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Thoughts on the Establishment of the Multilateral Investment Guarantee Agency

by Dietrich Keschull, Hamburg*

After years of preparatory work, the World Bank's Board of Governors has now given its assent to the Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) for foreign investment in developing countries. Is such a system adequate to mobilise large amounts of additional capital?

Throughout its existence, the policy of bilateral and multilateral cooperation in development has been oriented towards bringing the transfers of financial resources from the industrial countries to the Third World nations up to a high level. These efforts have again been clearly in evidence in the recent past. The main reasons for this are:

- the difficulties many developing countries face in raising themselves the capital needed to finance the growth process, whether as a result of inadequacies in their own economic policies or of protectionist measures taken by other nations which impede or prevent their making successful use of international markets;
- the still modest pace of growth in the world economy even now that the recession of the early 1980s has been overcome, meaning in particular that there has been no general revitalisation of demand in the raw materials sector which is especially important to the developing countries;
- the tendencies prevailing in many donor countries to at least slow down the increase in official aid, if not to reduce official net payments in the course of the third development decade;
- the obvious reluctance of the private sector to provide further credit to Third World countries which in a proportion of cases are already highly in debt.

Increased Direct Investment as a Solution

Proponents of economic cooperation generally recommend two mutually complementary paths in such a situation. Firstly, they advocate that scarce funds for

development aid be more efficiently spent, and secondly that available sources of finance be tapped to a greater extent. For want of any alternatives, direct investment by private enterprise is the focus of interest from industrial countries, developing countries and multilateral organisations alike.

Following a phase in which direct investment as a phenomenon and the behaviour of foreign investors in developing countries were heavily criticised – this applies particularly to the late 1960s and early 1970s – a more pragmatic view of private economic cooperation of this nature now appears to be reasserting itself. Evidently, developing countries' governments are now more strongly aware of the means at their disposal to ensure foreign investment fits into their own economy and monitor it. Companies from industrial countries – verbally, at least – are signalling a greater readiness than ever before to integrate their activities into the prevailing conditions and regulations in the host country.

Direct investment, for Third World countries more than any others, has a significance ranging beyond the transfer of capital involved. A factor considered to be at least as important comprises the opportunities for transferring technological and management know-how. The hope, therefore, is that this combination will not only bring short-term relief to the balance of payments, but will also improve the chances of saving hitherto vital imports and/or bringing a lasting increase in export earnings over the longer term.

From the donors' point of view direct investment has an important part to play in improving the efficiency of cooperation. This is because, as a rule, it is prerequisite upon a market-based economic order, and this implies an overall economic environment and regulatory

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mechanisms which, according to recent empirical investigations, carry the promise of greater success in achieving growth.

Actual Development Unfavourable

It must be said that there is a stark contrast between the positive attitude voiced towards direct investment and the amount which is actually carried out in the Third World. The developing countries' share of the direct investment made by companies from the industrial nations is less than 30 %. At the same time, there is a clearly declining trend among the world's leading investor countries. Although the USA was able to slightly raise its share of developing country investment (out of its total direct investment abroad) from 21.8 % to 23.1 % between 1977 and 1984, the United Kingdom's and West Germany's shares fell from around 20 % to 18.6 %¹ and 16.7 %² respectively. Also, the share of Japan's direct investment going to developing countries – well above average at the still high level of 53.3 % in 1984, and of an order of magnitude which has always improved the picture for Third World investment – has been falling since 1980.

To add to this, all the large industrial nations concentrate their investment on a small number of developing countries – usually NICs – largely excluding the overwhelming majority of the remaining countries from this transfer of resources. This particularly applies to those categorised by the World Bank as least developed countries, and to most of those in its lower middle-income category. The USA, for example, has been placing almost two-thirds of its investment in Central and South America; 60 % of the investment made by West Germany in developing countries went to the four countries of Brazil, Mexico, Argentina and Nigeria.

Causes of the Decline

All manner of investigations have been made and opinions been voiced on the reasons why developments have been so unsatisfactory for those countries which have an interest in seeing that more growth-creating investment is made. However, all agree with one another that investment capital flows to wherever there are safe investment opportunities with the promise of being comparatively profitable. There are a great number of additional considerations which come into play in any investment decision. Nevertheless all of these can be traced back in some way to the goals of

security and profit. These, then are the crucial criteria when judgements are made on the investment climate.

Assessing the degree of security – and hence also of risk – is always a subjective process. However the presence of risks does mean that premiums are calculated which take up a proportion of the profits it is believed can be achieved. The more uncertain the situation is felt to be in a particular country, the greater the profit opportunities it therefore needs to offer if it is to attract any foreign investment.

Risk Reduction through National Insurance Agencies

To mitigate the risks involved in foreign investment, most industrial countries from 1948 onwards established quasi-governmental institutions offering insurance. The main underlying considerations were:

- ☐ firstly, the aim of improving the international division of labour by way of increased foreign investment and thus securing benefits for the home economy; there were also individual cases where development policy considerations played a part;
- ☐ secondly, the state felt it was its responsibility to see that domestic and foreign investments were treated equally in certain ways. With this in mind risks which only arose through conducting business abroad were intended to be protected by a state guarantee.

These additional risks, so the widely agreed view runs, are linked to events occurring outside the commercial field, the latter remaining a matter for the entrepreneur himself. The most important group of risks is subsumed under the term "political risks". The purpose of a guarantee in this context is to indemnify the investor against damages occurring in the wake of war, armed conflicts, revolutions, etc., or resulting from nationalisation, the blockage of payments, moratoria or restrictions on the transfer of funds or their convertibility. In certain cases cover may also be provided for risks associated with natural disasters in the country chosen for the investment.

As they are conceived in theory, guarantee systems are intended to bring a worldwide improvement in the allocation of capital by means of a reduction of the investor's risks. By entering into agreements protecting legal rights host countries can give clear signals to would-be investors that they would face a favourable climate. The existence of such provisions is an important aspect of guarantee systems designed not only to encourage the national export of capital but also to bring a lasting intensification in world economic

¹ UK figures for 1981, including petroleum, banking and insurance.

² West German figures for 1983.

cooperation. The points normally secured in these agreements are:

- ☐ that the signatory countries will not discriminate against capital investment flowing between them in favour of domestic investment,
- ☐ that foreign nationals working in any signatory country in connection with capital investment will not be treated any worse than the country's own citizens,
- ☐ that any state expropriation will only take place in the public interest and will be subject to compensation equivalent to the value of the assets concerned,
- ☐ that the transfer of capital, profits, liquidation proceeds or compensation payments can be made without delay at the currently prevailing rate of exchange,
- ☐ that in the event of dispute a mutually acceptable arbitrating authority is called upon at the investor's request,
- ☐ that affairs are conducted in accordance with the most-favoured-nation principle.

Between 1948 and 1984, 21 nations took steps towards ensuring equivalent competitive positions for their enterprises by establishing guarantee systems for foreign investment risks. Preparations for such measures have also been made in Portugal and South Africa.

Aspects of a Multilateral Guarantee System

From the development policy point of view, risk-covering facilities are significant primarily because they offer the possibility – due to the favourable effect accruing to individual entrepreneurs – of encouraging a more substantial flow of capital into productive enterprises in numerous Third World countries. This always assumes that

- ☐ a large number of highly profitable investment opportunities exist in almost all Third World countries;
- ☐ political risks which individual companies rate as very high are the reason for not making the investment concerned.

The World Bank, which has been intensively studying plans to increase the flow of investment capital into Third World countries since 1973, sees major gaps and deficiencies in national systems as well as in the private sector insurance arrangements which have played an increasingly significant role in recent years. The following five points are singled out for special attention:

- ☐ The insufficient spread of risks because investment

is concentrated in a small number of developing countries.

- ☐ Increasingly restrictive guarantee provisions as a consequence of this regional concentration of private sector investment.
- ☐ Problems in covering transactions where several investors have different countries of origin.
- ☐ Limited opportunities to buy reinsurance in the private market because of the narrow risk spread.
- ☐ The lack of national insurance agencies in certain capital-exporting countries, particularly the OPEC states.

By establishing a Multilateral Investment Guarantee Agency, the World Bank believes there is a chance of compensating for these deficiencies. Only a system of this kind in which countries importing and exporting capital are all involved on an equitable basis, so the argument runs, is capable of ensuring an additional flow of funds to developing countries over a longer term.

The Run-up to MIGA

Plans to introduce a multilaterally functioning investment guarantee system on a worldwide basis are nothing new. Because, above all, there was a lack of national facilities in the immediate post-war period, no less than twelve initiatives for a multilateral system had been launched by the early 1960s. These were followed in 1973 by the World Bank's proposal to found an International Investment Insurance Agency (IIIA), by UNIDO's proposal in 1980 for an International Insurance System, and by a paper issued by the Club de Dakar in 1981 on an International Guarantee Fund. Also worthy of mention are one project which was limited to a particular sector – the USA's plan for an international raw materials bank – and the proposals – confined to a specific region – for a multilateral system within the framework of the European Communities and the Inter-American Development Bank (IDB).

Only one system (with a regionally limited number of investor and host countries) ever became a reality. The system, launched in 1966, is the Inter-Arab Guarantee Corporation. The main reason that the multilateral approach has not actually been realised is probably the fact that, for most countries, the sense of urgency steadily diminished over time once they had established systems of their own. In addition, the Western industrial nations, being the largest exporters of capital, showed little inclination to renounce one of the few remaining ways they had of influencing their capital and trade flows. They were also critical of the lack of provisions for

legal protection in the multilateral facilities, and were fearful of the red tape an international organisation might involve.

The recipient countries, for their part, voiced concerns centering mainly upon the danger of decisions on the treatment of foreign investment being made over their heads, and of investors having too great an influence in the country. Furthermore, there were fears that the multilateral agency's assessment of the investment climate would influence the apportionment of multilateral development aid.

Against the background of these concerns, which ultimately led to the rejection of the IIA, the World Bank set out a new proposal for a Multilateral Investment Guarantee Agency (MIGA) in 1982. At its Annual Meeting in 1985, the convention establishing this agency was passed by the Bank's Board of Governors and now awaits signature. The convention can be expected to come into force in the course of this year provided that two conditions are fulfilled:

- ☐ at least five capital-exporting countries and fifteen capital-importing ones ratify the document,
- ☐ those countries between them subscribe to at least one third of the MIGA's equity capital.

Aims and Methods

The new institution's aims and objects are oriented to conceptions of what is needed in development policy, and to the deficiencies felt to exist in national systems. The MIGA's main task, then, will be to channel additional capital into developing countries for directly productive purposes. Chances of mobilising more resources are envisaged particularly with regard to countries without any guarantee system of their own to date. The agency is also intended to identify and publicise investment opportunities, and to give advice to developing countries on matters of policy towards investment from abroad.

Moreover, the agency is expected to contribute to removing boundaries which have been built up against investing in certain countries by national systems. Emphasis is also placed on its role in covering syndicate transactions involving companies from various countries which, up to now, have been very difficult to obtain coverage for. MIGA is not intended to displace national and private investment insurance programmes, which already exist in many countries. Instead, it is to complement these by providing additional insurance cover and reinsurance.

The Agency aims to tailor the cover it provides more closely to the special features of investments than existing organisations do. Apart from the usual political risks where damages occur due to war, revolution or state appropriation, other circumstances constituting a grey area where the effects are similar to appropriation will also be taken into consideration. The situations involved are:³

- ☐ Risks of loss flowing from legislative or administrative actions or omissions on the part of the host country's government which result in the foreign investor losing the rights of ownership connected with the investment, the control over it or substantial benefits from it.
- ☐ The risk of repudiation of government contracts where investors have no access to a competent forum, face unreasonable judicial delays, or are unable to enforce rulings issued in their favour.

It is further intended to allow for the inclusion of other noncommercial risks in the cover on a case-by-case basis with the approval, by a special majority, of MIGA's Board.

In addition to the comprehensive risk cover provided, the term "investment" is to be broadly defined to accommodate companies' special requirements. Apart from direct investment, medium and long-term loans made by owners of equity in the enterprise concerned and special forms of participation such as franchising, licensing, leasing or production-sharing will also be included.

Organisation and Voting Rights

Guarantees can be granted to any investors who are citizens of, or have their company headquarters in, a MIGA member country. Membership is open to all World Bank members and to Switzerland. The guarantees will only be available for investment in developing countries which are members of the facility. Priority is intended to be given to the lesser developed countries. MIGA can also cover investments sponsored by member countries as trustee for these countries. In contrast to the guarantees which will be financed out of subscribed capital, the sponsorships are funded by voluntary payments from members, who are jointly liable in cases of loss.

A capital base of SDR 1 billion is considered necessary for the start-up phase. Of this, members will be asked to put down 10 % in cash. A further tranche of 10 % is to be in promissory notes. The remainder constitutes callable capital. In the long term the system is intended to finance itself – as do existing systems –

³ Cf. The Multilateral Investment Guarantee Agency: an update, in: Finance & Development, No. 4, 1985, p. 54.

from premium income. The plan is that premiums should not be on a country-based scale, but one determined according to the nature of the risk being covered and the type of business involved.

The proposal to create the multilateral guarantee system is unequivocally based on a World Bank initiative. However, the MIGA is intended to be independent of the Bank. It will take the form of an autonomous agency with its own directing bodies (Board of Governors, Directorate, President). Nevertheless, it is likely that a cooperation agreement will be arranged with the World Bank in order to make use of available know-how and avoid expensive duplication. Close contact is assured simply from the fact that the President of the World Bank will also be the *ex officio* Chairperson of the MIGA Board.

The stress laid upon multilaterality and upon equal treatment for investing countries and those where the investment takes place is particularly evident in the regulations on voting rights. In the organisation's finished form, industrial countries and developing countries should each, as a group, have equal voting power. During the first three years the minority group will be entitled to 40 % of the votes, and a $\frac{2}{3}$ majority will be necessary to carry any decision. Whenever any guarantee is to be granted, the host country for the investment will always have a right of veto. The latter stipulation is intended to ensure that the developing countries' rights are safeguarded over the long term.

Advantages of MIGA

At first sight the multilateral system now proposed appears to offer a number of clear advantages over national guarantee institutions. These consist, in the main, in the fact that:

☐ investors based in countries (including developing countries) which have not so far had any national or private-sector guarantee facilities available will now be able to enjoy guarantee protection;

☐ the spectrum of insurable risks is now to be extended to include some of the hitherto grey areas;

☐ the definition of investment has been cast sufficiently widely to allow for covering more than just share-owning participation;

☐ transactions involving investors from several different countries of origin (syndicates) can be covered under the same conditions for all participants;

☐ private underwriting agencies can expand their activities by reinsurance or co-insurance with MIGA.

Whether these new possibilities will be exploited in reality is crucially dependent on how the business is managed and whether losses are treated effectively and smoothly. Corporate confidence in MIGA, which has yet to be built up, is an important prerequisite if it is to succeed. For only if a substantial amount of business can be turned over will the desired effect in development-policy terms occur, namely the channelling of additional capital to the Third World countries. However, there are still substantial doubts as to whether the desired positive effects will show up very rapidly.

Inadequate Legal Protection

Pride of place amongst these doubts goes to the poor provision of legal security. In contrast to national guarantee institutions, the MIGA is unable to fall back upon bilateral investment protection agreements. Although it is true that World Bank sources underline that the guarantees are always made with the host country's agreement so that the latter enters into a firm obligation, it is nevertheless a matter of some doubt whether governments whose actions or omissions result in the investor losing control over his investment, or which fail to recognise the contracts they have entered into, will then later truly honour such obligations.

The World Bank's tendency to err on the side of generosity in its treatment of the protection of legal rights cannot hide the fact that this is an area of crucial

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significance in determining the investment climate. Effective agreements in this field are, basically, the precondition for at least being able to start out to make political risks and grey-area risks insurable. In assessing MIGA the fact must be taken into consideration that relatively strong bilateral agreements already exist. At any rate preemptive measures need to be taken against MIGA's weak legal protection undermining these investment protection agreements in the long term, and hence also the position of national guarantee agencies.

Legal protection plays an important part in determining the degree of trust placed in the new institution, and thus also the amount of use made of what it has to offer. The proposal to cover additional risks to which investors in the prominent capital-exporting industrial countries are exposed will not be able to attain significance unless and until the MIGA can stand on firm foundations where legal protection is concerned. These circumstances are all the more important given that many companies could in any case well have reservations when it comes to using an agency

- ☐ which is not based in their own country, is probably far away and difficult to reach,
- ☐ in which business has to be conducted in a different language and
- ☐ whose principles of doing business one is unfamiliar with.

Doubts on Supplementary Effects

The above barriers – some of which may indeed be more psychological than anything else but are no less important for that – are already raising the first doubts as to whether MIGA can help in really managing to channel a greater volume of additional private-sector funds into developing countries. This is not a question of seeking to deny the agency's ability to substantially influence the underwriting of risks. What needs examining, though, is the hypothesis that there is a large number of developing countries which really offer worthwhile investment opportunities. This applies especially to countries with small domestic markets, limited purchasing power and only modest export potential.

The sales-oriented investments, which are clearly to the fore for the majority of capital-exporting countries, are largely concentrated in countries with high purchasing power and favourable long-term growth prospects. The lack of sales opportunities, appropriate technology, suitably qualified staff or a good-capacity infrastructure are often the key factors in decisions not to invest in other countries, and particularly in relatively

small and less developed countries. These disadvantages are not sufficiently balanced out by a reduction of the investment risk.

Investments which, on the other hand, are relatively little influenced by the recipient country's economic situation are those made in the raw materials sector and hence oriented to the procurement of supplies. Because of the long lead-times and maturity periods involved, political risks can be presumed to play a greater part in the decision in this instance. For such decisions, the reduction of political risks is both a worthwhile and a much-needed measure. Even so, it could hardly be regarded as enough to mobilise large amounts of additional capital, as the infrastructure in the country concerned and the mechanisms for channelling and controlling capital investment from abroad are at least as significant when locational decisions are taken. Thus the claim made by MIGA that it can bring about an enhanced flow of investment capital and a broader regional spread of direct investment, by making use of investment opportunities in the poorer countries in particular, would appear to be rather ambitious.

Reduction of Regional Concentration

In view of the above considerations, it cannot be regarded as conclusive that a multilateral agency will be in a position to eliminate the regional concentration which is so clearly evident in the case of a number of national guarantee schemes. For the concentration is not a result of the business policy of the insurance agencies but, rather, flows from a great many individual entrepreneurial decisions. The decision-making parameters used will not be fundamentally influenced by MIGA in favour of investing in those countries which are economically especially disadvantaged. The tendency to make investments in just a small number of countries which are especially attractive in business terms, or with which close relations already exist due to geographical proximity, is hardly likely to change.

Besides this, the only situation in which such concentration represents an obstacle to continued investment from one country of origin is when guarantees are regarded as absolutely necessary and the national organisations put a stop to further activities by way of strictly defined country ceilings. However, such cases are only of significance in the US American system. Country ceilings do not play a crucial part in any other important countries of origin for investment. MIGA cannot therefore be expected because of the allegedly too strong degree of regional concentration in the national systems to be able to mobilise substantial additional funds for investment (which would in any case

flow to the same countries as before, leaving the poorer countries neglected yet again).

Services to Countries without Insurance

One fact which is beyond dispute is that enterprises in virtually all of the developing countries lack access to this form of support. The problem has not been eliminated by the establishment of a few additional national systems in newly industrialising countries. The limited relevance of mutual investment in the South-South context to date, which is expressed in the modest level of such capital investments, however, coupled with the significance attached to other factors in determining the location of investment, casts doubt upon whether a multilateral investment insurance will lead to any decisive mobilisation of risk capital. Most developing countries today still lack the preconditions for making sizeable investments in other countries, even though this would be a good thing.

Even where the OPEC countries are concerned, the question arises as to whether

- ☐ they have yet reached a position, in terms of their own pattern of production, to undertake any significant amount of direct, rather than portfolio, investment,
- ☐ these investments will take place in developing countries,
- ☐ their balance-of-payments surpluses are likely to persist for such a long period that they can be expected to make a lastingly high level of use of any multilateral facility.

A Necessary and Sufficient Measure?

To summarise, one must conclude that only very slight effects on the mobilisation of private capital for the development process can really be expected of the Multilateral Investment Guarantee Agency. The immediate basis for such a conclusion is that the effectiveness of the existing national guarantee agencies has been underestimated while their supposed shortcomings have been overestimated. With the exceptions of Greece and Eire, all Western industrial nations now have systems of their own. This is not to say that companies looking for guarantee cover would not give preference to more extensive arrangements than are obtainable from their national systems if the terms were favourable. This, however, is not normally the case, as the advantage of improved risk cover is reduced by the more limited legal protection and possibly also by higher premium rates as the example of the Overseas Private Investment Corporation (OPIC) has shown in the USA. Because of this, and the difficulties of access which in any case arise with a

multilateral organisation and the complex communications it involves, there are many signs that companies in the most important industrial countries will continue to fall back primarily on their national organisations.

Even among the NICs the attitude appears to be a similar one. The guarantee systems established in India and South Korea, at least, suggest that here, too, preference would be given to the national route.

Hence, for any of the above countries a multilateral institution designed to mobilise private capital for developing countries by covering political risks does not by any means appear to be an absolute necessity. Its necessity can only be supposed for those developing countries which do not have their own guarantee systems. Any genuine demand, however, is only likely to occur in a few OPEC nations and NICs, meaning that the overall potential is likely to be limited.

Whether the multilateral agency, then, is really necessary if additional capital is to be mobilised is a question which can only be answered with a qualified yes. MIGA's limitations become still more obvious if one enquires into its adequacy for bringing an effective and lasting reduction in the developing countries' capital bottlenecks. For even in the case of MIGA guarantees, one can expect the general tendency to carry out investment in a small number of particularly profitable countries to set in at a relatively early stage. It cannot, at any event, be in the interests of an organisation intended to be self-financing in the longer term to take on only particularly risky business in countries with high risk levels. Thus, the hope of channelling free enterprise capital into the relatively poorer countries and into the poorest of all is likely to prove soon to be an illusion.

Even if the ratification of MIGA proceeds rapidly, which is not at all certain, expectations regarding the effectiveness of this instrument must remain subdued. Certain at present is only the fact that the new organisation is liable to absorb large amounts of additional resources. Whether it will be useful to the world economy and to development policy remains to be seen.

It would, at any rate, appear to make more sense if, instead of seeking to insure against risks, more emphasis were placed on eliminating the causes of those risks. This cannot be achieved by paying too much respect to policies in developing countries which inhibit investment: what is needed is an open dialogue with a sense of partnership, allowing the conditions on which political and economic stability are contingent to be addressed openly.