet success is difficult when corruption networks are pervasive. A global focus on **accountability and anti-corruption** is clearly emerging. While a greater consensus on the 'how' could be helpful solutions are likely to be country specific and require actions on preventing corruption in contracts, anti-money laundering and stolen asset recovery by international partners and investors, as well mobilizing civil society, media and legislatures in fragile states. Anti-corruption organizations often do not work as intended in environments where corruption is widespread and judicial systems are weak, and have become instruments for harassing political opponents.
- Much of the international system is predicated on relations with and between states and their governments. Less clear is whether and how organizations are mandated and empowered to interact with the space for ***civil society and citizenship***, beyond the humanitarian organizations tasked with protection of human rights, and the space that has been created by citizens, NGOs and civil society organizations that engage in advocacy and programs. Given the fast shifting demographics in most fragile states resulting in a growing young population, often with growing expectations of participation through social media in public discussions, this space is becoming ever more important.

**Section 2: The role of the private sector – what it can do, how to strengthen its engagement**

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[13] And the integration of these concepts needs to be thought through and should not be merely an "add-on" to the process, for example, through "quick wins" over the award of natural resource concessions. As difficult as this may be, these deals need to be struck in the context of the most durable and broadly-based benefits for a fragile and emerging state.

[14] This is a reinforcing nature of such structures is also often evident too, with the World Economic Forum "Competitiveness" indicator shows a strong pattern of highly competitive countries with strong institutions, and the opposite.

***Role of private sector in fragile states***

20. According to the *World Development Report 2011*[15], the private sector has an important role to play in fragile states as an engine of sustainable growth and stability. Foreign companies in particular can contribute to the domestic economy in terms of new capital formation, skills and job creation, technology transfer, export development, greater integration into the global economy and, critically, the building of a sustainable tax base on the basis of a resilient economy. In fragile states, involvement of the private sector, especially foreign companies, can help reduce the risk of conflict recurrence through increased economic opportunities and provide critical infrastructure (e.g. telecom services) by helping to 'jumpstart' the domestic economy and by integrating into the global economy. The private sector can also provide innovative solutions to overcome the limitations of public institutions, e.g. providing cash transfers directly to people through mobile phone networks. The challenges for governments of fragile states - and indeed for their private sector counterparties - is the creation of an environment that promotes healthy business formation for both domestic and foreign investors and ensuring that critical inputs such as infrastructure, land, an educated and healthy workforce are available.

21. A further real and existing problem for fragile states and their growing need for private capital investment is declining foreign aid budgets in an age of cutbacks and austerity in the donor community – fragile states are typically highly dependent of foreign aid, but foreign direct investment and worker remittances are the next highest sources of capital. Despite the continuing importance of and need to increase official development assistance and other public sector funds (in 2010, total official development assistance from OECD countries amounted to $128.7 billion), it is clear that there will be huge opportunities for private finance and investment as well.

22. The notions of fragility and conflict and private sector engagement are not incompatible, as illustrated by the fact that it is often the private sector that continues to operate in fragile states, even during the most difficult times. In fact, fragile states can provide significant investment opportunities to both foreign and domestic companies, especially as these countries transition to greater stability and improved growth prospects. Indeed, the private sector offers the opportunities for a virtuous circle within the fragile context – creating new opportunities to escape political and economic deadlock. Key questions then become how to nurture and foster such virtuous cycles, as well as to make sure that the investors remain, and where there is a natural resource involved that they strike balanced deals with the government .

23. To maximize this effect it is necessary to identify the constraints facing companies, especially foreign ones, that limit their full engagement in fragile states. These include the capacity of policy makers to create and implement appropriate policies that address macroeconomic mismanagement, operating budget deficits and spending that does not reflect economic and social priorities, capital flight, over-regulation, large shadow (or illegal) economies, and restricted formal trade (but active illegal trade). Appropriate policy

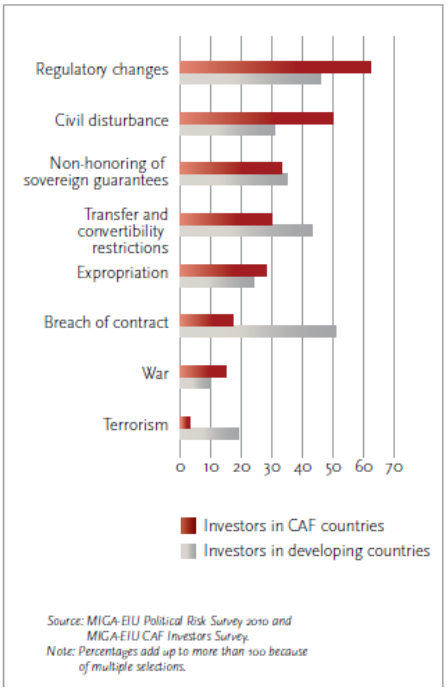
[15] And followed up in works such as Brian Ganson's edited volume, *Managing in Complex Environnments*

reforms are crucial for fragile states to bounce back from a period of conflict and create an overall environment conducive to private sector engagement. In fact, the period immediately following a conflict may offer a unique opportunity for a new era of improved or even radically different policies compared to those of the pre-fragility or pre-conflict stage to tackle structural problems facing the country, supported by the expectations of a population seeking change. However, often the technical capacity to create and implement such reforms is lacking and such opportunities are squandered.

24. Furthermore, the legal system pertaining to the private sector in various fragile states is often ineffectual, with property rights not well defined, lack of clarity regarding land ownership, unreliable commercial law and an overall lack of transparency. All of these give rise to increased commercial risks that deter foreign and domestic private investors from doing business in the country. Weak legal systems in fragile states are sometimes inadequately balanced by stronger legislation in home countries (e.g. with respect to bribery), or foreign firms adhering to international voluntary rules and standards (e.g. with respect to human rights, labor practices and the environment)[16]. However, the disparity in regulation and criminalisation between home countries and fragile states can also make it difficult or risky for private investors to do business in fragile states. To fully flourish, private sector investment needs to be accompanied by a credible process aimed at improving those aspects of public governance that constrain private investment. Moreover, the sequence, pace and simultaneity are of essence, with transparency needing to be accompanied by inclusion, participation and accountability if it is to work to maximum effect.

*Figure 1. Political risks of most concern to foreign investors*

*(Percent of respondents)*



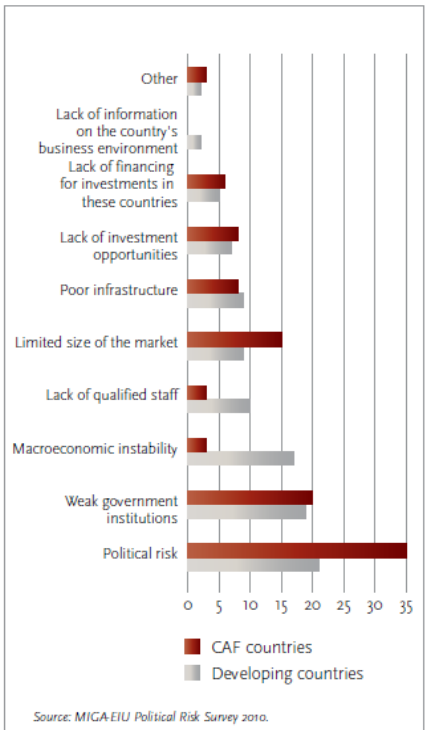

*Source: MIGA-EIU Political Risk Survey 2010 and MIGA-EIU CAF Investors Survey.*
*Note: Percentages add up to more than 100 because of multiple selections.*

25. The World Bank Multilateral Investment Guarantee Agency (MIGA) *World Investment and Political Risk 2010* has highlighted that most foreign investors in fragile states are concerned about adverse regulatory changes that could have important negative effects on their investments (Figure 1). According to the World Bank's *Doing Business 2014*, the majority of fragile states are at the bottom of the Ease of Doing Business ranking, which means that investors in fragile states have to deal with significant regulatory and administrative hurdles and broader country crises. However, the technical capacity of

[16] Though there have been improvements here - legislation such as Dodd Frank 1504 and the EU Transparency Directive require oil and mining companies to declare their payments to governments on a project by project basis, and is independent of, eg, the legal system in fragile states.

*Figure 2. Constraints for FDI in fragile states and developing countries*

*(Percent of respondents)*




*Source: MIGA-EIU Political Risk Survey 2010.*

policy makers to create a regulatory environment that encourages foreign investors to enter and boost private sector engagement in general may be limited, and there may also be formidable opposition from political constituencies and incumbent firms which stand to lose from reform. Capacity constraints also extend to priority 'good' projects (i.e. those projects with a positive development impact in those areas of particular relevance to fragile states, such as job creation and linkages to the domestic economy, and which have undergone conflict analysis/conflict impact assessments to ensure that they do not exacerbate the risk of conflict recurrence). The recurrence of conflict, which has a higher likelihood in fragile states than in other low income economies, is another concern of foreign investors. Besides asset destruction, this risk can cause abrupt declines in domestic demand that affect domestic and foreign business. Again, the capacity of policy makers to address this risk is limited.

26. A key consideration at a domestic level is the role of political leadership in bringing the country out of fragility. This can sometimes be characterized in simplistic terms, almost as if recommending a country to "stop being fragile". A closely related issue in the characterization is a demand for "strong" leaders, though in some contexts such actors may simply sweep fragility under the carpet, deferring rather than resolving issues. In all of this it is critical to understand the "political will" of the leadership to embrace the right reforms or make the decisions of national interest, especially if these decisions affect their personal and political interests. International partners will need to continue to think more creatively on such matters, for example involving facilitating a new elite consensus responsive to pressures to development and to an approach driven by solving a country's problems.

27. More broadly a critical gap in fragile states is the existence of elevated political risks[17] and the capacity constraints of fragile states to address them. This also impacts the confidence of domestic investors as well. The MIGA report highlights that among different challenges facing foreign investors in fragile states, perceptions of political risk were by far the most salient constraint (Figure 2). Furthermore, this constraint was perceived to be far more important for fragile states than for developing countries in general. Apart from small market size the MIGA report shows that other risks in fragile states are not significantly different from other developing countries, while the risks from macroeconomic instability and lack of qualified staff are substantially lower. It indicates that investors need a

[17] Defined here as expropriation, breach of contract, transfer and convertibility restrictions, political violence (war, civil disturbance, terrorism) and non-honoring of sovereign financial obligations.

nuanced and country specific analysis of risk in case they miss opportunities for profitable investment.

28. Countries receiving private investments also face risks, including a lack of symmetry in negotiating power, the risks of signing contracts with reputational risks if they need to be renegotiated later, social dislocation in project areas, environmental degradation, increased corruption, undermining of democratic politics and loss of economic value through transfer pricing and tax avoidance. These risks can be exacerbated by unscrupulous investors (and their home country governments) seeking unbalanced contracts and managing risks through unorthodox means such as bribing officials, commercial espionage and support to political factions. Such unorthodox approaches also contribute to fragility and may be counterproductive if political risks increase. Most of these risks can be mitigated or avoided, particularly if the government obtains high quality advice. Mitigating risks to the country also benefits responsible investors, since a contract perceived as fair by stakeholders is likely to be stable when events such as a change of government takes place.

*What can be done differently/better*

29. This section focuses on the role that can be played by Political Risk Insurance (PRI) to catalyze investment, looking both at how it might work, but also how donors and multilaterals might make a contribution to strengthening its role. There are various approaches to understanding "best practice" in fragility contexts, and we ask how it might be possible to squeeze more developmental/fragility-reducing benefit from current forms of investment (procurement, employment practices etc.). The section focuses on policy recommendations for bridging the gap identified above, so that the foreign private sector (and also the domestic one) can enter and engage fully in fragile states, thereby having a catalytic positive effect on areas critical to these countries. Such policies can help ensure maximum utilization of the private sector and foreign private capital in fragile states in search of higher risk and higher reward investments, and its maximum coordination with limited supplies of public official development aid.

### *(a) Availability and affordability of political risk insurance (PRI)*

30. Typically, foreign companies in fragile states have been using mostly non-contractual political risk mitigation tools, such as engagement with the government of the country in question (Figure 3). The elevated risk in many fragile states has meant that only a few political risk insurers are ready to underwrite investments in these countries and capacity of individual insurers can be constrained. Fewer firms have therefore used political risk insurance (PRI) when investing in fragile states than in developing countries in general, according to the MIGA report (Figure 3). The reasons cited include:
    - the views that PRI is a "niche" product to be used in cases of potentially significant losses associated with certain types of risk (e.g. expropriation), rather than in dealing with broader categories of risk;
    - the belief that potential insurable losses are limited in fragile states because losses

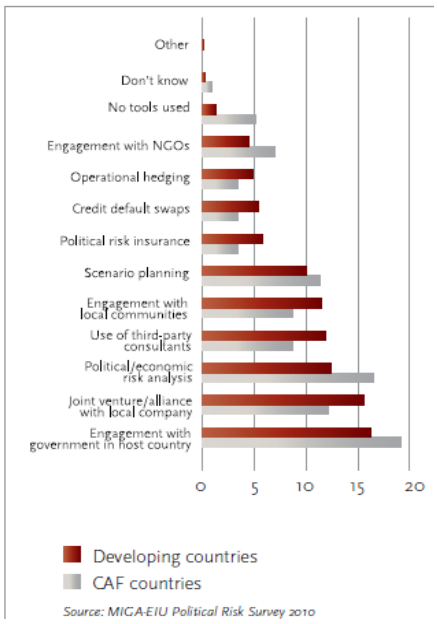
stem mostly from what is regarded as uninsurable acts of political violence; or

- simply lack of familiarity with PRI.

31. Yet, PRI can be an effective tool to mitigate political risks and can enable foreign firms and lenders that have already invested in fragile states to continue operations even during periods of conflict. An illustrative example of the value of PRI is the case of SN Power, an international Norwegian-based hydropower company, which continued to operate its power plant in Nepal despite damages from the conflict[18] and Tea Importers Inc., a United States-based company with a joint venture tea plantation and processing plant in Rwanda, which remained engaged during the civil-war by rebuilding operations after receiving claims payments.[19]One final example might be the combination of loan guarantees from the US Overseas Private Investment Corporation (OPIC), alongside EU grants, which allowed the reopening of Sierra Rutile Company early in the aftermath of the Sierra Leone civil war, allowing new capital to come in for a key employer at a critical moment for the country[20].

*Figure 3. Tools used by foreign investors to mitigate political risk*

*(Percent of respondents)*




*Source: MIGA-EIU Political Risk Survey 2010*

32. Development of specialty PRI products tailored to investors' specific requirements in fragile states allow greater flexibility in sectors or areas deemed too risky for firms to engage. Such products may be aimed at:

- particular sectors (e.g. the OPIC's comprehensive insurance products covering natural resources and specifically petroleum exploration, development and production in developing countries);
- particular types of engagement (e.g., international contractors, cross-border leasing), capital markets transactions and institutional loans;
- extending PRI to investments already present in fragile states, which may have not availed them of PRI at the time of the initial investment, as a way of supporting existing investors; and
- providing PRI to firms exporting to fragile states, as such insurance facilitates the import of capital goods and equipment that is crucial for rebuilding the country's damaged infrastructure.

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18 MIGA, World Investment and Political Risk 2010, Box 2.4.

19 Overseas Private Investment Corporation website - http://www.opic.gov/project-profiles/rwanda-tea-importers.

20 http://iipdigital.usembassy.gov/st/english/article/2003/04/20030404114208kcihcnihcamk0.1897852.html#axzz36F4mxH3T

33. With the cost of PRI often prohibitively high for fragile states, programs that subsidize premium rates can go a long way in boosting demand for PRI and ultimately enabling investment. SMEs can be in a particularly disadvantageous position and programs tailored to them, such as MIGA's Small Investor Program, can help nudge both domestic and foreign investors to engage in fragile states.

34. Donor country measures encouraging the use of PRI may also be helpful in enabling investors achieve the level of comfort they need to put their capital to work in fragile states. An illustrative example is a program by the Ministry of Foreign Affairs in the Netherlands designed to assist Netherlands-based investors interested in the West Bank, not only by providing a grant contribution to the project in question, but also by making mandatory the issuance of PRI for that project (by MIGA) and by paying the premium for the insurance for the first three years. Such measures can encourage foreign investors to invest in fragile states, especially SMEs with limited resources, by safeguarding investments and reducing the costs of political risk mitigation. PRI may also be regarded as a credit enhancement and help reduce the cost of borrowing by donor country firms.

35. Related to donor country measures is the establishment, possibly on a selective basis, of donor-funded "first loss" arrangements, whereby funds from donor countries are pooled together to cover losses borne by foreign investors in fragile states associated with political risk events. MIGA has administered a few such donor-funded arrangements in the context of Bosnia-Herzegovina (Box 2), Afghanistan and the West Bank and Gaza, which, in most cases, have mobilized additional reinsurance capacity. In the case of West Bank and Gaza, PRI coverage was extended to domestic investors, who often desire such protection, but are not eligible for it by individual private providers of PRI. While the experience of this has been positive, a number of key lessons have been learned in terms of how to best structure such a fund. MIGA's experience of its own Conflict Affected and Fragile Economies Facility highlights the importance of donor coordination in establishment, and a logical next step would be to canvas more broadly amongst the donor community to establish what terms would be most acceptable and appropriate for a more broadly defined arrangement.

***(b) Natural disaster insurance***

36. Fragile states may also reduce their vulnerability to natural catastrophes, food crisis and other exogenous risks that can easily sidetrack efforts to put themselves on a sustainable growth path by utilizing different instruments available, such as traditional insurance to insure assets, CAT-Bonds, and pooling their resources into multi-country facilities. Examples of risk pooling mechanism include the Caribbean Catastrophe Risk Insurance Facility and the Pacific Disaster Reserve Fund; such facilities can be supported by donor contributions and global reinsurance.

***(c) Sector initiatives – Natural resources sectors***

37. The metals and mining, oil and gas sectors loom large as economic sectors in fragile states. Closely related, logging and plantations are other natural resources with often important economic consequences where fragility exists. If the sector is approached in the right way, it can be foundational for the country's future development as a revenue source, a catalyst for infrastructure development and secondary industries, and a creator of jobs in a range of roles. However if corruption and mismanagement set in, the sector can bring with it a host of problems including the well known "resource curse", corruption and a host of corrosive practices, pollution, land rights issues and labor exploitation, and see the heritage of the country squandered. In some cases it has even exacerbated and fuelled violent conflict. Most of the fighting in the recent South Sudan conflict has been in oil producing regions. Land rights issues have turned violent in countries such as Peru, Brazil and Honduras, and industrial logging has been exploited to several countries' loss, taking advantage of weak states and poor governance in countries such as Liberia and the DRC.

38. A set of initiatives including EITI (the Extractive Industries Transparency Initiative), the Natural Resource Charter, the World Economic Forum's Responsible Metals and Mining Initiative, the UN Guiding Principles for Business and Human Rights, the Conflict-Free Gold Standard of the World Gold Council and Australia's new Mining for Development initiative (Box 1) are all underway and show promise in tackling some of the gaps and challenges that fragile states face in getting the mining sector right.

39. To make good on this promise, greater focus is required on the part of mining companies, country governments, international organizations and civil society to ensure that the development of a mining sector benefits the country's citizens.
    - *Companies* can accelerate their efforts to commit to full transparency in contracting and put into practice the principles of EITI and other relevant charters and principles. The Equator Principles adopted by many financial institutions for guiding socially and environmentally responsible lending also offer a model for how the private sector can shape and adopt "best practices" in these areas[21]. They can also find strategic ways to bring to bear their operations and investments to benefit a country's people and development pathway, possibly taking a more engaged and supportive stance through their Chambers of Commerce or industry bodies, using these as the organizing basis for their commitments. The BRIC investors which have taken the lead in investing into the riskier and more frontier markets for mining in recent years could also send out a signal that they are compliant with these new and higher standards.
    - *Country Governments* Host can sign and implement EITI and commit to full accountability and transparency in governing, managing and regulating the mining sector. They can also look for ways to improve the social and environmental impact of operations, and to engineer appropriate public – private – citizen partnerships as the resources are developed. The governments of the investor governments can implement laws similar to the US Dodd Frank 1504 or the EU Transparency Directive. Again too, the BRIC governments could have a meaningful impact if they enforce such laws on their investors.

[21] http://www.equator-principles.com/index.php/about-ep/about-ep

- *International and Development Organizations, Law associations and civil society groups* can provide appropriate technical advice, monitoring and advocacy in setting up the right collaborative frameworks and holding parties to account for implementation, including on whether and how the revenues generated from the sector are used – whether as part of a country's general budget or a specific sovereign wealth or futures fund – to benefit the citizenry as a whole. One such example is the AfDB's African Legal Support Facility, which has been supporting African governments in the negotiation of complex commercial transactions since 2010.

**Box 1: Australia's Mining for Development Initiative**

The mining sector makes a major contribution to Australia's economic and social growth and development. Mining contributed more than $113 billion to Australia's wealth in 2010–11 and employed more than 220 000 Australians, many of whom live in remote and regional areas.

The Mining for Development Initiative is a collaboration between the Australian Government and some of the country's leading academic institutions, the mining industry and non-government organisations. It has been designed to work in partnership with developing countries, as well as non-government organisations, other donors, and development institutions.

The Mining for Development Initiative supports the implementation of the following key drivers of change in the mining sector in developing countries, which are critical to support achievement of the Millennium Development Goals:

1. Governments—government capacity and willingness to: (i) transparently and effectively collect, manage and reinvest extractives revenue; (ii) establish and enforce clear, stable and fair regulatory, institutional and policy frameworks (including appropriate legislation on land issues, occupational health and safety and human rights); and (iii) attract and negotiate with foreign investors.

2. Companies—corporate policies and practices in relation to issues such as local employment and environmental stewardship.

3. Civil society—community representation and participation in decision-making processes; effective civil society oversight.

Other countries are also expanding on similar initiatives. For instance, on October 27 2012, Canada announced the creation of a new Canadian International Institute for Extractive Industries and Development, an initiative aimed at fostering knowledge and technical assistance to support resource-rich developing countries manage their natural resources responsibly and transparently,

### *(d) Sectoral initiatives - Infrastructure*

40. Infrastructure is both foundational to the lives of citizens – providing the health, education, transportation, water, telecoms and energy systems that enable urban and rural life – and the construction industry is an economic sector in its own right. The provision of infrastructure services and their associated financing challenges is an area that requires particular attention. For example, as the world becomes increasingly urbanized, investment in infrastructure for long-term economic growth and sustainable development, such as in energy, water and transportation, will become more important.

41. Construction and infrastructure firms have extensive potential in fragile states, where infrastructure is typically underdeveloped. Many least developed countries have an inadequate economic and social infrastructure and experience difficulty obtaining long-term capital for investments in infrastructure from the private sector.

42. While there are concerns about the risks of instability and expropriation, there is also huge opportunity in these markets. Often, foreign investors can expand their investment in transport and electricity, built for their own needs, to connect it with public infrastructure services. Private infrastructure on a regional scale can lower risks by diversifying customer bases across several countries. Key constraints remain the availability of prepared projects, intermediation services, and risk guarantees, especially by multi-lateral banks. For the development of export-oriented agriculture, which is one of the most promising areas of activity in many fragile states, transport infrastructure is of crucial importance. Even when agriculture is mainly focused on domestic consumption, improved transport networks are crucial for the development and optimization of local markets so that subsistence farmers can generate some cash income. Again best practices can focus on supporting governments in negotiating the best deals for large public-private projects, encouraging transparency and open bidding processes as well as making sure that the governments are technically supported enough that they are able to evaluate the best deals on offer. A critical factor in infrastructure is also the disconnect which often exists between the pay-off to the private investor/financier and the outlay. Because of uncertainty about political and commercial risk in these environments there may be a mismatch between the preparedness to lend and the need (for example, a large power plant or road can have an economic life of several decades, how to set up the structure so that the payoff isn't heavily front-loaded). In this respect, Political Risk Insurance can play a role in mitigating some of the payment risks and extending the tenors, but other forms of guarantees, from sovereigns, DFI's or ECA's might also be deployed to address the market failure.

### *(e) Sector initiatives - Agriculture and Agribusiness*

43. Many Fragile States possess significant resources of arable land and labour, which potentially give them a comparative advantage in agriculture and agribusiness more broadly. Despite this, very few Fragile States have been able to fully harness this potential, with agricultural productivity remaining persistently low, made worse by large post-harvest losses, particularly for perishable commodities, limited agro-processing activity and

capacity and significant internal and external market barriers.

44. The convergence of strong demand for food and non-food agricultural products with favourable supply conditions – such as abundant arable land and labour – make agriculture and agri-business development a viable option for most Fragile States. Changing demographics and consumption patterns, both in Fragile States and in the rest of world, are likely to raise the demand for food and non-food agricultural products and sustain high prices for these goods in the years to come. Private sector investment – both foreign and domestic – in agriculture and agri-business activity could yield both high profit returns and employment growth. Such investments could set the stage for structural transformation in these countries if local government and populations share in the profitability of the enterprise through mechanisms such as cooperatives.

45. Developing value chains in agriculture would require the creation of linkages and fostering knowledge flows between medium- and large-scale processors and local farmers. The potential for value chain development in agriculture can be tapped if the factors inhibiting productivity and private investment in agriculture are relieved. Raising productivity would require, among other things, improving physical infrastructure, increased funding for agricultural research, increasing use and promotion of yield-enhancing and environmentally-sustainable technologies and practices, and improving institutional and regulatory frameworks. In fragile states, where land-title is often a contentious or highly-charged issue, issues of "land-grab" must also be carefully assessed, with state-actors potentially depriving farmers of their livelihood and land, as well as signing away country assets at lower returns. The need for responsible investment practices to this backdrop is all the more relevant.

46. The voluntary "code of conduct for responsible international investment in agriculture" promoted by FAO, UNCTAD, IFAD, OECD and the World Bank outlines the basic principles that should guide responsible investment behaviour, including the principles related to land and resource rights, transparency, participation, and food security.

### *(f) Host country policy measures*

47. Fragile states suffer from extensive institutional weaknesses and limited domestic capacity to adopt frameworks and measures to address risks, a concern elaborated upon above in the context of "political will". However, to the extent to which the internal incentive structures permit them (and the external environment supports this), they can begin to do so with appropriate technical assistance and advisory support from multilateral organizations and the donor community. In this way, fragile states can begin to address political risks by gradually strengthening national regulatory framework pertaining to domestic and foreign investors, assuring due process of law and legally enforceable international commercial arbitration regimes in particular, adopting international voluntary best practices and initiatives (e.g. labor standards, transparency, environment), and adhering to international instruments (such as bilateral investment treaties and international investment agreements) that protect foreign investors. Such measures not only strengthen investor protection, but also send a signal to the international investor community that the country is 'open for

business' and is responsive to private sector concerns about elevated risks. The implementation of reforms, naturally, will take time and faces a number of important domestic obstacles may need to be overcome, but some early gains can be achieved by strengthening those elements of the regulatory framework that are particularly important for investors, such as property rights or sector legislation, which in turn can help attract transformative investments (e.g. telecoms, Box 3). In fact, fragile states, donor states, domestic and international investors, and MIGA and PRI firms should look to agree on minimum policy conditionalities as a precondition for access to enhanced PRI regimes covering such areas as EITI, agreed environmental, labor and tax standards, investment protection agreements and agreed international commercial arbitration regimes.

48. Concluding bilateral investment treaties and international investment agreements also adds another layer of protection by offering foreign investors recourse to international arbitration in the case of a dispute. Fragile states have concluded numerous such treaties, but the majority of them have concluded ten or less.[22] Support in this regard can take the form of building capacity in fragile states to allow them to negotiate effectively agreements that are balanced and reflect their own interests.

**Box 2. The EU Investment Trust Fund for Bosnia-Herzegovina**

In 1997, the European Commission, in partnership with MIGA, established a $12 million investment guarantee trust fund to support the re-engagement of foreign investors in the country. Some European export credit agencies did not cover Bosnia and Herzegovina, prompting investors to turn to the fund. With a presence on the ground, the fund was fully utilized, issuing PRI for projects in financial services (establishment of foreign bank branches), the health sector (a dialysis clinic in Banja Luka), manufacturing (the expansion of a soft drinks plant). The fund generated additional capacity through coinsurance and reinsurance with other PRI providers.

Foreign direct investment into Bosnia and Herzegovina ballooned from $1 million in 1997 to $177 million in 1999 and $710 million in 2004. While the fund played an important role in ensuring investors against political risks, a number of factors contributed to the post-conflict surge in foreign direct investment. The heavy presence of NATO troops in a relatively small country mitigated the risk of a return to conflict. Bosnia and Herzegovina's economy was relatively well developed and offered promising business prospects. In the heart of Europe, the country was also a familiar environment for most investors in the immediate region. In addition, banking reform introduced became instrumental in attracting foreign investment in financial services, although investment in other sectors continued to suffer from weak business laws, a divided country, and a local government that was barely functioning. In 2007—over a decade after the conflict ended—Bosnia and Herzegovina attracted over $2 billion in foreign direct investment, equivalent to 14 percent of its GDP.

*Source: MIGA, World Investment and Political Risk 2010, chapter 3.*

[22] MIGA, World Investment and Political Risk 2010, appendix 4.

**Box 3. MTN in Afghanistan**

Investments in telecom, especially mobile telecom services, often takes place immediately after the end of conflict and sometimes even before. MTN in Afghanistan as an example of a successful, transformative project in a country that has faced prolonged conflict. Following decades of armed conflict, Afghanistan had a barely functioning and severely limited communications network. The majority of the Afghan population had no access to communications services, such as telephones or the Internet. The Ministry of Communications operated telephone services in only five major cities, and over 60 percent of the 57,000 functioning lines were in Kabul. In response to this need, the World Bank Group mobilized to reform the telecommunications sector in Afghanistan.

In FY06, IFC and MIGA made a commitment to provide support directly to Areeba Afghanistan. MIGA issued a guarantee of $74.5 million to Areeba Afghanistan (now part of the MTN Group) to cover its direct equity investment of $85 million in Afghanistan. The coverage was for 15 years against the risks of transfer/convertibility restrictions and expropriation. MTN also acquired coverage for the risk of war and civil disturbance through its global corporate political violence insurance program.

The project entailed providing cellular telecommunications services, including the installation, operation, and maintenance of a GSM (global system for mobile) network, wireless communication services, Internet and satellite services, and public pay phones. Because of the significant development impact, MIGA chose to support the project despite the obvious risks. MTN Afghanistan's network implementation and maintenance would be subcontracted to local businesses. Some network equipment, such as base station towers, would be produced locally (other operators were coming in, but coverage was still very limited). In addition, under the new Afghan telecommunications law, the government had committed to establishing best practice in telecommunications sector reform, including market liberalization in the mobile and fixed line segments. The license itself was awarded for a period of 15 years after a competitive and transparent bidding process by the Ministry of Communication (with significant assistance from the World Bank ICT team). The project would support private sector involvement in the telecommunications sector, which was a key goal of the Afghan government's liberalization plan and supported strongly by MIGA.

The project had a transformative impact on Afghanistan's economy. It introduced the latest GSM technology covering over 80 percent of the country's territory. MTN Afghanistan's current subscriber base stands at 3.2 million, with profitability margins higher than expected. The project achieved an internal rate of return of 31 percent and a higher than expected economic rate of return. Such high returns were partly attributable to the sector; mobile telecommunications (especially with prepaid services) have proven to be an effective business model in the developing world over the last 10–15 years.

MTN's substantial experience in providing mobile services in challenging environments (such as across Africa) made it possible for the project to exceed initial expectations, establishing advanced networks and selling its services in a competitive market. This success was due in large part to MTN's management systems, operational policies, and strong capitalization, which enabled it to effectively handle the many challenges of operating in a conflict-affected country.

*Source: IFC, Smart Lessons, February 2011, "Where Did It All Go Right? Supporting MTN Telecommunications in Afghanistan".*

**Conclusions**

Responsible companies, through taking advantage of profit-making opportunities, can contribute substantially to social and economic development in poor countries and fragile states. At the most basic level, they can do this through their activities in promoting innovation, economic growth and development, a necessary condition to help fragile and post-conflict states progress (as equally, the very lack of economic growth – and resultant continued poverty – can create or perpetuate an environment that can feed political instability). Often the literature has focused too little on this important facet of breaking the fragility cycle. One of the key goals of this paper is to promote discussion on the very ways in which the private sector can achieve and promote stability, and to consider some of the ways in which it might be supported to this end. A key suggestion has been to encourage support and expansion of PRI products to underpin investment into fragile states. With respect to the PRI product, suggestions have also included expansion of national public PRI products, as well as finding platforms for donor states to possibly subsidize PRI costs, including such ideas as to fund first loss arrangements to cover losses that investors might encounter in such countries. Other suggestions include fragility "best practice" approaches to make sure that the investment is supportive of a country's goals as well as to squeeze more developmental/fragility-reducing benefit from current forms of investment (for example, in procurement, employment practices, and fairer agreements etc.) At a sectoral level, transparency supporting initiatives such as EITI are especially relevant to support in mining, oil and gas sectors, but initiatives such as the Equator Principles for project finance are also proving helpful.

Certainly, the intention here is not to present the private sector and private sector investment as a panacea to cure all of the ills facing fragile countries. There is a need to be realistic in the role that the private sector can actually play and the contribution it can make – as well as the role which needs to be played by actors – state, multilateral and non-state in resolving fragility issues. Collaborative efforts with governments, communities and the international development community remain critical to ensure sustained improvements in the standard of living, reduce poverty and improve access to better services and opportunities. Overall, though, the private

sector has a central role to play in the fragile context. And it is a role that it can perform more successfully if it is encouraged and supported along the lines suggested in this paper.