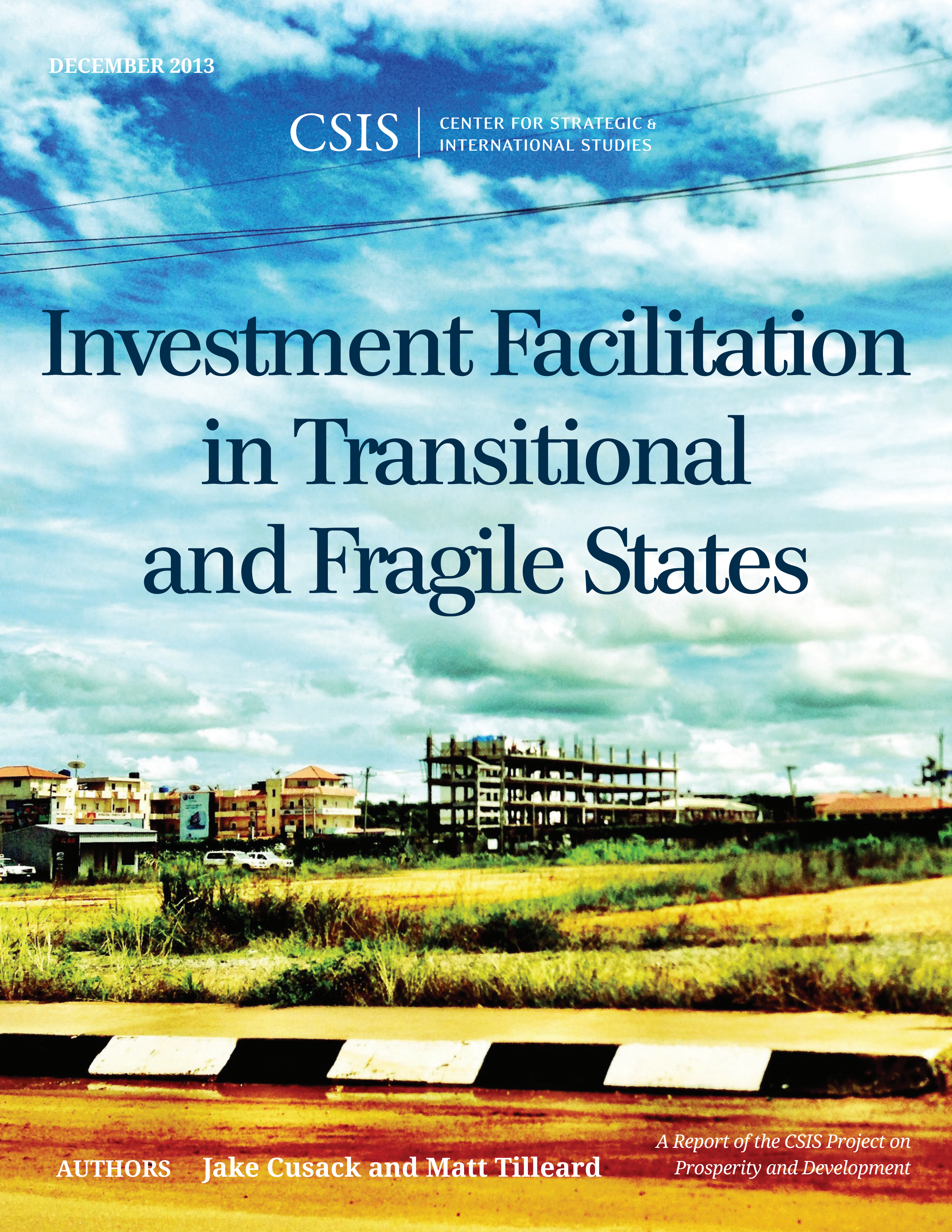

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Investment Facilitation in Transitional and Fragile States

AUTHORS Jake Cusack and Matt Tilleard

A Report of the CSIS Project on Prosperity and Development

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Contents

Executive Summary

This paper outlines a new tool for policymakers to deploy to encourage private-sector development in developing nations. Specifically it argues that in fragile states there are systemic failures that cause an intermediation gap between sources of capital and entrepreneurs seeking investment. This gap prevents investment by raising transaction costs and exacerbating information asymmetry. We present a case study of this gap as observed in our work in South Sudan. Then we propose a model of investment facilitation that bridges the intermediation gap. The model is based on donor funding of a neutral nongovernment facilitator to identify attractive investment opportunities, link them to capital, and facilitate transactions.

Investment Facilitation in Transitional and Fragile States

Jake Cusack and Matt Tilleard

Investment into Fragile States Is Vital

In March 2013 the Center for Strategic and International Studies published *Our Shared Opportunity: A Vision for Global Prosperity*.[1] The report was the result of a year of consultations among the Executive Council on Development—a group of government, business, nongovernmental, and philanthropic leaders convened to consider the role of the private sector in U.S. development policy.

The report observed that the private sector was the key lever by which the United States engages developing countries and identified the need for the U.S. government to bring "a stronger focus on broad-based growth and private-sector-led development." It tasked policymakers with seeking new ways to leverage the private sector to achieve our foreign policy goal of promoting economic development.

Core to this goal is the attraction of foreign and private investment into developing nations. Such investment is already a much more significant source of capital than official assistance to developing nations. *Our Shared Opportunity* called for the U.S. government to seek further means of leveraging its programs to attract investment into developing nations.

Within that context, this paper emphasizes that "developing nations" are not a homogenous entity. Many developing economies are already defined as "emerging markets" and are established destinations for investment. Smaller and less developed "frontier markets" are also beginning to see large international capital flows. Yet post-conflict and conflict-affected markets remain relatively isolated from broad-based investment. These "fragile states" urgently need foreign capital, yet they struggle the most to obtain it. The capital that does enter fragile states is generally directed to resource extraction, infrastructure, and servicing foreign aid presence. These are necessary investments but are not sufficient to create the broad-based economy essential to sustainable growth and lasting peace.

This paper presents an analysis of the barriers to investment in fragile states, based on our experience operating as investment advisers in markets across Africa, the Middle East, and Asia. It argues that most of these barriers are being addressed by current development interventions. However, there are obstacles at the firm level that remain unaddressed by current tools and lead to paralysis in the investment ecosystem. As a

[1] CSIS Executive Council on Development, *Our Shared Opportunity: A Vision for Global Prosperity* (Washington, DC: CSIS, March 2013), http://csis.org/files/publication/130304_Nesseth_DevCouncilReport_Web.pdf.

case study, we briefly illustrate how these barriers have acted in South Sudan. The paper then proposes a new tool for development agencies to deploy in attracting capital into fragile states.

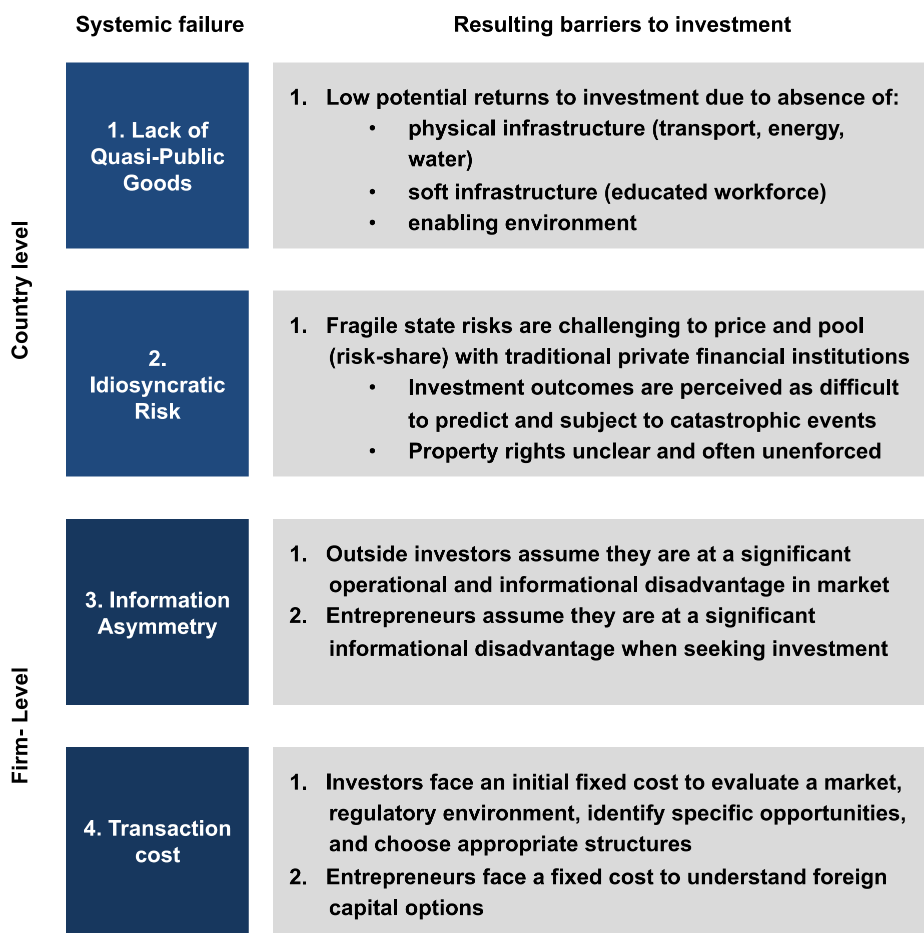
Four Barriers to Investment in Fragile States

Given the will of the U.S. government to encourage private-sector investment in fragile states we must consider the available tools to do so. A useful starting point is the existing barriers to investment in these markets.

Four Failures Discourage Investment in Fragile States

The barriers to investment in fragile states are wide ranging and overlap in their symptoms, fundamental causes, and possible solutions. The framework in Figure 1 characterizes the most important barriers to investment in fragile states and the systematic failures that are their underlying cause.

Figure 1: Systemic Failures That Prevent Investment in Fragile States

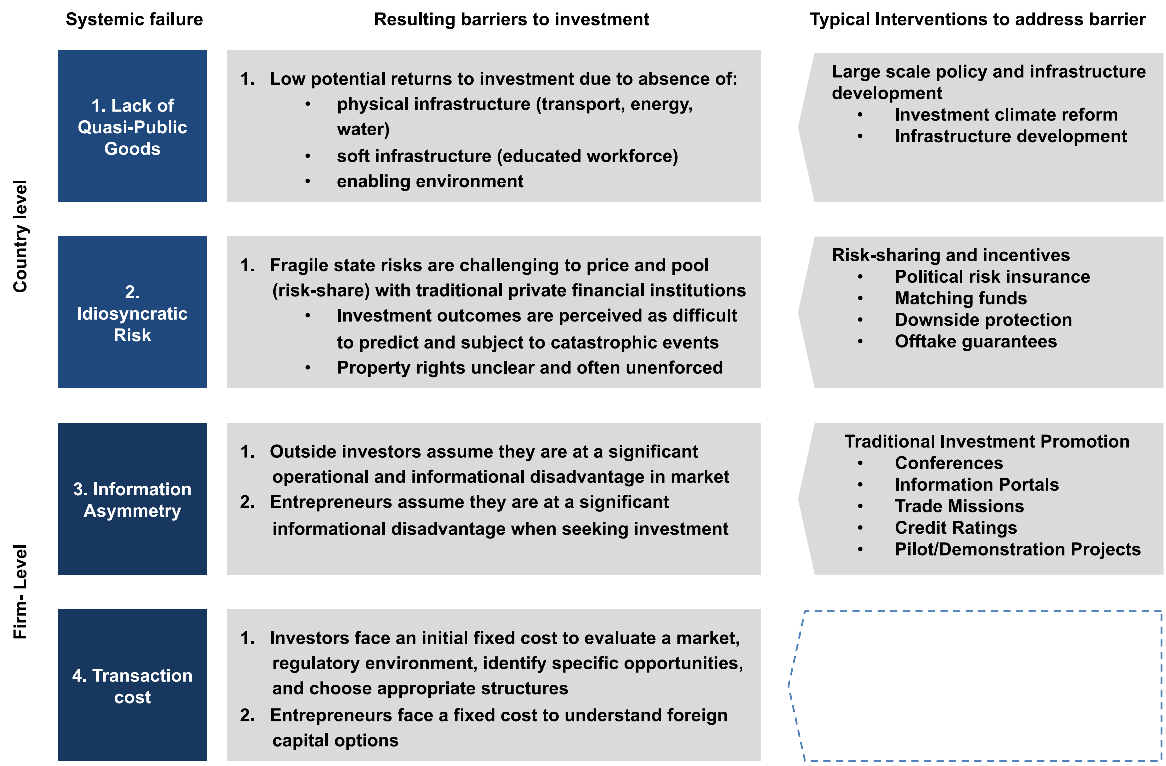


The first two barriers operate at the country level, presenting a broad disincentive to investment. The second two barriers operate at firm-level decisionmaking. Together these four barriers prevent adequate investment into broad-based growth in fragile states.

Country-level Failures Are Being Addressed, but Firm-level Costs Are Neglected

U.S. government policymakers recognize that the systemic failures preventing investment in fragile states are a major constraint to growth. Policymakers are especially *cognizant of the country-level barriers* described above and already undertake interventions to address these failures. The most important existing interventions are depicted in Figure 2.

Figure 2: Typical Interventions Addressing Each Systemic Failure



This wide range of interventions includes investment climate reform and offering incentives to offset uncertainty and the low availability of quasi-public goods. Traditional investment promotion acts as a country-level intervention that also partially addresses firm-level information asymmetry. Broadly, however, the third and fourth types of barriers are generally ignored.

Firm-level Constraints: Neglected Barriers

Firm-level constraints remain unaddressed because they are poorly understood. However, our experience working directly in fragile states leads us to believe that the firm-level constraints of high transaction costs and distrust due to information asymmetry form substantial barriers to investment.

Transaction Costs Are a Barrier to Investment

High firm-level transaction costs prevent investors and entrepreneurs from connecting in these markets. These costs manifest in three main forms:

- *Investor costs:* Outside investors cannot justify investing the fixed cost to assess the investment climate, determine macroeconomic potential, and undertake sourcing of potential opportunities, particularly in shallow markets with limited deal sizes. Instead they invest in markets they already understand.

- *Sponsor costs:* Entrepreneurs cannot justify the fixed cost of understanding their available capital options and gaining the skills to represent themselves in a transaction effectively. This is exacerbated by the huge complexity of potential capital options in fragile states, where multiple donors and financial institutions provide competing options of debt, quasi-debt, equity, guarantees, grants, and procurement agreements.

- *Deal costs:* There are insufficient transactions to create common legal and practical templates and norms on which future transactions can be modeled.

Fixed costs to both investors and sponsors appear to prevent otherwise economically beneficial transactions. These transactions could have resulted in jobs, knowledge transfer, income growth, and structural improvements in the economy.

In developed and emerging markets high transaction costs are also a potential systemic failure. However the identified gap is largely nonexistent for two reasons: First, *markets are more transparent*. Due to better provision of public goods, information is freely available and many “templates” and rules of the game are clearly understood and established by precedent. Second, *specialist intermediaries such as investment banks and investment advisory firms fill the remaining gap*. These intermediaries overcome the fixed cost on each side of the transaction by aggregating opportunities and socializing these fixed transaction costs across the multiple investors, sponsors, and deals that exist in deep and liquid markets.

However, such intermediaries generally do not operate in fragile states. The cost of entry cannot be justified as neither the “buy” nor “sell” side of the typical transaction is willing or able to provide sufficient fee or retainer income. Intermediaries do exist, but they are generally better described as “brokers” who add value only through insider relationships. These brokers often have hidden incentives and do not provide technical support. Substantive intermediaries who provide neutral and data-driven recommendations to both sides are largely absent. This is particularly true within the sectors that will lead to robust broad-based growth. This absence obstructs otherwise economically beneficial deals from being struck.

Firm-level Information Asymmetry Is a Barrier to Investment

At the firm level, distrust due to perceived information asymmetry forms another powerful barrier to investment. Policymakers have sought to address information asymmetry by making more information available through investment promotion. However, in fragile states information asymmetry is more than just distorted perceptions and the lack of reliable accessible data. Instead, the connective tissue of social capital has eroded and the default position of entrepreneurs and investors is distrust. Distrust on the part of investors is commonly discussed and expected. Yet sponsors are often also unsure they are receiving fair terms. For example, even in emerging markets such as Malaysia, it can be difficult to manage entrepreneur expectations as they transition from family-funded businesses to accepting international capital. Outside investors often have certain presumptions on minority shareholder rights and valuation that may be unfamiliar or seem onerous to local companies. Without access to third-party advisers who can screen and signal that *both* parties and their offerings are credible, dialogue is difficult to begin. If discussions do commence, they often break down due to rumor or mistranslation.

The Identified Firm-level Barriers Prevent Investment

In summary, two significant barriers to investment operate at the level of the firm. In fragile states, high transaction costs and firm-level information asymmetry are systemic failures that create a barrier to otherwise economically beneficial transactions. Both barriers have been neglected by policymakers but could be addressed by trusted intermediaries that (1) socialize high transaction costs and (2) screen and signal credibility between parties. However, such intermediaries are largely absent from fragile states.

These firm-level constraints provide an explanation for a common paralysis: development banks stand ready with low-cost financing; international political risk guarantees provide comfort; vocational schools have educated the required labor; large-scale development has improved input factors (electricity, transport infrastructure); and the investment authority has widely promoted the most attractive sectors. Yet, investments are not happening.

Notably, this scenario also exists in reverse. The market quickly utilizes donor incentives and guarantees when intermediaries and networks are already in place. To state this more bluntly, donor incentives are most likely to be drawn down in the markets where they are not as necessary. For example, a development credit authority (DCA) guarantee recently issued by the U.S. Agency for International Development (USAID) to a bank in Kenya, intended to last several years, saw its entire potential line of funds deployed in weeks. In contrast, similar DCAs from USAID stand ready but untapped in many fragile states.

We believe the absence of intermediaries is a key barrier to transactions in fragile states. Introduction of effective intermediaries will remove this substantial firm-level barrier to investment. Measures to fill this gap will also complement existing country-level interventions and enhance their effect.

Firm-level Constraints in the Field: Example of South Sudan

The function of transaction costs as constraints are best understood by direct example. We recently conducted interviews with major potential sources of capital for South Sudan and found compelling evidence for the action of firm-level constraints in preventing investment:

- *Private-equity firms, family offices, and impact investors:* Nairobi-, Kampala-, and Addis Ababa–based investment firms with a sub-Saharan remit all expressed strong interest in examining South Sudan deals if they were brought to them. This included willingness to make trips into Juba, the capital city, if a basic investment opportunity was confirmed. Regional investment firms had additional interest in entering through their portfolio companies. However, no firm consulted was willing to commit resources to actively seek opportunities in South Sudan.

- *Donor-financed institutions:* Donor-financed institutions have development mandates and are therefore more likely to sustain the fixed cost of market entry. The International Finance Corporation (IFC) is present and active in South Sudan. The Overseas Private Investment Corporation (OPIC) has an announced presence and is in talks with potential investors. The Norwegian Investment Fund for Developing Countries (Norfund) is investing both directly and through Kinyeti Venture Capital, an intermediary entity. However, as DFIs generally must take the passive approach of waiting for opportunities to be brought to them, most South Sudanese and regional entrepreneurs consulted were not aware of DFI capital. Even companies that are aware of DFI capital face significant fixed costs in acquiring the ability to access that capital.

- *Local capital:* Local capital involves less fixed cost for both investor and sponsor and is therefore the most common transaction. The problem is that bank capital is expensive, requires high levels of collateral, and is available on only restrictive terms. Related capital (friends and family) is the remaining option and commonly used. However, such capital is distributed on relationships and ethnicity. This entrenches elites and conglomerates, discourages innovation, and does not empower entrepreneurs to succeed on merit.

These firm-level constraints were further evidenced at a spring 2013 investment conference on South Sudan, hosted in Washington, DC. Private-sector investors and multinational company executives mentioned that South Sudan was one of many African countries where they were considering devoting resources. But they said it often took months to hear back from local companies or the government of South Sudan. Even when eventually provided, the information received was difficult to understand and lacked specifics. Because of this disconnect, the investors focused their efforts on other countries. Conversely, South Sudanese stakeholders and companies noted their frustration at exchanging contact details with interested international investors but seldom receiving any follow-up.

It seemed that potentially economically beneficial transactions were languishing in South Sudan. The fixed costs on either side of the transaction were too great for either side to commit to the required concentrated effort to overcome. Incoming investment has been largely limited to extractive and aid-driven sectors and connected local elites.

High transaction costs for both investors and entrepreneurs were driving a market failure that has prevented otherwise economically beneficial transactions from proceeding.

A Proposal to Address Firm-level Barriers

This paper proposes an intervention to address the intermediary gap in fragile states. Specifically it outlines an approach to Donor-Supported Investment Facilitation. This is an innovative tool that we have implemented with early success in Afghanistan and East Africa, including a recently begun two-year USAID-supported project to address the firm-level constraints seen in South Sudan.

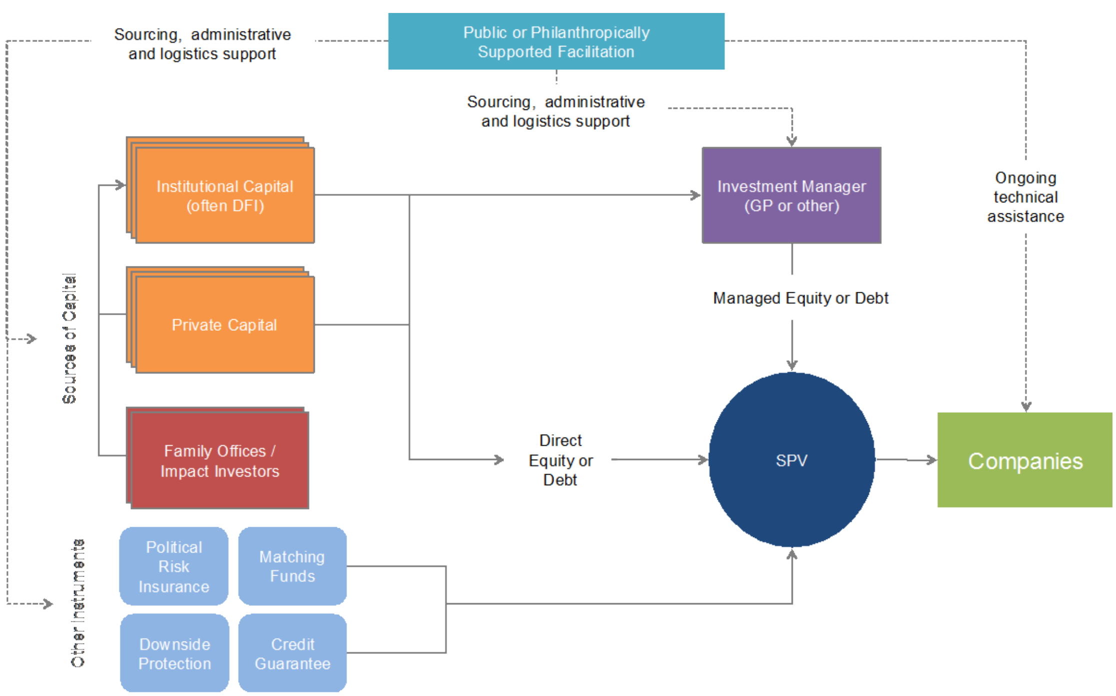
How Donor-Supported Investment Facilitation Works

Donors fund an intermediary firm to serve as an investment facilitator. The firm acts as a neutral arbiter of transactions between entrepreneurs and investors. This has two primary benefits.

First, donor financing enables the intermediary to absorb the fixed investor, sponsor, and transaction costs described above. Once the intermediary has absorbed these fixed costs, the firm is able to spread the benefit across multiple investors, sponsors, and transactions.

Second, intermediaries can also provide an independent, credible screen that assists to overcome the barrier of information asymmetry in fragile states. Figure 3 illustrates the intermediary role for a specific transaction. The intermediary acts as a facilitator bringing all the necessary parties to the table.

Figure 3: The Role of a Donor-supported Intermediary



Through directly reducing the immediate barriers of firm-level transaction costs, intermediaries directly catalyze beneficial transaction that may otherwise not have occurred

The process of catalyzing transactions also can create secondary benefits:

1. *Level the playing field for international investors seeking to follow Environment, Social, Governance (ESG) metrics, Foreign Corrupt Practices Act (FCPA), and other best practices:* Investors from the United States, United Kingdom, and many other countries are subject to strict compliance regimes, which are laudable but create an additional cost during diligence and in subsequently maintaining compliance. The work of an intermediary reduces some of these costs, allowing such investors to compete on equal footing with firms from origin countries with looser requirements.

2. *Test and prove the functionality of country-level reforms:* Country-level investment climate reform may result in new laws and governance infrastructure in form and theory. However, only by investors and entrepreneurs going through each stage of business investment and development can they prove the practical function of promised changes. The work of the intermediary can provide an independent window to donors, business, and local government to tangibly verify investment climate progress.

Principles and Tactics of Implementation

During our work, we have developed seven principles for effective donor-financed facilitation.

1. *Baseline requirements:* Not all countries are ripe for this type of investment facilitation. A basic level of security and governance is required. It must be possible to complete transactions in compliance with local, international, and origin-country law. In some cases, this means independent facilitation may be relevant in only a couple of cities or subarea of a country, or not at all.

2. *Fair and transparent process:* It is vital to ensure that assistance to both sponsors and investors is apportioned through a clear and transparent process. This implies a system of application for assistance open to all and clear published criteria for selection of investors and entrepreneurs to support. However, later stages of the process must also accommodate the standard period of exclusivity after an investor negotiates initial terms with an entrepreneur.

3. *Independent adviser:* Given the adviser is funded by a third party, the adviser can remain a neutral arbiter in the transaction. There should be no internal buy- or sell-side incentives. As with any advisory firm that serves multiple clients, potential conflicts of interest must be identified, disclosed, and actively managed, and include seeking informed consent from the affected parties.

4. *Small highly skilled team:* The scale of this activity is deliberately smaller than typical development projects. The objective is to catalyze high-potential projects at the firm level rather than conduct grand interventions. It is vital that the team is

small enough to benefit from shared knowledge and relationships. A countrywide intermediation team should generally have less than a dozen expatriate and local professionals. Team members must have the requisite backgrounds to be credible with top-tier international investors and the skills to build relationships with fragile state entrepreneurs and government actors.

5. *Structured for maximum impact on priority-constrained sectors:* The selection process should use market feedback but also a public-minded screen for transactions that will support broad-based growth. Size and scope should be tailored to strategic priorities of the donor and the extent to which the transaction would ease existing constraints. This implies extensive outreach so capital flows go beyond connected elites and other savvy entrepreneurs. The intermediary should seek to partner for catalytic effect, not just transaction completion.

6. *Focused on sustainability:* The purpose of the facilitation project is to create sustainable private capital markets that can operate without ongoing donor intervention. This contrasts to existing donor interventions that often set up entirely new organizations to deploy grant or investment capital, and that are then contractually wound down after three to five years. Instead, an appropriate intermediary acts as a temporary accelerator that leads to (1) investors establishing a permanent presence in market, (2) entrepreneurs forming outside relationships and gaining a greater understanding of available capital options, and (3) template transactions being established that smooth the way for later entrants. These elements guide a facilitation activity that forms lasting connective tissue in the investment ecosystem that will persist long after the donor intervention ends.

7. *Engagement with but not reliance upon government:* The relationship with the local government must be carefully managed. An outside donor, rather than host-country government, is the appropriate sponsor for this activity. The intermediary must be seen as independent by the government, investors, and investees. However, at the same time, the advisers must have a close relationship with the country's investment authority, supporting its capacity and synchronizing some investment promotion activities. Ideally, the local government will see the presence of the facilitation activity as a powerful enticement they can offer to the most credible outside investors.

These principles should be tested and expanded upon as this model of intervention is deployed in more fragile states.

Conclusion

Economic statecraft is a new priority for the United States. Support to the private sector can be an effective mechanism for leveraging official development assistance into a greater impact. The need for this support is most evident in fragile states where the systemic failures that prevent investment in development economies are most prevalent. U.S. government agencies are already undertaking interventions that address the most common systemic failures in fragile states. However, firm-level costs are a neglected barrier to foreign investment. This paper has outlined a model of donor-supported investment facilitation that broadens the suite of policy interventions to address firm-level constraints, such as transaction costs and information asymmetry (Figure 4). Removing these constraints will increase private investment in fragile states.

Figure 4: Proposed Suite of Interventions

	Systemic failure	Resulting barriers to investment	Typical Interventions to address barrier
Country level	1. Lack of Quasi-Public Goods	1. Low potential returns to investment due to absence of: • physical infrastructure (transport, energy, water) • soft infrastructure (educated workforce) • enabling environment	Large scale policy and infrastructure development • Investment climate reform • Infrastructure development
	2. Idiosyncratic Risk	1. Fragile state risks are challenging to price and pool (risk-share) with traditional private financial institutions • Investment outcomes are perceived as difficult to predict and subject to catastrophic events • Property rights unclear and often unenforced	Incentives and risk-sharing • Political risk insurance • Matching funds • Downside protection • Offtake guarantees
Firm- Level	3. Information Asymmetry	1. Outside investors assume they are at a significant operational and informational disadvantage in market 2. Entrepreneurs assume they are at a significant informational disadvantage when seeking investment	Traditional Investment Promotion + Credible Third Party Advisor • Independent screening mitigates adverse selection • Completed transactions signal credible players
	4. Transaction cost	1. Investors face an initial fixed cost to evaluate a market, regulatory environment, identify specific opportunities, and choose appropriate structures 2. Entrepreneurs face a fixed cost to understand foreign capital options	Investor focused facilitation • Proving pipeline • Direct exposure of key personnel • Focused technical assistance to catalyze transactions

Appendix: Historic and Current Examples of Donor-sponsored Intermediation Activities

While the types of intervention we suggest have not been widely employed, there are some historic and modern analogues.

The INOVAR program in Brazil: The Brazilian government's agency for innovation studied the local funding environment in 1999 and found specifically that "there was no effective bridge between investors and SMEs [small-medium enterprises]." They sought to design a project that would address many aspects of the environment simultaneously: "entrepreneurs needed to be trained in raising money and what to expect from VC investors; fund managers needed to be trained in raising and managing funds, assessing investment opportunities, and managing portfolio companies; and potential limited partners—particularly the pension funds—had to learn how to do due diligence on funds."[2] At a cost of around $13 million over a 10-year lifespan, supported by the Brazilian government, the resulting program has facilitated over $1 billion of commitments into Brazilian private-equity and venture-capital funds and another $2 billion invested into companies. As the industry has matured, government sponsorship has been reduced and the Brazilian Association of Private Equity and Venture Capital (ABVCAP) is filling the education and facilitation role. Considered key to their success was a facilitation team with appropriate private-sector backgrounds and focus on their role as an intermediary rather than directly investing into companies.

Department of Defense's TFBSO: Along with the DOD's Task Force for Business and Stability Operation (TFBSO) in Afghanistan, we implemented a structured program that develops, qualifies, and manages a pipeline of credible investment opportunities. The intermediation team then facilitates outside investor engagement with specific opportunities through both formal and informal avenues. Given the particular challenging environment, facilitation activities go beyond sourcing, due diligence, and investment structure support to include logistics assistance for outside firms and specific technical expertise relevant for investing growth capital into light manufacturing companies.

U.S. Agency for International Development's PCGA: The recently established Private Capital Group for Africa (PCGA), staffed by private-sector investment professionals rather than traditional development experts, seeks to engage investors, accelerate deal closings, and model sustainable transactions that can be replicated across Africa. Aspects of the USAID project include negotiating "as an independent advisor representing the transaction" and "identifying bankable transactions" that can be shown to strategic and financial investors. Though in its infancy, the team has been successful in encouraging interest in local investment from African pension funds and supporting transactions in the energy sector.

[2] Ann Leamon and Josh Lerner, *Creating a Venture Ecosystem in Brazil: FINEP'S INOVAR Project,* Harvard Business School Working Paper 12-099, May 8, 2012, http://download.abvcap.com.br/Anexos/Harvard/Artigo%20-%20HBS.pdf.

About the Authors

Jake Cusack is the founder of CrossBoundary, an investment and economic development advisory firm focused in frontier markets, including Afghanistan, Iraq, and South Sudan. He has a joint master's degree in public policy and an MBA from the Harvard Kennedy School and Harvard Business School. He is originally from Michigan, and graduated from the University of Notre Dame's Honors Program, subsequently becoming a Marine Corps officer. He served in Iraq from 2005 to 2008 in intelligence and special operations capacities; his military decorations include the Bronze Star, Navy Commendation Medal, and Combat Action Ribbon. Subsequently, Mr. Cusack worked as a geopolitical analyst for the U.S. government and at Abraaj Capital, a large emerging-market private-equity fund. He is on the board of the Harvard Leadership Institute, has written for the *New York Times*, *Harvard Business Review*, *Inc. Magazine,* and *Forbes*, and is a contributing author to the recent book *Passion & Purpose*. He has conducted extensive research in frontier markets, including Afghanistan and Iraq, with resultant reports published by the Center for a New American Security and Kauffman Foundation. He has spoken at the Council on Foreign Relations, Center for Strategic and International Studies, Center for Public Leadership, the U.S. Senate Foreign Relations and Appropriations Committees, and appeared on *National Public Radio*, in the *Wall Street Journal*, *Fortune*, and *Bloomberg Businessweek*.

Matt Tilleard is managing partner at CrossBoundary and holds a master's degree in public policy from the Harvard Kennedy School of Government and an MBA from the Stanford Graduate School of Business, where he studied as a Fulbright Scholar. He also completed a bachelor of laws (honors) and a bachelor of science at the University of Melbourne. Mr. Tilleard has extensive experience undertaking complex projects in the private and public sectors. At The Boston Consulting Group he designed evidence-based solutions to complex challenges in leading private-sector organizations. He also has significant development experience in difficult environments, with a particular focus on private-sector development. He was a key member of a team assembled by the Department for International Development (DFID) to establish the Afghan Investment Climate Facility. This Afghan-led $50 million facility was mandated to help remove barriers to private-sector development in Afghanistan. Mr. Tilleard served as a lead policy adviser to Noel Pearson, one of Australia's most influential indigenous leaders during a period of intense policy reform. He also conducted the institutional design of a $25 million Water and Sanitation Development Facility in Sierra Leone. He has worked for the United Nations in East Timor and at the Executive Office of the Secretary General in New York. He was a featured speaker at the *Aspen Ideas Festival*.

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