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June 26, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Foreign Direct and Portfolio Equity Investment in Developing Countries

Attached for consideration by the Executive Directors is a paper on foreign direct and portfolio equity investment in developing countries, which has been tentatively scheduled for discussion on Wednesday, July 18, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Lanyi (ext. (5)7401).

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INTERNATIONAL MONETARY FUND

Foreign Direct and Portfolio Equity Investment in Developing Countries

Prepared by the Research Department

(In consultation with other Departments)

Approved by Wm. C. Hood

June 22, 1984

Contents

Contents

Contents

Page

Appendix Tables

Foreign Direct and Portfolio Equity Investment in Developing Countries

I. Introduction

Since the early 1970s foreign equity investment flows into developing countries, 1/ although continuing to increase in absolute terms, played a less important role than in previous years, as foreign private capital flows were dominated by bank credit. Some observers have argued that this shift in the composition of private capital flows has increased the vulnerability of the developing countries to external payments difficulties. Moreover, it has also been evident that, with a relatively slow growth of bank lending to these countries in prospect for the medium term, other sources of external financing, including private equity investment, will need to be sought if the development effort is to resume its former impetus. With these considerations in mind, this paper examines the causes and consequences of the decline in relative importance of equity investment since the early 1970s and discusses the modifications in policies in both lending and borrowing countries that might be required to encourage a larger flow of such investment.

Direct investment refers to investment made to acquire a lasting interest and an effective voice in the management of an enterprise, while portfolio equity investment usually involves no significant influence over an enterprise's operations. 2/ In fact, portfolio equity investment in developing countries--although potentially of significance--has been relatively small up till now. Consequently, much of the paper will focus on direct investment, although many of the issues are common to both types of capital inflow.

One of the principal issues to be addressed is why the upsurge in private capital flows to developing countries during the 1970s largely took the form of medium- and short-term bank credits rather than foreign direct or portfolio equity investment. This increased role of banks in financial intermediation reflected ongoing changes in the structure of the international financial system that were accelerated by the increase

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1/ It should be noted that the term "country" used in this document does not in all cases refer to a territorial entity which is a state as understood by international law and practice; the term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

2/ Some of the guidelines used to distinguish between the two in practice are discussed in Appendix I.

in oil prices and the accumulation of substantial short-term deposits by the principal oil exporting countries. Much of the increased borrowing from banks was undertaken either by governments of developing countries, to finance balance of payments or fiscal deficits, or by state enterprises, often with a government guarantee, to finance their investment programs. It might have been difficult for foreign equity capital, which is more directly associated with private enterprise investment, to substitute for a substantial proportion of such borrowing, especially given the limited and fragmented capital markets that exist in most developing countries. Nevertheless, policies adopted by many developing countries seem to have contributed to a greater reliance on bank credit rather than foreign equity investment. For instance, the existence of restrictive policies toward foreign private investment in many developing countries appears to have played a significant role in preventing a major increase in flows of equity investment.

The composition of capital inflows can have important consequences for a country's adjustment process. Most important, the distribution of a country's external liabilities between debt and equity instruments can significantly affect its vulnerability to unanticipated changes in economic conditions. This is because, unlike interest payments on external debt, no payments are required on equity unless the investment earns a positive return, so that future expenditures do not have to be reduced to generate resources for repayment. However, the distribution of profits between remitted dividends and reinvested earnings also affects the short-term foreign exchange outflow and there are some indications that--at least during the recent recession--remitted dividends fluctuated less with changes in economic conditions than did reinvested earnings. Finally, it can be argued that a larger share of direct investment in capital inflows makes these flows more sensitive to a country's adjustment policies, since such investment often responds significantly to shifts toward more appropriate exchange rates and interest rates.

With regard to future prospects, a number of developing countries may find it advantageous to reappraise their policies toward foreign private investment, in the light of the sharp decline in new commercial bank lending since the onset of widespread debt-servicing difficulties. New net bank lending is likely to continue to be constrained, particularly for those countries with especially large amortization payments of rescheduled debt coming due over the next several years, and a greater emphasis on policies designed to attract direct and portfolio equity investment could offset part of the decline in bank lending.

Section II of this paper discusses trends in the size and composition of foreign private investment and in income payments on such investment. Section III considers some of the possible advantages and disadvantages of allowing foreign private investment a greater role in the development process, with the emphasis on policies of host countries that are likely to increase their net benefits from such investment. Sections IV and V describe the policies of host developing countries and capital-exporting industrial countries, respectively, toward such investment. Section VI discusses the influences of foreign private investment on a developing country's adjustment to economic disturbances, and Section VII considers future prospects for and policies toward such investment, in the context of the medium-term scenario for developing countries given in the World Economic Outlook. Section VIII outlines a few of the principal issues on which the Board may wish to focus during its discussion. Appendix I discusses some of the many problems involved in measuring direct investment flows, and Appendix II describes some of the restrictions and regulations concerning foreign direct and portfolio investment in the 25 major borrowing countries.

This paper is expository in nature. It does, however, raise a number of policy issues concerning the appropriate balance among the major forms of obtaining foreign capital, and in particular between equity investment and borrowing from commercial banks, that are of direct concern to the Fund.

II. Trends in Foreign Private Investment

Although foreign equity investment into developing countries continued to grow in absolute terms during the last decade, its declining importance relative to bank credit brought about major shifts in the composition of these countries' external liabilities, which (as discussed in Section VI) contributed to an increased vulnerability to economic disturbances. In addition, the industrial composition, means of financing, and forms of organization of direct investment all underwent structural changes during the last two decades, and these changes also influenced the role of such investment in the host developing countries.

1. Overall developments

Net inflows of direct investment into developing countries generally increased throughout the 1960s and 1970s. Direct investment flows from industrial to developing countries grew from an average of under $2 billion a year during the early 1960s to an average of around $9 billion a year during 1974-80 (Table A.1). However, their share in total capital flows declined substantially as external borrowing, particularly from commercial banks, grew rapidly. During the 1960s, direct investment accounted for well over half of all private capital flows from industrial to developing countries, but by the late 1970s it represented barely one quarter of a much larger volume of such flows, most of which took place through medium-term bank lending or export credits.

Although the rapid expansion of commercial bank lending to developing countries was already under way before the first large increase in oil prices, that event accelerated the decline in relative importance of direct investment flows, since non-oil developing countries financed most of their larger current account deficits through external borrowing, while a number of oil exporting countries used part of their increased revenues to reduce the foreign-owned share of their oil industry. In 1973, direct investment flows still financed some 20 percent of the combined current account deficit and net accumulation of reserves of non-oil developing countries, but met an average of only about 12 percent of the substantially larger financing needs of later years (Chart 1). Nevertheless, net direct investment flows to non-oil developing countries did continue to grow after the first oil price increase, rising at an average rate of around 3 percent per annum in real terms 1/ through the 1970s, compared with an average annual real growth rate of around 5 percent for the combined GDP of these countries. This was only slightly less than the growth in gross direct investment inflows into industrial countries, which rose at an average rate of around 3 1/2 percent in real terms over the same period.

Net direct investment flows into non-oil developing countries reached a peak of some $13 billion in 1981, but fell substantially in 1982 and 1983 as a result of the recession (Table 1). Nevertheless, they were less severely affected by the recession than was borrowing from private creditors, falling by 40 per cent from 1981 to 1983, while net borrowing from private creditors fell by more than 70 per cent over the same period. The decline in direct investment appears to have been largely concentrated in Latin America, while other regions were only moderately affected.

The shift in the composition of financing of current account deficits is reflected in the changing structure of non-oil developing countries' external liabilities. The stock of foreign direct investment (at book value) is estimated to have grown at an average annual rate of 11 1/2 percent between 1973 and 1983 while total external debt grew at a rate of almost 18 percent 2/ (Table 2). Public and publicly guaranteed debt to financial institutions grew even more rapidly. Consequently, the share of direct investment in total gross external liabilities 3/ of non-oil developing countries declined from an estimated 26 1/2 percent in 1973 to 17 percent in 1983, while the share of public and publicly guaranteed debt to financial institutions rose from 10 percent to 26 percent. Expressed as a percentage of exports of goods and services, the stock of direct investment in non-oil developing countries declined from 1973 to 1983, whereas the stock of external debt grew quite rapidly (Table 2).

1/ Deflated by the index of wholesale prices in the United States.

2/ These figures understate the relative importance of the stock of foreign direct investment, since the current market value of most of such investment would be higher than its book value, which is based on historic cost.

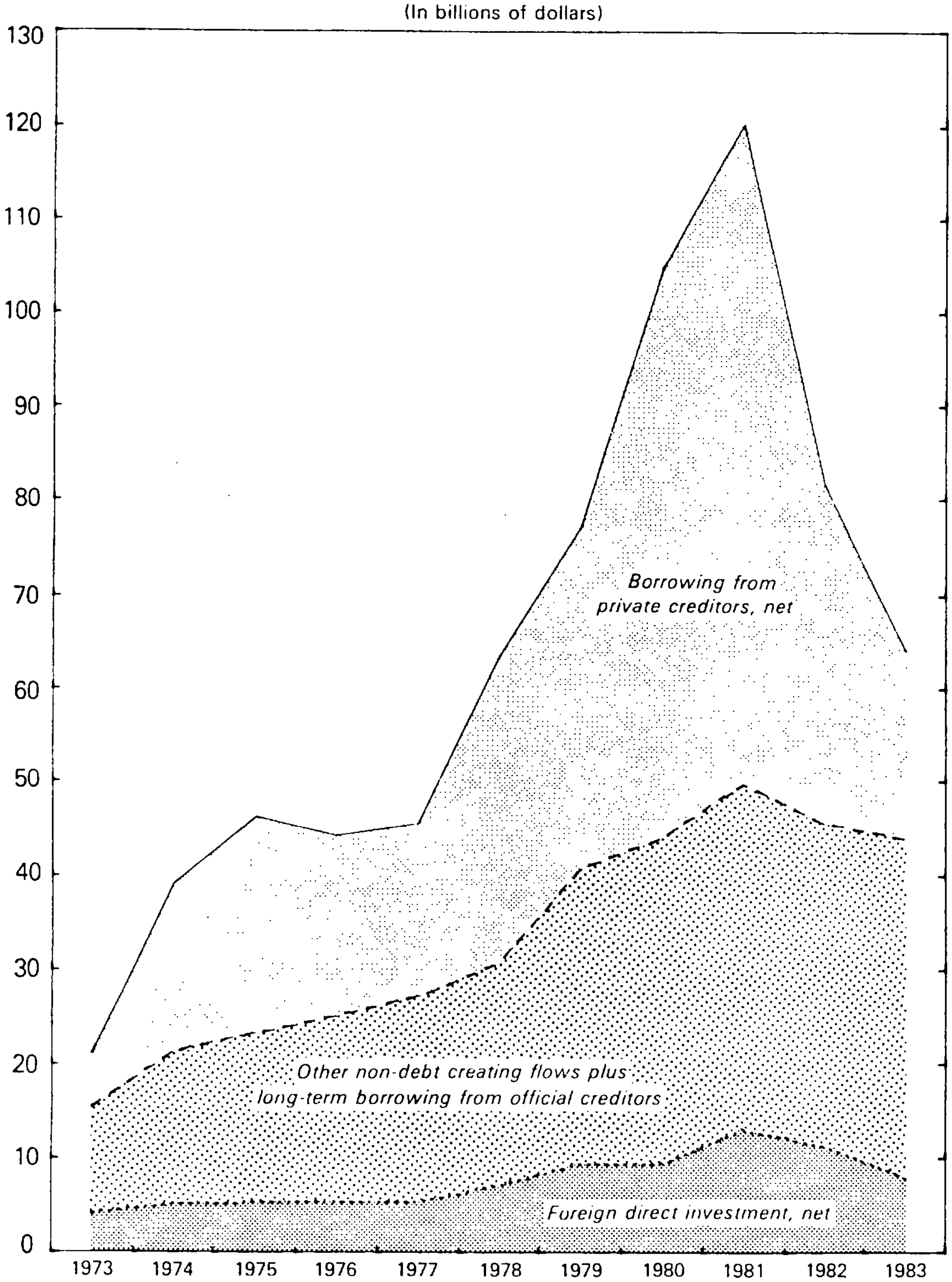
3/ Total external debt plus stock of foreign direct investment.

CHART 1

NON-OIL DEVELOPING COUNTRIES;

DISTRIBUTION OF FINANCING FLOWS[1]

(In billions of dollars)



Source: Table 1.

[1] Excluding reserve related liabilities and errors and omissions.

Table 1. Developing Countries: Composition of Financing Flows, 1/ 1973-83

(In billions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Non-Oil Developing Countries											
Direct investment flows, net	4.2	5.1	5.3	5.3	5.4	7.1	9.3	9.4	13.1	11.2	7.9
Other non-debt-creating flows 2/	5.5	9.3	6.9	7.5	8.7	9.9	14.4	14.7	14.1	12.7	13.4
Long-term borrowing from official creditors, net	5.7	6.8	11.0	12.3	13.1	13.8	17.0	20.0	22.6	21.6	23.1
Other net external borrowing 3/	5.6	17.9	23.0	19.2	18.4	32.8	36.5	60.6	70.5	36.2	20.2
25 Major Borrowers											
Direct investment flows, net	2.9	3.4	4.5	3.0	3.9	4.9	6.3	5.4	8.8	7.8	4.1
Other non-debt-creating flows 2/	2.4	4.5	2.4	3.7	3.2	3.8	6.7	5.0	4.0	3.7	3.9
Long-term borrowing from official creditors, net	4.4	5.2	8.3	8.7	8.9	8.7	9.9	11.8	13.0	12.1	14.0
Other net external borrowing 3/	5.4	12.4	18.7	19.0	20.4	37.1	37.7	53.3	61.1	36.6	19.1

Source: World Economic Outlook exercise.

1/ Excluding reserve-related liabilities and errors and omissions.
2/ Official transfers, SDR allocations, and valuation adjustments.
3/ Except for minor discrepancies in coverage, amounts shown reflect almost exclusively net external borrowing from private creditors.

Table 2. Non-Oil Developing Countries:
External Liabilities, 1973 and 1983

	Stock of Liabilities 1/ 1973	Stock of Liabilities 1/ 1983	Implied Average Annual Growth Rate, 1973-83
	(In billions of U.S. dollars)		(In percent)
Foreign direct investment 2/	47.0	138.0	11.4
Total external debt 3/	130.1	668.6	17.8
Short-term debt	18.4	102.2	18.7
Long-term debt	111.8	566.4	17.6
Official creditors	51.0	211.9	15.3
Private creditors 4/	60.8	354.5	19.3
of which:			
Financial institutions 5/	(17.3)	(209.6)	(28.3)
	(As percent of exports of goods and services)		
Foreign direct investment	41.5	30.9	
Total external debt	115.4	149.5	

Sources: OECD: Development Cooperation, various issues, and Geographical Distribution of Financial Flows to Less Developed Countries, various issues; 1984 World Economic Outlook; Occasional Paper No. 27, and staff estimates.

1/ End of year.
2/ Book value; net of disinvestments and nationalization.
3/ Excluding reserve-related credits.
4/ Including debt not guaranteed by government of debtor country.
5/ Guaranteed debts only.

These global trends mask a wide diversity of experience in individual countries, resulting from differences in both economic environment and policies toward foreign direct investment. Much of this investment is concentrated in a small number of countries that have large domestic markets, are rich in natural resources, or have significant advantages as a base for export-oriented production. Five countries (Brazil, South Africa, Mexico, Singapore, and Malaysia) accounted for one half of the estimated end-1983 stock of direct investment in non-oil developing countries (Table A.2). However, other countries with large domestic markets (such as India and Turkey) or that have successfully pursued an export-oriented development strategy (such as Korea) were much less reliant on direct investment. Among the major oil exporters, direct investment grew quite rapidly in Indonesia, but stagnated in most other countries, including Nigeria and Venezuela, partly as a result of government purchases of foreign oil companies' assets.

The wide variations in countries' reliance on direct investment are reflected in the share of such investment in gross external liabilities. 1/ At the end of 1983, direct investment was estimated to account for less than 5 percent of the stock of total external liabilities of Algeria, Korea, and Yugoslavia, but for over one third of liabilities for Malaysia and Hong Kong, almost one half for South Africa, and over 90 percent for Singapore.

Although little information is available on foreign portfolio purchases of equity in enterprises based in developing countries, such purchases appear to have been very small. For instance, the total stock of equity held by U.S. residents in corporations based outside North America, Japan, and Western Europe at the end of 1981 was estimated at only $575 million, 2/ a substantial proportion of which consisted of stock in companies based in Australia or in tax havens. Among the many causes for the slow development of portfolio equity investment in developing countries have been the restrictions on such investment in many of them. These are sometimes even more stringent than those applied to direct investment. However, although the overall size of such investment is still very modest, there has been some growth in recent years. A number of mutual funds were recently established, sometimes with the assistance of the International Finance Corporation, with the aim of investing in corporate equity of selected developing countries (such as the Mexico Fund and the proposed Korea Fund).

1/ Total external debt plus stock of foreign direct investment.
2/ Survey of Current Business, August 1982, p. 45, Table 3.

The United States has been the principal source of private direct investment in developing countries, although it declined in relative importance in recent years along with the two other traditional sources--the United Kingdom and France--while direct investment from Germany and Japan grew rapidly. The stock of U.S. direct investment in developing countries grew at an average annual rate of less than 10 percent during 1970-82, compared with growth rates of 17 percent and 21 percent for Germany and Japan, respectively. However, in 1982 the United States still accounted for almost half of the total stock of such investment (Table A.3). The stock of direct investment from the United Kingdom and France grew even more slowly, at less than 9 percent per annum during 1970-82, although direct investment from the United Kingdom grew more rapidly after 1979. During 1980-82, U.S. direct investment flows into developing countries averaged about $5 billion a year, U.K. direct investment around $1 3/4 billion a year, while investments from France, Germany, and Japan were each estimated to be in the range of $1-1 1/4 billion a year; together, the five largest source countries accounted for some 85 percent of direct investment flows from industrial to developing countries. 1/

There has also been a small but growing level of direct investment outflows from a number of developing countries, much of it directed to neighboring developing countries. The total recorded direct investment outflow from non-oil developing countries (excluding South Africa) amounted to an average of $640 million a year during 1980-82, compared with $120 million a year during 1973-75; Brazil, Korea, and the Philippines were the principal source countries 2/ (Table A.4). The outward flow of direct investment from South Africa also increased rapidly in recent years, to an average of around $1/2 billion a year. After the first large oil price increase a number of major oil exporting countries also increased their overseas direct investments, but this primarily took the form of acquisition of equity in existing companies in industrial countries.

2. Sectoral composition of foreign direct investment

The distribution across industries of foreign direct investment in developing countries has changed substantially during the last two decades, in response both to changes in economic structure and to policies designed

1/ OECD: Development Cooperation, 1983 Review, Tables J5, 6, and 8.

2/ These figures do not include direct investment outflows from Hong Kong and Singapore, which were substantial. For instance, the stock of Hong Kong- and Singapore-based direct investment in East Asian countries amounted to around $1 billion and over $1/3 billion, respectively, by the late 1970s. See Louis T. Wells: "Multinationals from Asian Developing Countries" in Research in International Business and Finance, Volume 4, JAI press, 1984.

to reduce the share of foreign capital in particular sectors of the economy. For each of four major source countries, the share of total direct investment in developing countries in petroleum and mineral extraction fell sharply, while the share in manufacturing and services rose (Table A.5). U.S. direct investment experienced the largest sectoral shift, as the share of the extractive industries in total investment fell from almost 50 percent in 1967 to 26 1/2 percent in 1980. Direct investment in agriculture, which accounted for only 6 percent of the stock of all foreign direct investment in developing countries in 1967, has become even less important in recent years.

The declining relative importance of direct investment in extractive industries was partly due to efforts of governments in a number of developing countries to increase domestic control of natural resources, either through nationalization of existing foreign-owned assets or through regulations restricting entry of new foreign capital into the sector. For example, since 1967 a large number of countries (including most of the major oil exporting countries as well as Bolivia and Peru) have partially or completely nationalized the local assets of foreign oil companies; foreign investment in oil production is also wholly or largely excluded in a number of other countries (including Brazil, India, and Mexico).

Much of the increased foreign direct investment in manufacturing industries of developing countries was undertaken primarily to serve growing local markets and often in response to trade restrictions imposed as part of a strategy of import-substituting industrialization. This was especially so in a number of Latin American countries, though not in some Asian countries (including Hong Kong, Korea, and Singapore) where more open trade policies encouraged manufacture for export. Majority-owned manufacturing affiliates of U.S. companies in Latin America exported only 6 percent of their total sales over the period 1966-76, whereas manufacturing affiliates in Asia had exports amounting to 24 percent of total sales. The contrast between the regions was even larger for Japanese-owned manufacturing affiliates. However, there are indications that, in recent years, the shift in some Latin American countries toward policies designed to improve external competitiveness has encouraged increased exports from both local and foreign investor-owned enterprises.

The services sector has attracted a growing proportion of direct investment, much of it concentrated in the finance and insurance industries as well as in trade and tourism. Direct investment in various public utilities, which was once considerable, particularly in Latin America, is now of minor importance. Their position as natural monopolies made them early candidates for nationalization, while regulated prices depressed profitability and discouraged new investment.

3. Financing of direct investment flows and changing forms of ownership

Direct investment flows can take the form of equity capital, reinvestment of earnings, or net short- and long-term borrowing from the parent company or its affiliates. Reinvested earnings generally constitute a large proportion of total flows. During 1975-82 they accounted for some 60 percent of all U.S. direct investment flows to developing countries, for over half of direct investment flows from the United Kingdom to all destinations, but for only 11 percent of total recorded German direct investment, reflecting that country's smaller initial stock of such investment. Many of the host developing countries do not collect information on reinvested earnings, but for a group of 12 non-oil developing countries 1/ for which data are available reinvested earnings represented an average of some 39 per cent of recorded direct investment during 1973-82.

Total net borrowing from the parent company or its affiliates accounted for an average of some 15 percent of all direct investment flows from the United States, 2/ compared with over 40 percent for Germany, but there were substantial year-to-year fluctuations in its importance. Part of the borrowing, even when classified as short term, is automatically rolled over and in practice forms part of an affiliate's permanent capital base. Another part, however, is much less stable and can be affected by short-term movements in exchange and interest rates; a substantial proportion consists of net payments due on trade with the parent company or other affiliates, and is akin to trade credit.

Direct investment capital generally provides only a proportion of the total financing requirements of a foreign-controlled affiliate. The affiliate can also sell equity in the host country and can borrow from third parties, either locally or abroad. Although external borrowing undertaken directly by affiliates of foreign companies is classified as external debt, it would often not be possible without the direct investment relationship between the affiliate and the parent company. The overall pattern of financing of the affiliate's capital expenditures determines both the extent of the foreign capital inflow as well as the apportionment of risks between local and foreign investors; both these factors can play an important role in the effects of direct investment on a country's external adjustment.

1/ Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone.

2/ Excluding the overseas borrowing of U.S. parent companies channeled through their finance affiliates in the Netherlands Antilles. See Appendix I.

This financing pattern is influenced by the host country's interest, exchange rate, and tax policies as well as by its policies with regard to the share of foreign ownership of domestic enterprises. Many developing countries have discouraged full or majority foreign ownership, and foreign investors have also increasingly sought local equity participation as a means of both sharing risks and increasing local acceptability. As a result, wholly- and majority-owned foreign affiliates have declined in relative importance. Arrangements not involving foreign equity participation, such as licensing, management contracts, and international subcontracting, have also grown rapidly in recent years. Although such arrangements generally do not result in any capital inflow, they do involve the transfers of technological and managerial expertise normally associated with direct investment.

4. Income on foreign direct investment

Developments in recent years had sharply contrasting impacts on developing countries' income payments on direct investment and on their external debt. In discussing these developments, however, one should distinguish between total income payments on direct investment (i.e., remitted dividends and interest plus reinvested earnings) and payments that are actually remitted abroad. The former, broader, definition affects the external current account balance, but the latter, narrower, definition affects the immediate foreign exchange outflow. (This is because reinvested earnings enter the balance of payments twice: once as an income outflow and once as a capital inflow of new direct investment.) 1/

Total net recorded income payments by developing countries on direct investment rose from $9 1/2 billion in 1973 to a peak of over $25 billion in 1981, but then declined sharply to around $16 billion in 1983, when profits fell sharply as a result of the world recession and the decline in oil prices. Most of the increase in income payments between 1973 and 1981 came from the major oil exporting countries, while income on direct investments in non-oil developing countries rose more slowly, from $3 1/2 billion in 1973 to $9 billion in 1981, before declining sharply to an estimated $6 1/2 billion in 1983. Most of the decline after 1981 was due to sharply reduced income on direct investments in some of the larger countries in Latin America. Remitted dividends and net interest payments (i.e., excluding recorded reinvested earnings) from non-oil developing countries rose from approximately $2 billion in 1973 to $5 billion in 1981. 2/

1/ In practice, total income payments on direct investment are underestimated since a number of developing countries do not collect information on reinvested earnings.

2/ Complete information for later years is not yet available, since income on direct investment is not disaggregated into remitted and reinvested earnings in the World Economic Outlook exercise, but, on the basis of balance of payments statistics for most of the larger non-oil developing countries, remitted earnings on direct investment do not seem to have declined substantially in 1982.

Expressed as a percentage of exports of goods and services, non-oil developing countries' total payments on direct investment declined gradually over the decade, to only 1 1/2 percent of exports of goods and services in 1983, compared with 3 percent in 1973 (Chart 2). Meanwhile, interest payments on external debt rose from some 6 percent of exports of goods and services in 1973 to over 13 percent in 1983. The divergence in trends was even wider for the group of 25 major borrowing countries (Chart 3).

However, a large proportion of earnings on direct investment are reinvested in the host country. For a group of 12 non-oil developing countries 1/ that collect information on reinvested earnings, an average of 52 percent of all direct investment earnings were reinvested during 1973-82. During the same period, an average of some 56 percent of all earnings by U.S. companies' incorporated affiliates in developing countries were reinvested. Moreover, the proportion of earnings reinvested fluctuated substantially as changing economic conditions affected the profitability of new investment and consequently the need to retain earnings to finance new projects. For instance, the earnings of U.S. incorporated manufacturing affiliates in developing countries fell from around $2 1/2 billion in 1980 to under $1 billion in 1982, but reinvested earnings fell even more sharply, particularly in Latin America. Consequently, gross dividend remittances 2/ from these affiliates to the United States actually increased from under $3/4 billion to around $1 billion over the period. The implication for developing countries' adjustment to economic disturbances of such divergent movements in remitted and reinvested earnings will be discussed in Section VI.

Royalties and licensing fees are payments for the transfer of technology and are not exclusively related to flows of direct investment capital. In practice, however, a substantial proportion of such payments took place between affiliates of the same parent company, reflecting the fact that much of the transfer of technology to developing countries occurred via direct investment. For instance, in 1982 payments of royalties and licensing fees by U.S. affiliates in developing countries were $1.2 billion, equivalent to about 85 percent of all such receipts from developing countries; between 1970 and 1982, these payments grew at an average annual rate of 9 1/2 percent, virtually the same as the growth in the stock of U.S. direct investment. Such intra-firm transfers, however, grew more slowly over the last decade than receipts from unrelated companies, particularly for developing countries in Asia. This reflected a trend toward a transfer of technological and managerial expertise through arrangements not involving direct investment capital.

1/ Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, and Sierra Leone.

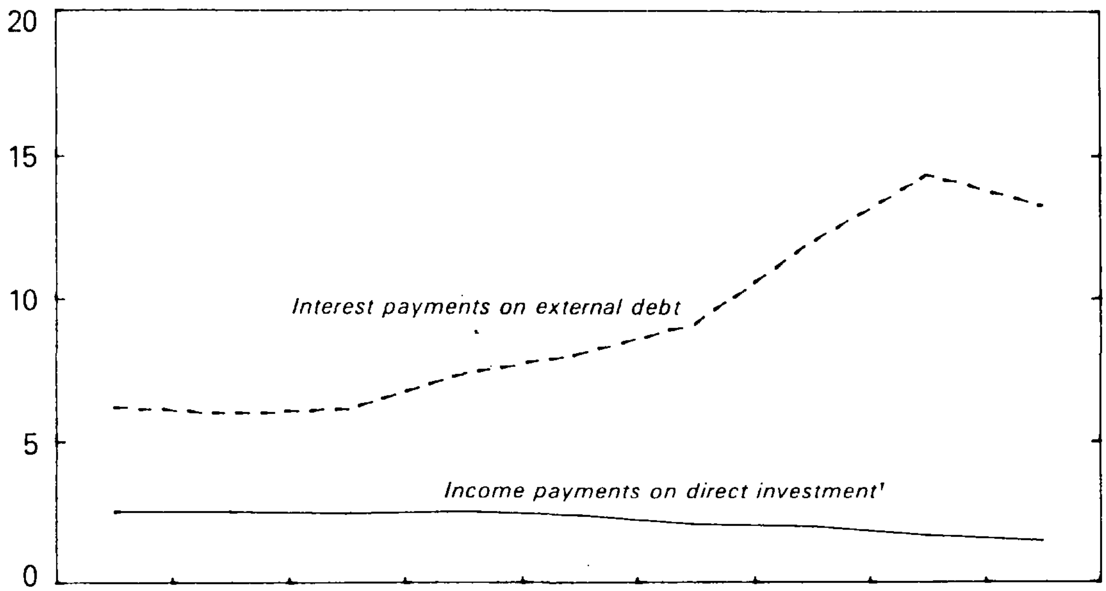
2/ Before deduction of the host countries' withholding taxes on dividends.

CHART 2

NON-OIL DEVELOPING COUNTRIES;

INCOME PAYMENTS ON DIRECT INVESTMENT AND INTEREST PAYMENTS ON EXTERNAL DEBT

(As percentage of exports of goods and services)



Source: World Economic Outlook.

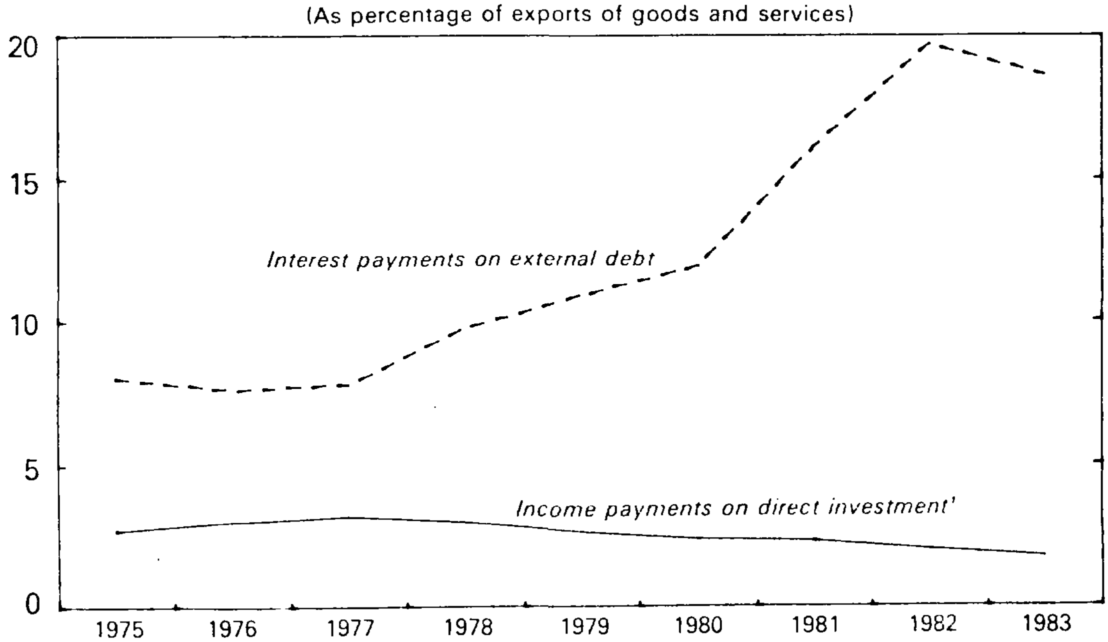
[1]Dividends and net interest payments plus recorded reinvested earnings.

CHART 3

DEVELOPING COUNTRIES-25 MAJOR BORROWERS;

INCOME PAYMENTS ON DIRECT INVESTMENT AND INTEREST PAYMENTS ON EXTERNAL DEBT

(As percentage of exports of goods and services)



Source: World Economic Outlook

[1]Dividends and net interest payments plus recorded reinvested earnings.

III. The Role of Foreign Direct Investment in Development

There is considerable controversy as to the relative costs and benefits to developing countries of foreign direct investment. The principal argument in its favor is that the package of capital, technological, and managerial resources associated with such investment generally increases the real income of the host country by more than the profits returned to the investor. The difference results in higher tax revenues, higher labor incomes, or lower prices. Moreover, since profits are earned only when the investment earns a positive return, part of the risk is borne by the foreign investor. However, the association of direct investment with some degree of overseas managerial control, generally as part of large multinational companies, can have wide-ranging effects on the economy of the host developing country. A concern that some of these effects might have adverse consequences for a country's development prospects is often the cause of restrictive policies toward foreign direct investment. In assessing the overall effects of direct investment, however, it must be noted that many of the principal benefits and costs are substantially affected by the economic policies of the host country. In particular, the types of investment project chosen will depend on relative prices in the host country and if these are inappropriate, then the investment will be of less benefit to the economy.

There are wide variations in the extent to which different developing countries have relied on direct investment as a source of resource inputs. Direct investment inflows made an important contribution to total capital formation in only a few developing countries, since most countries relied on overseas borrowing for access to foreign savings. Over the period 1979-81, direct investment inflows were the equivalent of about 25 percent and 11 percent of total fixed capital formation in Singapore and Malaysia, respectively; around 5 percent in Chile and the Philippines; but only about 1 1/2 percent of fixed capital formation in Brazil, Indonesia, and Mexico; while they were negligible in relation to capital formation in India, Korea, and Nigeria. 1/

It is more difficult to measure technology transfers, 2/ but, as discussed in Section II, a substantial proportion of such transfers took place between overseas parent companies and their subsidiaries. Once again, however, the importance of such intra-firm technology transfers

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1/ However, these measures understate the contribution of foreign-owned enterprises to gross capital formation. Reinvested earnings are not recorded for some developing countries and, in addition, the depreciation funds of direct investment enterprises, which are not included in the definition of direct investment, finance a substantial proportion of their gross capital expenditures.

2/ Defined broadly to include managerial and marketing expertise.

relative to transfers between unrelated parties varied substantially among developing countries and across industries. In Korea, where direct investment was regulated and channeled into particular sectors, some three quarters of all overseas licensing agreements between 1973 and 1980 were concluded by locally-owned firms; whereas in Singapore, where there were relatively few restrictions on direct investment, most licensing agreements were entered into by firms that were at least partly foreign owned. 1/ In industries with new or highly firm-specific technologies (such as the electronics industry), most transfers were between a parent company and its fully- or majority-owned affiliates, since there was concern with retaining close control of the technology involved. In many other industries, however, technology transfers through various licensing agreements grew more rapidly than the transfer of technology through the direct investment process.

The overall economic impact of enterprises established through direct investment goes well beyond the direct transfer of capital resources and technology. Since these enterprises also borrow in the host country and from third parties abroad, the share of total resources affected by their decision-making process can be much larger than the recorded direct investment inflow. Moreover, direct investment is often concentrated in import-substituting or export industries, so that the foreign trade performance of direct investment enterprises can have a significant impact on host countries' balance of payments, although once again there are wide variations across countries. For example, during the 1970s subsidiaries of multinational corporations accounted for over 90 percent of manufactured exports from Singapore, around 30 to 40 percent of manufactured exports from Argentina, Brazil and Mexico, but for 10 percent or less of such exports from India, Hong Kong, and Pakistan. 2/

Many developing countries have been concerned over some of the possible adverse effects of direct investment. Substantial foreign ownership of major sectors of the economy has frequently been regarded as involving a loss of local autonomy, a weakening of indigenous industry, and the growth of oligopolistic market structures. In addition, it has been argued that foreign-controlled firms adopt overly capital-intensive production techniques, extract excessive profits that are hidden by

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1/ See B.Y. Koo: "Status and Changing Forms of Foreign Investment in Korea," OECD Development Centre, 1982 and P. Eng Fong "Foreign Direct Investment in Singapore: A Preliminary Report," OECD Development Centre, 1981.

3/ Transnational Corporations in World Development, UN Centre on Transnational Corporations, 1983, Table IV.3, p. 137.

artificial transfer prices, and exert strain on the balance of payments because their position as part of firms with multinational production facilities makes them less able to expand exports and overly dependent on imports.

In considering these and other consequences of direct investment for an economy, it should be borne in mind that they are strongly influenced by the host country's economic policies; an inappropriate set of policies can significantly increase the costs and reduce the benefits of such investment. For example, much of the initial inflow of direct investment into the manufacturing industries of developing countries, particularly in Latin America, was to establish import-substituting production, encouraged by high tariff barriers and quantitative restrictions on imports. The results of such investment were frequently disappointing, with high costs of production, low value added at international prices, small exports, and high dependence on imported intermediate inputs. At the same time, import restrictions contributed to an overvalued exchange rate that, together with fiscal incentives often granted to attract direct investment, increased the real resource costs of profits earned on the investment. Disappointment with such results frequently led to attempts by host developing countries to increase their net benefits by the imposition of more detailed regulation of direct investment, including requirements for a minimum level of exports or local value added. Nevertheless, such regulations were generally a less effective alternative than the adoption of more open exchange and trade policies. The effects of more open trade policies were apparent in Singapore and Korea, where affiliates of multinational companies were responsible for some 90 percent and 27 percent, respectively, of total manufactured exports in the late 1970s, even though their share of total manufacturing sales in these countries was much smaller (around 30 percent and 10 percent, respectively). 1/

A related issue on the trade orientation of foreign-controlled companies concerns whether their foreign trade is less responsive to shifts in relative competitiveness because much of it consists of intra-firm transactions. There are indications that such intra-firm trade between industrial countries is less sensitive to relative price changes than trade between independent producers, who are unconcerned with the effects of their actions on the profitability of other affiliates. 2/ Although

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1/ See Eng Fong (1981) and Koo (1982), op cit.

2/ See D. Goldsbrough, "International Trade of Multinational Corporations and its Responsiveness to Changes in Aggregate Demand and Relative Prices," Staff Papers, September 1981.

intra-firm trade is generally less important for developing than for industrial countries, it plays a major role in certain developing countries, particularly those with substantial exports from technology-intensive industries. In recent years, trade between related parties (defined as parties one of which owns 5 percent or more of the voting stock of the other) accounted for only around one quarter of U.S. manufactured imports from all developing countries, compared with over one half of such imports from industrial countries. However, related party trade accounted for around three quarters of manufacturing exports to the United States from Malaysia, Mexico, and Singapore, over one third of such exports from Brazil, but less than one tenth of those from Argentina and India. 1/

The transfer prices used in such intra-firm transactions can diverge from the equivalent "arm's length" market price that would be set in trade between unrelated parties. Although under- or over-invoicing to shift profits for tax purposes or to avoid exchange controls is a problem for all foreign trade, the opportunities for such actions are clearly greater in intra-firm trade. This places a correspondingly greater burden on the monitoring ability of customs services, especially for highly differentiated products (such as pharmaceuticals) or for specialized intermediate components for which there is often no ascertainable arm's length price.

In regard to the choice of production techniques, it is frequently argued that since the technology transferred to developing countries through direct investment was generally developed for industrial countries, it involves overly capital-intensive techniques, especially since multinational enterprises conduct little research and development in most developing countries. The evidence on this point, however, is ambiguous. Although in many developing countries average capital-labor ratios of foreign subsidiaries in manufacturing are higher than those of local firms, this is in large part due to their greater concentration in industries with high capital requirements, while differences within the same industry are less clear cut. Moreover, host country governments can influence significantly the choice of production techniques: a number of frequently adopted policies encourage the substitution of capital for labor, including over-valued exchange rates that reduce the cost of imported capital equipment, administered interest rates that are below current rates of inflation, as well as various fiscal incentives for investment.

The entrance of foreign direct capital into a developing country can have complex and wide-ranging effects on indigenous enterprises and the level of competition. It can stimulate local entrepreneurship through

1/ G.K. Helleiner, Intra-Firm Trade and the Developing Countries, 1981.

increased competition and by providing opportunities for subcontracting by local suppliers, but it can also lead to a reduced number of locally-owned firms, either by take over or because such firms are not able to compete with the greater resources of foreign-controlled subsidiaries. For instance, it is estimated that around one third of foreign subsidiaries in developing countries were established through the acquisition of existing enterprises, 1/ although whether such takeovers reduced overall competition would depend partly on the competitive position of other firms in the industry. In this respect, the policies of the host country again play an important role, since the costs of excessive market concentration are greater when the domestic market is insulated against competition from imports.

Although the overall costs and benefits of specific direct investments depend on the particular circumstances of a developing country and also involve questions of the desired extent of local autonomy, it is evident from the foregoing discussion that the net benefits of such investment are strongly influenced by the host country's economic policies. The distribution of any net benefits will depend, in part, on the relative bargaining position of the direct investor and the host country, but there are clearly opportunities for mutual gain through policies that can both increase the attractiveness of a country to potential investors and increase the likely benefits that the country receives from such investment.

IV. Policies of Host Developing Countries Toward Foreign Investment

The relatively slow growth of foreign direct investment in developing countries in the 1970s seems to have resulted in part from those countries' policies with respect to such investment. Most developing countries combine some degree of regulation and control of direct investment, aimed at improving net benefits to the host country, with various incentives designed to attract such investment. During the 1960s and much of the 1970s there was in general a trend toward greater restrictions. Increased availability of alternative external financing, disappointment with some of the perceived results of direct investment in previous years, and growing nationalist sentiment in many countries all contributed to this trend. A number of developing countries also restricted foreign portfolio investment in securities of domestic enterprises. In recent years, however, a number of countries have adopted more flexible policies, partly because of the need to bolster weakening external economic and financial positions. This section will discuss overall developments in these policies, as well

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1/ R. Vernon, Storm over the Multinationals, 1977, p. 72, based on data in the Harvard Multinational Enterprise Project.

as the effects of some of the principal restrictions and incentives that have been adopted in many developing countries. In discussing such policies, however, it should be remembered that the provision of a stable economic environment and the adoption of appropriate financial and exchange rate policies are probably at least as important for encouraging foreign investment and for increasing the flow of net benefits to the host country, as are policies related specifically to such investment.

Although the combination of policies chosen depend to a large extent on a country's development strategy and market philosophy, its underlying attractiveness as an investment location is also important since this affects its relative bargaining strength vis-a-vis potential direct investors. Factors such as size of the domestic market, suitability for export-oriented production, and natural resource endowment all influence the combination of regulatory and incentive policies. A number of countries (particularly in Africa and the Caribbean) with small domestic markets and limited natural resources were unable to attract significant inflows of direct investment despite offering substantial incentives. However, a few countries with relatively small domestic markets (including Hong Kong, Singapore, and, to some extent, Malaysia) that pursued open economic policies and maintained few restrictions on foreign investment were able to attract substantial export-oriented direct investment, while generally offering only moderate incentives. In contrast, many countries with larger domestic markets (including India, Nigeria and most of the larger Latin American countries) and consequently with greater potential for attracting direct investment for import-substituting production, imposed a number of restrictions or specific performance requirements on such investment as they sought to extract greater benefits. These restrictions were usually combined with various incentives, so that direct investors faced a complex set of signals that sometimes differed substantially from prevailing market prices. The complicated mixture of incentives and disincentives sometimes made it difficult to evaluate the overall net contribution of direct investment, while the complexity of the arrangements themselves acted as a barrier to the entry of new investment.

1. Restrictions on foreign investment 1/

Many developing countries restrict foreign investment in certain sectors of their economies either on the grounds of political sensitivity of certain industries (especially public utilities, broadcasting and publishing, banking, and the petroleum industry) or so as to reserve for

1/ A brief description of various restrictions and regulations concerning foreign direct and portfolio investment in effect at the end of 1983 in the 25 major borrowing countries is given in Appendix II.

local enterprises those industries with relatively simple technical and financial requirements (such as retail and wholesale trade). Some countries (such as Nigeria) have established comprehensive lists of industries, with the permitted degree of foreign participation varying according to an industry's technological complexity and capital requirements; others have drawn up lists of priority industries in which foreign investment would be welcome and where it is often eligible for special incentives. Some countries (including Brazil, Egypt, India, Mexico, and Nigeria) also reserve important sectors exclusively for state-owned enterprises.

Many countries also set limits on the permitted degree of foreign ownership of enterprises and prohibit the takeover of existing local firms except in special circumstances. A number of countries (including India, Mexico, the Philippines, Yugoslavia, and most centrally planned economies) generally require that foreign investors hold only a minority equity participation in enterprises, although most allow majority or even full foreign ownership in some high priority industries or where production is mainly for export. In some cases, foreign companies are required gradually to release ownership and managerial control through the sale of shares to residents over a specified time period; such "dilution" requirements are incorporated into the common regime for foreign investment of the Andean Pact countries and are also a major element of foreign investment policies in India and Nigeria.

The case for restricting the scope of foreign capital in particular sectors is similar to that for the protection of "infant" industries. It promotes domestically-owned enterprises that may eventually be able to compete on equal terms with foreign enterprises, but with initial costs in terms of higher prices or lower quality and reduced foreign capital inflow. Attempts to restrict or dilute the share of foreign ownership may create substantial disincentives to foreign investment in high technology industries where firms are especially concerned to protect proprietary information; a number of foreign firms have withdrawn when faced with such situations (for example, in India). Nevertheless, some countries (such as Mexico) with fairly strict rules on foreign ownership were still relatively successful in attracting direct investment. Limitations on the proportion of foreign participation in particular industries are likely to be less damaging in terms of reduced foreign investment than outright sectoral limitations. Perhaps a greater danger is posed by a country's attempts to accelerate unduly the takeover of foreign firms before domestic enterprise is in a position to take their place. For instance, the program to encourage a rapid local takeover of many foreign-owned enterprises in Zaire during the early 1970s led to a substantial decline in productivity as well as a loss of foreign investment inflows and was later partially reversed.

Remittances of interest and dividends on direct investment as well as fees for technology transfers are subject to restrictions in various developing countries. Some countries impose restrictions as part of their permanent direct investment policies; in some cases (including the Andean Pact countries and Greece) remittances are limited to a certain percentage of invested capital, while in other cases overseas dividend transfers are subject to additional taxation or are limited to a proportion of an enterprise's foreign exchange earnings. Other countries have imposed temporary restrictions on transfers of profits and royalties as part of broader exchange restrictions when faced with serious external imbalances. Both permanent and temporary restrictions are obvious major disincentives to new investment and are also likely to encourage disguised remittances through artificial transfer prices that would also reduce the host country's share of profit tax receipts. Moreover, dividend remittances are sometimes subject to greater restrictions than interest payments on loans from the parent company and this may encourage an excessive debt/equity leverage in an affiliate's capital structure.

A growing number of countries impose specific performance obligations on foreign-owned firms, most frequently in the form of requirements for either a minimum level of exports or a given share of domestic content in total output (such as in the automobile industry in most Latin American countries). Other countries impose no specific requirements, but condition access to various incentives according to a firm's performance with regard to exports or domestic content. Such arrangements raise the costs of foreign investors, by requiring them to engage in presumably unprofitable activities in order to gain access to the local market. They are similar to trade restrictions, in that they create an implicit subsidy to exports and import substitution, and have similar disadvantages in that they distort resource allocation, can lead to the development of an inefficient industrial base that is unable to compete without such protection, and can invite trade retaliation.

The access of foreign-owned firms to local capital markets is restricted in many developing countries (including Argentina, Kenya, Nigeria, Peru, the Philippines, and Turkey). For most of these countries, such a restriction is part of wider controls on capital movements, as the authorities attempt to insulate the domestic financial system so as to maintain noncompetitive interest rates. Without a restriction on local borrowing, the combination of interest rates below those consistent with the demand for and supply of local financial resources, together with the generally greater creditworthiness of foreign firms, could lead to a crowding-out of domestic enterprises and a net capital outflow. However, all such selective credit restrictions can have costs in terms of the distorted allocation and reduced productivity of investment, while low interest rates contribute to the substitution of foreign for domestic savings.

Many developing countries have also imposed restrictions that hinder foreign portfolio investment, including outright prohibition; restrictions on the types of shares in which foreign investment is allowed; limits on capital repatriation; lengthy minimum investment periods; and taxes on dividends and capital gains often well above international averages. Until recently, only a few countries (including Jordan, Malaysia, the Philippines, Singapore, and Thailand) could be considered to have tax and foreign exchange arrangements conducive to foreign portfolio investment. 1/ In addition, such investment was also frequently deterred by complex administrative arrangements, lack of adequate reporting requirements on company performance, as well as by the narrowness of securities markets in many developing countries, which greatly reduced the liquidity of investments and the possibilities for spreading risks in a diversified portfolio. The narrowness of the market for equities was often exacerbated by government policies, such as tax systems that discriminated against equity investment and restrictions on equity purchases by domestic institutional investors.

Recent trends in a number of countries have been toward a liberalization of policies so as to attract a greater inflow of foreign investment. This was partly due to increased external financial constraints faced by many of these countries, but also reflected a greater confidence in the potential benefits of foreign investment, partly as a result of investors' greater willingness to adopt arrangements such as joint ventures and minority equity participation that suited host country sensibilities. Some countries (including Egypt, Jamaica, the Philippines, and Turkey) shifted from policies that emphasized detailed control of direct investment to much more flexible arrangements, while more gradual policy changes took place in other countries (including Korea, Mexico, Morocco, and Pakistan). A few countries also introduced some relatively modest provisions to encourage the conversion of outstanding external debt into equity investments. Turkey allowed claims arising from non-guaranteed trade arrears to be used for direct investment during 1980-82, and these claims financed a large proportion of new foreign direct investment over the period; 2/ a similar arrangement is available in Indonesia, while Brazil granted a tax credit for nonresidents converting their loans into investment during 1983. A few countries also relaxed controls on foreign portfolio investment. Korea has announced a program of gradual liberalization of its securities market, beginning with the establishment of international investment trusts on a limited basis; and Brazil has substantially reduced the minimum investment period for foreign portfolio investment.

1/ See "Presentation by the International Finance Corporation on Portfolio Investment in the Third World Through a Third World Equity Fund" (mimeo), at a seminar organized by Salomon Brothers and the International Finance Corporation, September 16, 1981.

2/ Foreign Investment in Turkey: Changing Conditions under the New Economic Program, OECD, 1983, pp. 8 and 15.

The policies of some centrally planned economies toward foreign direct investment were also modified in recent years. A number of countries (including China, Hungary, and Romania) permitted the entry of foreign capital through joint equity ventures, generally with minority foreign equity participation. In addition, China encouraged foreign investment in its special economic zones, either through joint ventures or through wholly-owned foreign enterprises, and also concluded a number of important agreements for foreign participation in offshore petroleum exploration.

2. Incentives for foreign direct investment

Many developing countries use a complex set of direct and indirect incentives to attract direct investment. Most can be classified as offering either commodity protection, which alter the prices of goods and services bought or sold by a firm (such as tariffs and quotas on imported competing products and exemptions from import duty on inputs), or factor protection, which alter the prices of factors of production employed by a firm (such as tax holidays, investment allowances, and subsidies for the training of local labor). 1/ The type and size of incentives offered by a country depend on the market orientation of the investment it wishes to attract and on the degree of competition it faces from other countries in attracting that type of investment. For instance, direct investments can be oriented toward production for a common market among a group of developing countries, for worldwide export, or for the domestic market of the host country. Competition to attract direct investment tends to be the most intense among members of a common market and the least intense for investment oriented toward a single domestic market. Incentives involving factor protection are more important among members of a common market and for countries concerned with attracting export-oriented investment, while commodity protection (particularly protection from competing imports) is more important for countries primarily concerned with attracting investment to serve the domestic market. For example, it has been estimated that for a large developing country in the latter situation commodity protection accounted for more than 80 percent of the total incentive provided. 2/

1/ A comprehensive list of possible incentives and disincentives for direct investment is given in S. Guisinger, "Investment Incentives and Performance Requirements: A Comparative Analysis of Country Foreign Investment Strategies" (mimeo), July 1983, Table 2, page 9; a study prepared at the request of the Development Committee Task Force on Private Foreign Direct Investment. This study also contains a more detailed analysis of some of the effects of various incentive policies.

2/ See Guisinger (1983), op. cit.

The variety and complexity of incentives make it difficult to evaluate their effectiveness in attracting additional investment. Incentives matter in the sense that an individual country might stand to lose much new direct investment were it to unilaterally abolish all its incentives. For example, a detailed investigation of investment location decisions in a cross section of developed and developing countries concluded that in two thirds of the cases analyzed the choice of country location for the investment was influenced by host country incentives, in the sense that the investment would have been located elsewhere in the absence of all incentives in the host country. 1/ It is less clear, however, that a country can attract significantly more direct investment by small increases in its existing incentives, especially if such increases were matched by other countries competing for the same investment. 2/ Moreover, there are strong indications that incentives become less effective the greater their complexity and the more frequently they are altered, since such factors increase the information costs and uncertainty facing potential investors. Given that incentives can be costly, in terms of either foregone fiscal revenues or the costs of increased protectionism, a group of countries may benefit from an agreement to limit competition in granting incentives. A number of such agreements have been concluded amongst groups of developing countries that are members of common markets (including the Andean Common Market and CARICOM) where the risk of such competition is greatest.

Finally, administrative procedures concerning foreign investment in developing countries can be a major deterrent to investment. Efforts to adapt and streamline such procedures may do more to facilitate such investment than moderate improvements in tax and other incentives. Some countries have already begun such efforts, at times (as in the case of Korea) through the establishment of one-stop service centers for potential foreign investors to assist them with necessary clearances, licenses, and legal referrals.

V. The Influence of Policies and Developments in Industrial Countries

Most industrial countries maintain relatively few restrictions on capital outflows and provide some encouragement for direct investment in

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1/ See Guisinger (1983), op. cit.

2/ In a survey of foreign direct investment decisions of major multinational companies conducted by the Group of Thirty, only 13 percent of respondents ranked host country incentives among the top three factors affecting direct investment in developing countries in 1983. See Foreign Direct Investment, 1973-87, Group of Thirty, 1984.

developing countries, through guarantee and insurance schemes and various forms of official financial support. The decline in relative importance of direct investment in total capital flows to developing countries was not due to any major change in such policies. Rather, it reflects changes in the structure of the international financial system over the last 15 years and, in particular, the greatly increased role of commercial banks in international financial intermediation. Nevertheless, an examination of policies of industrial countries toward direct investment in developing countries may suggest approaches to encouraging higher levels of such investment.

Structural changes in the financial system were already underway by the late 1960s as major banks increased their international operations and, attracted by promising growth prospects, greatly increased their lending to some of the more rapidly industrializing developing countries. For instance, long-term debt of the 25 major borrowing countries to financial institutions increased at an average annual rate of over 30 percent between 1967 and 1973. This trend was continued after 1973, as the relatively risk-averse asset preferences of oil exporting countries led them to hold many of their assets in the form of liquid bank deposits. Together with greatly increased demand for medium- and longer-term financing by developing countries, this provided banks with the opportunity to expand their role as international financial intermediaries.

Much of the new lending was either to, or guaranteed by, governments and was encouraged by a view that the risks associated with such sovereign lending were relatively low in comparison to normal commercial lending. In contrast, there was much less scope for large immediate increases in direct investment, which depended on the identification of individual opportunities for profitable investment and was influenced by a wide range of institutional restraints that could not be altered quickly. Also, the prevalence of low or negative real rates of interest during the period 1974-78, together with expectations that such rates would continue, probably encouraged developing countries to rely on external borrowing for their financing requirements.

Virtually all industrial countries pursue relatively open policies with respect to equity capital outflows. In a few countries, such outflows are subject to certain exchange controls, generally as part of broader restrictions on capital flows designed to support the balance of payments. For instance, some countries (including France and, prior to 1979, the United Kingdom) require most outward investment to be financed by borrowing in foreign currencies or have arrangements whereby total purchases of foreign securities by residents must be matched by proceeds from the sales of such securities. A few countries (such as Australia and Sweden) require individual authorization of direct investment proposals, although such authorization is generally granted, especially if the proposed investment would boost home country exports. Few such restrictions (but including those of Sweden) discriminate in favor of investment flows to developing countries. Finally, regulations governing the composition of investment institutions' portfolios in some industrial countries limit these institutions' ability to purchase foreign securities, including those of developing countries. 1/

There has been concern in many industrial countries about the effects of outward direct investment on employment opportunities and real wage levels. Most studies have concluded that such investment does not result in a net loss of employment in the capital-exporting country, once indirect effects on employment through such factors as increased export generation are included. Nevertheless, while such concerns have not generally resulted in greater controls over outward direct investment, they have contributed to a reluctance by some industrial countries to grant greater incentives for investment in developing countries. Of even greater importance is the spread of protectionist trade measures during the recent period of high unemployment. Although these new protectionist measures are not directly aimed at reducing direct investment flows, they often have this result, since they discourage new export-oriented investment in those sectors where developing countries have the greatest comparative advantage.

The systems of corporate taxation of developed countries can have a significant effect on a number of major aspects of direct investment in developing countries. They affect relative after-tax rates of return to domestic and foreign investment; influence net benefits to developing countries through the apportionment of tax revenues between home and host countries; and have a major impact on the way direct investment is financed. A number of industrial countries have concluded tax treaties with various developing countries, often with some provisions that were more favorable than in similar agreements with other developed countries. Some developing countries have argued, however, that the conventional pattern of such treaties tends to favor capital-exporting countries and consequently have been reluctant to conclude them. The 1979 UN Model Double Taxation Convention Between Developed and Developing Countries provided a framework in which greater taxing rights were granted to developing countries 2/ and a number of treaties have been concluded along these lines.

Two key issues in industrial countries' tax policies are their neutrality between domestic and foreign investment and whether any tax

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1/ The effects of various institutional restrictions in the industrial countries were considered in detail by the Development Committee Working Group on Developing Country Access to Capital Markets.

2/ See S. Surrey, "United Nations Model Convention for Tax Treaties between Developed and Developing Countries, A Description and Analysis," 1980, International Bureau of Fiscal Documentation.

incentives granted by the host developing country will be offset by increased taxes in the home country. Most industrial countries avoid double taxation of foreign source income, either by exempting such income from home country taxation or by granting a credit for foreign taxes paid. 1/ Under the former system, the tax-related attractiveness of foreign as opposed to domestic investment depends on the relative size of taxes in the home and host countries; the home country can not easily grant incentives to foreign investment, but host-country incentives are not nullified by offsetting changes in home country taxes. Under the latter system, which is used by many industrial countries (including Japan, the United Kingdom, the United States, and the Federal Republic of Germany), firms are allowed a credit for foreign taxes paid against the domestic tax liability established on the basis of worldwide income. Consequently, any tax incentives granted by the host country are liable to be offset by higher home country taxes. To allow developing countries to offer such incentives, a number of industrial countries (but not including the United States) allow notional tax credits for foreign taxes that would have been paid in the absence of incentives. In fact, a few developing countries (including Singapore) grant some kinds of tax incentives only to firms from home countries that have such provisions. In practice, however, the effectiveness of host country tax incentives can also be maintained, to a considerable extent, when home countries (such as the United States and most other industrial countries) defer taxing the profits of overseas subsidiaries until they are remitted as dividends. Such tax deferral can also reduce the effective tax rate on foreign source income (if the host country tax rate is lower than that of the home country) and thereby provides some inducement to investment overseas; it also creates a strong incentive to finance additional direct investment out of reinvested earnings. 2/

Most industrial countries make available insurance for new direct investment in developing countries, generally with coverage of noncommercial

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1/ A more detailed discussion of various possible treatments of investment income from developing countries in industrial countries' tax laws is given in E. Jehle, "Tax Incentives of Industrialized Countries for Private Undertakings in Developing Countries," Bulletin for International Fiscal Documentation, No. 3, 1982. In addition, the Fiscal Affairs Department has also prepared a survey of the tax treatment of investment income in the major industrial countries, J.R. Modi: "Survey of Tax Treatment of Investment Income and Payments in Selected Industrial Countries," FAD/83/3, May 1983.

2/ Tax deferral also means that the investment decisions of "mature" subsidiaries (i.e., those which do not require new capital inflows from the parent company) are independent of the rate of home country tax on foreign source income. See D. Hartman, "Tax Policy and Foreign Direct Investment," National Bureau of Economic Research Working Paper No. 689, June 1981.

risks such as expropriation, losses due to war, and inconvertibility of dividend and capital transfers. 1/ Such insurance can help promote investment by reducing risks, particularly for small and medium-size firms. However, with the exception of Japanese direct investment, more than half of which is covered by such insurance, existing official arrangements cover only a small fraction--generally less than 10 percent--of industrial countries' total direct investment in developing countries. This is because of restrictions in coverage, self-insurance by large multinational firms, and the availability of some private insurance against political risk. In this regard, the World Bank is exploring a multilateral investment insurance scheme that would build upon and complement existing national and private schemes.

Some financial support for direct investment in developing countries is provided by most industrial countries. Much of this is through public investment corporations, including the International Finance Corporation (IFC) as well as similar national organizations, that usually invest directly in projects as partners with domestic and foreign investors. They play an important role in generating total investments much larger than their own contributions, since their participation can both increase private investors' confidence in the security and financial viability of projects, as well as assuring host governments of their development contribution. The IFC has also played a major role in promoting increased foreign portfolio investment in developing countries and has encouraged the setting up of a number of private investment funds for the purchase of equity in particular developing countries. A number of industrial countries also offer loans and loan guarantees for direct investment, usually in a form similar to the various export credit schemes. By far the largest volume of such loans has been extended by Japan, where the outstanding stock of official loans in support of private direct investment in developing countries amounted to over $6 billion at the end of 1982.

VI. Foreign Investment and External Adjustment

The shift in the composition of capital inflows into developing countries, toward a relatively greater reliance on bank credit and lesser reliance on foreign equity investment, is likely to have increased their vulnerability to various economic disturbances. Total income payments on direct investment depend directly on the profitability of the underlying investments and consequently tend to move more closely with a country's ability to service such payments than do interest payments on external

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1/ A description of the programs of individual countries is given in Investing in Developing Countries, OECD, 1982.

debt, which continue even if the original borrowing financed unprofitable investments or consumption. In this sense, the greater the share of equity investments in a country's portfolio of external liabilities, the greater is the share of risk associated with economic disturbances that is borne by foreign investors. In addition, since direct investment can be sensitive to changes in a host country's relative competitiveness, as well as to its interest rate and credit policies, a higher proportion of such investment in total capital flows can increase their responsiveness to a country's adjustment policies.

Since the greater risk-bearing associated with equity investment generally needs to be compensated by higher expected returns, total service payments would usually be higher, the greater the share of equity instruments in the portfolio. 1/ The desired composition of the portfolio will, therefore, depend on the desired trade-off between risk and return. The combination of risk and return that a country is willing to accept will be determined not only by individual preferences within the country, but also by the costs associated with maintaining service payments on foreign liabilities when economic conditions deteriorate. These costs generally result from the need to restore a sustainable current account position either by reducing aggregate expenditures or by switching resources from nontraded to traded sectors. The relatively low levels of per capita consumption and limited consumption and limited supply responses in many developing countries mean that the costs of making large adjustments over a short time period can be substantial. However, although a country's long-term ability to service its total external liabilities depends on the size of total service payments, relative to its total output and its ability to earn or save foreign exchange, the way in which it adjusts to economic disturbances in the short term will also depend on the composition of those service payments. In particular, service payments on direct investment consist of both dividend remittances and reinvested earnings and the costs of adjustment may differ depending on which is most affected by economic disturbances.

The effects of the composition of a country's external liabilities on the costs of adjustment can be illustrated by considering the divergent effects of economic disturbances on two economies in which investment is financed by external debt and by external equity investment, respectively. An external economic disturbance that affected foreign exchange earnings (such as a decline in the terms of trade or a reduced volume of exports

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1/ This does not imply, however, that a host country would necessarily need to raise the expected rate of profit to foreign investors in order to attract a greater volume of foreign equity investment, since a removal of restrictions on such inflows would probably generate increased investment at existing profit rates.

caused by a world recession) would not alter interest payments due on external debt. Future expenditures would have to be reduced and resources would have to be switched from the non-traded to the traded sectors to generate foreign exchange to meet the interest payments. Profits on equity investment would be likely to decline, however, either because they were affected directly by the external economic disturbance (if the investment were in the export sector), or indirectly by policies adopted to restore external equilibrium. 1/ Consequently, the required reduction in future expenditures to generate resources for repayment would be less than in the case of debt-financed investment. However, whether the immediate foreign exchange outflow was also lower than for debt-financed investment, thereby reducing the need for a transfer of resources between traded and non-traded sectors, would also depend on whether the decline in profits resulted in lower dividend remittances overseas or in lower reinvested earnings; some limited evidence on this aspect will be discussed later in this section.

Comprehensive empirical tests of the above relationship between movements in service payments on direct investment or on external debt and a country's ability to make those payments are hampered by lack of reliable information on some key elements and, in particular, by the absence of time series on reinvested earnings in many developing countries. However, there is some evidence that total returns on equity investment are more correlated with a country's ability to service its external liabilities than are interest payments on external debt. For a group of 12 non-oil developing countries 2/ with sufficiently long time series on reinvested earnings, the estimated annual rate of return on direct investment 3/ was positively associated with the annual rate of

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1/ Although it is possible that the adjustment policies could increase profits on foreign investment--for example, as a result a large devaluation if the foreign investments were concentrated in the import-substituting sector and if output were not affected by shortages of imported inputs. The effects of exchange rate changes on the profitability of direct investment is discussed in greater detail later in this section.

2/ Brazil, Bolivia, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone.

3/ Calculated as direct investment-related payments (i.e., dividend and interest payments plus reinvested earnings) as a percentage of the average of the estimated stock of direct investment outstanding at the beginning and end of each year. The time series for stock of direct investment was calculated by adding annual direct investment flows to an end-1978 benchmark stock figure. See footnote 1 to Table A.2. It could be argued that it would be more appropriate to compare rates of return on direct investment with movements in real interest rates, since the value of direct investment assets are likely to rise with inflation. However, no measure of the true rate of return on direct investment is available since data on the stock of direct investment are reported at book value rather than current market prices. Consequently, all comparisons between estimated rates of return on direct investment and market interest rates can only be approximate.

growth of GDP. An above (or below) average rate of growth of GDP was associated with an above (or below) average return on direct investment in all but one year over the period 1974-82 1/ (Chart 4). By contrast, there was little association between these countries' rate of growth of GDP and the average interest rate paid on their outstanding external debt (Chart 5). 2/ The contrast in movements in rates of return and interest rates was particularly marked during the recent recession. Over the entire period, however, the estimated average return on direct investment was higher than the average interest rate on outstanding debt (at around 11 percent and 8 1/2 percent, respectively), so that there does appear to have been some positive trade-off between the risks and returns associated with equity and debt instruments.

More comprehensive information is available for rates of return on U.S. direct investment in developing countries, and there appears to be

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1/ Average rates of return and rates of growth for the group of countries were calculated on a GDP-weighted basis, with GDP in terms of dollars.

2/ These trends can also be illustrated by simple least squares regressions over the period 1973-82 of rates of return to direct investment (R.FDI) and to external debt (R.DEBT) against rates of growth of nominal GDP (g) in the host countries (all time series are weighted averages across the 12 countries, with GDP in terms of dollars as weights):

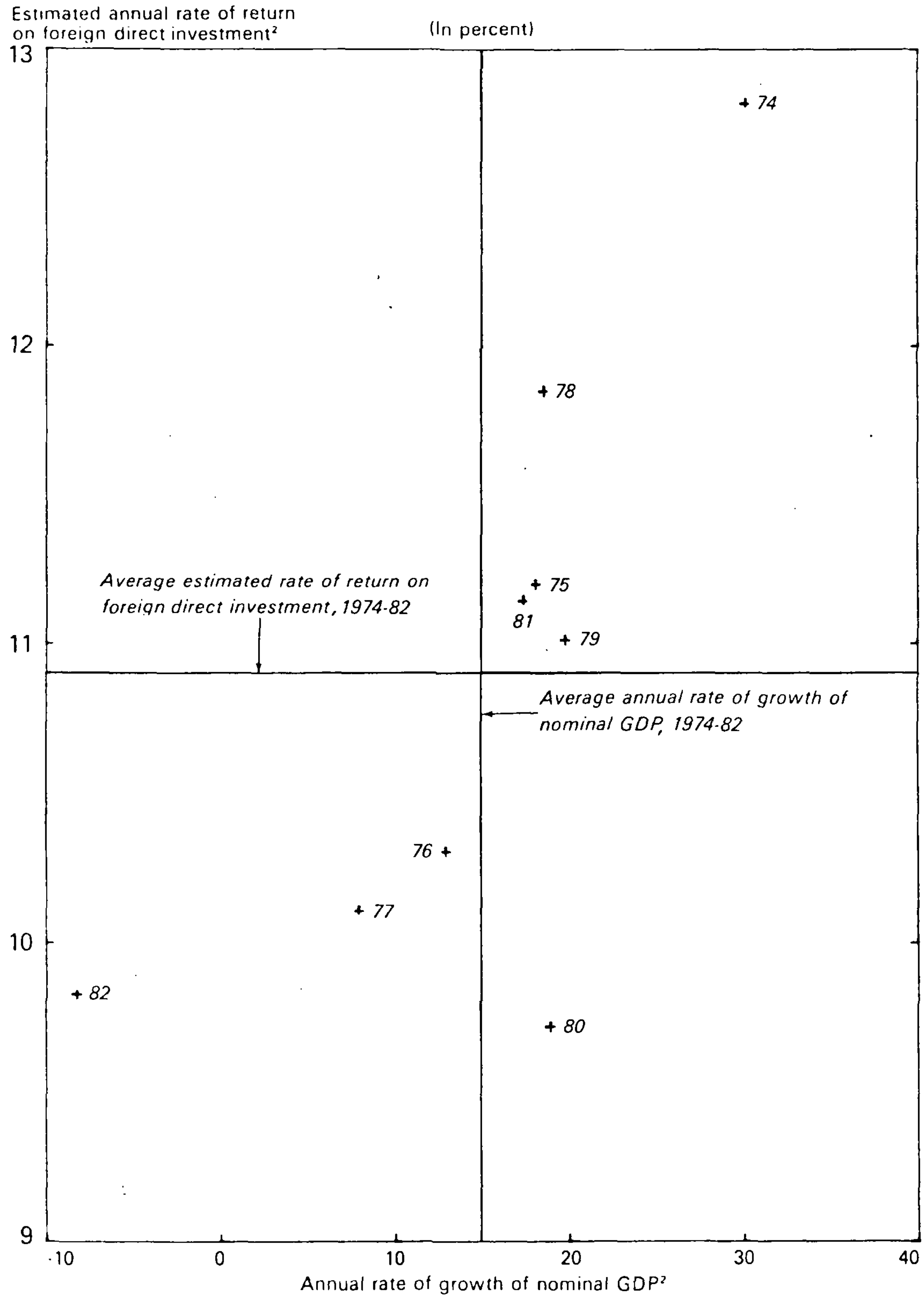
$$R.FDI = \underset{(21.4)}{9.8} + \underset{(2.72)}{0.069^{*}g} \qquad R^2 = .51$$

$$R.DEBT = \underset{(7.1)}{9.7} - \underset{(1.15)}{0.088\ g} \qquad R^2 = .16$$

where the figures in brackets are t-statistics and * denotes significance at the 5 percent level. There was a significant positive association between growth of GDP and returns on direct investment, but no such association with interest payments on external debt. The choice of growth rate as the independent variable should not be taken as implying a single direction of causation since growth rates are also likely to be higher as a result of successful investments, as well as contributing to them. The return on direct investment appears to be less closely related to the rate of growth in exports of goods and services: regressions similar to the above were obtained, but the fit was much poorer and none of the coefficients was significant. However, this is not surprising since direct investment in many countries used in the sample tended to be largely oriented toward import substitution rather than exports. In particular, it was not possible to include any countries from Asia, because of lack of information on reinvested earnings.

CHART 4

SELECTED NON-OIL DEVELOPING COUNTRIES[1]
ANNUAL RATES OF GROWTH OF NOMINAL GDP AND ANNUAL RATES OF RETURN ON FOREIGN DIRECT INVESTMENT, 1974-82



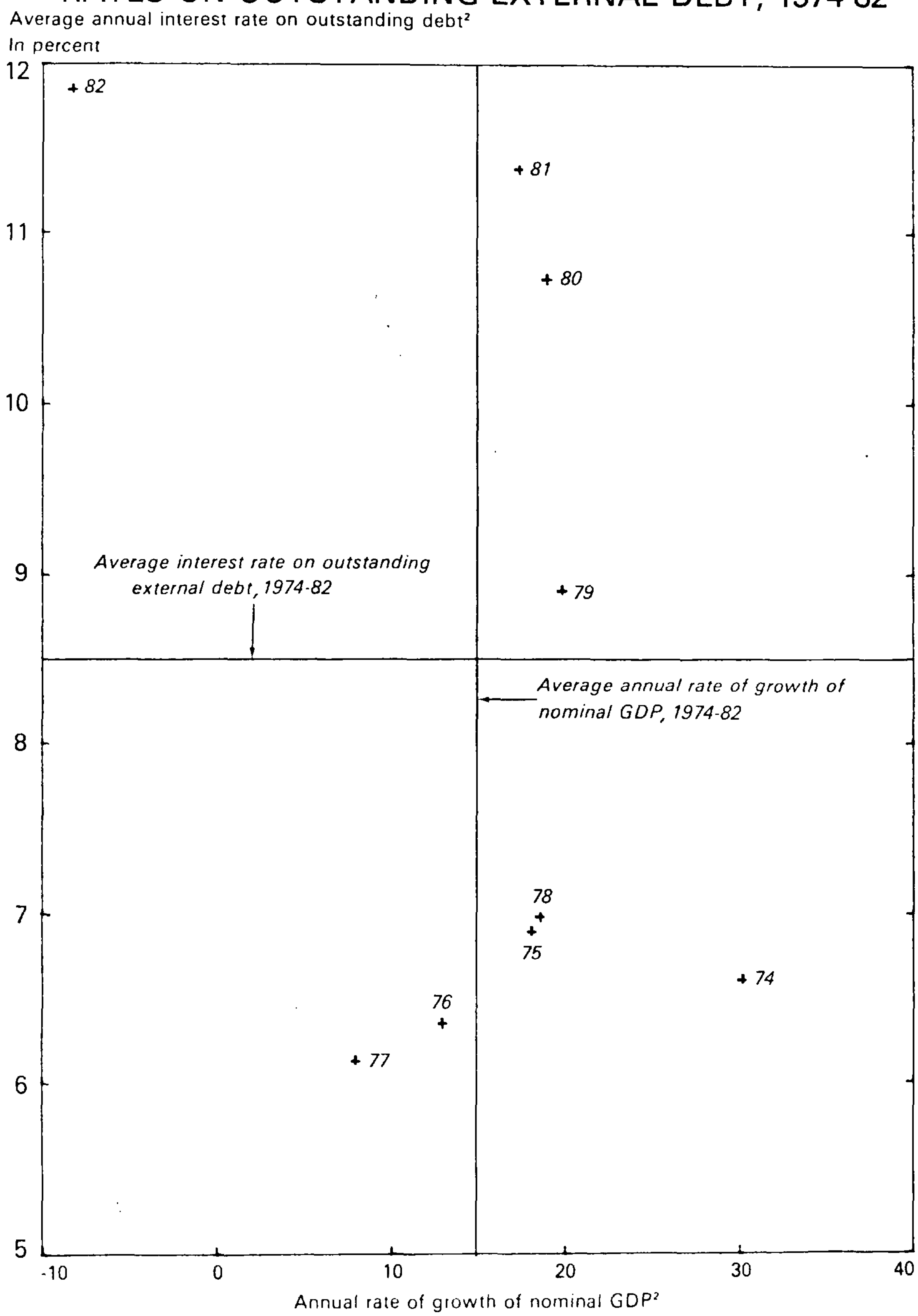
[1] This chart plots the GDP-weighted estimated annual rate of return on foreign direct investment against the GDP-weighted rate of growth in nominal GDP (in U.S. dollar terms) for a group of 12 non-oil developing countries for which sufficient data was available: Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone.

[2] Calculated as direct investment-related payments (i.e., dividend and interest plus reinvested earnings) as a percentage of the mean of the estimated stock of direct investment outstanding at the beginning and end of each period. The time series for stock of direct investment was derived by adding annual flows to an end 1978 benchmark stock figure. See footnote 1 to Table A2 for further details.

CHART 5

SELECTED NON-OIL DEVELOPING COUNTRIES[1]

ANNUAL RATES OF GROWTH OF NOMINAL GDP AND ANNUAL INTEREST RATES ON OUTSTANDING EXTERNAL DEBT, 1974-82



[1] This chart plots the GDP weighted average annual interest rate on outstanding external debt against the GDP weighted rate of growth in nominal GDP (in U.S. dollar terms) for the same group of 12 non-oil developing countries as in Chart 4.

[2] Interest payments as a percentage of the mean of the stock of external debt outstanding at the beginning and end of each period.

a positive association between rates of return on U.S. direct investment in manufacturing and growth rates in non-oil exports and non-oil GDP in these countries (Chart 6). Developments during the recent recession were particularly striking, as rates of return on direct investment fell sharply along with growth rates of GDP and exports, while interest rates rose to unprecedented levels. 1/

There is, therefore, some evidence that total returns paid on direct investment are, in general, more positively correlated with changes in a country's ability to service those payments than are interest payments on its external debt. This should ease the process of adjustment to economic disturbances in countries with a large proportion of direct investment in total external liabilities. This is illustrated by an examination of the relative importance of direct investment in total liabilities of countries that have encountered debt-servicing difficulties in recent years. For instance, for 28 developing countries 2/ that rescheduled part of their external debt during 1983, the stock of direct investment accounted for an average of only 14 percent of their total external liabilities (i.e., direct investment plus external debt) at end-1983, compared with an average of 24 percent for those 49 developing countries with available data that did not reschedule debt. 3/

1/ These trends can be demonstrated through regressions of rates of return on direct investment in manufacturing in developing countries (US.ROR) on growth rates in non-oil GDP and non-oil exports of goods and services of developing countries (g and g.exp, respectively) over the period 1973-82:

$$\underset{}{US.ROR} = \underset{(6.97)}{8.57^{**}} + \underset{(3.98)}{0.309^{**}}g \qquad R^2 = 0.69$$

$$US.ROR = \underset{(6.58)}{10.70^{**}} + \underset{(1.58)}{0.118}\ g.exp \qquad R^2 = 0.26$$

where the figures in brackets are t-statistics and ** denotes significance at the 1 percent level. Rates of return on direct investment were again more closely related to developments in non-oil GDP than in non-oil exports of goods and services. Regressions (not reported) of LIBOR on growth rates of non-oil GDP and exports yielded negative, and insignificant, coefficients.

2/ Argentina, Bolivia, Brazil, Central African Republic, Chile, Costa Rica, Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Madagascar, Malawi, Mexico, Morocco, Nicaragua, Niger, Nigeria, Peru, Philippines, Senegal, Sudan, Togo, Uruguay, Venezuela, Yugoslavia, Zaire, and Zambia.

3/ The difference between the two means is statistically significant at the 1 percent level, on the basis of the Mann-Whitney test.

However, the way in which variations in profits affect adjustment also depends on their distribution between remitted dividends and reinvested earnings, since this influences the immediate foreign exchange outflow. As discussed in Section III, a large share of earnings are generally reinvested and these constitute a substantial proportion of total direct investment in developing countries. For 12 non-oil developing countries 1/ with relatively long time series on reinvested earnings, they constituted an average of some 39 percent of total direct investment during 1973-82. The share of earnings that are reinvested, however, fluctuates substantially along with changes in economic conditions. For instance, reinvested earnings of U.S. incorporated affiliates in developing countries were much less stable than their gross dividend payments, particularly for affiliates in manufacturing (Table 3). Like those of companies in industrial countries, the affiliates' dividend payments were to a large extent unaffected by short-term fluctuations in profitability. This was particularly so in 1982 when earnings of manufacturing affiliates fell by 60 percent while dividend payments remained unchanged. However the decline in the share of earnings reinvested was much less marked for nonmanufacturing affiliates and during earlier recessions.

Other elements of the affiliates' sources and uses of funds adjusted to the lower level of reinvested earnings: either new capital expenditures were reduced or affiliates increased their borrowing from sources other than the parent company. Consequently, it appears that part of the automatic adjustment achieved when returns on foreign direct investment fall as economic conditions deteriorate results not from a decline in foreign exchange outflows for dividend payments, but from a reduction in the level of domestic aggregate demand. This may be brought about directly (as capital expenditures of affiliates decline) or indirectly (as affiliates' increased demand for credit to maintain capital expenditures and dividend payments crowds out other borrowers). This may involve short-term costs similar to those that would have been involved in maintaining service payments on external debt, although, in the longer term, the reduced level of reinvested earnings implies a lower level of foreign liabilities.

Although direct investment flows grew much less rapidly than bank lending to developing countries over the last decade, they have generally been a more stable component of resource inflows, particularly during the last two years. Direct investment inflows have tended to fall during periods of adverse economic conditions, because of declining opportunities for profitable investment and tighter cash-flow positions of the parent company and its affiliates. Nevertheless, they held up rather better

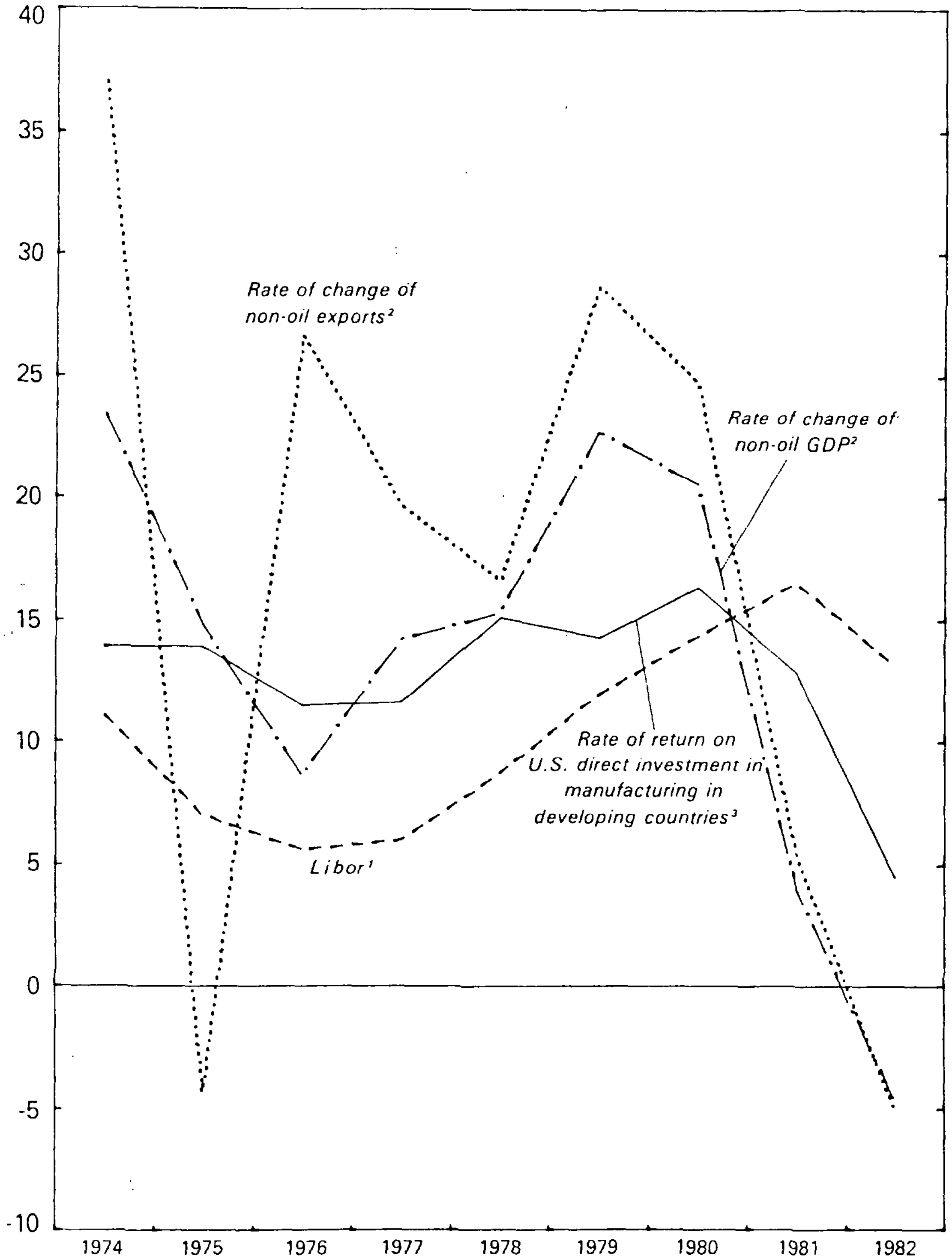
1/ Bolivia, Brazil, Cameroon, Colombia, Costa Rica, El Salvador, Honduras, Israel, Jamaica, Mexico, Morocco, and Sierra Leone.

CHART 6

DEVELOPING COUNTRIES;

TRENDS IN RATES OF RETURN ON U.S. DIRECT INVESTMENT IN MANUFACTURING AFFILIATES; RATES OF CHANGE OF NON-OIL GDP AND NON-OIL EXPORTS; AND NOMINAL INTEREST RATES

(In percent)



[1] London Interbank Offered Rate on three-month deposits.
[2] In U.S. dollars.
[3] From Department of Commerce Survey of Current Business, various issues.

Table 3. U.S. Incorporated Affiliates in Developing Countries
Trends in Earnings and Their Distribution, 1973-82

(In billions of U.S. dollars)

	All Industries				Manufacturing			
	Earnings	Gross Dividends 1/	Reinvested Earnings	Reinvestment Ratio 2/	Earnings	Gross Dividends 1/	Reinvested Earnings	Reinvestment Ratio 2/
1973	3.0	1.4	1.6	.52	0.9	0.3	0.6	.66
1974	3.6	2.1	1.5	.43	1.0	0.3	0.7	.70
1975	4.0	0.9	3.1	.78	1.3	0.4	0.9	.71
1976	3.6	2.3	1.2	.34	1.2	0.5	0.7	.54
1977	3.9	1.7	2.3	.58	1.3	0.5	0.8	.63
1978	4.8	1.9	2.9	.60	1.9	0.6	1.3	.68
1979	6.1	2.5	3.6	.59	2.2	0.9	1.3	.58
1980	7.2	2.8	4.4	.61	2.6	0.7	1.8	.72
1981	8.1	3.1	5.0	.62	2.3	1.0	1.3	.54
1982	6.3	3.4	2.9	.46	0.9	1.0	-0.1	-.17

Source: Survey of Current Business, various issues.

1/ Before host country withholding taxes on dividends.
2/ Reinvested earnings as a proportion of total earnings.

during the recent period of recession and widespread debt-servicing difficulties than did private, and especially commercial bank, lending. Direct investment also has the added advantage of a greater balance between the maturity structure of an investment and its financing. This helps avoid the debt-servicing problems that can arise when longer-term investments are financed by short-term bank loans and a deterioration in a country's external financial position makes banks reluctant to roll over such loans.

A larger share of direct investment in capital inflows is likely to make such inflows more sensitive to the adjustment policies undertaken by a developing country. For instance, although the major impact of exchange rate policy will be on the current account balance, movements in the exchange rate and domestic prices and costs affect the profitability of direct investment. A depreciation of the real exchange rate will tend to increase the profits and output of an enterprise, provided that its output is more traded than the inputs used to produce it. 1/ Most enterprises established through foreign direct investment probably fall into this category, and so will be encouraged by an exchange rate policy that maintains international competitiveness. A real exchange rate depreciation may decrease the profitability of some direct investments, where output is less traded than inputs. Investment in public utilities or in production of final goods for domestic markets protected by quantitative import controls on the basis of large-scale imported inputs are probably in this category. However, a policy of maintaining an overvalued exchange rate is unlikely to encourage a substantial inflow of such direct investment, since the probability of periodic adjustments in exchange rates to more appropriate levels increases the uncertainty associated with such investment. Available evidence for direct investment flows between industrial countries indicates that, on balance, direct investment inflows into a country increase when its relative competitive position is improved. 2/

Moreover, direct investment flows are only one component of the overall financing of a foreign-controlled firm's total capital expenditures. As such, they can be strongly affected by the host country's interest rate and credit policies. A policy of increasing interest rates toward market-clearing levels is likely to encourage reduced domestic financing of a firm's expenditures and to result in an increased direct investment inflow,

1/ Some hypothetical examples of the possible effects of various changes in real exchange rates on the earnings of direct investment enterprises in selected Latin American countries are given in R.R. Rhomberg: "Private Capital Movements and Exchange Rates in Developing Countries," Staff Papers, March 1966.

2/ For instance, see D. Goldsbrough, "The Role of Foreign Direct Investment in the External Adjustment Process," Staff Papers, December 1979.

particularly during the initial period as the firm's stock of liabilities adjusts to the new interest rate differentials. Conversely, the presence of substantial direct investment in a country can significantly increase the costs of inappropriate policies. Affiliates of foreign-controlled companies have substantial opportunities to engage in short-term intra-company lending in response to shifts in interest rate differentials and exchange rate expectations. This can make capital movements sensitive to monetary and exchange rate policy even in countries with rudimentary capital markets and severe restrictions on most capital movements.

VII. Future Prospects and Policies for Foreign Private Investment

The financing pattern that supported the upsurge in current account deficits of developing countries through 1981 is unlikely to be repeated. In particular, new net lending through the international banking system is likely to be much more constrained in the future, so that foreign equity investment will probably contribute a greater share of future capital inflows. New net bank lending to countries with heavy principal payments on rescheduled debt is likely to be particularly constrained. These countries could find it advantageous to encourage a greater inflow of direct and portfolio equity capital so as to maintain resource inflows sufficient to support an adequate growth rate, as well as to reduce vulnerability to any future deterioration in economic conditions.

The scope and need for an increased role for direct (and portfolio equity) investment can be illustrated in the context of the medium-term scenario for developing countries prepared for the World Economic Outlook. Over the period of the scenario, 1986-1990, foreign direct investment flows to non-oil developing countries are assumed to increase by around 5 percent per annum in real terms. While this would be somewhat faster than the average growth rate of around 3 percent a year experienced from the time of the first oil price increase through the 1970s, 1/ the assumption is actually a modest one, since much of the growth would simply represent a recovery from the downturn in direct investment that occurred in 1982 and 1983. The volume of direct investment inflows would only reach the peak level achieved in 1981 by around 1988.

Consequently, such growth appears achievable--for the group as a whole although not necessarily for each country--without major changes in

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1/ In comparison, the survey of direct investment intentions of major multinational companies by the Group of Thirty suggests that the real increase in direct investment flows to developing countries during the period 1983-87 may be slower than during the previous ten years, although it will still be significant. See Foreign Direct Investment, 1973-87, Group of Thirty, 1984.

policies toward direct investment, provided that the generally more encouraging policy environment of recent years is maintained and that the 3 1/4 percent average annual rate of industrial country growth assumed in the medium-term exercise is achieved. If the exposure of international commercial banks evolves as assumed in the "base" scenario (i.e., with total exposure unchanged in real terms, except for trade-related credits, which increase in line with imports), the share of direct investment in total financing of the combined current account deficit and reserve accumulation of non-oil developing countries would rise moderately, to around 15 percent in 1988-90 compared with some 11 percent during 1979-81. A more substantial liberalization of policies toward foreign private investment could lead to much greater inflows.

However, the existing stock of direct investment is distributed very unevenly among developing countries, and those countries that experienced debt-servicing difficulties in recent years also generally attracted much less direct investment. 1/ Consequently, many of the more heavily-indebted countries will need to make more substantial changes in policies toward direct investment if they are to achieve the level of inflows consistent with the growth prospects of the "base" scenario. This will be especially so if, as assumed, new bank lending to countries with a large volume of rescheduled debt expands less rapidly than lending to countries with a lesser debt burden. For instance, direct investment flows to the 25 major borrowing countries are assumed to grow somewhat faster than for the group of non-oil developing countries, to offset less buoyant bank lending; in the "base" scenario, the share of direct investment flows in the overall financing of the combined current account deficits and reserve accumulation of these countries is projected to reach some 17 percent during 1988-90, compared with only 11 percent during 1979-81. To achieve this, there would need to be a greater effort to attract such investment on the part of a number of major borrowing countries.

The initial direct impact on growth rates of more or less favorable outcomes with respect to direct investment flows would probably be relatively small, since they finance only a small proportion of imports (around 2 1/4 percent of non-oil developing countries' total imports over the period of the base scenario). It is estimated that, assuming no other changes in the base scenario, if the annual growth rate of direct investment inflows into non-oil developing countries were 5 percentage points lower throughout the period of the scenario (i.e., no growth in

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1/ Moreover, a recent survey of direct investment intentions suggests a sharp fall in the number of multinational companies expecting to increase their real direct investment flows to Argentina, Brazil, Mexico, and Uruguay during the period 1983-87. See the responses to Question 6, Group of Thirty (1984), op. cit.

real terms) then by 1990 the level of imports would be approximately 1 percentage point lower than in the base scenario. This would contribute to a level of GDP in 1990 that--in very approximate terms--would be 1/2 a percentage point lower than in the base scenario. However, the indirect impact on growth rates of lower direct investment, in terms of the loss of its contribution to the efficiency of resource use and the transfer of technological and managerial expertise, could well be more significant than the direct effect of a lower contribution to financing imports.

The policies of developing countries that are likely to have the greatest impact on direct investment and portfolio equity inflows are overall macroeconomic policies affecting demand management and the efficiency of resource use. The pursuit of fiscal and monetary policies that lead to greater financial stability and a more manageable external position will improve foreign investors' confidence in the longer-term viability of their investments and will reduce the risk of future restrictions on profit repatriations because of foreign exchange constraints. An appropriate set of relative prices, especially for exchange rates and interest rates, will also generally tend to both encourage investment inflows and increase the net benefits that the host country receives from such investment.

As regards policies directed specifically at foreign investment, those which involve substantial direct regulation over entry or restrictions on the repatriation of profits probably represent the major obstacles to encouraging greater inflows. Other policies discussed in Section IV, including tax and subsidy policies, can sometimes play a significant role in attracting investment, but are unlikely by themselves to be sufficient if the general economic environment is not conducive. The various fiscal incentives for direct investment will also tend to be more effective when they are relatively stable over time and not overly complex.

In a number of developing countries, a substantial expansion of foreign direct investment could encounter political difficulties because of concern over foreign domination of industry and a loss of domestic autonomy. These concerns may be eased by the greater willingness of many investors to consider alternative arrangements involving less than full control by the parent company, including various forms of joint ventures and production-sharing arrangements. In addition, inflows of portfolio equity capital, which in some developing countries face even greater restrictions than direct investment, do not involve overseas managerial control of domestic industry. Moreover, the experience of recent years has demonstrated that there can also be substantial costs associated with the increased vulnerability to economic disturbances that results from heavy reliance on external borrowing at commercial rates of interest.

In this context, one proposal for reducing debt and increasing equity currently being sponsored by the International Finance Corporation involves the establishment of "national investment trusts." The basic concept is to establish a country-specific closed-end investment trust, the foreign currency-denominated shares of which would be issued to participating commercial banks in exchange for a small portion of their present foreign currency loans to private and parastatal entities of the particular developing country. The proposed exchange would be a non-cash transaction involving little or no discount. The investment trust would negotiate the conversion, on suitable terms, of the loans so acquired to a diversified portfolio of local currency equity and quasi-equity securities of the underlying obligors. Subsequently, at an appropriate time, the investment trust shares held by participating commercial banks could be sold via a secondary offering to institutional investors. It is reported that there has been widespread discussion of this proposal, but as yet no indication that any particular country wishes to support the concept. The reaction of commercial banks has been mixed with some banks being supportive and some feeling that it is impractical.

As regards policies of industrial countries, although at present there do not appear to be substantial barriers to outflows of direct investment and portfolio capital from the principal capital-exporting countries, some countries could further encourage such outflows to developing countries by relaxing remaining restrictions (such as limits on domestic financing of overseas investment), and by easing supervisory requirements on portfolio composition to allow various investment institutions in developed countries to make greater purchases of developing country securities. Further progress in modifying systems of taxation of overseas investment so as to encourage investment into developing countries and to allow developing host countries to reap a greater share of the global tax revenues from such investment would also be helpful. However, probably the greatest contribution that industrial countries could make to encourage greater investment flows to developing countries would be to roll back the accumulated protectionist measures of recent years, so as to increase the opportunities for profitable investment in those sectors where developing countries have demonstrated a comparative advantage.

VIII. Issues for Discussion

This paper has reviewed the experience of developing member countries with foreign direct and portfolio equity investment over the last decade and concluded that the decline in the relative importance of this type of capital transfer, although strongly influenced by the growth of international bank lending, was also related to barriers to direct investment in host countries. While policies in investing countries have on the whole not discriminated against such investment, scope exists for additional incentives. Two major reasons for encouraging larger flows of foreign direct investment were suggested: first, that income payments on foreign direct investment may create less difficulty than interest payments on foreign borrowing during periods of adjustment to external or domestic shocks; and, second, that the future external financing needs of many developing countries may considerably exceed the amount of available international banking credit. It was recognized, however, that on all these issues there exist differing views. These considerations suggest the following issues for discussion:

1. Is a more rapid growth of direct and portfolio equity investment in developing countries a desirable goal of international economic policy for both investing and host countries?

2. What measures on the part of investing and host countries might be most useful in encouraging such investments?

3. Should the Fund, in its consultations and discussions with members, pay greater attention to developments and policies with regard to direct investment? Should the Fund take a view with regard to a member's policies toward direct investment?

Table A.1. Net Flow of Financial Resources from Industrial Countries to Developing Countries, 1960-82 1/

(In billions of U.S. dollars)

	Average 2/ 1960-66	Average 2/ 1967-73	1974	1975	1976	1977	1978	1979	1980	1981	1982
Official development assistance	5.5	7.4	11.3	13.6	13.9	15.7	20.0	22.8	27.3	25.6	27.9
Other official flows	0.5	1.2	2.2	3.0	3.3	3.4	5.5	2.9	5.3	6.6	7.4
Of which:											
Official funds in support of private investment	(...)	(...)	(...)	(...)	(0.8)	(0.4)	(0.7)	(0.7)	(0.8)	(1.5)	(2.0)
Private flows	3.2	8.5	7.3	22.2	27.9	31.3	44.0	48.1	40.7	55.5	46.1
Direct investment	1.8	4.3	1.1	10.5	7.9	9.4	10.8	12.4	10.5	15.7	9.9
Portfolio (bilateral and multilateral)	0.7	2.1	3.7	7.6	13.2	13.4	23.3	26.3	18.7	29.3	28.9
Of which:											
Resident banks	(...)	(...)	(...)	(...)	(11.4)	(10.2)	(19.4)	(22.9)	(17.5)	(25.3)	(23.5)
Export credits	0.7	2.1	2.5	4.1	6.8	8.5	9.9	9.4	11.5	10.5	7.3
Grants by private voluntary agencies	...	0.8	1.2	1.3	1.4	1.5	1.7	2.0	2.4	2.0	2.3
Total	9.2	17.9	22.0	40.1	46.6	52.0	71.2	75.8	75.6	89.7	83.7

Source: OECD: Development Assistance, 1961-71 issues; Development Cooperation, 1972-83 issues.

1/ Industrial countries include all members of OECD Development Assistance Committee. Classification of developing countries is that of the OECD, which differs somewhat from that of the Fund.
2/ Figures prior to 1972 exclude flows from New Zealand and Finland.

Table A.2. Trends in Stock of Foreign Direct Investment in Selected Developing Countries, 1973-83

(In billions of U.S. dollars, unless indicated otherwise)

	Stock of Foreign Direct Investment 1/			Total Outstanding External Debt 3/	Share of Foreign Direct Investment in Total Gross External Liabilities 2/	
	1973	1983 Estimate	Average Annual Growth, 1973-83 (percent)	1983	1983 (percent)	
Algeria	0.3	0.6	7.2	12.8	4.5	
Argentina	2.5	5.7	8.6	40.7	12.3	
Brazil	7.5	23.6	12.1	87.4	21.3	
Chile	0.5	3.0	19.6	17.4	14.7	31
Colombia	1.0	2.4	9.1	10.7	18.3	
Egypt	0.1	2.5	38.0	18.2	12.1	
India	1.8	2.5	3.3	26.2	8.7	
Indonesia	1.7	6.9	15.0	32.6	17.5	
Israel	0.2	1.3	20.6	23.5	5.2	
Korea	0.7	1.4	7.2	40.4	3.3	
Malaysia	1.2	7.1	19.5	13.4	34.6	
Mexico	3.1	12.8	15.2	90.0	12.5	
Morocco	0.3	0.8	10.3	12.7	5.9	
Nigeria	2.3	3.8	5.1	17.1	18.2	
Pakistan	0.5	1.2	9.1	9.6	11.1	
Peru	1.0	2.4	9.1	11.0	17.9	
Philippines	0.9	3.0	12.8	24.9	10.8	
Portugal	0.2	1.2	19.6	14.5	7.6	
South Africa	8.4	17.1	7.4	17.4	49.6	
Thailand	0.5	1.4	10.8	13.7	9.3	
Turkey	0.4	1.3	12.5	17.5	6.9	
Venezuela	3.6	4.2	1.6	32.1	11.5	
Yugoslavia	0.1	0.2	7.2	17.6	1.1	
23 major borrowers 4/	38.4	106.4	10.6	601.4	15.0	
All non-oil developing countries:	47.0	138.0	11.4	668.6	17.1	
Of which:						
Hong Kong	0.9	3.3	13.9	5.5	37.3	
Singapore	0.6	7.3	28.4	0.6	92.9	

Sources: OECD: Development Cooperation and Geographical Distribution of Financial Flows to Less Developed Countries, various issues; World Bank: World Debt Tables, 1983-84; Quarterly Bulletin, South African Reserve Bank; IMF: World Economic Outlook; and staff estimates.

1/ End of year; net of any disinvestment or nationalization. The 1983 stock figures are estimated as follows: Estimated book value of stock of direct investment from industrial countries at end-1978 plus total direct investment inflow during 1979-83; consequently the estimates exclude direct investment inflows from non-industrial countries prior to 1979.

2/ Total Gross External Liabilities are defined as Stock of Foreign Direct Investment plus Total Outstanding External Debt.

3/ End of year. Includes short-term debt, but not reserve-related liabilities.

4/ Excludes Romania and Hungary from the list of 25 major borrowers as defined in the 1984 World Economic Outlook.

Table A.3. Industrial Countries: Stock of Foreign direct Investment in Developing Countries, 1970-82 1/

	1970	1982	Average Annual Growth Rate, 1970-82
	(In billions of U.S. dollars)		(percent)
Australia	0.3	1.5	14.4
Belgium	0.8	2.1	8.4
Canada	1.7	4.5	8.5
France	3.8	9.6	8.0
Germany	1.9	12.6	17.1
Italy	1.2	3.8	10.1
Japan	1.2	11.4 2/	20.6
Netherlands	2.2	5.3	7.6
Sweden	0.3	1.4	13.7
Switzerland	0.9	3.4	11.7
United Kingdom	5.9	15.8	8.6
United States	22.3	68.6	9.8
Other industrial countries 3/	0.2	1.1	15.3
Total	42.7	141.1	10.5

Source: OECD: Investing in Developing Countries, November 1982 and Development Cooperation, 1983.

1/ End-of-year figures. Uses OECD definition of developing countries, which differs from Fund classification.
2/ Excludes official support for private investment (estimated at over $6 billion).
3/ Austria, Denmark, Finland, New Zealand, and Norway.

Table A.4. Non-Oil Developing Countries: Net Recorded Foreign Direct Investment Abroad, 1973-82

(In millions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Non-oil developing countries 1/	146	228	270	335	333	520	338	1,425	1,039	861 2/
Of which:										
Brazil	37	59	112	183	146	125	195	369	208	371
Colombia	1	6	5	12	21	38	23	109	53	32
Israel	0	0	-1	6	6	6	1	-8	83	69
Korea	2	14	4	6	21	28	19	13	43	146
Philippines	1	0	1	6	17	30	126	222	71	177
South Africa	50	114	121	32	68	259	11	756	647	...

Source: IMF Balance of Payments Yearbook.

1/ A number of non-oil developing countries (including Hong Kong and Singapore) do not report data on direct investment outflows.
2/ Excluding South Africa.

Table A.5. Four Industrial Countries: Trends in the Sectoral Composition of the Stock of Foreign Direct Investment in Developing Countries, 1967-80

(In percent)

	1967 1/			1980 2/		
	Mining and Petroleum	Manufacturing	Other 3/	Mining and Petroleum	Manufacturing	Other 3/
United States	49.6	27.1	23.3	26.4	34.5	39.1
United Kingdom	12.5 4/	34.0	53.5	2.8 4/	54.4	42.8
Germany	7.5	85.0	7.5	3.9	72.4	23.7
Japan	44.4	33.6	22.0	24.0	42.7	33.3

Sources: OECD: Stock of Private Direct Investments by DAC Countries in Developing Countries, End-1967; United States: Survey of Current Business, various issues; United Kingdom: Trade and Industry, Nov. 15, 1973; Business Monitor, May 1978 Supplement; Japan: Ministry of International Trade and Industry and Economic Survey of Japan, 1980-81; Germany: Monthly Report of the Deutsche Bundesbank, August 1982.

1/ 1969 for Japan.
2/ 1978 for the United Kingdom.
3/ Mainly services, but also agriculture, public utilities, transport and construction.
4/ Excludes investment in petroleum sector.

Conceptual and Statistical Issues in Measuring Foreign Direct Investment

The Fund's Balance of Payments Manual defines direct investment as investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management. Consequently, the establishment of a borderline to set direct investment apart from other types of capital flow can be difficult, since the difference basically depends on the motives of the investor. Many countries set a minimum proportion (generally between 10 and 25 percent) of foreign ownership of the voting stock as evidence of direct investment, or sometimes several percentages depending on the degree of dispersion of ownership among foreign investors. 1/

In principle, foreign direct investment flows include all funds provided by the direct investor, either directly or through other affiliates. This includes equity capital, reinvested earnings and net borrowing from the direct investor or its affiliates. Third-party loans guaranteed by the direct investor are not included, even though the investor assumes a potential liability and the loan might not have been possible without the existence of the direct investment relationship between the subsidiary and the parent company. In practice, many developing and some industrial countries do not collect information on reinvested earnings, while borrowing by a subsidiary from a parent company is sometimes included in portfolio capital movements.

Statistics on direct investment flows to developing countries can be derived on the basis of either the source or the recipient country:

Source country basis: Direct investment flows from the principal capital-exporting industrial countries (i.e., members of the Development Assistance Committee) to developing countries are collected by the OECD. In principle, the flows include reinvested earnings, although in practice these are partly estimated and cannot always be allocated to individual recipient countries. Direct investment flows from the major oil exporting countries, or between other developing countries, are not included.

Recipient country basis: Direct investment flows received by each developing country are reported to the Fund as part of its balance of payments statistics. However, many countries do not report information on reinvested earnings.

1/ A survey of member country concepts and practices concerning direct investment flows is given in Appendix E of the Balance of Payments Manual (Fourth Edition), 1977. See also "Detailed Benchmark Definition of Foreign Direct Investment," OECD, January 1983.

Even for countries that do report reinvested earnings, there are often significant differences between statistics derived on the source and recipient country basis. These differences are partly due to differences in coverage, since the source country data only cover capital-exporting industrial countries, but are also partly due to differences in accounting conventions, timing differences, and incomplete reporting. Such differences are not confined to developing countries--for instance, there are substantial differences between U.S. and U.K. statistics on direct investment flows between the two countries--but do indicate that too much emphasis should not be placed on small fluctuations in recorded flows.

The statistics on direct investment flows to developing countries have been adjusted where necessary to exclude the effects of borrowing and other net capital flows between U.S. parent companies and their finance affiliates in the Netherlands Antilles. Such borrowing, which is substantial (amounting to over $9 1/2 billion in 1982) largely consists of Euromarket borrowing by the U.S. parent companies that is routed through their finance affiliates for tax purposes.

Restrictions and Regulations Concerning Foreign Direct and Portfolio Investment in the 25 Major Borrowers Among Developing Countries

The table lists a number of restrictions and regulations concerning foreign direct and portfolio investment, as well as repatriation of profits and capital from such investment, that were in effect at the end of 1983. Various fiscal incentives and disincentives affecting direct investment are not included; and a few restrictions (such as limits on foreign investments in national security and defense sectors) that are common to most countries are not mentioned specifically. The *Annual Report on Exchange Arrangements and Exchange Restrictions* was one of the principal sources for the table; as in that publication, it is not implied that any particular regulation necessarily constitutes an exchange restriction.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Algeria	Investment subject to approval.		Joint ventures receive special advantages, including guarantee of fair return on investment, tax exemptions of up to five years on profits, reduced taxes on reinvested profits and the repatriation of royalties on technology transfers.	Remittances of profits and transfers of capital permitted only in respect of approved investments. Profit remittances on approved investments permitted up to 15 percent annually of original foreign capital.	Guaranteed for approved investments.
Argentina	Prior approval by the National Executive required for, inter alia, investments in most public utilities, communications, energy, and in financial and insurance institutions; as well as for all investments exceeding \$20 million.	Prior approval required if investments exceed \$2 million for each foreign investor, or if total foreign investment exceeds 2 percent of the capital of the company involved.	Prior approval by the National Executive required for investments which involve changing the national ownership structure of a local firm with net assets exceeding \$10 million. No prior approval required for new investments that do not exceed 30 percent of the registered capital of the receiving firm.	Annual after-tax profits on registered foreign capital are subject to an additional, progressive, tax when they exceed 12 percent of registered capital. In times of severe foreign exchange constraints profit transfers can be suspended and foreign investors will receive the equivalent sum in external public debt securities. Registered foreign investments may be repatriated after three years, unless a longer period was fixed when the investment was approved.	The extension of domestic credit to firms with foreign participation is subject to special provisions.
Brazil	Inward transfers are generally unrestricted, but, together with any reinvested profits, must be registered to assure repatriation of capital and profits. Oil exploration is controlled by the state petroleum monopoly.	Investments are subject to registration, and must be chanelled through a Brazilian "Investment company." The minimum participation in portfolio investment companies is \$1,000. Portfolio investments are exempt from capital gains tax.		Profit remittances and capital repatriation allowed for registered investments Portfolio investments must remain in the country for at least three months.	Remittances of royalties by a branch or subsidiary to its head office are not allowed when 50 percent or more of the local firm's voting capital is held by its foreign parent company. Foreign investment in certain sectors (e.g., computers) has also been restricted by the award of manufacturing licenses.
Chile	Authorization for investment is granted through a contract containing undertakings regarding the phasing of the investment program, which will normally not exceed eight years for mining and three years for other projects. Foreign Investment in the oil sector is subject to authorization by the Empresa National de Petroleo.			There are no limitations on profit remittances. Capital may be repatriated after three years.	Foreign investors can opt for a guaranteed 49.5 percent a year total corporation income tax over a period of 10 years, or may subject themselves to the tax system applicable to domestic corporations (currently 48.5 percent).

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Colombia	All foreign investment subject to prior approval. New direct foreign investment in banks, insurance companies and other financial institutions is restricted to member countries of the Andean Pact, on the basis of reciprical treatment, and to "national" (over 80 percent local ownership) and "mixed" (51 to 80 percent local ownership) companies. Foreign participation is also restricted in companies engaged in international resale of imported domestic products or in tourism. Capital invested in the petroleum industry is subject to special rules.		All foreign banks and their branches must have Colombian (or other Andean Pact Country) majority participation and purchases of 10 percent of more of the shares of a Colombian financial institution require the prior approval of the Banking Superintendent. To benefit from the duty free program of trade in the Andean Common Market, foreign-owned companies must agree to a gradual program of increased local participation.	Transfer of profits limited to 20 percent of the investment a year. An additional 7 percent may be reinvested. These limitations do not apply to enterprises in which at least 80 percent of the capital is held by investors in countries of the Andean Pact, or for profits resulting from investments of outstanding importance or involving special risks.	
Egypt	The law concerning the investment of Arab and foreign funds and the Free Zones of 1974 (amended 1977) defines the treatment of new foreign investment. All incoming investment is subject to approval, which is based on its contribution to realizing development objectives. Special priority is given to projects designed to generate exports, encourage tourism, or reduce the need to import basic commodities.		Investment must generally take the form of joint ventures, but no specified minimum local participation is required, except for local currency banks (51 percent local participation), construction contracting (50 percent) and consultant firms (49 percent).	Specific rules for the repatriation of profits from each project are generally set at the time the project is approved, subject to overall policy guidelines. (For instance, permitted profit remittances on export-oriented projects are normally linked to the projects' export earnings). Repatriation of capital normally requires prior approval but this is generally granted provided the capital has been in Egypt for at least five years.	
Hungary	Foreign investment in the form of joint ventures may be established subject to the approval of the Minister of Finance. Joint ventures may also be established in duty free zones, where they are subject to fewer regulations.		Foreign participation is generally limited to 49 percent, but a higher proportion may be allowed in the banking and service sectors. In other sectors, foreign majority participation requires special permission of the Minister of Finance.	A guarantee is given for the transfer of the foreign investors' share of profits.	A guarantee may also be obtained from the National Bank, covering losses on invested assets as a result of state measures, or from Hungarian banking institutions, covering the fulfillment of obligations of the Hungarian partner.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits	Other Restrictions or Regulations
India	Reserve Bank permission is required for any business activity conducted by nonresidents, noncitizens, and Indian companies with over 40 percent nonresident interest.	Prior approval of the Reserve Bank is required for all transfers of shares of Indian companies by or to nonresidents.	Nonresident participation is normally limited to 40 percent, but participation up to 74 percent is allowed (on a sliding scale) depending on the extent to which a company is engaged in "core" industry or export-oriented production, or in manufacturing industries that require sophisticated technology. Full nonresident ownership is allowed for companies that export their entire production. In addition, all companies are subject to "dilution" formulas which require minimum percentages of the estimated cost of any expansion to be raised through additional equity capital issued to Indians.	Profit remittances by branches of foreign firms require the prior approval of the Reserve Bank. Remittances of dividends to nonresident shareholders do not require prior approval, provided certain conditions are met. Capital invested in approved projects after January 1950 may be repatriated, but Reserve Bank approval must be obtained before effecting a sale which involves repatriation of assets. Proceeds of approved sales are allowed to be remitted in suitable installments, not exceeding four.	Without Reserve Bank permission, residents are prohibited from lending to companies in which the nonresident interest exceeds 40 percent.
Indonesia	All investments require the approval of the President on the recommendation of the Investment Coordinating Borad. The operating permit for foreign investment is usually valid for a maximum of 30 years.		In principle, investments may be undertaken only through a joint venture with an Indonesian partner.	No restrictions on profit remittances. The law provides that no transfer permit shall be issued for capital repatriation as long as investments benefit from tax relief; at present, however, foreign payments do not require a transfer permit.	A debt/investment conversion scheme exists, allowing foreign creditors holding nonguaranteed claims against Indonesia to use these claims to make investments under the Foreign Capital Investment Law.
Israel	No restrictions, but investments in certain approved sectors (including agriculture, industry and tourism and export-oriented production) may be granted preferential treatment.	Nonresidents are permitted to purchase Israeli shares. In order to repatriate principal and profits, proof is required that purchases were made with foreign currency through an authorized dealer.		No restrictions.	
Korea	All foreign investment requires approval. A list of eligible projects and activities open to foreign investment is maintained; this list has been expanded in recent years.	Korea has announced a program of gradual liberalization of the domestic securities market. At present, local investment trusts can sell unit certificates to foreign investors, and international investment trusts are permitted on a limited basis, but direct foreign acquisition of equity in local companies is normally not permitted.	Lists of activities are maintained in which full, and 50 perccent, foreign participation is permissible.	No restrictions, but proposed remittances must be notified to the Ministry of Finance 90 days prior to the end of the fiscal year.	Foreign-controlled firms in certain industries are subject to limits on the proportion of their output which can be sold domestically.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Malaysia	Foreign investment requires prior approval, but most industries are open to such investment.		Under the New Economic Policy (NEP), targets have been set for minumum percentages of local ethnic- (bumiputra) and non-ethnic Malay ownership of total corporate assets by 1990, but these percentages do not necessarily apply to each individual company. Guidelines set targets for local ownership in manufacturing industry, on a sliding scale based on exports and new technological inputs.	No restrictions.	The Industrial Coordination Act of 1975 requires all firms (whether domestic or foreign-owned) to obtain a license for each product manufactured. Granting of the license may be subject to various performance criteria, including dilution of foreign ownership.
Mexico	New foreign direct investment in Mexican banking or insurance companies and investment funds is prohibited, and certain sectors (including radio and television, public transportation and forestry) are reserved exclusively for Mexicans. Other sectors (including petroleum, basic petrochemicals, electricity and nuclear energy, railroads and telecommunications) are reserved for government investment. All foreign direct investment must be registered.	All acquisitions of stock in Mexican companies by foreigners must be registered within 30 days.	Foreign acquisition of more than 25 percent of the capital of a Mexican company requires prior authorization by the National Foreign Investment Commission. All new investments must have a majority participation of Mexican capital, except for cases specifically approved by the Foreign Investment Commission.	Payment of royalty and profit remittances are permitted up to 15 percent of equity, subject to foreign exchange availability. Balances in special foreign exchange accounts held by enterprises in the border areas and free zones can be used to make profit remittances.	
Morocco	A new industrial investment code, which came into force in February 1983, provides for full foreign ownership and an easing of repatriation of capital. In addition, there are special incentives for investment in tourism.	Most transactions in securities involving nonresidents require approval.		After-tax earnings on approved investments by nonresidents are freely transferable. Transfer of dividends on nonresident-owned shares of Moroccan companies requires the approval of the Exchange Office.	Subject to approval, nonresidents blocked capital accounts may be debited for investments in Morocco, provided that the amount debited does not exceed 50 percent of the investment undertaken by the nonresident and 25 percent of the company's total capital.
Nigeria	Nonresidents intending to make direct investments in Nigeria may apply to the Ministry of Finance for approved status, the granting of which means that sympathetic consideration will be given to future requests to repatriate capital.	Approved status is not normally granted for share purchases unless this forms an integral part of an approved investment project.	Ceilings are set on foreign participation in the equity capital of enterprises in various sectors of the economy.	Profits and dividends remitted abroad and disbursed locally may not exceed 30 percent of a company's capital stock. Repatriation of foreign capital requires approval from the Ministry of Finance.	Ministry of Finance permission is required for local borrowing by foreign-controlled companies.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Pakistan	Investments by nonresidents are subject to approval, but the Government has announced a liberal policy toward foreign investors, to encourage industrial development.	Nonresident investments in shares of Pakistani companies is permitted, provided the investment is made on the basis of nonrepatriation of capital and dividends. Repatriation is not granted unless the share purchases are an integral part of an approved investment project.	There are no conditions laid down regarding local capital participation, but it is expected that local currency expenditures will ordinarily be met from local equity capital.	Profit remittances are allowed freely where the investment was made with Government's approval. Foreign capital invested in approved industries after September 1954, including reinvested earnings and capital gains, may be transferred without restriction.	
Peru	All foreign investment must be authorized and registered.		The required participation of national investors in the capital of an enterprise is not less than 15 percent, and this must be raised to at least 45 percent after 10 years and to at least 51 percent after 15 years. Foreign investment in firms engaged in basic industries or in mining (including petroleum) or that export over 80 percent of their production to outside the Andean Common Market are exempt, but these firms do not benefit from duty-free trade in the Andean Common Market.	Remittance of profits, including depletion and depreciation allowances, requires approval. In accordance with Andean Pact rules, profit remittances are limited to 20 percent of foreign capital a year, but a higher percentage may be permitted for investments that generate employment, are in underdeveloped areas, or help to diversity exports.	The effective interest rate on a new loan from a foreign parent company may not exceed by more than 3 percent the prevailing interest rate for first-class assets in the money market of the country in whose currency the transaction is conducted. Foreign enterprises may not have access to domestic credit on terms longer than three years or in amounts greater than their capital and reserves. Local-content rules are applied in the automobile industry.
Philippines	All investment is subject to the prior approval of the Central Bank. Preference is given to projects approved by the Board of Investments (BOI), to export-oriented industries, and to other industries not utilizing domestic credit resources.		New enterprises where investment by non-Filipinos exceeds 30 percent, and which are not covered by the Investment Incentives Act, require prior approval by the BOI. If purchases of shares by foreign nationals would reduce Philippine ownership in a firm to less than 70 percent, then permission from BOI is required. There are different arrangements for "pioneer" and "preferred" investments. Normally, enterprises owned or controlled by foreigners are allowed only in "pioneer areas of investment," and at least 60 percent of outstanding voting capital stock of enterprises in "preferred areas of investment" must be owned by Philippine nationals.	Profit remittances are permitted in full, provided they are not financed from domestic borrowing. Full repatriation is guaranteed by law for cash investments made after March 1973 in export-oriented industries, enterprises approved by the BOI and in securities certified by the central bank and traded on the Manila and Makati stock exchanges. Securities must be held for a minimum of 90 days. Noncash investments and cash investments made before March 1973 can be repatriated in a number of annual installments, according to the category of the investment and its net foreign exchange earnings.	Foreign companies can borrow locally provided they have a debt-equity ratio of no more than 60:40 in high priority sectors, 55:45 in medium priority sectors, and 50:50 in low priority sectors. Rules specifying a minimum local-content have been established in various industries.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Portugal	Foreign investment is permitted in all sectors except those closed to private enterprise			Under the Foreign Investment Code, remittances may be subject to phasing for up to one year, depending on the balance of payments situation. Special provisions allow transfers to be phased over a period not exceeding five years in cases of serious external imbalance, but these special provisions were not in force at the end of 1983.	
Romania	Foreign investment in joint ventures is permitted.		Foreign capital participation is permitted up to 49 percent of total capital of the joint venture.	Repatriation of profits and capital is guaranteed.	
South Africa	Inward transfers for investment in equity capital are freely permitted.			Profit remittances are permitted automatically provided they are not financed by local borrowing. If local credit facilities are used to finance such transfers then Reserve Bank approval is required, but favorable consideration is given provided the local borrowing is not excessive.	Local borrowing by nonresident-owned or controlled firms is subject to limitation.
Thailand	Certain economic activities are reserved for Thai nationals.			No restrictions on profit remittances. Foreign investments under the Investment Promotion Act are given a guarantee of capital repatriation. The repatriation of other capital is considered on the merits of each case, but approval is normally granted if it can be shown that the funds originated abroad.	There are also limits on the degree of foreign equity participation allowed in various activities. Eligible for incentives under the Investment Promotion Act. Local-content requirements exist in the automobile industry.
Turkey	Foreign investment requires approval.	Transactions in securities by nonresidents require approval. There are special facilities for the acquisition of Turkish shares and bonds by Turkish citizens working abroad.		Profit remittances and capital repatriation is guaranteed for investments made under the Law for the Encouragement of Foreign Investment. Foreign capital imported under the Petroleum Law is accorded additional preferential treatment. Other foreign investments are not entitled to any transfer facilities for earnings or liquidation proceeds.	Local borrowing by foreign companies is subject to quotas set according to their equity capital in Turkey. There are special arrangements for the utilization of blocked funds of nonresidents for investment in the tourist industry.

Country	Regulations on Entry of Foreign Direct Investment	Regulations on Entry of Foreign Portfolio Investment	Regulations on Degree of Foreign Ownership	Regulations on Repatriation of Profits and Capital	Other Restrictions or Regulations
Venezuela	All foreign capital imported for investment purposes must be registered. Foreign direct investment is governed by Andean Pact Regulations. Natural gas and iron mining operations are reserved for the state and foreign investment in the petroleum sector is prohibited. New foreign investment in financial institutions is also prohibited.		Certain activities (including most financial services, public services, broadcasting and communications) are reserved for "national" companies (i.e., with under 20 percent foreign ownership). To benefit from the duty free program of trade in the Andean Common Market foreign-owned companies must agree to a gradual program of increased local participation. Companies that export over 80 percent of their production outside the Andean Common Market are not subject to this regulation.	In accordance with Andean Pact rules, profit remittances are limited, in principle, to 20 percent a year of registered foreign capital.	The Central Bank regulates domestic bank credit to companies more than 50 percent owned by nonresidents. Royalty payments are prohibited between parent companies and their majority-owned subsidiaries
Yugoslavia	Foreign investment is permitted through joint ventures only.		Apart from exceptional cases, foreign investment is limited to 49 percent of a joint venture's capital.	Profit transfers are permitted up to one half of the joint ventures foreign currency earnings from exports of goods and services. Profits from investments in underdeveloped regions may be repatriated in full.	If the law governing joint ventures were to be amended, a foreign investor would have the option of adopting the new legal provisions or of continuing under the old law during the entire life of the investment contracts.