

FDI in Fragile and Conflict-Affected Situations

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Foreign direct investment (FDI) in fragile and conflict-affected situations (FCS)¹ represents just 1 percent of global flows, more than five times less per capita than the world average, according to latest estimates. Despite increasing tenfold over the last two decades, FDI is still mostly concentrated in a handful of fragile countries, all middle-income or resource-rich or both. Furthermore, differences in FDI potential and dependence within the FCS group are also stark: FDI inflow as a share of gross national income (GNI) ranges from more than 40 percent in Liberia to virtually zero in South Sudan.

In response to the proliferation of conflicts and forced displacements in this decade to date, the development community has committed itself to doing more for fragile countries. Foreign investment is a central part of that commitment, yet consensus on the facts, drivers, and imperatives surrounding it has not yet been achieved. Better understanding is key for the development community to design the right interventions.

But can FDI support stabilization and prevent violent conflicts? FDI can create jobs, generate wealth and tax income, and thereby affect what fragile societies risk losing by engaging in conflict (that is, the opportunity

cost of war). Yet, while the argument makes intuitive sense, the empirical evidence on the direct relationship between foreign investment and conflict remains inconclusive. Some argue that a foreign presence can generate grievances by adversely affecting income distribution and worsening political unrest in low-income countries (Gissinger and Gleditsch 1999), while others contend that trade and FDI complement each other in reducing conflict risk (Polachek and Sevastianova 2012). More nuanced effects have been acknowledged, too, such as that FDI reduces the duration of civil wars but not the likelihood of their onset (Barbieri and Reuveny 2005).

Clearly, not all FDI has the same effects on host countries. The sectoral distribution of FDI, especially amid distorted conditions, can potentially reinforce opposite trends. This is partly why policy discussions have focused on dilemmas surrounding “good” and “bad” FDI in fragile contexts, often related to the exploitation of natural resources (International Dialogue for Peace-Building and State-Building 2016). Recognizing the limitations of econometrics in addressing the question is also critical. The pro-cyclical movement of foreign investment,² and the indirect channels through which it affects

the opportunity cost of conflict, complicate the identification of its effect on peace and stability.

The purpose of this chapter is to take a step back from this discussion and fill in a gap in understanding FDI across these sensitive environments. The discussion rests on a fundamental notion of FDI's *potential* to generate jobs, increase wealth, and improve public goods—all of which are essential for a stable and prosperous society. The chapter considers the *where*, *who*, and *how* of foreign investment in FCS before delving into difficult questions of *why* and of ways to support investment through policies that, in principle, would also enhance stability.

Foreign investment in fragile situations has the potential to deliver good results. Apart from resource-seeking investment, the structure of economic activity in these countries reveals a strong potential for FDI-driven value creation in sectors with low domestic competition or others experiencing growth attributable to postconflict reconstruction. But investors are cautious: outside natural resource sectors, they concentrate their investment in a limited number of capital-intensive activities. They also tend to commit to smaller projects, create fewer jobs, and avoid geographical exposure to security risks. FCS pose unique conditions and risks at both the operational and institutional levels where investment climate reforms could make a difference.

Investment climate reforms that unlock opportunities for the private sector and create jobs are necessary to consolidate peace and move from fragility to resilience. Broad and deep changes to the rules of the game are essential. An investment climate reform strategy requires proper sequencing and prioritizing and must take into account the country's conflict dynamics, economic opportunity, institutional capacity, and willingness to reform. The strategy must be implemented in a balanced way to secure short-term gains while building the momentum for deep institutional transformation. The key elements of the strategy should be reducing risks to investors while maximizing investment opportunities and rewards.

The Where, Who, and How of Foreign Investment in FCS

Foreign sources of income sustain a large part of economic activity in fragile and conflict-affected situations. Yet international investors do not typically consider FCS as hosts, owing to economic fundamentals and fragility, which are mutually reinforcing. While fragile situations are remarkably heterogeneous (box 5.1), commonalities do exist: investment opportunities arise in capital-intensive activities sustained by foreign demand, particularly during transitions from conflict to peace. But investors are cautious in how they leverage these opportunities. Those who understand the context do better.

FCS Depend Heavily on Foreign Sources of Income

Foreign investment, along with other sources of income sustains a large part of economic activity in fragile and conflict-affected situations. The combination of remittances from the diaspora, official development assistance (ODA), official aid, and foreign investment often exceed a third of national income at varying degrees of dependence (figure 5.1).

Diaspora income, ODA, and FDI interact in a variety of complementary ways in fragile states. For example, although remittances are largely used for consumption, they are increasingly seen as a resource for investment.³ And while a lot of debate has been had on the relationship between ODA and FDI, conventional wisdom and empirical evidence point to the catalyzing effects of ODA on FDI. The composition of ODA matters in this respect: Assistance used to finance complementary inputs, such as public infrastructure and human capital investments, has been shown to draw in FDI, while assistance in the form of pure physical capital transfers may crowd out investment (Selaya and Sunesen 2012).

The prevalence of FDI among foreign sources of income reflects to a large extent heterogeneous conditions among FCS.

BOX 5.1

FCS Are Highly Heterogeneous in Terms of Risks and Opportunities for Investment

Although encountered mainly in low-income countries, fragile and conflict-affected situations (FCS) persist also in middle-income countries where opportunities for investment are markedly different. Abundant natural resources explain the middle-income status of such FCS as Iraq or Libya, but not exclusively. The former Yugoslavia and Lebanon are examples of middle-income countries with a history of violent conflict. Investment opportunities in this group are associated not only with greater purchasing power of the population and market growth, but also with existing industrial structures, skills, and government capacity that allow working toward more ambitious targets in terms of investment climate.

The risks facing investors also vary across FCS, affecting investor decisions as well as the scope and depth of necessary reforms. Along the so-called fragility chain, conflict-affected situations include territories under severe risk of conflict, others experiencing active conflicts, and states in postconflict transitions.

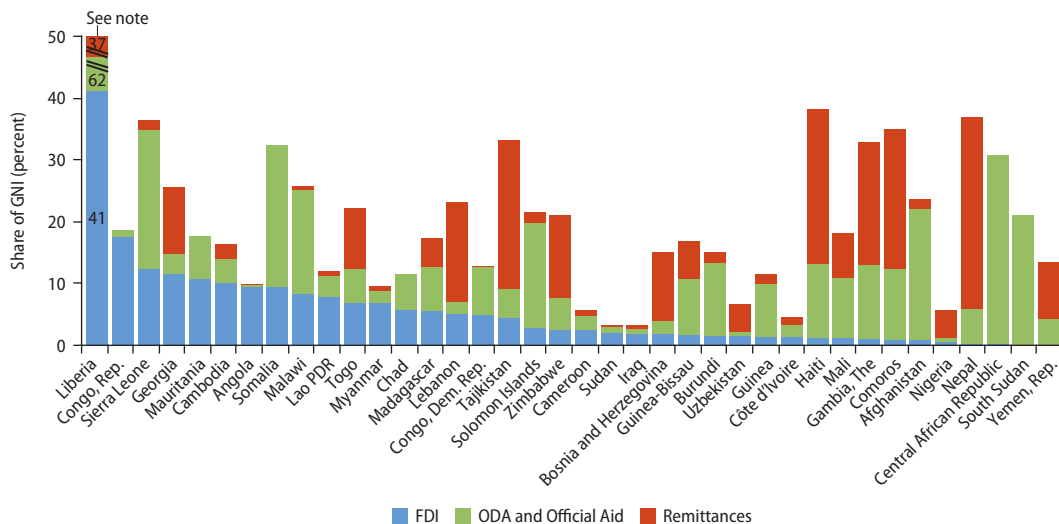
Countries at risk of conflict suffer substantial economic marginalization, political polarization, and external stresses, which heighten uncertainty and point to the need for prevention of conflict-related situations, including through foreign direct investment (FDI).

Subnational conflict within otherwise stable countries means that foreign investment can take place on a large scale in stable parts of the territory, and that government capacity for reform exists.

Active large-scale conflict and crisis situations are distinct in that investment no longer takes place and priority is given to political solutions and basic stabilization.

Finally, *states in postconflict or frequent conflict-to-peace transitions* typically suffer from weak institutions with poor governance but offer the greatest opportunities for economic transformation through investment, as well as momentum for reform.

FIGURE 5.1 FCS Depend on Income from ODA, the Diaspora, and Foreign Investors, 2015



Source: Computation based on World Development Indicators, World Bank.

Note: The figures for ODA and official aid and remittances for Liberia have been scaled, and the actual figures are noted in the graph. The Central African Republic and South Sudan have missing values for remittances. FCS = fragile and conflict-affected situations; FDI = foreign direct investment; GNI = gross national income; ODA = official development assistance.

Remittances, for example, are important for a few fragile states with large diaspora populations (for example, Haiti, Lebanon, Liberia, and Nepal). Foreign investment represents a substantial share in such resource-rich countries as the Republic of Congo and Sierra Leone, while smaller low-income states (for example, island territories) rely far more on ODA and official aid. Unstable territories in transition fall under this category too: Afghanistan, the Central African Republic, Libya, Somalia, and South Sudan depend heavily on aid for reconstruction and less on FDI despite their wealth of natural resources.

Investment in Many FCS Is below Potential

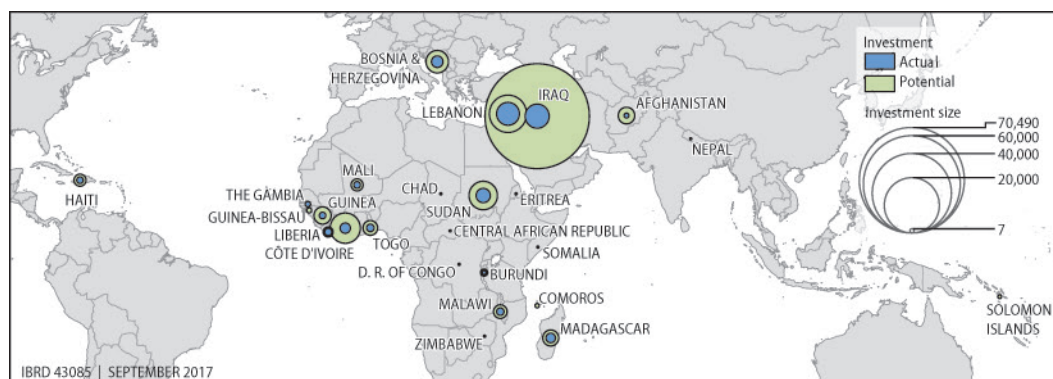
Economic fundamentals alone—such as current size of the market, growth, and savings—in addition to remoteness, trade openness, and natural resources would suggest lower levels of expected investment in FCS than in the rest of the world (annex 5B). Among emerging economies, the bottom quartile of investment predicted by economic fundamentals is populated mostly by FCS (figure 5B.1). This result is not surprising because fragile and conflict-affected situations represent small and remote markets

that trade less with the rest of the world than other emerging economies.

Fragility also takes a heavy toll: the distance between expected and actual investment is considerable (map 5.1), highlighting the extent to which investment opportunities remain unleveraged. Considering that fragility affects existing economic fundamentals that are used to form expectations, the distance between actual investment and what would likely have taken place under stability and peace is likely even greater. Only a few countries had high levels of both expected and actual investment in recent years: Iraq, Lebanon, Bosnia and Herzegovina, Sudan, Côte d'Ivoire, and others. Countries currently experiencing high levels of violence, such as Libya, the Syrian Arab Republic, and the Republic of Yemen, also presented high expected values at points of their latest available data (that is, before conflicts escalated).

All the countries with higher expected values within the group are either middle-income with developed local markets that can attract market-seeking investment or countries possessing natural resources with high potential for investment. Remoteness to large industrial economies makes even fewer of them attractive for export-oriented, efficiency-seeking FDI; notable examples being Bosnia and

MAP 5.1 FDI Flows to FCS Remain below Potential, 2008–14



Source: Computation based on Investment Map Database, International Trade Centre; World Development Indicators, World Bank. CEPII Database; Fragile States Index (2014), the Fund for Peace.

Note: Investment expectations based on economic fundamentals, represented with green circles, shed light on how much FDI can be expected net of the effect of fragility from the predicted inflow (that is, fitted value) from a regression on FDI determinants yields this estimate. Actual investment flows are represented with a blue circle for comparison. Data are only presented for selected countries officially designated as FCS (in millions of US dollars). Countries with latest data from before 2012, or significantly changed circumstances since the latest data point, are excluded. FCS = fragile and conflict-affected situations; FDI = foreign direct investment.

Herzegovina, Lebanon, and to a lesser extent, Haiti. The gap between expected and actual investment is the highest in Iraq, a country suffering from protracted instability and violence for more than two decades. Most FCS have many disadvantages—as in market size, growth, connectivity, openness, and natural resources—making them less appealing to investors. Burundi is typical of FCS, with low expectations for market-seeking, efficiency-seeking, and resource-seeking investments, all of which are almost entirely unrealized.

Investment Is Concentrated in Capital-Intensive Activities

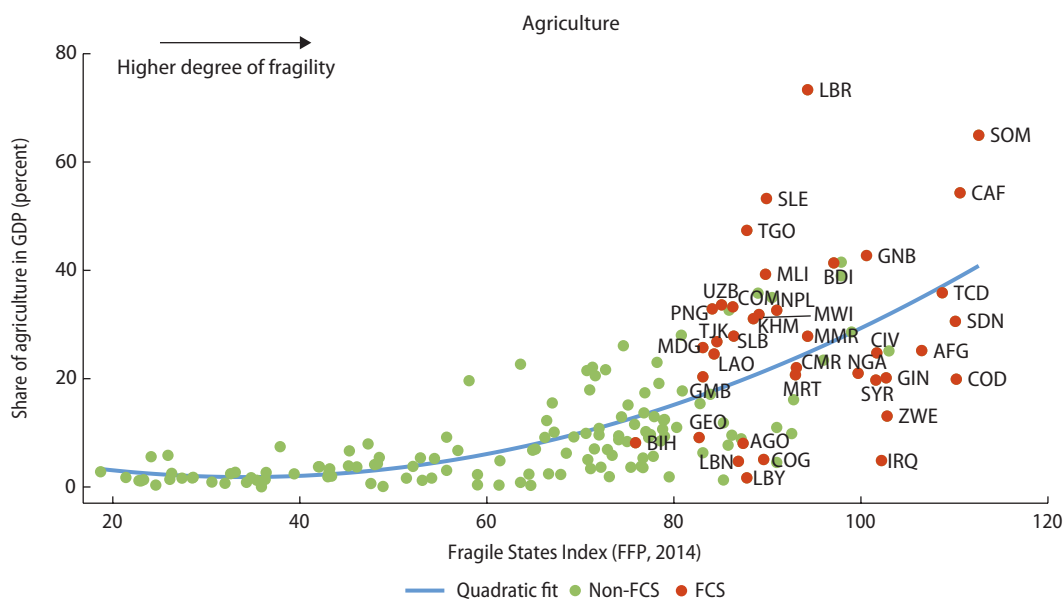
Opportunities for investment vary considerably from one fragile situation to another since the group is highly variable in economic development terms. While most are low-income, middle-income countries in the group (for example, Angola, Bosnia and Herzegovina, and Iraq) offer different opportunities and development prospects.

Furthermore, economies in active conflict present dynamics that differ sharply from what is experienced in pre- or postconflict cases (see box 5.1).

However imperfect,⁴ the available evidence broadly confirms the scarcity of capital-intensive activities in FCS, except for mining, and oil and gas in some resource-rich states. One can argue that it is precisely in these capital-intensive sectors where large business opportunities lie, given the lack of local competition. Yet this is not always so because fragility discourages financial market development, which in turn creates barriers to growth. Labor-intensive activities, especially services and agriculture, are essential for the survival of much of the population and hence dominate the economy. However, variation within the group is pronounced: for example, the share of services ranges from 17 percent in Liberia to 90 percent in Lebanon, and in agriculture, from 1 percent in Libya to 64 percent in Liberia (figure 5.2).

FIGURE 5.2 Agriculture Dominates Highly Fragile Economies

Share of agriculture in GDP of FCS, 2014 or latest year



Source: Computation based on the United Nations Statistics Division database on gross value added across sectors; Fragile States Index, the Fund for Peace. Note: Not all countries at high degree of fragility, according to FFP, are officially classified as FCS by the World Bank. The latter group is designated with red and labeled. FCS = fragile and conflict-affected situations; GDP = gross domestic product.

The agricultural sector itself is highly fragmented. The bulk of employment in FCS is in the small farmer and household enterprise⁵ sectors, driven by necessity and resilience rather than growth.

Whether a country is at a high risk of conflict, is in conflict, or is postconflict matters for how prevalent different economic activities are, explaining at least partly the variation within the group. For example, construction accounts for a large share of economic activity in such FCS as Lebanon, which are not in full-blown conflict, or countries where large reconstruction efforts are taking place, such as Afghanistan or Angola. The weight of the sector in countries with deep fragility and frequent peace-to-conflict transitions like Somalia or Sudan is significantly smaller. More capital-intensive activities, such as manufacturing, exhibit reverse linear relationships with the levels of fragility—specifically because of the capital flight in the face of fragility (IFC 2017).

Opportunities Grow during Transitions from Conflict to Peace

Within the group of FCS, postconflict economies offer significant new business opportunities. The reestablishment of peace is associated with renewed investment confidence and growth. In fact, evidence points to distinct episodes of high growth in the wake of conflicts and many opportunities for investment. Recent evidence shows that, a year after the end of conflict, FDI increases dramatically, and, three years after the end of conflict, inflows about double relative to the last years of conflict (Mueller, Piemontese, and Tapsoba 2017). By sector, construction and services experience high growth and pull labor out of agriculture in postconflict years. An illustration of the average share each activity gains or loses over a 12-year period after peace is established (figure 5.3) suggests common trends across postconflict countries⁶ and time periods. For example, the weight of agriculture in gross domestic

FIGURE 5.3 Postconflict Growth Clocks
 Median change in shares of GDP by sector 1–12 years postconflict, 1990–2014

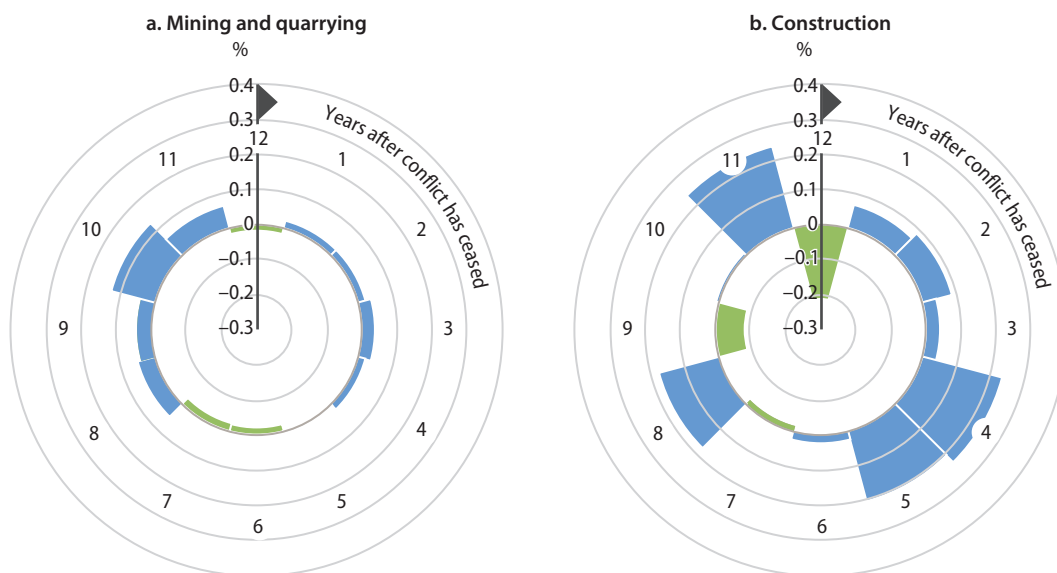
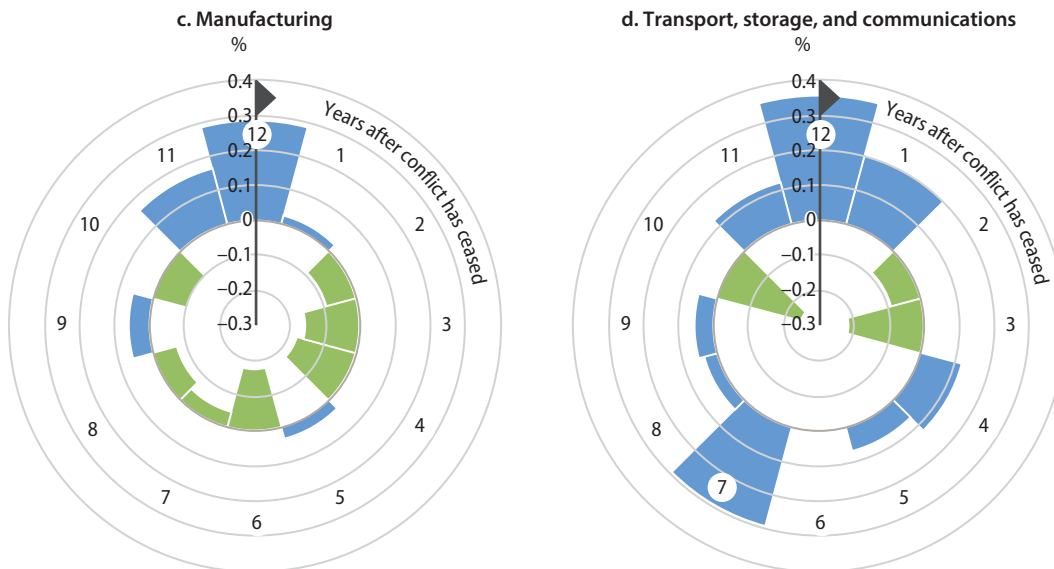


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FIGURE 5.3 Postconflict Growth Clocks (continued)

Source: Computation based on United Nations Statistics Division database on gross value added across sectors on selected postconflict economies; Uppsala Conflict Dataset (1990–2014).

Note: “Growth clocks” present for each sector the median year-to-year change in shares of gross domestic product (GDP) across economies that have recently transitioned from conflict to peace. The bars for each of the 1–12 years postconflict are illustrated at the positions of hours in a hypothetical clock. The inner circle represents zero growth, the blue bars represent a positive change, and the green bars a negative change. The exact year the conflict has ceased is identified using the Uppsala Conflict dataset, and the sample covers postconflict economies for the period 1990–2014.

product (GDP) gradually declines after the cessation of hostilities.⁷

Of all economic sectors, construction shows the most pronounced growth in the aftermath of conflicts. The sector grows in the short run in response to reconstruction efforts and fluctuates around a steady state over the medium term. Much of this growth represents an opportunity for foreign firms (box 5.2). Higher rates of growth in telecommunications and transport are apparent over the medium term—infrastructural weaknesses possibly explaining the time lag in growth. The necessary conditions for diversification only materialize after a substantial period. Manufacturing, for example, tends to exhibit slower growth in postconflict economies, specifically because conditions for its growth take more time to materialize.⁸ In contrast, mining and other sectors that rely on natural resources remain stable throughout, possibly because of the sectors’

resilience during conflict, which translates into little transformation in the aftermath of conflicts.

Foreign Investors Are Cautious

Investment opportunities exist in fragile and postconflict situations but are generally hard for foreign investors to exploit. Multinational corporations (MNCs) will choose to do business in FCS only when the reward outweighs, by a sufficiently large margin, the risk. In addition, MNCs will tend to concentrate in activities where there is limited domestic competition, owing to advantages enjoyed by domestic firms in markets where the political economy is distorted.

High rewards and low competition occur simultaneously only for selected natural resource and other capital-intensive activities, which depend on high demand outside FCS. This exact pattern is confirmed by comparing the distribution of sectoral shares in aggregate

BOX 5.2**Postconflict Growth in Construction and FDI Opportunities**

Construction opportunities abound in postconflict countries, where sizable funds are available from donors. For example, in the first decade after conflict ended in Lebanon, the country received about \$10 billion for reconstruction, while Bosnia and Herzegovina received \$5.4 billion in the same period. How much of this activity actually benefits foreign firms and investors? A disproportionately large part. Local firms are at a disadvantage in seizing these opportunities for several reasons: they lack the capacity and skills to carry out large, complex projects,

and they do not have prior experience with such contracts or how to bid for them. A snapshot of reconstruction efforts in Haiti in 2012 shows that, of the billions spent by the U.S. Agency for International Development, more than 99 percent went to foreign firms. The extent to which the local private sector benefits from the presence of multinational firms depends on supply linkages, the development of which remains a priority in many postconflict contexts.

Sources: Bray 2005; Porter Peschka 2011; Ramachandran and Walz 2012.

investment inflows across FCS and non-FCS low-income countries. While countries in these two groups show significant variation, FCS exhibit systematically different shares in four broad industries: extractives (mining, petroleum, mineral products), construction, forestry and fishing, and food and beverages. Of those, only construction, and food and beverages rely largely on local demand, supplemented in some cases by foreign aid. The opportunity is presumably generated by the absence of downstream value-chain development and capital scarcity for large-scale production. All these sectors are relatively capital-intensive (figure 5.4).

But investors are more cautious when they enter FCS markets, as revealed by green-field investment patterns across countries (figure 5.5). In natural resource sectors, the range of their choices on scale and location are bound by the location and volume of reserves. By contrast, in sectors other than extractives, the more fragile a country, the less investors will tend to commit to large projects. Avoiding financial exposure at the beginning makes sense where there is significant uncertainty. Investors also tend to commit to fewer jobs for every dollar they invest in FCS. These patterns are probably due to the concentration of projects in capital-intensive

industries coupled with the difficulty of bringing in skilled expatriate staff. Finally, investors tend to concentrate their investment spatially in the most stable territory of the fragile countries.

Understanding the Context Helps in Seizing Opportunities

From capturing local demand and mitigating operational risks to avoiding unintentional consequences, a deep understanding of the local context is necessary for successful foreign investment. While this applies for international business in any context, it is particularly relevant for investment in FCS. Firms employ many strategies in doing so.

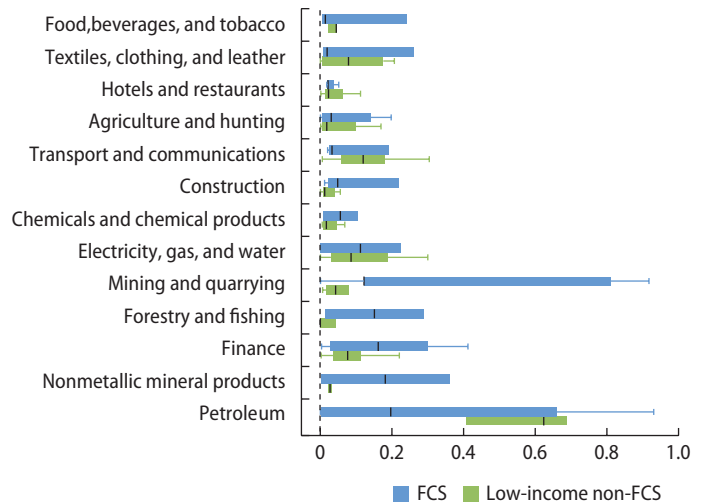
Engaging with the local private sector in domestic supply chains features prominently among strategies of foreign firms. Local firms tend to have a higher risk tolerance, know the local market and political economy, and have contacts with the authorities that mitigate risks faced by MNCs (USAID 2016). Some of the risk borne by these entrants can be shared with local suppliers, for example, through license agreements or “contract manufacturing,” both of which are safer for MNCs than joint ventures (Campbell 2002).

Operating in a so-called conflict-sensitive manner is another strategy deeply rooted in understanding the local context. Firms in a fragile context stand to aggravate local tensions unintentionally by disproportionately employing staff from one community or another, providing revenue for authorities that engage in human rights violations, or training security forces that can later be deployed in conflicts. To avoid such pitfalls, and the associated risks to their businesses, large MNCs increasingly add to their operational policy such concepts as “do-no-harm” or “conflict sensitivity,” which originated in the development and humanitarian community. Adopting a conflict-sensitive approach means that a company invests in understanding the context in which it operates, becomes aware of potential positive and negative effects it may have on a conflict environment, and takes all the necessary steps to avoid causing, or worsening, conflict.

On all these accounts, regional MNCs may have a comparative advantage in these challenging contexts relative to global firms. This category includes, for example, companies

FIGURE 5.4 Foreign Investors Concentrate in Natural Resources and a Few Other Capital-Intensive Activities

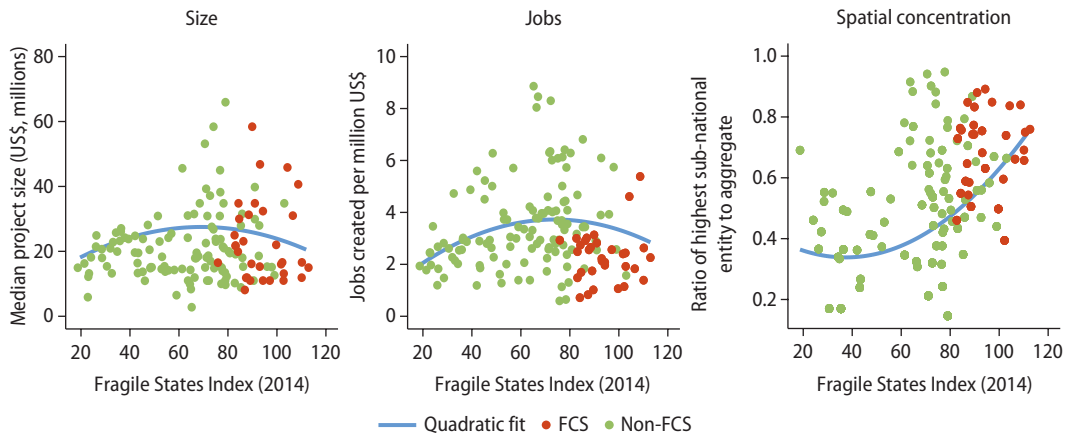
Distribution of sector shares in inward FDI flows across FCS, 2008–14



Source: Computation based on Investment Map Database, International Trade Centre; World Development Indicators, World Bank.
 Note: The distribution of shares of sectors in total FDI inflows across all FCS (in blue) is compared with the same distribution across all low-income and lower-middle-income non-FCS countries (in green) for which data exist after 2008. Each horizontal box illustrates the median of the distribution across the two groups with a black line; the box delimits the 25th percentile (left) and 75th percentile (right) of each distribution—i.e., the top and bottom quartile; and the lines extending from the box illustrate the full range of shares. FCS = fragile and conflict-affected situations; FDI = foreign direct investment.

FIGURE 5.5 Outside of Natural Resource Sectors, Investors Are Cautious

Characteristics of greenfield FDI project announcements, nonextractives, 2008–16



Source: Computation based on fDi Markets database, the Financial Times; Fragile States Index (2014), the Fund for Peace.
 Note: The sample does not include extractive industries. Not all countries that are highly fragile according to FFP are officially classified as FCS by the World Bank. The latter group is designated with red. Green represents all other countries. FCS = fragile and conflict-affected situations; FDI = foreign direct investment.

from Lebanon investing in other countries in the Middle East and companies from Morocco and Nigeria expanding into places in West Africa. These firms leverage the fact that they are “local” in a particular area of the world, and have sufficient affinity with their target markets because of the similarity with their home market. Lower risks resulting from this affinity would tend to make investors, in principle, commit to larger projects, and lower information asymmetries for local recruitment that can make a greater difference in terms of stability and in catalyzing further investment. These firms deserve special attention from the development community.

But how much of greenfield investment comes from regional firms? The evidence

suggests that it represents a considerable amount (figure 5.6). While the footprint of France and the United Kingdom remains large in Africa and the Middle East, greenfield investment, for example, from the Russian Federation to Uzbekistan, Malaysia to Cambodia, South Africa to Nigeria, Japan and Thailand to Myanmar, and the United Arab Emirates to Iraq confirm that intraregional investment takes place in FCS on a large scale.

Barriers to Investment: Risks and Obstacles

The previous sections have painted a clear picture of the investment potential for most fragile and conflict-affected situations. Even at its lowest benchmark, this potential remains unfulfilled. The data also show that investors are cautious and keep a small footprint, creating fewer jobs relative to similar investments in less risky environments and concentrating in capital-intensive sectors. Understanding the reasons for these trends will help create deeper and more inclusive markets in FCS and expand their investment opportunities.

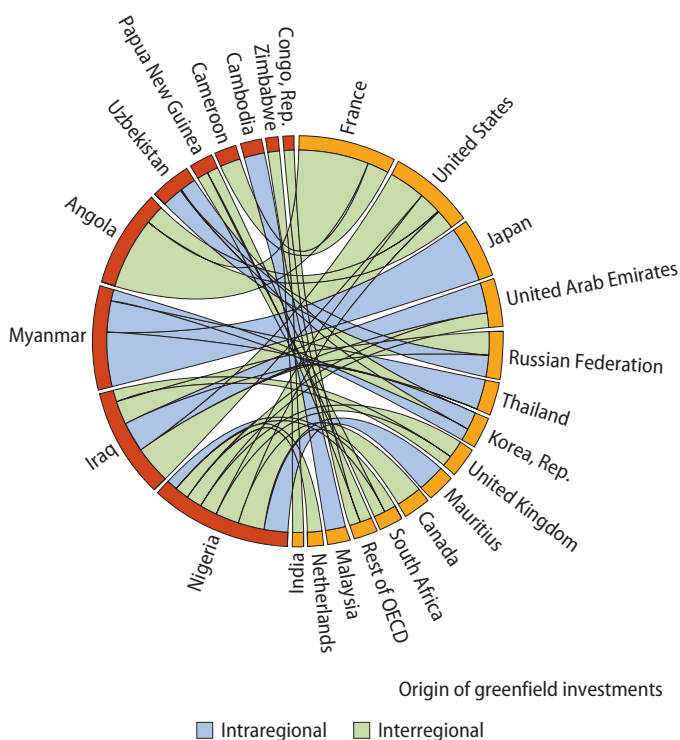
Several global data sources document what investors and businesses perceive to be the biggest obstacles hindering their ability to expand their investment in a given market. Among these sources are the World Bank Group’s Enterprise Surveys⁹ and the World Economic Forum’s (WEF) Executive Opinion Surveys.¹⁰ Surveys of business executives such as these are frequently used to measure *perceptions* about problems whose severity can be compared across countries and over time. These surveys are particularly appealing when quantitative data are either unavailable or difficult to gather, as in many FCS.

This section looks into the recent findings of the Executive Opinion Survey and the Enterprise Surveys to examine what they tell us about the obstacles and risks that limit the willingness to invest in FCS. Building on these findings, the section analyzes the institutional realities in FCS to understand the scope for

FIGURE 5.6 Regional Investment Occurs on a Large Scale

Origins of greenfield FDI project announcements in FCS, 2008–16

FCS recipients



Source: Computation based on Financial Times FDI Markets database, the Financial Times.
 Note: Origins (on the right side of the chord diagram, in orange) and FCS destinations (on the left side, in red) of greenfield projects exceeding \$3 billion since 2008. Blue chords indicate intraregional investment. FCS = fragile and conflict-affected situations; FDI = foreign direct investment; OECD = Organisation for Economic Co-operation and Development.

government action to promote foreign investment.

Charting the Obstacles Facing Investors

The fundamental questions that arise from the analysis of market conditions and risks facing businesses in fragile situations are:

- How pervasive the challenges are (that is, how disruptive risks and market conditions can be for business), and
- How specific they are to FCS (that is, how distinct they are to fragility and conflict rather than a specific level of development).

However imperfect, the WEF Executive Opinion Survey offers answers to both questions. Average *perceptions* on the intensity of constraints across fragile states shed light on the major challenges. And the difference in averages between FCS and non-FCS low-income countries determines how FCS-specific a problem is. By charting these two variables on a scatter plot (figure 5.7, severity on the horizontal axis and FCS specificity on the vertical axis), four groups of challenges can be distinguished: those that are both severe and FCS-specific (top-right hand corner of the panel); those that are severe but similar to what is experienced in other low-income countries (bottom right); those that are FCS-specific but not severe (top left); and the remaining variables, which are less relevant on both dimensions (bottom left).

Operational Constraints Are Most Pervasive

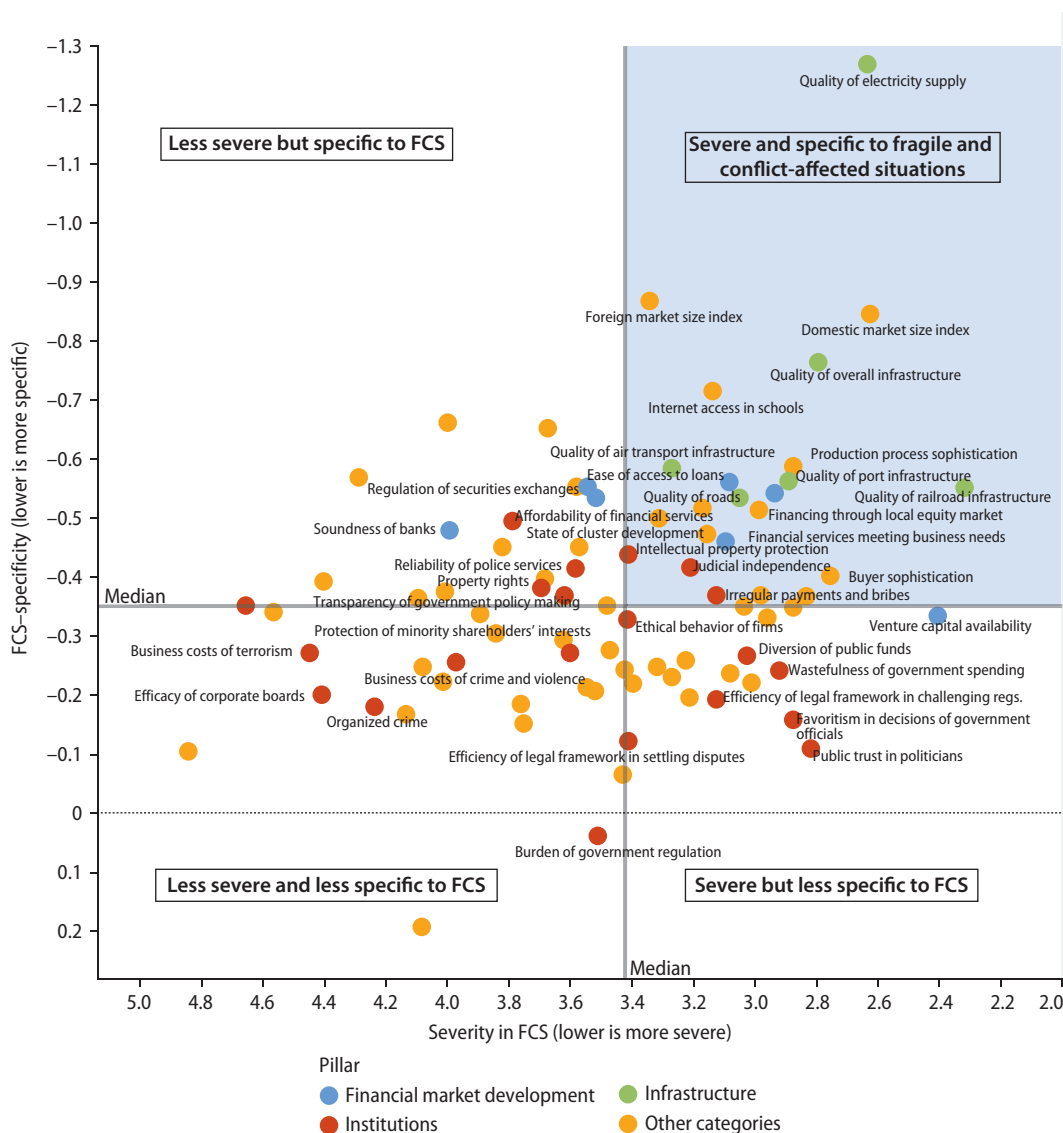
Operational constraints are high on the mind of surveyed businesses as an obstacle to growth, affecting the opportunity for investment in fragile environments (figure 5.7). The quality of electricity is at the top of this list, followed by constraints related to the size of markets (domestic and foreign), transport infrastructure, and access to finance. The results are hardly surprising: frequent and prolonged power outages, as

well as shortages in the supply of water, are more common in FCS than in non-FCS, according to several surveys (Speakman and Rysova 2015). In the Republic of Yemen, for example, three out of four firms surveyed by the World Bank in 2013 reported power outages as a major constraint on their operations. Because of similar power grid failures, in South Sudan two-thirds of all power consumed by firms in 2014 was produced by privately owned generators, imposing added costs of operations, an upper limit to their scale, and narrower returns to investment (Speakman and Rysova 2015). The numbers are equally striking in other domains and countries. Banking penetration in Guinea-Bissau, for example, remained below 1 percent of the population in 2013, and access to finance was cited by three out of four businesses as an important constraint for business operations, on par with electricity (Arvanitis 2014). The constraints identified by executives are also interrelated. Low local demand, for example, boils down to widespread poverty, limiting the volume of business activity that the local population can sustain, while foreign markets often remain out of reach because of the poor quality of transport infrastructure.

Institutional Constraints Are Severe and Diverse

Business executives also identify a number of institutional constraints that hinder business expansion in FCS. Two clusters of institutional concerns can be identified: one relates to property rights and the means for their enforcement, and the second concerns the quality of public governance. Executives responding to the survey identified weaknesses in intellectual property rights, judicial independence, and hence dispute settlement as severe obstacles in FCS. Weakness in property right regimes was given a score of severity below the median, which may be more reflective of the small footprint that investors keep in FCS and the coping mechanisms they deploy (including political risk insurance).

FIGURE 5.7 Perceptions on Severity and FCS-Specificity of Challenges, 2016



Source: Computation based on Global Competitiveness Index database, World Economic Forum.
 Note: FCS = fragile and conflict-affected situations.

The quality of public governance is also a major obstacle to private investment in FCS. Issues of irregular payments and bribes, weak public trust in politicians, and favoritism in decision making by government officials were perceived as severe obstacles.

The analysis of the WEF Executive Opinion Survey Data points to another element that strongly influences the choice of

approach to private sector development in FCS. Executives operating in FCS rank the burden of government regulations below average in terms of severity. It also ranks very low in terms of FCS-specificity. This is corroborated by the findings of the Enterprise Surveys, which show that the amount of time that senior management spent on dealing with government regulations is lowest on

average in FCS, at 8.6 percent, rising to 11 percent in past-FCS (figure 5.8). Thus, the problem in FCS may be less one of regulatory burden and more the absence of needed market regulation.

The Link between Operational and Institutional Constraints

The analysis now turns to the state of public institutions in FCS using global indicators. It aims to illustrate that, while institutional weaknesses are a defining feature of FCS, cross-country variations are significant for the design of private sector development approaches in FCS.

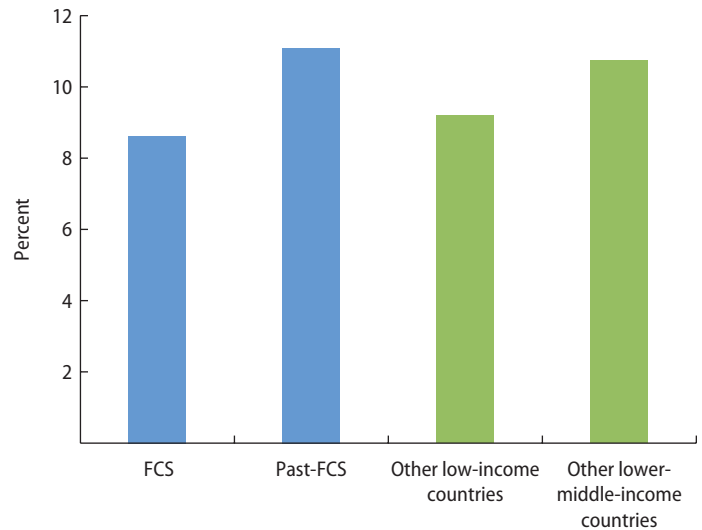
Institutional weaknesses in FCS are partly the cause of operational constraints that worry foreign investors. Government capacity, regulatory effectiveness, and institutional quality are fundamentally interconnected with market conditions that constrain businesses. Infrastructure projects, for example, require a minimum government capacity to deliver¹¹ but also basic regulation and enforcement to protect investor property rights.

Examples of the relationship between institutional and operational constraints abound. Successful power projects in Afghanistan, Côte d'Ivoire, Guinea, Iraq, Mali, Myanmar, and Nepal all involved extensive work developing regulations and government sector plans, building the relevant government capacity, providing up-front advisory resources in project development, and supporting complementary government investments (for example, electricity distribution and provision of co-financing support and risk guarantees) (Mills and Fan 2006, 29; USAID 2009, 45, 48).

The same applies to development of financial services to address the scarcity of capital. Banks avoid setting up operations in territories without viable banking laws and foreign exchange regulations (Bray 2005). Initially, they tend to concentrate on international customers—such as diplomats and aid

FIGURE 5.8 Senior Management Spent Less Time Dealing with Government Regulations in FCS

Average share of senior management time spent dealing with the requirements of government regulation (percent)

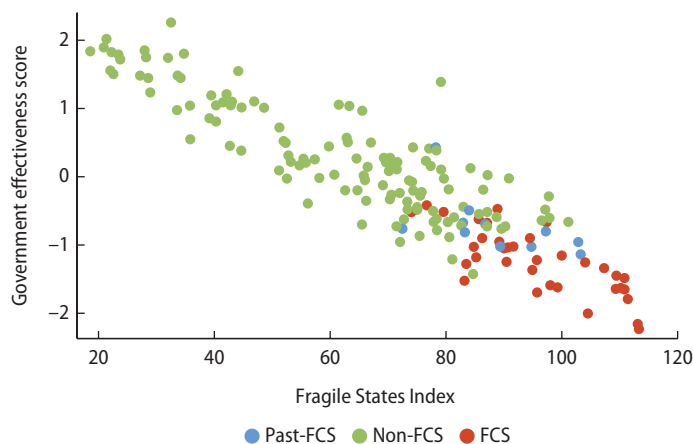


Source: Computation based on Enterprise Surveys, World Bank.

workers—and may not develop a retail market for several years after the end of the conflict, until such regulatory conditions are met. In addition, a key reason that foreign market access is prohibitively expensive for firms, including MNCs, in fragile countries is the logistical burden of certification requirements, corruption in customs authorities, and other failures directly related to institutional and governance weaknesses (Hoeffler 2012).

To conclude, investors and businesses face severe challenges in FCS. The obstacles range from market characteristics to infrastructure and access to finance constraints combined with a myriad of institutional constraints. Institutions in FCS are weak and the weakness has persisted over the years. There are, however, significant variations in weaknesses among these countries (figure 5.9). These variations matter in determining the best approach to facilitating and attracting investment in a particular country.

FIGURE 5.9 Varying Levels of Fragility and Government Effectiveness among FCS



Source: Worldwide Governance Indicators, World Bank; Fragile States Index, the Fund for Peace.
 Note: Government effectiveness is an aggregate indicator that reflects perceptions of the quality of public services, the quality of the civil service and its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. This is part of the Worldwide Governance Indicators dataset.

Investment Climate Reforms Can Create Markets and Maximize Investment

Investment climate reforms are essentially legal, regulatory, procedural, and institutional reforms that enhance a country's investment competitiveness. Such reforms can affect, in different ways, the risk–return equation that investors use to make their investment decisions. Some reforms reduce risk to investors by improving the transparency and predictability of investment policy making. Other investment climate reforms contribute to increasing investment opportunity and maximizing the return on investment by facilitating access to the market or by encouraging clustering and interfirm linkages.

Analysts agree that investment climate reforms are *necessary* but *insufficient* for private sector development in fragile countries. Where they diverge is on the appropriate timing and sequencing of reforms (box 5.3) and the balance between broad-based interventions and direct interventions that benefit specific communities, firms, sectors, economic spaces, or identified value chains.

As the challenges in FCS mount and the pressure for short-term returns on reforms increases, policy makers tend to de-emphasize broad-based deep reforms in favor of interventions with quicker yields in terms of job creation and investment flows. This tendency, however, poses some risks. The transformation from a conflict economy to a peace economy, and from a fragile market to a resilient and inclusive one, is not possible without changing the rules of the game. A targeted approach that strengthens the institutional foundation for the market is therefore the way to go.

This section analyzes the limits of traditional approaches to investment climate reform and outlines a path forward to successfully de-risk investment and expand investment opportunity through reforms that take into account countries' institutional capacity, the investment opportunities that they offer, and the nature of conflict and instability.

Traditional Approaches to Investment Climate Reforms Have Their Limits

Private investment attracted attention as an area of focus in FCS development only in the early 2000s. A 2013 review conducted by the World Bank Group's Independent Evaluation Group (IEG) of the investment climate portfolio identified some 120 projects implemented in FCS with an average of 12 active projects a year. This indicates significant attention paid to private sector issues in FCS in the past decade.

Traditional investment climate reforms in FCS have tended to focus mostly on business licensing, permitting, and administrative barriers to the growth of the private sector, as well as investment promotion and public–private dialogue. Many FCS have used *Doing Business*¹² indicators to map and frame their strategy for business environment reform, focusing initially on simplifying burdensome administrative processes (IEG 2015).

BOX 5.3**Prioritizing Economic Reforms**

The *World Development Report 2011 on Conflict, Security and Development* (World Bank Group 2011) identifies legitimate institutions as the common “missing factor” in countries affected by violence relative to those that do not slide into violence despite comparable threats and stresses. The 2011 Report found that countries with good governance indicators have 30 to 40 percent lower risk of civil war than their peers with weaker governance indicators. Therefore, the path to resilience must be through institutional transformation. Yet institutional reform is difficult, even more so in countries starting from a low base. Prioritization, thus, is a central theme of the path out of violence as envisioned by the WDR.

The Report advocates prioritizing “ending and preventing violence” as the main impact that all interventions in fragile and conflict-affected situations should aim to achieve. Armed by research and analysis, the Report identified three key outcomes as essential to achieving this ultimate objective: security, justice, and jobs. It also showed how the three outcomes are interlinked. In Kosovo, for example, creating jobs by encouraging regional trade depended on securing the main road connecting Kosovo to neighboring countries. In Mozambique, providing livelihood opportunities to ex-combatants was essential to achieving security.

As far as economic reform is concerned, the Report defines job creation as the priority outcome that all efforts should be geared toward. As such, this outcome determines the sequencing path identified by the Report. It argues for starting the process by *building confidence* through signaling change and achieving short-term results and moving from that to *transforming institutions*. It also stresses that this process is a repeated one with transition being an ever-expanding spiral of change.

Regulatory simplification and removing barriers to investment entry were identified by the Report as good confidence-building signals that can yield early results. In the same vein, addressing infrastructure constraints, such as access to electricity and transit, were also identified as good early confidence-building interventions that can stimulate the private sector. The Report also highlighted the importance of value chain development through skills building, access to finance and technology, and connecting producers to markets as a second stage of intervention suitable for fragile environments. Deeper institutional reform such as, privatization, may take longer and may not be suitable for early-stage interventions.

The Report stresses, however, that prioritization should be based on the local context. Priorities should be identified not based on a prototypical prescription but rather on the basis of assessment of the reality in each country. The Report indicates that countries with a long tradition of strong institutions, such as some of the middle-income countries affected by conflict, may be able to take on more ambitious institutional transformations at an early stage that other countries affected by conflict may be unable to do.

The central message of the Report is that strengthening legitimate institutions that can provide citizens with security, justice, and jobs is crucial for breaking the cycle of violence. This institutional transformation, however, should adopt “best-fit” not “best practices” approaches. Institutional transformation takes time. It took the fastest reforming countries in the 20th century 20 years to achieve a functioning bureaucratic quality. So, proceed with realism and recognize that the “scope and speed of reforms are themselves risk factors.”

Evaluations of these reforms did not find clear evidence of the relationship between simplification and investment flows or job creation. They also questioned the realism of such reform efforts considering the low levels of institutional capacity and political commitment found in many FCS. It is now clear that

investment climate reforms must go well beyond simplifying procedures and must respond more clearly to the challenges and characteristics of FCS.

There is value in prioritizing the simplification of business regulations over revamping and expansion at the early stages of reform

in FCS. The rationale for this approach is that such reforms give the necessary signal of friendliness toward business and mark a departure from the past. They have also been seen to produce short-term results needed to build confidence in the reforms (World Bank Group 2011, 157–66).

It therefore bears noting, before outlining an approach that takes into account the limits of traditional approaches to reform, the continued relevance of such approaches as part of a more targeted package of reforms:

1. Improving the business environment with the guidance of the *Doing Business* indicators gives reformers in FCS the quick wins needed to sustain the momentum for reform.
2. *Doing Business* reforms cut across government agencies and, when implemented effectively, they can be an opportunity for building a coalition of reformers.
3. Simplifying regulations and removing obsolete rules is a key step toward freeing the capacity of government to regulate effectively and reduce opportunities for rent-seeking.

New Approaches to Investment Climate Reforms Create Markets

The agenda for investment climate reform in fragile countries is long, yet institutional capacity is typically low and patience for results limited. Thus, such reforms must be designed for the long-term goal of institution building with an eye on the short-term goal of creating jobs and attracting investment. The long-term effort of building institutions and developing regulatory capacity should be combined with faster-yielding reforms that target priority sectors and support value chains.

Sectors offering the most immediate promise should have priority in long-term interventions. For example, in postconflict construction booms, construction permit reforms and removal of entry barriers that benefit the construction sector, among other

sectors, should get priority. Targeted approaches to reform, thus, can be seen to have a greater influence on reforms in FCS.

A market-creation approach to investment climate reform would focus on reducing the risk to investment in fragile countries, and on expanding the investment opportunity and maximizing its rewards. Moreover, the risk–return equation differs by type of investor. Investors with affinity for the jurisdiction—such as local investors, diaspora investors, or investors from neighboring countries with cultural ties to fragile countries—are equipped with local knowledge that may offset some of the risks precluding other investors. Noting this distinction is important for designing policies that remove obstacles to investment faced by this amenable group of investors.

De-Risking: Reducing Risks Faced by Investors

The defining risks of a fragile country for investors, domestic or foreign, are:

- Security risks arising from political conflict or private criminal violence, and
- Political risk arising from institutional fragility.

Investment climate reforms that better protect investments, improve transparency, and encourage rule-based decision making reduce the perception of political risk among investors. Spatial solutions that create secure zones for investors to operate also contribute to reducing the security risk and make investment opportunities more accessible.

Existing investors are the first category of investors that should be targeted by de-risking interventions. As noted earlier, FCS attract their own pioneer investors, albeit at a lower rate. When the return to investment exceeds the cost of risk, investors come. They often initially invest mainly in the extractive sector, but also in telecommunications, finance, and construction. The first step for investment climate reform in fragile countries is to identify the pool of existing investors and to set up systems for investor aftercare and grievance

redress so that these investors remain. This approach works for all FCS regardless of their level of institutional capacity.

Government services that seek to retain investors should also target domestic investors. These investors, especially high-growth ones, also leave the country if the risks exceed rewards. So investor retention interventions that reduce the risks to investment can also be used to prevent this type of capital flight and protect domestic private sector capacity.

Recent unpublished investor surveys conducted as part of the World Bank Group's engagement in FCS have revealed that investors in these economies are well acclimated to the risks of violence and terrorism but are less willing or able to handle the challenges posed by adverse regulations or cumbersome processes. In one case, investors indicated that the number one reason for considering divestment and relocation out of a particular market was regulatory and procedural constraints.¹³

Investor aftercare systems and grievance redress mechanisms should take into account the government's institutional capacity. They should also reflect the political economy of the country. In FCS, investors' grievances are as likely to arise from formal government action as they are from informal rules and institutions such as customary laws and tribal authorities. Any mechanism set up to identify and address such grievances should be able to influence formal and informal decision making (Echandi 2013).

Targeting investment climate reforms to subnational regions that demonstrate higher levels of security and stability is another way of lowering the risk to investors and creating safer spaces for economic activity. This approach can be combined with special economic zones (SEZs) or other types of spatial solutions to reassure investors in FCS. In addition to minimizing geographical exposure to conflict, SEZs can help address several other problems, such as infrastructural, regulatory, or skills deficiencies. At a critical mass of companies, the zones can also foster knowledge and skills transfer along local

value chains. Variations of these approaches have been tried in fragile states with mixed results. A key difficulty is the requirement for sufficient state capacity in formulating and implementing a coherent, responsive, and reasonable SEZ package, without either failing to do so or being captured by vested interests (AfDB 2015).

In Iraq, where more than 50 percent of the population were affected by conflict in 2016, private investment flowed to more stable regions, such as Basra in the South and the Kurdish region in the north. Institutional reforms to encourage private sector development were undertaken at the subnational level. In Iraq, with natural resources, large population, high GDP per capita, and long institutional tradition, severe and widespread conflict did not preclude opportunities for both investment and reform.

Maximizing Investment Opportunities

Encouraging Formalization and Supporting Firms with High Growth Potential

One of the key effects of conflict and insecurity is excessive business informality. In response to conflict and fragility, high-potential domestic firms tend to flee the country while small firms tend to be informal and "go under the radar" to avoid harassment or extortion by public authorities. These trends reduce the size and productivity of economic activities, and undermine market development. They increase the cost of operations as they mandate reliance on foreign input. In some cases, where needed inputs cannot be secured, they may render the investment opportunity unrealizable. Encouraging formalization and supporting domestic firms with high growth potential is therefore a key component of a private sector development strategy in fragile states.

While not all economic activities have to be formalized, a high degree of formality is necessary for markets to be created and for investment to flow. Domestic firms cannot attract equity investment and foreign investors cannot enter the market by partnering with domestic firms without formalization.

Investment climate reforms that help high-growth economic activity shift to the formal sector are key to this process. Depending on the degree of fragility, the demand for reform can be as basic as setting up a well-functioning company registration process and introducing appropriate company laws. In other contexts, other incentives to formalization may be needed.

Linking Domestic Firms to Foreign Direct Investors

Another cost of conflict and fragility is the fragmentation of the market and the loss of firm clusters and cross-sectoral linkages. The underdevelopment of business clusters poses a severe constraint specifically for fragile countries. This, combined with the typically small size of the local market, underscores the importance of focusing on investment climate reforms that target the development of local suppliers and link them to foreign investors operating in the country.

Since investment in fragile states concentrates reforms in a small number of sectors—such as extractives, construction, and telecommunication, with variations across countries—to support the development of linkages, they should focus on sectors that attract investment in the specific countries.

Targeted Investment Promotion Efforts

In addition to conflict and fragility, one of the key inhibitors of investment flows to FCS is the lack of reliable and accessible country-level information important for investor decision making. Better access to information may help offset the adverse impact of poor country image and reputation that result from media reporting of conflict and fragility. For this reason, reforms must build the capacity of the country's institutions to carry out *targeted* investment promotion. The country must also be able to map its investment opportunities and identify sectors with potential for investment attraction.

Finally, as noted earlier, highly skilled labor and large domestic investors tend to flee the country during conflict. This potential pool of diaspora investors also demands a strategy of

targeted investment promotion and attraction. The political economy of diaspora engagement varies from country to country, and tailored strategies that take the reality of conflict into account are critical.

Taking a Regional Approach

Many FCS are characterized by small domestic markets and weak institutional capacity, which limits their ability to attract investment and mitigate risks for investors. For this reason, a regional approach to investment climate reform can enhance the market-creation potential of the intervention. Interventions can benefit from a regional dimension in several ways:

1. The investment opportunity for some FCS may lie in a large neighboring market. Investment opportunity derived from market size is measured not just by the size of the domestic market, or by access to the global market, but also by the size of the regional market bordering the fragile country. A small fragile state, such as Bosnia and Herzegovina or Kosovo, secures significant investment opportunities through its proximity to affluent regional markets. Investment climate reforms that aim to develop the domestic private sector and attract foreign investment must be designed with this potential in mind.
2. One of the key reasons for fragile and conflict-affected situations' low growth and weak trade is a lack of investor confidence and a high perception of risk. Commitment mechanisms are needed for these countries to signal commitment to change that assures investors and raises their confidence (World Bank Group 2011, 283–84). Regional integration agreements with market access commitments and legal harmonization initiatives offer fragile states an opportunity to signal commitment by participating in such agreements and in their mutual monitoring mechanisms.
3. Cooperation among regional actors to pool technical and administrative resources can compensate for lack of

institutional capacity in FCS (World Bank Group 2011, 283–84). Such approaches may be considered a part of investment climate reform. For example, neighboring countries can set up national quality infrastructure and standards necessary for implementing them as shared regional institutions. Good and well-enforced product quality standards are a prerequisite for market access and competitiveness in foreign markets.

Neighboring countries and countries within the same regional block have an incentive to support fragile states in transitioning out of fragility. Conflict dynamics do not stay within borders and both reputational and conflict risk tend to spill over to neighboring countries. Regional organizations thus have a growing role to play in reducing fragility within their regions.

In summary, investment climate reforms are necessary for markets to move from conflict to peace, and from fragility to resilience. Deep changes to the rules of the game are essential. The limited capacity of governments in FCS, combined with the urgent need for quick and positive returns on reform efforts, require a balanced strategy that substantially enhances the investment climate in the country. De-risking and retaining investment, targeting investment promotion toward realistic investment opportunities, and optimally formalizing the economy to promote linkages between foreign and domestic investment are key elements of such a strategy.

Conclusion

Investors in fragile countries face a wide range of adverse market conditions, although some are similar to what they face in other developing markets—such as shortages of skilled labor, capital scarcity, and infrastructure shortcomings. The severity of these conditions in FCS, combined with security risks and lack of institutional capacity and legitimacy, create a seriously deficient investment climate in FCS.

Investment in FCS is thus well below potential. It is also concentrated in a limited number of capital-intensive sectors and creates fewer jobs than it would in less fragile environments. Investors are naturally cautious. If a firm decides to invest, the rewards must outweigh the risks. But the high risks in fragile states render many investment opportunities unviable.

Firms operating in FCS have several options for responding to the obstacles they face and to minimizing costs, risks, and challenges. Strategic choices of multinationals in terms of scale, staffing, and location often aim to address multiple challenges and risks at once. For example, hiring local staff provides access to local intelligence that helps mitigate security risks, as well as engage the local community. Some of the strategies documented by interviews with investors (IFC 2017) include integrated management and due diligence systems; strategically locating warehouses and production sites; tiered investments; international standards; flexibility in scale, supply, and business plans; and supporting government functions.

Investors with more knowledge of the local context, such as regional investors and diaspora investors, have still other mechanisms for coping in fragile states. Such investors familiar with the FCS environment tend to be able to cope better, take more risk, and accept lower returns. Data show that intraregional investment flows to fragile states are growing. These trends underscore the importance of regional sources of investment and regional approaches in transitioning out of fragility.

As development assistance becomes more constrained relative to the demands of reconstruction and development in FCS, the role of private investment in moving countries out of fragility will continue to grow. This underscores the need for active strategies for attracting investment and for developing the private sector in FCS.

The central message of this chapter is that, considering the centrality of the economic underpinnings of conflict, graduating from fragile status requires serious modifications to

conventional methods of economic development. Market-creating investment climate reforms that reduce the risk to investors and maximize the opportunity are crucial to success.

Firm-specific strategies are clearly limited in what they can achieve. And, although they can keep a company out of harm's way, they cannot address the risks associated with fragility holistically or permanently. Given that many risks are inherently part of the definition of fragile states, even a large company's strategies can go only so far in addressing them. Investment climate reform tailored to the FCS context can go a long way toward reducing investors' risks and creating markets for investment.

Annex 5A. Definitions of FCS

The World Bank Group's (WBG) Fragile, Conflict and Violence Group (formally the Center on Conflict, Security and Development, CCSD) annually releases the Harmonized List of Fragile Situations. The first such list was compiled in fiscal year 2006 and has had a series of classification changes from the *Low-Income Countries Under Stress* List (LICUS) (2006–09), to the *Fragile States* List (2010), to the current *Harmonized List of Fragile Situations* (2011–15). The concept and the list have evolved as the WBG's understanding of the development challenges in countries affected by violence and instability has matured (see World Bank Group 2016).

"Fragile Situations" have either a harmonized average Country Policy and Institutional Assessment (CPIA) country rating of 3.2 or less or the presence of a UN or regional peacekeeping or peace-building mission during the past three years. This list includes only IDA-eligible countries and non-members or inactive territories/countries without CPIA data. Countries in the International Bank for Reconstruction and Development (IBRD) with CPIA ratings below 3.2 do not qualify for this list owing to

nondisclosure of CPIA ratings; IBRD countries included here qualify only by the presence of a peacekeeping, political, or peace-building mission—and their CPIA ratings are thus not quoted here.

The 2017 list of FCS includes Afghanistan, Burundi, the Central African Republic, Chad, the Comoros, the Democratic Republic of Congo, Côte d'Ivoire, Djibouti, Eritrea, The Gambia, Guinea-Bissau, Haiti, Kiribati, Kosovo, Liberia, Madagascar, Mali, the Marshall Islands, the Federated States of Micronesia, Myanmar, Papua New Guinea, Sierra Leone, the Solomon Islands, Somalia, South Sudan, Sudan, Togo, Tuvalu, and the Republic of Yemen. Territories: West Bank and Gaza. Blend: Zimbabwe; IBRD only: Iraq, Lebanon, Libya, and Syria.

Countries that have appeared in the World Bank list since the first compilation include Angola, Bosnia and Herzegovina, Cambodia, Cameroon, the Republic of Congo, Georgia, Guinea, the Lao People's Democratic Republic, Lebanon, Malawi, Mauritania, Nepal, Nigeria, São Tomé and Príncipe, Tajikistan, Timor-Leste, Tonga, Uzbekistan, and Vanuatu.

Annex 5B. Investment Expectations Based on Economic Fundamentals

Predicted values of FDI and deviations to actual investment are used in the literature to form expectations based on specific questions of academic or policy interest (For examples, see Bellak, Leibrecht, and Stehrer 2008; Brenton and Di Mauro 1999; Demekas and others 2007). Non-econometric estimations in the form of composite indexes have also been published for the same purposes (see Maza and Villaverde 2015; Rodríguez, Gómez, and Ferreiro 2009; UN 2012), although they do not map directly onto flows of foreign investment.

These exercises have clear limitations: they depend on assumptions about the drivers of

foreign investment, on past records rather than forecasts, and they are designed to answer questions that vary from one study to another. In addition, estimations are constrained by data availability for specific countries. Data constraints are particularly acute for FCS, most of which lack a complete and up-to-date set of drivers. As such, the estimates serve only to illustrate the cost of fragility at some specific point in time, and

are not suitable for forward-looking country-specific policy advice, nor for country rankings.

In this exercise, predicted values of FDI flows are calculated to determine how much FDI inflows would be expected, based on recorded economic fundamentals *nett* of an estimated effect of fragility. Separating the negative impact of fragility from the predicted inflow (that is, fitted value) of this

TABLE 5B.1 Regression Coefficients

Variables	OLS Estimation				
	I	II	III	IV	V
GDP growth (percent)	0.023*** (0.008)	0.026 (0.017)	0.026 (0.017)		0.052*** (0.012)
GDP (log)	1.136*** (0.035)	0.876*** (0.053)	0.909*** (0.022)	0.919*** (0.021)	0.938*** (0.029)
Population (log)	-0.207*** (0.034)	0.042 (0.061)			
Trade openness ((X+M)/GDP)	0.011*** (0.001)	0.011*** (0.001)	0.011*** (0.001)	0.011*** (0.001)	0.010*** (0.001)
Natural resources (percentage of GDP)	0.003 (0.002)	0.008*** (0.003)	0.008*** (0.002)	0.008*** (0.002)	0.014*** (0.004)
Landlocked (=1)	-0.113 (0.071)	-0.261*** (0.092)	-0.253*** (0.095)	-0.203** (0.087)	-0.339*** (0.116)
Proximity to world markets Σ (Foreign GDP/distance)	0.111 (0.079)	0.115 (0.093)	0.098 (0.094)	0.091 (0.093)	0.275*** (0.094)
Fragile States Index		-0.016*** (0.003)	-0.014*** (0.003)	-0.013*** (0.003)	-0.019*** (0.003)
Savings (percent of GDP)					-0.014*** (0.004)
Country fixed effects	No	No	No	No	No
Time (year) fixed effects	Yes	Yes	Yes	Yes	Yes
N = Number of observations	2074	882	882	884	738
R ²	0.753	0.766	0.765	0.761	0.771

Source: Computation based on data sources in the note.

Note: Standard errors are provided in parentheses under the estimated coefficients.

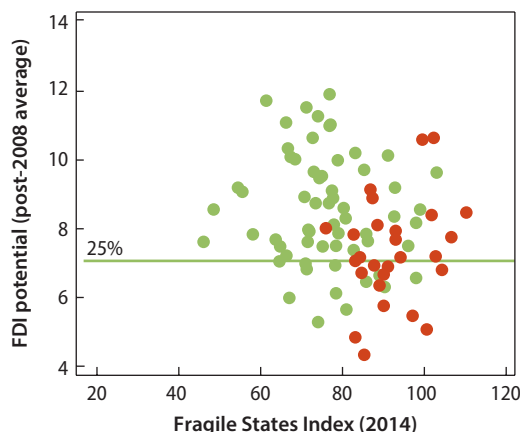
*** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$.

Data sources for the table are as follows:

Variable	Source
FDI inflows (log)	Investment Map Database, International Trade Centre
Fragile States Index	The Fund for Peace (2014)
GDP (log)	World Development Indicators (2016), World Bank
GDP growth	World Development Indicators (2016), World Bank
Population	World Development Indicators (2016), World Bank
Savings	World Development Indicators (2016), World Bank
Trade openness	World Development Indicators (2016), World Bank
Distance to world markets	CEPII (2012)
Landlocked	CEPII (2012)
Natural resources	CEPII (2012); World Development Indicators (2016), World Bank

FIGURE 5B.1 Expected Inward Investment Varies across FCS

Fragility and predicted FDI flows, 2008–14



Source: Computations based on Investment Map Database, International Trade Centre.

Note: The green line crossing the panel indicates the upper threshold of the bottom quartile. The scatterplot shows predicted FDI and levels of fragility with FCS indicated in red and other developing countries in green. FCS = fragile and conflict-affected situations; FDI = foreign direct investment.

regression would yield an estimate of that expectation.

Investment is modeled using the following log-linear equation:

$$I_{it} = a + y_{it}\beta + f_{it}\gamma + d_t + \varepsilon_{it}, \quad I_{it} \in \mathbb{R}^+,$$

where the dependent variable I_{it} corresponds to the logarithm of investment inflows of country i at year t ; y_{it} is a vector of country characteristics (table 5B.1); f_{it} corresponds to the FFP's Fragile States Index; d_t are fixed-effects for year t ; and ε_{it} is the error term. The sample comprises all but the high-income countries of the world and standard errors are heteroscedasticity-consistent (robust estimation). In addition, the sample is not bilateral, hence the presence of few zeros, not warranting regressions based on special distributions.

Among five variants, the preferred specification used for the investment presented corresponds to the last column of table 5B.1, without population as a measure of size, but includes savings as share of GDP. Fixed effects are only included for years but not for

countries, to avoid the absorption of the effect of fragility by the idiosyncratic effect.

The prediction is decomposed into two vectors: (a) a vector of covariates unrelated to fragility, and (b) the estimated impact of fragility and the error. The Structural Prediction corresponds to the first vector for country i at year t only:

$$\begin{aligned} \hat{I}_{it} &= (a + y_{it}\hat{\beta} + \hat{d}_t) + f_{it}\hat{\gamma} \\ &= \text{structural prediction} + f_{it}\hat{\gamma} \end{aligned}$$

Granular FDI flows by origin or sector of activity are available for some of the FCS, but information based on investment potential at that level reduced the sample enormously and was not preferred.

Notes

1. See annex 5A for definition of FCS and list of economies.
2. Capital flees uncertainty and conflict (Knight, Loayza, and Villanueva 1996; Fielding 2004); and foreign firms are frequently targeted during insurgencies (Czinkota and others 2010; Lutz and Lutz 2014).
3. The *Liberian Diaspora Fund* is an example, with remittances from Liberians abroad pooled and matched to investments in a variety of sectors.
4. National Accounts data do not include the informal economy, which can be substantial in fragile and conflict-affected situations. Latest estimates of the size of the informal economy for the period 2005–2010 reveal very high numbers: 69 percent in Chad, 77 percent in DRC, 86 percent in Nepal, and 87 percent in Mozambique (see Charmes 2012). The numbers on the formal economy also likely suffer from errors due to the resource constraints of statistical agencies (inadequately trained staff; absence of resources for surveys; obsolete monitoring systems) also preventing regular updates. Conflict, lastly, brings about shocks to demographic and economic structures that statistical agencies are only able to capture years after violence has ceased. In Eritrea, Libya, and Syria, for example, GDP figures have not been updated for the last six years.

5. Household enterprises can include various service activities (for example, hairdressing, repairs, selling of goods), as well as industrial activities (for example, making of charcoal, bricks, iron work, grain processing), and artisanal activities (for example, woodworking, dressmaking, construction). Household enterprises in manufacturing tend to be replaced over time by factories, so they disappear faster over time than household enterprises in services (see Filmer and Fox 2014).
6. Post-conflict countries, for the purposes of this chart, include the subgroup of FCS where conflict has occurred since 1990, in addition to 11 outside the official list: Algeria, Colombia, Ethiopia, Guatemala, Mozambique, Nicaragua, Peru, Rwanda, Sri Lanka, Uganda, and Ukraine.
7. Afghanistan, the Central African Republic, the Republic of Congo, Sudan, and Zimbabwe are where the growth of services as a result of the associated shift of labor from agriculture to other sectors has been most pronounced.
8. Growth in manufacturing is only experienced in small countries such as Lebanon, the Federated States of Micronesia, Timor-Leste, or Tuvalu for reasons that are probably unrelated to transition along the postconflict continuum.
9. An Enterprise Survey is a firm-level survey of a representative sample of an economy's private sector. The surveys cover a broad range of business environment topics including access to finance, corruption, infrastructure, crime, competition, and performance measures. Since 2002, the World Bank has collected this data from face-to-face interviews with top managers and business owners in over 155,000 companies in 148 economies. See www.enterprisesurveys.org.
10. The World Economic Forum's (WEF) Executive Opinion Survey is one of the most comprehensive datasets that provides detailed insights into the challenges that firms face across countries. In its most recent version for 2016, 14,723 business executives from 141 countries assessed their domestic markets and countries on more than 80 variables.
11. In Liberia, for example, government's consistent underinvestment in infrastructure resulted in a poorly maintained public road network and energy infrastructure, much of which was subsequently destroyed during the prolonged conflict. Despite the reconstruction in the wake of the conflict, ports and other essential infrastructure could not satisfy local demands.
12. The Doing Business project by the World Bank Group provides objective measures of business regulations for local firms in 190 economies and selected cities at the subnational level. See <http://www.doingbusiness.org/>.
13. Such surveys are often conducted as part of the diagnostics necessary for advising governments on the best way to improve the investment climate. They are not published and, thus, specifying the country where such survey was conducted is not possible.

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