Co-investments and African infrastructure deficit: Understanding and mitigating political risks in Conflicts Affected and Fragile States

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29 November 2018

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Abstract

This article through a qualitative assessment identifies political risks confronted by FDI in infrastructures project in African Conflicts Affected and Fragile (CAF) States and studies the structure for infrastructures financing which allows lessening political risks. Outside hydrocarbon sector which remains attractive even in a worse political context, African CAF regions infrastructures sector as other sectors remain unattractive to foreign investors. By considering global investors' weak preferences for CAF countries infrastructures assets, due to high levels of political risks, we argue that: to fill the CAF States' infrastructure gap and addressing at the same time political risks concern, an optimal solution is located in a strategic tricky balance between African SWFs as kick-started, Multi-Development Banks (MDBs) (like MIGA agency under the World Bank Group) and long-term institutional investors like foreign SWFs. In the initial phase, MDBs with both their flexibility and experience ought to help finance the riskiest phases of infrastructure projects after African SWFs have to identified bankable projects. In the second period, MDBs ought to disengage and transfer their mature green infrastructure projects to secure the path for a workable involvement of long-term institutional investors such as sovereign wealth funds. With the aim to foster a vast African infrastructure bonds' markets in which the African CAF States could play a pivotal role, strengthening rules of law (regulatory and legal frames) should begin straightaway.

Keywords : Sovereign wealth Funds, Africa, CAF States, Political risks, infrastructure financing, co-investments, Multi-Development Banks (MDBs).

JEL codes : G32, H13, H54, O55, D61, D74.

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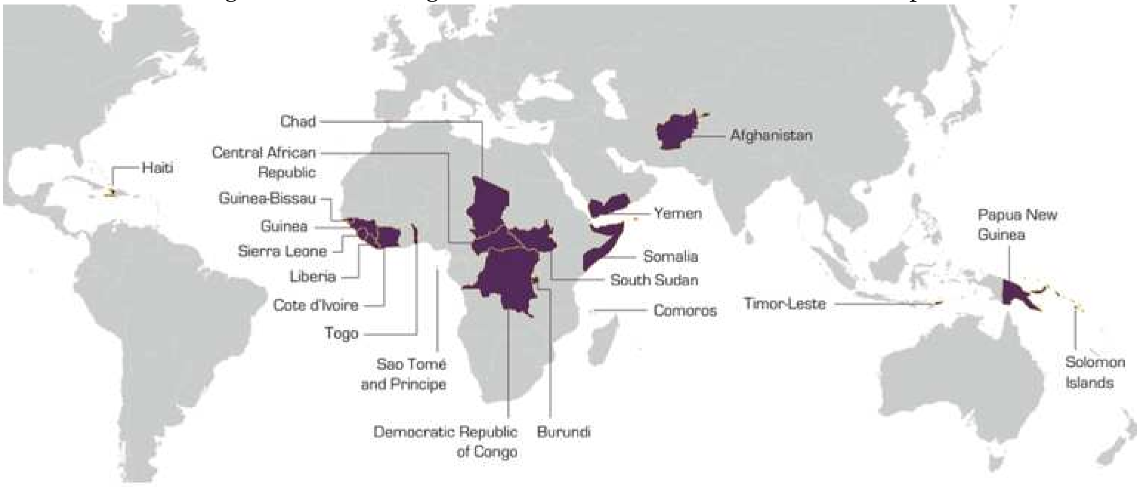
1 Introduction

Years of internal violent armed conflicts can affect foreign investors' perception of risks, those of non-business type. In 2013, a survey carried among foreign investors by the Multilateral Investment Guarantee Agency (MIGA), revealed that political risks were by far their main anxiety investing in developing countries (MIGA, 2014).

Regions classified as vulnerable and inclined to conflict display unique challenges due not only to increased risks of new or recurring political violence but also structural and institutional weaknesses (Collier et al., 2008). The size and structure of foreign capital flow to these countries differ from developing countries (MIGA, 2011). In African Conflicts Affected and Fragile (CAF) countries, infrastructures gap is the most and have been damaged by a decade of civil war in some countries. Figure 1 presents the global landscape of CAF countries where we can observe that most CAF states are in the Africa region. These countries cannot reach the sustainable development goals (SDGs) goals : 6,7,9 11 and 16 [1] without co-investments to achieve them.

Figure 1: Most Fragile and Conflicts affected States Landscape



Source : www.G7plus.org

As shown in figure 2, the key constraints of SWFs investments in the CAF States are neither lack of infrastructures nor macroeconomic constrains but political risk. This article provides one of the first efforts to conceptualize how infrastructure financing in the CAF States can grow up and suggest it in three stages with core aims to undermine political risks and overcome infrastructure shortage. First, allowing and letting well-informed Multi- Development Banks (MDB) undertake the riskiest stage of wide projects. Second, transferring advanced projects to independent institutional investors, such as sovereign wealth funds, to withdraw self-financed projects from State debt stock. Third, developing a bond market through Africa to facilitate this position. Co-investments merger the inception skills and risk taste of well-informed investors with depth pockets of arms-length institutional investors.

The idea of this article comes from the recent work of Arezki and Sy (2016) who explore how co-investment between development banking and long-term investors can help to address the financing of Africa's infrastructure deficit. However, contrary to Arezki and Sy (2016), our article focus on the identification of political risks in the African CAF States and how to mitigate them,to make those countries attractive to deep pocket institutional investors like sovereign wealth funds.

The rest of this article is organized as follows : section 2 presents the stylized facts on urgent infrastructures needs in the CAF States. section 3 presents an overview political risks literature and co-investment literature as a solution for mitigation of political risks. Section 4 gives suggestions of structured infrastructure financing framework in CAF States including host States, multi-development banking and armed length sovereign wealth funds.In section 5 we conclude.

[1]Goal 6: Clean Water and Sanitation, goal 7: Affordable and Clean Energy, goal 9: Industry, Innovation and Infrastructure, goal 11: Sustainable Cities and Communities and goal 16: Peace and Justice Strong Institutions

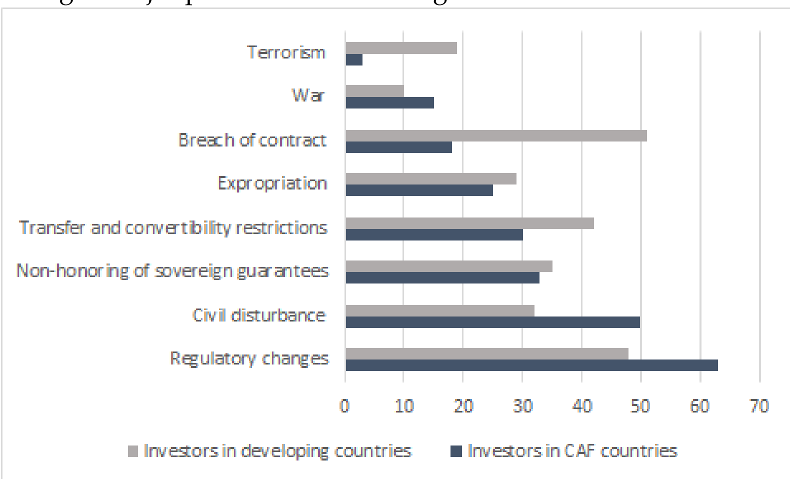
Figure 2: Ranking of most important constraints for SWFs investment in developing world

Source : MIGA (2011).

2 Stylized facts

African CAF States' infrastructure deep deficit represents a vast investment opportunity. Although investment climate differ in the CAF States, they are following four common threads : First, despite of the worsening security conditions, there are still investors searching business opportunities in countries, as long as the expected profit on investment is high to cover up a required level of return augmented to a risk premium, most of them are foreign institutional investors such as sovereign wealth funds from Asia and Middle-East (Oh, 2015). Paul and Khalid (2014) found that the mean rate of investment return on FDI in the CAF States (14.5%) between 2006-2011 was much higher than that low- income countries (9.7%) and the global mean (6.2%).

Figure 3: Ranking of major political risks of foreign SWFs investments in developing world



Source : MIGA (2011).

For investors active in the CAF States, their worries are more concentrated on unanticipated switches and steadiness in government policy, more than a matter of security itself (Oh, 2015). Most aspects of state proceedings are riskiness that investors have no control over, such as the renewal of permits and licenses, taxes and diverse compacts with the host government. Sovereign wealth funds, for example, cross different political cycles in their investment horizon in the long run. An agreement by the current government does not warranty the approval of the next government.

This remark joins findings of the Multilateral Investment Guarantee Agency[2] (MIGA) 's, where

[2]As part of its tenure to foster investments in developing countries, the Multilateral Investment Guarantee Agency

central risk factors were identified by investors operating in CAF countries as shown in graph 3. In this graph, 62 % of respondents pick out "regulatory changes" as the top political risk a worry, while just 15 % and 4 % responded that civil war and terrorism were primary preoccupations for their investments (Villar et al., 2010).

Figure 4: Central Africa Republic

Figure 5: Kalait,Chad

Figure 6: Syrte,Libya

Figure 7: Juba,South Sudan

Second, CAF States combine numerous traits. All-round features comprise a country where the central government is ineffective that it has little practical control over much of its territory; non-provision of public services; rampant corruption and criminality; refugees and forced movement of populations; and sharp economic decline ; As shown in our figures 4[3], 5[4], 6[5] and 7[6], there is also a great need for the rebuild of the elementary infrastructures, such as power electricity and roads for economic improvement in CAF countries like Angola, Chad, Libya and South Sudan. Due to the large investments and the technologies, the involvement of private investors

(MIGA) aims to gain a better understanding of the role of political risk and the instruments to remedy it.

[3] RAC is the world's most fragile state. RAC has experienced serious unrest and instability since 2012. It has suffered periods of a civil war involving the government, rebels from the Séléka coalition and the Anti-balaka militias. Conflict have created a tremendous population displacements, raised food prices and shortage of earning opportunities along with epidemics continued to bring out a dire humanitarian situation in early 2018. RAC is faced with the complex and pressing challenges of state building and reconstruction with extremely limited public revenue, and with hardly any institutional capacity

[4] Infrastructure problems in Chad are due to civil wars and poor government management. Decades-long civil war has damaged numerous of the country's roads, and the remaining roads are made of dirt and are likely to be eroded like in Kalait one of the few supply centers in northeastern Chad . Despite the fact that water and electricity are available in the capital, they are expensive and inaccessible to most rural people in Chad.

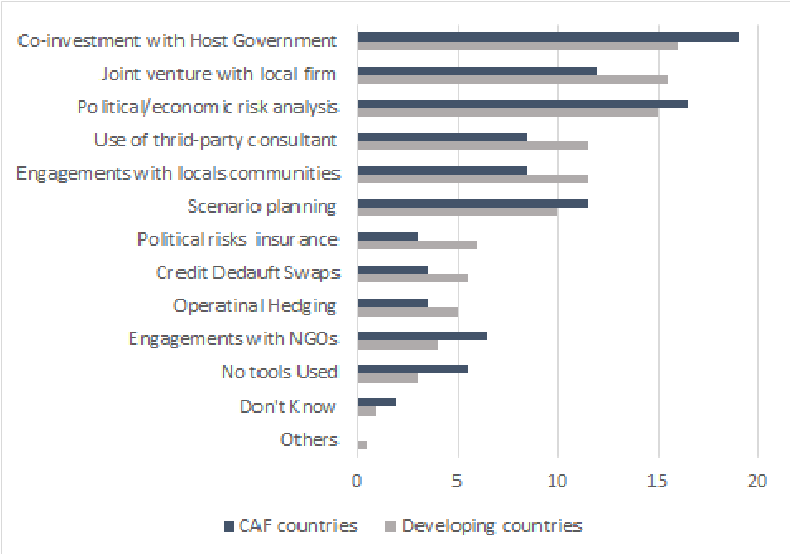
[5] Sirte and other parts of Libya became destabilized after the death of Moammar Kaddafi in 2011, and former President Obama recognized that a lack of planning after the U.S intervention was his worst mistake(Chivvis, 2013; Kuperman, 2013). In fact, when United Nations-Security Council lifts sanctions against Libya in 2003, the Kaddafi regime concentrated on increasing the quantity and quality of the infrastructure. However, Libya's National Transitional Council (NTC) said even before the 2011 revolution, neglect had left the country with very scanty infrastructure. It has been estimated that it would take at least ten years to rebuild areas damaged by the civil revolution.

[6] On July 9th 2011, South Sudan became the world's 193rd nation following a referendum in which nearly 99 % of its voters chose to detach from Sudan. Africa's newest sovereign State will also join the group of the world's least-developed countries because of decades of civil war and overlook by Khartoum's government. The new government well aware of the difficulties declared that one of his biggest obstacles to development is the infrastructure's shortage. South Sudan, the size of France (643,801 km^2 of area), has only 50 kilometers of paved streets, no national rail network and no paved highways. South Sudan will need more than $10 billion to build and upgrade around 10,000 km of roads

is essential to closing the funding gap and producing the infrastructure development technologies. Private investors are often reluctant to take part in long-term and large infrastructures and electricity projects in CAF states without a certain level of legal or regulatory and institutional surroundings has been set up .

Those investments are often made based on contractual obligations by the government (or governmental investment vehicles) implies mighty needs to cover risks of contracts' breaking by the government. To address, this concern, MIGA (2011) Political Risk Survey shows that co-investment with the host Government could solved both cut down political risks and fill the gap of infrastructures shortage mostly in CAF regions and in developing the world as shown in figure 8.

Figure 8: Tools used by foreign investors to manage political risk



. Source : MIGA (2014) and MIGA (2011).

3 A brief Literature on Political risks and infrastructures financing in CAF States

We relied on the economics literature of PPPs (see Grimsey and Lewis (2002); Iossa and Martimort (2012) for an overview). One of the main ideas of this well-developed literature is that, it is an incentive to build concession agreements by combining building and service requirements into a single private operator. The reason for the Group's effective impact is that the latter has a strong incentive to share in the construction work and operations with the same supplier to minimize the future operating costs. Beyond emphasizing on incentives questions, it is startling to observe how economics literature has paid little attention to the basic question of how infrastructure investment funding, including the PPP framework, should be structured to address political risks in developing countries and in the CAF States.

According to the Oxford English dictionary, infrastructures are the basic physical and organizational structures and facilities (e.g. buildings, roads, power supplies) needed for the operation of a society or enterprise. 'the social and economic infrastructure of a country'. From an economic and investors angle's, infrastructures assets are capital assets that are high-cost investments but hight return too and are vital to a country's economic development and prosperity (Sawant, 2010).

Although there is no agreed definition to the notion of "fragile states" or "Fragility", most development institutions have moved toward the OECD DAC's definition, according to which: A country is considered in situations of fragility when "state structures lack political will and/or capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their population" (OECD, 2008).

This mirrors to the dominant picture of states fragility as the defeat of states to fulfill certain functions to address citizenry's basic needs and expectations. The fragile States are often presented as Governments unable to guarantee basic security, the rule of law and fairness or the provision of essential services and business opportunities for its citizenry (Mcloughlin, 2009).

3.1 Understanding Political risks

Political risk is a broad notion concerning non-commercial risks as creeping expropriation in investments and business agreements caused by political turns or instability. It covers several characters, among which : legal, credit risks and regulatory (Fitzpatrick, 1983; Howell and Chaddick, 1994). To run uncertainty of international political landscape in developed, emerging and in developing economies, investors in infrastructure projects and operative assets conduct political risks ratings and alleviation strategies into their projects investment decision-making process. In the Conflicts Affected and Fragile States , where demand for infrastructure projects is the most severe, the greatest challenges for investors comprise domestic political stability, fiscal surplus, and rule of law (or more protection of properties rights). Political risk decrease appetite for co-investments infrastructure deals.

An analysis of political risk insurance contracts finds inadequate structures and insurmountable prices Mardirosian (2010). This author concludes that to better mitigate political risks and optimize investments return arrangements, new types of insurance products and support mechanisms need to be developed. The insertion of commercial breaches for contract protection would soften a key political risk for venture developers(Mardirosian, 2010).

When is come fresh infrastructure opportunities in an overseas host country, investments may be subject to political risks. This risk may increase more for overseas investors who need to engage their own funds for a long-term, considering projects are non-liquid and project recovery times are often longer than in other areas. A new host government program and folk mandate for changing may interfere with underlying basis a deal model for long-term investments in emerging and developing States. Even in developed Western jurisdictions such as Europe, the view that this region is a land to a secure refuge of steady Governments with low vulnerability to social shocks and terrorist attacks have been reversed its top. Table 1 presents some selected risks in infrastructures investment from the literature review on political risk classified in three mains groups : political risks, regulatory risks and reputation risks.

Table 1: Some selected of non-commercial or macro risks in infrastructure investments

Risk category	Risk sub-category	Examples of issues
Political risks	Safety and instability	Social upheaval Terrorism War, coup d'état, revolution
	Legal	Expropriation Deletion or revision of existing agreements Change in political direction of infrastructure asset management
	Leadership and regime	Election (e.g., democratic, quasi-democratic) Coup d' Etat
	Politics and policies	Tax legislation Labor laws Environmental standards Foreign direct investments and trade openness
Regulatory risks	Regulatory certainty	Renegotiations of existing agreements Modification of public-private partnership framework Sudden and unexpected cut in subsidy schemes Change in regulatory price point, e.g., stipulated prices, interest rates, asset base Limitations in price point changes Limitations to trade (e.g., of critical spare parts), e.g., trade tariffs, local content requirements, import/export quotas, bottlenecking inspections Inconsistent definitions and enforcement
	Regulatory efficiency	Unclear requirements Delays to decision making and timelines
Reputational risks	Environmental, social, and governance	Environmental damage, e.g., air and noise pollution, chemical spills Re-settlements Lack of local content or diversity Corruption Executive remuneration and perks
	Health, safety, and (work) environment	Injuries Long-term disabilities or chronic conditions Fatalities
	Stakeholder disagreements	Energy supply vs. amenity disruptions Local industries and minority interests vs. foreign technology
	Litigation	Indictment (e.g., related to ESG or HSE) Involuntary co-plaintiff (i.e., end-investor could be implicit co-plaintiff)
	Other negative publicity	Allegations or adverse press campaigns, e.g., about profiteering, corruption, embezzling Subject in political debate, i.e., false accusations of adverse events, e.g., blackouts, community issues Picketing by special interest groups, e.g., labor unions, community leaders, environmental activists Association with second-party, e.g., partner accused of corruption Association with third-party, e.g., partner with close ties to administration accused of corruption

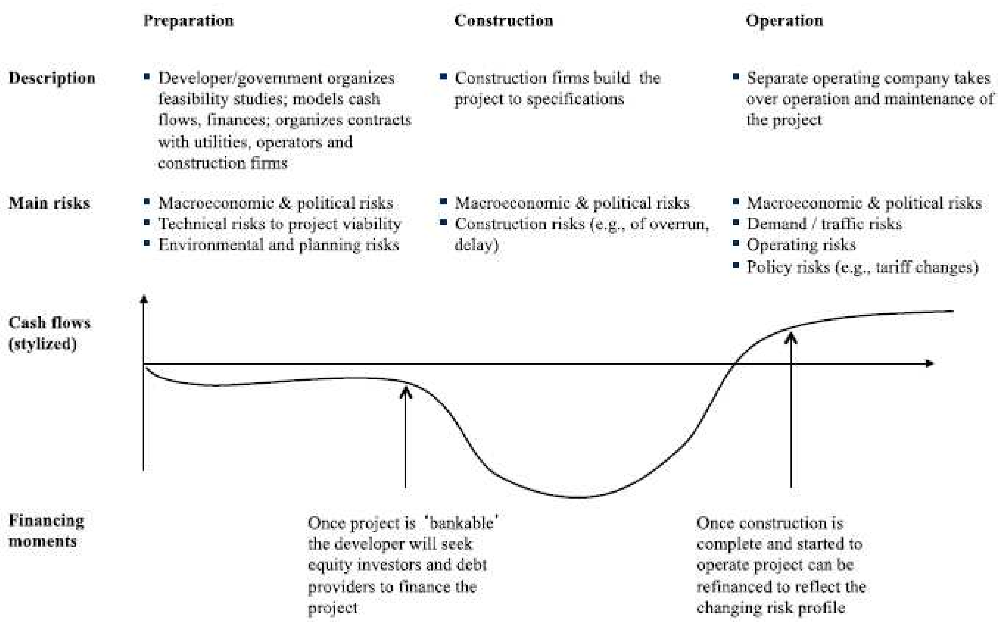
Source : Based on Miller (1992); Howell and Chaddick (1994)

3.2 From multilateral development banks to SWFs long-term investing as tools to mitigate political risks

The biggest problem that the African CAF States confront to structure their infrastructure funding is the balance between investors' preferences and political risks as shown in figure 3. Due to the new nature of Africa's infrastructure needs, development banks have to play a more important role both in the creation and funding of the first phase of major infrastructure projects. However, they must show a cautious but rapid balance to encourage institutional investors participating to prevent eviction of these international institutional investors with deep pockets like the largest SWFs.

Most CAF States have their own SWFs just to mention a few likes Libya, South Sudan or Angola with development goals which can be useful to attract foreign institutional investors, structure their infrastructural funding in order to both undermine political risks and address infrastructure gap. At the first stage, the strategy is to let to Multilateral Development Banks (MDBs) and African SWFs undertake the riskiest phase of vast projects. Second, transferring well-advanced projects to arms-length foreign sovereign wealth funds to suppress self-funding projects from the host State debt stock. Third, develop in Africa a vast capital bond market of infrastructure projects to ease these transfers. Co-investment harmonizes the original skills and risk tastes of well-informed investors with deep pockets arms-length SWFs. Figure 9 below provides risks and financing decisions at each stage of an infrastructure project's life-cycle.

Figure 9: Illustrative Infrastructure project's life-cycle with risks and financing decisions at each stage



Source: Based on Bhattacharya et al. (2012).

Arezki and Sy (2016) and Amoako-Tuffour (2016) maintain that MDBs are better appropriate for starting large projects for two reasons. First, it is their ability to create and manage large risky projects. Second it is due to their greater taste for risk for a social and financial return. Well-informed investors have a tendency to make more loaning of cheapen quality and lofty cost than arms-length investors who bound their investments to mitigate disadvantageous choices (Rajan, 1992; Von Thadden, 1995; Agarwal and Hauswald, 2008). MDBs are well adapted to infrastructure projects than traditional banks, as the latter have been discouraged by long-term loans under the Basel III agreement because of the short duration of their short-term liabilities (Härle et al., 2010).

4 Why do Infrastructure assets fit Sovereign wealth funds new investment trend

SWFs are important for many resource-rich developing countries that do not yet have access to global capital markets, for the CAF States. SWFs are ideal for financing infrastructure in African FCS countries for several reasons.

First, sovereign wealth funds have a long-term investment horizon and hold limited or sometimes non-existent explicit obligations (because funded derived from natural resources taxes) compared to other institutional investors, such as pension funds (funded from citizen savings retirement plans). Greenfield assets provide a higher return and inflations covered output joined to a lower connection to other financial assets, that suggests a weak risk, which may be ideal for sovereign wealth funds (Della Croce and Yermo, 2013). Greenfield projects such as highways, ports, and power electricity also supply expected and steady streams of long-term cash flow which lines up with the long-term investment time horizon and risk profile of SWFs particularity development SWFs. Sovereign wealth funds can also more invest in illiquid or long-term assets(Hove et al., 2016).

Second, contrary to official reserves running by Central banks confined to small fixed-rate assets, SWFs may be set up to optimize investments' risk-adjusted returns and to accumulate resource for present and future generational through financing infrastructures projects in the CAF States. Once build, infrastructures are less vulnerable to economic busts than other more cyclical assets. Thus it makes infrastructures more appealing for SWFs looking for new sources of diversification to protect their portfolios against economic busts over time (Hove et al., 2016). Due to the demographic data in the African fragile and conflict-affected States and urgent reconstruction process in terms of basic infrastructures as a major tool for peace recovery, the channeling SWFs' resource into infrastructures in FCS countries is a constructive step towards the building of physical assets for current generations, for rural zones.

Third, scarcity of long-term funding in the African CAF States and weak liquidity of regional African financial markets where they exist combined with the high demand for infrastructure financing make up an opportunity for sovereign wealth funds for funding infrastructure projects. In CAF countries, SWFs are likely to less encounter concurrence in infrastructure financing and due to their financial power, they can negotiate and be granted helpful conditions for long-term infrastructures Greenfield projects.

Fourth, the cost of capital from foreign SWFs may be low due to the origin of funds. Costs of capital may also be reduced when African SWFs increases country credit ratings. For example, fragile and affected countries like Libya, South Sudan have upgraded their credit ratings because of the creation of their own SWFs. Low capital costs are critical for all infrastructure projects and may even be more useful to enable the delivery of social infrastructure which may not be possible from funds raised from international financial markets.

5 Conclusion

The aim of this article was to identify political risks faced by institutional investors in infrastructure projects in African CAF states and to suggest an optimal political risk insurance (PRI) tool mitigate political risk and attracting more institutional investors in those states. We use a comparative analytical approach base on a survey from MIGA on political risks for our research.

Infrastructures are sort of that good spending in the middle, where even if Government has mis-allocate national wealth from resource revenues a little bit, it still has something to show for it. It's tangible; it may help economic growth and others sectors. Some infrastructures projects clearly demand massive, coordinated investment: interstate highways for example. Others don't need to. African Government should be unafraid of pilot projects and learning, particularly in the CAF States.

The paradox is that, although there's a huge concern in infrastructures deficit in developing countries with more acuity in the CAF States (where existing infrastructure have been severely damaged), it's taking a long-time to make them happen. Nowadays, any Government looking for long term reliable investments financing sources that pay a decent yield should pay attention to the growing perception of political risks in infrastructure projects. Government predictability matters count.

Our work suggests that, due to the specific nature of African CAF States' infrastructure urgent needs, MDBs have to play a more important role both in the identification and funding of the first phase of major infrastructure projects. However, they must show a cautious and rapid balance to encourage institutional investors participations; to prevent eviction of these international institutional investors with deep pockets like largest SWFs.

At the first stage, the strategy is to let to MDBs and African SWFs undertake the riskiest phase of vast projects. Second, transferring well-advanced projects to arms-length foreign sovereign wealth funds to suppress self-funding projects from the host State debt stock (Arezki and Sy, 2016; Amoako-Tuffour, 2016). Third, develop in Africa a vast capital bond market of infrastructure projects to ease these transfers. Co-investment harmonizes the original skills and risk tastes of well-informed investors with deep pockets arms-length SWFs.

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