Investment and non-commercial risks in developing countries

by C. Kasatuka* and R.C.A. Minnitt*

Synopsis

Globalization creates investment opportunities for enterprises around the world. Attracting foreign investment has been a key challenge for economic growth in developing countries. Corruption, political instability, armed conflict, and other internal problems affect foreign direct investment (FDI) inflows negatively. A framework of criteria provides a basis for comparing non-commercial risk (NCR) among twenty-three mineral economies. Countries competing for foreign direct investment inflows are ranked from least to most risky. This study compares Inward FDI Performance Index (IND) with NCR ratings in developing countries and shows that risk is increasingly mitigated by means of appropriately structured insurance. Given the option for countries with similar mineral potential, investors will generally invest in the country that offers lower non-commercial risk.

Keywords: foreign direct investment, non-commercial risk, developing countries.

Introduction

The global mining industry has undergone profound structural reforms over the last decade, including the size of mineral companies, their policies towards sustainable development and the way that business is conducted. During the same period, foreign direct investment (FDI) has increased as a consequence of global demand for commodities and the more favourable investment conditions in many countries, partly as a result of the change in foreign investment regimes (Otto, 2002). The growth of FDI in the mining sectors of developing countries in the near to medium term has occupied the attention of governments. Notwithstanding the under-performance of resource-rich countries, global increases of foreign investment particularly in the mining sectors, promises stimulation of economic development and creation of new investment opportunities in developing nations.

However, there is an ongoing international debate on the inability of some countries to attract FDI. According to a World Bank (2000) study, financial and economic environments in many developing countries are perceived by investors to pose the highest levels of non-commercial risks anywhere in the world. All sources of risk negatively affect overall private investment, particularly in developing countries where non-commercial risks dominate. A number of empirical studies have shown potential instability as a result of weak institutions and low credibility has lower overall foreign investment rates. To some countries high corruption is also another contributing factor (Irwin, Klein, Perry and Thobani, 1998).

According to an analysis of insurance associated with political risks, Gentile and Valahu (2003) defined commercial risk as to the aggregated effects of operational, business, and financial risks. Operational risks include such things as interruption of power supply or telecommunication services, infrastructure service failure, and environmental factors that could lead to the total closure of a production facility, while business risks include indiscriminate policy changes, financial system instability, and currency fluctuations. Financial risks cover the areas of capital adequacy, problems of liquidity, fluctuations in interest rates, loan default or delayed payment of suppliers’ credits, repudiation of contracts by government, and losses from exchange controls. The second kind of risk relates to all actions of undesirable political events that many investors are not capable of controlling. Non-commercial risk (NCR) is often associated with political uncertainty, civil wars, armed conflict, civil unrest, high corruption and expropriation. This form of risk has been intensively studied in recent years and is a focus of attention by international capital markets as well as by agencies specializing in risk assessment. NCRs affect commercial risks.

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by increasing operating and capital costs (Percy and Olesen, 2002). NCRs include traditional political or country risk that is characterized by fragile political systems and institutional structures, expropriation, war and border conflict, weak governance, poor administration, weak regulatory regimes, confiscation, corruption, deprivation, instability of government, unrest, and institutional deficiencies. NCRs also include natural risk marked by calamity, flood and famine (PRS Group, 2004).

Present investigation

The paper briefly reviews characteristics of the mineral economies, the importance of FDI in countries where mining and mineral developments contribute significantly to their economies, and the damaging effects of non-commercial risks on foreign investment. Linkages between non-commercial risks and different levels of foreign economic participation in 23 developing countries are established using the Inward FDI Performance Index (IIND) (WIR, 2001), a measure created by the United Nations to rank countries according to their levels of FDI. Countries are ranked according to their intensity of non-commercial risk using the International Country Risk Guide (ICRG), which is risk ratings used by the World Bank, United Nations and many other international bodies as a standard against which other ratings can be measured. Furthermore, we link the Inward FDI Performance Index to non-commercial risk ratings. The criteria used to select countries for analysis are described together with a comparison of non-commercial risk ratings for the countries. The result of the analysis is followed by the conclusion and recommendations.

Literature review

In a recent study, Michael (2004) analyses FDI inflows between corrupt and non-corrupt countries using UNCTADs inward FDI Potential Index and Inward FDI Performance Index. He finds that, overall the least corrupt countries attract a significantly larger amount of FDI inflows compared to the most corrupt countries. He found that low growth, minimal exports, lack of telecommunications and energy infrastructure, minimal R&D expenditures, low education level and political risk characterize the countries with a low potential for inward flows of FDI.

Hoti (2002) provides a comparison of the propensity for risk in ten representative developing countries, which he compiled using the International Country Risk Guide (ICRG). He uses various risk rating agencies that employ a combination of qualitative and quantitative information about political, economic and financial risk. Markusen, Rutherford, and Tarr (2000) examine the effects of policy liberalization on the formation of foreign companies that provide intermediate services and found that although there is a clear trend among developing countries to liberalize their economies, the importance of FDI in countries where mining and mineral industry. Payments to other stakeholders include royalties to the mineral rights owners, interest and capital repayments to financial institutions, wages to labour, and a share of profits to entrepreneur. In the wake of the sustainable development initiatives, contributions will also be made to environmental interests and social welfare.

The goals of stakeholders, including multinational mining corporations, financial institutions and the governments of host countries, can come into conflicts of different interests because each of these has its own interest as follows:

The objectives of transnational mining companies in the long run, in addition to preserving ‘corporate image’, are to maximize shareholders wealth in a long and short-term plan, and to avoid complicated, management problems and excessive risks (Otto, 1997).

Financial institutions that arrange the investment are principally concerned about the security of the investment, particularly during the period of payback, which may require the use of insurance or market derivatives.

Host governments are mandated in the interest of national patrimony, insurance, and management of proper resource utilization for the benefit of the nation. They consider their mineral wealth an asset, to be used to stimulate or enhance their economic growth potential.

Identification of the actual and potential areas of conflict among the principal stakeholders provides an awareness of the need to employ a sustainable mechanism for conflict resolution (MIGA, 2005). The Multilateral Investment Guarantee Agency (MIGA) is a member of the World Bank Group. Its purpose is to facilitate the flow of foreign direct investment in developing regions. MIGA plays an important role by providing guarantees against certain non-commercial risks to eligible foreign investors for qualified investment in countries, where other insurers are often not willing to go. MIGA’s guarantee programme helps reduce the non-commercial risks to an investment, providing investors with the confidence they need to start business in a developing country.
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Examples of such conflicts can arise out of the excessive taxation on companies. The higher the tax, the greater the benefits that accrue to the host government, but this will be met by reluctance on the part of the company to locate its processing facilities in the developing country (Otto, 1997). The unfamiliarity on the part of multinational companies with the cultural, social and economic environments of developing countries may also result in a prejudice against foreign investment that arises from a sense of insecurity and attendant risk. Thus, although Dunning (2002) has suggested that transnational mining companies prefer locating mining operations in developed countries, the attendant costs associated with environmental and compliance issues in such countries can be onerous.

The international financial institutions aim at placing their resources in businesses that will yield at, or above, going rates of interest with the minimum of inconvenience and risks. Investors share the reluctance of transnational mining corporations to fund ventures located in developing countries because of the unfamiliar investment environment. This is because they do not feel as exposed to the risk of unilateral action on the part of the host governments, as do the mining companies (Radetzki and Zorn, 1980). The financial institutions are, on other hand, careful to ensure that the projects, to which they lend, shall be economically viable.

Mineral economies are nations from developing region because of their dependence on mineral potential. The range of definitions that exists in the literature for good mineral potential is a function of the variability of the principal components in the definition, namely, the percentage of export earnings and the contribution to GDP from mineral production. The first measure provides an indication of mineral dependence, while the second one provides an indication of the importance of mining in the total set of economic activities. Davis (1995) describes mineral-based economies as those where mineral production accounts for 8 to 10% of GDP and mineral exports constitute at least 40% of total merchandise exports. Eggert (2004) has defined mineral economies as those where mineral exports are more than 25% of total merchandise exports. Some countries earn more than 40% of their exports earnings from minerals, but have a contribution to GDP of less than 10%, adds Eggert.

The importance of foreign direct investment (FDI) in the mining industry

Countries with rich mineral endowment compete to attract foreign investment inflows. The multinational companies are viewed by governments of developing economies as potential sources of funds that could result in stimulating economic growth. FDI is one means of capital formation, and the deeper and stronger the nature of the investment, the greater is the potential to relieve shortages of financial resources, poverty, and unemployment and improve levels of skill and technology (Mwilima, 2003). In fact, Mwilima finds 5 reasons why host country wants to attract FDI: capital formation, particularly when the capital base is low; transfer of technology is expected because multinational companies will use technology from their home country; employment creation, transfer of management skills and the anticipation of increasing export competitiveness.

The limitations on this study are related to the investment data embedded in the FDI flows, which are available from UNCTAD (2005). These data are necessarily highly aggregated and for this reason it is not possible to separate the mining and minerals industry specific investment from other types.

The presence of large multinational companies in a developing mineral economy can enhance the country’s competitiveness and stimulate inflows of FDI that result in economic growth. Lloyd (1992) finds that sustainable development implies that economic activity should be designed to create wealth for the use of present and future generations. If natural resources cannot be developed and exploited to create wealth for the nation, the result may be poverty and deprivation. Many developing countries have created conducive investment environments by providing favourable policies, but for all the effort, fail to attract meaningful investments (Mwilima, 2003). Policies that protect domestic investors in favour of foreign investors can have a perverse effect on investment and subsequent development. FDI brings particular advantages that can overcome scarcities of capital, entrepreneurship, access to foreign markets, superior technology and innovation, efficient managerial techniques, and employment creation (Markusen and Venables, 1996). FDI is an important source of finance for mineral development in the developing countries. Uri and Carlos (2005) find that political and economic stability of mineral economies is an important determinant of FDI. Uri and Carlos identify six important determinants of FDI: investors’ perspective. They include political and economic stability, market size and prospects for growth, predictable rules for investment and a sound legal framework, availability of infrastructure, stability of the tax system and productivity of labour.

Furthermore, Dunning (1981) identified three conditions under which foreign investment will occur. The prerequisite of such investment is that firms have a strong motive for undertaking the investment supported by favourable policies for ownership (O), favourable location (L) relative to the internalization (I). These three conditions are what Dunning called the ‘OLI framework’. Ownership advantage for foreign companies comes in a variety of forms including market power or cost advantage to the firm, sufficient to outweigh the disadvantages of doing business in a foreign country. Another important condition for multinational company commitment to foreign investment is related to the advantages foreign markets offer through their locations. While tariffs, quotas, transport costs, and cheap factor prices should allow multinational companies to generate profits in foreign countries, factors such as direct access to customers can provide specific advantages. Companies that produce domestically and export to foreign countries do not enjoy the benefits that multinationals reap through producing in a foreign country. This can also provide a competitive advantage to the host country. Finally, the third condition is the advantage that multinational companies have through their international position, one of the main benefits being the increased export competitiveness.

A principle factor in determining foreign investment is a country’s level of risk as determined by its political stability. Countries experiencing civil war, fragile political systems and
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structures, expropriation, border conflict, and corruption, are unlikely to be considered as investment destinations. Given the many dimensions of the risk, however, the relationship between investment and risk is complex, with some foreign companies being accused of political destabilization for commercial gain (Anyanwu, 2004). Anyanwu investigated the cause of civil war in Africa. A collection of case studies of countries provides a comparative perspective on the causes of civil war and the processes by which internal conflict may be resolved or eliminated.

Given this, the need for risk assessment and its impact on international investment in mining is crucial. Concern over country risk, along with traditional economic and financial risks, has increased over the last two decades, and managing country risk is now a part of corporate decision-making for multinational companies investing abroad (MIGA, 2005). Various risk agencies, including Standard & Poor’s, Moody’s, Euromoney, Institutional Investor, Economist Intelligence Unit, and the International Country Risk Guide, provide an independent analysis of the risk of a country by combining qualitative and quantitative factors of political, economic and financial risk (Hoti, 2002).

Despite the dramatic increase in total foreign direct investment flows to developing countries in the last few years, the bulk of the inflows have been directed to a limited number of destinations. It has been argued that mineral economies from the developing regions might enhance their attractiveness as locations for FDI in mining by pursuing competitive policies that raise the level of local skills (Farhad, Paloni and Ali, 2001; UNCTAD, 2004). The World Investment Report (WIR), released by UNCTAD (2005), states that inflows to developing countries surged by 40 per cent to $233 billion, while developed countries as a group saw a 14 per cent decline in their inward FDI. However, within the group of developing countries, the distribution of FDI inflows varies widely both across regional groupings and individual countries. China has been the largest recipient of FDI since 1992, with $54 billion of FDI per year during 2001–2004, equivalent to 27.6% of FDI inflows to developing economies and 7.6% of global FDI inflows over the same period. China is the second largest recipient in the world behind the United States. With $96.6 billion on average in annual inflows during the same period, South, East and Oceania received two-thirds of the developing country total inflows over the same period, excluding China.

Investment inflows into Latin America and the Caribbean increased to a record of $63.5 billion per year during 2001–2004. Mexico has been the largest recipient of FDI inflows in this part of the world, with $17.7 billion of FDI per year during 2001–2004, followed by Brazil ($16.8 billion).

Investment inflows into Africa have increased from an annual average $4.3 billion during 1994–96 to an annual average of $17.3 billion during 2001–2004. Africa’s share of developing economies inflows was 8.9%, the lowest share during 2001–2004. Angola’s investment inflows was $2.3 billion, followed by South Africa $2.2 billion of FDI inflows over the same period. Table I displays the amount of the level of FDI inflows in some mineral economies during 2001 to 2004.

Several factors help explain why the growth of FDI was pronounced in developing countries over the last few years (UNCTAD, 2002). Firstly, intense competitive pressures in

### Table I

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</table>

Source: UNCTAD Online FDI Database
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many mineral economies are leading firms to explore new ways of improving their competitiveness. Secondly, higher prices for many commodities have further spurred FDI to mineral economies, rich in natural resources. In some developing countries, increased inflows in 2004 were linked to an upturn in cross-border merger and acquisition (M&A) activity, while greenfield FDI continued to rise for the third successive year in 2004 (UNCTAD 2004).

Non-commercial risk assessment
The International Country Risk Guide (ICRG) compiles economic, financial, political data, and composite risk ratings for 140 countries on a monthly basis. The ICRG rating system comprises 22 variables representing the three major risk components of a country, namely economic, financial and political. The ICRG is the only risk rating agency to provide detailed and consistent monthly data over an extended period for a large number of countries around the world (for further details, see Hoti, McAleer, and Shareef 2002).

Political risk, being a broader category of risk than either economic or financial risk, is measured in terms of 12 aspects that measure the political stability of a country. In particular political risk affects the country’s ability and willingness to service its financial obligations. Political risk takes into account 12 variables that include government stability, socio-economic conditions including investment profile, internal and/or external conflict, corruption in government, military in politics, political terrorism, civil war, quality of bureaucracy, political party development, racial and nationality tensions, religious tensions, economic planning failures and/or expectations versus reality (Hoti, 2001).

Generally economic and financial risk are referred to as commercial risk, whereas political risk refers to risk other than commercial and business risks. For this reason in this study, the term political risk is replaced by the term non-commercial risk (NCR) as this is a more specific term covering the 12 facets of non-commercial risk. One could argue that given the nature of risk of a country, we should have considered the three components of risk. However, we chose non-commercial risk for one reason: in addition to commercial risks, foreign business in developing countries could face the risk of undesirable political events that many investors are not capable of handling (Gentile and Valahu, 2003).

NCRs have gained prominence in recent years, as civil war, armed conflict, civil unrest, corruption and expropriation have escalated around the world (Percy and Olesen, 2002). Investors perceive business environments in developing regions to have the highest levels of non-commercial risks anywhere in the world. NCRs are divided into country risk and natural risk.

Purchase of appropriately structured political risk insurance is the most common tool that foreign investors use to manage the risk (Wells, 1999). Non-commercial risk insurance’s experience demonstrates that this form of protection can play a critical role in easing investors’ concerns about breach of contract, lack of stability and others. However, insurance is not likely to completely cover all the risks that foreign investors face in developing countries. Thus, non-commercial insurance can reduce country-related risk for the investor while protecting the interests of the host countries (Wells, 1999). Non-commercial risk guarantees are an effective way of controlling investment risk and may promote positive returns for foreign investors. The Multilateral Investment Guarantee Agency (MIGA) has issued more than 600 guarantees for projects in 82 developing countries over the past 14 years, involving total direct investment of 42 billion US dollars (MIGA, 2005).

Following the ICRG classification, the non-commercial risk (NCR) ratings for the developing mineral economies with a high mineral potential index is given in Table II. In order to facilitate direct comparison between these economies, each country is rated in terms of its non-commercial risk, each of the 12 risk variables mentioned above being equally weighted to give a score of 100 points. Some level of autocorrelation is to be expected between mineral economies and developing countries endowed with good potential for mineral development. The Mineral Potential Index established by The Fraser Institute, rates a region’s attractiveness based on companies’ perceptions of geology. In a survey of six geographical regions, namely East Europe, South America, North and Central America, Asia and the Pacific, Middle East and North Africa, and Sub-Saharan Africa, respondents were asked to rate the region’s mineral potential, independently from any policy restrictions. Countries with a good Mineral Potential Index fulfill the qualifications for mineral economies and provide the basis for the ranking of the non-commercial risk (NCR) in each of these mineral economies, as shown in the Table II.

The NCR score is calculated as described above, such that the lower the risk rating, the higher the non-commercial risk. In general the high risk countries include Indonesia (52.0), Venezuela (50.5), and Zimbabwe (44.5), while those with the lowest risk ratings are Chile (81.0), Botswana (78.5), Malaysia (76.5), Mexico (74.0) and South Africa (71.0).

The inward FDI performance index (IND)
The Inward FDI Performance Index ranks countries around the world by the FDI inflows they receive. The IND yields a single number that allows developing mineral economies to be ranked according to their relative economic size and their levels of foreign investment receipts. This method uses the

Table II
Descriptive statistics for non-commercial risk ratings (2005)

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<th>NCR</th>
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levels of FDI and gross domestic product of each country. The only problem with this method is that this index does not consider other factors such as political stability, infrastructure, corruption, or mineral potential. The index considers the market size of the country, assuming other things being equal. The IND is the ratio of a country’s share in global FDI inflows relative to its share in global GDP (UNCTAD 2001). The fact that the countries analysed are mineral economies indicates that mining contributes a sizable proportion of the export earnings and contribution to GDP. However, it should be noted that while this ratio is not specific to mining investments, it does provide an indication of investment flows, which in mineral economies is likely to be minerals related. The IND ratio is calculated as follows:

\[ \text{IND} = \frac{\text{FDI}_i}{\text{GDP}_i} / \frac{\text{FDI}_w}{\text{GDP}_w} \]

where
- IND = The Inward FDI Performance Index of the ith country
- FDI = The FDI inflows in the ith country
- FDIw = World FDI inflows
- GDP = GDP in the ith country
- GDPw = World GDP

If the IND is greater than one (IND > 1) the given country receives a greater proportion of foreign investment relative to the size of its overall economy as measured by GDP. A value of less than one (IND < 1), indicates that the country receives less foreign investment relative to the size of its overall economy. In fact a negative value indicates foreign disinvestment in that period (UNCTD, 2005).

Results of the analysis

The results of the IND calculations for the 23 countries under investigation reveal significant differences among them, as shown in Figure 1. While Chile, Botswana, and Malaysia rank lowest in terms of NCR, Angola and Ecuador performed better on a relative basis in terms of IND. In total, five of the 23 countries listed in Table II, namely Argentina (0.79), Indonesia (0.049), Philippines (0.4), South Africa (0.51), and Zimbabwe (0.32), experienced disinvestment.

Fifteen of the 23 developing countries listed in Table II experienced significant investment while three countries, Congo DR, Cuba, and Saudi Arabia attracted FDI inflows in proportion to their relative GDP. Angola attracted over ten times more FDI than the amount that might have been expected based on its relative economic size. This was followed by Ecuador, over five times, while Chile attracted over four times the amount suggested by its relative size. China and Papua New Guinea attracted over three times while Venezuela, Malaysia, Peru, Colombia, Bolivia, and Brazil attracted twice the amount of FDI inflows expected based on their relative GDP.

Interpretation of the results

The results of this investigation provide strong indications that NCR deters foreign investment in countries even though they may have highly attractive mineral potential indices. Since NCR is one of the most important determinants of FDI, the damaging impact of risk is not to be underestimated. This is evident when one looks at the plot of IND versus NCR shown in Figure 2 for the 23 developing mineral economies examined in this study.

A comparison between the NCR and IND ratios provides a useful insight into the relationship between these determinants of investment. The distribution of points in Figure 3 suggests that high NCR deters foreign investment. It is evident that mineral economies with high NCR experience lower FDI or disinvestment. It should be noted that statistical correlation between the variables NCR and IND is not as relevant as the position of countries and their relative distribution, as shown in Figure 3. Since these variables are both determinants of investment, it is possible to subdivided Figure 3 into zones of low, medium, high and very high investment attractiveness. While the authors believe that these two variables explain most of the behaviour in regard to the determination of investment destinations, they are not a complete analysis of the problem; other factors may also be
important. This study suggests that few countries really benefit from opportunities to enhance their economy growth potential created by foreign investment. Turning national endowments of mineral resources into national wealth remains a challenge.

The position of South Africa in Figure 3 is enigmatic. Even though this country has among the highest GDP (purchasing power parity) of all countries investigated in 2005, at $533.2 billion, which translates into a per capita GDP of about $12,100, it has attracted less foreign investment than it should have, relative to its economic size (IND = 0.51). South Africa is a stable, middle-income, emerging market with an abundant supply of natural resources. It has well-developed financial, legal, communications, energy, and transport sectors, a stock exchange that ranks among the 10 largest in the world, and a modern infrastructure. However, the position of South Africa in Figure 3 suggests that economic growth has not been matched by intuitively equivalent foreign investment. According to the CIA (2005) the high unemployment rate, corruption, and daunting economic problems, especially poverty and lack of economic empowerment among the disadvantaged groups, override the incentives to invest. In addition, local compliance with sustainable development initiatives and black economic empowerment adds to the price tag for investment.

Angola has an anomalous position relative to the other mineral economies shown in Figure 3. This is due to the poorly documented, but perceived very rich mineral endowments that this underdeveloped country enjoys. With GDP (purchasing power parity) of $45.93 billion, which represent a per capita GDP of about $3200 in 2005, Angola has attracted over ten times the amount of investment that it might have, as suggested by its relative economic size. Angola’s high economic growth rate is driven by its mineral endowments, especially diamonds and oil, the latter contributing 65.8% to GDP in 2005. This could be offset by relatively high NCR if the country fails to reform government policies and to reduce corruption. However, it is evident that Angola will play an increasingly important role in the global supply of minerals as her mining industry expands over the next four to five decades.
Investment and non-commercial risks in developing countries

Conclusion

Most developing mineral economies depend heavily on the production and sales of their mineral products for the effective benefits through taxation, employment and the multiplier effect that generates economic development. Efforts to achieve the national objectives through minerals developments are thwarted by their lack of capital, which creates a dependence on inputs from foreign investors. However important foreign investors may be, they are generally risk averse and their aims often bring them into conflict with host governments. Furthermore, they are selective when making investment in developing countries.

The analysis suggests that higher non-commercial risk is correlated with low FDI inflows. This supports the argument that the non-commercial risk has a profound impact on FDI because of the foreign investors’ sensitivity to all types of risk. Such an evaluation permits a critical assessment of the relevance and practicality of political theories about non-commercial risk. The analysis also suggests that countries such as South Africa, Botswana, Chile, Malaysia and Mexico could represent preferred destinations for further foreign investment.

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