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Early investments in fragile states: a role for Norfund?

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Introduction: investment and growth is crucial for recovery

Afghanistan faces at present a serious economic challenge: a decade of massive aid inflow has distorted the economy and economic policy-making. The looming decrease in aid levels over the next few years could augment political instability and cause a reduction in growth. While there may be immediate positive impacts associated with individual aid projects, indirectly, as this report will illustrate below, the total aid inflow may hurt the prospects for long-term economic recovery.

Afghanistan's predicament illustrates a wider problem associated with recovery in fragile states. This group of countries receives a large share of global aid flows. The global commitment to continuing the support to fragile states is also high, as demonstrated at the High Level Forum on Aid Effectiveness in Busan.¹ However, economic analysis also tells us that the link between aid and economic growth is weak, and aid levels over a certain percentage of GDP may be detrimental to growth.² This is of serious concern to fragile states since their aid levels in relation to GDP tend to be high. Moreover, their absorptive capacity of aid is often low, due to the havoc waged on governing institutions during the conflict years.

This report argues that fragile states are best served with a mix of aid and foreign direct investments (FDI), since FDI can help create a long-term fundament for growth. However, fragility discourages investment and the bulk of FDI often comes well after a country has stabilised. The key question for fragile states is how FDI can come earlier and how its larger development effect may best be nourished. This report discusses these challenges and assesses how Norfund may contribute.

The report is particularly concerned with FDI in fragile states that are recovering from armed conflict, but will also refer to states facing related challenges, such as that of a difficult political transition in countries like Myanmar.

¹ *Busan Partnership for Effective Development Co-operation*, Busan Republic of Korea, 29 November – 1 December 2011

² Collier, Paul and Anke Hoeffler 'High-value natural resources, development and conflict: channels of causation', in P Lujala and S. A. Rustad eds. *High-value natural resources and peacebuilding* (London: earthscan) 2012, Collier, Paul Post-conflict recovery: how should strategies be distinctive? *Journal of African Economies* vol 18, AERC Supplement 2009

War is typically looked at as a time of despair, destruction and insecurity. Certainly, the loss of life and dignity in war must never be underplayed. Neither the developmental backlash nor loss of productive assets should be ignored. However, war also has a number of creative elements that must be recognised and built on. David Keen defines war as an alternative system of power, profit and protection.³ While war includes two or more sides fighting over political goals, the war years are also signified by old and new powerbrokers asserting control over economic sectors and entrepreneurs taking advantage of opportunities that come in the wake of war.⁴

Using these observations as starting points we can recognise that war creates a distinct set of assets and opportunities. Participation in an armed group may bring important social capital to combatants and commanders: they enlarge their networks, travel more widely and acquire new skills. Refugees and migrants form diaspora communities that acquire new knowledge and gain better access to global resources such as education and investment. Moreover, as Paul Collier notes, states emerging from conflict often experience a commodity export boom. The end of conflict allows for an intensification of economic activity that produces a ‘quantity windfall’ (see page 12). This may pertain to natural resources, industry and agriculture alike. In the agricultural sector farmers re-emerge from subsistence farming and turn to export commodities, while in the extractive industries planned exploration from the pre-war years may finally be commenced and export volumes enlarged.⁵

These are signs that the post-war moment is one of both great fortune as well as despair. The role of outside investors is to identify the positive elements vested in post-war economies and magnify their potentials and effect. As the peacebuilding scholars Mats Berdal and Nader Mousavizadeh note ‘encouraging and building on (..) local ingenuity in a way that avoids the reproduction of violent political economies is the most promising route to economic recovery and both the domestic and foreign private sector can play an important role.’⁶ The crucial importance of economic recovery, moreover, for guarding the peace should not be underplayed. Growth in the

³ Keen David ‘Incentives and disincentives for violence’ in Berdal and Malone eds. *Greed and grievance: economic agendas in civil wars*. (Boulder, Colo: Lynne Rienner Publishers) 2000.

⁴ Jonathan Goodhand identifies ‘combat economies’, ‘shadow economies’ and ‘coping economies’ as typical forms of economic activities that appear during war.

⁵ Collier, Paul Post-conflict recovery: how should strategies be distinctive? *Journal of African Economies* vol 18, AERC Supplement 2009

⁶ Berdal, Mats and Nader Mousavizadeh Investing for peace: the private sector and the challenges of peacebuilding *Survival* 52:2, 2010 p. 43

first post-conflict decade significantly reduces the risk of instability.⁷ Conversely, in studies of the situation in Africa the risk of civil war correlates strongly with low economic growth.⁸

In the following the report discusses three key features of fragile states: instability, distorted economy and weak institutions. The report then turns to an assessment of key trends associated with FDI in fragile states. Distinct challenges and opportunities related to FDI are also debated. The report ends with a section assessing how Norfund can navigate the particular challenges that fragile states pose. It concludes by noting that a rethink of how support to fragile states is best done is well underway, triggered in part by failures in Afghanistan. Issues of growth and investment are key ingredients in the new paths that are forged and Norfund is well positioned to contribute.

⁷ Collier, Paul Post-conflict recovery: how should strategies be distinctive? *Journal of African Economies* vol 18, AERC Supplement 2009

⁸ Ibid.

Fragile states: weak institutions and distorted economy

Countries falling into the category ‘fragile states’ form a heterogeneous group.

In this report we focus on the Asian and African countries listed on the World Bank Harmonized List of Fragile Situations.⁹ The heterogeneity of fragile states call for a cautious approach when attempting to identify common trends. Three overarching challenges may nevertheless be identified. Needless to say, this is not intended as an exhaustive list or comprehensive discussion, but represents an attempt to single out some central aspects that may be relevant for the later assessment of the role of FDI in fragile states.

Insecurity and political tensions

Post-war settings are profoundly insecure. Countries that have endured civil war are more likely to experience a new onset of conflict: a report from 2004 finds that around half of all post-conflict countries relapse into conflict within a decade.¹⁰ Moreover, even if there is a formal end to war, violence rates typically continue to be high. A historical study of violence for the period 1900 to 1976 found that societies were overall considerably more violent than before the war, in many cases homicide rates doubled.¹¹ This phenomenon has also appeared in many of the countries in Latin America, Africa and Asia suffering from civil war in the 1990s and onwards. Central American countries were especially hard hit, with a state like El Salvador having four times higher homicide rates than before the war. Astri Suhrke notes that ethically-directed violence erupted in Kosovo and Northern Afghanistan after the NATO invasions had established a new order in these areas. In Liberia rebels forcefully took control over rubber plantations after the end to the war and East Timor experienced a severe episode of violence seven years after the secession from Indonesia when the police and army fought each other.¹²

⁹ The African and Asian states on the list are Afghanistan, Angola , Burundi, Central African Republic, Chad, DRC, Congo, Republic of, Cote D’ivoire, Eritrea, Liberia, Myanmar, Nepal, Sierra Leone, Somalia South Sudan, Sudan, Timor-Leste (www.worldbank.org)

¹⁰ Collier, Paul *Development and Conflict*, Oxford University, 2004

¹¹ Suhrke, Astri ‘Peace in between’ in Suhrke and Berdal eds. *Peace in between: post-war violence and peacebuilding* (London: Routledge) 2011 p. 1-2.

¹² Ibid. There are of course exceptions to this, the post-civil war period in Tajikistan was by and large marked by exceptionally low levels of violence, see Torjesen, Stina and S. Neil MacFarlane, ‘R before D: the case of post conflict reintegration in Tajikistan’, *Journal of Conflict, Security and Development* Vol 7, no.2 June

There is also often a regional dimension to civil wars and an unstable regional neighbourhood may drive insecurity in states attempting to recover from conflict. An unstable regional context may allow for spill over of weapons and mercenaries or political, economic or security interest may motivate regional actors to engage in conflict ridden countries. At the very least this adds tension to a fragile environment, in the worst case it may trigger a relapse back into civil war.¹³

Post-war settings are riddled with political tensions. A number of countries need to deal with ‘spoilers’ of peace, disgruntled armed sub-factions that are unhappy with the peace settlement and try, often through violent means and political rhetoric, to carve out a larger role.¹⁴ This comes at a time when the international community push for democratisation and market reform. In a seminal study from 2004 Roland Paris found that the emphasis on early elections in the absence of well functioning institutions increased, rather than decreased instability.¹⁵

Political tensions may in a part stem from deep grievances fought out in the conflict years, such as deep disagreements on the nature of the state (i.e. the Maoists vs. the government in Nepal). These are disagreements that may not be fully resolved with the peace settlement and may continue to shape political struggles in the post-conflict years. Alternatively, political tensions may reflect greed driven agendas of civil war actors. In the war years as well as the post-war period violent entrepreneurs and strongmen may be driven by economic motivations. If the post-war settlement fails to deliver tangible rewards, this could cause tensions. The rebel movement M23 currently operating in Eastern Congo, illustrates this phenomenon. Disgruntled with the meagre share of the post-war ‘pie’ of economic privileges and benefits the group is rebelling against the government and triggering considerable political tension.¹⁶

Distorted economy

Conflict ridden states face a number of economic challenges. GDP drops significantly in the war years and many commercial activities break down, including industrial

¹³ Gleditch, Kristian Skrede, ‘Transnational dimensions of civil war’, *Journal of Peace Research*, vol 44, no 3. May 2007

¹⁴ Stedman, Stephen J. ‘Spoiler problems in peace processes’ *International Security*, vol 22, no 2, 1997

¹⁵ Paris, Roland *At war’s end: building peace after conflict* (Cambridge: Cambridge University Press) 2004

¹⁶ Washington Post ‘M23 rebels return to peace talks’ December 11, 2012

production.¹⁷ With insecurity and disruptions in supply and demand many farmers revert into subsistence farming and agricultural production contracts. Capital flight is a considerable problem in low-income countries, and is likely to be even more severe for countries suffering from armed conflict. Public spending is diverted towards military and security ends and formal revenues collection drops significantly.¹⁸ Informal and illicit economic activities, such as smuggling expand, creating considerable fortunes for a select few and a broader tradition for circumventing state regulation and control. These indigenous features make economic recovery difficult. Arguably, however, a large outside involvement, add to the macro-economic challenges facing a post-war country. There is increasing evidence that countries have a ‘saturation point’ for when the effect of aid on growth becomes negative. One study found that in countries where governance and policy making processes worked well aid contributed to growth if it was no more than 30 percent of GDP. In countries where policies were poor the saturation point of aid came at 10 to 15 percent of GDP.¹⁹ The reasons for the potential negative effect of large aid volumes are both economic and political.

In economic terms, aid inflows represent additional revenues for countries and their inflows raise the exchange rate, thereby potentially hurting export sectors, including manufacturing (‘Dutch disease’). The aid-fuelled sectors also drive up salary levels and draw the most skilled and talented workers away from the government or local private sector (brain drain and ‘carving out’).

In political terms, the additional revenue associated with aid runs the risk of ‘detaching’ the government from the electorate, largely because taxation becomes less important. Deborah A. Brautigam and Stephen Knack note that ‘when revenues do not depend on the taxes raised from citizens and businesses, there is less incentive to for government to be accountable to them’.²⁰ A less accountable government will likely be

¹⁷ Collier, Paul *Post-Conflict Economic Recovery*, International Peace Academy 2006. Collier also estimates that GDP is typically reduced by around 15 percent in the war years, see Collier, Paul ‘Post-conflict recovery: how should strategies be distinctive?’ *Journal of African Economies* vol 18, AERC Supplement 2009

¹⁸ Collier, Paul *Post-Conflict Economic Recovery*, International Peace Academy 2006

¹⁹ Collier, Paul and Anke Hoeffler ‘High-value natural resources, development and conflict: channels of causation’, in P Lujala and S. A. Rustad eds. *High-value natural resources and peacebuilding* (London: earthscan) 2012

²⁰ Brautigam Deborah A. and Stephen Knack Foreign aid, institutions, and governance in Sub-Saharan Africa, *Economic Development and Cultural Change* Vol 52 no 2, 2004, p. 265, This resonates with the findings of who found that the larger the share of government expenditures financed through taxation the more likely the government was to become representative, Ross, Michael L. ‘Does taxation lead to representation?’ *British Journal of Political Science*, 32, 2004

less able to develop economic policies that serve larger national interests and it may turn to policies that serve narrow private ends, thus decreasing the prospects for growth and recovery. This ties in with the concept of rent seeking, which denotes efforts to use government mechanisms to access wealth or economic privilege without contributing to new wealth.²¹ By way of example, Stephanie Mattie traces how practices of rent-seeking evolved in the Democratic Republic of Congo (DRC) from 1965 and onwards. She notes that President Mobutu used the state finances to buy support from the Congolese elite. Mobutu drew on resources stemming from mineral wealth, while in recent years Mattie argues that the inflow of foreign aid has allowed current Congolese authorities to continue these practices. Foreign aid has also allowed spending to remain high, while domestic revenues generation is low. She notes that authorities have not taken any concerted efforts to create a comprehensive taxation system.²²

The Afghan economy: aid overflow contributes to insecurity

Aid to Afghanistan spiked after the fall of the Taliban in 2001 (see figure 2: FDI vs. ODA in Afghanistan, Sierra Leone and Timor-Leste). By 2009 Afghanistan received the highest rates of development assistance of any developing country in recent history. Aid also constitutes an exceptionally high share of the economy. Afghanistan's GDP in 2011-2012 is estimated to be around 18 billion USD, while total aid expenditure is around 15 billion USD. This raises two macro-economic concerns. First, the level of aid is well above the rates deemed sound by Paul Collier (10-30 percent of GDP), and may prove to be detrimental to growth and recovery. Second, there is considerable uncertainty tied to the level and volatility of aid in the years to come. Indeed, the level of aid is expected to be reduced significantly as the NATO military engagement draws down in 2013-2014. The reduction may hurt the economy and create additional uncertainty at a time when Afghanistan needs to face the military threat from the Taliban on its own and manage a transfer of power in the presidential and parliamentary elections in 2014 and 2015.

In addition to these macro-economic worries, the aid inflow has created a number of unintended consequences at the community level. Stephen A. Zysk notes that much of the aid has been channelled toward the insecure areas in the east and south, in efforts to provide incentives for peace. In fact, Zysk argues, these measures have backfired in two ways. Aid has contributed to negative governance outcomes, such as increases in corruption, and this has alienated rather than build support for the Afghan state among the Afghan population. Moreover, as much as 10 to 20 percent of the reconstruction and development financing in the insecure southern and eastern regions may have gone to insurgents and their intermediaries as part of protection rackets, thus providing financing and incentives for continued fighting. Taken together these macro and micro-level features associated with the inflow of aid give grounds for profound concern over how the overall reconstruction efforts in Afghanistan have been managed. In an in-depth survey of the ten-year long Western engagement in Afghanistan, Astri Suhrke finds that the intervention has suffered from a number of deep structural contradictions. One was the near impossibility of helping to develop a self-sufficient and competent state able to generate its own revenues when external aid money was lavished on all government sectors. An other structural contradiction was the difficulties of assisting the emergence an independent government machinery when the international development and military engagement, even if stressing the virtues of 'afghan ownership', was bent towards maintaining considerable degrees of control, especially over spending. These and other profound contradictions made it impossible, Suhrke concludes, for the international military and civilian missions to succeed in its effort to build a stable, peaceful and prosperous state.

²¹ Conybeare, John A. C. 'The Rent-Seeking State & Revenue Diversification' *World Politics*, vol 35, 1, 1982

²² Stephanie Mattie 'Resources and rent seeking in the Democratic Republic of the Congo' *Third World Quarterly*, Vol 31 no 3, 2010

Weak institutions

The key government institutions that are tasked with managing the transition from war to peace are often severely weakened after war or their historic malfunctioning before the war may in some cases have contributed to the onset of conflict.²³ This feature has triggered a profound interest on the part of outside actors (i.e. United Nations, World Bank) seeking to assist with stabilisation and recovery in war-torn states as to how institutions can be rebuilt. Indeed, the overarching doctrine for outside engagement in fragile states is usually described as ‘peacebuilding’ or ‘statebuilding’. The end goal of these approaches are presented as the strengthening and transformation formal institutions (including the constitution, political system, macro-economic management, justice sector and security services) in such a way that they address grievances that may have fuelled conflict and guard against future instability.

The promise and peril of large-scale attempts to strengthen institutions under the auspices of the statebuilding doctrine have been extensively debated.²⁴ It falls, however, well outside the remit of this report to do a stocktaking for these effort. In the context of a discussion of FDI it may suffice to merely highlight three features of the institutional set-up in fragile states that may be particularly challenging.

First, legal frameworks and regulatory procedures may be highly cumbersome or even defunct. This may include uncertainty over property rights, including which registries or traditions are in use and how transfers of ownership should be done. Second, the capacity of government staff may be weak due to disruption in education systems, outward migration and local brain drain (see section above).

Third, institutions may be subject to undue pressure from informal actors. Christine Cheng notes that post-war governments are often over-powered by informal actors that draw their strengths from war-time networks and activities. These may be elite individuals tied to security, crime or economic activities during the war years. Cheng argues that these actors can draw on their networks, access financial capital and insider information so as to fix rules, regulations and processes in their own favour. She concludes that ‘the exceptional malleability of a post-conflict government’s

²³ While this is often the case there are notable exceptions, Christine Cheng mentions Uganda and Sri Lanka

²⁴ see Berdal, Mats and Dominik Zaum eds *Political Economy of Statebuilding: power after peace* (London: Routledge) 2012

institutions means that informal actors have an opportunity to shape the political and economic realms in ways that provide substantial private benefit to informal actors, often at the expense of the public interest'.²⁵

With these predictions of weak institutions and failing governing capacity it comes as little surprise that fragile states perform badly on global rankings for corruptions and ease of doing business. Indeed fragile states are overwhelmingly placed at the very lowest end of these rankings.²⁶ Needless to say this it considerably more challenging to succeed with transparent and formal investments.

Challenges and opportunities with investing in fragile states

In the above section I outlined key challenges facing post-conflict states. Given these profound problems is it advisable to argue for increased FDI into such settings? Mats Berdal and Nader Mousavizadeh note that the debate about investments in fragile states have long been polarised. On the one hand 'market fundamentalists' argued, particularly in the 1990s, for an overreliance on market actors to address social challenges, including those facing post-conflict societies.²⁷ On the other hand, arguments have been put forward that there can be no role for the private sector in post-conflict settings because market actors searching for quick profits are likely to fuel rather than mitigate conflict. They will feed into and reinforce exploitative and predatory war economies that have evolved in the course of conflict.²⁸ Berdal and Mousavizadeh note, however, that neither extreme view are helpful and argue for a new understanding of the role of business in fragile settings.

This section builds on Berdal and Mousavizadeh's perspectives and discusses challenges and opportunities associated with investments in fragile states. First, however, it provides an outline of general trends related to aid and investments in these settings.

²⁵ Cheng, Christine, 'Private and public interests: informal actors, informal influence and economic order after war' in Berdal, Mats and Dominik Zaum eds *Political Economy of Statebuilding: power after peace* (London: Routledge) 2012 p. 77

²⁶ Transparency International, *Corruption perception index 2012* (<http://cpi.transparency.org/cpi2012/results/>) and World Bank *Doing business: measuring business regulations*, 2012 (<http://www.doingbusiness.org/rankings>)

²⁷ Berdal, Mats and Nader Mousavizadeh Investing for peace: the private sector and the challenges of peacebuilding *Survival* 52:2, 2010, p. 37-38,

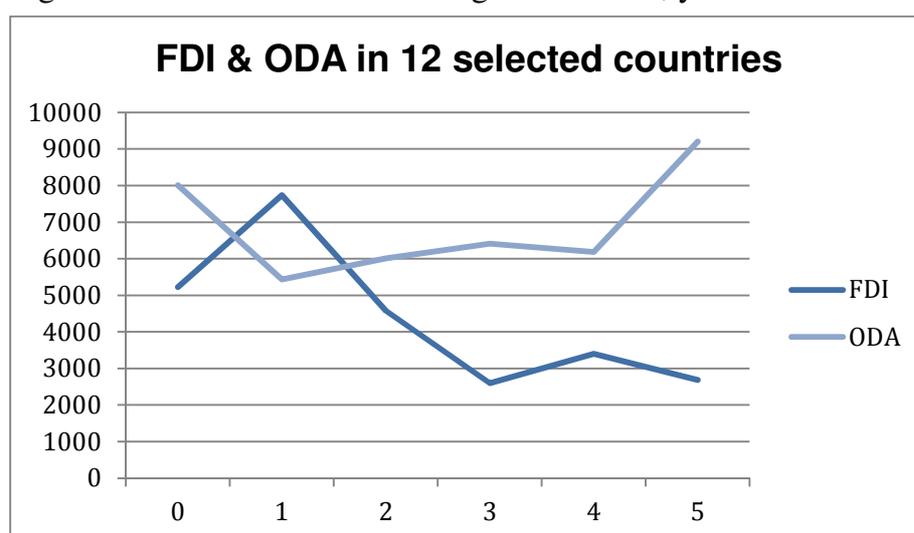
²⁸ *Ibid* p. 38

Trends

In the introduction to this report it was noted that FDI investments tend to come late and well after the end of the conflict. There is also a striking gap between the level of aid, which tend to be high, and levels of FDI, which tend to be low.

A compilation of statistics undertaken by the University of Agder for this report indicates that the size of aid in fragile states vastly outstrips that of FDI in the first five years after the formal end to conflict aid. In the figure (1) below we see that FDI has an increase just after the formal end to conflict, but overall remain low in the first five years.

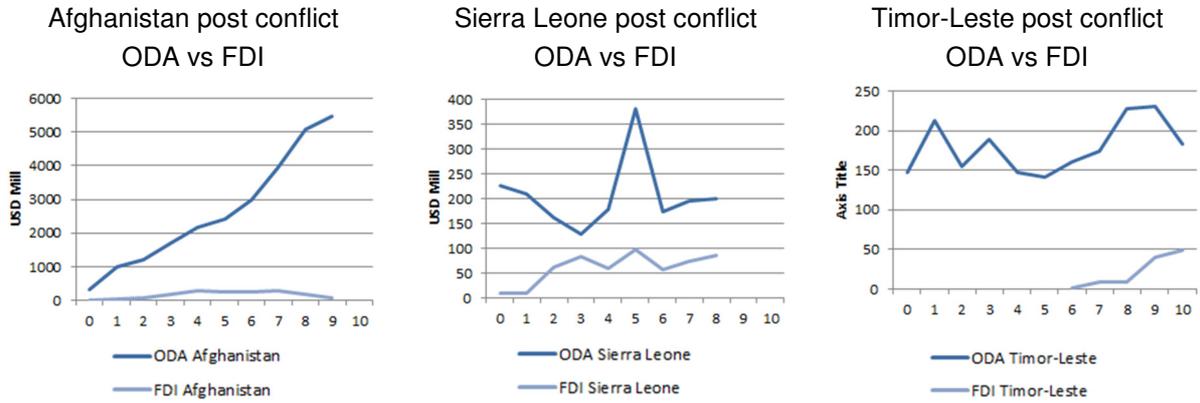
Figure 1: FDI and ODA in 12 fragile countries, year 0-5 after conflict (million USD)²⁹



Moreover, a look at patterns in individual countries indicates the tendencies for FDI to come late. In Afghanistan FDI levels continue to remain markedly low, while in Timor Leste some FDI appears after year six. Sierra Leone saw an increase in the third year after the peace agreement was forged.

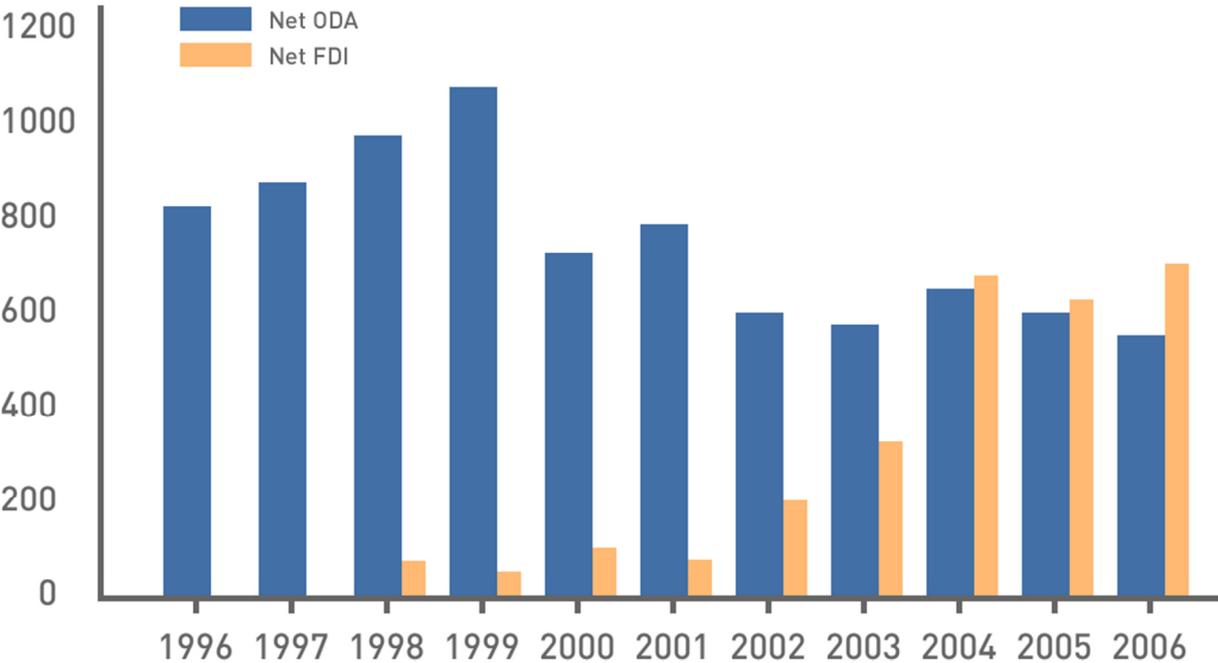
²⁹ The countries surveyed are Afghanistan, Angola, Burundi, Demo rep Congo, Rep. Congo, Cote d'Ivoire, Eritrea, Liberia, Rwanda, Sierra Leone, Sudan, Timor-Leste. Data is drawn from the World Bank and OECD DAC databases.

Figure 2: FDI vs ODA in Afghanistan, Sierra Leone and Timor-Leste (year 0-10 after conflict)



These patterns mirrors John Bray’s survey of the situation in Bosnia Herzegovina. FDI have been substantial, but again, strikingly absent in the first post-war years. Bray’s overview shows that FDI is absent in the early years after the Dayton peace agreement in 1995, low in years up to 2004, but begin to pick up after that.

Figure 3: ODA vs FDI in Bosnia Herzegovina (million USD)³⁰

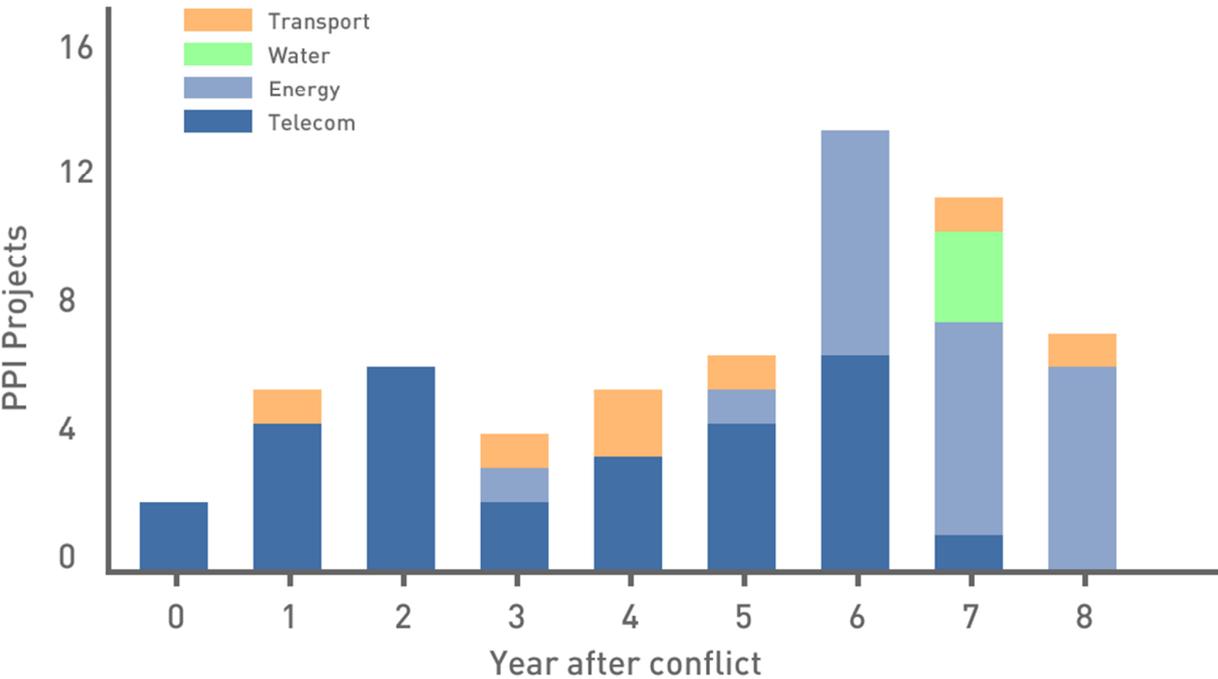


³⁰ Amounts are for million USD. Figure draws on presentation in Bray, John ‘The role of private sector actors in post-conflict recovery’ *Conflict, security and development* vol 9, 1, 2009. Bray uses data sets European Bank for Reconstruction and Development and OECD.

There are few readily available and comprehensive breakdowns of the sectors that draw FDI in fragile states. John Bray, however, notes that among the early movers one typically find mobile phone operators, construction companies, transport and logistic providers and petroleum and mining companies.

In an assessment of Private Participation in Infrastructure (PPI) investment, the World Bank found a similar pattern in terms of the initial slowness of investment and a bias towards telecommunications.

Figure 4: PPI by sector³¹



A final trend to note is the difference in types of foreign direct investors in fragile states. One important category is the diaspora investors, businessmen that hail from the country but are well established abroad. Regional companies operating out of more prosperous neighbouring countries (typically Austrian firms in the Balkans or Turkish firms in Afghanistan) are also important early movers. Finally, large multinational

³¹ Figures taken from Schwartz Jordan, Shelly Hahn and Ian Bannon *The private sector's role in the provision of infrastructure in post-conflict countries: patterns and policy options* (Washington: World Bank) August 2004

companies also operate in some fragile countries, although, as John Bray notes, truly global companies are unlikely to take the risk of investing in small and dangerous markets and will leave these opportunities for smaller regional or international players to exploit. The exception is if they identify truly 'global' opportunities, such as large oil reserves.³²

Overall, the surveys indicate an overreliance on aid, strikingly low level of FDI and a likely bias towards distinct sectors such as telecommunications and extractive industries. It follows that FDI should come earlier, in larger portions and serve as a better complement aid flows. Moreover fragile states are in need of much larger and considerably more diverse inflows of investment than have hereto been the case.

Opportunities

Above this report outlined three key features of fragile states: insecurity, political instability, distorted economy and weak institutions. These hamper development and also serve as severe barriers to FDI. Indeed, explaining why there is an absence of FDI in fragile states does not seem to be difficult. However, is it possible to identify distinct opportunities and pull factors related to FDI in fragile states?

Overall, more 'normal' pull-factors will likely be in play in relation to investments in fragile states. Peter Dicken note growing markets, natural resources and cheap labour as important standard pull factors.³³ These are certainly present in many fragile states.

In addition however, Paul Collier assess particular assets that we may expect to find in society emerging from conflict. Collier identifies three sectors which, in a post-conflict period, are both promising and in great need of outside investments.³⁴ First, investment in infrastructure should be recognised as a major economic opportunity with high returns. Collier notes that it is particularly roads, ports and powers that have the greatest needs and where the knock-on effects on larger development may be substantial. Associated with this is, as second opportunity, the likelihood of a

³² Bray, John 'The role of private sector actors in post-conflict recovery' *Conflict, security and development* vol 9, 1, 2009 p .6-7

³³ Dicken, Peter *Global Shift: Reshaping the Global Economic Map in the 21st Century*. (London: Sage) 2003

³⁴ See also Moloo, Rahim and Alex Khachaturian 'Foreign investment in a post-conflict environment', *Journal of world investment and trade* vol 10, 3

construction boom in the post-conflict years. Indeed, Collier predicts that there often comes a sharp increase in demand for construction services, but that this coincides with limited capacity in the construction sector, producing, in turn, a rise of prices in the construction services. By way of example, the cost of constructing a school in Liberia doubled a year after the new credible government took office. Collier encourages firms to build local capacity in construction, target key bottlenecks (shortages of equipment and skills) and bring in outside expertise. Third, Collier notes that post-conflict states experience a ‘quantity windfall’ in the commodities sectors, due to the inactivity of the war years. Natural resources, such as mining and oil extraction are examples of sectors where new assets can be accessed (see discussion below). But as important is the ‘quantity windfall’ in agriculture. Collier notes production for export agriculture drops during war year as peasant farmers retreat into subsistence farming. These sectors (i.e. coffee, tea and cocoa) are, however, easily revived after war. It follows that outside investments into agribusiness will likely have good prospects.³⁵

Transparent business practices as positive contributions

Clearly, increased outside investments into the productive sectors discussed above could prove both profitable for the investors and hold great development effect for a receiving country. However, this argument hinges on an understanding of the role of business in fragile states as positive.

C.K Prahalad presented in 2004 a forceful argument for the potential virtues associated international commercial players operating in development settings. Essentially Prahalad argued that there were 4-5 billion consumers globally ‘at the bottom of the pyramid’ that were unserved by the formal private sector, including by multinational companies. Prahalad argued that not only did this market segment constitute a major business opportunity for companies. He also argued that the product and services of large companies, when made available to the lower segments, were vastly more preferable to poor consumers because they were less likely to involve ‘local monopolies, inadequate access, poor distribution and strong traditional intermediaries’

³⁵ Collier, Paul Post-conflict recovery: how should strategies be distinctive? *Journal of African Economies* vol 18, AERC Supplement 2009

which imposed ‘poverty penalties’ when offering goods and services to the poor.³⁶ Involvement of large private sector players could increase competition. These companies were also well positioned to increase government transparency and impartial enforcement of rules, thereby improving business climate and lessening the entrenched power of local elites.

Mats Berdal and Nader Mousavizadeh echo Prahalad’s argument in relation to fragile states. They find in their interview material that among government officials and investors there is an ‘increasing understanding of the fundamental development benefits of having foreign investors enter these markets on openly commercial terms freely entered into by both sides within a robust, transparent and accountable legal framework’.³⁷ In this way the way of doing business, if conducted in a transparent and appropriate manner, could have clear signalling effects and contribute to improved governance and business conduct. This is of no minor importance to fragile states, given, as discussed above, that weak institutions is a key feature.

Reform and investment trigger recovery in Mozambique

Mozambique emerged from a long-fought and destructive civil war in 1992. It was, and remains, one of the poorest nations in Africa, but its economic prospects are highly promising.³⁸ Investments and the role of business in the run up to the peace agreement and afterwards have been considerable. Alex Vines documents how the UK multinational Lonrho got deeply involved with the conflicting parties during the war years. Lonrho built and managed an oil pipeline in Mozambique and was forced to pay protection fees to the insurgent group Renamo (around 5 million USD transferred over a ten year period).³⁹ However, Lonrho also became a significant player in efforts to get a negotiated peace settlement. Lonrho provided a number of financial incentives in the negotiations and made company assets, such as the company jet, available for participants in the negotiation efforts. Vines argues that the efforts of Lonrho significantly shaped the nature of the negotiations, and that the role of business in bringing about peace in Mozambique must not be underplayed.⁴⁰

Mozambique’s post war recovery has been shaped by early economic reform (some initiated during the conflict in the late 1980s) and aggressive efforts to increase outside investment, including from neighbouring South Africa. This has resulted in the establishment of a number of ‘mega projects’, chief among which is the 1.3 billion USD aluminium plant MOZAL.⁴¹ Construction of the plan started in 1998, only six years after the peace agreement, and was completed in two years. Considerable investment and future export revenues are expected from coal and off-shore gas development. Tax and customs systems have been reformed and revenues are increasing. Mozambique is still one of the largest aid recipients in Africa, but level of aid to GDP is still well under 10 percent of GDP.⁴²

³⁶ Prahalad C. K *The fortune at the bottom of the pyramid: eradicating poverty through profits* (New York: Pearson Education) 2004

³⁷ Berdal, Mats and Nader Mousavizadeh Investing for peace: the private sector and the challenges of peacebuilding *Survival* 52:2, 2010 p. 39

³⁸ EIU, *Mozambique country report* December 2012

³⁹ Alex Vines ‘The business of peace: ‘Tiny Rowland, financial incentives and the Mozambican Settlement’ in *The Mozambican peace process in perspective*, Conciliation resources, 1998

⁴⁰ Ibid.

⁴¹ Schwartz Jordan, Shelly Hahn and Ian Bannon *The private sector’s role in the provision of infrastructure in post-conflict countries: patterns and policy options* (Washington: World Bank) August 2004

⁴² EIU, *Mozambique country report* December 2012

Challenges

It follows from the discussion above that the investments flows as well as the type of business conduct can have significant development effects and positively support post-conflict growth and recovery. However, it is important to stress that this assertion is open to empirical investigation. The potential for positive contributions by business is beyond contestation, however, the actual conduct and impact of business behaviours in fragile states so far may still constitute a mixed track record.

This section highlights some of the major problems that have surfaced in relation to FDI in fragile states and identifies some specific challenges facing businesses.

Two debates have shaped how the role of business in fragile societies is understood: the resource curse and writings on the economic agendas in civil wars. Both debates have been touched on already in this report, but briefly the ‘resource curse’ theory finds that countries with an abundance of natural resources (especially minerals and oil) have less growth and development than other similar countries with less resources available.⁴³ A variant of this also finds that countries with a reliance on export of natural resources are at greater risk of conflict.⁴⁴ Writings on economic agendas in civil wars have indicated that the prospect of economic gain, especially control over natural resources, have fuelled fighting in war torn countries. This has put international companies under considerable scrutiny. Have the kind of contracts international companies have forged with fragile states privileged the few and been detrimental to development? Or have the activities of international companies fuelled the (profit) motivations of the belligerents in civil war by helping to provide resources or services that could be used to prolong the fighting? A UN report by a Panel of Experts found for example that international firms in the Democratic Republic of Congo had been involved in large-scale looting of timber and minerals during the war years, and that this in turn had offered substantial illegal benefits to armed factions and their leaders.⁴⁵

⁴³ Ross, Michael L ‘What do we know about natural resources and civil war?’ *Journal of Peace Research* May 2004

⁴⁴ Collier, Paul and Anke Hoeffler ‘High-value natural resources, development and conflict: channels of causation’, in P Lujala and S. A. Rustad eds. *High-value natural resources and peacebuilding* (London: earthscan) 2012

⁴⁵ Report of the Panel of Experts on the illegal exploitation of natural resources and other forms of wealth creation of the Democratic Republic of Congo, April 2001 (<http://www.un.org/News/dh/latest/drcongo.htm>)

These theoretical perspectives and empirical findings point to the need for considerable caution on the part of foreign investors when engaging in fragile states, in particular in extractive industries. Clearly a number of investments have turned out wrong. The massive attention to the extractive sectors and the role of national and international companies in them, is also a sign of a problematic bias: fragile states are better able to attract outside investors in extractive sectors than other sectors where quick profits are not so readily available. This is a powerful argument for the need for diversification in these countries.

It could also be that investments in other more complex commercial sectors are less likely to bring on the same negative effects that many investments in the natural resource sectors caused in the 1990s and early 2000s. Still, some challenges will not be confined to the natural resource sectors and call for caution. One example is the use of private security providers to guard commercial activities in areas where there is still unrest or insecurity. In Afghanistan, the extensive use of private security contractors have meant that many ex-combatants have not disarmed, but simply taken up new security related tasks in the new security firms, many of which are controlled by old war-time strongmen or warlords. This ensure that fighters can be easily mobilised in the future, while tacit political games of strength, security and protection continue with unrelenting strength. This undermines the monopoly of violence that Afghan security forces are hoping to obtain and it stalls the development of the Afghan state.⁴⁶

⁴⁶ Matthieu Aikins, *Contracting the commanders: transition and the political economy of Afghanistan's private security industry*, New York University, Centre on International Cooperation, 2012

Chad: oil as a catalyst of conflict

A consortium of Exxon, Shell and Chevron (later replaced by Elf Aquitaine) signed an exploration treaty with the government of Chad in 1988. The consortium was criticised, however, by NGOs for pushing through an 'abusive' contract with few of the potential profits going to Chad. In an effort to deflect criticism and also guard against expropriation and potential erratic behaviour on the part of the government, the consortium invited the World Bank to act as an intermediary. The World Bank recognised this as an opportunity to ensure that potential new resource wealth be used for pro-poor purposes and to demonstrate that the 'resource curse' could be overcome if the right legal frameworks were created. Chad passed, after lengthy negotiations with the World Bank, a Petroleum Revenue Management Law, which stipulated in detail how oil revenues were to be spent and created an oversight committee. The World Bank was also particularly concerned that the revenues would be shared equitably socially and regionally, so as to reduce the potential for conflict in a country with a tense political situation.

However, in an in-depth assessment of the World Bank's efforts John A. Gould and Matthew S Winters find that it was unable to overcome Chad's heritage of illiberal politics, patronage politics and conflict. They note that 'between 2000 and 2006, President Deby reshaped the Bank's broad revenue distribution scheme to meet his own political needs'.⁴⁷ The president also systematically undermined the power of the new oversight bodies and avoided accountability. Profits were used to strengthen the security apparatus and buy support. Wealthy politically connected supporters, mostly from one region, siphoned wealth from public projects and demanded side deals in exchange for political support. As wealth benefitted some but not others it fuelled resentment. Violent conflict erupted in 2003 and lingered in different forms, partly interwoven with conflicts in neighbouring Sudan (Darfur) in the following years. Between 2000 and 2009 Chad's military spending rose from 14 billion USD to 315 million USD in 2009. Gould and Winter stress in their assessment that foreign investments in oil did not cause the conflicts in Chad, nor were they the reason for the malfunctioning of the Chadian government. 'Oil, did however, shape both conflict and governance in mutually reinforcing and ultimately destructive ways. In particular the pattern of armed conflict in Chad demonstrates how oil revenues can build up the military capacity of the state while undermining the consolidation of political institutions'.⁴⁸

This section has presented some key trends, challenges and opportunities related to FDI. It has also presented three different trajectories of how outside engagement has played out in Chad, Mozambique and Afghanistan. Taken together the material highlights how difficult it is to get outside engagement right. Chad demonstrates that flawed institutions are difficult to mend and easily subverts well-indented plans. Afghanistan is a case where aid overspending seems to have generated adverse outcomes and hurt prospects for long-term stability and indigenous growth. Mozambique underlines how conflict entrenches poverty, but still highlights the potential positive role of business during and after conflict.

⁴⁷ Gould John A. and Matthew S Winters 'Petroleum blues: the political economy of resources and conflict', in P Lujala and S. A. Rustad eds. *High-value natural resources and peacebuilding* (London: earthscan) 2012 p. 324

⁴⁸ Ibid. p 332

The overview gives ground for concern. It may nevertheless be, that, actors working with the private sector are well placed to deal with some of the key challenges raised. The next section discussed Norfund's potential contributions.

Norfund's role: early and diversified investments in fragile states

Norfund establishes and develops profitable and viable enterprises in developing countries. Its mandate is to provide capital to poor countries beyond what would happen in the market place and to serve as a catalyst. By demonstrating profitability in its portfolio and by seeking partnership with other investors Norfund generates additional capital.⁴⁹ A significant share of Norfund's investments goes to the least developed countries (LDCs) and it has opened up for engaging in the fragile states South-Sudan and Myanmar.⁵⁰

Norfund's increased attention and engagement with fragile states is a welcome development. One of the key messages of this report is that more investment is badly needed in fragile states and that greater diversification, away from the predominance of extractive industries, and towards a broader spectrum of potentially vibrant post-war economic activity may strengthen post-war growth and stability. Moreover, it is in particular in the early years after a peace settlement has been forged that available capital is low. Norfund's catalytic engagement, whereby it mobilises capital from several sources, could have considerable positive impact, especially if it helps address the need for investment in the early years after conflict ends.

Fragile states are, however, as this report has highlighted, challenging environments in which to do business. Below we discuss particular constraints and opportunities facing Norfund in relation to the three key features of fragile states: instability, distorted economy and weak institutions.

Insecurity and political tensions

Norfund is already engaged in a number of projects with high risks. Investing in fragile states will increase risk levels even further, but the institution has demonstrated an ability to handle risk and create profits in difficult environment. The high risk levels increases the importance of country specific knowledge and ability to monitor political as well as economic development. Continuing Norfund's tradition of hiring staff with in-depth regional knowledge will thus be important.

⁴⁹ Norfund, *Report on operations* (Oslo: Norfund) 2011

⁵⁰ Norfund, *Norfund in numbers* (Oslo: Norfund) 2011

Moreover, the Norwegian government, Norfund's owner, should continue to be involved in the decisions to move into fragile states and be encouraged to provide extra guarantees on investments. This will make the risk-levels in fragile settings more tolerable for Norfund, and encourage broader engagement.

South Sudan: early investment from Norfund contributes to diversification

South Sudan gained its independence in 2011 but has continued to face a number of political and economic challenges. Sustained disagreement with Sudan over border delineation and oil transit caused a shut down in oil production in 2012 that severely strained the economy. The Economist Intelligence Unit estimates that GDP fell by 55 percent because of the cessation in oil production.⁵¹ This highlights South Sudan's heavy dependence on oil revenues: oil accounts for 98 percent of government income (excluding aid).

South Sudan's predicament is in many ways one typical of fragile states. Challenges include: dependence on oil revenues and aid makes the economy vulnerable to external shocks; governing capacity is low; the old guerrilla movement Sudan People's Liberation Army (SPLA) dominates politics; and corruption is widespread.⁵² At the same time, some positive features are visible in the economy. Kenya, Uganda and Ethiopia are generating foreign direct investments and South Sudan might be eligible for a large soft loan from China. Further inflow of investment is predicted to come in construction, manufacturing, power and telecommunication.⁵³

Norfund is actively engaged in South Sudan through a large investment in a hydropower project and as owner and manager of a venture capital initiative. Norfund has been instrumental in generating further foreign private investment to the hydropower project and it will likely cooperate with entrepreneurs from neighbouring countries in some of the venture capital initiatives in the years ahead. This is a sign that Norfund is able to deliver on one of its main mandates (trigger additional investments) even in a highly challenging business environment such as South Sudan.

Norfund, along with other investors in the country, faces nevertheless a number of profound challenges. Low level of business skills means that Norfund needs to take a more hands-on approach than usual to management and capacity building in the venture capital initiative. It will need to navigate the challenges that corruption and the dominant role of the SPLA network in politics and economics pose. This will likely entail slow progress in effectuating investments. However, should Norfund succeed with generating profit on investments done in a transparent manner, the positive signalling effects will be substantial. Moreover, South Sudan's economy will likely have high growth rates and considerable business opportunities in sectors such as construction and agribusiness in the period ahead. Norfund is well positioned to contribute diversified investment and gain considerably from being an early mover.

⁵¹ Economist Intelligence Unit *Sudan country report*, December 2012, p. 7

⁵² Ibid.

⁵³ Ibid.

Distorted economy

Fragile states are faced with, as this report has highlighted, a difficult economic predicament. Nevertheless there are considerable economic opportunities as countries transition from war to peace. Norfund can take on an early mover role and engage in the promising new sectors, such as agriculture, or, as it has done in a number of other countries, contribute to the strengthening of financial institutions and SME development by building microfinance organisations and local investment funds. Norfund's expertise in investing in the developing hydropower installations is also particularly relevant in post-conflict settings. Moreover, its experience in mobilising new investors is useful, and Norfund should in particular seek out partnership with regional and diaspora investors.

Finally, it is important to reflect on the contributions to domestic tax revenue collection that Norfund will likely offer. Restoring the practice of transparent tax collection strengthens governance and reduces dependencies on foreign aid or extractive industries.

Weak institutions

Weak institutions will be a major challenge for Norfund's work. Inadequate government procedures or low capacity among officials that manage the paper work associated with foreign investments will slow down Norfund's activities and make it more difficult to succeed. However, engagement by Norfund with the government may also be one important contribution by gradually helping to build a better investment framework in the country in question. Norfund will need to allow for slow progress, but find ways of recognising and communicating that formal dialogue and transparent interaction with government authorities may in itself have considerable positive development effects in the long run.

The tendency of institutions to be captured by elite interests, as outlined earlier, is a particularly serious and difficult challenge. Norfund must ensure that the way it engages in fragile states contributes to openness and fair competition. This calls for a rigorous and continuous assessment of how Norfund and companies that it invests in interacts with government institutions. Investments and the generation of profit that

end up supporting malfunctioning institutions or private elite interests must be avoided at all cost. In some cases it may very well be that there are some sectors and areas that cannot be invested in, because of the potential negative contributions it may have on a country's institutional set-up.

Overall, Norfund is well position to take the role of being 'best-in-class' as a post-conflict investor. This will entail providing early and diversified capital within Norfund's current strong areas such as SME development, financial institutions and renewable energy. However, given the challenging environment it is important to move forward slowly: the way business is done and the positive precedence transparent and appropriate business conduct may make, could prove to be as important as the actual capital invested or revenues gained.

Myanmar: investments in times of transition

Myanmar is undergoing large-scale economic and political change. The government has initiated a process of political liberalisation, which has (temporarily) lifted some international economic sanctions on the regime. The World Bank and the International Monetary Fund has re-established contact with Myanmar and is advising the government as it embarks on economic liberalisation. For now though, the economy continues to be dominated by state-owned enterprises and large military holding companies.⁵⁴ Nascent regulation on investment and finance has been introduced, but is slow to take effect in a still difficult regulatory environment. In parallel with the transition process, upheaval in the Western area Rakhine continues. Majority Buddhists have clashed with Rohingya Muslims and triggered a heavy-handed response from the law enforcement. Hostilities also continue between the government and Kachin rebels in the north.⁵⁵ The combination of a wrought and challenging democratisation process together with continued unrest in some areas makes continued political instability in the years to come likely, even as the government has forged pace with some rebel groups.

Myanmar is facing, from an investor's perspective, a double challenge. First, it is transiting from a heavily government and military regulated and controlled economy towards a free market economy. Second, there are profound difficulties with doing business in parts of the country due to ethnic and religious clashes. This implies that regulation on foreign investment and financial transactions is likely to be cumbersome and also effectuated by inexperienced government bureaucrats. Entrenched elite interests, in particular from the military, will likely unduly dominate some of the profitable sectors of the economy. Transparent business transactions may be slow and difficult to conduct. Moreover, with tension and spats of violent conflict unfolding in some areas of the country launching nation wide economic initiatives will be difficult: extra security measures may be needed in some areas and careful consideration must be undertaken so as to prevent the economic engagement adding to perceptions of unfairness or contribute to an escalation of conflict.

Norfund has so far taken a cautious approach to Myanmar, but may engage, with other partners, in micro finance activities in the period ahead. Opening up credit lines to small-scale entrepreneurs on market terms may prove to be an important contribution towards economic liberalisation and inclusive growth. In particular it will help mitigate against the old political and military elites reaping a disproportionate share of the economic gains that liberalisation brings – as has been the case in so many other transitions in Eurasia and Asia. In any case, Norfund will need to be patient as it navigates government bureaucracies and tolerate that progress will be slow. Indeed, with the scale of economic reform that Myanmar has ahead of it, a slow pace is advisable, not only for a potential Norfund engagement, but also for other investors seeking to do transparent business.⁵⁶ Finally, if any Norfund operations expand to cover all of Myanmar, in-depth considerations of the security and conflict situation in specific areas will no doubt be required.

⁵⁴ Economist Intelligence Unit *Myanmar country report*, December 2012

⁵⁵ *Ibid.*

⁵⁶ Bloomberg Business Week, *The race for Rangoon*, 7 September 2012

Conclusion: rethinking international engagement

This report has assessed the inflow of investment and aid to fragile states and found that FDI is often concentrated in a few sectors and tends to come many years after a country transits from conflict to peace. More investment that comes sooner and is spread across a more diverse spectrum of sectors is badly needed. Norfund, with its mandate to help build profitable and viable enterprises in high-risk settings is particularly well positioned to play a positive role. It is paramount however, that Norfund recognises the distinct challenges associated with fragile states (instability, distorted economy and weak institutions) and adopts operating procedures that can mitigate against risks linked to these three features.

While not intended as a survey of how the international community engages with fragile states, this report nevertheless points to some key flaws. In particular, the high aid to GDP ratios in many countries gives grounds for concern. The situation in Afghanistan is particularly dire. A fundamental rethink on involvement in fragile states is underway. This will indeed likely pick up speed as the international community, with considerable disillusionment, winds down its engagement in Afghanistan, which has been one of its biggest reconstruction projects in recent history.

A good place to start is to look beyond the large internationally staffed organisations towards smaller engines of growth. The private sector in the form of local, diaspora, regional and international investors hold considerable promise and likely further untapped potential. Norfund can, by playing its familiar role as catalyst, help shape how the private sector is mobilised to create growth and consolidate recovery in fragile states. Moreover, triggering business activities that enable the government to increase its revenue collection is an indirect and bottom-up way of helping to build better governance. It may very well prove that this is a more sustainable way of doing statebuilding than unleashing large aid sums for top down capacity building programmes, which has been the predominant practice in the past decade.

In this way, even relatively small Norfund investments, if done in the right way and with tangible benefits generated for the host country, may help the international community alter its engagement with fragile states and improve the chances that

international assistance creates the fundament for long-term prosperity rather than perennial cycles of aid dependence.

Annex 1: international standards

There are a number of voluntary social and environmental standards for company conduct and many of these are particularly relevant for companies operating in fragile states. The table below highlights some of the most important frameworks. It builds on an overview developed by Jill Shankleman.⁵⁷

Origin	Applicability	Objective	Key Elements
IFC Performance Standards on Social and Environmental Sustainability: July 2006, created by IFC in consultation with companies, recently upgraded (2011)	All IFC projects	Create a comprehensive system for identifying and managing social and environmental risks	Eight specific standards plus requirements for consultation and public disclosure information
Equator Principles: June 2003, initiated by ten commercial banks	Financing for major projects carried out in non-OECD countries	To apply IFC standards to projects financed by signatory banks	A common framework for assessing and managing environmental and social risk in project financing
Voluntary principles on Security and Human Rights: December 2000, created by US and UK governments, oil/mining companies and NGOs	Oil, gas and mining	To provide guidance to companies on maintaining the safety and security of their operations while respecting human rights and fundamental freedoms	General requirements of addressing risk assessment; use of security contractors; working with government security forces
Principles for good international engagement in fragile states and situations: launched and endorsed by OECD DAC 2007	International actors (including aid organisations and companies) engaged in fragile states	Help international actors foster constructive engagement between national and international stakeholders in countries with weak governance and conflict	Ten principles that guide action in fragile states, including 'take context as starting point', 'prioritise prevention' and 'promote non-discriminations'.
UN Guiding Principles for Business and Human Rights (adopted by the UN Human Rights Council on June 2011)	States and companies, particularly relevant for companies operating in areas where rule of law is weak. Applies to companies of all sizes and structures.	Provide a blue-print for companies on how to know and show that they are respecting human rights.	Outlines how states and companies should act to uphold human rights. Companies operating in areas where violations are a risk are asked to do 'human rights due diligences', develop a human rights policy, provide remediation if any wrong-doings and establish a grievance mechanism

⁵⁷ Jill Shankelmann 'Mitigating risks and realizing opportunities: environmental and social standards for foreign direct investment in high-value natural resources' *Environmental Law Reporter*, 6, 2012

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