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Private Sector Investments from Small States in Emerging Markets: Can International Financial Institutions Help Handle the Risks?

Hilmar Þór Hilmarsson
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Abstract

The private sector plays an important role in the economic reconstruction of emerging market economies, and international financial institutions (IFIs) increasingly work in partnership with the private sector to increase economic growth and reduce poverty in those economies. IFIs, for example, offer: (i) equity financing and/or loans for private sector projects, (ii) investment guarantees against political risks (or non-commercial risks), (iii) technical assistance, and (iv) advisory services, etc. This article will briefly discuss the services that IFIs offer the private sector in emerging markets and cases in which these services could be useful for Icelandic companies. The institutions discussed are (i) the World Bank Group, (ii) the European Bank for Reconstruction and Development (EBRD), (iii) the Asian Development Bank (AsDB), (iv) the Inter-American Development Bank (IDB), and (v) the African Development Bank (AfDB). A few Icelandic firms already have plans for relatively large projects in emerging market economies, especially in the energy sector, some of them in countries that could be classified as being risky. The ongoing economic crisis in Iceland will make project financing in emerging markets more problematic than before and therefore investments in partnership with international financial institutions could be an option that Icelandic firms will increasingly need to consider if they intend to invest abroad. However, increased private sector and IFI partnerships will not happen without government action. Iceland is a member of only two of the above-mentioned IFIs: the World Bank Group and the EBRD. The decision for Iceland to become member of the AsDB, IDB and AfDB rests solely with the government. Further government inaction in this area could become an impediment for foreign direct investment from Iceland to emerging markets and increase risks when the Icelandic private sector invests in those economies. Unnecessary risks might not only hurt Icelandic companies but also put Iceland's economy in jeopardy. This is especially the case with large energy investments with long repayment periods. In addition to the specific case of Iceland, the discussion in this article could also be relevant to other small states which do not have the same leverage as do large states in the event of a dispute with the host governments, making partnership with IFIs more feasible in emerging markets.

1. Support from international financial institutions for activities led by the private sector in emerging markets

The private sector plays an important role in the development and economic reconstruction of emerging market economies[1], and international financial institutions (IFIs) focus increasingly on cooperation with the private sector to boost economic growth and reduce poverty in the developing world. Among the

1 The term "emerging markets" is used in this article to refer to countries with low or middle income according to the World Bank (see, e.g., International Finance Corporation 2006). This article thus uses a broad definition of emerging markets. Several other definitions of the term can be found in popular textbooks on international business (see, e.g.,: Czinkota, Ronkainen and Moffet, 2005; Rugman and Collinson, 2006; Wild, Wild and Han, 2008, and Daniels, Radebaugh and Sullivan, 2007).

services that IFIs offer in emerging markets are: (i) equity financing and/or loans for private sector projects, (ii) guarantee/insurance against political risk (non-commercial risk), (iii) technical assistance and (iv) information and advisory services. In addition, IFIs often engage in a broad-based policy dialogue with the governments of emerging market economies to improve economic policy and management.[2] This includes reforms to improve the business and investment climate for the private sector, to promote business activities, and to encourage foreign direct investment. The work of the World Bank's Doing Business Team is a good example of this sort of activity, where the bank engages in dialogue with governments on a variety of issues to encourage policy reforms. IFIs also provide loans and credits to various government-led projects in developing countries and emerging markets that are subject to international competitive bidding. This allows private sector firms to participate in the bidding process and potentially to benefit from those public sector projects supported by the IFIs.

This article will attempt to outline some of the services offered by international financial institutions to private sector firms investing in emerging market economies, and discuss cases in which those institutions might offer services that are useful both for Icelandic firms and firms from other small states that are considering international investment.

2. Icelandic cooperation with the private sector arms of IFIs

Cooperation between the private sector in Iceland and IFIs has so far been minimal. Only a few Icelandic companies have attempted to work in partnership with IFIs in emerging market economies, and with limited success. The increasing interest of Icelandic companies in becoming involved in emerging market economies, especially in the energy sector, could make private sector partnership with IFIs increasingly relevant to Icelandic companies. In fact, one could argue that partnership with IFIs could be more useful for the internationalization of firms from small states like Iceland than firms from large countries. Membership of, and cooperation with IFIs may be especially worth considering for small states like Iceland as a means of reducing risks, especially where knowledge of the economy, culture, politics, business and investment environment, etc., is limited. In some cases the Icelandic government also has weak diplomatic ties with emerging market economies where Icelandic companies intend to invest, and in many cases Iceland does not have embassies in those countries. Partnership with IFIs could help mitigate risks, since small states usually can apply only limited leverage if government intervention in the host country inhibits or threatens the

2 The Icelandic government has recently been engaged in such a dialogue with the International Monetary Fund because of the ongoing financial crisis. The international financial institutions discussed in this article only engage in a policy dialogue with low and middle income countries, whereas the IMF is prepared to talk to countries like Iceland, which is classified as a high income economy.

viability of private sector projects. Iceland's case could therefore also be relevant to other small states whose private sectors have so far had limited engagement with IFIs. The ongoing international financial crisis and the banking crisis in Iceland will make project financing in emerging markets more problematic than before, and investments in partnership with international financial institutions could therefore be an option which Icelandic firms will increasingly have to consider. In addition to the funding mechanism that IFIs could offer investors, Icelandic companies could learn more about risk analysis and management in emerging market economies by working with IFIs. Icelandic engagement in emerging markets would not necessarily involve investments in all cases. In some cases, Icelandic companies might also be interested in transferring their knowhow to less developed countries. This could be done in cooperation with IFIs, as they frequently procure consulting services from the private sector for projects they support in emerging markets, to strengthen the economic and sector analysis they use in policy dialogue with the governments of emerging market economies and for their advisory services.

Iceland was among the founding members of the World Bank, yet up to now there has only been one case where its private sector arm, the International Finance Corporation (IFC), has approved funding for an Icelandic private sector project. This was a project sponsored by Bravo Holdings Limited in the food and beverage sector in the Russian Federation. The total project cost was estimated at USD 45 million and the proposed IFC investment included: (i) a senior A loan for IFC's own account of USD 5 million, (ii) a syndicated B loan of USD 7 million, and (iii) a subordinated C loan for IFC's own account of USD 15 million (International Finance Corporation 2000).

Icelandic energy companies are beginning to show an interest in the services offered by the IFC. One example of this is Enex (http://www.enex.is/). Enex's experience in the geothermal and hydropower field spans nearly four decades. The company was founded in 1969 by several Icelandic geothermal and engineering companies which, collectively, had several decades of experience in the development of geothermal energy and hydropower. In 2001, the company changed its name to Enex and reshaped its main objectives. Its focus shifted toward designing, constructing, operating and financing power plants, both geothermal and hydropower. Since then, Enex has expanded its operations into developing new projects and technical solutions in the geothermal energy sector. Enex has worked on projects in emerging market economies including China, Hungary, Poland and Slovakia (Enex 2008a). According to its website, some cooperation has already taken place with the World Bank. For example in 2006 the World Bank (Geo Fund) approved a USD 3.7 million Geological Risk Insurance for Enex's Hungarian Geothermal Project (Enex 2006a). In 2004 Enex worked as a consultant to the World Bank's ECA Region on restructuring the Geotermia Podhalanska geothermal power plant in Zakopane, Poland. (Enex 2008b). Finally, Enex has sought funding from the IFC for a geothermal district project in Xianyang China (Enex 2006b). These examples demonstrate that Enex is accumulating experience in working with the World Bank's private sector arm that could also be valuable for its future operations.

The current owners of Enex, Reykjavík Energy Invest (REI) (http://www.rei.is/) and Geysir Green Energy (http://www.geysirgreenenergy.com/), are now becoming increasingly involved in energy projects in emerging markets. Reykjavík Energy Invest provides information on its website on projects that are in various stages of development in Djibouti, the Philippines and Indonesia (Reykjavík Energy Invest 2008) and Geysir Green Energy is involved, e.g., in projects in the Philippines and in China (Geysir Green Energy 2008). Cooperation with IFIs, including the private sector arms of the World Bank, the IFC and MIGA, could become increasingly relevant for these companies. Given that most of these projects are in Asia, Icelandic membership of the Asian Development Bank (AsDB) could be an issue for those companies, especially since infrastructure, including the energy sector, is a priority area for the AsDB. Although several Icelandic business delegations have been to Asia under the leadership of cabinet ministers, the Icelandic Ministry for Foreign Affairs has still not considered membership of the AsDB or carried out any study to assess the feasibility of membership.

3. What international financial institutions?

The institutions discussed in this article are the following:
The World Bank Group (http://www.worldbank.org/)
The European Bank for Reconstruction and Development, EBRD (http://www.ebrd.org/)
The Asian Development Bank, AsDB (http://www.adb.org/)
The Inter-American Development Bank, IDB (http://www.iadb.org/)
The African Development Bank, AfDB (http://www.afdb.org/).

The World Bank Group is engaged in all the continents where emerging market economies exist. The EBRD operates in Europe and Central Asia; the AfDB concentrates on Asia and the Pacific; the AfDB operates in Africa and finally, the IDB operates in South and Central America. Although all these institutions, except for the World Bank Group, limit their operations to specific regions, they have contributing member countries outside those regions. For example, all the Nordic countries, except for Iceland are members of the AsDB, the AfDB and the IDB.

The main goal of the IFIs mentioned above is to increase economic growth and reduce poverty in the regions they assist. To do this, they maintain an ongoing dialogue with the governments of emerging market countries on improved economic policy and its implementation. Different opinions have been expressed about the relationship between economic policy and growth and also about the relationship between economic growth and poverty reduction in the developing countries. Many specialists have debated these issues in recent years and decades.[3] However, it is quite clear that in a world of limited development aid, the war against poverty will, in the long-run, not be won without economic growth in the poorest countries. That growth cannot be achieved without a vibrant private sector.

In their policy dialogue with the governments of emerging market economies, IFIs are increasingly applying the policy that the country receiving the assistance take the lead in the discussions. This helps ensure implementation of the agreed policy reform agenda. Through the policy dialogue and the technical assistance and advisory services provided, IFIs are certainly able to influence the policies adopted by emerging market economies. Frequently, they also provide budget support, with conditions, to implement reforms that have been negotiated and provide technical assistance that supports the implementation of the policy reforms. All these institutions stress the importance of improvements in the business and investment climate of private firms in emerging markets. This is important for promoting international trade and investment, which are the key to sustainable economic growth.

Iceland is a member of only two of the institutions discussed in this article, the World Bank and the EBRD. Nevertheless, membership of the other three institutions (the AsDB, the IDB and the AfDB) will also be discussed as it could promote the internationalization efforts of Icelandic firms. However, the decision to join those institutions would rest solely with the government of Iceland.

4. Icelandic foreign direct investment flows abroad

Foreign direct investment from Iceland has increased substantially since 2000 (see Table 1). Most foreign direct investment in 2007, about 80 percent went to Europe. Next comes America about 20 percent, followed by Asia, Africa and Oceania. Obviously, the current financial crisis is likely to reduce foreign direct investment from Iceland at least for some years to come.

Table 1. Iceland: Net foreign direct investment flows abroad, by geographical destination[4] (ISK millions)

	2002	2003	2004	2005	2006	2007
Europe	27.107	26.721	177.187	355.745	330.231	679.357
America	2.103	2.494	1.178	85.375	29.778	185.042
Africa	29	-699	7	3	2	-13
Asia	356	193	2.125	3.393	6.771	9.017
Oceania	83	179	63	52	127	-432
TOTAL	29.678	28.888	180.560	444.567	366.909	872.972

Source: Central Bank of Iceland, 2008a and 2008b

3 There is still an ongoing debate about the relationship between good policy environment and economic growth (see, e.g.: Burnside and Dollar 2000; Easterly, Levine and Roodman 2004; and Rajan 2005).

4 Figures for direct investment are sometimes negative; according to the Central Bank of Iceland,

Recorded foreign direct investment abroad in the energy sector has so far been minimal and, as noted above, the companies that are exploring investment opportunities in emerging markets economies in the energy sector are only taking their first steps in this area. However, the fact that many countries where basic infrastructure support is critically needed (e.g. in the former Soviet Union, Eastern and Central Europe, Asia and Latin America) have been liberalizing creates opportunities for foreign investment on a scale that did not exist before and, in fact, Icelandic investors already have relatively large plans for projects in countries that could be considered risky, including Indonesia, the Philippines, Djibouti and China (Reykjavík Energy Invest 2008; Geysir Green Energy 2008; Enex 2008b). The current financial crisis could delay the implementation of some of these plans, but there is no reason to believe that at least some of these plans will not be able to proceed in a few years' time, especially if the Icelandic firms can find strong institutions and/or firms to form partnerships with.

It is clear that the demand for electricity will grow in the coming years and decades and most of this increase will be in emerging markets. It is expected that the world electricity demand will double by 2030, with the largest increase coming from developing countries (see, e.g., Tooman 2004). It has also been estimated that by 2025, developing Asia will consume 2.5 times as much electricity as they did in 2001. Foreign direct investment will be needed to meet this increased demand.

The international community is addressing these problems at various conferences and meetings and Iceland is taking part in this dialogue. For example, in April 2008, the IFC and its donor partners (Denmark, Finland, Iceland, Norway, and Sweden) hosted a multi-stakeholder symposium on climate change in Copenhagen. The symposium focused on the theme *Global Climate Change – Financing Private Sector Opportunities in Developing Countries*. This was the first time that private sector leaders, development agencies and commercial and development finance institutions from the Nordic region had discussed opportunities to collaborate and address climate change in developing countries (International Finance Corporation 2008). Industry leaders, including some from Iceland, also took part in this important dialogue. The key issues discussed were: (i) The role of the public sector in creating a conducive environment for private sector climate-related financing/investments that contribute to improving energy efficiency and reducing greenhouse gas emissions, (ii) How to establish strong public-private partnership for climate-friendly financing and investments, and (iii) What are the specific needs of the private and public sector engaging in climate-

this can be attributed to partial or total sales of shares in enterprises by residents/non-residents, or to high dividend payments or operating losses by the enterprises. A reduction in claims can also contribute to a negative figure. The reasons for negative figures may vary from one year to the next, e.g. with high dividend payments one year and a heavy operating loss and sales of operational units the next year. For further information, see the website of the Central Bank of Iceland: http://www.sedlabanki.is/?pageid=488.

related financing and investment markets (Nordic-IFC Symposium 2008). Clearly, such gatherings are important for the Icelandic private sector, and in fact Iceland led the discussion on geothermal energy at the meeting.

There is no doubt that, from a technical standpoint, Icelandic companies could contribute to the enhancement of the existing infrastructure in emerging market economies. International investment opportunities could also be mutually beneficial for the private sector and the receiving country. Many of the world's largest untapped energy resources are in countries with potentially significant political risks. Given the risk involved, a discount rate needs to be applied that includes a measure of that political risk. A process that is too strict may result in under-investment with companies effectively leaving returns, while one that is not strict enough may result in over-investment and the inability to generate returns sufficient to cover the cost of capital (see, e.g., Tooman 2004, 62). Inappropriate project size and selection could have serious consequences for Icelandic companies. The services that IFIs offer for managing risks might therefore be more relevant for Icelandic investors now than in the past. This is especially the case with investments in cases where the projects have long repayment periods. If an Icelandic company invests in the energy sector in an emerging market economy, it must consider a long-term horizon to receive sufficient return on its investment. The investment contains a higher degree of risk simply because the company remains exposed to risk for a long period of time.

5. What is country risk?

When business transactions occur across international borders, they carry risks that are not present in domestic transactions. These additional risks are called country risks. For an analysis of the country risk associated with cross-border investment, see, for example, Meldrum (Meldrum 2000). According to Meldrum, analysts have tended to separate country risk into six main categories:

Economic risk
Transfer risk
Exchange rate risk
Location or neighborhood risk
Sovereign risk
Political risk

Economic risk refers to a significant change in the economic structure or growth rate in the host country that may result in a major change in the expected return of an investment. *Transfer risk* is the risk arising from a decision by a foreign government to restrict capital movements. *Exchange Rate risk* is an unexpected adverse movement in the exchange rate of the host country's currency. *Location or neighborhood risk* includes spillover effects caused by problems in the region, in a country's trading partner, or in countries with similar perceived characteristics. *Sovereign risk* involves whether a government will be unwilling or unable to meet its loan obligations, or is likely to renege on loan guarantees. Finally *Political risk* concerns risk of a change in political institutions stemming from a change in government control, the social fabric, or other non-economic factors (for more detail, see Meldrum 2000).

International financial institutions tend to focus on guarantees against political risks (non-commercial risks). However, it must be borne in mind that the risk categories mentioned above overlap. Economic risk, for example, overlaps with political risk, since both involve policy. Sovereign risk is connected with political risk, since a government decision not to honor its commitments could be taken for political reasons, etc.

The World Bank's Multilateral Investment Guarantee Agency (MIGA), for example, provides guarantees to foreign investors against losses caused by non-commercial risks, such as expropriation, currency inconvertibility and transfer restrictions, war and civil disturbance, or breach of contract. MIGA also provides investment dispute mediation upon request. Thus, MIGA acts as an umbrella of deterrence against government actions in emerging markets that could disrupt investments, and its role allows it to influence the resolution of potential disputes. The presence of the World Bank's International Financial Corporation (IFC) in private sector projects can also provide reassurance to investors in emerging markets. The institution assists with negotiations and its participation provides a measure of political risk cover. Furthermore, it assists firms with risk management such as intermediation of currency and interest rate swaps, and provisions of hedging facilities (World Bank 2003). Such services, including dispute resolution, can certainly be of value for firms from small states that operate in emerging market economies. The services of these institutions and other IFIs will be discussed further in the following sections.

6. The World Bank Group and the private sector

The World Bank was established in 1944 and has its headquarters in Washington, DC. Iceland was among its founding members. It was founded to help with the reconstruction of Europe after World War II. In recent decades the bank has served developing countries and middle income countries. It consists of five institutions:

The International Bank for Reconstruction and Development, IBRD, established in 1944.
The International Development Association, IDA, established in 1960.
The International Finance Corporation, IFC, established in 1956.
The Multilateral Investment Guarantee Agency, MIGA, established in 1988.
The International Centre for Settlement of Investment Disputes, ICSID, established in 1966.

The first two institutions, the IBRD and the IDA, primarily serve the governments of developing and emerging market economies. The IBRD (http://www.worldbank.org/ibrd) provides loans, guarantees, and analytical and advisory services to middle income countries. These include, e.g., most Central and Eastern European countries and the Baltic States. The IBRD provides loans to the public sector on terms that usually are more favorable than the market and the institution requires government guarantees for its loans. Private companies cannot borrow from the IBRD, but since it demands international competitive bidding for its projects, they can participate in the projects and offer consulting services. The international Development Association (http://www.worldbank.org/ida), provides loans to the poorest developing countries on concessional terms. Like the IBRD, the IDA provides loans to the public sector and demands government guarantees. IDA loans carry zero interest rates and have a 10-year grace period, and the repayment period is up to 40 years. Many Sub-Saharan African countries borrow from the IDA. As with the IBRD, private sector companies can participate in bidding for projects and offer consulting services to the IDA. In addition to the loans for projects, the IBRD and IDA provide loans to support structural adjustment. These include conditions on the reform of economic policy and governance in the receiving countries.

The IFC, MIGA and ICSID primarily serve the private sector. The International Finance Corporation (http://www.ifc.org) promotes sustainable private sector investments in emerging markets. It is the largest multilateral provider of financing for private enterprises in developing countries. It provides equity, long-term loans, loan guarantees, structured finance and risk management products, and advisory services to the private sector in emerging markets. The IFC does not require government guarantees for its projects and only invests in viable projects. It can assist private companies to mobilize capital from other sources, facilitates trade and helps clients improve social and environmental sustainability. It also provides technical assistance and advisory services to governments and businesses. It can be said that the presence of the IFC in projects reassures investors in emerging markets. The institution assists with negotiations and its participation provides a measure of political risk cover. IFC participation can be a catalyst for other investors to participate in projects in emerging markets. The IFC administers technical assistance trust funds which are financed by donor countries and fact constitute grants from developed member countries to emerging market economies. One such fund is financed by the Icelandic government. Technical assistance trust funds provide finance for, e.g., the preparations of feasibility studies and technical advisory services on privatizations. They are administered under IFC rules but in cooperation with the contributing donors. The IFC has operated an advisory service for foreign investment (Foreign Investment Advisory Service, FIAS) since 1985 (http://www.fias.net/). The FIAS provides governments of emerging markets with advice on legislation, policy formulation, regulation and institution building for foreign investment. It offers a comprehensive range of services tailored to governments' needs to help them improve their investment climate for domestic and foreign investors and maximize poverty reduction.

Concerns about investment environments and perceptions of political risk often inhibit foreign investment, with the majority of flows going to a few countries and leaving the world's poorest economies ignored. The Multilateral Investment Guarantee Agency provides guarantees against political risk, i.e. non-commercial risk[5], for investments in emerging markets. It also provides technical assistance and dispute mediation services. For large infrastructure projects, including those in the energy sector, investors must pay considerably more attention to political risk management issues. It is clear that a guarantee in this area will reduce the risk of foreign investment for firms. Risk reduction can reduce the cost of funding projects and facilitate longer loan periods. Political risk insurance, especially from multilateral agencies, may act as an effective deterrent against host government interference in insured private investments. Developing countries would hesitate to take measures that would negatively affect projects that the MIGA is involved with because of the concern that it could adversely affect their relationship with the IDA and/or the IBRD and possible credit or a loan (see, e.g., West 1999, 29-30). If disputes do arise, the MIGA's leverage with host governments frequently enables it to resolve differences to the mutual satisfaction of all parties.

Finally, the role of the International Centre for Settlement of Investment Disputes (http://www.worldbank.org/icsid), is to provide support to resolve disputes that can occur in connection with investments by firms from member countries in another country. Thus, the ICSID helps encourage foreign investment by providing international facilities for the conciliation and arbitration of investment disputes, thereby helping to foster an atmosphere of mutual confidence between states and foreign investors.

The World Bank also operates a Municipal Fund (http://www.ifc.org/municipalfund) to facilitate cooperation between the private sector and municipalities. This does not require central government guarantees. The fund supports investments in electricity, power, water and transportation and could therefore be an appropriate venue for cooperation for Icelandic companies.

The World Bank conducts research on the business and investment environment of its member countries. Each year it publishes the Doing Business report (www.doingbusiness.org), which provides information on the business and investment environment in most countries in the world (the 2009 report analyzed 181 countries). The report shows what countries have improve and what countries have not. Such information can be useful for private sector investors and provides encouragement for the governments to improve their environment to attract

5 Non-commercial risk coverages include: Transfer restriction and currency inconvertibility, expropriation, war and civil disturbance and breach of contract.

private sector investment. The indicators examined in the Doing Business report are:

Starting a Business,
Dealing with Licenses,
Employing Workers,
Registering Property,
Getting Credit,
Protecting Investors,
Paying Taxes,
Trading Across Borders,
Enforcing Contracts and
Closing a Business.

The Doing Business reports contain a detailed description of the methodology used for each indicator. In addition, extensive research is carried out and several research papers have been published (see www.doingbusiness.org). Obviously this information can be useful for investors in emerging markets, and the best investment opportunities are not necessarily in the countries that have the best business and investment climate, but rather in those countries that have problems, but are improving rapidly. For example, this is the case with many countries that are involved in accession negotiations with the European Union. The fact that the Doing Business report is published yearly encourages governments to engage in policy reforms and in the implementation of those reforms.

As has been shown above, the services provided by the World Bank are extensive. The World Bank is the largest IFI and is very influential in dialogue on economic reconstruction in emerging markets. It focuses on partnership with the private sector and an improved business and investment climate. In its efforts to improve economic policy and governance in developing countries it often works closely with the International Monetary Fund, IMF.

7. The European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development was established in 1991 after the fall of the Soviet Union. Its role is to assist with the transition of Central and Eastern European countries and members of the Commonwealth of Independent States from centralized economies to market economies. Like the IFC, the EBRD provides loans, equity, and guarantees for private sector projects in emerging markets. Iceland was one of the founding members of the EBRD. Relations with the EBRD are handled by the Ministry of Commerce, not the Ministry for Foreign Affairs, which is the case with the World Bank Group.

The Ministry of Commerce organized a meeting with EBRD representatives in March 2007 (Morgunblaðið 2007) at which the agenda focussed on the new business and investment opportunities in Russia, and Eastern and Central Europe, particularly in the financial and energy sectors. Many opportunities are related to the ongoing privatization in these regions. The EBRD also offers advisory services and funding in the form of loans or equity investments. It is clear that after 17 years of operating in Eastern and Central Europe and in Central Asia, the EBRD has accumulated a great deal of knowledge opportunities and the possible pitfalls in these regions.

At the meeting in March 2007, the EBRD representatives gave priority to partnerships with firms that are doing business in Russia, Eastern and Central Europe and companies interested in investing in this region. The EBRD could be an attractive partner for firms that want to reduce risks in their business in this region and need to mobilize funding for new projects and for expansion.

8. The regional development banks

Iceland is not a member of the regional banks discussed below. These are the Asian Development Bank (AsDB), the Inter-American Development Bank (IDB) and the African Development Bank (AfDB). In the discussion that follows I will focus on what these banks have to offer and some of the issues that need to be considered by Iceland should it consider membership.

8.1 The Asian Development Bank

The Asian Development Bank was established in 1966 and has its headquarters in Manila in the Philippines. The AsDB increasingly concentrates on cooperation with the private sector in Asia and in the Pacific: “Only the private sector can provide the trillions of investment dollars needed in the foreseeable future.” (Asian Development Bank 2008a). Regarding financing for the private sector, the AsDB invests in equity in the private sector and provides loans and guarantees, including political risk guarantees. The bank focuses on reconstruction in the financial sector and in infrastructure in the countries where it operates (Asian Development Bank 2008b, 11-12). Infrastructure investments that receive priority from the AsDB include projects in the energy sector.

The fact that the AsDB has extensive experience in the financial and energy sectors in Asia should be an ample reason for Iceland to consider membership. Membership would give the Icelandic government, and also the private sector, greater access to information on the emerging markets in Asia, and Icelandic companies could use the financial products, technical assistance and advisory services offered by the AsDB, participate in competitive bidding and offer consultant services. It should be borne in mind that the AsDB has operated in Asia for over 40 years and has cooperated with the private sector there for 25 years. It is owned by 67 countries both in and outside Asia. This broad ownership reduces the risk that the host government will negatively affect investment projects in which the AsDB participates. AsDB participation in projects provides a certain stamp of approval that host governments appreciate. The bank has an ongoing dialogue with its member states in the sectors in which it invests in and it can promote a better business and investment climate in the host country and help reduce or eliminate impediments that private firms may face and would have difficulty handling on their own. The Bank also has an extensive network into the financial sector companies and other companies that can be useful for the projects that it participates in (Asian Development Bank 2007, 7-8).

All the Nordic countries, except Iceland, are members of the AsDB. Although the Icelandic government has sent numerous business delegations to Asia, with the participation of cabinet ministers, the Ministry for Foreign Affairs has not made any kind of feasibility study regarding membership. As with other international financial institutions, part of such a feasibility study would be to examine the terms and the loans the bank offers, and the cost of its other services. This could, of course influence the final decision about whether or not membership would be sought in the end.

8.2 The Inter-American Development Bank

The Inter-American Development Bank was established in 1960 and has its headquarters in Washington, DC. It serves both the public and the private sector. The IDB has a Private Sector Department that was established in 1994 and provides loans and guarantees to the private sector without government guarantees. In addition to this, the IDB has two institutions that serve the private sector:

the Inter-American Investment Corporation (IIC), established in 1986, and
the Multilateral Investment Fund (MIF), established in 1992.

The IIC invests in equity and provides guarantees and loans to the private sector, and the MIF provides technical assistance, amongst other things (Inter-American Development Bank 2008). When the bank provides loans to the public sector, and engages in policy dialogue, it strives to establish a better business and investment climate for the private sector. In fact, the IDB considers unfavorable business and investment climates as being among the most serious impediments for private sector growth in Latin America (Inter-American Development Bank 2004, 3). The IDB focuses specifically on reform because it is difficult for private firms to influence government policy in emerging markets (Inter-American Development Bank 2004, 20).

The IDB has strengths that the Icelandic government should keep in mind when considering membership. Over the years, the IDB has developed strong relations with governments in Central and South America and can influence government policy if it threatens private companies. It has worked with the private sector in its region for more than 20 years and has acquired experience and connections that can be of value to companies, and draws on support from member states both in and outside the region. The IDB is able to provide long-term funding and help mobilize funding from other institutions and firms in the region. Membership of the IDB reduces political risks for investors. As with other institutions, the companies that work with the IDB should evaluate the costs involved when doing business with the IDB, including the cost of loans, guarantees, technical assistance and advisory services.

8.3 The African Development Bank

The African Development Bank was established in 1963 and has its headquarters in the Cote D'Ivoire. It offers similar services similar to those offered by the other regional development banks, i.e. loans, equity investments, advisory services, etc. In addition, AfDB membership could be useful to Icelandic businesses as it would open up opportunities for them to participate in competitive bidding. Most Icelandic bilateral development contributions have so far gone to Africa, and this is likely to continue in the future. AfDB membership could result in increased cooperation with the AfDB and better access to information, which would be of use when countries are selected for development cooperation. Membership could also give better access to African leaders, which could be useful for Icelandic development cooperation and reconstruction led by the private sector.

Conclusions

Why have Icelandic companies so far shown little interest in using the services of international financial institutions and in seeking partnership with them in emerging markets economies? One reason is that Icelandic firms have not yet invested much in emerging markets where IFIs are active. Icelandic companies and their projects have been small in a global context. The government has shown little interest in contributing to development cooperation and devoted limited funding and few human resources towards its relationship with IFIs. Thus, knowledge of IFIs is limited, both in the government and in the private sector, and in fact Iceland is not a member of certain key institutions, e.g. the AsDB, the IDB and the AfDB. The government has not even conducted a feasibility study to assess the potential costs and benefits of membership in the regional development banks.

The situation has been changing in recent years. Increasingly, Icelandic firms are going through a process of internationalization and are becoming larger than before. Examples of this are particularly evident in the energy sector. Investments in the energy sector are often capital-intensive and have long repayment periods. The profitability of such investments can be influenced by the decisions of the host governments during the lifetime of the projects. This is one important reason for Icelandic companies to work in partnership with IFIs as part of their risk-management strategy. The ongoing financial crisis is likely to delay investment plans that Icelandic energy companies have made and will certainly make project financing in emerging markets more problematic than before. Consequently, investments in partnerships with international financial institutions could be an option that Icelandic firms will increasingly need to consider.

It is clear that knowledge concerning the IFIs of which Iceland is a member is rather limited. Iceland also needs to seriously consider participating in other IFIs. In this context, cooperation with the other Nordic and the Baltic countries could be useful, as has been the case with the World Bank Group and the European Bank for Reconstruction and Development. The Ministry for Foreign Affairs should consider allocating more funds to build up a relationship with IFIs, including the institutions and departments within the IFIs that serve the private sector.

It could be useful to make greater use of Icelandic experts to cooperate with the IFIs as consultants with financial support from the government of Iceland. Universities could also play a larger role in education and research related to the role and operations of IFIs. Icelandic universities could assist the government in making feasibility studies on membership of IFIs and examining the usefulness of the instruments they offer to the private sector.

Membership of, and cooperation with, IFIs could be particularly worth considering for small states like Iceland as a means of reducing risk, especially where knowledge about the economy, culture, politics, etc., is limited. In some cases, the Icelandic government has weak diplomatic ties with emerging markets economies in which Icelandic companies are planning to invest, and in many cases it does not have embassies in those countries. In the event of a dispute, a small country like Iceland does not have the same leverage as large states and partnership with IFIs could therefore be of advantage. Thus, partnership with IFIs could reduce risks both for the private sector and the government of Iceland.

Obviously, the costs of working with IFIs must be weighed against the potential benefits. Their services are not a free lunch, and loans, advisory services, and guarantees cost money. The price of these services will influence the final decision on whether or not it is feasible for Icelandic companies to work with IFIs in emerging markets.

Besides cooperation with IFIs, there could be alternative ways for Icelandic investors to learn more about, and minimize, risks when working in emerging markets, and perhaps at less cost. An obvious one is for Icelandic entrepreneurs to work within international consortia, for example choosing Nordic partners or partners who are closer to, and more likely to be knowledgeable about, the target region.

Finally, cases of Icelandic private sector cooperation with IFIs are few and far between and no studies can be made at this stage that would yield statistically significant results. However, the examples given in this article show that there already are some Icelandic companies taking their first steps in working in partnership with the IFC in emerging markets.

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